Discussion: Liquidity and Financial Cycles

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Financial System and Macroeconomic Resilience Conference

June 2007

The views expressed in this presentation are those of the speaker. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation

Paper's objectives

1. Document relationship between balance sheet size and pro-cyclical leverage for financial intermediaries using mark-to-market accounting
2. Outline aggregate consequences of pro-cyclical leverage, and document that expansions and contractions of balance sheets have asset pricing implications
3. Shed light on concept of liquidity

Don't blame the accountants

- Paper implies mark-to-market accounting is cause of pro-cyclical leverage effects
- Based on assumed incentive to maintain constant financial reporting leverage
  - Banks likely aim for optimal capital structure, considering solvency and credit ratings
  - But, it seems that economic, not accounting, factors would be first-order effects
- Need to look beyond financial reporting to solve this problem

Questions on some assumptions

- Why would banks target a financial reporting, not economic, leverage ratio?
- Why can't banks manage leverage by issuing or repurchasing equity?
- Why would credit rating agencies not alter their analysis if data changes?
- What about permitting change in asset supply with change in economic cycle?

Questions on empirical analyses

- What about effects of
  - Non comparable accounting amounts?
  - Cross-sectional and inter-temporal correlation on test statistics?
- If concern is accounting, why not compare
  - Investment banks to non mark-to-market entities?
  - Before to after fair value accounting standard?
  - Booms to busts, because accounting differs?

What should regulators do?

- Ensure banks manage economic capital structure?
- Support financial reporting based on mark-to-market?
- Specify different capital requirements differ depending on economic cycle?
- Take other actions to curb undesired pro-cyclical effects?
- …

Concluding remarks

- Interesting paper
- Points out pro-cyclical leverage as a potential concern for bank regulators
- Implies possible remedies
- Financial reporting is not an enemy, it can be an ally!

Thank you