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Review

Bank loan loss provisions research: A review

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Abstract

We review the recent academic and policy literature on bank loan loss provisioning. Among other things, we observe that there exist some interaction between LLPs and existing prudential, accounting, institutional, cultural, religious, tax and fiscal frameworks which differ across countries; and we find that managerial discretion in provisioning is strongly linked to income smoothing, capital management, signalling, tax management and other objectives. We also address several issues including the ethical dimensions of income smoothing, factors influencing income smoothing, methodological issues in LLP modelling and the dynamic loan loss provisioning experiment; which opens up several avenues for further research such as: finding a balance between sufficient LLPs which regulators want versus transparent LLPs which standard setters want; the sensitivity of abnormal LLPs to changes in equity; the persistence of abnormal LLPs following CEO exit; country-specific interventions that induce LLP procyclicality in emerging countries; the impact of Basel III on banks' provisioning discretion; LLP behaviour among systemic and non-systemic financial institutions; etc. We conclude that regulators need to pay attention to how much discretion lending institutions should have in determining reported provision estimates, and this has been a long standing issue.
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1. Introduction

Banks are financial institutions that primarily collect deposits and issue loan to individuals, firms and governments to finance consumption, investment and capital expenditure; thereby contributing to economic growth. Bank lending to borrowers often give rise to credit risk if borrowers are unable to repay the principal and/or interest on the loan facility due to unfavourable economic conditions and related factors. To mitigate credit risk, in principle, banks will set aside a specific amount as a cushion to absorb expected loss on banks' loan portfolio and this amount is referred to as loan loss provisions (LLPs) or provisions for bad debts; therefore, loan loss provision estimate is a credit risk management tool used by banks to mitigate expected losses on bank loan portfolio.

Bank LLP continue to receive much attention from bank regulators/supervisors and accounting standard setters because (i) banks' large amount of loan on their balance sheet makes them vulnerable to loan default arising from deteriorating economic conditions which affects borrowers' ability to repay, requiring banks to keep sufficient LLPs in anticipation of expected loan losses (Laeven & Majnoni, 2003), (ii) LLPs are often procyclical and could worsen an existing recession if unanticipated, and this was evident at the peak of the 2008 global financial crisis as many US and European banks significantly increased their LLP estimates which further eroded bank profit and led to losses that depleted bank capital,

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requiring Central Bank intervention in the form of bailouts, (iii) bank LLP is a significant accrual and bank managers have significant discretion in the determination of LLP estimates and such discretion can be exploited to meet opportunistic financial reporting objectives rather than solely for credit risk purposes (Wahlen, 1994), (iv) bank LLP estimate is a crucial micro-prudential surveillance tool that bank supervisors use to assess the quality of banks' loan portfolio, (v) bank LLP is also a crucial indicator of the informativeness of bank accruals from an accounting standard-setting perspective, and (vi) bank LLP has become the most debated accounting number in bank financial reporting after bank profitability and derivatives since the 2008 global financial crisis.

Bank LLPs play a crucial role for bank stability and soundness while fulfilling their lending function to individuals, firms and governments; therefore, bank regulators require banks to keep adequate (or sufficient) LLPs to mitigate expected losses although there is no agreement among banks for what constitutes ‘adequate’ or ‘sufficient’ loan loss provisioning. Moreover, despite the growing concern that bank managers can opportunistically exploit their discretion to overstate LLPs when expected credit risks are actually low, bank supervisors still require banks to maintain higher LLPs persistently as a safety net for present or future loan losses.

In the literature, we commend Wall and Koch (2000)'s early review that present a broad overview on bank loan loss provisions for over a decade now. Since Wall and Koch (2000), emerging studies have examined several issues in the loan loss provisioning literature including: provisioning behaviour during fluctuating business cycles and crisis periods (Laeven & Majnoni, 2003; El Sood, 2012; Agenor and Zilberman, 2015), how procylical LLPs contribute to systemic risk and financial system instability (Borio, Furfine, & Lowe, 2001, pp. 1–57; Wong, Fong, & Choi, 2011), dynamic provisioning to mitigate LLP procyclicality (Saurina, 2009; Perez et al., 2011), the role of LLP in bank earnings management, regulatory capital management, signalling and tax management (Lobo & Yang, 2001; Kanagaretnam, Lobo, & Yang, 2005; Anandarajan, Hasan, & McCarthy, 2007; Perez, Salas-Fumas, & Saurina, 2008; Ozili, 2015, 2017a,b; Andries, Gallemore, & Jacob, 2017), bank manager's provisioning discretion under different accounting and regulatory regimes (Alali and Jaggi, 2011; Hamadi, Heinen, Linder, & Porumb, 2016; Kilic, Lobo, Ranasinghe, & Sivaramakrishnan, 2012; Leventis, Dimitropoulos, & Anandarajan, 2011; Marton & Runesson, 2017; Ryan & Keeley, 2013; Wezel, Lau, & Columba, 2012), provisioning and competition (Dou, Ryan, & Zou, 2016), provisioning under different auditor type, reputation and specialism (Dahl, 2013; Kanagaretnam, Lim, & Lobo, 2010; Ozili, 2017a), provisioning discretion under strong corporate governance mechanism and institutional controls (Fonseca and Gonzalez, 2008; Bouvatier, Lepetit, & Strobel, 2014; Curcio & Hasan, 2015) and provisioning behaviour in several country, regional and international contexts (Pain, 2003; Bryce et al., 2015; Ozili, 2017a,b, etc.).

To complement Wall and Koch (2000), we identify the need to bring together in one article the most recent developments in LLP research to provide a comprehensive understanding of the role of bank LLPs for accounting information quality, micro-prudential regulation and macro-financial stability. To do this, we explore several strand of literature in LLP research to identify recent advances and challenges in the literature, and suggest possible directions for future research with some concluding remarks.

Our analysis in this review article contributes to the extant LLP literature in the following way. One, our review contribute to the literature that examine the link between bank provisioning and capital regulation as well as other countercyclical policy designs aimed at ensuring banking soundness and solvency during stressed periods. Two, by relating LLPs to income smoothing, our survey contribute to the literature that examine how LLP estimates are manipulated by bank managers to influence the level of reported earnings which reduces the informativeness of LLP estimates. Three, our survey contribute to the LLP literature that examine how institutional monitoring and corporate governance mechanisms limit bank managers' ability to distort LLP estimates to meet opportunistic financial reporting objectives. Four, our study contribute to the policy debate about how the current incurred-loss provisioning model contribute to bank instability. The incurred-loss provisioning model is criticised for its backward-looking characteristic and its potential to reinforce the current state of the economy because it delay provisioning until it is too late which makes bank provisioning procyclical with fluctuations in the economy.

Furthermore, we did not elaborate extensively on some issues, the most important ones being the following two. First, we did not elaborate extensively on bank loan loss provisioning among Islamic banks because the distinction between Islamic and conventional banks is often unclear and the provisioning rules for both Islamic and conventional banks are the same. Second, we did not elaborate extensively on dynamic provisioning because research on dynamic provisioning to date appears to be biased towards single country analyses, notably Spain, Chile, Peru and Uruguay. Likewise, we did not elaborate on the relationship between discretionary provisions and stock returns because changes in stock prices may be driven strongly by other unobservable factors rather than discretionary loan loss provisions. Therefore, our remarks on the challenges and prospects of LLP research in this review article are limited to issues in the literature that we find to be particularly significant. Finally, while we note that the value of a research review is measured by its success to inspire researchers to produce new ideas to this line of research, our aim in this review is to elicit comments and stimulate debates that can potentially advance LLP research in the broader banking literature.

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