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The impact of economic slowdowns on financial institutions and their regulators: an overview

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The recent wave of large corporate failures and high-profile accounting scandals has renewed interest in understanding the incentives corporate managers have to fully reveal, on a timely basis, the financial condition of their companies. In the aftermath of the most recent recession, one can point to significant accounting irregularities at some of the largest publicly owned companies in the United States, despite the fact that the financial statements were audited and fell within the regulatory oversight required of public filings. This is particularly disconcerting given the extensive accounting standards, disclosure requirements, and oversight by stock exchanges, self-regulatory organizations, and other regulators in the United States. With the length of time many of these accounting irregularities were allowed to go on, many have begun to question whether outside auditors, hired by the firms they are auditing, have the appropriate incentives to uncover inappropriate or fraudulent activities.

Such problems may potentially be less prevalent in a regulated industry such as banking, where bank supervisors are responsible for closely monitoring the financial condition of banks. Supervisors do not have the direct financial incentive to conceal problems and have access to proprietary information through the on-site bank exam process. Supervisors also have the authority to require remedial action to be taken by a bank, such as requiring a change in accounting procedures, improvements to reserving policy, or enhancements to public disclosures, to just name a few. Whether supervisors effectively discover and rectify such accounting irregularities, however, has not been widely studied. The papers presented in this issue provide important insights into how bank management, as their bank's financial condition deteriorates during economic downturns, reveal such deteriorating condition to outsiders, given the potential impact of regulators on how banks cope with and report information during downturns. At a broader level, the question is: To what extent is bank regulation state-contingent?

The two papers published here were presented as part of a conference on the economic impact of economic slowdowns on financial institutions and their regulators held at the Federal Reserve Bank of Boston in April 2002. This general topic has received increased research and policy attention of late, in part due to the Basel II capital proposal where regulatory capital would increasingly rely on internally generated measures of bank risk exposures. Such a framework would require an enhanced role for bank supervisors, as they

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would be required to assess the appropriateness and accuracy of bank risk analyses. The papers presented in this issue focus on supervisory oversight of banks.

The paper by Gunther and Moore (this issue) directly examines the role that bank supervisors play in auditing banks. The authors hypothesize that troubled banks, often during economic downturns, have an incentive to hide the full extent of their financial problems by using aggressive, or in some cases, fraudulent, accounting practices. The authors also hypothesize that bank supervisors limit the ability of banks to use such aggressive techniques. To test this hypothesis, the authors compare the accuracy of bank financial statements when there is an on-going bank exam with the accuracy of bank financial statements when there is no on-going bank exam. The authors construct a unique database that includes original financial statement data as well as the final financial statement data that reflect any revisions to the original submission. These data are combined with bank exam data to determine if the financial statement revisions are the result of bank exams. The empirical tests show that bank exams often lead to significant restatements of financial results and that these misstatements are more likely to occur at troubled banks, though the authors find that misstatements do occur at healthy banks as well.

The results indicate that bank supervisors do play an important auditing role in uncovering unreported problems. In addition, these problems often occur at early stages of financial deterioration, giving the bank and its supervisors time to react to the emerging problems. While these results indicate an important role for bank supervisors in discovering financial difficulties and enhancing the transparency of financial conditions, it raises questions on the role of auditors and the ability of investors to rely on financial statements in the absence of this additional external review.

The paper by Laeven and Majnoni (this issue) examines bank loan loss reserving practices across several countries. Provisions (additions/subtractions to the reserve) for the loan loss reserves are the means for credit losses to be realized by banks. However, banks and bank supervisors have significant discretion in determining when a loan has become sufficiently impaired to require additions to loan loss reserves. The authors hypothesize that bank managers have a variety of reasons to manipulate the timing of loan loss provisions, including taxes, income smoothing, and forbearance. The authors' empirical work provides evidence of both income smoothing and postponing recognition of loan losses during economic downturns. In addition, they find significant variation in provisioning across countries.

The differences in provisioning policies have significant implications for prudential supervision of banks and for one of Basel II's goal of making a more level playing field for globally active banks. The results suggest that coordinated capital requirements will not result in consistent regulation of banks across countries, as long as there is inconsistent treatment of loan loss provisions across countries. Significant policy work needs to be done to harmonize policies across countries.

These two papers highlight the need for more research into understanding the role that bank managers, bank supervisors, and bank regulations play in disclosing a bank's true health, particularly during economic downturns. These papers highlight the lack of managerial incentive to accurately report losses during economic downturns. In addition, the authors show that poor reporting can be significantly altered by the bank supervisory or regulatory regime. As our largest financial institutions become increasingly global, our need to better understand where across-country differences remain increases, as does our need to enhance the skills of bank examiners to insure more accurate reporting of bank financial condition. A very interesting question that this line of research raises has to do with the interaction between information disclosure by regulated institutions *to investors* and regulatory initiatives. Given the linkages between information disclosure, earnings management, and stock returns that have been explored in various strands of the literature, the design of regulatory policy to potentially influence these linkages promises a rich harvest of insights in the future.