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## Article

# Islamic deposits and investment accounts in income smoothing in post-reclassification of the Islamic Financial Service Act 2013

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# Islamic Deposits and Investment Accounts in Income Smoothing in Post-Reclassification of the Islamic Financial Service Act 2013

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*This study attempts to determine the impact of the reclassification on income smoothing practices by Islamic banks in Malaysia through loss provisions. It is well acknowledged that Islamic banks set up an allowance for loss provisions in order to absorb any future losses. However, alternative mechanisms, such as Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR) instead of loss provisions, are used to smooth income. This study determines whether the exercise by Islamic banks in Malaysia to reclassify Islamic deposits to investment accounts after the enacted Islamic Financial Service Act (2013), may have caused unintended consequences in less profit payout to investment account holders. The results do not indicate any unintended consequences of less profit payout to investment account holders from the present exercise by the Islamic banks in Malaysia to distinguish Islamic deposits from investment accounts.*

**Keywords:** *Islamic banks, Islamic deposits, investment accounts, Profit Equalization Reserves, Investment Risk Reserves*

**JEL classification:** *G21, G32*

## 1. Introduction

The enacted new rules governing the Malaysian's Islamic finance sector, the Islamic Financial Service Act (2013) is a way of enforcing a closer adherence to shariah. It gives regulators greater oversight over Islamic scholars whose duties and functions are for advising to assure that Islamic financial products are in compliance with shariah. In the rules, one provision is that it requires Islamic banks to distinguish deposits made for saving - where the principal is guarantee from those made for investments - where the principal is not guarantee. The Islamic banks in Malaysia are given a two year transition period until 30 June 2015 to comply with the reclassification process. It involves engaging their customers to provide information and clarification on the differences between Islamic deposits and investment accounts.

This study attempts to determine the impact of the reclassification on income smoothing practices (*income smoothing practice is considered a violation of internationally accepted accounting standards - IAS39 or IFRS*) by Islamic banks through loss provisions. It is well acknowledged that Islamic banks set up an allowance for loss provisions in order to absorb any future losses. However, in a recent study, Taktak, Zouari and Boudriga (2010) observe that alternative mechanisms, such as *Profit Equalization Reserve (PER)* and *Investment Risk Reserve*

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(*IRR*) instead of loss provisions, are used to smooth income. This study extends their findings to determine whether the exercise by Islamic banks in Malaysia to reclassify Islamic deposits to investment accounts may have cause in unintended consequences in less profit payout to investment account holders.

This study is different from a previous study by Zoubi and Khazali (2007) on income smoothing practices of Islamic banks in the Gulf Cooperation Council (GCC) not only it analyzes the impact from the reclassification exercise by Islamic banks from one country, Malaysia; but also, it extends to determine whether the reclassification may have cause in unintended consequences in less profit payout to investment account holders. Further, unlike the study by Zoubi and Khazali that analyzes the Islamic banks from different countries such as Bahrain, Kuwait, Oman and Qatar that may be subject to different regulatory changes thus their approach may complicate their findings; this study limits its scopes to one country.

This study adds to the Islamic finance literature in at least two important ways. First, by revealing evidence on how the impact of reclassifying from Islamic deposits to investment accounts on income smoothing by Islamic banks through loss provisions that is widely practiced. Because if Islamic banks rely more on investment reserves to smooth their income instead of loss provisions, it may have reduced the profit payout to investment account holders. As a consequence, this practice might jeopardize the position of Islamic banks.

Second, notwithstanding any changes in the impact of the reclassification, the study determines whether declined reliance on loss provisions has caused it to become any less informative. Thus the study reinforces the notion that the efficiency of a given regulatory measure should not be assessed on a standalone basis without giving due consideration to any unintended consequences. The remainder of this paper is as follows: Section 2 is a review of literature on income smoothing by Islamic banks. Section 3 is on data methodology, hypothesis development as well as variable definitions. Section 4 is discussion on results obtained of regression equations for pre-reclassification years and post-reclassification years in using E-views and Stata software, and section 5 concludes the paper.

## 2. Literature review

When Islamic banks smooth their income through loss provisions, that will reduce excessive profits which rises during economic growth by means of increased loss provisioning, and vice versa. With prefect income smoothing, their earnings are either not affected or less affected by fluctuations in credit losses over the cycle. Whilst smoothened incomes through loss provisions are a natural practice by Islamic banks just as that is widely practiced by their conventional counterparts, in a recent study on loss provisions for earnings management purposes by Islamic banks in various countries, Taktak, Zouari and Boudriga (2010) disputed they are used for earnings management. Instead, they discovered the banks use alternative mechanisms such as, *Profit Equalization Reserve (PER)* and *Investment Risk Reserve (IRR)*. The authors warn this may have resulted in less profit payout to investment account holders.

In several previous studies in Islamic finance literature, the two investment reserve accounts are actively used by Islamic banks to reduce the volatility of rates of return on investment accounts. (Sundararajan, 2005; Khan and Ahmed, 2001; Archer and Karim, 2006; and Archer et al., 2010). Also, Taktak et al. (2010) infer the calculations of the two mechanisms are based on discretion by the banks.

In a study on effects of smoothing income of conventional banks but extended to examine the enhancing of outside investors' and regulators' ability in monitoring and disciplining the banks' risk-taking behavior, Bushman and Williams (2012) discovered that smoothing earnings resulted in unintended consequences. From examining 55,236 bank-year observations over 27 countries than spans 1995-2006, the authors highlight that whilst smoothing income reduces pro-cyclicality in earnings, it dampens discipline over risk-taking behavior of the banks in their sample. The result is consistent with diminished transparency inhibiting outside monitoring.

In their reference to writings by V. Sundararajan on issues in managing *Profit Equalization Reserve (PER)* and *Investment Risk Reserves (IRR)*, Ahmed and Kohli (2011) indicate that the former as an amount that is appropriated out of gross income in order to maintain a certain level of returns to investment account holders so that a desired level of returns can be provided in face of volatility in assets return, thereby to help to manage displaced commercial risks. The latter reserves are attributable entirely to investment accounts, but maintained specifically to absorb periodic losses, as the authors indicate further.

Subsequently, in extending the study on smoothing returns by the reserves, Taktak, (2011) attributes the majority of the banks' smoothing practices due to the nature of the Islamic financial products rather than intentional

smoothing. The author concludes the banks did not exercise their discretions to smooth their results. In the study, he provides empirical evidences that shariah-based products exhibited higher variability than shariah-compliant revenues to conclude that the banks did not exercise their discretions to smooth their results.

According to Kanagaretnam, Krishnan and Lobo (2008), bank managers use loss provisions for communicating private, inside information and for opportunistic purposes. The latter include for income smoothing, as signaling tool, and for capital management. Further, the authors from their study on market valuation of bank's loss provisions add that auditors act to mitigate information asymmetry associated with the loss provisions.

In another study, the information on bank's financial is more valuable and relevant according to Dechow, Ge and Schrand (2010) in a specific decision setting by a specific decision-maker. The authors imply that the information can only be defined in the context of the specific decision setting. In this study, that specific decision setting is where the information on loss provisions is used. For instance, in a study by Vyas (2011) that measures timeliness of financial information, he finds that investors respond to information about the loss exposure of risky assets faster for financial firms with timelier write-downs. In another instance, Huizinga and Laeven (2009) document that banks used discretion to overstate distressed asset valuations, and banks with large exposures to mortgage-backed securities provisioned less for bad loans.

### 3. Methodology

#### 3.1. Data

In order to focus on the impact of the reclassification occurring around the publication of the Malaysia's Islamic Financial Service Act (2013) on 22 March 2013, the pre-reclassification data is restricted to reporting figures for fiscal years prior to 2013 (that is, 2009, 2010, 2011 and 2012).

And, the post-reclassification data to reporting figures for fiscal years 2013 and 2014. (Note: for the fiscal year 2014, where interim and unaudited data is available, it is included in the analysis).

Detailed information on the observed periods is as per Table 3.1.1 below. All Islamic banks in Malaysia are included where the necessary data are available for the pre-reclassification period for fiscal years 2009, 2010, 2011 and 2012 (including the Islamic banking operations of foreign-owned banks).

And for the post-reclassification period, for fiscal years 2013 and 2014 are included (where for the fiscal year 2014 where interim and unaudited data is available, it is included). These requirements result in a total sample of 107 bank-year observations.

*Table 3.1.1. Observation years included in the analysis*

No.	Islamic Banks	Pre-reclassification years	Post-reclassification years	
		2009, 2010, 2011 & 2012	2013	2014
1.	Affin Islamic	√	√	√ -Financial quarter 30/6/2014
2.	Alliance Islamic	√	√	√ -1 <sup>st</sup> quarter 30/6/2014
3.	AmIslamic	√	√	√ -Financial year ended 31/3/2014
4.	Bank Islam	√	√	√ -Half-yearly ended 30/6/2014
5.	Bank Muamalat	√	√	√ -Audited Financial Report as at 31/3/2014
6.	Agrobank	√	√	×
7.	CIMB Islamic	√	√	√ -Interim 2 <sup>nd</sup> quarter 30/6/2014
8.	HongLeong Islamic	√	√	√ -Unaudited as at 30/6/2014
9.	Maybank Islamic	√	√	√ -Half-year ended 30/6/2014
10.	MBSB	√	√	×
11.	Public Islamic	√	√	√ -Interim unaudited 30/9/2014
12.	RHB Islamic	√	√	×
13.	Bank Rakyat	√	√	×
14.	BSN	√	√	×
15.	AlRajhi Malaysia	√	√	√ -Interim financial quarter ended 31/3/2014
16.	Asian Finance	√	√	√ -Interim for 6 months ended 30/6/2014

17.	BNP Paribas Najmah	×	×	×
18.	Citibank	√	√	√ -Unaudited as at 30/6/2014
19.	HSBC Amanah	√	√	√ -Interim half-year ended 30/6/2014
20.	Kuwait Finance	√	√	√ -Interim as at 30/6/2014
21.	OCBC AlAmin	√	√	√ -Unaudited up to 30/6/2014
22.	Standard Chartered Saadiq	√	√	√ -Half-year ended 30/6/2014
23.	AlKhair	×	×	×
24.	Elaf Bank	×	×	×
25.	PT Mandiri Bank	×	×	×
26.	BOT Mitsubishi-UFJ (Malaysia)	×	×	×

Note: “√” - included in the analysis; “×” - excluded from the analysis.

Sources: Banks Annual/Interim Reports

### 3.2. Hypothesis development

The new provision in the Islamic Financial Service Act 2013 in Malaysia that requires Islamic banks to reclassify Islamic deposits to Investment accounts may have an impact on income smoothing through loss provisions as is widely practiced by Islamic banks, and further, the declined reliance on loss provisions may cause it to become less informative.

Accordingly, the hypothesis posits that Islamic banks following the post-reclassification exercise are likely to rely less on loss provisions for smoothing income. In other words, the hypothesis posits a greater association between discretionary *Loss Provisions (LP)* and *Profit before Zakat & Taxation (PZT)*. This indicates suggestive evidence that following the post-reclassification exercise they rely more on *Profit Equalization Reserve (PER)* and *Investment Risk Reserve (IRR)* to smooth their income. This may cause in unintended less profit payout to investment account holders.

Because the disclosure of information on the practices of *Profit Equalization Reserve (PER)* and *Investment Risk Reserve (IRR)* is still limited whether in pre and post reclassification years, henceforth it is not possible to directly assess the extent of these reserve accounts for all banks in the sample to examine on the extent that they may have used the reserves to achieve their smoothing objectives. However, banks have significant discretion in timing and recognition of the reserves appropriated out of their gross distributable income, henceforth *Profit before Zakat & Taxation (PZT)* is used as a proxy for the reserves account. Thus, higher coefficient of the *Loss Provisions (LP)* with the *Profit before Zakat & Taxation (PZT)* in the post-reclassification years reflects smoothing practices via the reserve accounts (after the post-reclassification years).

#### 3.2.1. Variable definitions:

The following regression model is estimated separately for pre-reclassification period (fiscal years 2009, 2010, 2011 and 2012) and post-reclassification period (fiscal years 2013 and 2014) to test this hypothesis.

$$LP_{it} = \alpha_0 + B_1 Pre_t + B_2 LP_{it-1} + B_3 NonPerformFin_{it} + B_4 PZT_{it} + B_5 Pre_t * PZT_{it} + B_6 TotalAsset_{it} + \varepsilon_{it}$$

where  $LP$  = loss provisions scaled by total assets

$Pre$  = an indicator variable that equals 1 if the observation belongs to the pre- reclassification period, and 0 otherwise

$NonPerformFin$  = Non Performing Finance scaled by total assets

$PZT$  = Profit before Zakat & Taxation scaled by total assets

$TotalAsset$  = Total assets

$\varepsilon_{it}$  = stochastic or random error term

The subscript “t” denotes time, subscript “i” denotes an individual Islamic bank. The lags of LP (i.e.  $LP_{it-1}$ ) is included in the explanatory variable in the same manner as applied by Frait and Komarkova (2013) in their study to analyze loss provisioning behavior in selected European banks; it is to capture the effects of omitted explanatory variables and the persistence of loss provisions.

Further, in the regression equation above, the coefficient on the interaction term,  $Post_t * PZT_{it}$  represents the difference in income-smoothing coefficients (that is driven by the effect of the reclassification) between post and pre-reclassification years.

The hypothesis as stated above predicts an incremental smoothing effect is higher in the post-reclassification than pre-reclassification. In other words, Islamic banks rely more on the reserves for smoothing income in the post-reclassification years than in the pre-reclassification years.

#### 4. Results and Discussion

The descriptive statistics for pre-reclassification years (2009, 2010, 2011 and 2012) and for post-reclassification years (2013 and 2014) are tabulated in table 4.1 and table 4.2, respectively.

**Table 4.1.** Descriptive statistics: Pre-reclassification years (Stata)

Variable	Obs	Mean	Std. Dev	Min	Max
LP	67	-98288.85	169366.6	-757216	57000
LP <sub>t-1</sub>	67	-105208.1	158439.1	-757216	57000
NonPerformFin	67	513655.3	873556.9	0	5192415
PZT	67	291414.8	445608.6	-626095	2113883
TA	67	1.93e+07	2.01e+07	28005	9.14e+07

**Table 4.2.** Descriptive statistics: Post-reclassification years (Stata)

Variable	Obs	Mean	Std. Dev	Min	Max
LP	40	-52545.47	129203.4	-749128	93163
LP <sub>t-1</sub>	40	-52166.07	112110.3	-633862	93163
NonPerformFin	40	292486.4	376602.6	0	1932532
PZT	40	276195.5	413946.8	-784	2125418
TA	40	2.41e+07	2.99e+07	0	1.32e+08

The coefficients of independent variables for pre-reclassification years and for post-reclassification years are tabulated in table 4.3 and table 4.4, respectively.

**Table 4.3.** Pre-reclassification years (E-views)

Variable	Coefficient	Std. Error	t-Statistics	Prob.
Constant	-5892.536	4272.141	-1.379293	0.1680
LP <sub>t-1</sub>	0.539368	0.024735	21.80616	0.0000
NonPerformFin	-0.034066	0.003578	-9.519968	0.0000
<b>PZT</b>	-0.087595	0.012831	-6.827026	0.0000
TA	0.000382	0.000268	1.426194	0.1540
R-squared		0.530007		
Adjusted R-squared		0.528834		

**Table 4.4.** Post-reclassification years (E-views)

Variable	Coefficient	Std. Error	t-Statistics	Prob.
Constant	9950.396	1768.851	5.625346	0.0000
LP <sub>t-1</sub>	0.894612	0.018689	47.86917	0.0000
NonPerformFin	0.005743	0.004791	1.198780	0.2309
<b>PZT</b>	-0.087354	0.008178	-10.68216	0.0000
TA	0.000275	7.85E-05	3.499691	0.0005
R-squared		0.911960		
Adjusted R-squared		0.911575		

The results indicate less smoothing effect in the post-reclassification years using the reserves account. This is as the coefficient of *Profit before Zakat & Taxation (PZT)* in the post-reclassification years is - 0.087354, a difference of 0.000241 from the coefficient of - 0.087595 in the pre-reclassification years. This provides

suggestive evidence that the Islamic banks rely less on the reserve accounts for smoothing their income in the post-reclassification years than in the pre-reclassification years.

The Random-effects GLS regression and Fixed-effects (within) regression for pre-reclassification years and for post-reclassification years are tabulated below in table 4.5, table 4.6, table 4.7 and table 4.8.

**Table 4.5. Pre-reclassification years: Random-effects GLS regression (Stata)**

Random-effects GLS regression			Number of obs = 67			
Group variable: Islamic banks			Number of groups = 23			
R-sq: within = 0.1533 <b>between = 0.9180</b> overall = 0.5300			Obs per group: min = 1 avg = 2.9 max = 3			
corr(u_i, X) = 0 (assumed)			Wald chi2(4) = 69.92 Prob > chi2 = 0.0000			
LP	Coef.	Std Err.	z	Prob> [z]	(95% Conf. Interval)	
LP <sub>t-1</sub>	.5393681	.12577	4.29	0.000	.2928635	.7858727
NonPerformFin	-.0340665	.0181954	-1.87	0.061	-.0697288	.0015959
PZT	-.0875953	.065241	-1.34	0.179	-.2154652	.0402746
TA	.0003823	.001363	0.28	0.779	-.0022891	.0030536
_cons	-5892.536	21722.83	-0.27	0.786	-48468.51	36683.44
sigma_u						
0						
sigma_e						
75949.834						
rho						
0 (fraction of variance due to u_i)						

**Table 4.6. Pre-reclassification years: Fixed-effects (within) regression (Stata)**

Fixed-effects (within) regression			Number of obs = 67			
Group variable: Islamic banks			Number of groups = 23			
R-sq: within = 0.4614 between = 0.6775 overall = 0.4109			Obs per group: min = 1 avg = 2.9 max = 3			
corr(u_i, Xb) = -0.9561			F(4,40) = 8.57 Prob > F = 0.0000			
LP	Coef.	Std Err.	t	Prob> [t]	(95% Conf. Interval)	
LP <sub>t-1</sub>	-.1881759	.1358022	-1.39	0.174	-.4626423	.0862905
NonPerformFin	.0641291	.0550267	1.17	0.251	-.0470841	.1753422
PZT	.4834681	.1265916	3.82	0.000	.2276169	.7393193
TA	.0005863	.0022678	0.26	0.797	-.003997	.0051697
_cons	-303227	57457.87	-5.28	0.000	-419353.7	-187100.3
sigma_u						
398403.81						
sigma_e						
75949.834						
rho						
.96493259 (fraction of variance due to u_i)						

F test that all u\_i=0:

F (22, 40) = 5.19

Prob > F = 0.0000

**Table 4.7. Post-reclassification years: Random-effects GLS regression (Stata)**

Random-effects GLS regression			Number of obs = 40			
Group variable: Islamic banks			Number of groups = 23			
R-sq: within = 0.2001 <b>between = 0.9640</b> overall = 0.9100			Obs per group: min = 1 avg = 1.7 max = 2			
corr(u_i, X) = 0 (assumed)			Wald chi2(4) = 195.19 Prob > chi2 = 0.0000			
LP	Coef.	Std Err.	z	Prob> [z]	(95% Conf. Interval)	

LP <sub>t-1</sub>	.8309241	.1157224	7.18	0.000	.6041124	1.057736
NonPerformFin	-.007573	.032986	-0.23	0.818	-.0722244	.0570784
PZT	-.0799082	.0416285	-1.92	0.055	-.1614985	.0016822
TA	.0001344	.0005016	0.27	0.789	-.0008487	.0011174
_cons	11670.53	13936.51	0.84	0.402	-15644.52	38985.57
sigma_u	27085.441					
sigma_e	23352.522					
rho	.57360691 (fraction of variance due to u_i)					

**Table 4.8.** Post-reclassification years: Fixed-effects (within) regression (Stata)

Fixed-effects (within) regression			Number of obs = 40			
Group variable: Islamic banks			Number of groups = 23			
R-sq: within = 0.3314			Obs per group: min = 1			
between = 0.1585			avg = 1.7			
overall = 0.1059			max = 2			
corr(u_i, Xb) = -0.9303			F(4,13) = 1.61			
			Prob > F = 0.2305			
LP	Coef.	Std Err.	t	Prob> [t]	(95% Conf. Interval)	
LP <sub>t-1</sub>	-0.3786645	.2542033	-1.49	0.160	-.9278372	.1705083
NonPerformFin	-0.0142258	.1853578	-0.08	0.940	-.4146669	.3862153
PZT	-0.0678055	.0731687	-0.93	0.371	-.225877	.090266
TA	-0.0112858	.0070933	-1.59	0.136	-.0266101	.0040384
_cons	222406.2	194212.7	1.15	0.273	-197164.9	641977.3
sigma_u	316226.47					
sigma_e	23352.522					
rho	.99457613 (fraction of variance due to u_i)					

F test that all u\_i=0:

F (22, 13) = 4.19

Prob > F = 0.0052

The results indicate the Random-effects GLS regression explains better differences in the errors variance components across the banks, and over the observed years. Further, differences between the banks varied more in the post-reclassification years as its *R-square (between)* is higher at 0.9640 than the *R-square (between)* in the pre-reclassification years of 0.9180.

In conclusion, the results do not indicate any unintended consequences of less profit payout to investment account holders from the present exercise by the Islamic banks in Malaysia to distinguish Islamic deposits from investment accounts.

## 5. Conclusion

The model to study income smoothing by managing loss provisions by Islamic banks may be extended in future studies to capture additional influence of development of Islamic financial system. As observed by Fonseca and Gonzalez (2008) in their study on income smoothing behaviour among conventional banks across 40 countries; the authors suggest there is more incentive to smoothen income with development of financial system. The relationship between financial system and bank income smoothing may be attributed to same root causes (La Porta et al., (1999); La Porta et al., (2002)). More widely dispersed ownership in a financially developed Islamic financial system such as in Malaysia - whose Islamic finance system has thus far achieves a remarkable growth path, may boost more incentives to smooth earnings. The reason is that the greater the number of users of financial statement makes the statements to become more important such that, bank managers have greater reasons to want to influences external perception about their bank's solvency. The previous empirical literatures indicate that developed market-oriented financial systems are more likely to represent high-quality financial institutional environments with strong investor protection and good enforceability (La Porta et al., 1998).



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