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The Value Relevance and Timeliness of Write-downs During the Financial Crisis of 2007–2009☆

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Abstract

This study examines the value relevance and timeliness of write-downs reported by North American and European banks during the financial crisis of 2007–2009. Our study extends Vyas (2011), considering the association between write-downs and stock returns to evaluate the performance of fair value standards during the crisis. Specifically, we investigate claims that strict enforcements of standards resulted in write-downs that were excessive or unnecessary due to temporary market price distortions, or conversely, that standards were flexible enough to allow managers to engage in earnings or capital management. Our empirical results show that both fair-value and aggregate write-downs are associated dollar-for-dollar with contemporaneous security returns, suggesting that, on average, write-downs were timely throughout the financial crisis.
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1. Introduction

The financial crisis of 2007–2009 led to unprecedented losses throughout the financial industry, particularly for banking institutions with significant exposure to the U.S. real estate

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market. As the number of mortgage delinquencies soared, the crisis produced large write-downs on risky mortgage-related positions, including loans, mortgage- and asset-backed securities, and related derivatives. One particularly noteworthy example was the announcement of write-downs totaling U.S. $19 billion by Citigroup on its mortgage and asset-backed securities portfolio in the final quarter of 2008. This led to the largest ever loss in the bank's 197-year history. During the crisis, U.S. financial shares dropped 78%, their worst performance since the Great Depression.

Between early 2007 and mid-2009, financial institutions worldwide reported many hundreds of economically significant write-downs totaling approximately U.S. $1.3 trillion. This study investigates the timeliness of the write-downs recorded by a broad sample of North American and European banks. Empirical evidence regarding the value relevance and timeliness of fair-value write-downs is fundamentally important in evaluating the various arguments put forward during the recent fair-value debate.

Many of the write-downs reported during the financial crisis applied to financial instruments held at fair value, which are marked-to-market under Statement of Financial Accounting Standards (SFAS) No. 115, SFAS No. 157 in the U.S., and International Accounting Standard (IAS) No. 39 in Europe. The use of fair-value accounting (FVA) in the financial industry is a contentious issue, and the subject of protracted and intense debate among academics, standard setters, and politicians.

The trend toward FVA gained pace during the Savings and Loan (S&L) Crisis in the late 1980s and early 1990s, when regulators presided over numerous bankruptcies involving S&Ls and thrifts that had reported positive net worth under the historical-cost regime (Barth, Landsman, & Wahlen, 1995). Proponents of FVA argue that attempting to align book values more closely with market values leads to improved reporting transparency and more timely identification of solvency issues.[1] Opponents believe that FVA can overstate the true extent of losses, and that "unnecessary" write-downs may force otherwise healthy firms into financial distress.

Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) now mandate the use of FVA for most debt and equity securities. Recently, FVA has come under fire from several financial-industry stakeholders, led by banks and financial-industry groups, who claim that it has led to institutions taking "unnecessary" write-downs based on temporarily depressed market prices for financial assets, particularly those of collateralized debt securities (American Bankers Association [ABA], 2009; Wallison, 2008; Whalen, 2008).

Numerous recent academic studies also echo this view (Bignon, Biondi, & Ragot, 2009; Hellwig, 2009). Some critics have gone so far as to suggest that these write-downs contributed to the severity of the Financial Crisis by forcing firms to needlessly curtail lending and engage in fire sales of their assets to maintain sufficient regulatory capital. The former Chairman of the Federal Deposit Insurance Corporation (FDIC), William Isaac,

[1] Numerous studies have established the incremental value relevance of fair values over historical costs (Ahmed & Takeda, 1995; Barth, 1994). The benefits of FVA in the financial industry are also well documented. These include a more efficient deposit insurance system and reduced bank failure costs (Barth et al., 1995; Bernard, Merton, & Palepu, 1995).

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