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Financial crisis and international supervision: New evidence on the discretionary use of loan loss provisions at Euro Area commercial banks

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ABSTRACT

We examine the discretionary use of loan loss provisions during the recent financial crisis, when Euro Area banks experienced not only a negative effect on the quality of their loans and a reduction in their profitability, but were also subject to a new form of stricter supervision, namely the EBA 2010 and 2011 stress test exercises. Overall, we find support for the only income smoothing hypothesis and we do not observe any difference in listed banks' behavior when compared to unlisted banks. Banks subject to EBA stress tests had higher incentives to smooth income only for the 2011 EBA exercise, when a larger and more detailed set of information was released. This may suggest an unwilled side effect that accounting setters and banking regulators and supervisors should account for.

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1. Introduction

Loan loss provisions (LLPs) are a relatively large accrual for commercial banks and have a significant impact on bank performance and regulatory capital. Even if in principle banks' LLPs should adjust loan loss reserves to reflect expected future losses on loan portfolios, due to the discretion that managers can exercise in assessing this item, LLPs can also be used to achieve other different objectives. Prior research especially found that LLPs are used to manage capital and stabilize income (see, among the others Collins, Shackelford, & Wahlen, 1995; Beatty, Chamberlain, & Magliolo, 1995; Ahmed, Takeda, & Thomas, 1999; Anandarajan, Hasan, & McCarthy, 2007) and for signalling future intentions to the stock market (Whalen, 1994; Anandarajan et al., 2007). The literature usually distinguishes two components of LLPs. The first one, also known as non-discretionary component, depends on expected future credit losses and is added to specific reserves (Beaver & Engel, 1996; Whalen, 1994). The non-discretionary component is at the basis of the cyclicality of LLPs and leads to a misevaluation of expected credit losses (Bikker & Metzemakers, 2005; Bouvatier & Lepetit, 2008; Laeven & Majnoni, 2003). The second component, called the discretionary component, is explained by the use of LLPs for the above mentioned management purposes. On the other hand, accounting practice distinguishes between specific and general provisions. The former depend on identified credit losses and increase specific loan loss reserves which are deducted from assets, whereas general provisions increase generic reserves to protect the bank against not yet identified losses and can be manipulated by managers' discretionary decisions (Bouvatier & Lepetit, 2008).

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Banks' provisioning policies are an important area of investigation not only for academic scholars, but also for international regulatory authorities, especially because of the relationship between LLPs and bank capital requirements with the credit cycle. Low specific provisions during expansion periods push banks to grant new loans while their incentives to supply new credits decrease during downturns, when banks are constrained to set aside a larger amount of provisions, it becomes harder to meet prudential capital requirements and credit institutions are more likely to reduce their lending activity. The pro-cyclical nature of both capital requirements and provisioning rules has been strongly emphasized following the introduction of the Basle II Capital Accord (see, among the others, Bouvatier & Lepetit, 2008; Bikker & Metzemakers, 2005) and requires greater collaboration between accounting setters and banking regulators, especially after the financial crisis started in 2007 in the US and expanded to Europe in 2008. As a response to the crisis, the European Union introduced relevant changes to its financial supervision architecture. In particular, a new body for macro-prudential supervision, the European Systemic Risk Board (ESRB), and, based on a sectoral approach, three micro-prudential supervisors, namely, European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) were created. Focusing on the banking sector, in order to ensure the proper functioning and integrity of financial markets and the stability of the financial system, the EBA has to monitor and assess market developments as well as to identify trends, potential risks and vulnerabilities stemming from the micro-prudential level. To conduct such an analysis the EBA has the powers to initiate and coordinate the EU-wide stress tests, in cooperation with the ESRB. These tests aim to assess banks' resilience to adverse market developments and to contribute to the overall assessment of systemic risk in the EU financial system.

Based on these issues and also motivated by the debate on the opportunity of a stricter banking regulation (i.e., Basel III counter-cyclical buffer) and supervision (i.e., EBA stress tests), this research investigates how the financial crisis have affected bank managers' incentives to discretionally use LLPs during the financial crisis erupted in 2008 in Europe by testing whether banks use of LLPs for income smoothing and capital management increased during the crisis. In particular, we analyze the period 2005–2011 for a sample of Euro Area banks, by detecting potentially different behaviors of listed banks and of banks subject to the EBA 2010 and 2011 stress tests. The consequences of the crisis on US bank managers' provisioning policies have been previously investigated by El Sood (2012), whereas, to the best of our knowledge, the effects on Euro Area banks have not been fully investigated yet in order to account for the following issues. The crisis severely affected loan portfolio quality and earnings of Euro Area banks and might have reduced the possibility to manage income and regulatory capital via LLPs, due to the increase of specific/non-discretionary provisions, that are inversely correlated with bank loans quality. Nevertheless, because banks' regulatory capital ratios decreased during the crisis due to the decline in their credit portfolio quality, even higher incentives to shift risk (Fonseca & Gonzales, 2008) arose. Moreover, a stricter supervision, as that imposed by the EBA amidst the crisis through the 2010 and 2011 stress testing exercises, required banks to be resilient to stressed scenarios and imposed more pressure on bank managers' decisions. To the best of our knowledge this is the first research investigating whether and to what extent managerial incentives have been affected by the financial crisis and the new, stricter form of financial supervision at the EU level, thus leading to an increased discretionary use of LLPs in the crisis period compared to the pre-crisis period.

The empirical analysis is based on an unbalanced panel of banks from 12 Euro Area countries observed over the 2005–2011 time horizon. In particular, the overall number of banks ranges from a minimum of 114 in 2005 to a maximum of 205 for the years 2007, 2008 and 2009; listed banks range from 35 in 2005 and 2011 to 42 in 2007, 2008 and 2009. The sample includes 28 credit institutions that were subject to both 2010 and 2011 EBA stress tests.

Our results show that banks tend to smooth income but not to influence regulatory capital via LLPs. In particular, the discretionary use of LLPs to smooth income increased even more during the crisis compared to the pre-crisis period, irrespective of the type of banks' ownership, suggesting that both publicly traded and private banks share the same incentives to shift risk and improve their risk perceptions. While this latter result is partially in contrast with previous literature (Anandarajan et al., 2007), this evidence can be explained by the peculiar features of the recent financial turmoil, originated by a toxic assets contagion in the financial markets, and the growing recourse to market-based funding by both listed and unlisted banks before the crisis broke out. As to the behavior of banks that underwent the EBA stress tests, we observe that the disclosure of the 2011 test results together with the release of a detailed set of sensitive information is associated with more income smoothing by tested banks via an increased discretionary use of LLPs, as they need to stabilize their income in order to improve the market's perception of their risk.

In order to confirm our results, we run a number of robustness checks. First, we test our hypotheses excluding Spanish and Greek banks due to the specific provisioning mechanism adopted in Spain and the extremely difficult financial and economic conditions in Greece during the investigation period. Then, from a methodological point of view, we also run the further two checks: to mitigate possible concerns about endogeneity issues, we run a GMM estimation; to address potential issues associated with the treatment of outlier observations, we winsorize our regression variables. In both cases, we find that our results are qualitatively unchanged.

Overall, this research contributes to the call for a better coordination of accounting setters', regulators' and supervisory authorities' actions, especially during a financial crisis, when stronger incentives to manipulate LLPs might arise and lead to an increase in the discretionary use of LLPs for income smoothing and capital management. Furthermore, by shedding more light on the behavior of banks that underwent this relatively new form of financial supervision, this paper contributes to the debate on the opportunity to disclose supervisory tests results.

This paper proceeds as follows. In section 2, we analyze the rationale for discretionary use of LLPs and develop our research hypotheses. Section 3 describes our data, sample selection and outlines methodological aspects of this study. Section 4 provides a discussion of our findings. Section 5 checks the robustness of our results and section 6 concludes.

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