The Economic Consequences of Relaxing Fair Value Accounting and Impairment Rules on Banks During the Financial Crisis of 2008-2009

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Abstract

Fair value accounting (FVA) has been blamed for amplifying the recent financial crisis. We conduct an event study of policymaker deliberations, recommendations and decisions about FVA and impairment rules in the banking industry. If FVA was a key contributor to the financial crisis as some industry pundits and academic research suggest, we first should observe positive stock market reactions to proposals to curtail FVA and negative reactions when policymakers support FVA. Second, we expect especially positive reactions to the curtailment of FVA and impairment rules for banks that are relatively sensitive to pro-cyclical contagion. Third, we investigate cross-sectional reactions to factors that potentially contribute to pro-cyclical contagion, including relatively (i) low regulatory capital, (ii) more assets recorded at fair value, (iii) poor asset liquidity, (iv) larger potential impairments, and (v) more trading assets. Finally, we expect banks that have fewer alternative sources of information about fair values beyond those reported in financial statements to experience relatively negative reactions to potential relaxation of FVA and impairment rules.

We examine ten event windows related to FVA and impairment rules for financial institutions. We find that events that signaled an increased (decreased) probability that existing FVA standards would be relaxed (retained) generally produced positive (negative) abnormal stock price reactions for sample banks. As predicted, the magnitude of the stock price reactions was positively related to our proxy for individual bank's susceptibility to contagion. Further, stock price reactions were associated with specific attributes that could contribute to contagion, including banks' capital levels, holdings of illiquid assets and banks' likelihood of being subject to other-than-temporary-impairments. Finally, stock price reactions were negatively related to the absence of analyst coverage, our proxy for the weakness of banks' information environment. In sum, while stock market participants appeared to welcome relaxation of FVA and impairment rules during the financial crisis of 2008-09, the potential loss of fair value information was perceived to be significant for banks with a thin information environment. We believe our study informs the debate about the role of FVA in the recent financial crisis.

Keywords: Fair value accounting, mark-to-market, financial crisis, credit crunch, contagion, subprime crisis, standard setting

JEL Classification: G21, G33, M41, M44

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