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# Information asymmetry, capital adequacy, and market reaction to loan loss provision announcements in the banking industry

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**Abstract**

This study finds significantly negative abnormal returns accompanying press announcements of loan loss provisioning in the banking industry. The negative reactions are shown to arise from both an informational asymmetry regarding asset value and the costs associated with capital adequacy regulation. It is further shown that the market reaction depends upon the type of asset being provisioned. Announcements regarding the provisioning of foreign debt are accompanied by positive market reactions, while announcements of the provisioning of real estate loans and other types of debt are accompanied by negative market reactions. 

## 1. Introduction

Several studies have found significantly positive excess returns associated with loan loss provision (LLP) announcements in the financial press. These findings have led some researchers to conclude that loan loss provisioning is, in general, good news and is accompanied by increases in stock prices. Beaver, Ryan, and Wahlen (1997, p. 45) summarize the recent research as follows: “According to recent empirical research, discretionary loan loss provisions are, on average, positively associated with bank stock returns; that is, they are ‘good news.’”

This paper finds, however, that positive excess returns are not representative of all market responses to LLP announcements. In fact, significantly negative abnormal returns are, on

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average, associated with these announcements. The negative abnormal returns are related to both informational asymmetry regarding asset value and to bank capital adequacy problems that are either precipitated or aggravated by the announced decline in the value of the assets. Further, the sign of the excess return depends upon the type of asset being provisioned; foreign debt LLP announcements elicit a positive response while LLP announcements for other types of loans (especially real estate loans) are accompanied by a negative response.

The results of this study are of interest to bank managers, regulatory authorities, security analysts, and investors. Bank mangers are concerned that unexpected loan loss provisions may adversely affect the price of the bank stock. This paper shows that such concerns are well founded. Bank managers and regulatory authorities are interested in and troubled by the costs associated with the regulation of capital adequacy. This paper shows that capital adequacy related regulatory costs have a negative influence on the price of banking stock. Investors and security analysts are interested in the valuation implications of LLP announcements. This study shows that, with the exception of foreign debt announcements, increased loan loss provisions convey adverse information to the market.

## 2. Background

The intrinsic value of bank assets changes over time. Loan portfolios decline in value as some of the individual loans become nonperforming. Accordingly, the intrinsic value of the assets will differ from the value as represented on a firm's books. From time to time, banks will adjust the book value of the assets to reflect the changes in value. At some point prior to the classification of the loan as uncollectible, an adjustment is made to a contra asset account—called an "allowance for loan losses" account—to account for a portion or for the entire loan. An offsetting expense called the "provision for loan losses" is charged against net income. This offset will reduce reported income but has no impact on taxes (prior to 1987, increases in loan loss provisions decreased taxes, but the treatment was changed by the Tax Reform Act of 1986).[1] When the loan is classified as uncollectible, the portion of the loan that is deemed uncollectible will be removed from both the asset account and from the allowance for loan losses account. The process of removal is often referred to as "charging off" or "writing down" the loan. When the assets are finally written down, a tax-deductible expense is created.

Loan loss provisioning affects a banking firm in several ways:

1. Reported net income will be less for the period in which the loan loss provision is taken.
2. If the bank eventually writes down the asset, the write down will reduce taxes and thus increase the firm's cash flows.
3. The loan loss provision affects manager compensation to the extent that compensation is tied to net income.
4. The loan loss provision may signal a change in strategy with regard to asset management.
5. Measures of capital adequacy are generally calculated using the book value of assets