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Bank accounting conservatism and bank loan pricing

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ABSTRACT

This paper studies the effects of bank accounting conservatism on the pricing of syndicated bank loans. We provide evidence that banks timelier in loss recognition charge higher spreads. We go onto consider what happens to the relationship between spreads and timeliness in loss recognition during the financial crisis. During the crisis, banks timelier in loss recognition increase their spreads to a lesser extent than banks less timely in loss recognition. These findings are broadly consistent with the argument that conditional accounting conservatism serves a governance role. The policy implication is that banks timelier in loss recognition exhibit more prudent and less pro-cyclical loan pricing behaviour.

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1. Introduction

This study examines the effect of timely loss recognition among banks on the yield spreads they charge on syndicated loans. We base our theoretical rationale on the corporate governance role of accounting conservatism. Agency conflicts between various parties to the firm are important drivers for the existence of corporate governance provisions. Classical agency theory attempts to model such conflicting relationships (Jensen and Meckling, 1976; Jensen, 1986). For example, Jensen and Meckling

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(1976) highlight that a lack of alignment between managers and other stakeholders' (e.g., shareholders') interests creates incentives for managers to expropriate firm's resources. Although contracts are written to align the interests of related parties, nonetheless contracts cannot eliminate all agency costs because of the incomplete nature of such contracts and thus assign significant control rights to managers (Shleifer and Vishny, 1997). Accounting conservatism is expected to serve a corporate governance role whenever accounting numbers are used as managerial performance indicators in such contracts.

Positive accounting theory (Watts and Zimmerman, 1986) stipulates that the use of accounting numbers in contracts can create incentives for managers to use aggressive accounting methods to accelerate gain recognition and/or delay loss recognition. Therefore, accounting numbers that are generated under conditionally conservative accounting can enhance contracting efficiency and the mitigation of agency costs (Watts, 2003). Existing studies (Beekes et al., 2004; Lobo and Zhou, 2006; Ahmed and Duellman, 2007; Garcia Lara et al., 2009) suggest that timely loss recognition can facilitate monitoring and contribute to corporate governance. Ball (2001) also provides arguments to support the corporate governance function of conditional accounting conservatism. He suggests that managers may seek to avoid negative impacts to their bonuses and promotion prospects by continuing to pursue some existing risky investments. However, if managers know ex-ante that economic losses will be recognized early, they are less likely to take on investments that they anticipate may underperform.

In the context of bank lending, without recognising losses on a timely basis, bank managers could be tempted to continue lending and/or increase lending to borrowers of higher credit default risks at low spreads. This is in spite of the fact that these loans give rise to high loan losses and negative net income in the long run. The reason why bank managers behave in this fashion is that such loans yield positive income and increase bank managers' bonuses and promotion prospects in the short run. Among banks that adopt more conditionally conservative accounting, it will be less possible to defer the recognition of loan losses to future periods. As a result, managers of the more accounting conservative banks are more likely to provide for expected loan losses by making higher provisioning compared to the less accounting conservative banks. Nevertheless, higher provisioning would negatively affect current earnings and capital adequacy ratios. Since earnings and adequacy ratios are important measures of managerial performance, bank managers would have incentives to take steps to positively influence these measures. Based on the rationale of Ball (2001), we predict that banks with more conditionally conservative accounting policies would charge higher spreads after controlling for other factors such as borrowers' credit default risk proxied by loan provisions and borrower credit ratings.

During the recent financial crisis, banks' lending behaviours are also expected to be influenced by their degree of conditional accounting conservatism. Beatty and Liao (2011) use the credit crisis theory to argue that banks suffer a loss of capital and hence face greater regulatory capital constraints during recessions. They suggest that banks with less timely loss recognition might not have built up sufficient loan provisions prior to economic downturns, and could have suffered greater loan losses and loss of capital when downturns occur. As a result, such banks are more likely to reduce their lending during recession periods than the more prudent banks. In other words, conditionally conservative accounting policies could moderate the negative impact of recessions on the supply of bank loans to the capital market. Based on this rationale of Beatty and Liao (2011), we predict that the increase of yield spread during the financial crisis period relative to the pre-crisis period will be less pronounced among banks with timelier loss recognition.

In this study, we test the aforementioned predictions empirically through a sample of 3327 syndicated loan deals based on 513 borrowers and 48 banks covering 16 countries. The countries are US, UK, Canada, Australia, Spain, Germany, France, Italy, Ireland, Switzerland, Denmark, Netherlands, Norway, Belgium, Sweden and Finland. To capture the degree of conditional accounting conservatism among banks, we use the Khan and Watts (2009) *C-Score* measure of timeliness of loss recognition for our main tests, and the Beatty et al. (2002a) approach of employing discretionary loan loss provisions as an alternative measure of timeliness of loss recognition for robustness. We provide empirical evidence consistent with our predictions that banks that adopt more conditionally conservative accounting charge higher yield spreads, but increase their spread less during the financial crisis than banks that are less timely in their loss recognition. These findings are robust to controls for borrower, lender, and deal characteristics. Furthermore, a novel feature of our analysis of the credit crisis is that we

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