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The impact of loan loss provisioning on bank capital requirements[☆]

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Abstract

This paper shows that the revised loan loss provisioning based on the International Financial Reporting Standards (IFRS) and the US Generally Accepted Accounting Principles (GAAP) implies a reduction of Tier 1 capital. The paper finds in a counterfactual analysis that these changes are more severe (i) during economic downturns, (ii) for credit portfolios of low quality, (iii) for banks that do not tighten capital standards during downturns, and (iv) under a more lenient definition of significant increase in credit risk (SICR) under IFRS. The provisioning rules further increase the procyclicality of bank capital requirements. Adjustments of the SICR threshold or capital buffers are suggested as ways to mitigate a regulatory pressure that may emerge due to the reduction of regulatory capital.

JEL classification: C51, G28, M48

Keywords: GAAP 326, IFRS 9, lifetime expected loss, loan loss provisioning, regulatory capital, SICR

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