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By

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DISCLOSURE OF INFORMATION AS A TOOL FOR FINANCIAL REGULATION

By

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ABSTRACT

Traditionally, financial institutions guarded with secrecy much information as to their own condition. They wanted to shield their operations from competitors, they sought to avoid regulatory pressure, and above all, they feared adverse publicity, loss of public confidence, and a bank "run." The regulators can and do now demand very extensive information reports, and field examiners check up regularly. Financial institutions whose shares are publicly traded are now obliged to divulge a great deal of information at quarterly intervals.

Yet there remain numerous areas of reporting for which the permitted accounting treatment often distorts the truth about a financial institution. Financial economists now press for greater use of "mark-to-market" valuation; despite its problems, more reliance on the market for updated valuation signals would convey true condition in a better way.

If financial firms knew that they would be obligated for regular and comprehensive informational disclosure, this would have the prophylactic effect forcing more prudent managerial choices. In addition to requiring public release of fully informative balance-sheet and income-statement reports, the regulators should specify a series of standard measures of merit which each firm would be obliged to publish with its financial reports. Public knowledge of these, and of the standing of each firm in comparison to others, would intensify the prophylactic effects of disclosure.

Finally, greater required disclosure by financial firms would force into the open the deficiencies of regulatory oversight. However, no miracles should be expected from greater informational disclosure. The S&L Bailout shows the need for firm and effective regulation.

Introduction

Financial firms -- banks and S&L's -- face numerous requirements of routine reporting to the governmental agencies that regulate them. Some information reaches the general public, but much has customarily been shared only between the firm and the regulatory agencies. Despite large information flows, both firms and regulators have sometimes been taken by surprise when significant losses materialized without apparent warning. In the unfolding S&L crisis and bailout, consumers, participants in the capital markets, and lawmakers have faced a long sequence of disclosures, analyses, and projections, each disclosing a much larger problem than the last. Was something wrong with the information? Did all concerned fail to interpret the available information correctly? These are significant questions for public policy.

Furthermore, the public disclosure of information is regarded as a good thing in itself, for it provides the consumer and investor with a better basis for decisions. It compels the business firms that know they must disclose information to anticipate that fact, and this alone may cause them to take actions that will reduce public criticism.

We will discuss how informative disclosure can induce the financial firm to behave more prudently; but we also show why this method has its limitations.

Finally, information concerning the financial firm and the financial industry has greater value over time if decisionmakers not only absorb it for what it can tell them immediately, but also learn from it over time -- establishing better methods of interpretation and

inference, better decision rules, and better predictive methods. Among other things, the S&L crisis signifies a failure to learn. Probing why this was so may help us to fend off or minimize other future crises.

Types of information the firm provides to the regulators

The financial regulators typically set up a standard format for periodic (monthly, quarterly, annual) reports of condition and performance, relying heavily upon accounting data. The regulated firm is then required to deliver the desired information according to established deadlines. In addition to regular reporting cycles, the regulators may demand special reports on matters of concern to them. An annual field examination procedure then facilitates what might be termed "investigative disclosure" -- that is, follow-up throughout the firm's accounting and other records and examination of particular transactions, to determine whether the firm has engaged in an improper practice, has concealed potential losses on assets held, or fails of compliance with regulatory standards.

This traditional examination has had an important place in the system of relationships between regulators and financial firm. In many states, the state-chartered S&L's, which were also Federally insured, were subject to joint state-Federal examination, to satisfy both state and Federal requirements at the same time. The traditional cycle was that of annual examination, with a highly conventional definition of the items dealt with in the examination. As more complicated financial products came into use, and as S&L's were permitted to engage in a widening range of business activities, the scope of

examination necessarily broadened. In addition to annual examination, the regulators have authority to order special examinations on a surprise basis. Often these have a limited and specific focus -- for example, to review the status of (often high-risk) loans for shopping centers or other commercial developments.

In addition to accounting reports, the regulated financial firm must file reports concerning a variety of other mandated requirements: compliance reports for the Community Reinvestment Act; reports on key personnel; reports concerning change of control; reports concerning dividend payments by the depository institution to its stockholders or to its holding company. The field examiners can cross-check these types of information as well as the accounting data of the firm.

The regulatory authorities can hold reported information about the firm in strict confidence, using it only to determine whether the firm is in trouble and should be visited with sanctions for unsound condition or for violations of regulatory standards; or, they may release portions of it to the public and the press.

Information provided by the financial firm to the capital market

Publicly traded financial firms also face disclosure obligations to their investors and to securities analysts. Every financial firm, public or private, is required to have an annual external audit. Both regulators and investors rely on the audit certification as a signal of the reliability of the books of account. For the regulators, the audit report serves as a cross-check of the validity of their examination and report flow. The significance of the external audit report has increased in recent years, as banks and S&L's have often

claimed to be in sound condition and then, suddenly, have been found to be insolvent. The Federal receivers for insolvent S&L's that had to be taken over have in some cases sought civil damages against an accounting firm that had provided audit certification to the accounts of a firm that, shortly after, proved to be insolvent.

Industry-wide reports compiled by the regulatory agency

The regulatory authorities typically provide quarterly and annual reports of the status and condition of the regulated industry. These are intended to inform the general public and the executive and legislative branches as to the problems facing the regulated industry. In addition, the regulatory authorities report on the status of the deposit insurance funds and the supporting institutions related to the industry.

As the S&L crisis emerged during the latter 1980's, and Congress was confronted with proposals for infusions of funds into the Federal Savings and Loan Insurance Fund, the Federal Home Loan Bank Board produced analyses in support of the bailout proposals. In retrospect, it is clear that each wave of reports underestimated the size and scope of the problems facing the industry. The estimated burden on the deposit insurance fund was therefore also seriously underestimated. Meanwhile, delay in confronting the critical problems resulted in additional losses and greater eventual costs.

Informational boundaries

The regulated financial firm does not have, in principle, any rights of accounting privacy, no protection against informational "search and seizure". The regulators can look at any transaction, in

as much depth as they wish. When it comes to the holding company of the financial firm, or to affiliated or subsidiary companies allied with the financial firm, there are likely to be inhibitions against following the trail of financial transactions into areas that are irrelevant to the condition and prospects of the financial firm itself.

Informational content

Accounting standards, set by the regulatory authorities and by the Financial Assounting Standards Board (FASB), determine how the books of account and the financial reports of the firm are to be structured. (Generally Accepted Accounting Standards (GAAP), however, are criticized by some economists because the true market value of each asset is not disclosed; more on this issue below.)

In addition, regulators have adopted "measures of merit", the reporting of which can be informative of the health of the firm. For example, in the 1960's, the California Savings and Loan Commissioner adopted a series of ratio measures. Ratios for the individual firm could be compared to industry averages for the firm's size-class. Certain of these measures were indicators of efficiency. The ratio of operating costs to total assets indicated the degree of success in cost control. The ratio of advertising expense to total deposit liability or to growth of deposit liability may indicate promotional efficiency.

Other measures were indicative of asset risk. In particular, the "Scheduled Items" ratio -- the sum of long-term delinquent loans, plus real estate owned after foreclosure (REO) plus loans to facilitate the

sale of foreclosed real estate (LTF), divided by the total portfolio -- became a widely-accepted signal of portfolio condition.

The financial context of the 1990's, however, requires attention to new types of asset instruments and new practices in financial management such as the use of hedging and options contracts. Also, firms can seek to benefit themselves through off-balance-sheet transactions, such as issuance of stand-by letters of credit. These developments imply that measures of efficiency and soundness must be redefined to keep pace with the marketplaces.

Impacts of informational disclosure to the public

Financial firms, regulatory authorities, and central bankers have a traditional bias against public disclosure of information concerning the safety and soundness of financial firms. Bankers have long feared that adverse information or rumors concerning a bank would precipitate a "run"; and of course there is ample historical evidence supporting this. A run on one bank can also spread to another, producing an epidemic of severe liquidity pressures. Experience of this in the 1929-32 Depression, plus the desire to protect the small depositor, led to the initiation of deposit insurance and formation of the Federal Deposit Insurance Fund (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC).

The financial regulators also issue reports of industry-wide conditions and trends. Industry trade-association spokesmen have sometimes inveighed against the release of adverse industry-wide information. Sometimes they have argued that such information heightens public anxiety and increases the probability of a run on an

institution acknowledged to be weak. Sometimes the argument is more general: that the health of the financial industry depends on a high general level of public confidence. While trade-association executives are notorious advocates of the "good news only" school of public relations, it would be of interest to understand whether a generally adverse public mood or climate can have specific effects on a major financial industry.

Disclosure of general, industry-wide weakness can lead to demands for new legislative protections and public policy interventions. However, most major financial reform legislation has passed as a reponse to a damaging crisis that already occurred. (Jones, 1979) The 1989 S&L Bailout legislation is of a piece with this general observation.

Financial-status disclosure as 'prophylaxis'

The regulator may place the reports of each institution on public file. News reporters and securities analysts can then use the information extensively for the business press and for investment analysis. There are several kinds of potential response. First, the consumer public and other depositors may become disturbed by indications of weakness and withdraw their funds from institutions reported to be in bad shape. Second, negative securities evaluations inhibit the market for the weakened financial firm's equity issues or other securities.

Both of these considerations convey a strong message to the executives of the firm: engage in more prudent behavior, for the future penalty cost of doing otherwise increases with the glare of

publicity. Thus, there are two types of significant prophylactic effects, but it is probably impossible to quantify the extent to which prudential behavior is induced.

General publication of ratios and other measures of merit also educates the public and the securities analysts to the use of indicative information. Industry-wide averages of the ratios provide a benchmark against which to measure the individual firm.

Also, publication of reports over time facilitates the tracking of industry trends. On this basis the regulator and an alert public can build a case for corrective actions or for greater regulatory authority.

Public disclosure and the mechanism of rewards and penalties through public response

The flows of savings to financial institutions can be affected by public disclosures. This has occurred to some extent in the savings and loan industry even though Federal deposit insurance protects the depositor up to the insurance limit. Institutions in weak condition have had to pay premium interest rates to hold deposits, and still higher premium rates if they were intent on deposit liability growth. More extensive public disclosure, even within the context of deposit insurance, therefore penalizes the weak firm, adding to its costs. Strong firms, meanwhile, claim to be somewhat adversely affected by rate competition, but they can still expand savings liabiity at the expense of the weaker firms.

Numerous current proposals would change the rules of deposit insurance. Chairman Henry B. Gonzalez of the House Banking Committee

proposes that, at the very least, deposits above the insured limit not be compensated. He also hints that a decrease in the insured limit, from $100,000 to some lower figure, and the elimination of many multiple coverages for the same individual, would be desirable. (See Gonzalez, 1990). If proposals such as these are enacted, the effects through redirection of deposit flows from weak to strong institutions will be intensified.

Regulatory costs of poor information

Recent experience in resolving closed S&L's indicates that for bad loans or other real estate-related assets, about 2/3 of the book value of a loan is eventually recovered. However, there is substantial variation around this approximate average percentage. Also, workout of loans involves heavy professional expenses (legal fees, workout specialists and brokers, etc.), substantial delays, and occasional instances in which the property collateral requires renovation investment prior to disposal.

An institution that emphasized high-risk, large-scale commercial and multi-family projects might have half or more of its assets turn sour. Thus, the overall loss from bad loans might be 1/2 X 1/3 = 1/6 of portfolio value. For a $1 billion institution, this comes to $160 million.

Perfect information, as defined by decision theorists, enables the decision maker to choose an action that avoids losses that would otherwise occur. Some irreducible level of risk attaches to lending operations in any case, and the minimum level actually differs for different loan categories. The lowest risk level can be represented

by the experience of the best-run firms in the industry. Golden West Financial Corporation and its World Savings subsidiary provide a base number from their experience: write-offs for bad loans are less than 0.1% of portfolio.

With perfect information and instantaneous response, the regulatory authority might be able to intervene early into a failing institution and save the deposit insurance fund almost the full amount of potential loss. In the above example, perfect information would be worth $160 million.

Some limits on the value of disclosed accounting information

Reported information on financial status may fail to reveal true condition. One example is the practice of establishing an "interest reserve" as part of a loan package for a multi-family property. If the proceeds of the project are for a time insufficient to meet current requirements, the borrower is allowed to "pay" interest from the interest reserve, a purely paper transaction. This, however, prevents the loan from being classified as delinquent. Such interest reserve arrangements may provide as much as two years of grace. Other problems stem from practices of accounting classification and transaction recording that conceal weaknesses of condition.

Financial institutions that engage in real estate finance are themselves acutely aware that the poor quality of a financial asset may not be evident at first; rather, the loan turns bad over time -- often, a period of months or years. (Previous studies of loan delinquencies have indicated that the highest probability of delinquency and foreclosure for single-family residential mortgages

occurs in the second through fifth years of the life of the loan.)

Given these accounting methods, and given the time-lags in the onset of observed risk of default, the regulatory authorities have problems in assessing the condition and future prospects of a regulated financial institution. In principle, they must reach a judgment of the future state of the institution; but the available accounting information is not fully reliable.

Predictive models of the financial firm

Financial economists have developed numerous predictive models of the financial firm. These are usually simulation models and are usually based on the accounting structure of the firm. Thus, they provide a projection of the balance sheet and income statement of the firm for a series of future time-periods. The starting point is typically the accounting record of the most recent past year or two of the firm's history.

Firms themselves sometimes use these models for their own planning. Staff of the regulatory agencies can use them to attempt to predict which firms will be seriously at risk. One basic difficulty of relying on such models, however, is that there is not a definitive consensus on the internal functional relationships that ought to be built into the models, or on the coefficients that need to be estimated and incorporated in these models. The other is that the models must work from some characterization of the firm's market environment and the risks stemming from that environment.

As more is learned about the economics of the financial sector, and as they acquire greater analytical sophistication, the regulatory

agencies will be able to make much more extensive use of predictive models. The first of the above-mentioned difficulties will be easier to overcome than the second.

Mark-to-market accounting

Financial economists have recommended the use of "mark-to-market" accounting for both assets and liabilities of financial institutions. Lawrence White, former member of the now-defunct Federal Home Loan Bank Board, has argued that this approach is needed as a correction against the artificial and often unrealistic book values that are ordinarily reported by financial firms according to Generally Accepted Accounting Principles (GAAP). (See White, 1990.) Congressman Gonzalez, in the statement already referenced, gives a cautious endorsement of mark-to-market.

As interest rates change, however, long-lived financial assets would gyrate in market value, upward or downward. Also, although some financial assets and liabilities have direct market referents, others are not traded in financial markets on any regular basis. (In fact, financial intermediaries are sometimes said to have a positive role in the economy because they are in a position to provide credit that is not immediately marketable.) An asset having no direct market referent for pricing could be approximately evaluated if there is a reasonable proxy by means of the market valuation of a close-neighbor financial asset that is freely traded. But to find the right proxy may be very difficult.

Both regulators and securities analysts would face a new problem if mark-to-market were mandated: net worth is a residual value, in

accounting terms, and net worth under mark-to-market accounting would fluctuate over a very wide amplitude. Regulatory standards of capital adequacy that are now based on book values of assets and liabilities would have to be reformulated in a mark-to-market accounting world. Further, some smoothing of the reported values, by formula, might well be needed in order to impart reasonable stability to the balance-sheet magnitudes on which both regulatory and investor judgments rely. No such smoothing formulation has yet been proposed or adopted.

With all of these reservations, mark-to-market accounting would help to dispell some fictions of financial condition that can now afflict the public, the financial executive, and the regulator. Even if adopted only partially, mark-to-market would inject a welcome note of market realism into financial firms' accounting.

Informative disclosure requirements vs. regulatory restrictions and interventions

With comprehensive Federal deposit insurance, and *de facto* coverage for multiple accounts and even above the generous limit of $100,000 per account, the depositor has no reason to seek a careful evaluation of the true condition of a bank or S&L. Informative disclosure would have a greater effect upon depositor behavior, however, if statutory limits on deposit insurance were in fact enforced, or if these limits were lowered. Depositors would more quickly steer their liquid assets away from firms thought to be weak or unsafe and toward firms thought to be safe.

Equity investors and holders of the debt securities of the financial firm already have a definite interest in accurate and timely

disclosure of profit performance and balance sheet integrity. They already tend to punish firms that are thought to be in poor condition and reward strong firms. Raising capital to meet higher capital adequacy standards becomes problematical for the weak firms. Thus, rewards and sanctions for management's performance do exist via the capital market. These would be further strengthened if more accurate, timely and comprehensive information were available and were fully disclosed.

Arguments against wider disclosure are of course made. Generally they emphasize that a financial firm may be able to work its way out of trouble, given time, and that disclosure has immediate consequences that will reduce the probability of the firm's recovery. The greater good, to the industry and to the economy as a whole, is generally best served, however, by emphasizing the positive benefits of the capital-market rewards and sanctions just discussed. The firm that fails to be efficient or fails to control its risks has to face penalties; otherwise it, and firms like it that are watching, will not take the course of prudent management.

When informative disclosure is not enough

First, the individual financial firm operates in a structure: defined marketplaces for assets and liabilities, and a set of rules of the game laid down by the regulatory system. From time to time, this structure needs reform or modification, as indeed it did when Congress considered and passed FIRREA in 1989. Such changes of structure result from public policy debate, which is made more sensible by the presence of full information about the industry and its firms, but

which is also predicated on public policy analysis and upon political choices among priorities and institutional devices for regulation. Such changes of the structure, therefore, go considerably beyond informative disclosure as such.

Second, the regulator may adopt standards and formulas as more-or-less automatic guides to acceptable behavior of the firm. For example, the law now sets forth the requirement that the firm must restrict its deposit growth unless it meets a high standard of capital adequacy. Such regulation by formula reflects the rationale of the public policy framework.

Third, the regulator is responsible for monitoring the population of regulated firms and for enforcing standards of safety and soundness. Some firms wilfully violate prudential and other regulations or work themselves into weak condition through bad underwriting of loans or other defects of management. The regulator must then have available some form of enforceable restriction -- typically, the cease-and-desist order. This goes beyond mere prophylactic effects of informational disclosure and tells the firm's management that it must observe certain imposed limits.

Finally, the financial regulator must have available the power of intervention. The purpose is to protect the public and the deposit insurance fund when a firm is engaging in unsafe and unsound operation and is approaching, or has reached, insolvency. Intervention can start with the placement of regulatory personnel inside the financial firm for continuous monitoring. (FDIC Chairman William Seidman announced in October 1990, that he had initiated a continuous

monitoring program for 400 US banks.) Intervention can then move through intermediate stages. Its end-point is seizure of control and displacement of the incumbent management and board of directors, with a view to liquidation of the firm or its forced merger.

Intervention strategy faces an informational dilemma. If the regulator is forced to wait until there is already available, completely definitive evidence of the firm's insolvency, the eventual losses to be absorbed are likely to be very large. These losses can be reduced through much earlier intervention, to cut off the firm's desperate attempts to recoup its position through high-risk actions. However, very early intervention may be difficult to justify, especially in a court action for which evidentiary justifications must be presented in order to avoid the charge of confiscation of property without due process and without just compensation. The cost-minimizing strategy and the easily-justified strategy are at odds. Financial economists such as George Kaufman recommend strongly a policy of early intervention, and they advocate a strong enough statutory base to enable the regulator to follow this strategy.

Learning, and failure to learn

Having accurate and timely information concerning its own condition and performance, the firm can compare itself to industry-wide benchmarks and seek to improve. Its immediate market environment, however, may or may not permit improvement. This sense that firms were sharply constrained by adverse local market conditions led to numerous pressures for "forbearance" (i.e., flexibility and delay) in the enforcement of tightened capital standards during the latter

1980's. Speaker Jim Wright held up the proposed 1987 recapitalization of FSLIC until he extracted promises for such forbearance.

The political economy of financial regulation has thus, ironically, sometimes prevented firms from accepting the information they receive and acting upon it to learn how to improve on their own. The political alternative of seeking an easier set of standards has for a time blunted the impact of adverse performance information. As we know now, this avoidance of the hard lessons of poor performance, both by the regulated firms and the regulators, added greatly to the cost of the S&L bailout. Industry trade associations abetted this avoidance, because they held themselves out to be effective in protecting the poor performers from enforcement of standards, and to be able to weaken the standards themselves through political pressure.

A regime in which clear, well-enforced regulatory standards set the framework of the firm's operation, and in which the firm is held accountable by having to meet risk-adjusted capital standards, will almost certainly induce more rapid organizational learning as the firm captures its own performance information and compares it with industry-wide data.

The failure to learn was, therefore, partly caused by the success of the financial industry in obtaining temporary political relief from the adverse performance impact of bad market conditions. In addition, however, the structure of rules within which firms were expected to operate was poorly designed. Not having enough emphasis upon tangible capital requirements and upon meeting risk-adjusted capital standards, the rules failed to alert the equity investors of these firms that

they must monitor carefully the behavior of the firm's management. The managers themselves were able to indulge the luxury of postponing recognition of serious problems, because they had available to them a quite wide array of accounting techniques for delaying the reportable impact of trouble. These defects in structure blunted the impact of information. Organizations did not face their situation and learn how to cope with their worsening problems.

The great five-year mystery: public policy paralysis, despite information and warnings.

The recent S&L Bailout came five years too late. That there was a serious problem of industry losses and a need for public policy action became evident in the mid-1980's from the research of financial economists, including the economic research section of the Federal Home Loan Bank Board. This research was widely reported and discussed. In 1984, in fact, the then-Chairman of the Federal Home Loan Bank Board requested additional examination staff and attempted, unsuccessfully, to install growth-restricting policies against weak firms. The prevailing climate in the Executive Branch, however, favored deregulation and shrinkage of government. Meanwhile, Congressional leaders were anaesthetized by campaign money. Five years of neglect and delay ballooned the cost of the Bailout to what is now estimated at several hundred billion dollars.

Informative disclosure of the condition of individual firms and the condition of a financial industry is not, in itself, sufficient to activate a meaningful public policy response. A painful lesson of this episode is that immediate political considerations can easily

negate prescriptions that are crafted through rationalistic use of firm and industry information.

A recommended disclosure policy

1. Balance sheet and income statement, quarterly and annually, made public.

The regulatory authorities now receive balance sheet and income statement information, quarterly and annually, from each depository institution. This accounting information, together with reporting of the mark-to-market value of assets and liabilities that can be priced and reporting of the contingent liability of off-balance-sheet items, should be made public for all to see.

2. Timely write-off of bad assets and public reporting of such write-offs.

In the past, financial institutions have not conveyed an accurate picture of their true condition if they could leave intact for protracted periods the apparent book value of bad assets, recognizing losses only when realized in actual transactions. This can be cured by requiring prompt write-downs of bad assets as soon as valid information about the potential loss becomes available. This would also have the effect of compelling the firm to safeguard the level of its net worth and replenish it if necessary, as write-downs would be subtracted from net worth.

3. Measures of merit.

The banking authorities and the Office of Thrift Supervision have numerous measures of merit which should be put into standardized form and reported publicly for each firm. These measures could include:

(1) the ratio of adjusted net worth to total assets. (The adjustments would consist of reserves against each category of risky assets.)

(2) the ratio of operating costs to total assets.

(3) the ratio of "Scheduled items" (delinquent and foreclosed loans) to total assets.

(4) the maturity distributions of assets and liabilities, and the computed net exposure to interest-rate risks.

(Other measures of merit may already be in use and could be added.)

4. Industry-wide performance reports, and reports of the condition of the deposit insurance fund, quarterly and annually.

The public's need to know can be met if the regulatory authorities publish summary reports, quarterly and annually. The Office of Thrift Supervision has made public a report, as of 3/31/90, showing how many S&L's were in each category of profitability and capital adequacy. Such reports should be continued and made public for all segments of the depository institution industry.

If substantial information in each of the above categories is made public by the regulatory authorities, they will thereby discharge an obligation to inform the general public of the state of the financial industry.

5. Public release of regulatory actions.

At times, the regulators have imposed restrictions on the regulated firm but have not made these actions public. Sanctions are likely to have much stronger effects, both on the offending firm

and on other firms in the industry, if they are made public for all to see.

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