Fair Value Reclassifications of Financial Assets during the Financial Crisis: Economic Determinants and Capital Market Consequences

Jannis Bischof
University of Mannheim

Ulf Brüggemann
Humboldt University

Holger Daske
University of Mannheim

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Executive Summary

At the peak of the financial crisis in October 2008, the IASB was put under strong political pressure and granted companies the option to abandon fair value accounting for selected financial assets. This study examines (1) whether reclassifications of financial assets under the October 2008 amendments to IAS 39 and IFRS 7 served banks as an effective means of regulatory capital arbitrage during the crisis, i.e. granted regulatory forbearance to those banks that would otherwise have risked costly regulatory interventions, and (2) whether these short-term benefits come at the long-term cost of increased information asymmetry and adverse selection due to the elimination of fair value information from financial statements when disclosure requirements are not complied with.

Using a comprehensive global sample of 302 publicly traded and IFRS reporting banks, we show that more than one third of the international banks chose to reclassify some assets, thus increasing aggregate profits by a total of 22.7 billion Euros and firm-specific profits by 44% on average. Further, we document that there is a substantial degree of non-compliance (by almost two thirds of the reclassifying banks) with the simultaneously introduced IFRS 7 disclosure requirements. Consistent with reclassifications being an effective means of regulatory capital arbitrage, we find that the risk of costly regulatory interventions and the lack of prudential filters for cumulative unrealized fair value gains are significantly associated with the reclassification choice at the bank level. For a small group of banks with severe financial difficulties and the highest risk of regulatory interventions, the regulatory benefit manifests in abnormally positive stock returns around the regulatory announcement on 13/14 October 2008. On the other hand, the short-term benefit is accompanied by the long-term cost of an increase in bid-ask spreads if the reclassified fair values are not fully disclosed in the footnotes, i.e. if we observe non-compliance

with the IFRS 7 requirements. However, we do not find evidence for increased information asymmetry if reclassifications are fully disclosed in the footnotes.

From a *standard setting* perspective, our findings serve as an example for what happens when a standard setter accedes to requests for special treatments. The results point to the link between regulatory capital and fair value accounting as a major reason for the political pressure observed in October 2008. As a result of the implementation in many different jurisdictions, IFRS are used for reporting objectives (such as prudential supervision) that may conflict with the usefulness of reporting to current and potential investors, at least under extreme circumstances. Indeed, the analyses of the capital market reactions to the October 2008 amendments provide evidence that beneficial effects for prudential supervision can be accompanied by adverse effects for equity investors. This is mainly because the approach to overcome the conflict between contradictory reporting purposes by shifting information from recognition to footnote disclosure has its limitations in an international environment where non-compliance with specific disclosure requirements is a severe issue.

From a *research* perspective, our findings contribute to the literature on banks' incentives for regulatory arbitrage by means of accounting choices and on the economic consequences of disclosure and non-compliance.

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