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# COMMENTARY

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## 1. INTRODUCTION

In the wake of accounting scandals and concerns over the reliability of financial statements, policymakers have increasingly focused on whether investors are receiving sufficient information to evaluate companies. In the banking industry, the proposed Basel II Accord would require much greater disclosure than has occurred traditionally in many countries. This controversial proposal has prompted a substantial number of industry responses during the public comment period.

Four major concerns have been raised with the enhanced mandatory disclosure requirements. First, banks are already providing information demanded by investors. If investors demanded greater disclosure, management would provide it. Mandated disclosure is likely to result in information that many investors would not utilize. Second, mandated disclosure is costly to produce. If the information is not useful for managing the bank or requested by investors, the costs will outweigh the benefits. Third, mandated disclosure frequently reveals proprietary information that could place the bank at a competitive disadvantage, particularly relative to financial intermediaries not subject to the same disclosure requirements. Fourth, mandated disclosure is too complicated to be understood by most market participants, which may raise stock price volatility. It is this fourth concern that Ursel Baumann and Erlend Nier investigate in their paper.

The paper empirically examines the relationship between bank stock volatility and disclosure of close to 600 banks in thirty-one countries over an eight-year period. Baumann and Nier focus on the cross-sectional volatility and use the release of financial variables in annual reports (as captured by BankScope) as their proxy for disclosure. They find that both a composite measure of disclosure and various subindexes of disclosure are negatively correlated with stock price volatility. They conclude that greater disclosure may be useful to banks and investors and may lower the cost of capital by reducing stock price volatility.

The paper contributes to the literature by providing empirical evidence on whether greater disclosure increases stock volatility. Of the arguments raised against disclosure by the banking industry, this is perhaps the weakest. While the authors' evidence suggests that enhanced disclosure decreases stock price volatility rather than increases it, this evidence alone is unlikely to be compelling to a skeptic. The empirical work focuses on disclosure, and given the empirical design, it concentrates on voluntary, not mandatory, disclosure, which is not at the center of the policy debate. Nonetheless, the reversal of the volatility argument should cause industry commentators to ponder whether they can muster alternative empirical evidence on the relationship between volatility and disclosure. If not, the controversy surrounding enhanced disclosure should focus on more cogent arguments.

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## 2. MANDATORY VERSUS DISCRETIONARY DISCLOSURE

No one opposes discretionary disclosure by banks. It is mandatory disclosure that is opposed by many bank commentators. Unfortunately, this paper provides little insight into the issue. The cross-sectional regression includes country dummy variables. These variables are needed because of the many country differences that could account for differences in bank stock volatility not captured by other variables. However, this implies that the explanatory power in the disclosure variables comes from differences in disclosure at banks within countries, or at least controlling for country-specific effects. Because these disclosures differ within a country, they are likely to reflect increased voluntary disclosure rather than increased mandatory disclosure. If increased voluntary disclosure reduces stock price volatility, it does not necessarily imply that increased mandatory disclosure would do the same.

This result does raise an issue: If voluntary disclosure reduces stock volatility, why wouldn't more banks increase their disclosure voluntarily? This is particularly true if bank management is using the information for its own internal purposes, and there is little incremental cost to producing the information. In fact, there are many reasons why bank management would oppose value-enhancing disclosures, including timing asymmetries, compensation timing, management flexibility, and potential advantages to not revealing the full risk of activities.

Timing asymmetries occur when management can choose to disclose good news quickly but defer bad news until it is offset. Thus, bad news is often characterized as one-time events and is frequently offset by favorable events. A good example of this behavior for many commercial banks is 2003:2, when securities losses resulting from unexpected movements in interest rates were frequently offset by gains elsewhere in their portfolios or in other operations. To the extent that disclosures are mandatory, managers lose flexibility in timing disclosures.

Compensation timing has become increasingly important in the financial services industry as bonuses and options have become increasingly important sources of senior management compensation. Should the bank experience a bad year, bunching all bad news into that year will make it easier to hit targets in future years. Similarly, being close to thresholds in compensation can cause management to bunch good news to surpass thresholds and enhance compensation in that year. With mandatory disclosure, such timing becomes far more difficult.

Discretionary disclosure provides management with flexibility in overseeing expectations. Smoothing gains and losses can give the appearance of stable earnings, which may be rewarded by investors. Similarly, management may prefer to disclose bad news

at times when competitors are experiencing problems or when other economic news may draw less attention to the problems.

Finally, it may be difficult for investors to ascertain the true risk of a bank. Opaque institutions may be taking on more operational or credit risk than is reported, with investors having no way to verify this other than by looking at ex-post results. If large-tail events occur infrequently, management may be willing to take positions that risk low-frequency, high-severity losses but have a low probability of being revealed during their tenure.

Given these competing incentives, even if voluntary disclosures were value enhancing, management may still prefer discretionary over mandatory disclosure. If enhanced disclosure decreased volatility in stock prices, *ceteris paribus*, that might be a justification for increasing mandatory disclosure. Nonetheless, the fact that it provides this benefit would still need to be examined against other factors, such as cost.

## 3. EVALUATING THE EVIDENCE ON DISCLOSURE AND VOLATILITY

Disclosure is difficult to test in a cross-sectional, cross-country study because disclosure occurs whenever a bank official discusses material issues. As the authors readily admit, they test a particular type of disclosure—disclosure in annual reports and captured by BankScope. Unfortunately, such reports are likely to be only the tip of the iceberg. While mandatory disclosures in a given country will be captured because they are likely to occur in annual financial statements, the country dummy variable should capture that effect along with all other country effects, leaving no ability to distinguish how much of the dummy is capturing mandatory disclosures. Since many of the most interesting disclosures are likely to involve economic capital, vector autoregression models, and accounting footnotes, many of the most relevant disclosures are omitted from the analysis. In addition, other communications, such as analyst calls, other U.S. Securities and Exchange Commission filings, and management announcements, are not being captured.

The authors raise an important question in their analysis: Is it disclosure, or the need to disclose once a problem faces increased scrutiny by investors, that is likely to reduce volatility? They note the case of Abbey National in the United Kingdom. However, it is not at all uncommon for voluntary disclosures to increase to reduce uncertainty. In Japan, as the nonperforming loan problems became more severe, the strongest banks provided more disclosure to signal that they had fewer problems than some of their more troubled peers. Third-world lending problems in the 1980s and emerging

market problems in the 1990s led to enhanced disclosure for institutions with significant exposures. In fact, one reason why a bank may provide more disclosure is that it has more exposure to an activity. If so, then the disclosure variable may be picking up differences in exposures, rather than differences in disclosures.

Although the authors have not chosen to examine the time-series properties of enhanced disclosures, I believe it is a fruitful area for future research. Understanding what causes banks to increase disclosure, how long the disclosure continues, and what benefits accrue to institutions that enhance their disclosure when peer banks do not may help to isolate the effect of the benefits of increased disclosure. In the absence of the time series, one can only speculate on why disclosures vary by banks in the same country. One hypothesis is that banks disclose based on what is most material to investors. Small banks have few contingent liabilities or off-balance-sheet items and thus do not disclose these items systematically. While the authors use log size as a control variable, it is unlikely to capture the nonlinearities that relate size, scope of activities, and disclosure. Potentially splitting the sample by size would help identify whether this might be a problem.

A second hypothesis is that banks disclose information according to what is required by supervisors. It is not unusual to require different disclosures for larger institutions, institutions depending on their mix of products (for example, home mortgages versus commercial loans), different activities (for example, internationally active versus domestic), or different regulatory charter environments (for example, federal savings and loan versus commercial bank). Thus, a more complete study would need to examine why banks within a country choose different levels of disclosure.

While many of the variables examined in the paper are related to the risk of institutions, Basel II will provide far more potential information on credit and operational risk,

particularly for IRB/AMA (internal ratings-based approach/ advanced measurement approach) banks. These risk measures will be needed to determine incremental risk, so there is little incremental cost in disclosing variables already necessary for calculating capital. Since Basel II is based on economic capital models used by banks, it should provide more direct information on the risk of organizations. However, these new measures are not captured by BankScope, so the benefits and costs of Basel II disclosures do not have a direct analogy to variables examined in this paper.

#### 4. CONCLUSION

Some opponents of greater disclosure argue that it increases stock price volatility. Baumann and Nier provide evidence to the contrary. Enhanced disclosure may decrease volatility, and their paper provides initial empirical support for that proposition. These results add to empirical papers noting other benefits of disclosure, such as event studies of banks that have increased disclosure on well-publicized problems and have improved their stock price. Thus, this paper provides additional empirical evidence that enhanced disclosure may be advantageous to management and investors.

This is an important policy issue given the current question of how much disclosure is appropriate for Pillar 3 of the Basel Accord. Some of the debate can benefit from additional empirical testing of the propositions of both opponents and proponents of greater mandatory disclosure. In addition, more work on understanding why banks choose different information to disclose, and how it is used by analysts and investors, would provide further insight into what types of disclosure should be mandated.

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