Remarks by Governor Susan M. Phillips

Accounting and auditing standards and bank supervision
At the 23rd Annual Accounting Lecture Series of the University of Tennessee, Chattanooga, Tennessee
October 24, 1996

It is a pleasure to join you today for the 23rd Annual Accounting Lecture Series at the University of Tennessee. I understand that one of the objectives of this lecture series is to foster discussion of accounting and auditing issues facing the accounting profession and to promote communication and coordination among professional accounting organizations. I applaud your efforts. U.S. accounting and auditing standards are central to the integrity of our financial system. They are also important to the Federal Reserve's efforts to supervise and regulate banking organizations, as well as efforts to enhance and harmonize such standards internationally. For these reasons, I welcome the opportunity to talk with you this evening about U.S. bank accounting issues and international harmonization from a bank supervisory perspective.

The Heightened Importance of Accounting and Auditing Standards

By way of background, four developments have heightened the importance of accounting and auditing standards in the bank supervisory framework. First, there has been a marked increase in the issuance of accounting and auditing standards that have had a major impact on the banking industry. This trend seemed to start with the accounting standard for foreign currency translation in 1981. Since then, and particularly in this decade, new Financial Accounting Standards Board (FASB) standards and proposals affecting banks have been issued at a blistering pace in such areas as loan-loss accounting, asset securitization, mortgage servicing, securities activities, and derivatives. Bankers and examiners have felt the impact of these accounting developments and have seen business strategies and transaction types change as a result. Indeed, many feel that the increased complexity of certain types of financial transactions has been driven, in part, by changes in accounting and disclosure requirements.

Second, new statutes have prompted more attention to accounting and auditing practices. For example, section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) sets forth new rules for audit committees and certain auditor and management reports by the larger banks. Section 121 of FDICIA requires that bank regulatory reporting requirements be consistent with generally accepted accounting principles (GAAP) or more stringent than GAAP.

Third, changes in accounting treatments can often dramatically affect reported results. For example, when implemented in 1994, FASB Interpretation No. 39 on netting of assets and liabilities -- called "FIN 39" -- increased the total assets of some of the largest banks by billions of dollars each and by around $100 billion for the banking industry as a whole. Later in 1994, another FASB interpretation on netting of repurchase transactions -- FIN 41 -- caused billion dollar decreases in assets at some of the money center banks. Thus, sometimes even obscure accounting standards can have a significant effect on the "bottom line" of financial institutions.

The fourth development that has increased the importance of accounting and auditing standards perhaps the most to bank supervisors is their crucial role in risk-focused supervision of financial institutions. During recent years, the Federal Reserve has endeavored to streamline the examination process to make it more focused on risks and to make greater use of technological innovations. This approach recognizes that while financial and technological innovations do not change the substance of the fundamental risks of banking, these risks may be repackaged in more complex forms that are difficult to measure and manage. Increasingly, since 1991, our examination guidance has stressed the need for banking organizations to implement sound risk management practices that provide for

- Active oversight by management and the board of directors
- Clearly defined policies, procedures, and authority
- Comprehensive risk measurement and reporting systems
- Adequate audits and systems of internal controls.

In this regard, the Federal Reserve recognizes that accounting, auditing, and disclosure play a crucial role in the financial marketplace. Accounting standards provide the foundation for credible financial statements and other disclosures that are key means for communicating a firm's operating results and its overall health, as well as for making more transparent various operating activities. Disclosure of reliable information facilitates market discipline, strengthens confidence, and reduces the chance that rumors and misleading information could cause market instability. Such results have obvious implications for supervisors' abilities to oversee the safety and soundness of depository institutions and for the Federal Reserve in its responsibilities for financial market stability.

These standards are also important to the federal banking agencies because of their critical role in regulatory financial reports -- such as the bank Call Report and bank holding company Y-Reports. The supervisory agencies monitor these reports to follow financial developments at depository institutions. When reported financial information indicates a deterioration in financial condition, these monitoring systems signal the need for on-site examinations, targeted reviews, and other appropriate actions. Because these reports are largely based on GAAP, accounting standards have an important impact on the information that is available for examination and other supervisory purposes. The better the quality of financial information -- and of the accounting standards that shape this information -- the greater our ability to monitor and supervise banks effectively. Moreover, because our quarterly regulatory financial reports are generally available to the public, they serve an important public disclosure purpose as well.

By facilitating market discipline, public disclosure helps reinforce supervisory efforts to encourage banks to maintain sound risk management practices and internal controls. In this regard, auditor attestations help ensure that market discipline is based on *quality information*.

Adequate audits and internal controls are critical to risk management. The risks inherent in bank operations are difficult to quantify and can pose a threat to the bank's safety and soundness. Controls assuring the quality and integrity of business processes are important, and breakdowns can be devastating. Indeed, a breakdown in internal controls or risk management systems was a root cause of several recent financial problems of large institutions. At Barings Bank, it was not market risk, credit risk, or inadequate risk measurement -- but poor internal controls surrounding a single trader that closed the bank.

Similar internal control weaknesses were apparent at Daiwa, Sumitomo, and Kidder Peabody. Internal controls are appropriately receiving more attention from not only supervisors but from boards of directors and senior management. This is a healthy market reaction to these problems.

For these reasons, the Federal Reserve has increasingly recognized that, together with on-site examinations and capital standards, improved standards for accounting, supervisory reporting, disclosure, and controls are important parts of its supervisory approach to addressing complex new transactions, such as those involving derivatives.

Return to top

Recent Initiatives

Domestic Efforts
In view of the importance of accurate accounting information, the Federal Reserve has renewed its focus on the quality of information in supervisory reports that are available to the public. Specifically:

- The Federal Reserve has been working with the other federal banking agencies to develop regulatory reporting requirements that are more consistent with disclosures in published annual reports. The Federal Reserve has long required that bank holding companies follow GAAP for purposes of its FR Y-9C regulatory financial reports, and, last year, the Federal Reserve strongly pushed for adoption of GAAP for the bank Call Report. We were very pleased that the banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), announced in November 1995 their plan to adopt GAAP as the basis of bank Call Reports in March 1997. Eliminating regulatory accounting principles or "RAP" -- for example, in the areas of asset sales with recourse, futures and options contracts netting, and excess servicing fees -- means that banks must no longer maintain a separate set of books for regulators. We hope that this Call Report initiative should thus reduce the reporting burden on banking organizations.
- In recent years, we have also significantly improved the information on derivatives in the bank Call Report and bank holding company FR Y reports and have made this information more consistent with derivatives disclosures required by FASB Statement No. 119.

In many cases, market developments or new products outpace the development of formal accounting guidance. This creates particular challenges for bank supervisors. Should new regulations or even examination guidelines be delayed until accounting standards are issued? In some instances, we have not felt that we could wait. For example, the Federal Reserve and the other banking agencies, under the auspices of the FFIEC, have gone beyond GAAP and SEC disclosures this year by requiring new regulatory report disclosures on derivatives' credit losses. Next year, new items will be added for net deferred losses or gains on derivatives used as hedges and for credit derivatives. Furthermore, the banking agencies plan to require new information for the assessment of overall interest rate risk. We hope that accounting guidance will be finalized soon in these areas, at which time we may have to revise our regulatory report requirements.

We are also encouraging banks to disclose in their annual reports more data on their risk exposures and provide more in-depth discussions of their risk management processes and operating results. For example, in September 1996 and 1995 we published, as the lead articles in our official monthly publication, the *Federal Reserve Bulletin*, analyses of derivatives disclosure in the 1993-95 annual reports of the top ten U.S. dealer banks. In reviewing qualitative and quantitative disclosures, the analyses address information about (a) market, credit, and liquidity risks of trading activities, (b) end-user derivatives activities, and (c) the earnings contribution of these activities. Furthermore, the tables presented in these articles summarize the major types of derivatives disclosures made by the top ten U.S. dealer institutions.

Improved public disclosure enhances market discipline, which in turn has the potential to allow regulation and supervision to be less intrusive. External audits attest to the fairness of public financial statement disclosures. In this regard, in July of this year, the Federal Reserve launched two Systemwide working groups to

- Explore ways of enhancing market discipline through further improvements in public disclosures about on- and off-balance-sheet activities
- Develop supervisory guidance on sound practices for banks' internal and external audit processes and improve the use of audit information in the risk-focused supervision process.

These working groups are chaired by Jerry Edwards, our chief accountant, and they are expected to issue supervisory guidance on audits and recommendations for improved public disclosure in 1997.

International Efforts
Turning to international initiatives, the Federal Reserve has been active behind the scenes in promoting improvements in supervisory reporting and public financial statement disclosures, as well as enhancements to reporting on global market statistics. As banking and financial markets generally have become increasingly global in scope, efforts to press for increased market transparency must proceed in an international arena.

- The Federal Reserve played a major role in developing the joint report by the Basle Committee and the International Organisation of Securities Commissions (IOSCO), which sets forth a framework for international supervisory reporting of derivatives. The report was issued last year and is being implemented by supervisors of banks and securities firms in many major industrialized countries. We expect that, over time, this initiative will lead to greater convergence among these countries in the supervisory reporting of derivatives activities.
- Turning to public disclosures, Peter Fisher, Executive Vice President, Federal Reserve Bank of New York, chaired an international working group of the Euro-currency Standing Committee that issued a report in September 1994 recommending improved qualitative and quantitative disclosures by financial intermediaries about the credit and market risks of their trading activities.
- Our 1995 analysis of the derivatives disclosure by the top ten U.S. dealer banks, which I mentioned earlier, was the model for a joint report issued in November 1995 by the Basle Committee and IOSCO that covered a sample of seventy-nine of the largest banks and securities firms in the G-10 countries. The joint study revealed major differences in the level of disclosure about trading and derivatives activities among the participating countries and highlighted the higher quality and quantity of information U.S. dealer banks provide. This study is being repeated this year and should be published by the end of this month.

- Turning to market statistics, another report by the Euro-currency Standing Committee was prepared on "Proposals for Improving Global Derivatives Market Statistics," and was made public in July 1996. The report described a framework of regular reporting from the major dealers in the G-10 member countries, which would provide internationally consistent information on the size and structure of derivatives markets in order to increase market transparency and thereby help central banks, other authorities, and market participants to monitor patterns of activity in the global financial system. Consultations with market participants and supervisors are under way, and central banks are considering implementation of the new reporting system as of the end of 1997.

Internationally, accounting and auditing standards are receiving increasing recognition from banking supervisors. For example, the Basle Committee has recently decided to restructure its activities in 1997, creating a new risk management subgroup that will be chaired by the Federal Reserve. This subgroup will develop supervisory guidance on bank risk management practices and on improved internal controls and audit standards. The Basle Committee also plans to form a new information subgroup that will encourage adoption of better standards for public disclosure, both for trading and derivatives activities and for traditional balance sheet risks. In addition, the Basle Committee will form a new accounting task force to address ways of improving international accounting standards.

Based on these initiatives, I expect that the Basle Committee will likely become more involved in providing comments to the International Accounting Standards Committee (IASC) as it moves forward with its project to develop a core set of international accounting standards by March 1998. These include the development or revision of international accounting standards for income taxes; presentation of financial statements; intangible assets, leasing, loan and securities impairment; provisions and contingencies; and financial instruments and investments. IOSCO has indicated that successful completion of this project will allow it to consider endorsing the IASC's standards for cross-border securities registrations in all global markets.

Return to top

Future Directions

I recognize that, while there is widespread interest in improved disclosure, there is not yet an international consensus on the precise form and content these added disclosures should take. What is most important is that disclosure reflect the risk management systems of the reporting entities. Individual firms should pursue better ways to disclose the nature and magnitude of the risks they assume and their earnings impact. We may well have to go through a period of experimentation to achieve a consensus on what comprises effective public disclosure. Clearly, the international efforts of the type I have outlined should help move over time toward a consensus regarding recommendations for improved disclosures by internationally active companies.

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 to continue its efforts to devise a reasonable, consistent framework for hedge accounting.

When major losses on derivatives contracts occur, a harsh light is cast on the deficiencies in current accounting and disclosure practices 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 their supervisory approaches and risk management guidance. I believe that regulators, by focusing on risk management systems and processes, will not interfere with the prudent development of new products that meet customer needs. Clearly, in the context of risk-focused supervision, accounting and auditing standards will continue to have heightened importance for years to come.

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? I understate the challenge when I say it is difficult to devise meaningful and understandable disclosure that is also comparable to previous reports and to those of other firms. The disclosure, moreover, should not compromise proprietary information; it 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 issues must be considered not only in the context of U.S. standards but also from an international perspective. Efforts now under way to develop international accounting, disclosure, and auditing standards are encouraging. Bank supervisors will be working in tandem to facilitate the efforts of the international professional accounting groups.

These are daunting challenges. Nevertheless, I am certain that as the profession moves forward to meet these challenges, new ways of viewing risks and reporting them in financial statements will be devised. Financial reporting and supervisory reporting will become even more critical to efficient financial markets and effective bank supervision activities.
Thank you.

Return to top

1996 Speeches
