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Bank earnings forecasts, risk and the crisis[☆]



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ABSTRACT

This paper explores the ability of financial analysts to gauge the risk taken by banks and investigates the impact of the recent financial crisis. Using a sample of 36,343 forecasts issued for 411 European banks over 2003–2009, we find that forecasting abilities are negatively influenced by bank-specific risks, except market risk. We also find that forecasting abilities vary over time: during the crisis (insolvency, credit, liquidity and market specific) risks increase earnings forecast errors, whereas before the crisis they do not influence forecasting abilities as expected. Finally, we find that during the crisis all risk indicators significantly reduce forecasting abilities of both types of analysts (optimistic and pessimistic). Analysts' forecasting abilities prove to be worse at the height of the financial crisis, when increasing uncertainty and informational asymmetries are built-up by European banks. This questions the effectiveness of analysts in the market discipline process.

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1. Introduction

The financial crisis highlighted limitations and distortions in the perception of risks faced by banks. Various parties were culpable to risk underestimation including: top management, boards of directors,

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rating agencies, regulatory and supervisory authorities and so on. However, the ability of outsiders to perceive the risk faced by banks is essential for the functioning of market discipline (Flannery, 2010; Maclachlan, 2001; Stephanou, 2010).³ Nevertheless market discipline does not appear to have prevented banks from taking-on excessive risk in the period preceding the recent financial crisis. Many of the world's largest banks held insufficient levels of capital relative to the risks taken (Crotty, 2009). Clearly, market participants were either misinformed or simply did not react appropriately to available information. We focus therefore on a key component of the financial community (analysts) to investigate whether they demonstrate a distinctive ability to gauge the risks taken by banks.

Consistent with Bradshaw (2009),⁴ we seek to open up the 'black box' of analysts' information processing, by examining their ability to gauge the risks taken by banks over the recent financial crisis. This framework leads us to address three research questions relating to bank earnings forecasts and risk. First, what is the influence of bank risks on forecasting abilities of analysts? Second, do forecasting abilities change in times of financial crisis? Third, do forecasting abilities vary for various types of analysts (optimistic vs. pessimistic)? Using a sample of 36,343 analyst forecasts issued for 411 European banks over 2003–2009, we find that forecasting abilities are negatively influenced by bank-specific risks, except for market risk. We also find that forecasting abilities vary over time: over the acute-crisis period (July 2007–March 2009) our risk indicators (insolvency, credit, liquidity and market specific) increase earnings forecast errors, whereas before the crisis they appear not to impact on forecasting abilities as expected. This is confirmed when we take into account all risk measures simultaneously, and when we consider interconnections among risk measures and their link to bank business models. As analyst views on the influence of different risks appear to vary over time, and their forecasting abilities prove to be worse at the height of the financial crisis when increasing uncertainty and informational asymmetries are built-up by European banks, our results question their effectiveness in the market discipline process. Finally, we find that during the crisis bank risks negatively affect the abilities of both types of analysts.

The paper is organised as follows. Section 2 presents the motivations for this study in light of the literature on analysts' forecasts. Section 3 considers methodological issues relating to the measurement of analysts' forecast errors and bank risk and Section 4 illustrates the sample and describes the empirical results. Section 5 contains robustness tests and Section 6 concludes.

2. Literature and hypotheses

Analysts, as a key component of the financial community, should demonstrate a distinctive ability to gauge risks taken by (listed) banks. Previous literature has shown that analyst forecast dispersion may reflect uncertainty in expected future cash flows (Avramov et al., 2009; Zhang, 2006) as well as information asymmetry (Barry and Jennings, 1992). Information asymmetries and uncertainties surrounding cash flows can act as an element of insolvency risk according to structural default models (Merton, 1974). As such, one should expect to see a positive link between measures of forecast errors/dispersion and insolvency (and other) risks if analysts accurately gauge an increase in default and other risks in the system. Accordingly our hypothesis is that the forecasting abilities of analysts are negatively influenced by bank risk.

There is an extensive empirical literature dedicated to non-financial firm analyst forecasts (see Kothari, 2001; Bessembinder, 2006; Ramnath et al., 2008; Schlumpf et al., 2008; Emery and Li, 2009; Balboa et al., 2009; Liu, 2011; Kim et al., 2011; Datta et al., 2011; Jordan et al., 2012; Hovakimian and

³ In an ideal situation, market discipline sanctions banks that take-on excessive risk by increasing the cost of unsecured funding (equity) and subordinated debt (wholesale deposits and bonds) which in-turn encourages a reduction in the volume of intermediation and other activity. Market discipline therefore should moderate the consequences of moral hazard that leads banks to assume excessive risk.

⁴ Bradshaw (2009) argues that analysts' decision processes should be viewed as a series of stages, and the most interesting ones are the 'black boxes' (information processing and valuation) that lead either to earnings forecasts or stock recommendations. It is the first of these black boxes that we consider here.

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