

The seduction of transparency and disclosure

April 16, 2014

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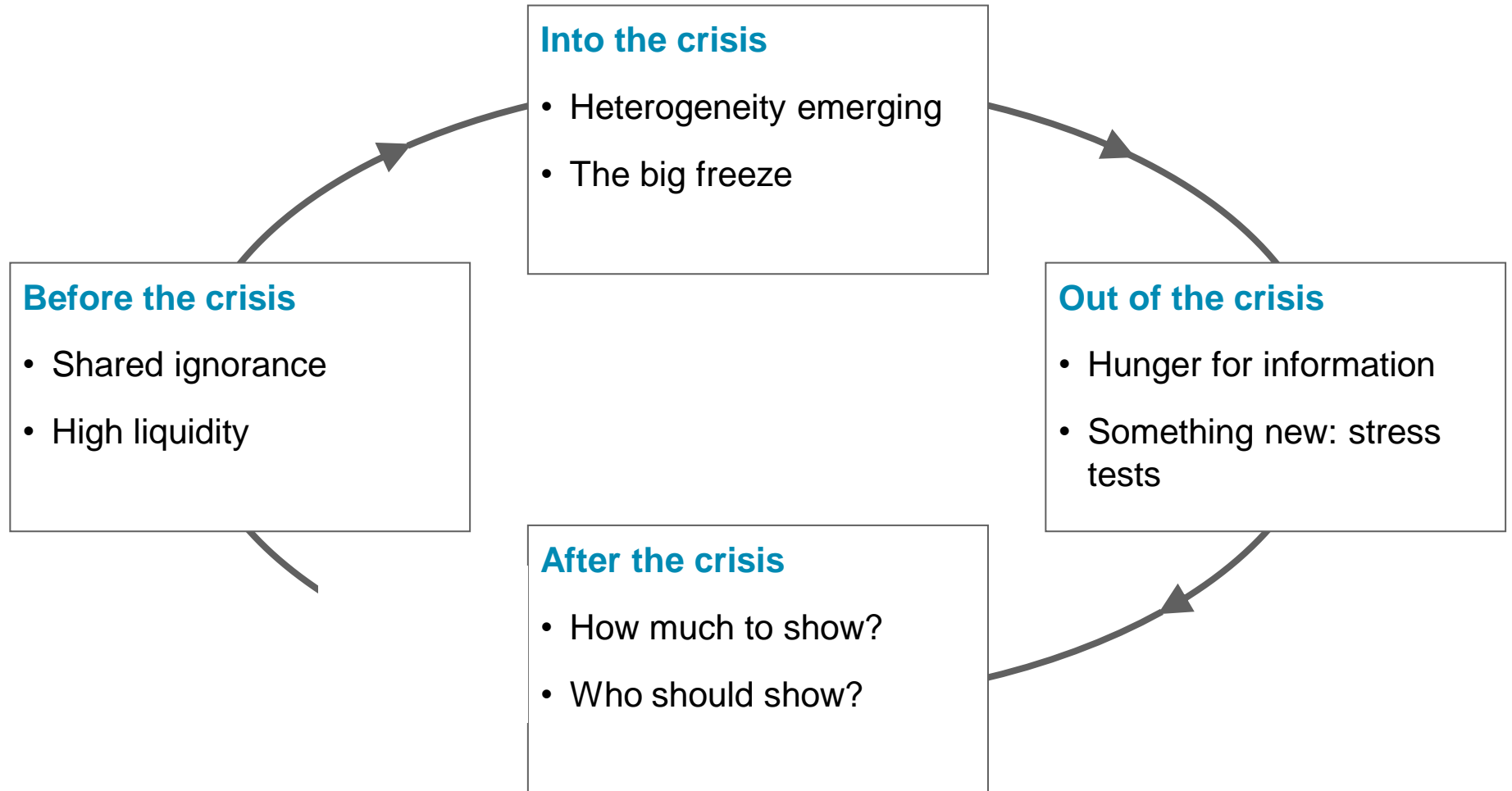
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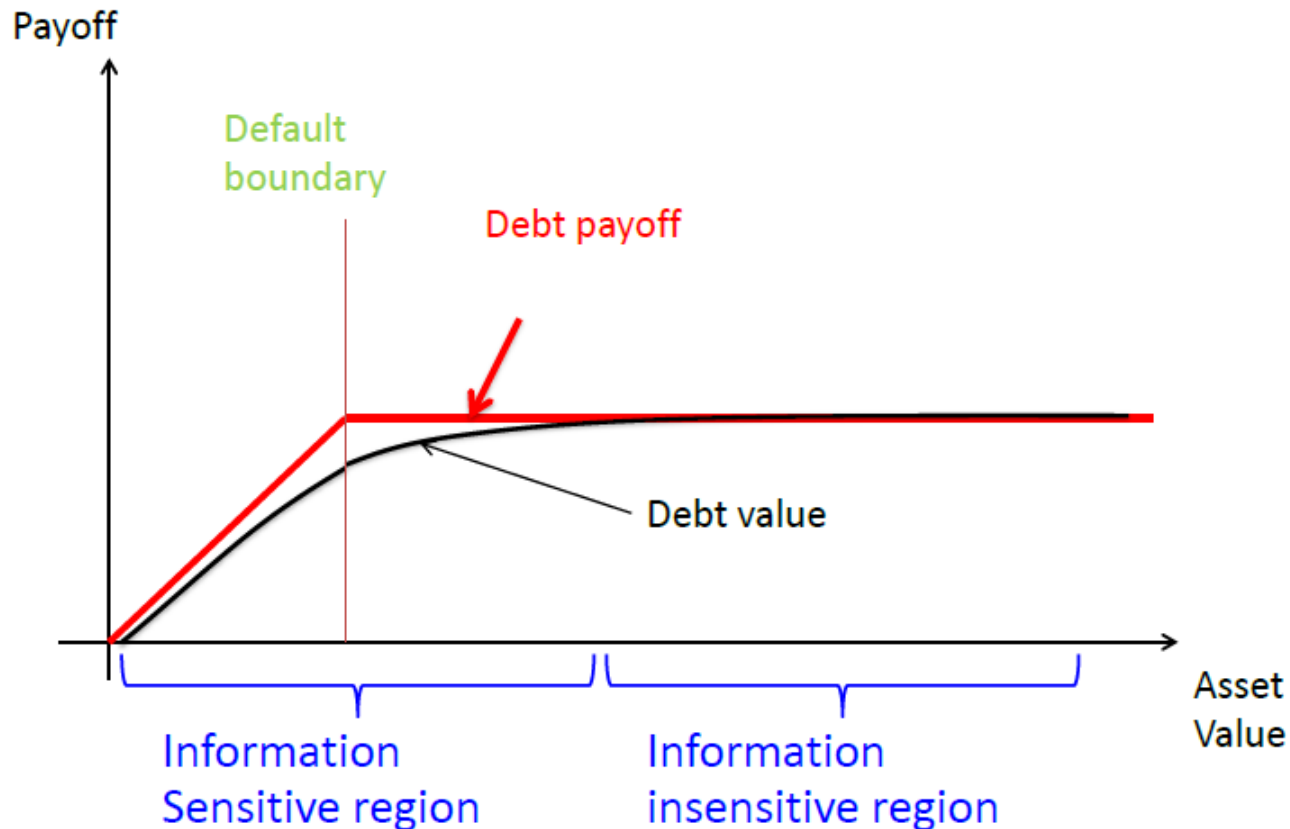
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Before, during and after the financial crisis



Before the crisis: ignorance is bliss

- (Borrow from Holmstrom's 2012 Presidential Address)
- Shared ignorance, common understanding, private information not important
 - Fast, liquid debt markets

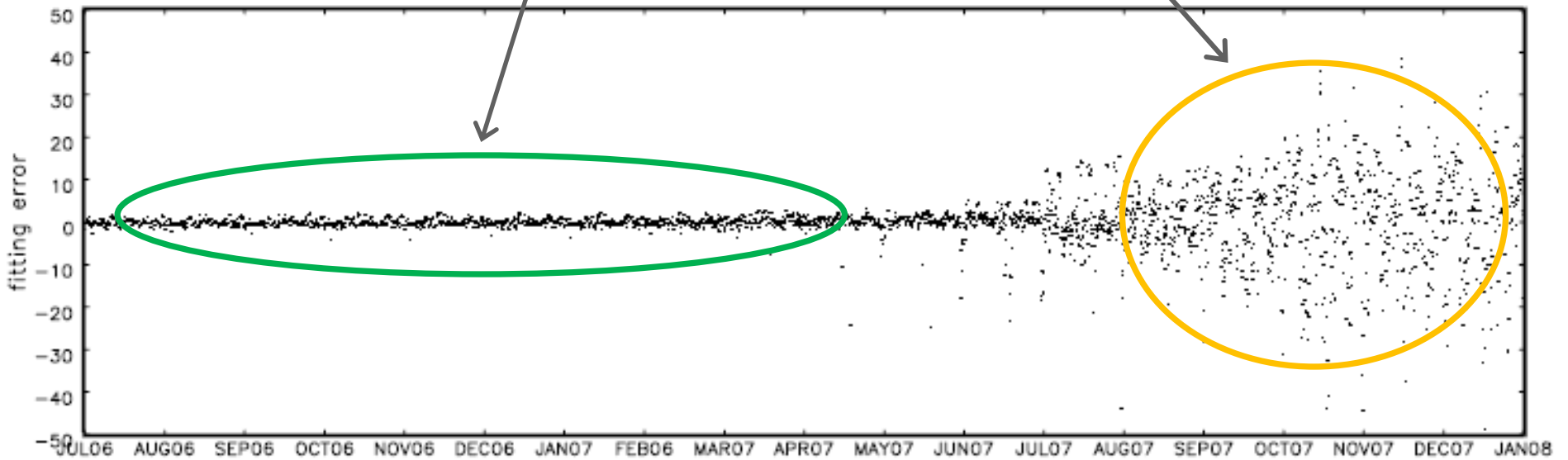


- Securitized assets
- Muni and some corp. debt
- Banks (some, then more)
- Sovereigns (some, then more)

Into the crisis: ignorance sucks

- Heterogeneity is revealed → private information becomes important
- “Trapped information” is released
- Discontinuity from information irrelevant to information relevant state (Holmstrom)

AA-Rated Home Equity Loan ABS Tranches



Source: Perraudin & Wu (2008)

Out of the crisis: how to restore trust

- How to restore trust, or how to get back to a common understanding
- Engage in massive information production
 - Instruments: everyone wanted collateral information
 - Institutions: everyone wanted details on balance sheets
- Also needed to restore trust in the guardians of the financial system: regulators & supervisors
 - Ancien regime: RWA, Basel
 - New approach: stress testing
 - Show your work: SCAP (2009) disclosure; [Ireland 2011; Spain 2012; ...]
 - Rich detail about prospective losses and resources under stress scenario
 - By major asset class
 - With detail on methodology and approach
- Transform uncertainty into risk
 - That I can manage!

After the crisis (and before the next one?): can there be TMI? What should be disclosed, and who should disclose it?

- (draw from Goldstein & Sapra, 2012, and Goldstein & Leitner, 2014)
 - There are benefits and costs to disclosure
 - Broadly, disclose more in crisis, less in good times
- Note we are now in a state of the world where trust has been largely restored (especially in the guardians of the financial system)
- Value of public signal especially high – and will drown out private signal
 - Knowing that, motivates strategic behavior
 - If you must disclose, it should be precise
 - Precision at bank level in the face of bank heterogeneity problem is especially critical for disclosure in good times
 - Argues for detail by asset class but aggregated across firms, and less detail at firm level
- Importantly for us today: regulatory disclosure in good times can be harmful because it can prevent optimal risk sharing by banks
 - Hirshleifer effect

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