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Loan loss provisions, accounting constraints, and bank ownership structure



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ABSTRACT

We examine bank-level changes in the relationship between earnings and loan loss provisioning, a measure of earnings management, following the tightening of accounting constraints associated with the SEC's 1998 SunTrust Bank decision. By exploiting both temporal variation in the regulatory environment and cross-sectional variation in bank ownership structure, we find evidence that shortly after the SEC action, the relationship between earnings and provisions weakened for publicly-held banks but not for privately-held banks, consistent with reduced earnings management among publicly-held banks only. This difference does not persist over time, with evidence indicating a weakening of the relationship for both ownership types.

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1. Introduction

Understanding the trade-offs between the supervisory and accounting standards for loan loss provisions and the economic significance of such trade-offs is critical for ongoing bank regulation. In the wake of the 2007–2009 financial crisis and the ensuing reforms in the Dodd–Frank Act and Basel III, policymakers, academics, and industry experts have debated the nature of embedded losses in banks' loan portfolios. Some argue that prior to the crisis bank managers underestimated the credit risk in their loan portfolios; others argue that bank managers may have been constrained by accounting rules from recognizing estimated loan losses early.

We present new evidence on bank-level changes in loan loss provisioning in response to a shift in the regulatory environment, evidence that is consistent with the second view. We utilize a natural experiment that occurred a decade before the financial crisis to obtain a cleaner examination of the accounting constraint. Specifically, the 1998 SunTrust decision (described below) by the Securities and Exchange Commission (SEC) indicated stricter enforcement of accounting priorities relative to supervisory priorities, but at first directly affected only publicly-held banks that fall under the SEC's purview. By exploiting both temporal variation in regulatory emphasis and cross-sectional variation in bank ownership structure, we identify the effects of the strengthening of the accounting constraint on loan loss provisioning.

We find that in the two years following the SEC action, the positive relationship between earnings and provisions weakened for publicly-held banks but not for privately-held banks, consistent with a tightening of accounting constraints affecting only publicly-held banks directly under the SEC's purview. This is true for both small and large banks, although large privately-held banks exhibit a stronger relationship between earnings and provisions after the SEC action. Measured over a longer time period, including several years following the joint interagency guidance of 2001, we find that both publicly-held and privately-held banks show a weakening of the relationship between earnings and provisions, consistent with the uniform application of provisioning standards for all banks by supervisory agencies. The only exception is large publicly-held banks, which do not show a significant weakening in earnings management over the long term. We also examine changes in loan loss reserves after the SEC action. We find that the reserves fell for publicly-held banks relative to privately-held banks, particularly among small banks, and that this difference persisted in the years leading up to the crisis. This too is consistent with a period following the SEC action during which publicly-held banks were constrained against provisioning as much as they may have desired while privately-held banks were not similarly constrained.

This paper makes several contributions to the literature on loan loss provisions and earnings management in banks. First, ours is the first paper to the best of our knowledge to examine the short term and long term implications of the 1998 SEC action on provisioning policies of U.S. banks, and does so for both publicly-held and privately-held banks, and banks stratified by size. Second, our paper speaks to the efficacy of financial regulation, as the evidence indicates that the SEC was successful in its intention of constraining earnings management among publicly-held banks. Third, and most relevant for the ongoing debate over bank regulation in the wake of the financial crisis, our evidence that the relative strengthening of accounting priorities reduced earnings management, and that the resulting difference in loan loss reserves persisted, supports the argument that binding accounting constraints prevented banks from recognizing loan losses early in the years prior to the 2007–2009 crisis. This implies that the subsequent need under the incurred-loss model for banks to procyclically increase provisions during the crisis potentially amplified the economic downturn.

2. Background

A bank's loan loss reserve account, also known as the allowance for loans and leases losses, is a contra-asset account used to reduce the value of total loans and leases on the bank's balance sheet

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