VECTOR ERROR CORRECTION MODEL APPROACH IN EXPLAINING THE RELATIONSHIP BETWEEN NON PERFORMING LOAN, CAPITAL RATIO AND EARNING BEFORE TAX AND PROVISION TOWARDS LOAN LOSS PROVISION PRACTICE BY PUBLIC BANK BHD

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ABSTRACT

Loan loss provision is directly related to the manipulation of accounting number by bank in order to control the performance in future. Based on the previous literature, loan loss provision is associated with earning management, capital management and signalling mechanism. The study done by Faridah and Wahida, (2011) highlight that Islamic and conventional banks in Malaysia use loan loss provisions in their earnings and capital management. Therefore, the overall objective of this study is to examine the determinant and to suggest the motivation on loan loss provision practice by bank. Public Bank Bhd has been chosen as the sample of this study from the fourth quarter 2004 until third quarter 2012 by using econometric model which is vector error correctiom model to see the relationship between depended variable with independent variable. The source of data is obtained from Bursa Malaysia Bhd. An empirical result indicates that EBTP is inverse relationships between LLP compare to other factor such as NPL CR that show positive relation with LLP. The limitation in this study will be on the difficulties to obtain the detail disclosure information on loan loss provision. In addition, this research will beneficial for banking institution in order for them to preserve in future by cautiously screening giving loan and avoid defaults and it is also to crystallized view on manipulation the accounting number towards academician.

Keywords: Loan loss provisioning, Motivation, Earning Management, Capital Management, Vector Error Correction Model (VECM)

CHAPTER 1: INTRODUCTION

Loan loss provisioning is predominantly used to absorb the future losses on loan in existing portfolio. The medium of LLP react as a cushioning mechanism in the banking industry fields as LLP will be charge on the commercial bank's profit and loss statements. According to Craigland and Elliot, (2011) the creation of LLP will create a reserve on bank balance sheets.

Because of that reason, bank is required to disclose LLP and as a drastic effect an increase in the LLP will totally reduce the reported earnings and the loan loss reserve that is considered as a part of the capital adequacy component is also increased. The adjustment is important as to avoid the amount of loan and advances on the balance sheet future losses. Bouvatier and Lepetit (2006) distinguished between non-discretionary and discretionary loan loss provisioning (as cited by Craigland et al. 2011).

The non-discretionary function use to cover expected loan losses in the bank's loan portfolio. The discretionary means managements use of loan loss provisioning for its own objectives. A study done by Faridah and Najuna, (2011) highlight that Islamic and conventional banks in Malaysia use loan loss provisions in their earnings and capital management. Therefore, the literature towards LLP has analysed on several provisioning issue as a whole but no others have investigated on the individually.