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Profit distribution management by Islamic banks: An empirical investigation

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ABSTRACT

The objective of this paper is to ascertain whether Islamic banks do in fact manage profit distributions and if so, what factors are associated with the extent of profit distribution management. The results suggest that most Islamic banks manage profit distributions, with the extent of profit distribution directly related to religiosity, financial development, asset composition, and existence of discretionary reserves, while it is inversely related to market familiarity with Islamic banking, market concentration, depositor funding reliance and the age of the Islamic bank.

1. Introduction

Islamic banks have the implicit flexibility to manage their depositor profit distributions *ex post* as a result of being able to vary the management fee attributable to the shareholders. To that extent, Sundararajan (2005) finds that Islamic banks do in fact manage profit distributions towards interest rates for his limited sample of 14 banks. He derives his sample from 8 countries (not specified) over the years 2002 and 2003.[3] His assertion that Islamic banks manage profit distributions relies on the strong significant correlation between market deposit interest rates and the distributions to depositors for the Islamic banks in his sample. This is in contrast to the insignificant correlation between asset returns and depositor distribution rates for the Islamic banks in his sample.

While Islamic banks have an explicit contractual obligation to share profits with depositors, Sundararajan's (2005) results essentially imply that Islamic banks may face competition costs which require an implicit contractual condition between the depositors and the bank to provide distributions similar to market based deposit interest rates. This study extends Sundararajan's study by first expanding the sample size, and second, considering factors that might be related to profit distribution management.

Besides being attractive economic questions by themselves, the questions of whether and why Islamic banks manage their profit distributions are interesting since the extent of profit distribution management may have a bearing on the risk outlook of the bank itself. To the extent that the bank engages in profit distribution management, it is arguably taking on more equity risk and thereby shielding investment depositors from the risk associated with the asset portfolio of the bank. This would implicitly require bank management to be more cautious about the risk profile of their investments and ensure that the shareholders' equity is not threatened. Alternatively, if the bank is not engaging in profit distribution management, the bank is passing on equity risk to the investment depositors. Being able to pass on equity risk to the

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[3] Sundararajan's sample of Islamic banks is widely dispersed from a number of countries (8 in total) and there is nothing in the results to suggest that this effect is limited to regulatory regimes in specific countries. However, it is acknowledged that the sample may have limited generalisability due to the limited number of observations (18 in total). This study seeks to remedy that limitation.

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investment depositors, the bank may have heightened incentives to engage in riskier investments and thereby increase moral hazard, under the implicit assumption that investment account holders will absorb some of the losses (Cihak & Hesse, 2010).[4]

This setting provides the principal motivation to investigate whether Islamic banks manage their profit distributions in an enlarged sample of Islamic banks and what factors are associated with the extent to which they manage their profit distributions towards market based interest rates or away from asset returns. The extent to which they manage profit distributions to depositors will also have implications on the Islamic bank's financial stability and financial reporting incentives.

This paper analyses two issues related to profit management by Islamic banks. First, the paper provides systematic evidence of the phenomenon of profit distribution management as anecdotally evidenced by Sundararajan (2005) using a full sample of Islamic banks. This objective is addressed in the results section by comparing depositor profit distributions with a range of other measures such as market deposit rates and asset return rates for each individual bank, country wise and for the aggregate sample of banks. The second objective is to ascertain the factors that are associated with variation in the extent to which depositor profit distributions are managed towards market based depositor interest rates and away from fundamental return on assets. This objective is addressed by conducting several regression analyses on an original empirical model developed in this study.

The evidence gathered in this study suggests that most Islamic banks manage profit distributions, with Islamic banks in Brunei, Malaysia and the United Arab Emirates demonstrating consistently lower average profit distribution management (based on Asset Spreads). In contrast, Islamic banks in Bahrain, Indonesia, Pakistan and Saudi Arabia have consistently higher average profit distribution management (based on Asset Spreads).

With the exception of banks from Bahrain, Kuwait, Turkey and Yemen, there is no evidence to suggest all Islamic banks in a specific country systematically and consistently manage profit distributions towards deposit rates and away from asset rates. No common underlying factor between these countries can potentially be found to ascertain why Islamic banks systematically manage profit distributions The results suggest that Islamic banks do manage profit distributions and such discretionary activity is directly related to religiosity, financial development, asset composition, existence of discretionary reserves, while it is inversely related to market familiarity with Islamic banking, market concentration, depositor funding reliance and the age of the Islamic bank.

The paper is divided into five sections. Following introduction, Section 2 develops the theory to explain the factors associated with the variation in profit sharing, while the subsequent section develops the specific hypotheses to be tested. Section 3 discusses the research design and Section 4 provides a description and analysis of the results, while Section 5 concludes this chapter.

2. Literature and hypothesis development

Islamic banks have developed two reserves called profit equalisation reserve (PER) and investment risk reserves (IRR) to be able to pay the investment account holders (IAH) a steady rate of return and keep their capital intact. The PER is created by deductions from income earned on investments prior to profit allocation between the bank and its IAH. The IRR is built up by appropriations from the share of profit allocated to the IAH after deduction of the bank's shareholders. The use of these reserves (PER and IRR) has similarities with the use of conventional revenue reserves to smooth dividend payouts to shareholders. Whereas in case of conventional reserves that belong to shareholders and are reflected in their share value, the IAH has no right to vote for or against the use of these reserves decided by the bank board of directors (Archer & Karim, 2006; Archer, Karim, & Sundararajan, 2010; Sundararajan, 2007, 2008). The calculation and use of PER and IRR are decided by Islamic banks based on their own discretion and there are no specific supervisory disclosure requirements regarding this. Indeed, the publicly available information on these reserves is rather limited (Sundararajan, 2005). Literature on income smoothing practices are limited, and results are mixed at best.

Using firm-level data over the period 2001–2006, Taktak, Zouari, and Boudriga (2010) examine income smoothing practices in Islamic banks and test the use of Loan Loss Provisions (LLP) to stabilise net income. Their results show that, unlike conventional banks, Islamic banks do not use LLPs to smooth their income. Rather they use IRR and PER to maintain stable income.

Using a sample of Islamic and conventional banks for the period of 2000–2003 in Gulf Cooperation Council (GCC) countries, Zoubi and Al-Khazali (2007) find support for income smoothing hypothesis. They find that banks in GCC use LLPs to smooth their income. In case of Malaysian banks, Ismail and Be Lay (2002) also find evidence of earnings management using LLP over the period 1997–1999. Similar results were also found by Shahimi, Ismail, and Ahmad (2006), based on a sample of 15 Malaysian Islamic banks over the period 1996–2003. However, later Ismail, Shaharudin, and Samudhram (2005), using again Malaysian Islamic banking data from 1998 to 2001, show that bank managers do not LLP to smooth their earnings, but they use security gains/losses to smooth their earnings.

A large proportion of the target market of Islamic banks is likely to be sensitive to market based price measures such as interest rates, particularly if these banks operate in competitive contractual environments with other Islamic and conventional banks and deposit taking institutions. As a result, Islamic banks may be pressured in varying degrees to provide distributions similar to other institutions or risk losing their depositor base.[5] The extent to which Islamic banks actually manage distributions to their depositors towards market based interest benchmarks will not only be associated with the pressures on the bank through its contractual environment, termed demand side factors, but also by the bank's own characteristics which define its interactions with this contractual environmental, termed supply side factors. This is because the Islamic bank is likely to position itself in the market based on its comparative advantage and this positioning will be reflected in its product or service attributes.

2.1. *Demand side analysis of profit distribution management of Islamic banks*

Given the potential markets for Islamic banks, there are essentially two broad inter-related factors which will have implications for the extent to which Islamic banks are pressured to manage profit distributions to depositors. These are the characteristics of the Muslim population and the characteristics of competition in the market for interest bearing deposits.

[4] This is under the assumption that banks do not have other risk management constraints imposed by regulators such as capital adequacy based asset risk weights.

[5] In the Islamic banking literature, this risk has been termed *displaced commercial risk*. It essentially refers to the risk that investors will withdraw their funds in droves, thereby subjecting the bank to insolvency, if the returns paid demonstrate a trend contrary to the investors' expectations of instruments/deposits of a similar nature.