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Regulatory pressure and income smoothing by banks in response to anticipated changes to the Basel II Accord [☆]

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ABSTRACT

We examine the effects of the revised Basel II rules on bank managers' discretionary behavior, specifically income smoothing and loan loss provisioning. As the revised rules exert greater regulatory pressure on corporate than retail banking, we predict corporate bank managers to reduce risk-taking activities or increase income smoothing. Analysis of segmental reports reveals greater (less) income smoothing in the corporate banking segments of low-capital (high-capital) banks during the Basel II period, with their managers recognizing loan loss provisions in a less timely fashion. We find no such effects for retail banking. Although we document an initially negative market reaction to the regulatory announcements, that reaction weakens over time. Overall, the study highlights the unintended consequences of the banking rule changes.

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1. Introduction

The Basel II Accord places greater emphasis on the risk sensitivity of bank assets than the 1988 Basel Accord (i.e., Basel I). Basel II's aim was to constrain banks' risk-taking activities by imposing higher capital requirements on banks with riskier assets (Basel, 2006). As banks make a trade-off concerning the returns and risks of various activities, they may engage in more or fewer risk-taking activities in response to the proposed changes in Basel II. In this study, we examine whether those changes are associated with a greater amount of discretionary behavior in bank financial reporting. Our findings suggest that the proposed changes to the banking rules in Basel II may have had unintended consequences. The decision to require banks to improve their capital adequacy placed some banks under increased regulatory pressure to engage in manipulative behavior in the form of income smoothing and less timely loan loss recognition.

Prior banking research shows that bank managers have incentives to engage in three types of discretionary behavior (e.g., Beatty et al., 1995; Collins et al., 1995; Beaver and Engel, 1996; Ahmed et al., 1999; Kanagaretnam et al., 2004; Perez et al., 2008). First, bank managers are prone to managing capital because proper capital management is crucial to determining the effectiveness of bank operations. More specifically, they decrease (increase) loan loss provisions when their banks' capital adequacy ratios are high (low). Second, bank managers have incentives to engage in income smoothing behavior, that is, to decrease (increase) loan loss provisions when current period income is low (high). Third, bank managers may also engage in discretionary behavior to signal future earning performance. Thus, they increase loan loss provisions when they anticipate that future income will be high.

Here, we examine how bank managers react to the proposed regulatory changes to Basel II. Our specific focus is on the effects of these changes on income smoothing and the timeliness of loan loss provisioning. By imposing more stringent capital requirements and the stricter monitoring of risky banks, the aim of the Basel II rules was to remedy a major weakness of the Basel I Accord, that is, its failure to distinguish between the levels of credit risk in commercial and industrial loans (Jacques, 2008). Under Basel I, all commercial loans, regardless of credit quality, are assigned a 100% risk weight. The Basel II rules, in contrast, take into account differences in the credit ratings of the loans banks hold (Basel, 2006). Thus, Basel II is expected to reduce banks' risk-taking incentives (Elizalde, 2007).

Corporate banking is generally viewed as riskier than retail banking (Kohler, 2013).[2] Hence, we expect the revised Basel II rules to adversely affect corporate and investment banking to a greater extent than retail banking. The increased regulatory pressure may induce corporate banking managers to either reduce their risky activities or engage in greater income smoothing to reduce earnings volatility and perceived risk. Corporate banking managers in banks with low capital adequacy ratios need to maintain risky activities to sustain their revenue streams. Hence, any reduction in those activities will negatively affect earnings and shrink the bank's earnings base. Accordingly, we predict the corporate banking managers of low-capital banks to be likelier to engage in greater income smoothing to reduce perceived earnings volatility and risk than their counterparts in banks with high capital adequacy ratios, who have the capacity to curtail their risk-taking activities, and hence may not resort to income smoothing.

We also examine the effects of the rule changes on the timeliness of loan loss recognition in both the corporate and retail banking sectors. The Basel II rules impose a more sophisticated risk assessment structure on banks than the Basel I rules. They require banks to assess their capital adequacy and risk positions with greater accuracy. Although the banks in our sample use the incurred loan loss provisioning method specified by either U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS), they still enjoy substantial discretion in determining their loan loss provisions. One possibility is that the greater risk sensitivity required in regulatory reporting may spill over to banks' financial reporting practices, with the result that they are timelier in recognizing loan loss provisions in their loan portfolios.

[2] We define retail banking as comprising the following segments: consumer/retail banking, including credit card services, community banking and commercial banking to small- and medium-sized enterprises (SMEs). Consequently, we define corporate banking as comprising the following segments: corporate banking and investment banking, asset/fund management, treasury/global markets, wealth/private banking and wholesale banking. Hence, for a typical bank, retail and corporate banking activities constitute the entirety of banking operations.