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Risk Management Disclosure Practices of Islamic Banks in the Mena Region: An Empirical Analysis

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Abstracts: Risk management disclosure practices of Islamic banks in the MENA region havebeen chosen as the focus of this study as the region is currently home to more than 50 percent of the worldwide share of Islamic banks [17]. Very little research has been conducted on risk management disclosure of Islamic banksin thisregion. This study examines the compliance level with the IFSB risk disclosure checklist by Islamic Banks using content analysis as a research design andthe OLS regressionas method of analysis. The research finds above average compliance with risk disclosure categories exceptdisplaced commercial risk (DCR), whichshowsa poor result and that size and having foreign subsidiaries can actually assist banks to report on risk factors. It is recommended that DCR should receive proper attention from regulators and supervisors as the importance of providing information to investment account holdersis crucial to the success of the Islamic banking model of profit and loss sharing.

Key words: Risk Disclosure Index · Risk Disclosure Categories · Islamic Banks · MENA Region · Risk Mitigation · Displaced Commercial Risk.

INTRODUCTION

Disclosure has always been a way of bridging the gap of information asymmetry that exists between the directors (managers) and shareholders (owners). Disclosure of adequate, timely and reliable information hasa remarkable impact on the proper functioning of the financial markets and economic systems, as investors largely base their decisions on thisinformation. However, the growing empirical and exploratory research on company disclosure levels hashighlighted insufficiencies in the level of disclosure made by managers, particularly the disclosure of risk related information [1]. The researchersidentifiedpoor disclosure of risk information as a main cause of corporate collapse, such as Enron and WorldCom, global financial crises and the present euro zone crisis, as investors are unable to objectively assess the true risk position of the companies they were investing in.

Risk management disclosure in this context is “the communication of information concerning firms’ strategies, characteristics, operations and other external factors that have the potential to affect expected results” [2]. Previous studieson risk disclosurepertain to risk reporting, risk management and managerial decision making [3, 4] amongconventional banks [5, 6] while a few examine riskmanagement in Islamic banks [7, 8, 9, 10, 11, 12]. However, research on risk disclosure in Islamic banks [13, 14, 15] uses country specific data and doesnot point out firm-specific characteristics influencing disclosure in these banks.

This study differs from others in thatit focuseson risk management disclosure (in Islamic banks offering full-fledged Islamic banking services) in terms of the firm-specific characteristics of these banks within a geographical entity known as the Middle East and North African (MENA) region,which has not been empirically evaluated, at least, not to our knowledge. The research further deviates from other research in its method of analysisby using empirical data with content analysis, disclosure index as well asregression analysis.

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The MENA region is an economically diverse region that includes both the oil-rich economies in the Gulf and countries that are resource-scarce in relation to population and oil wealth, such as Egypt, Morocco and Yemen. The region's economic fortunes over much of the past quarter of acentury have been heavily influenced by two factors – the price of oil and the legacy of economic policies and structures that had emphasized a leading role for the state [16]. The MENA Region is made up of twenty-one countries, with twentyindependent states and one state in observer status at the UN. These include Six Members of the Gulf Cooperation commission (GCC) –Saudi Arabia, United Arab Emirates, Bahrain, Kuwait, Qatar and Oman. Other members of MENA from the Middle East include Yemen, Iran, Iraq, Syria, Jordan, Malta, Lebanon, Israel, Palestine including West Bank and Gaza strip. The othersinclude Libya, Egypt, Morocco, Algeria, Tunisia and Sudanfrom the North African group.

Islamic banks in the MENA region have been chosen as the focus of this study because of thearray of Islamic banks present in the region. The region produced the first Islamic bank -Dubai Islamic Bank (one of the selected banks in the study's sample), which was established in 1975 [17], since then it has experienced an exponential growth/expansion in its Islamic financial services industry. Between 2004 and 2008, the Islamic banking assets of the Middle Eastern banks grew from 29 percent of the worldwide Islamic banking assets to 50 percent of the worldwide share [17]. Among the MENA countries, the most developed Islamic banking sectors are found in Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates" [17]. Although the Islamic banks in the region operate alongside conventional banks, even conventional banks, such as Citi Bank and HSBC, have established Islamic windows to cater for the demand of the populace for *shari'ah* compliant products.

The objectives of this research are i) to identify various services or products offered by Islamic banks that make them unique and different from conventional banks, ii) to ascertain the types of risk faced by Islamic banks when offering these services, iii) To determine the extent of risk disclosure by Islamic banks in the MENA regionin compliance with the IFSB risk disclosure checklist [18, 19, 20] and iv) to identify the impact of firm characteristics on the extent of risk disclosure by Islamic banks in the MENA region.

The next section focuses on the literature review and hypotheses development. The research methodology is covered in Section 3 while the results and conclusion are presentedin Sections 4 and 5, respectively.

Literature Review and Hypotheses Development: The key role of any financial system is financial intermediation. Financial intermediation in an Islamic financial system is based on the principles of *shari'ah* (Islamic Law). *Shari'ah* sets clear guidelines with regard to economic dealings and financial transactions, which are underlined by basic prohibitions and advocacies so as to ensure the proper functioning of the economy and, as a result, add value to human existence. While the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions, which seek to enhance equality and fairness for the good of society as a whole [6].

A solid risk management system is essential for the profitability and long-term success of the Islamic Banks [10]. There are two general approaches to risk management for banks as well as other organizations, i.e. risk decomposition and risk aggregation. Risk aggregation is simply a way of reducing or mitigating risks through risk diversification, while risk decomposition involves a process of identifying risks and mitigating or dealing with each one separately [20].

The hypotheses developed in this study are in line with the research objectives in examining the impact of firm characteristics (size, cross-border listings, number of subsidiaries and credit rating) on the extent of risk management disclosure.

Size of an Islamic Bank: The researchhypothesizesthat the size of a bank, proxiedby total assets of the bank has a positive relationship between firm size and extent of disclosure. Prior studies have found similar results [22, 23, 24, 25, 26]. This is because large firms come under more public scrutiny than smaller firms. They are also likely to be more complex. Complexity requires an efficient management information system to meet the need for managerial and financial control.Size was identifiedas being significantly associated with the level of disclosure [22, 27]. Larger companies may tend to disclose more information than smaller companies in their annual reports due to their competitive cost advantage [28].

Although a study [29] in UAE finds that size, debt equity ratio and the profitability have an insignificant association with the level of disclosure, another study [24] suggests that the larger the firm the more likely it will be able to attract a wide variety of highly skilled individuals necessary to be able to introduce more sophisticated management reporting systems that can disclose an extensive array of information. The accumulation and dissemination of information is costly. Smaller firms may not possess the necessary resources for collecting and presenting an extensive array of information.In addition, large firms suffer political cost. This is because some large firms may come under heavy attack from voters who would put more pressure or lobby their representatives for increased regulations on such companies or particular industries. In response to such potential government intrusion, corporations employ a number of devices to counter such intrusions, by introducing social responsibility campaigns in the media, thus making information about the company much more available to the public. Such cost can only easily be borne by large firms [30].

This research therefore hypothesizesthat:

H_1: There is a significant positive relationship between bank size and the extent of risk management disclosure.

Cross-Border Listings of an Islamic Bank: The research hypothesizesthat multiple listings on stock exchanges may improve the disclosure practices of banks in the MENA region. Listed companies face additional capital market pressure for the provision of information if they are cross-listed internationally [31]. In a similar vein,another research [32] findsa positive association between disclosure and a US listing for a sample of European and Asian-Pacific companies. Empirical research has shown evidence of greater information disclosure for companies that are listed both domestically and on foreign stock exchanges [33]. Firms with greater external capital need will have to disclose more information. This is because when a bank wishes to raise external capital or have its stock traded on a stock exchange it needs to comply with listing requirements. These requirements call for the inclusion of a considerable amount of information pertaining to the bank's affairs in addition to quarterly, semi-annual and annual reports. In addition to the financial statements, it is necessary for several other specific disclosures to be included in the annual report. When such multiple listingsinclude foreign stock exchanges the bank has to comply further with the additional listing requirements of a particularforeign stock exchange. Most of these banks have their listings on foreign stock exchanges, for example, Al Ahli bank hassubsidiaries and is quoted on the stock exchanges of six countries – UK, Egypt, Iraq, Qatar and Bahrain - while Al Baraka bank is quoted on the stock exchanges ofLebanon, Sudan, Tunisia, Egypt, Turkey, Algeria and Jordan. The research hypothesizesthat:

H_2: There is a significant positive relationship between a bank having multiple listings on stock exchanges and the extent of risk management disclosure.

Number of Subsidiaries of an Islamic Bank: It is assumed that banks with more subsidiaries have a more sophisticated reporting system and less incremental cost of additional disclosure as compared to other companies without subsidiaries. It is therefore hypothesized that the extent of a subsidiary company's mandatory disclosure is influenced by its affiliation with a parent, because the parent company's direct financial investment in their affiliates (subsidiaries and associates) tends to demand a greater amount of information than is required by the regulations in order to evaluate their performance and prospects. A study on the impact of corporate attribute on the extent of mandatory disclosure and reporting by listed companies in Zimbabwe,findsthat multinational corporation affiliation with their subsidiaries has asstatistically significant positive effect on mandatory disclosure and reporting practices of the sampled companies [34]. Thus, the research expects a positive association between the number of subsidiaries and disclosure:

H_3: There is a significant positive relationship between a bank having a number of subsidiaries and the extent of risk management disclosure practices.

Credit Rating of an Islamic Bank: Credit rating agencies, such as Standard and Poor's (S&P), Moody's Investors Service (Moody's), or Fitch Inc., provide qualitative statements on the creditworthiness of entities and their financial obligations. The use of credit ratings has expanded in recent years, mostly due to the globalization of the financial markets, the growing complexity of financial products and, generally, an increasing usage of ratings in financial regulation and contracting [35]. Another researchsuggests that the quality of corporate disclosure impacts on the precision of information that

professional analysts incorporate into their forecasts of annual earnings [36]. The researchers findthat when forming their annual earnings forecasts, analysts rely more heavily on publicly available financial data rather than privileged communications with management. This suggests that banks that are rated by professional rating agencies or forecasting analysts rely on publicly available information and that such banks should be willing to disclose more information. The research hypothesizesthat:

H_4: There is a significant positive relationship between a bank having external credit rating and the extent of risk management disclosure.

MATERIALS AND METHODS

The research used secondary data from the annual reports of Islamic banks within the MENA region obtained from the banks' websites, securities commission's website and other databases including Zawya database, Data Stream, Bankscope, Ebscohost, Googlescholar and El-SharaniCentre for Islamic banking and Finance. The MENA region has a population of thirty banks cut across the twenty-one member states with about 50 percent of the total Islamic financial assets. Twenty banks (representing about 67% of the banks in the region) were selected for this study covering the geographical spread of the three sub groups (GCC, North Africa and others) of the region. The criteria for selection included being listed on a capital market in the country of operation, availability of published financial report for three consecutive years, offering of full Islamic banking services and population of such banks in a particular subgroup. Banks with only Islamic windows were excluded from the study as theirrisk disclosures may be influenced by exogenous factors. Based on the above criteria the following banks were selected: 2 from Saudi Arabia, 4 from UAE, 1 from Yemen, 4 from Kuwait, 2 from Qatar, 5 banks from Bahrain, 1 from Jordan and 1 from Sudan, making twenty Islamic banks in total from 7 countries. Some of the banks that were filtered out only had annual reports for two years available on their website, whilst others thathad the annual reports availablefor three years, such as Iraqi Islamic Bank,onlyhad them published in Arabic.

The data under analysis covers the three years immediately following the release of the IFSB disclosure guidelines (2008-2010) as these are expected to increasingly reflect the requirements of these guidelines.

This research employeda content analysisand disclosureindex in order to objectively compare the content of Islamic banks financial reports with the requirements spelt out in the BASELaccord [37], AAOIFI standards [38] and IFSB riskdisclosure guidelines [18]. In addition the study testedthe relationship between firm characteristics and disclosure indices using regression analysis.

Similar to previous financial statement analysis [39, 3], sentences, phrases and words were the unit of analysis when examining qualitative risk information while words were used for examining quantitative risk information.

A disclosure index was developed in this research to capture the extent of compliance by Islamic banks in the sample to the IFSB disclosure checklist. Disclosure indexes have similarly been developed in previous studies that employed content analysis in examining companies' disclosure levels [40, 41].

The IFSB document outlines a checklist of disclosure items for risk management disclosure category, general disclosure, credit risk, credit risk mitigation, liquidity risk, market risk, operational risk, rate of return risk, displaced commercial risk and contract-specific risk. It further classifies the list for each risk type into quantitative and qualitative disclosures.

To date, two methods have been widely used to construct the disclosure index, namely, the weighted and the unweighted method [41]. The weighted method requires subjectivityin ranking the relevance of the disclosed items and is often criticized on the basis of this subjectivity [42, 43]. Thus, this study adopted the unweighted method, which involves dichotomous scoring whereby an item is scored as one (1) if disclosed and zero (0) if it is not, similar to that adopted by others [40].

In order to arrive at a disclosure index for each bank the following formula was used:

$$RDI_j = \frac{\sum X_{ij}}{\sum M_{ij}}$$

where,

RDI_j = Risk disclosure index for bankj

M_{ij} = Number of items expected to be disclosed by bankj.M_i= 50

X_{ij} = Number of disclosure items idisclosed by bank j.

I = 1 if disclosure is made, otherwise 0.

This computation was carried out for each year and the mean score for the three years was subsequently taken to obtain the final disclosure score of 50 pointsfor each bank.

Our third objective in this research –to investigate the relationship between bank characteristics and risk disclosure index of these banks – is done by the use of ordinary least squares(OLS) regression model as below.

$$RDIit = \beta o + \beta 1\ MULTit + \beta 3SUBS\ it + \beta 4\ CRit + \beta 5SIZEit + \varepsilon it$$

where,

RDI = Risk disclosure index,

MULT = Multiple listings of a bank (1 if a bank has multiple listings, otherwise 0)

SUBS = Number of subsidiaries.

CR = If a bank has been rated by any of the credit rating agencies(1 if a bank has ever had a credit rating, otherwise 0)

SIZE = Log of average total assets of Islamic banking operation. This is to avoidscale effect and problem of heteroscedasticity

RESULTS AND DISCUSSION

In this study, 60 Islamic Bank annual reports (3 years of annual report for 20 banks) were examined for 50 risk disclosure items required by IFSB. The resulting disclosure index, which can be viewed in Table 1 is presented by disclosure category for each Islamic bank. The RM disclosure index ranges from 40% to the highest of 81%, obtained by Bahrain Islamic Bank. On average, risk management disclosure among public listed companies in the MENA region is only 59.8%, demonstrating that much is needed to be done to improve the level of risk disclosure.

As shown in Table 2, 60% of the 50 risk disclosure items were disclosed by the 20 IBs over the three-year period (60 firm- years). It is also observed that the information on market, operational and credit risk were properly disclosed by most of the banks as the mean scores show that more than 70% of the disclosure items required by the IFSB for these risk disclosure categories (RDC) were made available by most of the banks. While general disclosure (GD), rate of return risk (ROR)[5] and credit risk (CR) hold average mean scores of between 50%-70% which indicate average compliance by the Ibs with IFSB for these RDCs. Display commercial risk (DCR) records a very low mean score with only about 3%, indicating poor disclosure by the Islamic Banks. Only three Islamic Banks mention the DCR risk as one of the risks they face. With a score of 56% and 17%, Bahrain Islamic Bank and Al Baraka were the only IBs who met some of IFSB's disclosure requirements under DCR.

Table 1: Risk Management Disclosure Index (RDI) based on individual banks

Islamic Banks	RM Disclosure Index (%)
Al Baraka (Bahrain)	67
Bahrain Islamic Bank	81
Ithimar (Bahrain)	65
Al Salam (Bahrain)	68
Arab Bank Corporation (Bahrain)	72
Kuwait Finance House (Kuwait)	63
Kuwait International	52
Al AhliUnitedBank (Kuwait)	53
Boubyan Bank (Kuwait)	55
Jordan Islamic Bank	68
Qatar International Islamic Bank (QIB)	56
Masraf Al Rayan Bank (Qatar)	62
Al Bilad Bank (Saudi Arabia)	62
Al Rajhi Bank (Saudia Arabia)	60
Sharjah Islamic Bank (UAE)	48
Dubai Islamic Bank (UAE)	70
Emirates Islamic Bank (UAE)	40
Abu Dhabi Islamic Bank (UAE)	61
TadhamonInternational Islamic Bank (Yemen)	41
Faisal Islamic Bank (Sudan)	52
Total Risk Management (Mean)	59.8

The total risk disclosure quality varied from a maximum of 81% (Bahrain Islamic Bank) to a minimum of 41% by (Tadhamon International Islamic Bank, Yemen). Bahrain Islamic Bank (BIB)'s position as the bank with the best RM disclosure quality is largely consistent with the findings of Hanifa and Hudaib's (2004) disclosure study on Islamic Banks general disclosure practices. GD, CR and DCR had the most number of disclosure requirements, this indicates that IFSB perceives these risks as the most crucial for Islamic banks and the most important for investor decision making and monitoring capabilities.

All of the IBs in the sample made reference one way or another to compliance with BASEL II or their local central banks with respect to their risk management and risk reporting practices, however, in addition to these, notably, only four banks (Bahrain Islamic Bank, Al Baraka, Boubyan and Jordan Islamic Bank) recognize IFSB as a relevant standard provider. This shows the importance

[5]Profit rate risk was used by many IBs in place of ROR risk, authors assumed they refer to the same while allotting scores

Table 2: Descriptive Statistics of Risk Management Disclosure Index (RDI) based on Risk Disclosure Category (RDC)

	N	Mean %	Median %	StdDev %	Min %	Max %
Total Risk Disclosure	50	59.8	61.3	16.8	2.0	80.8
General Disclosure(GD)	11	52.7	58.0	16.2	1.70	75.0
Credit Risk (CR)	9	70.0	67.0	22.0	0.00	90.0
CR Mitigation (CRM)	6	49.0	45.0	26.0	0.00	75.0
Liquidity Risk (LR)	4	75.0	75.0	20.0	0.00	100
Market Risk (MR)	4	88.0	84.0	25.0	0.00	100
Operational Risk (OR)	5	80.0	79.0	27.0	0.00	100
Rate of Return (ROR) risk	4	61.0	50.0	34.0	0.00	100
Displayed Commercial Risk (DCR)	7	3.10	0	12.9	0.00	56.0

Table 3: Descriptive Statistics of Risk Management Disclosure Index and Banks characteristics

	N	Minimum	Maximum	Mean	Std. Deviation
Risk Management Disclosure Index (RDI) (%)	60	40	81	59.80	10.153
Cross Border (MULT) (%)	60	00	100	65.00	48.099
Credit Rating (CR) (%)	60	00	100	75.00	43.667
Subsidiaries (SUBS)	60	00	10.00	1.850	2.5961
SIZE	60	00	2.850	1.063	.70122
Valid N (listwise)	60				

Table 4: Regression Analysis on Firm Characteristics and Risk Management Disclosure Index (RDI)

	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
Model	B	Std. Error	Beta	t	Sig..	Toleranceee	Olerance
1	(Constant)	.599	.035		17.340	.000	
	CR	.039	.030	.167	1.297	.200	.932
	MULT	-.035	.031	-.165	-1.117	.269	.700
	SIZE	-.045	.026	-.309	-1.704	.094*	.465
	SUBS	.022	.008	.564	2.780	.007**	.374
	R^2	0.156					
	F	2.534					
	Significance	0.050					
	DW	2.003					

a Dependent Variable: RDI. ** Significant at 5% significant level. * Significant at 10% significant level

and influence of BASEL standards for banking worldwide and infact explains the commendable disclosure quality of particular RDCs (market and operational risk) by the IBs under study.

As shown in Table 3, Islamic banks in the MENA region only have 60% compliance with items required by IFSB (2007) on risk disclosure. Further, 75% of these banks are assessed by credit rating agencies, such as Moody's, S & P and Fitch rating agencies. It is also highlighted that 65% on average of the Banks within the MENA region have multiple listings, with an average of two (1.85) foreign subsidiaries operated per bank in the region. The total assets of these banks, on average, are about $11.6Billion (Antilog of 1.0630 = 11.5611) with an average dispersion of about 70%. This is because some of them have very meagre capital.

The regression results in Table 4 show that having subsidiaries within the group structure of the bank has a significant impacton risk disclosure index at the 5% level, thus supporting hypothesis 3. This is consistent with earlier research [34]. The size of the Islamic bank also has a significant impact on the disclosure index, thus accepting hypothesis 1. This means that larger banks have a greater propensity fordisclosing risk factors than smaller Islamic banks. This is consistent with earlier research [22, 23, 24, 25, 26]. For cross border listings on the exchanges, there is no statistical evidence to accept hypothesis 2 that there is a significant relationship between cross border listings and the risk disclosure management indices of the banks within the MENA region. This is inconsistent with earlier work [31, 32]. This may be due to the fact that most of the foreign listed banks are listed in countries with less developed financial markets than the parent company and, hence, no added disclosure value from these cross border listed companies to compel additional disclosures.

There is also no statistical evidence to accept hypothesis 4 that there is a positive significant relationship between credit rating and risk management disclosure of the banks within the MENA region. This result is also inconsistent with earlier work [35, 36]. This may be due to the fact that the Islamic banks do not rely on rating from these bodies. In fact the IFSB disclosure guideline is silent on credit rating.

On average, based on beta coefficients, having a subsidiary shows more power in predicting risk disclosure index, followed by size, credit rating and then multiple listings. The F ratio confirms the existence of a slope at 1% and 5%, but with very poor model fit with only about 16% of variation in independent variables accounting for the risk disclosure index in these banks. This is understood as many of these Islamic banks are yet to come to terms with the IFSB disclosure requirements. Infact some could hardly report up to 40% of what is required from them (Table 2). Sample size and missing explanatory variables may be limiting factors. The model, however, shows high positive DW statistics indicating no autocorrelation andacceptable tolerance statistics, thereby implying little multicollinearity.

CONCLUSION, IMPLICATIONS AND RECOMMENDATIONS

Disclosure of adequate, timely and reliable risk information have a remarkable impact on the proper functioning of the financial markets and economic systems as investors largely base their decisions on thisinformation. This study finds,on average, that there is slightly above average compliance with the IFSB disclosure checklist of risk related information by Islamic banks in the MENA region, but very low reporting on some risk disclosure category, especially, displaced commercial risk (DCR), which is one of the unique risks to Islamic banks. This should receive proper attention from regulators and supervisors as the importance of providing information to investment account holders (IAH) is crucial to the success of the Islamic banking model of profit and loss sharing (PLS). Investors often hold back from holding IAH mainly because of the extent of information asymmetry involved, Islamic banks must do well to break down these barriers.Banks characteristics, such as size and having subsidiaries, especially foreign subsidiaries, are crucial in the disclosure of information, as banks with such subsidiaries and capital capability are required by such countries to satisfy more stringent disclosures.

It is suggested that future research in this area should consider external auditors, ownership structure and profitability, as they play a major role in the disclosure policies and practices of banks. Other researchers have found evidence that firms audited by the big four are likely to disclose more information than those audited by others [44, 45]. Similarly, it is found that a wider dispersion of share ownership of a company is associated with its compliance with mandatory disclosure rules. This is because agency costs tend to be higher for companies with widespread public ownership of securities, therefore, the shareholders of such companies press for more adequate information for monitoring purposes [34, 46]. Profitability is a measure of management performance and, as such, the management of a profitable company is likely to disclose more information to support the continuance of their positions and the performance-related compensatory schemes that may be due to them [22]. These characteristics were not covered by this research as they were not part of the IFSB documents and, in fact, some ownership structure was not disclosed by the banks and, hence, it is further recommended that they should be incorporated in the revised document.

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