

## Description for the general public

Banks conduct loan granting activities that are always connected with a certain credit risk, meaning that some loans may be not repaid. In order to account for such losses banks are obliged to create loan loss reserves that cover non-performing loans. The creation of these reserves decreases annual profit of banks, but the resolution of reserves may affect profit in a positive way. Banks are found to take advantage of this feature of reserves and adjust their level not only to credit risk of their loan portfolio, but also to the underlying profitability of the bank in a given period. In particular, banks try to avoid reporting too high profit fluctuations and use higher earnings periods to make reserves that are extensive in relation to underlying risk. These buffers help to increase profitability when bank earnings fall. Such a process is called income smoothing.

However, there are still questions regarding the origin of such loan loss reserve adjustments. Some authors say they are due to inside information possessed by bank managers on credit losses that will appear only in the future. Others indicate that managers are trying to maximise their private benefits and use smooth income streams to show their high managerial capacities. The objective of our research project is to study a possibility of shareholders influencing the decision on the loan loss reserve creation in Central European banks. Financial institutions in this part of Europe are mostly held by large international banking groups and we aim to verify if various traits of these shareholders may affect the level and fluctuations of reserves created in subsidiaries.

Shareholders receive dividends from subsidiaries in which they own a majority stake and dividends are paid out from net profit. As a result, managing the amount of loan loss provisions is likely to affect subsidiary net profit and indirectly - returns generated by shareholders. Hence shareholders have an incentive to affect loan loss provisions in banks where they hold majority stakes, as well as influence the income smoothing process. This may be especially the case during difficult periods, such as the financial crisis of 2007-2009, where large multinational banks suffered losses due to economic downturns and their previous high risk exposures. We aim to study the effect that such negative events at the shareholder level may have on reserves created in subsidiary banks.

In order to analyse links between shareholders and credit policy of subsidiary banks, we use financial data of Central European banks from 11 European Union countries belonging to the EU (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia, Slovakia). We include data from the period 2004-2014, so include both the pre-crisis and post-crisis results. We enrich this data by information on majority shareholders of these banks and macroeconomic data on countries of both shareholders and subsidiary banks.

Our unique dataset, created for the purpose of this research project, will allow to assess the effects of shareholder incentives on loan loss reserves and income smoothing in subsidiary companies. As a result, we are going to be able to show if the discretionary interventions of managers into the level of reserves created stems from pressure from their majority shareholders, or if they are more connected with autonomous managerial decisions. In a special case, we will also verify the effect of negative consequences suffered during the financial crisis of 2007-2009 by majority shareholders of Central European banks on credit policies in these banks.