THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

Fair Value Accounting and the Business Model of Banks

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Abstract

Bank lobbyists and regulators frequently argue that fair value measurement inadequately mirrors a 'banking book' business model aimed at originating and holding financial instruments. As an outcome of this political position, existing and recently proposed accounting rules for financial instruments can be characterized as an option-based mixed measurement model in which most financial instruments are held at cost. Using a comprehensive global sample of banks, we study in a first step the empirical validity of the argument's conceptual underpinning. Contrary to common claims, we find that operating characteristics (i.e., trading vs. banking book business) and risk exposures of banks are only weakly related. In a second step, we discuss why the 'business model' argument has been (successfully) brought forward in the recent political debate against FASB's proposed full fair value model. Our findings suggest that fair value accounting imposes costs for those banks that run open risk positions and enjoy reporting discretion under the current cost-based model in the banking book. Specifically, we show that risky and discrete banks (1) utilize optional fair reporting less (2) support the American Bankers Association's E-Mail lobbying campaign against full fair value more frequently.