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What drives diversity of loan loss provisions' procyclicality in the EU?

This paper documents a large cross-bank and cross-country variation in the relationship between loan loss provisions and business cycle and explores bank management specific, bank activity specific and country specific (institutional and regulatory) features that explain this diversity in the European Union. Our results indicate that LLP in large, publicly traded and commercial banks are more procyclical. Better investor protection and more restrictive bank regulations reduce the procyclicality of LLP. Additional evidence shows that moral hazard resulting from deposit insurance renders LLP more procyclical. We do not find support for the view that better quality of market monitoring reduces risk taking behavior of banks. Our findings clearly indicate empirical importance of earnings management for LLP procyclicality. Sensitivity of LLP to business cycle seems to be limited in the case of banks with more stable profits and with prudent credit risk management applied.

JEL Classification : *E32, E44, G21*

Keywords: loan loss provisions, procyclicality, earnings management, investor protection, bank regulation, bank supervision