

THE CONSEQUENCES OF BANK REPORTING FAILURE FOR LIQUIDITY CREATION: EVIDENCE FROM ACCOUNTING RESTATEMENTS

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ABSTRACT

This paper examines the effect of bank accounting restatements on bank liquidity creation. Banks play a central role in creating liquidity in the economy by financing relatively illiquid assets, such as business loans, with relatively liquid liabilities, such as demand deposits. Theory predicts that bank restatements can impede liquidity creation by impairing banks' access to external funding sources, weakening bank-customer relationships, and triggering the unravelling of risk overhangs that banks accumulate when misreporting. I find that bank liquidity creation declines significantly following restatements for small banks, but not for large banks. Moreover, the decline in bank liquidity creation occurs predominantly through changes in banks' holdings of illiquid assets, liquid liabilities and liquid assets. I also find the liquidity creation effects to be more pronounced when a bank restatement identifies severe reporting issues and when confidence in the banking system as a whole is relatively low. Further analyses show that restating banks increase deposit interest rates to retain their deposit base. Overall, the results inform the ongoing discourse on the implications of financial reporting transparency for bank stability and, more broadly, for the allocation of economic resources.