An empirical assessment of procyclicality of loan-loss provisions of banks in EMEAP economics

Comments by
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Setting

• Empirical study of whether increased loan-loss provisions (LLP) in economic downturns reduce credit supply
• Bank level panel data, 194 listed banks from 11 EMEAP countries
• Period 1988 – 2008
• EMEAP = Executives’ Meeting of East Asia-Pacific Central Banks
... Setting

• Three equations:

1. \( \text{LLP/Loans} = \alpha \times \text{GPD growth} + \text{controls} \)

2. \( \text{Loan growth} = \beta \times \text{LLP/Loans} + \text{controls} \)

3. \( (\alpha \times \beta)_+ = "\text{capitalization" + "bank size" + } \text{loans/assets + "share of private sector credit" + "dummy for developed countries"} \)
... Setting

• $(\alpha \beta)_+^*$ is a measure of bank procyclicality:

  – Measures the effect of LLP on loan growth (via $\beta$) conditional on that LLP rises in downturns ($\alpha$)
  – $\alpha$ and $\beta$ are expected to be negative so product is positive
  – Banks with positive measure are further studied in equation (3)
Results

• Clear evidence that LLPs are procyclical

• Effect of LLP on loan growth is mixed:
  – LLP has negative impact in developed country banks
  – mixed effect in emerging market banks
... Results

- In developed countries, bank characteristics have expected effects on the measure of bank procyclicality (eq. 3)
  - Higher Equity/Assets reduces procyclicality
  - Bigger (more international?) banks less procyclical (error in the text?)
  - Larger share of private sector credit increases procyclicality
• Credit supply or demand effects captured?
  – This is a standard comment
  – Increasing LLP could coincide with weakening demand among banks’ (relationship) customers
  – Then again, equation (3) for bank characteristics helps confirm that the supply effect is captured
  – There could be more explicit discussion of this (standard) problem and how the study tackles it
Comment 2

• Developed country banks procyclical, emerging market banks not
  – This is somewhat counter-intuitive:
    • Should it not be easier to get new external capital in developed countries?
    • Banks more sophisticated, reserve buffers to counter procyclical credit constraints? (see theory by Repullo-Suarez 2009)
      – True though, as the Crisis has indicated, that sophisticated banks do not necessarily behave prudently
... Comment 2

- Paper gives explanation that developed country banks more exposed to market conditions and hence are more procyclical
  - Plausible
- Why emerging market banks less procyclical?
  - Is there more concentrated ownership that might help?
  - Government involvement?
  - Country-specific histories in the Asian crisis (end of 90s); might such experience have spurred prudent behavior? (cf. Finnish experience)
Other comments

• Equation (3): Could also consider liability structure (deposits+LT finance / total liabilities)
  – The Crisis has pointed out fragility of short-term financing and how it may amplify deleveraging
• Standard robustness: output gap -> GDP growth
• Table 2: provide percentiles of +/- alphas
• A bit short on literature
  – Papers on credit crunch
  – Repullo-Suarez 2009 (buffers and procyclicality)
Thank you