

## Box 5

### Assessing the accuracy of euro area bank analysts' earnings forecasts

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**For some time, the prospect of continuing low profitability of euro area banks has been highlighted in the FSR as a key risk for financial stability.** This risk remains a cause for concern, as both cyclical and structural factors continue to weigh on banks' ability to generate sustainable profits. In monitoring this risk, the ECB and other institutions make regular use of bank analysts' earnings forecasts. Looking at data for euro area banks, this box evaluates the accuracy of those forecasts.

**The academic literature has found that analysts' earnings forecasts could be prone to excessive optimism and herding behaviour, owing to inherent incentive structures.** These forecasts are typically produced by institutions that may have an intrinsic interest in a positive stock market outlook for the bank concerned, for instance because they offer related brokerage and underwriting services. In addition, the literature has shown that concerns about a possible loss of unhindered access to company information – should adverse expectations regarding the firm's earnings outlook be published – may influence some analysts.<sup>40</sup> To combat this, a range of regulatory safeguards have been instituted to address potential conflicts of interest that may arise from investment research.<sup>41</sup> Nonetheless, a large body of empirical literature in this field has found compelling evidence that analysts' forecasts tend to be biased upwards.<sup>42</sup> While the reputational costs associated with large forecasting errors should, in principle, serve to temper potential bias, there is evidence that analysts' recommendations tend to be characterised by herding behaviour, which dilutes the disciplining role of market scrutiny. One reason for this is that forecasting errors that stem from a view that deviates from the consensus may be perceived to be more damaging to an analyst's reputation than errors of an equal size that stem from a view that was aligned with the consensus. Indeed, it is common to observe an unbalanced proportion of “buy” vis-à-vis “sell”

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<sup>40</sup> See Clayman, M. and Schwartz, R., “Falling in Love Again – Analysts' Estimates and Reality”, *Financial Analysts Journal*, Vol. 50, 1994.

<sup>41</sup> In the EU, two main pieces of legislation include provisions that address the issue of conflicts of interest relating to investment research. They are the Market Abuse Directive and the Markets in Financial Instruments Directive (MiFID). For an overview, see <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52006DC0789&from=en>

<sup>42</sup> For an overview, see Chopra, V., “Why So Much Error in Analysts' Earnings Forecasts?”, *Financial Analysts Journal*, Vol. 54, 1998, and Das, S., Levine, C. and Sivaramakrishnan, K., “Earnings predictability and bias in analysts' earnings forecasts”, *The Accounting Review*, Vol. 73, 1998.

recommendations among analysts. For example, an analysis of S&P 500 stock ratings in 2015 found that only 6.7% carried a sell recommendation.<sup>43</sup>

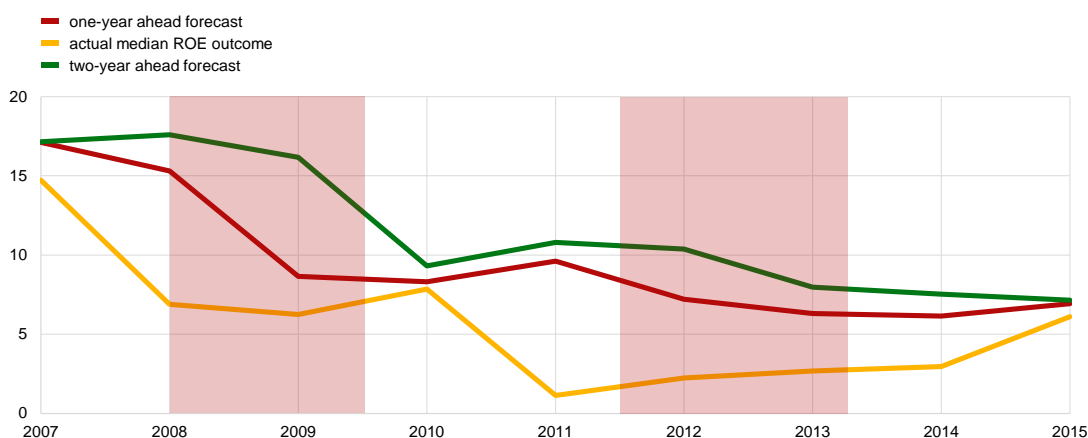
**This box makes use of analyst forecast data for 27 euro area banks included in the EURO STOXX Banks index.** Weekly data on analysts' forecasts of euro area banks' return on equity (ROE) were collected over the period 2007-15. To ensure representativeness of the analysis, coverage criteria were applied, requiring that 90% of the EURO STOXX banks were covered by analysts and that at least 50% of the banks covered had ten or more analysts providing ROE forecasts. Based on these criteria, the analysis focused on forecasts with a horizon of one or two years ahead.

### Chart A

Bank earnings forecasts have, on average, exceeded actual outcomes since 2007

#### Forecast ROE and actual ROE outcomes for euro area banks

(2007-15; annual aggregate observations; percentage points)



Sources: Bloomberg and ECB calculations.

Notes: Large outliers are excluded from the calculations (absolute deviations between forecasts and outcomes above the 90th percentile). The shaded areas refer to periods of euro area recession as defined by the Centre for Economic Policy Research (Q1 2008 to Q2 2009 and Q3 2011 to Q1 2013).

**Analysts' ROE forecasts for euro area banks have, on average, been overly optimistic over the past decade.** To illustrate the evolution of the forecasting errors, **Chart A** plots the difference between one and two-year-ahead analysts' forecasts of ROE against subsequently reported ROE figures since 2007. Three notable features can be discerned from the chart. First, analysts have, on average over the sample period, provided an overly optimistic outlook concerning euro area banks' profitability prospects. Second, analysts' overestimation of banks' profitability prospects increases with the length of the forecast horizon. While this may partly result from more information becoming available over time, improving the capacity to produce more accurate forecasts, which increases the signal-to-noise ratio, the reputational cost of being too optimistic just before the publication of actual ROE outcomes probably also reduces any inherent bias over time. Third, the forecasting errors have varied over time. In particular, forecasting errors were particularly large during periods of economic recession in the euro area (see shaded areas in **Chart A**). This may simply reflect the fact that unexpected adverse macroeconomic shocks, after forecasts were produced, contributed significantly to an overestimation of earnings. In addition, high litigation costs and regulatory fines

<sup>43</sup> See the article entitled "Sellside research would be little missed", *Financial Times*, 16 February 2017.

dampened profitability for some banks over the sample period.<sup>44</sup> Such fines are often difficult to predict and therefore probably also contributed to forecasts being more optimistic than outcomes.

**To sum up, analysts' earnings forecasts should be treated with some caution when evaluating risks and vulnerabilities for the euro area financial system.** An assessment of euro area banks since 2007 reveals that analysts' forecasts tend to be systematically more optimistic regarding banks' earnings outlook than the actual outcomes. Furthermore, analysts' forecasting errors have varied substantially over time and were particularly large during periods of recession. In recent years, as the profitability of banks has partly recovered (albeit from low levels), the forecasting errors have been reduced.

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<sup>44</sup> See the box entitled "Global banks' legal costs: trends, drivers and implications", *Financial Stability Review*, ECB, May 2016.