

Enron et al: Market Forces in Disarray

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Douglas Flint · Trevor Harris
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Group of Thirty, Washington, DC



Occasional Paper 66

This Occasional Paper is the product of a discussion at a meeting of the Group of Thirty in Madrid, Spain hosted by the Banco de España in May, 2002. The views expressed are those of the presenters alone and do not represent the views of the Group of Thirty. Copies of this report are available for \$20 from:

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Occasional Papers
No. 66

**Enron et al:
Market Forces in Disarray**

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*Published by
Group of Thirty®
Washington, DC
2002*

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Foreword

Fair and honest accounts, and the market discipline that factual reporting of financial results should bring with it, are fundamental to the effective operation of a market economy. The strong attachment to Generally Accepted Accounting Principles in the United States and the drive for a single set of internationally accepted accounting standards underscore this point. But consistent standards are worth little if not fairly and accurately applied.

Today's financial news features a seemingly endless barrage of stories about firms restating profits, artificially embellishing revenues and creating obscure "special purpose vehicles" conveniently off their balance sheets. The apparent weakening of auditing discipline over the past decade has been paralleled, not entirely coincidentally, by two developments: a growing fascination in the markets for high flying "new economy" companies whose valuations bore no relation to current profitability; and an increased emphasis within the big accounting firms themselves on marketing a variety of non-auditing services to their audit clients. The former development made markets indifferent to the value of sound accounting and auditing; the latter has risked loss of focus and discipline in the auditing process itself. Together they place at risk the central mission of the accounting profession to serve the investing public.

A hopeful sign is that recent revelations of accounting irregularities have begun to generate change in the marketplace. Directors and

audit committees at public companies have become more sensitive to auditor conflicts and the implications of “aggressive” accounting practices. Chief executive officers and their chief financial officers have been put on notice that they should not expect to escape responsibility for lapses in financial controls and reporting. The accounting firms themselves are surely motivated to review their internal procedures and they have responded to client concerns by shedding some consulting services, particularly information systems work.

These are positive developments but they offer scant comfort as accounting scandals continue to surface, and on an increasing scale. What looked like misrepresentation on a massive scale in the Enron case is no longer extraordinary after the WorldCom restatement. The challenge will be to ensure that reformist zeal continues once Enron, Global Crossing, Xerox, WorldCom and other scandals are no longer dominating the financial news.

As we consider how to restore a strong sense of confidence out of the present uncertainty, it is important to maintain focus on the fundamental mission of the accounting profession. The professional responsibility of the auditor – the responsibility that justifies an exclusive license to perform the required audit of public companies – is to attest to the “fairness” and accuracy of a client’s financial reports to the investing public. Our goal must be to ensure adequate support for that essential mission. One element of the solution must be the willingness of clients to pay fees commensurate with this responsibility and with attracting the auditing talent required; but official support, including truly effective oversight, will almost certainly be needed.

It was these fundamental concerns about the future of the accounting profession that motivated the Group of Thirty to examine the present crisis at a plenary meeting hosted by Governor Jaime Caruana and the Banco de España in May, 2002. The Group of Thirty invited recognized private experts in the field of financial reporting together with senior public officials with responsibility in this area to explore the challenges posed by failures of financial reporting.

We would like to express the appreciation of the Group for their hospitality, and for the insights offered by all those whose presentations are included in this volume. Our members were sufficiently concerned about what they heard that it was decided to publish the presentations

so that this information could be more widely shared. Although some of the information provided is rather disturbing, our purpose is not to alarm but to better inform the present debate. And although it focused on Enron, the lessons are certainly relevant to today's news.

Accounting and auditing reforms are a matter of urgency and meaningful action is needed to resolve the current accounting crisis. If we do not accept this challenge, we risk more than the demise of Enron, Arthur Andersen or WorldCom. We place at risk a fundamental underpinning of our market economy.

PAUL A. VOLCKER
Chairman of the Trustees
Group of Thirty

JACOB A. FRENKEL
Chairman
Group of Thirty

Overview of the Issues

Presentation by Andrew Crockett

Introduction

“Enron” is shorthand for a set of issues that have been pushed to the top of the policy agenda by the recent wave of corporate failures and downgrades, in the United States and elsewhere. These have revealed weaknesses in accounting, auditing, corporate governance and market oversight. This overview addresses five questions:

- i What background factors allowed the emergence of the practices that led to these weaknesses?
- ii How systemically significant was Enron?
- iii What are the specific weaknesses that need to be addressed?
- iv What responses are called for?
- v Who should take responsibility for the required measures?

The background factors

There are at least three trends that have contributed to the development of some of the accounting and disclosure problems revealed by recent corporate failures:

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- The increasing complexity of financial instruments and structures. Financial engineering has produced financial contracts with complex, non-linear payoff structures, and difficult-to-understand risk characteristics. Such contracts are often valued on the basis of models developed by their originators. There has been, in addition, a proliferation in the use of special purpose vehicles and financing techniques to transfer risk among entities within the same group. All these devices have made it harder to “see through” corporate accounts, and indeed sometimes this is their purpose.
- The long bull market of the 1990s. So long as prices are rising, and everyone is getting rich, at least on paper, there is a strong incentive not to call for a stricter dental examination of the gift horse. It is much easier to overlook lax standards of financial information if they do not prevent, and may even promote, the inflation of asset prices. Moreover, rising prices induce a search for leverage to further increase gains. These feed back into the search for new instruments to deliver additional leverage.
- The evolving role of the equity market. Equity values have become the currency for rewarding not just entrepreneurship, but also labour and capital. Stock options have become increasingly widespread as a means of incentivising management and compensating employees. Enron showed that equity values could also be used to support off-balance-sheet subsidiaries. And equity market valuation has become the currency of corporate survival. In the Darwinism of the business world, rising equity values lead to survival and growth, falling values to takeover. It is therefore little surprise that managers of enterprises focus on measures that tend to promote the short-term strength of equity valuations.

How systemically significant was Enron?

Some have argued that Enron did not lead to serial failures of counterparties, and did not provoke major disruptions in the markets in which it was active. In this sense, the “system” proved resilient and therefore Enron should not be seen as systemically significant.

However, there are several reasons for regarding the systemic implications of this episode as very large indeed: First of all, Enron is emblematic of problems that have caused or contributed to a number of other corporate failures or downgrades (Global Crossing, Tyco, Marconi, Xerox, Kirch, etc.). The cumulative losses of market capitalisation

have been huge. Further, the accounting and other practices that contributed to the Enron debacle have now become quite widespread. Nor are they confined to the United States. No country is in a position to say “it couldn’t happen here”. Finally, there has been an erosion of confidence in the information and oversight mechanisms that underpin the integrity of financial markets. If not dealt with, this will generate: (a) a misallocation of capital; and (b) an increase in the average cost of capital. The conclusion is that the costs of the weaknesses in market infrastructure illustrated by the Enron episode could easily surpass those of more conventional financial “crises”.

Specific weaknesses

Failures of corporate governance

Several levels of corporate governance appear to have been ineffective. The Enron Board seems to have been insufficiently independent of management and to have been unaware of, or misunderstood, key activities of the company. Its audit committee appears to have been inattentive to a number of questionable accounting practices. Even the chief executive claims not to have been informed about critical accounting policies. Moreover, the organization’s internal code of conduct seems to have been disregarded. Lying behind all this is a corporate culture which, while superficially stressing ethics, placed excessive weight on the maximization of short-term accounting earnings and boosting option values through rising equity valuations.

Weaknesses in external control mechanisms

The audit process is supposed to provide shareholders and other external users of company accounts with an independent opinion as to whether the financial statements give a fair view of the company’s financial condition. In the case of Enron, it did not. It seems as though the risk and reward structure facing Enron’s external auditors aligned their interests more closely with those of management than with those of the owners of the company.

The accounting principles applied and Enron’s public disclosures were also a source of weakness. A first problem was allowing the deconsolidation of special purpose entities whose risks and rewards were largely borne by the parent company. (These would have been true even if Enron had always observed the 3% external ownership

threshold for deconsolidation — which it did not). A second problematic aspect was the ease with which accounting rules allowed a future stream of income to be discounted into the current period profit, even when such income was quite uncertain. And finally, stock options were used to reward management and underwrite the obligations of non-consolidated subsidiaries, without affecting the income statement.

Failures of market oversight

It is expected that counterparties, creditors and shareholders will have the ability to “see through” a company’s accounts enabling its financial condition to be fairly reflected in the price of the securities it has issued. This was not the case with Enron. Counterparties and creditors seemingly lent without asking the right questions. Many of them apparently enjoyed profitable involvement in the establishment of the numerous Enron SPEs and in other transactions. Analysts and rating agencies also failed to spot looming trouble until a very late stage. Weaknesses existed in the quality, timeliness and relevance of information made available to the market, as well as in the ability and incentive for market participants to make use of it.

Market dynamics

In the endgame of Enron, it became apparent that there was a self-fulfilling prophecy element to external assessments of Enron’s creditworthiness. Enron depended on retaining an investment grade in order to make its borrowing sustainable. This feature of debt contracts, which is by now quite common, meant that a downgrade of the company’s debt would arguably precipitate its demise.

More generally, recent corporate failures revealed that at almost every level of governance there have been actual or potential conflicts of interest, and a failure to make available or utilise necessary information.

What responses are called for?

A first point to stress is the need to avoid rushing to judgement. Since many of the issues that are now being discussed are complex, they are not necessarily amenable to simple solutions. Remedial measures may have unintended consequences that need to be thought about before implementation.

Corporate governance

The responsibilities of Boards and their subcommittees (especially the audit committee) need to be made clear. Boards need members with the requisite expertise to fulfil their functions, and the authority, capacity and independence to demand necessary information from management. Directors also need to have the proper incentives to perform their fiduciary duties on behalf of shareholders (i.e. penalties for negligence need to be clear and appropriate).

Auditing reforms

In most of the major recent corporate failures and downgrades, there have—so far—been few claims that the auditors' technical competence was insufficient. Instead, the key issue has been auditor independence. There have been several proposals aimed at strengthening auditors' independence. One concerns audit firms' consulting activities, often provided to audit clients on the basis of cross selling. From the auditor independence perspective, the concern is that this may increase auditors' economic dependency on the client, and that auditors may, to some extent, find themselves auditing their own work. Some believe that the range of consulting activities that audit firms should be permitted to sell to audit clients should be limited, while others believe that audit firms should not be permitted to sell consulting services to audit clients at all. Still others believe that audit firms should entirely exit the consulting market.

A different proposal to strengthen auditor independence is mandatory rotation of audit firms. One reason given for this is that an audit firm that has made errors may be reluctant to later acknowledge them. A second reason is that a new firm may bring a fresh perspective and be more effective in identifying problems.

Another key issue is the question of oversight of the profession. Some more formal mechanisms of oversight of audit firms may be needed to ensure the maintenance of high standards in the audits of public companies.

Lastly, there is the issue of concentration in the audit profession. It is likely that there will soon be only four audit firms with a global practice. This is widely believed to be too few. How should such an oligopoly situation be dealt with?

Accounting standards

Recent lapses have revealed the shortcomings of excessive precision in accounting standards. Precise rules encourage the mindset of observing their letter rather than their spirit. They lead auditors to ask the question “is it permissible under the rules?”, rather than “does it present a true and fair value of the underlying economic reality?” Thus, it seems appropriate that accounting standards move towards a principles-based, and away from a rules-based, approach. There now seems to be a surprising amount of agreement on this point.

Three specific areas require priority consideration.

- The treatment of options. It seems hard to justify the present approach of not counting share-based payments as an expense in arriving at profits, particularly if they are deductible for tax purposes.
- Consolidation/deconsolidation. Enron showed that present guidelines for when subsidiaries or special purpose vehicles can be taken off the balance sheet of the parent entity are unsatisfactory. Entities should clearly be consolidated if in substance they are subsidiaries.
- Full fair value accounting and income recognition. Fair value or mark-to-market accounting is laudable in principle but raises important questions, including the risk of abuses. For example, companies (like Enron) may discount very long-term streams of estimated income into the present, using proprietary models, and add the resultant calculation to current year’s profit. More generally, some qualification is needed when fair value is calculated on a model basis, or when the market from which prices are drawn is thin and illiquid.

Market oversight

Updated guidelines are needed to cover the duties and obligations of other market participants. Lending institutions should exercise greater diligence in the monitoring of loans, stock analysts have to have the right information and incentives to exercise independent judgement, and rating agencies need to be able to exercise impartial and timely judgements.

Who should do what?

The foregoing is a major set of reforms to current mechanisms for accounting, auditing, corporate governance, and market oversight. Who should undertake the task of carrying it into effect? Rather than catalogue specific responsibilities, it may be better at this stage to signal a few generic issues.

- The relative roles of market discipline and regulation. Markets have already begun to react to, and correct, some of the lapses revealed by the Enron episode. It will be important to decide which matters can be left to the selfcorrective forces of the market, and which could benefit from, or require, supporting regulation or legislative action. Regulation may be necessary for some purposes, but it is well to recognise that, wrongly used, it can be counterproductive. After a crisis, over-reaction may be as big a danger as inaction.
- Self-regulation versus official action. Even when something more formal is required, it is not always the case that a structure of officially-administered regulation is the best approach.
- International versus country-by-country approach. With an integrated global capital market, some reforms may need to be internationally coordinated to avoid fragmentation. For example, different accounting conventions or stock exchange listing requirements could impose unnecessary additional costs on internationally active companies with multiple listings. In other cases, however, it may be less necessary to strive for internationally harmonized approaches. Corporate board structures have traditionally differed between, for example, the US model, with a unitary board in which the Chairman is typically the CEO, and the German model of a Supervisory and Executive Board. It will be important to distinguish between measures which need to be internationally coordinated and those which can more easily be left to national discretion.
- Piecemeal versus comprehensive approaches. Given the wide range of topics on which actions need to be taken to restore market integrity, the question arises whether these should be taken individually, as and when responsible authorities are ready, or else planned in a comprehensive strategy. If a comprehensive strategy is favoured (to ensure that actions are consistent and

mutually supportive) who should be involved and how should their activities be co-ordinated?

- Scope of regulation. Enron (an unregulated entity that was a major player in financial markets) once again illustrates the dilemma of where to draw the line in regulation, to say nothing of who should be the supervisor where regulation is deemed necessary. On the one hand, it can be argued that participants in wholesale markets ought to be able to police each other's activities (no consumer protection justification). On the other hand, the large scale on which some unregulated entities operate and the central role they play means that their actions can have a significant impact on market stability both at the wholesale and consumer level.

Role of International Accounting Standards

Presentation by Tom Jones

I intend to attempt to be brief and informal. Obviously, we will have some time for debate and questions, and I'm happy to answer any questions later on. I will focus on accounting standards, but I think it's very important to remember that the best accounting standards in the world are completely useless without integrity in the management process, without high quality auditing and without a strong enforcement process. So standards are fine, but only one leg of at least a three-legged stool.

I also make the assumption that you have some knowledge and in many cases quite a detailed knowledge of the IASB and its mission and structure. Our role in life is to achieve convergence in accounting—convergence, that is, on high-quality solutions. Accounting is not rocket science. There's no reason on earth why a transaction should be accounted for differently because it happens to be in Seattle or in London or in Sao Paolo or anywhere else. There's no reason at all why there should be multiple accounting systems around the world.

I became interested in standard-setting as a preparer because at Citibank, operating in a hundred countries, you see firsthand the waste in preparation. This is troubling not just because of the additional cost of keeping the books on a hundred different systems and then converting them to one, but because of the confusion caused even within the company by the multiplicity of systems. When you extend consideration

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of costs to the higher interest rates that are charged in jurisdictions whose accounting is suspect, the total costs are very high. Our objectives are worth-while because these are very expensive inefficiencies and deficiencies.

By definition international standards are “principles-based” as opposed to “rules-based”. I agree with Andrew that the fact that the US over many years has been obsessed with rules-based standards is a major part of the current weakness in the US. For example, if you have a leasing standard that says that assets essential in conducting the business must be on the balance sheet as opposed to the detailed cook-book of rules for lease accounting of today, it would be much more difficult for financial engineers to get around the standard. The rules-based approach is in effect a handy guide to finding loopholes. A few of our rules which were modelled on US standards do not look like principles-based standards, but comparing broadly IASB standards to US GAAP, you will find them to be much shorter, more easily understood, and quite comprehensive. We have thirty-four standards in existence. They’re numbered 1 to 41, but there are only thirty-four standards in effect. They are used in a number of countries by a number of large companies. They are quite consistent, quite operable. We are going through an improvements project as the first task of the new Board, to clean up issues which have been criticised. But even now they’re a usable set of standards, and they will be a lot more usable very shortly.

If you read the US rules, I think it’s generally acknowledged that no one individual can even begin to understand the complete set. At Citibank we employed individuals, smart, qualified accountants, to implement one standard at a time. So the idea that anybody, even the most expert accountant could follow the whole lot is at least debatable. You simply cannot do it. No knowledgeable person that I’ve debated has argued that anybody could comprehend the whole gamut of rules and all the interpretations, hundreds of them, that follow the rules. I am not suggesting that international standards are simple – but at least they are more understandable.

I ought to deal with the accounting issues at Enron first and then get on to the broader philosophical issues. I don’t think we have all the facts yet, but obviously, there were weaknesses in the standards. However, just as Andrew said, it appears that there was outright fraud. No standards are going to combat outright fraud. I am sure Douglas is going to say that 99 per cent of management is attempting to be honest but that leaves a number of preparers who are attempting to manipulate

the results and it is impossible to devise systems which will catch that, especially given that within Enron it appears that there was a failure of governance at all levels. These include the company's financial staff, the senior management, the internal auditors, the audit committee of the board, the board itself, the external auditor, the external analysts, the company's lenders and finally the regulators.

The other comment I would make is that it is not just Enron. Enron is the most dramatic because it has wiped out both the company and their external auditors but there are many other indications of flaws in the fabric. It is also not just accounting standards, in fact it is barely even the accounting standards. However the main accounting standard which is involved is the consolidation standard. The US consolidation standard is very old. I think it was originally created by the FASB's predecessor, the APB. It is weak, and very rules-based. That's why you get this 3 percent rule. It didn't cause the problem, because Enron didn't even comply with the 3 percent rule, but the 3 percent rule is a key indicator of a rules-based standard which can easily be got around. The discussion is to raise the 3 to 10, but that doesn't answer the issue of principles-based. The FASB has had a project to improve consolidation for many years and the criticism is that the FASB is slow to update its standards is true in this case, partly because it is blocked by preparers and auditors and to some extent by politics.

There are also questions about related-party disclosures. There are standards on this subject, but again, I don't think Enron complied with the standards, so it is hardly useful to blame the standards if the company did not comply, and the governance failed to catch it. I agree with Andrew that the mark to market model is debatable. Just for the record, IAS and many standard setters are interested in mark to market, but they recognise that mark to market across the whole balance sheet opens the door to more manipulation than it ever closes. This is the absolute perfect case. Enron invented the model themselves and then they marked to the model and lo and behold the result was fortuitously a profit!

Finally, stock compensation. I agree again with what Andrew said. I don't know if everyone is quite familiar with the full extent of this issue, but there are examples of large entities in the US having reported large profits (after ignoring the cost of stock options) and simultaneously reporting large losses for tax purposes since the cost of options which is not an expense for US accounting purposes, is a tax

deduction for US tax purposes. So in one fell swoop, we eliminate the tax liability while leaving profits untouched – not a bad deal!

I think if Paul Volcker were here, he would say that when he first became chairman of the Board of Trustees, this was unknown territory to him. Pretty quickly he smelled corruption in the system. I think the issue of stock compensation is the issue of corruption in the system, rather than pure accounting. The temptation for management to manipulate the numbers to enhance the value of options is almost overwhelming. At a minimum, it is a perverse incentive when performance options – favoured by shareholders, are charged to expense, while straight options with no performance hurdles are exempted.

That's enough of standards. The standards in Enron were a minor part of the issue, not a major part. Let me come to the real significance of what I want to say. Enron caused a sea change in the attitude in US markets to the reliability of US accounting. For many years we've said that US accounting standards are the best in the world. That was certainly true up to some point in time.

I think the last ten years probably have seen a change. It might have started when the FASB tackled the stock compensation issue. It was highly criticised by preparers, by business. Phil Livingston, who represents the FEI and is on our advisory board, would tell you that the FEI spent \$70-100 million at that time fighting the standard. You ask yourself, whose money was that? I'll leave that one aside. The political process also interfered with this change.

I think probably there is a perception now that that which was rock solid, the best accounting in the world, is at least debatable. I think people are scared of what else is out there, because if these things have happened (and Enron is pretty spectacular) the question is, what else is out there? And there are many examples of accounting manipulation under investigation.

It is important to us because the international standards project is in high gear. Our standards are used by many countries and by many large companies. The European Parliament will pass a law in early June that requires all listed companies in Europe to comply with IAS from the beginning of 2005, which means more or less today in business terms. The European choice was very simple. There were many references yesterday to a single financial market in Europe. You cannot have that without accounting standards which are common across Europe. There are of course many other requirements, but accounting standards are

an obvious necessity. The choice was very simple, FASB or IAS. They chose IAS.

In the interest of time, I won't go through the work programme in detail, but we have four "Improvements" projects to clean up issues in IAS which have been criticised or to make application easier. The other four major technical projects address insurance accounting, business combinations, the stock compensation issue, and performance reporting. They are all important projects, and we are also reviewing other standards in the light of lessons learned as the Enron case unfolds.

But coming back to the convergence issue, this is our major task and both we and the FASB must be prepared to change standards in the interest of convergence. Obviously we cannot have international standards move only towards the US. Some US Standards are not the best in the world, and we shouldn't move towards those. So the Enron pressure on the US to move is very important.

Bob Herz is becoming the new chairman of FASB, and has been a member of our Board for the past 12 months. That is very good news from our point of view, because he is a convinced internationalist.

The crunch for convergence will probably be the stock compensation issue. People have asked why this subject is on the agenda at all – remember that outside the US there is not even a disclosure standard and there are at least four competing proposals in Europe, all different from each other and from the US. I expect that our board will pass a stock compensation standard which requires a charge to earnings. It is dependent on resolution of the difficulties of valuation but my guess is that it will happen within the next 6-9 months. There will be pressure on the FASB to move, and pressure on us if they don't. So this is going to be a tough fight and it is coming down the road. Europe should take the moral high ground on this issue.

An Analyst's Perspective

Presentation by Trevor Harris

I appreciate the invitation to participate in this G30 discussion and to offer some examples of the problems currently facing the accounting profession. Let me start by saying that the recent accounting scandals are a systemic and structural problem, not anecdotal or short term. The problem afflicts many companies across different sectors, as the examples that I am going to lead you through demonstrate. These are taken from presentation materials that we use at Morgan Stanley to explain these issues.

What I regard as the core issues are as follows:

- Accounting rules have created a false perception of precision where it cannot exist
- Accounting regulators find it difficult to consider predictive aspects of a rule, so making the data difficult to use for forecasting purposes
- Accounting regulation is frequently inconsistent with economic principles
- A myth has been created that cash flows avoid accounting measurement issues

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- Auditors stopped focusing on the business but attested to compliance with a rigid interpretation of code
- Market players lost sight of fundamentals
- Lobbying efforts led to compromises in the final rules that missed the mark
- Educators have provided a narrow training, lacking in a conceptual framework

A few items deserve highlighting, especially the third point that accounting rules are frequently inconsistent with economic principles. While this problem was brought to the forefront by Enron, it has been emerging for more than ten years and revising accounting standards is not going to correct it. This represents a much deeper disconnect between economic reality and its accounting representation, which I will address further.

Before doing so, however, I want to dispense with the popular misconception that if companies and their auditors would just use cash flows to represent financial performance, all accounting problems would be solved. That is simply not true because of the difficulty of accurately measuring or forecasting cash flows.

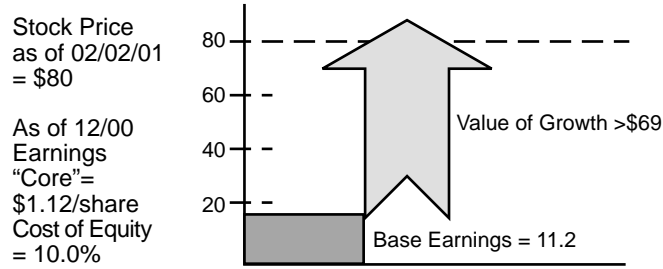
The major reason for the deeper disconnect that I have highlighted is that auditors have stopped auditing to the business and have begun auditing to the accounting rules. This is not a failure of auditor independence, although lack of independence complicates it. The problem is that auditors have applied the rules but ignored the specific characteristics of the businesses they are auditing, a point on which I will focus in my presentation.

It should be noted, however, that notwithstanding these fundamental accounting deficiencies and the apparent fraud that existed, Enron's financial statements still contained plenty of red flags to warn of trouble. If read carefully, they contained ample data to let investors know there were problems.

In fact, it was possible to see problems at Enron without even analyzing the company's financial statements for earnings quality. Exhibit 1 examines the rate of earnings growth reflected in the company's stock price. On this basis, Enron's expected earnings growth already in the price was equivalent to seven times capitalized current earnings (at the time they announced year 2000 results).

Exhibit 1

How investors missed the mark - Enron

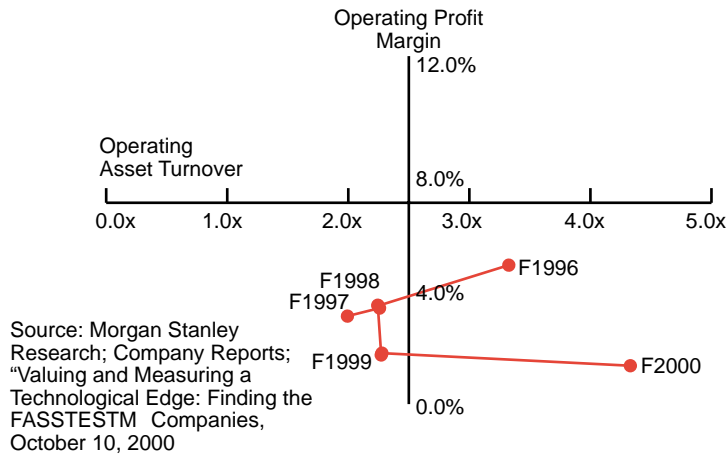


Source: Morgan Stanley Research Estimates; Company

In order to justify that multiple, a business should have very fast growing profitability. Yet Enron's profitability map, as shown in Exhibit 2, indicates deteriorating margins on increased operating asset turnover, (revenue over net operating assets) that together indicate a return on capital below the cost of equity from 1996 onward.

Exhibit 2

Enron Profitability Map - Reported Annual



This clearly indicates a pricing problem because that level of profitability does not justify the price, and managers that target high share prices start searching for ways to get their earnings up to justify the price.

Another issue highlighted in the Enron example is that the apparent rapid revenue growth was driven by an accounting rule that treats the trading of energy companies differently from the trading of investment banks. This rule, devised by the Emerging Issues Task Force of the Financial Accounting Standards Board (FASB) in the United States, forced companies with energy businesses to report nominal values of their trading activity as revenue and cost of goods. Without this rule, Enron would probably not have been in the *Fortune* 10 or even the *Fortune* 500, but, instead, would have been seen as a much smaller and slower growth company. This was a case where the economics of transactions were significantly distorted by a very prescriptive and obscure accounting rule.

The next few exhibits are important to understanding the causes of present accounting problems. The particular case examined in Exhibit 3 involves sales and swaps of fiber-optic transmission capacity by Qwest, a well-known telecommunications firm. The specific examples, which represent Morgan Stanley analysis, involve Qwest acquisition of trans-oceanic fiber transmission capacity to complete a transmission network based on land fiber. Thus there is a legitimate economic objective underlying the transaction.

Exhibit 3		
How Auditors Get it Wrong - Fiber Sales		
<u>The sales - inflation opportunity:</u>	<u>If Open Market</u>	<u>Potential "Barter" Agreement</u>
A sells land fibre to B		
Sales	100	200
Cost of fiber sold	(60)	(60)
Profit	40	140
Annual depreciation for B (20 years)	(5)	(10)
Reported Profit for A (after depreciation)	\$34	\$129
B sells ocean fibre to A		
Sales	120	220
Cost of fiber sold	(70)	(70)
Profit	50	150
Annual Depreciation for A (20 years)	(6)	(11)
Reported Profit for B (after depreciation)	\$45	\$140
Questions to Ask:		
Source: Morgan Stanley Research, Company Reports	<ul style="list-style-type: none"> •What has happened to the market for fibre? •What has happened to capacity and prices? 	

The first column in the table is based on the assumption of an open market. Company A, Qwest, sells excess land fiber for \$100 million to Company B, actually receiving cash in that amount. With an inventory cost of fibre of \$60 million, they record a profit of \$40 million from the sale, and Company B has capital expenditure of \$100 million and a depreciation expense of \$5 million per year. One minute, one hour, or one week later, they send \$120 million back to Company B, let's say Global Crossing, to purchase ocean fiber. The inventory cost of the fibre to B was \$70 million so its reported profit on that transaction is \$50 million, and A would record a depreciation expense of \$6 million a year for 20 years. The net cash transaction is \$20 million.

The second column represents what can happen when the prices are negotiated, as can occur in any market consisting of a few players who trade with each other under conditions of oligopoly. The two companies might agree that there is so much future demand for broadband that the real market value of the fibre is actually \$100 million higher in each case. Therefore, Company B sends cash of \$200 million for purchase of land fiber, and Qwest sends back \$220 million in cash for ocean fiber. While the net cash transaction is still \$20 million, both companies have inflated revenue and profits by roughly \$100 million, the only cost being incremental depreciation which the market was ignoring or which is later charged off.

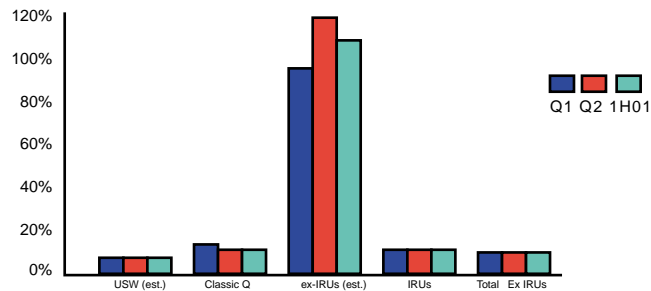
With the higher cash amounts actually being delivered the company could argue these were cash transactions between unrelated parties and the company's auditors seeing such cash transactions would check them off, and believe that they were done. The problem is that this approach ignores the fundamentals of the business activity underlying the transactions.

As shown in Exhibit 4, growth of Qwest's fiber sales increased 100 percent in the first half of 2001 while underlying demand for fibre was actually falling and real market prices had fallen by more than 50 percent. An auditor looking at the underlying economic reality would know that this growth is a fiction and clearly unsustainable. The fact that auditors do not look behind the transactions or GAAP rules is the core of the problem.

Exhibit 4

Are Sales and Growth Sustainable?

Sales Growth for Qwest First Half 2001



We have assumed that US West's growth rate is 5.8% and that USW revenues represent 70% of the total company revenues.

Takeaways:

- Most of the first half growth came from fiber and equipment sales
- Question source of growth and sustainability

Source: Morgan Stanley Research estimates; Company Reports; "Qwest: Listening to the 10K" June 2001

Exhibit 5 shows Enron's financial disclosure: \$100 million of fiber sold to a related party, with a recorded profit of \$67 million. That also makes no economic sense. The fiction is exacerbated by the fact that the company also got a \$25 million marketing fee for reselling the fiber to a special purpose entity they created.

Exhibit 5

Enron: Notes to Financial Statements 10K F00

In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for \$30 million cash and a \$70 million note receivable that was subsequently repaid. Enron recognized gross margin of \$67 million on the sale.

Questions to Ask:

- Does this margin make economic sense?
- Why was the transaction made with a related party?
- Is this revenue or income sustainable?

Source: Morgan Stanley Research, Company Reports

The problem illustrated in Exhibit 6 is the most worrisome because it represents a type of activity that we view as widespread. Again the example is taken from our analysis of Qwest. The economic rationale was to get Internet users onto its network. To do this, it needed to undertake investments in property, plant and equipment to locate routers in the right locations to serve customers. Instead of doing that directly, Qwest found an intermediary (distributor), bought equipment as they would normally, sold it to the intermediary and recorded revenue and income from the sale—which is arguably fine.

Exhibit 6

Getting it Wrong: Timing and Source of Revenue

	<u>2000Q1</u>	<u>2000Q2</u>	<u>2000Total</u>	<u>2001Q1</u>	<u>2001Q2</u>	<u>2001Total</u>	<u>2002E</u>	<u>2003E</u>	<u>2004E</u>	<u>2005E+</u>
Revenue from Equipment Sale	134.4	168.6	NM	65	83	NM	NM	NM	NM	NM
Effective Date of Sale	March	June	-	March	June	-	-	-	-	-
Estimated cost of equipment sold	(131)	(164.4)	NM	(63.4)	(80.9)	NM	NM	NM	NM	NM
Profit Equip. Sale	3.4	4.2	NM	1.6	2.1	NM	NM	NM	NM	NM
Est. Prmts by Qwest for use of equipment	-	-	(75.3)	(55.2)	(65.3)	(130.7)	(282.2)	(285.5)	(272.8)	(169.2)
Estimated Revenues Required to Break Even	(3.4)	(4.2)	75.3	53.6	63.3	130.7	282.2	285.5	272.8	169.2

Questions to Ask:

- Is timing of sale coincidental
- Is commitment disclosed?
- Is potential future revenue from user flowing through distributor sufficient to cover commitment?
- How sustainable is this source of revenue?

Notes: Cost of equipment is estimated by use of a 2.5% standard margin on such through sales.
Source: Morgan Stanley Research, Company reports

However, this intermediary's business was too small to pay for such equipment or take the risk of this investment, so Qwest simultaneously provided a multi-period revenue guarantee (for around four years) to the intermediary. That revenue guarantee was then used as security to borrow the money to pay for the equipment. The economic reality is a sale-and leaseback transaction. But because the arrangement under this type of executory contract does not fit exactly within the hundreds of pages of lease accounting rules, Qwest was able to record revenue and income on the equipment sale and not disclose any of its commitments. The process becomes even more complicated when we layer on the potential to inflate the sales price of the equipment as with

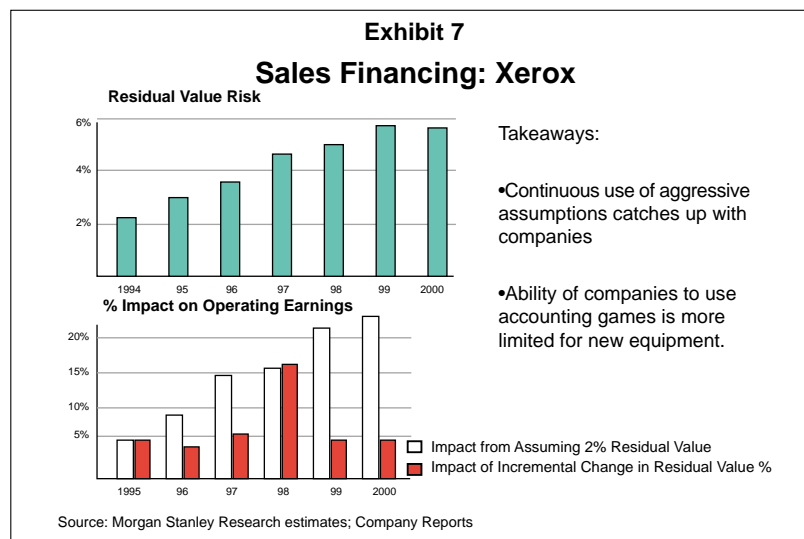
the inflated fiber sales transactions discussed earlier. These situations can arise in many other types of transactions with the result that huge commitments linked to large amounts of lending are showing up nowhere in the financial statements of the companies who have actually made the commitments.

Could auditors be expected to detect and question this? If they had looked at the estimated revenue required to break even they would have seen that, given prices charged, there are probably not enough Internet customers available in the areas served to generate revenue sufficient to repay the funds borrowed. But this is not the way most audits have been done.

The final cautionary note in this set of transactions is that the dates of sale happen to be near the end of the fiscal quarter, and in one case seems to be on the last day of the quarter, a Saturday. Any auditor doing a proper job would know that the transaction is being done to achieve a reported income effect.

My next example is the Xerox leasing case, which our research highlighted in 1998. A market with high barriers to entry and low competition in the early 1990s shifted to conditions of low barriers to entry and much more competition in the late 1990s. In these circumstances, with increasing technological obsolescence, one would expect the salvage value of equipment to go down.

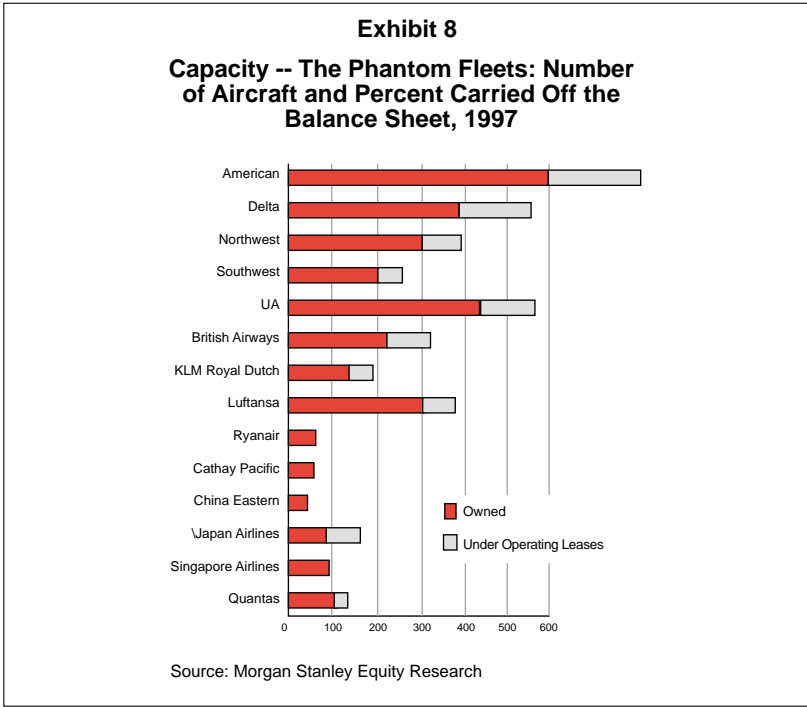
Yet as part of their sales financing, Xerox assumed increasing salvage value or, as it is known, residual value. (Exhibit 7) In this way, Xerox added 4 percent to operating income in 1995, 8 percent in 1996 and so on. This was an accident waiting to happen.



This example is worth particular mention because when we highlighted the issue in 1998, the reaction of market participants was: “who cares, it’s just accounting.” But it really represented an unsustainable economic situation that had to catch up with the company unless they could come up with a blockbuster new product. Unfortunately, the result was not only the indictment of several executives and possible legal action against auditors and other executives, but also significant loss of value to investors and jobs for many employees. Again the fundamental problem was there for all to see in 1998 if they had chosen to take a careful look, and the fact it was missed demonstrates that there was also an SEC and regulatory oversight problem.

In the remainder of my presentation, I focus on five areas where the present regulatory approach misses the economic mark. They are: (1) leasing; (2) foreign currency translation; (3) loan loss reserves; (4) derivatives; (5) pensions. Without going into all the details of these areas, I want to give you a sense of the problems.

Of particular concern is the accounting rule governing leases which, to my mind, crystallizes the distinctions between a principles-based and rules-based accounting system. Under US Generally Accepted Accounting Principles, or GAAP, guidance on lease accounting is provided in a publication of over 400 pages. Yet our research indicates that these massively detailed rules did nothing to reflect the economic reality with respect to off-balance-sheet financing. Based on 1997 data, Exhibit 8 shows that US airline companies kept more of their fleet and associated debt off the balance sheet than airlines of any other nation. So the rules just provided the path to avoid balance sheet recognition rather than get the economics right. Although the focus is on US GAAP, the problem was not just a U.S. phenomenon as it also occurs at Japan Airlines, at Lufthansa, to some extent at British Airways and at Qantas. The problem is really systemic.



In fact, the proper rule is so simple it could be written in one sentence. All contractual obligations and all non-cancelable leases must be capitalized; full stop. However, that straightforward approach would expose structural problems for the airlines and many other companies, and induce changes in financial market practices that people do not want to face.

The next problem area is foreign currency translation. Problems in this area can become very detailed but they are worth noting since foreign exchange issues appear elsewhere on the agenda for this meeting.

Again looking at Enron, an examination of their Statement of Comprehensive Income for 1998-2000 in Exhibit 9 shows that more than one-third of income was being lost to translation adjustments. The operating earnings is in reported income, but the bulk of the financing cost of those operations, reflected in the translation losses, does not show up as a financing cost in income under prevailing accounting rules. Reported income looks better than reality and many managers and investors, who do not understand the complexity of the accounting rules, believe their earnings are higher than they actually are. This is a problem under the accounting regimes in most countries.

Exhibit 9

Enron: Financing and the Currency Translation Adjustment

Statement of Comprehensive Income 10K-F00
(in millions except per share amounts; shares in thousands)

Accumulated Other Comprehensive Income	2000 Amount	1999 Amount	1998 Amount
Balance, beginning of year	\$(741)	\$(162)	\$(148)
Translation adjustments and other	(307)	(579)	(14)
Balance, end of year	(1,048)	(741)	(162)
Net Income (as reported)	979	893	703
Net Income after Translation adjustment	672	314	689

Takeaways:

- Translation adjustments often reflect hidden financing costs
- Translation adjustments associated with investments in countries with weak currencies are not expected to reverse. So this is a loss to shareholders.

Source: Morgan Stanley Research, Company Reports

The issue of loan-loss reserves is something that all lending institutions deal with. From a simple economic perspective, a borrower receives a credit rating and faces borrowing spreads that reflect credit risk. However, under the accounting rules in the United States and much of the rest of the world, taking a reserve against that credit risk is prohibited, clearly a conflict between the accounting and the economics. This is proscribed on the assumption that managers would manipulate their earnings with such reserves. Yet looking at the Bank of America example provided in Exhibit 10, it was clear in FY 2000 that their reserves were probably too low but they were presumably complying with required rules. The process of setting reserves is clearly subjective and can be gamed, but the governing accounting rules are counterproductive, and it is impossible for auditors to enforce a sensible approach.

Exhibit 10
Bank of America:
Loan Loss Reserves

(Dollars in millions)	2001	2000	1999	1998	1997
Balance, Jan 1,	6,838	6,828	7,122	6,778	6,316
Net charge-offs	4,244	2,400	2,000	2,467	1,852
Provisions for credit losses	4,287	2,535	1,820	2,920	1,904
Other, net	(6)	(125)	(114)	(109)	410
Balance, Dec 31,	6,875	6,838	6,828	7,122	6,778
Loans and Leases outstanding at Dec. 31	329,153	392,193	370,662	357,328	342,140
Allowances for credit losses as a percentage of loans and leases outstanding at Dec. 31	2.09%	1.74%	1.84%	1.99%	1.98%
Average loans and leases outstanding during the year	365,447	392,622	362,783	347,840	343,151
Net charge-offs as a percentage of average outstanding loans and leases during the year	1.16%	0.61%	0.55%	0.71%	0.54%
Ratio of the allowance for credit losses at Dec. 31 to net charge-offs	1.62	2.65	3.41	2.89	3.66
Allowance for credit losses as a percentage of nonperforming loans at the end of year	152.58	131.30	224.48	287.01	321.03

Takeways

- Loan loss reserves may not reflect economic reality, so always evaluate.
- Trends are critical.

Source: Morgan Stanley Research, Company Reports

Just to touch briefly on derivatives, Exhibits 11 and 12 illustrate how reporting of mark-to-market derivatives values can be used to distort earnings.

The first shows a company that uses a very complex accounting standard—one that the International Accounting Standards Board is going to endorse very soon—to put unrealized gains from derivatives in the Income Statement that everyone watches while putting unrealized losses in Other Comprehensive Income that everyone ignores.

Exhibit 11
Trading Activity -- Calpine 2001 10K

(\$millions)	Gross	Net
Revenue:		
Electric generation	\$6,587	\$2,878
Oil & gas production	948	447
Other	55	55
Total Revenue	7,590	3,380
Cost of revenue:		
Electric generation	4,064	355
Oil & gas production	606	113
Fuel expense	1,116	1,107
DD&A + operating lease	457	457
Other	16	16
Total cost of revenue	6,258	2,048
Gross profit	1,332	1,332
Impact of Derivatives on Reported Profit		
Electricity		
Relalized gain	10	10
Unrealized gain	98	98
Subtotal	108	108
Oil & Gas		
Relalized gain	19	19
Fuel expense		
Unrealized gain	37	37
Subtotal	56	56
Total gains in gross profit	164	164
Percentage realized gains to gross profit	2%	2%
Percentage unrealized gains to gross profit	10%	10%
Percentage of growth from unrealized gains	28%	28%

Source: Morgan Stanley Company Reports

Exhibit 12

**Impact of Derivatives on Operating Cash Flows -
Calpine 2001 10K**

Adjustments to reconcile net income to net cash provided by operating activities:

Deferred income taxes, net	\$(69,513)
Other comprehensive income, net of tax	(183,377)
Change in operating assets and liabilities:	
Current derivative assets	(763,162)
Long-term derivative assets	(564,952)
Current derivative liabilities	625,339
Long-term derivative liabilities	822,848
Other assets	(3,725)
Accounts payable and accrued expenses	591
Other current liabilities	(1,190)
Net cash used by operating activities from SFAS No. 133	\$(50,341)

Source: Morgan Stanley Research; Company Reports

The last example touches on pension plans, for which accounting standards are really controversial and accounting rules in the United States have obscured the economics for years. The UK is now trying to get this right and hopefully the IASB will follow its lead. Without going through the details, a company like General Motors has increasing pension obligations but lower cash contributions being paid right now—not a sustainable situation (Exhibits 13 and 14).

Because of the present low discount rate and declining asset values, a lower return on plan assets will hit many companies who will need cash to meet pension obligations. Some could be forced to go out of business as a result.

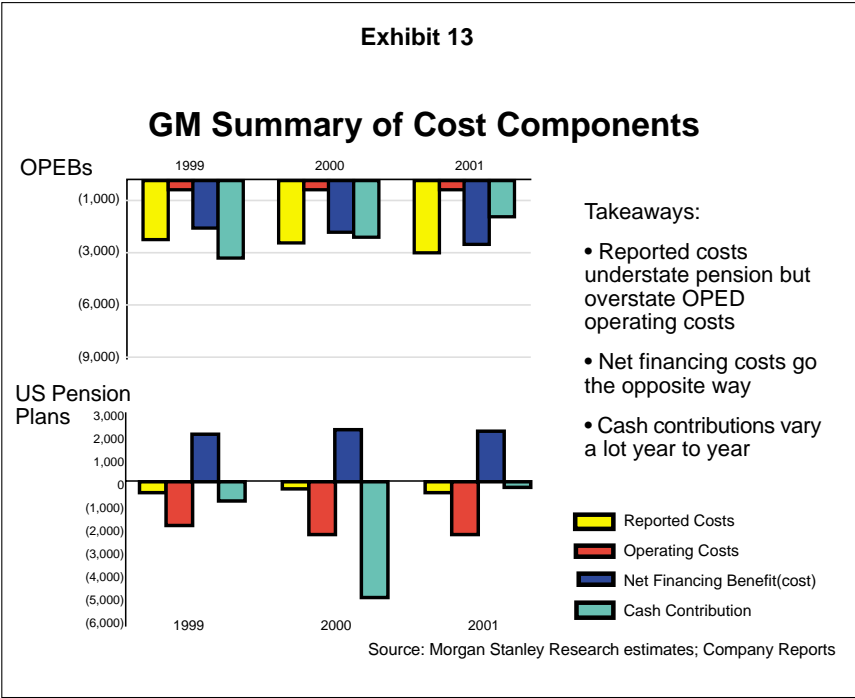
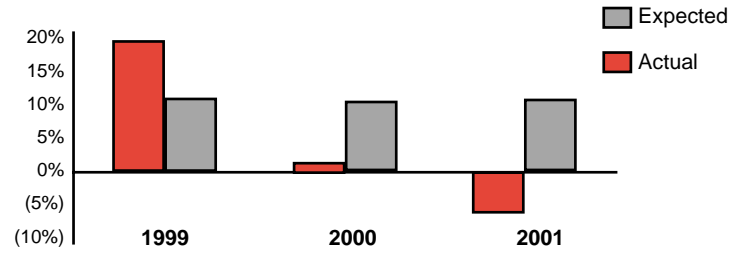


Exhibit 14

GM Expected vs. Actual Returns on Plan Assets



Takeaway:

- Expected returns may be hard to sustain without a sharp turnaround in actual returns.

Source: Morgan Stanley Research; Company reports; Estimates based on US pension plans only

The resulting disruption—to the equity markets in particular but capital markets in general—represents a country rather than just a company problem.

With that example, having completed my list of problem areas, I will stop.

A Banker's View

Presentation by Douglas Flint

It is paradoxical, that the reason there is such outrage currently over the apparent failure in accounting is because—over time—capital markets and investors have become confident in the robustness and relevance of financial information produced under generally accepted accounting principles (“GAAP”) from the major countries of the world, with U.S. GAAP having had the highest reputation and apparently the most rigorous rules.

Perhaps like any reaction to an unexpected failure, the mood swing currently is an extreme, and almost certainly too severe. We all ought to remain concerned that the ultimate response should be measured and appropriate, and does not prolong market disruption by establishing governance and reporting standards which encourage unachievable expectations, by promising more than can be delivered. The last thing we want is an extension of the rule books to an unmanageable extent and annual reports moving from 200-300 pages to 2,000-3,000 pages, because someone thinks that somehow solves the problem.

It's relevant to ask how we got to where we have got to.

I would like to step all the way back and consider what the role of reporting and indeed auditing is. If we go back to first principles, accounting is part of the social fabric of control, necessitated because owners of businesses became distinct from those who managed them. The role of accounting and the role of auditing was to report performance,

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to report stewardship. As the accounting profession matured, financial reporting evolved to include information that was helpful in a predictive nature in terms of highlighting trends which were useful in gauging how the business was going to perform financially in the future.

I share the comments that have been made by those who have gone before that the spectacular recent failures have been less failures of accounting standards per se than of the abuse of the spirit and intention of the standards that exist, with such abuse being a misguided desire to fulfil the perceived expectations of interested parties whose reaction to reported performance has had more impact on short-term price movements than the underlying economics that were being measured and reported.

The question in all of this should not be whether agile minds were able to construct the sort of interpretations of U.S. GAAP which fitted the results that Enron was trying to achieve, but whether it would have been easier to apply U.S. GAAP in a way that gave the right answer. Of course, it would have been easier to do the latter. In fact, it would have been very easy to get the right answer under U.S. GAAP because it would not have been necessary to engage in all the complex constructions that Enron did to get the wrong answer.

Probably the most dramatic example of accounting ceasing to be applied properly, and highlighting the impact of a flawed culture within an organization as evidence of what went wrong, is an extract, which we should be grateful to the Powers Report for highlighting, from Enron's risk management manual.

Exhibit 1

Enron's Risk Management Manual

“Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However corporate management's performance is generally measured by accounting income, not underlying economics. Risk management strategies are therefore directed at accounting rather than economic performance”

Exhibit 1 is an extract from Enron's risk manual, which we are told was reviewed by their Audit Committee. Within that manual, they basically say what's on the slide, which is that reported earnings follow accounting, accounting is not the same as economics, but we get measured in accounting terms and therefore we will manage accounting earnings and forget about economics. For that to be written into the risk manual of a company says more about its culture than anything else. For anyone to knowingly accept that from a Board of Directors, I find absolutely incredible.

The obvious next question is, so how can it be that we can have economics and accounting standards so different? Yet we've had any number of examples already explained today. And, we have in the UK at the moment a great deal of protest because the accounting standard on pensions is being modernized to reflect the reality that there is a fixed obligation to deliver retirement benefits from a pool of assets which is of uncertain future value. The new proposed accounting standard seeks to reflect the reality of that mismatch through highlighting the difference between the market value of the asset pool and the market value of the pension liability. The reaction, particularly from those who have the largest pension obligations is intense and yet the proposed accounting standard is not changing reality, it is only reporting it.

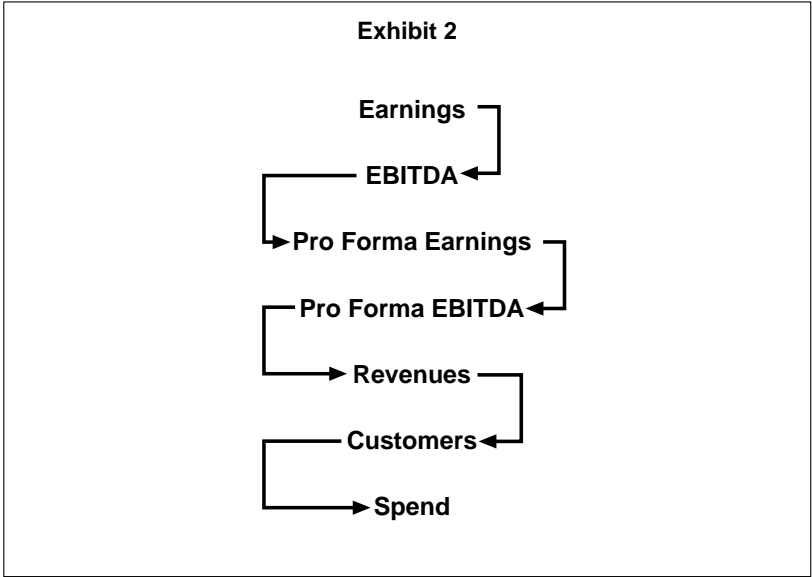
Similarly, we see intense pressure to avoid implementing a further accounting policy change that reflects economic reality, which is to put the charge for share-based payment through the profit and loss. Nobody argues this is not a cost, nobody argues it is not a value to those who receive it, but there are very many who say that we should not put it through the profit and loss account. I think that this is a flawed conclusion.

Even in my own narrow world of banking, it is a worry to many of us that the IASB is about to publish a revised version of IAS-39 on financial instruments that will require banks to reconsider the way they have managed risk throughout time as the proposed standard will enforce hedging rules that are at variance with the sound economic basis which banks use to manage their business. Sadly, prospectively, there will be a difference between the accounting impact and the impact on the economics of the business as a result of mandated hedging rules. Simply put banks do not run their business in the way that the accounting standards will require them to report it. Regrettably, the standard is written the way it has been to deal with perceived

abuses of the past but it illustrates a further example of how economics and accounting are diverging.

There is probably nothing truer, as we all know, in the phrase “what gets measured, gets done”. Probably another extension of that is “what gets rewarded, gets measured”. The mantra of the corporate world for at least the last four years or so has been shareholder value, that being stock price movement, with dividends reinvested. The stock price movements in the last few years in many sectors have become detached from any assessment of long-term value creation and have been focused more on whether or not the company has met or exceeded analyst expectations, with such expectations getting more and more demanding to meet the analysts’ own explanation, or rationalization, as to why stock prices were getting higher. It is perhaps worth reflecting separately whether this is partly attributable to a higher proportion of stocks being locked into passive funds or in individual personal pension plans, making share traders as opposed to long-term investors an ever-increasing proportion of the activity in the stock market.

If we turn to Exhibit 2, I think this shows clearly how reporting practices evolved to give the markets what they wanted. The mantra of the last four years has been shareholder value, and within that growth is the ultimate good.



Traditionally, companies were valued on the basis of their earnings, but earnings are perhaps an inconvenient measure because earnings have to be achieved. Achievement of earnings often means investment, investment means either raising more money from shareholders by issuing shares or borrowing more money. Borrowing has a cost and increasing shares in the short term as the business is built dilutes earnings.

So the analyst community, with the help of the preparers, invented EBITDA, earnings before interest tax depreciation and amortization, which was an incredibly convenient measure for those industries that have high capital spending and little or no profits. Inevitably, one thinks specifically of the telecoms industry, which came to rely on EBITDA measures because as they built capacity the depreciation and amortization did not count and if they funded this investment with debt then neither did the interest. So effectively we had a measure that we could see growing steadily without taking into account the investment needs of the business.

But just adjusting for interest tax depreciation and amortization was never quite enough because sometimes there were other inconvenient debits to eliminate. That led to pro forma earnings and pro forma EBITDA, or as David Tweedie at the International Accounting Standards Board calls it, EBBS, 'earnings before bad stuff'. I think the most perceptive discrediting of such measures comes within Warren Buffett's letter to shareholders this year, where he records with great triumph that his golf has become considerably better because he no longer counts the putts.

But there was a problem even with pro forma EBITDA, because you still had to have a positive result, or if you were embarrassed that the multiple that you were showing by comparing your stock price against EBITDA was in the thousands, you then moved to a model that looked at revenue and revenue growth. If you didn't have revenue you moved to a model that measured the number of customers or eyeballs that you had. And finally, if you did not have customers you moved to a model that said how much were you spending to create the successful company of the future. That gets us all the way from the old economy through to the Internet companies, with an articulated rationalization on the basis of Wall Street growth models as to why such companies were valued as they were.

Perhaps my favorite, and perhaps the most spectacular example of communicating what people believed the market wanted as opposed to providing anything with any information content, was a full-page

advertisement in the Financial Times earlier this year from Wanadoo, which is the Internet subsidiary of France Telecom. If anyone can explain the predictive value of the highlighted extract from the full-page advertisement shown in Exhibit 3, then I will be surprised but impressed. How the statement communicates anything to anybody, I do not know.

Exhibit 3

Financial Times

Annual Results for 2001

Wanadoo: EBITDA figures positive
for 2001 on a pro forma basis*

During this period the metrics used in the analyst world to identify successful companies continued to selectively highlight the elements which were supportive of the analyst's own valuation models. This put pressure on companies to deliver against these attributes. Again, using Enron as an example, Enron was indeed a victim of this hype.

Exhibit 4

**Enron was a victim of its own hype and the market's
desire to believe in new Paradigms**

The "buzz"

- from 1996-98 60% of earnings were generated in businesses which Enron was not in 10 years previously.
- 30-40% were arising in businesses not existing 5 years earlier.

But...

- Enron's business needed huge capital investment with low initial returns.
- Enron's trading businesses needed to be investment graded by rating agencies.

The new paradigm was that companies that were continually reinventing themselves and generating earnings streams that had never been seen before. Enron described and the market parroted the fact that 60 percent of its earnings were being generated in businesses that it did not have ten years ago, and that 30-40 per cent were in businesses that did not exist five years ago.

But of course in Enron's case, being in the energy business, it needed a huge capital investment, which in the initial period had very low returns. Its trading businesses which were generating most of the reported profits needed a very strong credit rating from the rating agencies. These two factors meant that it could not use share capital to fund investment because it would dilute returns and it could not borrow because it would damage its ratings. Hence this led to the whole struggle that Enron went through to build its business by borrowing extensively off balance sheet.

But in a world where growth was key to valuation premiums, it is no wonder that more imaginative ways were being found to maximize the historically simple spread between revenues and costs. For the eighteen years I was in an auditing firm, I was very proud to be an auditor and learned a great deal. One of the easiest things to audit in my day was sales. It was conventionally reflected by cash or debtors.

But consider where we have got to today with something as simple as revenue, particularly when the term gets applied to such constructed transactions as capacity swaps in the telecoms industry. Revenue today, that historically simple figure of sales, can be any or all of the following: cash received from an historic exchange, a market valuation of a liquid asset received from an historic exchange, an assessed valuation of an illiquid asset which has been received from an historic exchange. It can be cash which is to be received, it can be a market valuation of a liquid asset which is to be received from a contracted exchange, it can be an assessed valuation of an illiquid asset to be received from a future exchange. The assets can be in fact discounted cash flows which extend for decades in the future or indeed in Enron's case can be the fair value of financial instruments constructed to represent the full net cash flow from an entire business model.

And all of these are aggregated as a simple revenue figure in the profit and loss account.

Part of the problem with all this is that current stock valuation techniques establish capital values for companies by applying a multiple to earnings yet the revenues which drive earnings include these vastly disparate sources of value, many of which are already discounted

future streams of cash flows which the market is unknowingly being invited to put a further multiple on. Indeed, one of the issues of the last decade is that through securitisation techniques, as interest rates have come down, more and more of the future margin has been discounted to the present, booked as revenue, and investors have been invited to put a multiple on what in fact is already a discounted value. The next period will be very interesting in this regard, as the revenues from this source cannot continue to grow now that interest rates have probably reached the low point.

But it is not just revenues that are of concern. On the cost side, we mix costs incurred where we have spent the cash with costs that are an amortization of historic cash expended, with costs which reflect future cash flow. Then we have to factor in how current costs are perhaps relieved because we have had 'big bath' restructuring provisions in the last few years and we are now utilizing them, or are suffering because we are restructuring the business now or are investing. We take the net of all these numbers for revenues and costs and invite users to assess the predictive quality of that net result.

On top of this, consider the number of fundamental accounting measurement bases which are under review. On top of this, consider the number of fundamental accounting measurement bases which are under review. These are: (1) revenue recognition; (2) reporting financial performance (3) pension accounting (4) share-based payments (5) scope of consolidation; and (6) fair value accounting.

I will not go into these in any great detail but there is clearly a huge issue in revenue recognition. Pension accounting is also a huge problem today.

In the 1980s, the big problem was dealing with holding gains in stocks within an inflationary environment. Today it is the other side of the balance sheet that is causing problems. The huge problem is that as interest rates come down, the fixed obligations in pension funds are a growing burden which may not be adequately funded as asset prices fall and people live longer. Share-based payments will be a battleground. They have to be recorded in earnings, as far as I am concerned. Those who say the world will end are wrong. In HSBC we reconcile to U.S. GAAP the several hundreds of millions of dollars that we would charge to earnings. That disclosure has never generated one question. It is there and people can assess it.

Finally, the scope of consolidation is an issue and fair-value accounting is a topic too wide for this meeting although I have a few

remarks to make later. In one sense it is not all the complicated stuff like pensions and stock-based compensation that needs urgent attention. If we could just measure revenue accurately and disclose what's in sales and in cost of sales, I think it would be a huge step forward.

Then we come to reporting financial performance itself. Simply giving a measurement number is not particularly helpful. Knowing how many strokes somebody scored in a round of golf is less predictive than knowing how they constructed the score. Therefore there is a tremendous effort in the International Accounting Standards Board and indeed in the FASB to think about whether a single columnar format of profit and loss account that comes down to one number at the bottom of the page is the most sensible way to report performance.

When you think how absurd it is to look at a huge organization simply through the prism of a single measure, it highlights the fact we must get away from a valuation model which focuses on a single net earnings per share figure. And why does it matter what First Call thinks that number is? That is extraordinary to me. And every time Reuters flashes up an earnings release in the U.S. it will disclose reported earnings compared against the First Call estimate of earnings. Then a few minutes later up come all the reconciling items between the reported number and the First Call estimate which are very often not on the same basis. Surely this is ridiculous.

It is perhaps because of this, that some are driven to call for a revised basis of accounting where everything is based on 'fair value'. This is clearly intellectually a very seductive term, because how can anything that combines 'fair' and 'value' be wrong? However, the dangers in that model of accounting need to be fully understood, because currently those who would prescribe fair value would do so on the basis of 'exit prices'. In my opinion using the last transaction price achieved on a trivial trade in an illiquid market as the best evidence of a 'value' is deeply flawed.

Enron, again provides a good illustration of the problem in Exhibit 5. Enron invested \$10 million, in an internet company in March 1998. The company floated in April 1999 at over 10-15 times what Enron had paid. By the end of the first day the stock price had tripled. Enron had paid \$1.85 a share and within six months the stock was trading at \$69 a share. Enron took the difference and booked it as income.

Exhibit 5

Rhythms

- **March 1998**
 - Enron invested \$10m in Rhythms NetConnections (\$1.85/share)
- **April 1999**
 - Rhythms IPO @ \$21/share. At close of trading the price reached \$69/share
- **By May 1999**
 - Enron's Rhythms stake was "worth" \$300m but it could not sell because of a "lock-up"
 - but it "marked the position to market" and so booked the gain

Of course, the company does not exist any more—and the \$300 million gain recognized was the cause of many of the complex deceptions that Enron undertook because having recognized the 'income' it sought to create mechanisms to protect the 'gain' already reflected in its earnings. In my view, a model of accounting that allows that kind of revenue recognition is completely and utterly absurd.

The way forward, is that we have to have a basis of reporting performance that de-emphasizes single measures of accounting. We have to put more emphasis on discussing drivers of performance that is, what drove revenues how much of these were historic exchanges, how much of these reflect future exchanges, and how much revenue reflects future discounted amounts.

We also need to control the avoidance industry, and clearly the financial industry is not without criticism. Financial engineering and financial innovation are very often good things, but when very clever people apply their minds and spend their time designing complicated structures to create an accounting result which is an economic fiction, I think that is wrong. In my view there has to be some basis of controlling such people, either through regulation or through letting their employing firms understand this is not acceptable.

Finally, in respect of accounting standards, I firmly believe we have to have a principles versus rules approach to accounting standards, because the more rules we create, the more we create an avoidance

industry to circumvent those rules. In the UK we have a concept of the true and fair view, which works and is an excellent framework. Accounting rules should only be a means to an end, that end being a fair presentation, a true and fair view. There should be an obligation to ignore a rule if it does not end up with a fair presentation of economics and to explain why this is the case.

To conclude, the issue of Enron is not about accounting rules, it is not even so much about financial reporting. It is about managing conflicts of interest, which is probably the biggest issue that comes out of Enron. The fact that the CFO was allowed to be the general partner of the partnerships that were off-balance sheet, the fact that the auditors allowed themselves to construct the vehicles that they then had to audit, the fact that the bankers involved had multiple roles in the whole engagement with Enron are facts that will be examined in regulatory bodies and through the courts over the next few years.

If there is one good thing that has come out of Enron it is that it has caused people to stop and reflect on the purpose of accounts and the quality of them. If we learn the lessons that need to be learned, we can move forward, I think, with some confidence. Thank you.

Banking Provisions and Asset Price Bubbles

Presentation by Jaime Caruana

One of the central topics of debate among economists has traditionally been the reasons for economic cycles, the factors that may amplify or smooth them, whether the authorities should aim to iron them out and, if so, how this can be done. More recently, the role of the financial sector in the dynamics of economic cycles has emerged as a key question in this debate.

I would like to focus today on some problems posed to regulators and policy-makers by asset price bubbles and the credit cycle, and to share with you some thoughts on a regulatory device we have recently introduced in Spain to deal with some of these problems: the so-called forward-looking provisioning, also referred to as the dynamic or statistical provision.

The pro-cyclical behavior of the banking sector, which is now generally accepted in the literature, is receiving increasing attention by academics, policymakers and market participants. There is a growing feeling that the financial sector contributes to the swings in real activity and may even intensify and accelerate them. Feedback effects between credit growth and rises in asset prices are increasingly evident, although not yet well understood. Transmission channels from the financial sector to the real sector are becoming more and more flexible, rapid and complex. This is particularly clear for industrial countries, whose financial markets are more sophisticated, but it is also affecting emerging

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markets, as a logical consequence of their rapid integration into global financial markets.

I will focus on these issues in the first part of my speech, in particular on whether the recent behavior of financial markets is exacerbating the volatility and cyclicity of the real economy. Insofar as this is the case, the next question we regulators should ask ourselves is whether this might be a result of the increasing weight of the financial sector in the economy or spontaneous financial market developments, such as new risk management techniques by market participants and/or a by-product of prudential regulations which might unintendedly amplify financial cycles.

This debate has gained momentum recently in the context of the discussions for a new Basel Capital Accord. One of the issues identified in the discussions was precisely to what extent there are factors in the old or new regulations favoring excessive pro-cyclicality. But we should not overemphasize this point. It is true that a certain degree of cyclicity in risk management techniques and regulations is not only unavoidable but also sensible. We regulators ask banks to be more risk-sensitive and risk-sensitive usually means pro-cyclical behavior.

The second part of my address will deal with the forward-looking provisioning system recently adopted in Spain. The merit of this regulation is that it introduces incentives for better risk management by banks, while at the same time attenuating the cyclicity of the financial sector and, thereby, swings in the real economy.

In my concluding remarks I will try to summarize the main lessons we have learned in discussing, designing and implementing the new system, with an emphasis on the broader economic view rather than on the purely supervisory one. Let me bring forward my main conclusion: there are regulatory mechanisms, like dynamic provisioning, that provide incentives for sound risk management and are anti-cyclical by nature and can therefore moderate cyclical swings.

Recent experience in a number of countries shows that credit expansion and asset price increases -and bubbles- are mutually reinforcing processes (see Exhibit 1). Asset prices may start to rise in an economy because new investment opportunities appear or simply because of overly lax financial conditions. When asset prices rise so does the value of collateral, which makes financing easier, increasing the demand for assets. That in turn pushes asset prices upward. In the downturn, as the value of collateral drops, financing possibilities decline, as does thus credit growth, a process often reinforced by financial institutions

pursuing much more cautious credit policies as they are incurring losses or making smaller profits in this phase of the cycle. Tighter credit policies reinforce recessionary forces and provoke additional reduction in asset prices.

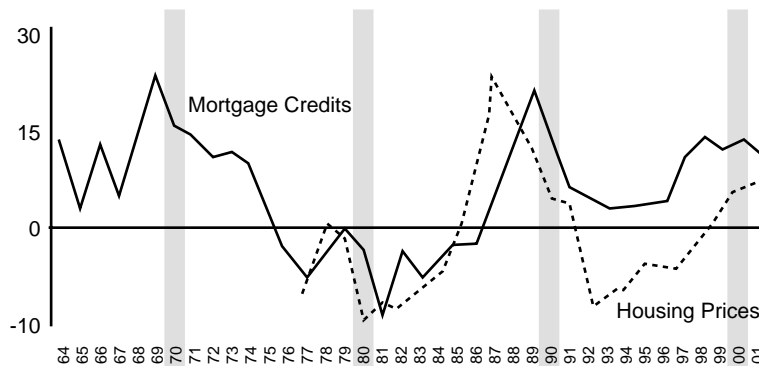
This sequence affects different categories of assets (commercial property, residential property, equity), whose impact on the real economy and transmission channels differ. Commercial property seems particularly linked to the business cycle, while residential property has a larger impact on consumption. Equity prices are intertwined with business profits and investment but are also related to spending through wealth effects, depending on the role equity plays in the determination of financial wealth.

This interaction between credit cycles and asset price bubbles poses a number of challenges for the authorities and regulators, both in the monetary policy and financial stability domains. In the upswing, inflationary pressures related to excessive credit growth are compounded by financial imbalances resulting from unwarranted optimism on the part of corporations and households and excessive risk-taking on the part of financial institutions. In the downturn, recessionary and deflationary forces are aggravated by credit contraction as a result of excessive risk aversion by lenders.

The possible explanatory factors of this potential amplification of the cycle in the financial sector are many-faceted and complex. First, heightened competition in the banking sector and in financial markets

Exhibit 1

Mortgage Credit and Housing Prices in Spain
Annual Real Growth Rates (%)



leads in an upturn to riskier strategies that are only corrected when the rise in bad debts becomes evident in the downturn. Second, there seems to be a tendency for economic agents to overreact to changes in their environment, leading to over-optimism in times of plenty and over-pessimism in bad times. Third, herding usually reinforces existing trends and causes overshooting. Fourth, the use of common assessment and risk management tools by market participants, and finally an excessive and shortsighted focus on “shareholder value” may also amplify swings. Prudential regulations may also occasionally have proven conducive to an excessive emphasis on the short term when assessing risks.

What can the authorities do to counter these tendencies? Debate among academics, policymakers and market participants has been intense in recent years, and is far from settled. This is an area particularly open to discussion, where new ideas and new evidence are forthcoming. Indeed, the way monetary stability and financial stability interact with each other seems a particularly complex topic, and the impact of specific measures on both fields is uncertain.

As far as monetary policy is concerned, the debate on whether it should react to asset prices has been one of the most interesting of recent years. Insofar as asset prices contain useful information that helps predict future price—and output—developments, they should clearly be included in the set of indicators the central bank uses for decision-making. This is not, however, as easy as it may sound. First, because empirical evidence on the usefulness of asset prices in predicting future price and output developments is not conclusive. And second, because the integration of asset prices in macroeconomic models poses a series of practical difficulties.

Going one step further, a related question is whether monetary policy should react directly to asset prices, over and above the impact of the latter on inflationary prospects. The argument would be that deflating an asset price bubble at an early stage contributes “per se” to long-term financial and monetary stability. Against this view, I tend to share the position of those arguing that asset price bubbles are very difficult to identify in practice and, even assuming that they were correctly recognized, there is a lot of uncertainty as to how asset markets would react to policy changes. Furthermore, this strategy may prove difficult to communicate to the public.

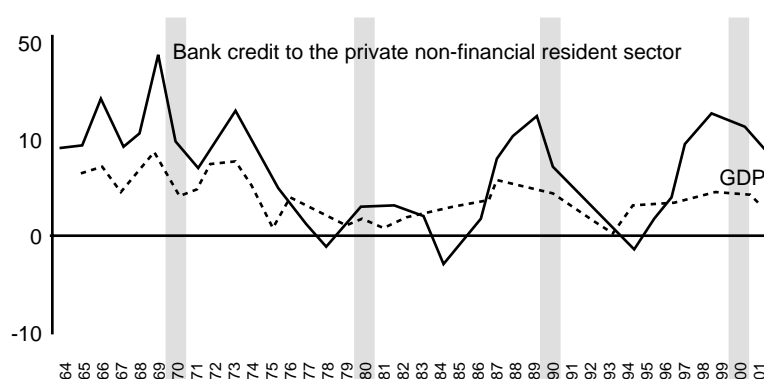
As concerns financial policy, the regulators’ task of ensuring the long-term soundness of the financial system entails creating the right

incentives for market participants not reacting in excess in a given cyclical position and avoiding excessive misalignments. To this end it is essential, first, to encourage better knowledge of the risks assumed, a long-term orientation to analyses and, consequently, more prudent management within financial institutions. Second, a greater heterogeneity among financial market players to avoid mimetic behavior seems desirable, although this is something the markets would normally develop by themselves. Third, greater transparency and disclosure by the authorities and private institutions would help market participants to focus on fundamentals. Fourth, a better understanding and evaluation of liquidity patterns in financial markets is called for, on the part of both market participants and supervisors. Finally, the regulatory authorities should obviously not introduce rules promoting short-term strategies.

Let me focus now on the relationship between bank credit, loan losses and provisions for loan losses. There is ample international evidence on the cyclical pattern of credit, which is very strongly correlated to GDP growth, as shown in Exhibit 2 for the case of Spain (with an elasticity higher than one, meaning that when real product grows, credit tends to grow more, and when real product falls, credit likewise tends to fall even more). Demand and supply effects are difficult to disentangle in credit cyclical dynamics. On the one hand, more economic activity tends to cause more credit demand. At the same time, credit rationing tends to diminish when the economy is

Exhibit 2

Long-Term Behavior of Credit in Spain
Credit and GDP Annual Real Growth Rates (%)



booming and tightens when the economy is in recession. Both demand and supply seem to account therefore for credit cyclical swings.

Competition is a key factor in explaining credit supply dynamics. Strong competitive pressures may exacerbate the trend towards looser credit conditions in the upturn, because the fight for a market share coincides with the observation of low non-performing loans, leading towards an over-optimistic perception of low risk.

The probability of losses exists from the moment the loan is granted, but it will only become apparent ex-post, with the emergence of default problems. Most credit risk mistakes are actually made during the expansionary phase, when optimism is prevailing, although only in the downturn will they become evident.

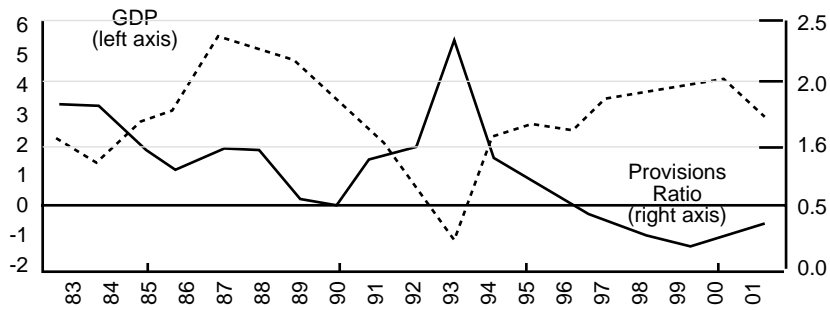
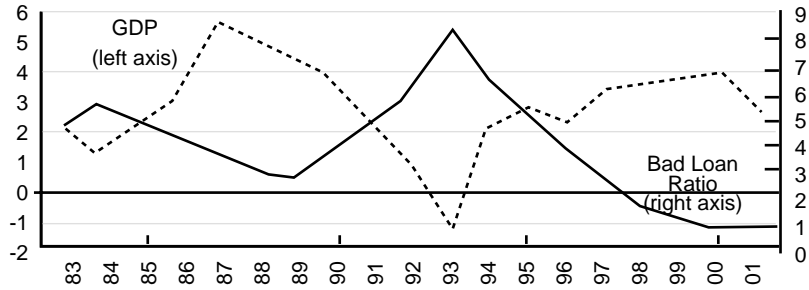
Empirical estimates show that there is a strong correlation between credit growth and bad loans, with an average lag of around three years (see upper part of Exhibit 3). This means that a credit expansion process is likely to lead to some credit quality problems in roughly that time horizon. The average duration of the economic cycle (from boom to bust) is similar. This implies that if banks only look at contemporary bad loans to determine their credit risk policies, they will restrain credit and increase risk premia in the downturn. The higher cost of funding for bank-dependent borrowers will feed back to activity, reinforcing recessionary forces.

I turn now to provisions. In Spain, until year 2000, loan loss provisions were strongly pro-cyclical (as in many other countries), because they were largely linked to the volume of contemporaneous problem assets. This static provisions are backward-looking, they are based on past events. Only are accounted for loan by loan when borrowers fail to repay or in some cases when the situation of the borrower deteriorates significantly.

As a consequence, the ratio of provisions to total loans fell therefore during periods of economic growth and tended to rise considerably during downturns (see lower part of Exhibit 3). As a result of this, the latent risk of loan portfolios was not properly recognized in the profit and loss account under the old system. In periods of economic expansion the fall in doubtful loans went hand in hand with the decrease in provisions, which in turn allowed bank managers to improve bottom-line profits.

However, one can argue that there is something wrong in the level of profits shown if the latent credit risk in the loan portfolio is not properly taken into account. Intrinsicly every loan has an expected

Exhibit 3



(or potential) loss that should be recognized as a cost by means of an early provision. Otherwise, the picture of the true profitability and solvency of the bank over time could be distorted. More dangerously, the overvaluation of profits might lead to an increase in dividends that could undermine the solvency of the bank. Therefore, the acknowledgment of latent losses is a prudent valuation principle (similar to the mathematical reserves set aside by insurance companies) that contributes to correcting the cyclical bias that currently exists in the profit and loss account. The management of credit risk in the banking sector has perhaps something to learn from insurance practices.

Theoretical papers on bank credit risk management also go in the same direction, stressing the importance of proper pricing (i.e. the interest rate charged should cover expected losses as well as the cost of holding capital for unexpected losses). Estimating expected losses

when the bank assesses the borrower is the first step for sound risk management.

Proper risk management is obviously a primary task of bank managers and shareholders. But we, as bank supervisors, should evaluate the effectiveness of a bank's policies and practices for assessment of loan quality and provisioning practices. The ability of a bank's loan review system to identify, classify, monitor and address loans with credit quality problems in a timely manner should be assessed by the supervisor on a regular basis as part of its risk-based approach. A misclassification of assets (and the corresponding under-provisioning) is always present in banks heading for profitability and solvency difficulties.

Sound credit risk management practices at the banks' level, including acknowledgment of expected losses in due time, collide to a certain extent with the current accounting framework. The problem stems from the fact that this framework does not support the notion of provisions on the basis of expected losses, with the result that the recognition of losses is frequently delayed. Some of the answers given by accounting-rules setters to this problem (i.e. full fair value accounting) may have other important drawbacks. I will touch upon this later.

Let me briefly summarize the content of our dynamic provision. In December 1999, the Bank of Spain introduced a new solvency provision, the so-called statistical or dynamic provision, focusing on the statistical risk embedded in the unimpaired portfolio. It started to apply in July 2000.

The main idea behind this provision is to try to capture, together with the other provisions of the Spanish system, expected losses. From the very moment that a loan is granted, and before any impairment on this specific loan appears, there is a positive default probability (no matter how low it might be) following a statistical distribution with an expected loss. The expected loss is known in a statistical sense but not yet identified in a specific loan operation or borrower. As the risk appears at the beginning of the operation, so does the statistical provision requirement. With this system, provisions run in parallel to revenues and are therefore distributed through the cycle allowing for a better mapping between income and costs in the profit and loss account.

The statistical provision that we have established works in practice as an addition to the "old" existing provisions: when "old" provisions are well below expected losses, the "new" dynamic provision is added.

In good years the net “specific” provisions are very low (or even negative, if there are substantial recoveries), so the new provision accumulates. But in bad years the “specific” provisions increase sharply, eventually exceeding the gross burden of the statistical provision. The net result is that with this system provisions are distributed over the cycle, providing a better recognition of expected losses.

More specifically, the amount of the statistical provision is the difference between the measure of latent risk (i.e. expected losses) and the specific provision (that covering impaired assets). In good times the specific provision is low and the statistical provision is positive. However, in a slowdown, as the impaired assets rise, the specific provision requirements increase and the statistical provision becomes negative. This means that the statistical fund (accumulated in previous years) starts being used, its proceeds (the difference between the latent risk and the specific provision) being credited to the profit and loss account. Therefore, thanks to the mechanism of the statistical provision, the burden of credit risk on the profits of banking institutions is better spread over the cycle and more in accordance with the evolution of expected losses.

The new scheme offers banks two options. First, to use their own internal measurements of the statistical credit risk and second, to use a standard method. The Bank of Spain expects that in the future an increasing number of institutions will be able to show robust computations, in the framework of an integrated credit risk management system. However, probably in the next year or two, most banks will use the standard method.

In the standard system the supervisor sets the parameters. The portfolio is distributed in six blocks, according to the relative riskiness of the different assets, or off-balance sheet items with credit risk. A vector of coefficients (ranging from 0 to 1.5%) is applied to the exposures contained in the six blocks. The resulting figure is the estimated expected loss for the bank portfolio.

The computation produces an aggregate annual gross burden (i.e. the expected loss) that, in relative terms, should equal the average annual net insolvency burden borne by the Spanish banking system in the last fourteen years. This time span covers more than a full economic cycle.

You might note that the internal approach to calculate the expected losses or the latent risk squares perfectly with Basel II developments.

The new provision has started with a vector of coefficients that will result in a burden lower than this average. This takes account of the improvements in risk management since the last cyclical peak (93/94), and facilitates acceptability of the scheme among institutions. Probably the scheme will be adjusted in the coming years, on the basis of the experience gained with its application.

A limit of three times the annual gross burden has been put on the accumulated statistical provision, to avoid an unnecessary or excessive accumulation of funds in the event of a prolonged cyclical bonanza.

At present, the impairment of assets and other credit risk is at an historical low in Spain; and it will remain so in the foreseeable future, due to good economic conditions. The new provision should thus accumulate a significant amount of funds, with a reasonable, acceptable impact on the bottom line of the profit and loss account. Those funds should allow extra solvency losses to be covered when the tide turns.

Technically, the new provision is considered a value adjustment. In the published accounts it will be deducted from the book value of the credit items that produce it. It is not considered a reserve to be integrated in the regulatory own funds. The annual accounts shall report the various solvency provisions (or value adjustments), and their method of computation.

The statistical provision is not a tax-deductible expense although banks can use an asset account of anticipated taxes (i.e. the impact on the profit and loss is neutral but still negative in terms of cash flows).

Finally, given the considerable internationalization of our banking system in recent years, it is important to keep in mind that the statistical provision is required on an individual level of all the members of a consolidated banking group. It is not possible to counter a positive statistical provision requirement in one bank with a negative one in another bank of the same group. This individual bank approach reinforces the statistical provision requirement and squares well with the fact that expected losses arise at an individual bank portfolio level.

By now, you are probably wondering about the real impact of the statistical provision in the Spanish banking system. As far as the profit and loss account is concerned, the statistical provision for depository institutions represents around 12% of 2001 total operating margin. At the end of 2000 the statistical fund reached 15% of its maximum amount (remember there is a cap of three times the latent risk) and at the end of 2001 it stands at 27%. At current rates, the statistical fund will reach its peak at the end of 2004.

As far as the cyclical behavior of banks, it is too soon to say, but we tend to think that the anti-cyclical nature of the statistical provision is influencing bank behavior.

I must confess that gaining acceptance among banking institutions for our new provisioning scheme was not easy. Banks were reluctant to see their bottom line profits indented, arguing that the Spanish provisioning system was already demanding (tight asset classification rules plus on-site monitoring and enforcement by Bank of Spain inspectors, not to mention high solvency ratios by international standards).

Apart from banks' initial, and understandable, criticism, some other voices have been raised, although not very loudly, against dynamic provisioning. Some of them can be readily refuted. Others merit careful discussion because the alternatives they propose may affect financial stability.

The most obvious criticism is that a system of dynamic provisioning smooths bank profits. It is true that the statistical provision tends to smooth profits over the course of the cycle. But it is no less true that the current ex post provisioning system (i.e. setting aside a specific provision when the impaired asset appears) artificially increases the volatility of banks' profits. And what is more important, this increased volatility in the latter case has less to do with economic fundamentals (i.e. expected losses) than with accounting rules. If expected losses appear from the beginning of the operation, banks should start to provision them at the very outset. This means an increase in provisions and a decline in bank profits during expansionary periods, just when credit risk expands the most. When the downturn arrived and expected losses turn into real losses, the impact of provisions on profits would be lower since a significant amount of the expected loss had been previously acknowledged.

To the extent that the extra volatility of bank profits is the result of an insufficient recognition of expected losses, dynamic provisioning only restores part of the distortion created.

From a prudential point of view, it is clear that dynamic provisioning limits dangerous capital erosions in times of plenty, requiring banks to provision expected losses and avoid paying out dividends (remember the insurance case). Some observers mention that there is no need for ex ante provisioning since future margin income is enough to cover expected losses. For supervisors, however, to rely on future margin income might be an overly adventurous stance.

Let me expand more on this. First of all, experience has painfully shown us that the pricing of a loan is not always properly adjusted to the risk involved in the operation (even taking into account fees and future customer relationships). I have already talked about strong competition for market share or over-optimism. Secondly, even if the risk is properly priced, the proceeds from a high margin could have been paid out to shareholders by the time the impairment appears. Moreover, dynamic provisioning allows for a timely recognition of both the income and costs stemming from bank loan portfolios.

An alternative to the current accounting framework is being promoted at some international fora. I am talking about full fair value accounting (FFVA), I would like underline the word “full” . It is quite clear to me that FFVA has, for the time being, insurmountable drawbacks for commercial banks both of theoretical and practical nature. I would place a big question mark over FFVA feasibility.

Dynamic provisioning is a reasonable approach to the fair value of a loan without the numerous drawbacks of FFVA. The statistical provision does not increase volatility of profits and facilitates prudent risk management.

To conclude, let me emphasize that this provisioning regulation in Spain was introduced for prudential reasons. It has three main advantages: First, it provides banks with incentives for better risk management (i.e. risk appraisal, pricing, internal models, etc.). Second, it reconciles good risk management with sound and prudent accounting practices. And finally, it is anti-cyclical in nature (therefore mitigating the tendency to reinforce cycles). Overall, these three advantages can be summarized as one: they reinforce the soundness of each single banking institution and of the whole system.

My answer to the first question posed at the beginning of this speech is that, although risk management techniques may induce risk-sensitive behavior, and risk-sensitive usually means pro-cyclical, that is not necessarily the case when some good regulatory practices, such as dynamic provisioning, are adopted, contributing to taming economic and financial cycles.

Let me finish by adding a word of caution. Regulatory devices per se do not suffice to attain a safe and sound banking system. A proper risk management culture deeply ingrained in banks’ practices is also a necessary condition to reach that goal. Consequently, banks and regulators should work hand in hand to improve financial stability.

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1990 M Street, N.W., Suite 450
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ISBN 1-56708-122-3