BANK FOR INTERNATIONAL SETTLEMENTS

Financial stability and risk disclosure

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To the FSB Roundtable on risk disclosure

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Good morning, and welcome to Basel. We are meeting at a time of great turbulence and uncertainty in the global economy and financial system. But although all of us are focused on immediate challenges and risks, it is important not to lose sight of the need to carry forward our longer-term agenda towards building a better, stronger financial system. Your discussions today are an essential part of making progress on this agenda. If we can achieve a significant improvement in the quality, comparability and timeliness of risk disclosures by financial firms, this will without a doubt help break the vicious cycles of contagion, asset sales and pullback from risk-taking that have paralysed markets repeatedly over the last few years.

The three pillars of Basel II continue to guide our efforts to strengthen financial regulation in the Basel III era and beyond. We've now accomplished a great deal on Pillar 1 – minimum capital requirements. The task now is to follow through on Pillar 2 by strengthening supervisory review, with a focus on firm-wide risk management and risk governance, and on Pillar 3 disclosures, by improving market discipline. And while Pillar 3 is a good step in the right direction, achieving our overall objective of stronger market discipline will require efforts that go beyond strictly regulatory approaches.

How do we promote market discipline? First, we need to make sure that the market has the information it needs. And a key element of market information is sound, consistently high-quality risk disclosures. That will be the subject of my remarks, and of course the theme of your discussions today. But I should also point out that market discipline only works when investors have the right incentives to use the information, and banks have the right incentives to take account of the signals sent by the market. For these incentives to be right, the perception of a public safety net for banks that are "too big to fail" needs to be eliminated. This points to the relevance of the work by the FSB and Basel Committee to reduce moral hazard by increasing loss absorbency, strengthening resolution procedures and enhancing supervisory intensity for systemically important banks. If we successfully follow through on this work, then investors will have stronger incentives to develop a comprehensive picture of the risks and exposures facing financial institutions, and the banks should face more pressure to be as accurate and transparent as possible about these exposures.

The FSB and the Basel Committee have long supported sound accounting and robust disclosure standards and practices. Examples include the risk disclosure template for structured credit products set out in the Financial Stability Forum's report to the G7 in April 2008, the Basel Committee's work on Pillar 3 disclosures, and the more recent work to encourage sound expected-loss provisioning rules and related disclosures.

Sound standards and practices enhance the quality of information available to investors, depositors and other market participants, as well as to prudential authorities and regulators – including about risk exposures, risk management practices and policies, governance, and capital measures and ratios. This can lead to greater transparency that can support market confidence, improve market discipline and facilitate sound risk management practices by

financial firms and other companies, and has the potential to lead to more consistent practices over time. Together with effective supervision, these can help to foster safe and sound banking systems and more stable financial markets.

We should recognise the limitations to what improved information about risks can achieve. The economy and the financial system are always changing and evolving, and our understanding of key relationships struggles to keep up. Risks often appear precisely in the areas to which market participants and public authorities have paid the least attention, and about which they have demanded the least accurate information. Given these limits to our understanding, we need to be prudent. This means protecting the system against the unknown and unexpected, for example by strengthening capital and liquidity buffers at institutions and initial margin in traded markets.

Nevertheless, strengthened, transparent disclosure is good for markets, because it helps investors make more informed decisions. It is good for prudential supervision, because it helps to make banks more accountable, both to supervisors and investors. And it is good for the stability of the system as a whole, because it reduces the chance that unexpected events will cause major system-wide disruptions. We should not forget that the official sector has a direct interest in promoting financial stability through increased transparency; the experience of the past four years has reminded us of the many costs that a poorly functioning financial system can impose on taxpayers and the real economy.

One might think that market participants would naturally provide comprehensive, relevant disclosure in a timely manner, since it's in the interest of investors, counterparties and institutions. But as we have seen, this is often not the case. For example, during the ongoing turbulence related to European sovereign debt, investors and market analysts have struggled to develop a comprehensive and reliable assessment of the exposures of financial institutions to troubled sovereigns through bond holdings and derivatives positions. Some of the disruptions to bank funding markets have reflected scepticism as to whether enough is known about these exposures, as well as the chain of exposures related to them – banks' exposures to other banks, and so on. We at the BIS regularly publish information on the aggregate exposures of national financial systems, but of course this says nothing about the network of exposures of individual institutions. Lacking adequate information to inform their risk assessments, providers of funds have naturally pulled back from European financial firms of all sorts – in the process undermining the stability of the system and putting still greater pressure on banks and sovereigns.

This suggests the public sector has a key role in promoting market transparency. Whenever one suggests the public sector should do something, it's good practice to identify the specific market failures that impel public action. With respect to risk disclosure, I would emphasise the following ones.

First, *common standards have externalities*. Just as everyone benefits from common weights and measures in the physical world, or from common standards for electronic media like DVD encoding, there's a social benefit from financial statements following a single standard, including key concepts, common definitions and principles, and, to the extent possible, common formats. In some cases, collaborative efforts by the industry can generate the needed standards; in others, especially where the subject matter is complex and there is a wide range of interested parties, some of whom may not support full, timely transparency, the public sector must play a role.

Second, *producing and gathering financial information are subject to "free rider" problems*. It's costly to produce, interpret and analyse information from disclosures. But if one investor or counterparty does so, prices adjust and others benefit from it. So while investors can and do make money from carefully studying publicly available information, there's still an incentive to "free ride" – to wait for someone else to gather relevant information, then to share in the benefit by trading on it. And preparers may face similar incentives to wait for

others before providing useful information about their risk exposures and risk management practices. As a result, everyone in the market may just watch each other, instead of making the investment in producing and obtaining accurate information. There's no way to completely eliminate such free-riding from markets, but establishing common standards goes part way, by reducing the costs – in time, effort and resources – needed to produce and acquire market-relevant information. We want to see a richer array of information made available that is less costly to collect, more widely available to market participants, more usable and more comparable. This should help take us towards markets where prices are moved primarily by new information, rather than by herd behaviour, leverage or sudden shifts in risk appetites.

Third, *if the information environment is murky, then markets overreact to bad news*. We saw this in the 2007–09 crisis – whenever problems were discovered in one asset class, or one institution, investors started to scrutinise similarly placed assets or institutions, and downgraded their valuations of them. This sometimes led to a self-fulfilling process that made things still worse. The same has happened in sovereign debt crises, including the current challenges in Europe – when one country gets into trouble, investors immediately look around to see who's next. This creates a kind of collective action problem – it makes sense for each player individually to pull back, but when many players do this the impact is devastating for the market as a whole. Greater transparency is one way to help break this cycle, by making it possible for investors to see more precisely where, and whether, their concerns are justified.

Saying there is a public sector role in promoting transparency, for the reasons I've just laid out, is not the same as saying that strengthening transparency is the public sector's job alone. Indeed, industry and investor efforts need to be at the centre of developing standards, since this will ensure that new requirements have the proper technical grounding and a strong buy-in by market participants. The public sector can contribute by catalysing private sector efforts and by directing those efforts in fruitful directions. At the same time, however, if the private sector does not step in to address these issues adequately, supervisory and regulatory authorities may need to undertake further reforms to improve disclosure standards and practices.

Alongside this work at the firm level, the international community has also been working to improve transparency by strengthening the collection, aggregation and dissemination of financial sector data. The BIS, together with the Committee on the Global Financial System, has long performed this role with respect to cross-border banking and OTC derivatives market activity. Looking forward, the FSB has made substantial progress in developing a data framework that facilitates monitoring of key interlinkages among the major global banks in a consistent manner. While this project is still very much work in progress, it is notable that national authorities and the FSB are considering storing and pooling the data collected nationally on a harmonised basis in a central hub, proposed to be hosted by the BIS. The FSB and national supervisors are also working to make sure that the shift of derivatives market activity to central trading and clearing platforms leads to a greater availability of useful market-level data on activity in these instruments.

Also, following the FSB recommendation earlier this year, the FSB's Standing Committee on the Assessment of Vulnerabilities, which I chair, is also assessing whether newly identified risks could benefit from improved risk disclosure practices.[1]

[1] See the FSB thematic review report on risk disclosure practices, March 2011, at www.financialstabilityboard.org/publications/r_110318.pdf.

But even as we work to improve the assessment of risks and the availability and quality of aggregated industry and market data through efforts by the official sector, strengthened disclosures by individual institutions still offer the most promising benefits in terms of strengthening financial stability. Going forward, I would emphasise a number of key challenges:

- *Following through on convergence of IASB and FASB accounting standards, including their risk disclosure requirements.* Progress in converging the two main international accounting standards frameworks will help ensure that users can make meaningful comparisons across institutions and entities operating in multiple jurisdictions.
- *Developing standards for the discussion and analysis that firms provide to complement the figures in the financial statements.* Common standards can be useful not only for financial data, but also for the interpretations given to them. Disclosures often seek to provide information "through the eyes of management" that reflects how organisations measure and manage their risks. While this approach can be helpful in understanding business models and risk management practices, it can lead to disclosure of information that is not comparable across firms, and therefore difficult for investors and regulatory bodies to assess.
- *Strengthening the contribution of external audits to the quality of risk disclosures.* What is the degree of assurance that auditors provide about public disclosures, including those in financial statements, managements' discussion and analysis sections of financial reports, and risk information on their clients' websites? To what extent, and in what ways, do they review or audit the accuracy and reliability of the financial reports that they examine, and how do they report on their assessments and findings to the public? These are deep questions about how to best evolve the audit function as financial systems and investor needs evolve, and they won't be resolved overnight. They need to be addressed, however, if we are to clarify and to strengthen the role of auditors in promoting transparency at firms.

The discussions at the FSB Roundtable today will mark important steps towards progress in many of these areas. I am confident the FSB and its standard-setting bodies are up to the task, and I encourage key stakeholders in the private sector to join together to encourage and to support better, more transparent risk disclosure practices.