Mr Meister remarks on the role of credit institutions against the background of banking supervision

Speech by Mr Edgar Meister, a member of the Directorate of the Deutsche Bundesbank, to the GASC Forum on International Harmonisation in Frankfurt on 16/12/98.

I

IASC (the International Accounting Standards Committee) and IOSCO (the International Organization of Securities Commissions) have undertaken to develop internationally applicable accountancy principles and to accept them worldwide as a precondition for cross-border stock exchange listing of securities. This plan has aroused considerable interest among central banks and banking supervisors. A theoretical distinction can be made between a national and an international perspective. In practice, however, both are interlinked. In an age of global interdependency of goods and financial markets, it is no longer meaningful to lay down national rules autonomously. The Asia crisis has once again highlighted - and has done so dramatically - that crises in one area of the world can spread like wildfire and adversely affect financial markets in other regions, however remote.

That event has stepped up the debate on how the international financial markets can be made more stable. Among the buzzwords we hear in this context are *intensify banking supervision* and *enhance transparency*. There is no disputing the fact that one of the major preconditions for a stable financial market is an effective system of banking supervision - in addition to sound economic and fiscal policies. If banking supervision is to be effective, however, the preparation and publishing of accounts are of major importance. As the member of the Bundesbank Board responsible for banking supervision, I would like to focus my remarks on the role of the credit institutions.

II

Banking supervisors depend on institutions fulfilling their reporting requirements and deriving the requisite capital adequacy on the basis of reliable accounts. Accounting functions such as the provision of internal information, documentation, ascertainment of profits and losses and informing the market are also useful for banking supervision. It will therefore come as no surprise if I emphasise the advantages of a prudent determination of profit in the banking field with the aim of capital maintenance. That does not necessarily imply undisclosed reserves, which impair the informativeness of the annual accounts. However, the historical cost principle and the principle of the lower cost or market should be retained in the case of banks, at all events where the objective is to ascertain the profit eligible for distribution.

Furthermore, thought must be given to the capital adequacy requirements laid down by the supervisory authorities. As the equity capital ratio is derived from the risk assets and the market risks, on the one hand, and from the capital resources, on the other, both the soundness of the accounts and their international comparability are of paramount importance. In view of the increasing number of ever-larger takeovers, the effects of different methods of accounting can be considerable. For example, differences in consolidation procedures, which may result in a sizeable goodwill item in one country but not in another, would give rise to unequal competitive conditions owing to the fact that the banking supervisors are required to deduct goodwill from the liable capital. This means that the equity capital ratios would present a bank in too positive a light if, for example, credit risks were not adequately reflected in the accounts.

III

There is no doubt that the informative value of the annual accounts is the main consideration in the present IASC-IOSCO plan. The German banking supervisory authority, too, is giving the project its explicit support. It agrees that the market players on the international financial markets must provide more transparency, thereby fostering the stabilisation of the financial markets. This stabilisation will be achieved through improving market discipline. A better flow of information will enable counterparties and shareholders of institutions to take more appropriate decisions on investment and loans and, consequently, will influence the actions of the banks. Market discipline is not a substitute for but a complement to banking supervision, and should prompt credit institutions to pursue a risk-conscious and prudent business policy.

The institutions themselves may also derive benefit from improved transparency. Creating a modicum of trust in the eyes of the general public through the regular flow of reliable information lowers the level of susceptibility to market uncertainty, enhances the accessibility of the capital markets and promises more favourable refunding conditions. Again, banking supervisors can expect compliance with prudential rules to be enhanced as well. Naturally, market discipline has the biggest role to play at the major listed institutions. It is primarily institutions that are in the public eye that have to expect sanctions as a result of insufficient information. However, those institutions are among the major channels through which regional crises are spread internationally.

Ladies and gentlemen, there is, of course, also scope for discretion in drawing up accounts. These discretionary powers can substantially impair the flow of information if they are deployed in different ways according to the interests of the institution concerned. In valuing assets, for example, the institutions have, in principle, to decide on their own initiative the basis of the valuation; despite subjective elements, however, discretionary powers should not unduly restrict the comparability of the results because information on the quality of a loan book can be assessed to some extent independently of the valuation basis selected according to objective criteria. Admittedly, there are other ways of assessing risk, as the example of Japan has taught us. It is customary internationally and appropriate for different payment arrears in servicing debt to serve as a yardstick. Furthermore, the comparable, because appropriate, use of discretionary powers when valuing assets is encouraged by the fact that, in principle, value adjustments on loans may be deducted from taxable profits. The banking supervisors are in favour of this. Indeed, they regard it as an incentive to make appropriate risk provision in good time. By contrast, the absence of such an incentive may be a destabilising element in a financial system. Japan is a good example of this, too. By the way, including value adjustments in tax assessment is also consistent with the principle of taxing on the basis of performance. Having made these remarks of rather a national nature, I shall now return to international transparency.

IV

The Basle Committee on Banking Supervision, which was established by the central bank governors of the G-10 countries as the Committee on Banking Regulations and Supervisory Practices as far back as 1975, also issued statements on transparency and accounting as part of its *Core Principles* in 1997. The Core Principles describe the preconditions for an effective banking supervisory system. Principle 21 requires, among other things, that “the bank publishes on a regular basis financial statements that fairly reflect its condition”. Regarding accounts, it is said that “market participants need access to correct and timely information in order for market forces to work effectively, thereby fostering a stable and efficient financial system. For this reason, banks should be required to disclose to the public information regarding their activities and financial position that is comprehensive and not misleading. This information should be timely and sufficient for market participants to assess the risk inherent in any individual banking organisation."

The Basle Committee has since explained and amended its Principles in various papers, the most recent being in October 1998. This was a consultation paper on the balance sheet treatment and valuation of credits and on the supply of information about credit risks in lending operations. A constructive relationship with IASC has also been maintained for some time in order to assist that committee in its further development of internationally recognised accounting principles. It is therefore also in the interests of the banking supervisors for the joint project of IASC and IOSCO to reach a successful conclusion. Whether the last core standard (on financial instruments) can actually be approved or not at the moment is not so important in my opinion. What *is* important is that the other partner, IOSCO, is subsequently able to fulfil its part of the agreement. As national financial markets in an open global environment can no longer be protected by national rules alone, it is in the interest of all of us that international accounting standards are applied worldwide, especially in the emerging countries as well. IOSCO can make a substantial contribution towards this goal by ensuring that the worldwide acceptance of IASC standards is a precondition for stock exchange listing.

The IMF and World Bank, which, incidentally, have also recommended that the Core Principles of the Basle committee be used worldwide, are focusing during their country inspections on whether and to what extent internationally recognised principles are being implemented and observed in the various countries. The Basle Committee itself supports national supervisors in the implementation of its principles.

V

Calls for greater transparency in the markets have also been made by the G-7 finance ministers and central bank governors for some time now. The call of October 30, 1998 to IASC to submit proposals for a complete range of accounting standards in the spring of 1999 implies a strengthening and international recognition of IASC as well as a great responsibility and commitment on the part of this body. The international organisations responsible for supervising securities trading, insurance and the banks are being called upon to put these standards to the test. Only the international acceptance of these standards can make sense in the end. At all events, the Basle Committee will do all it can on the banking supervisory side to contribute to this end.

VI

From Germany's point of view, it is particularly gratifying to see that the latest core standard within the IASC-IOSCO project is being approved during a German Accounting Standards Committee forum.

A natural person as young as the GASC would not be able to talk yet.

The commitment of the G-7 finance ministers and central bank governors to apply the recognised principles in their respective countries will necessitate some adjustments in Germany, too, which will give rise to interesting discussions and make particular demands on our fledgling GASC. I am thinking here of the introduction of current value accounting for the trading portfolios of credit institutions. A further point of conflict arises in the application sphere. Can the information function of the annual accounts be confined to the overall group results? Do the individual accounts remain concerned with dividend assessment and thus with the traditional principle of caution? Can internationally operating institutions be subject to <u>other</u> accounting principles and disclosure requirements than nationally or merely regionally operating institutions? It is difficult to imagine that institutions will comply at national level with the traditional accounting principles but that internationally they will comprehensively conform to the recognised international accounting standards. In the light of this, it should be quite understandable if the banking supervisors wanted to see capital maintenance aspects being taken into account as well when the IASs are being developed. At all events, the banking supervisors have difficulties where <u>all</u> financial instruments are deployed, no matter how the "fair" valuation is arrived at.