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Huizinga, Harry

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IN-DEPTH ANALYSIS

An effective dialogue between supervisors and auditors – how can its implementation be monitored?

External author: Harry Huizinga

Provided at the request of the
Economic and Monetary Affairs Committee

March 2016
EN

ECON

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External author: Harry Huizinga

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Abstract

Weak banks and their auditors have incentives to overstate bank asset values. In its dialogue with the auditor, the supervisor should stress the need for unbiased accounting data. However, only a supervisor that does not need to apply regulatory forbearance to distressed banks can credibly insist on receiving unbiased accounting data. The introduction of bail-in as the main avenue to resolve failed banks offers the prospect of ending the need for regulatory forbearance, and of improving the quality of accounting data.

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AUTHOR

Harry Huizinga

RESPONSIBLE ADMINISTRATOR

Marcel Magnus
Economic Governance Support Unit
Directorate for Economic and Scientific Policies
Directorate-General for the Internal Policies of the Union
European Parliament
B-1047 Brussels

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ABOUT THE EDITOR

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E-mail: egov@ep.europa.eu

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LIST OF ABBREVIATIONS

AQR Asset Quality Review
ECB European Central Bank
CDS Credit Default Swap
CET1 Common Equity Tier1
ECB European Central Bank
FDIC Federal Deposit Insurance Corporation
GDP Gross Domestic Product
IAS International Accounting Standard
IASB International Accounting Standards Board
MBS Mortgage Backed Securities
PCA Prompt Corrective Action
SSM Single Supervisory Mechanism

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EXECUTIVE SUMMARY

In their financial reports, banks provide accounting information to interested stakeholders, including investors in bank shares and bonds, and bank supervisors. High-quality accounting data are necessary for investors and supervisors to make appropriate decisions, and hence these are important for a smooth functioning of the banking sector.

Stressed banks face incentives to overstate the value of their assets, and hence their capitalization rate, to avoid disciplinary action from capital market participants as well as from the supervisor. During a financial crisis, the supervisor similarly may be inclined to accept exaggerated bank asset valuations, as these can be used to rationalize a policy of regulatory forbearance. By applying forbearance, the supervisor allows an insolvent bank to continue to operate, as the alternative of bank resolution is deemed to be impracticable.

A main purpose of an effective dialogue between the supervisor and the auditor should be to prevent systematic overvaluations of bank assets and capital, especially if banks are experiencing difficulties. A prerequisite for an effective dialogue in this sense is that the supervisor is able to recommend the resolution of failed banks without a need to resort to regulatory forbearance, including the acceptance of inflated financial reports. The ECB as the supervisor in the Single Supervisory Mechanism (SSM) should be in a better position to forego forbearance than its predecessors, as the planned application of bail-in rather than bail-out implies that banks can be resolved without ruining the public finances. Bail-in of a major failed bank, however, has not yet been attempted, and at his point the ECB should do what it can to make the application of bail-in in the future more credible. For instance, the ECB should counteract large concentrations of bail-inable debt in bank portfolios that potentially could make bail-in impracticable.

At the level of individual banks, the dialogue between the auditor and the supervisor should focus on the risk that a bank is inflating its reported asset values and capitalization. To be able to assess this risk, the supervisor needs to have an understanding of the determinants of asset and capital overvaluations at the individual bank level. Very useful in this regard is recent research by Homar (2016) on the determinants of the Common Equity Tier1 (CET1) capital ratio adjustments that resulted from the Asset Quality Review in 2014 of the 130 SSM banks that are directly supervised by the ECB. This research, in particular, shows that capitalization overstatements are more likely in the case of banks that are located in countries with adverse macroeconomic conditions and that themselves are weak.

1. INTRODUCTION

In their financial reports, banks provide accounting information to interested stakeholders, including investors in bank shares and bonds, and bank supervisors. High-quality accounting data are necessary for investors and supervisors to make appropriate decisions, and hence these are important for a smooth functioning of the banking sector.

Good bank accounting data are most critical at a time of financial crisis, when doubts arise about the solvency of financial institutions individually and collectively. However, during a financial crisis the correctness of bank accounting data is most likely to be compromised. Stressed banks face incentives to overstate the value of their assets, and hence their capitalization rate, to avoid disciplinary action from capital market participants as well as from the supervisor. During a financial crisis, the supervisor similarly may be inclined to accept exaggerated bank asset valuations, as these can be used to rationalize a policy of regulatory forbearance. By applying forbearance, the supervisor allows an insolvent bank to continue to operate, as the alternative of bank resolution is deemed to be impracticable.

Japan in the 1990s offers an example of a financial crisis where banks failed to recognize massive loan losses with the acquiescence of the supervisors. These supervisors were guided by the concern that large-scale loan write-offs would result in major bank insolvencies, and that these bank insolvencies might upset the entire financial system. However, forbearance in Japan led to a decade-long economic stagnation, and the eventual costs for the taxpayer seem to have been far higher than they would have been if banks had been forced to immediately reveal their losses in 1992 (according to the Advisory Scientific Committee of the European Systemic Risk Board, 2012, points 21 and 31 on pages 7 and 8).

Regulation No 537/2014 of the European Union requires the establishment of an effective dialogue between the supervisor and the auditor of banks.[1] The European Banking Authority (2015a) has published a consultation paper with detailed guidelines on how such a dialogue can be structured; it intends to finalise the proposed guidelines during 2016, with a projected application date in the last quarter of 2016. Going beyond the detailed structure of the dialogue, this paper argues that a main purpose of an effective dialogue should be to prevent the occurrence of a Japan-like scenario of non-recognition of asset deterioration condoned by the supervisor and eventually leading to high macroeconomic costs.

A prerequisite for an effective dialogue in this sense is that the supervisor is able to recommend the resolution of failed banks without a need to resort to regulatory forbearance, including the acceptance of inflated financial reports. The ECB as the supervisor in the Single Supervisory Mechanism (SSM) should be in a better position to forego forbearance than its predecessors, as the planned application of bail-in rather than bail-out implies that banks can be resolved without ruining the public finances. Bail-in of a major failed bank, however, has not yet been attempted, and at his point the ECB should do what it can to make the application of bail-in in the future more credible. For instance, the ECB should counteract large concentrations of bail-inable debt in bank portfolios that potentially could make bail-in impracticable.

At the level of individual banks, the dialogue between the auditor and the supervisor should focus on the risk that a bank is inflating its reported asset values and capitalization. To be able to assess this risk, the supervisor needs to have an understanding of the determinants of asset and capital overvaluations at the individual bank level. Very useful in this regard is recent research by Homar

[1] See European Commission (2014b, Article 12). Earlier, the European Commission (2010, p. 14) considered that there was a need to reinforce the dialogue between regulators and auditors. Similarly, in its report on the banking crisis in Ireland the Houses of the Oireachtas (2016, p. 83) call for strengthening the capacity for direct reporting of critical business risk to the regulatory authority by an external auditor of banks.

(2016) on the determinants of the Common Equity Tier1 (CET1) capital ratio adjustments that resulted from the Asset Quality Review (AQR) in 2014 of the 130 SSM banks that are directly supervised by the ECB. This research, in particular, shows that capitalization overstatements are more likely in the case of banks that are located in countries with adverse macroeconomic conditions and that themselves are weak.

In the remainder, Section 2 discusses how accounting discretion, which to some extent is unavoidable, can lead to biased financial reporting by banks. Section 3 discusses empirical evidence on biases in bank accounting data available from prior studies, and it further shows that there is a negative relationship between the intensity of the auditor-supervisor relationship and the CET1 capital ratio adjustment from the AQR for the 130 SSM banks. Section 4 discusses how the auditor-supervisor dialogue can be made an instrument to reduce the bias in banks' financial reporting. Section 5 concludes.

2. ACCOUNTING DISCRETION CAN LEAD TO BIASED FINANCIAL REPORTING

Through their financial reporting, banks reveal asymmetric information about their income and assets to bank stakeholders, including investors, bank customers, and supervisors. Banks necessarily have some discretion as to which information they reveal. This is unavoidable if financial reports are to be informative at all about present circumstances, which implies that they need to go beyond reporting easily verifiable information based on past transactions.

The existence of discretion implies that there will be some range of asset valuations that can be justified on the basis of accepted accounting standards. The auditor in principle has the discretion to approve any valuations within this possible range. The accounting biases that auditors actually sign off on are co-determined by the pressures that are applied to them by the banks as well as by the supervisor.

Auditors will be inclined to accept some biased financial reporting put forward by the banks, as these are their paying customers. At the same time, auditors will take cues from the supervisor regarding the extent to which bias in bank accounting data will be tolerated. The supervisor, as the auditor, has a stake in ensuring that banks' published accounts are informative about their financial health, which implies that biases need to be limited. However, the supervisor also uses accounting data as an important input into the supervisory process, including the decision whether a distressed bank should be resolved. However, in practice the supervisor may feel unable to resolve a bank, even if it is economically insolvent, as the bank may be too-big-to-fail, or alternatively there are several insolvent banks that may be too-many-to-fail, given fiscal constraints on the authorities. Brown and Dinc (2011) show empirical evidence of the too-many-to-fail phenomenon that inhibits supervisors to simultaneously close many insolvent banks, especially if there is a large government budget deficit.

If bank resolution is not practicable, the supervisor needs to forbear on a bank, allowing it to continue to operate although it does not meet basic solvency requirements. A supervisor that is forced to apply forbearance to a bank may be interested in seeing upwardly biased bank asset valuations to mask the fact that forbearance is applied. This may lead the supervisor to acquiesce to overstated asset values that are presented to it by the bank and its auditor. As an egregious example, in 2008 US regulators publicly approved the reclassification by Citigroup of part of its portfolio of Mortgage Backed Securities (MBS) from the available-for-sale category to the held-to-maturity category, with positive repercussions for asset valuation and bank capitalization.[2]

Direct communication between the auditor and the supervisor, in the form of a structured dialogue makes it easier for the supervisor to signal to the auditor the extent to which it will tolerate accounting bias. A dialogue thus makes it more likely that actual accounting data reflect the preferences of the supervisor regarding the degree of accounting bias.

[2] Similarly and more generally, the IASB amended IAS 39 to allow banks to reclassify financial assets from categories for which fair value accounting is required to categories for which amortized cost accounting is possible under extreme pressure from the European Commission and with abandonment of its normal due process (Acharya and Ryan, 2015, p. 76).

3. EVIDENCE OF BIASES IN BANK ACCOUNTING DATA

Evidence on the determinants of biases in bank accounting data is useful as input into the auditor-supervisor dialogue to reduce accounting bias in the future. This section reviews some evidence on accounting bias in the US during the recent financial crisis, and also in the Eurozone as implied by the AQR data as of December 31, 2013. A key additional question is whether the auditor-supervisor relationship itself facilitates or impedes accounting bias. To start to address this question, we show some evidence on the empirical relationship between the intensity of the auditor-supervisor relationship and accounting bias as implicit in the AQR data.

3.1 US banks during the recent financial crisis

At the height of the recent financial crisis in 2008, the market values of US banks were far below their book values. Using market valuations, many US banks were insolvent, although most banks continued to show adequate capitalization rates in their accounting data. This suggests that the banks were using their accounting discretion to be able to report inflated book asset and capital valuations relative to true values. Huizinga and Laeven (2012) provide three pieces of evidence of such accounting bias:

- Using bank stock price data, they find that the stock market applied significant discounts to the valuations of MBS and real estate loans relative to bank book valuations. Importantly, the estimated market discounts on these real-estate related assets implicit in bank stock prices were relatively large for big banks. This suggests that larger banks were more able to overvalue these assets on their books due to their too-big-to-fail status, as regulatory forbearance was being applied to larger banks.

- Banks with large MBS holdings, which had declined sharply in value, were systematically reporting relatively low loan loss provisioning and loan charge-off rates. This suggests that banks that had to cope with significant losses stemming from their MBS portfolios held back on their loan loss provisioning and loan charge-offs in order to mitigate the negative impact on bank capital.

- Banks used their discretion on how to classify their assets to take advantage of valuation differences between different accounting methods. In particular, banks were increasing the share of MBS that were reported as held-to-maturity (and valued at amortized cost) rather than as available-for-sale (and valued at fair value) at a time when fair values tended to be relatively low compared to amortized cost. Again, the purpose was to boost reported asset valuation and capitalization.

Overall, this evidence shows that US banks were applying accounting discretion to mitigate the impact of the financial crisis on the book valuation of assets and on regulatory capital, probably with the acquiescence of regulators as part of regulatory forbearance.

3.2 Eurozone banks and AQR data

The Asset Quality Review provides an assessment of the correctness of bank accounting data as of December 31, 2013 for the 130 banks that the ECB would directly supervise under SSM. The ECB (2014) published the results in October 2014. Table 12 of the report provides information on the adjustments that were made to each bank's Common Equity Tier1 (CET1) capital ratio. These adjustments for the most part reflect an effort to obtain an economically accurate assessment of the banks' financial position using accepted accounting standards (and hence to filter out bias in the

application of these standards) rather than an effort to find and correct wrongful misstatement.[3] Hence, the AQR capital ratio adjustments can be seen as a measure of the accounting bias of Eurozone banks in 2013, at a time when they were still recovering from a period of economic and financial crisis.

In a recent study, Homar (2016) examines the determinants of the accounting biases of Eurozone banks as revealed by the AQR. In particular, he relates the CET1 capital ratio adjustments from the AQR to a range of macroeconomic variables, indices of supervisory and regulatory quality, and indicators of the strength of the banks themselves. The results, reported in Table 5 on p. 96, can be summarized as follows:

- *Banks that are located in countries with worse macroeconomic conditions are more likely to engage in accounting bias.*
  Specifically, Homar (2016) shows that the CET1 capital ratio adjustment is larger if GDP growth over the prior 5 years has been lower, and if unemployment as a 3-year average has been higher.

- *Banks are more likely to engage in accounting bias if there is less regulatory and market discipline of banks.*
  Specifically, the CET1 capital ratio adjustment decreases with i) a capital regulatory index summarizing the stringency of capital regulatory requirements, ii) a supervisory power index measuring whether supervisory authorities have the power to prevent and correct problems, and ii) a private monitoring index that is higher when financial statements issued by a bank have to be audited, when a large share of the 10 largest banks is rated by international rating agencies, and when there is no explicit deposit insurance and if bank accounting fulfills certain requirements.

- *Weak banks are more likely to engage in accounting bias than strong banks.*
  Specifically, the capital ratio adjustment increases with the ratio of impaired loans to total loans, and with the bank 5-year CDS spread."

Overall, these results suggest that the supervisory and regulatory regime potentially plays an important role in preventing or correcting the upward biases in bank capitalization that weak banks are likely to report.

3.3 The auditor-supervisor dialogue and accounting bias in the AQR data

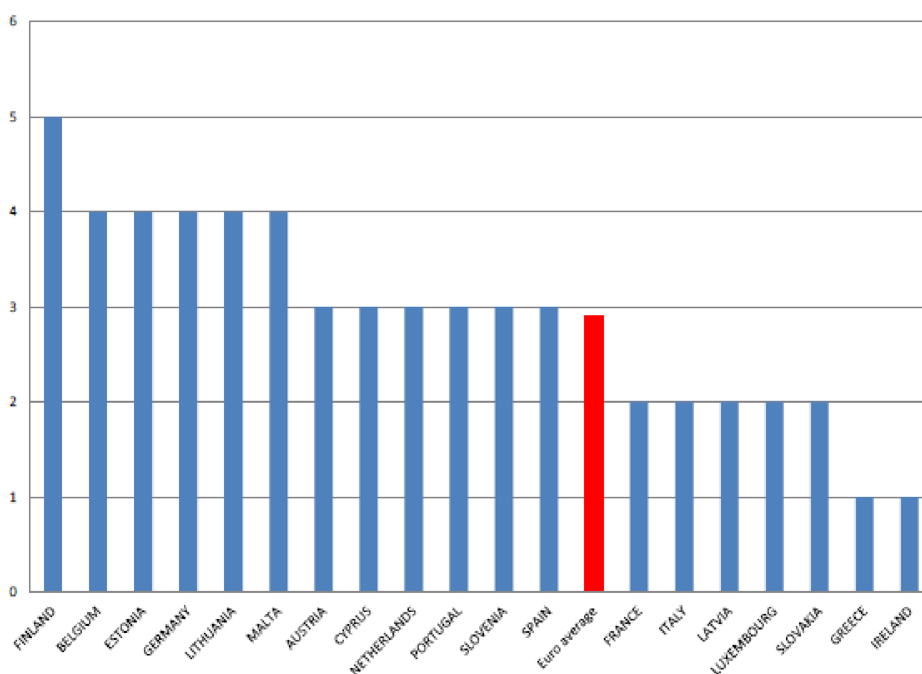
As discussed in section 2, the supervisor may tolerate or even favor a certain degree of accounting bias, as this may facilitate regulatory forbearance. In practice, the auditor may have an imprecise view of the degree of accounting bias that the supervisor is willing to tolerate at a certain bank. Direct auditor-supervisor communication provides the supervisor with the means to signal to the auditor the degree of bias that it will tolerate. Hence, regular dialogue between the supervisor and the auditor is expected to align the actual accounting bias more closely to the level of the bias that is desired by the supervisor. By having a dialogue with the supervisor, the auditor may learn that less or more bias will be tolerated that it anticipated, and hence the impact of more dialogue on the actual level of the bias is a priori unclear. Thus, the relationship between the intensity of the auditor-supervisor dialogue and the degree of accounting bias ultimately is an empirical issue. To provide some evidence on this, we next relate the Masciandaro (2015) index of the intensity of the

[3] The ECB (2014, p. 17) states that in some cases where more than one approach was consistent with accounting rules the comprehensive assessment prescribed a favoured approach following prudential and economic logic. It is the responsibility of participating banks to assess whether adjustments have to be reflected in their statutory accounts. That said, the comprehensive assessment will form the basis for extensive follow-up work beyond addressing capital shortfalls (see p. 18).

auditor-supervisor relationship to data on the CET1 capital ratio adjustment for the banks in the AQR.

Masciandaro (2015) constructs an index of the intensity of the auditor-supervisor relationship using data from the international survey on bank supervision and regulation of Barth et al. (2013).[4] The index, which ranges from 0 to 5, will be higher if : a) the supervisor has the right to meet with the auditors without the approval of the bank (1 point) ; and/or b) the auditors are subject to independent oversight by a public authority (1 point); and/or c) the supervisor has the power to take action against the auditors (1 point) ; and/or d) the supervisor has the power to delegate part of its supervisory task to auditors as part of the regular supervisory process (2 points), or just an on exceptional basis (1 point). Figure 1 shows that in the Eurozone the auditor-supervisor relationship index ranges from a low value of 1 for Greece and Ireland to a high value of 5 for Finland.

Figure 1: The Auditor-Supervisor Relationship Index in the Eurozone

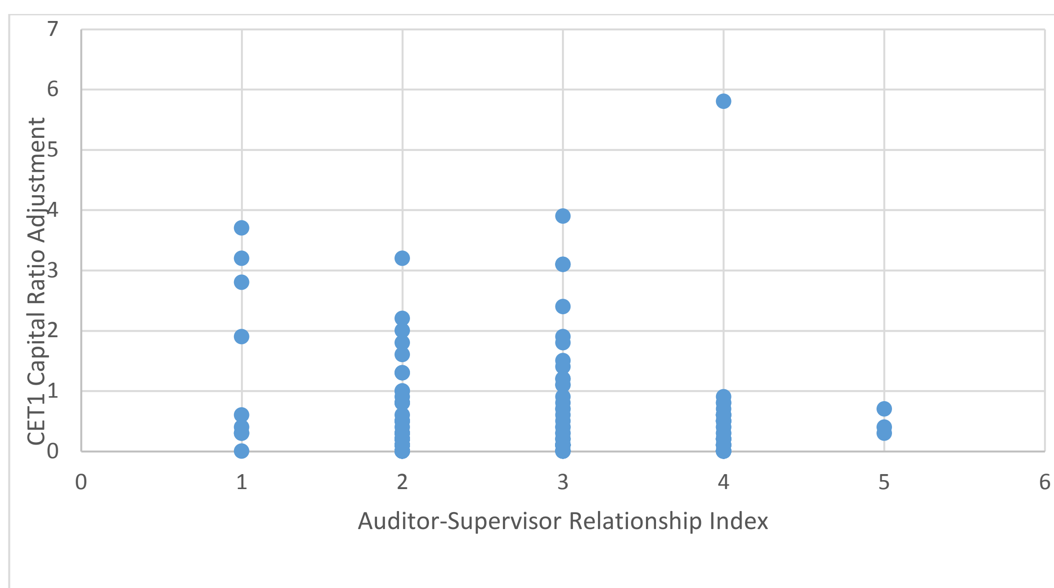


Source: Masciandaro (2015, Figure 11)

Figure 2 provides a scatter diagram of the auditor-supervisor relationship index on the horizontal axis and the CET1 capital ratio adjustment on the vertical axis. Overall, the diagram suggests a negative relationship between the relationship index and the capital ratio adjustment, suggesting that a more intense relationship between the auditor and the supervisor is associated with lower upward bias in the reported capital ratio.

[4] The accuracy of the data from Barth et al. (2013) is potentially limited by the fact that it stems from a survey.

Figure 2: The CET1 Capital Ratio Adjustment and the Auditor-Supervisor Relationship Index



Note: The CET1 Capital Ratio Adjustment is calculated as the difference between the reported and adjusted capital ratios from ECB (2014, Table 12). The Auditor-Supervisor Relationship Index is from Masciandaro (2015, Figure 11).

This negative relationship is confirmed by a simple regression of the CET1 capital ratio adjustment on the relationship index as reported in column 1 of Table 1 The auditor-supervisor relationship variable, in particular, receives a negative coefficient of -0.172 that is statistically significant at the 5% level. Similarly, in column 2 the estimated coefficient is negative at -0.219 and significant at 1%, after we remove AS DNB Bank in Slovenia, which is a clear outlier with a capital ratio adjustment of 5.8%, from the sample.

Table 1: Regression Analysis of the CET1 Capital Ratio Adjustment

	(1)	(2) Without outlier
Index	-0.172	-0.219
	(0.08)**	(0.07)***
Constant	1.170	1.264
	(0.25)***	(0.22)***
Number of obs	130	129
R-squared	0.03	0.06

Note: The dependent variable is the CET1 Capital Ratio Adjustment calculated as the difference between the reported and adjusted capital ratios from ECB (2014, Table 12). Index is the Auditor-Supervisor Relationship Index from Masciandaro (2015, Figure 11). **, *** denote significance at 5% and 1%.

The estimated negative relationship between the auditor-supervisor relationship index and the CET1 capital ratio is consistent with the negative relationship that Homar (2016) finds between the supervisory power index and the CET1 capital ratio adjustment. This is not surprising as both the auditor-supervisor relationship index and the supervisory power index are based on the survey by Barth et al. (2013), although the supervisory power index is defined more broadly and based on more survey questions. Broader indices, such as the more general supervisory power index, are constructed exactly because in practice it is not possible to unambiguously identify the separate effects of various facets of the supervisory regime, such as the auditor-supervisory relationship, on banking outcomes, such as the bias in the reported capital ratio. All the same, the regression results in Table 1 are suggestive of a negative impact of the intensity of the auditor-supervisor relationship on the upward bias in the reported CET1 capital ratio.

4. HOW TO ESTABLISH AN EFFECTIVE DIALOGUE

An effective dialogue between the auditor and the supervisor should ensure that banks' financial reporting is the most correct possible within the confines of accepted accounting standards. Three aspects of the dialogue can be distinguished that are important in getting the auditor to deliver unbiased accounting data. First, the auditor has to be convinced that the supervisor truly wants to receive unbiased accounting data, as regulatory forbearance of weak banks will no longer be pursued. Second, the auditor and supervisor should use their knowledge of the determinants of accounting bias to evaluate the risk of accounting bias at a particular bank. Third, the supervisor should have the means to enforce a no-bias accounting regime in its relationship with the auditor to the extent possible.

4.1 The need to end regulatory forbearance of weak banks

The supervisor needs to signal to the auditor that it will no longer apply forbearance to weak banks, and that it will no longer acquiesce in receiving upwardly biased accounting data as a means to facilitate such forbearance. Relative to its predecessors as supervisors of Eurozone banks, the ECB as the supervisor within the SSM is in a better position to end regulatory forbearance, as bank supervision at the Eurozone level should imply that regulators are better able to withstand national pressures to forbear on influential national banks.

Even more importantly, the Bank Recovery and Resolution Directive (see European Commission, 2014a), emphasizes bail-in rather than bail-out the way to resolve distressed banks, which implies that fiscal constraints on bank resolution should apply less than before. The mainstreaming of bail-in as a resolution mechanism holds the promise that regulatory forbearance of even the Eurozone's largest banks will no longer be necessary in the future. Bail-in, however, still is a relatively new feature of European bank supervision and regulation, and so far it has not been applied to a major Eurozone bank. At present, a main task for the ECB is to use its supervisory powers to prepare Eurozone banks for the potential future application of bail-in in order to make the bail-in regime more credible. As an operational issue, it should, for instance, prevent the build-up of high concentrations of bail-inable debt in bank portfolios that could make bail-in impracticable. Once a credible bail-in regime is established, the supervisor can more convincingly convey to the auditor that it will not tolerate upwardly biased accounting data.

In addition, the supervisor can strengthen its perceived interest in receiving accurate accounting data by specifying ahead of time how regulatory actions will depend on the reported accounting data. In the EU, the Capital Requirements Directive IV introduces some regulatory pre-commitment into EU bank regulation in the form of capital conservation measures, which restrict the share of a bank's income that it can pay out as dividends if it does not fully meet the capital conservation buffer requirement.[5] These new capital conservation measures only make sense if they are based on economically accurate capitalization data, and hence their introduction can be seen as a commitment on the part of the regulator to insist on receiving economically accurate financial reporting from the bank and the auditor.[6] The potential for additional pre-commitment to supervisory action is provided by the Bank Recovery and Resolution Directive, which provides the supervisor with an extensive set of early intervention options if a bank breaches certain triggers.[7]

[5] See European Commission (2013, Article 141).

[6] In the US, the Federal Deposit Insurance Corporation Improvement Act of 1991 requires supervisors to classify banks into one of five capital categories, and to take increasingly severe supervisory measures, dubbed Prompt Corrective Action (PCA), as a bank's capital deteriorates. For instance, the supervisor is required to quickly resolve a bank after its ratio of tangible equity to total assets has fallen below 2%. US Government Accounting Office (2011) evaluates the operation of PCA provisions during the recent financial crisis, and it discusses possible improvements in the definitions of the PCA triggers that would potentially better shield the FDIC from loss in the future.

[7] See European Commission (2014a, Article 27).

The Directive, however, does not explicitly mandate a course of supervisory action if the early intervention regime is triggered.[8] Here there is potential for the ECB to provide more clarity on how and when early intervention measures will be applied. This would render the supervisory process in the Eurozone more rule-based, consistent with a regime of a reduced tolerance for accounting bias.

4.2 The application of knowledge of the determinants of accounting bias

The research of Homar (2016), as discussed in 3.2, shows that the expected upward bias in a bank's reported capital ratio is larger i) under adverse macroeconomic conditions, ii) with a lax regulatory and supervisory regime, and iii) for weak banks. Research along these lines can be used to predict the extent to which a bank's reported capital ratio is overstated. Information on predicted biases would be useful input for the dialogue between the auditor and the supervisor. The size of the predicted bias gives an indication of the likelihood that a bank and its auditor are actively overvaluing assets and overstating capital, even if statistical evidence of this kind cannot be used to prove that a particular bank and auditor are actively biasing the accounting data. All the same, the supervisor can use this type of statistical information to alert the auditor to an enhanced risk of accounting bias in particular instances, and it can require the auditor to report to the supervisor what it has done to detect and correct any biases in these instances.[9]

4.3 Enforcement towards reduced accounting biases

The supervisor needs to be prepared to use its supervisory and investigative powers to ensure that the auditor appropriately cooperates with the supervisor to minimize bias in banks' financial reporting.[10] Clearly, the powers of the supervisor should not be applied arbitrarily, and hence it is important that the supervisor communicates clearly to the auditor what it considers to be appropriate cooperation by the auditor to prevent and correct biases in bank financial reporting.

The AQR has proven valuable as a second opinion of the correctness of banks' financial reporting. As discussed, research based on the AQR results can be a useful input into the dialogue between the auditor and the supervisor to prevent systematic overstatement of bank asset values and capitalization in the future. Beyond that, the supervisor should retain the option to again organize an AQR for any set of banks where it suspects accounting bias could be considerable. The possibility that the supervisor will again investigate the correctness of bank accounting data in a systematic way should act as a deterrent for banks and their auditors to engage in considerable accounting bias. Clearly, an AQR is a rather expensive and invasive method to correct accounting bias – compared to the organization of an effective dialogue between the auditor and the supervisor. Therefore, an effective dialogue between the auditor and the supervisor is preferred as a way to prevent the occurrence of systematic bank accounting bias.

[8] The European Banking Authority (2015b) has published guidelines on triggers for the use of early intervention measures that similarly leave the supervisor with ample discretion on whether and how to apply the early intervention measures after certain triggers have been breached.

[9] The European Banking Authority (2015a, p. 25) mentions potential management bias in the audit approach as an issue on which the supervisor and auditors could share information.

[10] See European Commission (2014b, Article 23) for a listing of a range of supervisory and investigate powers related to the accounting of public-interest entities such as banks, including making requests for experts to carry out verifications or investigations, and referral for criminal prosecution.

5. CONCLUSIONS

Stressed banks have an incentive to overvalue their assets in order to prevent discipline from market participants and from supervisors. Biased financial reports, however, make banks less transparent with the risk that affected stakeholders, including investors and supervisors, are misinformed, potentially resulting in high individual and aggregate economic costs.

A main purpose of the dialogue between the auditor and the supervisor should be to reduce as much as possible bias in banks' financial reporting. Having a dialogue, however, is no guarantee that the bias will be reduced. To the contrary, such a dialogue potentially worsens the scope for accounting bias, if the supervisor directly or indirectly communicates to the auditor that it is interested in receiving biased accounting data that would facilitate regulatory forbearance.

To ensure that the dialogue reduces rather than facilitates bias, the supervisor needs to be able to forego regulatory forbearance in the future, even in the case of large distressed banks that until now have been considered too-big-to-fail. The application of bail-in rather than bailout in future European bank resolutions potentially obviates the need for regulatory forbearance in the future. To make this happen, the ECB, as the supervisor of Eurozone banks, should do what it can to make the application of bail-in in future bank resolution more credible. For instance, the ECB should aim to prevent the occurrence of large concentrations of bail-inable bank debt in other banks' portfolios that potentially could make bail-in of a large bank impracticable.

The supervisor can further use research on the determinants of the accounting bias to assess the risk that a particular bank engages in substantial accounting bias. The supervisor can share its assessment of this risk with the bank's auditor, requiring the auditor to apply special effort to prevent accounting bias in cases where the ex ante assessment of bias risk is relatively high. To help enforcement of a no-bias accounting regime, the supervisor needs to be prepared to use its range of supervisory and investigate powers vis-à-vis the bank and its auditor, including its capacity to obtain an independent opinion of the correctness of banks' financial reporting.

The auditor-supervisor dialogue will be conducted in private, which constrains the ability of outsiders, including parliamentary bodies, to assess how effectively the supervisor uses its dialogue with the auditor to counteract bias in bank financial reporting.

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