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Bank income smoothing, ownership concentration and the regulatory environment

Vincent Bouvatier [a], Laetitia Lepetit [b,*], Frank Strobel [c]

[a] Université de Paris Ouest, Nanterre La Défense, EconomiX, CNRS, Nanterre, France
[b] Université de Limoges, LAPE, Limoges, France
[c] University of Birmingham, Department of Economics, Birmingham, UK

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ABSTRACT

We empirically examine whether the way a bank might use loan loss provisions to smooth its income is influenced by its ownership concentration and the regulatory environment. Using a panel of European commercial banks, we find evidence that banks with more concentrated ownership use discretionary loan loss provisions to smooth their income. This behavior is less pronounced in countries with stronger supervisory regimes or higher external audit quality. Banks with low levels of ownership concentration do not display such discretionary income smoothing behavior. This suggests the need to improve existing or implement new corporate governance mechanisms.

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1. Introduction

The question whether banks use loan loss provisions (LLP) to manipulate their reported earnings is examined by a fairly large empirical literature, with rather mixed results.[1] A certain degree of latitude in managing earnings can arise through the element of judgement banks can exercise in the determination of loan loss provisions, which require an assessment of expected loan losses. This assessment of expected loan losses may naturally involve a significant element of subjectivity. Therefore, banks may have the ability to also pursue additional management objectives in the process, such as smoothing their income by exaggerating loan loss provisions when income is high, and understating them when income is low. Analyzing the earnings management of banks is of importance as income smoothing compromises the faithful representation of their underlying economic condition; accounting numbers no longer reflect the economic reality of underlying risk conditions in this case, reducing the ability of stakeholders, such as regulators and debtholders, to properly monitor banks. The last financial crisis has shown that when bank insiders exploit banks for their own purposes, the likelihood of bank failures increases curtailing economic development and welfare more generally.

In this paper, we investigate whether ownership structure and national institutional factors play an important role in determining these financial reporting characteristics of banks. More specifically, we examine if differences in ownership concentration can explain differences in the level of earnings management, and if the regulatory environment plays a role in potentially disciplining such corporate behavior. Banks with a high level of ownership concentration (one or two controlling owners) could use discretionary LLP to smooth their income, e.g. in an effort to conceal behavior such as extraction of private benefits of control. Arguably, such income smoothing behavior should, however, be less prominent for banks with a dispersed ownership structure, or banks located in countries with stronger regulatory controls.

The existing literature analyzing the relationship between corporate governance and earnings management mainly focusses on US firms with their widely dispersed ownership structure, and mostly on non-financial firms. It sees income smoothing mainly as an act of managerial self-dealing and as such as an agency problem arising from the separation of ownership and control (e.g. Lambert (1984) and Rozycki (1997) for non-financial firms). This

* Corresponding author. Tel.: +33 555149213.
E-mail addresses: vbouvatier@u-paris10.fr (V. Bouvatier), laetitia.lepetit@unilim.fr (L. Lepetit), f.strobel@bham.ac.uk (F. Strobel).

[1] See e.g. Greenawalt and Sinkey (1988), Wahlen (1994), Beatty et al. (1995), Beaver and Engel (1996), Ahmed et al. (1999), Cavallo and Majnoni (2001), Kanagaretnam et al. (2003), Laeven and Majnoni (2003), Hasan and Wall (2004), Bikker and Metzemakers (2005), Liu and Ryan (2006), Anandarajan et al. (2007), Fonseca and Gonzalez (2008) and Bouvatier and Lepetit (2012).

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agency problem can be addressed through internal corporate governance mechanisms such as board effectiveness and managerial compensation (e.g. Klein (2002), Park and Shin (2004) and Zhao and Chen, 2008, and specifically for banking firms Cornett et al. (2009) and Leventis and Dimitropoulos (2012)). However, when large shareholders are also involved in firm decision making, as prevalent in continental Europe and Asia (La Porta et al., 1998), the conflict of interest shifts away from manager vs. shareholders to controlling owner vs. minority shareholders, as large shareholders have incentives to maximize their own benefits at the cost of other shareholders. Internal corporate governance mechanisms are less likely to limit such agency problems as large investors elect representatives to the board of directors that will act in their interest. Where controlling shareholders have incentives to manipulate earnings, it therefore becomes important to determine if governance by external stakeholders, in particular regulators, can curb such behavior. To date, the empirical literature analyzing the relationship between the level of ownership concentration and management of earnings is very scarce. Using country level measures of ownership concentration for panels of listed firms, several authors find mixed results showing that ownership concentration can be associated with either lower or higher levels of earnings management (Leuz et al. (2003), Fan and Wong (2002) for non-financial firms, Gebhardt and Novotny-Farkas (2011) for banking firms).

To investigate the effect of ownership concentration on earnings management, we use a firm-level data set on the ownership structure of banking firms. We focus on banks as they play a particularly important role in the financial intermediation process of modern economies, and because they have additional characteristics that require a separate analysis from non-financial firms. The financial structure of banks' assets combined with high leverage makes them inherently more opaque than other firms (Morgan, 2002), while they are also heavily regulated in response to significant negative externalities associated with bank failures. Banks have consequently a unique form of corporate governance (Adams and Mehran, 2003), with more stakeholders than non-financial firms, including depositors, non-insured debtholders, deposit insurers and regulators. Maintaining a well-functioning and stable financial system requires a better understanding of how these different stakeholders behave and interact together. The global financial crisis triggered in 2007 has shed light on the severe malfunctioning of several mechanisms of the internal and external governance of financial institutions, prompting the need to investigate better ways to strengthen accounting quality and ensure sound corporate governance mechanisms in the banking industry.

Using a sample of European commercial banks over the period 2004–2009, we find that whether or not a bank practices income smoothing through LLP does indeed depend on its degree of ownership concentration and the regulatory environment. For banks with a high level of ownership concentration, we find evidence of income smoothing through the use of LLP. This is significantly less pronounced in countries with stronger supervisory regimes or higher external audit quality, but independent of the level of shareholder protection, the type of audit firm (Big Four or non-Big Four) and the level of non-insured debt**.** Banks with low levels of ownership concentration are found not to display such income smoothing behavior throughout.

Our contribution to the literature is then threefold. Firstly, we contribute to the literature exploring the relationship between corporate governance and earnings management by analyzing if ownership concentration is an important determinant of earnings management, focussing on the banking sector. Secondly, as a number of institutional factors, such as banking supervision, audit quality and investor protection, can have an impact on accounting quality and earnings management, we further examine whether national regulatory factors can play an important role in the relationship between ownership concentration and the earnings management behavior of banks. Thirdly, by analyzing the relationship between ownership concentration and earnings management using detailed bank level data especially on their ownership structure, and examining a wider dataset containing both listed and unlisted banks, we aim to obtain a better understanding of the underlying mechanisms at work. For this we focus on a European dataset which provides a substantial amount of variability between individual levels of ownership concentration given the lack of regulatory limitations on the percentage of bank capital owned by a single entity in Europe.

Section 2 discusses the relevant literature and develops the research questions we address; Section 3 describes our data, the ownership characterization used and our baseline model specification; Section 4 presents and discusses our results regarding the impact of ownership structure and regulatory environment on income smoothing; Section 5 discusses further issues and contains several robustness checks; and Section 6 concludes the paper.

2. Literature review and research questions

The relationship between corporate governance and earnings management has given rise to a large literature mainly focusing on the conflict of interest between managers and shareholders when firms' ownership structure is widely dispersed. Several theoretical papers show why managers might engage in earnings management. Managers can manipulate earnings in order to influence the information set used by external investors and to maximize their own interest in relation to career concerns (Amihud and Lev, 1981), their non-diversifiable human capital (Jensen and Meckling, 1976) and private benefits of control (Demsetz and Lehn, 1985; Kane, 1985). Consistent with this literature, the existing empirical literature, focussing predominantly on US non-financial firms, shows that managers engage in earnings management to increase their compensation, to minimize their chance of being fired, to positively affect the risk perception of the firm or to reduce future expected income tax liabilities of investors (see e.g. Lambert, 1984; Greenawalt and Sinkey, 1988; Rozycki, 1997).

Boards of directors can play a significant role in controlling agency problems between managers and shareholders as their role is to appoint/dismiss and compensate management with the objective to maximize shareholder value (Fama and Jensen, 1983). Empirical studies provide mixed results on board effectiveness in monitoring management in the financial reporting process (see e.g. Klein (2002), Park and Shin (2004) and Zhao and Chen (2008) for non-financial firms, and Cornett et al. (2009), Leventis and Dimitropoulos (2012) and Leventis et al. (2013) for banking firms). Another mechanism to control management is the market for corporate control: the threat of a hostile takeover can make managers behave in accordance with the interests of current shareholders (Jensen, 1988). In banking, hostile takeovers are extremely rare (Prowse, 1997), mainly due to the opacity of banks and the regulatory approval process for M&As in the banking industry.

These different corporate mechanisms aiming to rein in managers' behavior are much less relevant, however, when the ownership structure is concentrated (Davies, 2000). Large investors can elect their representative(s) to the board of directors who will appoint a manager that will act in the interest of these controlling shareholders. The conflict of interest then shifts away from managers vs. shareholders to one of controlling owner vs. minority shareholders.[2] The effect of controlling ownership on firm value and on

[2] Even if the minority shareholders may collectively hold more voting shares than the controlling shareholders, the control of the firm will lie in the hand of the blockholder if the shares held by the minority shareholders are widely dispersed.

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