Can supervisors enforce transparent accounting when the rules leave room for management discretion?

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Summary of the paper

- The ECB published valuation adjustments as part of its Asset Quality Review (AQR) before starting supervision of significant institutions on November 4, 2014
- This paper relates these AQR adjustments to subsequent bank outcomes
- The paper finds that banks with higher AQR adjustments:
 - raised loan loss provisions
 - improved accounting quality
 - experienced greater stock market liquidity

Why do banks change behavior following published AQR adjustments?

- The authors attribute this to 'soft and informal actions to nudge' according to the abstract
- This interpretation can not be proven or disproven, as the relevant private communication between the ECB and the banks cannot be observed
- However, there are alternative explanations that in part can be checked

Alternative explanations

- Accompanying supervisory interventions by the ECB that go beyond nudging:
 - supervisory engagement with the Audit Committee
 - capital regulation
- Variation in supervisory guidelines regarding loan loss provisioning
- Market discipline following the publication of the AQR results

Accompanying supervisory interventions by the ECB

• The ECB states in the Aggregate Report on the Comprehensive Assessment (ECB, 2014, p. 4):

... even where banks do not reflect adjustments in their accounts all conclusions will be captured in ongoing supervision and in supervisory capital requirements.

Supervisory intervention at the Audit Committee

- The ECB can engage with the Audit Committee
 - The Audit Committee is expected to draw up an audit plan that takes into account and follows up on findings of supervisory authorities (ECB Supervision Newsletter, May 2024)
 - It determines the pay of the head of the internal audit function
- The ECB should be able to influence the composition of the Audit Committee, and the appointment of its chair
- Did AQR adjustments trigger personnel changes in the bank's audit function?
- If so, this would go beyond 'nudging'

Capital regulation

- The ECB can interpret overly optimistic asset valuations as a risk factor
- To counter this, it can increase the P2 capital requirement
- P2 capital requirements were generally not disclosed during the sample period
- Furthermore, rationales behind P2 capital requirements remained confidential
- Hence, it is difficult to check whether high AQR adjustments led to high P2 capital requirements
- Higher P2 capital requirements, if any, provide incentives to increase loan loss provisions, and they are 'hard' policy

Capital regulation

- The adoption of SSM led to higher risk weights at significant institutions (Haselmann, Singla, and Vig, 2022)
- Higher risk weights create inconsistency between accounting and regulatory approaches of dealing with credit risk
- Hence, they could trigger higher loan loss provisions
- Previously, AQR adjustments were shown to be lower for banks in countries with more stringent pre-SSM capital regulation (Homar, Kick and Saleo, 2015)
- After SSM, are higher risk weights associated with higher loan loss provisioning?

Supervisory guidance on loan loss provisions

- Supervisory guidance on loan loss provisions provides minimum provisioning levels depending on the status of the loan
- These guidelines supplement and overwrite accounting rules
- Before SSM, countries had different stringencies of guidance on provisioning
- Banks subject to stringent pre-SSM guidance could display lower AQR adjustments and lower subsequent provisioning
- To check this, one can use the Provisioning Stringency index in the World Bank's Regulation and Supervision survey (Barth, Caprio, and Levine, 2013)
- This index measures 'the minimum required provisions as loans become substandard, doubtful and loss'
- This index is a better indicator of supervisory preferences than institutional characteristics such as High Government Efficiency currently used in Table 4.

ECB issued guidance on non-performing loans in 2017

- This guidance provided expectations for prudential provisioning of nonperforming exposures
- The issuance year of 2017 was within the sample period of the study of 2011-2017
- Hence, impact of the SSM on, say, provisioning, probably was not uniform during the SSM period. This can be checked

Enhanced market discipline

- The publication of the AQR results induced a negative average stock market reaction (Carboni, Fiordelisi, Ricci, and Lopes, 2017) that varied by country (Sahin and De Haan, 2016)
- CDS premiums for banks reacted as well (Sahin and De Haan, 2016)
- Markets reacted to the AQR results as they conveyed information about asset values per se and also about the informativeness of bank accounting information
- Negative market reactions incentivize banks to change their behavior
- They could, for instance, increase loan loss provisions to make their accounting information more informative, or they could announce changes to the composition of their Audit Committee

How to separate supervisory and market discipline?

- Market discipline should be more subdued for banks without a stock market listing
- Carboni et al. (2017) use data for 50 stock market listed significant institutions
- This suggests that many significant institutions do not have a stock market listing
- Was the response to the AQR results different depending on whether the bank has a stock market listing?

Conclusion

- This is a very nice paper that shows that banks changed their behavior in response to the AQR results
- There are several potential explanations for this that go beyond 'nudging' by the ECB
- Further tests can shed light on some of these alternative explanations