ABSTRACT
This paper examines the relation between loan loss accounting policies and banks’ ability to respond to increases in local demand for loans. The research design maps the locale of natural disasters to banks, thereby identifying banks which are treated by natural disasters versus banks that are enjoying relatively calm lending environments. We use a matched sample, where banks affected with disasters are matched to similar banks that are not affected by disasters. We first examine how natural disasters impact loan loss accounting using a difference in difference specification. Our evidence suggests the main effect of a natural disaster shock on loan loss provisioning is negligible. Nevertheless, there is an increasing weight on loan loss indicators during the four quarters that encompass the disasters. Most importantly, the slope coefficient on forward-looking information increases for large banks in the post disaster period. This finding raising the concern that disasters impact loan loss provisions in such a way that they confound the interpretation of provisioning-timeliness measures which have been used in prior research. In our second set of tests, we use the residuals from the loan loss provisioning model to examine whether banks that exhibit more conservative provisioning prior to disaster periods are better able to respond to new loan demands that are created by disasters. Our results suggest that smaller banks which have policies of over-reserving for loan losses are better able to show loan growth following a disaster. However, this result disappears if the model includes small banks’ Tier 1 capital ratio, suggesting the role of capital and the role of conservatism are difficult to disentangle. Finally, our results fail to find evidence that the timeliness of loan loss provisions mitigates capital constraints for small banks.

(Copies of the paper are available in the AOIS Department offices)