The seduction of transparency and disclosure

April 16, 2014

Til Schuermann
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Before, during and after the financial crisis

**Before the crisis**
- Shared ignorance
- High liquidity

**Into the crisis**
- Heterogeneity emerging
- The big freeze

**Out of the crisis**
- Hunger for information
- Something new: stress tests

**After the crisis**
- How much to show?
- Who should show?
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)

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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