Fair Value Accounting and Procyclicality: Accounting for Securitization*

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Abstract
The purpose of this study is to examine whether fair value accounting promotes procyclicality by focusing on securitization transactions before the recent financial crisis. The financial crisis has lead to heated debates on the pros and cons of fair value accounting from the perspectives of illiquidity and procyclicality. Previous studies investigated the relationship between fair value accounting and procyclicality and found mixed evidence of this relationship during the financial crisis (economic recessions). However, few studies examined this relationship before the financial crisis (economic booms).

This study investigates and demonstrates the relationship between securitization accounting and procyclicality using a parsimonious model. The findings are as follows. Sale accounting increases the capital ratio compared with that before a securitization transaction. Banks’ executives have incentives to increase both assets and debt within the limits of their target capital ratio (leverage ratio) for executive compensation and market reputation: assets (lending) will be increased. When banks conduct securitization transactions and adopt sale accounting to enhance short-term profits, the capital ratio increases under the certain condition. Thus, banks will increase assets (lending) within the limit of their target capital ratio (leverage ratio). As banks increase and expand their lending during economic booms, the economic booms are accelerated. It is expected that both sale accounting and fair value accounting promote procyclicality during economic booms.

This study makes two contributions to the accounting literature and accounting standards setting. First, it proposes a new perspective on the relationship between fair value accounting and procyclicality. Second, this study suggests that accounting standard setters reconsider the movement in accounting for securitization.

Keywords: Fair Value Accounting, Procyclicality, Securitization Transactions, Sale Accounting