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Capital and Earnings Management: Evidence from Alternative Banking Business Models

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ABSTRACT

This paper examines whether institutional characteristics distinguishing Islamic from conventional banks lead to distinctive capital and earnings management behavior through the use of loan loss provisions. In our sample countries, the two banking sectors operate under different regulatory frameworks: conventional banks currently apply the "incurred" loan loss model until 2018 whereas Islamic banks mandatorily adopt an "expected" loan loss model. Our results provide significant evidence of capital and earnings management practices via loan loss provisions in conventional banks. This finding is more prominent for large and loss-generating banks. By contrast, Islamic banks tend not to use loan loss provisions in either capital or earnings management, irrespective of the bank's size, earnings profile, or the structure of their loan loss model. This difference may be attributed to the constrained business model of Islamic banking, strict governance, and ethical orientation.

1. Introduction

A well-established stream of literature has identified the use of loan loss provisions (LLP) by bank managers in capital and earnings management.[1] Their motivation is: to avoid regulatory capital adequacy charges that are incurred in falling below the minimum capital adequacy requirements; to increase earnings-based compensation; and to prevent debt covenant violations (see e.g. Ahmed, Takeda, & Thomas, 1999; Anandarajan, Hasan, and McCarthy, 2007; Leventis, Dimitropoulos, and Anandarajan, 2011; Moyer, 1990; Wahlen, 1994). The discretionary use of capital and earnings management practices is an obvious focus for standard setters, but little emphasis has been given to study the comparative use of LLP to manage capital and earnings across Islamic and conventional banks.

Capital and earnings management can be achieved through the exercise of discretion in the magnitude or timing of the recognition of certain loan losses and in the levels reported for LLP (Ahmed et al., 1999). Where banks might deliberately engage in capital and earnings management practices via LLP, this may compromise the quality of financial reporting and generate excessive agency costs (see Anandarajan et al., 2007; Beaver and Engel, 1996; Jensen and Meckling, 1976).

The primary motivation of this study is to compare capital and earnings management practices of conventional and Islamic banks

Abbreviations: LLP, loan loss provisions; I-LLM, incurred loan loss model; *E*-LLM, expected loan loss model

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[1] In line with Healy and Wahlen (1999) and Ahmed, Takeda, and Thomas (1999), we define capital and earnings management as the use of management's judgment in financial reporting and in structuring transactions where the objective is to manipulate regulatory capital adequacy ratios reported in line with Basel II requirement and/or overstate/understate reported earnings in order to mislead stakeholders or to influence contractual outcomes.

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located in the same countries but operating under different regulatory requirements. Our investigation informs regulators and investors as it responds to calls for research to establish the relevance of bank type on LLP decisions and the possible opportunistic behaviour of bank managers (Abdelsalam, Dimitropoulos, Elnahass, and Leventis, 2016; Belal, Abdelsalam, and Nizamee, 2015; Bushman and Willams, 2012; Elnahass, Izzeldin, and Abdelsalam, 2014; Fonseca and González, 2008).

The profit-loss sharing business model of Islamic banks requires contractual arrangements between a bank and its investment account holders (IAHs), i.e., depositors. This tends to constrain Islamic banks' ability to manage capital and earnings through LLP. Moreover, agency costs are relatively higher in Islamic banks, because IAHs are not directly involved in financial and business decisions (i.e., they have no representation on the board of directors) and so must monitor their investments through published financial information. This gives rise to the possibility of managerial opportunism (Abdel Karim and Archer, 2002; Safieddine, 2009). In attempting to protect their investments, the motivation of IAHs is to try to influence regulators to monitor and develop additional governance mechanisms in Islamic banks in order to raise the quality of financial reporting.

Unlike the single governance-layer in conventional banks (i.e., board of directors and audit committees), Islamic banks are subject to an extra governance mechanism of the Shariah supervisory boards[2] (see Belal et al., 2015). Furthermore, the ethos of Islamic banking emphasizes ethical behavior and moral accountability, which would be expected to place limits upon managerial opportunism through the use of LLP. From those unique institutional bank characteristics and the constrained business model of Islamic banks, our premise is that capital and earnings management using LLP is less likely in Islamic banking than conventional banking. That premise is supported by the conventional banking literature which shows that a strong institutional environment may restrain the use of accounting discretion and aggressive earnings management (Dyreng, Mayew, and Williams, 2012; Kanagaretnam, Lobo, and Wang, 2015; McGuire, Omer, and Sharp, 2012).

With growing concerns over the discretionary use of LLP, added consideration is given to the structure of loan loss models. After the financial crisis of 2007, the “incurred” loan loss model (I-LLM), as defined by IAS 39 *Financial Instruments: Recognition and Measurement*, was perceived to have exacerbated the upheaval by the pro-cyclical[3] lending that is associated with low levels of LLP (see Fillat and Montoriol-Garriga, 2010; Wezel, Chan-Lau, and Francesc, 2012). In response, the International Accounting Standards Board (IASB) proposed a change from the “incurred” to the “expected” loan loss model (*E*-LLM) under IFRS 9 *Financial Instruments*.[4]

For conventional banks, the implementation of the *E*-LLM was deferred until 2018. However, for Islamic banks, LLP has matched the requirements of the E-LLM since at least 2010 (see Taktak, Zouari, and Boudriga, 2010; Zoubi and Al-Khazali, 2007). For Islamic banks in Bahrain, Jordan, and Qatar, the E-LLM is now mandatory (see AAOIFI, 2015; ACCA and KPMG, 2010; Sarea and Hanefah, 2013). This offers an attractive setting to further examine capital and earnings management via the use of LLP as reported by Islamic and conventional banks that are located in the same countries but currently apply different regulatory frameworks (i.e., E-LLM versus I-LLM).

For the period 2007–2013, we use panel data for Bahrain, Qatar, and Jordan, comprising 441 bank-year observations (63 banks). Those three countries have a homogenous culture, similar macroeconomic features, and a dual banking system in which there is a relatively high concentration of Islamic banks (Ernst and Young, 2015b). Our findings indicate that during the whole sample period, banks tend to use LLP to manage Tier 1 capital ratio and to smooth earnings. However, the two bank types show significantly different capital and earnings management behavior. We find no evidence that Islamic banks manage capital or earnings through LLP. This is regardless of bank size and profitability position. For conventional banks, we find significant evidence of capital and earnings management practices via LLP. This tendency is more obvious when reporting financial losses than profits. We also note that regulatory capital management via LLP is more prevalent for large conventional banks while the use of LLP to manage earnings is evident irrespective of bank size. Finally, where the *E*-LLM model for Islamic banks mitigates lending pro-cyclicality, for conventional banks the I-LLM model accentuates pro-cyclicality in lending.

This paper contributes to the literature comparing Islamic and conventional banks in a number of ways. It is the first attempt to examine how distinctive financial reporting standards and loan loss models could lead to differentiated earnings and capital management behavior. We extend previous work on the implications of discretionary acts on financial reporting quality by Islamic and conventional banking (Abdelsalam et al., 2016; Elnahass et al., 2014; Safieddine, 2009). Second, our findings highlight the influence of adopting a constrained banking business model, characterized by risk-sharing and additional governance mechanisms, on the opportunistic use of LLP (see Cieslewicz, 2014; Dyreng et al., 2012; Leventis and Dimitropoulos, 2012; McGuire et al., 2012). In this regard, we further contribute to understanding the relevance of bank institutional characteristics on earnings management and financial reporting practices. Finally, by studying a subsample of Islamic banks that is ahead of conventional banks in applying the *E*-LLM, this study extends the findings of Bushman and Willams (2012) in documenting the opaqueness of this *forward-looking model* and its possible use in accounting discretion.

Examining the use of LLP in capital and earnings management across the two banking sectors raises issues that are relevant to investors, auditors, and regulators who seek enhanced quality of reported financial information. Our empirical assessments of the

[2] The Shariah supervisory board operates as an internal audit unit or internal control mechanism to certify that a bank's operations are free from any element prohibited by the Islamic principles (Safieddine, 2009).

[3] Pro-cyclicality implies that banks expand their loan portfolio in a boom without raising their total capital. During a cyclical downturn, capital accumulation may be insufficient for LLP to cover credit losses. Banks are then forced to reduce lending, thereby intensifying pro-cyclical effects (see Jokipii and Milne, 2008).

[4] The I-LLM is a *backward-looking model* in that the creation of LLP is triggered by past events with no provision for the accumulation during booms of resources necessary to meet subsequent/sudden credit shocks. The *E*-LLM is a *forward-looking model* by which banks tend to build LLP in line with estimates of long-term expected loan losses; the aim is to reduce banks' exposure to increased credit risk and sudden economic shocks experienced under the *backward-looking model* (see Ernst and Young, 2014).