

Banks' Financial Reporting and Financial Stability

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2008 Financial Crisis: A Ten-Year Review

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Overview

- Bottom line: Bank financial reporting requirements and practices affect financial stability, but these effects often are misunderstood, overstated, or otherwise mischaracterized
- A (fairly painless) matched set of readings
 - Ryan (ARFE 2017): background and influential prior research
 - Three main bank financial reporting areas—loan loss reserving, fair value accounting, and securitizations—and related allegations made during the financial crisis
 - Main channels for bank financial reporting to affect stability
 - Ryan (ARFE 2018): summary of five recent research papers on these areas/allegations and channels
 - Kim, Kim, Ryan (2018): Effect of AOCI filter removal for advanced approaches banks
 - Khan, Ryan, Varma (2018): Effect of fair value versus amortized cost accounting in insurance setting
 - Three papers involving Ertan: Effect of disclosure of individual originated or securitized bank loans under the European Central Bank's ABS Loan-level Initiative and country-level public credit registries

Three Main Bank Financial Reporting Areas and Associated Allegations

1. Loan loss reserving

- Under the incurred loss model (ILM), accrue only for loan losses that are incurred, probable, and reasonably estimable
- Allegations: Too little accrual in good times? Too much in bad times? Procyclical effects on regulatory capital?
- Research suggests true but overstated:
 - Loan loss provision timeliness associated with lending in downturns (Beatty and Liao 2011), consistent with capital crunch theory
 - But numerous other explanations for this result: quality of bank management and credit risk modeling (Bushman and Williams 2012,2015; Bhat et al. 2018), market discipline, regulatory pressure (Gallemore 2016, Wheeler 2018)
 - Reasonable alternative loan loss reserving approaches yield small differences in regulatory capital ratios in absolute terms and relative to the variation in realized credit losses when the cycle turns

Three Main Bank Financial Reporting Areas and Associated Allegations (2)

- Allegations motivated expected credit loss (ECL) models in IFRS 9 effective 2018 and ASU 2016-13 effective 2020
 - Immediate write-down of net loans for all expected credit losses, unmatched by interest revenue
 - Prediction: Compared to the ILM, the ECL approach will exacerbate procyclical lending in bad times owing to larger loan loss accruals at origination

Three Main Bank Financial Reporting Areas and Associated Allegations (3)

2. Fair value accounting

- Allegation: Illiquidity yields unrealized fair value losses that will not be realized by banks able to hold assets to recovery of liquidity or maturity?
- Logic and research suggests hugely overstated:
 - Banks fair value only a few, typically fairly small items (derivatives, trading securities, AFS securities on balance sheet only)
 - Xie (2016) shows unrealized gains and losses on banks' typically low-risk securities are counter-cyclical
- Allegation motivated
 - Significant change in OTT impairment accounting for securities FSP FAS 115-2 (2009) and
 - Mild tinkering with fair value accounting for miscellaneous financial instruments (e.g., equity securities, firm's own debt) to capture only gains and losses expected to be realized

Three Main Bank Financial Reporting Areas and Associated Allegations (4)

3. Securitizations

- Up to 2010, FAS 140 (sale versus secured borrowing) and FIN 46R (securitization entity consolidation) yielded off-balance sheet treatment for almost all securitizations
 - FAS 140 made QSPEs immune to consolidation
 - FIN 46R's majority of expected losses approach to consolidation ignored tail risks
 - Only certain multi-seller ABCP conduits were consolidated, and even they were excluded for regulatory purposes
- Off-balance sheet treatment is not economically descriptive for securitizations with significant tail risk retention by sponsor or issuer
- Allegation: Encouraged excessively risky lending pre-crisis?

Three Main Bank Financial Reporting Areas and Associated Allegations (5)

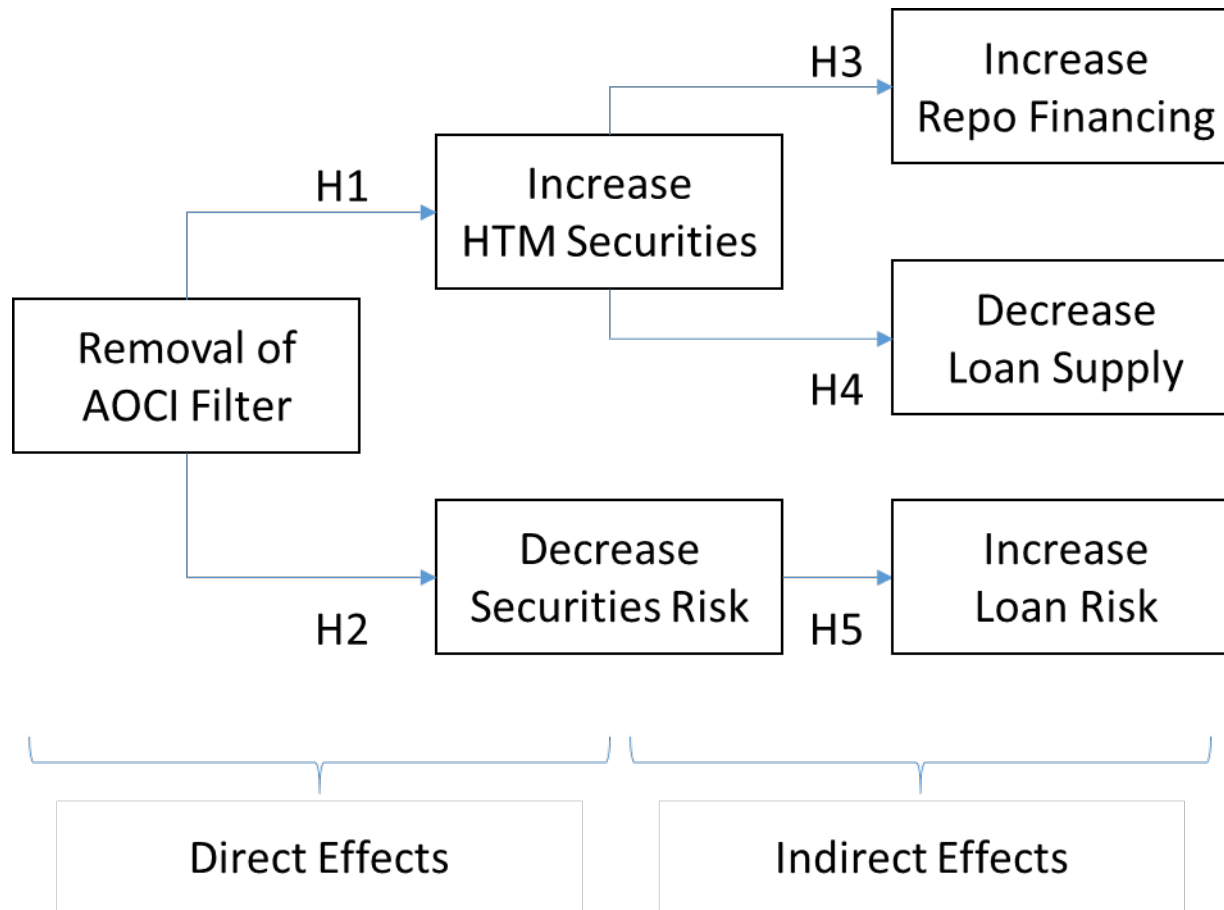
- Research suggests true but overstated:
 - On-balance sheet accounting beginning in 2010 has appreciable effects (~0.5-2%) on regulatory capital ratios and reduces lending for a few large securitizing banks (Dou, Ryan, Xie 2018)
 - However, this treatment did not remotely threaten the well-capitalized status of these banks at the beginning of 2010
- Recent research examining loan-level disclosures required under Reg AB II beginning in 2016 better addresses this allegation (Neilsen, Ryan, Xie, Wang 2018)
- Allegation motivated FAS 166 and FAS 167, effective 2010, which sensibly
 - Eliminate QSPEs
 - Requires securitization sponsor or issuer to consolidate securitization entities if it has control over what matters and bears reasonable possibility of significant loss
 - These standards primarily led banks to consolidate credit card trusts and ABCP conduits

Three Channels for Bank Financial Reporting to Affect Stability

1. Regulatory capital

- While the focus of most prior research and usually an issue, not usually the main one
- Good research setting: AOCI filter removal for advanced approaches banks (Kim, Kim, Ryan 2018)

Kim, Kim, Ryan (2018)



Three Channels for Bank Financial Reporting to Affect Stability (2)

2. Internal discipline

- Some financial reporting approaches (e.g., ECL, fair value) require better modeling, personnel, systems
- Good research setting: Fair value accounting by PC insurers and amortized cost accounting by life insurers for the same non-agency mortgage-backed security (Khan, Ryan, Varma 2018)

Khan, Ryan, Varma (2018)

- **H1 (Direct Effect of Fair Value Measurement of Given Securities):** *PC insurers recorded timelier OTT impairments of given non-agency RMBS with NAIC designations from 3 to 5 during and shortly after the financial crisis than did life insurers.*
- **H2 (Spillover Effect of Fair Value Measurement of Similar Securities):** *PC insurers recorded timelier OTT impairments of given non-agency RMBS with NAIC designations of 1 or 2 during and shortly after the financial crisis than did life insurers. This spillover effect is weaker than the direct effect posited in Hypothesis H1.*

Three Channels for Bank Financial Reporting to Affect Stability (3)

3. External market or regulatory discipline

- Transparency
- Good research settings: Loan-level disclosures under
 - ECB's ABS Loan-level Initiative (Ertan et al. 2017, Balakrishnan and Ertan 2017a)
 - Country-level public credit registries (Balakrishnan and Ertan 2017b)
 - Reg AB II (Nielsen, Ryan, Xie, Wang 2018)

ECB ABS Initiative (Ertan et al. 2017)

- “We expect that the comprehensive information collection and recurring reporting imposed by the ECB under the transparency regime will...”
 - Internal discipline: “Provide banks with a greater amount of loan and borrower information on which they can rely in making lending decisions...allow banks to enhance their screening efforts and underwriting standards...result in banks’ issuing and securitizing better quality loans.”
 - External discipline: “Increase market discipline, with greater investor and regulatory oversight incentivizing banks to issue higher quality securitized loans.”

Summary

- Remember the bottom line