Testimony of Governor Susan M. Phillips

FASB proposals for derivatives and risk management

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I welcome this opportunity to discuss the Federal Reserve Board's views on proposed accounting standards for derivatives and risk management activities issued by the Financial Accounting Standards Board (FASB).

In approaching this complex matter, it should be acknowledged up front that most responsible observers and market participants share an interest in improved accounting standards and disclosure of information that is useful and relevant to the broad range of users of financial statements. Thus, the desirability of meaningful disclosure is not the issue. All would agree, I think, that enhanced financial disclosure and market transparency can lead to more efficient financial markets, more accurate pricing of risks, and more effective market discipline.

With respect to financial disclosures, the interests of most firm managers, investors, and other market participants are essentially the same. Market participants can benefit from enhanced disclosure by being in a better position to understand the financial condition of their counterparties and competitors. Investors have an obvious interest in being able to make meaningful assessments of a firm's performance, underlying trends, and income-producing potential. Sound, well-managed firms can benefit if better disclosure enables them to obtain funds at risk premiums that accurately reflect their lower risk profiles. Inadequate financial disclosures, on the other hand, could penalize well-managed firms if market participants are unable to assess their fundamental financial strength.

While most market participants favor sound accounting standards and meaningful disclosure, a key question is how to ensure that accounting practices and techniques reflect, and are consistent with, how a business is run, that is, its overall business strategy. Indeed, accounting methodology should measure the results of a business purpose or strategy, and not be an end in itself. For example, in the case of a company that actively trades financial instruments or other products to profit from short-term price movements, such as a securities firm, reporting trading positions at fair values appropriately measures the success or failure of that business strategy, and market participants expect this reporting treatment. However, for many other types of businesses, such as a manufacturer or a lender that funds loans with liabilities of equal maturity, market value accounting in the primary financial statements may not accurately reflect business strategies or appropriately measure the firm's underlying performance and condition. In these cases, although information about fair value can be useful in supplemental disclosures, it is questionable whether there is widespread demand for market value accounting to become the basis for the preparation of the primary financial statements.

Although the needs of financial statement users may vary, a critical function of financial statements is to reflect in a meaningful way underlying trends in the financial performance and condition of the firm. The application of market value accounting to business strategies where it is not appropriate, and particularly when applied on a piecemeal basis, may lead to increased volatility or fluctuation in reported results and actually obscure underlying trends or developments affecting a firm's condition and performance. Requiring companies to adopt market value accounting where it is not consistent with their business strategies can cause them to incur significant costs to provide information that may not reflect in a meaningful way their underlying circumstances or trends in their performance. Moreover, from the standpoint of financial statement analysts and other users, having to make adjustments to remove the effects of this accounting volatility from income statements and balance sheets--volatility that is not consistent with a firm's risk positions--can also impose significant costs without offsetting benefits.

These problems can be minimized by placing market values in meaningful supplemental disclosures rather than by forcing their use in the primary financial statements. Such an approach would give analysts the information they need, without imposing the broader costs of having to reverse or back out the effects of artificial volatility from the primary financial statements. Of course, financial statements and supplemental disclosures must be accurate and not misrepresent a firm's financial circumstances--a problem that can be minimized when financial reports are subject to thorough review by management and external auditors.

Federal Reserve's Experience

The Federal Reserve Board has a long-standing interest in the quality of financial reporting. This arises from our role as the nation's central bank, and as the supervisor of bank holding companies, state member banks, and the U.S. operations of foreign banking organizations (FBOs). The Federal Reserve and other bank supervisors are responsible for assessing the safety and soundness of the institutions they regulate. In this regard, the Federal Reserve relies on off-site monitoring, on-site supervision, capital and other regulatory requirements, and policies that encourage sound risk management practices. We believe that market discipline--supported by appropriate accounting standards and public disclosure--complement these supervisory efforts by fostering healthy financial institutions and efficient capital markets.

In the course of supervising financial institutions, the Federal Reserve has developed considerable familiarity with financial instruments, both derivative and non-derivative, that are characterized by a wide range of complexity and risk. We have learned that in supervising trading and derivatives activities it is the underlying characteristics of a financial instrument--and how it contributes to the overall risk profile of the firm--that are important, not the instrument's name. Two instruments that differ in name only may have entirely different treatment under existing legal and accounting frameworks, even though the economic risks (including market, credit, liquidity, operational, and reputational risks) they embody are identical. Financial engineering can certainly create derivative instruments that combine risks in complex ways. But the same engineers can create cash instruments that appear simple and traditional, but may have greater risk than many instruments labeled "derivative." Indeed, placing financial instruments in regulatory or accounting pigeonholes without regard to their true risks and economic functions can create disincentives for prudent risk management.

The Federal Reserve is increasingly emphasizing the need for institutions to manage the aggregate or portfolio risks of banking and de-emphasizing a focus on specific instruments. Risk should be measured and managed comprehensively. That is, an institution should manage the dynamics of its portfolio rather than manage specific instruments. A focus on individual transactions can ignore the interaction of the specified instrument with other instruments. Although portfolio theory is widely appreciated by bankers and regulators, putting its principles into practice in banking has not been easy. For example, past banking crises have, in part, reflected a failure by some institutions to recognize and limit concentrations of risk within their portfolios.

The Federal Reserve is increasingly recognizing the need for supervisory and regulatory policies to be more "incentive-compatible," in that they encourage sound risk management within an institution. Furthermore, supervisory and regulatory policies are placing increasing emphasis on minimizing burden by using internal risk measurement systems, and by reinforcing supervisory objectives through market forces. We believe that market discipline--supported by appropriate accounting standards and public disclosure--complements our supervisory efforts by fostering strong financial institutions and efficient capital markets. We believe this approach is more constructive than rote adherence to rules and regulations that may not be consistent with the firm's own risk management systems.

Consistent with these policies, the Federal Reserve and other banking supervisors have explored regulatory approaches that encourage more use of market-value-based measures in risk management approaches. For example, beginning next year, internationally active banks meeting certain criteria for risk management will calculate the amount of capital necessary to support the market risk of their trading activities using their own internal value-at-risk (VaR) measures. A significant effort that could increase supervisory reliance on market discipline in the future is the Federal Reserve's so-called "pre-commitment" approach to determining capital for market risk. It seeks to provide banks with stronger regulatory and market incentives to improve all aspects of market risk management. Other initiatives have improved the focus of our supervision policies and examination practices on institutions' risk profiles and risk management activities in ways that emphasize sound practices and strong internal controls.

Moreover, the Federal Reserve has called for improved U.S. accounting and disclosure standards and has had a key role in sponsoring major international initiatives to encourage improved disclosures by the largest banks and securities firms of their trading and derivatives activities. For example, our 1995 and 1996 analyses of the derivatives disclosure by the top ten U.S. dealer banks were used as models for the joint reports by the Basle Committee on Banking Supervision and the International Organization of Securities Commissions, which covered a sample of the largest banks and securities firms in the G-10 countries. These studies revealed major differences in disclosure among the participating countries and highlighted the greater level of disclosure by U.S. dealer banks. In addition, a representative of the Federal Reserve chaired an international working group of the Euro-currency Standing Committee that in 1994 recommended improvements to disclosure by financial intermediaries of the credit and market risks of their trading activities. The Federal Reserve and the other federal banking agencies also developed improvements in derivatives disclosure standards for regulatory reports that are similar to disclosure requirements issued at the same time by FASB in Statement No. 119, "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments."

Specific Issues Raised by the Derivatives Proposal

We share several objectives with the FASB for improving financial reporting. For example, we both support the fundamental objectives of promoting clear and understandable financial reports that increase the transparency of companies' activities. We also share the view that accounting and disclosure standards which faithfully represent financial condition and performance can improve investor and counterparty decisions, thus improving market discipline on banking organizations and other companies. Further, we also agree that current accounting and disclosure standards for derivatives--as well as for other financial instruments--should be improved.

We recognize the difficult task that FASB has in developing a standard that is acceptable to its many constituents. In this regard, we understand that FASB has considered and rejected a number of approaches to hedge accounting for derivatives because particular problems were identified with each approach. We also believe that the approach of reporting all financial instruments at fair value in the primary set of financial instruments, while having some theoretical appeal at least for some types of firms, is not an appropriate solution in the near term. In this regard, fair value estimation techniques are not yet sufficiently robust for exclusive reliance in financial statements. For example, difficult valuation issues arise for highly illiquid instruments for which fair value is based on models rather than observed prices, core deposits with varying durations, and the liabilities of a firm whose credit quality has weakened. Furthermore, fair value estimates can be highly subjective, and little guidance is available for measuring fair values in the financial statements. Another difficult issue relates to whether fair value is the most relevant measurement for commercial banks and other firms that are in the business of holding illiquid loans and other assets for the long term. The success or failure of such a strategy is not measured by evaluating such loans on the basis of a price that indicates value in the context of immediate delivery. In this regard, an appropriate value for many bank loans and off-balance-sheet commitments--the one that reflects the nature of a bank's business--is the original acquisition price adjusted for the expectation of performance at maturity.

Given the many difficulties of FASB's task, it is not surprising that their proposal raises a number of complex issues. For example, the proposal is likely to lead to increased volatility in income and stockholders equity by companies that manage risk with derivatives. This volatility could be artificial due to the piecemeal approach of marking certain risk positions to fair value, but not all positions contributing to the risk. As a result, there could be accounting volatility that bears little relation to an institution's overall risk position. Supervisors and analysts will have to strip out the artificially created volatility to assess the true performance of the firm. On the other hand, companies that do not manage their risks, or manage their risks solely through cash instruments that are not covered by the standard, would not reflect similar volatility.

A simple example might illustrate this concern. Assume a company's activities consist solely of lending long term at fixed rates and funding these loans with variable-rate deposits. I think we can all agree that this company has a significant exposure to interest rate risk. If the company does not manage its risk with derivatives, it would not be affected by the derivatives accounting proposal and would not report any volatility from fair value changes in its financial statements. If, however, the company has a strategy to use derivatives to reduce its interest rate risk and move it closer to a match-funded position, the company may report greater volatility in income and stockholders' equity--a result not consistent with its reduced risk exposure. For example, if the company specified under the framework set forth in the FASB proposal that the derivatives are "cash flow" hedges of variable rate liabilities, the company would have volatility in equity or earnings based on the specifically linked effectiveness tests set forth by the proposal. Thus, the firm in using derivatives reduces its economic volatility, yet increases its accounting volatility.

More important, by taking a transaction level approach to hedging, the proposal would not describe well the efforts of more sophisticated market participants to hedge their risks on a comprehensive, portfolio basis. Thus, these firms would effectively be required to keep different sets of books, and their financial reporting may not be consistent with the derivatives' intended use. This leads me to conclude that the proposal could discourage or constrain prudent risk management practices that rely on derivatives. Furthermore, it may not improve transparency of financial information.

The proposal also introduces into the financial statements an untested method for reporting loans, deposits, and other assets and liabilities being hedged. These assets and liabilities would be valued at a "hybrid" historical cost and fair value amount on the balance sheet when they are hedged with derivatives that are designated as fair value hedges. For example, generally, the historical cost values of these assets and liabilities would be adjusted for changes in fair value related to the risk being hedged. However, certain other changes in fair value would not be recognized (such as those that arise from other risks, that are the results of an ineffective hedge, or that do not offset a gain or loss on the hedging instrument). These hybrid amounts could differ significantly from--and potentially exceed--fair values. They may also be difficult to verify by auditors and examiners, thus reducing the reliability of amounts reported in the financial statements.

The proposed approach is complex, which may increase related developmental systems costs. In this regard, the proposal may cause significant systems changes for institutions that hedge with derivatives. At the same time institutions are making these systems changes, they need to upgrade their systems to address Year 2000 issues. The cost of systems changes arising from the derivatives proposal should be evaluated along with other costs and benefits arising from the proposal. This is particularly important since the derivatives proposal is intended by the FASB to be an interim treatment, and its long-term goal is to measure all financial instruments at fair value. Indeed, the FASB already has under way a project that is evaluating issues related to that goal.

Looking Forward

Because of our concerns about FASB's derivatives proposal, we have assessed various alternative approaches to accounting and disclosure for derivatives and financial instruments. In this regard, we have discussed this issue with other banking regulators in this country and overseas, accounting professionals, and others. We also considered FASB's long-term objectives of accounting for all financial instruments at fair value and recognize the difficult challenge of trying to address derivatives even on an interim basis. It is unlikely that any one solution will please everyone.

While we have heard a number of different views, several themes emerged from our discussions. One is that there is a need for accounting and disclosure standards that faithfully represent risk profiles and thus encourage better risk management, result in transparent financial reports that enhance market discipline, and minimize the costs of systems changes and reporting burden. Second, derivatives accounting and disclosure standards can be improved to the extent that they better reflect portfolio hedging strategies. Third, many major market participants believe that existing derivatives accounting practices can be improved by focusing on the best of current accounting practices, rather than developing significantly novel and untested approaches. Lastly, many believe that existing disclosure requirements for fair values could be improved. We encourage the FASB to carefully consider these ideas as they move forward in their derivatives accounting project.

One approach to accounting and disclosures for derivatives and financial instruments that takes into account these commonly expressed themes has received broad support from banking supervisors both domestically and internationally, as well as from some other major constituents. The Federal Reserve recently offered this idea to the FASB as one possible approach for addressing financial reporting issues raised by derivatives. Likewise, the Basle Committee on Banking Supervision suggested this approach when commenting to the International Accounting Standards Committee (IASC) on its project on financial instruments. In addition, the European Commission provided comments to the IASC that offered a substantially similar approach.

Under this approach, FASB would (1) enhance the current historical cost-based financial reporting framework by issuing a derivatives accounting standard that is based on the best current accounting practice for derivatives, and (2) supplement the historical cost-based statements with expanded disclosures of financial statements based on fair values, including the fair values of derivatives and other financial instruments. Such disclosures should be limited for the time being to larger market participants and be coupled with enhanced accounting guidance on the estimation of fair values. This framework is intended to be a broad template which would be consistent with management and market participant needs for better information from companies, such as financial firms with extensive trading operations. Additional work would be needed by the various groups which set accounting standards, in consultation with interested constituents, to provide a basis for implementing more specific standards. We believe that this framework could more faithfully represent risk profiles and thus encourage better risk management, as well as increase transparency of financial reports to improve market discipline. Furthermore, we believe the supplemental comprehensive fair value financial statement disclosures would be a useful adjunct to the accounting paradigm we currently have, and the two bases of accounting could act as a check and balance for each other.

In addition, this approach would minimize reporting burden by utilizing the best of current accounting practices and existing disclosure standards. In this regard, companies are now required to disclose in footnotes the fair value of all of their financial instruments and to report "comprehensive income," which takes into account changes in fair value of certain (but not all) financial instruments that are not currently reflected in net income. The approach could provide a framework for FASB to explore ways to improve these disclosure requirements. Although the Federal Reserve has suggested this alternative approach to the FASB, there may also be other acceptable ways of addressing the many concerns expressed by commenters to the FASB proposal. For example, FASB could in the near term focus on improvements to existing derivatives accounting practices under the historical cost framework, and leave improvements in fair value information to its longer term project on financial instruments. Alternatively, FASB could defer the effective date of the proposed standard to provide more time for institutions to address implementation issues and make systems changes.

In the end, it is the responsibility of the FASB, SEC, and IASC to find the best practicable solutions for accounting and disclosures for derivatives and other financial instruments. These organizations are given the difficult charge of determining the best accounting and disclosure principles, evaluating all of the factors, and considering the views of all constituents. We look forward to working with these organizations in their efforts to improve these standards. We are glad to be able to participate in the public comment process and look forward to doing so in the future.

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