Comments of

Mohammad Al-Suhaibani*

on:

Transparency and Market Discipline in Islamic Banks

By Noraini Mohd Ariffin, Simon Archer and

Rifaat Ahmed Abdel Karim

First, I would like to express my appreciations to the authors for their effort. The topic is relevant, timely, and of interest to the policy makers and standard setters. The paper is generally well written; clearly addresses the topic; well organized and presented in a format that is accessible by practitioners.

Below, I will provide general and specific comments aimed at enhancing the paper.

1. General Comments:

It would be very useful to the reader to know the current status regarding transparency in Islamic banks reporting and the regulations to strength market discipline by their supervisors. Therefore, I suggest expanding section 2.6 of the paper to include the current status of transparency and market discipline in Islamic banks as basis for the forthcoming analysis. Potential sources that can help in this regard include: Bank of International Settlement (BIS) policy papers, Islamic Financial Services Board (IFSB) publications, and the World Bank webpage on Islamic finance.

The global trend is toward a more deregulation of the financial services industry, which in return demands a change in the role of supervisors. Against these developments, regulators have reassessed existing rules and adopted a consolidated supervision framework to prevent regulatory gaps that could become a source of systemic concern. As a result, Central Banks in countries where Islamic banks operate will either change their mandate or leave more power to other regulatory bodies to supervise bank operations (FSA in UK is a good example). I noticed that the survey covers only central banks as they are the current supervisors of Islamic banks. I wish that the authors will discuss how this trend is changing the role of supervisors in Islamic countries (central banks vs. Other regulator of financial services) and the future implications of potential changes in the regulatory environment on Islamic bank reporting.

* Imam Muhammad University, P.O. Box 270844, Riyadh, Saudi Arabia, e-mail: mohisuh@yahoo.com

The paper's conclusions are based on the assertion that Islamic banks are based on profit sharing arrangements, as it can be understood from these quotations:

> "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 1)

> "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" (section 4)

However, it is well known that debt-based financing is widely used by Islamic banks, and with the spread of *tawarruq* mode of finance, the differences between Islamic and conventional banks are diminishing. As a result, the current recommendations to have a different set of requirements for Islamic banks become irrelevant. This fact actually highlights the need to develop the financial infrastructure, markets and institutions that are designed to reduce the asymmetric information problems faced by bank in their working environment to encourage them to base their operations in optimal PLS contracts.

Certainly, transparency is critical for financial institutions to gain public and investor confidence and for the regulators to conduct effective supervision. As expected, the respondents to the survey, on average, rated all statements demanding more information to be very important, even by banks that tend to resist releasing more information. I think that the general statements used in the survey have led to this consensus, and as a consequence, directed the paper to broad recommendations to policy makers. However, policy makers and standard setters are more eager to have specific recommendations to act upon and design policies and standards that can improve the transparency in Islamic banks. I think the paper will be more useful if it addresses the situation in more detail by complementing the survey with case study research methodology to examine the issues in detail and to provide more specific recommendations for policy maker at least in that particular case. Also, expanding the survey to include other information users (other than bank supervisors) will add to the credibility of the results.

2. Specific Comments

A clarification of market discipline concept in the introduction and how it relate to transparency is useful. I suggest highlighting the fact that market participants need to have four prerequisites for market discipline to be effective: sufficient information to reach informed judgements (transparency); the ability to process it correctly; the right incentives; and the right mechanisms to exercise discipline.[1]

[1] Andrew Crockett: Market discipline and financial stability, Banks and systemic risk

In the absence of strict regulation to strength transparency (weak market discipline), lateral voluntary solutions such as signalling and screening will prevail. Signalling will become the choice for good Islamic banks (to distinguish themselves from bad type of banks) and screening will be the choice for market participants (to differentiate between good and bad type of banks). Forcing transparency by a third party (regulators) will increase the quantity of public information vs. Private information, and as a result will reduce the adverse selection risk faced by market participants and the moral hazard risk for banks. This is not consistent with the authors view stated in section 2.2 "*If market discipline is weak, theoretically, the signalling theory would be less applicable*".

I suggest highlighting, in the literature review, the contribution of Chapra and Khan in their prominent paper on regulation and supervision of Islamic banks.[2]

Finally, I do not see appropriate to quote selective responses from the interview in this paper unless we are sure that they represent the opinions of the most respondents. The survey result can be generalized but the comment received is not.

---

conference, Bank of England, London, 23-25 May 2001. In this speech, Crockett uses the term "market discipline" in a broad sense, to denote internal and external governance mechanisms in a free-market economy in the absence of direct government intervention.

[2] Chapra M. Umer and Tariqullah Khan, Regulation And Supervision Of Islamic Banks, Islamic Research And Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, 2000.

THIS PAGE IS DELIBERATELY LEFT BLANK