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How accounting and auditing systems can counteract risk-shifting of safety-nets in banking: Some international evidence

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Abstract

This paper suggests that accounting and auditing systems can be effective devices to counteract tendencies for firm risk-taking associated with bank safety nets. Results are obtained from an international sample of publicly traded banks after controlling for other regulatory control devices for bank risk such as restrictions on banking activities, minimum regulatory capital requirements and official discipline. The efficacy of accounting and auditing systems in controlling bank risk diminishes with bank charter value and increases with moral hazard stemming from a country's deposit insurance. The results also indicate that accounting and auditing systems are complements for minimum capital requirements, but substitutes for restrictions on bank activities and official discipline.
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1. Introduction

Analysis of bank stability revolves around the counterpoised effects of deposit insurance. On the one hand, the introduction of deposit insurance is aimed at stemming the threat of depositors' runs in the short-run. On the other, in the long-run it reduces incentives for depositors to monitor and police their banks. The net benefits that accrue to society depend on how effectively government

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regulators can control bank risk-shifting through other regulations and supervision (Buser et al., 1981; Brickley and James, 1986; Kane, 1995; Hovakimian et al., 2003). The new Basel Accord II emphasizes the strengthening of regulations (e.g., minimum regulatory capital requirements in Pillar 1) and of supervision by the authorities (Pillar 2), as well as market discipline (Pillar 3) as tools to increase bank stability, and such international institutions as the Bank for International Settlements, the International Monetary Fund, and the World Bank are all encouraging countries to move towards enhanced bank supervision. Greater information disclosure and external audit requirements that provide greater transparency can both play a crucial role in the above context, since they encourage not only improved market discipline but also better regulatory devices by providing regulators and supervisors with useful information.

All research providing evidence on the role of accounting and auditing systems comes from the industrial sector; as yet, there is no evidence from the banking sector, where its usefulness as a tool to supervise and monitor managers may be different for two basic reasons. First, in banking there are alternative regulatory devices that may limit investors' incentives to apply accounting and auditing systems to control and assess bank managers' performance. Regulatory restrictions on activities that banks may involve themselves in and regulatory minimum capital requirements both limit bank managers' scope of action and may reduce incentives of depositors and shareholders to supervise, thereby limiting the usefulness of accounting and auditing for such ends. Secondly, the role of supervisors as new information petitioners partially takes over the role of the market, which may influence the usefulness of accounting and auditing systems if the market provides different information. Avery et al. (1988) show that the private sector ratings and the regulators' assessment of bank risk (the FDIC index) are uncorrelated. Such discrepancy between the regulators' and the market's assessment of bank risk may reflect that each stakeholder uses different sources of information and that accounting and auditing systems may be being put to different uses.

Moreover, differences in regulations and official supervision presumably mean that the role and relevance of accounting and auditing requirements in banking will also differ from one country to the next. However, to our knowledge, no empirical study of the changing roles of accounting and auditing systems in banking across countries has yet been undertaken. This paper attempts to offer evidence on this issue and applies an international bank database to analyze differences in the effectiveness of accounting and auditing systems in producing a more stable banking system across countries depending on the national characteristics of bank regulation and official supervision. Our basic aim in the paper is to answer three questions: (1) What is the contribution of accounting and external auditing requirements to controlling bank risk taking, given the regulatory environment of banks including the restrictions on banking activity, minimum regulatory capital requirements and the discipline that supervisors impose upon bank management? (2) Is the effectiveness with which bank risk is controlled different for each of these instruments? (3) Are these control mechanisms complements or substitutes?

The paper that ties in most closely with our work is that of Barth et al. (2004), which applies data from 52 countries to an analysis of the varying likelihood of banking crises across countries as a function of each country's different regulatory and supervisory characteristics, and which finds that bank stability is negatively associated with restricting bank activities, with barriers to foreign bank entry and with the generosity of deposit insurance schemes. In contrast, they find no significant impact of measures targeting supervisory power, resources, independence, loan classification stringency and provisioning stringency, though they do claim that the development of regulatory and supervisory practices that empower private-sector corporate control of banks is the way to promote bank stability. However, our work differs from that of Barth et al. (2004)

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