Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Vikram Pandit's Suggestion for Transparency in Comparative Risk Assessment — Summary and Reaction*

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Barnett Summary

In a ***speech*** before a Bretton Woods gathering in Washington D.C. on September 23, 2011, Citigroup's CEO, Vikram Pandit, suggested a variety of ideas to make the delivery of financial services to be more transparent, simple and fair. One of those ideas presented a possible solution to the problem created by opaqueness of the view of risk taken by management teams at peer companies, and therefore an inability for third parties to correctly judge capital levels at those companies.

Third parties simply do not know all aspects of company balance sheets, and with respect to capital ratios, are obliged to accept the measurements of reserves, response to stress, etc., that the companies assign. Why they make the choices that result in those numbers remains behind the veil. A ratio of 10% Tier I at company A, therefore, may or may not mean the same thing as one of 10% at Company B.

Pandit suggests that regulators should create a hypothetical portfolio and require all financial institutions to measure risk against that. On a quarterly basis, companies would be obliged to produce a hypothetical loan loss level, value-at-risk, stress test results, and risk-weighted assets. The same risk measures run by each company against their own balance sheets would be required to run against the hypothetical balance sheet. The results from each company for the tests against the hypothetical balance sheet and against their own would then be made public.

The requirement would apply to all financial institutions, not just banks,

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and it is likely that there would have to be more than one hypothetical portfolio, perhaps as many as three, created for company's of different size or complexity. Absent that, perhaps the requirement might be limited to companies over a certain size.

The result would be that third parties would then have a frame of reference with which to compare the way each management thinks about risk. An individual company's balance sheet would remain as confidential as now, but third parties could make more enlightened analysis of the risk situation in each company. There would be more reality behind capital ratios.

Longbrake Reaction

Disclosure of relevant information in sufficient detail is essential to the ability of market participants to exercise market discipline over the activities of financial services firms. However, as Vikram Pandit points out, transparency of relevant information is necessary but not sufficient in facilitating effective market discipline. Measurement regimes either must be rigorously standardized, as is the case for regulatory stress tests, or the measurement methodology used by each financial services company must be explained in sufficient detail so that market participants can assess how each firm assesses critical information and can discern effectively critical assessment differences among financial services companies.

Anyone who has played the game of Boggle knows that finding words depends heavily on one's vantage point. Simply by rotating the Boggle tray, one quickly finds new words that were not apparent from the previous viewpoint. This is equally true for financial services companies. Given the same financial information, each company will assess it and evaluate the risks from the perspective of its own culture and traditions. This could result in widely varying differences in opinions and conclusions, even though the information is exactly the same.

Pandit proposes that regulators create one or more "benchmark" portfolios and require financial services companies to assess the information and measure risks through standard measures such as loan loss reserve level, value-at-risk and risk-weighted assets. The results of each firm's assessments would be made public which would enable third parties to understand differences among firms' information and risk assessment methodologies.

What Pandit does not say, but which is implicit, is that each "benchmark" portfolio needs to be accompanied by explicit assumptions about the current state of financial and economic conditions. This still leaves open to question each financial services firm's forecast or expectations about future prospects. Either future prospects would need to be spelled out explicitly by regulators, as they are for stress tests, or each firm should be required to disclose explicitly the assumptions which have guided its assessment of the "benchmark" portfolios. The latter would result in richer information but would add complexity to the ability to discern differences in each firm's information and risk assessment methodologies.

While the concept of comparative assessments starting from an identical information set is appealing as a potential means of comparing how different managements think about risk, the exercise could well turn out to be just as artificial as the "benchmark" portfolios. Managements might intentionally or unintentionally gear their analysis in the direction of what they think is expected or reasonable rather than what they would actually do with their own internal information. Also, especially in large financial services companies, there is a high degree of professional collaboration across companies and this might lead to outcomes which reflect a collective, rather than a specific firm, view.

Notwithstanding such possible limitations, the kind of exercise that Pandit advocates surely will improve the market's ability to apply market discipline to individual financial firms. However, by itself, it is unlikely to be a complete panacea.

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