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

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<th>Bank Balance Sheet</th>
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*Depiction of underlying real bank*

*How the underlying economic reality is measured matters!*
Bank opacity can create uncertainty

- Creditors
- Equity investors
- Counterparties
- Taxpayers

Bank Regulators
Drivers of opacity: The accounting depiction of reality

Accounting Rules:
- Fair Value Accounting
- Incurred loss model
- Securitization

Incentives of Bank Managers

Bank’s Financial Reporting

Accounting Discretion
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’s Financial Reporting

Accounting Rules

Accounting Discretion

Incentives of Bank Managers

Opportunistic Accounting decisions

Signal private information
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

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

- Obscures true capital cushion
- Increases uncertainty about bank fundamentals
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!
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

LLP Timeliness

Non-Discretionary
Noise
Discretion

External Pressures
Competition
Accounting discretion does not occur in a vacuum

- Increased competition
- Operating Decisions
  - Shift Revenue Mix towards Non-interest Sources
  - Ease Lending Standards
  - Increase Leverage/Lower Tier1 capital
- Future
- Accounting Decisions
  - Delayed Expected Loss Recognition
  - Greater loan write-offs
  - More severe tail risk and correlation in tail risk