

Public Abstract

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Title:The Consequences of Bank Reporting Failure for Liquidity Creation: Evidence from Accounting Restatements

My paper examines the effect of bank financial reporting failure on bank liquidity creation. Banks play a central role in creating liquidity in the economy by funding relatively illiquid assets, such as commercial loans, with relatively liquid liabilities, such as savings deposits. Existing academic theory implies that reporting failure by banks can have negative consequences for bank liquidity creation by 1) increasing the cost of banks' external financing, 2) eroding the trustworthiness of bank management and thereby weakening bank-customer relationships, and 3) limiting banks' capacity to take additional risks for liquidity creation due to the excessive amount of risks taken by the banks during the period of misreporting. This paper empirically tests the theory and investigates whether and how bank liquidity creation changes around bank accounting restatements. I find that relative to the eight quarters before the restatement, bank liquidity creation declines materially during the eight quarters after the restatement, and this effect is concentrated among smaller, community-bank like institutions. Looking at specific bank activities, I find that the decline in bank liquidity creation occurs primarily through contractions in banks' holdings of illiquid assets as well as liquidity liabilities, and increases in banks' holdings of liquid assets such as cash. The liquidity creation effects are also more pronounced when restatements uncover severe reporting issues, when banks have lax credit screening standards when misreporting, and during financial crises. Additional tests reveal that after restatements, banks appear to increase deposit interest rates offered to customers in an attempt to retain deposit base. Taken together, my findings help inform the public about the implications of financial reporting transparency for banks' real activities and, more broadly, for the allocation of economic resources.