Income smoothing over the business cycle changes in banks' coordinated management of provisions for loan losses and the role of opacity of bank asset

Provision for loan losses is known to be a tool for the income smoothening for a bank. Liu and Ryan (2006) argued that this income smoothening occurred in the financial institution through provisioning the loan losses over the business cycle. They researched this question in the 90s for the bank holding companies. They found that higher profitable banks made more provisioning of the loan losses and they also found that more homogenous loans were associated with more provisioning of the loan. They argued that banks made more charge off that was related with the recovery of the next year. They got the reverse argument also true. Again Recovery of the loan was associated with the gross loan charge off. Basically banks use the gross loan charge off and recovery components together to keep the allowance a good shape in every year. The authors mentioned that net loan charged off was associated with the future earnings. On the other hand, Jones, Lee, and Yeager (2013) argued that opaque assets generated more profit than transparent asset. The authors mentioned that investors demanded more return for opaque asset. In my paper, i argue that opaque assets are related with provisioning of loan losses. The rationale behind is that banks which are holding more opaque assets are capable of making more provision for loan losses for income smoothening. In mortgage backed securities, there are lots of covenants, which are not known to investors, in the agreement of the mortgaged backed securities. So these assets create information asymmetry between investors and decision making body. So managers can make more provisioning for this kind of less transparent assets. My research question is basically extension of the Liu & Ryan's (2006) paper to observe whether opaque asset or transparent assets have any association with the income smoothening of the bank holding companies. My sample period is from 2001 to 2013. I consider those banks which return on asset is high. In my sample size, Profitability and homogenous loan is associated with the provisioning for loan losses and recovery of the loan is associated with the gross loan charge off. These results are consistent with the liu and Ryan's (2006) paper. Few results are not consistent with the Liu and Ryan's (2006). But I found that opaque assets are associated with the provisions for loan losses. Opaque assets are also associated with the recovery and gross loan charge off. It indicates that opaque assets help management to smoothen the income. As there is a huge shock in the economy in my sample period from 2007 and 2008, I create dummy variables for this period. After controlling the crisis, most of my results are consistent.

References:

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