Accounting discretion, loan loss provisioning, and discipline of Banks’ risk-taking

Robert M. Bushman a, Christopher D. Williams b,*

a Kenan-Flagler Business School, University of North Carolina-Chapel Hill, USA
b Ross School of Business, University of Michigan, USA

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Examining banks across 27 countries, we estimate two measures of the forward-looking orientation reflected in discretionary loan provisioning practices within a country. We document that forward-looking provisioning designed to smooth earnings dampens discipline over risk-taking, consistent with diminished transparency inhibiting outside monitoring. In contrast, forward-looking provisioning reflecting timely recognition of expected future loan losses is associated with enhanced risk-taking discipline. Thus, proposals to change loan loss accounting embed significant risks of unintended consequences, as gains from reducing pro-cyclicality may be swamped by losses in transparency that dampen market discipline and increase the scope for less prudent risk-taking by banks.

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1. Introduction

The objectives of accounting standard setting differ from those of bank regulation. General purpose financial reporting is concerned with providing information to those outside the firm to support a wide range of decision contexts and contractual arrangements. In contrast, prudential bank regulation seeks to limit the frequency and cost of bank failures, and to protect the financial system as a whole by limiting the frequency and cost of systemic crises (e.g., Rochet, 2005). These differing objectives are at the center of a standing debate over loan loss accounting as reflected in recent high profile proposals by the Financial Stability Forum (2009) and U.S. Treasury (2009). Policy makers argue the incurred loss model underlying current loan loss accounting reinforces pro-cyclical effects of bank capital regulation, and should therefore be...
changed to allow bank managers more discretion to incorporate forward-looking judgments into loan loss provisions. However, while mitigating pro-cyclicality is an important objective, it is also important to understand other possible consequences of changing loan loss accounting.

In this paper, we explore consequences of increased loan provisioning discretion for accounting information's role in supporting outside discipline of bank risk-taking. Using a large sample of banks from 27 countries, we estimate two distinct constructs of the extent to which discretionary loan provisioning practices within a country reflect a forward-looking orientation. We investigate whether each aspect is associated with stronger or weaker discipline of bank risk-taking. We find that discretionary, forward-looking provisioning can be associated with either enhanced or diminished discipline of bank risk-taking, depending on the specific nature of the forward-looking orientation embedded in provisioning practices. That is, some manifestations of forward-looking provisioning dampen disciplinary pressure on risk-taking, consistent with diminished transparency inhibiting outside monitoring. Our results suggest that any attempt to achieve more forward-looking loan provisioning must take care to avoid significant unintended consequences.

Financial accounting information plays a fundamental corporate governance role, supporting monitoring by boards of directors, outside investors and regulators, and the exercise of investor rights granted by existing laws (e.g., Bushman and Smith, 2001). Related to this idea, the banking literature posits that informational transparency of banks plays a fundamental role in promoting market discipline as a lever of prudential bank regulation. Market discipline is conceptualized as a process by which market participants monitor and discipline excessive risk-taking by banks. A key building block of market discipline is public availability of timely, consistent and reliable information on banks' financial performance and risk exposures (Stephanou, 2010). Financial accounting is clearly a primary source of such information.

Loan loss provisioning is a key accounting choice that directly influences the volatility and cyclicality of bank earnings, as well as information properties of banks' financial reports with respect to reflecting loan portfolios' risk attributes. While the precise form that more forward-looking provisioning should take remains an open question, proposals to date generally incorporate a broader range of information and create an expanded role for managerial discretion in assessing future expected losses. However, accounting discretion is a double-edged sword (e.g., Dechow and Skinner, 2000). While increased discretion may facilitate incorporation of more information about future expected losses into loan provisioning decisions and mitigate pro-cyclicality, it also increases potential for opportunistic or misguided accounting behavior by managers that can degrade bank transparency and lead to negative consequences along other dimensions (e.g., Wall and Koch, 2000).

To investigate implications of discretion in loan loss provisioning for risk-taking, ideally we would directly compare the incurred loss model with specific alternatives. However, this is not possible as such alternatives have not yet been implemented. Instead, we use a large sample of banks from 27 countries to exploit cross-country variation in allowable discretion in loan provisioning behavior. Discretionary provisioning is estimated relative to an extensive set of non-discretionary determinants of loan loss provisions. We estimate two distinct aspects of provisioning practices that can be construed as reflecting a forward-looking orientation.

Our first measure is smoothing, defined as the coefficient from a regression of loan loss provisions on contemporaneous earnings, after controlling for non-discretionary determinants of loan loss provisions. Higher sensitivity of current provisions to current period earnings realizations is interpreted as greater discretionary smoothing. The banking literature posits that smoothing is implicitly forward-looking in nature and can mitigate pro-cyclicality. The idea is that smoothing allows a buildup in reserves when earnings are high and current losses are low, and a reserve draw down in future periods when earnings are low and current loan losses are high (e.g., Borio et al., 2001; Laeven and Majnoni, 2003; Bikker and Metzemaekers, 2004). However, providing more discretion to smooth provisions permits opportunistic earnings management that obscures fundamentals, instead of enhancing earnings informativeness. We indirectly distinguish these possibilities by investigating the implications of smoothing for the discipline of bank risk-taking.

Our second measure uses a future outcome variable to isolate the extent to which explicit forward-looking information is reflected in current loan provisioning within a country. We use the coefficient from regressing current period loan loss...
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