Analysis of the Disclosure Level by Brazilian Financial Institutions Following the Basel Capital Accord (Basel II) – A multiple case study

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ABSTRACT: The purpose of this study is to examine the disclosure factors adopted in the annual reports of the Brazilian financial institutions. For such, the data necessary to subsidize the research will be obtained through analysis of the disclosure performed by the financial institutions selected and by semi-structured interviews conducted by the researcher with executives of these institutions and analyzed in the light of the literature on disclosure and the recommendations of the Basel II accord on transparency and disclosure. To this effect, this study intends to analyze what the adherence level of the disclosure practiced by the financial institutions is in relation to the recommendations of the Committee, so as to permit better perception of the information presented in the annual reports of these financial institutions.

Keywords: transparency, annual report, Basel II.

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1. INTRODUCTION

Public disclosure and supervisory information that promote safety and soundness in banking systems. (Basel Committee, Enhancing Bank Transparency, 1998).

The bank activity, through its nature, implies the exposure of the financial institution to several types of risks, namely: credit; country and transparency; market; liquidity; operational; legal; and reputation. These factors require so much from the regulatory and supervisory bodies as well as from the institutions actions that aim at preserving the interests of several agents who interact with the financial system as a way of avoiding situations such as the situations of a number of financial institutions, from retail banks to insurance companies, which after recording multi-billion losses, were sold or went bankrupt in the last year as a result of the financial crisis, which originated in the United States and spread through Europe, especially. Therefore, the disclosure on the risks incurred and their management is fundamental for a more appropriate assessment of returns earned.

The discipline of the market constitutes one of the three fundamental pillars of the structure established in the New Capitals Accord (Basel II) by the Basel Bank Supervisory Committee, hereinafter referred to as “Committee. The logic of a New Capitals Accord, whose proposes has been discussed since 1999, is based on the need to build a structure with greater flexibility and sensitivity to risks, more adequate and adaptable to constant financial transformations and to the evolution of the practices of supervision and risk management.

For the Committee, transparency is a key element for a financial system effectively supervised, safe and healthy. “The Committee strongly supports the concept of transparency. The Committee sees the increase of disclosure, the intensification of transparency and market discipline becoming an increasingly important tool and would encourage all member countries to adopt the recommendations contained in this document as soon as possible”. (Basel Committee, 2000; p. 3)

Recent studies, conducted by Xavier (2003) and Goulart (2003), indicate that the level of disclosure of financial institutions in Brazil, if compared to the disclosure criteria recommended by the Bank for International Settlements (BIS), is incipient. Xavier (2003) emphasizes that, from the items researched, only 26% was disclosed by Brazilian banks, whereas international banks, analyzed in a research conducted by the Basel Committee disclosed 63% of these items. However, these studies do not reveal the possible reasons that would lead to the low adherence in relation to the BIS recommendations.

In this context, this study proposes to analyze what the level of adherence of the disclosure practiced by the financial institutions is in relation to the recommendations of the Committee and how the financial institutions assess potential changes in the standard of disclosure practiced.

2. THEORETICAL REFERENTIAL ON DISCLOSURE

For Healy and Palepu, the demand for disclosure and for financial disclosure arises out of the existence of asymmetric information and of conflicts of interest among managers and investors.

“Corporate disclosure is essential for the operational of an efficient capitals market”. (Healy and Palepu, 2001, page 1)

Verrecchia (2001, p.1) emphasizes that there is no unified theory on disclosure. The author highlights that in the literature on disclosure there is no central paradigm, there is no well-
integrated theory or a concept that gives rise to all subsequent researches. According to the author, the current literature on disclosure is characterized by an “eclectic, highly idiosyncratic group, of economic models, each trying to examine a small piece of the total puzzle of disclosure”. The eclecticism will be increased by the fact that disclosure is a subject that covers three different areas: accounting, finance and economics, and, therefore, acquires characteristics from all of these areas.

Notwithstanding, in this research, the vision proposed by Healy and Palepu (2001) will be adopted. It divides the theory on disclosure into the following topics:
- Regulation of disclosure and financial reporting;
- The role of auditors and intermediaries in the disclosure process;
- Factors that influence management decisions on disclosure;
- Consequences of disclosure decisions and disclosure.

For Healy and Palepu (2001), the empirical research on voluntary disclosure focus on the international role of financial reports for the capital market. Such researches depart from the premise that, even in an efficient market, managers have superior information in relation to that provided to external investors regarding the future expected performance of the company. Authors argue that, if the accounts regulation and audit worked perfectly (i.e., guarantee ideal disclosure), external investors would be informed about the changes in the business of the company. On the other hand, if this regulation were imperfect, which would constitute the most probable possibility, managers would face the decision of balancing the level of disclosure adopted in relation to the capital market for contractual, political or corporate governance reasons, and the superior knowledge held with respect to the company’s performance.

3. BIS DISCLOSURE MODEL

In public consultations that preceded the publication of the final version of the New Accord, the Committee presented a vast set of recommendations and requirements in relation to the disclosure of information, both of a quality and quantitative nature. The large quantity generated concerns with respect to the possibility of ending up by confusing the market, instead of informing it on key aspects in relation to the financial institution. In the final version of the document “International Convergence of Capital Measurement and Capital Standards: a Revised Framework” published in June 2004, the quantity of information was significantly reduced. But, this information started to be considered essential to support the objective of Pillar III: facilitate market discipline. In this document, the Committee emphasizes that the logical foundation of Pillar III is sufficiently strong to ensure the introduction of disclosure requirements for the banks that use the structure proposed in the New Accord. Moreover, some of these disclosures will constitute qualification criteria for the use of internal methodologies or for recognition of transactions and instruments in particular.

The disclosure requirements are divided into three comprehensive categories of information: Scope of Application; Capital (structure and adjustment); and Exposure to Risks. Moreover, the Committee established a general principle of disclosure in which the institutions must have a formal policy of disclosure approved by the Board of Directors that deals with the information that will be disclosed, as well as that of internal controls on the disclosure process. The objective of the category “Scope of Application” is to provide the market participants with information that favor the assessment of how the recommendations of the new Accord apply to the structure of the group to which the financial institution belongs and how the other group entities are treated for purposes of adjustment of capital. The category “Capital” provides for the supply of information on the amount, components and
characteristics of capital for regulatory purposes to the market participants. Moreover, it provides for the disclosure of information that permits to assess the capital of the institution. This information will permit to assess the capacity of the financial institution to absorb eventual losses resulting from its activities. The category “Exposure to Risk” must supply the market participants with the elements necessary to understanding of the risks inherent to the activities of the financial institution – credit risk, market risk, interest rate risk and operational risk – in addition to techniques used to identify, measure, monitor and control these risks. This category includes information related to operations that may alter the risk profile of the institution: mitigation of credit risk; and securitization of assets.

4. RESEARCH IN BRAZIL ON DISCLOSURE OF FINANCIAL INSTITUTIONS

In the study “Contribution to the Improvement of the Level of Transparency of Banks in Brazil”, Andrezo (2000) conducted a critical analysis of COSIF in light of international models (IASC, SEC, BIS) with the objective of identifying which information a bank must disclose in Brazil to be able to better assess its performance and financial situation. He concludes that it is possible to expand the Brazilian rules on disclosure requirements on information to the public by the banks, so that the market itself can collaborate indirectly with the supervision performed by the Central Bank of Brazil. To this effect, it proposes the simplification of the Balance Sheet, greater detailing of the Statement of Result, presentation of average balances of the main accounts of assets and liabilities, segregation of assets and liabilities according to the incidence of interest (earnings or financial charges), qualitative information in connection with the criteria adopted for classification of credit at a certain risk level, rules of renegotiation of credits, concentrations and exposure to risk, etc).

In the study “Transparency of the Accounting Statements of Banks in Brazil: Case Study on the Perspective of the Accord “Basel 2”, Xavier (2003) analyzed the transparency of the accounting statements of the principal Brazilian banks in light of the recommendations of the “Basel 2” Accord. The objectives of its research were, to: (i) specify the relationship existing between transparency of accounting statements and bank supervision and (ii) compare the degree of transparency of the accounting statements published by the main Brazilian banks and the disclosure criteria which shall be established by this agreement.

The author examined the statements of 10 Brazilian banks, selected by the representativeness of their assets, shareholders equity and net profit in the National Financial System. These banks were segregated considering the following criteria: with shares traded in the Stock Exchange and with shares traded in the stock exchange. According to the author, in Brazil, the banks disclose spontaneously items of little aggregate value. It highlights that the banks belonging to the group without shares traded in the stock exchange basically the information required by the regulation, whereas another group publishes an expressively superior quantity of data, however constituted by general data and not conclusive on the real situation of the companies. It emphasizes that international banks disclose, on average, more items considered qualitative, while Brazilian banks tend to disclose a greater number of quantitative items. It concludes the research as follows: “The disclosure of banks in Brazil is incipient, as only 26% of items researched were selected, near the minimum required by the Brazilian legislation in force, while international banks, analyzed in a research conducted by the Basel Committee disclosed 63% of items”. However, the research highlights the existence of controversial questions that deserve deeper study: movement of the group of banks listed in Bovespa, which restricted the disclosure of information of 2001 to 2002 and the movement of the group of banks not listed, which increased disclosure of information.
In the study “Account Evidencing of Market Risk by Financial Institutions in Brazil”, Goulart (2003) analyzed the degree of evidencing in connection with the issues related to market risk by financial institutions with performance in Brazil considering as a parameter the recommendations of evidencing of the Basel Bank Supervision Committee.

The author examined the statements, in the period 1997 to 2002, of 4 Brazilian banks: Banco do Brasil, Bradesco, Itaú and Unibanco, in addition to 1 bank of foreign origin: Banco Santander Banespa, which constituted the set of banks, in the domestic market, with more advanced practices of evidencing in the area of market risk. The author highlights the excessive use of statistical and visual resources in certain annual reports to the detriment of the informative content, which is not in line with the objective of effectiveness of the accounting evidence (provision of useful information for decision-making). The disclosure of information without a standard format is considered a factor that compromises or at least hinders comparisons among different institutions.

It concludes that the bank evidencing in the domestic market, despite showing indicators of evolution in the area of market risks still presents an incipient level when compared to the practices of evidencing of institutions of the international financial system.

It identifies the need for improvement of the level of bank evidencing in Brazil. Moreover, it points out as an object of future investigation the more detailed and accurate identification of the reasons that lead the financial institutions to superior practices of evidencing to the legally required ones.

5. RESEARCH METHODOLOGY

5.1. Nature of the Research

Having in view that this study intends to analyze the level of transparency of the financial institutions in relation to the new capitals accord (Basel II), the research can be classified as analytical or explanatory, as it intends to analyze and explain how or why the facts are happening and, with respect to media, the research is qualitative, as, in addition to examining, it intends to cause to reflect on the data evidenced (Collis and Hussey, 2005). With respect to typology, it is a multiple case study as it intends to make comparisons between the different cases, as describes Yin (1981) and Roesch (2005). Regarding the collection of data, these will be obtained through the examination of documents and interviews on which the content analysis will be made.

5.2 Selection Criteria and Collection and Analysis of Data

In 2006, the selection of institutions took as a basis the differentiated levels of corporate governance implemented by BOVESPA, namely: Level 1; Level 2 and Novo Mercado. Nossa Caixa and Banco do Brasil were the only financial institutions listed in Novo Mercado. Bradesco and Unibanco, in addition to Itaú, constituted the three financial institutions listed in Level 1. In Level 2, there were no financial institutions listed. Notwithstanding, for reasons of accessibility, the following financial institutions were selected to compose the research: Nossa Caixa, Bradesco and Unibanco.

Initially, the collection of data was made based on periodical reports provided by the financial institutions aimed at analyzing the evolution of the disclosure level practiced selected in the period of 2001 to 2005, having in view the regulation in force at the time. Moreover, the current standards of disclosure of the institutions selected were compared with the recommendations of the Committee on Transparency and Market Discipline.
A field research was conducted, between February and April 2006 through semi-structured interviews with key persons of selected institutions, accredited to answer the questions, with the objective of obtaining data and information that permitted to analyze the determining factors of the disclosure decisions by the financial institutions in the period analyzed, as well as the expectations with respect to adoption of superior disclosure standards, having in view the recommendations made by the Committee and by the Central Bank of Brazil in connection with the implementation of Pillars II and III for all the institutions of the National Financial System.

In the course of analysis of the cases, having in view the requirements of confidentiality by the answering financial institutions, disclosure conditions will not be identified by institution. Considerations will be made of the state of disclosure without mentioning each specifically.

Additionally a set of data was collected in connection with the fiscal years 2006 and 2007, which would permit a more updated view of the adherence level of the information disclosed by the selected financial institutions, per category of disclosure.

6. RESULT OF THE RESEARCH IN CONNECTION WITH ADHERENCE TO THE NEW ACCORD

In this topic, the results obtained from analysis of the information presented by the financial institutions selected, in a consolidated manner, in the fiscal years 2004 and 2005, in relation to the research conducted by the Committee on Transparency (Public Disclosures by Banks: Results of the 2001 Disclosure Survey) and to the recommendations of the Committees set forth of Pillar III – Market Discipline (International Convergence on Capital Measurement and Standards: A Revised Structure – Pillar III). Additionally, information is presented in connection with fiscal years 2006 and 2007.

Initially, it should be highlighted the expectation in connection with the implementation of the New Capitals Accord by the financial institutions, represented in the Administration Report in the form of specific comments about the risk management and alignment to best international practices of risk management. One of the institutions emphasizes that it is conditions of complying with the guidelines of the New Accord in the schedule established by BACEN and, moreover, have as its objective comply with the qualification requirements for the use of advanced risk management model for purposes of verification of the regulatory capital, including for the management of the operational risk level, which represents one of the innovative points of the New Accord.

With respect to the research conducted by the Transparency Committee (Public Disclosures by Banks: Results of the 2001 Disclosure Survey), the Table 1 presents the average percentage of disclosure of the items researched in the reports by the financial institutions analyzed, in 2005 and 2004, which was 33% and 31%, respectively. For 2007 and 2006, the average percentage of disclosure was 35% and 32%. Even if the percentages obtained in the research performed by Xavier (2003) were superior, these percentages are far less than those raised in the research conducted by the Committee and performed with internationally active financial institutions (2001).
Analysis of the Disclosure Level by Brazilian Financial Institutions

Table 1 – Average % of Disclosure by Nature

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</tr>
</thead>
<tbody>
<tr>
<td>Qualitative Disclosures</td>
<td>43%</td>
<td>40%</td>
<td>39%</td>
<td>38%</td>
<td>24%</td>
<td>24%</td>
<td>67%</td>
</tr>
<tr>
<td>Quantitative Disclosures</td>
<td>32%</td>
<td>28%</td>
<td>30%</td>
<td>28%</td>
<td>28%</td>
<td>29%</td>
<td>27%</td>
</tr>
<tr>
<td>Qualitative and Quantitative Disclosures</td>
<td>28%</td>
<td>25%</td>
<td>31%</td>
<td>28%</td>
<td>21%</td>
<td>19%</td>
<td>60%</td>
</tr>
<tr>
<td>Average % of items disclosed</td>
<td>35%</td>
<td>32%</td>
<td>33%</td>
<td>31%</td>
<td>26%</td>
<td>25%</td>
<td>63%</td>
</tr>
</tbody>
</table>

Even with respect to Table 1, the level of adherence of the disclosures of a qualitative nature, especially in the categories Securitization Activities, Internal Models for Market Risk and Credit Derivatives. The introduction of securitization operations as an instrument to obtain additional funding and use of credit derivatives for mitigation of risks in the Brazilian financial institutions, as well as the development of internal models of management of market risk can be considered as important factors in the evolution of this type of disclosure. Table 2 demonstrates the level of adherence of the information disclosed by the financial institutions selected by category of disclosure.

Table 2 – Average % of Disclosure per Category

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Capital Structure</td>
<td>40%</td>
<td>38%</td>
<td>43%</td>
<td>38%</td>
<td>39%</td>
<td>37%</td>
<td>81%</td>
</tr>
<tr>
<td>2. Capital Adjustment</td>
<td>38%</td>
<td>38%</td>
<td>38%</td>
<td>38%</td>
<td>29%</td>
<td>29%</td>
<td>54%</td>
</tr>
<tr>
<td>3. Internal Models for Market Risk</td>
<td>23%</td>
<td>19%</td>
<td>19%</td>
<td>19%</td>
<td>16%</td>
<td>13%</td>
<td>68%</td>
</tr>
<tr>
<td>4. Internal and External Rating</td>
<td>42%</td>
<td>42%</td>
<td>33%</td>
<td>42%</td>
<td>25%</td>
<td>30%</td>
<td>46%</td>
</tr>
<tr>
<td>5. Credit Risk Model</td>
<td>33%</td>
<td>40%</td>
<td>33%</td>
<td>33%</td>
<td>20%</td>
<td>20%</td>
<td>33%</td>
</tr>
<tr>
<td>6. Securitization Activities</td>
<td>17%</td>
<td>17%</td>
<td>17%</td>
<td>17%</td>
<td>1%</td>
<td>3%</td>
<td>45%</td>
</tr>
<tr>
<td>7. Quality of Assets</td>
<td>41%</td>
<td>38%</td>
<td>38%</td>
<td>38%</td>
<td>31%</td>
<td>31%</td>
<td>61%</td>
</tr>
<tr>
<td>8. Credit Derivatives and &quot;Credit Enhancements&quot;</td>
<td>11%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>35%</td>
</tr>
<tr>
<td>9. Derivatives</td>
<td>33%</td>
<td>22%</td>
<td>33%</td>
<td>22%</td>
<td>34%</td>
<td>29%</td>
<td>62%</td>
</tr>
<tr>
<td>10. Geographic and Business Diversification</td>
<td>47%</td>
<td>40%</td>
<td>47%</td>
<td>40%</td>
<td>31%</td>
<td>28%</td>
<td>65%</td>
</tr>
<tr>
<td>11. Accounting and Presentation Policies</td>
<td>57%</td>
<td>57%</td>
<td>57%</td>
<td>57%</td>
<td>59%</td>
<td>59%</td>
<td>84%</td>
</tr>
<tr>
<td>12. Other Risks</td>
<td>47%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>18%</td>
<td>16%</td>
<td>84%</td>
</tr>
</tbody>
</table>

In the category of disclosure “Capital Structure”, the evolution observed in the period 2004 to 2005 is due to the evidencing of new instruments of capture of resources by two financial institutions in 2005: perpetual bonus. The lack of a standard of disclosure of information with respect to the composition of the equity of reference of the institutions impairs its comparison and assessment. One of the institutions analyzed presents in an explanatory notice the information with respect to the formation of the reference equity by levels (level 1 and 2), as well as the impact of reduction in connection with the excess of tax credits established by regulation. The two other institutions presented only the aggregate value of the reference equity and one of them has also disclosed the existing margin in relation to the minimum equity required by the regulation.

The second category, which contemplates the adequacy of capital, did not present alterations in the disclosure performed by the institutions analyzed. It should be emphasized more objective information with respect to the equity of reference and the value of assets weighted by risk, known as the Basel Index or Solvability Index, and the equity value of...
reference, were evidenced by all the institutions. However, the same frequency is not observed when dealing with presenting more detailed information with respect to the exposure to risk of the assets of the balance sheet or to analysis of the alterations in the capital structure of the institution. Only one of the financial institutions disclosed information on the alterations occurred in the period of composition of the reference equity and of the assets weighted by risk, which permit to analyze the impacts on the Basel Index.

Notwithstanding the importance of the third category “Internal Models for Market Risk” for financial institutions, significant alterations were observed in the period analyzed. The three institutions disclosed in a specific explanatory note information on market risk management, especially the use of the Value at Risk (“V@R”) model. However, the disclosure of parameters (trust level, holding period and observation period) employees in the internal model is still very limited, being restricted basically to the trust level of the model.

Two institutions presented quantitative information, not audited, only with respect to the aggregate “V@R” per risk factor (pre, foreign exchange coupon, TR, income variable, etc) at the end of the period, but they did not disclose information on the minimum, average and maximum “V@R”, during the period. Once again, the inexistence of standards of disclosure impairs comparison among the financial institutions: one of the institutions mentions having included in the calculation of the “V@R” of the current fiscal year positions held abroad, but the two institutions do not evidence objectively the portfolios covered by the internal model.

Information on procedures for validation of the internal model used, i.e., the use of techniques of backtesting was evidenced only by one of the institutions and, even then, concisely: “the methodology applied and the statistical models existing are validated daily using backtesting techniques”. With respect to the performance of stress tests in the model, the three institutions mentioned that they perform simulations with stress scenarios in the internal model, but only one of them mentions that the results of these simulations are analyzed and used as support for operationalization of hedge policies.

The categories “Internal and External Rating”, “Credit Risk Modeling” and “Quality of Assets” reflect basically compliance with the information requirements established in Resolution 2.682. Information on basic parameters considered in the internal process of risk rating was presented by two financial institutions in 2004 and by only one institution in 2005. With respect to the use of “credit scoring”, two institutions mentioned its used in the decision process of concession of credit, but did not disclose more specific information involving this model.

With respect to the category “Securitization Activities”, even if it did not present alterations in the period analyzed, certain considerations must be made. From 2003, two of the institutions analyzed used securitization operations as a way of obtaining additional resources for their transactions. However, only one of the institutions evidenced this information objectively in an explanatory note – the use of the term securitization – and highlighted its responsibility of redeeming the instruments issued in the case of default or termination of the transactions of the specific purpose entities (EPEs). Moreover, it presented information on the nature of the assets associated to the instruments issued, as well as the objectives of the institution with these transactions: “accords to optimize its funding and administration of liquidity activities through Specific Purpose Entities (EPEs)”.

The category of disclosure “Credit Derivatives and Credit Enhancements” presented evolution in 2007, reflecting the performance of credit swaps by one of the financial institutions analyzed as a form of mitigation of credit risk. However, such transactions are not very diffused in Brazil.
With respect to the category “Derivatives”, the percentages observed portray basically the information necessary to compliance with the information requirements established in Resolution No. 3.082 of BACEN, which covers the registration and accounting assessment of derivative financial instruments. The three institutions presented general information in connection with the objectives and policy of use of derivative financial instruments, in addition to the market value of these instruments. Two institutions presented including definitions with respect to the type of operations that could be characterized as derivative financial instruments: future contracts, swap contracts and option contracts.

From the eleven categories of disclosure, the category “Accounting and Presentation Policies” presents the highest level of adherence, but alterations were not observed in the period analyzed. This is because information with respect to the method of assessment of assets, the policy of recognition of revenues and the basis for determination of the time when the assets are considered due (with problems) compose part of the information usually presented in the explanatory note “Main Accounting Practices” or are presented in the explanatory note of credit transactions in compliance with Resolution 2.682.

In relation to the category “Other Risks”, it is highlighted the evidencing practiced by the three institutions with respect to the existence of legal contingencies - presenting a brief description of the values provisioned by nature of the process (labor, civil and fiscal) – and the information on management of liquidity risk, but the latter are limited to general disclosures of the qualitative nature: concept of liquidity risk used in its management. Only one of the institutions presented, even if partially, the parameters used in the management of liquidity risk, related to the following items: composition of liquid assets, behavior of the variation of liquidity, minimum liquidity required, contingency plan, study of liquidity in the secondary market of public instruments, application of holding period of the liquidity of the institution and profile of behavior of deposits (ABC Curve). In relation to the operational risk, the institutions presented only conceptual definitions about this risk regarding the development of internal models for the management of this risk and the perspective of compliance with the orientations of the New Accord.

With respect to the recommendations of the Committee of Pillar III – Market Discipline (International Convergence of Measurement and Capital Standards: A Revised Structure – Pillar III), Table 3 presents the average percentage of the items researched of the financial institutions analyzed. In 2007 and 2005, the average disclosure percentage was 21% and 20%, respectively. It highlights, once again, the adherence level of the disclosures of a qualitative nature, especially in the categories Scope of Application and Capital.
Table 3 – Average % of Disclosure by Nature

<table>
<thead>
<tr>
<th>By Nature</th>
<th>2007</th>
<th>2005</th>
<th>Qty. Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualitative Disclosures</td>
<td>22%</td>
<td>20%</td>
<td>23</td>
</tr>
<tr>
<td>Quantitative Disclosures</td>
<td>20%</td>
<td>19%</td>
<td>40</td>
</tr>
<tr>
<td>% General Average</td>
<td>21%</td>
<td>20%</td>
<td>63</td>
</tr>
</tbody>
</table>

Table 4 demonstrates the adherence level of the information disclosed by the financial institutions per category of disclosure. From the three categories, the category “Capital” is the one that presents the highest level of adherence, with average percentage of disclosure of 48% of items researched.

<table>
<thead>
<tr>
<th>Per Category</th>
<th>2007</th>
<th>2005</th>
<th>Qty. Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Scope of Application</td>
<td>33%</td>
<td>33%</td>
<td>6</td>
</tr>
<tr>
<td>2. Capital</td>
<td>49%</td>
<td>48%</td>
<td>11</td>
</tr>
<tr>
<td>3. Exposure to Risks</td>
<td>12%</td>
<td>11%</td>
<td>46</td>
</tr>
<tr>
<td>% General Average</td>
<td>21%</td>
<td>20%</td>
<td>63</td>
</tr>
</tbody>
</table>

Table 4 – Average % of Disclosure per Category

With respect to the subcategory Capital Structure, one should highlight the disclosure of items researched by, at least, two of the institutions selected, resulting in an average percentage of disclosure of 73%. In relation to the subcategory Capital Adjustment, it should be highlighted the disclosure of more detailed information in connection with the legal requirement of capital by nature of risk (credit, market, operational), it was not performed by any of the institutions analyzed. As mentioned previously, more objective information, such as the ratio between reference equity and value of assets weighted by risk and value of reference equity was evidenced by all institutions. The average percentage of disclosure in this subcategory was 28%.

In the category of disclosure “Scope of Application”, the average percentage of disclosure was 33%, highlighting the evidencing by 100% of the institutions analyzed of two of the items of disclosure: information relative to the applicability of the accord structure (individual or consolidated) and information on the consolidation process. It should be highlighted that, today, the financial institutions may choose for the consolidated verification of the operational limits instead of individual verification. With respect to the category “Exposure to Risks”, the average percentage was the lowest among the categories analyzed: 11% and 12%. From the nine subcategories presented in Table 5, only four were the purpose of disclosure, even if partial, by the financial institutions: “Credit Risk”, “Securitization”, “Mitigation of Credit Risk” and “Operational Risk”. In the first, the adherence level reflects compliance with the requirements of information established in Resolution 2.682: general qualitative disclosure in connection with credit risk and criteria adopted for the characterization of credits due and for the provisioning of credits; exposures by sector, exposure by maturity; movement of provisions and segregation of specific provisions (minimum value according to Resolution 2.682) and general (added value established based on the experience of the Administration). With respect to subcategory “Securitization”, only one of the institutions analyzed presented information which complied with two items, from the total of ten items, in connection with the objectives of the institution with the activity of securitization and outstanding exposures of these transactions, which is why the average
percentage of disclosure was 7%. With respect to subcategory “Mitigation of Credit Risk”, only one of the institutions analyzed presented in 2007 information, which complied, even if partially, one of the three items in connection with the instruments that mitigate credit risk.

<table>
<thead>
<tr>
<th>Risk Exposure</th>
<th>2007</th>
<th>2005</th>
<th>Qty. Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Credit Risk</td>
<td>54%</td>
<td>54%</td>
<td>8</td>
</tr>
<tr>
<td>3.2 Credit Risk: disclosures to portfolios subject to the standardized method and weighting of supervision risk in IRB</td>
<td>0%</td>
<td>0%</td>
<td>2</td>
</tr>
<tr>
<td>3.3 Credit Risk : disclosures to portfolios subject to the IRB method</td>
<td>0%</td>
<td>0%</td>
<td>6</td>
</tr>
<tr>
<td>3.4 Mitigation of Credit Risk (Disclosure for Standard Approach and IRB)</td>
<td>11%</td>
<td>0%</td>
<td>3</td>
</tr>
<tr>
<td>3.5 Securitization</td>
<td>7%</td>
<td>7%</td>
<td>10</td>
</tr>
<tr>
<td>3.6 Market Risk</td>
<td>0%</td>
<td>0%</td>
<td>6</td>
</tr>
<tr>
<td>3.7 Operational Risk (Standardized Method)</td>
<td>11%</td>
<td>0%</td>
<td>3</td>
</tr>
<tr>
<td>3.8 Equity Participations</td>
<td>0%</td>
<td>0%</td>
<td>6</td>
</tr>
<tr>
<td>3.9 Risk of Interest Rate in Bank Registration</td>
<td>0%</td>
<td>0%</td>
<td>2</td>
</tr>
<tr>
<td><strong>Average % of Category</strong></td>
<td>12%</td>
<td>11%</td>
<td>63</td>
</tr>
</tbody>
</table>

Table 5 – Average % of Disclosure of Category Exposure to Risks

With respect to the five subcategories of “Exposure to Risk”, in which there was no disclosure by the financial institutions analyzed, such fact is due, partly, to the stage in which is found the implementation of a new capital structure (Basel II) by BACEN, as shall be commented below.

The use of the approach based on internal ratings (Internal Ratings Based - IRB) by the financial institutions for credit risk is contemplated in the Communication BACEN 12.746, of December 9, 2004, for bigger institutions. However, in the transition period, all the financial institutions shall adopt the simplified standard approach, which represents the current approach (1988 Accord) with the incorporation of enhancements associated to risk exposures, which explains the adherence observed in relation to the items of disclosure which deal with the IRB method.

In relation to the subcategories “Market Risk” and “Equity Participations”, the absence of adherence in the disclosures performed by the institutions portrays the difference between the Amendment to the 1988 Accord, published in 1996, and its implementation by BACEN in the Brazilian financial market. Despite the requirement of capital to cover the market risk not being altered in the New Accord, the implementation of the new structure by BACEN, set forth in Communication 12.746, provides for the implementation of the current structure of verification of the capital requirements for coverage of this type of risk by including exposures in connection with commodities and shares, as well as permission for the use of internal systems (proprietary models) of risk management.

To this effect, BACEN has recently put in a public hearing Notice No. 26, until mid July 2006, drafts of rules to be submitted to the CMN, which contemplated the verification of the required net equity - PLE (or required reference equity - PRE) in connection with the exposures subject to commodity price variations (commodities), to the risk of transactions subject to share price variations and exposures subject to variation of the coupon of the US dollar and those of transactions with US dollar denominated instruments, in addition to revision of the portions of PLE in connection with: the exposures weighted by risk factor,
which includes the use of instruments that mitigate risks; risk of exposures in gold, foreign currency; and exposures subject to the variation of prefixed interest rates denominated in reais.

With respect to subcategory “Operational Risk”, the disclosures made by the institutions do not meet the information requirements established for this type of risk, being limited to conceptual definitions and general comments regarding the development of internal models for the management of this type of risk and compliance with the orientations of the New Accord, despite the provisions set forth in Resolution 3.380, of June 29, 2006. This Resolution contemplates the implementation of the operational risk management structure, including minimum activities to be performed by the structure implemented and the need to disclose the operational risk management structure in an explanatory note to the accounting statements.

Notwithstanding the perception of benefits with respect to the improvement of risk management practices and the intention of the institutions to adopt disclosure standards adherent to the New Accord (Basel II), the average disclosure percentage observed reflects the conservative position of the institutions in relation to disclosure, which intend to follow strictly the implementation schedule established by BACEN through Communication 12.746 and adjusted by Communication 16.137, by virtue of the uncertainties relating to the adjustments necessary to the characteristics of the legislation and of the Brazilian financial market.

7. CONCLUSION

The objective of this research is to investigate the determining factors of the disclosure adopted in the Annual Report by the Brazilian financial institutions in light of the recommendations of BIS on transparency and disclosure.

For the accomplishment of the objectives intended by the research, three financial institutions participating in one of the special listing segments of BOVESPA were identified (Level 1, Level 2 and New Market), which constituted the case study. The data necessary were obtained by analysis of the disclosure performed by these institutions in the Annual Report and by semi-structure interviews with executives of these institutions, which were analyzed in light of the literature on disclosure and recommendations of BIS on disclosure and transparency.

The analysis of the disclosure adopted in the Annual Report, in the period 2001 to 2005, permitted to observe an evolution in the disclosure of the information provided by the financial institutions analyzed in terms of number of explanatory notes and enhancement of the content presented, especially in the case of the institution which performed the first public offering of shares in the fiscal year 2005. However, with the exception of one of the institutions that takes the attitude of harmonizing the information disclosed in the Annual Report in Brazil with those disclosed abroad, and, consequently, discloses a larger quantity of information, the information disclosed by the other institutions comply basically with the disclosure requirements already contemplated in the regulation.

The adherence to the recommendations of the Committee was assessed by comparison between the disclosure by the financial institutions in the Annual Report and the recommendations of the Transparency Committee (Public Disclosures by Banks: Results of the 2001 Disclosure Survey) and Market Discipline (International Convergence of Measurement and Standards of Capital: A Revised Structure – Pillar III).

As a result of the first comparison, in the fiscal years of 2005 and 2004, the adherence observed was 33% and 31%, respectively. For 2007 and 2006, these percentages reached 35%
and 32%. Even if superior to the percentages obtained in the research conducted by Xavier (2003), of 26% in 2002, such percentages are much beneath those raised in the research conducted by the Committee and performed with internationally active financial institutions, of 63% in 2001.

In relation to the second comparison, the adherence observed was even lower: 20% of items researched for the fiscal year of 2005 and 21% of items researched for the fiscal year 2007. It is highlighted the low adherence of the category “Risk Exposure”, of 11% of items researched, in part, due to the fact that the use of the approach based on internal classifications (IRB) was contemplated in Communication 12.746, of December 9, 2004, only for larger institutions and, moreover, being subject to the use of the simplified standard approach – current approach with the incorporation of enhancements associated to risk – at a first moment.

With respect to the subcategory “Operational Risk”, despite the absence of adherence verified in the disclosures made by the financial institutions, it is expected that the quality and quantity of information about the management of this type of risk will be increased, having in view the publication of Resolution 3,380, which covers the implementation of the operational risk management structure by financial institutions.

Notwithstanding the position that the regulation represents the minimum to be complied in terms of disclosure of information, the financial institutions showed a conservative attitude when questioned about the adoption of disclosure standards adherent to the recommendations of the Committee voluntarily (before implementation by BACEN). By assessing the potential changes in the standard of disclosure practiced, the institutions emphasized the need to closely assess, in Internal Committees, the information to be evidenced and wait for the implementation of a New Accord by BACEN by virtue of the adjustments to be made given the stage of development of the Brazilian market, in addition to the intention of following the schedule established by the regulatory and supervisory body.

Therefore, the events of transactions in the capitals market and proprietary costs configure determining factors of the level of disclosure practiced by the financial institution, in light of the theory on disclosure. In addition to the regulation applicable to financial institutions, important disclosure factors stand out: the role of external audit in assuring the quality of disclosure practiced; benchmark in relation to the information presented by other financial institutions and by strategic partners; and comments and questions presented by investors and market analysts in institutional presentations.

Finally, it is important to emphasize that transparency in disclosure of information by disclosure must be considered as a continuous process, an ideal to be reached, especially in financial institutions, in which exposure to risks is inherent to its transactions. The establishment of disclosure standards by the regulatory and supervisory body is fundamental to ensure disclosure by financial institutions of a group of essential information, especially in relation to the risks incurred, adequately, which will make it possible to compare the financial institutions among themselves and provide the conditions necessary to reach the objective intended in the New Accord, in connection with the control exercised by the market: market discipline.
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