Market-driven transparency

*Much of the legislation written in response to the financial crisis is intended to force greater disclosure and increase transparency for both market participants and regulators. However, there may be a better way to achieve this badly needed objective, argues **David Rowe***

Transparency has been the abiding watchword throughout the financial crisis. Significant elements of legislation spawned by the crisis have been intended to force greater disclosure and improve the quantity and quality of the information available to market participants and especially to regulators. In virtually all the discussion over transparency, though, it has been assumed that information will always be hoarded by private actors and that only legal compulsion can change that. It is worth asking whether there might be a better way.

You have to be of a certain age to remember when the US government bond market was nearly as opaque as derivatives are today. It remained so until the early 1970s, when Cantor Fitzgerald bought a controlling interest in Telerate and launched screen-based trading in US government bonds. Needless to say, the established bulge-bracket players fiercely resisted this innovation. Buy-side participants, however, loved it – they finally had a simple, cheap and transparent way to check their dealer quotes against alternative executable prices. When the major dealers began to lose business, often after being told their prices were 'well off the market', the writing was on the wall. In the end they had to capitulate and find ways to adapt to the new reality.

Today, there are many markets that are just as opaque as government bonds once were. The long-term health and stability of such markets depends on buyers being able to conduct in-depth research on the basis of detailed, reliable and objective information. This does not mean these instruments must be identical and completely fungible, any more than corporate bonds of different issuers are fungible. What is needed is standardised, reliable, up-to-date and persistent information on the instruments.

Until recently, the cost and availability of computer information storage, processing power and communication capacity presented significant obstacles to the development of such an arrangement. Today, those obstacles have largely disappeared. A system where the underlying details of every individual mortgage in a mortgage-backed securities transaction (such as up-to-date information concerning payment status, geographically related comparables, original and current loan-to-value ratios and much more), along with the cashflow structure of the security and the implications of pre-existing defaults or repayments, could be maintained in a coherent database available to buyers. The main obstacle to this is resistance to divulging information that is deemed to convey competitive advantage.

How could such a facility become a standard feature of the markets for complex financial products? We will not accomplish this by appealing to the benevolence of the investment banking executive – vested interests that reap immense benefits from existing information asymmetries will resist any such arrangement with all the force of their K Street lobbyists. The dramatic improvement in transparency that technology now makes possible will only be realised through appeals to self-interest.

First, it will require a well-heeled insurgent organisation with little or no stake in the current market arrangements to underwrite the technical development of such a system. Second, it will require participation commitments from a core group of buy-side firms that would be helped by the greater transparency, lower risk and sharper pricing that such a system would create. Finally, it will require commitment from some aspiring second-tier sell-side firms that would benefit from a first-mover advantage in adopting such a transformative arrangement, and the big increases in trading volume it would create.

Essential to the success of such an arrangement will be incentives for continued supply of liquidity in the form of transaction credits that can be used to offset future transaction fees, or for enhanced access to the valuable detailed data the system makes available. Incentives must also extend to issuers of the underlying instruments to agree to make detailed information available (made anonymous where appropriate) to holders of their obligations. The obvious way to do this is to offer a more attractive price or interest rate in exchange for such agreement.

It seems to me the stars are well aligned to support such a development. My feeling in this respect is reinforced by the fact that the first such transformation is actually in initial operation. LexisNexis has collaborated with the Council of Insurance Agents and Brokers and Marketcore to create the LexisNexis Insurance Exchange (see *www.lexisnexis.com/risk/newsevents/press-release.aspx?Id=1264611168794267*). It is initially focused on property and casualty policies, but it has plans to expand into life and health as well as reinsurance. Since a similar mechanism would be equally applicable to various heterogeneous credit and derivatives instruments, this might just be the beginning of a much broader market transformation. ■

David Rowe is president of David M Rowe Risk Advisory, a risk management consulting firm. Email: davidmrowe@dmrra.com