Paper Four

29th September 2008

Transparency is not the answer.

John Eatwell and Robert Reoch

The “Bailout Bill” passed by the US Congress requires the Secretary of the Treasury to “review the current state of the financial markets and the regulatory system and submit a written report to … Congress not later than April 30, 2009, analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, … and providing recommendations for improvement”.

The Bill was produced in haste. It is important that regulatory reform should be considered more carefully.

But already there is a head of steam building up behind that proposition that “greater transparency” should be a dominant theme of the reform package. Precisely what is meant by “greater transparency” is not made clear: does this refer to improved availability of market information or to enhanced understanding of the structure of complex instruments? Unfortunately in neither case will “greater transparency” reduce systemic risk in financial markets. Indeed, in some cases greater transparency could make things worse.

Current events in financial markets have demonstrated beyond all reasonable doubt that the sophisticated market-sensitive risk models deployed by banks and other financial firms, and espoused so enthusiastically by the regulators, have totally failed to ensure stability in financial markets. On the contrary, to the extent that anyone believes them any more, the models have been a major factor in the failure of credit markets since in the face of extreme events, they all tended to endorse the same actions at the same time – guaranteeing widespread illiquidity. One of the drivers of the consequent lemming-like behaviour has been the greater transparency that regulators have campaigned for over the past twenty years or so. Greater transparency meant that more firms shared the same information, had access to the same procedural knowledge and even the same modelling – so it is hardly surprising that they all behaved in the same way.

But the risk modellers should not be blamed. Their models are not capable of measuring market liquidity risk, nor are they intended for that task. A firm’s risk model seeks to price the risks that are the result of its actions in the market place. They are necessarily market sensitive, and greater transparency will tend to increase that sensitivity. But it’s not just that market sensitivity may increase the likelihood of stampedes. In the presence of the systemic externalities, such as liquidity risk, even the most transparent competitive market will be inefficient, and therefore risk will be mis-priced. The current turmoil is clearly a systemic event. There is no way it could

have been accurately priced by an individual firm Greater transparency will only add to the illusion of accuracy, and, by reinforcing herd behaviour, may well make things worse. Indeed, a number of writers have suggested that the requirement to mark complex investments to market, hence increasing transparency, has been an important element in rapid de-leveraging and subsequent financial collapse.

The second interpretation of the case for “greater transparency” rests on frequent references to securitized market instruments that “no-one understands”, and “no-one knows how to price”. Once again the call for greater transparency is mis-conceived. What is at issue is not the transparency of such instruments but their complexity and the controls employed by buyers and sellers. Firms have bought complex instruments without understanding the risk, often relying exclusively on rating agencies to assess the risk, and in most cases have relied on valuations provided by sellers. Banks have sold complex products to unsophisticated investors with little attention to whether the investment is appropriate or whether the risks are understood, and have provided valuations using models that cannot price liquidity risk accurately (see above). Where all parties involved believe in a particular asset class and in the rating of such assets, and where both sides of a transaction are financially motivated to see the transaction completed, then no amount of transparency will result in greater stability.

Of course reducing informational inefficiencies can often be worthwhile and may result in greater market efficiency. And ensuring that complex instruments come with “full disclosure” at least places some responsibility on buyers to understand what they are buying.

But transparency has nothing to do with the systemic risk that is the proper object of regulation. Indeed the persistent emphasis on transparency is a dangerous diversion from the massive task of regulatory reform that is now required in the UK and the US. Unfortunately, for the past twenty years or so the regulators have swallowed the argument that superior market sensitive risk management by firms would result in greater overall stability. They must now abandon their belief in the tired trinity of greater transparency, more disclosure and better risk management by firms. Surely it must now be recognised that that regulatory model has failed? Instead they must turn to finding ways to develop a systemic approach to regulation, including pro-cyclical provisioning and system-wide stress testing, and confront the vicious market cycle of rising asset prices accompanied by rising leverage, and the even more vicious cycle running in reverse.

Those who argue that greater transparency is the answer, don’t understand the question.

Lord Eatwell is the President of Queens’ College, Cambridge. Robert Reoch is a Director at New College Capital Ltd.