

**Transparency in Financial Markets and Institutions:
A Catholic Social Thought Perspective**

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Abstract:

We argue that transparency, or information disclosure by public and private sector institutions should be viewed as an important component of the Catholic Social Thought process. A higher degree of transparency by a single institution denotes revealing a greater magnitude of truthful information that leads to optimization of actions by other individuals and institutions, thus ultimately, to maximization of social welfare. Based on the precepts of Catholic Social Thought, more detailed and unbiased information allows individuals to make more truthful observations of reality that subsequently rationalize their judgment and actions. This is particularly relevant for financial markets and institutions that are inherently forward-looking in their reasoning and actions, thus highly sensitive to information disclosure. We analyze this causal dependence with respect to transparency of selected central banks and financial reporting requirements.

Keywords:

Catholic Social Thought, transparency, financial markets, financial institutions

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I. Introduction

Transparency of public and private sector institutions can be defined as a full disclosure to the public at large of detailed information about the institution's economic strategies, policies, tactics and operations. Such information disclosure improves effectiveness and credibility of institutions and rationality of actions of individuals that ultimately enhance social welfare. The link between institutional transparency and welfare-enhancing economic optimization has recently received extensive coverage in the literature, particularly among the studies pertaining to information disclosure by central banks and other financial institutions¹. We argue that transparency is remarkably consistent with the basic precepts of Catholic Social Thought (CST).

A full, unbiased and truthful information disclosure allows individuals and institutions to improve the quality and depth of their observations, which comprises the first step in the CST process. Subsequently, a wider scope of ingenuous observations improves their ability to make rational judgements and to undertake social welfare-enhancing actions, which respectively signify CST second and third steps. Following on this premise, our paper is aimed at identifying specific areas of association between transparency and CST, as well as demonstrating prevalence of such a nexus in business practice on the basis of carefully selected case studies.

The paper is organized as follows. In Section II, we elaborate on the role of institutional transparency within the CST process. Section III addresses the importance of transparency for financial markets and in central banking. Recent developments of transparency in the corporate and investment sectors are presented in Section IV. Section V summarizes our findings and conclusions.

II. Transparency of Institutions in a Catholic Social Thought Framework

Institutional transparency as defined in the introductory section of our study is particularly important and indispensable for the first step of the CST process, that is, for the ability of individuals and institutions to *observe* as a basis for their ability to judge and to act. In quintessence, the CST methodology is composed of three steps: a situation analysis, discerning the principles and values of the faith tradition, and the appropriate action. This methodology is commonly known as 'the Cardijn Method' after its original founder Joseph Cardinal Cardijn². The approach was described in the 1961 papal encyclical. Pope John XXIII, noted "There are three stages which should normally be followed in the reduction of social principles into practice. First, one reviews the concrete situation; secondly, one forms a judgment on it in the light of these same principles; thirdly, one decides what in the circumstances can and should be done to implement these principles. These three stages are usually expressed in the three terms: observe, judge, act."³ Full, unbiased and truthful information is an economic and social right of every person that contributes to an improvement of human life and fosters engagement of individuals

¹ Noteworthy survey studies addressing problems of transparency in the global financial sector include Amato, et al., (2003), Ejjfinger and Geraats (2006), Hahn (2002), and Thornton (2002). The pivotal role of transparency for corporate governance has been addressed in Monks and Minow (2001).

² For an exhaustive overview of the 'Cardijn Method' of CST see, for instance, Mich (2005).

³ *Mater et Magistra (Mother & Teacher)*, Pope John XXIII, 1961

in the economic development of the human community. Well-informed people are more likely to actively participate in the economic, political and cultural life of a society. In other words, transparency and information are vital for ensuring integration of individuals into a human society and for overcoming the sense of isolation or recalcitrant attitudes.

To reiterate, transparent and truthful information enables individuals and institutions to formulate a set of appropriate observations. In combination with the normative process of value judgement that is, in principle, guided by the common system of ethical foundations of CST, the full information analysis leads to appropriate actions (US Bishops, 2003). It is imperative to understand that from the CST perspective, these actions ought to be aimed at fulfilling the objectives that are consistent with the major CST themes⁴.

Within the context of the major CST themes, it can be generally concluded that full, unbiased and truthful information is an economic and social right of every person that contributes to an improvement of human life and fosters engagement of individuals in the economic development of the human community. Well-informed people are more likely to actively participate in the economic, political and cultural life of a society. Thus in hindsight, transparency and the overall extent and quality of information are vital for ensuring integration of individuals into a human society and for overcoming the sense of alienation and recalcitrant attitudes.

A synergy between information sharing and a social engagement of individuals results in active participation and contribution of people to institutional development. It further promotes mutual understanding and social functioning on the basis of truth, not deception (U.S. Bishops, 1998b).

It can be further noted that transparency of public and private sector institutions is pivotal for promulgating participation and active engagement of all members of a society. Imperfect, partial or, in the most undesirable case, distorted information brings about doubts and suspicion, which in turn lead to social disengagement. Under such circumstances, recipients of imperfect information face considerable risk associated with their possible future actions. This phenomenon translated into economic and financial conditions implies that imperfect information is always associated with higher required returns, exemplified for instance by higher yields demanded by bond investors.

III. Information Disclosure in Central Banking and Financial Markets

The problem of truthful and comprehensive information disclosure is particularly relevant for financial markets and institutions since pricing of financial assets is predominantly influenced by expected economic conditions ascertained on the basis of all available information. Financial markets are particularly susceptible to transparent and symmetric information because such news and scenarios pertaining to future conditions drive investment decisions. In essence, financial markets are inherently forward-looking.

⁴ Major CST themes include: dignity of human person, common good and community, option for the poor, human rights and responsibilities, moral function of the State, economic justice, stewardship of God's creation, peace and disarmament, participation, and global solidarity and development. Their substance and relative significance within the CST process is discussed by the U.S. Bishops (1998a).

A key provider of information affecting financial markets is a monetary authority (a central bank). Any indication about future changes in the interest rate target will change the expected return on bond investments and, indirectly, on stock returns. Therefore, a higher degree of central bank transparency will set the course of actions of investors and will likely reduce market shocks attributable to investment (interest rate or exchange rate) risk. Moreover, transparency is particularly important for smoothing out market fluctuations in an autonomous monetary policy environment in which a central bank has a decision-making power over the directional changes in domestic financial variables (Amato, et al., 2003). In contrast, under the conditions of non-autonomous policy exemplified mainly by fixed exchange rate regimes, investors become more sensitive to decisions of a foreign central bank, thus transparency of a domestic monetary authority becomes less relevant. In a special case, transparency is crucial for a central bank for which targeting low inflation rather than output growth or stable exchange rate is the main policy objective (Bernanke, et al., 1999; Fink, et al, 1998; Jarmuzek, Orlowski and Radziwill, 2004).

In central banking and financial markets, greater transparency of policy-makers decreases the potential for volatility of financial variables and thus helps mitigate financial risk. Investors are then prone to expand the time horizon of their investment decisions and banks assume more long-term lending positions that ultimately foster tangible capital investment as well as job creation. In other words, institutional transparency is pivotal for diminishing market vicissitudes and contributes to a sustained long-term growth of real output and overall social welfare. However there are possible limits to full information sharing. For instance, a premature disclosure of untested optimistic news poses a risk of undermining credibility of an institution. In particular, institutions should not make promises about results that they cannot plausibly achieve. Also, disclosure of proprietary information on product development and strategic policies of individual firms, particularly those operating in a competitive oligopoly environment, may compromise the competitive market advantage that is commensurate with the firm's developmental efforts.

In summary, higher degree of transparency, or a more detailed and honest information disclosure to the public at large helps reduce financial (credit, interest rate, exchange rate, etc.) risk. From a CST perspective, it is important that the released information is truthful and politically unbiased. In such a case, financial and tangible investment decisions will be aimed at creating jobs and maximizing social welfare in accordance with the main CST precepts, rather than at bolstering speculative profits.

IV. Transparency in Financial Reporting

Transparency in financial reporting refers to the widespread public dissemination of accurate financial information by corporations and other entities. As increasing numbers of individuals in the United States and elsewhere must take responsibility to invest for their retirements in 401K and similar plans, transparency in financial reporting has become increasingly important. While the importance of accurate financial information is widely heralded, the Enron collapse, numerous reports of options backdating, and other accounting scandals point toward the need for improvement. During the past decade significant strides have included new requirements in the

United States for disclosure of material risks, new treatment of expenses related to stock options, and most importantly, the Sarbanes-Oxley Act. Still, transparency is neither uniform nor complete.

In this section we examine six recent changes in U.S. financial reporting requirements that we believe will lead to significant improvements in the transparency of financial reporting:

1. Expanded requirements for the disclosure of material risks
2. Additional disclosure requirements of the Sarbanes-Oxley Act of 2002
3. Enhanced requirements for reporting of “insider” transactions
4. Accounting for expenses related to stock based employee compensation
5. The FASB statement 158 on defined benefit postretirement plans
6. The convergence of GAAP and IFRS accounting standards

1. Expanded requirements for the disclosure of material risks

In January of 1997, the U.S. Securities and Exchange Commission adopted rules related to disclosure of policies used to account for derivatives and quantitative and qualitative information about market risk exposures. Items 303 and 305 require discussion in the Management Discussion and Analysis (MD&A) of known events, trends or uncertainties that are reasonably likely to impact the firm materially. The aim is to provide information about the quality, and potential variability, of a company’s earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. These rules provide increased transparency of potential risks faced by a firm or bank. Prior to enactment, this information was difficult to obtain, particularly for smaller investors.

Section 409 of the Sarbanes-Oxley Act of 2002 (SOx) requires public disclosure on a “rapid and current basis” of material changes in the financial condition of any public firm. Prior to SOx firms could wait to disclose such information until the next quarterly or annual report.

2. Additional disclosure requirements of the Sarbanes-Oxley Act of 2002

On June 17, 2002 the SEC issued “Additional Form 8-K Disclosure Requirements and Acceleration of Filing Dates”. Three key requirements resulted. First, information required to be reported was expanded to include: termination of business relationships with key customer, creation of contingent liability, material impairment or restructuring charges, changes in credit ratings, and delisting of securities. Second, the rule requires that when companies disclose material non-public information to certain specified persons, the information must be simultaneously disclosed publicly. In the past, analysts at large investment banking firms, for example, were provided with information prior to truly public disclosure, allowing them to trade with an informational advantage. Third, financial restatements must be formally disclosed and labelled. In the past, firm restatements of prior earnings reports could simply be included in more recent filings. The SEC now mandates that so called “stealth restatements” are not

permitted. As part of SOx, the SEC developed a form to accompany any restatement. Firms restating past reports during a current filing must file the form and clearly and publicly describe the restatement.

3. Enhanced requirements for reporting of “insider” transactions

The section 16 reporting rules of the SOx act require executive officers, directors and stockholders with ownership exceeding ten percent to report changes in ownership or purchase or sale of a security-based swap agreement before the end of the second business day following the transaction date.⁵ The significance of this act is that it requires that “insider” trading information is reported publicly on a timely basis. Prior to the act, such trades could be reported up to the tenth day of the subsequent month (a lag of up to 40 days). The act also requires electronic reporting of these trades and mandates that the information is posted to the investor relations section of the corporate web site.

4. Accounting for expenses related to stock based employee compensation

Evaluation of a firm’s performance and operating costs has been difficult if the firm uses employee stock options as a form of compensation because historically these expenses were not reported and therefore did not impact net income. While many firms do not use stock options as a form of compensation other firms, especially firms involved in technology, offer a significant portion of compensation in this form. This meant that comparison of performance between firms using different compensation techniques was difficult.

In December 2004, the Financial Accounting Standards Board issued SFAS 123 requiring that stock based employee compensation plans be recorded as expenses. These plans include stock purchase plans, stock options, restricted stock and stock appreciation rights. The statement requires that a fair value method of accounting for the plan be used and that the financial statements include disclosure regarding the arrangements.

5. The FASB statement 158 on defined benefit postretirement plans

For over twenty years US accounting standards for pensions and other post employment benefits (OPEBs) permitted a “smoothing” process that while reducing the volatility of reported income, inhibits the transparency or related expenses and fund surpluses or deficits. Funded status is important since it measures the adequacy of pension and OPEB assets available to fund future pension and OPEB obligations. The shortcomings of current reporting standards became very apparent last year when the federal agency that insures traditional pensions noted that some plans were significantly under-funded. About one year ago, General Motors announced the SEC was investigating how it accounted for pensions and other post retirement benefits. In October, 2005, the Economist reported that at General Motors the “unfunded liability for what are known as “other post-employment benefits” (OPEBs), which consist mostly of retiree health care, are

⁵ Securities Exchange Commission 17 CFR Parts 240, 249 and 274. Available at www.sec.gov/rules/final/34-46421.htm.

estimated by industry analysts at almost \$70 billion. That compares with GM's current stock market capitalization of \$15 billion.”⁶

The pension and post retirement funding and reporting issue concerns employees, unions, investors and policy makers. In the fall of 2006, the Financial Accounting Standards Board released a new statement – FAS 158- aimed at addressing these issues. The standard will be implemented in two phases. Phase 1 requires firms to report on the balance sheet (for the first time) the funded status of both pension and OPEB plans. The second phase of the standard will review accounting for pension and OPEB expenses. This measure will greatly enhance the transparency of the financial status of post retirement plans. The significance of this issue becomes apparent if you consider that Standard & Poor’s press release on “2005 Pensions & Other Post Employment Benefits Report” concludes that the S&P 500 defined benefit plans as a group were under-funded by \$140.5 billion in 2005 while OPEBs were under-funded by \$320.9 billion.

6. The convergence of GAAP and IFRS accounting standards

Historically, the United States has had among the world’s most rigorous accounting standards, referred to as generally accepted accounting standards (GAAP). Other nations set their own accounting standards and since standards differed – often dramatically - interpretation and comparison of financial statements from firms located in different countries was often quite difficult. About five years ago the International Accounting Standards Board (IASB) was formed to revamp accounting standards for the countries in the European Union. All EU countries were required to adopt IFRS by 2006 and it is expected that about 100 countries will use the standards by 2007. As more nations adopt IFRS and as the GAAP and IFRS standards converge, transparency will be enhanced. Progress is expected to continue since in April 2006 the FASB and the IASB agreed to work jointly on all major projects.

Despite the improvements in financial reporting described above, challenges remain. Robert Herz, Chairman of the FASB, remarked that “Perhaps most significant and pressing of these (challenges) is the need to reduce complexity and improve the transparency and overall usefulness of reported financial information to investors and capital markets.”⁷ Recent cases of “late trading”, market timing and insider trading abuses at mutual funds and broker dealers suggest that the public could benefit from improved transparency and enhanced enforcement of existing regulations.

⁶ From *The Economist* print edition October 13, 2005. “Corporate America’s Legacy Costs. Now for the Reckoning”.

⁷ Remarks from December 5, 2005 statement to the 2005 AICPA National Conference in Current SEC and PCAOB reporting developments.

V. Conclusion

Recent research in economics has demonstrated the link between information disclosure and social welfare. We have argued that transparency is also an important part of the Catholic Social Thought process referred to as “the Cardijn Method.” Only through a full unbiased disclosure can individuals and institutions accurately observe and use these observations to judge and act. Transparency is especially critical to smooth functioning of financial markets since the valuation of financial assets depends on expectations of future economic conditions. Higher levels of transparency of information lead to lower levels of volatility and reduced financial risk. In this sense transparency by central banks can enhance social welfare. As well, transparency in financial reporting is essential for individuals in their roles as employees, investors and policy makers.

- . Full disclosure by central bankers mitigates volatility and therefore risk.

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