Should More Supervisory Information Be Publicly Disclosed?

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Within our financial system, a bank's prospects and viability depend on its ability to attract investors and customers. This fundamental need means that banks and bank management must operate under the framework of market discipline and in a manner that meets the dictates of market participants. In other words, market discipline serves as the principal force influencing the performance of our financial markets.

The financial revolution we are now experiencing is clearly increasing the importance of market discipline in banking. Most notably, the removal of many traditional bank regulatory restraints and controls over the past few decades is expanding the role of the marketplace in allocating financial resources, encouraging innovation, and exerting discipline over banks.

However, as the importance of market discipline is increasing, an essential prerequisite for effective market discipline – timely and accurate information to guide market participants – is becoming more difficult to achieve, even with the many advances we are making in processing and analyzing financial data. In particular, the ongoing financial revolution is contributing to a rapidly growing complexity in financial instruments and services, as demonstrated by the substantial increase in bank trading activities, derivatives, securitization, and global markets. The increasing size and scope of major institutions also is contributing to this complexity, along with the continuous changes in these institutions' balance sheet and off-balance sheet positions.

Consequently, a critical goal for us to explore is how to enhance market discipline by providing market participants with adequate, timely, and accurate information for making decisions. A recent and very important example of this goal is the third pillar of the revised Basel Capital Accord framework. This pillar seeks to reinforce market discipline by requiring banks to make more effective disclosure of their risk profiles and capital adequacy.

In my comments today, I will focus on the issue of what bank supervisors might be able to do to improve market access to information on banking organizations and to thereby enhance financial market discipline. I will first explore the role of market discipline in banking and look at recent steps taken to improve bank disclosures and transparency. Then I will examine what value might be added by increased supervisory disclosure and what options bank supervisors have to improve the flow of information to bank investors and customers.

## The Role of Market Discipline

Market discipline and the related need for information disclosure have a variety of meanings and implications for each of us. In banking, market discipline can be described most directly through the various ways the market and its participants voice their views on the performance of a bank's directors and management. An extremely important aspect in this market discipline is the value stockholders place on a bank's equity. These valuations, in fact, provide a forward-looking guide to how well investors expect a bank and its management to perform. Equity values further reflect the market's view of the safety of a bank's portfolio, its liquidity, and the expected returns adjusted for risk. If the market judges management as failing to pursue appropriate risk-return tradeoffs, investors will drive a bank's value below that of other investment choices.

Bank debtholders and large depositors also constitute part of the market discipline over a bank. Both debtholders and depositors seek to place their funds in safe, solvent institutions. Furthermore, they expect to be compensated for any added risks they elect to assume.

For bank managers, equity values and the interest rates on deposits and debt thus provide signals that cannot be easily ignored, since a manager's job and

compensation will depend on the bank's performance in these areas. Declining equity values and increases in funding costs, for instance, provide a clear indication that a bank's management is failing to meet the competitive standards of the marketplace and will need to improve or be replaced. This need to satisfy market participants thus constitutes market discipline. Ultimately, market discipline is the force to which all managers must answer. Moreover, market discipline has nothing to do with how well supervisors can read the market or what actions supervisors might take themselves – instead this market force represents the combined views of all market participants.

Supervisors, though, can play an important role in market discipline by assuring that valid information is brought forward – not only to bank management, but also to the market itself. The goal of disclosing such information would be to influence the actions of bank management while allowing the market to value bank assets, income streams, and the risk-return equation more accurately. As a result, examination and other supervisory information, if delivered correctly and well, could serve to enhance market discipline.

## Recent Steps to Improve Bank Disclosures

Current bank disclosures largely consist of regulatory reporting requirements; SEC disclosure requirements for banking organizations with publicly traded securities; voluntary disclosures banks make to investors, financial analysts, and rating agencies; and disclosures under international accounting standards for banks with foreign operations. In all of these areas, the demands of investors and customers for more information --along with technological improvements in information processing -- are leading to a number of notable changes in bank disclosure requirements and policies. It is important to understand these changes and their implications for market discipline and

bank transparency before going on to look at the options for increasing supervisory disclosure.

The amount of information that banks are asked to report in their regulatory Reports of Condition and Income has continued to expand over the past few decades, and this trend likely will continue. Banks now report far more detailed information by individual loan categories and in a number of other areas, such as off-balance sheet activities and risk exposures. Also, from a supervisory perspective, formal regulatory enforcement actions and CRA ratings have been disclosed since 1990.

In addition, the Sarbanes-Oxley Act of 2002 and market reactions to Enron and other recent accounting scandals are bringing strong pressure for greater and more accurate reporting by publicly traded organizations. The Sarbanes-Oxley Act, for instance, requires the CEOs and CFOs of all public companies to certify the accuracy of the reports they file with the SEC and comment on the effectiveness of their internal controls. This act also directs public companies to disclose material changes on a rapid and current basis, shortens the time for reporting insider transactions, strengthens the SEC disclosure review process, tightens audit committee requirements, and provides for greater oversight of accounting firms and limits the non-audit services these firms may offer.

While the Sarbanes-Oxley legislation is directed at publicly traded corporations, portions of this act will apply to a much larger group of banks. For instance, FDICIA filing requirements will extend the act's auditor independence provisions to banks with over \$500 million in assets, and the banking agencies have proposed extending various corporate governance provisions of the act to nonpublicly traded banks, as appropriate.

As I mentioned earlier, the third pillar of the Basel II Capital Accord will further increase public disclosures by the largest U.S. banks. Although the final disclosure standards haven't been specified, the recently released Third Consultative Paper (2003)

indicates that large U.S. banks adopting the Basel II framework will be subject to extensive disclosures related to their capital structure, credit risk mitigation, asset securitization and their assessment of credit risk, market risk, interest rate risk, and operational risk.

Bank supervisors will necessarily have an important role to play in each of these steps. All of these steps, moreover, will help to bring a broader range of information to investors and bank customers over the next few years and increase the level of scrutiny over bank reporting. However, as banks continue the shift toward more complex and actively traded financial instruments, transparency in banking, undoubtedly, will continue to be a challenge.

### What Unique Information Could Supervisors Bring Forward?

Because of the banking industry's systemic role in our economy and given the complexity of its activities and difficulty with the reporting of these activities, bank supervisors are mandated to engage in a process of formal bank examinations. These examinations provide supervisors detailed access to bank activities and place them in a unique position to collect and analyze banking data.

In their assessment of banks, for instance, examiners make use of proprietary and internal information at each bank, as well as confidential information on customers – all of which is generally unavailable to market participants trying to track an institution's condition and performance. The analysis of such information and the steps banks take to control and manage risk, when aggregated, form much of the basis needed to understand the risk exposures at banks.

Supervisory agencies also devote extensive resources to examining banks and have developed the CAMELS and BOPEC rating systems and related procedures for analyzing banking organizations. These supervisory resources, along with the access to

internal information, allow bank examiners to come to factual findings and conclusions that would be of strong interest to bank investors and customers. Much of this in-depth analysis is not readily available from other independent sources.

As a result, examiners have a detailed knowledge of individual bank conditions that could prove useful in several ways. Disclosure of financial positions, risk concentrations, and asset profiles, for instance, could provide a new and valuable source of information to the market. In addition, examiners would be in a good position to identify deficiencies in a bank's own public disclosures.

#### Possible Options for Increasing Supervisory Disclosure

As we move toward the third pillar of the revised Capital Accord and greater reliance on market discipline, some have suggested, and I believe reasonably so, that supervisory information could help the markets be better informed and, thus, enhance market discipline. There are a number of different ways supervisors could help to increase the level of disclosure in banking and thereby enhance market forces. Let me mention three of the basic approaches that could be followed.

#### Supervisory Review and Evaluation of a Bank's Own Disclosures

One possible initiative would be to have examiners review the adequacy and accuracy of a banking organization's own disclosures. Examiners are already being drawn, in part, to this role as they carefully review internal and external sources of information on a bank or banking organization during an examination and assess the inherent risk exposures. As an example, PNC Financial Services Group restated its 2001 earnings after Federal Reserve examiners objected to the manner in which PNC was accounting for loans that it sold to several subsidiaries. Most of us believe that

examiners should continue to extend this role, as recommended in the 2000 Federal Reserve Staff Study on "Improving Public Disclosure in Banking."

However, there are some questions regarding how far examiners should go in reviewing bank disclosures and how they can effectively supplement, rather than duplicate, similar efforts by internal and external auditors, the SEC, and the new Public Company Accounting Oversight Board. In particular, we will have to be careful that we don't turn bank exams into audits. Such a step could shortchange the traditional role of examiners in assessing bank risk exposures and make less than optimal use of examination resources.

### Disclosure of Significant or Material Examination Findings

As a second option, supervisors could require banks to disclose significant or material examination findings. Although the SEC already requires publicly traded banks to disclose any significant news in a timely manner, different banks have followed different practices with regard to disclosing what supervisory items might be considered material or useful to the market. These differences in interpretation and disclosure practices may leave some important issues unknown to outside parties. Disclosure of significant examination findings could, therefore, help make a bank's own disclosures more accurate and more reflective of supervisory concerns. At the same time, the prospect of having to make such disclosures would provide banks with an added incentive to monitor and manage their risk exposures carefully and to comply with regulatory objectives. In other words, such disclosures would certainly facilitate the market's role.

To implement this proposal, examiners would have to discuss with bank management those examination findings considered to be significant. Such findings could include credit quality problems, serious weaknesses in internal controls and risk

management systems, substantial market risks, or loan portfolio or activity concentrations. They could also encompass shortcomings in board or management structure or a failure to maintain adequate capital relative to bank risk exposures. Significant regulatory violations, as cited by the examiners, should further be disclosed to the public. The bank or bank holding company, not the examining organization, would be responsible for making the appropriate disclosures or showing that these findings were already reflected in the bank's reporting.

In their conversations, examiners and bankers could also work toward reaching an agreement on what descriptive terms would be used to disclose significant examination issues and findings. This step would help ensure that the examining agency adequately documents its findings, the bank clearly understands its responsibility for making the disclosures, and market participants are less likely to misinterpret the severity of any problems. These discussions could further work out ways of disclosing weaknesses or problems in sufficient detail, while fully preserving the confidentiality of customer information. In addition, bankers should be given an opportunity to report supplemental information to the public, along with what steps they plan to take to address supervisory issues.

Overall, the disclosure of important examination findings and the underlying discussions between bankers and examiners could help provide for a constructive, and at times intense, dialogue among bankers, the market, and supervisory authorities. I would also note that this disclosure option could help to reduce the severity of many of the problems identified by examiners, since bankers would be encouraged to disclose and begin addressing these problems at an early stage. The disclosure of examination findings further represents a natural outgrowth of the examination process, and it would help provide greater consistency to the information publicly traded banks should already be disclosing under SEC regulations.

A final implementation question concerns which banks should be required to disclose key examination findings – just the large complex banking organizations, all publicly traded banking organizations, or every bank. Because all publicly traded banking organizations are already required by the SEC to disclose any significant or material findings, such organizations would provide a logical starting point. These organizations report to investors on at least a quarterly basis and more frequently when necessary. Depending on the importance of examination findings, these organizations could make the relevant disclosures in their next quarterly report or, if more urgent, through special press releases. For nonpublicly traded smaller banks, the disclosure of important examination findings is more problematic. The stock of these institutions often is closely held or not widely traded, so there is no ready means to foster disclosure in a systematic way.

## Disclosure of Bank Examination Ratings

Another option for consideration is the disclosure of bank or holding company examination ratings. Since examination ratings reflect the assessments of experienced examiners, disclosure of these ratings might provide important insights regarding the condition of banks.

However, I am less comfortable with disclosing examination ratings than with the disclosure of significant supervisory findings. In fact, there are a number of issues associated with ratings disclosure that will need further study and discussion. Most important, examination ratings are designed for the internal use of the banking agencies. They come with little explanation, little dialogue with the bank and one typically needs considerably more information than can be provided to the market to fully understand the analysis behind the rating.

If examination ratings were to be publicly disclosed without significant additional data and commentary, several significant problems could arise. A major concern, for instance, would be possible overreactions by market participants whenever they fail to correctly interpret exam ratings. Also, examinations could become less useful for supervisory purposes if circumstance required examiners to simplify the ratings system and its underlying analysis. Another potential difficulty would be maintaining reasonably consistent ratings across banks, given existing differences in bank activities, size of operations, and primary supervisors. One other critical concern is whether the disclosure of examination ratings would serve to replace, reduce or be confounded with private market sources of information and analysis – an outcome, that could weaken rather than enhance the market's role.

I also am concerned that the assignment of examination ratings, in part, may be backward looking, focusing on what bank management has previously done instead of where a bank is now headed. For example, examiners may continue to rate a bank adversely after it begins to take appropriate steps to address past problems – a good reason for doing so is to ensure close supervisory oversight of the bank until it fully recovers. To the extent this occurs, the disclosure of examination could involve misunderstandings in the market and, thus, fail to provide a positive force guiding ongoing activities.

I recognize that supervisors have taken significant steps in recent years to make examinations more risk-focused and reflective of current and prospective risk exposures. I also recognize that examiners could disclose to the market some of the supplemental information behind their ratings, but I doubt that this would be sufficient, or even possible, in all cases and could lead the market to an incorrect view of a bank. I believe such problems could largely be avoided by focusing disclosures on significant examination findings and related information rather than the ratings themselves.

# **Concluding Comments**

A variety of factors are increasing the importance of market discipline and information disclosure in banking. The financial revolution that is now taking our banking industry into many new directions is giving the market a growing role in determining what banks do, how they do it, and what their rewards will be. In return, we have seen the banking industry become more innovative and responsive to the needs of financial customers and investors. However, for all of this market process to work and to foster a sound and capable banking industry, market participants must have access to accurate, comprehensive, and timely information. This need for information, moreover, is occurring at the same time that banking and financial products are becoming more complex and, in many ways, more opaque.

Although bank supervisors must be very careful in defining the role they will play in financial markets, they could inject a key source of transparency into the market process. Most notably, supervisors have access to a variety of information at banks, including both public and confidential data. In addition, supervisors expend substantial resources in analyzing this information and assessing the condition of individual banks.

As a result, increased disclosure of supervisory information could be of significant value to the market and is consequently a topic that deserves further thought and study by all of us. I believe that one supervisory option -- requiring publicly traded banks to disclose any significant weaknesses or material findings identified by examiners -- could be readily incorporated into examination and disclosure policies and could greatly help to enhance the effectiveness of market discipline.