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The effect of corporate taxation on bank transparency: Evidence from loan loss provisions ☆

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ABSTRACT

We examine how the corporate tax system, through its treatment of loan losses, affects bank financial reporting. Exploiting cross-country and intertemporal variation in income tax rates and loan loss provision deductibility, we find that loan loss provisions are increasing in the tax rate for countries that permit general provision tax deductibility. When general provisions are deductible, a 1 percentage point rate increase leads to a provision increase of 4.9% of the sample average. This effect is driven by the tax system's encouragement of timelier loan loss recognition, suggesting that corporate taxation is an important determinant of bank financial reporting transparency.

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1. Introduction

The role of the corporate tax system in the stability of the financial sector has received considerable attention in the wake of the 2007–09 financial crisis (Slemrod, 2009; Shackelford et al., 2010; Shaviro, 2011; Admati et al., 2013). For the most part, academics and policymakers have focused on the potential negative effects of taxation on banks. For example, some have explored whether the tax-favored status of debt financing encourages banks to become excessively levered and the corresponding effect on financial crises (Admati et al., 2013; de Mooij et al., 2013; de Mooij and Keen, 2016; Schepens, 2016). Whether the tax system has other effects on banks, including beneficial ones, is not clear.

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In this study, we investigate the effect of the corporate tax system on bank financial reporting choices. Specifically, we examine whether loan loss provisioning behavior and timely loan loss recognition are affected by tax incentives. In recent years, regulatory agencies and policymakers have contemplated increasing the tax deductibility of loan loss provisions because doing so may encourage timely loan loss recognition. For example, an IMF Staff Note suggested that "[u]nfavorable tax treatment can create disincentives for adequate provisioning" (International Monetary Fund 2015).[1] However, empirical evidence as to whether the corporate tax system affects provisioning is scarce.

Understanding whether tax incentives affect loan loss provisioning is critical because the loan loss provision is the most important and discretionary bank financial reporting choice (Ryan, 2011; Beatty and Liao, 2014), and one that conveys important news to investors (Grammatikos and Saunders, 1990; Docking et al., 1997). Prior research has shown that provisioning and timely loan loss recognition can affect the length of economic downturns (Laeven and Majnoni, 2003), lending (Beatty and Liao, 2011), the monitoring and discipline of risk-taking (Bushman and Williams, 2012), systemic risk (Bushman and Williams 2015), and regulatory oversight (Gallemore, 2016). During the 2007–09 financial crisis, insufficient loan loss reserves may have contributed to bank instability (Balla and Rose, 2015) and banks exploited provisioning discretion to boost earnings (Huizinga and Laeven, 2012).

We focus on two aspects of the corporate income tax system that jointly can affect loan loss provisions: the corporate income tax rate and the tax deductibility of loan loss provisions.[2] While most countries require banks to recognize loan loss provisions for financial accounting purposes, the tax treatment of these provisions varies widely. Some countries allow banks to deduct general provisions (provisions for existing loans that have not yet been specifically identified as impaired) for tax purposes, whereas others only allow the deduction of provisions either for specifically identified impaired loans or not at all.[3] The value of the tax deduction depends on the corporate income tax rate. Of course, higher provisions can be costly to bank managers if regulatory scrutiny increases as a result of lower capital ratios, or if compensation decreases as a result of lower earnings. Thus, it is an empirical question as to whether the corporate tax system has an economically important effect on loan loss provisioning.

Furthermore, there are two mechanisms through which the corporate tax system could affect loan loss provisioning. First, the system could encourage banks to recognize loan portfolio deteriorations in the provision in a timelier manner. This is often referred to as timely loan loss recognition. Alternatively, the corporate tax system could encourage greater loan risk-taking if banks anticipate the tax deduction benefits generated by provisions when deciding on the riskiness of their loan portfolio. These mechanisms have very different regulatory implications: prior research associates the former with greater transparency because it provides timely signals of bank health and risk-taking to regulators and creditors (Bushman and Williams, 2012, 2015; Gallemore, 2016), whereas the latter suggests that taxation could have a potentially destabilizing effect on the banking sector.

Our identification strategy exploits cross-country and intertemporal variation in both the statutory corporate tax rate and the tax deductibility of loan loss provisions. Most of the tax system's characteristics—in particular, the top statutory corporate tax rate—are unlikely to be driven by an individual bank's loan loss provisions. To deal with possible correlated variables, we include either country or bank fixed effects, plus several variables that capture economic and institutional factors that vary at the country-year level. Our identification strategy is akin to a difference-in-differences design, with the first difference comparing provisions before and after a tax change and the second doing so for a country with a tax change to a country without one. Our sample includes 91 tax rate changes of at least one percentage point and 11 changes in the deductibility of the loan loss provision, which occur at different points in time and in different countries, providing us with an extensive set of counterfactuals.

Using an international sample of banks from 2001 through 2013, we find that the loan loss provision is increasing in the corporate tax rate for countries that permit the tax deductibility of general provisions, supporting our hypothesis. The economic effects of the corporate tax system are substantial: a one percentage point increase in the corporate tax rate increases provisions by 4.9% of the sample average, or $5 million based on the median bank assets, if general provisions are tax deductible. We further show that bank managers do not appear to exercise discretion in other earnings components to offset the increased loan loss provisions and thus provision tax deductibility affects overall earnings.

We conduct several tests to address identification concerns. First, we examine how the impact of the corporate tax system on loan loss provisions varies across banks. We find that the effect of the tax system on provisioning holds for both large banks (which are more systemically important) and small banks (which are less likely to exert influence over the design of the corporate tax system). Second, we use a within-country difference-in-differences design to isolate the effect of provision tax deductibility and to address concerns that our results are driven by unobservable, time-varying differences across countries. We exploit the change in provision tax deductibility introduced by the U.S. Tax Reform Act of 1986 (TRA86), and find that banks no longer able to deduct provisions from taxable income after TRA86 reduced their provisions relative to banks that still could do so.

[1] Other recent examples include a IMF Staff Note on Poland (International Monetary Fund, 2013), a European Parliament Staff note (European Parliament, 2016), a Bank of England working paper (Bholat et al., 2016), and a Bank of Italy working paper (De Vincenzo and Ricotti, 2014).

[2] We use the term "corporate tax system" in this study to jointly reference both aspects.

[3] If provisions are not tax deductible, the bank must wait until the loan is charged off (and thus removed from the bank's balance sheet) before claiming the loss as a tax deductible expense. See Section 2.2 for more details.

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