Book Review

Lamaj, M. (Ed.). *The Effect of Covid-19 on Loan Loss Provisions and Earnings Management of European Banks*. Springer Fachmedien Wiesbaden GmbH, 2023

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1. Introduction

This book review aims to describe and analyze Merjona Lamaj's (2023) book *The Effect of Covid-19 on Loan Loss Provisions and Earnings Management of European Banks*. The book focuses on the recent pandemic crisis, COVID-19. Although many countries have tried to counteract its effects by acting with interventions aimed at reducing the spread of the virus (e.g., containment measures) (Deb et al., 2022), this pandemic has brought many adverse effects to the global economy (Chetty et al., 2024). The pandemic adversely affected every unit of the economy, including banks and non-financial companies. As a result, these units paid for the consequences of this crisis (Bloom et al., 2021; Elnahass, 2021).

Generally, the literature shows contradictory evidence for EM during crises, as some findings support a decreasing trend in EM practices (Cimini, 2015: Filip & Raffournier, 2014), and some findings support an increase in EM practices (Iatridis & Dimistras, 2013; Bornemann et al., 2012). The same contradictory findings can be observed for the EM during the COVID-19 crisis, with evidence of an increase in EM (El-Feel et al., 2024; Khanchel & Lassoued, 2024) and a decrease in EM (Cimini et al., 2025; Brannan et al., 2024). However, the main literature shows an increase in EM during COVID-19, mainly as an easy fix to meet stakeholder expectations and avoid their adverse reaction (El-Feel et al., 2024; Ricapito, 2024; Yaşar & Yalçın, 2024) and overcome the crisis (Rahman et al., 2023; Hsu & Yang, 2022).

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Another relevant aspect of the crisis is the effect on banks on calculating loan loss provisions (LLPs). The research evidence shows that LLPs created more uncertainty in the financial market (Barnoussi et al., 2020), and banks used LLPs to manipulate earnings (Nguyen et al., 2023; Taylor et al., 2023). For the banks, literature generally evidences a spread use of discretionary through LLPs during crises (Allini et al., 2025; Curcio et al., 2017; Morris et al., 2016), also during the COVID-19 crisis (Nguyen et al., 2023; Taylor et al., 2023). This happens especially through earnings smoothing (Abou El Sood, 2012), namely the practice of disclosing a stable income over the years (Coronella, 2023; Gao & Zhang, 2015; Trueman & Titman, 1988).

Focusing on the banking sector, this book attempts to investigate these two relevant aspects that developed during the pandemic crisis through an analysis conducted with the model used by Beatty et al. (2002) for estimating normal (expected) LLPs and adjusting the model used by Gebhardt & Novotny-Farkas (2011) for estimating income smoothing. The book concludes that during COVID-19, banks used discretionary LLPs to a greater extent than before COVID-19, and banks used upward EM, whereas before COVID-19, they engaged in downward EM.

In the following sections, we introduce an overview of the main concepts presented in the book, followed by an in-depth analysis of these concepts. Finally, we conclude the review with a recommendation of the book alongside explaining the implications and novelty of the book.

2. Summary of the book

The book is divided into seven chapters: 1. Introduction, 2. IFRS 9 and the Expected Credit Loss (ECL) Model, 3. Covid-19 and European Banks, 4. Hypothesis Development, 5. Descriptive Statistics, 6. Research Design and Results, 7. Conclusion. Table 1 summarizes the main concepts included in the chapters.

Table 1 – Main concepts presented in the chapters of the book

Chapter	Main concepts presented
Chapter 1	COVID-19 pandemic and its global economic impact Challenge of banks in calculating LLPs Guidelines for the application of IFRS 9 introduced by regulators Objectives of the book
Chapter 2	Principles of IFRS 9 ECL model Main differences between IFRS 9 and IAS 39 Practical implications of the ECL model

Chapter 3	Government measures and regulators' recommendations to mitigate the economic impact Implications of IFRS 9 during COVID-19 pandemic
Chapter 4	Hypotheses on the effect of COVID-19 on EM through LLPs Banks' incentives to manipulate earnings to avoid losses or fluctuations
Chapter 5	Dataset used for the analysis Descriptive statistics on bank-specific variables and measures of response to the COVID-19 crisis Correlations between economic variables and changes in credit risks
Chapter 6	Discretionary use of LLPs during COVID-19 Income smoothing before and during COVID-19 Differences in practices between countries with more stringent or less stringent restraint measures Trend of LLPs about the three stages of the ECL model
Chapter 7	Key findings of the study Implications for regulatory authorities and future economic crises

The book is divided into three main parts, namely the introductory chapters to the topic (chapters 1-3), the quantitative analysis (chapters 4-6), and the overall conclusion of the entire work (chapters 7).

The first chapter presents the introduction to the work and lays the foundation for subsequent hypothesis development and quantitative analysis. The adverse effects of COVID-19 on the world Gross Domestic Product (GDP) and employment and the level of volatility are summarized, and interventions by governments and regulators to counteract the adverse effects (e.g., suspension of debt payments) are also discussed. Another point being presented is IFRS 9 – Financial Instruments, which represents a shift from banks recognizing provisions based on only incurred credit losses (i.e., provisions were built only for credit-impaired assets) (IAS 39) to incorporate expected credit losses into their LLPs (IFRS 9). It is pointed out that the pandemic crisis has made the estimation of LLPs more uncertain and that the flexibility provided by IFRS 9 may increase the incentives for banks to manipulate earnings. The book, therefore, aims to examine the effect of the pandemic crisis on banks' EM using LLPs under IFRS 9.

The second chapter presents the transition from IAS 39 to IFRS 9 and then clearly and concisely presents the fundamentals of IFRS 9, starting with the ECL model. The calculation of the ECL is reported as follows:

$$ECL = EAD \times PD \times LGD \qquad (1)$$

Where:
EAD = exposure at default
PD = probability of borrower's default
LGD = loss given default

Next, the three stages of credit risk are presented and considered for quantitative analysis. The three Stages presented by IFRS 9 are Stage 1, 12-month expected losses; Stage 2, expected losses over the life of the loan; and Stage 3, losses based on evidence of credit losses. The provisions for determining the Significant Increase in Credit Risk by IFRS 9 and the main implications of the ECL model are summarily reported.

The third chapter gives an outlook on the main implications of the COVID-19 pandemic on banks' LLPs, restating the uncertainty in estimating LLPs during the pandemic crisis and the relief measures provided by governments and regulators. In this scenario, the author pointed out five primary elements, namely the concerns over procyclicality, the use of flexibility, the worries expressed by the IASB over the mechanistic approaches, the short-term forecasts over the long-term forecasts, and the transparency and disclosure.

After the first three chapters, in the fourth chapter, the book presents the hypothesis development, moving from the main literature and the characteristics of IFRS 9.

Table 2 summarizes the hypothesis developed:

Table 2 – Hypothesis developed in the book

H1	Under IFRS 9, banks use loan loss provisions to smooth income.
H2	During the COVID-19 pandemic, banks use loan loss provisions to smooth income to a greater extent than before COVID-19.
H3	During the COVID-19 pandemic, banks located in countries with strong COVID-19 response measures use more income smoothing than banks located in countries with weak COVID-19 response measures.

H1 is theoretically supported by the flexibility of the ECL model by IFRS 9, H2 is anecdotally supported by the behavior of some banks in introducing adjustments in applying IFRS 9, and H3 is supported by the evidence that countries that implemented stronger containment measures experienced more adverse economic consequences.

The fifth chapter presents the sample, which moves from 36 European countries, including EU and non-EU country members, from the first quarter of 2018 to the third quarter of 2021. An in-depth presentation of descriptive statistics is presented. Last, the author shows the results of the COVID-19 response measures by countries. The rationale followed to determine the extent of the responses is that countries are indicated to have a strong (weak) COVID-19 response policy if the median number of response measures implemented by the country is higher (lower) than the median

number of response measures implemented by all countries throughout the pandemic.

Starting from the assumptions of the previous chapters, the sixth chapter presents the model applied and analyzes the data. The author used the Beatty et al. (2002) model proper to estimate normal LLPs. The author relies on residual errors to define discretionary LLPs, observing that the median of discretionary LLPs increases during the pandemic year in 2020 compared with the prior years and decreases again in 2021 and that while the pre-pandemic period is characterized by an understatement of LLPs, during the pandemic year of 2020 banks have tended to overstate LLPs, and in 2021 banks returned to understating LLPs. For the cross-country analysis, the authors found that banks in countries with strong response measures exhibited more significant variability of discretionary LLPs than those with weaker COVID-19 response measures. Overall, the analysis results show that during COVID-19, banks used more discretion when accounting for loan losses, a phenomenon amplified by banks from countries with stricter COVID-19 responses.

For detecting income smoothing, the author relied on the model used in Gebhardt & Novotny-Farkas (2011), adjusting that to include the three stages of the ECL model. As a result, the author found that in the post-COVID period, provisions are more related to loan changes in Stage 2. In contrast, such a relation is not evident in the pre-COVID period, explaining these findings with the increasing credit risk of banks' loan portfolios during the pandemic. Finally, the author analyzes the direction of EM through a regression model, finding that the banks used a loss use direction to a greater extent in (both) the pre-COVID and post-COVID periods. Moreover, in the pre-COVID period, banks overstated LLPs to smooth income, while in the post-COVID period, banks understated LLPs, engaging in upward EM. In the last chapter, the author synthesizes the research results, giving a summarized interpretation of them.

3. Critical insights and future research

The results of the analysis presented by Lamaj's (2023) book suggest interesting insights into the topic of EM about LLPs and the period of the pandemic crisis. However, such a broad topic may provide further study and understanding opportunities. Based on what is reported in the book's discussions and conclusions, some of the aspects covered can provide the

stimulus for further research and could be addressed in future studies. First, the book focuses on the period from the first quarter of 2018 (the time of the IFRS 9 implementation) to the third quarter of 2021, so it would be interesting to analyze the results of an updating of the research to the second part of the COVID-19 crisis and post-crisis period. In addition, the book considers the countries' response measures to the COVID-19 pandemic. Still, the author points out that the results may also be driven by other countries' characteristics than those related to the response measures implemented during the COVID-19 pandemic, whereby future studies can consider this aspect. The book also presents additional results, e.g., that LLPs are positively related to changes in sovereign Credit Default Swaps, especially in the post-COVID period, particularly for banks in countries with strong COVID-19 response measures. Further studies can more deeply analyze this positive relationship between LLPs and sovereign Credit Default Swaps. Finally, the study can be extended by considering generating big data and applying machine learning to detect earnings management.

4. Conclusion

The book offers interesting insights by combining three relevant aspects: the COVID-19 crisis, the discretionary use of LLPs, and the EM. The introductory part (chapters 1-3) presents accurately the scenario in which the research is conducted and lays the foundation for the quantitative analysis in the second part (chapters 4-6) and the conclusions (chapter 7). The assumptions underlying the hypotheses development are robust, as they combine existing literature with aspects of the phenomenon under analysis (the flexibility of the ECL model by IFRS 9, the behavior of some banks in introducing adjustments in applying IFRS 9, and the evidence that countries that implemented stronger containment measures experienced more adverse economic consequences). Therefore, the hypothesis development is robust. The sample is selected from companies in various European countries, allowing the authors to conduct additional cross-country analysis, which adds interesting evidence to the research. The research design is well developed and based on tested models, to which the author adds an interesting and novel adjustment for including the three stages of the ECL model. Finally, the discussions of results and conclusions are consistent with the rest of the work and give fascinating insights not only on the discretionary use of LLPs during the pandemic but also provide cross-country

evidence and investigate the direction of EM upwards or downwards. Overall, the book is well structured and offers an interesting analysis of the period of the COVID-19 crisis, fitting appropriately into the relevant literature and providing an extension to the academic knowledge on COVID-19, LLP, and earnings management.

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