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Introduction

Accounting, Transparency and Bank Stability

In 2004, the *JFI* and the Bank for International Settlements (BIS) organized the second biannual conference on banking regulation, in Basel, Switzerland at the BIS headquarters. The first conference, organized in 2002, had led to an outstanding issue of the Journal, edited by Ludwig von Thadden, and published in 2004. The issue was dedicated to the Basel II Capital Accord, and it represents an excellent source of fresh new insights about the Accord as well as bank regulation in general. Pushing further the research agenda defined by the 2002 conference, the 2004 conference was titled "Accounting, Transparency and Bank Stability." The papers evaluated issues connected with informational transparency and bank regulation, with a focus on capital regulation and the associated concerns related to risk-taking entailments and procyclicality. As with all issues of the *JFI* that are related to conferences, the process for inclusion of papers in the conference was separated from the review process for possible publication in the Journal. Every paper accepted for publication went through the same rigorous "double-blind" reviewing process that any submission to the *JFI* goes through. We believe this has resulted in an excellent issue once again. We were the special issue editors responsible for processing the papers included in this issue, and our objective here is to provide a brief overview of the papers in this issue of the *JFI* and indicate the common themes that connect these papers.

This issue contains five papers in addition to our introductory piece. These are "Disclosure, Investment and Regulation" by Per Östberg, "The Transparency of the Banking System and the Efficiency of Information-based Bank Runs" by Yehning Chen and Iftekhar Hasan, "Market Discipline, Disclosure and Moral Hazard in Banking" by Erlend Nier and Ursel Baumann, "An Analysis of VaR-based Capital Requirements" by Domenico Cuoco and Hong Liu, and "Procyclicality in Basel II: Can We Treat the Disease Without Killing the Patient?" by Michael B. Gordy and Bradley Howells. Out of these, all but the Cuoco–Hong paper were presented at the 2004 JFI–BIS conference; the Cuoco and Hong paper was submitted to the *JFI* as a regular submission. We included it in this issue because its topic fits the theme of the conference very well.

There are many who believe that there are three important factors affecting bank risk taking at the individual bank level and safety and soundness at the industry level. These are: (1) informational transparency; (2) the effect of regulatory supervision and market discipline; and (3) capital requirements. These three factors correspond closely to the three pillars of Basel II, the key being that greater informational transparency can facilitate both regulatory supervision of banks as well as market discipline. And informational transparency may also impinge on the design of capital

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requirements.[1] Thus, there are potentially interesting linkages among these three factors. Most of the papers in this issue consider primarily one or the other of these factors, although the Gordy and Howells (2006) paper discusses all three factors in the context of the three pillars of Basel II.

To some observers, the proposition that more information disclosure increases firm value is almost axiomatic. However, an extensive accounting literature (dating back at least to Verrecchia, 1983) examines the costs and benefits of greater disclosure. In his paper, "Disclosure, Investment and Regulation," Östberg (2006) develops a theoretical framework to analyze the effects of voluntary and mandatory information disclosure on a firm's value. He offers two important results relating to the broader topic of disclosure and financial regulation. First, disclosure mandated by regulation may diminish inefficient private-benefits extraction and enhance investment efficiency. Second, however, harmonization of disclosure standards may not be advisable because it reduces the average firm's market value. These results provide considerable food for thought for banking regulators as they contemplate international convergence of regulatory standards.

Information transparency and market discipline have their beneficial effects in part by punishing firms whose portfolio decisions turn out badly. Many bank regulators seem to fear that improved incentives for individual firms will therefore threaten the solvency of the overall financial system. Such concerns are reinforced by the idea that any system for evaluating bank condition—including market pricing of bank liabilities—will unavoidably entail some mistakes. So market discipline might improve the average bank's solvency by threatening to close banks for which risks turn out badly, but it might also close some solvent banks in the process. In other words, the effects of transparency and market discipline need not be the same for individual banks and for the entire banking system. Yehning Chen and Iftekhar Hasan (2006) address this important tradeoff in their paper, "The Transparency of the Banking System and the Efficiency of Information-based Bank Runs." The key question they address is: does greater information transparency always increase bank safety and improve depositor welfare? Building a simple model of bank runs, they show the surprising result that greater informational transparency may *reduce* depositor welfare by increasing the chance of an inefficient run. However, this does *not* necessarily imply that mandatory information disclosure—such as that prescribed by Östberg—is something that should be eschewed. The reason is that allowing bank managers to determine the timing of information disclosure will eliminate (contagious) inefficient runs, it may also eliminate efficient bank runs.

For many, including the Basel Committee on Banking Supervision, market discipline relies on informational transparency. But "discipline" only exists if market participants not only understand a bank's condition, but can also effect salutary changes (Bliss and Flannery, 2002). Can we determine if information disclosure can actually provide incentives for banks to limit their risk exposure? This question is empirically examined by Nier and Baumann (2006) in their paper, "Market Discipline, Disclosure and Moral Hazard in Banking," who examine whether the information environment limits bank default risks by causing them to hold sufficient capital buffers. Using a cross-country panel data set that includes banks from 32 countries and spans 1993–2000, they show that the effectiveness of market discipline in inducing banks to hold large capital buffers depends on both the regulatory environment and the bank's counterparties. They find that uninsured liabilities and greater information disclosure induce banks to hold larger capital buffers. However, this effect is weakened by an extensive government safety net. The efficacy

[1] Chan, Greenbaum and Thakor (1992) show the difficulty in designing incentive-compatible capital requirements under asymmetric information. See also the Nier and Baumann (2006) paper in this issue.

of market forces is also affected by competition policy: interbank competition tends to generate higher risk-taking, but market discipline is more effective in controlling such incentives in countries with strong interbank competition. Thus, the paper appears to be making a forceful case for greater informational transparency joined with a diminished governmental safety net and greater interbank competition. Apropos of Östberg's paper, Nier and Baumann would contend that a uniform, mandatory disclosure policy is probably sub-optimal, since its effects depend on each country's safety net and competitive conditions.

Domenico Cuoco and Hong Liu (2006) are also concerned with capital buffers in their paper, "An Analysis of VaR-based Capital Requirements." The Internal Ratings Based (IRB) approach to setting minimum capital ratios under Basel II descends from the value-at-risk ("Internal Models Approach") method for regulating market risk, which has been used in the U.S. since 1996. In order to generate some information about the likely effects of self-reported parameters in the IRB approach to credit risk measurement, Cuoco and Liu evaluate the theoretical properties of the 1996 market-based capital regulation. They point out that the affected firms select an optimal *combination* of reporting and investment strategies, and ask how closely the reported risks will correspond to the true investment strategy. Their numerical simulations of optimal portfolio strategies indicate that elicit truthful revelation of private information about asset portfolio risk. Furthermore, VaR-based capital requirements effectively offset the moral hazard distortions associated with insured deposit funding. These results seem to bode well for the success of Basel II's capital requirements for credit risk.

In their paper, "Procyclicality in Basel II: Can We Treat the Disease Without Killing the Patient?", Michael Gordy and Bradley Howells (2006) focus on a different aspect of the Basel II Capital Accord, namely whether it generates procyclicality in capital requirements. They argue that the Pillar I formula for adequate capital is a component of the information required for market discipline, and ask how to limit the New Accord's impact on loan cyclicality without destroying the information value of the banks' minimum capital ratios. Using a simulation approach and casting their discussion squarely within the three pillars of Basel II, they show that the impact of Basel II on bank lending depends crucially on the extent to which market discipline (as opposed to minimum capital formulas) causes banks to vary lending standards over the cycle. Rather than focusing on the usual peak-to-trough variation in minimum *regulatory* capital requirements, they acknowledge that market discipline may also impose capital standards, as found by Nier and Baumann. The cyclicality of bank lending then depends on the cyclicality of both regulatory and market capital requirements, depending on which one is more binding. Moreover, they argue that engaging in a debate over potential procyclicality without considering the effect of alternative measures on the information value of Basel II market disclosures may be misguided. For examples, measures that reduce intertemporal capital volatility may significantly diminish the ability to infer economic capital from regulatory capital.

While it is difficult to extract any sort of unified message from this set of papers because they touch upon a wide set of issues, they do collectively point out that the problems of information disclosure/transparency, banking risk, capital requirements and market discipline are closely intertwined. The Chen and Hasan (2006) paper cautions that greater informational transparency should not be an unqualified goal by itself, the papers in this issue do collectively suggest that a judicious combination of greater transparency—possibly through mandatory disclosures as indicated by Östberg—combined with reduced government safety nets, greater interbank competition, and carefully-designed capital requirements may help generate the appropriate degrees of informational transparency and risk taking. Further research on these topics seems to hold much promise.

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