**The Reaction to Unexpected Bank Earnings During the LDC Debt Crisis: An Investigation of the Market’s Assessment of Earnings Quality**

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**Abstract**

 I exploit the regulatory environment of the 1970s and 1980s to study the market’s assessment of *earnings quality*, focusing on reported earnings in the banking industry. The uniqueness of this environment stems from the fact that, at that time, regulators were lax in pushing banks to re-classify problem loans to lesser-developed countries (LDC) as “non-performing”, and in many instances even actively discouraged banks from doing so for fear of inciting a panic. Thus, during this time period, banks that had significant exposure to LDCs reported at best misleading earnings, and in the worst case completely phony accounting numbers. I show that during the height of the LDC debt crisis the market significantly discounted reported earnings of exposed banks relative to those of unexposed banks. This first became apparent in 1979 and 1980 in spite of banks not being required to publicly release information on foreign loan exposure until 1982.

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1. **Introduction**

It is a well-established notion that stock prices react to new information. Numerous studies in the accounting and finance literature have documented that stock prices respond to unexpected corporate earnings announcements.[[1]](#footnote-1) More recently, research in this area has focused on the *nature* of this response by estimating the magnitude of stock price response per unit of earnings surprise (i.e., the earnings response coefficient or ERC) and analyzing how that quantity varies with certain firm characteristics, such as firm size and stock return volatility.[[2]](#footnote-2) In this paper we examine the impact of earnings *quality[[3]](#footnote-3)* on the magnitude of the estimated ERC.

Finance theory suggests that the market’s assessment of firm value (as measured by stock price) should be equal to the value of the firm’s current earnings plus the present value (PV) of the firm’s expected future earnings. This value thus depends on investors’ expectations of current earnings and future earnings, as well as the riskiness that these expected future earnings will be achieved. What is important for firm value is the firm’s true “economic” earnings rather than the earnings figure reported by accountants.[[4]](#footnote-4) Because the data generally released by firms are accounting data, it is important to measure both how well reported accounting earnings correspond to economic earnings, and whether investors are aware of differences in the quality of reported accounting numbers (or can they be fooled by the possible manipulation of accounting numbers?).

**Financial crisis and market value accounting (same idea: MV accounting tries to make accounting earnings more correspond to economic earnings)**

In general, such questions of earnings quality are difficult to address because economic earnings are a latent variable and we must rely on accounting earnings as a proxy for economic earnings. However, due to the regulatory treatment of troubled Latin American loans in the 1970s and 1980s, the reporting of earnings by US banks provides us an opportunity. Specifically, as Sachs and Huizinga (1987) have noted, during the Lesser-Developed Country (LDC) debt crisis, many large US banks were allowed (and even encouraged) by Us regulators to report obviously misleading earnings numbers in their annual and quarterly earnings releases.

Problem loans to Latin American countries (and other LDCs) that were trading at substantial discounts on the secondary market were allowed to be kept on the banks books at full value[[5]](#footnote-5) **(similar phenomenon during the recent financial crisis?)** and the interest payments on those loans recorded as income even though in many cases additional loans needed to be advanced to the LDC just to service the original debt. In fact, regulators often urged large banks not to take excessive loan-loss provisions for fear of exacerbating a panic **(Saunders?**). This left LDC-exposed bank earnings unaffected by the troubled LDC loans on their books and meant that reported earnings were unrepresentative of the true financial condition of the reporting bank. Simultaneously, banks that had little or no involvement in Latin America were reporting *relatively* “clean” earnings numbers. My purpose in this paper is to assess whether the market is able to distinguish the quality of reported bank earnings, and, if so, when it starts to penalize banks whose earnings are of low quality. My focus is on the earnings response coefficients of exposed versus un-exposed banks.

Holthausen and Verrechia (1988) model the stock price response to the release of new information as a function of prior uncertainty as well as the precision of the information release. They show that the stock price response is an increasing function of prior uncertainty and an increasing function of the precision of the announcement. These intuitive conclusions are supported by the experimental work of Coller (1996). An earnings announcement is an example of a noisy information release. According to Holthausen and Verrechia (1988), if two otherwise identical firms release earnings, the firm with the higher quality (more precise) earnings should induce a stronger stock price response per dollar of earnings surprise, i.e., the ERC should be higher. Herein lies the role of the ERC in our analysis: if the ERCs of LDC-exposed banks are small relative the ERCs of similar non (or lesser)-exposed banks, it will be clear that the market regarded future expected LDC-exposed bank earnings as riskier and/or downgraded its forecast of future LDC-exposed bank earnings relative to those of non-exposed banks. Alternatively, if there is little or no distinction between ERCs of exposed and unexposed banks, I would conclude that investors were not able to correctly assess the quality of reported bank earnings.

Based on a sample of earnings announcements of 42 large bank holding companies over the period 1975-1992, I show that the ERCs of LDC-exposed banks were significantly lower than the ERCs of unexposed banks during the period 1982-1988, while the ERCs of exposed and unexposed banks were insignificantly different from one another in the 1975-1981 period, and the ERCs of exposed banks were higher in the 1989-1992 period. In addition, a year-by-year analysis shows that the market first reacted to the lower quality of LDC-exposed bank earnings in 1979 and 1980. This is a testament to the efficiency of the financial markets becausebanks were not required to report their cross-border exposure until the end of 1982, and it was not until 1982 that a viable market for secondary LDC loans developed.[[6]](#footnote-6)

The remainder of the paper is organized as follows: Section 2 discusses some issues of modeling bank earnings and computing ERCs for banks, Section 3 outlines my methodology and describes my dataset. The results (and interpretation of those results) are presented in . Section 5 concludes the paper.

1. **The Response to Surprises in Bank Earnings**

Several papers have examined the stock market’s response to unexpected changes in various components of bank earnings (see Ahmed and Takeda (1995), Warfield and Linsmeier (1992), and Scholes et al. (1990)). These papers show that the market reacts differently to unexpected changes in earnings from continuing operations and unexpected changes in one time realized gains or losses on the sale of securities. On average there is a positive correlation between unexpected changes in earnings from continuing operations and announcement period stock returns, while the correlation between unexpected changes in security gains and losses and stock returns depends on the circumstances surrounding the particular choice of realization[[7]](#footnote-7), though overall it is negative. In this paper, my concern is with the market’s response to unexpected changes in earnings from continuing operations (henceforth, UECO) because earnings from a bank’s loan portfolio, in particular the earnings (losses) from troubled LDC loans, appear in this category. My hypothesis about earnings quality has nothing to say about the valuation of unexpected changes in realized securities gains and losses (UGSL).[[8]](#footnote-8) However, it is necessary to separate the effects of UECO from the effects of USGL in order to focus on the reaction to unexpected changes in UECO. What follows is a model of the response to UECO.

Assume that stock prices are set according to classical valuation theory, namely, stock price equals the present value of expected future cash flows. To simplify the mathematical exposition, further assume that investors view the firm’s cost of capital, grow rate in earnings, and dividend payout ratio as constants.[[9]](#footnote-9) According to these assumptions, the stock price at time t, assuming the can be purchased cum dividend, is given by:

 (1)

Where *ρ* is the dividend payout ratio, *g* is the growth rate in earnings/dividends, *k* is the cost of capital, and *Yt* are earnings from continuing operations per share in period *t*. Furthermore, we need the condition, *k* > *g*, to hold. Assume we are standing at time *t* – *Δt*, an instant prior to the earnings announcement at *t*, and that investors have a forecast of time t earnings, E[*Yt* | *It-Δt*], where E[• | *Is*] denotes expectation conditional on the information set, *Is*, given by E[*Yt* | *It-Δt*] =

*Yt-1(1+g).* Realized earnings at *t* are then given by (2) below:

 (2)

Where *Ɛt* is the error in the forecast of *Yt*. Once *Yt* is announced at time *t*, then the uncertainty over *Yt* is resolved and E[*Yt* | *It*] = *Yt* . If we now move forward and consider the expectation of Yt+1 conditional on the information available just prior to time *t+1*, E[*Yt+1* | *It+1-Δt*] = *Yt-1(1+g)* = *Yt-1(1+g)2 + Ɛt (1 + g)*. In other words, the time *t* earnings surprise, *Ɛt*, also propagates through time, growing at the same constant rate, *g* per period. Assuming that the earnings surprise does not change investors’ beliefs about *k*, *g*, and *ρ*, then the change in stock price due to the earnings surprise will be given by:

 (3)

This represents the capitalization of the propagation of the earnings surprise through time, where future earnings are discounted at the firm’s cost of capital, k. If we now divide both sides by the pre-announcement stock price, *Pt-Δt*, we have an expression relating announcement period returns to unexpected earnings:

 (4)

where *γ* is the ERC. Earlier I asserted that investor’s perceptions of differences in earnings quality would manifest themselves in perceptions of earnings growth, *g* (an increasing function of earnings quality), and earnings riskiness, *k* (a decreasing function of earnings quality). How does this impact the ERC, *γ*? Define *γE* and *γU* to be the ERCs of LDC-exposed and unexposed banks, respectively. Finally, define *λE* and *λU* as follows:

 (5)

My hypothesis states that *earnings quality* may impact on either the growth rate in earnings, *g*, or the cost of capital, *k*, or both. Recall that my main hypothesis is that, during the LDC debt crisis years, the earnings of LDC-exposed banks were of lower quality due to the fact that those banks were actively discouraged by regulators from writing off poorly-performing LDC loans, and instead were encouraged to use any means necessary (including lending the impaired debtors additional funds) to maintain those loans on full accrual status. This being the case, we should have *gU* ≥ *gE* and *kU* ≤ *kE*, with at least one strict inequality. This implies that *kE* – *gE* > *kU* - *gU*, which implies *λE* < *λU* and hence *γE* < *γU* , when unexposed and exposed banks report earnings of differing quality. This is the central hypothesis to be tested in Section 4. During non-crisis years, it is conceivable that we might have *gE* ≥ *gU* , because banks with opportunities to invest in LDCs might have been considered to have better growth opportunities. In general the large multi-national banks, a category to which many of our “exposed” sample belongs to, might be considered to have had better growth opportunities than the smaller regional banks since they also derive income from derivatives dealing, LBO loans, and other Highly Leveraged Transactions (so-called HLT loans) that command very generous yield spreads, and more recently investment banking activities such as underwriting.

1. **Methodology and Data**

Because I am interested in measuring the market’s stock price response to earnings surprises, we need to compare the actual stock return of the announcing firm that is observed in a window surrounding the given earnings announcement with the stock return that should have been observed had the announcement not occurred – i.e., the expected return. This requires specifying a model of expected returns (a return generating process). I use the standard market model that states that the return on any stock, *i*, at time, *t*, *rit*, may be described in terms of its correlation with the overall market return at time *t*, *rmt*, and firm-specific factors captured in a stochastic error term, *eit*, assumed to have expected value of zero:

 (6)

where *αi* and *βi* are coefficients to be estimated over a pre-announcement period of 100 days from event dates t=-111 through t=-11 using ordinary least squares (OLS). Stock *i*’s abnormal return on day t, *ARi,t*, is found by subtracting the realized return, *rit*, from stock *i*’s expected return:

  (7)

where *ai* and *bi* are the OLS estimates of *αi* and *βi*, respectively. By focusing on the abnormal return I hope to control for any economy-wide news that may be released concurrently with the earnings news. My main interest is in the relation between earnings surprises, *Ɛt*, and announcement period abnormal returns, *ARi,t*, as seen through the earnings response coefiicient (ERC), and whether the ERCs vary with the quality of earnings as dictated by finance theory and consistent with the model in Section 2 – i.e., the ERC is larger for banks reporting higher quality earnings. To compute ERCs for banks I will estimate regressions of the form (based on Equation 4):

  (8)

where *Yi* is firm *i*’s announced earnings from continuing operations, *E*(*Yi*) is the market’s forecast of I’s earnings (as measured by the most recent forecast in the *Valueline Investment Survey*), *Pi* is firm *i*’s stock price at the end of the quarter prior to the earnings announcement, *γ1* is the ERC, *ARi*, is the sum of *ARi,t* from *t*=-1 to *t*=+1 (in event time)[[10]](#footnote-10), and *ηi* is a random error term. Although, as an industry, large banks may represent a fairly homogeneous group, there may be differences across banks other than earnings quality that may affect the estimates of bank ERCs (such as the differing growth opportunities mentioned above). Thus, I control for these differences with variables such as the bank’s provision for loan losses, its capital adequacy, and its dividend payout ratio. In addition, Easton and Zmijewski (1989) argue that the given forecast may be out of date at the time of the earnings release and suggest including the compound return on the given starting on the date of the forecast and running through two days prior to announcement to capture any information that may have been known to the market but not included in the forecast from *Valueline*. I proxy for earnings quality by the fraction of bank assets at risk in the form of loans to LDCs (>4% of total assets[[11]](#footnote-11)). The main hypothesis tobe tested is the following:

**H0**: The market’s sensitivity to the earnings surprise is unrelated to the quality of earnings.

against the alternative hypothesis:

**H1**: The market’s sensitivity to the earnings surprise is an increasing function of earnings quality.

This hypothesis will be tested by estimating the following equation:

 (9)

where *EXPj* is a dummy variable that takes on the value 1 when bank I has significant loan exposure in problem LDCs in period j and 0 otherwise, the *Ck*s are the above-mentioned control variables, and *δi* is a random error term. My hypothesis will consist of a test for the sign and significance of the *γj* for each value of *j* – that is for each sub-period.[[12]](#footnote-12) Either an insignificant of positive value of *γ2* would favor the null hypothesis over the alternative, since period 2 (1982-1988) represents the crisis years,[[13]](#footnote-13) while a significantly negative estimate of *γ2* would reject the null in favor of the alternative. Under both the null and the alternative hypotheses I expect insignificant values of *γ1* and *γ3* , though positive values make sense under certain conditions, e.g., the aforementioned enhanced growth opportunities of large banks during the build-up of LDC loan portfolios, as well as assorted sources of income (e.g., derivatives dealing, HLT loans, etc.) for large banks in the later period.

 My database consists of data on the 42 large banks routinely followed by the *Valueline Investment Survey* for a substantial portion of the period 1975-1992. For each bank in my sample, I collect data on the following: quarterly earnings announcement dates, total assets, book and market value of equity, loan-loss reserves, provision for loan losses, realized security gains and losses,[[14]](#footnote-14) daily stock return data,[[15]](#footnote-15) LDC loan exposure,[[16]](#footnote-16) and forecasted and realized earnings per share as reported by the *Valueline Investment Survey*. A total of 2078 bank quarters met these criteria for inclusion in the study. Summary statistics on several of the variables are reported in Table 1.

 The most recent *Valueline* earnings forecast[[17]](#footnote-17) serves as my proxy for the market’s estimate of expected earnings. In years prior to 1983, banks were required to report earnings from continuing operations and earnings from security gains and losses separately, and the *Valueline* earnings was only a forecast of earnings from continuing operations. However, since 1983, banks reported a composite of earnings from continuing operations and securities gains and losses and the *Valueline* earnings estimate was an estimate of this composite number. This might at first cause concern, but as Warfield and Linsmeier (1992) suggest, there is no obvious pattern in realized securities gains and losses. Therefore, it seems reasonable to assume that *expected* securities gains and losses are zero.[[18]](#footnote-18) Under such an assumption, the *Valueline* forecast of the composite figure may be assumed to be an estimate of earnings from continuing operations. I follow Warfield and Linsmeier (1992) and Barth et al. (1990) and make this assumption.

1. **Empirical Results and Interpretation**

Given the previous evidence of the stock market’s ability to assess information as it is made public, we anticipate that the market was aware of differences in earnings quality between LDC-exposed banks and other large banks. However, prior to testing how the market responds to differences in earnings quality, I test for differences in the ERCs of LDC-exposed and unexposed banks over the entire period (1975-1992). In particular I estimate the following regression:

 (10)

where *UEPSi* is the unexpected earnings from continuing operations of bank *i*, *EXPi* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and zero otherwise, *Pi*, is bank *i*’s stock price at the month end prior to earnings announcement *i*, *USGLi* are bank *i*’s unexpected realized gains and losses on securities (per share), and the *Ck*s are control variables that include bank *i*’s provision for loan losses, dividend payout ratio, a proxy for the capital adequacy ratio (book value of equity to assets), and bank *i*’s stock return from the date of the earnings forecast to 2 days prior to the earnings announcement. Finally, *δi* is a random error term assumed to be independent across banks and through time, and uncorrelated with any of the regressors. Equation (10) will be estimated with weighted least squares (WLS) to account for the possibility of heteroskedasticity in the error term.

 The results of the estimation of Equation (10) are given in Table 2. It is clear that over the sample period as a whole, there is no significant difference between the ERCs of LDC-exposed and unexposed banks. Specifically, the coefficient on EXP is insignificantly different from zero at any standard level of significance (point estimate = -0.0369, t-value = -1.014). The regression itself is significant at the 0.0001 level with the expected signs on all variables. The overall ERC, i.e., the coefficient, *γ0* is positive and significant at the1% level. Furthermore, the overall relation between USGL and AR is negative and significant, in agreement with Warfield and Linsmeier (1992) and others.[[19]](#footnote-19) The significant coefficient, *λ4* (the return from the forecast date to two days prior to the earnings release) indicates that there was value-relevant information released between the forecast date and the announcement date for the average bank, and the negative sign on the coefficient implies that the information reduces the surprise in the earnings announcement which is fairly intuitive. Finally banks that had taken a large loan-loss provision showed a more positive reaction to the earnings news, and banks with higher dividend payout ratios showed a more negative reaction to the earnings news. In short, there is no evidence to suggest that LDC-exposed and unexposed banks were valued any differently by the market for the overall sample period. Whether this relationship changes over time is the subject of the next section.

* 1. ***Does the Market Value Earnings Quality?***

To test my hypothesis concerning the market’s assessment of earnings quality, I estimate the regression given in Equation (11) below:

 (11)

where *EXP1* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1975 and December 31, 1981, and zero otherwise, *EXP2* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1982 and December 31, 1988, and zero otherwise, and *EXP3* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1989 and December 31, 1992, and zero otherwise. Other variables are as defined earlier. Equation (11) is estimated with WLS to account for the possibility of heteroskedastic errors. The test of my main hypothesis is a test of the sign and significance of the *γi*s. The null hypothesis, as stated in Section 3, is that each of the *γi*s is insignificantly different from zero. The alternative is that *γ2* is significantly negative.

 Table 3 provides estimates of Equation (11) for the full sample of 2078 individual bank quarters. The coefficients estimated for each of the control variables are virtually identical as in the estimation of Equation (10), as are the intercept term and the overall ERC. However, partitioning the LDC exposure variable, EXP, into subperiods shows distinct differences from the earlier regression. Moreover it is clear why the estimate of Equation (10) showed no distinction between exposed and unexposed banks’ ERCs. Most notably, while *γ1* is insignificantly different from zero with a t-stat of 0.415, *γ2* is significantly negative at the 5% level with a t-stat of -2.089. Seemingly the market was aware of the low quality of the earnings of LDC-exposed banks relative to those of unexposed banks. Furthermore, *γ3* is positive and significant at the 5% level, likely reflecting the enhanced growth opportunities of the largest banks (those exposed to LDC problems were primarily the largest of the large banks) following the resolution of the LDC crisis. These opportunities included derivatives dealing as well as HLT loans – a segment of the loan portfolio more carefully policed by regulators, with banks bring encouraged to get ahead of the problem resulting in earnings of better quality. Finally, the last period marked the beginning of the end of the Glass-Stegall act that had kept banks out of underwriting since the Great Depression.

 This evidence suggests that the market was aware of the differences in earnings quality between LDC-exposed and unexposed banks. Furthermore, after LDC-exposed banks came to terms with their difficulties in 1987 and 1988, I observe and immediate reversal of the circumstances. Next I more carefully look at timing.

* 1. ***A More Complete Test of the Valuation of Earnings Quality***

Now that I have established that the market was aware of the differences in quality across banks, I turn to the question of when the market started to value exposed and unexposed banks differently. I am also interested to see if any documented differences disappear once the crisis abates. I estimate an extension of Equation (11) given below in Equation (12):

 (12)

where *EXP1* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1975 and December 31, 1975, and zero otherwise, *EXP2* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1976 and December 31, 1976, and zero otherwise, and so on. Finally, *EXP18* is a dummy variable that equals one if bank *i* is classified as LDC-exposed and the earnings announcement was between January 1, 1992 and December 31, 1992, and zero otherwise, while other variables are as defined earlier. Equation (12) is estimated with WLS to account for the possibility of heteroskedastic errors.

 The results of the estimation of Equation 12 are reported in Table 4. The coefficient, *γ0*, is positive and significant at the1% level (as in Equation (11)). The distinction between Equations (11) and (12) comes from the fact that Equation (12) breaks down the exposure dummy into a year-by-year comparison rather than just 3 subperiods. The difficulty with this approach is that the value of each *γi* is estimated using far fewer observations, suggesting the results need to be taken cautiously. Looking at the results we see that there is a significantly positive coefficient in 1978. What is most interesting in Table 3 is that there is a significant negative value estimated for the years 1981, 1987, and 1988 (1987 significant at the 1% level, while the other two significant at the 5% level. Furthermore, although not significant in any of the remaining intervening years, the γs are almost entirely negative between 1981-1988 (the exception being 1986). Final the γs in the years in the post LDC debt crisis period are all insignificantly different from zero. Overall the results in Table 4 show that the market reacts to differences in earnings quality, and that the first perceptions of differences were in 1981 – a remarkable finding given that banls were not required to reveal their foreign, and in particular their LDC loan exposure until the end of 1982 (in their 1982 annual reports).

 Overall the results in Table 3 strongly support the alternative hypothesis over the null, and Table 4 is a testament to the market’s efficiency showing that, already in 1981, differences between the ERCs of LDC-exposed and unexposed banks were apparent.

* 1. ***The Reaction to Securities Gains and Losses: An Additional Test***

Earlier it was stated that the main hypothesis concerned banks’ unexpected earnings from continuing operations (UECO) and not the realized gains and losses from the sale of securities (USGL). As a further test of my main hypothesis, I test for differences in the response to USGL between LDC-exposed and unexposed banks. There is no a priori reason to think that responses to USGL should differ based on LDC exposure. In fact, a finding that significant differences existed would call into question my earlier results and be suggestive of an omitted variable or other problem.

To compare the reaction to USGL across exposure classes, I estimate the following equations that correspond directly to Equations (11) and (12):

 (13)

and

  (14)

where all variables are as defined earlier. Here the γs capture differences in the response to USGL rather than UECO, based on LDC exposure. The results from the estimation of Equations (13) and (14) are given in Tables 5 and 6, respectively. From these tables it is clear that the control variables have similar signs and significance to earlier. Moreover, none of the γs are significant. This indicates that the market did not distinguish between LDC-exposed and unexposed banks in reacting to unexpected gains and losses from the sale of securities. It appears less likely that the earlier results based on UECO are driven by an omitted variables problem.

1. **Concluding Remarks**

The flexibility of accounting standards and principals as outlined in the GAAP and various regulations set forth by FASB imply that the quality of reported earnings will likely vary significantly across firms. However, differences in earnings quality across firms are difficult to assess because “economic” earnings are not observable. Furthermore, no obvious proxy for earnings quality exists.

I argue that the reporting of earnings by large banks during the 1980s provides an instance when earnings quality is more assessable due to the presence of a regulatory “shock”: large banks exposed to problem LDC credits were allowed and even encouraged to skirt the rules about classifying loans as non-performing. Maintaining non-accrual loans categorized as “performing” meant that income and capital were inflated relative to what was warranted, and bank financial statements gave a rosy picture of bank solvency. Troubled LDC loans were kept on the books with full accrual status thereby giving a distorted picture of the income of affected banks. Meanwhile, this flexibility meant little to banks that had little or no exposure to LDC debt.

I show that between 1981 and 1988, the stock market responded to differences in earnings quality by showing that the ERCs of banks with substantial LDC exposure were significantly smaller than the ERCs of banks with little or no exposure, while between 1975 and 1981, and between 1989 and 1992, these differences were not apparent. Finally, I show that these differences began to show up as early as 1981, a shocking finding given that banks were only required to publicly release their international exposure in 1982.

These results are a testament to the efficacy of disclosure of value-relevant information. This is especially relevant at a time when the details of the Dodd-Frank bill are being ironed out, and any additional oversight or disclosure requirements are automatically viewed as onerous.

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1. See, for example, Ball and Brown (1968), Beaver, Clark, and Wright (1979), Beaver, Lambert, and Morse (1980), among many others. [↑](#footnote-ref-1)
2. See, for example, Collins and Kothari (1989) and Easton and Zmijewski (1989). [↑](#footnote-ref-2)
3. By *earnings quality* I mean the precision with which accounting earnings measure true “economic” earnimgs. [↑](#footnote-ref-3)
4. The one exception would be firms that rely on self-discipline of clean surplus accounting. In such a case, firm value can be stated strictly in terms of book values, and earnings “quality” is a moot point. See Ohlson (1992) and Bernard (1993). [↑](#footnote-ref-4)
5. The trouble with carrying problem (non-accrual) loans on the bank’s balance sheet at full accrual status is as follows: loans on the asset side of the bank’s balance sheet are supported by deposits and other costly liabilities. Typically, if a bank is earning a high enough interest rate on its loans relative to the interest rate it pays on its deposits, it generates income for shareholders. However, if interest payments on loans cease, the bad loans will be a drain on shareholder income and hence bank capital, because the bank will have larger and larger quantities of non-earning assets supported by interest-bearing deposits. [↑](#footnote-ref-5)
6. 1982 was also an important year because it was in 1982 that Mexico became the first Latin American country to suspend foreign debt service. [↑](#footnote-ref-6)
7. Warfield and Linsmeier (1992) and Ahmed and Takeda (1995) show that under certain conditions the correlation between security gains and losses and stock returns is positive, while under other conditions it is negative. The distinction centers on the bank’s tax status as well as its tendency to manage (smooth) earnings. In this paper, my interest is on the coefficient on earnings from continuing operations since this is where distinctions in earnings quality between exposed and unexposed banks will appear. Therefore I am not concerned with the motivation for, and valuation of, security gains and losses, be it for earnings manipulation or tax planning. However, it is important to separate out the effect of earnings from continuing operations from the effect of realized gains and losses from the sale of securities, in order to focus on earnings from continuing operations. [↑](#footnote-ref-7)
8. There is no ex-ante reason to expect that the response to unexpected changes in securities gains and losses should differ across banks based on their exposure to LDC loans. Evidence later in the paper bears this out. [↑](#footnote-ref-8)
9. Hence stocks are valued according to the familiar “Gordon” growth model (see Gordon and Shapiro (1956) and Williams (1938). [↑](#footnote-ref-9)
10. We include t = -1 to capture any leakage of information just prior to the earnings announcement, t=0 is the announcement day itself, and we include t=+1 in case the announcement came after normal trading hours. [↑](#footnote-ref-10)
11. It should be pointed out that although the cutoff of 4% is somewhat arbitrary, it is chosen for a reason: starting in 1982, banks were required to report exposure to all countries that exceeded 1% of total assets. I consider the exposure to the four largest debtor countries (Argentina, Brazil, Mexico, and Venezuela), see Grosse and Goldberg (1996). Though unlikely, it is conceivable that a bank reported no exposure to these countries when in fact it was close to 4% of assets as a group. By setting the hurdle higher, I hope to reduce the likelihood that a bank in the “unexposed” group had more exposure to LDC problems than even one member of the exposed group. [↑](#footnote-ref-11)
12. *γj* measures the difference between the ERCs of banks exposed to LDC problems and those that are unexposed in period *j*. In particular, *j*=1 represents the period from 1975-1981 (prior to any obvious problems in the LDC debt market and prior to banks being *required* to release information on LDC exposure), j=2 represents the crisis years from 1982-1988 (1982 being the year of the first LDC debt moratorium (Mexico), and j=3 represents the post LDC debt crisis period containing regulatory refinements such as the Basel accord and FDICIA, as well as a big push from regulators to ensure that banks properly reserve for souring loans including HLT and LDC among others. [↑](#footnote-ref-12)
13. This period contained defaults by Mexico (1982), Bolivia (1984), and Brazil (1987). In addition to these actual defaults, fears of defaults by other countries were rampant throughout the period, hence I use the term “crisis period” to refer to the period between 1982-1988. [↑](#footnote-ref-13)
14. All from Standard and Poor’s quarterly Compustat. [↑](#footnote-ref-14)
15. From the Center for Research in Security Prices (CRSP) [↑](#footnote-ref-15)
16. From bank annual reports and 10-K filings. [↑](#footnote-ref-16)
17. The most recent forecast is defined as the last forecast made prior to the given earnings announcement. There was typically a one to two week lag between forecast and actual announcement, however, for a few banks, the lag was considerably longer. [↑](#footnote-ref-17)
18. In fact, in my sample, earnings from securities gains and losses have a mean value of a mere two cents per share (see Table 1). [↑](#footnote-ref-18)
19. Warfield and Linsmeier (1992) go on to show conditions under which *γ0* will be positive. Because my primary objective is to clarify the reaction to earnings from continuing operations, I refrain from any analysis on USGL. [↑](#footnote-ref-19)