

Bank Failure, Mark-to-market and the Financial Crisis

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Abstract

This paper is concerned with the allegation that fair value accounting rules have contributed significantly to the recent financial crisis. It focuses on one particular channel for that contribution: the impact of fair value on the actual or potential failure of banks. The paper compares four criteria for failure: one economic, two legal and one regulatory. It is clear from this comparison that balance sheet valuations of assets are, in two cases, crucial in these definitions, and so the choice between 'fair value' or other valuations can be decisive in whether a bank fails; but in two cases fair value is irrelevant. Bank failures might arise despite capital adequacy and balance sheet solvency due to sudden shocks to liquidity positions. Two of the most prominent bank failures cannot, at first sight, be attributed to fair value accounting: we show that Northern Rock was balance sheet solvent, even on a fair value basis, as was Lehman Brothers. The case study evidence is augmented by econometric tests that suggest that mark-to-market accounting has had only a very limited influence on the perceived failure risk of banks.

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