Christian Noyer: Lessons from the crisis. A central banker's reflections on some accounting policy issues

Speech by Mr Christian Noyer, Governor of the Bank of France, at the European meeting of the accounting profession, Paris, 11 December 2008.

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Ladies and Gentlemen,

I am delighted to be taking part in this European meeting of the accounting profession. This discussion seems to me to be especially timely since the current crisis has raised a whole series of questions related more or less closely to accounting policy. It is no coincidence that the latest Banque de France *Financial Stability Review* is devoted to issues of valuation. I am convinced that the crisis will force us to carry out an in-depth assessment of the concepts and tools relating to valuation.

I am not an accountant. The point of view I am putting forward today is that of a central banker who is responsible in particular for financial stability. With this perspective in mind, I propose that together we take a look at three topics.

- an overview of the crisis from the point of view of valuation
- the issue of the neutrality of accounting conventions
- the consistency of rules and practices with regard to valuation

Financial crisis, a crisis of valuation

In many respects, the current crisis is about valuation. To be sure, the factors underlying and accounting for the crisis are numerous. However, one of its significant features is that the uncertainty surrounding the "true" value of complex financial instruments has undermined the confidence of global markets, increased uncertainty about counterparty risk and led to contagion across asset classes, financial markets and economic regions. The crisis has highlighted the fact that the valuation of financial instruments is not only a question of accounting. It raises issues about risk measurement and management by financial institutions, prudential issues via the definition of capital requirements and, more widely, financial stability issues. However, valuation is also without any doubt an accounting issue. It is therefore hardly surprising that the debate about the application of accounting standards to financial instruments is a highly topical one.

I think it interesting to note that the crisis has occurred in a financial system that has seen two far-reaching developments. I am referring first of all to the rapid growth in securitisation and products whose valuation is complex. I will not dwell on this aspect as it is not the subject of today's meeting. The aspect I would like to focus on is the transition to the "fair value" accounting of financial instruments.

The rationale behind this accounting development is understandable and can be summarised as follows. The aim is to enable investors and financial system participants, which include supervisors, to have a better understanding of the risk profile of financial institutions in order to better assess their position. In order to achieve this, financial statements must – in the case of instruments for which it is economically relevant – be sensitive to price signals from markets, which reflect transaction values.

I believe that two elements are important in this argument. The first is that financial statements have the crucial merit of providing information. The second is that the rationale of fair value valuation contains within it its own limitations. The concept of "transaction", which is fundamental in this context and, as a result, that of "market", should constitute the limits of the scope of application of fair value accounting.

Are accounting choices neutral?

It goes without saying that the greater sensitivity of balance sheets to market fluctuations resulting from fair value accounting obviously has an impact on financial stability. A central banker may legitimately wonder whether accounting conventions are neutral with respect to the behaviour of financial players and market dynamics.

The current crisis and volatility that we have been faced with over the past few months suggest that accounting conventions have an impact in terms of financial incentives and may have had a not insignificant impact on financial players' strategies.

One example serves to illustrate this point. It is macroeconomic in nature and relates to risk-taking by financial institutions. It is the possibility, in the case of some instruments, of recording as of the first trading day all of the discounted future profits even though the risks remain on the balance sheet. If we are to believe the financial industry itself, this possibility has an impact on investment strategies. It cannot be ruled out that because this rule makes it possible to record substantial income flows during cyclical upswings, it has contributed to greater risk-taking by some institutions in order to maintain these income flows year after year. In a more general way, the extension of the scope of application of fair value accounting has very probably, during cyclical upswings, also contributed to many assets being accounted for at market value whereas the intention of market participants to manage these assets on a fair value basis was not clear.

My aim here is not to make a judgement about the relative merits of accounting choices. It is to highlight the fact that these choices have implications that go beyond accounting policy. In concrete terms, therefore, the question that we need to ask collectively is: what is the optimum policy response? Do accounting conventions need to be modified? Or can other regulatory frameworks correct these effects?

Consistency of valuation rules

This leads me to the last point that I would like to an address today: the consistency of rules and practices with respect to valuation.

There are currently differences of approach between accounting practices, prudential regulation and risk management practices. It is thus wholly accepted in the financial industry that there is inevitably uncertainty surrounding the valuation of financial instruments, particularly when they are complex or illiquid. In addition, the limitations of mathematical models are recognised. These two factors, i.e. price volatility over the financial cycle and the limits of quantitative techniques highlight a number of divergences between internal risk management and fair value accounting. More generally, the application of accounting rules, which give the value of a company or activity at a given moment, does not always allow the forward-looking valuation of financial instruments or sound risk management practices. Yet these aspects are important for prudential authorities. Conversely, choices in terms of prudential regulation can have an impact on financial stability when they interact with certain accounting rules. For instance, the hitherto favourable treatment given by prudential rules to the trading book has without doubt encouraged behaviour aimed at generating very short-term profits via transactions booked at market value.

Like me you will have noted that, in their press release in November, the G20 Heads of State and Government gave particular attention to accounting issues. The work programme they have assigned to ministers and experts addresses several areas. It is aimed at "harmonising accounting standards, particularly for complex instruments, during times of stress". It also aims to "address weaknesses in accounting and disclosure standards for off-balance sheet vehicles". Lastly, it aims to "enhance the required disclosure of complex financial instruments by firms". The Heads of State and Government have assigned an ultimate objective to accounting standard setters, i.e. the creation of a "single high-quality global standard". It is striking that the attention given to accounting issues is linked to financial stability considerations.

To conclude this address that has already been rather too lengthy, I should just like to remove any ambiguity that may have arisen from the discussions that have intensified with the crisis. I do not think that it is in anyone's interest in the current period to weaken accounting conventions. Accurate, rigorous and fully transparent financial statements are the bedrock of financial activity. The aim of the work and discussions that have been actively pursued over the last few months and that will continue in the coming period is in fact both a modest and a difficult one. It is to ensure that accounting conventions fully reflect the reality of financial activities and are not overambitious. This undoubtedly means reviewing the role of fair value in the accounting treatment of financial instruments.

Thank you for your attention.