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Phil Molyneux, John O.S. Wilson

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## Contemporary Issues in Banking

Phil Molyneux<sup>+</sup> & John O.S. Wilson<sup>x\*</sup>

<sup>+</sup>Phil Molyneux, Bangor Business School, Bangor University, Bangor, Gwynedd, UK, LL57 2DG  
Email: p.molyneux@bangor.ac.uk.

<sup>x</sup>John O.S. Wilson, School of Management, University of St Andrews, St Andrews, Fife, UK  
KY16 9RJ Email: jsw7@st-andrews.ac.uk.

Over the past decade or so, banks have been affected by an array of shocks, which have transformed the industry. The global financial crisis of 2007-2008 coupled with the euro sovereign debt crisis of 2010-2012 and the subsequent recessions in many countries all combined to create a new macroeconomic environment with slower economic growth, low (or negative) interest rates and a new policy environment (where credit and quantitative easing and other alternative monetary policies are prevalent). All these forces have affected the performance and strategies of banks. Extensive regulatory and supervisory reforms have also taken place in order to reduce the risks in the banking and wider financial services sector (Berger, Molyneux and Wilson, 2015). In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has introduced controls designed to reduce the likelihood of future taxpayer bailouts of major banks by limiting proprietary trading and other volatile business areas. Similar major reforms have taken place in the European Union, not least the moves to create a European Banking Union and the introduction of a Single Resolution Mechanism that became partially operational after the

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<sup>x</sup>Corresponding editor.

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introduction of the EU-wide Bank Recovery and Resolution Directive in 2015 (Schoenmaker, 2016).

Regulations relating to bank solvency and liquidity have been substantially strengthened (under Basel III that comes fully into force in 2019). Also, systemically important banks and other systemic institutions (including large insurance companies, exchanges, market infrastructure providers) are also subject to increased capital requirements and tougher regulatory oversight (Herring and Carmassi, 2015). These regulations and other structural reforms have compelled banks to reduce riskiness of their asset portfolios in order to meet more demanding capital and liquidity requirements, and pass ongoing stress tests undertaken by various regulatory agencies (such as the US Federal Reserve, and the European Banking Authority (EBA)). For example, many large European banks have moved away from the higher risk (higher regulatory capital) areas of investment banking and securities trading toward lower risk areas such as retail banking and wealth management. Banks have also reduced their exposure to private equity and hedge funds.

Measuring and managing risk has become an even more critical feature of the business carried out by banks and other financial services firms. During the financial crisis of 2007-2008 it became evident (as mortgage and bond defaults increased) that market participants and regulators had seriously underestimated the extent of credit and extreme (tail) risks in the financial system. This has led many to reconsider both the measurement and management of credit, market, liquidity and operational risks. Of particular interest has been the accounting treatment of credit risk indicators such as loan loss-provisions and reserves, the (fair) valuation of financial instruments as well as issues covering transparency of off-balance sheet activities. Bank financial reporting under International Financial Reporting Standards (IFRSs) has changed, the most important being modifications to IFRS 9 on valuing financial instruments and aligning this with new rules introduced under Basel III. There has also been a growing interest in using market indicators of credit risk, such as CDS spreads and credit ratings as a complement to accounting indicators (such as loan-loss provisioning). The credit ratings industry has also come under particular scrutiny, given that credit rating agencies provided over-optimistic credit risk assessments of securitised mortgaged based instruments prior to the global financial crisis. The ratings industry has also been blamed for conflicts of interest (moral hazard) that incentivised agencies to

provide generous bond ratings. This has resulted in new regulations limiting certain activities of rating agencies in both the U.S and Europe.

The global financial crisis also brought to light both the causes and consequences of financial sector liberalization and an environment that incentivised excessive risk-taking. Some have blamed inappropriate bank corporate governance that encouraged CEOs and senior managers to focus on shareholder value maximization at the expense of safety and soundness. Executive remuneration tied to stock and option valuations prioritised risk-taking as it boosted returns over the short-term and neglected longer-term wealth creation objectives. There has been much discussion about perverse incentives and appropriate governance structures in banking and this debate remains ongoing (Bank of International Settlements, 2015). Perceived bad behaviour in the boardroom is not the only area where inappropriate actions have occurred. We have witnessed the LIBOR scandal regarding the rigging of interbank money market rates as well as allegations of price fixing in other financial benchmark settings (foreign exchange rates, gold prices, oil prices among others). Also there are ongoing legal cases in the US and Europe relating to the mis-selling of mortgage backed securities (in the run-up to the 2007-8 crisis). In the UK the mis-selling of payment protection insurance and pensions has been another scandal. These examples provide apt illustrations of bad behaviour of banks when dealing with clients, and have led to calls for the industry to adhere to higher ethical and professional standards. Recognition of these problems has also helped push consumer protection issues into the forefront of regulatory and supervisory policy.

In the light of these major developments, this special issue of the *British Accounting Review* aims to provide a timely and comprehensive overview of advances in banking research. The contributions contained in the special issue engage and inform current and emerging debate on the actual and likely effects of the aforementioned structural and regulatory reforms on the banking and financial services industry. This special issue is associated with the *Contemporary Issues in Banking* conference which was held at the Centre for Responsible Banking and Finance at the School of Management, University of St Andrews on December 8<sup>th</sup> and 9<sup>th</sup> 2015. This special issue is structured as follows.

The paper on *Bank Transparency and the Crisis* by Panayotis Manganaris, Elena Beccalli and Panagiotis Dimitropoulos investigates accounting practice and the treatment of bank loan-losses. Using a large sample of European banks the authors evaluate the first few

years (2005-2007) of IFRS adoption and find little evidence of conservative provisioning behaviour. However, (and as expected) banks become more conservative with the onset of the crisis in 2007. The observed behaviour of banks accords with the extant literature, which suggests accounting practice becomes more conservative during contractionary periods. Put simply, loan-loss provisioning became more timely and transparent, presumably because banks wished to mitigate the adverse consequences of reporting (excessively) opaque financial statements in the aftermath of the crisis. During this period banks also focused on cleaning up balance sheets by removing bad credit risks. The regulatory desire to make more transparent bank credit risk is also reflected in recent moves by the European Banking Authority to harmonise reporting on loan-loss provisions.

Regulatory measures designed to improve bank soundness and reduce the likelihood of future taxpayer financed bank bailouts have focused substantially on boosting the capital strength and liquidity of banks. Laura Chiamonte and Barbara Casu investigate *Capital and Liquidity Ratios and Financial Distress* in their study of European banks. In particular, they investigate whether the liquidity and capital features of banks reduce the probability of failure. Increased liquidity reduces the probability of bank distress. An interesting finding is that it seems that capital standards only appear to reduce fragility for the EU's largest banks. The author's findings appear consistent with the recent regulatory focus on reducing the fragility of globally systemically important banks (G-SIBs) under Basel III.

Loan-loss provisioning behaviour of banks is inextricably linked to the specific accounting setting. In the paper *The predictive ability of loan loss provisions in banks – Effects of accounting standards, enforcement and incentives*, Jan Marton and Emmeli Runesson examine how different accounting treatment of loan-loss provisioning may help predict future credit losses. Using a sample of EU and Swiss banks covering the period 2000 to 2011, the authors find that the current IFRS approach to provisioning (incurred loss model) provides more objective guidance on credit losses than alternative accounting treatments under Generally Accepted Accounting Principles GAAP, but yields poorer forecasts of future credit losses. This is explained by the fact that the incurred loss model reduces the timeliness of provisioning and this can also have pro-cyclical effects potentially reinforcing the detrimental effects of accounting treatment of credit losses at times of crisis. Earlier recognition of credit losses are revealed using local GAAP rules subject to there being strong enforcement in terms of reporting expected losses. The authors note that their

findings are consistent with the IASB's and FASB's introduction of expected loss models for recognition of future bad credits.

Domenico Curcio, Antonio De Simone and Angela Gallo investigate the *Financial Crisis and International Supervision: New Evidence on the Discretionary use of Loan Loss Provisions at Euro Area Commercial Banks*. The authors examine bank provisioning behaviour over the period 2005 to 2011. The authors find that Euro Area banks provision to smooth income, but not capital. This effect is more pronounced after the financial crisis. In terms of the EBA stress tests, the authors find no difference in capital smoothing for banks subject to stress testing and their non-tested counterparts. There is some evidence that for the 2011 stress tests the biggest banks under-provisioned to smooth earnings. The authors argue in order to aid bank financial statement transparency there should be (more) timely reporting of the EBA stress tests.

Since the global financial crisis the credit rating industry has been subject to significant regulatory reform, particularly in Europe, with the introduction of Credit Rating Agency (CRA) I Regulation in 2009 that put in place an EU system for certifying and regulating rating agencies (effective from July 2011 onwards). Part as a response to this new environment Standard & Poor's (S & P) converted the solicitation status on several sovereigns to unsolicited (these are simply ratings where the debt issuer has not paid or worked with the rating issue to come up with the rating). In their study on *Does the Disclosure of Unsolicited Sovereign Rating Status Affect Bank Ratings?* Patrycja Klusak, Rasha Alsakka and Owain ap Gwilym investigate whether changes in sovereign rating status influence bank ratings. It is long known that the sovereigns have the highest quality ratings and big bank ratings just hover below, usually moving in tandem with the sovereign. The authors utilise a sample of 147 listed banks from 42 countries between 2006 and 2013. They find that banks from countries whose ratings convert to unsolicited status have a higher probability of a rating downgrade and lower probabilities of rating upgrades compared to other banks. The authors argue that the most likely explanation for this effect is strategic conservatism, where S&P have less information on borrowers when ratings are unsolicited so they tend to rate them more conservatively (less favourably). This feeds through into lower bank credit ratings.

The governance of banks has been of substantial public and policy interest especially post-crisis (Wilson et al, 2010; Hagendorff, 2015). In their paper on *Governance, Efficiency and Risk Taking in Chinese Banking*, Yizhe Dong, Claudia Girardone and Jing-Ming Kuo investigate whether various board features (size, composition and functioning) influence risk-taking and efficiency. Using a sample of Chinese banks over the period 2003 to 2011, the authors find that board characteristics have a more marked impact on bank profit and cost efficiency than on credit quality. Having a larger proportion of female directors on the board boosts efficiency and lowers credit risk. A higher level of board independence is linked to greater profit efficiency whereas the opposite is found in the case of dual leadership (where the CEO is also the chair of the board). The authors also find that ownership concentration influences governance and efficiency relationships, and bank liquidity is also found to be a key driver of both cost and profit efficiency. Overall, the results suggest a case for greater gender diversity on bank boards.

Following the financial crisis there has been discussion as to whether large and / or complex financial institutions should be regulated differently from their smaller counterparts. In the paper *Irish Credit Unions: Differential Regulation based on Business Model Complexity*, Barry Quinn and Donal McKillop use the credit union industry in Ireland over 2002-2013 as a laboratory to investigate whether credit unions adopt different business models, and what the effects are on performance. The authors utilise a latent class approach, which uses financial and other characteristics of individual credit unions to identify different business models. The authors identify three distinct types of credit union based on efficiency and other financial indicators. They find that credit unions suffer from diseconomies of scale in two of the three classes identified. Having three distinct types of business model suggests that a uniform regulatory approach for dealing effectively with the sector may not be appropriate, and a case can be made for reducing the scale of two types of credit union so they can realise greater scale economies.

As noted earlier, consumer protection issues in the financial services sector has become an important topic, especially after a range of mis-selling scandals in the UK and elsewhere (Campbell et al, 2011). In *The Price, Quality and Distribution of Mortgage Payment Protection Insurance: A Hedonic Pricing Approach*, John Ashton and Robert Hudson investigate the pricing of a form of insurance that is sold to pay off mortgage credit in the event of job loss, accident or illness. Concerns regarding Mortgage Payment Protection

Insurance (MPPI) led the UK's Competition Commission to rule that after February 2011 the product should not be sold jointly with mortgage loans within seven days of the credit transaction. The authors focus on this prohibition via an investigation of MPPI premiums when the product is sold independently or sold jointly with a mortgage. They find that policies sold jointly are more expensive for a given set of benefits and conditions than those sold independently, suggesting that premiums were uncompetitive in the former case. This disparity disappears after the introduction of the new rules.

In addition to major banks, other large financial firms are subject to stress tests and increased regulatory oversight, not least large insurance firms, some of which are deemed globally systemic financial institutions. In the paper *Curbing Systemic Risk in the Insurance Sector: A Mission Impossible?*, Paola Bongini, Laura Nieri, Matteo Pelagatti and Andrea Piccini use an event study approach to evaluate whether the introduction of new Global Systemically Important Insurance (G-SII) regulations led to a reduction in the market value of affected insurers. Using a sample of the world's largest insurance firms the authors investigate whether the publication of the first list of nine G-SIIs had any market reaction. Overall the authors find that the market values of G-SIIs were unaffected by the introduction of the new regulations. This implies that investors believe that tougher capital and other forms of enhanced regulatory oversight were not expected to influence future performance. This is similar to the results from banking studies that find little stock price reaction to being announced too-big-to-fail (Abreu and Gulamhussen, 2013).

Overall, this special issue of selected papers from the Contemporary Issues in Banking Conference provides the reader with new insights into recent research issues related to the study of banks and other financial institutions. Most noticeably recent research focuses on risk measurement and the accounting setting, corporate governance, consumer protection and regulating systemically important banks and other financial institutions. There is also a continued interest in how these factors feed through into bank performance, competition and innovation in the financial sector. We hope you find the special edition of interest and a guide for future research.

JW and PM



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