Why Do Banks Hide Losses?

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Motivation

Truthful reporting of bank profitability and risk is vital to banking regulation:

- Capital regulation, Deposit insurance, Bailout Assistance, Market Discipline

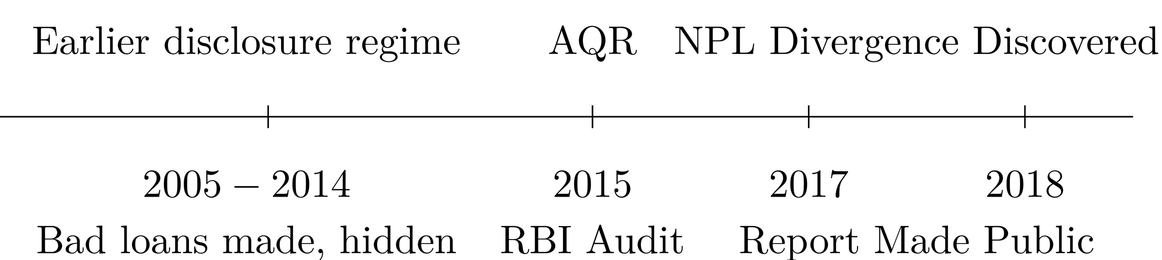
With bank misreporting, these policies become questionable.

We observe scattered instances of hiding, still no systematic study on economic drivers of this behavior.

Empirical Setting

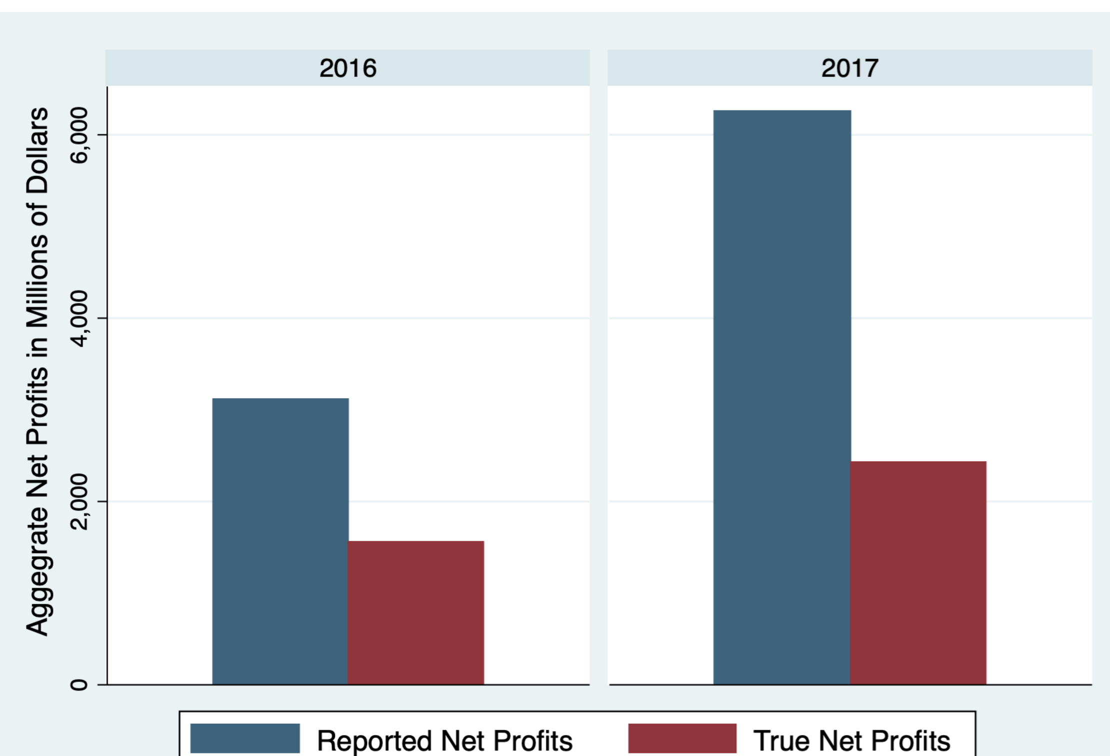
We exploit an unexpected regulation change in India that forced all banks in the country to report the extent of hiding.

- Understand the role of shareholder monitoring and managerial incentives, as suggested by the theoretical literature, on this behavior.



- Misreporting decisions undertaken before the policy change.
- Consistent Methodology: RBI looked at list of 120-150 accounts – all banks must deem NPA – same set of loans for everyone.

Economic Magnitude of Underreporting



Theory

Economic Motivations for Hiding:

- Capital Regulations
- Managerial Agency Issues
  - Misreporting boosts managerial compensation
  - Managers better able to take advantage of uninformed shareholders

Empirical Proxy of Monitoring

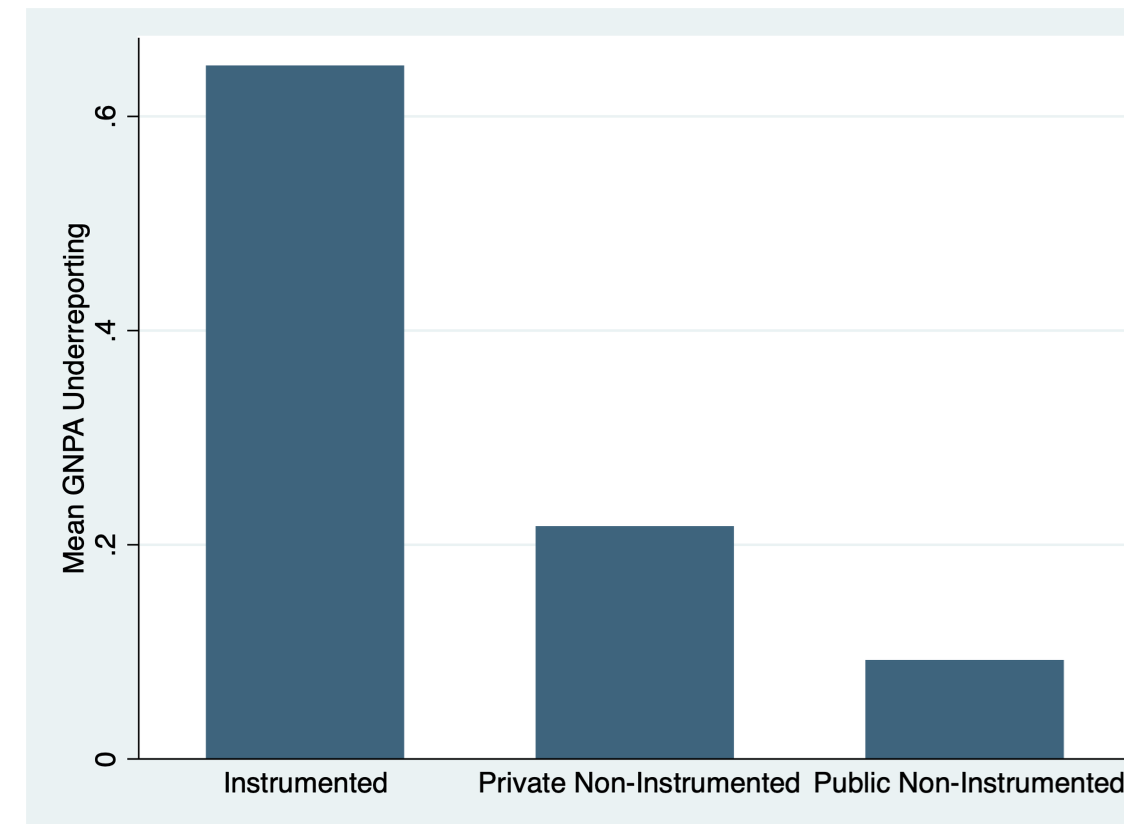
- Monitoring: Shareholders and the Board
- Exploit unique feature of Indian Banks: **Foreign Institutional Investors (FII)**

Distant Shareholders as Monitors

- Physical distance ⟷ information asymmetry
- Invest in emerging market for diversification benefits (MSCI inclusion).
- On the flip side, FIIs may be more effective as an objective monitor.

MSCI - Identification

Instrument: Inclusion in MSCI index.



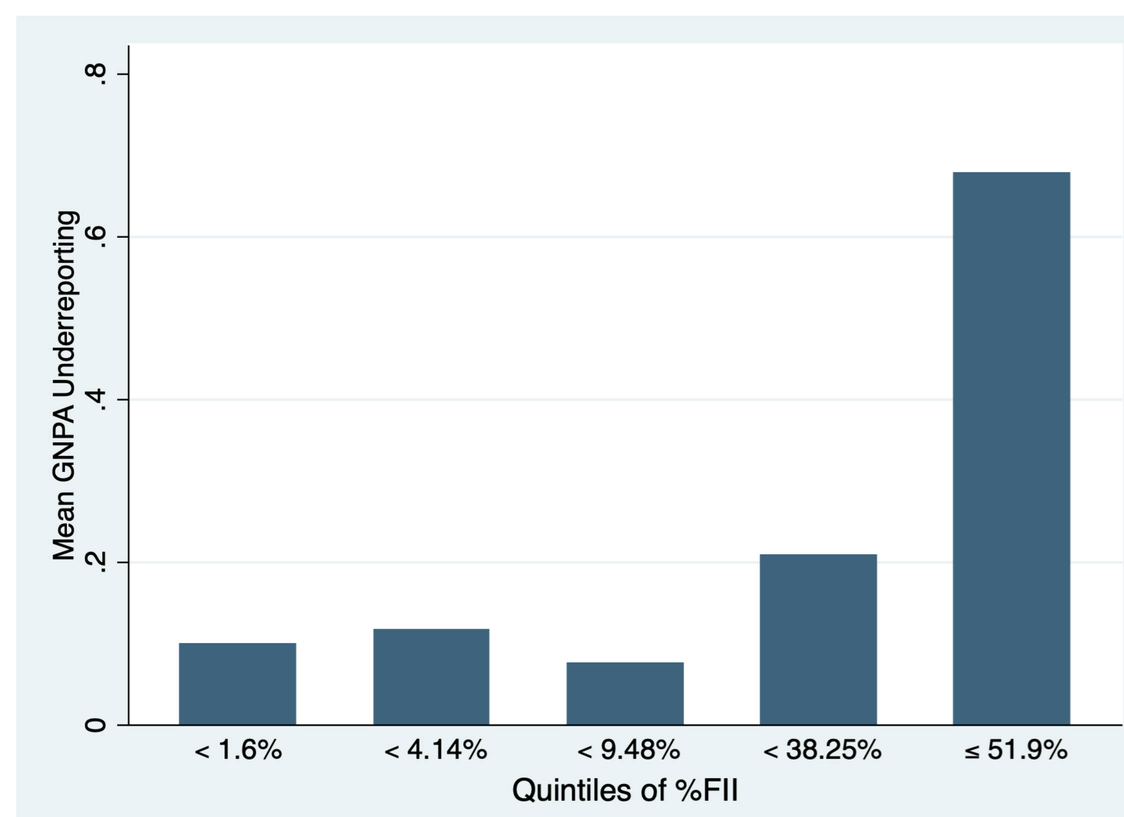
MSCI inclusion→ ↑ passive, diversification-seeking FII → ↑Underreporting

Broad Takeaway

Distant monitors should use caution in relying on performance-linked compensation contract as a substitute for monitoring: it can make the problem worse by providing the managers incentive to engage in untruthful reporting.

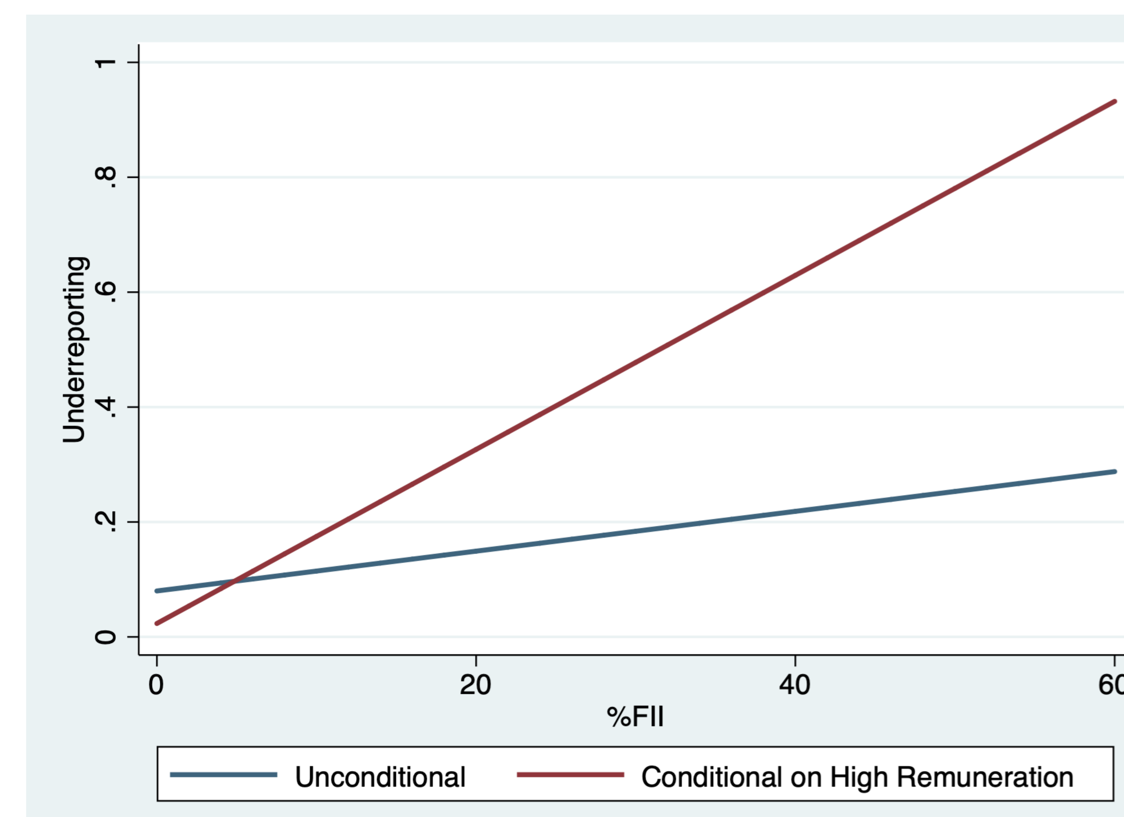
Shareholder Monitoring

Underreporting increases in % FII



High-Powered Incentives

High Remuneration Drives Underreporting



Compensation Regressions

FII rely on Hard Information

	Full Sample	High FII	Low FII
ROE	0.017	0.055	-0.188
	(0.26)	(0.85)	(-1.31)
GNPARatio	-7.424*	-7.644**	-1.554
	(-1.93)	(-2.37)	(-0.15)
Log(Assets)	0.720**	0.797**	0.919
	(2.19)	(2.42)	(1.22)
Bank FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
R^2	0.86	0.91	0.40
Within R^2	0.06	0.13	0.01
Observations	274	153	121

t statistics in parentheses

* $p < .10$, ** $p < .05$, *** $p < .01$

↑ %FII → Reliance on reported measures → Banks respond by underreporting

Conclusion

- First systematic study to look at why banks hide info from the market.
- Managers are more likely to engage in underreporting their banks' risk, and thus inflate short term profits, when their shareholders are distant.
- Behavior was essentially concentrated among banks where CEOs stood to benefit from reporting better-than-true results.
- Implications for banking regulators around the globe: understand the proximity-objectivity trade-off of shareholder discipline.

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