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Banks' Use of Accounting Discretion and Regulatory Intervention: The Case of European Banks' Impairments on Greek Government Bonds

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ABSTRACT

This paper analyzes troubled banks' use of accounting discretion and its interaction with regulatory intervention in a time of financial distress. We analyze impairment losses that Europe's largest banks recognized on Greek Government Bonds (GGB) during 2011, the time during which GGB were considered impaired. Our findings reveal considerable variation in the impairment ratios across banks. Banks with larger GGB exposures, for which a full impairment would deplete a large share of regulatory capital, recognize significantly lower impairment ratios. Furthermore, we find that troubled banks delay full impairments until state aid is provided. Troubled banks recognize significantly lower impairment ratios in the quarter before they are provided with state aid, but substantially increase their impairment ratios afterwards. This pattern is consistent with the notion that troubled banks initially understate impairments to conceal the full extent of their financial difficulties from less sophisticated non-regulator outsiders (e.g., depositors and the general public), which increases regulators' ability to practice forbearance by not intervening immediately.

1. Introduction

This paper analyzes troubled banks' use of accounting discretion and its interaction with regulatory intervention. During economic downturns, troubled banks have a strong incentive to exploit room for accounting discretion to overstate assets and, consequently, equity and regulatory capital. This may allow troubled banks to conceal their financial difficulties from outsiders, prevent or delay intervention by regulators, and ultimately enable these banks to continue operating.

There is evidence that troubled banks use accounting discretion to overstate capital, particularly during economic downturns (e.g., Huizinga & Laeven, 2012; Shrieves & Dahl, 2003; Vyas, 2011). Our study contributes to this literature by examining two research questions: Do troubled banks use accounting discretion to overstate capital when this overstatement is highly visible to outsiders? Does banks' overstatement of capital, in such a situation, serve (i) to mislead regulators or (ii) to mislead non-regulator outsiders?

We analyze impairment losses that European banks recognized on Greek Government Bonds (GGB) as of June (Q2), September (Q3), and December (Q4) of 2011, the time when the Greek debt crisis intensified and GGB were impaired. Our sample includes

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54 banks. Together, these 54 sample banks' GGB holdings account for nearly the entire GGB exposure held by European banks. Some of the sample banks were initially well capitalized but held considerable exposure in GGB, so that recognizing full impairment losses on GGB would have depleted a major share of their regulatory capital (referred to as "troubled banks" in the following). Our findings indicate that banks' GGB exposure was the major determinant for banks' financial distress and significantly predicts the amount of state aid that banks received during 2011 and 2012.

We find a large variance in the impairment ratios across banks, even though observable market prices should have effectively limited banks' room for discretion. Banks with larger GGB exposures, for which a full impairment would deplete a large share of regulatory capital, recognized significantly lower impairment ratios. When trying to reconcile this variance in observable impairment ratios with the measurement requirements in International Accounting Standard (IAS) 39, it appears that banks took considerable liberty in applying the measurement requirements, especially during Q2 and Q3 2011.

Because banks' opportunistic use of accounting discretion is highly visible in our setting, this finding raises the question as to whether banks' overstatement of capital was aimed at misleading regulators or non-regulator outsiders. There are two alternative mechanisms through which troubled banks' overstatement of capital could translate into a lower risk (or delay) of intervention by regulators (Bushman & Landsman, 2010). These two mechanisms differ in terms of which group of outsider is unable to "see through" troubled banks' overstatement of capital.

On the one hand, regulators could be misled by banks' use of accounting discretion. If regulators are not able to see through banks' overstatement of capital, then regulators cannot identify troubled banks and are unable to assess the full extent of their financial difficulties, which keeps regulators from intervening.

On the other hand, there exists an alternative mechanism: regulators are able to see through this overstatement of capital, but less sophisticated outsiders, such as depositors and the general public, are misled. When depositors and the general public are unaware of banks' financial difficulties, depositors cannot exercise market discipline (i.e., by withdrawing their funds from troubled banks) and regulators feel less pressured to intervene. Hence, if banks are successful in concealing their financial difficulties from less sophisticated outsiders, then regulators' ability to practice forbearance on these banks increases (Gallemore, 2016).[2]

To examine whether troubled banks overstate capital to mislead regulators or to enable regulators to practice forbearance by misleading less sophisticated outsiders, we chose to investigate a setting (i) where troubled banks' opportunistic use of accounting discretion is unlikely to mislead regulators and (ii) which allows us to analyze the interaction of banks' use of accounting discretion and regulators' reaction (i.e., the provision of state aid).

Our findings illustrate that the amount of state aid provided is significantly associated with banks' GGB exposures. This indicates that state aid was provided to compensate banks for the losses associated with impairments on GGB. However, the question is whether state aid is provided *after* or *before* banks recognize full impairments on GGB. For this reason, we examine the chronological sequence of banks' GGB impairment decisions (impairment ratios) and the provision of state aid.

If troubled banks are successful in concealing the full extent of their financial difficulties from regulators by understating impairments on GGB, then we should observe that state aid is provided *after* banks recognize full impairments on GGB. This chronological sequence would suggest that regulators did not become aware of a bank's financial difficulties until the bank recognized a full impairment on GGB. Only then would the full extent of the bank's financial difficulties be revealed and provoke the provision of state aid. If, however, we observe that state aid is provided *before* banks recognize full impairments on GGB, we conclude that regulators had been able to "see through", but chose to tolerate, banks' understatement of impairments on GGB (regulatory forbearance).

Indeed, we find that troubled banks delay full impairments until state aid has been provided. More specifically, in the quarter before troubled banks are provided with state aid, their impairment ratios are significantly lower than those recognized by the remaining sample banks. After state aid has been provided, we find that troubled banks substantially increase GGB impairments (i.e., after state aid is provided, troubled banks recognize comparable or even higher GGB impairments than their peers). This pattern indicates that troubled banks are willing to recognize high impairments only after state aid has been provided, because the capital injected by the government can absorb the associated impairment losses.

In line with this, we find that a bank's GGB impairment ratio predicts the amount of state aid that the bank will subsequently receive. Banks that recognize lower impairment ratios in the respective quarter receive a higher amount of state aid in subsequent quarters. This finding is consistent with the notion that regulators (governments) could identify troubled banks, and could even determine the amount of equity capital that these banks need to catch up with the GGB impairment ratios of their peers (i.e., full impairment ratios).

Against the backdrop of our findings, it is hard to escape the conclusion that regulators were able to identify troubled banks already in the quarter when banks aimed to conceal their financial difficulties by understating impairments on GGB. However, this understatement of GGB impairment ratios might have misled less sophisticated non-regulator outsiders (e.g., the general public and depositors) and enabled regulators to practice forbearance by not intervening immediately. In this situation, regulatory forbearance would have provided governments with additional time to organize the provision of state aid, which may take considerable time if the government is facing financial difficulties as well.[3]

[2] Similar to Gallemore (2016), we use the term "regulatory forbearance" to refer to a situation where regulators decide not to close a troubled bank, but allow the bank to continue operating.

[3] Countries that provided state aid to troubled banks and were financially constrained themselves first had to request financial assistance from EU member states until they were able to recapitalize their domestic banks. For instance, while Spain had already requested financial assistance from the Eurogroup for its troubled banks in June 2012, the funds were only provided to Spanish banks in December 2012 (ESM, European Stability Mechanism, 2013; Quaglia & Royo, 2014).

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