Discussion: Liquidity and Financial Cycles

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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