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Enhancing financial stability: the role of transparency – speech by Donald Kohn

In a speech delivered at the London School of Economics, Donald Kohn - External Member of the Financial Policy Committee – considers how greater transparency of both the financial system and policy makers can enhance financial stability.

Donald Kohn says that the establishment of the Financial Policy Committee (FPC) brings an important macro-overview to the job of regulating the financial system. But he argues it is private decisions that will ultimately determine financial stability, despite the best efforts of regulators. In the build up to the crisis, badly informed private sector decisions resulted in financial instability. "A variety of risks were poorly understood, poorly managed, and badly priced", he says. "Institutions, markets, instruments, and the interactions in the financial system became more opaque in the years leading up to the crisis."

There is a need for greater transparency among financial **institutions, instruments, and markets**, Kohn contends.

Counterparties and investors need to be able to make a reasonably accurate assessment of the financial health of an **institution** and how that health would be affected as economic and financial conditions change. That requires institutions to provide timely, up to date, and comprehensive information, which fairly represent the condition of the firm. Firms can also help relieve uncertainty about their balance sheets by publishing enough information to enable market participants to apply their own informed judgment about the effect of changing circumstances. Moreover, the reporting conventions of firms should be more uniform, so that data can be compared.

But greater information about the **instruments** sold and bought by institutions is also needed. "Complex and poorly understood instruments were at the heart of the crisis ", Kohn says. "Transparency about these structures—full information about them readily available to all market participants—is required to protect financial stability." A lot more information is now available about these instruments and structures are simpler. But Kohn points out, "... the FPC is concerned about backsliding as confidence returns" and "...the re-emergence of complex instruments with chains of counterparty exposures that are not transparent or well understood."

Complexity and interconnectedness in **markets** had posed problems. But Kohn argues, "the increased use of central counterparties for clearing derivative trades will reduce the complexity of many of the connections and interdependencies in this huge and growing sector of the financial markets". At the same time, information about centrally cleared and other derivatives transactions will be gathered in trade repositories. Donald Kohn believes that these data warehouses present an opportunity to improve transparency in a number of dimensions. More complete reporting of price information should help in price discovery and enhance competition. Release of information about aggregate trade volumes should help policymakers and market participants assess how participation in markets for risk is changing over time.

Even so, Kohn points out that problems remain due to fragmentation of financial markets. Fragmented markets themselves create complex interdependencies as institutions and final users operate in more than one venue. And the data available from each market may not be consistent or in a common format that permits market participants or regulators to see the relationships readily or aggregate positions by counterparty and across markets. Continued industry effort is needed to develop common data classification systems to enable effective utilization of this new information.

Donald Kohn concludes his speech by arguing that in addition to greater transparency in the financial system, the effectiveness of policy will depend on how open the FPC is about its concerns recommendations, and deliberations. "To be effective in influencing the private sector, the FPC’s concerns need to be credible and focused. They will be credible if they are well reasoned—backed up by facts and cogent analysis. That in turn will require a good deal of openness about our deliberations". Kohn adds that, "Open, well-reasoned analysis also will help to build public support for the work of the FPC and understanding of its linkage to financial and economic stability. This support may be helpful when the FPC needs to take potentially difficult steps to contain emerging systemic risks." Furthermore he argues that transparency will be important for the FPC’s democratic legitimacy, "Transparency about our processes and reasoning is also a particularly critical aspect of the FPC’s accountability to the public and Parliament."

Key Resources

Enhancing financial stability: the role of transparency – Full speech