"Disclosure and transparency in banking"

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Abstract:

Greater transparency and disclosure of the 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.

This study reports the results of an empirical investigation of the extent of voluntary disclosure by listed banking companies in India. It also reports the results of the association between company specific characteristics and voluntary disclosure of the sample companies. The study reveals that Indian banks are disclosing a considerable amount of voluntary information. The findings also indicate that size and assets-in-place are significant and other variables such as age, diversification, board composition, multiple exchange listing and complexity of business are insignificant in explaining the level of disclosure. However, this paper has contributed to the academic literature that financial institutions provide voluntary corporate information including social information as discharging their social responsibility and corporate citizenship

Over the past years, a number of initiatives have sought to increase the transparency of financial institutions. Among those initiatives, a push toward more disclosure of information in published accounts has been prominent. In particular, policy proposals have introduced a number of disclosure requirements that aim to improve the market's ability to assess a bank's risk and value. Whether such initiatives are beneficial is an open question. Indeed, there are a number of good reasons to be skeptical.

First, it can be argued that banks are inherently opaque institutions, and increases in disclosure may not be able to materially change this. "The push for increased market discipline and disclosure may shed light. But reformers should remember what they are dealing with.

Second, an increase in quantitative disclosures may not necessarily increase transparency. In the words of Federal Reserve Chairman Alan Greenspan: "A more complex question is whether greater volume of information has led to comparable improvements in transparency of firms. In the minds of some, public disclosure and transparency are interchangeable. But they are not. Transparency challenges market participants not only to provide information but also to place that information into a context that makes it meaningful".

Third, disclosure is costly. Clearly, requiring disclosure of information imposes a cost on banks, as on any firm, and this cost must be offset by resulting benefits for it to be justified. The costs of disclosure include the direct costs of producing and disseminating information, but also indirect costs that might arise when a bank's competitors are able to exploit the information that the bank provides to the financial market. To date, there is less empirical evidence has been found to help resolve the questions about the benefits of bank disclosure.

This paper attempts to fill this gap by presenting evidence on whether disclosure is beneficial for banks and whether disclosure is useful for financial markets. We investigate empirically the relationship between the volatility of a bank's stock price and the amount of information the bank discloses to the market. In particular, we ask whether banks that disclose a lot of information might have lower stock volatility than do banks that disclose little information.

Key words:
Banking system, Volatility of Banks, Extent of Disclosure, Risk, Annual report

Introduction:

The concept of disclosure and transparency holds a vital role in the era of modern economic growth where the availability of capital is the major driving force. The developing countries strive towards rapid economic growth and this can be achieved only by efficient and effective allocation of capital. The economic information therefore should be available in the most efficient manner to provide well- informed decision-making process. The most important aspect is reporting the success or failure of an economic unit that is utilizing a substantial portion of the capital of the country. A bank, which is an economic unit should therefore inform about the efficiency of their capital utilization to all the interested parties. Hence, effective disclosure and transparency means, communicating clearly to the diverse stakeholders of a banking entity, most important amongst which, are the capital providers.

Disclosure and Transparency is the extent to which investors have ready access to required financial information about a bank or company such as price levels, market depth and audited financial reports. This helps reduce price volatility because all market participants can base decisions of value on the same data.

Banks also have a strong motivation to provide disclosure because disclosure and transparency is rewarded by the stock's performance.

Banks play a vital role in the economy growth and the strength and stability of the banking system is of paramount importance. High ethical standards are necessary in banks and financial institutions to ensure their accountability to the society. The subject of disclosure and transparency has attracted worldwide attention with a series of collapse of high profile banks. In the recent years, the banking system in India has become more and more complex and open. It is at this juncture that a need for qualitative standards is felt. Disclosure and Transparency regulations include standards such as internal controls, composition and role of the Board, disclosure standards, risk management, financial reports etc. Consequently, only banks that follow sound and efficient governance practices will enjoy the confidence of the people.

In India, the increasing awareness and importance of disclosure and transparency in the industry, particularly in the banking sector can be attributed to a number of factors such as liberalization, corporate failures in banks, mainly co-operative banks, grim financial and other irregularities that have led to a growing public distrust of the governance process in the banking sector, competition due to the entry of new private and foreign banks and increased participation of shareholders. Banks that attach importance to Corporate Governance Standards always command a high premium due to the transparency of their transactions. Transparency of transactions and a high degree of disclosures mean that the stakeholders, internal and external, shall always have all the information that they need easily available at hand. This will result in banks gaining the confidence of its stakeholders, which will evidently have positive effects for the banks in return. While there have been a few previous studies along these lines, relatively little is known about actual trends in disclosure and transparency, their correlates, and their implications. Theory has provided useful insights, as we shall see below, but its implications are less than general. Our goal in this study is therefore to contribute new evidence.

Objective:

- To understand the challenge of information overload by the banks
- To understand the requirement of market analysts or investors with respect to information assessment for judging transparency
- To understand the constraints from the banks in disclosing the information as per the requirement of the stakeholders to measure the negative impact of stakeholders due to information overload

The fundamental objective of disclosure and transparency is to enhance shareholder's value and protect the interest of the other stakeholders by improving the banking performance and accountability. Hence it harmonizes the need for a bank to strike a balance at all times between the need to enhance shareholder's wealth whilst not in any way being detrimental to the interests of the other stakeholders in the bank. Further, its objective is to generate an environment of trust and confidence amongst those having competing and conflicting interests. To through light upon issues like, disclosure and transparency is seen as a compliance task where only the minimum is presented and then somewhat complainingly and fear of disclosing competitive information as competitors will use it.

An important unresolved issue is the extent to which bank transparency promotes or undermines bank stability. A large theory literature explores bank transparency and how it affects the risk profile of individual banks and the financial system as a whole. Overall, this literature tries to find what credible public information about individual banks can enhance the ability of regulators and market participants to monitor and exert discipline on bank's behavior, there are also endogenous costs associated with disclosure and transparency that can be detrimental to the banking system.

On the negative side, theory holds that transparency can lead to inefficient bank runs driven by coordination failures; create reputational contagion when disclosure of a bank's failure causes creditors in other banks to lose confidence in the bank regulator's competency; adversely affect incentives of bank managers and lead them to make inefficient investment decisions; restrict interbank risk-sharing arrangements; and undermine bank's ability to produce private money.

The conflicting views on disclosure and transparency revealed in this literature create a demand for empirical research that can provide insights into the nature of transparency and when, where, and how it positively or negatively affects banks and the banking system. However, bank transparency is a subtle construct that emerges as an indirect output from the interaction of disclosure and incentives of both bank managers and market participants. This complexity raises a number of empirical challenges. In this regard, financial accounting information is an integral component of transparency and as such is a powerful point of entry for empirical investigation into the nature of bank's disclosure and transparency and its economic consequences.

Review of the Literature:

Information asymmetry between the bank and third parties, whether these are investors, creditors, employees or the public authorities, can thus safely be considered as one of the main culprits of financial and economic crises and, as such, lies at the heart of actor's concerns. Disclosure and Transparency, whether voluntary or mandatory, would have the virtue of reducing information asymmetries and of allowing effective control of managers, and re-establishing good governance. In sum, though the problem is not new, the current crisis has installed transparency, and thus disclosure, as a one-stop shopping solution. Is such a position justified?

This review distinguishes itself from the existing ones by the adoption of an economist's point of view on this topical issue. More precisely, our perspective is to look at the issue from an economic growth perspective, while Leuz and Wysocki (2008), for example, consider the issue from the accounting, financial and legal perspectives, a view too broad to grasp for a interested reader not acquainted with the issue. Our argument is that, presently, both the media and the policy-makers present disclosure and transparency as a panacea to avoid financial crisis in the future, whereas the academic literature is more qualified. We particularly underline the important informational problems surrounding the issue, up to the paradox that too much information may kill information. In other words, we provide a skeptical guide to the present political emphasis on transparency as a panacea to real world crises.

As a background to the discussion, we start by defining disclosure and transparency, and the different forms it can take. We then turn to the objective of disclosure then we focus on the fact that the disclosure, voluntarily or compulsorily, can paradoxically reduce the available information. The last part synthesizes our results and concludes.

Banks, like business firms in other industries, must attract outside funding in competitive capital markets, face competition in product and labor markets, and deal with disclosure and transparency issues deriving from managerial self-interest and asymmetric information. As result, transparency plays similar roles in banking as it does in any other industry. However, in other respects banks are special and introduce additional considerations unique to the financial sector. It is often asserted that banks are inherently less transparent than non-financial firms (Morgan, 2002 and Flannery et al., 2004, 2013). An inherent lack of transparency is presumed to derive from the fact that banks' investment decisions are based on private information that is not available to those outside the bank (e.g., Diamond, 1984; Boyd and Prescott, 1986). Banks may also have incentives to suppress public information about their assets to support their role as liquidity providers (Gorton, 2013; Dang et al., 2014). The fact that banks take on risks that are opaque and difficult to verify raises concerns about excessive risk-taking by individual banks and the contribution of individual banks to the risk of the financial system (e.g., Financial Stability Forum, 2009, Brunnermeier et al., 2009, Hanson et al., 2011).

Findings:

Our findings also speak to studies that examine the role of financial reporting disclosure and transparency in the financial system (e.g., Beatty and Liao [2014], Goldstein and Sapra [2014]). The theoretical literature argues that, in certain circumstances, reporting transparency impairs financial stability. Goldstein and Leitner [2013] suggest that transparent reporting might destroy socially desirable risk-sharing agreements, while Rochet and Vives [2004] find that transparency could generate coordination failures and precipitate panic-based bank runs. Nevertheless, the traditional view is that reporting transparency promotes stability and development by allowing market participants to monitor the financial condition, risk-exposures, and overall performance of bank managers (e.g., Bushman and Smith [2001], Costello, Granja, and Weber [2015]). In addition, Barlevy and Alvarez [2014] suggest that disclosure could prevent credit markets' freezes by reducing information asymmetry about the location of risks in the economy. My work informs future theoretical and empirical studies about the empirical evidence on the long-run effects of regulatory policies that raise bank reporting transparency.

Summary:

An important concept in the theory of banking is disclosure and transparency. An important unresolved issue is the extent to which bank transparency promotes or undermines bank stability. A large theoretical literature explores bank transparency and disclosure, and how it affects the risk profile of individual banks and the financial system as a whole. Conflicting views on transparency revealed in this literature create a demand for empirical research that can provide insights into the nature of transparency and when, where, and how it positively or negatively affects banks and the banking system. Financial accounting information is an integral component of transparency and, as such, is a powerful point of entry for empirical investigation into the nature of bank transparency and its economic consequences. This article discusses key insights from recent research examining the relationship between bank transparency, viewed through the lens of financial accounting, and bank stability. The article focuses on the real consequences of accounting policy choices on individual banks' downside tail risk, codependence of tail risk among banks, and regulatory forbearance. The article emphasizes the role played by managerial discretion over accounting decisions in influencing bank stability through two distinct accounting channels: bank transparency and the accounting numbers as numerical quantities.

This study is related to several strands of the banking regulation, disclosure, and accounting literature. First, it is related to studies examining the disclosure and transparency policies promote stability and development in the banking system. My paper focuses on measuring the economic effects of adopting disclosure and transparency regulations in a powerful setting with staggered adoption of these regulations.

Conclusion:

Our general conclusion is that the disclosure and transparent behaviour of the banks in the post-transition period is mostly a result of objective factors (size, model of privatisation, overall economic development, capital market development, legislation, etc.), rather than a thoughtful assessment of the bank of its upcoming funding requirements. The insignificance of the profitability variable and the negative sign of the need for external financing indicate the low level of importance of the capital markets when they are illiquid and inefficient.

The aim of this article was to summarize the lessons from an expanding literature on the consequences of corporate disclosure of banks. However, the improvement in the quality of disclosed information, in peculiar thanks to better intern and extern control, and the enhancement of governance practices may provide a solution. The policymaker's emphasis on transparency thus may seem over optimistic, and at least calls for further reflection on how disclosure should be required.

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