



IGNITED MINDS
Journals

*International Journal of
Information Technology
and Management*

*Vol. VI, Issue No. II,
May-2014, ISSN 2249-4510*

**ROLE OF ETHICS IN TRANSPARENT FINANCIAL
SYSTEM**

AN
INTERNATIONALLY
INDEXED PEER
REVIEWED &
REFEREED JOURNAL

Role of Ethics in Transparent Financial System

Sharad Kumar¹ Dr. Abha Purohit²

¹Ph.D. Scholar, Jodhpur National University, Rajasthan

²Dean Faculty of Management, Jodhpur National University, Rajasthan

Abstract – The paper presents a theory of optimal transparency in the financial system when financial institutions have short-term liabilities and are exposed to rollover risk. Our analysis indicates that transparency enhances the stability of the financial system during crises but may have a destabilizing effect during normal economic times. Thus, the optimal level of transparency is contingent on the state of the economy, with the regulator increasing disclosure in times of crises.

Keywords: Financial, Transparency, Liquidity

1. INTRODUCTION

Financial crises are often associated with demands for an increase in the transparency of the financial system. For instance, chapter 3 of the Squam Lake Report (2010) includes the following recommendation: “large financial institutions should report information about asset positions and risks to regulators each quarter” and “the systemic regulator should prepare an annual “risk of the financial system” report”. The fact remains, however, that the level of transparency is generally deemed to be optimal before crises, and that even during crises there is some reluctance to increasing transparency (Acharya, *et. al.*, 2011). This suggests that, while transparency certainly has its benefits, it may also come with costs. This paper studies the trade-offs faced by regulators when setting the level of transparency in the financial system. We develop a stylized model of financial intermediation with rollover risk, in which financial institutions –banks– have exclusive access to a long-term investment technology that is illiquid (Acharya, Yorulmazer, 2008) Banks are ex-ante identical but they differ ex-post in the quality of their investment technology, and hence, in the quality of their balance sheet. Investors may have information about the state of the economy, and hence about the average quality of banks in the financial system, but they do not know the relative quality of each individual bank. While banks cannot credibly communicate about their own quality, the regulator has access to information about their relative quality and can credibly disclose it to the public (Barnea, *et. al.*, 1980).

In this setting, we show that the optimal disclosure policy depends on the average quality of banks in the financial system. When the average quality is high enough that investors are willing to rollover their credit,

it is optimal not to disclose information as transparency may expose lower-quality banks to a run. On the contrary, when the average quality is sufficiently low, the regulator will choose transparency, that is, it will disclose the quality of the balance sheet of each individual bank. Otherwise, if investors knew that the average quality was low but could not tell which banks are of higher relative quality, there would be a run on the whole banking system. This result relies on the threshold nature of the equilibrium which makes the probability of a run a nonlinear function of a bank’s quality. That is, investors run on any given bank only if its expected quality is below some threshold. Thus, if economic conditions are such that many banks are well above this threshold, pooling these banks with a few lower-quality banks does not have a significant effect on their rollover risk, while it may avert runs on the lower-quality banks.

2. REVIEW OF LITERATURES:

The optimal disclosure policy is also related to recent regulatory proposals that call for the need to distinguish risky assets according to their systemic component, e.g., Morris and Shin (2008). In the paper, we extend the basic model to make each bank’s idiosyncratic risk a choice variable and show that the optimal disclosure policy allows achieving some of the benefits of diversification while avoiding some of its costs. Specifically, when the average quality of banks in the financial system is high, the lack of public information about each individual bank insures banks against negative bank specific shocks. Alternatively, when the average quality of banks is low, diversification can be costly since those banks that are liquidated hold, on average, higher-quality assets than in the absence of diversification

(Caballero, 1991). This result highlights the shortcomings of taking each bank's asset volatility as a measure of aggregate risk for the financial system. Intuitively, if banks are connected—in our case through the disclosure policy—an optimal regulation should take into account assets correlations across banks. In most of the paper we take rollover risk as a given. Banks, however, may attempt to address rollover risk by increasing the liquidity of their balance sheet – for instance, by reducing the maturity of their assets or increasing the maturity of their liabilities. In such a case, the optimal disclosure policy depends on the average quality of banks in the financial system as well as on the liquidity of banks' balance sheets. In particular, *ceteris paribus*, an increase in liquidity across the board is associated with less transparency: a liquid balance sheet reduces investors' incentives to run, which, in turn, allows decreasing transparency and prevents runs on lower-quality banks, without compromising the stability of the whole system. Given this interplay between the liquidity of the balance sheet and the optimal disclosure policy, we show that regulators can fall into policy traps, and that banks may end up with a balance sheet that is either more or less liquid than is socially desirable. This is due to the fact that the optimal disclosure policy depends on the average liquidity of banks in the financial system, and that each individual bank takes this average liquidity as given when choosing its own liquidity. For instance, consider the case in which a bank expects other banks to have a liquid balance sheet and hence the optimal disclosure policy by the regulator to be one of low transparency. Then this bank has incentives to also have a liquid balance sheet as it may otherwise suffer a run if the average quality turns out to be low and no disclosure takes place.

3. TRANSPARENCY AND TRUST

Trust in the financial reporting system is the fundamental requirement for the proper functioning of the system and can be considered a public good, from which all participants in the system benefit, but which is being eroded by those who deceive. Trust is based on the truthfulness or transparency of financial reporting. This means that the numbers must be honest. They should reflect real processes and states of affairs of the company under consideration in an adequate manner, that is, according to appropriate rules of reporting. Moreover, they should be generated by trustworthy people who are competent and motivated by the knowledge that they are being trusted and by a moral commitment to honor this trust (see Hausman, 2002). In short, transparency and trust are the outcome of a combination of factors at the macro, meso, and micro level.

If financial reporting is inadequate and deceiving, trust will shrink or may even collapse. As a result, investment activities will drop and possibly come to a halt, with far-reaching consequences for the economy and for individual businesses as well. It is noteworthy that the vital importance of transparency and trust can

be argued for from both the perspective of consequences (that without transparency and trust, the system would break down) and the perspective of principles (that honesty should be lived up to for its own sake).

Generally, "transparency" implies openness, communication and accountability. It is a metaphorical extension of the meaning a "transparent" object is one that can be seen through. With regard to the public services, it means that holders of public office should be as open as possible about all the decisions and actions they take. They should give reasons for their decisions and restrict information only when the wider public interest demands it (Chapman, 2000). Radical transparency in management demands that all decision making should be carried out publicly. All draft documents, all arguments for and against a proposal, the decision about the decision making process itself, and all final decisions, are made publicly and remain publicly archived.

4. A TRANSPARENT FINANCIAL SYSTEM

If there is any consolation in the latest credit crisis it is the vigorous global debate now unfolding on regulatory reform. Regulators and market participants see an opportunity to reassess, and to get organized around guiding principles that can help financial institutions and financial markets handle the mounting complexities of global trends in business, markets and the economy. In my view, three principles in particular – transparency, a level playing field and systemic oversight – are the essential elements we need to be considered as we look at how best to frame these reform discussions. The goal of the debate should be to advance global coordination among central banks, regulators and financial institutions in ways that increase our understanding and ability to manage systemic risk. Markets cannot clear without transparency. We all know that and yet we're seeing again the consequences of a lack of full transparency. Fixed income and credit markets currently are among the most opaque markets. Transparency concerns can lead to illiquidity. Yet transparency is difficult to achieve. It requires continual vigilance to standardize products when appropriate, introducing them to exchanges, creating counterparty clearinghouses and settlement systems and, finally, amassing accurate data on prices and transaction volumes. Transparency must also include public disclosures to investors about pertinent risk and financial information that give the market a chance to make informed judgments. Moreover, transparency means that systemically significant institutions – essentially any institution whose uncontrolled failure would impact the financial system in a significantly adverse way – should meet robust information requirements set by the overseeing regulatory agency.

The next principle is a level playing field, which includes two distinct issues: standards and capital requirements. Rating agencies, independent monitoring entities and risk bureaus are all important if accredited correctly. Global coherence and consistency on accounting standards can also help, including clear guidelines regarding off-balance-sheet instruments. In recent dysfunctional markets, we have seen different accounting standards applied that were based on an institution's form and regulatory jurisdiction. Accounting based on a mark-to-model has been severely tested by unobservable inputs intended to estimate the market. This has fed into difficult, far-reaching decisions that impacted capital and other factors as one misinformed trade set off a chain of similar trades. This raises an important question: Are there alternative accounting approaches we should apply, particularly in dysfunctional markets?

We also need consistent capital requirements for systemically significant institutions. As we consider how to define a level playing field, we ought to ask what now constitutes a "financial institution." When judging which institutions should be allowed access to the playing field, focusing on function, rather than form, seems a sensible answer. Financial services and parallel banking activities in many ways are becoming ubiquitous, and to some extent interchangeable. The third suggested principle is a need for oversight for systemically significant institutions. We cannot and should not legislate away an institution's ability to lose shareholders' money. But none should have the right to impose externalities on the rest of the financial system. Does an institution warehouse risk? Does it borrow short and lend long? Does it leverage its investments? Once a company gets large enough to impact the financial system, shouldn't it operate under the same systemic risk umbrella in terms of capital, liquidity and transparency?

In the U.S., we recently saw the unprecedented opening of the Federal Reserve discount window to nonbanks. By definition, unprecedented events set a precedent. And regardless of whether that window is officially opened or closed, the market now assumes that it will be open if necessary on an ad hoc basis. Capital and liquidity speak for themselves. Systemically significant institutions need to be as transparent to regulators as regulated institutions are. Without this level playing field, regulators charged with safeguarding the world's financial systems simply won't have enough information to mitigate systemic risk.

An uneven application of regulations and accounting standards in an environment where capital and talent are mobile and where traditional classifications are being redefined has the potential to increase systemic risk. Applying rules partially is not the second best option to applying them consistently.

In order to realize all the possibilities in the global trends reshaping our world and our financial systems, we welcome a more robust regulatory architecture that embraces standards broad and clear enough to apply to all participants, but is flexible enough to be adaptable to unforeseeable changes in a dynamic market.

5. FINANCIAL SYSTEMS AND PROCESSES

The Transparency and Accountability Initiative (T/A Initiative) examines current work and emerging innovations aimed at improving the transparency of markets and other aspects of the financial sector.

Our research examines the reform and regulation of:

- The flaws and abuses of the banking system
- global financial flows, including money laundering, tax havens and payments to governments by extractive industries
- financing of international development, including debt relief, World Bank funds and International Monetary Fund debt conditions

CONCLUSION

One of the reactions to the recent financial crisis has been the demand for an increase in the transparency of financial institutions. In fact, regulation authorities in Europe and the United States have tried to improve the quality of public information on individual banks by performing stress tests, and more importantly, by releasing their results to investors. One stated objective of these tests is to prevent a contagion of investors' distrust to the entire banking system by providing information on the specific risk exposure of each financial institution. This is consistent with the view that, partly, the banking crisis was a run on the liability side of banks' balance sheets. This paper studies the optimal level of transparency in the banking system when banks have short-term liabilities and are exposed to rollover risk. In particular, it shows that increasing transparency during crises increases the stability of the banking system by reducing the number of bank runs. The paper, nonetheless, cautions against a permanent increase in transparency as it may have a destabilizing effect on the financial system during normal economic times. Thus, the optimal disclosure policy is one contingent on the state of the economy in which transparency is increased in times of crises. Implementing this optimal policy, however, can sometimes be difficult. Under such policy, an increase in transparency signals a deterioration of the economy's fundamentals, and hence, the regulator

has ex-post incentives to hide this deterioration from investors by not disclosing.

REFERENCES:

- Acharya, V., and T. Yorulmazer, (2008). "Cash-in-the-Market Pricing and Optimal Resolution of Bank Failures," *Review of Financial Studies*, 21, pp. 2705–2742.
- Acharya, V., D. Gale, and T. Yorulmazer, (2011). "Rollover Risk and Market Freezes," *Journal of Finance*, 66, pp. 1175–1207.
- Barnea, A., R. Haugen, and L. Senbet, (1980). "A Rationale for Debt Maturity Structure and Call Provisions in the Agency Theoretic Framework," *Journal of Finance*, 35, pp. 1223–1234.
- Byrant, J., (1980). "A Model of Reserves, Bank Runs and Deposit Insurance," *Journal of Banking and Finance*, 4, pp. 335–344.
- Caballero, R., (1991). "Crisis and Reform: Managing Systemic Risk," XI Angelo Costa Lecture, 2010. Calomiris, C., and C. Kahn, "The Role of Demandable Debt in Structuring Optimal Banking Arrangements," *The American Economic Review*, 81, pp. 497–513.
- Carlsson, H., and E. van Damme, (1993). "Global Games and Equilibrium Selection," *Econometrica*, 61, pp. 989–1018.
- Chakraborty, A., and R. Harbaugh, (2007). "Comparative Cheap Talk," *Journal of Economic Theory*, 132, 70–94. , "Persuasion by Cheap Talk," *American Economic Review*, 100 (2010), pp. 2361–82.
- Chen, Q., I. Goldstein, and W. Jiang, (2010). "Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows," *Journal of Financial Economics*, 97, 239–262.
- Diamond, D., and P. Dybvig, (1983). "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, 91, pp. 401–19.
- Eisenbach, T., (2010). "Rollover Risk: Optimal but Inefficient," working paper, Princeton University.
- Farhi, E., and J. Tirole, (2010). "Collective Moral Hazard, Maturity Mismatch, and Systemic Bailouts," *American Economic Review*, forthcoming,
- French, K., M. Baily, J. Campbell, J. Cochrane, D. Diamond, D. Duffie, A. Kashyap, F. Mishkin, R. Rajan, D. Scharfstein, et al. (2010). "The Squam Lake Report: Fixing the Financial System," *Journal of Applied Corporate Finance*, 22 , pp. 8–21.
- Goldstein, I., and A. Puzner (2005). "Demand–Deposit Contracts and the Probability of Bank Runs," *Journal of Finance*, 60, pp. 1293–1327.
- Gorton, G., and A. Metrick, (2011). "Securitized Banking and the Run on Repo," *Journal of Financial Economics*, forthcoming,
- He, Z., and A. Manela, (2011). "Information Acquisition in Rumor-Based Bank Runs," working paper, University of Chicago.
- Hertzberg, A., J. Liberti, J., and D. Paravisini, (2011). "Public Information and Coordination: Evidence from a Credit Registry Expansion," *The Journal of Finance*, 66, 379–412.
- Hirshleifer, J., (1971). "The Private and Social Value of Information and the Reward to Inventive Activity," *The American Economic Review*, 61, pp. 561–574.
- Kashyap, A., R. Rajan, and J. Stein, (2008). "Rethinking Capital Regulation," Federal Reserve Bank of Kansas City, 2008 Economic Symposium,
- Landier, A., and D. Thesmar, (2011). "Regulating Systemic Risk Through Transparency: Tradeoffs in Making Data Public," NBER Chapters.
- Morris, S., and H. Shin, (1998). "Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks," *American Economic Review*, 88, pp. 587–97.