How government guarantees give banking customers peace of mind and keep banks open

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Spooked by volatile reports from the Silicon Valley Bank in early March, many customers panicked and withdrew their money, creating the largest bank failure since the 2007-2008 financial crisis. The problem—investors and customers lost confidence in the bank, proving the perception of a bank's reliability can significantly impact its success.

Investors tend to respond negatively to volatility in firms' performance. To mitigate investors' concerns, when some banks receive extremely high income, they occasionally delay reporting that amount until a later date when the income has dropped. In most cases, this practice is completely legal and is known in the industry as "income smoothing."

A new study at the University of Missouri shows that the frequency at which banks participate in income smoothing may be lessened by government guarantees—or guaranteed support from the government in the event the bank needs help ensuring every customer has access to their money. For the study, Felipe Bastos Gurgel Silva, an assistant professor in the Robert J. Trulaske, Sr. College of Business, analyzed the reports of several European banks during two historical situations when the amount of their government support fluctuated.

"The banking sector wouldn't function at all without government guarantees," Silva said. "They help the banks be prepared for extreme situations. And we found that as a result of this, the banks feel less pressure to artificially create the perception of performance consistency in their public reports."

Silva and a team of researchers, including Manuela Dantas, an assistant professor at California State University-Northridge, and Ken Merkley, a professor at Indiana University, analyzed several reported numbers, including loan loss provisions and pre-provision earnings. Because government guarantees cannot be randomized as they often are in biotech trials, the researchers analyzed two situations where government guarantees changed due to "external" factors not related to the individual banking sectors of their study. Specifically, the authors analyzed the increase in implicit government guarantees caused by the creation of the Eurozone and the removal of explicit government guarantees granted to the Landesbanken, a group of large state-owned banks in Germany.

The Eurozone creation in 1999 happened for geopolitical reasons. However, the creation of a monetary union and the European Central Bank as a lender of last resort increased the implicit government guarantees of the banks headquartered in the first countries that formed the Eurozone. Conversely, the Landesbanken had their explicit guarantees removed in 2005 because other banks in Germany complained that such guarantees violated terms of the European Union Treaty.

"While our study of the Eurozone creation does not prove a causal relationship, we show the findings can be applied to many banks, not just the ones studied," he said. "And while the findings about Landesbanken may not be proven to be applicable to other banks, we were able to find much more of a causal relationship between government guarantees and income smoothing. Together, the fact that we study two complementary settings and that the results of the two are directionally consistent give us a great sense of how these guarantees impact banks all over the world."

While income smoothing adds to the total amount of manipulation in public reports, Silva said there are positives and negatives about the trend. He suggested that if reports are smoother overall, it boosts the total amount of investors in the market, potentially positively impacting the economy. However, he said prior research also shows it may be beneficial to limit the total amount of income smoothing occurring at once to help decrease manipulation overall.

"There is prior research, by people right here at the University of Missouri, that shows that accounting manipulation can be an indicator of an upcoming recession," Silva said. "Income smoothing is one form of accounting manipulation. Even though it isn't necessarily done with the intent of manipulating investors' perceptions, many argue it still is a form of distortion."

More information: Manuela M. Dantas et al, Government Guarantees and Banks' Income Smoothing, *Journal of Financial Services Research* (2023). DOI: 10.1007/s10693-023-00398-3

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