

ESSAYS ON DISTRESSED ASSETS AND BANKING



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Abstract

The proposed dissertation studies two important concepts in financial markets: the presence of high levels of distressed assets, the banking system, and the relationship between the two. It consists of three essays that investigate the efficacy of procedure adopted by banks for distressed asset disposition, accounting outcomes associated with distressed assets in banks and valuation relevance of accounting metrics representing distressed assets.

In the first essay, we examine a unique application of contingent payment auction mechanism in the sale of nonperforming loans by banks in India to privately held asset management companies. We provide a stylized proof that establishes the revenue dominance of a security bid auction over cash auction under a first-price, sealed bid mechanism where the security bid constitutes a combination of cash and debt. We also establish the lack of separation in a bid with a combination of cash and debt where cash proportion is either an insignificant amount of the highest possible payoff or is dominated by the management fees paid to the bidder. We identify the issues involved in considering auction bids as the fair market value of nonperforming loan since the bid amount is conditional on the type of auction mechanism. Our findings provide guidance for banks, regulators and standard setters to consider auction mechanisms where cash component constitutes a meaningful amount of the overall bid to ensure the efficiency of the auction.

The second essay investigates whether the valuation relevance of the discretionary and nondiscretionary components of loan loss provision is influenced by the type of specification used for estimating the components, selection of valuation model, choice of deflator and type of regression. We develop estimates of discretionary and nondiscretionary loan loss provision using nine different specifications and two scale related deflators. We test the valuation relevance of these estimates on the market capitalization using two different valuation models and different regression approaches. Our empirical results indicate that valuation relevance of the components of loan loss provision is conditional upon the choice of loan loss provision specification, valuation model, regression approach, and a combination thereof.

In the final essay, we examine the role of government ownership concentration in earnings management and valuation relevance of loan loss provision components for banks. Using a firm-level data set of listed Indian banks for a nine-year period, we find evidence that the banks with a concentrated government ownership use loan loss provision to smooth their income. We also report evidence that the valuation relevance of the discretionary component of loan loss provision is conditional on the government ownership concentration. The valuation of the discretionary component of loan loss provision is negatively influenced by majority government ownership.

Keywords: Security Bid Auction, Contingent Payment Auction, Asset Management Companies, Loan Loss Provisions, Earnings Management, Ownership Concentration, State Ownership

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