

# ANALYSING the ANALYSIS

Bangor Business School's PROFESSOR PHILIP MOLYNEUX examines the factors involved in forecasting banking risks, highlighting what influences the conclusions of sector analysts.

The financial crisis highlighted the problems faced by banks in gauging their own risks. Many of the world's largest banks held insufficient levels of capital relative to the risks taken, meaning market participants were either misinformed or simply did not react appropriately to available information. One area worth investigation is looking at whether banking sector analysts were able to effectively assess the risks taken.

## OPTIMISM VS PESSIMISM

Studies have shown that variation in forecasts for the same firm may reflect uncertainty in expected future cash flows, as well as information asymmetry. Information asymmetries and uncertainties surrounding cash flows can create doubt about a firm's earnings prospects and therefore increase risks. As such, one should expect to see a positive link between risks and variation in analyst forecasts.

Analyst earnings forecasts tend to be positively biased, with earlier studies from the 1980s and 1990s generally optimistic in their conclusions, with consistent overestimation

of company earnings. However, more recent literature suggests a reversal, with a shift towards a more pessimistic outlook, particularly for US firms. This shift has been explained by legislative restrictions to mitigate various conflicts of interest, for instance links between investment divisions and research arms of investment banks and regulations to limit the flow of private information from management to analysts. Two main pieces of legislation that impacted the US were the Global Analyst Research Settlement, April 2003 and Regulation Fair Disclosure (RegFD), August 2000. The former (enforcement) agreement was between the Securities Exchange Commission (SEC), National Association of Securities Dealers and the New York Stock Exchange (NYSE), and ten of the US' largest investment firms, in order to address conflict of interest within their businesses. Various regulations were introduced, such as Chinese walls, to prevent markets abuses stemming from pressure by investment bankers on analysts to provide "favorable" earnings forecasts and other "appraisals". RegFD was promulgated by the SEC and mandated that all publicly

traded companies had to disclose material information to all investors at the same time.

## FORECASTS AND RISK

Research into bank analyst forecasts, in contrast to that into non-financial firms, is somewhat limited. Early work looking at the US finds that analysts revise bank earnings forecasts significantly less often than for non-banks, and that bank earnings are also more accurately predicted, with forecast errors significantly lower for banks compared to non-banks. Some suggest the greater accuracy of bank earnings forecasts can be put down to the less frequent changes in the "true value" of banks compared to their non-bank counterparts. Others state that banks are better placed to manage their earnings via loan-loss provision manipulation, in order to meet analyst expectations.

Analysts have an additional challenge to biases when investigating banks, most notably how to measure risk. The empirical banking literature employs a variety of accounting and market risk measures. Accounting-based proxies include:

indexes of the degree of bank insolvency, such as the Z-score; levels of non-performing loans; and return volatility, such as the median standard deviation of the rate of return on assets. A main criticism of the measures, however, is that they are typically backward-looking and, as such, market-based measures are often preferred. These include indicators of total risk proxied by the standard deviation of stock returns, and also its decomposition into systematic risk (beta) reflecting common market factors and bank-specific idiosyncratic risk. Dispersion in the analyst forecasts for banks can also be viewed as a risk indicator, given that it is believed to reflect greater uncertainties relating to future cash flows as well as heightened information asymmetries.

## EUROPEAN BANKING EVIDENCE

A recent study by Anolli, Beccalli and Molyneux (2014) seeks to investigate the influence of bank risk on the forecasting abilities of analysts. Typically, it would be expected that dispersion in analyst forecasts would be positively related to a variety of risk measures. Having a better understanding of the link

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between risk and forecast earnings variation should help improve the quality of future earnings forecasts.

Using a sample of 36,343 analyst forecasts issued for 411 European banks over 2003-2009, Anolli, Beccalli and Molyneux find that forecasting abilities are negatively linked to most bank risks. Interestingly, they also find that analyst forecasting abilities vary over time: over the banking crisis period of July 2007 to March 2009 the risk indicators – insolvency, credit, liquidity and market specific – increase earnings forecast errors, whereas before the crisis they appear to have little impact. This is confirmed when we take into account all risk measures simultaneously, and when we consider interconnections among risk measures and their link to bank business models.

Analyst views on the influence of different risks on bank earnings, therefore, vary over time, and their forecasting abilities worsen at the height of the crisis. It seems that when increasing uncertainty and informational asymmetries are built-up by European banks, the effectiveness of analysts in the market discipline process weakens.

Overall, analyst forecasting abilities are reduced by risk and this can have a differential impact over time and for different types of analysts. Given that bank analysts seem to evaluate types of bank risk in a varying manner this questions their effectiveness in the market discipline process. Most worryingly, they appeared to virtually ignore the role of risks in banking building up prior to the crisis. Future work should seek to investigate whether alternative risk measures can be consistently linked to earnings forecasts volatility and whether various elements that influence risk can be factored in that models the determinants of such forecasts. <sup>35</sup>

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