



Original Search

The determinants and value relevance of banks' discretionary loan loss provisions during the financial crisis

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ABSTRACT

We examine the economic determinants and value relevance of US banks' loan loss provisions (LLP) during the financial crisis. We consider whether LLP is determined by non-discretionary incurred loss variables only, or also by discretionary LLP (DLLP) that smooths reported earnings, signals favourable future earnings, or anticipates future losses. In a sample of 5187 bank-quarter observations from 2006 to 2010, our results show that LLP increases substantially, consistent with it being pro-cyclical, although LLP/equity levels remain modest. LLP severely and negatively impacts reported earnings, especially during 2009–2010. We also find that DLLP is used for smoothing and signalling, primarily where the two incentives reinforce each other, but smoothing occurs more frequently. Further, DLLP anticipated next quarter's losses in 2006–2008 but not in 2009–2010. The market positively values the use of DLLP in 2006–2008 to reduce reported earnings of poorly performing banks, and in 2009–2010 to smooth reported earnings of better performing banks.

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1. Introduction

The 2008 financial crisis¹ was a major macroeconomic shock with wide-ranging consequences. Whether fair value accounting, especially in banks, worsened the crisis has been a controversial issue.² However, Barth and Landsman (2010) suggest that loan loss accruals are likely to have played a greater role than fair value accounting in reducing US banks' profits through their effects on pro-cyclical bank lending and market discipline (Beatty and Liao, 2014). Loans are banks' largest asset class and loan loss accruals are the largest expense in banks' income statements (Beatty and Liao, 2011, 2014). Available evidence suggests that loan loss accruals increased four-fold from 2006 to 2008 (SEC, 2008, exhibit II.45) and far outstripped fair value losses during the crisis (Archaya and Ryan, 2016; Shaffer, 2010), yet were still very inadequate compared to contemporary outside estimates of loan losses (Laux and Leuz, 2010). However, this evidence is of limited generalisability because it is based on small samples. So, whether loan loss accruals contributed to the financial crisis remains an unresolved question.

This is an extensively reworked version of our paper "Changes in the Market Reaction to Banks' Discretionary Allowance for Loan Losses and Discretionary Loan Loss Provision during the Financial Crisis" presented at the AFAANZ conference 2014 and JCAE conference, Kuala Lumpur 2015. We are grateful for comments received at those conferences, from the JCAE reviewer and editor, and from Latrobe University staff seminar participants.

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¹ We acknowledge that this financial crisis had its origins in the earlier subprime mortgage crisis in the US and, in addition, there is a debate on when the financial crisis began. Given that the crisis in question worsened substantially and spread globally in 2008, we refer to this crisis as the 2008 financial crisis.

² See Laux and Leuz (2010) and Badertscher et al. (2012) for discussions of the role played by fair value accounting in the financial crisis.

We examine the economic determinants and value relevance of US banks' loan loss accruals during the years 2006–2010. How the level of loan loss accruals evolved as economic conditions deteriorated is documented. Our focus is on US banks' loan loss provisions (LLP), which is the periodic expense account for banks' estimated uncollectible loans. It is related to the Allowance for Loan Losses (ALL) account, a contra asset account netted against the gross amount of loans on the balance sheet. ALL is reduced by Net Charge-Offs (NCO), the actual net losses charged off against loans, and replenished through recognition of the current period's LLP.

Bank financial reporting is influenced by regulations aimed at maintaining banking sector stability. In particular, minimum capital adequacy regulations are based on accounting numbers and create an implicit demand for income smoothing over the economic cycle (Archaya and Ryan, 2016). However, income smoothing is outside the scope of most accounting standards. A tension thus exists between the objectives of bank regulation and those of financial reporting (Bushman, 2014).

Loan loss accounting standards in the US (and elsewhere) during the financial crisis used the "incurred loss" model in which only actual incurred losses, not anticipated losses, were accounted for in LLP. The model delays the recognition of expected future losses during economic downturns (Barth and Landsman, 2010; Beatty and Liao, 2011; Bushman and Williams, 2012; Kanagaretnam et al., 2009). A criticism is that the incurred loss model leads to inadequate provisioning for loan losses, especially anticipated losses, during good times, so that during bad times higher charges against regulatory capital occur as these losses are realised (Laeven and Majnoni, 2003). This can result in pro-cyclical lending where banks lend more in good times, but lend less in bad times when their capital adequacy ratios are compromised by large loan loss accruals, thereby worsening the economic downturn (Beatty and Liao, 2011; Hodder et al., 2014).

Research before the financial crisis shows that banks appear to smooth reported quarterly earnings using discretionary loan loss provisioning (Kanagaretnam et al., 2003, 2004) and to anticipate future losses (Bushman and Williams, 2012; Liu and Ryan, 2006), the incurred loss model notwithstanding. Prior research (e.g. Kanagaretnam et al., 2004; Kanagaretnam et al., 2005) also shows that banks use discretionary loan losses to signal expected future earnings changes, which are positively valued by the market. Overall, there is more evidence for smoothing than for signalling (Beatty and Liao, 2014; Beaver and Engel, 1996; Bushman and Williams, 2012; Kanagaretnam et al., 2004).

Using a sample of 5187 bank-quarter observations, we investigate the determinants and value relevance of LLP for US banks over the years 2006–2010, comprising sub-period I (2006–2008) and sub-period II (2009–2010) which have differences in their economic characteristics explained in Section 4.1. As in prior research (e.g. Beaver and Engel, 1996; Kanagaretnam et al., 2004; Kilic et al., 2013), we decompose LLP into non-discretionary (NLLP) and discretionary components (DLLP). We then examine (a) whether loan losses appear to be calculated according to the incurred loss model *only*; (b) whether banks calculate loan losses *as if* they include discretionary aspects,³ in particular expected future losses and proxies for income smoothing and signalling; and (c) whether these aspects of DLLP are priced by the market. If the market demands income smoothing and signalling, then proxies for smoothing and signalling should be positively priced; if DLLP contains future expected losses, these should be negatively priced.

We find that LLP increased nine-fold from Q1 2006 to Q4 2008 (double the rate in the SEC, 2008 Report) and eleven-fold from Q1 2006 to Q4 2009. Despite these increases, however, average LLP in Q4 2009 was still only a modest 4.1 percent of equity outstanding. Similar results are observed for NCO and ALL accounts. However, LLP as a proportion of quarterly earnings before LLP rose significantly from 2006 to 2010 and, in sub-period II, caused earnings to change from a profit before LLP to a loss after LLP for 24.5 percent of banks.

Our findings on banks' incentives to smooth income and/or to signal via DLLP show that, in the pooled data and in sub-period I, DLLP appears to have been used to accrue additional expenses where increases in next quarter's non-performing loans (NPL) were expected, a finding inconsistent with the incurred loss model; also banks with low pre-managed earnings use DLLP to further decrease those earnings – an example of conservatism. On the other hand, in sub-period II, only the smoothing incentive is supported. DLLP is value relevant for *all* firms with high pre-managed earnings for the pooled sample, for sub-period II, and also for *all* firms with low pre-managed earnings in sub-period I. This is consistent with the market valuing conservatism in 2006–2008 (sub-period I) as economic conditions deteriorated and valuing smoothing in 2009–2010 (sub-period II). Banks have value relevant DLLP in subsets of firms where both smoothing and signalling incentives are high and also where only the smoothing incentive is high. Therefore, smoothing is more important than signalling.

We contribute to the literature in several ways. First, we document that, although LLP increased substantially over 2006–2010, the levels of LLP as a proportion of equity appear modest, but the impact of LLP on reported earnings is substantial in sub-period II. Second, we show that US banks accrue DLLP differently depending on underlying economic conditions and their pre-managed earnings levels.

Third, smoothing appears to be value relevant for high profit firms in sub-period II, but further reduction in reported earnings is valued by the market for low profit firms in sub-period I. Therefore, during a period of severe economic turmoil and reversal, banks act as if they respond to a demand for conservatism when economic conditions are deteriorating and to a demand for income smoothing as economic conditions are recovering.

³ Our methodology is correlational so it is impossible to make causal statements about whether banks consciously choose LLP accruals to smooth, signal or anticipate future losses. Nevertheless, we find variation in the first two issues consistent with partitions of the data that correspond to either the presence or absence of incentives to smooth and to signal.

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