1 Introduction

Inadequate disclosure by commercial banks has been cited as a contributing factor to the financial crisis. Banks did not report enough information about the assets they were holding or the risks that they were exposed to, and inadequate disclosure meant that investors were less able to judge risks to a bank’s solvency than bank insiders, such as managers. Investors did not demand sufficient disclosure prior to the crisis. Possible reasons for this include risk illusion, or expectations that governments would be willing and able to bail out failing banks.

Increased uncertainty aversion during a time of systemic stress led to investors withdrawing funding from the most opaque banks. The lack of transparency is likely to have intensified the crisis – for example, by leading to much higher funding costs, even for relatively healthy banks. Increased disclosure can help to alleviate the problem of asymmetric information between banks, who have good information about their own financial resilience, and investors that provide funding to banks, who have less information.

Better disclosure can be beneficial to financial stability in non-crisis times, too. With good information, debt investors are able to price risk more accurately and, if the incentives are right, this can act as a disciplining force on banks. As debt investors become aware of the risks that banks are taking, they are less likely to provide funding to banks that are not providing an attractive trade-off between risks and returns. This can affect the risk-taking decisions of bank managers. This market discipline mechanism empowers investors to ensure that managers are acting in their interests, and reduces the likelihood that a bank takes risks that its investors are not aware of. Therefore publishing better information may reduce the probability of future financial crises, as it can make sudden changes in investor sentiment less likely.
Public disclosure reduces information asymmetries between insiders (managers of banks) and outsiders (investors), and so means greater certainty for investors in their ability to forecast the performance of banks’ debt and equity. In a perfectly functioning market, investors would demand that managers of banks disclose information about risks in order to allow those investors to correctly price the banks’ liabilities. In principle, in the absence of social externalities this market discipline mechanism could make prudential regulation redundant: investors would ensure that banks do not behave in a socially harmful way by influencing management. The idea that investors may be able to effectively monitor financial institutions and constrain socially harmful risk-taking has been a cornerstone of regulatory policy for years. Basel II explicitly states that the purpose of “market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The [Basel] Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution” (Basel Committee on Banking Supervision 2006).

However, frictions exist which prevent this market discipline channel from functioning correctly. That leads to information asymmetries, a tendency for banks to become overly leveraged, and a higher probability of banking crises, all of which reduce social welfare.

Mandatory disclosure policies can – if correctly calibrated – correct for these market failures and increase social welfare. These can act as a complement to prudential regulation, allowing both market participants and regulators to take responsibility for ensuring that bank managers’ incentives are aligned with those of their stakeholders, and leaving regulators to address any externalities to which stakeholders do not attend. This chapter discusses the evidence for whether investors monitor the financial institutions in which they invest and the reasons why this “monitoring channel” may break down. We conclude with a discussion of whether more information and increased market discipline is actually optimal for financial stability.

2 Modeling and measuring market discipline: testing the “monitoring channel”

Empirical studies disagree on whether private sector agents reliably engage in risk monitoring. Researchers cannot directly observe whether every agent pores over financial statements, or participates in conference calls with banks. In practice, testing for whether investors monitor a bank usually means examining whether the return that private sector agents demand is commensurate