

Transparency is no quick fix **Jean Pisani-Ferry**

European politicians' instant response to the market turmoil of August 2007 has been in most cases to call for more and better information and to blame those accused for not providing it. Their precise target may not be the same – some blame the rating agencies, others hedge funds, others again the banks – but their common theme is that greater transparency is the proper response to the risks revealed by the latest upheaval.

There are very good reasons to push for transparency. Until financial deregulation began some twenty years ago, the philosophy inherited from the Great Depression was that financial stability implied, first, preventing excess risk-taking through limiting the range of available financial instruments and regulating access to the available ones and, second, segmenting markets to limit contagion. This, it was hoped, would reduce the probability of accidents and contain the consequences if they occurred.

Widespread financial deregulation has swept that philosophy away. Markets are interconnected and financial innovation has created many more new instruments than anyone thought possible. In this context, while some players with a systemic dimension like banks are still subject to specific regulations, for a large part of the market risk prevention must rely on a new approach. What has gradually emerged as a response is systematic and comprehensive dissemination of information, both about global market conditions and from specific issuers of securities. To use a naval analogy, instead of telling market players that they need to avoid iceberg-infested waters and have hulls with watertight compartments, the idea is to make sure that everyone has access to real-time weather forecasting and radar technology.

It is this philosophy that inspired the reactions to recent financial crises. In 1999, in response to the Asian crises and the collapse of Long-Term Capital Management, a hedge fund that had taken very large, potentially destabilising positions in some market segments, the G7 called for the dissemination of better data by sovereign issuers and established the Financial Stability Forum to 'assess vulnerabilities' in the international financial system, 'identify and oversee action needed' and 'improve co-ordination and information exchange'. 'Financial stability' has become a major concern of official financial institutions and most major central banks nowadays publish biannual financial stability reports which provide detailed assessments of market developments and risks.

So what has this effort delivered? The latest available Global Financial Stability Report of the International Monetary Fund (<http://www.imf.org/external/pubs/ft/gfsr/2007/01/index.htm>) released in April 2007 is a good place to check. In this report, the Fund first warned that market risk was on the rise and that 'competitive pressures and risk models may help to perpetuate risk-taking that, from an individual institution point of view, responds rationally to the current environment but may raise systemic risk', adding that 'a market correction potentially triggered by a volatility shock could be amplified by leveraged positions and uncertainty about concentrations of risk exposures stemming from the rapid growth in innovative and complex products, some of which have rather illiquid markets' – a rather accurate *ex-ante* description of what has just happened.

Furthermore, the Fund report includes an in-depth study of the potential spill-over effects of the deterioration in the US subprime market. What this study indicates is that a fair amount of information was in fact available on the situation in this market, for example the proportion of defaults and delinquencies for each loan vintage. Aggregate information was also available on derived securities such as the now famous Asset-Backed Securities and Collateralised Debt Obligations. Interestingly, a large part of this information appears

to derive from the securitisation of subprime loans: instead of remaining the private information of lenders, statistics allow a real-time assessment of the subprime risk.

Warnings and frightening statistics have thus been supplied in abundance. So what could greater transparency bring? At the aggregate level, there is certainly room for improvement, especially on the location of the credit risk that securitisation has dispersed but which may have been concentrated somewhere, as suggested by the collapse of the funds launched by IKB and SachsenLB. To know better whether risk is concentrated, and where, would help central banks to assess potential for market disruption and to decide how to respond to requests for liquidity. But it is doubtful that it would change investors' behaviour. As pointed out in the IMF warning, the low valuation of risk observed in recent months was not the result of insufficient information but of a market structure that provided incentives to participants to follow the herd and behave imprudently.

The other way in which transparency could help is in making individual investors more aware of the risk incurred in complex products. Ratings assess default risk, not the liquidity risks that become widespread in panic situations nor those resulting from correlations across markets. Here again, there is certainly room for improvement, as there is in the field of consumer protection. But information asymmetry is inherent to finance and it is an illusion to believe that additional transparency would have made investors aware of the full extent of risk involved in new and complex product such as mortgage-based CDOs. To claim that better information would have cut investors' appetite for risk to an extent sufficient to avoid a boom-bust cycle is an audacious claim, to say the least.

So transparency is needed, but it is no quick fix. The reason why it is put forward as a panacea is that it is politically attractive, not that it is effective. It amounts to printing 'Smoking kills' on cigarette packets, which is true, preserves civil liberties, but does not solve the public health problem.

Crucially, the call for transparency should not be a pretext for overlooking more difficult issues. For European politicians, there is no shortage of puzzling questions raised by the latest crisis. To mention just a few: does the fact that Europe has been more severely hit than the US (on 20 August, US stocks were down 3% on early July, European stocks 8%) indicate a lesser ability to process risk or a higher inclination to imprudence on the part of European banks and investors? If so, is the structure of the European financial industry to blame? Especially, have newcomers to deregulated markets been especially adventurous (as was often the case in the past)? Is it wise to retain existing national arrangements for market oversight, since the structure of these arrangements varies widely from one country to another and seems to be governed as much by inertia and bureaucratic interests as by the search for efficiency? Is European governance by committees up to the task of swift action? Can pan-European banks be supervised by still-national authorities? It would be advisable to direct at these issues at least some of the energy that is about to be invested in the quest for transparency.