



# Earnings announcements and quoted bid-ask spreads of U.S. Bank Holding Companies



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## ABSTRACT

This paper investigates the relationship between earnings announcements and quoted bid-ask spreads of US Bank Holding Companies (BHCs). Using a large sample of daily BHC market data, I hypothesize and find evidence of a positive relation between earnings announcements and the quoted bid-ask spread. I argue that this result is due to earnings releases helping to increase information asymmetries between informed traders and market makers.

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## 1. Introduction

Early work by Demsetz (1968) demonstrates that quoted bid-ask spreads are related to a security's trading properties, while Bagehot (1971) suggests that one of these properties is the amount of asymmetry of information between traders. Since this time, several information asymmetry models have been proposed (e.g., Copeland and Galai, 1983; Glosten and Milgrom, 1985; Kyle, 1985; Admati and Pfleiderer, 1988; Easley and O' Hara, 1987, 1992). These models typically assume two types of traders i) uninformed traders and ii) informed traders, which according to Kim and Verrecchia (1994) create information asymmetries by processing public information, such as earnings announcements, into private information.

In these information asymmetry models, uninformed traders are merely passive suppliers of liquidity and market makers fall into this group. Thus, market makers and other uninformed traders are likely to sustain losses from trading with informed traders due to information asymmetry. Therefore, to cover these losses market makers require a spread between the quoted security bid and ask prices, where this spread is composed of three main components i) order processing costs, ii) inventory holding costs, and iii) adverse selection costs (Glosten and Harris, 1988; Ho and Stoll, 1981; Huang and Stoll, 1997; Roll, 1984; Stoll, 1978, 1989). Additionally, as the degree of information asymmetry between informed traders and market makers increases, market makers are expected to widen their quoted bid-ask spread (or at the very least the adverse selection component) *ex ante* given their exposure to adverse selection risk.

Altogether, these theoretical models suggest that the quoted bid-ask spread should widen in the face of earnings announcements as these releases help to increase information asymmetries between informed traders and market makers (Kim and Verrecchia, 1994). Recent empirical studies do indeed find evidence of a positive relationship between earnings

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**Table 1**

Definition of variables. This table presents descriptions of the variables.

Symbol	Definitions
<i>SPREAD</i>	= Daily percentage spread computed using the daily bid-ask spread scaled by the sum of the bid and ask prices divided by two;
<i>EAD</i>	= Dummy variable coded 1 on earnings announcement dates and 0 otherwise;
<i>PRICE</i>	= Daily closing stock price adjusted for stock splits and dividends;
<i>VOLTRAD</i>	= Natural logarithm of the daily volume of shares traded;
<i>NUMTRAD</i>	= Natural logarithm of the daily number of trades executed.

announcements and the bid-ask spread. For example, [Patel \(1991\)](#) documents an increase in spreads after earnings announcements. Furthermore, [Skinner \(1991\)](#) reports an increase in spreads after earnings announcements, but only for announcements that convey large earnings surprises. Meanwhile, [Lee et al. \(1993\)](#) offer evidence that spreads widen during the half-hour period containing earnings announcements and remain wide up to one day after the announcement. Similarly, [Krinsky and Lee \(1996\)](#) report that earnings releases significantly increase the adverse selection component of the bid-ask spread. [Yohn \(1998\)](#) finds that spreads increase gradually four days prior to the announcement but increase sharply the day before, of, and after, taking around six to ten days to return to pre announcement levels. [Kanagaretnam et al. \(2005\)](#) report that bid-ask spreads widen prior, to, and following earnings announcements. In a more recent paper, these authors find that higher levels of corporate governance reduces the bid-ask spread around earnings announcements ([Kanagaretnam et al., 2007](#)).

However, somewhat surprisingly there is little evidence concerning the nature of the relationship between earnings announcements and quoted bid-ask spreads in US banks. Further, prior works also document results in conflict with the dominant theoretical models ([Acker et al., 2002](#); [Morse and Ushman, 1983](#); [Venkatesh and Chiang, 1986](#)). As a consequence, I explore the relation between earnings releases and quoted bid-ask spreads for US publicly listed Bank Holding Companies (BHCs). To be clear, the US banking industry represents an under explored sector that has been growing in economic significance with the entire financial services industry expected to represent approximately 12% of US GDP by 2018 ([Saunders and Cornett, 2014](#)). What is more, I am motivated to investigate US banks because of this industry's unique mode of financing, which makes earnings releases very important, regulatory peculiarities that entail highly standardized reporting, and heighten public scrutiny, thereby making it an interesting area of research concerning the impact of earnings releases on information asymmetry. In addition, BHC opacity is likely to make it harder (although not impossible) for informed traders to obtain alternative sources of private information compared to nonfinancial firms, and this lack of transparency is likely to exacerbate information asymmetries among traders when public disclosures are made.

I argue and find that earnings releases help to increase the adverse selection information asymmetry between specialist traders of BHC securities and market makers, and as a result leads to a widening of BHC quoted bid-ask spreads ([Chung et al., 2009](#); [Copeland and Galai, 1983](#); [Glosten and Milgrom, 1985](#); [Kanagaretnam et al., 2005, 2007](#); [Kim and Verrecchia, 1994](#); [Krinsky and Lee, 1996](#); [Kyle, 1985](#); [Lee et al., 1993](#); [Patel, 1991](#); [Skinner, 1991](#); [Yohn, 1998](#)). The widening of quoted bid-ask spreads indicates that market makers assume, *ex ante*, higher levels of information asymmetry; meanwhile, narrowing the spread is consistent with expected lower levels of information asymmetry. In addition, I find that quoted BHC bid-ask spreads widen five days prior to the earnings announcement dates and remain wide five days after earnings releases, and that BHC quoted spreads are sensitive to the favorableness of news.

The remainder of this paper is presented as follows. The data and research design are described in [Section 2](#). [Section 3](#) highlights the empirical results; while [Section 4](#) discusses the empirical results and concludes the paper.

## 2. Data, variables and summary statistics

### 2.1. Data and variables

Data consisting of daily financial market information pertaining to US publicly traded BHCs for the period February 1, 2010 to December 31, 2014 are obtained from the Center for Research in Securities Prices (CRSP) Daily Stock Master files. This study period is chosen because in February 2010 the Securities Exchange Commission (SEC) introduced a new short sale price test restriction designed to restrict short selling from driving down the price of a stock that has dropped more than 10% in one day. This restriction is likely to disproportionately impact the trading activity of informed traders relative to uninformed traders (since informed traders short sell more often). Therefore, observations obtained subsequent to February 1, 2010 make for a more comparable study sample. Earnings announcement dates are obtained from the Institutional Brokers Estimate System (I/B/E/S) database provided by Thomson Financial. These data are merged with the CRSP market data. [Table 1](#) presents a list of the study variables used in the multivariate analysis, where the variable *SPREAD*, represents the quoted bid-ask spreads, *EAD*, indicates whether the date is an earnings announcement date, *PRICE*, the adjusted price of the security, *NUMTRAD*, denotes the daily number of trades executed, and *VOLTRAD*, the daily volume of shares traded.

In an effort to mitigate the effects of outliers, all continuous variables are winsorized at the 1%–99% levels. In addition, to limit survivorship bias, BHCs that became inactive, and/or were acquired by another BHC are retained in the sample. Finally,

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