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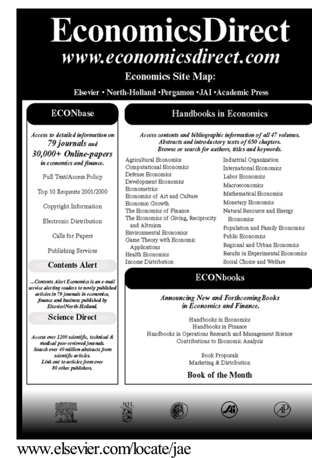

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The economic consequences of extending the use of fair value accounting in regulatory capital calculations: A discussion

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The economic consequences of extending the use of fair value accounting in regulatory capital calculations: A discussion

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Abstract

When the Federal Reserve, following Basel III, proposed removing the accumulated other comprehensive income (AOCI) filter that shields regulatory capital from unrealized gains and losses on available-for-sale (AFS) debt securities, it triggered fierce opposition. The topic is at the heart of the debate about the role of fair value accounting for financial stability. Chircop and Novotny-Farkas (2016) investigate banks' stock price reaction and investment behavior around news events up to the announcement of the final decision. I focus on the question of whether their evidence is sufficiently strong to convince either side in the debate.

Keywords: Banks; fair value accounting; prudential regulation; AOCI filter; regulatory capital

1. Introduction

The debate about the role of fair value accounting for financial stability culminated in the dispute about the role of fair value accounting in the financial crisis of 2007-2009. Several empirical papers conclude that fair value accounting did not magnify the crisis. (See, for example, Ryan (2008), Laux and Leuz (2009, 2010), Barth and Landsman (2010), Bhat et al. (2011), and Badertscher et al. (2012) for the arguments and empirical evidence.) One reason why fair value accounting did not play a large role in the crisis is that there were many filters and circuit breakers. One of these filters is that in many countries, including the U.S., unrealized gains and losses on available-for-sale (AFS) debt securities did not affect regulatory capital.

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