Adding Accounting Expertise to OFR Recommendation

Recommendation: In considering its staffing needs, the Office of Financial Research (OFR) needs to include people who have accounting expertise (ideally in financial institutions) that can provide accounting measurement insights to all other OFR research, data and applications. The person(s) hired must be able to work with other staff members and researchers to provide critical insight into the impact of accounting on their work as well as monitor regulatory changes and assess how they may impact financial stability.

Background:

Critical analyses of past financial crises frequently include accounting-related issues that are considered by some to have contributed to the crisis. For example, in the most recent crisis the role of fair value accounting and revenue recognition associated with the establishment of securitized products were two of the items debated. Any forensic evaluation of financial stability is dependent on metrics and these metrics are frequently dependent on the underlying measurement issues. Consequently, the OFR must have such expertise to be able to perform its required duties.

Examples of the underlying need can be found in the OFR's 2013 Annual Report. The Financial Stability Monitoring Framework (section 2) has several components that depend on the underlying accounting measures, as do the monitoring tools described on page 9 and some of the macroprudential tools described in Figure 27. A pervasive metric that is used to assess vulnerability and is also a regulatory tool is leverage. Yet this is a measure that is strictly dependent on notions of assets, liabilities, and equity, accounting constructs which are fraught with measurement-related complexities. These are rarely even discussed in any of the research or policy-related debates. Related to this is the area of capital definition. For many years, if not decades, there have been debates on how closely measures of regulatory capital should follow generally accepted accounting practice (GAAP). This philosophical debate is not the crux of the problem, rather there needs to be a clearer understanding of each resource and obligation being measured and how this evolves over time. This then naturally links to metrics like liquidity that tie in to concepts of realization in an accounting system which, in the case of financial instruments and institutions, can be particularly tricky, given the legal entity and operating structures in different financial markets.

Many of the OFR's research projects and potential projects are also impacted by accounting issues. For example, Figure 34 of the 2013 Annual Report illustrates liquidity transformation via financial intermediation, with asset liability and net worth measures for intermediary firms. It makes a difference how (and when) different participants in the market measure the amounts and then recognize gains, losses and cash flows with the passage of time and economic activity.

These need to be considered at the entity and consolidated group levels to truly understand the process. Analogously, the contagion index, described on page 65 of the report will also be impacted by accounting measurements at the entity level.

Stress tests, which are now part of the regulatory oversight regime, are themselves dependent on how various assets and liabilities are measured. Any assessment of stress tests needs to consider the impact of accounting issues which can vary (within bounds) across entities.

Given OFR's responsibility to help in the evaluation of future threats to financial stability, it is also critical to have someone on staff who can be monitoring the accounting regulatory environment in the US and globally to be able to assess how future requirements might impact the financial system. For example, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have items under active consideration in the areas of revenue recognition, accounting for financial instruments, insurance, and leasing; each area can impact companies and the financial system in significant ways. Other areas like pensions are likely to be put on the agenda soon. It is worth noting that as these changes take place, it is not only their impact on the financial system that must be evaluated but also their effects on the historical time series of measures used to construct many of the research and oversight analyses. It takes an expert in the area who can focus on this to understand the implications.

This rationale is not comprehensive but is illustrative of the critical need and hence our recommendation. It also suggests that the ideal candidate would have financial services accounting expertise with forensic accounting training.