Defining the Roles of Accountants, Bankers and Regulators in the United States

A Study Group Report

Group of Thirty, Washington, DC
All members of the Study Group, with the exception of Charles Taylor and John Walsh, participated in their personal capacities, and the views and judgements expressed in the report do not reflect the policies of their institutions. Publication does not imply that the Group of Thirty endorses the views expressed herein.

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1. Introduction

The smooth functioning of the financial system and its effective supervision are fostered by a constructive working relationship among bank management, the external auditors they engage, and government, including bank supervisory agencies. In fact, bank management and external auditors effectively serve as private agents in the supervisory process when they publicly report on the financial position of depository institutions.

Regulatory systems in a number of countries in Europe and elsewhere have been characterized by a strong spirit of cooperation among the public and private participants. In many countries, regulators rely extensively on examination reports prepared by external auditors, or by management assisted by external auditors. In some of these countries, the external audit firm formally serves as agent for the regulator. Even where the U.S. model of primary reliance on regulatory examinations is followed, the process is often collaborative, with regulatory reviews involving discussions among management, their external auditors and the regulators.

Despite the obvious merits of cooperation and the experience of other countries, a close working relationship among bankers, external auditors and regulators has not been the norm in the United States. Until the late 1960s, there was no pressing need for such a relationship. The business of banking was much simpler and external auditors played a limited role in bank reporting. Beginning in the late 1960s, however, the role of external auditors in banking began to expand as most major banks adopted a holding company structure subject
to broader public disclosure and audit requirements and as the banking agencies expanded the financial reporting required for regulatory purposes.

Increasing competition, rapid financial innovation and technological change in the U.S. financial sector introduced increasing complexity into the management of banks, as well as their financial reporting and regulatory oversight. New banking laws increased the cost and complexity of bank regulation and reporting. As a consequence, the information needs of managers, the financial markets and regulators grew in scope and complexity as did financial reporting requirements.

While these developments would seem to argue for closer cooperation, the relationship among U.S. bankers, external auditors and regulators has instead suffered a serious setback over the last five years due to the shockwaves emanating from the collapse of the savings and loan industry, large loan losses among U.S. banks and the aggressive legislative and regulatory responses to those events. As a result of these shocks, the working relationships among regulators, bank management and external auditors have become increasingly contentious.

Implications for the Economy

Concern has arisen within the financial, regulatory, legal and accounting communities that the regulatory and legislative response to the events of the 1980s has harmed the credit function on which the health of the real economy depends. Some observers argue that the marked slowdown in lending by financial institutions that began in 1989 represented a “credit crunch” in which the supply of credit was being constrained, to a considerable degree, by excessive regulatory zeal and resulting reluctance by bank managers to lend. This is not to say that other important factors were not at work. Other analysts point simply to deteriorating creditworthiness of some borrowers and reduced demand for credit during this period, and note that a slowdown in lending was also evident across Europe and Japan.

While the extent of the linkage may be open to debate, there is no denying that growth of credit and economic output did decline precipitously. At the very least, more intrusive regulation has discouraged risk-taking by banks and driven up the cost of audits and control. As a result, banks shifted from traditional lending activities to other less costly alternatives. Furthermore, their higher
cost structure is undermining bank competitiveness vis a vis other financial services providers.

Rather than promoting the long-term financial health of the banking system, these effects are likely to undermine the financial position of banks, surely with unintended consequences. Thus, even though bank lending has begun growing again, every effort must be made to ensure that overly intrusive regulation does not restrain access to credit or the effective operation of financial institutions.

The Report’s Approach

The Group of Thirty formed this Study Group on Accountants, Bankers and Regulators out of concern that these problems were serious and out of a conviction that an effective working relationship among regulators, management and external auditors must be promoted. The Report finds that the regulatory system is out of balance, emphasizing protection of the deposit insurance fund at the expense of the credit function and overall competitiveness. Change is needed in three areas to encourage more effective supervision.

• The performance of all participants in the supervisory system must be improved; closer cooperation is needed to improve the quality of financial reporting and supervision. For many institutions that failed or found themselves in serious financial difficulty, everyone’s assessment of asset quality was wrong. Confidence in supervision and financial reporting was badly eroded. As a starting point, everyone must understand the roles of the respective participants in the process and cooperation among them must be encouraged. Improvements in management systems, safety and soundness standards, supervisory approaches and accounting practice and principles are needed. Those responsible for reviewing the financial health of institutions must operate on the basis of consistent standards and procedures.

• Unnecessary overlap among managers, external auditors and regulators must be eliminated. Revisions in U.S. banking law have drawn external auditors closer to the regulatory process, assigning them additional duties intended to strengthen bank oversight. More management judgements have been subjected to regulatory direction. Rather than producing greater collaboration, however, these changes are likely to produce costly duplication. Roles
must be better defined so that the skills of each participant are used to best advantage and at lowest cost.

- *If cooperation is to be achieved, mistrust must be reduced.* Greater interaction between external auditors and regulators must be institutionalized. Enforcement actions against external auditors must be open and fair.

To set the stage for its recommendations, Section 2 of the Report examines regulatory practice abroad and the lessons it offers for the United States. Section 3 examines U.S. bank supervision by reviewing the evolving roles of management, external auditors and regulators in the U.S. regulatory process. Section 4 describes the financial upheavals that underlie the present regulatory debate, the legislative response to it, and efforts underway to provide regulatory relief. Section 5 discusses the threat of litigation hanging over external audit firms. And Section 6 explores issues of interpretation that hinder effective financial reporting. Based on this analysis of the context for U.S. regulation, Section 7 concludes with the Study Group’s recommendations for improving the working relationship among the principal participants and better defining the division of labor between the public and private sectors.
2. International Approaches to Bank Supervision

The approach to supervision of financial institutions varies substantially among OECD countries. This reflects the historical differences in the style of governance in these countries. Table 1 on the next page provides an overview of approaches to supervision.

- The number of banks varies greatly among countries. For example, according to OECD statistics for end-of-year 1992, Canada had 66 commercial banks in operation; Japan had 141; Germany had 276; the UK had 518 banking institutions; and the United States had 11,417.

- Unlike the US, many OECD countries routinely permit banks to deal in securities and insurance products as part of the services they provide, although these services often must be provided through subsidiaries.

- In most OECD countries, primary responsibility for supervision of deposit-taking institutions is assigned to a single national agency, which may be the central bank, the finance ministry or a specialized bank regulatory agency (sometimes under the jurisdiction of the finance or other ministry). In a number of countries in which the central bank is not the principal bank supervisor, the bank shares responsibility for monitoring the safety and soundness of the financial system.
<table>
<thead>
<tr>
<th>Country</th>
<th>Main Supervisor(s)</th>
<th>Responsibility for Handling Distressed Banks</th>
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<tbody>
<tr>
<td>Australia</td>
<td>Reserve Bank</td>
<td>Same</td>
</tr>
<tr>
<td>Austria</td>
<td>Ministry of Finance</td>
<td>Same</td>
</tr>
<tr>
<td>Belgium</td>
<td>Commission for Banking and Finance</td>
<td>Same</td>
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<tr>
<td>Canada</td>
<td>Superintendent of Financial Institutions</td>
<td>Superintendent, Canada Deposit Insurance Corporation, and Department of Finance</td>
</tr>
<tr>
<td>Denmark</td>
<td>Financial Inspectorate</td>
<td>Inspectorate with Danmarks Nationalbank</td>
</tr>
<tr>
<td>Finland</td>
<td>Bank Inspectorate(^2) (within the Bank of Finland)</td>
<td>Bank Inspectorate and Finance Ministry</td>
</tr>
<tr>
<td>France</td>
<td>Banking Commission(^3)</td>
<td>Banque de France</td>
</tr>
<tr>
<td>Germany</td>
<td>Federal Banking Supervisory Office Deutsche Bundesbank</td>
<td>Federal Banking Supervisory Office</td>
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<tr>
<td>Greece</td>
<td>Bank of Greece</td>
<td>Same</td>
</tr>
<tr>
<td>Ireland</td>
<td>Central Bank of Ireland</td>
<td>Same, with Finance Ministry (in certain cases)</td>
</tr>
<tr>
<td>Italy</td>
<td>Bank of Italy</td>
<td>Same</td>
</tr>
<tr>
<td>Japan</td>
<td>Ministry of Finance</td>
<td>Ministry of Finance</td>
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<td>Luxembourg</td>
<td>Monetary Institute</td>
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<tr>
<td>New Zealand</td>
<td>Reserve Bank</td>
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<tr>
<td>Norway</td>
<td>Surveyor of Credit Institutions</td>
<td>Finance Ministry</td>
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<td>Portugal</td>
<td>Bank of Portugal</td>
<td>Finance Ministry, with Bank of Portugal</td>
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<td>Spain</td>
<td>Bank of Spain</td>
<td>Bank of Spain, and Deposit Guarantee Fund</td>
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<tr>
<td>Sweden</td>
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<td>Switzerland</td>
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<td>Undersecretariat of Treasury Central Bank of Turkey</td>
<td>Undersecretariat of Treasury</td>
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<td>United Kingdom</td>
<td>Bank of England</td>
<td>Same</td>
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\(^1\) For the United States, see section 3.
\(^2\) The Ministry of Finance is responsible for the state-owned Postipankki and the Central Bank for authorized foreign exchange banks.

\(^3\) The Banking Commission does not oversee the central bank, Treasury or certain other government entities. It relies on the Banque de France for on-site examination of banks; the Committee on Bank Regulation for prudential and accounting standards; and on the Committee on Credit Institutions for licensing of new banks.

**Sources:** Prudential Supervision in Banking, OECD, Paris, 1987; individual government reports.
Regardless of its role in supervision or handling distressed banks, the central bank in almost all OECD countries has authority to provide temporary liquidity to individual banks, in some cases to assist banks with liquidity problems, but most often as a normal part of its duties in conducting monetary policy.

**Relations Among Accountants, Bankers and Regulators**

Broadly speaking, the approach in the United States to supervision has placed greater emphasis on on-site examinations, formal regulations and legal procedures and less emphasis on the work of external auditors than has been true in other OECD countries. However, there has been a worldwide trend toward formalization and specification of licensing requirements and entry conditions as well as tightening of prudential supervision. In addition, the legal basis of the relationship between external auditors and supervisors has been strengthened in a number of countries and the level and intensity of contacts between them has increased.

While the approach to bank supervision varies from country to country, three basic models of supervision and external auditor-regulator relations recur in most OECD countries.

The model in **Australia**, **New Zealand** and the **United Kingdom** has relied primarily on statistics supplied by banks and interviews with senior management. Since the mid-1980s, supervisors in Australia and the United Kingdom have also begun to establish a direct working relationship with banks' external auditors and accountants on prudential matters.

In the **United Kingdom**, the Bank of England does not carry out on-site examinations on a regular basis and supervision is based on regular reports which detail various aspects of a bank's business, supplemented by frequent interviews and discussions with its senior management. In recent years, a working relationship has begun to evolve between the Bank of England and banks' external auditors. The Banking Act of 1987 formally empowered the Bank to require an institution to commission reports for the Bank by a "reporting accountant". These include an annual report on whether the bank's accounting and other records and internal control systems have been maintained adequately, and reports, usually annual, on whether prudential returns submitted to the Bank have been completed accurately. A bank's reporting accountants are usually, but not always, the same firm that audits the financial statements required of all British public companies. To encourage the free exchange of
information, the Bank of England, bank management and a bank's external auditors meet annually to review the annual accounts and the report on systems and controls. While the 1987 Act allowed both external auditors and reporting accountants to bring matters of concern directly to the Bank, 1994 legislation imposes a statutory duty on both parties to raise such matters with the Bank. While prior discussion with management is normally expected, in exceptional circumstances (such as suspicion of fraud) they can come directly to the Bank.

In New Zealand, a new system of supervision will be implemented in early 1995 that will entirely eliminate the Reserve Bank's role in reviewing bank operating results. Quarterly prudential returns and interviews with the Bank will be abolished in favor of comprehensive, quarterly, public-disclosure statements. The chairman and directors of New Zealand banks will have to sign statements attesting to the accuracy of the reports and the adequacy of risk management systems. At half-year intervals, the disclosure statements will have to be audited by an external audit firm. Under the new system, the incentive for prudent management is to derive from market discipline rather than regulatory oversight.

In Austria, Belgium, Germany, and Switzerland, the supervisors place primary reliance on the work of external auditors who are responsible for reporting to bank supervisors. However, in Austria, a limited program of on-site examinations is being initiated by the Austrian National Bank.

In Germany, the Federal Banking Supervisory Office (BAK) within the Ministry of Finance supervises banks in cooperation with the central bank. The BAK relies upon the external auditor to review information provided in annual financial statements for accuracy and adherence to legal requirements. The external auditor is appointed by the bank but the BAK may require appointment of another auditor if necessary to achieve the purposes of banking regulations. The external auditor reports to bank management and has a professional duty of confidentiality, but a copy of the auditor's annual financial report must be sent directly to the BAK and the local office of the central bank. The external auditor is under a legal obligation to inform the regulator directly of serious problems found in an audit, including serious violations of legal or fiduciary responsibilities by management. The BAK may also commission spot audits by external auditors (other than the bank's auditor of financial statements). If a bank is engaged in specialized activities, an external auditor is appointed by the BAK to review those activities.
In Switzerland, the Federal Banking Commission licenses “bank law auditors.” Each bank’s board of directors appoints its bank law auditor from the list of licensed bank audit firms but the firm may only be appointed or changed with Commission approval. The Commission relies on direct contact with the external auditors, board of directors and management of regulated institutions. The annual external audit is based on documents provided by the bank and must include interim reviews to prove the existence of assets and test the reliability of the bank’s records. The external auditor’s report is addressed to the board of directors and directly to the Commission. The report covers not only financial activities and results but compliance with the requirements of Swiss banking law including the adequacy of capital, reserves, licensing conditions and internal controls as well as proper conduct of business by controlling shareholders, managers and directors. The external auditors have to report urgent matters of supervisory concern immediately to the Commission. The Commission can also order special audits or ask the bank to change the audit firm. If an audit firm does not fulfill licensing conditions, the Commission can withdraw its license with the effect that the firm can no longer perform bank audits.

In the remaining OECD countries, supervisors rely upon on-site examination of financial institutions together with review of regular financial reports submitted by the institutions (and, in some cases, external auditors). The frequency and extent of on-site examinations vary by country, with the examination cycle usually ranging from 1 to 4 years. External audits are generally mandated, and appointment or dismissal of external auditors often requires regulatory approval, but these reports are a secondary source of information.

In Canada, the Superintendent of Financial Institutions faces a legal obligation, as in the United States, to conduct an on-site examination at least annually. This examination is conducted at the head office of the bank and focuses on capital adequacy, liquidity, profitability, asset quality and management. The Superintendent has full access to bank documents, receives the bank’s external audit, and maintains ongoing contacts with senior management and the bank’s external auditors, whose appointment and duties are regulated by national law. A bank’s shareholders are required to appoint a qualified auditing firm that is completely independent of the bank. The Superintendent also has the power to revoke the appointment of an external auditor and may require the auditor to report on bank procedures affecting safety and soundness, to expand
the scope of an audit, or to follow specific audit procedures or undertake a specific examination.

In Japan, two different agencies are empowered to conduct examinations. The Ministry of Finance conducts on-site inspections in accordance with legal authority provided in the Bank Law and other legislation. The Bank of Japan conducts examinations in accordance with contracts concluded with banks and other financial institutions that maintain accounts with the Bank pursuant to its responsibility for “the maintenance and strengthening of the credit system” (The Bank of Japan Law, Article 1). Japanese banks that are in the form of stock companies are required to have external audits while most others are not. Even in the case of stock companies, the supervisors rely upon their own examinations rather than financial reports audited by external auditors.

Regardless of the choice of supervisory model, some generalizations are broadly applicable to the respective roles of external auditors and bank management in the supervisory process. First, bank management’s primary responsibility for the accuracy of financial statements and the information provided to regulators is clearly recognized and enunciated, including where external auditors report directly to supervisors. Second, supervisors often have significant interaction with external auditors, even if they do not rely primarily on their audit work.

European auditing practice was detailed in a 1993 survey of twelve countries (including half of the OECD) by the Fédération des Experts Comptables Européens (FEE).¹

• **Appointment.** Supervisors must be informed of a change in external auditors in nine countries. In eight, they can object to an appointment or reappointment.

• **Reporting to supervisors.** In most countries surveyed the external auditor is required, or can be requested, to report to the supervisors, directly or through the bank. In eight countries, supervisors can appoint extraordinary auditors to carry out specific investigations on their behalf.

• **Extent of reporting.** In addition to the requirements of the annual audit, external auditors may be responsible for reporting on: the reliability of internal controls and computer reporting systems, large credits and credit limits, money laundering and insider trading. In seven of twelve countries, the external auditor is required to provide a description of, or opinion on, the bank’s exposure to credit, liquidity and market risks; the bank’s
approach to monitoring risk; and the adequacy of the bank's risk assessment and hedging activities.

- **Reporting irregularities.** In ten countries, external auditors are responsible for informing the authorities of irregularities found in the course of their work, although the reporting requirement may be limited to significant issues in some countries. Thus, in France, the public prosecutor must be informed of serious infringements, while in Switzerland, the external auditor has to inform the Banking Commission of any violation of law or any irregularity along with the deadlines set for corrective action.

Obviously, client confidentiality does not apply to the substantial range of matters on which external auditors must report to supervisory authorities. However, in all countries in the FEE survey, information communicated to or received from the bank is to be kept confidential from all other parties, including the tax authorities. As regards the free flow of information between external auditor and client, only in Germany (when acting on behalf of supervisory authorities) and Greece (when mandated to do so) is information communicated to supervisors required to be kept confidential from the external auditor's bank client. In the case of information generated by internal auditors or by inspectors employed or appointed by supervisors, the external auditor has access to such information directly or through the bank in eight countries. In Austria, Germany and Greece, the external auditor does not have a right to information gathered by or on behalf of supervisory authorities, unless it is provided to the bank. In the UK, the Bank of England has the right, but not a duty, to disclose information to the external auditor.

**Policy Developments**

Greater involvement of external auditors in the supervisory process has been recognized and endorsed in a variety of policy statements. In July 1989, the International Federation of Accountants (IFAC), in association with the Basle Committee on Banking Supervision\(^2\), issued a statement on supervisory issues. The statement called for greater mutual understanding between external auditors and supervisors and more communication—with management present or at least informed, unless this would compromise the purpose of the communication. It also urged supervisors to take the auditing profession into their confidence and hold periodic discussions with professional accounting bodies.
Without endorsing changes in relative supervisory roles, the statement listed supervisory tasks for which external auditors are well suited including: verification of prudential returns; evaluation of information and control systems on the basis of criteria provided by the supervisor; the expression of an opinion on adherence to appropriate accounting policies, particularly with regard to provisions against potential losses; and the examination of accounting records and controls systems regarding the bank's fiduciary activities. In its 1993 report, the FEE Banks Working Party cautioned that "any extension of the auditor's responsibilities should be undertaken only on the basis of a thorough understanding of the normal range of competence of the auditing profession" and only "by agreement between the supervisory authorities and the auditing profession"—not unilaterally imposed by the authorities.

In 1990, the Basle Committee itself underlined the importance of a thorough and reliable external audit and endorsed greater cooperation between external auditors and regulators. In a Supplement to its 1983 statement of principles for bank supervision, the Committee recommended that all supervisory authorities should have the capacity for two-way communication with a bank's external auditors; should direct criticism of an inadequate audit to the local representative body of auditors; and should have the authority, where necessary, to have an external auditor replaced.

In response to the closure of the Bank for Credit and Commerce International (BCCI) in 1991, authorities in the United Kingdom launched an inquiry into the supervision of the bank under the leadership of Lord Justice Bingham. The Bingham Inquiry explored a number of issues related to the role of external auditors and recommended that they should be placed under a statutory duty (as opposed to the earlier right) to communicate directly with the Bank of England where necessary to safeguard a bank's depositors. As discussed above, that change is now reflected in UK banking law. On a wider front, the UK Auditing Practices Board has proposed that companies should have to confirm in their annual reports that they will remain a going concern until the next report. Whether external auditors should sign off on such a "going concern" statement, however, is a subject of continuing debate within the British accounting profession.

In July 1993, in response to the closure of BCCI, the European Commission proposed a directive imposing a duty on external auditors to report directly to bank supervisors in certain circumstances. External auditors would be required to report any fact or decision
which is liable to constitute a material breach of the laws or regulations governing the authorization or activities of a financial institution; affect the continuous functioning of the financial institution; or lead to refusal to certify the accounts or to express reservations about them. The proposal is currently under review and is expected to be adopted by the end of 1994, with full implementation expected by the end of 1995. If adopted in its current form, the reporting requirements in the directive would govern the activities of external auditors in all member states of the European Union.

Responding to Financial Problems

In Europe and Japan, it is relatively rare for supervisors of a financial institution to close it outright and it is very unlikely that one of the few large institutions in each country would be allowed to default on its financial obligations. This is not to say that there is any guarantee of support for an individual institution or that current management or shareholders are certain to be protected. In describing Bank of England policy, Governor Eddie George has said there is “nothing automatic” about the Bank’s assistance, even for large institutions, and that “no bank should assume that it would be immune from penalty.”

While a bank and its management may not be immune from penalty, it is nonetheless likely that, in the event of severe financial difficulties at a major institution in an OECD country, confidential consultations would be held prior to its failure resulting in central bank support until a merger or takeover could be arranged. In the US, on the other hand, Federal law strictly limits the central bank’s ability to provide financial support for a troubled bank and the ability of the deposit insurer to provide assistance, other than the protection of insured deposits. Consequently, it is often necessary for the regulators to seize a financially troubled institution and to force its merger or, if problems are sufficiently serious, its outright liquidation.

Like the United States, a number of countries, including the Scandinavian countries, the United Kingdom, France, Germany, Italy, Australia, Spain and Japan, have experienced substantial difficulties in their banking sectors. Large loan losses by financial institutions in Australia and Japan, as well as government rescues of banks in Norway, Spain and Sweden, are similar to the problems in the U.S. financial system.
These widespread problems in OECD banking systems are a reflection of the concurrent, extraordinary collapse of portfolio values across almost all OECD countries caused by abrupt changes in shared common beliefs or assumptions about classes of credits. In the early 1980s, a fundamental change in the structure of oil prices altered everyone’s assumptions about cash flows associated with oil and gas related loans, whether associated with repayment of loans in Mexico or Oklahoma. Moreover, because the growth of international debt was energy related, the value of all international loans declined together. Similarly, in the early 1990s, a global real estate problem developed when inflationary pressures over several years were followed by a period of disinflation across the OECD.

Financial problems experienced by banking systems abroad have been addressed by financial rescue operations and through strengthening of regulation. Most often, bank rescue operations have taken the form of cooperative efforts by national legislatures, bank supervisors and heads of major private financial institutions rather than the politically charged confrontations seen in the United States. For example:

- In the UK, while there was substantial criticism in Parliament of the Bank of England’s handling of BCCI and the Bingham Inquiry was launched to examine supervisory practices, remedial action has largely been undertaken by the Bank and the auditing profession, with only modest changes made by Parliament in banking law.

- In Japan, various private estimates place the level of problem assets held by the large banks at $100 billion or more. To address this problem, the Cooperative Credit Purchasing Company (CCPC) was established in January 1993, financed solely by private financial institutions. The CCPC is intended to purchase real estate loans at fair market prices and thereby help the banks to speedily write off the troubled loans. Official cooperation for the CCPC is in the form of speedy tax write-offs approved by the Ministry of Finance.

While litigation against banks and their advisors has not been the issue in Europe or Japan that it has been in the United States, some of the Anglo-Saxon countries have witnessed aggressive legal action against external auditors much like that seen in U.S. courtrooms.

- In the UK and Luxembourg, the liquidators of BCCI have claimed $8 billion against Price Waterhouse and Ernst & Young
in connection with the 1985 audit of the collapsed bank and additional claims filed in connection with the 1986 and 1987 audits are expected to total $5 billion.

• In Australia, KPMG Peat Marwick recently settled a $1.1 billion suit in connection with an audit of Tricontinental Corporation, a government-owned merchant bank, for $100 million. Ernst & Young was sued for A$175 million by the liquidator of the Duke Group, an investment bank, and settled for A$35 million.

• In Canada, Ernst & Young and a predecessor of Peat Marwick Thorne in 1990 paid the major portion of a C$125 million settlement resulting from the failure of two Canadian banks.
3. Bank Supervision in the United States

The United States has the most complex system of regulation among the OECD countries. There are four Federal regulators of banks and thrift institutions and their holding companies: the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). In addition, the National Credit Union Administration regulates credit unions. The Securities and Exchange Commission (SEC) regulates the securities industry, and the Commodity Futures Trading Commission (CFTC) regulates certain types of commodities-based financial instruments at the Federal level. Finally, there are banking regulators and insurance commissioners in each of the 50 states—although the same agency performs both functions in some states—charged with ensuring the safety and soundness of the institutions they regulate. All these agencies have supervisory and regulatory responsibilities for the institutions they oversee. Most conduct on-site inspections including, at times, multiple regulatory examinations of the same institution.

Before considering how the working relationship among bankers, external auditors and regulators can be improved, it is important to understand their respective roles and how they have evolved over time in the U.S. system.

The Role of Bank Management

The safety and soundness of the banking system depends, in the first instance, on the competence of bank managers and the quality of oversight exercised by the board of directors at each individual
institutions. Primary responsibility for the soundness and efficient operation of a depository institution rests with the board of directors elected by the shareholders. They are accountable to the shareholders for ensuring that the institution’s business goals are established, that competent management is selected, and that their institution meets legal and regulatory requirements.

It is the central responsibility of management to reflect accurately the value of the institution's assets, to identify problem assets and to set aside adequate reserves against them. These are matters of judgement that depend importantly on economic and other assumptions. Making the right judgements and assumptions is critical because most bank failures result from a decline in asset values.

Central to the effective exercise of these responsibilities is an institution’s internal audit function which should have the competence and status to provide an objective view of the institution's condition to senior management, the board and the audit committee. While external auditors often focus on testing financial transactions and balances, internal auditors have come to focus increasingly on internal control policies and procedures as a means of ensuring that financial data is accurately recorded, processed and reported and of providing evidence of potential misstatements or misconduct.

Both external auditors and regulatory examiners rely upon the work of internal auditors. AICPA Statement on Auditing Standards (SAS) 65 provides specific guidance to external auditors on evaluating the adequacy of internal audit and the extent to which it may be relied upon in the external auditor's work. Under pressure to reduce costs, management is seeking to limit the combined cost of internal and external audit, a process that is likely to produce closer cooperation between internal and external auditors.

The pivotal role of management and the directors is reflected in the results of an SEC staff study of 119 actions against public companies and 42 actions against their external auditors that the agency brought during the 1980s. In considering the implications of these results for banks, it must be remembered that the SEC experience is based primarily on firms other than banks.

- Most alleged frauds were perpetrated by upper-level management (CEO, President, CFO) by use of improper revenue recognition or overstatement of assets. Very few frauds involved actual diversion of corporate assets.
- The majority of the alleged frauds occurred because of a breakdown of internal controls.
• A substantial number of the public companies involved in the actions did not have an audit committee (31 percent) and, for the 69 percent that did, the effectiveness of their committees was questioned.

The regulatory reporting burden on banks was relatively light until the late 1960s. Banks were required to prepare reports for regulators—earlier versions of the Call Report for banks and the Thrift Financial Report for S&Ls—in accordance with regulatory accounting policies (RAP). The directors were required to verify that an institution’s cash and liquid assets were physically on hand. Bank securities were exempted from the disclosure, registration and reporting requirements of the federal securities laws; so financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) were not required.

Then, between 1965 and 1975, larger banks reorganized to become subsidiaries of publicly held holding companies and thus became subject to a GAAP-based reporting requirement. In 1968, the Bank Holding Company Act formally required audited annual reports for holding companies that were subject to SEC oversight with the goal of ensuring fair and accurate reporting to shareholders. In 1974, similar reporting requirements were imposed on publicly held banks not owned by a holding company if the bank had more than 500 shareholders and assets in excess of $5 million. Since that time, the SEC and bank regulators have moved in tandem, adding requirements to the annual reports and call reports to keep pace with financial innovation and an expanded perception of material risks.

Management’s responsibility for the accuracy of financial reports has long been clear under common law and federal statute. In 1938, the Sixth Circuit Court of Appeals held the directors of a bank liable where the chief management officer of the bank had falsified the financial reports of the institution. 

_Atherton v. Anderson._ 99F.2d 883 (6th Cir. 1938). More recent examples can be found in the numerous FDIC suits against bank directors alleging negligence in supervising the financial reporting at banks that ultimately failed.

These responsibilities have been further elaborated in reaction to the discovery of payments to foreign officials in the 1970s and bank failures in the 1970s and 1980s. Under the Foreign Corrupt Practices Act, companies that are required to make reports under the securities laws face several additional internal accounting and control obligations. They must keep books and records which “in
reasonable detail, accurately and fairly reflect the transactions and
dispositions of the assets of the issuer.” They must devise and
maintain internal accounting controls to ensure that transactions
are executed in accordance with management’s authorization,
transactions are recorded in such a manner that financial statements
can be prepared that conform to GAAP or other applicable criteria,
and records are maintained to assure accountability for assets.

The importance of management’s attention to its reporting
responsibilities has been the focus of attention by a number of
independent commissions. The Treadway Commission\(^3\) stressed
that “the tone set by top management...is the most important factor
contributing to the integrity of the financial reporting process” and
recommended a strong and independent audit committee of the
board of directors to, among other things, oversee management’s
performance of that responsibility. The New York and American
Stock Exchanges and NASDAQ require all listed corporations to
have an audit committee composed of at least a majority of outside
directors.

Both the Treadway Commission and the Public Oversight Board
of the SEC Practice Section, American Institute of Certified Public
Accountants (AICPA)\(^4\), proposed to strengthen the accountability of
audit committees by recommending that annual financial statements
should be accompanied by a statement of the audit committee. In
the Public Oversight Board formulation, the statement would attest
that the members of the committee have reviewed the audited
financial statements, conferred with management and the external
auditors, and believe that the financial statements are complete and
reflect appropriate accounting principles.

The Cadbury Committee,\(^3\) set up in 1991 to review issues
related to financial reporting and accountability in the UK, underscored
the central importance of the chairman’s role in ensuring good
governance and recommended that the role of chairman should in
principle be separated from the role of chief executive officer to
ensure “that no individual has unfettered powers of decision.” In
the German corporate model, the separation of powers within the
corporation is achieved for major enterprises by requiring them to
have both a supervisory board of directors and a managing board—
with no overlap of membership.

However achieved, an independent authority at the board level
provides a means for external auditors to complain if they believe
that management is not providing necessary information or that
their concerns are not being addressed. This provides an opportunity
for external auditors to maintain their confidential and clear client relationship while ensuring that they can provide shareholders with an objective check on management’s financial statements.

The Role of External Auditors

Private oversight of financial reporting of banks is provided by the external auditor. The auditor’s primary objective has traditionally been to render an opinion on the fairness of presentation in all material respects of annual financial statements prepared in conformity with GAAP. The external auditor’s opinion is based on an audit conducted in accordance with generally accepted auditing standards (GAAS). Integral to an effective audit process is broad agreement on the body of GAAP and recognition of the accounting profession as experts in applying those principles.

In the United States the external auditor is hired by the board of directors but nevertheless represents the interests of the shareholders. The external auditor’s report is normally addressed to the board of directors and shareholders of the institution audited. The external auditor’s opinion provides reasonable assurance of the fairness of presentation of an institution’s financial statements and plays an important role in the operation of the financial markets by providing background for many economic and business decisions. Although external auditors have no explicit duty to regulators, the external auditor’s opinion on the financial statements is available to supervisors and, since enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), certain other reports to management prepared by the external auditor—as well as the auditor’s workpapers—are also available to supervisors.

While the external auditor’s advice on financial accounting matters is influential, it does not carry the force of law and it may be ignored in some circumstances by the board and management. The audit focuses on differences between reported values and underlying facts and circumstances to determine if such differences would constitute a substantial—material—difference in the financial statements. If management ignores the external auditor’s advice on small matters, such as correcting minor internal control weaknesses or preferred accounting presentation, there is little the external auditor can do since management’s financial statements would still be prepared in accordance with GAAP in all material respects.

In the relatively rare event in which an external auditor identifies irregularities that materially affect the financial statements, SAS 53
directs the external auditor to express a qualified or adverse opinion on the financial statements and communicate the findings to the audit committee or the board of directors. Likewise, irregularities involving senior management should be reported directly to the audit committee. If the identified problems are not resolved or the client refuses to accept the audit report as modified, SAS 53 states that the external auditor should withdraw from the audit engagement. In the case of an SEC registrant, the securities laws require a public declaration of the reasons for the withdrawal.

The key to the external auditor’s effectiveness and credibility is independence of judgement and adherence to recognized auditing procedures and high professional standards. In the SEC staff study previously cited, review of enforcement actions against external auditors showed that most alleged audit failures involved failure to obtain sufficient information and to exercise appropriate professional skepticism. Three-quarters of the actions were against non-national firms and, of those, nearly 90 percent were not members of the AICPA’s SEC Practice Section.

The fact that external auditors are remunerated directly by the banks they advise might raise questions about the independence of their judgements. Because the profession has long recognized the importance of this issue, the AICPA and the SEC have sought to define the concept of independence through a series of rules and regulations, and individual firms have developed their own extensive rules and controls.

In recent years, external auditors have been criticized for missing too many of the problems at U.S. financial institutions, even long after the alarm had been raised about problems in the financial sector. This criticism is part of a growing “expectation gap.” External auditors tend to limit their role to expressing an opinion on financial statements after employing GAAS procedures; they disclaim the broader role of watchdog of corporate behavior. The public, however, expects the external auditor to play a greater role in ensuring that asset values are accurate and reserve levels are sufficient and in detecting and exposing fraud and mismanagement.

The Treadway Commission report prompted the accounting profession to adopt new professional standards in response to the “expectations gap” problem—SAS 52 through 61 by the Auditing Standards Board of the AICPA—that require external auditors to conduct audits so as to provide reasonable assurance of detecting illegal acts (and errors and irregularities) that have a direct and material effect on the financial statements. The external auditor has
a professional responsibility to ensure that the company’s management and audit committee or board of directors are adequately informed of any irregularity that comes to his/her attention, unless it is clearly inconsequential.

Approach to Financial Reports. Audit procedures are applied to information provided by management and are limited to those necessary to render an opinion on the financial statements of the institution, which are based on management’s assumptions and judgements. The external auditor’s procedures generally include:

- review of record keeping procedures and evaluation of the work of the internal auditors;
- appraisal of internal controls over financial reporting;
- testing of selected assets, liabilities, revenues, expenses and off-balance sheet items;
- evaluation of the accounting principles used by the institution for compliance with GAAP; and
- review of adequacy of disclosures.

In carrying out these procedures, the external auditor is responsible for evaluating the reasonableness of management’s estimates and judgements (SAS 57) and communicating his/her findings to the audit committee (SAS 61).

Because the reliability of the information provided by management is heavily impacted by the internal control structure within the institution, it has been general practice for external auditors to consider the adequacy of internal controls, including the internal audit function. To a limited extent, external auditors also consider the potential for noncompliance with laws and regulations. In all these instances, however, the scope of review is limited to determining the degree to which the external auditor may rely on the institution’s records and controls and the extent to which weakness or failure in these areas is likely to cause a material misstatement of financial position or operating results.

The fact that GAAP serves as the basis for preparation of financial statements subjected to external audit represents one set of limitations on the use of the external auditor’s work. As discussed in Section 6, GAAP is based on the historical cost accounting model and that model’s underlying assumption of continuation as a going concern for at least the next year. It has been traditional auditing
practice to focus on past performance and to presume continuing viability in the absence of a serious financial weakness. Audited financial statements look backward, presenting the institution's financial position at a point in time and its financial performance for only a specific period. Assets, except those that are actively traded or held for purposes other than redemption at maturity, traditionally have been carried at their acquisition cost, adjusted only for declines in realizable value that are other than temporary.

A critical area of judgement for the external auditor—as for regulators—is valuation of assets and the related issue of adequacy of reserves. Traditionally, the external auditor has attempted only to provide an objective evaluation of the reasonableness of values presented by management in its financial statements. Generally, this evaluation begins with an assessment of the policies, processes and procedures employed by management to identify impaired assets and to establish adequate reserves. For the specific assets tested, the external auditor looks at likely repayment and potential loss, asset by asset. No judgements are made about a bank's strategic plans or the quality of management itself. Absent evidence of immediate financial difficulties, it has not been standard practice under GAAP or GAAS for external auditors to "stress test" an institution's financial condition for future viability or to value assets at liquidation value.

However, in response to the "expectations gap," GAAP has evolved and is now described by the profession as having "mixed attributes" that include reporting and footnote disclosure of current values. While historical cost remains the underlying assumption of GAAP and GAAS, the external auditor has a responsibility to evaluate "whether there is substantial doubt about the entity's ability to continue as a going concern" (SAS 59) and to report any concerns to the audit committee.

Furthermore, in response to the massive asset quality problems with which the financial system has had to contend, the accounting profession has developed a substantial body of professional guidance on asset quality and valuation issues. For instance, in its 1993 Audit Risk Alerts, the AICPA advises external auditors to pay careful attention to management valuation allowances. Furthermore, the Financial Accounting Standards Board (FASB) has also issued a number of Statements of Financial Accounting Standards on difficult valuation issues including loan impairment, accounting for loss contingencies, market values of securities available for sale, and troubled debt restructurings.
A key challenge to external auditors has been the shift from a relatively stable environment with known quantities to a world of volatile market developments, including rapid creation of new types of financial instruments. In this regard, the Public Oversight Board has noted:

"The deregulation of the financial industry led to new ways of doing business that stretched the ability of the accounting profession to keep up with the changes. New financial instruments proliferated, each presenting novel accounting challenges. It was difficult to determine how these assets and liabilities should be measured and classified. Financial regulators often tolerated non-traditional financial reporting practices to help the institutions under their authority stay open. The problems were compounded by the vast devaluation of property values which made shambles of many financial institutions' balance sheets. These developments created enormous problems for management and for the auditing firms which were trying to value complex assets and account for transactions which they had never seen before."

The Role of Regulators

Official oversight and ultimate responsibility for the supervisory system rests with the regulators. The regulatory agencies are statutory bodies authorized by law to supervise the financial system for the purpose of making its institutions operate in a safe and sound manner. Their concern with the condition of individual banking institutions is driven, above all, by that general duty to the system as a whole. Unlike bank management or external auditors, regulators do not have a primary concern with the information provided to bank shareholders about their investments. Their responsibility is to protect depositors and the financial system. If bank management fails in its duties, it is the regulators' responsibility to attempt to ensure that deficiencies are corrected. Their power to compel remedial action is substantial. They have broad enforcement authority and the ultimate sanction to withdraw banking licenses.

Regulators are also charged with protecting the deposit insurance funds of the FDIC that, in turn, protect depositors. When an institution is deemed to be critically undercapitalized by its primary regulator, it can be taken over by its primary regulator or by the FDIC which have authority to compel a merger or acquisition or, in the extreme, to close and liquidate the institution.
The regulators assess the soundness of an institution by monitoring reports of performance and financial condition, and by conducting periodic on-site examinations.

**Monitoring** involves the review of periodic reports prepared by each bank. Each institution files, at least quarterly, a report of condition and income (the Call Report or TFR). Regulators review these reports for compliance with specific regulatory criteria such as capital standards and for financial changes or trends that cause regulatory concern. Regulators also receive and review dozens of other periodic reports intended to:

- provide information useful for broad regulatory or economic policy matters such as the advance report of deposits from banks or the country exposure report;

- measure compliance with specific financial requirements, such as reserve requirements or the payment of FDIC insurance premiums; or

- report on compliance with specific laws, such as those regarding loans to insiders, money laundering and fair lending.

Regulators can also require the submission of additional, specific information by a bank whenever they deem it necessary.

**On-site examinations** are undertaken periodically for a variety of reasons. Safety and soundness reviews typically evaluate the following items:

- loan portfolio management;
- loans and the adequacy of loan loss reserves;
- risk management including credit underwriting, interest rate and other market risks, foreign exchange and other trading operations;
- liquidity management;
- the quality and quantity of earnings;
- propriety of regulatory reports and compliance with laws and regulations;
- management and board supervision; and
- capital adequacy.

The purpose of regulatory examinations goes well beyond the fair presentation of the financial condition of an institution. The regulators are required to make judgements about the competence
of bank officers and directors. They also assess the reliability of information provided by management, even though errors may be of minimal financial significance.

While regulatory examiners accept management assumptions and judgements as a starting point for their analysis, they neither focus on the financial statements examined by the external auditors nor limit their inquiries to matters materially affecting the financial statements. The regulatory examiner's general methodology for establishing likely loss levels is to sample the loans on an institution's books, classify criticized loans into broad categories, and apply percentages to each category to indicate likely losses. At some agencies, this treatment is limited to homogeneous loans such as auto loans, mortgages and credit card debt while large loans and those internally classified as problems by the bank are reviewed individually.

In addition, regulators review compliance with specific laws as well as whether management has in place reasonable policies or procedures to achieve compliance. Violations of law or reporting errors which themselves have little financial significance can lead to enforcement actions, including substantial civil money penalties.

Finally, U.S. regulators are charged with enforcing banks' compliance with an array of social concerns and enforcement objectives which Congress has mandated for the banking system—fair lending, full disclosure of lending terms, minimum services for the poor, prevention of money laundering, etc. These objectives are achieved by evaluating individual institutions' compliance with the applicable laws and regulations. Some of these reviews—Community Reinvestment Act or fair lending assessments or consumer compliance—are so diverse that regulators have developed separate, specialized examinations for them.

**Approach to Financial Reports.** In some areas, bank regulators follow regulatory accounting procedures (RAP) rather than the GAAP rules. Despite significant efforts to narrow differences in approach, RAP continues to differ from GAAP in a number of areas and also differs slightly among regulators.

If the institution's capital, liquidity, risk management, asset quality and earnings potential appear favorable, the regulator will generally adopt the GAAP approach to asset valuation that is generally applied by bank management and the external auditor. If, however, an institution is identified as a candidate for potential failure or there is concern regarding the stability of its asset values, the regulator may assign values to some or all of the institution's assets
on more of a liquidation basis. The regulator's objective, in this respect, is to assess the potential cost of a problem bank to the deposit insurance fund.

The presumption of liquidation, even if only for a portion of the assets, can dramatically change the reported financial condition of an entity because values even of performing assets plunge in an unplanned or forced sale mode. This explains, in part, why losses of 30-40 percent of asset value incurred in the course of liquidation by the FDIC often far exceeded loss projections made in advance of the FDIC's assumption of control.

Regulators bear the burden of protecting the financial system. External auditors, on the other hand, are more concerned with neutrality in financial reporting and operate within the limitations of GAAP and the concept of materiality. Given the differences in the purposes of their examinations and the standards applied, regulators are much more likely to see the need for liquidation analysis than are external auditors.

**Relations Between External Auditors and Regulators**

While external auditors and regulators look at much the same information at the same institutions, they work to different standards in preparing their separate analyses. They are most likely to disagree in critical areas, such as asset valuation and the adequacy of loan-loss reserves, involving subjective judgements. In these areas, different methodologies, assumptions and even the passage of time between audits of financial statements and regulatory examinations can lead to very different results—and very different assessments of the financial health of an institution.

External auditors and their management clients generally view regulators as taking the dimmest possible view of asset quality and reserve adequacy in order to protect themselves from criticism if an institution later encounters difficulties, and they often see the steps taken by regulators to compel remedial action as abrasive, arbitrary and intimidating. For their part, when regulators discover internal control weaknesses or less accepted accounting principles at troubled institutions, they see this as a mark of auditor leniency or lack of independence from management. When differences in critical judgements between regulator and external auditor represent the difference between an institution's continuation as a going concern or not, the regulators take a decidedly dimmer view of the external auditor's performance.
External auditors attribute at least part of the regulator's attitudes to a misunderstanding of the auditor's role and the purposes of audited financial statements. For example, in drafting regulations to implement FDICIA, the FDIC proposed that external auditors perform a variety of tasks outside their area of expertise, including reporting on FDIC assessments and possible criminal activity. Furthermore, the proposed regulation would have governed external auditors' qualifications, peer reviews, and other professional matters already covered by professional standards and by SEC regulations. Regardless of the extent of such misunderstandings, however, it is very hard to explain fundamental disagreement between the regulator and external auditor on the continued viability of an institution.

Obviously such misunderstandings and fundamental differences of judgement would be reduced by more frequent and routine communication between external auditors and regulators. Despite recognition of this fact, past attempts to promote contacts between auditors and U.S. regulators or to pursue joint training and exchanges of personnel have never lasted very long or produced very satisfactory results. The successes have generally been the result of individual auditors or regulators who recognized the desirability of closer cooperation. Recently there has been renewed recognition of the need for better coordination in the United States. In the past two years, the AICPA has called for regular communication between external auditors and bank examiners while the Federal banking agencies have encouraged increased communication, including access to each other's working papers.
4. Regulatory Environment in the United States

In considering how to restore trust and encourage cooperation among bankers, external auditors and regulators, it is important to recognize the scale of the financial upheaval experienced in the United States and the steps being taken to recover from it.

Scale of Financial Losses

Between the near-collapse of the savings and loan (S&L or thrift) industry and unprecedented loan losses by commercial banks, U.S. financial institutions have experienced losses on a scale not seen since the Great Depression of the 1930s. The U.S. thrift industry is finally emerging from a prolonged crisis that will have cost an estimated $150-175 billion in public funds (in present value terms) to protect depositors. As has been widely discussed, this was a slow-motion disaster aided and abetted by errors of judgement by management, outright fraud within the industry, and errors of judgement and policy by government and regulators over more than a decade.

In the midst of the S&L debacle, and in part as a consequence of it, major problems also developed in bank loan portfolios, especially loans in the Southwest, New England and California. As a result, between 1986 and 1993, 1,236 banks with assets of more than $200 billion failed. While bank losses were large, banks were never granted the same flexibility by State legislatures and Congress to pursue the type of speculative activities that were the stock in trade
of the S&Ls. Furthermore, all costs of bank failures were borne by the bank-financed deposit insurance fund rather than by taxpayers. The banking industry has returned to record profitability and capital levels, and the extensive reserves established by banks during 1990 and 1991 in the midst of the crisis are now contributing, in certain instances, to bank profits.

The United States was not alone in confronting severe strains in its financial system during this period. However, the scale of the financial losses suffered and the costs borne by taxpayers were far greater than in other OECD countries. And the legislative and regulatory response in the United States was similarly unparalleled.

**Legislative Response**

With the insolvency of the Federal Savings and Loan Insurance Corporation, the Bush Administration, shortly after taking office in 1989, proposed the creation of a $50 billion facility to resolve the financial crisis in the thrift industry. In response, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). It established the funding facility for thrifts; restructured regulation of the thrift industry; imposed stronger capital requirements and activity limitations like those that apply to banks; and greatly increased enforcement and penalties.

FIRREA established a pattern of extremely close regulatory scrutiny of management decisions. For example, hiring directors and senior officers was subjected to regulatory approval not only at troubled institutions but at any institution chartered or undergoing a change of control within the previous two years. In the area of bank-regulator relations, the confidentiality that had previously applied to administrative enforcement proceedings was removed in favor of public scrutiny, unless publication of such proceedings would seriously threaten the safety and soundness of the institution.

Penalties were also vastly increased. Removal authority by regulators was expanded to reach major shareholders and external auditors and other advisors, and to permit industry-wide disqualification. Administrative penalties were increased a thousand-fold and maximum prison sentences quadrupled. Moreover, penalties applied to a broader range of offenses—including a late, erroneous or misleading Call Report—and to a broader range of parties, including outside advisors.

With funds continuing to pour into the thrift bailout, evidence emerged that the FDIC's bank insurance fund could be rendered
insolvent as well. Under pressure from the General Accounting Office, the FDIC adjusted its balance sheet for "expected losses" with the result that the bank insurance fund projected a negative net worth of roughly $7 billion as of December 31, 1991. In light of these developments, the Bush Administration proposed a $30 billion line of credit from the Treasury to fund the FDIC until industry insurance premiums could restore the insurance fund. To deal with more fundamental weaknesses in the banking system, relaxation of geographic and product limitations on banks was also proposed.

Congress then enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA provided the standby line of credit and greatly increased regulation of financial institutions but did not expand the scope of bank activities. Coming in the wake of FIRREA, the drafting of a second, large "bailout bill" was also a politically charged affair. In many areas, the new law was more a reflection of Congress' and the Administration's desire to be tough than a response to regulators' requests for expanded authority.

FDICIA matched FIRREA's emphasis on enforcement and adopted its approach to mandated, aggressive regulatory action against troubled institutions. But whereas FIRREA had focused on S&L failures, FDICIA rewrote the rules of the regulatory system, reaching into every corner of the relationships between regulators and among regulators, bank management and their external advisers.

In many cases, legislated rules were substituted for regulatory judgement. Federal regulators were given expanded authority over many areas of management decisionmaking, substituting their rulemaking for case-by-case judgement over basic operations. Examiners were given much greater authority over regulated banks and legal penalties and examiner sanctions were dramatically increased, including, for example, the power to bar an external auditor or audit firm from performing services for a particular institution or all institutions upon a showing of "good cause."

In the interest of strengthening internal review of financial management, FDICIA mandated additional reports by the management of larger institutions. These included annual financial statements prepared in accordance with GAAP and a statement of management responsibilities for preparing the financial statements, maintaining internal controls for financial reporting, and complying with designated safety and soundness laws and regulations.

External auditors were in turn directed to attest to management's assertions regarding the effectiveness of internal controls and compliance with safety and soundness laws. External auditors must
report any material weakness in internal controls and any instances of noncompliance with the designated laws. Together with the requirement that audit working papers were to be made freely available to the regulators, there is very little of the formerly confidential auditor-client relationship that is not now open to the regulators. Regulator and external auditor were also drawn more closely together by the requirement that regulatory reporting standards should be "no less stringent than GAAP," which has increased the authority of the Financial Accounting Standards Board (FASB) over all bank reporting.

Regulatory Relief Efforts

The Executive Branch and the Congress have both recognized that the layers of reporting and regulation created by FDICIA have increased risk aversion at every stage of loan review—from the lending officer to the internal auditor to management to the external auditor and finally to the various regulators. This risk aversion increases costs and places deposit-taking intermediaries at a serious competitive disadvantage to other financial institutions.

In 1991, the OCC, FDIC, Federal Reserve and OTS issued a series of policy statements on workout of problem loans, valuation of real estate loans and review and classification of commercial real estate loans intended to ensure that excessive regulation did not inadvertently curtail availability of credit to sound borrowers. The Bush Administration proposed regulatory relief legislation in 1992 but no action was taken on it by Congress prior to the change of Administrations.

As part of this effort, steps have been taken to improve communication between regulators and external auditors, who are being drawn more explicitly into the supervisory process. The Office of Thrift Supervision has assigned an official in each of its regions to meet periodically with groups of accountants to review relevant policies. OTS examiners are encouraged to identify cost-effective opportunities to use the external auditor to accomplish supervisory objectives. These include use of audit work papers and findings in low risk areas; asking the external auditor to perform additional procedures; inviting management and the external auditor to examination planning, interim and exit meetings; and making examination work papers available to the external auditors.

In July 1992, the U.S. regulators issued a joint statement⁸ that sought to encourage full and candid contacts with external auditors
to ensure that they are fully informed of all bank interactions with regulators and all documents provided to regulators by financial institutions. The statement also suggested that, in unusual circumstances, examiners might meet with external auditors "without representation from the institution's management", but this has raised concerns about unnecessary interference by regulators with the auditor-client relationship.

In early 1993 the Clinton Administration announced plans to address the apparent reluctance of banks and thrifts to lend, especially to small and medium-sized businesses. In March, the four supervisory agencies announced an administrative action plan to reduce documentation, encourage character loans, reduce appraisal requirements, streamline the appeals and complaint process, and reduce the burden of the examination process, among other small steps. Additional actions were announced in May and June of 1993, including procedures for returning certain nonaccrual loans to accrual status and procedures for eliminating duplicative exams by the primary regulator and the FDIC, as back-up regulator, and coordinating exams where duplication is required.

In December 1993, the Federal Financial Institutions Examination Council issued an interagency policy statement on loss reserves, including a formula for calculating reserve levels, in an effort to provide an objective standard against which bank management and their external auditors can assess the adequacy of reserves. The new policy represents a guideline rather than a safe harbor; examiners are directed to "view a shortfall relative to this amount as indicating a need to more closely review management's analysis" of its reserve position. Underlining the subjective nature of the judgement, the policy guidance goes on to list a number of variables that management should consider to determine if past loss experience is a reliable guide in setting reserve levels.

These variables include management lending policies, underwriting standards and collection and charge-off practices; national and local economic business conditions; the nature and size of the institution's portfolio; changes in the quality of lending management and staff; trends in the volume and severity of non-performing loans; and the quality of loan review and oversight by the board. Management is also advised to consider credit concentration and the impact of external factors, such as competition and legal or regulatory requirements, on credit losses.

At the same time, the policy statement recognizes the limits of the examiner's ability to assess asset quality and the stronger position
of management to accumulate up-to-date information necessary to accurately estimate losses on specific loans or classes of loans. Therefore, the statement directs examiners to accept management estimates of losses when management has maintained effective systems and controls for monitoring asset quality problems in a timely manner; analyzed the collectibility of the portfolio in a reasonable manner; and established an acceptable loss reserve evaluation process.

While the regulators are continuing efforts to ease regulatory burden administratively, the Administration has not sought legislative relief in this area. However, the Congress has passed regulatory relief legislation that is expected to be signed by the President shortly. While the relief provided will also be modest, the shift toward regulatory easing represents a major shift from legislative attitudes of the recent past.

Among other things, the legislation mandates the coordinated examinations among supervisors being pursued administratively by the Clinton Administration and, within two years, requires a unified examination by a single agency on behalf of all others. Furthermore, duplicative filings among regulators and inconsistent policies or requirements are being eliminated, and more banks are to be eligible for less frequent on-site examinations. Regulatory management standards are being downgraded to guidelines and the agencies will be required to develop a simplified, unified Call Report and to provide for its electronic filing and dissemination to the public. The new legislation also establishes a regulatory appeals process.

The regulatory relief that has been provided thus far has been positive and is encouraging lending. However, the overall impact on financial institutions is still modest and further steps are needed to produce fully cost effective supervision of the U.S. banking system.
5. The Threat of Litigation

Lawsuits by regulators against bankers and external auditors have become so frequent and the claims so large that litigation stands as a major impediment to effective cooperation in the supervisory process. The level of misunderstanding and mistrust has been heightened by fear of aggressive use of regulatory enforcement powers, including the greatly expanded powers given to the regulators in FIRREA and FDICIA. But litigation involving regulators is only one part of a much larger litigation problem facing the accounting profession.

In a joint public statement, the six largest U.S. accounting firms referred to the current situation as an “epidemic of litigation” that “is threatening the independent audit function and the financial reporting system, the strength of U.S. capital markets and the competitiveness of the U.S. economy.” In their view, the current litigation system is totally out of control, forcing “marginally culpable or even innocent defendants” into making settlements under the threat of substantial legal defense costs, particularly in the face of a possible judgement based on joint and several liability that is completely out of proportion to one’s share of fault.

It is not surprising that this is the profession’s view given the fact it is facing more than $30 billion in damage claims. Total annual litigation costs of the six largest accounting firms, before considering the impact of insurance, have risen from $367 million in 1990 to $1,082 million in 1993, three times their level just three years earlier. Thus, the direct costs of settlements, judgements and legal expenses
have risen from 7 percent of accounting and audit revenues in 1990 to nearly 20 percent in 1993—a figure which far exceeds the comparable statistic in virtually every other profession and industry in the United States. The 1993 figures include Ernst & Young’s payment of $400 million but do not yet include Deloitte & Touche’s agreement to pay $312 million to settle all claims of the FDIC, RTC and OTS or the recently announced settlement by KPMG Peat Marwick for $186 million.

Clearly there have been cases of external auditor negligence or wrongdoing and, in those cases, firms should be held accountable. Such accountability encourages renewed vigilance and quality control in audit practice. What is of concern is that frivolous lawsuits or excessive settlements could reduce the number and quality of external auditors available to advise banks at a time when financial institutions are moving into increasingly sophisticated and complex lines of business. It is ultimately in the interest of investors, depositors and the health of the financial system that financial institutions have access to the best possible audits and professional advice.

There is evidence that some accounting firms may be abandoning lines of business that, because of frivolous litigation, are considered too risky. For instance, in May 1993, Ernst & Young indicated its intention to reduce its liability risks by shrinking the number of small bank clients it is willing to service. An analysis in Emerson’s Auditor Change Report covering the two years ended June 30, 1993 estimates that “around 100 auditor changes occurred as a result of Big 6 firms culling (SEC audit) clients they considered too risky from a professional liability standpoint.” Furthermore, with professional liability insurance becoming more costly and difficult to obtain, this trend is likely to grow.

Clearly other firms have stepped in to provide needed audit services. Moreover, the same Auditor Change Report analysis found evidence that for the 100 firms culled by Big 6 firms, the new auditors were “primarily other Big 6 firms.” However, the situation may also be changing. For instance, the January 31, 1994 issue of Public Accounting Report, analyzing SEC auditor change data, indicated that the Big 6 showed a net loss of 81 audits to local and regional firms during calendar 1993. While audit services are therefore available, there is cause for concern over a decline in the availability of audit services from the largest and strongest firms, given the evidence noted above that most SEC enforcement actions have involved smaller firms that did not belong to the AICPA’s SEC Practice Section.

Much of the accounting profession’s complaint goes to the disproportionately large awards and the increasing number of class
action suits being brought under U.S. securities laws in which auditing firms serve as a convenient "deep pocket" from which to recover losses on poor investment decisions. The standard of joint and several liability is particularly problematic in this regard, because it can hold the external auditor and other secondary defendants liable in full even though a judge or jury might otherwise conclude they are responsible for only a small portion of the losses suffered. Added to such large financial stakes is the uncertainty of making one's case before a jury of non-experts who are asked to consider highly technical issues and to decide, once an institutional failure or financial loss has already occurred, whether audit professionals should have foreseen it. Under these circumstances, the vast majority of claims have been settled rather than taken to trial.

The unpredictability of going to trial is illustrated by the outcome of a suit involving Price Waterhouse's audit of the United Bank of Arizona. In that case a jury awarded Standard Chartered plc $338 million in damages. This was the largest jury verdict ever against an external auditor and was 2,400 times the $140,000 annual fee for the audit engagement. But the verdict was overturned by the judge and a new trial ordered because, in the judge's words, "the jury was either hopelessly confused or the verdicts are irreconcilable. Either way, the verdicts cannot stand."

While the liability problem looms large, some limits have begun to be drawn. In March, 1993, the Supreme Court narrowed substantially the exposure of outside advisers to liability under the Racketeer Influenced and Corrupt Practices Act (RICO)\(^ {11} \) by limiting application of the law's extraordinary civil remedies (treble damages and recovery of costs and attorneys' fees) to those who have participated in the operation or management of the institution itself. In April of this year, the Court decided that private civil liability under the Securities and Exchange Act of 1934 for manipulative or deceptive acts in connection with the purchase or sale of securities does not extend to those who aid and abet a violation. While this would appear to relieve most advisors from private claims of civil liability, most suits filed against external auditors allege a broader range of violations and few suits have been dropped as a result of this ruling. Finally, the Supreme Court recently ruled that the FDIC, acting as manager of a failed savings institution, possesses no greater right than the failed institution itself to sue the institution's outside lawyers and external auditors for malpractice.

In an attempt to remedy what they view as the excesses of the system and the tendency to go after any available "deep pockets",

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the auditing profession, together with the high tech community, securities industry and investor groups, have argued for, among other things, a "separate and proportionate" liability standard for allocating damages. Under this standard, the courts would determine each defendant's share of responsibility and each would be liable only for that portion of the award, unless they were found to have knowingly committed fraud. These groups have been pressing the U.S. Congress to establish this principle in Federal securities law and have been advocating an array of other changes, including shifting legal fees to the losing side under certain circumstances.

In its March 1993 report, the Public Oversight Board indicated its support for enactment of a proportionate liability standard in all litigation against accountants in the United States. Furthermore, in a December 1993 letter to the leadership of the Securities Subcommittee of the Senate Banking Committee, a broad coalition of interest groups advocated proportionate liability in the context of litigation pursuant to section 10b of the Securities and Exchange Act of 1934 and implementing rule 10b-5. Legislation to address the liability problem, recently introduced in the U.S. Senate by Senators Dodd and Domenici, would establish a modified proportionate liability standard in this circumstance. Even if Federal law is successfully amended, however, resolving the liability problem will require changes in State laws under which the majority of claims against external auditors have been filed—roughly two-thirds of claims pending at the end of 1992.

Deciding on the appropriate resolution of the liability issue exceeds the mandate of this Study Group. Nonetheless, it is an important issue whose sensible resolution has important implications for the future financial health of the banking system and the economy as a whole. It seems clear that the working relationship among bankers, external auditors and regulators will remain tense as long as a large number of lawsuits and enforcement actions are pending against audit firms, including many of the largest firms. Even a change in liability standards for 10b-5 claims will not affect the litigation brought against external auditors by the regulator.

Consequently, the only avenue for reducing tension is to promote a dialogue between external auditors and regulators aimed at ensuring fair treatment in the future. Only if this is done can external auditors be expected to provide the level of cooperation necessary to the effective working relationship contemplated in the recommendations of this study. For example, external auditors are unlikely to be fully candid about difficult professional judgements in workpapers made
available to regulators if they know that such information is likely to be used against them in subsequent litigation against their firms.
6. Uncertainties of Interpretation

In addition to the other reasons for misunderstanding and lack of communication, there is ample evidence that external auditors and regulators have neither understood nor embraced one another’s methodologies, including the accounting rules used to describe the financial condition of depository institutions. Financial statements used in the financial markets are prepared using Generally Accepted Accounting Principles (GAAP) while regulatory reports are prepared using Regulatory Accounting Principles (RAP) which differ from GAAP in some areas, especially with respect to asset valuation and loan-loss reserve methodologies.

Under the best of circumstances, it would be difficult to develop regulations and accounting principles that are so precise and mechanistic that there would be no debate over their meaning or value. However, this problem is exacerbated by the use of different accounting standards and methodologies. It is difficult for the markets, bank management, external advisors or regulators to fully comprehend or explain the implications of two different statements of financial condition for the same institution—especially if they diverge significantly. The differences become especially problematic when an institution gets into financial difficulty and the differences become the basis for enforcement action against management and external auditors.
GAAP vs RAP

GAAP is a system of reporting rules traditionally used in U.S. public financial reports. GAAP is valuable because it represents the "universal language" of U.S. finance and investment, equally applicable to depository institutions and to insurance and finance companies with which they compete. Financial statements prepared in accordance with GAAP promise both comparability among institutions and consistency over time. New rules are developed through lengthy due process procedures, including exposure by and comment to the Financial Accounting Standards Board (FASB) under the general oversight of the Securities and Exchange Commission.

As discussed in section 3, GAAP is based on the historical cost accounting model. The standards are based on the assumption that, absent serious perceived financial weaknesses, an institution will continue as a going concern for at least the next year. An asset held for the long term is generally carried at its acquisition cost, adjusted only for declines in realizable value that are other than temporary. Assets that are actively traded or held for purposes other than redemption at maturity are valued at current market prices.

As previously discussed, GAAP continues to evolve. Not only is the going concern assumption subject to greater scrutiny where the external auditor finds "substantial doubt" about the entity's ability to continue in existence, but financial statements now must contain increased reporting and footnote disclosure of current values.

Regulatory reporting dates back to the 1860s when institutions were required periodically, at the call of the Comptroller of the Currency, to file and publish statements of financial condition. The process of regulatory reporting has been formalized and become more complex over time and all U.S. depository institutions now provide a Call Report or Thrift Financial Report to their regulators at least quarterly.

While the process of reporting has become more formalized, RAP has not—at least to the same degree. RAP has generally been less specific and less well documented than GAAP, relying on guidance from individual regulators and even examiner opinions rather than a formalized set of written procedures. The need to better document RAP, differences in RAP among regulators and GAAP-RAP differences have been the focus of attention for a number of years and were specifically highlighted in both FIRREA and
FDICIA. Partly as a result, RAP has moved towards GAAP, and RAP differences among regulators are being eliminated.

In their 1993 and 1994 reports to Congress on RAP differences, the regulators have indicated that there are “no material differences” in standards for commercial banks and savings banks, while eight significant differences remain between thrift accounting rules and those for banks. Some of the differences arise from longstanding differences in bank and thrift accounting approaches and some from the statutory provisions of FIRREA relating to phase-out of activities now impermissible for thrift institutions. The continuing process of reporting differences in RAP procedures and the eventual expiration of transitional accounting rules for thrifts in FIRREA are likely to produce continuing convergence among regulators. Convergence between GAAP and RAP is likely through the regulators’ continuing work with FASB and AICPA on new rules and their review of GAAP-based reports.

As a rule, RAP proceeds from the same set of assumptions as GAAP regarding historical cost accounting for assets held for the long term and market valuation of others. However, there are three areas of difference between the conclusions of a regulatory analysis prepared pursuant to RAP and a GAAP-based financial statement: differences in accounting rules; differences in interpretation under the rules; and regulatory capital requirements.

- **Differences in Rules.** The regulatory agencies have undertaken a number of assessments of the differences between GAAP and RAP in recent years. A recent staff assessment identified 9 cases in which RAP differs from GAAP; 9 cases in which RAP is consistent with one or more options available under GAAP; and 4 cases in which a treatment prescribed under RAP is not specifically addressed by GAAP. While GAAP-RAP differences have narrowed in some areas, they remain in areas such as sale of loans with recourse, deferral of gains and losses on futures and forwards contracts, nonaccrual treatment of loans, and treatment of intangibles. Given the mandate of regulators to maintain reporting requirements “no less stringent” than GAAP, differences will likely become fewer but “a few limited exceptions” are likely to continue.

- **Differences in interpretation.** Even applying GAAP, significant differences in valuation can result depending on the economic assumptions used. As previously discussed, bank examiners have tended to take a more skeptical view than have external
auditors of institutions and assets that the examiners believe are in questionable financial condition. Significant divergence of asset and capital values does emerge when assets valued at historical cost under GAAP are treated as questionable, and particularly if they are marked to liquidation value.

- **Regulatory Capital Requirements.** Banks and thrifts are required to maintain capital at or above a minimum percentage of total risk-weighted assets; under the Basle standards, the minimum level is 8 percent. Regulatory capital is not a GAAP concept and therefore GAAP-based reports do not encompass these calculations.

Regulatory capital is composed of Tier 1 and Tier 2 capital. Tier 1, which consists of equity and retained earnings, is referred to as "core capital" and is subject to its own minimum requirement (4 percent under the Basle standards). It differs from Stockholders Equity, as defined under GAAP, in six areas:

- cumulative preferred stock is excluded from Tier 1 capital;

- unrealized gains and losses on available-for-sale securities are excluded from total capital;

- investments in unconsolidated banking and finance subsidiaries are deducted from total capital for purposes of calculating capital ratios, and investments in other subsidiaries and associated companies may be deducted on a case-by-case basis;

- intangibles other than purchased mortgage servicing rights and credit card intangibles are excluded from capital and those included are subject to overall percentage limitations;

- agricultural loan losses are deferred and amortized over 7 years, as required by statute, although no new losses may be deferred; and

- a limitation on deferred tax assets is proposed.

Tier 2 capital, which includes non-equity forms of capital, is sometimes referred to as supplementary capital. It consists of subordinated debt and intermediate-term preferred stock (with an original maturity of more than five years); cumulative and long-term preferred stock (with original average maturity of more than 20 years); various hybrid instruments; and the
allowance for loan and lease losses (excluding reserves against specific assets) subject to the limitation of 1.25 percent of total risk-weighted assets.

Because these are not GAAP concepts, even if Call Reports and TFRs were prepared completely in accordance with GAAP, further adjustments would be required to determine a bank's regulatory capital position. These adjustments could have profound implications for an institution's ability to continue operations without regulatory intervention under the Prompt Corrective Action regime created in FDICIA.

**Market Value Accounting**

A challenge to both GAAP and RAP is accurately accounting for financial value in times of economic turbulence and rapid financial innovation. This has been a recurring problem during the last twenty years. Economic developments (e.g., high inflation, interest rate and exchange rate swings, and asset price deflation) and the rapid development of new financial products and activities (e.g., derivatives) have tended to outpace the development of accounting rules.

Given the rapid growth of the derivatives market, both FASB and the SEC have indicated support for improved disclosure of derivatives exposures. FASB is now engaged in two projects related to derivatives: one on derivatives disclosure rules, intended to become effective in 1995, and a larger project on financial instruments.

The natural lag that occurs in any rulemaking process is accentuated in the case of accounting rules by the careful and deliberate approach of the profession to new rulemaking.

The accounting profession, acting through FASB and other bodies, achieves a consensus about best reporting practices for all public companies and, based on that consensus, adopts new or modified GAAP reporting standards. This is a very slow process. To keep pace with rapid changes in the meantime, banks and external auditors have developed interpretations of, or analogies based on, current rules to fit new types of transactions. In this process, further GAAP-RAP differences emerge as the regulators adopt, modify or ignore new GAAP rules or evolve their own interpretations or analogies.

Given this rapid pace of change, and the failure of external auditors and regulators to have caught problems at some financial
institutions in a timely fashion, a debate has ensued over whether the assumptions of GAAP reporting are sufficient for the situation of financial institutions. Is a snapshot of an institution’s past performance and current financial position most relevant in assessing the future prospects of the business, or would the current market value of an institution’s entire portfolio of assets and liabilities be a better measure?

Calls for market value accounting (MVA) have increased since the S&L crisis. It has been argued that the declining value of assets on the books of many S&Ls would have been visible much sooner if market values had been used during the 1970s and 1980s. Had their loss of value not been disguised by historic accounting, management would have been forced to respond to declining net worth and regulators would have been forced to recognize sooner declines in regulatory capital. More timely action would have prevented the accumulation of losses, thus reducing the scale of the ultimate bailout.

The GAO, the SEC and the academic community have been in the forefront of the debate regarding the use of market value accounting. They argue that this system would capture declining asset values, off-balance sheet activity and the impact of interest rate volatility and other market risk in a single snapshot. This single measure would improve the comparability of financial data. In the case of traditional assets, current market valuation would be helpful in two areas: assessment of credit quality and valuation of problem assets. Disclosure of non-traditional and off-balance sheet activities—securitization, derivatives, mutual funds, commercial paper—would also be improved by a comprehensive market valuation approach. Such disclosure is increasingly important as there has been rapid growth in these areas.

The case for historical cost accounting is made by bank regulatory agencies and most depository institutions. This methodology was adopted during the Depression at the urging of the Treasury Department to encourage stability in the financial sector. Proponents argue that banks hold traditional assets for the long term and that the market and depositors expect steady and predictable asset values, return on assets and capital levels. MVA would increase volatility in reported earnings and capital based on interest rate fluctuations, thereby weakening confidence in financial institutions.

The shift to MVA might also encourage bank management to shift away from long-term investments held to maturity, and significantly shorten the maturity of investments to minimize market
risks. This would reduce the availability of longer-term credit. The cost and reporting burden of MVA would also be significant. Finally, even if MVA had no other drawbacks, the values would be highly subjective because market values are known with certainty only at the time of purchase or sale and reliable estimates are not available for many instruments (such as loans) at other times. Since valuation approaches and assumptions would vary across institutions, the financial statements produced would not be readily comparable.

Furthermore, the United States is already ahead of other countries in exploring use of market value accounting; if it adopted this approach comprehensively, it would be alone among national banking systems. While there are differences in national approaches to accounting now, so dramatic a change would have uncertain consequences for the international competitiveness of U.S. banks and for international cooperation on bank supervision. For instance, application of the capital standards adopted by the Basle Committee would have to be reevaluated in light of this very different approach to bank accounting.

The AICPA’s Special Committee on Financial Reporting (known as the Jenkins Committee) noted that surveys of industry users of financial information have indicated opposition to replacing the historical cost model with one based on fair market value. Reasons cited were the subjectivity and volatility of the information and estimation of costs versus benefits.

Notwithstanding the reluctance of financial institutions and the regulators, there has been a steady movement toward greater market value disclosure in recent years—principally in the form of supplemental information. For instance, FDICIA requires Federal regulators to develop a method for insured depository institutions to provide supplemental disclosure of the estimated fair market value of assets and liabilities, to the extent feasible and practicable, in reports to regulators.

In December 1992, Financial Accounting Standard or FAS 107 amended GAAP rules to require all entities (not just financial institutions) above $150 million in total assets to disclose the fair value of all financial instruments. Market value is to be disclosed to the extent practicable. If estimating fair value is not practical, descriptive information relating to the value of an instrument must be provided. If estimation is possible, instruments are to be placed in two groups—those with quoted market prices, which is the preferred value, and those without quoted prices for which various estimation techniques are to be used.
The regulators have also adopted the FAS 107 approach for use in Call Reports and other reports submitted to them. Moreover, in May 1993, the Federal Financial Institutions Examination Council published a proposed approach to market value accounting for comment, but no final action has been taken by the regulators.

While the popularity of market values is growing, their reliability remains uncertain. A study conducted by KPMG Peat Marwick showed wide variances in fair value estimates. For residential mortgages and exchange-traded instruments with an active secondary market and where no subjective estimation was needed, test values varied from under 2 to 5 percent. On the other hand, for many traditional loans that required subjective estimation, fair value estimates diverged by from 3.5 percent for good quality loans to more than 30 percent for poor quality loans.

In its March 1993 report, the Public Oversight Board recommended that FASB place on its agenda a project to study comprehensively the possibility of requiring the reporting of values and changes in values rather than historical transaction prices. The recommendation does not prejudge the outcome, but argues that the accounting profession must respond to criticism of the present accounting methodology by deciding to change it or by explaining publicly why a change in accounting standards is impractical or inappropriate.

A period of experimentation is now underway with market value accounting. Despite some gaps and areas of subjectivity, the markets will soon begin to compare the current market value of a bank's assets to their historical costs and assess which is the more reliable measure. At the very least, reporting estimated market values for poor quality loans may serve as a "stress test" of bank portfolios, although it would still not reflect liquidation values. This type of disclosure would help to protect against the excessively positive valuations of troubled institutions that have occurred in the past. However, as noted above, the reliability of such valuation remains uncertain.
7. Recommendations

The recommendations that follow are intended to improve the cost-effectiveness of the U.S. regulatory system by improving performance of accountants, bankers and regulators; eliminating unnecessary overlap; and reducing mistrust. They include recommendations for actions by management and the accounting profession, administrative changes by the regulators and, where necessary, changes in U.S. law.

Improving Performance

If the financial problems of the recent past are to be avoided in the future, it is vital that management, external auditors and regulators sharpen their ability to detect, report and remedy declining asset quality in a timely manner. Reporting and regulatory systems that failed to keep pace with economic and market developments in the 1980s will face far greater risk management and reporting challenges in the rapidly evolving markets of the 1990s.

While management, external auditors and regulators are pursuing different mandates and priorities, it is important that there be basic agreement on the fundamental conclusions of their analysis. Experience in other countries demonstrates the benefits of a more cooperative and collaborative approach among the three parties. In the interest of better, more reliable financial reporting, these lessons should be applied in the United States. To keep pace with the increasing sophistication of the marketplace, management must upgrade its risk management capabilities; accounting standards must evolve
quickly; and external auditors and regulators must improve their understanding of increasingly complex financial institutions and instruments.

- **In order to achieve a common assessment of asset valuation and the adequacy of loan-loss reserves among bank management, external auditors and regulators, the three parties should work together to reconcile differences in the methodology and assumptions applied to their analysis.** Management judgements regarding asset valuation and loan-loss reserve levels are critical to the financial health of depository institutions. However, they are subjective in nature and depend importantly on economic and other assumptions. The results of external reviews by external auditors and regulators could differ from management’s judgements and from each other because of differences in key assumptions as well as differences in the methodology applied and timing of their respective analyses. In order to achieve a common view on valuation questions, bank management should disclose key judgements and assumptions made in its analysis. External auditors and regulators should work with bank management and with each other to reconcile differences in assumptions and methodologies in order to reach a common understanding of the financial condition of an institution.

- **The independent audit committee should encourage interaction among the regulators, external auditors and bank management as part of its oversight of financial reporting.** Results of external audits and bank examinations should be presented to the audit committee in the presence of both the external auditor and the regulator with each invited to participate in discussion of the other’s work with bank management. Engaging the parties in discussion and debate on areas of disagreement should produce more reliable conclusions over time.

- **Regulators and external auditors should expand working level contacts and cooperation.** Regulators and the accounting profession discuss issues at senior policy levels but there is relatively little interaction at the working level in individual financial institutions. Audit workpapers are now available to regulators but examiners have to justify their use. Final examination reports are available to external auditors but not examination workpapers. A closer working relationship should be established between external auditors and regulators.
Examiners should routinely make use of audit workpapers, relying on the external auditor’s analysis wherever possible and appropriate. External auditors should likewise have access to examination workpapers and utilize the examiner’s analysis. In all cases, appropriate standards of confidentiality must be established and maintained.

- **Management should ensure that risk management systems keep pace with financial innovation and regulators should encourage this process.** Improving management of portfolio risk should be an ongoing process in any bank and the subject of careful review by the audit committee. In many large banks involved in derivatives and other non-traditional activities, a separate risk management function and sophisticated, computer-based risk models are already the norm. For smaller institutions, this means greater attention to credit and other risks on a regular basis. Institutions should invest in the system improvements and personnel necessary to ensure that this important function is performed effectively. Superior risk management capabilities should be recognized by the regulators.

- **To keep pace with the challenge of auditing financial institutions, better training is required for external auditors and regulators.** The pace of change in the financial sector and the development of new products and services have been very rapid. Financial instruments are becoming more complex as are the systems for modeling and tracking risk. The accounting profession and the regulators must pursue, as a matter of high priority, continuing education for external auditors and examiners to ensure that their analytical skills keep abreast of these developments.

- **All financial reporting should be based on GAAP accounting rules.** Because U.S. law now defines GAAP as the minimum regulatory reporting standard, the regulators should explicitly adopt GAAP as the basis for regulatory financial reports. RAP differences between the banking agencies and OTS should be eliminated as soon as possible and RAP-GAAP differences should be reduced to an absolute minimum. In the case of regulatory capital requirements or where additional information or tougher reporting standards are essential to meet regulatory objectives, these additional RAP requirements should consist of a series of well defined, well publicized and understandable adjustments to GAAP reports.
• **GAAP must keep pace with the rapid pace of innovation in financial institutions and instruments.** The FASB should complete its project on the recognition and measurement of financial instruments and develop a process to stay current on continuing changes in such instruments as a matter of the highest priority.

**Eliminating Unnecessary Overlap**

Bank officers and directors, their external auditors and regulatory agencies focus on the same financial data and, to varying degrees, make judgements on the same issues. While a certain amount of double-checking can be useful, counterproductive overlap now exists that indisputably increases costs. Duplicative external reviews of management actions should be minimized and duplicate regulatory examinations eliminated. In the interest of economy and efficiency, the roles and competencies of management, including the audit committee, the external auditor and the regulator should be recognized and used to full advantage.

• **Duplicate regulatory examinations should be eliminated.** Coordination of examinations among primary Federal regulators, State regulators and the FDIC is welcome but duplicate exams should be eliminated completely. Normal regulatory review should be limited to a single examination, coordinated among the various regulatory agencies, in any relevant time period. To that end, all regulators should adopt comparable standards and procedures for conducting examinations.

• **Basic management standards and procedures should not be dictated by regulators.** Required standards for loan documentation, credit underwriting, asset growth, interest rate exposure, classified asset ratios, internal controls, minimum earnings, compensation limits and information systems under FDICIA should be downgraded to guidelines or eliminated all together.

• **Division of labor.** While it is beyond the capacity of this Study Group to specify a division of labor, the accounting profession and the regulators should jointly identify areas for reliance on one another’s work and eliminate duplicative analysis. In pursuing this objective, the relative skills of external auditors and examiners should be a key determinant of the division of labor. A first step has already been taken in the area of internal
controls as a result of the external auditor's report mandated by FDICIA. Another area for consideration would be complex computer systems and risk models. As confidence grows, additional areas for mutual reliance could be identified.

Reducing Mistrust

While there were many causes for the financial problems of the last decade, some of the problems addressed in this report are attributable to lack of trust, lack of understanding and failure of communication among the multiple regulatory agencies, industry associations and professional bodies directly concerned with the health and soundness of the U.S. banking system. In part, these deficiencies will be remedied by the closer, more cooperative working relationship among management, external auditors and regulators at individual institutions that has been proposed above. However, dispelling mistrust will require more than communication about broad policy issues of common interest at senior levels.

The judgements of external auditors must be seen as truly independent. On the other hand, individual auditors need to believe their good faith judgements will not be subjected to enforcement actions simply because subsequent events require modification of those judgements.

• If external auditors are to enjoy the full confidence of the markets, the public and regulators, their independence of judgement must be unquestioned.

—External auditors must actively engage the board, or audit committee, in considering problems that arise in the conduct of their audits. Both the Treadway Commission and the Cadbury Committee stressed the importance of an active and independent board to the integrity of the financial reporting process, and FDICIA directed every institution over $500 million in assets to have an audit committee composed entirely of outside directors who are independent of the institution. The surest way to underscore the independence of auditor judgements is to ensure active discussion and review at the board level.

—An engagement time limit should apply to the engagement partner on the audits of all depository institutions. The SEC Practice Section of the AICPA requires that the
engagement partner on the audit of an SEC registrant (and certain other public entities) be rotated at least every 7 years and that a partner with no significant involvement in the audit undertake a second review of such engagements prior to issuance of the audit report. The AICPA’s 7-year limit and review requirement should be applied to all depository institutions, not just to SEC registrants. The same principle should perhaps be extended to the assignment of regulatory examiners to individual institutions.

—Existing conflict of interest guidelines should be strengthened. A “cooling off period” of one year should be imposed before a partner or manager engaged in auditing a specific bank client can assume a position with that client.

- **As a more collaborative relationship is achieved between external auditors and regulators, enforcement policy should take account of this collaboration. New enforcement policies should be developed through a process of notice and comment.** If, as suggested in these recommendations, regulators and external auditors work toward a common understanding of asset values, achieve a division of labor and come to rely on one another’s work, this should be reflected in enforcement policy. No enforcement actions should be taken against external auditors based on the work product that results from their collaboration absent evidence that the work was performed fraudulently or recklessly. Furthermore, all developments in enforcement policy should be clearly explained and widely publicized, even if they arise within the context of individual enforcement actions or negotiations. Enforcement standards should be developed pursuant to the notice and comment rulemaking procedures of the Administrative Procedures Act, to the extent possible, and in consultation with appropriate professional organizations.

- **Cross-disciplinary training should be instituted between external auditors and regulatory examiners.** External auditors should be trained about the duties, methods and expectations of bank examiners. Examiners should be trained in what is and is not appropriately expected from a financial audit. More opportunities should be pursued for secondment of personnel between regulatory agencies and accounting firms.

- **Regulatory oversight of external auditors should be exercised carefully and fairly to foster cooperation.** Before any disciplinary
referral or action is taken by a regulator, provision should be made for professional accounting review within the agency, including consultation with the agency’s chief accountant, and for discussions with the auditing firm.

- **A permanent board should be established consisting of representatives of each of the federal bank regulatory agencies, the SEC, the accounting profession and the banking industry.** The AICPA Banking Committee is a good starting point for this. Its mission would be to recommend improvements in the relationship between regulators and external auditors. Its responsibilities would include:

  — Recommending areas in which external auditors and regulators could rely on one another’s work and achieving consensus on the specific terms and conditions of any such division of labor;

  — Reviewing regulatory enforcement issues with a view toward encouraging a more open and public process of formulating and implementing enforcement policy; and

  — Identifying areas in which external auditors and regulators require training to keep pace with the evolution of financial institutions and instruments and cross-training to understand better the objectives and procedures of the other.
Endnotes

1 The Fédération des Experts Comptables Européens (FEE) is the trade association for the accounting profession in Europe. Its Banks Working Party conducted a survey of current developments and trends in the involvement of the external auditor in prudential control of banks by supervisory authorities in Austria, Belgium, Denmark, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, Spain, Switzerland and the United Kingdom.

2 The Basle Committee on Banking Supervision is a committee of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It was formed by the central bank governors of the Group of Ten countries in 1975 to address supervisory issues of importance to the international banking system and usually meets at the Bank for International Settlements in Basle, Switzerland.

3 The National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, was a private-sector initiative chaired by James C. Treadway, Jr., former SEC Commissioner. The Commission, which issued its report in October 1987, was sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants.

4 The Public Oversight Board is an independent board that was created in 1977 by the American Institute of Certified Public Accountants to oversee and report on its Peer Review Program for firms that audit publicly held entities. It is administered by the SEC Practice Section.

5 The Committee on the Financial Aspects of Corporate Governance, known as the Cadbury Committee, was established in 1991 under the chairmanship of Sir Adrian Cadbury by the London Stock Exchange, Financial Reporting Council and the accounting profession. Its terms of reference called for a review of issues related to financial reporting and accountability with recommendations on good practice, including the reporting responsibilities of executive and non-executive directors and the form and frequency of reports; the role and composition of audit committees of the board; the responsibilities of external auditors; and the links between shareholders, boards, and external auditors.
Gonson, Paul and John W. Avery, "Practicing Securities Law: A Search for Uniformity of Professional Standards". Reforming Legal Ethics in a Regulated Environment, American Law Institute-American Bar Association, August 1994. A reporting company is required to file a disclosure with the SEC in the event of the resignation or dismissal of an external auditor; to inform the auditor of the reasons stated in its disclosure; and to solicit a letter from the auditor to the Commission indicating whether it agrees with those disclosures and the basis for any disagreement.

See the joint statement issued in 1989 by the International Auditing Practices Committee of the International Federation of Accountants as well as statements by the BIS.

Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.


Statement issued on August 6, 1992 by Mr. Lawrence A. Weinbach, Managing Partner - Chief Executive of Arthur Andersen & Co.; Mr. Eugene M. Freedman, Chairman of Coopers & Lybrand; Mr. J. Michael Cook, Chairman and Chief Executive Officer of Deloitte & Touche; Mr. Ray J. Groves, Chairman of Ernst & Young; Mr. Jon C. Madonna, Chairman and Chief Executive of KPMG Peat Marwick; and Mr. Shaun F. O'Malley, Chairman and Senior Partner of Price Waterhouse.

In Reves v. Ernst & Young, the Court ruled that, in order to be subject to the extraordinary civil remedies available under RICO, a defendant must have participated in the operation or management of the institution itself. Thus, an audit firm that conducts an audit and issues a report on an institution's financial statements should generally be excluded from the law's reach in the future.

The coalition included the American Business Conference, American Electronics Association, American Institute of Certified Public Accountants, Association of Publicly Traded Companies, Electronic Industries Association, Information Technology Association of America, National Association of Manufacturers, National Investor Relations Institute, National Venture Capital Association and the NASDAQ Stock Market.
FASB Statement No. 107, Disclosures about Fair Values of Financial Instruments, requires all entities to disclose the fair value of financial instruments, both assets and liabilities, for which it is practicable to estimate fair values. Estimation is considered practicable if it can be accomplished without incurring "excessive costs".

The Federal Financial Institutions Examination Council, an interagency body that prescribes uniform principles, standards and report forms for the federal examination of financial institutions, consists of the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, a member of the Board of Governors of the Federal Reserve System, the Chairman of the National Credit Union Administration Board, and the Director of the Office of Thrift Supervision. Their proposal on fair values, developed by the four federal banking agencies, calls for supplemental disclosure of: financial instruments, in accordance with FAS 107, and nonfinancial assets and liabilities, as unaudited supplements to annual financial statements using the concepts and principles set forth in FAS 107.

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