Information Age: Transparency Is More Powerful Than Regulation

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In 1933, newly elected president Franklin D. Roosevelt had to make a tough choice in dealing with the aftermath of the stock-market crash that wiped out much of the equity in American companies. Leading members of FDR's brain trust wanted federal regulators to get the power to make key decisions over markets, such as which companies deserved to be publicly traded. Today, many of President Barack Obama's advisers want unprecedented authority to oversee details of the credit markets, and how banks lend.

FDR decided instead to side with advisers who argued for disclosure as the key operating principle of our markets. Helping markets function better, they reasoned, was a sounder safeguard than trusting regulators to decide.

Supreme Court Justice Louis Brandeis had made the point that "sunlight is the best disinfectant," and the Securities Act of 1933 mandated the information that public companies would have to share. One indicator that disclosure was more important than regulatory power is that it wasn't until the following year that the Securities and Exchange Commission (SEC) was created.

What worked to restore confidence in the equity markets then can help to restore confidence in the debt markets now: more disclosure, aimed at making the terms of debt such as mortgages more transparent. Unlike the case of stocks, under current law no one in the chain of making, insuring and rating debt is required to disclose full terms to regulators or to the market. Instead, debt markets function based on best estimates, with mathematical models determining probabilities of cash flows and defaults.

Ever since the models failed due to an unpredicted bubble, the market has been paralyzed with uncertainty. There is still a wide gap between what banks think their bad debt might be worth and what the Treasury or private investors are willing to pay.

It didn't get much attention, but earlier this month Congress got a lesson on the potential of better disclosure. "Today's financial crisis was driven in part by a lack of accurate, easily usable information to give investors what they need to make informed, responsible decisions," testified Mark Bolgiano, chief executive of a non-profit technology and accounting consortium called XBRL US. "The value of toxic asset-backed securities remains a mystery because information on the underlying loans and ongoing viability of those loans and the securities themselves was not collected consistently and even if it had been, it would not have been in a usable, portable form."

XBRL sounds complicated, but eXtensible Business Reporting Language is simply a new technology language that allows data to be easily extracted, searched and analyzed. XBRL is already being used for some equity disclosures, tagging financial information into a globally consistent, computer-readable format.

Philip Moyer, who runs the Edgar Online service that distributes SEC data, studied more than 500 mortgage-backed securities priced between 2006 and mid-2008. He found there were only 600 relevant data points needed to assess the risk of a mortgage, which is many fewer than the tens of thousands of factors used to report on stocks. "This crisis has proven that lack of transparency ultimately destroys a market," Mr. Moyers said.

The good news is that with the innovation of XBRL, tracking debt instruments is no longer a technological challenge. Instead, it's a political challenge.

Regulators would need to define new disclosures robust enough that data can be collected and compared, even as credit instruments continue to be rolled into complex securities and their derivatives. Other factors would include tracking the institutions holding various positions and how much leverage is involved. Put another way: If bar codes can track down bad peanuts on store shelves, shouldn't we be able to use technology to track details of mortgages and other debt instruments?

Paul Wilkinson, a lawyer who worked with former SEC Chairman Chris Cox to support the development of XBRL, has set the goal of making debt markets as regularized as titling property or registering shares. "Thanks to XBRL, there is a means to achieve the goal of moving from pseudocapitalism based on speculation to real capitalism based on facts, and a world where willing buyers and sellers can make markets based on those facts," he said.

This is an encouraging vision during these anxious times. But even with the country's long tradition of relying on disclosure, the discussion in Washington has focused almost exclusively on new powers for regulatory agencies.

FDR was no Milton Friedman, and neither was Brandeis, but they grasped what we seem to be forgetting, which is that markets are too complex for even the most powerful regulators to dictate. Better transparency is the surest way to make markets more efficient and less volatile. Market wisdom results when more people access better information.

The global credit crisis was made possible by real-time markets powered by new technologies that enabled massive global trading and the creation of opaque securities. It would be fitting now to use another new technology, in the form of XBRL, to make the credit markets simpler, more transparent and better insulated against bubbles.