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Corruption in bank lending: The role of timely loan loss recognition ☆

Brian Akins [a], Yiwei Dou [b], Jeffrey Ng [c]

[a] Jones School of Business, Rice University, United States
[b] Stern School of Business, New York University, United States
[c] School of Accounting and Finance, The Hong Kong Polytechnic University, Hong Kong, China

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Building on the recent literature on corruption in bank lending, we examine the effect of country-level timely loan loss recognition by banks on lending corruption using a unique World Bank dataset that covers more than 3,600 firms across 44 countries. We find evidence consistent with timely loan loss recognition constraining lending corruption because it increases the likelihood of problem loans being uncovered earlier. In further analysis, we find timely loan loss recognition to be less associated with reduced corruption in countries where there is significant government ownership in the banking system and deposit insurance schemes. This evidence is consistent with timely loan loss recognition being less of a deterrent to lending corruption when banks are less disciplined by their capital providers.

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1. Introduction

Banks provide a significant portion of firm financing and play an important role in economic development. Lending corruption is one of the major reasons for problem loans in many countries (Adams, 1991; Lardy, 1998; Udell, 1989). Loans involving corruption are typically lower quality loans that may not have been otherwise approved and are therefore more likely to go bad. These loans are approved because the loan officer, while enjoying private benefits from the corruption, does not believe she will bear the full cost of the potentially bad loan. Hence, corruption in lending can be regarded as a classic agency problem in which the agent (loan officer) extracts private benefits at the expense of the principal (e.g., investors and depositors).

Lending corruption as a prevalent phenomenon reduces the banking system's efficiency in distributing scarce capital. Prior studies have examined various institutional factors—bank supervisory policies, competition among banks, information sharing about borrowers, and the media—that could help mitigate such corruption (Barth et al., 2009; Beck et al., 2006; Houston et al., 2011). But while these papers generally offer evidence that external monitoring, and more information in general, deter lending corruption, no study has examined specifically how the recognition of bad loans in a country can do so.

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E-mail addresses: akins@rice.edu (B. Akins), ydou@stern.nyu.edu (Y. Dou), tee-yong-jeffrey.ng@polyu.edu.hk (J. Ng).

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Our paper focuses directly on the timeliness of loan loss recognition as an important mechanism constraining lending corruption. The stewardship role of accounting predicts that one important outcome of accounting is its ex-ante effect of curtailing bad corporate practices (Watts and Zimmerman, 1979; Holthausen and Watts, 2001). In the context of bank lending, loan loss recognition is an important accrual process through which banks recognize future expected loan losses in the current period. Banks make reserves to capture expected losses. Making these reserves immediately reduces bank profits and regulatory capital, which, in turn, can alert the board, managers, and external stakeholders to problems the bank is facing (Bushman, 2014).[1] As part of the typical internal control process to ensure proper independence, the accounting for loans (in particular, recording reserves for loan losses) is handled by bank accountants, not lending officers. Bank examiners and auditors also pay close attention to this separation of duties (Dahl et al., 1998). More timely loan loss recognition thus serves as an early warning mechanism for problem loans, including those that arise from lending corruption. As a result, the corrupt bank personnel have less time or opportunity to conceal and/or escape with the gains from corruption. In anticipation of the sequence of events that could be triggered by earlier loan loss recognition, loan officers are more likely to refrain from lending corruption at loan origination.

To measure corruption, we follow prior studies (Barth et al., 2009; Beck et al., 2006; Houston et al., 2011) that have examined issues related to corruption in bank lending by utilizing the World Bank's World Business Environment Survey (WBES).[2] In particular, the survey includes the question: “Is the corruption of banking officials an obstacle for the operation and growth of your business?” We rely on the response by firms (borrowers or potential borrowers) to measure the degree of bank lending corruption. To measure the timeliness of loan loss recognition within a country, we follow Beatty and Liao (2011) and construct the ratio of loan loss reserves to non-performing loans. To better reflect the predictive power of loan loss reserves, we use as the denominator, next year's non-performing loans, which capture the current year's non-performing loans and the next year's changes in non-performing loans.[3] The ratio is then averaged for each country to measure the timeliness of loan loss recognition in anticipating loan losses in a country's bank reporting environment.

The merging of the data on banking corruption, the timeliness of loan loss recognition, and other variables results in a sample of 3,611 firms from 44 countries. Controlling for a large array of bank-, firm-, and country-level characteristics (e.g., corporate governance, information environment, and financing obstacles), we document that more timely loan loss recognition is incrementally associated with less lending corruption. These results are robust to alternative measures of the timeliness of loan loss recognition, alternative sets of control variables, various analyses that check the sensitivity of the results to data limitations, and an instrumental variable probit regression.

Next, given that timely loss recognition is useful to the extent that monitors use it to discipline banks, we examine how the strength of market discipline affects the association between timely loan loss recognition and lending corruption. In particular, we focus on two major capital providers for banks: government, and depositors. We argue that government ownership increases the likelihood that a bank will be bailed out in the event that it is in trouble due to problem loans, thus mitigating equity investors' incentives to monitor the bank (Borisova and Megginson, 2011; Li et al., 2009; Guedhami et al., 2009; Wang et al., 2008). We also argue that deposit insurance reduces depositors' incentives to monitor banks and to withdraw their deposits when it is revealed that their bank is suffering from significant loan losses (Billet et al., 1998; Demirguc-Kunt and Huizinga, 2004; Goldberg and Hudgins, 2002; Greenbaum and Thakor, 2007). In line with these arguments, we find evidence that more timely loan loss recognition is less negatively associated with lending corruption in banking systems with more government ownership and with deposit insurance. Collectively, the results further enhance our confidence in interpreting the main effect, as it is more difficult to conceive an alternative story that explains both our primary results and interaction effects (Rajan and Zingales, 1998; Christensen et al., 2013).

We contribute to the literature in three interrelated ways. First, we extend the lending corruption literature (e.g., Barth et al., 2009; Beck et al., 2006; Houston et al., 2011) by focusing on loan loss recognition timeliness as a specific accounting mechanism that is closely tied to bank lending practice. In particular, loans arising from lending corruption are typically bad loans, and their early revelation has the potential to constrain corruption ex ante. As noted in Shleifer and Vishny (1993), Mauro (1995), and many other studies, corruption plays an important role in resource allocation, especially in less developed countries, and is costly to economic development. A better understanding of the mechanisms that curtail corruption could lead to changes (e.g., improvements to loan loss accounting) that facilitate economic development.

Second, we contribute to the literature on the real effects of more timely loan loss recognition (e.g., Beatty and Liao, 2011; Bushman and Williams, 2012). Beatty and Liao (2011) show that more timely loan loss recognition is linked to a greater willingness to lend during a financial crisis because the earlier recognition of credit loss means less credit loss has to be recognized during recessionary periods when regulatory capital declines and external financial frictions increase. Bushman and Williams (2012) find that more timely loan loss provisioning reduces excessive risk taking. Our study suggests that the disciplining effect of more timely loan recognition on lending corruption is another reason to expect this recognition to induce greater lending efficiency in the banking industry.

[1] The importance of accruing for loan losses can be seen from the numerous banking studies that have examined the implications of loan loss recognition. See the survey by Beatty and Liao (2014) and discussion by Bushman (2014).

[2] As noted by Houston et al. (2011) and other studies, the relative lack of papers on lending corruption is not surprising given the difficulty of measuring lending corruption. The recent literature relies on the survey by the World Bank to gauge lending corruption.

[3] Beatty and Liao (2011) argue that the ratio of loan loss reserves to current non-performing loans captures banks' tendency to recognize not only incurred losses but also the expected risk in their performing loans. They use current non-performing loans as the denominator. All our results are robust to this alternative specification and the other measures of the timeliness of loan loss recognition that we discuss later.

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