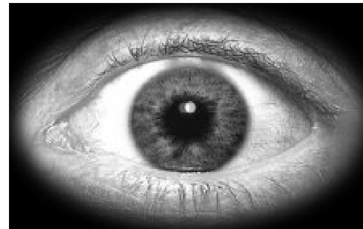
Reported financial statements feed the regulatory process and are the anchor of the publicly available information set

Bank Balance Sheet	
Assets:	Liabilities:
Cash & Due From Banks	Deposits
	-Non-Interest Bearing
Investment Securities	-Interest Bearing
	ST Liabilities
Loans	-Fed Funds
	-Repos
MSRs & Other Assets	-Other Short-term Liabilities
	LT Subordinated Debt
	Equity

Depiction of underlying real bank

How the underlying economic reality is measured matters!

Bank opacity can create uncertainty

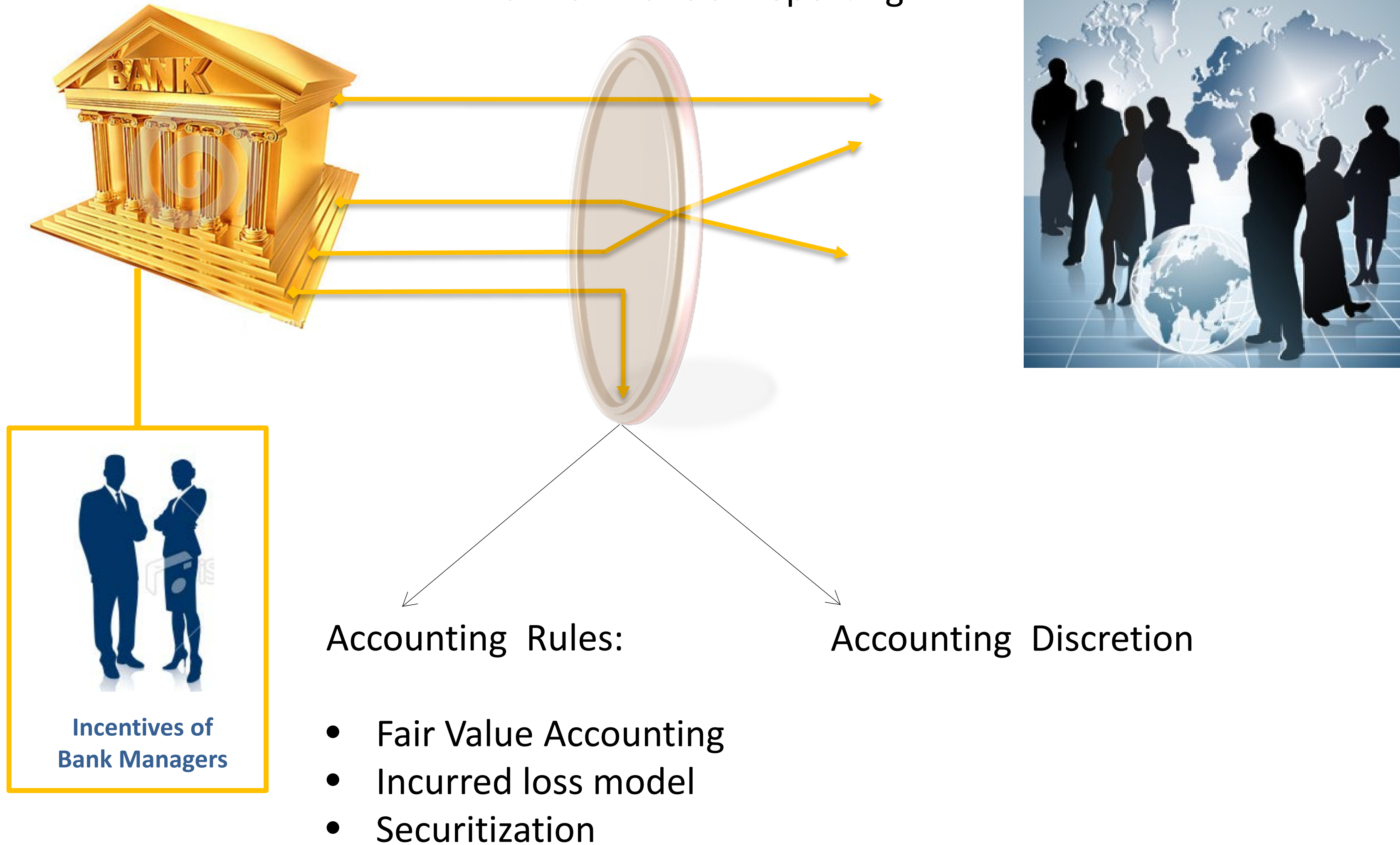


Bank Regulators

Bank Managers

- Creditors
- Equity investors
- Counterparties
- Taxpayers

Drivers of opacity: The accounting depiction of reality



Accounting rule changes post crisis

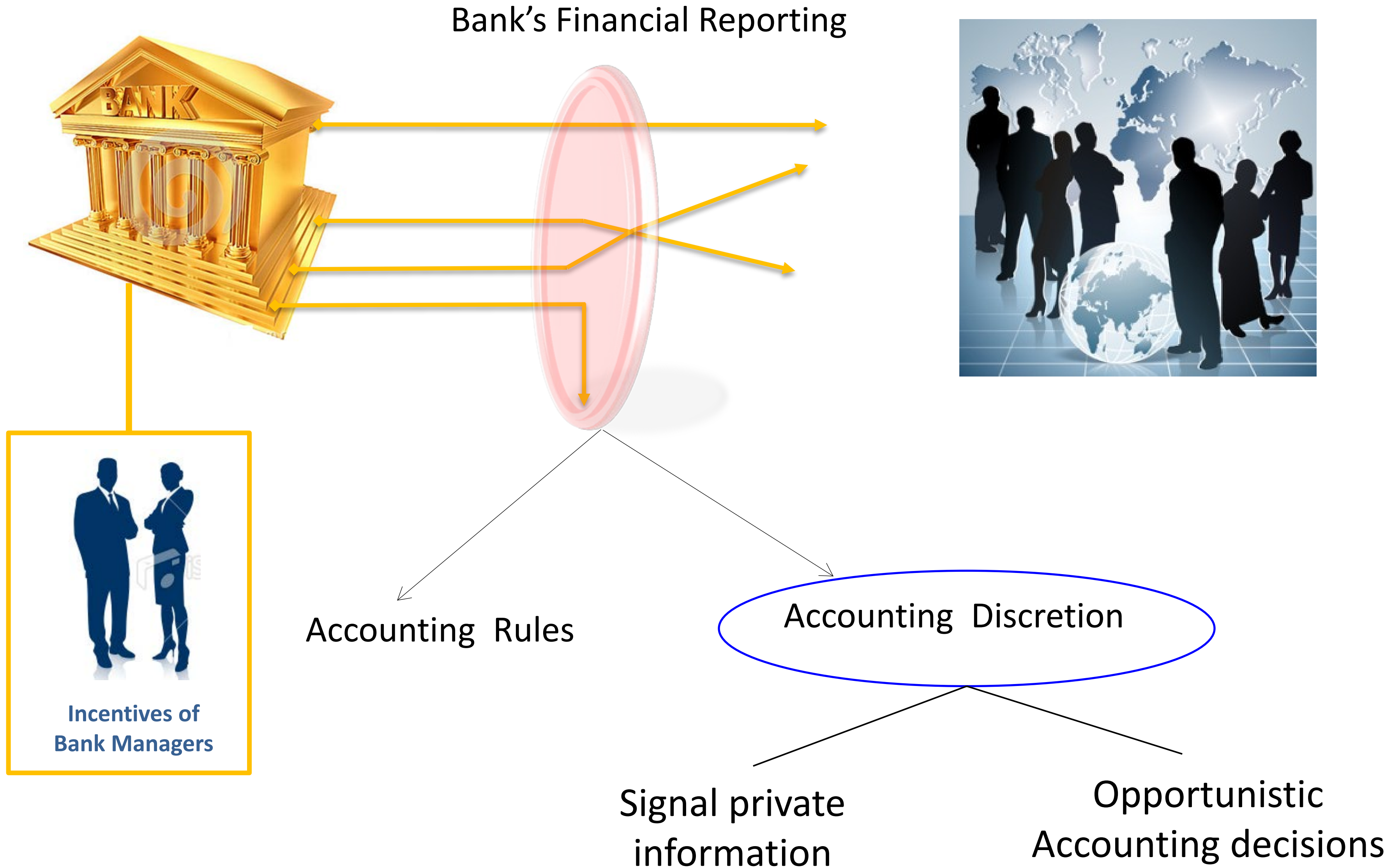
- Accounting for securitizations: QSPE's eliminated

- Proposed news rules for recognition and measurement of financial assets and financial liabilities
  - ♦ The contractual cash flow characteristics of the asset
  - ♦ The entity's business model for managing the asset

- Proposed change to loan loss accounting:
  - ♦ Replace incurred loss model with "current expected credit loss" (CECL) model.
  - ♦ Under this model, allowance for loan losses reflects management's current estimate of the contractual cash flows that the company does not expect to collect over the *entire life* of the loan.

Accounting discretion is likely higher under this new regime!

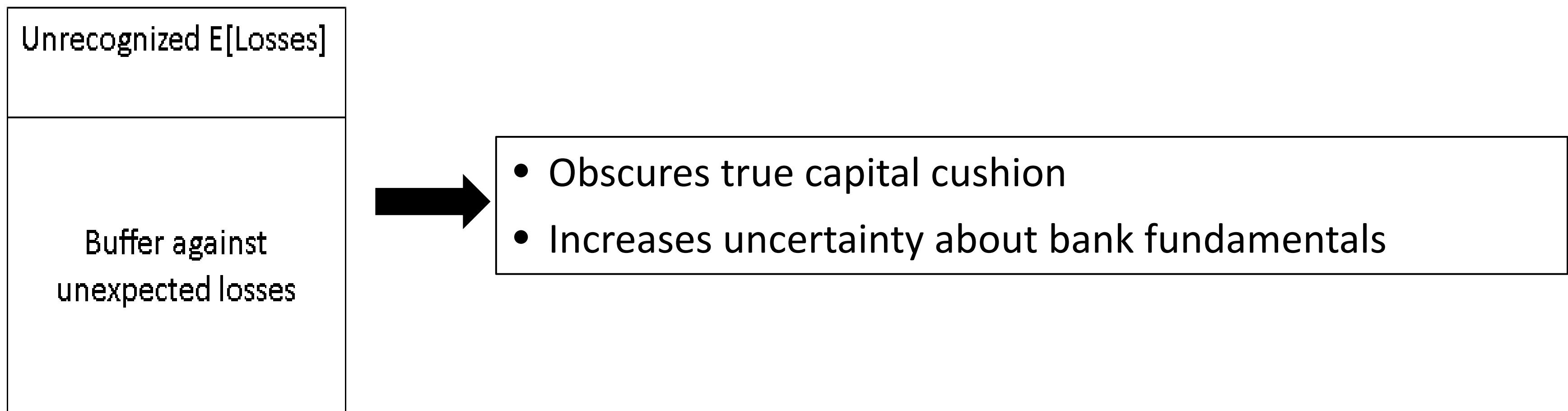
Drivers of accounting opacity



Bank opacity and discretion in loan loss provisioning

- **Delayed Expected Loss Recognition (DELR)**: Known expected loan losses are not recognized in current provisions, but carried forward to future periods.
- Significant cross-sectional variation in DELR across U.S. banks

$\Rightarrow$ provisioning not directly tied to true performance of the loan portfolio
$\Rightarrow$ overhang of unrecognized expected losses carry forward
$\Rightarrow$ bank capital mingles unrecognized expected losses with economic capital



Bushman & Williams (2013):
Delayed Expected Loss Recognition & The Risk Profile of Banks

Consistent with *DELR* reducing transparency & increasing uncertainty over fundamentals:

- Stock market liquidity of high DELR banks decreases relatively more during downturns.

- Liquidity of high *DELR* banks co-moves relatively more with aggregate market liquidity, especially during economic downturns.

=> High DELR banks simultaneously become more opaque and face increased equity financing frictions!

Bushman & Williams, 2013
Delayed Expected Loss Recognition & The Risk Profile of Banks

During recessions:

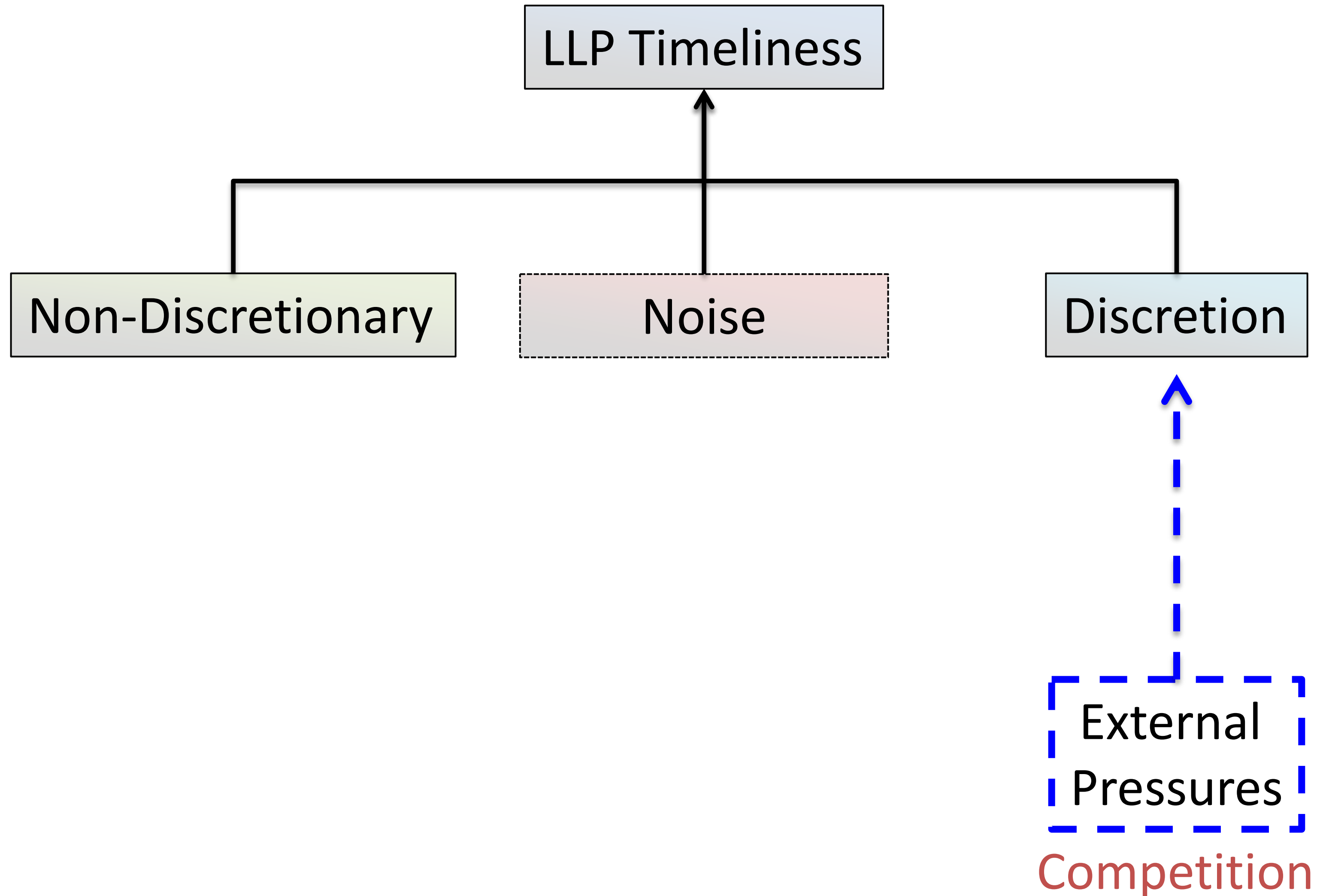
- Higher *DELR* banks have higher risk of severe drop in equity value;
- Distress at High DELR banks => significant increase in tail risk of severe drop in equity value of the ***banking system***.

When many banks simultaneously delay expected loss recognition in good times

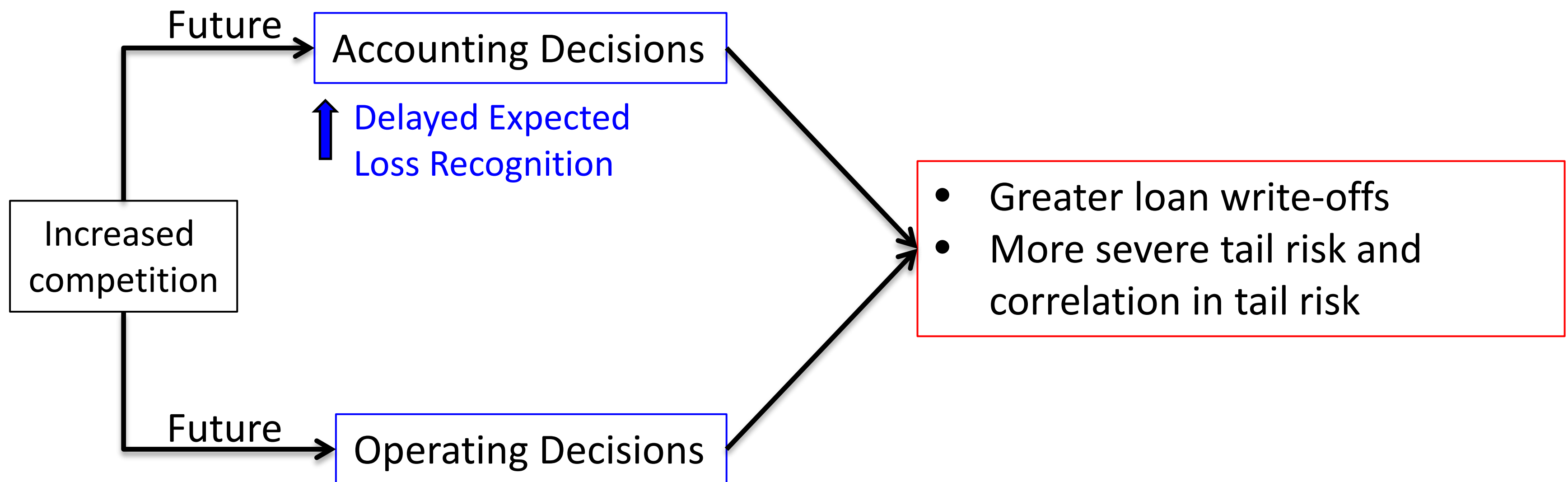
⇒ group members simultaneously face consequences of opacity, loss overhangs and financing frictions during downturns.

⇒ *DELR* acts like a systematic risk factor where *DELR* banks as a "herd" are negatively impacted and transmit pain to the economy.

Profit Pressure & Discretionary Accounting Choices



Accounting discretion does not occur in a vacuum



- Shift Revenue Mix towards Non-interest Sources
- Ease Lending Standards
- Increase Leverage/Lower Tier1 capital