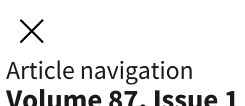
A convenient scapegoat: Fair value accounting by commercial banks during the financial crisis



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A Convenient Scapegoat: Fair Value Accounting by Commercial Banks during the Financial Crisis

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ABSTRACT

Critics argue that fair value provisions in U.S. accounting rules exacerbated the recent financial crisis by depleting banks' regulatory capital, which curtailed lending and triggered asset sales, leading to further economic turmoil. Defenders counter-argue that the fair value provisions were insufficient to lead to the pro-cyclical effects alleged by the critics. Our evidence indicates that these provisions did not affect the commercial banking industry in the ways commonly alleged by critics. First, we show that fair value accounting losses had minimal effect on regulatory capital. Then, we examine sales of securities during the crisis, finding mixed evidence that banks sold securities in response to capital-depleting charges. However, the sales that potentially resulted from the charges appear to be economically insignificant, as there was no industry- or firm-level increase in sales of securities during the crisis.

JEL Classifications: *M41; M42; M44*.

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Pozen (2009) show that during the financial crisis many analysts blamed the ‘fair value’ or ‘mark. to market’ accounting rules because it required banks to write down their troubled assets to the. prices they were sold on the open market at the time which was almost zero, and valuing the. troubled assets at the fair value at the time drove financial institutions toward insolvency. Ozili. and Arun (2018) find that systemic banks engage in income smoothing accounting practices. A convenient scapegoat: Fair value. accounting by commercial banks during the financial crisis. The accounting review, 87(1), 59-90. Bezemer, D. J. (2010). The role of fair value accounting in the subprime mortgage crisis of 2008 is controversial. Fair value accounting was issued as US accounting standard SFAS 157 in 2006 by the privately run Financial Accounting Standards Board (FASB)—delegated by the SEC with the task of establishing financial reporting standards. This required that tradable assets such as mortgage securities be valued according to their current market value rather than their historic cost or some future expected value. When the market