Accounting standards and solvency ratios : short-term prudence vs long-term vision

Discours prononcé par **M. Jacques de Larosière**
lors de la conférence internationale

The Paris Conference For Long-Term Value & Economic Stability

organisée par le "Long-Term Investors Club" en partenariat avec l'OCDE

à Paris, le 22 juin 2009

One of the underlying themes that comes out of the analysis of the present crisis can be summarized as follows.

The financial system at large -i.e. including fiscal, monetary policies, regulation, accounting rules, risk assessment and management- has been dominated by short term incentives, and has insufficiently focussed on the mid-long term vision.

I shall try to illustrate that theme under four headlines :

- the global financial setting,
- prudential regulation,
- accounting standards,
- governance.

1/ The global financial setting

For the last twenty years or so, the world has built up large current account imbalances. The structural deficits of the US -reaching some 5 to 6% of GDP- have been financed by the surpluses of emerging countries which have – through exchange rate intervention – accumulated massive foreign reserves. This phenomenon that lead to a skyrocketing increase in liquidity and in the US indebtedness, which was not sustainable.

How did fiscal and monetary authorities react ? Did they put in place policies that would have moderated the pace of indebtedness ? No. On the contrary. As consumer price inflation did not appear as a problem, monetary policies were lax, interest rates were kept low -hovering around zero in real terms- and nothing was done to curb credit expansion.

The consequences of that absence of reaction are well documented: leveraging ballooned, bubbles appeared in asset prices (bonds, equities, real estate…) and the overextended financial system at large became extremely vulnerable to a downturn and to a fall -which was inevitable- in asset prices.

This official behaviour favoured short term expansion versus the long lasting stability of the financial system. We are all paying a very high price for this shortsightedness.

2/ Prudential regulation and solvency ratios

How many times did I hear, over the last ten years or so these words : “we know that the macro imbalances are not sustainable, but, at least, we have a strong and resilient banking system”.

That perception was, to a large extent, based on the apparent progress in prudential regulation. Indeed, the Basle Committee standards much refined the notion of “risk sensitive” capital requirements. But there was a flaw in the implementation of that concept. Regulators relied excessively either on risk assessments made by rating agencies or on internal risk models conceived by the banks themselves.

It appeared, after the crisis erupted, that rating agencies had not been able to adequately assess the riskiness of complex structured financial products and that internal bank models had grossly underestimated the probabilities of default and hugely overestimated the ability and willingness of short term markets to continue to fund the banking and “parallel” systems. These models were based on too short term statistical data and did not sufficiently take into account the liquidity dimension and the medium term consequences of a reversal of financial markets.

Therefore, it is fair to say that too short term horizons in the way prudential risk assessments were conceived contributed to procyclicality. In the good years no extra capital requirements were imposed on high asset valuations, but when things reversed, sudden and brutal increases in capital requirements were imposed, thus forcing banks to sell their assets, hence contributing to the fall in the markets.

3/ Accounting standards

The US adopted some twenty years ago the “mark to market” principle. They were active in exporting this rule to Europe through the anglo saxon dominated IASB (International Accounting Standards Board).

The IFRS rules - coupled with the risk sensitive prudential standards mentioned above - exerted a strong pro-cyclical influence. Indeed, two things went fundamentally wrong :

- when markets dried up, assets became very difficult and most often impossible to “mark to market”. In order to avoid the extreme consequences of “fire sales”, the IFRS system had to give way to other -imperfect and heterogeneous- measurements that were “model based” ;

- but, more fundamentally, the extreme application of the “mark to market” rule is dangerous. Indeed it leads, in booming times, to asset valuations that are, by definition, high. But no discount is made on these valuations for the future losses that will undoubtedly occur through the cycle. This is a serious methodological flaw that favours credit expansion in good times and credit retrenchment in bad times.

I think it would make more sense to distinguish between trading books (that should be marked to market) and assets that are kept on the banking books for a long period. The latter should be accounted for amortized costs at original value (corrected, of course, for future impairments).

The US accounting board (FASB) has, last April, corrected the first flaw mentioned above : it has agreed that banks will only have to recognize the definitive losses incurred on debt investments

classified as "available for sale". The difference between these incurred losses and the market value will not have to be impaired.

Why doesn't Europe take advantage of this bold decision ? Let us not forget that we live in a competitive global world where a level playing field is of the essence. Besides, accounting rules are not just "technical" standards. They can have a major impact on banking business models and on financial stability at large. Hence, regulators should have adequate representation and influence on the IASB.

4/ Governance

It is not surprising that with this dangerous environment and with those often misleading regulatory incentives, financial institutions took advantage of the situation.

We have thus observed over the recent period a number of governance issues, e.g. :

- the abuse of securitization has contributed to a worsening of credit standards (since questionable assets could easily be passed on to misinformed investors);

- the abuse of off balance-sheet operations (SIVS have prospered beyond imagination and were not caught in the regulatory net) ;

- the abuse of short-term based remuneration systems (it seems obvious that bonuses should be calculated on a multiyear basis and not exclusively focussed on short term results).

& & &

In conclusion, I should like to stress that regulation, while it is not the only solution to those problems, has a substantial role to play.

It is not the only answer.
Of course, central bankers should always be concerned by excessive credit expansion and asset bubbles.
Of course, multilateral surveillance - the major mandate of the IMF - should be more effective in curbing excessive imbalances.
Of course bankers should anticipate bad days and make adequate provisions.
Of course they should focus on the creditworthiness of their clients…
But since this "natural governance" has been so faulty over the past years, some form of well designed, prudent and anticyclical regulation is important.
This is what we have tried to propose in our report.