Will Greater Disclosure and Transparency Prevent the Next Banking Crisis?

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Abstract

Greater transparency and disclosure of bank activities will not prevent future banking crises unless appropriate monetary, fiscal, and regulatory policies are also adopted. Nonetheless, greater disclosure of banking problems can reduce the costs of banking crises, even if transparency is not a panacea for preventing banking crises.

key words: Disclosure, Transparency, Banking Crisis

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Countries around the world have been experiencing serious banking problems, often resulting in slower economic growth and large taxpayer bailouts (Caprio and Klingebiel 1996, 1997). The most recent string of banking problems is occurring in Asia, where troubled banks are compounding difficulties from exchange rate crises (Kaminsky and Reinhart 1998; Kaminsky 1998). The Asian banking problems have been complicated by the lack of transparency and disclosure in the banking system, making it difficult to gauge the severity of the situation or propose timely solutions (Goldstein 1998a, 1998b). As a result, a common policy recommendation by the International Monetary Fund, the World Bank, the U.S. Treasury, and leading academics has been to adopt greater transparency and disclosure in the banking system.

Few would deny that a more open and transparent banking system would have moderated current problems in Asia and improved the chances of a more rapid resolution, but the benefits of transparency should not be oversold. Transparency can ameliorate problems but it cannot prevent them. So long as banks continue to be intermediaries that transform assets by taking short-term demand deposits and investing in longer-term loans, they will be susceptible to large macroeconomic fluctuations. Intermediation serves a highly useful role in linking savings and investment, and the solution is not to prevent banks from playing this role. Rather, the solution to these problems requires measures that extend well beyond improving the financial information disseminated by financial intermediaries, since the failure of a banking system, as opposed to the failure of a few banks, reflects more serious macroeconomic problems.

The next section will briefly discuss what is meant by greater transparency in the context of banking operations. The second section will discuss why transparency is likely to reduce the costs of bank failures but not to prevent them. The third section will provide some recent evidence on the benefits of transparency, and the final section will provide some conclusions.

I. Defining Transparency

While "transparency" is often discussed, only rarely is it clearly defined. This is unfortunate, because an accounting and management information system cannot be isolated from the purposes the information is to serve. By carefully examining what is meant by a transparent banking system, the paper by Jerry Fons (1998) makes a substantial contribution. Its primary focus is an examination of the association between countries with a pattern of corruption and countries with particularly opaque banking systems. Fons finds that countries where corruption is endemic are also countries with little transparency in their banking systems. A troubling implication, if this were to be viewed causally, would be that transparent banking systems could not be achieved until the pattern of corruption was broken. Such societal changes would likely be quite difficult to implement.

The association between banking transparency and corruption is useful in understanding why transparency is often difficult to achieve, but transparency requires more than a society with a willingness to obey rules. Many Northern European countries are viewed as having very little corruption; nonetheless, their banking systems are far from transparent. For example, the exposure of many of these banking systems to problem loans in emerging markets is impossible to deduce with current levels of disclosure. This is because disclosure and market discipline have not been the foundation of bank regulation in these countries.

A low level of corruption is also not a sufficient condition for avoiding banking crises. The Scandinavian countries appear to have among the lowest levels of corruption. Nonetheless, banking systems in several Scandinavian countries experienced widespread failures at the beginning of this decade. Thus, while many corrupt countries have poor transparency in banking, a low level of corruption is not sufficient for achieving a transparent banking system or avoiding serious banking problems.

Rather than defining transparency by association, I would prefer to define banking transparency by the information I would want available: in particular, three types of information critical to evaluating the financial condition of banks. First, are loans that fail to make payment of principal and interest classified and disclosed as nonperforming loans? Many countries in Asia did not disclose nonperforming loans, or used such restrictive definitions as to render the disclosure meaningless. Nonperforming loans should include "evergreened" loans, loans transferred to subsidiaries or affiliates, and direct and indirect loan exposures to failing companies.

Second, does reported capital closely reflect economic capital? Not only is this frequently not the case but Japan, in the midst of a banking crisis, has chosen to move further from this standard. Japanese accounting rules have been changed to allow equity holdings to reflect book rather than market values; the netting of assets and liabilities to reduce the level of risky assets; bank management discretion in evaluating the value of real property; and capital infusions by the government. Such accounting gimmickry greatly reduces the value of international capital adequacy guidelines.

Third, can bank risks and strategies be determined from publicly available information? While most Asian countries fail to meet this criterion, so do most accounting systems in the developed world. Country exposures, industry exposures, hedge fund exposures, derivatives exposures, all are examples of information that would be useful in evaluating the financial condition of a bank but is rarely fully disclosed. In reality, few banks provide sufficient data for an outside monitor to be able to evaluate worst-case scenarios.

II. Are the Roles of Banks Inconsistent with Full Transparency?

While disclosure is woefully inadequate in most banking systems, how compatible is transparency with the vital economic role banks play? One critical aspect of banking is the fact that banks utilize private information to make credit decisions. Part of a bank's value added is its ability to monitor and evaluate difficult-to-value assets. Thus, it is likely to be impossible for outsiders, with no access to loan files and no ability to monitor financial contracts, to accurately evaluate the bank. This is why any banking system, to be transparent, must also have reliable bank supervision. Bank supervisors have the knowledge and authority to monitor the management information system to verify that the private information is accurately portrayed in the financial statements. Thus, a condition for a truly transparent banking system must be the resources and human capital to provide adequate bank supervision.

A second critical aspect of banking is the fact that banks transform assets, and to intermediate requires taking risks. Any institution with liquid liabilities and illiquid assets is taking on risks. This transformation of assets provides a valuable service to the economy, by better linking saving and investment. However, the societal cost of these services is that the banking system becomes susceptible to large unanticipated shocks.

An example is the experience in the United States in the late 1980s and early 1990s. The United States has been a market leader in disclosure and transparency in its banking system. Yet, in New England, without any dramatic decline in exchange rates or unprecedented movements in interest rates, 79 of the 509 banks there failed. A large drop in real estate prices was sufficient to cause 14 percent of the banks in New England to fail, even though bank real estate exposures, nonperforming loans, and real estate prices had all been disclosed. The reason is clear from the table. When collateral values drop, bank capital can disappear quickly. Among the 79 banks that failed, 22 had a drop of more than 10 percentage points in their leverage capital ratio in a single year, and all but three of the failed banks experienced a one-year decline of more than 3 percentage points. That such large and rapid declines in bank capital can occur, in a country with substantial transparency and relatively stable macroeconomic policies, suggests the possibility of much greater losses in countries whose economy, interest rates, and exchange rates are far more volatile.

Any institution that provides substantial intermediation services may be endangered if macroeconomic policies are mismanaged. Large and unanticipated exchange rate declines, inflation rate increases, or collapses in collateral values are likely to bankrupt even well-managed intermediaries. While intermediaries can adjust to mismanaged economic policies, they do so by “gaming” the system, by ceasing to provide standard intermediation services. Thus, banks did not disappear during the Brazilian hyperinflation, but they no longer provided the transformation of assets that is possible in economies with more stable monetary and fiscal policy. Even with perfect transparency, intermediaries will not survive with inappropriate monetary, fiscal, and regulatory policies.

III. The Benefits of Greater Transparency and Disclosure

Disclosure can reduce the probability of a banking crisis and aid in the recovery, however. Transparency did not prevent the widespread failure of banks in New England, but disclosure did force prompt realization of losses, the transfer of assets to new owners, and quick recovery in the real estate markets. In contrast, the Japanese banks have delayed disclosure, allowing the banks and the government to remain in control of assets that would be better utilized after quick and efficient transfer to new owners.

Disclosure also forces the closure of clearly insolvent institutions. This reduces moral hazard problems and removes overcapacity in the market. Weakened banks with poor underwriting policies can affect the lending environment for stronger banks. Failing banks in New England were closed, allowing healthier banks to recapitalize quickly. In contrast, the failure to disclose has allowed insolvent Japanese banks to remain in operation, deferring necessary consolidation.

Even with such limited disclosure, however, market pressures are forcing Japanese banks to take unpopular actions. This can best be seen in the effect of increases in the "Japan premium" (Peek and Rosengren 1998). The Japan premium emerged in August 1995, coinciding with the failure of Hyogo Bank and the Kizu Credit Union. As the premium has widened, Japanese banks have been forced out of low-margin business, reducing their exposure in Hong

Kong and Singapore and pulling out of markets in Europe and the United States. The large Japan premium has exacerbated pressures already created by capital constraints (Peek and Rosengren 1997). As Japanese banks have had trouble getting international funding, many have been forced to withdraw from international operations and focus on domestic banking. Thus, pressure created by the Japan premium has encouraged Japanese banks to reduce their dollar exposures and avoid expanding further into Asia. This pressure has also forced banks to adopt strategies of looking for opportunities for higher returns and reducing assets and the number of branches and subsidiaries, in order to better accommodate their reduced capital. The Japan premium has also placed pressure on government officials to adopt bank bailout plans more quickly and encourage greater consolidation of the banking industry.

III. Conclusion

Disclosure and transparency are not a panacea, but they can reduce the costs of banking problems. Financial markets are quick to react to problems in institutions with large exposures to troubled sectors. This provides an incentive to limit exposure in any one area, and to quickly reduce exposure as problems emerge. Disclosure of problems can force banking consolidation, transfer of problem assets, and closure of insolvent institutions -- necessary conditions for quick recovery of a troubled banking sector. The lessons from the United States and Japan indicate that other Asian economies may be better off following the U.S. rather than the Japanese model. While the resolution of banking problems in the United States was controversial and unpopular, it resulted in a rapid resolution. In contrast, Japanese banks, by failing to disclose problems and not being transparent, have delayed their recovery and exacerbated their difficulties.

Table 1
Largest One-Year Decline in the Leverage Ratio at Each New England Bank, 1988:I to 1996:IV

Percentage Point Decline	Banks That Did Not Fail	Failed Banks
Less than 1	149	
1 to 2	110	1
2 to 3	66	2
3 to 4	41	7
4 to 5	25	12
5 to 6	18	13
6 to 8	15	13
8 to 10	3	9
Larger than 10	3	22
Total	430	79

Lesson: Capital can dissipate very rapidly.

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