BANQUE DE FRANCE
EUROSYSTÈME

some economics of mark to market

personal thoughts

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outline

- (very) brief overview of Pr Verrechia's paper

- financial reporting has several – very different - purposes

  - Mark to market is adapted for some
  - But highly inefficient for others, **even with liquid markets**

- Need for a more differentiated approach to financial reporting (in addition to mark to market)

overview and commentary of Pr Verraghia's paper

- "agnostic" about virtues of fair value

- heuristic behavior of managers (not of investors) who are functionnaly fixated on one signal: reported earnings (even if they can see through it)

"Reported earnings follow the rules and principles of accounting.The results do not always create measures consistent with underlying economics. However, corporate management's performance is generally measured by accounting income, not underlying economics. Risk management strategies are therefore directed at accounting rather economic performance"

Enron's internal risk management manual quoted by Borio and Tsatsanoris BIS WP 180

- Two approaches :
  - financial reporting is a description of reality
  - financial reporting shapes reality
- I read the paper (may be wrongly) as coming out in favor of the second approach
- Because financial reporting crystallizes all information in one specific signal : reported earning
- I would go one step further : financial reporting has an impact on incentives and changes behaviours

- managers have an incentive to pile up risky assets in order to generate immediate returns
- outside investors have an incentive to minimize capital in the banking sector (which causes financial fragility and creates moral hazard)
- mark to market may increase (or aggravate) those incentives

mark to market and managers' incentives

- *"There was a breakdown of incentives and risk control systems within banks. A key factor contributing to this breakdown is that, over short periods of time, it is very hard, especially in the case of new products, to tell whether a financial manager is generating true excess returns adjusting for risk, or whether the current returns are simply compensation for* ***a risk that has not yet shown itself*** *but that will eventually materialize*."

(Ashyap, Rajan and Stein)

risk and return are not recognized at the same time

- Consider an increase (decrease) in value in very liquid markets
- No way to know ex ante whether :
  - an increase (decrease) in expected cash flow
  - a decrease (increase) in risk premia
- If change in value totally and instantly recognized as an income (loss) it only reflects part of the underlying economic reality
- Through increase (decrease) in capital base, it can trigger expansion (contraction) of balance sheets and movements in risk premia (Adrian and Shin) : feedback loop

disconnection in time between return and risk reporting changes incentives

- very short run : "delegated" traders have an incentive to manipulate market prices in OTC markets (GORTON)

- long run : managers have an incentive :
  - to choose strategies with "high tail" risks
  - or to engage in excessive maturity transformation

- outside investors (shareholders) have an incentive to take money out of the system before risks materialize

mark to market and investor’s incentives

<u>asymmetry in capital flows</u>

- profits are distributed in good times
- capital is not available in bad times

profits are distributed in good times

- capital is costly relative to debt (RAJAN)
- Expectations of high ROE (better fulfilled by dividends if there is uncertainty about future risks)
- Any profits generated by MtM capital gains is likely to be distributed
- One objective of capital requirements is to constrain that behavior : countercyclical requirements may help. May not suffice, however : act as buffers, not as disincentives to take risk (if return perceived as higher than cost of capital)

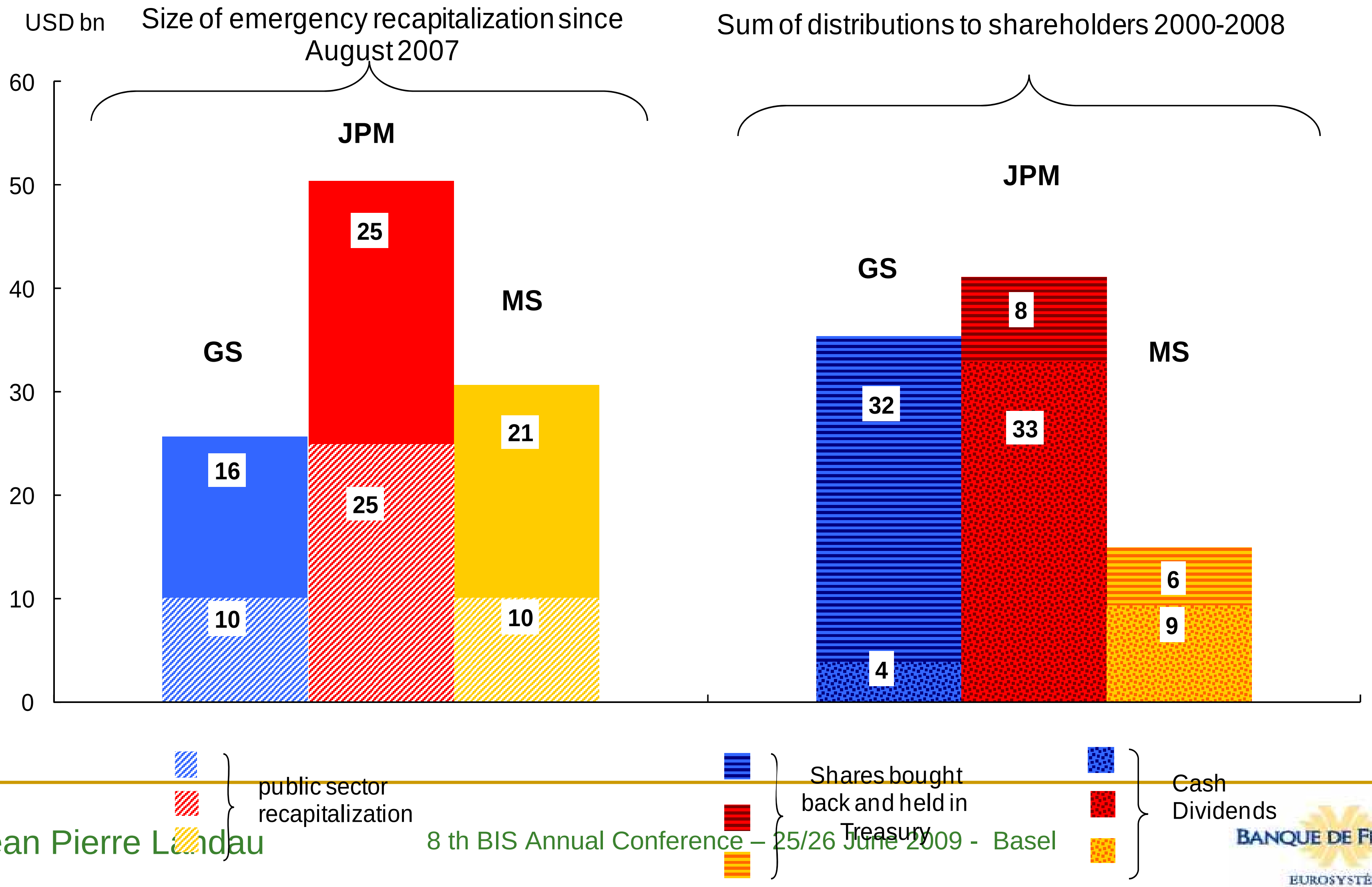
capital not available in bad times

- expectations of MtM losses when value is uncertain
- fire sales externalities create collective action problem
- "slow moving "capital (SHIN) : a trade off between the opportunity cost of "sitting aside" and the risk of illiquidity
- **overall, a very significant moral hazard issue** : managers and investors take the returns and risk is shifted to the future

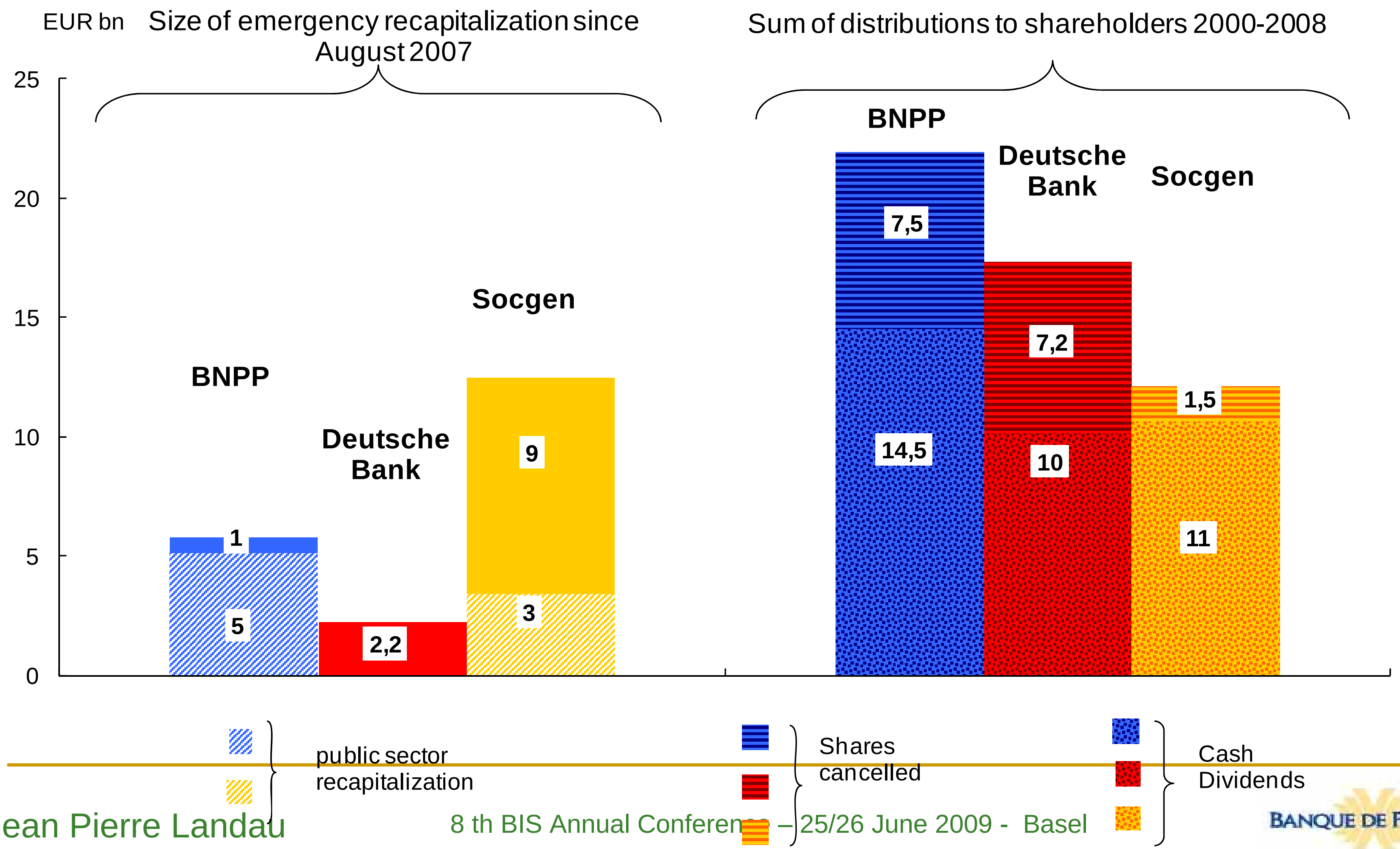
"*I would like to take this opportunity to thank the US taxpayers for their support of our company during the height of uncertainty in the financial markets*"

US Bancorp's Chairman

US Banks


USD bn
Size of emergency recapitalization since August 2007
Sum of distributions to shareholders 2000-2008
60
50
40
30
20
10
0
GS
JPM
MS
16
10
25
25
21
10
GS
JPM
MS
32
4
8
33
6
9
public sector recapitalization
Shares bought back and held in Treasury
Cash Dividends

European Banks



possible policy responses :

- capital insurance
- a differentiated approach to financial reporting

a differenciated approach to financial reporting

- three objectives for financial reporting :

  1. provide information on the value of the firm
  2. measure performance
  3. income recognition and earning distribution

- not the necessarily the same "value" can fulfill the three functions

- keep MtM for (1) and adjust it for risk for (2) and (3)

- keep MtM for valuing traded and liquid assets and portfolios
- ..and "fair value" for less liquid and traded assets
- introduce a "filter" between valuation and income recognition/ distribution
- transparent provisions and / or reserves
- aimed at "internalizing" the risk in the incentive structure

How does it compare with prudential response ?

- more direct impact on incentives
- better quality of information when fundamentals are uncertain

how does accounting framework deal with value uncertainty ?

- current approach : one number and general guiding principles on how to reach it

- better approach : recognize uncertainty through a range ➢ valuation reserves and dynamic provisioning

Thank you