Keep It Simple, Smarty

Optimal Bank Regulation in a Tumultuous Time

Keynote Address

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

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It is a real pleasure to be here this morning and kick off this conference. I'd like to try to do what Carlos has asked: put critical industry developments on which you will be focusing over the next two days into the framework of broader financial-market trends to identify the challenges you will face as the banks you examine and the deposit insurance fund you run come under stress not seen in decades.

This morning, I'd like to cut through the complexity of current accounting rules to highlight two critical points. First, as accountants and advisers to the Federal Deposit Insurance Corporation, your obligation is different than that of accountants who advise publicly-traded firms. This means you can't just focus on what is or isn't GAAP – regardless of the complexities that result and the confusion this may sow. To cut through the opacity of current accounting standards to identify risk, you need to hone in on reporting that doesn't compute with larger institution and market realities – in short, to give complex reports the sniff test and advise your fellow regulators when – GAAP-right or not – accounting results point to prudential problems. We've seen all too many companies – bank and non-bank – where the books met all applicable accounting rules and showed no problems right up to the moment of collapse.

If you uncover the realities buried in complex financial reports, you will be critical to the next round of bank regulation: ensuring that complexity and nominal compliance do not cloud underlying risk. The President's Working Group on Financial Markets and your chairman, Sheila Bair, have rightly targeted complexity as a major market trend that needs immediate correction. I think you can not only enhance transparency through some of the reports under discussion, but correct a lurking problem: we'll all be buried by the new disclosures. Thus, I think two new ones – public disclosures of CAMELS ratings and a benchmarked bank comparison – should be provided by bank regulators to inform bank depositors, investors and other regulators.

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 and you all are the ones to spot these and ensure that regulatory policy anticipates and addresses them.

The Green Eyeshade as Fashion Apparel

All too often, accountants and auditors are seen as the stereotypical bean-counter – but then you knew that. You're supposed to be sitting in your little corner wearing the proverbial green eyeshade and counting nits. However, think back to the old movies in which some geezer in a green eyeshade suddenly sits up and realizes a fundamental truth

hidden in plain sight. That's you – not the geezer part – you can parse complex financial reports to point to fundamental regulatory realities.

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.

FAS 157 is a case in point. A published report may well meet FAS 157 in terms of appropriate segregation of assets into the right valuation categories. However, you can look through this to identify cases in which, for example, large balances of assets are transferred to determine if – GAAP-happy or not – this may point to problematic asset quality not reflected in a bank's capital and reserves. You can similarly spot cases in which large asset blocks are marked to model and – despite the fact that this may meet accounting standards – alert examiners to potential risk. Conversely, if GAAP is forcing recognition of artificial loss – as is sometimes also the case at present – you can inform examiner review of bank representations on this critical issue.

Let me point to a real-world example: Fannie Mae and Freddie Mac. Their regulator, the Office of Federal Housing Enterprise Oversight or OFHEO is required by law to make its annual examination conclusions public in reports to Congress. Up to and including its 2003 report, OFHEO saw nothing but the best of all possible worlds at each of its GSEs – repeatedly saying that every aspect of each of the GSE's operations, controls, capital adequacy, asset quality and so forth were above reproach. Indeed, Fannie's CEO at the time, Frank Raines, famously told an audience that he only wished other financial-services firms were as perfect as Fannie Mae.

At the time, of course, each of the GSEs had massive accounting and auditing problems that I think should have sent up red flags not only for their internal and external auditors, but also for the examiners and accountants at OFHEO. Case in point: Fannie Mae at the time hit its earnings targets to the hundredth of a basis point to clear huge bonuses – a complex task that resulted in a simple fact that couldn't be right. During this time period, Fannie also said its manufactured-housing paper was just dandy even though others who held it were taking big losses on comparable assets – with Fannie using an internal model blessed by its examiners to reach a completely counter-intuitive conclusion.

Although both GSEs have now cleaned up their acts, the most current – and audited — results point to exactly the same variance between external reality and accounting results that should send up supervisory firecrackers. Last week, Freddie Mac announced its earnings and – seemingly alone among all the holders of subprime and Alt-A private-label MBS, the GSE's losses dropped. In fact, several of its reports showed considerable improvement from the fourth quarter of last year to the first quarter of 2008 even though the residential-housing market has of course seen a sharp spike in foreclosures and steep drops in house prices over the same period of time. GAAP compliant? Probably. Prudential issues? Surely.

Critical Early-Warning Indicators

The President's Working Group and others have recommended that one of the most immediate reforms needed is transparency. It is suggested – rightly so, I think – that more information will enhance market discipline and, thus, guide regulators to emerging prudential problems. However, while more transparency is indubitably a good thing, it could have unintended and adverse consequences due to the resulting deluge of new information. Transparency may well bring new facts out for the first time, but the dumpsters of disclosures that might constitute "transparency" could easily bury them back again.

So, as you look through bank disclosures – call reports, publicly-released financials, analyst reports and all the other data you have now and will soon get – what to do? In keeping with the suggestion that simplicity is a sound principle to guide bank regulation, here are critical factors on which I urge you and other supervisors to focus:

- Capital: If you're playing with other people's money, you'll play harder and faster. We learned to considerable cost in the S&L crisis that low capital is a "heads-I-win, tails-you-lose" bet. We have since tried to correct this in regulated financial institutions, but I would argue we did a mediocre job of that because of some very large loopholes in Basel I. For example, the flat-out exception from risk-based capital for short-term off-balance-sheet instruments was spotted a decade ago as a key cause of emerging risk. We didn't deal with it until the larger problems of Basel II were, to some extent anyway, addressed —yet another example of the best proving the enemy of the good in bank regulation. You should look through current complexities and those to come under Basel II. If something doesn't look right, it probably isn't and the capital rules related to it need to be addressed ASAP. If this drives certain financial instruments into "unregulated" markets, it's wise to remember that that's why they're called unregulated and investors should be sure they know the difference. If "unregulated" institutions enjoy the federal safety net – as now seems the case in the wake of recent Fed actions – then comparable capital rules should extend to them as well.

- Liquidity Risk: this looks very complex, but it isn't. At its heart, liquidity risk is about borrowing short to lend long. You remember that from the S&L crisis – or, at least I do. Bundle this equation up into structured investment vehicles or ABCP conduits or what you like, but it's still the same high-risk bet based on expectations about long-term market stability that never pan out. If you see complex instruments based on untested models, you can and should ensure that supervisors intervene to bring them back to economic fundamentals.

- Compensation: If people get paid a lot up-front, they often won't care what happens later. When one reads about mortgage brokers getting $20,000 in fees for each $200,000 mortgage they closed, it's clear that something went seriously awry – at least at the banks, if not in the bars in which all these big bucks went into $1,000 champagne. All of the bank regulators were warned as early as 2002 about growing mortgage-market problems, but none did anything until late 2006, in part transfixed by views that somehow the market always knows more than regulators. Sometimes, it knows a whole lot less because it's getting paid so much more.

- Paying Heed to Pricing: Just as incentive compensation is a warning indicator, so too is pricing. If pricing seems wildly out of whack, it probably is. That investors were getting only basis points above LIBOR for junk tranches of complex subprime MBS was another Roman rocket across the sky. To be sure, 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.

- Ratings: This is old news, but just because something's AAA doesn't make it the equivalent of a U.S. Treasury or, if you don't like that, gold. Here too the FDIC and other regulators should have known enough to crimp the market's style. There's simply no way – and I don't care how complex a CDO is structured – to take a subprime, no-doc mortgage on an investor condo and turn 80% of its value into a AAA security. The regulators are now talking a good deal about discounting ratings, but yet still relying on them in emerging policies like the Fed's collateral criteria or those the FDIC is using for covered bonds. Capital at risk is a clear bottom line that can and should drive supervisory policy. Going back to my first point: if no one is at risk, risk will be taken.

- Reputational risk has to count: One reason regulators trusted the AAA rating was the view that the credit ratings agencies wouldn't throw their franchises to the wind by egregious conflicts of interest that led to inflated ratings. Oops. In fact, the ratings agencies have done that over and over and yet their franchises have gotten stronger and stronger. Market discipline is a chancy thing, especially if complexity obscures emerging risk. If reputational risk is to have real meaning, supervisors have to enforce it through bans on new transactions, real management and board changes and other sanctions that dearly cost those who bet the banks.

Making Bank Regulation Make Sense

Finally, in the keep it simple section, let me offer some suggestions for all of you here today. First, you can bring needed transparency into financial markets – and offer clear, simple disclosures – by making CAMELS ratings public. I know there are fears that this would violate the bond between the regulated and the regulators, but I think nothing would buttress market discipline more than a simple statement of regulatory judgment. It would also bring needed sunshine into the regulatory process – if all of the banks supervised are 1s and 2s, then something's wrong with the way judgments are being handed out, even in the best of times. More disciplined CAMELS ratings subject to better public discussion will help to ensure ongoing focus on fundamental economic realities in the blizzard of public disclosures and regulatory policies.

Each of you also has a keen sense of which disclosures matter and which provide only useful detail to specialists or experts. One take-away you may want to consider today is simple public disclosures the FDIC could craft from the call reports for each insured depository and holding company. With this, depositor, investor and press attention will be directed to fundamental factors that determine safety and soundness, supplementing the new risk-based premiums and other safeguards now under consideration to insulate the deposit insurance fund. To enhance these statements, each bank's disclosure could be compared to industry benchmarks to show how it stacks up to its peers. To make the disclosures better, these key factors could be benchmarked on indices designed for, say, community banks or larger ones to avoid apples-to-oranges comparisons that might show some banks in an unfair light.

However, to avoid the complexity problem that threatens efforts at transparency, I'll leave you with one last thought – keep this simple too. With these new disclosures from the FDIC, I think a lot of sunshine could quickly be shed on all insured depositories – regardless of who owns them. In conjunction with urgently-needed capital, liquidity, and other prudential reforms, these new disclosures would bring the industry back to self-disciplined, long-term prosperity. I even think they'll ensure advantageous competitiveness for U.S. banks, as these standards will show our strength and help to restore global confidence in our national banking system.