GETTING IT RIGHT AND MAKING IT CLEAR:
How U.S. Rules Will Change After Enron

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The questions you have asked me to address are among the most pressing facing Washington policy-makers and senior financial industry executives. In the wake not only of Enron, but also of a mounting number of other cases in which public financial reports and agency ratings missed the boat by a wide mile, a massive re-evaluation of our financial reporting and auditing system is underway.

Some have said that these crises prove the failing of the U.S. market system, but I would strongly counter that our response to them shows its strength. In sharp contrast to other nations that have let their financial systems go from bad to worse to disastrous over the last ten years, we are looking hard at our problems and considering hard solutions to them. Action on these initiatives is, of course, the acid test of the U.S. market, but I am confident that major reforms will shortly be enacted.

You have asked that I address issues that should guide Vietnam as it moves ahead with its ambitious effort to introduce market-based incentives and disciplines in your emerging financial system. Getting the balance right between government supervision and market incentives is, I think, your key challenge. Too much government, and you will not move from the bureaucratic, rule-driven system that now hinders Vietnam's ability to harness your human and natural resources and take a major role on the world's economic stage. Too little, and you run the risk of the types of corruption and market distortion that have made your Southeast Asian neighbors vulnerable to costly booms and busts. Both Russia and China are immediate examples of nations that have not gotten the balance between the private and public sectors right, and their failure to do so undermines not only their political stability, but – even worse – the dreams of millions of their citizens to own their own home, drive their own car and see their children better educated – in short, to share the wealth.

GAAP vs. RAAP

As I mentioned, Enron may be the biggest current financial scandal, but it isn't the only one. In the last few weeks, several other high-profile events have forced a new look at the way U.S. institutions review their own financial performance and then report it to their regulators and – most important – their investors. Among these cases is one in which PNC, a large Pittsburgh-based financial holding company – was forced by its bank regulator to restate earnings because of prior asset transfers.

I should like to discuss this case in some depth because it points to a major issue you must resolve as you design Vietnam's new rules. In the U.S., banks and their holding crannies are subject to two sets of accounting standards. Regulator-Accepted Accounting Principles (RAAP) are special standards bank regulators use to determine such critical factors as capital adequacy, while Generally-Accepted Accounting Principles (GAAP) are those required by the Securities and Exchange Commission for investor financial reports. In the 1980s, RAAP and GAAP were very different, and banks were allowed to count as capital assets that had no comparable treatment under GAAP. The result was a multi-billion dollar collapse of our housing-focused banks (known then as savings & loans). Congress then ordered the regulators to bring RAAP and GAAP into closer alignment, but major differences remain.

One important example is in the treatment of loan loss reserves. Bank regulators understandably want these as large as possible to protect bank safety and soundness. However, the SEC believes that large reserves can be used to manage earnings, hiding important investor information as reserves rise and fall to mask other problems. To date, the bank regulators have largely forced the SEC to take a regulatory, not investor, view of loan loss reserves, but this GAAP vs. RAAP fight is far from done.

Another example is the continuing struggle over fair-value accounting. The Financial Accounting Standards Board (FASB) defines the rules that make up GAAP. It – along with the SEC – has long wanted banks to mark their portfolios to market on a daily basis, reporting market valuations of their books when financial reports are released. Bank regulators, in sharp contrast, fear that fair-value accounting will result in big ups and downs in bank performance reports, possibly undermining confidence in some institutions and, therefore, potentially threatening a bank's solvency. An uneasy compromise resulted in which banks need report the market valuation only of investments held for sale, and large portions of their books are exempt from this system.

However, RAAP and GAAP are getting closer, and the impact of the Enron scandal will give the SEC and FASB far more power to force an even closer union. I would suggest close consideration of the way market discipline-focused disclosures in fact protect systemic soundness, even if a few banks from time to time find them extremely awkward. Japan is a clear example of a nation where the relationship between RAAP and GAAP is remote, and the depth of its current banking crisis suggests Vietnam follow the sometimes faltering progress the U.S. is making towards uniting financial and market accounting standards.

Letting Directors Direct

Another area of potential tension between public regulation and private markets is over the role of directors. In Asia, directors are often senior insiders promoted to the board as a final acknowledgement of long service. "Outside" directors are often large customers or even family members of a company's founders, individuals often with a solid understanding of the business, but little ability to impose a perspective different than that of senior management. This can create corporate unity, but it masks and muffles the dissent that is often a necessary precursor to desirable change.

In the U.S., the Enron case is focusing a new spotlight on the role of corporate directors, especially with regard to the quality of financial reports provided to the public and the ability of internal risk management to stop problems before they grow to threatening proportions. Although best-practice for years has mandated independent board audit committees – a standard required by law for banks – many firms – Enron of course among them – had little independence in the board audit review. This will soon change, and Congress may well expand the bank requirement to all publicly-traded companies. Audit committees should consist largely of directors who have independent financial resources and professional reputations, ensuring that they do not fear the result of any bad news they must carry to the rest of the board and to senior management. They should change frequently to ensure a fresh perspective and – even more important – they must change the firm's outside auditors on a regular schedule that ensures independence from those on which the audit committee relies.

These U.S. reforms are designed to ensure auditor independence from insider demands, allowing them freely to give the market objective financial information. In Vietnam, the challenge for auditors may be different. In your country – as in much of the EU – auditors play a role very close to that of outside regulators, reviewing compliance with various government standards and, as needed, reporting on violations to government officials. This can make auditors more concerned with RAAP-type government issues than with ensuring GAAP-style real financial reports. A proper balance between the duties of auditors to ensure compliance and to give free and fair financial information is essential if Vietnam's financial markets are to advance to true competitiveness.

Conclusion

I have provided only a brief overview of some of the issues with which financial industry executives and Washington policy-makers are wrestling. We will resolve the problems Enron revealed — not permanently and not completely, to be sure — but to the greatest degree a democratic system fraught with rivalries can muster. It's not a tidy process, but we do try to move in the right direction. I shall welcome your questions and any thoughts as to how we can improve still more.