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Fair Value Accounting for Financial Instruments: Some Implications for Bank Regulation

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Abstract

I identify issues that bank regulators need to consider if fair value accounting is used for determining bank regulatory capital and when making regulatory decisions. In financial reporting, US and international accounting standard setters have issued several disclosure and measurement and recognition standards for financial instruments and all indications are that both standard setters will mandate recognition of all financial instruments at fair value. To help identify important issues for bank regulators, I briefly review capital market studies that examine the usefulness of fair value accounting to investors, and discuss marking-to-market implementation issues of determining financial instruments' fair values. In doing so, I identify several key issues. First, regulators need to consider how to let managers reveal private information in their fair value estimates while minimising strategic manipulation of model inputs to manage income and regulatory capital. Second, regulators need to consider how best to minimise measurement error in fair values to maximise their usefulness to investors and creditors when making investment decisions, and to ensure bank managers have incentives to select investments that maximise economic efficiency of the banking system. Third, cross-country institutional differences are likely to play an important role in determining the effectiveness of using mark-to-market accounting for financial reporting and bank regulation.

Keywords: Fair values, financial instruments, information asymmetry**JEL Classification:** E58, G15, G21, G28, M41, M44[Suggested Citation](#) >[Show Contact Information](#) >

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