Accounting for Change:

Critical Challenges for Effective Regulation

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It is an honor to join you today to kick off a conference that focuses on a critical – if all too often overlooked – aspect of effective regulation: getting the numbers right. That's the job each of you does at the banking agencies, and I applaud you for it. Sometimes, I'm sure it seems that no one cares, but the near-death experience of the financial crisis showed how essential it is to have the basics firmly in place for sound regulation and effective supervision. Financial engineering based on fancy formulas with complicated results is fine in its place, but a skeptical look from under the proverbial green eyeshade to see if the numbers made sense would have saved your agencies, the financial system and taxpayers a lot of grief and a whole lot of money.

With this in mind, I'll this morning highlight several major reform initiatives where accounting and audit issues are key driving factors. In several cases – the leverage rule and single-counterparty credit limits – they may even be the most important unanswered questions in determining if these rules will work as intended or backfire with disastrous consequences. The banking agencies are also working hard on new resolution protocols to bar too big to fail. Measuring risk in a clear, comparable way is also a critical dimension of this urgent national priority, and one in which all of you can play a vital role. Knowing what loan-loss reserves are for and whether they are sufficient is another critical "accounting" issue with far reaching safety-and-soundness impact.

Your agencies are hard at work crafting tools not only to improve these prudential regulations at each bank – "micro-prudential" regulation – but also to develop macro-prudential standards to spot emerging, high-risk trends. All of this is needed, but none of it will work without better governance by each bank – big or small – and its board of directors. Effective audit and risk-management controls are critical here, and I'll thus also spend a bit of time on them today.

How Exposed to Whom?

But, first, let me return to several pending regulations where the accounting used to determine key numbers has vital policy impact. There are several major measures that fall into this category, but I'll highlight two major ones this morning where the issue is the same: how to measure a bank's exposure to a third party.

This sounds simple – look at the loan docs to see how much went out the bank's front door or how much is left uncommitted on a line of credit. But, as you know, new financial instruments have made measuring credit exposures anything but simple. We need soon to answer this question because in my view we can't finalize leverage rules or credit-exposure limits without an informed discussion of how in fact to judge outstanding risk from a balance-sheet and single-counterparty perspective.

Set the exposure limits too low, and banks will take undue risk. But, set them too high, and we'll shut down a critical element in financial-market liquidity, as well as undermine the central counterparties many think vital to reform of the over-the-counter derivatives market.

Put simply – very simply – GAAP measures exposures on a netted basis and IFRs count it on a gross basis. I've already grievously over-simplified the gross-versus-net accounting issue, but instead of dwelling on the gulf in international-accounting requirements, I'll note also that pending bank rules measure these exposures in different ways – essentially through standardized formulas or reliance on internal models. Given recent financial-market harsh experience, it is tempting to say first that exposures should be grossed up and internal models should be trashed. I'm sympathetic to these points, but these are also simple responses that do violence to a far more complex reality.

Gross exposures might seem the right way to go from a prudential perspective, but setting capital on them or setting counterparty limits on a gross basis creates a strong regulatory disincentive to hedge risk and diversify it across the financial system. You may say in response, "Hedges are too fancy for my taste." Fine, although many proved their worth in the crisis. What, though, about collateral and margin requirements – critical to tri-party repos and securities financing on which U.S. financial market liquidity relies. If we at the same time require banks to hold prudential collateral or margins to limit exposures and then discount them for measuring leverage capital or counterparty exposures, we create a strong push forcing banks to exit markets vital to the economy.

I urge you all to take a look at the pending rule to create an "enhanced supplementary" leverage charge for the very largest U.S. banks not only to inform decisions on how to measure exposures in it, but also to ensure that exposures are rightly calculated across the array of pending rules. Many of you spend most of your time with smaller banks, but the exposure-limit question is critical to them as well. It doesn't make sense to define exposures one way for big banks and another way for small ones. Instead, this should be set by the nature of exposures which, since they are largely a lot simpler at small banks, makes this calculation in practice a lot easier for them unless a small bank is taking big, complex bets that you need to catch and catch fast.

Counterparty Risk and Orderly Resolution

Many of you are immersed in the thousands of pages filed so far in big-banks' "living wills," and you're also doing bench-presses to ready the strength for these plans from the next round of U.S. and foreign banking organizations. There's a lot in all of them that's vital to readying for resolutions without resort to taxpayers, with one critical goal a complete, advance understanding of a bank's likely exposure under acute stress.

The methodological questions here parallel those I've already discussed – should the exposures be measured on a gross or net basis and the extent to which future, not just current, exposures are considered. However, the challenge is even greater because one needs here to consider not just credit-risk exposures, but also the extent to which explicit and implicit liquidity risk could morph into counterparty exposures under seriously-adverse conditions.

To do so, banks need to stress not just their books for capital-distribution and exposure-limit purposes, but also to craft robust self-rescue strategies. Banks must thus identify exposures such as those arising from reputational-risk considerations in their mutual-fund and asset-management operations, and plot these against more traditional credit, liquidity and market risks in similar asset classes, geographic markets or customer segments. Netting here is a critical risk mitigant, but one that might dry up overnight if exposures are ill-matched, and collateral safeguards might go poof if valuations are not well-founded and stress tested to ensure ready recovery or, if worse comes to worse, deployment of the Bankruptcy Code without resort to Title II's orderly-liquidation authority.

Banks are just beginning to map their exposures out on an enterprise-wide basis and taking account of where legal barriers to effective netting, cross-border liquidity flows, and other resolution options bar a desired recovery route. Each of you can play a vital role here by determining the best way to measure exposures not just from a capital or counterparty-exposure perspective, but also – and critically – from the vantage point of looking into the abyss to see what might be left if a bank is put under acute capital, liquidity, or market stress.

These living wills are of course a requirement only for bank holding companies with assets over $50 billion, so many of you again may say they don't matter to you and the small banks with which you work. Again, though, I'll say that these issues indeed do matter for smaller banking organizations. They also come under acute stress – take a look at the $685 billion cost to the FDIC of the 484 insured depositories that have failed since 2007. None of them alone or in aggregate posed systemic risk, but each of them was a cost not just to the FDIC, but also to their communities that would have been reduced or even averted with better advance planning taking into account asset concentrations like commercial real estate or individual counterparties like somebody's brother-in-law.

Reserving for Risk

As you all know, FASB is considering a change to the way financial firms are to calculate loan-loss reserves, moving this from the incurred model (GAAP) to something closer to the expected-loss approach long under consideration in the international arena. The OCC has been pushing for this change for years because – rightly – it believes that the SEC's worries about earnings management run smack into the micro- and macro-prudential need for the largest possible reserves at firms with taxpayer-supported backstops. As we see now, reduced losses are leading banks increasingly to rely on reserve recapture as an earnings bulwark even though the economy isn't anywhere near out of the woods – thanks, Congress. The reserve question is a critical one in which competing needs of "accounting" and safety and soundness must be resolved with an emphasis on safety and soundness at banks large and small.

The Board of Directors

Let's now return to the question of board accountability. I've had the pleasure of sitting on the boards of regional and smaller banks, so I've a sense of what directors can and can't be expected to do. Let me address first what they shouldn't need to do: manage the bank. Tempting though this is for some directors and desirable though some rules suggest it might be, directors should not be required to validate each procedure or review detailed, technical matters on a regular basis. Does this leave them above the fray?

Absolutely not. Instead, directors can and should govern the bank and its parent company to ensure not only shareholder value, but also adherence to risk tolerances that set parameters for key risks and – even more importantly – ensure that transgressions above these tolerances are swiftly spotted, immediately corrected, and clearly explained so that tolerances are again respected not just in word, but also practice.

To make this happen, Directors can and should use audit and risk-management committees as meaningful sessions for decisions, not just to review really cool power points from high-priced consultants or the bank's own quants. If something doesn't seem to make sense, it probably doesn't make sense. If senior management can't make it make sense, the board should demand clearer explanations or order a change in policy and practice.

And, if you as supervisors spot failures by boards, this is a red alert. It's all too tempting for examiners to check the box to see if this or that rule has been reflected in one or another policy or procedure. But, this isn't effective supervision, nor is sign-the-form policy effective governance. If risk tolerances are breached without rapid remedy, the bank's board is letting risk get out from under them and you need to press them to reverse course forthwith. If quarterly numbers don't make sense, it doesn't matter if they technically meet requirements under GAAP or RAAP or IFRs or whatever. Qualitative accounting judgment backed up by effective assessment of internal audit and control procedures is a vital part not just of governance, but also supervision.

In short, if it looks funny, it might well be wrong. If it's wrong, that might be a minor error quickly corrected. But then again, maybe it's an early warning signal of serious lapses in internal controls that signal undue concentrations of single-counterparty exposures, growing capital shortfalls, worrisome liquidity exposures, or dangerously-low reserve levels.

Conclusion

Each of you plays a critical role in ensuring effective supervision of banks ranging from the world's very largest ones to those that might never make the headlines but are still vital to the economic health of their customers and communities. You identify accounting issues like the differences between U.S. and global standards that drive real risk and measure critical factors like fair value on which safety and soundness rely. You can also evaluate filings – call reports and so many others – to see if they make sense. You know the rules, but you also know the point at which the rules aim – prudential governance of banks and bank holding companies to protect depositors, customers, investors, and – yes – the taxpayer.

In short, the rules redefining the industry will benefit importantly from your knowledge of which standards rightly judge which risks and which audit protocols rightly hold whom to account in bank senior management and on boards of directors. So, dust off those green eyeshades – they are among the most critical tools each of the banking agencies has on hand to restore banking to its critical role as a sound source of financing to support communities across the country and around the world.