Getting Closure on Disclosure

A Boalt researcher rethinks the power of financial transparency

Assistant Professor of Law Robert Bartlett, who joined Boalt’s faculty in fall of 2009, believes in the power of markets and free-flowing information. So to better understand the financial crisis, he decided to explore how disclosure and transparency in the market for collateralized debt obligations (CDOs)—mortgages, often subprime, bundled as securities—might have affected the way the financial system behaved. He says he was “puzzled” to find that some information that investors needed to make better decisions was readily available, but they didn’t appear to use it. “The epicenter of the financial crisis was these CDOs—in particular, financial institutions’ exposure to CDOs, for which there was really no disclosure,” Bartlett says, explaining his research. Calling failed insurance giant AIG the “poster child” for companies with undisclosed CDO exposure, he says, “It’s pretty amazing that
publicly-traded companies with significant reporting obligations could build up huge positions with virtually no disclosure."

**Monoline thinking**

Bartlett was looking for empirical evidence of how disclosure might have affected CDO markets. He found that evidence in the financial guarantee industry—sometimes called the monoline insurance industry because the insurers originally provided insurance only on municipal bonds but have since expanded to insure bonds issued by structured finance vehicles.

Like AIG, the monoline insurers—the largest are Ambac Financial Group and MBIA—had derivative exposure to CDOs by insuring them. But there was one big difference: "They did exactly what AIG did, but as financial guarantee companies they were subject to statutory accounting," Bartlett explains. "This means they had to disclose all of their largest structured finance positions. So in 2007 and 2008, you had some of the biggest insurers in the CDO market doing what AIG was doing, but disclosing their individual positions." One position Ambac held was a $2.4 billion insurance contract on a CDO called Kleros Preferred Funding VI, or Kleros VI.

In the heat of the subprime mortgage collapse, on March 14, 2008, Kleros VI was downgraded 16 notches, from AAA to CCC+. "If you were an investor in Ambac, you should have thought, ' Geez, this company is toast,'" Bartlett says. But Ambac investors didn’t react to the news. "If investors were paying attention to these disclosures that are supposed to be so much work, there should have been a decline in the stock price of Ambac," Bartlett says. "I found nothing."

Ambac’s stock price did finally plummet on April 23, 2008, when the company announced a record loss in its quarterly earnings—weeks after the Kleros VI downgrade that contributed to the earnings loss. Bartlett conducted six different event studies on market reactions to large downgrades that should have affected the monolines, and found no abnormal stock-price reactions.

Skeptical of his own findings, Bartlett checked the short sales and credit default swaps markets for Ambac, where people could have profited from the company’s losses. Again, nothing. "Even in the most sophisticated corners of the market, you don’t see people paying attention to these downgrades," he says. For comparison, he also looked at Ambac’s stock price when California utility PG&E declared bankruptcy in 2001; although Ambac’s exposure to PG&E was much smaller than it was to Kleros VI, its stock price hit was actually greater when PG&E’s debt was first downgraded.

"This is cause for less optimism that disclosure by itself is really going to fix anything," Bartlett concludes. "You’ve got all these highly incented investors who are searching for information on which to make a buck, and yet here’s critical information that was seemingly overlooked, but which even a lowly academic was able to discover." He has some ideas why disclosure didn’t work in this case and how it could be improved.

**Technology and psychology**

"We should be attentive to the very real logistical challenges," he says. "That means encouraging or requiring disclosures in a fashion that is more data-driven." Bartlett thinks that Extensible Business Reporting Language (XBRL), an open-standard interactive reporting format, can help by requiring financial disclosures to be presented in a consistent digital format. XBRL can potentially increase the speed and usability of financial disclosures, Bartlett thinks, by minimizing transcription costs (disclosures sometimes have to be re-entered into analysis systems) and making real-time evaluation of periodic filings more feasible.

And investors may occasionally need help focusing on certain types of information. He thinks the market may not have been able to perceive the import of Ambac’s CDO downgrades because of extraneous buzz surrounding the collapse of the subprime market. The low salience of the CDOs—and not their analytic complexity—may have played a role in investors’ failure to respond, Bartlett thinks, and adjusting the way disclosures are presented could help. "This is the intersection between law and psychology," he says. "Understanding the psychological process that occurs with information processing can lead to increased salience."

None of the fixes is simple, Bartlett admits, but he would like to see his ideas reflected in regulatory changes that will emerge from the financial crisis. To that end he will be publishing his paper later this year in the *Journal of Corporation Law* and presented his research at the annual meeting of the American Law and Economics Association in May 2010.

And he’s continuing to work through the problem. "I started this project believing in the power of markets, and thought it was going to be evidence of the power of disclosure," Bartlett says. "But these are the results, and I’m still trying to figure out where to go from here." — Fred Sandmark