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MANAGERIAL PREFERENCES FOR GAMBLING ON EXPECTED LOAN LOSS RECOGNITION

Abstract:

In this paper, we study the incentives of bank managers to keep low loan loss reserves (LLR) relative to nonperforming loans and address the long-term consequences of this activity on firm's fundamentals. The central premise is that LLR inadequacy results from a class of speculative decisions that essentially trades off current costs implied by timely credit risk recognition with potentially magnified, but uncertain costs implied by delayed recognition. Because there is a straightforward analogy with insurance avoidance, we hypothesize that a greater mismatch between LLR and impaired loans can be related to the main drivers of the demand of hedging and insurance, namely, risk preferences and hedging costs. We analyze a broad sample of publicly traded U.S. banks in the period 2001-2017. The results from our analysis show that, all else equal, the propensity to leave impaired loans uncovered is greater for banks characterized by (1) a corporate risk culture with stronger preferences for gambling, (2) poor performance, (3) systemic characteristics such as size and interconnectedness, and (4) greater discretion in loss provisioning. Our analysis also shows the pervasive consequences of this activity. A greater propensity to gamble with loss recognition significantly increases the likelihood of future losses and the probability of bank failure, the volatility of earnings and stock returns, and anticipates significant reductions in the bank's future lending supply.

Keywords:

Loan Loss Reserves, Allowance, Gambling, Delayed Expected Recognition, Expected Losses.

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