Agency Conflicts, Prudential Regulation, and Marking to Market

Discussion

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Fair-Value versus Historical Cost…

- Which dominates?
- Paraphrasing Authors: "It depends."
- Quoting: "Put differently, even if prices fully reflect fundamentals, we show the fair value measurement regime may still be dominated by the historical cost regime."

The Battleground

- First period: Hidden effort/investment to increase final payoff.
- Interim: *Public* signal about final payoff.
- Second period: If capital regulation/covenant met, shareholders can risk-shift. If covenant violated, assets seized & no risk-shifting.
- HC: No covenant = ignore public signal. Assets never seized.
- FV: Use public signal to transfer control to lenders/regulator via covenant.
- *Which is better?*

Is FV Better? Well, consider…

- With moral hazard, should we condition compensation on informative signals?
- Are (state-contingent) covenants value-enhancing?
- If we have less noise in performance signals, will value increase?
- In all cases, the answer is YES.
- *So then isn't it obvious that FV dominates HC (at least within the context of this model)?*

Put another way…

- Anything one can do with HC one can do strictly better with FV by just setting the covenant so that it binds only in, say, extreme circumstances.
- So surely FV must dominate HC!
- But authors conclude…
- “In fact, if the solvency constraint in the fair value regime is suboptimally chosen to be tighter than a threshold, historical cost accounting dominates fair value accounting.”

My preferred policy take-away

- *FV clearly dominates HC in context of this model.*
- We should be using more price-based regulation and trying to make prices more informative about underlying value.
- Perhaps demands of the publication process stand in the way of economists delivering much-needed advice to policymakers who appear anxious to avoid market discipline.
- And banks will be anxious to say “academic research shows it’s not clear which dominates.”

Another way to think about paper

- FV dominates HC by facilitating state-contingent transfers of control.
- And this paper helps us think about *optimal stringency of covenants*.
- Key tradeoff: A tighter covenant mitigates ex post risk-shifting but exacerbates ex ante underinvestment/moral hazard.
- "A more novel *(?)* and interesting implication of our analysis is that…the debt overhang problem in period 1 is actually alleviated by the possibility of risk shifting in period 2."
- Myers 1977 makes a very similar argument.

Beyond Myers 1977

- Quantitative estimate of value gain from FV based covenants?
- Better way of providing effort incentives than permitting asset substitution? E.g.: If good interim signal, permit call at low price. If bad signal, transfer control.
- *In this model no reason for solvency regulation or an accounting standards board! Introduce some wedges. And then answer…*
- How does privately optimal covenant/leverage differ from publicly optimal covenant/leverage?

Is this *really* a paper about accounting rules?

- In model, the information (signal) is *public*.
- Paper is about whether (HC vs FV) and how (optimal c) to use *public* info in contracting.
- What does that have to do with accounting rules? In model setting, accounting reports would be redundant.
- The HC vs FV debate is about *disclosure*—whether and how we should try to compel banks to disclose their *private* information about assets.
- Disclosure raises very different questions and makes the HC vs FV fight more interesting.

Thinking about FV disclosure…

- Some potential costs/benefits of FV *disclosure*…
- Benefit: Increased liquidity if FV disclosure mitigates informational asymmetries.
- Cost: More disclosure can decrease liquidity if some are better at processing FV reports.
- Cost: FV disclosure could lead to runs/panics.
- Problem: IC? Quality of FV disclosure will erode precisely when covenants/regulations should bite. And regulators (EBA) appear happy to play along.

Summary…

- I agree with the true take-away of model—that FV accounting has an advantage in improving private contracting outcomes and regulation.
- But, still plenty of open questions for financial economists to address (work-in-progress)!
- Optimal security design? Contingent-convertibles, etc
- Public versus private optima?
- Should we compel *disclosure of private information*? Tradeoffs? At what level of detail? How do we induce truth-telling? Should enforcement by cyclical? Who will watch the watchman?