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MANDATORY DISCLOSURE AND BANK EARNINGS MANAGEMENT IN INDIA

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Abstract:

The study examines how mandatory disclosures impact banks' earnings management in India. The Reserve Bank of India (RBI) enforced disclosures fearing under declaration of non-performing assets (NPA) and attributable loan loss provision (LLP). In a way, such disclosure requirement was a "name and shame" strategy by the RBI. Our study hypothesizes disclosures to reduce information asymmetry and moral hazard - in a way reflected in the discretionary LLP. The results broadly support our hypothesis that regulatory enforcement through disclosures had the intended effect of hamstringing the banks' ability to manage earnings. Thus, mandatory disclosures positively affect discretionary LLP reduction, consequently minimizing the latitude that banks enjoy.

Keywords: Financial Sector, Commercial Banks, Private Banks, Government owned Banks.

Highlights:

Regulatory enforcements requiring mandatory disclosures do have an impact on earnings management. Disclosures reduce information asymmetry, thereby forbidding bank managers to use discretion in loan loss provision accrual. Weaker banks do not play down their asset quality and related loan loss provision as they are under the supervisory radar.

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Introduction:

The failure of the banking system has always led to prolonged economic distress (Bernanke, 2023). The 2007–2009 Global Financial Crisis and the earlier banking failures have a record of finding the same problem (non-performing loans), which often bent or, if not broken, the financial system. In most cases, it was evident that banks did not provide enough to cover for delinquencies. Such myopic attitude by banks provoked research around earnings management, an outcome of either under or over-provisioning for non-performing loans (Beatty et al., 1995). As loan loss provisions (LLP) require an assessment of asset quality, the identification process of bad loans is fraught with a margin of imprecision despite clear rules set by bank regulators. This gap in the identification process often leads to creating a buffer or imprudence in LLP estimates, commonly referred to - as discretionary accrual of LLP which could exacerbate the financial pressure on the bank. Thus, LLP creates increasingly undue incentives for managers to influence their capital management, earnings goals, taxes, and signaling future intentions to the stock market (Anandarajan et al., 2007; Curcio and Hasan, 2015).

The motivation for our study comes from the recent debacle of a private sector bank in India, Yes Bank, which reported only a small magnitude of bad loans (Economist, 2020). This under-reporting was possible through rolling over loans and/ or postponing the cognizance of impairment in loans i.e., the non-performing assets (NPA). Delaying recognition of credit impairment leads to lower LLP furthering earnings management practices. Earnings management studies received attention world-wide and primarily focused on two aspects - determinants of LLP and the outcome on the bank (Hasan and Wall, 2004) and incentives behind this opportunistic behaviour (Wahlen, 1994; Beatty and Liao, 2014). Regulators have tried their hands on conducting bank cleans ups, introducing disclosures, imposing penalties, and even debarring banks to operate. We find there are limited studies on the virtues and impacts of mandated disclosures on the opportunistic behaviour of banks/firms. There is considerable literature on the implications of bank/corporate disclosure on the functioning of an efficient capital market. Studies have shown how bank managers increase disclosure before raising equity, insider trades, equity vesting, patenting (Glaeser et al., 2020; Edmans et al., 2018). Regarding disclosure choices, studies have found that managers strategically disclose news that boosts stock prices and withholds bad news (Verrecchia, 1983). Banks provide disclosure through financial reports and other regulatory filings and also through conference calls, managerial guidance of earnings (Healy and Palepu, 2001). Although market impacts of voluntary disclosure are positive, there is increasing evidence that managers are reluctant to disclose negative information (Bertomeu and Cheynel, 2016). There is increasing regulatory initiative to mandate disclosure of certain crucial parameters where managers are unwilling to do so. The present study is cast in the background of episode of mandatory disclosure in the form of asset quality review (AQR) introduced by the Reserve Bank of India (RBI) - the banking regulator in India. The RBI in 2015 conducted an independent exercise to assess the true state of delinquent assets and clean-up of bank balance sheets (Rajan, 2016). During the same time, the RBI also withdrew the regulatory forbearance on delinquency recognition allowed by them since 2008 for restructured assets. The forbearance allowed a special regulatory treatment for asset classification related to restructured advances (Reserve Bank of India (RBI), 2008). This special allowance permitted all banks to enjoy non-degradation of 'standard asset' to any 'sub-standard' category upon restructuring, which was not the case earlier. Similarly, this kept the deterioration of 'sub-standard/doubtful accounts' undergoing restructuring to any subsequent category in abeyance. In parallel, the RBI acted swiftly to also bring the effects of the AQR exercise reflected to the public. In its fourth Bi-monthly Monetary Policy Statement, the regulator hinted the existence of the divergences between banks and the supervisor as regards asset classification and provisioning which was causing an incorrect reflection of the true value of the banking assets (Reserve Bank of India (RBI), 2015). The RBI signalled the introduction of disclosure requirements in the notes to accounts to the financial statements of banks where such divergences exceed a specified threshold for bringing in greater transparency, and better discipline concerning compliance with Income Recognition and Asset Classification Provisioning (IRACP) norms. Following this, in April 2017, the RBI brought in additional disclosures in the financial statements showing the divergence in asset classification, i.e., divergence in gross non-performing assets and provisioning, i.e., divergence in loan loss provision (Reserve Bank of India (RBI), 2017; Reserve Bank of India (RBI), 2019). In sum, during this 2013–2015 period, the RBI did three things. First, they conducted AQR to understand if the banks were following the prudential norms, i.e., Income Recognition and Asset Classification Provisioning (IRACP) norms. Second, they withdrew the forbearance in asset classification for restructured loans. Third, to ensure that the AQR efforts were reflected on the financial reports, the RBI introduced a divergence disclosure. This is the premise of our study. As the AQR exercise is an ongoing process, the banks disclose the divergence in gross non-performing assets and loan loss provisioning in their annual reports. We study between two time periods pre-AQR (pre-disclosure regime) and post-AQR (post-disclosure regime). As AQR came along with the disclosure requirement of the divergence in asset quality and provision, we interchangeably refer to AQR and divergence disclosure regime throughout the paper. We examine the impact disclosures imposed on banks through an exogenous event like an AQR conducted by the Reserve Bank of India (RBI) during 2015 in an emerging market economy (India). AQR is akin to the comprehensive assessment (CA) program, conducted in Europe, which attempted to quantify the bank risks to determine the appropriate capitalization level (Barucci et al., 2018). Regulators conducted similar exercises either through AQR or stress tests to achieve financial stability (Petrella and Resti, 2013; Lazzari et al., 2017). The AQR in India was necessary to ensure balance sheet clean ups, as banks enjoyed the forbearance in asset classification due to asset restructuring norms. This forbearance permitted non-deterioration of 'standard asset' or 'sub-standard/doubtful asset' to any next degraded category on restructuring. Thus, AQR was a jolt to the mushrooming practices of rolling over loans, commonly known as the "ever-greening" or "zombie-lending" due to decades of supervisory forbearance (Tantri, 2021; Chopra et al., 2021). AQR went a step further and imposed a mandatory disclosure of "divergence" which attempted to fast-track the identification of delinquencies. Regarding AQR, the RBI in its report on trends and progress in banking stated that: "AQR brought to the fore significant discrepancies in the reported levels of impairment and actual position and hence led to an increase in provisioning requirements" (Reserve Bank of India (RBI), 2016, p.1). Our motivation for this study is based on the movement worldwide from primary financial statement disclosure to supplemental disclosures (Beaver et al., 1989). The present study attempts to evaluate the effectiveness of mandated disclosures like a "name and shame strategy" in an emerging market context (India). Ghosh (2007), Das et al. (2012), Vishnani et al. (2019), Misra et al. (2020), and Biswas et al. (2022) have examined earnings management in Indian context. We extend this literature by examining the impact of mandated disclosure program on earnings management. The study is important as it provides evidence whether mandatory disclosures bring behavioural changes in the conduct and performance of banks and whether they have market impacts. Our study extends research on the impact of regulatory enforcement on earnings management (for e.g., Dal Maso et al., 2018, Mathuva and Nyangu, 2022) and makes the case for mandatory disclosures in emerging economies where market failures are prominent. We contribute to the literature in the following ways: First, the efficacy of mandatory disclosure measures on the conduct and behaviour in banks is an under-researched area. As India shifts from "incurred loan-loss model" to the "expected loan-loss model" in the coming years (Reserve Bank of India (RBI), 2022a) it is critical to understand whether better disclosures help in hamstringing opportunistic behaviours. Second, we examine whether weak banks have any heterogeneous banking behaviour. This is the context of a tendency among weak banks to manipulate earnings and defer recognition around the reporting date. Hence, this study would enable us to trace any differential behaviour among strong and weak banks.

Objective:

We examine the impact disclosures imposed on banks through an exogenous event like an AQR conducted by the Reserve Bank of India (RBI) during 2015 in an emerging market economy (India). AQR is akin to the comprehensive assessment (CA) program, conducted in Europe, which attempted to quantify the bank risks to determine the appropriate capitalization level (Barucci et al., 2018). Regulators conducted similar exercises either through AQR or stress tests to achieve financial stability (Petrella and Resti, 2013; Lazzari et al., 2017). The AQR in India was necessary to ensure balance sheet clean ups, as banks enjoyed the forbearance in asset classification due to asset restructuring norms.

Research Methodology:

Indian Banking Structure:

Banks are the dominant financial intermediaries in India, with bank deposits being the household sector's predominant portion of financial savings. Presently, there are about 78 scheduled commercial banks with around 151,304 branches at the end of March 2022 (see Table 1a). The aggregate deposits of banks as a percentage of national income come to 70% in 2022; the corresponding share of credit in national income is as high as 72%. The public sector banks (PSBs) still have a significant stake in

Literature Review and Hypothesis Development:

Signalling theory provides the theoretical foundation for disclosure by firms (Arrow, 1971; Spence, 1978). The underlying foundation of signalling theory is information asymmetry between the principal (owners) and agents (managers). Beaver et al. (1989) articulated the relevance of signalling theory in banking and provided evidence that banks with higher allowances for loan reserves tend to have higher market values. Signalling uses LLPs to convey fiscal prudence and future profitability to

Data Source:

The study is based on the data from the statistical tables related to banks published by the RBI and Prowess database of Centre for Monitoring Indian Economy. We build the econometric model using 48 scheduled public and private commercial banks which constitute nearly 95% of the deposits and credit of the entire banking system in India from 2016 to 2022. However, with a consistent consolidation spree in the banking space since 2015, the total

Empirical Results:

The average divergence in estimates of gross NPA of banks from RBI estimates (DIVNPA) was sizeable- INR 7138 million. As a proportion of the previous year's total assets, divergence in NPA (DIVNPATA), the average comes to 0.0025. The average divergence in LLP between RBI and the bank (DIVPROV) was also sizeable ~ INR 3330 million – slightly less than one-half of the NPA (DIVNPA) divergence.

Conclusions:

The Asset Quality Review (AQR) introduced in India in 2015 by RBI mandated banks to disclose the divergence in non-performing loans and LLP estimates from the RBI's assessment as supplementary disclosures. The main contribution of our study is the examination of how mandated disclosures impact the earnings management of banks. The mandatory disclosure of divergence in NPAs reduced discretionary loan loss provisions. This paper is the first attempt to demonstrate the efficacy of mandatory

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