Federal Financial Analytics, Inc.

Petrou Tells Bank Supervisors, "Keep it Simple, Smarty"

"Some have suggested that supervisors should only intervene when they fully understand all aspects of complex quantitative models and, to be sure, it would be nice if regulators knew as much – or even more – in these arenas as their charges. To expect this, though, is to make the best the enemy of the good in bank regulation. Sometimes, simple truths are the most compelling. If a disclosure, price, capital ratio or incentive doesn't seem to make sense, it probably doesn't."

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WASHINGTON, D.C. – In a keynote address today, Karen Shaw Petrou, managing partner of Federal Financial Analytics, told the FDIC's annual accounting conference that a critical lesson from financial-market turmoil is the value of simple truths. She urged the agency's auditors and accountants to look past the degree to which bank disclosures are GAAP-compliant to identify results that are at variance with economic fundamentals. She also suggested that regulators consider public disclosures that parse complex call reports and published financials to guide depositors, investors and other regulators to the most critical features of a bank's safety and soundness, noting that transparency only enhances market discipline if observers understand the disclosures they receive.

Petrou noted that, "As I said, your role is different from that of an accountant for the banks you regulate. They are responsible only for ensuring GAAP-compliant reports and can rightly assist management in presenting the most favorable – albeit still truthful – picture of a firm quarter to quarter. Your responsibility – really your challenge – is to evaluate GAAP-compliant and truthful reports for emerging risks." She noted two specific cases, including disclosures by Fannie Mae and Freddie Mac, that should have pointed regulators to serious supervisory problems well before crises emerged. She also criticized the banking agencies for coming far too late to recognize growing mortgage-market risk.

Petrou urged auditors and accountants to monitor simple facets of complex factors like capital, liquidity, compensation structures and pricing to identify emerging risk. "To be sure," she said, "regulators shouldn't try to govern pricing – a critical marketplace right – but when risk is no longer reckoned with, regulators must intervene to ensure that capital and reserves are at the ready." She also pushed hard for new standards that ensure capital is at risk in complex securitization or off-balance sheet structures.

The speech is attached.

Federal Financial Analytics, Inc. has for the past twenty years counseled large financial institutions and even their regulators on major legislative, regulatory and policy issues that pose strategic risk. It does not lobby on behalf of clients, but advises them on appropriate responses in light of identified challenges, working on an array of GSE, Basel II, and acquisition-value issues. The firm publishes numerous information and analytical services, including Financial Services Management and GSE Activity Report.

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