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Remarks by

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Introduction

Thank you for inviting me to speak at the nineteenth annual accounting conference on banking. In the two decades since the first conference, the banking industry has undergone a metamorphosis. This change was necessary so banks could offer new financial products, compete with various financial intermediaries, and serve new types of customers. Distinctions between banks and other financial firms, and among products, have become blurred. Market participants now think not just in terms of the legal and operational characteristics of the instruments they trade, but also in terms of underlying risk factors.

Derivative products are an important and controversial part of these changes in financial markets. Twenty-one years ago, Fischer Black and Myron Scholes published their seminal paper on options pricing. Since then, further theoretical innovations and rapid improvements in technology have allowed derivative instruments to move from intellectual exercises to a widely used means for unbundling and pricing specific risks. Banks increasingly have incorporated these innovations into their strategies and product offerings as the profitability of traditional business lines have come under competitive pressure, and as banks have sought to improve their own risk management.

As their products have changed, so have the risk profiles of banks. Although the credit and market risks of derivatives are not new to banking, the ability to quantify and quickly alter exposures is new. Credit risk from derivatives positions can change abruptly as a result of movements in interest rates, exchange rates, or other market factors. Likewise, traders today can establish within minutes, or even seconds, positions that carry substantial market risks. Moreover, many banks that do not trade derivatives use them to manage risks from other, more traditional activities. These changes in product mix and risk profiles require banks to develop new, more powerful approaches to risk management.

This transformation of financial markets has not taken place without considerable growing pains. Some events have raised legal issues about derivatives that must be addressed. In addition, some recent, well-publicized losses have highlighted the need for risk assessment systems and controls that are at least as sophisticated as the instruments being used. Other events seem to point out that internal controls should not be thought of as merely abstract points on an auditor's flowchart, but rather involve human beings who sometimes may not understand their role in the company, may be influenced to bend the rules, or may have incentives that conflict with shareholder interests.

I hasten to point out that while much attention seems to be focused on derivatives (off-balance-sheet instruments and structured notes), losses can also occur from commercial real estate loans and plain vanilla government bonds as well. It is not derivatives *per se* that are troublesome, but management's ability to identify, measure and control risk.

Regulating Risk Management

The challenge for regulators caused by change within the financial system is to strike a balance between economic efficiency and risk: That is, how can oversight be structured in a manner that respects both the desirability of accommodating user demands for financial services and the need to protect the financial system? There are several categories of issues, two of which I think are of particular interest to CPAs. First is supervision, including both the examination process and capital requirements. Second is transparency, which involves accounting and disclosure. I will discuss each in turn, but I hasten to point out that they are closely interrelated.

As a general matter, the Federal Reserve and other U.S. bank supervisors rely on on-site examinations as an important and flexible approach to assuring the safety and soundness of the banking system. This emphasis on examinations reflects our awareness that regulations cannot substitute for effective management by senior bank executives. This is particularly evident in the case of derivatives and other complex financial instruments. The kinds of regulatory capital standards that have been devised for these instruments, both for market and credit risk, cannot possibly encompass all of the risks these instruments represent. There are, for example, no specific capital rules for legal and operational risks because of difficulties in measuring these risks. Thus, prudent management of derivatives risks depends on the policies, procedures, and information systems demanded by senior bank management and the board of directors.

The examination process complements and is a flexible adjunct to regulatory capital requirements. A number of efforts are underway, both internationally and within the United States, to modify current risk-based capital standards to deal with derivative instruments. Last year, the Basle Supervisor's Committee proposed a framework for assessing capital for market risks relating to traded debt, equity, and foreign exchange. Various working groups are now developing revisions to the 1993 proposal. A key consideration under review is the possible use of banks' internal risk measurement systems for assessing capital adequacy. This creates appropriate incentives to supervise risk on the same basis as it is being managed. At the same time, both firms and their regulators could take advantage of evolving technology and hopefully compliance burdens would be minimized.

Before using internal models for capital purposes, however, several issues must be addressed. One such issue involves validation of the calculated capital level or the risk modelling process itself — in short, ensuring that the results of the internal models accurately reflect the institution's risk. Guidance for bank examiners will be needed, and bankers will have to understand the supervisory basis for assessing internal risk management systems. I might note that this is a particularly challenging area for regulators, especially when considering international and interagency dimensions and complexities.

Bank regulators have been involved for some time in guiding risk management processes. The focus of our guidance has been to ensure that practices are safe and sound and that the long term stability of financial markets is enhanced. We have found that judging an institution's internal systems for risk measurement and control must become an increasingly important part of the examination process. One step in meeting this objective has been the development by the Federal Reserve of a trading activities manual for bank examiners. The manual provides a structured approach to reviewing risk management activities and is a reference on financial instruments. The Federal Reserve has also written guidelines that broadly describe sound risk management practices for banks that use off-balance-sheet instruments.

Improving Risk Management Practices and Internal Controls

Efforts to implement financial theories and information systems sophisticated enough to manage portfolios of derivatives have set the stage for a revolution in conceptualizing, measuring, and controlling risk. For example, applying risk management techniques to such areas as the pricing and market risk of loan portfolios is still in its infancy. Furthermore, research and development is now focusing on applying risk management methods to the entire firm, not just to individual segments, business lines or portfolios. This, in turn, brings new challenges. The risk management methods and data processing requirements are as complex and expensive as those required for derivative instrument valuation and management, especially for firms that have multiple product lines or operate on a global basis. Thus, even for the largest and most sophisticated banks, implementation of these systems can be a major challenge. Encouraging the development and use of new technology for risk management, however, is an appropriate function of a bank supervisor.

So given the new methods for assessing and managing risk and possibility of using internal models to evaluate capital adequacy, where can market participants turn to for advice on integrating theories into operating practices? I believe the accounting profession can play an important role. As you know, the accounting profession has made many significant contributions to the art of designing effective systems of internal control. The Committee of Sponsoring Organizations of the Treadway Commission, or COSO, has already had a large impact on corporate governance. One example of COSO's influence is the growing recognition that senior management must set the tone for ethics and "control consciousness." Indeed, internal controls must be woven throughout all layers of the organization. Another aspect of the COSO framework, risk assessment, is increasingly viewed as a function that requires the involvement of all levels of line management and cannot be relegated to corporate staff, such as internal audit.

Among banking organizations, for years it was sufficient to have independent loan review and internal audit functions address credit and operational risks. Now, however, a number of organizations with significant market risks are finding that an independent risk management function is an appropriate control approach.

CPAs, by virtue of their professional training, experience and credibility within the business community, will have a critical role in improving risk management. In meeting this challenge, the AICPA has written helpful guidelines to directors for assessing the use of derivatives. I understand that COSO is also working on an illustration applying its framework to derivatives. I would urge that the illustration deal with the larger issue of risk management, particularly hedging, rather than focus exclusively on a particular class of financial instrument. The illustration should clearly describe the responsibilities of the board of directors, senior executives and line management in the risk management process. It would also be very useful to provide operational illustrations of such abstract principles as control consciousness.

Regulatory Efforts to Improve Disclosure

Turning to the second issue, accounting and financial disclosure are areas in which intensive efforts are underway, but are also areas where much more progress needs to be made. Market transparency is of great interest to the Federal Reserve, and is an area that other public policymakers, both in the United States and abroad, will continue to emphasize.

From a regulatory standpoint, efforts are underway to improve information about the overall size of the marketplace and measures of systemic risk. The international scope of derivatives markets and the geographic breadth of many firms are compelling arguments for international coordination of reporting efforts. Any attempt to measure market size must be global in scope. Governors of the central banks of the G-10 countries have decided to collect data on derivatives in conjunction with the next foreign exchange turnover survey scheduled for the spring of 1995. This survey is conducted every three years and has been useful to monetary authorities and market participants alike.

For regulatory Call Reports filed by individual banks, the banking agencies required new data in the March 1994 reports, and will require more information beginning in March 1995. By expanding the data being collected about derivatives, the agencies will have better information on types of contracts and their underlying risks, and management's purpose for holding the instruments will be more evident. Fair values and net credit exposure will also be reported. Furthermore, the agencies will receive more detailed disclosure of trading revenues and the effect of derivatives on various other components of net income. These new regulatory disclosures are only a step in improving the reporting of off-balance-sheet instruments. We also anticipate further improvements in regulatory reporting as interest rate risk capital standards are implemented in the future.

The Need for Improved Financial Reporting

Financial statements are a key source of information to market participants for making their investment and credit decisions. Trading and risk management techniques, however, have evolved at a faster pace than public disclosure of these activities. This gap between management's ability to assess the firm's financial risks and the capability of outsiders to accurately estimate those risks could lead to inefficient allocation of capital. Many firms active in financial markets made distinct improvements to their 1993 annual reports and have found that increased disclosure is in their own best interest as one part of an effort to better communicate with investors and the public at large.

The Board is encouraged to see the FASB issue its new disclosure standard, FAS 119, to start closing the information gap. We believe that the standard's requirement to disaggregate trading income according to risk exposures or business lines will be a major step in making the activities of dealers more transparent. No less important is additional disclosure about the fair value of traded derivatives, although we are hopeful that dealers will include information about other instruments or assets to put derivatives positions into perspective.

The new requirement for 1994 that firms disclose qualitative information about how and why they use derivatives should increase the awareness of investors and creditors about a firm's risk management policies. These disclosures may also serve as a useful indicator of management's sophistication and comfort with derivatives if they are able to state clearly in the report how they assess their firm's risks and provide an adequate context for relating details about their overall concepts of risk management.

Frankly, I was disappointed that the FASB did not require quantitative disclosure about risk management practices and results. It is not sufficient to describe strategies without also reporting how successful the strategies were in achieving the firm's objectives. A significant narrowing of the gap between risk management techniques and public disclosures could be accomplished with such quantitative information. However, FAS 119 was an initial response by the FASB to heightened public concerns and I view it as just the latest step in improving the quality of disclosure about derivatives and strategies for risk management. Future steps could be taken to improve disclosure as risk management practices evolve and meaningful, voluntary disclosures are worked out.

In addition to the FASB, there have been other private sector efforts to improve disclosures. Last August, the Institute of International Finance published a preliminary framework for disclosing information about the credit risk of derivatives. One recommendation of the report was that firms disclose the positive replacement cost of derivatives according to the credit ratings (by either outside agency or internal analysis) of counterparties. Although not authoritative for accounting purposes, it is nonetheless thought provoking. This recommended disclosure would give financial statement users interesting new insights about overall credit risk if similar information were also disclosed about other financial instruments having credit risk.

In the public sector, the Euro-currency Standing Committee of the G-10 Central Banks published in September a discussion paper, *Public Disclosure of Market and Credit Risk by Financial Intermediaries.* The paper was written by a working group chaired by Peter Fisher of the Federal Reserve Bank of New York. The Committee concluded that institutions should disclose quantitative information about their management of market risks. In the Committee's opinion, qualitative discussions run the risk of being meaningless boilerplate unless quantitative information about risk exposures and risk management performance are available as a framework for the discussion. Like the disclosures encouraged by FASB in FAS 119, the Euro-currency Committee advocates that the quantitative data disclosed be consistent with how risks are managed by the firm.

Many respondents to the FASB Exposure Draft that preceded FAS 119 were concerned about responsibility for forward-looking information if quantitative disclosures were required. The FASB said in its basis for conclusions that it disagreed with the premise that such data must be prospective. Indeed, the Euro-currency Committee's report should be read by those respondents. Using value at risk as a possible approach for disclosure, the Committee's report offers such examples as comparing value at risk to actual portfolio volatility, reporting a frequency distribution of daily changes in portfolio value, or reporting how often portfolio value changes exceeded the daily value at risk. Another example in the report seems to be inspired by the mutual fund industry: A comparison of the managed portfolio against a benchmark portfolio or index. Disclosures that have been modelled after these examples would be based entirely on historical results and would be independently verifiable.

I recognize that while there is widespread interest in improved disclosure, there is not yet a consensus on the precise form and content these added disclosures should take.

Nevertheless, this lack of consensus should not deter individual firms from pursuing better ways to disclose the nature and magnitude of the risks associated with these activities. We may well have to go through a period of some experimentation to achieve a consensus on what comprises effective public disclosure.

In turning from disclosure to accounting standards, I will state the obvious that if developing new and useful disclosures is a difficult task, then establishing better methods of accounting for derivatives and hedging must be even more challenging. Nevertheless I strongly encourage the FASB staff and board to maintain their efforts to devise a consistent framework for hedge accounting until this goal is achieved.

When losses on derivative contracts occur, a harsh light is cast on the deficiencies in current practice for disclosing and accounting for derivatives. Such losses highlight how critical it is that auditors thoroughly understand the risks inherent in their client's business and their need to maintain prudent skepticism when encountering leveraged or other high-powered contracts that are being represented as hedges.

Summary and Conclusion

In summary, I think the Federal Reserve and other regulatory agencies have made significant progress in strengthening the framework for supervising derivatives and risk management activities. Concurrently, many participants in financial markets have increased enormously their understanding of the risks involved in derivatives. Parallel developments in public and private sector policies also are going forward. In risk management, there is no single correct way of measuring and controlling risk. Individual firms are devoting substantial resources to improving risk management systems and exploring alternative approaches. This should continue and be encouraged by the regulatory process. However, the regulatory process should not attempt to get out in front of these developments in measurement, as it may lock the industry into one "solution" and stifle future innovation.

I also believe that regulators, by focusing on risk management systems and processes, will not interfere with the rapid development of new products that meet customer needs. Public policy should accommodate new, useful instruments and the development of new markets. Regulators must not discourage innovation if we want the marketplace to benefit fully from the risk reallocation afforded by properly-designed derivative transactions.

One of the financial market's greatest challenges is to the accounting profession: How can financial statements best convey information about risk management activities to shareholders, creditors and other interested parties? It is an understatement to say it is difficult to devise meaningful and understandable disclosure that is also comparable to other firms and to previous reports. The disclosure, moreover, should not compromise proprietary information and must be flexible to accommodate future advances in risk management. Furthermore, the benefits derived should exceed the cost of providing the disclosure. To further complicate the challenge, the information needs to be independently verifiable.

These are daunting obstacles. Nevertheless, it is essential that the accounting profession overcome these impediments. I am certain that as the profession moves forward to meet this challenge, new ways of viewing risks and reporting them in financial statements will be devised, and financial reporting will become an even more critical element to the efficient allocation of financial resources.