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Towards global financial reporting standards: a critical pillar in the international financial architecture

Speech by Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, at the US-Europe Symposium 2002, Rüschlikon, Switzerland, 27 February 2002.

When historians look back on the last quarter of the 20th century, they will no doubt regard it as a defining period in the evolution of global financial arrangements. Advances in information technology and the ascendancy of free market principles underpinned the transformation from a government-led to a market-led global financial system. At the same time, the period also saw the emergence of financial instability as a key policy concern. The question of how to ensure financial stability rose to the top of the international policy agenda.

The stakes are high. The objective is to lay the foundations of the financial system of the 21st century, a system better capable of promoting robust improvements in living standards within an open international economic and political order.

The main approach followed has been to develop, seek global acceptance of, and implement a set of codes or standards that pertain to key elements of the financial system infrastructure. The set defines the "rules of the game" of a well functioning and sound financial system. This endeavour has come to be known, somewhat grandiosely, as the building of a new international financial architecture.

Today, I would like to focus mainly on one critical pillar in this new financial architecture, namely a set of globally accepted standards for financial reporting. Their objective is to ensure the reliable provision to the public of essential information about firms' financial condition, performance and risk profiles. Arguably, not enough attention has been given to this pillar of the architecture. Notably, despite enhanced efforts to develop and agree on a set of international accounting standards, much still needs to be done. We need to ensure that agreement on a set of such standards becomes a reality. We need to find ways for firms to provide a richer set of information about risk than is normally included in accounting standards. And we need to strengthen enforcement mechanisms.

The outline of my remarks is as follows. First, by way of background, I will sketch the salient changes in the economic environment, highlight the need to address financial instability in ways consistent with the emerging globalised financial system, and describe the policy response under way. I will next explain in more detail the critical role of financial reporting standards. Finally, I will outline the progress made in this area and the challenges ahead.

I. The changing environment: the rise of financial instability

The transformation of the global financial system in the postwar period from government-led to market-led has gone hand in hand with growing policy concerns with financial instability. Let me elaborate briefly.

The government-led financial system that prevailed from the end of World War II to at least the early 1970s was characterised by financial repression. To varying degrees across countries, a web of regulations on activities, balance sheets, financial prices, domestic and cross-border transactions hindered market forces.

This period secured a degree of financial stability. Episodes of *overt* financial distress were limited. But it did so at unacceptable costs in terms of the allocation of resources and, ultimately, economic growth.

The recognition of these costs and the ascendancy of free market principles, combined with technological advances in the transmission and processing of information, underpinned the subsequent financial liberalisation. This shift to a market-led system was a natural complement to, and in part a consequence of, the growing real economic integration of the world economy.

The new financial regime greatly improved prospects for long-term growth in living standards. Market discipline played a key role. Market forces supported the shift towards greater fiscal and monetary prudence. And they were instrumental in redirecting resources towards more productive uses, both within and across borders.

At the same time, episodes of financial instability increased in frequency and intensity. This has been especially the case in emerging market countries. Think, for instance, of the serious financial crises that engulfed countries in Latin America and East Asia. But they did not spare the more advanced industrial countries either. While the experiences of the Nordic countries and Japan are the most obvious examples, significant financial strains were also evident in many other countries with very different financial structures, such as the United States, the United Kingdom or Australia.

To a considerable degree, the seeds of this instability had been sown in the previous regime. The rigours of competition exposed the hidden sources of fragility that had developed in a sheltered environment. Competition revealed bloated and rigid cost structures, the limited ability of bankers to manage and price risk, and the disruptive effects of ill-designed financial safety nets. In addition, efforts to bring inflation under control through higher and more variable interest rates added to the financial difficulties.

Even so, it is hard not to suspect that, to a significant degree, much of the observed instability is inherent in the behaviour of a liberalised environment. Episodes of instability in both industrial and emerging market countries following pronounced boom and bust cycles in the financial sector have been too common to be coincidence.

Occasional episodes of financial instability may well be part of the price to pay for the undoubted long-run economic benefits of a free market economic system. But the price paid in recent years has been unnecessarily high. The economic costs of financial crises have been estimated to run in some cases in the double digits of GDP forgone, figures that speak by themselves!

Against this background, the need to address financial instability has risen to the top of the international policy agenda. The policy challenge is to reap the long-run benefits of a market-oriented financial system while limiting the potential macroeconomic costs associated with episodic financial instability. Doing so requires strengthening the current efforts to put in place a framework that enlists and underpins as far as possible the disciplining forces of markets.

II. Safeguarding financial stability: the global approach

A key aspect of the policy response has been to strengthen the various pillars of the financial infrastructure, broadly defined. And in line with the increasingly global nature of the financial system, over the years these efforts have taken an increasingly international character. The approach has been extended and formalised in the wake of the East Asian crisis, through the systematic concerted formulation of standards and the development of mechanisms for their global implementation. Let me say a few words about the *scope* of the standards and the *process* through which they are established.

As regards **scope**, while as many as over 70 standards have been developed, or are in the process of being developed, 12 of them represent the core and are now internationally deemed as deserving priority in implementation. These standards cover a number of key pillars of the global financial system and economic policy more generally. They broadly define the way in which the financial system should be managed. They include, inter alia, standards defining the prudential framework for financial institutions and for the smooth functioning of payment systems and markets. Accounting and auditing standards belong to this core, as do others relating to macroeconomic transparency.

As regards **process**, most of the standards have been developed, and their implementation sought, through what might be termed a "*soft law*" approach. "Soft law" is characterised by non-legally binding international agreements reached by national authorities, implemented through peer-group pressure within national jurisdictions, possibly after adjustments to the local law. These agreements can then be applied well beyond the circle of the national authorities directly involved in their formulation. "Hard law", by contrast, is characterised by binding intergovernmental agreements and formal mechanisms for monitoring and enforcement. The operation of the WTO and the IMF, especially as it functioned during the Bretton Woods system, falls into this latter category.

The soft law approach seems to be especially well suited to financial matters. Finance evolves rapidly and is a very technical area. In addition, the institutional features of individual financial systems still differ considerably, reflecting different historical experiences, cultural and legal traditions. These factors put a premium on speed, flexibility, technical expertise and knowledge of country-specific circumstances. Working together, national experts are in the best position to guarantee the quality of the product.

Moreover, accountability of the experts to the national institutions and implementation through peer-group pressure foster close ownership. Such a process may be more politically acceptable that its hard-law alternative, as might be represented by an all-encompassing global financial regulator, with the power to set and enforce regulation on a worldwide basis in all financial areas.

The BIS and the Financial Stability Forum (FSF) play a significant role in this process. The "soft law" approach was pioneered by the Basel Committee on Banking Supervision, and then extended to other areas of the financial system. In addition, the BIS provides the secretariat for other groups involved in the development of standards, focusing on the payments infrastructure and on ways to improve market functioning more generally, not least through the provision of market-wide information.

The FSF was established as recently as 1999. Its membership includes senior representatives from the finance ministries, central banks and supervisory authorities of a number of financially important countries, from international regulatory bodies and from international financial institutions (the BIS, IMF, OECD and World Bank). Given its unique composition, the Forum is well placed to help establish priorities among the standards and to encourage their implementation, in particular working in close cooperation with the IMF and World Bank. In recognition of the significance of accounting practices for financial stability, the Chair of the International Accounting Standards Board (IASB) is a member of the FSF.

III. Financial reporting standards: a critical pillar

Given the critical role played by financial reporting in a well functioning financial system, the inclusion of standards in this area in the core set should come as no surprise. Let me, however, elaborate on the importance of financial reporting so as to highlight the stakes involved. In what follows, I will use the term "financial reporting" in a very broad sense, to refer to three sets of arrangements: arrangements for the *measurement* of the financial position, performance and risks of firms; arrangements for their *presentation and disclosure*; and the corresponding *monitoring and enforcement* mechanisms.

Alongside the legal framework of property rights, financial reporting, so defined, ranks among the most basic elements of the financial infrastructure. Meaningful and reliable financial reporting is essential for an efficient and sound financial system.

In a nutshell, financial reporting is essential to convey core financial information about firms to all potential users. This information has a dual function. First, it has a *signalling* function. It facilitates the identification of the most productive uses of economic resources. As such, it forms the basis for assessments of prospective returns and risks. Second, it has a *control* function. It facilitates control over the effective utilisation of those resources. As such, it forms the basis for the allocation of income among the various claimants on the firm and the exercise of financial discipline.

When put in these terms, the critical role played by financial reporting is obvious. And yet, precisely perhaps because it is so obvious, it is easy to take it for granted. Indeed, there is a rather common strand of thought that would contend that "markets" generate the required information spontaneously, regardless of what financial reporting arrangements might be. In the extreme, according to this view markets "see through", drilling to the core of the true worth and activity of firms, irrespective of how much or little, right or wrong information is provided to them. Market forces are an omniscient eye guiding an invisible hand.

Even eschewing extremes, this perspective is, in my view, materially incorrect. It can be dangerous if used to set the strategic basis for policies. Providing high-quality information is essential for proper market functioning, and will not come about spontaneously.

Recent experience has hammered this message home with a vengeance. The harmful effects of deficiencies in financial reporting were highlighted by episodes of financial distress in emerging and industrial countries alike. The lack of transparent and reliable accounts contributed to the build-up of financial imbalances and to the virulence of the Asian crisis. Too much money flowed in, and too much flowed out indiscriminately, as lenders and investors found it hard to distinguish sound from unsound firms. Most recently, the bankruptcy of Enron has revealed that not even the most advanced financial systems are immune. This formerly highly regarded firm was able to hide its true financial condition. Another, somewhat different, instance was LTCM, which was able to operate while providing only minimal information to counterparties and markets.

The bottom line is simple. Misplaced trust in the quality of the information provided or in the ability to overcome any informational deficiencies can severely impair the functioning of the financial system. It can do so by allowing the misuse of economic resources and by undermining confidence in the very fabric of the financial system once those limitations are exposed.

Hence the importance of putting in place a set of reliable financial reporting standards. Ultimately, these standards could bring within reach a better balance between official and market discipline. The better the information that market participants have, the greater is the likelihood that they will exert the necessary financial discipline on institutions. Market discipline can then relieve part of the burden at present placed on the shoulders of prudential authorities.

Moreover, in an environment that is increasingly global, there has been a growing demand for global standards both on the part of the users and the original suppliers of financial information.

For *users,* global standards hold out the promise of increasingly comparable information. Comparability is essential for the day-to-day decisions of market participants, lenders and investors. For instance, as investors take increasing responsibility for their pensions, a growing pool of retirement savings is looking for international investment outlets. And it is essential for prudential authorities. The risks run by the institutions they supervise are more and more incurred, directly or indirectly, across many jurisdictions. Likewise, the raw material on which prudential controls are based can vary substantially across those jurisdictions. For instance, it has long been recognised that differences in loan loss recognition practices can undermine the achievement of the much sought-after level playing field in capital regulation.

For the *providers* of the information, that is firms, global standards hold out the promise of significant cost savings. Complying with a single set of accounting standards would be a major improvement compared with the present national multiplicity. The cost savings would be especially important for those companies that seek listings in the stock markets of various national jurisdictions.

Finally, and not to be underestimated, a set of agreed global financial reporting standards would greatly facilitate the task of those countries that are trying to strengthen their current arrangements in the field. At present, these countries face difficult choices regarding which "model" to follow.

IV. Progress made and challenges ahead

In recent years, the realisation of the need for global financial reporting standards has been gaining ground. Let me next briefly review the progress made so far and look ahead to the remaining challenges.

In reviewing progress, it is worth clarifying the distinction between two closely related, if distinct, segments of financial reporting. The first consists of what might be called "*supplementary risk disclosures*". The second includes more *basic accounting information*.

The efforts to strengthen **risk disclosures** have been spearheaded mainly by prudential authorities, concerned about the limited public information on risk profiles of financial institutions. These efforts reflect a welcome major cultural change relative to, say, one or two decades ago. At that time, it was not uncommon for prudential authorities to regard public disclosure as not necessarily conducive to financial stability.

Efforts have been broadly based, covering a whole range of risks. The rapid growth of derivatives, and consequent greater opaqueness in balance sheets, initially led to steps to improve the disclosure of market risk. The LTCM incident provided renewed impetus to attempts to strengthen disclosure standards. More recently, it is credit risk that has received special attention, as highlighted by the so-called Pillar 3 of the proposed New Basel Capital Accord, known as "market discipline". All such risk disclosures go well beyond what would normally be included in accounting standards.

In a rapidly evolving and technically complex area like risk management, defining the **content** of the information to be disclosed has not proved straightforward. Notably, the nature of the information has complicated the task of balancing the need for information that is *standardised* across institutions, so as to improve its comparability, and that is *tailored* to firm-specific internal risk management processes. This applies to institutions within comparatively homogeneous groupings, such as banks, as well as across functionally distinct ones, such as banks, securities firms and insurance companies.

Considerable efforts have been made in recent years to address this question. So far, the balance has been tipped strongly in favour of firm-specific solutions. These are seen as helpful in containing the costs of producing the information and ensuring its meaningfulness.

Looking further ahead, however, one may wonder whether it might not be worthwhile to explore further the possibility of a somewhat greater degree of standardisation. This might be *desirable* because, as already discussed, comparability is a critical quality of useful information. It might be *feasible* because, I suspect, much of the existing heterogeneity reflects our current limited state of knowledge. Firms are still learning how best to measure risks starting from very different traditions. And the same is true for supervisors. The risks run by firms are fundamentally the same.

Over time, the common stock of knowledge is likely to grow.

Turning next to the area of **basic accounting** information, incipient and rather diffused efforts to develop global standards go back to at least the 1970s. However, an important step forward was the restructuring of the International Accounting Standards Committee (IASC), which culminated in 2001 with the establishment of a new governance and operating structure. The objective was to ensure that the organisation would become globally recognised and accepted as the focal point for efforts in the field.

The nature of the process falls squarely in the "soft law" tradition. The standards developed by the relevant body of the organisation, the International Accounting Standards Board (IASB), do not have ipso facto legal validity in the national jurisdictions; they need to be accepted and enacted by the relevant national authorities.

At the same time, by comparison with the approach followed by, say, the Basel Committee, at least one difference is apparent. The standards are not developed jointly by representatives of the member national standard setters, but by experts chosen on the basis of their technical skills and relevant experience by a group of trustees. Some of these experts are in turn responsible for liaising with the major national standard setters. The trustees are chosen so as to ensure broad geographical representation.

The IASB is developing a full set of accounting standards, based on an extensive body of work carried out over the years. The IASB also recognises that the development of standards is an ongoing task. Continuous adjustment and refinements will be necessary in light of changing conditions.

In concluding my remarks, I would like to focus on three more immediate challenges ahead. First, securing acceptance of international standards by national standard setters and securities regulators. Second, reconciling the different perspectives of accounting and prudential authorities. Finally, ensuring the monitoring and enforcement of the standards.

Securing **acceptance of international standards by national standard-setting bodies and securities regulators** will be an important test of the effectiveness of the process and of the determination to reach the necessary compromises. Deep-seated differences in national traditions have complicated the task.

One example of such differences, typical of the distinction between public shareholder and creditor perspectives, has been the debate over whether the accounts should reflect a "true and fair" or "conservative" view of the condition of the firm. The distinction between Anglo-Saxon countries, on the one hand, and a number of countries in continental Europe and elsewhere, on the other, is often made in this context. The principle of conservatism is consistent with financial systems where open capital markets have historically played a limited role and where accounting standards may have been drawn up partly with the intent of limiting financial distress. The principle may be deeply enshrined in some legal frameworks. For some countries, therefore, reconciling this perspective with the prevailing "true and fair" orientation can be difficult. The issue has been especially delicate in the context of accounting for financial firms.

A second example is represented by differences in views concerning the merits of principles as opposed to specific rules, the former being more characteristic of the British tradition and the latter, it is probably safe to say, of the American one. This reflects differences in the appreciation of which of the two is more robust to manipulation and more amenable to effective enforcement.

The prospects of acceptance of international standards look better than ever before, a testimony to the efforts made so far. In particular, the European Commission has supported strongly the concept of international standards. It has proposed that quoted companies in the Union produce consolidated accounts according to international standards by 2005. And it has set up a two-tier mechanism (political and technical) for endorsement. At the same time, uncertainties remain. General support by the US authorities has been tempered by what they see as the potential risk of weakening national standards. It is important that the current momentum be maintained and, if possible, increased.

The need to **reconcile the different perspectives of accounting and prudential authorities** - the second challenge - arises because of the critical role that information can play in securing a safe financial system. While differences in perspectives exist within the two groups, prudential authorities are inevitably more concerned with downside risks. This is evident in their greater focus on risk disclosures already discussed. But it is also apparent in differences in perspective over basic accounting standards. While the international standards tend to stress "true and fair" valuations, banking supervisors lay comparatively more emphasis on prudence.

The debate under way on provisioning and loan valuation neatly illustrates this point. Many banking supervisors are favourably disposed towards various forms of early provisioning that could provide a cushion against potential losses. By contrast, the prevailing view among accountants, and securities regulators, is that such practices are a possible means of artificially smoothing profits. Likewise, looking further ahead, banking supervisors tend to be more concerned about fair value accounting proposals. Quite apart from feasibility issues, some of them believe that this form of accounting risks imparting excessive short-term volatility and procyclicality to measured profits.

This tension in perspectives will have to be addressed and overcome. I believe it can be. Indeed, the tension can be quite helpful, as the process of developing standards can greatly benefit from an open and constructive dialogue between the various parties involved. I have little doubt that such a dialogue helps us deepen our understanding of the issues. At present, a common language has not yet fully emerged, sometimes clouding the discussion. In cases where prudential authorities may finally reach different conclusions from those of the accounting standard setters, they have a number of options at their disposal. These include securing additional risk disclosures, adjusting accounting measures for regulatory reporting, or adjusting the prudential standards themselves, if needed.

Developing and securing the acceptance of global accounting standards still leaves open question of ensuring their **monitoring and enforcement** - the third and final challenge. Without effective enforcement, developing the standards would be of little value. As highlighted by the Enron bankruptcy in the United States, effective enforcement is by no means an easy task even in the most advanced and mature financial systems. And the challenge is even greater at the international level, as the quality of monitoring and enforcement varies substantially across countries.

These issues, too, will need to be squarely addressed. The task is a broad one indeed. It hinges on ensuring a mutually supportive role for auditors, national bodies with enforcement powers and mechanisms for internal and external corporate governance. We need to ensure that the various parties are endowed with the necessary means and incentives to pursue their task effectively, with the appropriate degree of autonomy and unhindered by conflicts of interest. Given the spotlight of recent events, the environment is probably more propitious than ever to pursue these objectives vigorously.

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My remarks have ranged widely. To conclude, however, I would like to leave you with a simple message. Financial reporting is a basic building block of the financial infrastructure. In today's highly integrated world, a set of global financial reporting standards that is accepted and, equally importantly, widely and effectively implemented is a critical missing pillar in the emerging international financial architecture. Progress is being made, but much still needs to be done. This will require the active cooperation of all the parties with a stake in the process. The current momentum should be maintained and, if possible, enhanced. This window of opportunity should not be missed.