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Mark-to-Market Accounting and Information Asymmetry in Banks

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Abstract

We examine the relation between mark-to-market (MTM) accounting for securities and information asymmetry among bank investors. Relative to historical cost, MTM incorporates more timely information in financial statements. The primary effect of more timely disclosure most likely is to reduce information asymmetry. Nevertheless, models in which public information triggers private information acquisition imply some offsetting increase in asymmetry due to differential information production among investors. Incrementally to disclosure effects, recognition (incorporating MTM gains and losses in earnings) can increase information asymmetry through a variety of channels.

We document an economically and statistically significant relation between banks' use of MTM and their bid-ask spreads, analyst following and management forecasting. Introduction of mandatory MTM by SFAS No. 115 reveals a significant increase in spreads for affected banks, no such increase for banks that previously used MTM voluntarily, but similar increases for banks that previously disclosed but did not MTM their gains and losses in earnings. Thus, information asymmetry appears to arise primarily from recognition effects and not from more timely disclosure. These results should not be interpreted as advocating abandoning MTM, but as highlighting the tradeoffs involved in choosing historical cost versus MTM rules.

Keywords: mark-to-market accounting, fair value, trading securities, banks, information asymmetry

JEL Classification: D82, G18, G21, G38, M41

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