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-Pasific Central Banks

… Setting

- Three equations:
  1. LLP/Loans = α*GPD growth + controls
  2. Loan growth = β*LLP/Loans + controls
  3. $(\alpha^* \beta)_+$ = ”capitalization” + ”bank size” + 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 β) conditional on that LLP rises in downturns (α)
  - α and β 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

Comment 1

- 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