BANK OF ENGLAND

Speech

Speech given by
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Accounting Standards and International Financial Markets

I am delighted to be here this evening - delighted but also slightly embarrassed to say that it is the first time I have visited this great city. I am doubly grateful therefore to you chairman, and to the Irish Chartered Accountants in Banking, for the invitation to your Annual Dinner and for putting right such a sad omission.

The second thing I should say is that I am sorry I am not the Governor! I mean this of course in the sense that he is sorry not to be able to join you. Your dinner happens to fall right in the middle of this month's meeting of the Bank's Monetary Policy Committee. The Committee will announce a decision tomorrow on interest rates, and a very nice judgment it will be in the present environment. I will say a little more about the UK, monetary policy and the euro in a few minutes. But I want to focus this evening on one or two issues under the heading of international coordination and harmonisation, especially but not exclusively in accounting standards.

First, however, why are central banks - and specifically why is the Bank of England - interested in such matters? There are several reasons.

The Bank's perspective derives from its responsibility for the stability of the UK financial system and for promoting financial sector efficiency. We have had this perspective, formally or informally, for a long time - certainly back to the 1930s. It has been coloured recently by episodes such as the early 1990s recession, when there were many examples of corporate failures - sometimes spectacular corporate failures - despite published accounts which apparently demonstrated rude health. It was a climate memorably castigated by Terry Smith in his book 'Accounting for Growth'.

Financial markets depend for their effective operation on timely and accurate information. The Bank gave its moral and financial support to the establishment of a revised financial reporting apparatus, comprising, as you know, the Accounting Standards Board and Financial Reporting Review Panel; these operate under the Financial Reporting Council, on which a representative of the Irish Department of Enterprise, Trade and Employment sits as an observer, as does a representative of the Bank. In the ten years of its existence, we believe this structure has made a big contribution to strengthening accounting standards in the UK and in Ireland. And the ASB, under the chairmanship of Sir David Tweedie, has built a formidable reputation for rigour in reviewing existing standards and in developing new ones which has given it real international credibility.

In the last three years, the Asian financial crisis and its aftermath have again concentrated the minds of financial and economic policy-makers on the quality and reliability of information. A report for the G7 prepared by Hans Tietmeyer, then President of the Bundesbank, led to the setting up of a new group, the Financial Stability Forum, to look at ways of reinforcing the safe functioning of the international financial system. The report emphasised, in particular, the need to develop and implement standards and codes of various kinds, including accounting standards, and this work has now been taken up by the Forum itself, as well as the IMF.

So these are some of the reasons for the Bank's interest in accounting issues. But I concede that there is another one - more personal but very important. It is that Sheila Masters, current President of the ICAEW, is also chairman of the Bank's non-executive directors!

Against that background, let me return to the issue of international harmonisation. Why is it now as high on the agenda?

For many years the debate about international accounting standards was low key, of limited practical interest to most companies, whose shareholder base and sources of finance were mainly national, or to investors, who in many cases, likewise, had national horizons. And it is perhaps fair to say that the International Accounting Standards Committee, founded in 1973, has for much of its history had a correspondingly low profile.

What has changed?

We can all, I am sure, think of the factors: the internationalisation even if not globalisation of many companies; the relaxation of regulatory restrictions on cross-border institutional investment; an increasing concern on the part of institutions to diversify their portfolios; and the globalisation - and here I mean globalisation - of financial markets, which has been driven by but has also facilitated these changes. All of this has reinforced the demand for greater comparability in financial reporting. The immediate catalyst for current moves towards harmonised standards can perhaps be dated to 1995 when the IASC agreed with IOSCO (the International Organisation of Securities Commissions) that they would produce a set of 'core standards', which IOSCO would then in turn consider for global endorsement as a requirement for company listing and capital raising. In December 1998 the IASC completed their side of this process, and the spotlight moved to IOSCO to consider whether it was prepared to endorse the outcome. The prospective benefits were obvious: artificial barriers between developed economies would come down; and, at least over the longer term, standards of accounting - especially in emerging markets - should be raised. Reaching agreement internationally necessarily involves compromises and trade-offs. This can be difficult, especially when positions on some issues verge on the theological! Economists are masters at upholding sharply opposing views on what to the layman may appear rather common-sense issues; but accountants seem to be more than a match. It would be welcome indeed if IOSCO decided at its Annual Meeting that it can support the IASC's proposals.

These changes, with far reaching implications across financial markets, have however raised important questions of governance and process. Agreed international standards must have credibility, and the way in which they are developed must respect current ideas about openness and accountability.

To whom, then, are accounting standard setters accountable?

In their 'Framework' and 'Principles' statements, which outline the conceptual approach underlying the standards themselves, the IASC and ASB interpret the 'stakeholders' pretty widely. They include not only shareholders, both actual and potential, and also creditors, regulators, and policy makers. Proper financial reporting therefore possesses many of the characteristics of a public good.

The IASC has hitherto existed as a private sector body. Since 1983 it has been composed of the 140 or so professional accountancy bodies represented in the International Federation of Accountants. It is, as you will all know, proposing to adopt an entirely new structure based on the recommendations of its Strategy Working Party in their report 'Recommendations on Reshaping the IASC for the Future', published last December. This promises to introduce a more appropriate structure for the IASC under which it will be established as an independent organisation, with a separate board of trustees designed to be geographically representative and a board for setting technical standards chosen on the basis of professional breadth and competence. You will know better than me that getting to this point has not been altogether plain sailing - there have, for example, been significant tensions between the US and continental Europe. But the latest news is more encouraging and there does now seem to be a real prospect that the new arrangements will be implemented. If they are, it is a step which should be warmly applauded.

Let me turn now to another, and in some ways related, enterprise in the area of international harmonisation - namely the review by the Basel Committee of the 1988 Capital Accord. While perhaps not of such direct concern to the accounting profession as accounting standards themselves, it does nevertheless raise important questions for the profession - for example about the appropriate way of measuring banking assets, about how to undertake prudent provisioning and about what constitutes reasonable disclosure.

As many of you will know, the 1988 Basel Accord aimed principally at setting capital requirements for internationally active banks based in G10 countries. It subsequently formed the basis for the European Union banking Directives. The Accord has served both banks and their supervisors well over the past decade, but financial markets have developed a great deal in that time and a review now is certainly sensible. Regulatory capital requirements need to reflect more accurately the increasingly complex risks which banks take on, and the greater diversity of risk management tools available to them. While the Bank of England no longer has operational responsibility for banking supervision, we continue to be a member of the Basel Committee alongside the Financial Services Authority, and the general approach to prudential regulation remains a key concern for us in the context of overall financial stability.

In June last year, the Basel Committee published a consultation paper on a proposed new Capital Accord. A parallel process was launched by the EU in November when the Commission published its own, similar proposals. The main difference is that the Commission's proposals would apply to all credit institutions and investment firms in the EU, not just to internationally-active banks.

Both sets of proposals are centred on three so-called 'pillars'. The first determines minimum regulatory capital requirements. The second - the supervisory review of management and control arrangements - will seek to ensure that a bank's financial resources are consistent with its overall risk profile and strategy. In practice, this should mean that supervisors have the ability to require banks to hold capital in excess of the minimum. In the UK we have always had this flexibility and I believe the same is true in Ireland, but this is not the case in all countries. The third pillar - market discipline - is intended to promote higher disclosure standards and reinforce market pressure on banks to hold adequate capital.

Let me say a word or two more on the first pillar. The key change here will be a move away from the current very broad categorisation of risk - which applies a limited set of weights to loans on the basis of the type of borrower (sovereign, bank or other) - to a more refined grading which aims to take better account of the "true" economic risk of a loan. Among other things, this will involve a wider range of weights on corporate assets, which are currently all lumped together at 100%.

In fact, there are likely to be two approaches. The standard recipe will depend heavily on external ratings. The alternative, internal ratings-based, approach represents a more radical departure from the current Accord. It will make use of a bank's own quantatitive and qualitative assessment of credit risk as a basis for setting the required level of capital. Banks should, so the theory goes, be better placed to assess their customers than some remote regulator. This alternative approach should also incentivise banks to refine their credit risk management techniques, paving the way for full credit risk models in the future. The obvious potential downsides are inconsistencies between rating systems employed by different banks, subjectivity in the process of assigning internal ratings and the demands placed on the regulators to assess both the technical robustness of a bank's methodology and the reliability of the data on which the analysis is based. There are, therefore, many important issues of both principal and practice which need to be resolved - but this is the direction in which the debate is moving.

These efforts to calibrate risk more sensitively have highlighted the relationship between capital and provisioning. While regulators strive to harmonise capital requirements, I think it is fair to say that much less effort is being made internationally on the provisioning front. Capital on its own does not protect a bank from failure. There have been many examples around the world - not excluding the UK - of banks that, at the point when difficulties emerged, have on paper been well-capitalised. But still they failed. On investigation, a major contributory factor has often been a serious overvaluation of loan assets. In such cases, banks' management have usually failed to implement the systems and controls which might have picked up the deterioration, or have failed to apply provisioning policies which would have taken it adequately into account.

In 1988 - when the Accord was first agreed - there was an active debate about whether provisions should be included in capital. The outcome was 'pragmatic', and left studiously vague the question of what exactly capital and provisions were for. Since then, more rigorous methods of measuring risk and distinguishing its components have again highlighted the question. What risks does capital cover, to what degree of confidence, and over what time horizon? How does this role for capital relate to the role of provisioning, or to the underlying method of valuing assets?

In 1996, with the introduction of bank capital requirements for market risk, these issues could no longer be fudged. The Basel Committee laid down a required valuation method for traded instruments - mark-to-market - which essentially means that expected losses are written out of capital. The remaining capital is there to deal with unexpected losses, calibrated over a relatively short time horizon.

In the current review, we are in a similar situation. In this case credit risk is the focus, but again the risk can be split into the expected and unexpected components. We can examine the influence of maturity on credit risk, raising the question of the time horizon for setting capital. As with market risk, we can now more accurately assess the capital cushion to cover unexpected losses only. But also, as with market risk, we then need to be assured that expected losses are properly dealt with. Short of full fair value accounting, whose merits I shall not launch into now, we have to turn to provisioning - but here too we run into controversy. To what extent should supervisors/regulators duplicate or even override the guidance issued by accounting bodies? Is a requirement for banks to cover expected losses with provisions reconcilable with the conventions of historic cost accounting? How do we avoid the pitfalls of profit smoothing and hidden reserves? How will the tax authorities view any changes in provisioning methodology?

I am sure there are answers to these questions - indeed there are almost certainly more answers than questions. What does seem important is that the accounting and regulatory treatments should be based so far as possible on a common analytical approach. We believe, for example, that banks' development of systems which are better able to calibrate risk and to measure expected loss can, and should, influence the current debate on fair value accounting and the valuation of non-tradable assets. But that's another story. From the point of view of financial stability, we are clear of the objective: banks need to have a buffer of capital which is adequate to give reasonable protection to their customers and to the financial system as a whole. We shall need to judge the outcome of the current debate against the yardstick.

Let me finally say a few words about another exercise in international harmonisation, of a rather different order - Monetary Union.

Over the past decade, few speeches and little conversation at dinners such as this have succeeded entirely in avoiding the issue. So let me bow to precedent. But so much has been said and written about EMU that it is hard to believe there is anything really new to say, except perhaps to note the behaviour of the Euro itself since its introduction sixteen months ago. Here, we like everyone else, find it hard to explain the extent of the euro's weakness.

So far as the merits and demerits of EMU membership are concerned, I think the first point is simply that it is as much, or more, a political question than an economic one, and therefore not something on which the Bank institutionally has felt it right to express a view. As for the economic arguments, they probably boil down to three. In favour, there is the undoubted benefit of exchange rate stability within an area which represents a substantial part of the market for each of the individual member countries. This benefit is wonderfully apparent when one looks at the way some of the 'out' currencies have moved against the euro. A second substantial plus is the prospect - and indeed to some extent already now the reality - of developing a wide and deep European capital market with the associated efficiencies in linking saving to investment. The crucial concern of the other side is simply about the implications of a one-size-fits-all monetary policy, given the diverse structural and cyclical positions of different countries. Ireland has seen some of the effects of this in credit growth, housing markets and so on. But the issue, of course, goes much wider and is reflected in, for example, the different behaviour of labour markets, the different degrees of public sector involvement in the economy, the different structure of tax systems and so on. In the end, from an economic point of view, it is a matter of balancing these factors and in the case of the UK, as the Governor has frequently pointed out, it is difficult to believe that the balance at present lies in favour of membership.

I am sure that does not tell you anything new. But I should make clear that, outside or in, we believe it is to everyone's benefit that the euro, now that it has been introduced, should be a credible, robust currency.