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Bank Risk and Analysts’ Forecasts

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2.1 Introduction

The financial crisis has highlighted, inter alia, that the financial community as a whole suffered from important limitations and distortions in the perception of risk faced by banks. The distortion materialized in a marked underestimation of risk by the major players in the system: top management, board of directors, rating agencies, regulatory and supervisory authorities, and so on.

Agents subject to regulation tend to adapt their behaviour to minimize its impact; regulatory and supervisory authorities can react to this behaviour by adapting the rules. However, regulatory and supervisory authorities have difficulties in keeping up with players (by generating new rules always fully adapted to current situations), because players have strong financial incentives to minimize the cost of regulation by exploiting the areas of action allowed by the regulation itself. Market discipline, at least ideally, consists of dynamic and highly motivated entrepreneurs, seeking to minimize the cost of regulation to maximize the return on their investment, in the guise of investors, who wish, acting in a competitive market, to maximize the return on their investment per unit of risk taken. In this context, avoiding regulation (gaming the system) would cease to be profitable because it could be immediately identified, and punished, by investors watching the actual risk-taking rather than the formal observance of the rules.

The ability of outsiders to perceive the risk faced by a bank is essential for the functioning of so-called market discipline. In an ideal situation, market discipline sanctions banks that take risk considered to be excessive by increasing the cost of unsecured funding (equity) and subordinated debt (wholesale deposits and bonds) and by lowering the levels of
their activity. Market discipline tends, therefore, to moderate the consequences of moral hazard that leads banks to assume the maximum risk (in order to maximize profitability) given the cost of funding. The correction to the banks’ incentives realized through market discipline, which makes risk-taking progressively more expensive, would align the incentives with those of society overall, given the known general implications of banking activity. The logic of the third pillar of Basel regulation, which promotes transparency in risk communication, does indeed have the objective of strengthening market discipline. According to the third consultative package of Basel 2, 1 ‘The purpose of Pillar 3 – market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2)’ 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 [financial intermediaries]’.

However, market discipline does not seem to have prevented banks from taking excessive amounts of risk in the period preceding the financial crisis that began in summer 2007, by taking insufficient levels of capital resources in respect of the risk taken and by operating with excessive levels of leverage. Clearly, the market was misinformed, or did not react adequately to the available information.

Financial analysts, as a key component of the financial community, should show distinctive ability to perceive the risk taken by (listed) banks. One might indeed expect that analysts, being professionals highly specialized in the study of the financial and economic characteristics of listed companies, are the agents in the best position both to estimate the risk faced by the issuers of securities for which they provide investment recommendations and to perceive, in advance of the rest of the financial community, the variation in risks taken by the issuer (in the case of interest a financial institution) whose securities they closely and thoroughly follow. A good ability to estimate the risk of an issuer should also translate into a ready ability to predict changes in the issuer’s profitability.

This chapter aims to explore the accuracy in the perception of risk by financial analysts and whether this ability has shown changes (in the direction of an improvement or a deterioration) in concurrence with the financial crisis.

The chapter is organized as follows. Section 2.2 presents the motivations for this study in light of the literature on analysts’ forecasts. Following on, Section 2.3 considers the methodological issues