

# **Transparency and Market Discipline in Islamic Banks**

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*It is widely believed that market discipline is generally enhanced if the activities of the bank are disclosed to the market participants. This widespread belief has given rise to a number of attempts to increase the transparency in banks particularly by the Basel Committee on Banking Supervision. There is no exception to Islamic banks. This paper attempts to see the issue of transparency and market discipline in the context of Islamic banks. Using a questionnaire survey directed to 28 Islamic banks in 14 countries and also the bank supervisors, rating agencies, external auditors and the representatives of IFSB and AAOIFI, the perceptions on several issues are highlighted. The findings show that Islamic banks are still lacking with regard to the risk disclosure, even though it is found that transparency in Islamic banks are more pertinent than conventional banks due their profit sharing arrangements. This finding is useful for the policy holders and standard setters to design policies and standards to improve the transparency in Islamic banks.*

## **1. Introduction**

Transparency means that market participants have the information they need to allocate their resources within the market. Transparency in this context is defined as public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practises (Basel Committee on Banking Supervision - BCBS, 1998). Greater transparency and disclosure keep corporate stakeholders better informed about the way a bank is being managed and governed. In addition, studies suggest that better disclosure has a positive impact on the efficient functioning of capital markets. In particular, Healy and Palepu (2001) review research on financial reporting and voluntary disclosure of information by management, and conclude that the increased pace of entrepreneurship and globalisation has increased the value of reliable information in capital markets.

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The use of market discipline as a complement to bank supervision and regulation has gained greater acceptance in the US and abroad. It is also widely recognized that effective market discipline depends on market participants' having information about the risks and financial condition of banking organizations.

The objective of this paper is to report the empirical research conducted to explore the issue of transparency and market discipline in Islamic banks. Since Islamic banks are based on profit sharing arrangement, transparency is more important in Islamic banks compared to conventional banks as investment account holders require greater information to monitor their investments. Section 2 provides the background of the study and discusses the previous literatures on this issue. Section 3, then covers the research method for and the results of this study. Finally, Section 4 concludes the paper.

## **2. Background of the Study and Previous Literatures**

### **2.1 Signalling Theory**

Signalling theory considers problems of information asymmetry in the market. The theory shows how this asymmetry can be reduced by the party with more information signalling to others (Morris, 1987). It was originally developed to address problems of information asymmetry in labour markets and how information asymmetry can be reduced by the party with more information signalling to others. However, signalling is a common phenomenon applicable in any market with information asymmetry (Morris, 1987).

Signalling theory suggests that when banks' performance is good, banks will wish to signal their high quality information to the market. It is hoped that this information could assist the financial statement users in their decision making (Watts and Zimmerman; 1986). Signalling is hoped to motivate corporate disclosure.

The signalling theory has been tested by examining the stock market's valuation of loan loss provisions. Loan loss provisions are a relatively large accrual for commercial banks, and therefore, have a significant impact on banks' earnings and regulatory capital. The motive for loan loss provisions that has been forwarded in the literature is to signal financial strength. Beaver et al. (1989) suggest that loan loss provisions can indicate that 'management perceives the earnings power of the bank to be sufficiently strong that it can withstand a "hit to earnings" in the form of additional loan loss provisions'.<sup>1</sup> Wahlen (1994), Beaver and Engel (1996) and Liu et al. (1997) investigate this theory. Consistent with this signalling theory, Wahlen (1994) documents a positive relation between discretionary or unexpected loan loss provisions and bank stock returns. Beaver and Engel (1996) document a positive

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<sup>1</sup> Note that the signalling effects in the loan loss provisions studies are opposite to the signalling effects hypothesised in the studies on discretionary accruals more generally such as Subramanyam (1996) and Ahmed (1996).

coefficient on the discretionary component of loan loss provisions in a regression of market value of equity on earnings (before provisions), loan loss provisions, discretionary component of loan loss provisions, and non-performing loans. Liu et al. (1997) find a positive relation between stock returns and unexpected loan-loss provisions for banks with low capital ratios, but a negative relation for banks with high ratios, which is also consistent with a signalling theory. Griffin (1998) provides evidence of a differential negative market reaction to bank loan loss announcements based on the timeliness of the announcement relative to the end of a fiscal quarter. His results are consistent with a stock market that obtains loan impairment information from timely sources of that information, for example, loss provisions reported in bank financial statements.

Gibson (2000) confirms these findings by developing a model in which banks use write-offs to signal private information about the credit quality of their loan portfolios in the Japanese banking sector. More recently, Kanagaretnam et al. (2003) find that managers of undervalued banks use loan loss provisions to signal their banks' future earnings prospects. In contrast the aforementioned empirical findings, Ahmed et al. (1999) find no support for the signalling theory. They do not find evidence of a positive relation between loan loss provisions and one-year ahead future change in earnings as in Wahlen (1994). Based on their argument, their findings suggest that Wahlen's (1994) and Beaver and Engel's (1996) results are likely to be specific to the time period examined in their study.

The empirical evidence indicates that the propensity to signal differs across banks based upon the degree of information asymmetry. Signalling is a reaction to informational asymmetry in markets. In this case, banks have information that the market does not. Asymmetries can be reduced if the party with more information signals to others. In this case, leading banks (for example UBS), will wish to distinguish themselves from non-leading banks through voluntary disclosures. The signalling theory suggests that when banks' performance is good, banks will wish to signal their high quality information to the market. It is hoped that this information could assist the financial statement users in their decision making (i.e. Market discipline exists).

## 2.2 Market Discipline in Conventional Banks

As explained above, signalling is a reaction to informational asymmetry, where the management has information that the market does not. This signalling theory is also relevant for market discipline. If market discipline is weak, theoretically, the signalling theory would be less applicable and a more prescriptive set of risk disclosure standards together with a more intrusive style of supervision would be necessary in applying Basel II.<sup>2</sup>

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<sup>2</sup> The Basel Accord has been introduced by the BCBS in July 1988. This Accord focuses on the total amount of bank capital, which is vital in reducing the risk of bank insolvency and the potential cost of a bank's failure for depositors. Basel II intends to improve safety and

In the context of banking, market discipline includes notably a market based incentive scheme in which investors in bank liabilities such as subordinated debt or uninsured deposits “punish” banks for greater risk-taking by demanding higher yields on those liabilities (Berger, 1991). Banks collect deposits and invest these funds in risky assets (loans). To safeguard against insolvency, banks hold a capital buffer against adverse outcomes in their investments in risky assets (loan default). But the bank’s private solvency target may not take into account the interests of depositors, or of society as a whole. As a result, banks may engage in excessive risk-taking. Market discipline is a mechanism that can potentially curb the incentive to take excessive risk, by making risk-taking more costly for banks.

There are a number of potential social benefits from enhancing market discipline in a country’s banking sector. First, by punishing excessive bank risk-taking, increased market discipline may reduce the moral hazard problems, which government guarantees create for banks by providing incentives to undertake excessive risks. Second, market discipline may improve the efficiency of banks by pressuring some of the relatively inefficient banks to become more efficient or to exit the industry (Berger, 1991). Finally, the social cost of supervising banks may be lowered if regulators cede greater control to market forces that can tell “good” from “bad” banks. In particular, the market is an anonymous and constant overseer, which is hard to lobby for forbearance, and may react more quickly than regulators to increases in bank risk-taking.

In order for market discipline on banks to be fully effective in ensuring financial stability, Crockett (2001) suggests four pre-requisites. First, market participants need to have sufficient information to reach informed judgements. Second, they need to have the ability to process it correctly. Third, they need to have the right incentives and finally, they need to have the right mechanism to exercise discipline.

The following section discusses Basel II in relation to market discipline issues.

### **2.3 Basel II: Pillar 3**

‘The BCBS aims to encourage market discipline by developing a set of disclosure recommendations (and requirements) which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment and management processes, and hence the capital adequacy of the institution’ (Consultative Document, January 2001)

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soundness in the financial system by placing more emphasis on banks’ own internal control and management, the supervisory review process and market discipline. There are three pillars in Basel II. The first pillar is minimum capital requirement; the second pillar is supervisory review and the third pillar is market discipline. Section 2.3 gives more explanation on this Basel II, particularly Pillar 3.

Bank's regulators and rating agencies have access to internal data which market participants do not. Hence from the standpoint of capital adequacy, public disclosure of validation data is largely irrelevant.

Basel II should benefit the banks which perform risk management well, with effective programmes to communicate their processes and results to the investment community, at the expense of the other less well performing banks. Isn't that what market discipline is supposed to accomplish?

Pillar 3 of Basel II relies on enhancing bank disclosure to strengthen market discipline. Imperfect understanding of a bank's actual risk exposure can impair the decisions made by bank regulators and shareholders. A prerequisite for the sort of market discipline envisioned by the BCBS is broad disclosure of bank's financial information to allow investors and other market participants to accurately assess a bank's risk profile.

## **2.4 Banking Crises**

For most banks, market risk accounts for only a small proportion of their overall risk profile. Despite changes in financial markets, the credit risk charge remains the most significant factor in determining the regulatory capital requirement for the majority of banks. Credit risk is the major risk faced by many banks, since loans are their major asset category. Experience from around the world (Rahman, 1999) indicates that poor credit quality coupled with weak credit risk management practises continues to be a dominant factor in bank failures and banking crises (Asia, Russia and Brazil). During such crises, it would appear that the risk during such periods was of a much greater magnitude than existing risk management techniques were able to capture. Therefore, it is clear that information on banks' credit risk management processes is crucial in market participants' and supervisors' assessments of their condition, performance and ability to survive in the long run.

Fons (1998)<sup>3</sup> examines the role that poor transparency played in the East Asian financial crisis and argues that weak transparency increases funding costs, especially in times of financial distress. Transparency can only help prevent a financial crisis and should not be seen as a cure for systems already under stress. According to him, the meltdown in currency, bond and equity markets, over the past year or more of his study has contributed to massive credit rationing for East Asia, particularly by foreign creditors.

Poor accounting standards enable banks to evade prudential and other restrictions on insider lending (Rahman, 1999). Furthermore, Rahman (1999) argued that inadequate disclosure contributed to the depth and breadth of the banking crisis. Since financial statements act as the most reliable and easily

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<sup>3</sup> Fons, S.J (1998), 'Improving Transparency in Asian Banking Systems' Paper presented at 'Asia: An Analysis of Financial Crisis Conference' sponsored by the Federal Reserve Bank of Chicago and the International Monetary Fund, 1998.

accessible vehicle for dissemination of banking information, lack of adequate accounting disclosures prevented investors and creditors from receiving necessary and timely information for choosing between successful and potentially unsuccessful banks. It is known that the very threat of disclosure influences behaviour and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practises of the banks in the crisis-hit countries. The financial statements did not reflect the extent of risk exposures and clear indications of the magnitude of debt problems.

Llewellyn (2002) analyses the causes of the recent banking crises, which include weak monitoring and supervision by official agencies, the absence of effective market discipline on banks and structurally unsound corporate governance mechanisms within banks and their borrowing customers

A permanent solution to the East Asian financial crisis will require a restoration of interbank confidence in the region's banks, which, in turn, will require credible transparency, massive restructuring and state-financed recapitalisation. Interbank creditors will demand solvency and transparency. The problem is that transparency could be seen as revealing insolvency, further shaking creditor confidence, wiping out existing shareholder claims and endangering non-depository creditors (e.g., subordinated debts in the case of conventional banks).

Regulators may not want transparency, to prevent public criticism arising from the failure to resolve or close a troubled bank. Certain banks would favour poor transparency, mainly because it costs money to institute timely, accurate and detailed accounting systems. Resources that might be more profitably employed elsewhere are relegated to a reporting function. Statements must be formatted to international standards and "Big Four"<sup>4</sup> auditors must be hired to give opinion on the quality of reporting. Many banks in developing countries are small and the costs of complying with transparent reporting practises may be significant. Transparency also restricts management's ability to engage in self dealing. Fully transparent reporting may also reveal competitive strategies or vulnerabilities where a bank holds a large unhedged position in some asset or currency. These may affect the market discipline's ability to be effective in the banking system.

Cordella and Yeyati (1998) examine how public disclosure of banks' risk exposure affects banks' risk taking incentives, and assess the impact of the presence of informed depositors on the soundness of the banking system. They used the data from New Zealand banks. The results show that when banks have complete control over the volatility of their loan portfolio, public disclosure reduces the probability of banking crises. However, when banks do not control their risk exposures, the presence of informed depositors may increase the

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<sup>4</sup> "Big Four" accountancy firms include Pricewaterhouse Coopers, KPMG Peat Marwick, Ernst and Young and Delloitte and Touche.

probability of bank failures. This indicates that banks must be able to have control over their risk exposure in order for public disclosure to be effective. This again shows the importance of enhancing the dissemination of financial information. However, their studies do not really look into the importance of risk disclosure by the banks, but rather at the relationship between public disclosure and banks' failures. The next section discusses the role of bank supervisors in enhancing the transparency in banks.

## **2.5 Supervisory Information**

Bank supervisors need timely and reliable information about the financial condition and risk profile of banks in order to conduct effective supervision. Although such information can be obtained in part from regulatory reports and public disclosure, a key source is on the on-site examination. Bank examinations enable supervisors to confirm the accuracy of information in regulatory reports. More important, the examinations allow supervisors to gather confidential information about bank's financial conditions and to assess qualitative attributes, such as internal controls and risk management procedures that affect bank risk profiles.

Sijben (2002) argued that the strategy to enlarge market discipline refers to the availability of information and transparency for both supervisors and market participants aiming at an appropriate judgement of the soundness of the banks. Hoenig (2003) suggests that increased disclosure to the market of supervisory information could be of significant value to the market which could help to enhance the effectiveness of market discipline.

Bank supervisors can play an important role by checking that the financial condition of the bank is as reported (De Young et al., 2001, Jordan et al., 2000; Berger et al., 2000; Flannery and Houston, 1998; Berger and Davies, 1998; Gilbert, 1993). Market participants, on the other hand, may not be able to uncover the deteriorating health of a bank in a timely manner, instead discovering it only when bank management, possibly at the investigation of bank supervisors, eventually makes financial disclosures that reveal the bank's problems (Gilbert, 1993). These could be announcements related to income and balance sheet statements such as lower earnings or increased non-performing loans.

In their assessment of banks, for instance, bank supervisors make use of proprietary and internal information in each bank, as well as confidential information on customers. As a result, bank supervisors have a detailed knowledge of individual bank conditions that could prove useful in several ways. Disclosure of financial position, risk concentrations and asset profiles, for instance, could provide a new and valuable source of information to the market. In addition, bank supervisors would be in a good position to identify deficiencies in a bank's own public disclosures.

A growing line of research provides empirical support for the proposition that bank supervisors at times have an information advantage over other outside monitors. Flannery and Houston (1998) show that financial markets evaluate accounting data differently when an examination by a supervisor has occurred recently. For a sample of banks examined in the fourth quarter of 1988, they find that accounting statements of examined banks are more informative than those of non-examined banks; they also find that examined banks' market values are slightly better. These effects are stronger for smaller banks, banks with higher stock return variances, banks with harder-to-value assets, and banks not rated by rating agencies. They argue that these findings provide evidence that bank supervisors (examiners) play a valuable role in the certification of banks' accounting data and that bank shareholders benefit from this activity.

## **2.6 Transparency and Market Discipline in Islamic Banks**

Islamic banks face great challenges to successfully serve the Ummah (nation) in which they operate. They have to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable and relevant information to financial statement users. The establishment of Islamic banks is intended to cater for the needs of Muslims in order to follow the principles of Shari'ah. Such ways and means are characterised by many features, including the prohibition of interest, the use of profit sharing and other investment vehicles. Since Islamic banks mobilise funds on a profit sharing basis, it becomes essential that all parties to their transactions should have full access to information covered by agreements. Adequate disclosure and transparency provide an assessment of the degree of risk associated with participation. Accordingly, the attractiveness of Islamic banks to Muslim stems mainly from their compliance with Shari'ah in their dealings, whether with shareholders, current and investment account holders or others for whom such banks invest their funds.

On the other hand, the Muslim's choice of investing or depositing funds in or dealing with one Islamic bank versus another, is based on his/her evaluation of and confidence in the bank's ability to maintain its capital at a level sufficient for solvency purposes. In addition, the bank's ability to realise rates of returns commensurate with the assumed investment risk for both its shareholders and the investment account holders is also important in decision making. Lack of such confidence might cause Muslims to stop dealing with the Islamic bank. Among the important sources of such information are the financial reports of Islamic banks which are prepared in accordance with standards that are applicable to Islamic banks.

## **3. Methods and Findings**

This study covers 28 Islamic banks and supervisors of Islamic banks in 14 countries (refer to Annexure I for the sample details) using the questionnaire



survey to obtain the perceptions about the transparency and market discipline in Islamic banks. The same questions are also asked to external auditors of Islamic banks, rating agencies and representatives of IFSB and AAOIFI. Furthermore, the study examines the information required by supervisors of Islamic banks in 14 countries to monitor the risk profile in Islamic banks.

The findings from the questionnaire survey, supplemented by material from the interviews where appropriate, will be presented in 2 sub-sections: supervisors of Islamic banks' opinions about the information required most to monitor risk profile and management of Islamic banks and transparency and market discipline in Islamic banks.

### **3.1 Supervisors of Islamic Banks' Opinions about the Information Required Most to Monitor Risk Profile and Management of Islamic Banks**

This section discusses the supervisors of Islamic banks' perceptions about the information required most to monitor risk profile and management of Islamic banks and the risk assessment approaches to supervise Islamic banks.

Table 1 shows that Islamic bank's supervisors rated all the risk information to be important to monitor the risk profile of Islamic banks (the mean values are between 3.84 and 4.84). The most important information as perceived by the bank supervisors is information on the type of risks, the risk management and the asset quality (all have the mean values of 4.84) and compliance with Shari'ah requirements (mean value of 4.79).

The interview with one of the supervisors of Islamic banks supports this finding. As stated by one Islamic bank supervisor: "Apart from annual reports, the supervisors of Islamic banks require additional information to be submitted to them either weekly, quarterly or annual basis, whether it is on the domestic or global position".

Table 1 also shows that the total number of respondents (supervisors of Islamic banks) in Bahrain is only 2. This is because according to Bahrain Monetary Agency's representative, the responses represent the collective views of all members of the directorate. Therefore, additional questionnaires would have the same response.

*Table 1: Mean Values for the Risk Information Required by Supervisors of Islamic banks*

Items	Required by IAS/AAOIFI	Total	Malaysia	Bahrain	Others
1. Type of risks	IAS 32, FAS 1	4.84	4.89	5.00	4.75
2. Severity of risks	No	4.63	4.56	4.50	4.75
3. Risk management	IAS 32	4.84	4.89	4.50	4.88
4. Breakdown – operating segments	IAS 14	4.26	4.22	3.50	4.50
5. Breakdown – geographical segments	IAS 14	3.84	3.78	4.50	3.75
6. Capital adequacy ratio and banks' own ratio	Statement of CAR, AAOIFI	4.74	4.89	5.00	4.50
7. Liquidity	FAS 1	4.68	4.89	5.00	4.38
8. Maturity matching	FAS 1	4.58	4.56	5.00	4.50
9. Profitability	FAS 1	4.37	4.44	5.00	4.13
10. Asset quality	No	4.84	4.78	5.00	4.88
11. Compliance with relevant accounting standards	IAS 1, FAS 1	4.58	4.44	5.00	4.63
12. Compliance with Shari'ah requirements	Governance Std 2	4.79	4.89	4.00	4.88
13. Shari'ah's view – permissibility of taking on certain risks	No	4.26	4.44	3.00	4.38
14. Shari'ah's view – risk mitigation techniques	No	4.00	4.44	3.00	3.75
Total (n)		19	8	2	9

In addition, from the open-ended questions asked to them, they also point out that they need additional non-public information (apart from the issue of frequency), which is also not required by financial reporting standards to supervise Islamic banks. They include:

1. Rating of the bank by a rating agency.
2. Any non-compliance to Shari'ah requirement - Reputational risk.
3. The implementation of good corporate governance.

This is consistent with the findings of studies in the literature that bank supervisors have an information advantage over other parties (De Young et al, 2001; Jordan et al, 2000, Flannery and Houston, 1998; Berger et al, 2000; Cole and Gunter, 1998 and Berger and Davies, 1998). They need more information than what is required by financial reporting standards in order to perform their supervision on Islamic banks, apart from the issue of frequency.

Additional questions were also asked in the questionnaire to get the survey respondents' perceptions on the role of supervisors of Islamic banks in improving bank's transparency (Statements 1, 2, 3 and 4).

Statements:

1. The most effective way to ensure the bank adheres to public risk disclosure requirements as required by accounting standards is to impose penalties for non-disclosure.
2. Sufficient attention has been given by bank supervisors to ensure that public risk disclosure requirements are proportionate to the nature and scale of the bank.
3. Bank supervisors have adequate information that enables them to assess the risks inherent in Islamic banks.
4. Bank supervisors impose on Islamic banks rules for public risk disclosure that improve banks' transparency.

Table 2 presents the descriptive statistics for statements 1, 2, 3 and 4. In general, a majority of the respondents agree or strongly agree that the Islamic bank's supervisors play an important role in improving transparency in Islamic banks by imposing rules for public risk disclosure. This is evidenced from the negative coefficient of skewness for all the statements, and the mode is 4 (Agree) for all statements.

Table 2: Descriptive Statistics for Statements 1, 2, 3 and 4

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
1	3.66	4.00	4	0.853	1	5	-0.525	65
2	3.43	4.00	4	0.918	1	5	-0.602	65
3	3.42	4.00	4	0.917	1	5	-0.307	65
4	3.80	4.00	4	0.754	2	5	-0.550	65

### 3.2 Transparency and market discipline in Islamic banks

This section intends to discuss several issues related to transparency and market discipline in Islamic banks. The section is divided into 3 sub-sections.

#### 3.2.1 Transparency with regard to risk reporting is perceived to be more important in Islamic banks than in conventional banks.

Statements 5 to 10 aim to get the opinion of the respondents on the importance of transparency in Islamic banks as compared to conventional banks. The main reason is that Islamic banks have profit sharing investment account holders which require more transparency in order to monitor their investment in Islamic banks.

*Statements:*

5. Investment account holders in Islamic banks need more information on all risks faced by the banks than conventional depositors.
6. The more information on risks that are disclosed, the greater the confidence felt by investment account holders to invest in Islamic banks.
7. Greater risk disclosure in Islamic banks informs investment account holders of the potential risks to which their investments are exposed.
8. Greater risk disclosure encourages new investments in Islamic banks.
9. The more risk information disclosed in the annual report of Islamic banks, the more is market participants able to monitor the banks.
10. It is necessary to have a separate statement in the annual report to highlight the Islamic banks' risks and risk management techniques.

*Table 3: Descriptive Statistics for Statements 5 to 10*

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
5	4.12	4.00	4	0.857	2	5	-0.704	65
6	3.98	4.00	4	0.893	2	5	-.0377	65
7	4.06	4.00	4	0.710	2	5	-0.365	64
8	3.71	4.00	4	0.765	2	5	-0.091	65
9	4.09	4.00	4	0.631	2	5	-0.456	65
10	3.97	4.00	4	0.847	1	5	-1.054	65

Based on the analysis in Table 3, the lowest value of the mean is 3.71 and the highest is 4.12, the median and the mode are 4 for all statements, and there is a negative coefficient of skewness for all. This implies that the respondents agree

with what was discussed by these statements. However, the lowest mean of 3.71 for Statement 8 means that the respondents were not strongly convinced that greater risk disclosure encourages new investments in Islamic banks. 21% of the Islamic bankers, 16% of the Islamic bank supervisors and 0% of other respondents strongly agree with this statement.

### **3.2.2 In the countries in which Islamic banks are surveyed, it is perceived that effective disclosure helps market participants to assess the bank's performance**

The question in this part aims to get the opinion of the survey respondents about the relationship between transparency, market discipline and disclosure. However, the researcher was aware about the social desirability bias<sup>5</sup> problem based on the ways the following statements have been phrased. But, the questions were still asked in order to get some general opinion from the respondents relating to these issues.

#### *Statements:*

11. Transparency is a pre-requisite for achieving market discipline.
12. Market discipline can work effectively only on the basis of adequate and accurate information disclosure and transparency.
13. Lack of transparency in financial reporting on risks could lead to difficulties in assessing the bank's performance.
14. Effective disclosure is essential to ensure that market participants have a better understanding of the banks' risk profiles.

*Table 4: Descriptive Statistics for Statements 11 to 14.*

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
11	4.44	5.00	5	0.639	3	5	-0.700	64
12	4.43	4.00	5	0.585	3	5	-0.446	65
13	4.48	5.00	5	0.589	3	5	-0.618	65
14	4.46	5.00	5	0.614	3	5	-0.684	65

<sup>5</sup> In some circumstances, respondents may be tempted to give the socially desirable response rather than describe what they actually think, believe or do. This has typically been assumed to be a function of two factors, the general strength of need for approval felt by an individual (personality trait) and the demands of a particular situation (Phillips and Clancy 1972).

Table 4 shows that the lowest mean value is 4.43 and the highest is 4.48, the mode is 5 for all these statements and the median is 5.00 (except for Statement 12, where the median is 4.00). There is a negative coefficient of skewness for all statements. This implies that the respondents strongly agreed with what was discussed by these statements.

### 3.2.3 Basel II is applicable to Islamic banks with some modifications.

The main theme of including statements 15 to 17 is to find out the perceptions of the respondents about Basel II.

Statements:

15. The New Basel Accord (Basel II) is a welcome development for Islamic banks.
16. There is a need to adapt the New Basel Accord (Basel II) to cover the uniqueness of Islamic banks.
17. Islamic Financial Services Board (IFSB) can facilitate the adoption of the New Basel Accord (Basel II) in Islamic banks.

Table 5: Descriptive Statistics for Statements 15 to 17

Statement #	Mean	Median	Mode	SD	Minimum	Maximum	Skewness	N
15	3.44	4.00	4	0.957	1	5	-0.768	64
16	3.94	4.00	4	1.037	1	5	-0.930	64
17	4.19	4.00	4	0.664	3	5	-0.226	64

It can be seen from Table 5 that the mean values are between 3.44 and 4.19, the median and the mode are 4 for all these three statements. There is also a negative coefficient of skewness in all statements as shown in Table 5, which again support the above findings.

The results from the interviews<sup>6</sup> indicated that there are problems in applying this Basel II to Islamic banks as stated by one Islamic banker: “The main problem to apply this Accord was in terms of human resource and costs to be invested in the system.” This problem is faced by conventional banks and is even worse for Islamic banks due their relatively small size.

<sup>6</sup> Follow-up e mails were used to the Islamic bankers in other countries than Malaysia to clarify several issues due to time and budget constraints. The answers obtained were used in this discussion chapter.

Another problem mentioned by one Islamic bank's risk manager related to the lack of rating agencies in Islamic banks and the fact there is no historical data to implement the Accord:

"No doubt that the Accord will serve the soundness of the financial institutions in the manner in which they operate. However, it may not suit all banks and financial institutions or rather the region in which they operate due to the requirement that all banks or financial institutions and their clients be rated by external rating agencies. There is a lack of rating agencies specialized in the Gulf region or the Arab world. As the Accord also suggests that in case there is no rating the company need to be rated in accordance to the internal rating model of the Bank or Basel I or the Financial Institution which may not reflect the soundness of the company or not take into consideration important facts or realities that form an important aspects for the business."

Another Islamic bank's risk manager stated that:

"Even not all conventional institutions would be able to subscribe to the Accord, let alone the Islamic institutions. Anyway, the IFSB should be of some assistance to this. Otherwise, the Islamic bank will have to apply the standard method which is disadvantageous. This is because the Islamic bank does not have the historical data to use the advanced method".

#### **4. Concluding Remarks**

The findings confirm that Islamic bank supervisors require additional information compared to what is required by financial reporting standards in order to supervise Islamic banks. This is consistent with the findings in conventional literatures regarding the informational advantage of bank supervisors (Berger and Davies, 1994; Berger et al., 1998). The results from the questionnaire survey show that type of risks, the risk management, asset quality and compliance with Shari'ah requirements are the most important risk information required by Islamic bank supervisors to monitor the risk profile of Islamic banks.

Other information required by Islamic bank supervisors, which are not required by current financial reporting standards (IAS and AAOIFI) include rating of the bank by a rating agency and the implementation of good corporate governance.

In view of the UK FSA's initiative on Risk Based Approach to Supervision of Banks (1998), Islamic bank supervisors tend to share the same view. The FSA's aim is to ensure that the attention is focused, in the case of each bank, on those areas which can put depositors' funds at risk, in which they adopt the RATE (for UK and EEA banks) and SCALE (for non-EEA banks) frameworks. Risk management and type of risks faced by the Islamic banks are perceived to be the most important information to Islamic bank supervisors. Looking at the risks

exposed by Islamic banks as discussed earlier, Islamic bank supervisors play even greater role to assess and evaluate these risks in their supervision.

Looking at Basel II, it is clear that the three Pillars in this accord complement each other. The supervisory review process (Pillar 2), together with Pillar 3 (market discipline), complements Pillar 1 (minimum capital requirements) in achieving a level of capital commensurate with a bank's overall risk profile.

Pillar 2 suggests that the banks to assess their capital adequacy relative to their overall risk exposures, and for supervisors to review and take appropriate actions in response to those assessments. This is a key component in effective banking supervision.

One key principle of Pillar 2 is that the assessment of risk and capital adequacy requires more than a simple assessment of whether the bank meets the minimum capital requirements. The supervisory review emphasises the need for both the banks and supervisors to have in place strong risk assessment capabilities and processes.

There is no exception for supervisors of Islamic banks. They have the same systems in place in their supervisions, even in most cases they require different information from that supplied by conventional banks due to Shari'ah requirements.

Transparency of risk reporting in Islamic banks is perceived to be more important than in conventional banks due to the existence of profit sharing arrangements, and in particular to unrestricted investment account holders. Effective disclosure may help market participants to assess the bank's performance. For Islamic banks, transparency is an important supervisory pillar and has considerable relevance for enhancing their ethical responsibility and credibility, thereby contributing to their greater acceptance, and elimination of any misconceptions of their activities. However, the information made available to the market must be of the right quality and volume, and it is important to avoid flooding the market with information that would be hard to interpret or to use in understanding the bank's actual risk profile.

In the countries with Islamic banks surveyed, it is perceived that effective disclosure is important to inform the market participants about the condition of the bank. As Islamic banks' shareholders play a lesser role in monitoring Islamic banks, this relates to the current level of disclosure in Islamic banks. The results of the questionnaire survey and interviews (also follow-up e mails) indicated a perception that transparency is still lacking in Islamic banks.

The BCBS has issued standards and principles in risk areas including credit, liquidity operations, consolidation and capital adequacy. Many of these standards are equally relevant and applicable to Islamic banks but with some modifications. The results from the interviews indicated that there are problems in applying this



Basel II to Islamic banks in terms of human resources and costs to be invested in the system. This problem is faced by conventional banks and is even worse for Islamic banks due to their relatively small size. Another problem mentioned by Islamic banker related to the lack of rating agencies in Islamic banks and the fact there is no historical data to implement the Accord:

This suggests that there should be some modifications to Basel II to suit the Islamic banks' transactions, which is also supported by the questionnaire findings. The results from the questionnaire survey suggest that majority of the respondents either agree or strongly agree (86%) that IFSB can facilitate the adoption of Basel II in Islamic banks and there was no significant difference in their perceptions of this. This implies that IFSB can play an important role as shown in the findings to adapt Basel II to suit the nature of Islamic banks.

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## Annexure I

### Sample

*Islamic banks included in the survey are as follows:*

Islamic banks	Country
1. Bank Islam Malaysia Berhad	Malaysia
2. Bank Muamalat Malaysia Berhad	Malaysia
3. Al Baraka Islamic Bank	Bahrain
4. ABC Islamic Bank	Bahrain
5. Bahrain Islamic Bank	Bahrain
6. Shamil Bank	Bahrain
7. First Islamic Investment Bank	Bahrain
8. Bank Mmuamalat Indonesia	Indonesia
9. Faisal Islamic Bank of Egypt	Egypt
10. Jordan Islamic Bank	Jordan
11. Islamic International Arab Bank	Jordan
12. Al Meezan Investment Bank Limited	Pakistan
13. Al Baraka Islamic Bank	Pakistan
14. Qatar International Islamic Bank	Qatar
15. Qatar Islamic Bank	Qatar
16. Islamic Development Bank	Saudi Arabia
17. Al Rajhi Banking and Investment Corp	Saudi Arabia
18. Tadamon Islamic Bank	Sudan
19. Sudanese Islamic Bank	Sudan
20. Al Shamal Islamic Bank	Sudan
21. Animal Resources Bank	Sudan
22. El Gharb Islamic Bank	Sudan
23. Abu Dhabi Islamic Bank	United Arab Emirates
24. Dubai Islamic Bank	United Arab Emirates
25. Kuwait Finance House	Kuwait
26. Al Barakah Turkish Finance House	Turkey
27. Faisal Islamic Bank of Kibris Ltd	Turkey
28. Islami Bank Bangladesh Ltd	Bangladesh
29. Bank Saderat Iran	Iran

*Central banks included in the survey are as follows:-*

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1. Bank Negara Malaysia
  2. Bahrain Monetary Agency
  3. State Bank of Pakistan
  4. Bank Indonesia
  5. Bank of Sudan
  6. Central Bank of Kuwait
  7. Qatar Central Bank
  8. Saudi Arabian Monetary Agency
  9. Bank Markazi Jamhouri Islami Iran
  10. Central Bank of Jordan
  11. Central Bank of Bangladesh
  12. Central Bank of Egypt
  13. Central Bank of the UAE
  14. Central Bank of the Republic of Turkey
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**COMMENTS**

**BY**

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