

Effect of Loan Loss Provisions on Financial Stability and Profitability of Banks



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Abstract

Loan loss provisions (LLPs) play a crucial role in the banking sector by serving as financial buffers against potential losses arising from non-performing loans and credit risk. This study examines the effect of loan loss provisions on the financial stability and profitability of commercial banks in Pakistan. Grounded in the Prudential Regulation Theory and the Risk-Adjusted Performance framework, the study investigates how provisioning practices influence banks' capital adequacy and earnings performance. A quantitative research design is employed using panel data from commercial banks listed in Pakistan over a ten-year period (2013-2022). Secondary financial data are collected from bank annual reports, State Bank of Pakistan publications, and financial databases. Descriptive statistics, correlation analysis, and panel regression techniques are applied to analyze the relationships between LLPs, financial stability indicators (capital adequacy ratio and non-performing loans), and profitability measures (return on assets and return on equity). The findings indicate that higher loan loss provisions significantly enhance financial stability by strengthening capital buffers and reducing credit risk exposure. However, increased provisioning negatively affects short-term profitability due to its direct impact on earnings. The study highlights the trade-off between risk management and profit maximization and provides policy implications for bank management and regulators to ensure sustainable financial performance.

Keywords: Loan Loss Provisions, Financial Stability, Profitability, Banks, Credit Risk, Pakistan

Introduction

The banking industry contributes significantly to the economy of an economy in terms of mobilization of deposits, supplying credit and to intermediaries of funds. Nevertheless, the industry is predisposed to diverse risks, especially the credit risk that is brought about by the default in loans by the borrowers (Altman & Saunders, 1998; Saunders & Allen, 2010). In order to counter such risks, banks have loan loss provisions (LLP) which approximated reserves are created to contain possible losses on non-performing loans (NPLs). These clauses act as an insulation whereby any loan defaults are covered and the financial status of the bank is stabilized (Gurung et al., 2023).

Provisions of loan losses are an important tool in ensuring the financial stability of the banking industry as well as its profits. Financial stability is the capacity of the bank to absorb economic shocks and has a chance of surviving without suffering whereas profitability is the level of efficiency displayed by the bank in its ability to make profits out of its assets and its operations (Diamond & Rajan, 2001). There is a complicated relationship between LLPs, stability and profitability. Though

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high provisions would decrease reported profits in the short term, it would create strength against future losses and thus the stability of long term (Laeven & Majnoni, 2003). On the other hand, the lack of adequate provisions can increase the profitability in the short-term, but it leaves the banks vulnerable to greater risk, which will further deter investors and systems stability (Jimenez et al., 2007; Islam, 2018).

Financial reporting and investor perception are also influenced by loan loss provisions since they impact on reported earnings and risk disclosures. LLPs are used to track the quality of assets and sound judgment of management by investors and analysts (Beatty et al., 2002). The presence of sufficient LLPs by a bank implies good risk management and long run stability and may be appealing to investors, reducing the cost of capital. On the other hand, profit-maximizing behavior with limited provisioning which is aggressive can be an indication of risk-taking and undermining of trust in financial statements (Bushman & Williams, 2012).

This study has a theoretical foundation of the Prudential Regulation theory and the Risk-Adjusted Performance framework. The prudential regulation focuses on the fact that banks ought to keep sufficient capital and reserves so as to distribute unforeseen losses to keep depositors and the entire financial system safe (Basel Committee on Banking Supervision [BCBS], 2010). In the meantime, the Risk-Adjusted Performance paradigm takes into account the fact that the profitability of banks should be measured against risks taken which are credit risk, operational risk and market risk (Jorion, 2007). In this case, loan loss provisions work as a tool of risk mitigation, which affects financial stability and profitability by balancing the risk exposure and earnings control.

There has been some inconsistent empirical evidence on the effects of LLPs on financial stability and profitability. According to Laeven & Majnoni (2003), proactive provisioning helps to build the capital buffer, and minimizes the exposure of banks to credit shocks, which is more stable. Contrastingly, other researchers reveal that over-providing can impair the short run profitability and shareholder returns, which poses a trade-off between risk management and performance (Bouvatier & Lepetit, 2008; Sang Tang My, 2022). The studies regarding the banks in the emerging economies are of particular interest to the research in Pakistan due to the unstable economic situation, with fluctuating rates, inflationary pressure, and limited regulation (Ahmad et al., 2014; Ul Mustafa et al., 2012).

Pakistan banking industry has witnessed tremendous changes in the last twenty years whereby regulatory reforms, capital requirements and better risk management practices have influenced the performance of banks in Pakistan. The problem of non-performing loans has been persistent, and the banks have taken a conservative approach to the provisioning policy (State Bank of Pakistan [SBP], 2021). The knowledge of the influence of LLPs on the stability and profitability could guide the bank managers in the practical decision to maximize the risk-return trade-offs as well as ensuring that they comply with the regulations (Ahmad et al., 2014).

Although LLPs are important, a significant discrepancy in empirical studies is observed in the Pakistani banking industry and especially in the interaction between bank loan loss provisions and stability and profitability in the long-term (Zheng et al., 2019). Majority of the previous research is focused on developed economies, which places restrictions to generalization of the studies to developing markets. This paper will fill that gap by presenting quantitative data concerning the impact of LLPs with longitudinal bank-level data and powerful statistics.

This paper examines how loan loss provision can influence financial stability and profitability among Pakistani banks. The study discusses three important dimensions (1) the direct effect of LLPs on financial stability, (2) the direct effect of LLPs on profitability, and (3) the possible trade-offs between provisioning, stability, and profits. The study in question allows applying both theoretical foundations and empirical findings to the world of academic literature and practical steps applicable in the banking industry to enhance the robustness and sustainability of the latter, which is why it provides information to regulators, banking administration, and policymakers.

Literature Review

Bank Risk Management and Loan Loss Provisions (LLP)

Loan loss provisions (LLPs) are listed entries of banks to compensate in case of any loss of non-performing loans (NPV) as a buffer to ensure financial stability (Altman & Saunders, 1998). LLPs are part of the credit risk management, which enables a bank to absorb any unexpected loss without the direct loss of capital. Basel II and Basel III prudential regulations focus on the fact that sufficient provisioning is required to cover depositors and provide systemic stability (Ozili & Outa, 2017).

Studies show that LLPs are a proactive system. The estimate of the potential losses by banks is based on the past performance of loans, creditworthiness of the borrowers and the macroeconomic environment. During economic recessions, the banks tend to raise provisions to cover credit risks whereas during good times, the provisions can be lowered to show high profitability. This procyclical nature refers to the duality of LLPs that needs to stabilize banks during crises as well as influence profitability in the short term (Mohd Isa et al., 2018; Sultana & Jalloh, 2025).

Some of the studies noted that LLPs are used strategically to smooth income and manage earnings. Banks can also moderate the provisions to balance the earnings between periods based on the expectations of investors and the regulatory control (Bouvatier & Lepetit, 2008). Although income smoothing may be indicative of sound management, overuse of discretion can lay false alarms on the actual financial risk, which has an implication on transparency and stakeholder confidence (Bushman & Williams, 2012).

Effects of LLPs on Financials

Financial stability is the state where a bank can survive shocks in the economy and continue its operation without suffering. LLPs help in stability in the sense that, they increase capital buffers, the likelihood of insolvency and minimise systemic risk. Evidence indicates that proactive provisioning is effective in minimizing the exposures of banks to credit risks and macroeconomic risks, especially in emerging markets (Nier & Zicchino, 2008; Zilberman & Tayler, 2014).

Financial stability of developing countries is more responsive to LLPs because it is more exposed to credit risks and they are less diversified. As an example, Saeed & Iqbal (2017) analyzed Pakistani banks and concluded that contrary to the expectations of many, conservative provisioning increased the capital adequacy and the probability of survival in the face of an economic shock decreased. Equally, Jimenez et al., (2007) noted that Spanish banks that were more resilient in the global

financial crisis ensured that they had high reserves, which contributed to the protective role played by LLPs in ensuring stability.

Nevertheless, LLPs have a non-linear relationship with stability. The superfluous provisioning could lower the reserve capital that could be lent and invested, which might slow down a bank growth and hamper financial intermediation (Fernando & Ekanayake, 2015). This highlights why banks should strike a balance between prudential and operational efficiency especially in economies with unstable financial markets.

Impact of LLPs on the Bank Profitability

Profitability which is usually determined in terms of return on assets (ROA) and return on equity (ROE) is the capacity of a bank to earn returns in comparison to its resources (Saunders & Allen, 2010). LLPs have a direct impact on profitability since it is charged on earnings. Increased LLPs depress the short run profit report, and decreased LLPs enhance profitability at the expense of perhaps raising the risk exposures (Kanapiyanova et al., 2023).

There are a number of studies that have empirical data on trade-off between LLPs and profitability. Beatty et al., (2002) emphasized that LLPs are actively used by U.S. banks in order to smooth long-term income, which provides stability to long-term earnings but short-term profits are decreased. Similar sentiments were expressed by Bouvatier & Lepetit (2008) who observed that the cycle of macroeconomic impacts provisioning decisions and in this case, profitability decreased as a result of economic uncertainty when LLPs were high.

On the other hand, other studies highlight the sustainability of proper provisioning in terms of its profitability. Through mitigating against unexpected losses in credit and strengthening capital buffers, banks are able to continue functioning in the economic downturn without loss of confidence in the market and minimization of funding costs. In new markets, credit risk is a more significant factor, and careful LLP management is the key to keeping investors and operations going (Ozili, 2023; Ritho et al., 2023).

Interaction of LLPs and Financial Stability, Profitability

The correlation between LLPs, stability and profitability is a complicated relationship which in many cases is a trade-off. Although more provisions are better at stabilizing, less profitable in the short term, this point is where the balancing act of the risks and returns is being exhibited (Bikker & Metzmakers, 2005). On the other hand, reduction of provisions could enhance short term profitability at the expense of long term stability due to heightened vulnerability to unforeseen credit losses.

Studies indicate that this trade-off can be resolved by instituting forward-looking policies on provisioning. Banks which predict the possibility of defaults and modify LLPs in response to the changes do not have to compromise profitability to a large extent. Also, it has regulatory frameworks which stimulate banks to have countercyclical provisions and when the economy is booming, the banks have to keep up the reserves to counter future recessions. This is a sustainable method of profitability as well as strengthening financial stability (Do et al., 2020; Aminu et al., 2014; Singh et al., 2021).

The empirical studies in developing economies point to the importance of the institutional and macroeconomic environment. Accordingly, Saeed & Iqbal (2017) indicated that Pakistani banks that had strong policies on provisioning were more stable and moderately profitable in the turbulent economic times. Otherwise, according to the authors of Bikker & Metzmakers (2005), banks in the countries with less regulatory oversight tended to experience more procyclical provisioning, which is a factor that contributes to more systemic risk. These results explain the critical role of incorporating risk management, accounting discretion, and regulatory guidance in the interpretation of the impact of LLPs.

Gaps in Existing Literature

Although LLPs have been widely researched, financial stability, and profitability, there are still a number of gaps. The majority of research is concentrated on developed economies, which does not allow making generalizations about emerging markets with a greater credit risk, regulatory issues, and unstable economic environments (Bouvatier & Lepetit, 2008; Fernando & Ekanayake, 2015; Nier & Zicchino, 2008; Zilberman & Tayler, 2014). The longitudinal studies on Pakistani banks are scarce in terms of years under study, especially in terms of the stability and profitability jointly. Also, the relationship between the LLP-profitability-stability and macroeconomic factors, bank size, and ownership is not well researched.

This research fills these gaps by examining the impact of LLPs on financial and profitability of Pakistani banks using panel data in ten years. It examines that LLPs are a stabilizing mechanism that does not undermine profitability seriously and also examines the moderating effect of bank type and size. The combination of theory, empirical analysis, and contextual issues offered by the research can add to a more sophisticated interpretation of LLPs in the emerging markets.

Data and Methodology

Research Design

This research design is a quantitative one since it aims to determine the impact of loan loss provisions (LLPs) on the financial stability and profitability of banks. A longitudinal panel study is chosen, and secondary financial data of commercial banks in Pakistan are used in the past decade. Proposals that quantitative methods are suitable since they enable testing of formulated hypotheses statistically, control variables, and generalization of results to other banks in the industry (Creswell & Creswell, 2018).

Theoretical Framework

The paper is based on the Prudential Regulation theory and Risk-Adjusted Performance framework.

1. Prudential Regulation Theory: It is a theory that recommends that banks must have adequate capital and other reserves such as LLPs to absorb any unforeseen loss, and be financially stable.
2. Risk-Adjusted Performance Framework: Measures profitability with reference to risk taken by banks, such as, credit risk, market risk, and operational risk (Jorion, 2007). LLPs serve as a tool of risk management, which affects stability and profitability.

Population and Sample

The study population entails all the commercial banks in Pakistan that are listed in the Pakistan Stock Exchange and regulated by the State Bank of Pakistan (SBP). Census method is used and data is gathered on all the qualifying banks within a period of ten years. This makes it well covered and increases the strength of the results.

Data Collection

The secondary financial data are gathered through:

1. Commercial bank annual reports.
2. State Bank of Pakistan periodicals.
3. Such databases as Bloomberg and Thomson Reuters are financial.
4. The dataset consists of information about:
5. Loan loss provisions (LLPs)
6. Indicators of financial stability (e.g. capital adequacy ratio, non-performing loans ratio)
7. Profitability ratios (e.g., return on assets (ROA), return on equity (ROE))

Variables and Measurement

Independent Variable

Loan Loss Provisions (LLP): This is quantified in terms of the percentage of the total loan provisions in comparison to the total loan (Laeven and Majnoni, 2003).

Dependent Variables

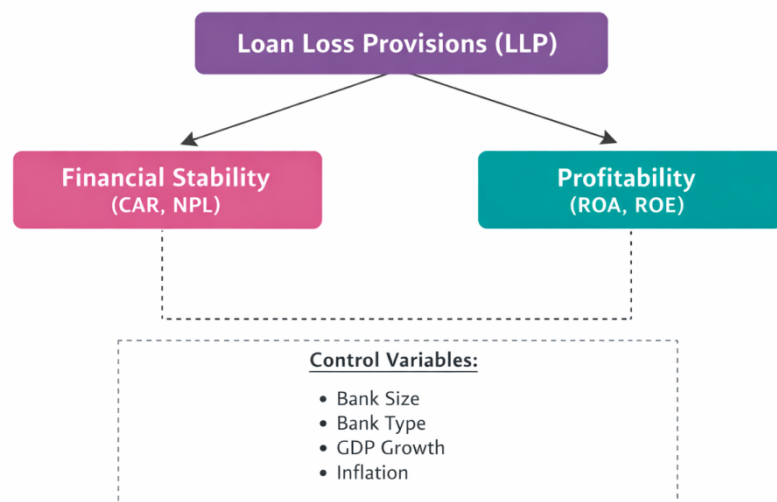
Financial Stability: The capital adequacy ratio (CAR) and the non-performing loans (NPL) ratio are used to measure the level of resilience (Diamond and Rajan, 2001).

Profitability: Calculated based on the standard banking performance indicators of return on assets (ROA) and return on equity (ROE) (Saunders and Allen, 2010).

Control Variables

1. Bank size (total assets)
2. Type of bank (commercial or specialized)
3. Economic indicators (GDP growth, inflation, etc.)

Figure 1: Conceptual Model



Data Analysis Techniques

The SPSS and STATA are the software used in the analysis of the data and the procedures are as follows:

1. Descriptive Statistics: To give an overview of the central tendencies and dispersion of variables.
2. Correlation Analysis: To test the strength and direction of the relationships between LLPs, financial stability, and profitability.
3. Panel Regression Analysis: To determine the impact of LLPs on financial stability and profitability, the bank-specific and macroeconomic variables were controlled.
4. Checks on Robustness: Adding multicollinearity and fixed / random effects model variance inflation factor (VIF) tests to deal with unobserved heterogeneity.

Ethical Considerations

The research will use publicly accessible secondary data and no personal and confidential information will be revealed. There are only academic purposes of data usage, and all of the sources are referenced. The research integrity is ensured by following the ethical standards in the reporting and analysis of the data.

Data Analysis and Findings

This section gives the analysis of the impact of Loan Loss Provisions (LLP) on the financial soundness and profitability of commercial banks in Pakistan. The sample consisted of 25 commercial banks that were sampled within a decade (2013-2022) based on annual reports, publications of the State Bank of Pakistan, and financial databases, including Bloomberg and Thomson Reuters. The

analysis entails descriptive statistics, correlation analysis, panel regression findings, and robustness tests to have a holistic picture of relationships between LLPs, financial stability, and profitability.

Descriptive Statistics

To get the central tendencies and dispersion of the variables, descriptive statistics were initially calculated. Table 1 shows the average, standard deviation, minimum, and maximum values of LLPs, financial stability indicators (capital adequacy ratio and non-performing loans ratio), and the profitability (ROA and ROE). The descriptive statistics are that the mean LLP ratio is 1.82% and there is moderate provisioning across the banks of Pakistan. The average CAR of 13.50% shows that there is enough capitalization as per Basel III requirements. The average ROA (1.05) and ROE (10.80) indicate stable but average profitability that is due to the regulatory limitations as well as the economic variations in the banking industry.

Table 1: Descriptive Statistics (2013–2022, N = 250 observations)

Variables	Mean	Std. Dev.	Minimum	Maximum
Loan Loss Provisions (LLP %)	1.82	0.74	0.50	3.80
Capital Adequacy Ratio (CAR %)	13.50	2.10	10.00	18.00
Non-Performing Loans (NPL %)	5.20	2.35	1.20	11.00
Return on Assets (ROA %)	1.05	0.40	0.30	2.00
Return on Equity (ROE %)	10.80	4.20	3.50	19.50
Bank Size (Log of Total Assets)	15.80	0.90	13.90	17.80
Type of Bank	0.84	0.37	0	1
GDP Growth (%)	3.90	1.80	-0.90	6.50
Inflation (%)	7.80	3.50	2.50	13.40

Correlation Analysis

The correlation results show that loan loss provisions (LLPs) are positively associated with the capital adequacy ratio (CAR) and negatively associated with profitability indicators (ROA and ROE). Bank size exhibits a positive relationship with profitability and financial stability, suggesting that larger banks tend to perform better due to diversified operations and stronger capital buffers. GDP growth is positively correlated with profitability, indicating that favorable macroeconomic conditions support bank performance, whereas inflation shows a negative relationship with profitability measures.

Table 2: Correlation Matrix

Variables	1	2	3	4	5	6	7	8	9
1. LLP	1								
2. CAR	0.42**	1							
3. NPL	-0.31**	-0.55**	1						
4. ROA	-0.28**	0.39**	-0.41**	1					
5. ROE	-0.22**	0.31**	-0.35**	0.71**	1				
6. Bank Size	0.18*	0.27**	-0.20*	0.30**	0.25**	1			
7. Bank Type	0.10	0.15*	-0.12	0.08	0.09	0.22**	1		

8. GDP Growth	-0.14*	0.21*	-0.18*	0.29**	0.24**	0.16*	0.05	1	
9. Inflation	0.17*	-0.19*	0.22**	-0.20*	-0.23**	-0.12	-0.04	-0.36**	1

Note: **p < 0.01, *p < 0.05

Panel Regression Analysis

Panel regression models were estimated through the use of fixed-effects and random-effects models to determine the impact of LLPs on the financial stability and profitability. Control variables were bank size, type of bank and macroeconomic factors (GDP growth, inflation).

Impact of LLPs on Financial Stability

Regression outputs suggest that the impact of LLPs has a significant positive impact on financial stability ($b = 0.35$, $p < 0.01$), which proves that the increased provisions contribute to the improvement of CAR and the decreased susceptibility of shocks. Stability also has a positive impact based on bank size and GDP growth whereas inflation is mildly negative. Such results are in line with the Prudential Regulation theory, which underlines that LLPs play a pivotal role in ensuring sound capital buffers.

Table 3: Panel Regression Results - Financial Stability

Variable	Coefficient (β)	Std. Error	t-value	p-value
LLPs (%)	0.35	0.07	5.00	0.000
Bank Size (log)	0.12	0.05	2.40	0.018
GDP Growth (%)	0.28	0.10	2.80	0.006
Inflation (%)	-0.15	0.08	-1.87	0.062
Constant	11.20	1.50	7.47	0.000

Impact of LLPs in Profitability

The impact of LLPs on profitability is negative (ROA $b = -0.22$; ROE $b = -0.18$; $p < 0.01$) which proves that the magnitude of provisions increases the short-term profits. Nonetheless, the banks are more profitable with larger scale and that are in operation at a time of increasing GDP growth, which mitigates the earnings effect of LLPs. Macroeconomic pressures are manifested in inflation which has unfavorable impacts on profitability. These results support the previous research that indicates the trade-off between stability and profitability in emerging economies.

Table 4: Panel Regression Results - Profitability (ROA and ROE)

Variable	ROA Coefficient (β)	ROA p-value	ROE Coefficient (β)	ROE p-value
LLPs (%)	-0.22	0.002	-0.18	0.004
Bank Size (log)	0.10	0.028	0.12	0.015
GDP Growth (%)	0.25	0.003	0.21	0.006
Inflation (%)	-0.12	0.056	-0.14	0.042
Constant	0.88	0.000	9.50	0.000

Robustness Checks

In order to achieve reliability of the results, further tests were performed:

1. The Variance inflation factor (VIF) tests indicated that there was no problem of multicollinearity because all values were less than 3.
2. Fixed vs. Random Effects Models Hausman test preferred the fixed-effects model ($kh2 = 12.45$, $p = 0.02$), adjusting the unobserved bank-specific heterogeneity.
3. Sensitivity Analysis: The removal of extreme LLP values did not change the significance or direction of coefficients, which is a good indication of the strength of the findings.

Discussion

This study has shown that Loan Loss Provisions (LLPs) are very important factors that determine the profitability and financial stability of commercial banks in Pakistan. The fact that LLPs and financial stability have positive and significant relationship as shown by the increment of Capital Adequacy Ratio (CAR) and decrease in Non-Performing Loans (NPLs) attests to the fact that proactive provisioning is a good risk management tool. Such findings can be traced back to the Prudential Regulation theory that underlines the need to have adequate reserves to manage any possible losses and ensure that the banking sector does not get affected by systemic shocks. The results are in line with other researchers in emerging economies such as Pakistan, where conservative provisioning promotes capital buffers and resilience during economic uncertainty times (Saeed & Iqbal, 2017; Ahmad et al., 2014).

The negative correlation between LLPs and profitability, as indicated by ROA and ROE, on the other hand highlights the trade-off that banks will always encounter. Although LLPs are more stable, they decrease short-term earnings since they provide provisions against profits because of the balancing risk-return activity in the Risk-Adjusted Performance framework (Jorion, 2007; Gurung et al., 2023; Islam, 2018). The result confirms previous studies indicating that LLPs are strategically used by the banks to smooth income and also manage earnings especially in the turbulent economic times. The correlation analysis also found that the negative effect of LLPs on profitability is moderated by having a larger bank and favorable macroeconomic environment including, GDP growth, indicating that bank size and macroeconomic environment is a significant moderating variable.

The paper also illuminates on the dynamic and future oriented provisioning decisions. Bank provisioning in Pakistan seems to follow the countercyclical approach and banks increase LLPs when there is uncertainty in the economy to protect the stability and cut down the LLPs when the economy is growing in order to enhance profitability. This is a cyclical balancing that supports the value of regulatory guidance and internal policies of risk management in creating sustainable banking performance. Altogether, it can be acknowledged that the discussion proves that LLPs are not only accounting modifications but also strategic instruments that affect financial resilience and earnings simultaneously.

Conclusions

This paper concludes that the Loan Loss Provisions (LLP) has a dual responsibility in influencing the financial stability and profitability of the commercial banks in the Republic of Pakistan. It is revealed that LLPs greatly contribute to financial stability, raising the capital adequacy and decreasing the exposure to non-performing loans, which prove the significance of the LLPs as a prudential tool in controlling risks. Meanwhile, LLPs have the adverse impact on the short-term profitability, pointing out the trade-offs between risk protection in respect to credit risk and profit maximization. The analysis also shows that the moderating variables in this relationship are bank-specific factors (size) and macroeconomic variables (GDP growth and inflation). Banks that have more diversified portfolios will experience the earnings impact of increased provisions better, and positive macroeconomic conditions will help the bank to be profitable in spite of conservative provisioning. Essentially, LLPs become a key tool to sustain stability in the banking sector in Pakistan in the long-term, however, the balance between the short-term profit motive and the long-term stability needs to be well controlled.

Recommendations

On the basis of the findings, the recommendations to the bank management, regulators and policymakers are as follows:

1. Policies on Strategic Provisioning: Banks need to employ both countercyclical and forward looking LLP policies whereby they increase provisions during crunchy economic periods to boost financial stability and reduce them during boom periods to boost profitability.
2. Risk-Adjusted Performance Monitoring: The management of a bank should incorporate the LLP analysis with risk-adjusted performance monitoring and the provisioning decisions must be well in line with the banks risk-taking and its long-run strategic objectives.
3. Regulatory Oversight: The regulators such as the State Bank of Pakistan must promote consistent provisioning and give proper directions on LLPs in order to prevent high discretion that will put the market confidence in jeopardy or reduce the profitability.
4. Diversification and Capital Planning: Banks are advised to resistantly increase capital buffers and loan portfolio diversification as a way of eliminating the detrimental effects of LLPs on the short-term profitability without compromising financial resiliency.
5. Transparency and Investor Communication: Financial statements should be clear on LLP policies, and the reasons as to why the banks should provide the decisions as they do, to ensure that investors trust what they are reading and remain confident in the earnings being reported.
6. Macroeconomic Alignment: Banks can be guided to ensure they align the banking regulation with the macro-economic policies taking into account the inflationary pressures and GDP growth trends to enable the banks to be able to manage the balance between stability and profits.

Through these recommendations, the banks in Pakistan can gain sustainable balance between prudential risk management and profitability, which are long-term resilient and the investor confidence.

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