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Islamic bank incentives and discretionary loan loss provisions

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ABSTRACT

The objective of this paper is to ascertain whether there are significant differences in the loan loss provisioning behaviour of Islamic banks as compared to conventional banks. We proposed that loan loss provisioning will be linked to the extent of profit distribution management. The results suggest that Islamic banks consistently record lower loan loss provisions. However, the association between profit distribution management and loan loss provisioning is mixed. The overall results tend to suggest that there is an inverse relationship between profit distribution management and loan loss provisions. The results also suggest that there are differential effects depending on whether the profit distribution management is for the benefit or the detriment of investment depositors. If there is a surplus of asset returns over profit distributions (positive profit distribution management), it is observed that Islamic banks increase their loan loss provisions. However, this result does not extend to the full sample containing both Islamic and conventional banks. Further, there is no effect where the profit distribution management is for the benefit of investment depositors.

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1. Introduction

A large array of theoretical and empirical literature has established that there are incentives for managers to smooth earnings and that they attempt to do so utilising either their real or accounting discretion. Smooth

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earnings are widely cited as an indicator of earnings quality, partly attributed to its ability to mitigate firm-specific information risk (Francis, LeFond, Olsson and Schipper 2004). Smooth earnings also have special significance for banks. While investors in banks can diversify bank specific risk, idiosyncratic risk associated with the volatility of individual bank earnings cannot be diversified away by either bank managers and/or regulators. Such risks have potential systemic implications since the volatility of earnings (or significant losses) for one bank may cause a domino effect type system wide bank run. As a result, both bank managers and regulators have vested interests to ensure that earnings volatility is kept to a minimum for individual banks. To ensure that banks operate within the regulators' tolerance levels, the regulators in most jurisdictions require monthly and quarterly reporting to monitor any potential unusual figures. To that extent, bank managers likely utilise both real and accounting choices to ensure that earnings demonstrate a smooth pattern. A large body of literature establishes the use of discretionary accounting choices such as loan loss provisions to manage bank earnings.

This study proposes that some Islamic banks may have greater incentives to utilise their loan loss provisions, commensurate with the extent of volatility the bank has to absorb as a result of profit distribution management. These incentives may be exacerbated by banks' inability to utilise real choices (as opposed to accounting choices) to smooth earnings and profit distributions in the short term. The study also proposes that Islamic banks that have discretionary profit distribution reserves will be able to mitigate the effects of profit distribution management on earnings variability and consequently financial stability.

The results indicate that Islamic banks manage their loan loss provisions, considering their levels of earnings and profit distributions. These results are markedly apparent for Islamic banks compared to conventional banks and are stronger for smaller Islamic banks. However, there is no persuasive evidence that the existence of discretionary reserves plays a role in any loan loss provision-related decision making process, as is evident by the insignificant relationship between loan loss provisions (LLP) and any of the variables containing the discretionary reserves variable (RESERV). Other interesting results that emerge are that Islamic banks consistently report lower provisions than conventional banks. This could potentially be attributed to more conservative credit criteria and lower risk investments for Islamic banks. Islamic banks are disallowed from investing in high risk investments or structured products as a result of Shari'a constraints on speculation and gambling. The results also suggest that Islamic banks also utilise loan loss provisions for earnings management, by increasing such provisions when earnings are high, and vice versa. In contrast, conventional banks consistently demonstrate the opposite relationship with loan loss provisions, reducing provisions when earnings are high, and vice versa (as established in the previous empirical literature).

This study supplements the existing literature on bank management of loan loss provisions to smooth earnings. It provides a new contractual setting in which bank managers potentially have increased incentives to utilise loan loss provisions. Partly attributable to the lack of extensive high quality data, there has been no study that has utilised empirical data to assess the relationship between two sets of discretionary choices in Islamic banks: the choice to manage earnings and the choice to manage profit distributions to depositors. Indeed, the results of this study are important, since they shed light on the actual differences in the behavioural tendencies of management in Islamic banks and conventional commercial banks.

Section 2 describes the contractual characteristics of Islamic banks and contrasts them with conventional banks. It also describes some of the methods utilised by Islamic banks to distribute profits to depositors, a unique feature arising out of the profit sharing contract of Islamic banks with its depositors. Section 3 elaborates on the research design while Section 4 discusses the results. Finally, Section 5 concludes the study.

2. Islamic banking institutions setting and hypothesis development

2.1. Financial contracting in Islamic banks

The contemporary term ‘Islamic Banking’ refers to a system of financing and investment that is consistent with Islamic law (*Shari'a*) and principles of Islamic jurisprudence (*Fiqh*). The most important constraint in Islamic Law relating to financing is that money cannot simply be earned out of lending money (the conventional definition of usury or *riba* and what is now defined as interest). Instead, money/assets must be invested in productive enterprises, the most important of which are trade (*bay*) and equity investment

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