Arnold Schilder: Dynamics in accounting and auditing in relation to banking supervision

Speech by Professor Arnold Schilder, Chairman of the BCBS Accounting Task Force and Executie Director of the Governing Board of the Netherlands Bank, at the Plenary Session of the International Conference of Banking Supervisors, Madrid, 23 September 2004.

The following speaking points should be read in conjunction with the related PowerPoint presentation. These points have been organised under the relevant slide numbers and headings.

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Good morning, everyone! It is a privilege and a pleasure to be asked to introduce today's panel discussions on the important changes taking place in accounting and auditing and their impact on banking supervision.

1. "Dynamics in accounting and auditing in relation to banking supervision"

It strikes me just how appropriate the title of my presentation truly is.

Yesterday's discussions on the new capital framework confirmed to me that dynamics exist everywhere and are not confined just to accounting and auditing matters. And last evening many of us were able to attend the wonderful and very dynamic Zarzuela performance, for which we thank our hosts from the Bank of Spain.

This morning, we have just heard Malcolm Knight speak about the remarkable and equally dynamic evolution taking place in accounting, fuelled by convergence trends within banking, between banking and insurance and across global markets. I'm pleased that my remarks today will echo many of these same thoughts, and that the topics chosen for our workshops will focus on some of the key issues we supervisors need to think about as we and the institutions we regulate prepare for these changes.

2. The interaction: an overview

This slide gives an overview of the different components that feed into and are supported by financial information. My presentation has been built around this overview and will look at these various interactions one by one.

The role of sound accounting and adequate disclosure in the creation of useful information for markets and investors is obvious. Sound auditing standards applied properly by auditors who also maintain high standards of professional conduct also contribute to market and investor confidence. In turn, these disciplines are also responsive to the changing needs of market, investors and other external stakeholders.

The remaining elements on this slide also interact with the financial information process. For example, yesterday Chairman Caruana mentioned the importance of alignment between sound risk management and financial information. On the one hand, financial information generated from risk management activity should be provided to all external users of financial statements, but at the same time that information also provides important feedback to risk managers about their own performance. On the other hand, the requirements of banking supervisors also shape what information is created about banking risks and risk management activities and will tend to influence bank behaviour. Such information is also an important tool used by supervisors to evaluate institutional and systemic safety and soundness.

And while our key focus at this conference is banking risk, we should not forget what Malcolm Knight said this morning about the growing similarities between banking and insurance, and, for us, the need to be able to supervise, or jointly supervise, financial services conglomerates.

3. Contents

The rest of my presentation is organised into three parts. The first is focused on accounting, the second on auditing, followed by some closing remarks.

Under accounting, I will look first at accounting and disclosure - what are the drivers and trends? Then, accounting and supervision - where they converge, and, unfortunately, where they diverge. Then I will look at the challenges this situation creates for banking supervisors and the need for regulatory action.

Under auditing, I'm going to look at recent developments first, then specific enhancements to the quality of the auditing process that have resulted from these developments, and finally what could be done to improve the process even further.

4. Accounting & disclosure; drivers & trends

First, developments in accounting and disclosure.

There is no question that trends in this area have been driven by a demand for greater transparency in financial reporting. One important development is the IASB's recently published Exposure Draft #7 on Financial Instruments Disclosures. This draft proposes several sound principles to guide what should appear in published financial statements.

Increasingly, international accounting standards also support broader and more sensitive recognition of risks in several ways. First, more risks are moving onto the balance sheet than ever before. Second, IAS 39's increased use of fair value measurement is helping to quantify various types of risk that may not have been identified or fully understood under the traditional cost-based model. Finally, the drive toward enhanced financial risk disclosures in the new ED 7 proposals should improve discussion of any risks that do not appear in the balance sheet and of how financial risks are being managed. It's clear that Pillar 3 disclosures were looked at by the IASB during development of the current exposure draft and we're happy about that.

Finally, we need to recognise that one major objective behind the current development of international standards is a desire by countries and markets for a single, high quality financial reporting model that will be widely acceptable and broadly applied. One important additional consideration is the potential for convergence between IFRS and US GAAP.

5. Points of convergence with banking supervision

There are strong parallels between these drivers and trends and those underlying Basel II.

As I noted on the previous slide, the IASB's work on disclosure of financial instruments - first in IAS 32, but especially in its new ED 7 proposals - has been inspired by concepts and guidance first proposed in Basel's Pillar 3.

Second, one of Basel II's starting points has been the need to develop more refined approaches to the measurement of risks. This means allowing banks to make greater use of their own risk modelling approaches where supervisors are satisfied that these models are sound and will be used responsibly.

Third, supervisors have become very conscious of the need to harmonise their principles and practices at both a global and regional level. Basel's Accord Implementation and Core Principles Liaison Groups are focused on this objective at the international level. A good example of similar activity at a regional level is the work of the Committee of European Banking Supervisors.

So far, so good. But now we're going to look at where standard setting and banking supervision diverge, and what this means for banking supervisors.

6. Points of divergence from banking supervision (1)

As this slide suggests, accounting is increasingly moving toward a neutral picture of enterprises and their risks. This may appeal to the markets and investors, but it is not consistent with the perspective that banking supervisors must adopt in order to look at longer-term safety and soundness issues. Malcolm Knight suggested this morning that this is due to different "DNA", and he could be right.

This drive toward neutrality is reflected in several ways. I mentioned increasing use of fair value accounting in a previous slide, and while this approach does have some benefits it is not without a few concerns.

For example, “prudence”, as a supervisor would understand it, will no longer play the same role in valuing financial assets and liabilities. “Fair values” won’t discriminate between gains and losses, or, in the case of gains, between those that are realised in cash and those that are not. “Prudent” valuations won’t be accepted any longer if they are materially different from those produced under a fair value scenario. And, as noted in other workshops, “rainy day” provisions that neutralise effects of the economic cycle won’t be permitted.

As a result, changes to current accounting practice will also have a direct impact on the quality of accounting capital and on how supervisors assess that capital for regulatory purposes.

7. Points of divergence from banking supervision (2)

Accounting standards operate under a different time horizon than capital standards and have their greatest impact in the area of loan losses.

Under IFRS and US GAAP, allowances for incurred losses must be based on the occurrence of a given loss event rather than historical trend information alone. For some banks at least, this means that allowances at any point in time are unlikely to be sufficient to meet full EL requirements although, amazingly, we did see some excesses during our QIS work.

Also, dynamic provisioning approaches that provide “through the cycle” accounting are unlikely to be acceptable. This means banks must take the credit risk premium charged to cover expected losses to income, even if the related losses cannot be recognised until a much later date.

8. Points of divergence from banking supervision (3)

Standard setters also don’t appear to give much consideration to the financial stability implications of their proposals. First, they seem indifferent to how much additional volatility could be created in banks’ financial statements as a result of the wider use of fair values. Second, they do not share the concerns of supervisors and many others that fair valuing changes in own credit risk is inappropriate, especially when this means recognising gains based on deterioration of one’s own credit. Even if supervisors can make appropriate adjustments to these items for regulatory capital purposes, how users will react to what is published in the financial statements is a worry for both banks and banking supervisors.

Finally, supervisors are deeply concerned with the apparent disconnect between how banks manage portfolios of risk and the models produced by standard setters to capture these activities. The key issue is that international standards apply fair value to whole instruments rather than the underlying risks, and to single contracts rather than portfolios, and we believe that standard setters need help to better understand the business of banking. As Chairman Caruana noted, good accounting should support sound risk management practices. Certainly the two pictures should not be in conflict.

9. Additional challenges for banking supervision

If these issues were not enough, supervisors must grapple with more subjective balance sheet measurements and what this means for the reliability of financial statement values. In this case, subjectivity takes two forms: the need to use models for instruments that do not have active local markets, and the potential for an enterprise to choose from wide ranges of possible “fair values” in pricing a given instrument.

Also, financial statement disclosure is moving toward a generic approach for all types of entities. This is most evident in the new ED 7 proposals on disclosure that are intended to replace bank-specific disclosures found in IAS 30. The key question for supervisors is how assets and liabilities of banks should be classified on the balance sheet - by measurement classification, or by type of product?

10. Need for regulatory action: a mixed blessing (1)

Despite these many challenges, banking supervisors are positioned to compensate through regulatory means. They can issue supervisory guidance (for example, on provisioning, and on various aspects of fair value accounting) at any one or all of the Basel, regional and local levels. They are able to apply prudential filters to the accounting results, such as was done through two recent press releases on suggested capital treatments of certain IFRS items. Developing supervisory reporting and disclosure frameworks, for example the current CEBS initiative) can also help to re-establish consistent and comparable information for supervisory use.

11. Need for regulatory action: a mixed blessing (2)

At the same time, these additional measures create additional administrative burdens for banks, and supervisors are very sensitive to the need to keep this additional burden to a minimum.

Also, as the Basel Committee supports the use of sound IFRS for supervisory as well as public reporting, applying prudential filters to these standards could create the perception that we do not have full confidence in the quality of IFRS-based financial information.

Now, let’s turn to auditing trends and issues.

12. Significant recent developments in auditing (1)

Recent accounting scandals - Enron, Worldcom, Parmalat and others - have raised fundamental questions concerning auditor responsibility, auditor independence and audit quality. Since that time, auditing standard setters and others have been hard at work on improvements needed to restore public confidence in the profession.

For example, the U.S. Sarbanes-Oxley Act and revision of the EU’s Eighth Directive have been designed to address several important elements related to standards development and approval, auditor independence and standards compliance. Also, the international profession is dealing proactively with a number of initiatives designed to promote improved audit quality and much more transparent quality control processes. These important developments are very similar to approaches found in Pillars 2 and 3 of the revised framework.

Auditors are also revising the scope of their work in ways that speak to many of the Basel Committee’s concerns. For example, strengthening the responsibility of a lead auditor in group audits should be helpful to home and host supervisors involved with the same financial services group. Also, enlarging the scope of audit responsibilities to address internal controls and fraud should support supervisory assessments of how “know your customer” risk is being managed.

13. Significant recent developments in auditing (2)

Another means to improve audit quality has emerged in the form of auditor oversight.

Internationally, a number of international regulatory organisations (the World Bank, the Financial Stability Forum, IOSCO, the Basel Committee, the IAIS and the European Union) have worked with the international auditing profession to agree on the creation of a Public Interest Oversight Board. In the United States, the Public Company Accounting Oversight Board is already up and running under the chairmanship of Bill McDonough. Knowing Bill from his days as chairman of the Basel Committee, that’s no surprise. And there are similar initiatives emerging in the EU and elsewhere.

These groups are interested in not only how audits are conducted but in the quality of auditing standards.

14. Audit enhancement benefits supervision (1)

In addition to helping supervisors carry out their Pillar 2 and 3 responsibilities, a stronger auditing regime provides several broader benefits. For example, auditors could be able to assist in verifying not only regulatory returns and financial statements, but, in the context of Basel II and IFRS, various capital and accounting models.

15. Audit enhancement benefits supervision (2)

The need for high quality audits is growing and auditors must keep pace with the increasing complexity of the banking business and bank accounting.

Identifying the substance of complex transactions, often tailored to meet unique customer or institutional needs, is not easy. Neither is understanding the complex rules that have been developed on how to account for financial instruments.

As much as auditors need to understand these developments, supervisors must also be in a position to appreciate the quality of their work so that we know how and how much to rely on it.

16. Further audit development and enhancement are welcome

For this reason, the Committee supports continuing work on improving the audit quality chain. This means several things: completing the process of creating and implementing the PIOB; evaluating governance processes within individual firms and dealing with any issues identified; improving transparency around the nature and scope of audit work performed; and, developing high quality standards to cope with critical challenges such as fair value measurement, marking to model, and transnational audits.

17. Closing remarks: accounting (1)

To wrap up, accounting is moving forward, but not necessarily in the same direction as supervisory guidance. This will require the Committee to do several things over the near and the longer term.

First, we must remain closely involved in the standard setting process if we are to be effective. Our task is to maintain and promote a prudent and forward-looking stance in the interest of financial stability.

Earlier this morning, Malcolm Knight referred to the benefits of creating a “common language”, and in principle we agree with that. However, as supervisors, we will still need to determine what role we feel fair value accounting should play in financial reporting, and do our best to encourage standard setters to adopt an even more appropriate credit risk accounting model than the one we have right now.

Nevertheless, I should give credit to the IASB, as IAS 39 already incorporates important concepts such as recognising impairments in groups of loans and applying experienced credit judgment to the determination of impairment. But they can still do better.

18. Closing remarks: accounting (2)

In parallel, we also need to develop ways to bridge the gap between the accounting and supervisory models where we can. This involves identifying where the gaps are and putting appropriate filters in place based on regulatory and capital reporting requirements.

I hope that these filters can be kept to an absolute minimum and only over the short term. Nevertheless, in the interests of maintaining financial stability and promoting sound risk management, these filters will have to remain for as long as the gaps exist. In addition, some buffers against the effects of short-term volatility may still be needed, although this need will be determined in the context of related prudential filters.

19. Closing remarks: auditing

For auditing, the Committee will need to remain focused on two objectives. First, improvement of the audit quality chain must continue. Second, we need to consider further what role the external auditor can play in relation to Basel II.

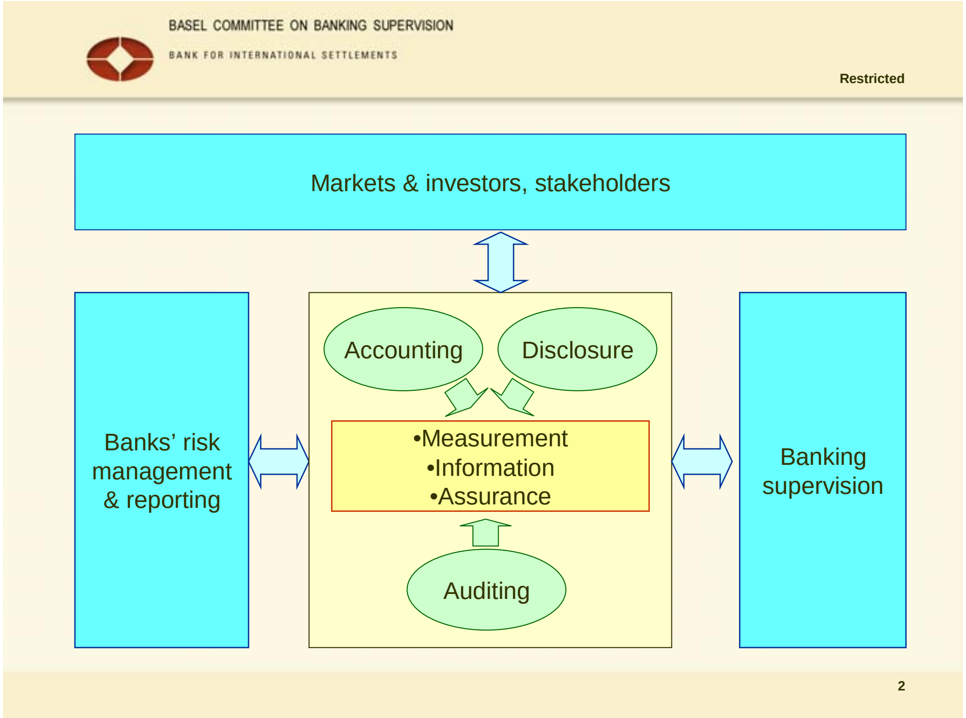
In a moment I’m going to introduce you to the chairs of our workshops who will lead today’s discussions of the four subject papers prepared for this conference. I’ve tried to incorporate many of the questions from these papers into my comments this morning.

Let me set out the objectives I would like to see achieved in these sessions.

First, I hope that you’ll share your experiences. We need to understand how these topics affect you, your banks and the way you supervise.

Second, please express your ideas on what we should be looking at. These will be useful in guiding the future work of the Committee and the ATF.

Finally, don't hesitate to ask questions or raise any short-term issues that we may have overlooked.



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Accounting & disclosure: drivers & trends

- Greater transparency
  - More usable and more useful information for market participants
- Greater risk recognition
  - More risks on balance sheet (e.g. derivatives, securitisations)
  - More risk-sensitive measurement of assets and liabilities (e.g. fair values)
  - More disclosure of risks not recognised on balance sheet
- Greater international harmonisation
  - Convergence of standards (e.g. IFRS/US GAAP)

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Points of convergence with banking supervision

- Greater transparency and greater risk recognition are also drivers behind Basel II
  - Transparency: Pillar 3 disclosures (compare with ED 7)
  - Risk recognition: More refined risk-weightings, IRB approaches
- International harmonisation is also a supervisory objective
  - Ongoing convergence of supervisory principles and practices at global and regional levels: Basel (AIG, CPLG), EU (CEBS)

So far convergence, but…

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Points of divergence from banking supervision (1)

- Trend in accounting is an equal appetite for upward potential and downside risk
  - More fair value accounting
  - The role and meaning of prudence is changing, e.g. in relation to (1) fair value accounting, (2) provisioning: no more “rainy day” provisions
  - The accounting trend has consequences for the quality of accounting-based regulatory capital, e.g. through the increased recognition of potentially temporary gains

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Points of divergence from banking supervision (2)

- Accounting standards consider a different time horizon compared to capital standards
  - IFRS/US GAAP require allowances for incurred loss based on a given loss event; Basel II requires a capital buffer for unexpected loss and, additionally, for expected loss not provided for in accounting (“shortfall”)
  - There is little room for through-the-cycle accounting (e.g. dynamic provisioning)

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Points of divergence from banking supervision (3)

- Financial stability issues are not a concern for the accounting standard setter
  - Potential impact of fair value volatility
  - Potential impact of fair valuing own credit risk
- Accounting standards often do not consider banks' risk management practices
  - With some exceptions (e.g. hedge transactions, embedded derivatives), entire financial instruments are fair valued, not the underlying risks (e.g. credit risk, interest-rate risk, other forms of market risk)

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Additional challenges for banking supervision

As if that is not enough…

- Accounting is moving towards greater subjectivity in measurement, thereby raising reliability issues
  - More mark-to-model accounting
  - Possibility of wide ranges in reported fair values
- Financial statement disclosure requirements are becoming less bank specific
  - Replacement of IAS 30 with a financial instruments-based standard (ED7)

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Need for regulatory action: a mixed blessing (1)

Advantages….

- Divergences & challenges result in need for supplementary norms and measures
  - Supervisory guidance (e.g. credit loss allowances; fair value accounting: fair value option, fair value measurement)
  - Prudential filters to adjust accounting figures for regulatory purposes: numerator, denominator, scope of consolidation
  - Supervisory reporting & disclosure framework (e.g. EU common regulatory reporting framework, Pillar 3 disclosures)

Need for regulatory action: a mixed blessing (2)

Disadvantages

- Supplementary norms and measures result in administrative burden for banks
  - Compliance with more than one standard
  - Need to administer various sets of data

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Significant recent developments in auditing (1)

- Greater focus on auditor responsibility, auditor independence and audit quality in the wake of accounting scandals
  - Revision of standards and guidelines (e.g. Sarbanes-Oxley Act, EU Eighth Directive)
  - Audit profession initiatives for greater transparency and better audit quality
- Revision of scope of work
  - Greater lead auditor responsibility in group audits
  - Broader field of work e.g. in relation to internal controls, fraud

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Significant recent developments in auditing (2)

- Establishment of auditor oversight to improve quality of audits
  - Global and national initiatives: PIOB, PCAOB
  - Oversight not only of practices but also of principles (e.g. PCAOB authority to approve audit standards)

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Audit enhancement benefits supervision (1)

- Continuing important role of audit in supervisory methodology
  - Data verification: Regulatory returns & financial statements
  - Model verification: increasingly important under Basel II with various risk-weighting approaches and greater application of marking-to-model

Audit enhancement benefits supervision (2)

- Growing business complexity, and related accounting complexity, enhances need for high-quality audits
  - Financial engineering & exotic products: reporting substance over form (e.g. securitisations, structured products)
  - Complex accounting rules for financial instruments: greater use of fair values, hedge accounting, accounting for (embedded) derivatives

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Further audit development and enhancement are welcome

- Continued work on audit quality chain
  - Actual implementation & operation of oversight process: roll-out & review of PIOB activities
  - Continued focus on governance at individual firms in addition to oversight
  - Greater transparency of audit process: what work have the auditors actually performed?
  - Further development of high-quality audit practices (e.g. fair value measurement, marking-to-model, transnational audits)

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Closing remarks: accounting (1)

- Significant emerging accounting developments are not all moving in parallel with supervisory developments
  - Need to remain vigilant, well-prepared and involved in the standard-setting process; constructive but critical dialogue
  - Importance of maintaining and promoting a prudent and forward-looking stance in the interest of financial stability
    - Determining the role of fair value accounting from a supervisory perspective
    - Working towards an appropriate credit risk accounting model

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Closing remarks: accounting (2)

- Significant emerging accounting developments are not all moving in parallel with supervisory developments (cont'd)
  - Need to bridge gap between accounting and supervisory models
    - Identifying the gaps and implementing appropriate filters: financial reporting vs. regulatory reporting, accounting capital vs. regulatory capital

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Closing remarks: auditing

- Not only accounting, but also auditing, requires continued supervisory attention
  - Continued involvement in improving the audit quality chain
    - Oversight, governance, transparency, high-quality audit practice standards
  - Assessment of external auditor's role in supervisory methodology
    - Refining the auditor's role in relation to Basel II

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