The role of transparency in the financial sector

TI EU Office
Group of Experts on Banking Issues (GEBI)
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„The reputation of a banking firm for integrity, generosity and thorough service is its most important asset, more important than any financial item. Moreover the reputation of a firm is like a very delicate living organism which can easily be damaged and which has to be taken care of incessantly, being mainly a matter of human behaviour and human standards“.

- Siegmund Warburg
What’s the interest of TI in financial services reform?

- Importance of Corporate Integrity Systems (CIS)
  - Ethical leadership
  - Good corporate governance
  - Anti-corruption compliance systems
  - Regulatory oversight

- Financial crisis revealed flaws in financial sector’s CIS

- High profile cases of conflict of interest, mis-selling and fraud

- Financial sector an important conduit for corruption, illicit financial flows and money-laundering

TI 2015 strategy: enshrine principles of transparency, accountability and integrity into the regulations that control the global financial system
The importance of transparency in financial systems

• Transparency: *the disclosure of all information that will ensure the proper accountability of institutions to their boards, investors, shareholders, regulators and other stakeholders.*

• Benefits:
  
  ➢ Fights fraud and corruption
  ➢ Improves market efficiency
  ➢ Investor protection
Evidence of benefits of transparency

Empirical studies:

**Positive effects on banking stability**

**Banking crises less likely where transparency and regulatory disclosure high**

**Lower financing costs and lower risk profile**
So why resistance in some quarters?

Possibility of negative impact of events beyond control of individual banks

In such cases greater transparency can lead to run on the bank (unfairly, perhaps)

But history shows that fears of negative impact of greater disclosure requirements are often misplaced

*Example: Financial Accounting Standards Board (FASB) and expensing options*
Transparency Paradox?

An apparent paradox: countries with most developed disclosure and transparency measures, and banks subject to most sophisticated regulation, were at the centre of the recent financial crisis.

*How to resolve this paradox?*

In the view of TI, trend toward greater transparency has been offset by 3 factors:

(i) Financial innovation and the growth of opaque financial markets

(ii) Lax supervision and enforcement at all levels

(iii) Failure to deal with systematic conflicts of interest
Financial innovation & growth of opaque financial markets

Opacity of financial derivatives markets allows individuals to evade disclosure requirements, breeds conflicts of interest and prevents regulators and risk-managers from carrying out their functions due to the build-up of hidden risk.

Examples:
• Goldman Sachs and CDOs
• Anglo Irish Banks and Contracts for Difference
• Evolution of “shadow” banking system
• Growth of private exchanges

Regulatory response:
• Greater transparency through central clearing and recording of transactions (Dodd Frank Act, EC EMiR proposal)
• More and better quality information and analysis (Office for Financial Research)
Lax supervision and enforcement

Supervisor passivity in the face of clear warning signals

E.g. Office of Thrift Supervision

Failure of governance regimes to curb excesses and question dubious practices

E.g. Washington Mutual, Lehman Brothers
What explains this failure of supervision?

• Group think
• Regulatory capture and revolving doors
• Lack of skills
• Lack of fiscal clarity
• Lack of information and information-sharing
• Competing and overlapping mandates
Systematic conflicts of interest

Many cases of conflict of interest, but 2 particular examples of pervasive, systematic conflict of interest:

• Credit Rating Agencies

• External Auditors
**What is to be done?**

In case of *market transparency*, role for greater regulation (need for coordinated and standardised disclosure)

Need to shed light on connections between regular banking system and problematic elements of *parallel banking system*

- E.g. Hedge funds, private equity, money market funds, special purpose vehicles
What is to be done (2)?

In case of *supervision* 3 different levels

First level: State of art governance and compliance systems at institutional level, with focus on:
- encouraging contrarian thinking through board diversity
- Whistleblower protection
- Remuneration policies
- Integrated risk management
What is to be done (3)?

Second level: good supervision, checks and balances at micro-level, with a focus on:

• Better dialogue between regulators and auditors
• Transparency in formation and oversight of supervisory colleges
• Resolution of conflicts of interest in credit rating agencies and audit firms
• Greater transparency in audit and credit rating processes
What is to be done (4)?

Third level: good supervision, checks and balances at macro-level:

Within EU this is new supervisory agencies and bodies, i.e.
• European Systemic Risk Board
• European Banking Agency
• European Securities Markets Agency

Crucially, there must be more transparency in how supervisors and regulators work. Need to be complemented by strong and informed media and civil society
Will greater transparency impact on economic growth?

Objections to greater transparency:

1. Unintended negative consequences for market liquidity (e.g. quote driven illiquid markets)

2. High degree of customisation necessary to create perfect hedges

In general, greater disclosure requirements will disrupt secondary markets, reduce available capital, raise the cost of capital, thereby hampering growth.
Responses

No ‘one size fits all’ transparency regime

Need to calibrate transparency requirements to particular markets

E.g. Distinguish pre-trading and post-trading

Change market structures to ensure more transparency?

Closely scrutinize rationale for waivers, exemptions, customisation
TI priorities

i. Transparency and accountability of EU level supervision (the effective functioning of the new supervisory structures will be important ensure a single rulebook/ level playing field in financial services. These will be monitored to ensure that their performance is not hampered by conflicts of interest)

ii. Ensure that the ongoing reforms are not undermined by the potential for regulatory arbitrage that the parallel or “shadow” banking industry represent

iii. Improve corporate governance and financial disclosure

iv. Removal of conflicts of interest in the wider system of checks and balances, e.g. credit rating agencies and auditing firms

v. Improve transparency in markets and financial products