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The rise of transparency as regulation

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Summary

Two big new EU legislative decisions this month have aligned the EU with the US in creating a strong new precedent for country by country tax and payments reporting requirements for multinational companies. Both epitomize the growing trend since 2008 of using various forms of transparency and disclosure as a regulatory tool. The co-opting of the market and the media into the business of scrutinising companies means new challenges for both corporates and their regulators.

Last week European Member States and the European Parliament reached a final agreement on the EU Accounting Directive. The anti-graft rules in the Directive make the EU the second major jurisdiction to move to a version of "Publish What You Pay" rules for resources groups in the minerals, energy and primary forestry sectors. This will include taxes on profits, royalties and a range of possible ancillary payments to host governments including bonuses, fees and funding for infrastructure development.

Following the US Securities and Exchange Commission, the European Parliament insisted that companies would have to break down payments to governments for any project more than €100000. The EU has chosen to go further than the US by applying the rules not just to listed companies, but to their private counterparts. The rules will apply even when such disclosures are a potential breach of local law.

The Accounting Directive decision followed two weeks after the European Parliament and inserted a similar country by country reporting provision into the final draft of the Fourth Capital Requirements Directive for European banks. This will require European-headquartered banks to report the profits they make and the taxes they pay in every market in which they operate globally. They will also have to declare any state aid received.

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These two agreements are a significant shift for both banking and the extractive industries and are more than enough to constitute a real trend. The principle that multinationals should routinely disclose both their payments and their profits in every country in which they operate now has a very significant foothold in both major jurisdictions. The UK is championing country by country reporting on the EU lines as part of its G8 Presidency agenda, although currently opposes the idea of extending the model to other industries. Nevertheless, the European Commission has been tasked with assessing the possibility of expanding the rules to other sectors. The UK is championing country-by-country reporting on the EU lines as part of its G8 Presidency agenda, although it has publically dismissed the idea of extending the model to other sectors.

Pressure on resource groups to disclose the tax they pay and the money they spend in developing countries is hardly new. Since the early 2000s development campaigners have argued that it would force a level of probity onto multinationals and states by providing a tool for activists to assess the extent to which monies paid to governments materialised in public spending. The wider political economy has swung behind the idea more forcefully since 2008 as the banking crisis and austerity politics have pushed the question of where multinationals pay tax onto the

political agenda. The G20 at Deauville in 2010 created an explicit international obligation to move the agenda forward.

But the trend is much wider than just operating disclosures such as these. Since 2008, transparency has increasingly been touted as a regulatory tool in its own right by politicians and regulators in the financial services sector. These initiatives tend to fall into three basic categories.

Dodd Frank	Section 1504 of the flagship US financial markets reforms contain disclosure requirements for natural resource groups. It also contains reporting obligations for all swaps derivatives.
EU Accounting Directive	The EU Accounting Directive requires country by country reporting of all payments to governments for companies in the extractive industries and primary forestry.
CRDIV	The EU Fourth Capital Requirements Directive applies country by country reporting to EU-headquartered multinational banks. The CRD legislation also contains provisions requiring the disclosure to regulators of aggregate remuneration by business area for banks.
AIFMD/IMD II	Both the EU Second Insurance Mediation Directive and the Alternative Investment Fund Mangement Directive require wider disclosure of fees, commissions and remuneration to customers and investors. The AIFMD also requires disclosure the size of stakes in companies and the level of leverage taken by funds.
MIFID II	Like Dodd Frank, the Second EU Markets in Financial Instruments Directive moves most OTC derivative trading onto exchanges and requires the reporting to trade repositories of all OTC derivative positions.

Now you see it: Major recent examples of transparency as regulation

The first is prudential. The assumption among regulators is that greater access to information about market flows and positions will improve the ability of regulators and market participants to police counterparty risk and elevated exposure. Moving certain forms of derivatives onto exchanges, pre and post trading clearing of derivatives are all based on this logic and are central to both Dodd Frank and EU market reform. The UK Prudential Regulation Authority, created to supervise the prudential safety of UK banks after the 2008 crisis, has developed a set of principles for disclosing its judgments about a bank's capital strength or exposure to the market as an additional spur to sound risk management.

The second is the field of consumer protection, where the perceived information asymmetry between customers and banks is routinely diagnosed as an underlying cause of mis-selling problems and key to improving the way customers invest. Both the European Key Information Document for Investment Products Regulation and the Second Insurance Mediation Directives introduce new expanded customer information rules for all products. The new British Financial Conduct Authority intend to disclose more openly to the market and the media the fact that it has issued warning notices against firms or products.

The third is closer to the instinct that drives "Publish What You Pay" initiatives in the extractive industries. This treats transparency as a check on corporate conduct. The primary focus here, especially in the EU, has been on pay. The CRDIII disclosure rules required the public disclosure of aggregate remuneration for staff in positions of material risk-taking. The Investment Mediation and Alternative Investment Fund Manager Directives both contain obligations on fund managers to disclose their fees and remuneration packages. This is in part a genuine attempt to manage the risk of skewed incentives or conflicts of interest. But there is a strong political thread of naming - and potentially shaming – those involved.

A little bit of knowledge…

The instinct of industries confronted with rising transparency requirements has often been to complain about the burden or sensitivity of producing and publishing information. Critics of country-by-country reporting, including the British government, argue that it will have to be so carefully contextualised to be properly understood as to be worthless. There is a germ of truth in this. But the

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much bigger issue is the simple fact that, generally, transparency in itself guarantees little in terms of risk or oversight.

Transparency as regulation obviously depends on the market's ability to interpret disclosures accurately. What this often means in practice is the ability of the media to do this. However, this cuts both ways. The media can also be a multiplier of effective forms of transparency. If Barclays had been able to explain to the UK Treasury Select Committee in 2011, in simple terms, the way it paid corporation tax in the fifty jurisdictions in which it operated globally, it might have avoided a wave of criticism for the apparently diminutive size of its corporate tax bill as a share of its global profits in the UK.

The same question of interpretive competence applies to regulators. The sheer volume of information implied by derivatives reporting obligations raises the prospect of trade repositories bulging with data that will either transform regulators' understanding of derivatives exposures or overwhelm them. The flood of new disclosure requirements created by three years of financial regulation on both sides of the Atlantic is going to put intense pressure on regulators to have the technical skills to analyse and understand data. Regulators will also have to develop the accountability structures for their own disclosures to the market, which can have far reaching consequences.

This raises an important point. The effectiveness of transparency also depends on the market's ability to know when it is being misinformed. The risk in the current push for transparency as regulation is the tension between a characteristically internet-age assumption that given enough information the market will identify risks and weaknesses, and the historic experience that in practice the market will treat certain forms of transparency – credit ratings, bank stress tests, regulator disclosures – as authoritative in a way that they do not necessarily merit. Laiki Bank and Bank of Cyprus both passed last year's European Bank Stress Tests.

But the pressure for greater disclosure of corporate tax structures is unlikely to weaken. The EU will almost inevitably return to the question of country-by-country reporting for all corporates, and there is little guarantee that the UK will ultimately have the instinct or the capacity to resist it. The instinct of regulators to see correcting information asymmetries between businesses and customers or shareholders as a basic tool in enforcing market discipline is here to stay.

There are good reasons to be concerned about a simplistic approach to transparency. Technology has made access to data unprecedentedly easy and its dissemination unprecedentedly quick and comprehensive. Anti-illegal logging campaigners can now use Google Earth or even satellite photography to track forest clearance. A vast amount of superficial balance sheet information is available on public listed companies. Regulators and markets have – or will have – more data than ever before on banks and financial markets. None of this necessarily makes them better at understanding or interpreting it, and therefore at acting on it.

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