



Are Banks Opaque?

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Abstract: We use the Jin and Myers (2006) model to examine the relative opacity of banks. Our results show that banks have less firm-specific information in their equity returns than industrial matching firms, consistent with banks being more opaque than industrial firms. We also provide new evidence on the opacity of specific bank assets. We find that higher proportions of agricultural and consumer loans are related to lower levels of bank opacity. Our results are robust to inclusion of various controls, consideration of differential fundamental cash flow risk between banks and industrial firms, and the stock exchange on which shares trade.

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1. Introduction

One rationale for the regulation and protection of banks rests on the assumption that banks are opaque, that outsiders cannot observe the risks involved in financial intermediation. Such opacity exposes banks and the financial system to runs and contagion, in which even healthy banks fall victim because opacity prevents outsiders from being able to distinguish between sound institutions and unsound ones. Thus, the logic goes, government regulation, the discount window as lender of last resort, and deposit insurance are necessary to protect healthy banks and the banking system (Morgan (2002), Flannery et al. (2004)).

But are banks really more opaque than industrial firms? To address this question, Morgan (2002) examines the ratings of new bonds issued by banks and industrial firms. If a firm is completely transparent, then the two major rating agencies should reach the same conclusion regarding the default risk of any given bond issued by the firm. However, if a firm is opaque, rating agencies must use partial information to arrive at a rating, creating the possibility of disagreement between the two agencies. Therefore, disagreement between the agencies (a “split” bond rating) is an indication of firm