

What Constitutes Appropriate Disclosure for a Financial Conglomerate?

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Abstract

This paper addresses the disclosure issues for financial conglomerates principally from the same perspective as that of the Basel Committee on Banking Supervision: that disclosure is important for the safety and soundness of banks. However, we reach substantially different conclusions with respect to three important disclosure issues: the role of market value accounting; the frequency of disclosures; and the role of subordinated debt.

We start by asking why any special disclosure might be required for financial conglomerates. This question immediately leads to a discussion of what is special about financial conglomerates. We also address the question of, "Disclosure to whom?" There are at least two potential audiences for information disclosures: financial regulators; and the public investors/creditors/customers of a financial conglomerate. Issues of the appropriate structure for a financial conglomerate, and the information revelation that should accompany that structure, are also raised. Finally, we return to the title topic: What constitutes appropriate disclosure for a financial conglomerate.

Unfortunately, by turning its back on the three most important steps that could be taken to improve information disclosure -- mandating market value accounting (MVA) for banks' reports to regulators, aiming toward daily submission of these reports, and requiring the issuance of subordinated debt -- the Basel Committee has fundamentally undermined its efforts to enhance banks' safety and soundness.

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I. Introduction

This is a propitious time to be discussing issues of financial disclosure for financial conglomerates. After two-plus decades of debating an end to the Glass-Steagall and Bank Holding Company Acts' limitations on banks' participation in other parts of the financial services universe, the Congress finally passed the Gramm-Leach-Bliley Act in 1999. Less than three years later, two large financial conglomerates -- Citigroup and J.P. Morgan Chase -- have received stunning public rebukes for their roles in the accounting and corporate governance manipulations of some of their clients.

Simultaneously, the Bank for International Settlements' (BIS) "Basel Committee on Banking Supervision" has proposed a revision ("Basel II") to its 1988 capital standards, in which "market discipline" -- driven by public disclosure -- is one of the three "pillars" for strengthening the safety and soundness of banks.¹

This paper will address the disclosure issues for financial conglomerates principally from the same perspective as that of the Basel Committee: that disclosure is important for the safety and soundness of banks. We will, however, reach substantially different conclusions with respect to three important disclosure issues: the role of market value accounting; the frequency of disclosures; and the role of subordinated debt.

We will start by asking why any special disclosure might be required for financial conglomerates. This question immediately leads to a discussion of what is special about financial

conglomerates. We will also address the question of, "Disclosure to whom?" There are at least two potential audiences for information disclosures: financial regulators; and the public investors, creditors, and customers of a financial conglomerate. Issues of the appropriate structure for a financial conglomerate, and the information revelation that should accompany that structure, will also be raised. Finally, we will return to the title topic: What constitutes appropriate disclosure for a financial conglomerate.

Much of the discussion will reference the financial and regulatory institutions of the U.S. and their experiences. The insights and lessons to be drawn from the discussion, however, have wider applications.

II. Why Should There Be any Special Disclosure for Financial Conglomerates?

We start with fundamentals: Why should there be any special disclosure for financial conglomerates? This, of course, naturally leads to an even more basic question: What is special about financial conglomerates that would warrant special disclosure?

The specialness of a financial conglomerate must rest with the presence of a depository and/or an insurance company embedded within it.² We will start with a depository -- specifically a bank.³

A. Why banks are special.

The specialness of banks is generally attributed to their generic combination of assets and liabilities: relatively illiquid assets (usually loans) and highly liquid liabilities (deposits). This combination makes them potentially vulnerable to depositor withdrawal "runs".⁴ In addition, banks are at the center of the payments system, so they have constant creditor-borrower relationships among themselves, leaving them exposed to potential losses (and preemptive runs) at each others' hands.

This specialness of a bank is best illustrated by a stylized balance sheet, presented in Figure

1. The bank's assets are primarily the loans that it makes. Its liabilities are primarily the deposits that it has gathered (and uses to fund its assets). The difference between the value of its assets and the value of its liabilities is its net worth or owners' equity. In the financial world, this is frequently described as "capital". The bank of Figure 1 is solvent and would be considered adequately capitalized by the standards established by the Basel Committee in 1988.⁵

It is important to note that the bank's capital is simply the arithmetic difference between the bank's assets and its liabilities. The bank's capital has no separate existence or measurement, except as represented by this arithmetic difference.

Let us now examine a second stylized balance sheet in Figure 2, where the bank has suffered a substantial reduction in the value of its assets. Instead of the positive capital of \$8 of Figure 1, the value of the bank's deposit liabilities in Figure 2 exceeds the value of its assets by \$12; its capital is \$-12. It is badly insolvent.

Typically, the depositors do not have recourse against the owner of the bank to cover the shortfall -- either because of a legal structure of limited liability for the owners of a corporation (the bank), or a legal structure of personal bankruptcy limited liability for the bank's owner, or both. Consequently, the depositors will have to absorb and distribute the loss somehow among themselves.

Though the absorption of loss by liability holders is a general problem where limited liability is present,⁶ it is a special problem with respect to banks, for at least three reasons. First, some bank depositors may be relatively unsophisticated and poorly informed, and in a poor position to protect themselves against the losses from a bank's insolvency;⁷ also, banks are more opaque (and thus more difficult to be informed about) than are other enterprises.⁸

Second, and related to the first, banks are especially vulnerable to withdrawal runs by imperfectly informed depositors, who may be uncertain about the financial condition of their bank and who fear that they may have to absorb some losses. Because the bank's loan assets are

generally less liquid (it typically keeps only a little cash on hand) than its deposit liabilities, even a solvent bank cannot immediately satisfy all of its depositors' demands for withdrawals -- or even the withdrawal demands by more than a small fraction of depositors. If forced to meet the demands of more than that small fraction, the bank must (a) borrow from somewhere;⁹ (b) call in its loans and/or liquidate its illiquid assets at short notice and likely at less value than would occur from a more orderly and leisurely sale; or (c) shut its doors and delay paying its depositors until its loans are repaid or assets can be sold in an orderly way, thereby reneging on its liquidity commitment to its depositors.

Accordingly, a "prisoners' dilemma" problem may well arise: Though a bank may be solvent and informed depositors know that it is solvent, they may fear that other depositors are worried about the condition of the bank and that the latter's withdrawals would strain the bank's resources. In that case, even the knowledgeable depositors would want to race to the bank to withdraw their funds first. But such a general race to the bank will put strains on even solvent banks, thus making everyone worse off.

Third, there may be a "contagion" effect, where depositors of one bank, seeing a run on another bank, may fear for the solvency of their bank -- or may just fear that other depositors of their bank will become worried and begin to withdraw, etc. Alternatively, because banks are at the center of the payments system and are frequently in the position of being a short-term lender or borrower vis-a-vis other banks, the insolvency of one bank may cause a cascade of insolvencies of other creditor banks (or may cause a contagion of runs by banks-as-creditors who have imperfect information and fear insolvency, etc.).

Some version of the above scenarios (plus the perceived position of banks as special lenders) has caused the American polity, since the early nineteenth century, to consider banks to be special and to develop special regulatory regimes to deal with their specialness. At the center of such regimes have been efforts to maintain their solvency -- to keep them "safe and sound". Since

1933, federal deposit insurance has provided an additional layer of assurance to depositors (and thus an additional damper on potential depositor runs), by protecting them against regulatory failure;¹⁰ in an important sense, with deposit insurance in place, safety-and-soundness regulation becomes the rules that protect the deposit insurer (as well as protecting uninsured depositors and other creditors).

There are four major components to safety-and-soundness regulation:¹¹ (a) minimum capital requirements;¹² (b) activities limitations;¹³ (c) management competency requirements; and (d) in-the-field examiners and supervisors to enforce the rules. The minimum capital requirements are the direct effort to maintain a bank's solvency. This was the primary focus of the 1988 Basel Accord and remains as the first of the three pillars of Basel II. The activities limitations can be seen as efforts to limit risk;¹⁴ there are some important structural issues related to activities limitations and information revelation, to which we will return below. Management competence is related to "operational risk", which is a component of the capital requirement that is the first pillar of Basel II. And the enforcement of the rules requires in-the-field examiners and supervisors, with effective supervision serving as the second pillar of Basel II.

B. Activities limitations, and the appropriate structure for a bank.

Let us proceed on the assumptions of the previous section: that banks are special, and that safety-and-soundness regulation is an appropriate means of dealing with their specialness. Activities limitation has been a traditional tool of safety-and-soundness regulation. The logic for limitations can be seen from a re-examination of Figures 1 and 2: If the bank is to remain solvent (i.e., its capital is to remain positive) despite the uncertainties of future outcomes, then minimum capital requirements must be specified for all of the activities that could negatively affect the bank's balance sheet.

There is an immediate implication:¹⁵ The only activities that are appropriate for a bank are those that are "examinable and supervisable" and thus can be regulated in a manner that is

consistent with the safe-and-sound operation of a bank. In practice, this would mean an activity for which regulators are capable of setting suitable capital requirements and making judgments about the competence of the bank's management in managing the activity.¹⁶ This examinable-and-supervisable decision ought to be a regulatory judgment; but the political appointees at the leadership of the regulatory agency should be held accountable for those judgments.

Any activity that is not appropriate for a bank (because regulators are not able to set capital requirements and/or judge managerial competence in the activity) should nevertheless be permitted for the owners of a bank, for a bank holding company, for an affiliate or subsidiary of the holding company, or for a bank subsidiary (so long as the bank cannot count the net worth of the subsidiary as an asset of the bank¹⁷). Figure 3 provides a highly stylized and condensed picture of the consequent structure of the locations of appropriate and inappropriate activities for a bank.

As a practical matter, it is clear that loans and loan-like products are highly likely to be deemed appropriate for a bank: Regulators are familiar with them and believe that they can set appropriate capital requirements and judge managerial competence. What about the two financial services that were at the center of two decades of contention in the U.S. about their appropriateness for banks -- securities activities and insurance activities? The logic of the "examinable and supervisable" approach is that their placement within a bank, or alternatively somewhere in a related entity, ought to be the result of a judgment by bank regulators about their ability to set capital requirements and judge managerial competency.

And what if a bank decides that it wants to operate a delicatessen? Though bank regulators might be able to hire restaurant consultants who could provide advice as to appropriate capital levels and ways of judging managerial competence, it seems likely that bank regulators would decide that this activity was not an area of their expertise and ought not to be permitted for a bank -- but should be permitted for a bank's owners or for a bank's subsidiary.

Finally, even with activities sorted by examinable and supervisable criteria, the transactions

(e.g., loans, or asset sales or purchases) between the bank and its owners, affiliates, and subsidiaries must be closely monitored, because they provide a ready means for resources to be siphoned from the bank. The bank may overpay for some services that it buys or undercharge for some services that it sells and thereby cause its insolvency.¹⁸ There are also indirect ways that a bank can be weakened to the benefit of its owners. The bank may mis-price transactions to friends of the owners, who in turn provide payment or favors to the owners. Or, in the context of a financial conglomerate, a bank may provide loans to a company whose equity shares are being underwritten by the conglomerate's securities affiliate. Though such loans may have a sound basis in the special information that the securities affiliate possesses and forwards to the bank, the loans may instead be a way that the bank provides risky support for the company so that the securities affiliate reaps benefits from the company through investment banking fees.¹⁹

Consequently, such direct and indirect transactions between the bank and its owners and affiliates must be on arms-length terms and monitored closely, and penalties for violations must be severe.

C. The similarities with insurance companies and defined-benefit pension funds.

Part of the logic of the case for safety-and-soundness regulation extends to at least two other financial institutions: insurance companies, and defined-benefit pension funds.²⁰ Figures 1 and 2 can readily be adapted to portray stylized versions of each. For either, the assets can be loans or other investments. Instead of deposit liabilities for banks, the insurance company would have its insureds' likely claims as its liabilities, and the pension fund would have its pensioners' likely claims. An insolvency for either, along the lines of Figure 2, would mean that the assets of the institution were inadequate to cover the claims.

Though neither type of institution is subject to the "runs" problems of banks, their claimants are likely to be poorly informed and/or in a poor position to protect themselves against actions that could put their claims at risk. Accordingly, it is not surprising that every state has a safety-and-

soundness regime that applies to insurance companies and that all states currently have mutual guarantee funds that serve as a financial back-up for a claimant whose insurance company has become insolvent. Similarly, since 1974 the claimants of defined-benefit pension funds have had recourse to guaranty coverage provided by the federal Pension Benefit Guaranty Corporation (PBGC), and the PBGC and the Department of Labor's Pension and Welfare Benefits Administration have safety-and-soundness regulatory powers vis-a-vis defined-benefit pension plans and their corporate parents.²¹

III. Appropriate Disclosure (1): To Regulators

The safety-and-soundness regulatory regimes that surround banks (and insurance companies and defined-benefit pension plans) need information about their regulated institutions. Since the maintenance of solvency is the primary goal of the regulation, we will first focus on the representation of solvency: the balance sheet of Figure 1.²² We will also discuss the riskiness of the balance sheet,²³ and the special concern about transactions with affiliated parties.

A. Financial statements.

1. A market value accounting approach.²⁴ Recall that capital serves two important functions. First, it is the direct indicator of solvency -- the direct buffer that protects depositors (or the deposit insurer) against a decline in the value of the assets. Second, because capital is essentially the owners' equity in the bank, greater capital is a disincentive to risk-taking, since owners' relative stake in the bank (which would be at risk) is larger.

The logic of these functions points strongly toward regulators' receiving balance sheet information that best represents this buffer and incentive/disincentive. *This logic points to the use of market-value accounting (MVA)*, where market values are used wherever possible for asset and liability values.²⁵

Unfortunately, that is not the accounting system that is the standard for financial statement

presentation, for regulators or for the public. Instead, the standard accounting system -- "generally accepted accounting principles" (GAAP) -- is a backward-looking, historical cost-based system for assigning values to assets and liabilities. Though GAAP does have some elements that reflect current market values,²⁶ it is primarily historical cost-based, and that is the perspective that pervades standard accounting.

The drawback to GAAP for the purposes of safety-and-soundness regulation is straightforward: A bank's solvency definitionally diminishes as the value of its assets declines (or the value of its liabilities increases). And it is just at the time of diminished solvency that the owners' incentives to take greater risks increase (since the owners have less to lose); but the "downside" of that risk-taking will mean even greater losses and possible insolvency. Accordingly, bank regulators should want to know about declines in asset values as rapidly as possible, so as to limit the risk-taking behavior that might exacerbate those declines.²⁷ But GAAP, with its historical orientation, is slow to recognize asset value changes, down or up, and thus does not serve regulators well.

Though this slowness to recognize asset value changes looks evenhanded, it is not. First, regulators' concerns are asymmetric. They care much more about insolvency than about overly high levels of capital. Second, banks have a ready but dangerous strategy to circumvent GAAP's slowness to recognize asset gains: sell the assets that have embedded gains.²⁸ But banks can continue to hold assets that have declined in value and continue to account for them at acquisition cost. In essence, GAAP provides banks with a valuable option.

This strategy of selling "winners" to recognize gains (which can be sent, via dividends, to owners), while holding "losers" at historical cost, can logically lead to a balance sheet with only overvalued assets, whose current (market) values are below their nominal values that are listed on the balance sheet. This is not a recipe for the maintenance of the true solvency of a bank.²⁹

It might appear that the numbers on the balance sheet would not matter, so long as

regulators know the "true" (i.e., market values) of assets and liabilities. And GAAP (since the mid 1990s) has required a footnote statement of the market values of financial assets. But regulators are largely driven by what is represented on the balance sheet, not what is in footnotes. The regulatory rules are largely written in terms of capital as reported on the balance sheet. The ability of regulators to restrict a bank's behavior is driven by the balance sheet's report of capital, as is the ability to appoint a receiver and thus wrest control from the owners.³⁰

There are two main objections to a system of MVA.³¹ First, opponents claim that it would introduce more volatility into banks' income statements. Support for this claim is sometimes provided by a "backcasting" of historical bank experiences and showing how their reported incomes would have been more volatile if a MVA framework had been in place. But this argument fails to acknowledge that volatility as measured by market values is what regulators should care about. Even more important, the backcasting exercise fails to recognize that banks would change their behavior if they knew that the MVA framework would be the standard for future reporting. To the extent that they care about reported volatility, banks would hedge and otherwise modify their behavior in ways that would reduce volatility as reported in the MVA framework. This additional hedging and other behavior modifications might be costly; but, if market value reporting is what is important, this is the right framework within which the tradeoffs between the smoothing of income flows and the costs of doing so should be considered.³²

A second objection is that some assets and liabilities may have no ready markets for valuation purposes, and thus estimates would be required -- opening the door to potential error and manipulation. This argument has gotten progressively weaker, as larger portions of banks' assets have become securitized or otherwise sellable. Further, significant parts of a bank's balance sheet already require estimates and judgments -- e.g., asset lives and depreciation, the timing of when the value of an asset should be considered impaired and written down and the extent of the write-down, the liability costs of future retirees' benefits.

Still, even where there are no perfect substitutes that have market valuations, there may be close substitutes that, through modeling, can be related to the balance sheet assets in question. The modeling, of course, must be validated, first by the bank's auditor and ultimately by the regulator. But even imperfect modeling, if done and monitored responsibly,³³ is likely to be an improvement over the backward-looking focus of historical cost accounting. Only where market analogs and reliable modeling are not available ought historical costs to be the standard.

The same general principles should apply to the valuation of liabilities as well.

2. The frequency of reporting. The current standard of frequency of reporting of financial statements is once a quarter, though regulators can require more frequent reports from banks that are of concern. This is far too infrequent. Banks do not slide into difficulties only at the end of a calendar quarter.

In an age when every bank is or should be wholly electronic in its financial accounts (and thus the marginal costs of frequent reporting ought to be quite small), more frequent reporting is both desirable and feasible. Weekly reporting should be the immediate goal, and daily reporting ought to be a near-term goal. Daily reporting is the standard for securities firms and investment banks. It should also be the standard for commercial banks and other depositories.

3. The Basel Committee's approach. Unfortunately, the Basel Committee is hostile to MVA, embracing the historical cost orientation of GAAP. Though the Committee acknowledges the "sell winners, hold losers" problem, the Committee is worried about increased volatility and imperfect estimates.³⁴ The Committee has consequently greatly weakened the effectiveness of its capital standards.

The Basel Committee's approach to frequency of reporting is one of silence as to specificity.³⁵ Again, this weakens the effectiveness of its capital standards.

B. Riskiness

1. The necessary information. The primary regulatory approaches to riskiness are the

insistence on adequate capital (for activities that are examinable and supervisable) and the exclusion of activities that are not examinable and supervisable. Essential to the determination of adequate capital levels is a measure of the risk characteristics of the assets and liabilities, including any covariance effects. And essential to that determination are forward-looking stress tests, that indicate how well the institution's capital (i.e., the net arithmetic outcome of assets less liabilities) survives a variety of unfavorable macroeconomic scenarios. Further, of course, all such outcomes must be calculated in MVA terms.

Consequently, regulators need detailed information about the types, amounts, characteristics, and histories -- including covariances -- of all assets and liabilities of a bank. And they need a standardized stress test that is sufficiently comprehensive and detailed so as to be able to use all of the information to forecast outcomes.

Further, because transactions with owners and affiliates are potential vehicles for siphoning resources out of the bank, detailed information about such transactions is essential. In addition, information about indirect transactional advantages provided to owners or their affiliates is necessary.

Finally, a requirement that banks issue a tranche of tradable long-term subordinated debt as part of their required capital -- say, equal to 2% of their assets -- would provide regulators with an additional source of information, from the capital markets.³⁶ The presence of subordinated debt would bring to the bank a group of stakeholders whose interests would be similar (though not identical) to those of the regulator, since the holders would not gain from the "upside" of risk-taking and would be the first parties affected by the "downside" after the owners' equity was erased. If issued as long-term debt with layered maturities, its holders could not all run on the bank simultaneously. The pricing of the debt would itself be an important source of information. And the layered maturities would mean that the bank would be rolling over and reissuing the debt at frequent intervals, providing an additional important source of information.

2. The Basel Committee's approach. The Basel Committee has three alternative approaches to risk. First, and simplest, is its "standardized approach" to credit risk.³⁷ Similar to its 1988 capital standards, the standardized approach has a number of risk categories ("buckets"), with a capital requirement (risk weight) for each category. The standardized approach expands the number of buckets (as compared to the 1988 standards) and includes as additional relevant information the bond ratings of any borrower that has rated debt;³⁸ but it does not encompass an explicit forward-looking stress test;³⁹ it does not acknowledge covariances;⁴⁰ and it relies on GAAP rather than MVA for measurements of capital.

Second is the Committee's "foundation internal ratings-based approach", whereby a bank can provide its own estimates of default probabilities.⁴¹ The Basel II document provides the other risk components, including loss given default, exposure at default, and allowances for offsets. Forward-looking stress tests are expected to be part of the bank's estimation procedure. But the stress tests need not be conducted any more frequently than once every six months. Again, covariances are not explicitly acknowledged. And, again, all capital measurements rely on GAAP rather than MVA.

The third method is the Committee's "advanced internal ratings-based approach", whereby a sufficiently sophisticated bank can provide its own estimates of the other risk components, but is otherwise similar to the "foundation" approach.

Further, the Committee takes no specific stand on what activities are or are not appropriate for a bank, although it is suspicious of "significant" equity holdings in commercial enterprises,⁴² and it recognizes the risks of transactions with affiliates.

The Committee's concerns about special disclosure with respect to financial conglomerates appear to be focused largely on the risks of multi-stage financial leveraging or gearing.⁴³ This issue is readily demonstrated in a modification of Figure 1, as shown in Figure 4. Instead of all \$100 of the top-tier bank's assets being devoted to loans, \$8 has been devoted to an equity investment in a

subsidiary second-tier bank. With that \$8 of equity, the subsidiary bank can attract \$92 in deposits and make \$100 in loans -- or even itself set aside \$8 for an equity investment in a third-tier bank, etc. Thus, in principle, the multi-tiering means that the original \$8 of equity in the top-tier bank has achieved substantially greater leverage (and reduced protection for deposits) than the 12.5-to-1 capital-to-assets of the simple bank of Figure 1. The Committee also points out that this multi-tiering could occur with an insurance company or a securities firm as the parent or the subsidiary.

The Committee's approach to the multi-stage leveraging problem is to insist on consolidation at the parent level for the purposes of determining adequate capital -- i.e., ensuring adequate capital at the parent bank level so as to take into account the full leverage of the overall conglomerate. However, the Committee fails to acknowledge explicitly that this multi-stage leveraging is a general problem that applies to any equity positions taken by the bank.

Finally, the Committee fails to endorse a requirement for the issuance of subordinated debt, a mechanism that (as was argued above) would yield additional valuable information for regulators.

In sum, the Basel Committee's approach falls substantially short of appropriate disclosure to regulators -- in terms of the accounting framework employed, the frequency of reporting, and the specifics of addressing risk.

IV. Appropriate Disclosure (2): To the Public

Appropriate public disclosure by publicly traded companies is a broad topic that extends considerably beyond the issues surrounding financial conglomerates. The Basel Committee's interests in disclosure do not extend broadly, however. They are solely concerned with disclosure as the third pillar to support the safe-and-sound operation of banks. Nevertheless, the broader context is worth considering before focusing on the Committee's concerns.

A. The broad issues.

Generally, the extent to which regulatory involvement in public disclosure is required

depends on one's view of investors. I will offer two broad views, in order to highlight the contrasts.⁴⁴

1. The asymmetric information-awareness model. This approach starts by assuming that potential lenders and investors are aware of the asymmetric information problems that pervade finance. They realize that potential borrowers⁴⁵ have more information about themselves and about their prospects for repayment than do the lenders and that actual borrowers may know more about their actions and the effects on repayment than do the lenders. Lenders therefore recognize that they need to acquire information about prospective borrowers, so as better to assess the riskiness of the prospective borrowers and to decide to whom to make loans (and to whom to say "no") and on what terms; and to monitor their actions after advancing a loan, so as to be able intervene if circumstances warrant.

Let us describe the lenders/investors in this paradigm a bit more. They are *aware* of their informational limitations. Loosely, we might describe them as "*knowing* that they don't know what they don't know." They may occasionally be fooled by deliberately misleading information; but they will learn from this experience and move on. They will rarely be fooled by vague or inadequate information. Because they are *risk-averse* as well as *aware*, the presence of less (or inadequate) information about a prospective borrower will cause the lenders to fear the worst about that borrower and to add a large risk premium in their consideration of whether to lend and on what terms.

In this context, financial statements provide an important source of information about enterprises that want to borrow, which will help the *aware* lenders to pierce the fog of asymmetric information in assessing prospective enterprise borrowers beforehand and in subsequently monitoring enterprise borrowers. Equivalently, financial statements allow an enterprise to emerge from the fog of asymmetric information and better show its true prospects.

However, financial statements are not free; resources are required to gather, process, certify,

and disseminate an enterprise's financial statements. Greater details and specificity of disclosure -- though providing greater assurance to lenders -- are generally more costly. Also, enterprises are reluctant to reveal proprietary information that they fear may be used by competitors to the latter's advantage and the former's disadvantage. Further, with respect to an enterprise's managers vis-a-vis its investor-shareholder-owners, the managers would generally prefer to reveal less to the shareholders, since less information revelation gives the managers greater flexibility of actions. But revelation of more (useful) information helps dispel the asymmetric information fog vis-a-vis investors and reduces the costs of equity capital to the enterprise.

Consequently, the enterprise will try to find the cost-minimizing point in the tradeoff between the higher direct costs of greater information disclosure and the lower costs of capital from greater revelation. This cost-minimizing point should yield the most efficient financial statement disclosures for that enterprise.

With a multiplicity of enterprises in an economy, this quest for efficient disclosure would appear to yield a multiplicity of formats and accounting systems -- perhaps one for each enterprise. But the transactions costs for lenders and investors of "translating" the various firms' financial statements -- in essence, the "network" aspects of financial reporting and the role of accounting -- indicate that such a multitude of systems would itself be costly for enterprises and their lenders/investors, because of the "incompatibility" (comparison) costs. Accordingly, enterprises face a further set of disclosure tradeoffs -- between the lower transactions costs of adhering to a more widely used accounting system, versus adhering to a less widely used system that is better at portraying a specific enterprise's information.

In this context, the role of government regulation with respect to disclosure is relatively modest. It consists primarily of policing disclosure fraud and helping the "system" of firms and their investors/lenders deal with the "network" aspects of disclosure. The latter would involve helping the system decide on whether one or a few⁴⁶ accounting systems will be the basis for

disclosures (as a "template"⁴⁷) by the enterprises that will be subject to the comparisons of the capital markets of an economy.

2. The "investor protection" model. As compared with the "awareness" paradigm that was just described, an "investor protection" model⁴⁸ entails more than just protecting investors from deliberately misleading information (i.e., fraud) and helping them navigate the "network" issues. Instead, the lenders/investors in this model are not fully aware of their informational limitations. They can be fooled by vague or inadequate information; they don't realize that they need to pierce the asymmetric information fog (or impose a large risk premium for remaining in the fog).

These lenders/investors need not be complete dupes; instead, they just can't deal appropriately with vagueness.⁴⁹ Consequently, opportunistic corporate managers will take advantage of this gullibility by remaining vague; some lenders/investors will experience losses as a consequence; and, rather than learning from their experience and moving on, the lenders/investors instead will subsequently stay away from the securities markets (and tell their friends to do likewise), thereby reducing the liquidity and depth of the markets and raising the costs of capital.⁵⁰

This paradigm calls for a much more active role for government regulation of disclosure, beyond policing fraud and dealing with network issues. Disclosure must be mandated, with extensive detail required.

B. Appropriate disclosure.

We can now address the question of appropriate disclosure of financial conglomerates to the public. As a first approximation, requiring the same general framework of financial disclosure from financial conglomerates as from other publicly traded companies in the economy seems about right. After all, from the perspective of shareholders or of creditors (other than insured depositors), financial conglomerates are just another set of firms embedded in the asymmetric information fog with which they must deal.

There are, though, two qualifications to this position that should be made: First, as was

argued above, banks (including, but not limited to those that are part of a larger conglomerate structure) ought to be required to issue subordinated debt. The holders of this subordinated debt may well demand additional financial disclosures from banks. This is all to the good.

Second, because securities firms are at the center of the operations of the securities markets, their errant actions are more likely to yield negative externalities for the overall markets. Consequently, they should bear a higher responsibility with respect to their disclosures concerning their activities.⁵¹ Accordingly, when a securities firm is an affiliate of the bank, the customers of the securities firm should receive disclosures about any connections between the securities affiliate's underwriting activities and analysts' recommendations and the bank's lending.

C. The Basel Committee's approach.

As was noted above, the Basel Committee's approach to public disclosure for financial conglomerates is not rooted in general disclosure concerns. Instead, the Committee envisions information disclosure as bolstering "market discipline", which serves as the third pillar for safety and soundness in banking.

The Committee's arguments in support of disclosure are surprisingly brief, consisting of about a page and a half in a supporting document.⁵² In essence, the Committee argues that the transactors with a bank can be a constraint on risk-taking by the bank if they are aware of the bank's actions and positions. With information revelation, the bank's creditors, counter-parties, customers, suppliers, counter-parties, etc., can find out about risk-taking earlier and can protect themselves earlier by ceasing their relationships with the banks or insisting on improved terms for a continuation of the relationship. These reactions, in turn, will deter the bank's management from embarking on the course of risk-taking in the first place.

Consequently, the Committee mandates an extensive menu of public disclosure for a bank. Indeed, it is difficult to distinguish between the Committee's expectations for information disclosure for regulators and its expectations for disclosure to the public. The former disclosures,

of course, can be expected to remain as confidential information; the latter most certainly are not. In that connection, the Committee does not address the tradeoffs between the short- and long-run efficiency consequences of the public disclosure of proprietary information and the potential benefits to transactors and ultimately for safety and soundness.

Further, the Committee does not address how effective market discipline can be if the transactors with banks believe that governments will intervene and "bail out" the bank and its transactors (beyond the explicitly insured depositors). If the belief in bailouts is pervasive, then the disclosure will be largely irrelevant, and market discipline will be largely absent. In addition, the transactors are likely to be sophisticated parties (and would have to be, in order to be able to absorb and use the elaborate menu of information disclosures recommended by the Committee). Why would they not be able to protect themselves by making their own information demands (or declining to transact)?⁵³ Finally, by not endorsing the mandatory issuance of subordinated debt, the Committee has forgone an important potential source of market discipline and of market pressures for information disclosure.⁵⁴

In sum, though "market discipline" has a resounding ring, the Committee's arguments for public information disclosures generally and for its specific disclosures are weak indeed. And the Committee has undermined its best opportunity for achieving market discipline by failing to endorse mandatory subordinated debt.

V. Conclusion

The appropriate information disclosures for financial conglomerates has been and will continue to be an important area for policy concern. As this paper has argued, there are at least two audiences for information disclosures: bank regulators, and the general public. They should be distinguished.

There is little doubt that the goals of Basel II -- to improve the safety and soundness of

banks -- are worthy. The specific measures chosen, however, are more open to question. By turning its back on the three most important steps that could be taken to improve information disclosure -- mandating market value accounting (MVA) for banks' reports to regulators, aiming toward daily electronic submission of those reports, and requiring the issuance of subordinated debt -- the Basel Committee has fundamentally undermined the achievement of those goals.

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Figure 1: Stylized Balance Sheet of the ABC Bank (solvent), as of December 31, 200X

Assets	Liabilities
\$100 (loans)	\$92 (deposits)

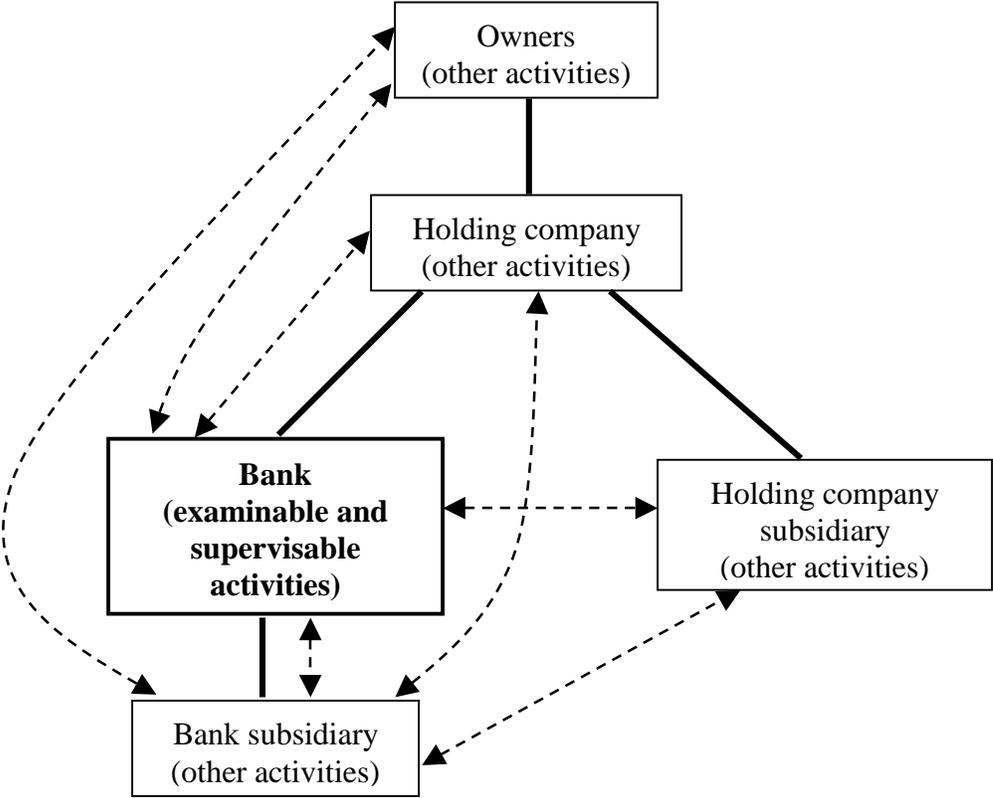
	\$8 (net worth, owners' equity, capital)

Figure 2: Stylized Balance Sheet of the ABC Bank (insolvent), as of December 31, 200Y

<u>Assets</u>	<u>Liabilities</u>
\$80 (loans)	\$92 (deposits)

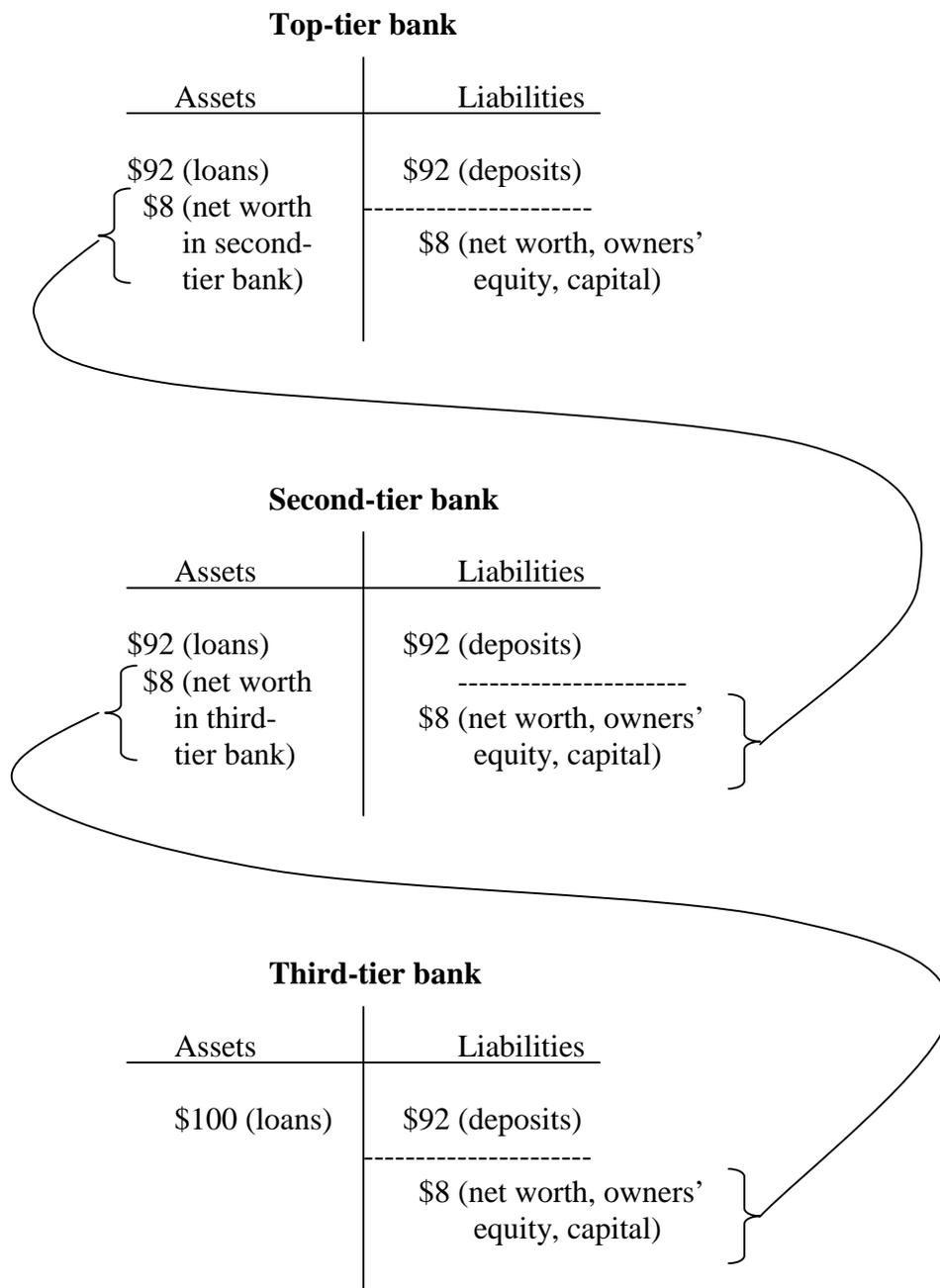
	\$-12 (net worth, owners' equity, capital)

Figure 3: Stylized Structure of Locations of Appropriate Activities for a Bank and of Other Activities



— Lines of ownership
↔ Transactions to be closely monitored

Figure 4: Stylized Balance Sheet of the ABC Bank (solvent, multi-tiered), as of December 31, 200Z



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¹ See BIS (1998b, 2000a, 2001b, 2001c, 2001d, 2001f, 2001h). One justification that is often advanced for the BIS's efforts to improve the safety and soundness of banks -- to reduce systemic risk internationally among banks -- is weak. National bank regulators already have the tools -- akin to restrictions on the size of loan that any bank can extend to a single borrower -- to limit the exposures of their national banks. Instead, the Basel approach should be primarily seen as an effort to limit the competitive subsidization of banking across countries: If a country permits its banks to operate at insufficient levels of capital (but everyone knows that transactors with those banks will be bailed out in the event of financial difficulties), this constitutes an implicit subsidy for those banks. See White (1996b).

² As will be argued below, some of the same issues that arise for depositories and insurance companies also arise for defined-benefit pension plans. But defined-benefit pension plans are almost always embedded in the employer that offers the pensions to its employees, rather than part of a separate financial conglomerate. Consequently, they are not relevant for the immediate issues at hand.

³ Unless otherwise indicated, we will refer to "banks" as the term that broadly covers all depositories: financial institutions that hold financial assets as their primary assets and fund themselves with "deposits" that are highly liquid (i.e., withdrawable largely on demand at fixed nominal values).

⁴ See, for example, Diamond and Dybvig (1983), Postlewaite and Vives (1987), and Chen (1999).

⁵ This bank has an assets-to-capital ratio of 12.5-to-1. This is frequently described as a leverage ratio. The concept of leverage is readily grasped by noting that an increase in the value of the assets by \$4 would also increase net worth by \$4; but the former *percentage* increase would be only 4%, while the latter *percentage* increase would be 50% -- a 12.5-fold multiple in the percentage increase. The same percentage-multiplying effect applies with respect to decreases in asset value.

⁶ And lenders (liability holders) generally try to protect themselves, through covenants and lending restrictions, against the risk-taking and other behaviors by corporate owners that could cause losses for the lenders.

⁷ I.e., they are unlikely to develop covenants and lending agreements.

⁸ See Morgan (2002).

⁹ A lender of last resort -- the central bank -- can provide loans to a bank and thus help it deal with depositor withdrawals. But then the central bank is effectively a creditor to the bank and must concern itself with the bank's solvency.

¹⁰ Deposit insurance that was provided by individual states stretches back to New York's initial efforts in 1829; the states' efforts did not have sustained success.

¹¹ Outside of the U.S., this is frequently described as "prudential" regulation.

¹² Capital plays two important roles. First, it is a direct indicator of the extent of the bank's solvency -- the buffer of protection for depositors against a fall in the value of the bank's assets. Second, since capital is the owners' equity, it provides a disincentive for the bank's owners to take risks.

¹³ By "activities" we mean broadly any kinds of assets, liabilities, or ongoing business operations.

¹⁴ However, limitations on banks' activities have also taken on a heavy political overtone in the U.S., as industries that have feared banks' competition have lobbied heavily to prevent banks from entering their areas.

¹⁵ This discussion draws heavily on White (1996a) and Shull and White (1998).

¹⁶ This concept of "examinable and supervisable" is consistent with the suggestions that bank deposits should be protected through a process of collateralization. In essence, the bank should always maintain a sufficient level of assets (the collateral) to cover the deposits, with an appropriate "haircut" (i.e., an extra amount of collateral) to cover uncertainties as to the value of the assets. But this haircut is the equivalent of the bank's capital in the discussion in the text; and a consideration of which assets are appropriate for this collateralization process (and what the appropriate haircuts for them should be) is equivalent to the "examinable and supervisable" concept. If the bank chooses to fund itself partly with liabilities that are not deposits (which goes beyond the simple model of Figures 1 and 2), then it can engage in other activities, so long as those liability holders understand that the depositors have the first claim on the "examinable and supervisable" collateral assets.

¹⁷ This is frequently described as the subsidiary's being "separately capitalized". If the bank could count the net worth of the subsidiary as an asset, then this is the equivalent of allowing the bank to undertake the activity directly. But, by assumption, the activity is not permitted in the bank because it is not "examinable and supervisable". With the subsidiary's net worth not counting as an asset of the bank, the financial failure of the subsidiary would not directly affect the bank; but the bank could still take advantage of whatever organizational or legal advantages that might apply to having the activity in the subsidiary.

¹⁸ The bank subsidiary has an advantage over the bank holding company as a place for such activities. If the bank overpays for some services from its subsidiary (or undercharges for some services sold to the subsidiary), any dividends from the subsidiary to the bank's "parent" holding company would have to pass through the bank and thus can be "trapped" there by regulators to offset the inappropriate transaction. However, to the extent that the subsidiary is less than 100% owned by the bank, it becomes more like a part of the holding company and thus more susceptible to straight siphoning (Edwards 1979). Also, even with a subsidiary that is 100% owned by the bank, if that subsidiary transacts directly or indirectly with the owner, then the subsidiary can overpay or undercharge and still be a conduit for siphoning.

¹⁹ There is also a converse possibility: that the securities affiliate touts and underwrites the equity shares of a weak company so that the commercial bank can have its loans repaid. Though this arrangement strengthens safety and soundness, it raises larger issues of investor deception that will be addressed below.

²⁰ A defined-benefit pension fund is one in which an employer has promised retirees a specified level of retirement benefit payments. By contrast, a defined-payment pension fund is one in which a retiree's receipts are linked to what the retiree (while employed) previously paid into the fund (along with any payments from the employer) and the subsequent investment performance of those paid-in funds.

²¹ Beyond these two categories of institutions, the Securities Investor Protection Corporation (SIPC) provides insurance for investors who leave their securities with a brokerage firm that become bankrupt. This is seen as protection for the poorly informed small investor. And the Securities and Exchange Commission (SEC) imposes minimum capital requirements on securities broker-dealers, as a system or network protection for broker-dealers that transact with each other. (It is unclear, however, why the knowledgeable securities firms themselves cannot impose capital/solvency discipline by informing themselves as to which of their potential trading partners is skirting insolvency and thus should be shunned in any transaction that requires the extension of credit to that firm.) Finally, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are regulated for safety and soundness by the Office of Federal Housing Enterprise Oversight (OFHEO), because of the two companies' federal charters and special privileges and the financial markets' consequent perceptions that the U.S. Government would cover their liabilities in the event of their financial difficulties.

²² Though our focus is primarily on the balance sheet, the profit-and-loss statement is inexorably linked to it, so our discussion will implicitly cover that as well.

²³ And thus activities limitations are implicitly covered.

²⁴ This section draws heavily on White (1991a; 1991b); see also Kaufman et al. (2000).

²⁵ In the accounting literature, this is frequently described as "fair value" accounting.

²⁶ For example, securities that are held in a "held-for-sale account" are marked to market; and where there is a clear diminished likelihood of repayment of a loan, the asset is supposed to be written down. Nevertheless, the orientation of GAAP is clearly toward historical costs rather than current values.

²⁷ The incentives for risk-taking behavior are likely to be driven by owners' knowledge of the market-value-based measurement of their net worth rather than by any GAAP-based measure.

²⁸ Under some circumstances, financial institutions may not even have to sell the assets but may be able simply to reclassify them within their portfolios, from a "hold-to-maturity account" to a "held-for-sale account"; see Barta (2002).

²⁹ Also, GAAP's slowness to recognize gains can lead companies generally to engage in uneconomic behavior, such as a sale and the leaseback of a facility, just so the company can recognize the gain on its balance sheet.

³⁰ During the period of the 1980s and early 1990s, when almost 1,500 commercial banks became insolvent and required regulatory action, bank regulators complained that they knew that some of these banks were in financial difficulties but that their apparently healthy (GAAP) balance sheets forestalled earlier preemptive action. See FDIC (1998).

³¹ See, for example, Engelke (1990) and Fisher (1992).

³² Similarly, the higher-volatility criticism of proposals that would place only some parts of the balance sheet on a MVA basis is misplaced. To the extent that banks care about reported volatility, they will modify their behavior. It is the tradeoff of the increased costs of that behavior, against the gains from the improved balance sheet information, that should be weighed and argued.

³³ This should rule out the wild over-optimism that apparently governed some of Enron's "mark-to-market" modeling and valuations.

³⁴ This hostility can be found in BIS (1998c, 1999b, 2000b).

³⁵ See BIS (2001e).

³⁶ This argument is advanced forcefully by Calomiris and Litan (2000) and Kaufman et al. (2000). See also Board of Governors and U.S. Treasury (2000).

³⁷ See BIS (2001g).

³⁸ For a critique of that inclusion, see White (2002b).

³⁹ To the extent that companies' bond ratings are part of the process, forward-looking stress tests are present, since that is a component of bond ratings.

⁴⁰ Except for explicit hedges and other offsets.

⁴¹ See BIS (2001a).

⁴² The Committee mandates that equity holdings that are in aggregate in excess of 60% of the level of the bank's capital should not be counted as an asset for the bank. See BIS (2001).

⁴³ See BIS (1998a, 1999a).

⁴⁴ This section draws heavily on White (2002a); see also Easterbrook and Fischel (1984), Diamond (1985), Fishman and Haggerty (1989), Diamond and Verrecchia (1991), Elliott and Jacobson (1994), and Ball (2001).

⁴⁵ In the interests of brevity, I will describe the problem in terms of lenders and borrowers; but the same issues arise with equal force with respect to investors and seekers of equity finance.

⁴⁶ As the number of accounting systems increase, the number of comparisons between systems increase more rapidly: If there are n systems (and one of them is considered to be the "base" system for comparisons), then there are $(n^2 - n)/2$ potential comparisons; hence, an extra system -- i.e., $(n + 1)$ systems -- yields $(n^2 + n)/2$ comparisons. The difference between them is n . Thus, each additional system adds ever-more comparisons and greater complexity and costs. For example, if we start with four systems, there are six comparisons; an additional system raises the number of comparisons to ten; an additional system after that (bringing the total to six) raises the number of comparisons to fifteen. White (1996b) points out that if each of the 50 states in the U.S. had its own GAAP, this would entail a potential for 1,225 comparisons between systems.

⁴⁷ See Sunder (2001) and Dye and Sunder (2001).

⁴⁸ This model appears to drive the policies of the SEC and of the Congress; see, for example, Sutton (1997) and Levitt (1998).

⁴⁹ "We [the SEC] pursue this mandate [to protect investors] not through merit regulation -- allowing only 'healthy' companies to trade their securities -- but by market regulation.... The goals of this approach are to prevent misleading *or incomplete* financial reporting and to facilitate informed decisions by investors." Levitt (1998, p. 79; emphasis added).

⁵⁰ In this model there can be the politically charged distributional aspects: Lenders (bond buyers) and especially investors are "little guys" (or, perhaps, "widows and orphans") who are fooled by the vague claims of "corporations". But there is also the negative spill-over effect: The "burned" lenders and investors (and their friends) exit from the capital markets, thereby raising the

cost of capital in these markets.

⁵¹ This would pertain, for example, to the disclosures that relate an analyst's recommendations to other aspects of the analyst and the securities firm. These disclosures could include the personal portfolio of the analyst, the past performance of the analyst, the past movement of the analyst's portfolio subsequent to a recommendation, and the securities firm's other relationships with the enterprise that is being recommended.

⁵² See BIS (1998b).

⁵³ Further, why might not the ratings provided by bond rating firms provide the information that transactors need?

⁵⁴ See Calomiris and Litan (2000).