Article Title Page

[Article title] Information Asymmetry and Regulatory shortcomings in Profit Sharing Investment Accounts

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Structured Abstract):

Purpose of this paper:
The purpose of this paper is to explore the shortcomings in the compliance of the full-fledged Islamic banks with the Bank Negara Malaysia disclosure guidelines related to the profit sharing investment accounts (PSIAs).

Design/methodology/approach:
This study uses interviews and survey.

Findings:
We found that only two out five full-fledged Islamic banks followed Bank Negara Malaysia (BNM) guidelines which are based on the idea of self-regulation. We developed a checklist of disclosure items, and probed whether the sample banks would adopt these new disclosure items. As it transpired, some banks have been disclosing these items selectively, and/or recording them for internal control and management purposes. Our findings show these banks do not disclose: policies, procedures, product design and structure; profit allocation basis, methodology of calculating profit attributable to Investment Account Holders (IAHs). Nevertheless, disclosure related to Shari'ah compliance was given to a reasonable extent. It is intriguing that full-fledged Islamic banks do not provide comprehensive disclosure related to profit sharing investment accounts because such disclosure is not mandatory; while foreign full-fledged Islamic banks provided such disclosure voluntarily.

Research limitations/implications (if applicable):
The banking sector regulator is not sure of whether individual Islamic banks have actually complied with all of its guidelines. The shortcomings in the disclosure are due to lack of expertise; outdated information system structure; shortage of support and highly trained staff. We propose that the Islamic jurists should use *Istiqra* – which is a comprehensive examination of contracting environment before a new definite ruling is made on the issue of accountability to the IAHs. This would involve exploratory study of how the securities regulator (not banking regulator) perceives the information risks faced by the IAHs and enforce new disclosure guidelines.

Practical implications (if applicable):

Social implications (if applicable):

What is original/value of paper:
This paper proposes new disclosure guidelines which incorporate transparency, appropriateness, and timeliness to reduce information asymmetry and enhance governance disclosure.

Keywords: information asymmetry, profit sharing investment accounts, Mudarabah, Islamic banks, Malaysia

Article Classification Research paper

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Running Heads:

1. Introduction

Mudarabah is a contract for profit-sharing. It is not mentioned in the Holy Quran but its permissibility is derived from the Sunnah of the Prophet Muhammad (PBUH). The permissibility of *Mudarabah* transaction is due to fact that, there are some capital surplus investors (*Rabbul mal*) who lack the business and investment expertise, and there are entrepreneurs who have business expertise but lack capital. Islamic bank acts as a *Mudarib* and initiate a two-tier Mudarabah. In the first tier, Islamic bank takes capital from *Rabbul mal*, while in the second tier; bank uses this capital for financing the projects selected by the entrepreneurs. If the *Rabbul mal* has not specified a business in which to invest their capital, in such a case, a *Mudarib* is free to invest capital in any type of Halal business. This contract is known as *al-Mudarabah al_mualaqah or Unrestricted Mudarabah*. In contrast, if *Rabbul mal* specifies a business in which to invest, then a *Mudarib* is restricted to invest only in such business. This is called *al-Mudarabah al_maqayyadah* or the *Restricted Mudarabah*. Any profit made by *Mudarib* is shared between *Mudarib* and *Rabbul mal* under profit sharing contract. The Shari'ah does not restrict or specify proportions to be distributed as profit between *Mudarib* and *Rabbul mal*, leaving it to the best judgment of the two parties. However, in practice, Islamic banks quote the profit distribution percentages prior to actual investment of the funds. All loses from the investments are borne by *Rabbul mal*.

Even though the *Rabbul mal*'s investment is equity investment in the business venture managed by *Mudarib* on its behalf, but it does not entitle them the rights of the investors (shareholders). They are not allowed to put in place the internal controls like conventional shareholders. Because *Rabbul mal* does not have a right to participate in the investment management subsequently, which is carried out by *Mudarib*, this situation creates information asymmetry in the profit sharing contract. As these investors do not take any part in the use and management of the funds, they face high level of information risk, Shari'ah compliance risk and market risk.

Previous works have theoretically identified the regulatory, moral hazard, information asymmetry, shortcomings in the supervision and regulations of PSIAs (see Archer and Karim, 2009; Archer and Karim, 2007; Hassan and Ahmad, 2007; Sundararajan and Erico, 2002). For instance, Archer and Karim (2007) highlight the regulatory problems related to PSIAs but they do not propose any solution in the form of changes to the disclosure of Islamic banks to reduce information asymmetry. Our work build on the views of Sundararajan and Erico (2002) who proposed that information disclosure requirements established for investment companies in conventional system should be adapted for the disclosure requirements of PSIAs. In this regard, this study fills an important gap in the literature by developing a new disclosure checklist for the full-fledged Islamic banks that provide a new reporting format to reduce information asymmetry as well as disclosing Shari'ah governance in the full-fledged Islamic banks. We believe that it is the first study to incorporate the attributes of appropriateness, timeliness and transparency in disclosure requirements. In this paper, first, we exposed the current state of art in the disclosure practices of the full-fledged Islamic banks using BNM guidelines. We discussed these findings with BNM officials, and later we significantly improved and refined the vague guidelines of BNM in a new disclosure checklist. We used this checklist in a survey of the full-fledged Islamic banks.

The rest of the paper is organized as follows: first, we show the trend and pattern of holding of the investment accounts in Malaysia followed by Bank Negara guidelines in section 2. We identify the gaps in the current disclosures of Islamic banks. Section 3 explains methodology and sample. We report survey results in section 4. Section 5 concludes the paper.

2. Profit sharing investment accounts (PSIAs) in Malaysia

The first Islamic bank was established in Malaysia in 1983. In 1993, commercial banks, merchant banks and finance companies begun to offer Islamic Banking products and services under the Islamic Banking Scheme (IBS Banks). In Malaysia, Islamic banking institutions offer two types of profit sharing investment accounts (PISAs)- General Investment Account (GIA-i, *Unrestricted Mudarabah* accounts) and Specific Investment Account (SIA-i, *Restricted Mudarabah*) accounts.

For GIA-i, the period of which money is accepted for GIA deposits can be less than one month and thereof up to a period of 60 months or any other period permitted by the Bank Negara Malaysia. The minimum amount is at the discretion of each Islamic bank but should not be less than RM 500. For SIA-i, the Islamic banks accept funds from investors with the minimum amount of RM 200,000. It is at the Islamic bank discretion whether to allow the investors to withdraw before maturity or otherwise (Ismail, 2010).

Fig-1 shows the trend and pattern of general investment account (or deposits) holdings according to the Investment Accounts Holders (hereafter IAHs). The IAHs are 42%, business enterprises; 25%, Malaysian government; 21%, financial institutions; and 12% individuals. There has been a persistent increase in the proportion of capital investment by the Malaysian government, financial institutions and business enterprises in such accounts. Fig-2 shows the trend and pattern of special investment accounts holdings according to IAHs groups. The proportionate holdings are 42%, financial institutions; 39%, business enterprises; 12%, Malaysian government, and 7% individuals.

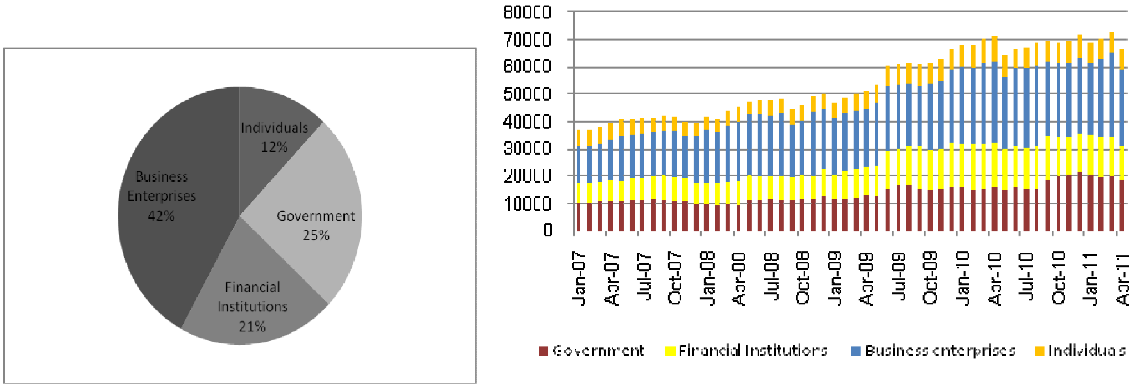
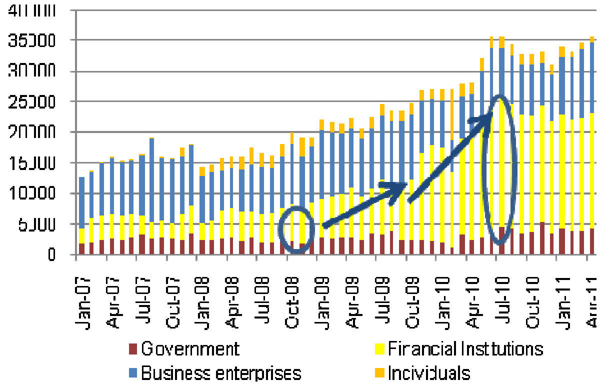


Fig-1 Trend and Pattern of General Investment Deposits holding (in RM) Jan2007-Apr-2011
This figure shows the total amount of General Investment Deposits held by Full-fledged Islamic banks, IBS Banks, and other Islamic Financial Institutions in Malaysia.



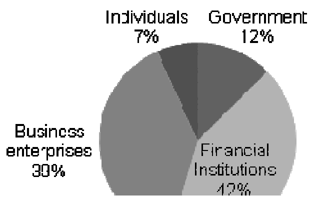


Fig-2 Trend and Pattern of Special Investment Deposits holding (in RM) Jan2007-Apr-2011
This figure shows the total amount of Special Investment Deposits held by Full-fledged Islamic banks, IBS Banks, and other Islamic Financial Institutions in Malaysia.

Clearly, the comparison of trend, and IAHs groups, in Fig-1 and Fig-2 reveals that, the individuals (retail customers) have small proportionate holdings of investment accounts (General and Special investment accounts). Though, the proportionate investment of individuals increased from 1.27% in Jan 2007 to 3.18% in Jan 2011; however it was modest increase compared to the proportionate increase in the investment of the financial institutions. Furthermore, this comparison shows that, financial institutions are major investors in the Special Investment accounts; while business enterprises are major investors in the General Investment accounts. Islamic financial institutions use Mudarabah inter-bank investments like their conventional counterpart to smooth their liquidity constraints. This market allows a deficit Islamic financial institution ‘investee bank’ to get short-term funds from the capital surplus or ‘investor bank’. The period of investment is from overnight to 12 months, while the rate of return is based on the rate of gross profit before distribution for investments of one year of the investee bank (Ismail, 2010).

Bank Negara regulations

According to Bank Negara Malaysia, the Islamic financial institutions should manage the investments wisely and safeguard the interest of the IAHs through establishment of sound and prudent policies. In this regard, Bank Negara Malaysia (BNM) has put forward guidelines on the Recognition and Measurement of PSIA as Risk Absorbent; financial disclosure (REF:

BNM/RH/GL/007-9), profit sharing disclosure[1] (REF: BNM/RH/GL007-11) and governance of Shari'ah committee (RE: BNM/RH/GL/012-1). These guidelines are applicable to all Islamic Banks licensed under the Islamic Banking Act 1983 and banking institutors participating in the Islamic Banking Scheme (IBS) licensed under the Banking and Financial Institutions Act (BAFIA) of 1989.

In this paper, we focus on the Profit sharing guidelines. The aim of these guidelines is to provide information on policies, procedures, product design or structures, profit allocation basis, difference between various types of profit sharing investment accounts. Islamic banks should provide this information to assess risk and return profile of PSIA including: policies governing the management of PSIA funds; Methodology in calculating profit attributable to IAHs; types of financing and/or investment under the assets portfolios of each PSIA funds; disclosure of amount of Profit equalization reserve (PER); historical performance on PSIA investment returns; methods for the valuation of underlying assets of PSIA, and risk profile and investment strategy of the assets portfolio.

3. Research Methodology

Our research design consisted of analysis of disclosure practices of Islamic banks using BNM guidelines. We used the latest annual reports of the banks for this purpose. These findings were later discussed with BNM officials in two interviews. We interviewed three officials from the Islamic banking policy department and supervision department of Bank Negara Malaysia on 19th Oct 2010. We developed a new checklist that significantly improved and refined the general and vague guidelines of BNM. Without this checklist, it was not possible to probe deeper into management of IAHs. In the psychology and management literature, 'checklist' is a standard approach to understand behavior. Later, we carried out a survey using this disclosure checklist inserted into the questionnaire (see Appendix). Starting 18th January 2011, a total of 4 questionnaires were delivered in-person in each of the full-fledged Islamic bank. For each bank, we asked the head of Shari'ah committee, head of risk management, head of operations, and internal

[1] This disclosure can also be made in the prospectuses or any other documents. BNM does not clearly specify the place for such disclosures. We had access to only the publicly available annual reports of these banks.

control /audit department to fill in the questionnaire. Only 10 questionnaires were received by 3rd March 2011. In the follow-up request, respondents from Bank Islam and Bank Muamalat declined to complete the survey; we did not get questionnaire back from the Kuwait Finance House because the respondent had resigned. Our initiative to get a replacement failed as other potential respondent declined to participate in the survey. We present the survey findings in section 4.2 based on these 10 completed questionnaires.

Our new disclosure checklist has three columns. The respondents were asked to indicate, whether the bank discloses a particular item, under “Yes” (Column 1). If a respondent did not place a tick the item, it indicated that bank did not disclose that particular item; therefore we treated it as a “No”. Table 3 and 4 in section 4.2 shows the results according to each item in checklist using “Yes” and “No”. If a bank plans to ‘disclose in the future’, then the respondents were asked to indicate, proposed future date (Column 2). We argue that, this approach allows us to decipher the Islamic banks intentions, to change their disclosure practices. It is plausible that Islamic banks might have received customers’ concerns about lack of information. Similarly, BNM might have also highlighted deficiencies in their disclosures, and these banks might want to improve their disclosure in future. If a bank does not plan to include any disclosure items in the future in their reporting, they were asked to indicate the reasons for doing so such as, not a requirement or not important (Column 3).

The full-fledged Islamic Banks in Malaysia made up the population and sample of study. We did not include conventional banks with Islamic banking windows because corporate governance issues in Islamic windows raise more serious and complicated concerns than in Shari’ah compliant full- fledged Islamic banks (El Tiby, 2011). In the treatment of IAH, Islamic windows not only face the issues of fairness but also the issue of balance-sheet segregation. We did not include Islamic subsidiaries of conventional banks because these are treated as a “bank within a conventional bank” in Malaysia. According to BNM official, even though these Islamic subsidiaries are separate from the parent ‘conventional banking operation’ but from supervision perspective these subsidiaries are not supervised separately. Therefore, this sample bias is deliberate as the research intends to investigate individual instances of good practices relating to *Mudarabah* contracting environment, which can be built into a body of knowledge that may be transferrable to full-fledged Islamic banks in other Islamic countries. Table 1 gives brief profile of full-fledged Islamic banks.

Table 1 Respondent bank profile

Bank name	Date of incorporation	Customer deposits concentration (%)	Branch network	Questionnaire sent	Questionnaire received
Al-Rajhi Bank Malaysia	2006	2.29	-	4	2
Asian Finance Bank Malaysia	2005	0.65	2	4	4
Bank Islam Malaysia	1983	15.45	117	4	-
Bank Muamalat Malaysia	1999	9.47	55	4	2
Kuwait Finance House Malaysia	2006	2.61	-	4	2
Total		***100***		***20***	***10***

Note: We used Bankscope database to calculate total customer deposits concentration. It does not segregate the total customer deposits according to Islamic and Non-Islamic modes of operations. Therefore, the total customer deposits concentration (in %) include all types of deposits including General deposits and Special investment deposits.

Even though population consists of only five full-fledged banks but it is comparatively better than the recent studies. For instance, Umaru et al (2011) surveyed four Islamic banks in Saudi Arabia; Anwar et al., (2010) used neural network modelling for predicting investment return on Mudarabah time deposits without using any Islamic bank data from Indonesia. Hassan, A. (2009) surveyed only three banks in Brunei Darussalam and Hassan, M. (1999) surveyed only one bank in Bangladesh. This research was carried out using a research grant from a Research Institute in Malaysia, which required survey of Islamic Banks in Malaysia.

4. Findings

4.1 Islamic banks' disclosure as per BNM guidelines

In this section, we report the findings from our content analysis on the latest annual reports of the 5 Islamic banks and responses from BNM officials. The content analysis procedure was carried out as follows: first, we collected the latest annual reports of the banks. Second, we used BNM guideline BNM/RH/GL007-11 as our reference point and read the wordings in the annual reports sections to match those required under each of these 7 guidelines (see Table 2). We found that currently Islamic banks' disclosure as per BNM Profit sharing guidelines was minimal (see Table 2).

Table 2

Profit sharing investment account disclosure (REF: BNM/RH/GL007-11)	**Bank**
Information on Policies, procedures, product design or structures, profit allocation basis, difference between various types of profit sharing investment accounts.	None
Information to assess risk and return profile of PSIA including:	
1.Policies governing the management of PSIA funds	1
2. Methodology in calculating profit attributable to IAHs.	1
3.Types of financing and/or investment under the assets portfolios of each PSIA funds	None
4.Disclosure of amount of Profit equalization reserve (PER)	None
5.Historical performance on PSIA investment returns	None
6.Methods for the valuation of underlying assets of PSIA	None
7. Risk profile and investment strategy of the assets portfolio	None

We discussed these shortcomings in the banks' disclosures with BNM officials, one of the officials from the Islamic banking policy department responded,

> "These guidelines are based on self regulation, which require market players to be knowledgeable about the risks and risk mitigation procedures... these guidelines do not stand on their own. It is complementary to our overall capital adequacy framework for Islamic banks which cater several components".

Though there has been support for self-regulatory regimes because fewer codes reduce costs associated with legislation but it may not always be feasible to address so many subtle issues lurking in the Islamic banking transactions which have to be Shari'ah compliant. There are several concerns regarding self-regulation which cast further doubt upon its effectiveness. These include: lack of credibility, lack of visibility, the potential for being anti-competitive, confusion about what compliance with a code means, and doubts about enforcement (Cartwright, 2009). We argue that at present Islamic Banks in Malaysia are not equipped to do self-regulation for PSIAs. BNM is not sure of whether individual banks have actually complied with its guidelines. We asked, does BNM supervise and monitor the Islamic Banks separately? The official from supervision department responded, "Supervision department in BNM has two modes of supervision: there is one department which caters for conglomerate supervision, and another department that looks at investment banks and overseas banks. Let say MayBank [holding], they will look at MayBank as a group and all the practices within MayBank group and inclusive of MayBank Islamic... we recognize the differences in the [operations] but we have to look at it holistically because I think we all are aware now even at the global level, people are talking about systematic risk"

Clearly, this style of supervision does not seriously consider the shortcoming of this supervision problem. On this note, the official responded,

"If you look at the wordings of our guidelines, I think most of it will say that these are the minimum requirements. That means they [banks] can go beyond, there is no restriction~~s~~, and I think it is better to resolve information [asymmetry] but I think of course bank will consider between the cost of disclosing more and what they want to disclose. So it is entirely their decision"

Another respondent from the policy department stated,

"We do not go beyond describing the general principle because we do not want to be micro-managing, how they [banks] should conduct their business. We do not want to dictate them".

"There is no country that has come up with a very comprehensive guideline for governance framework."

Based on these findings, we argue that BNM guidelines are not stringent because banks do not get any severe penalties for non-compliance. Contractually, IAHs are a type of equity investors but these investors do not have the governance rights of either creditors or shareholders (Archer and Karim, 2009). We argue that it might be a sign of ineffective corporate governance in Islamic banks. In next section, we present our survey findings using our disclosure checklist. The disclosure checklist (see Appendix) consisted of two sections. Section A: *Investment Account Holders (IAH) Disclosures* (*General disclosure, disclosure on unrestricted and restricted investment account holder*). Section B: *General Governance and Shari'ah Governance Disclosures* i.e., governance practices of the Islamic banks.

4.2 Survey findings

In this section, we report the results of survey using new checklist (see Appendix). These findings are aggregated at the bank level however we also provide tabular results for each item in the checklist in Table 3 and 4.

A-1 General disclosure

The respondents from Asian Finance Bank and Al-Rajhi Bank indicated that the banks disclose the range of investment products available for investors as well as profile of the investors for whom investment products may be suitable. This approach is akin to Know Your Customer (KYC) policy. However none of the banks (except Asian Finance Bank) provide details of procedures. Similarly, none of the banks provide qualification, experience, duties, responsibilities of the investment managers and advisers hired by the banks to manage the investment portfolio. Al-Rajhi Bank provides such information only in the prospectus of the products. Asian Finance Bank and Al-Rajhi Bank reports profit distributed by type of unrestricted and restricted IAHS but they do not disclose the computation of Profit Equalization Reserve (PER) and Investment Risk Reserves (IRR). One of the respondents from Bank Muamalat mentioned that the bank does not maintain PER as it has been utilizing income from shareholders' fund to stabilize the rate of return to depositors. The respondent from Asian Finance Bank indicated that bank records only the total asset financed by type (unrestricted and restricted IAHs, in RM); in contrast, Al-Rajhi Bank provides this information only in the product prospectus. Both banks report changes in PER during the year and profit available for sharing between shareholders and IAHs. We also asked the respondents about their intention to disclose, those items which they do not disclose currently, and the bank might intend to report in future. However, none of the respondents indicated that their banks have intentions to provide this information in future without giving any reasons.

A-2 Disclosure on Unrestricted Investment Accounts

The respondents from Asian Finance Bank and Al-Rajhi bank indicated that their banks explain general investment objectives and risk sharing policies when offering investment products under unrestricted PSIAs. The rest of the banks do not provide information related to the general investment objectives and risk sharing policies. Furthermore, only Asian Finance Bank and Al-Rajhi bank report concentration of its investment in industrial sectors, economic, business, or political developments or changes that may affect the industry in which IAHs funds have been invested. The banks record but do not report, the total investments out of unrestricted IAHs funds (without any description of assets invested); degree of exposure to any securities or other assets having liquidity risk; actual allocation of IAHs funds by type of assets and as percentage of total invested funds. None of the banks currently report total expenses incurred on unrestricted IAHs; details of administrative expenses charged; proportion of profit earned by unrestricted IAHs before transfer to or from reserves. One of the respondents, from Asian Finance Bank mentioned that the bank does not plan to include the disclosure of these expenses in its annual report because such information is only for internal control and statutory compliance purposes.

Furthermore, none of the banks report the profit earned and paid out over past 5 years and profit rate on unrestricted IAH by maturity. A respondent from Al-Rajhi Bank mentioned that the information about administrative expenses charged to unrestricted IAHs is usually disclosed in the prospectus.

We find that the critical issues such as risk management policies related to these unrestricted investment accounts are not disclosed, which seem to suggest inadequate information sharing in relation to risks faced by these unrestricted investment account holders. A particular disquiet is the absence of the information related to the degree of exposure of these unrestricted investment account holders to the risks of different industrial sectors. These findings suggest that unrestricted

IAHs are exposed to variety of risks which might not be properly monitored by these banks or currently not being properly addressed.

A-3 Disclosure on Restricted Investment Accounts

A similar pattern in terms of responses from the two banks, Asian Finance Bank and Al-Rajhi Bank emerged when inquiry was made about the operations of restricted investment accounts. The respondents from these two banks indicated that, banks explain investment objectives and risk sharing policies when offering investment products under restricted PSIAs. None of the bank discloses limits on the amount of money that can be invested under these accounts[2]. One respondent from the Asian Finance Bank mentioned that the bank observes the statutory limit. Asian Finance Bank discloses profit rate on restricted IAH by maturity- 3 months, 6 months, 1 year, 2 years, 3 years, and 5 years, and the profit earned and paid out over past 5 years to IAHs.

These findings seem to suggest that though some of the Islamic banks in Malaysia are currently keeping a record of information for tier-1 supplier of the capital but this information is not being relayed to the funds providers. In particular, there are four items of which none of the respondents disclosed. These are: historical returns over the past 5 years according to asset type; description and actual allocation of funds by type of assets and as percentage of total invested funds; administrative expenses incurred on restricted IAHs; and changes in asset allocation in the last 6 months. From the fund management perspective, banks should report such expenses incurred because bank as a *Mudarib* is accountable to *Rabbi-ul-Mal* about the total expenses incurred on the allocation of the funds and monitoring of invested capital. However, the local jurists view that *Mudarib* should not interfere in the running and management of the funds, which provide Islamic banks leeway and therefore no obligation. Table 3 shows the individual respondent's response according to disclosure items A-1, A-2 and A-3 without disclosing their identity. None of the respondents indicated that they have plans to introduce these items in disclosure in future.

[2] Jurists have different opinion on this matter.

Table 3
Individual responses as per Checklist item
This table shows each respondent's response to checklist items. The respondents were asked to indicate, whether the bank discloses a particular item, "Yes". If a respondent did not place a tick the item, it indicated that bank did not disclose that particular item; therefore we treated it as a "No".

Item no.	Yes	No	Item no.	Yes	No	Item no.	Yes	No
A1.1	5	3	A2.1	3	7	A3.1	3	7
A1.2	2	8	A2.2	4	6	A3.2	1	9
A1.3	1	9	A2.3	2	8	A3.3	3	7
A1.4	1	9	A2.4	3	7	A3.4	3	7
A1.5	1	9	A2.5	3	7	A3.5	0	10
A1.6	2	8	A2.6	3	7	A3.6	2	8
A1.7	3	7	A2.7	2	8	A3.7	0	10
A1.8	5	5	A2.8	0	10	A3.8	0	10
A1.9	3	7	A2.9	1	9	A3.9	0	10
A1.10	0	10	A2.10	3	7	A3.10	1	9
A1.11	2	8	A2.11	2	8	A3.11	2	8
A1.12	3	7	A2.12	2	8	A3.12	1	9
A1.13	4	6						
A1.14	4	6						

B-1 General Disclosure

We inquired the respondents about the banks' disclosure related governance issues (see Section B of questionnaire in Appendix). In this section, our main intention was to identify whether banks have robust Shari'ah oversight. We wanted to know whether there was ever lapse or weak judgment on the part of Shari'ah committee or board. And, how does the bank report such weaknesses in their Shari'ah compliance. Starting with key disclosure on the list of fatwa(s) that facilitates (or otherwise stops) provision of the Islamic banking services, respondents from Asian Finance Bank indicated that currently the bank does not list fatwa(s) but the Shari'ah committee provides its assurance that the bank's products comply with Shari'ah principals in all aspects. Nevertheless, the bank plans to implement disclosure of this kind in future. In contrast, one of the respondents from Bank Muamalat indicated that since it is not a requirement of BNM, therefore, bank does not report the list of fatwa(s). The respondents from Al-Rajhi Bank, Bank Muamalat and Asian Finance Bank stated that the banks disclose the range nature, size and number of violations of

Shari'ah compliance by the bank during the year. Only Al-Rajhi Bank reports when and why it has employed guarantors to mitigate risk exposure in PSIA. Al-Rajhi, Asian Finance Bank and Kuwait Finance House provide information on mediation and advice for IAHs set up by Bank Negara Malaysia including procedures for lodging complaints. Al-Rajhi bank and Kuwait Finance House describes the monitoring and auditing procedures specific to investment projects to ensure that shares of profit are fairly calculated and reliable information on progress and performance of the invested entities.

The respondents from Asian Finance Bank indicated that their bank is planning to implement the disclosure on type of breach and time period allowed to the entities to settle the issue as well as the punishment or action taken against incompetent entrepreneurs who deliberately cause loss to bank. Only Al-Rajhi Bank and Kuwait Finance House disclose the exit mechanism including the conditions that they shall immediately relinquish their board representativeness in the invested entities. Under second tier of *Mudarabah* contract, IAHs money is used by the entrepreneurs for production of goods and services, and after certain time, the income generated by this entrepreneur is to be distributed between the entrepreneur and the banks. If such entrepreneur purposely failed to earn income from the project, then the bank does not suffer losses contractually, since IAHs bear this loss. Though, these IAHs only recourse is to withdraw funds, subject to loss of accrued profit share if they do not observe the waiting period set out in the *Mudarabah* contract. They cannot expect central bank to protect their investment by the same method they use for depositors such as current account holders (Archer and Karim, 2007).

B.2 Shari'ah Governance Disclosure

The role of Shari'ah has been in place since the beginning of Islam, traders were not permitted to close any transaction unless they knew Shari'ah principles concerning the transactions. Shari'ah scholars used to educate the traders in Islamic Law so that they would refrain from conducting any transactions that contradict Shari'ah. At present, this job has been taken over by the Shari'ah boards and committees (Garas and Pierce, 2010). Therefore, Islamic banks must abide by their rulings due the Shari'ah board importance from the religious position. The respondents from Al-Rajhi, and Asian Finance Bank indicated that banks report procedures for screening and selection of Shari'ah committee members, whereas, Kuwait Finance House stated that it is not a requirements and therefore bank does not plan to provide this disclosure in future. Nearly all the respondents indicated that their banks disclose the duties and responsibilities of Shari'ah board members and the remuneration of Shari'ah board member. The respondents indicated that their banks report on Shari'ah Supervisor Board (SSB)'s role to work with management to ensure that everything about the financial products comply with the principles and percept of Shari'ah. Furthermore, these respondents stated that these board members verify transactions to check their compliance and most importantly they are able to provide an unbiased opinion on all matters.

The respondents from three banks - Al Rajhi , Kuwait Finance House and Asian Finance Bank indicated that their bank disclose expenses incurred on the external Shari'ah auditors and consultants. SSB members are involved in the calculation and payment of Zakat as well as disposing of non-Shari'ah compliant earnings. The respondents from Al Rajhi, Kuwait Finance House commented that it is a statutory requirement in Malaysia that SSB are not sitting on more than one SSB. When we asked about whether the bank reports on SSB members' verification of the contractual documents and terms and conditions observed by the invested entities, we obtained different answers. The respondents from Asian Finance House indicated that it is verified through audits. While, the respondent from Bank Muamalat indicated that the responsibility of such disclosure rests with Shari'ah committee. The respondents from Bank Muamalat indicated that it is not a requirement of BNM. Table 4 shows the individual respondent's response according to disclosure items B-1, and B-2 without disclosing their identity.

Table 4
Individual responses as per Checklist item
This table shows each respondent's response to checklist items. The respondents were asked to indicate, whether the bank discloses a particular item, "Yes". If a respondent did not place a tick the item, it indicated that bank did not disclose that particular item; therefore we treated it as a "No".

Item no.	Yes	No	Plan to disclose in future	Item No.	Yes	No
B1.1	3	6	1	B2.1	4	6
B1.2	6	4	0	B2.2	10	0
B1.3	3	7	0	B2.3	9	1
B1.4	2	8	0	B2.4	5	5
B1.5	4	6	0	B2.5	4	6
B1.6	3	7	0	B2.6	3	7
B1.7	4	6	0	B2.7	7	3
B1.8	2	8	0	B2.8	7	3
B1.9	2	8	0	B2.9	5	5
B1.10	3	7	0	B2.10	7	3

5. Discussion and Conclusions

Our survey findings show that, most of the items proposed in our checklist are not being disclosed in the annual reports currently; such items are being recorded for internal record purposes only. This attitude is contrary to Islamic teachings which back contractual obligations and the disclosure of information as sacred duty. The *Rabbul mal* must be made aware of, through any means necessary that the Islamic bank in its capacity of *Mudarib* will monitor investment of the funds in the *Halal* businesses. Islamic bank is expected to report a true and accurate profit (loss). Thus, the question of trust is of utmost importance to reduce information asymmetry.

Our findings show that, information such as risk management procedures to mitigate market risks faced by IAHs, is not provided in appropriate and transparent manner. In terms of Shari'ah governance, the banks record, but do not report adequately the progress and performance of invested entities under second tier of Mudarabah. Furthermore, banks do not inform about the actions taken against entrepreneur to address the moral hazard, as well as, banks do not report their exit strategy to IAHs in the case of unfavourable incidents. No doubt, our survey has certain limitations and therefore we cannot generalize findings to different Islamic banks which are explored in recent studies (see e.g., Sufian, 2010). We were not able to get responses from all full-fledged Islamic banks. It is quite unsettling issue as why Bank Islam did not participate in this survey.

Our findings suggest that, IAH should pressure for stringent procedures and regulations. According to Archer et al., (1998, p.167) mitigating existing deficiencies would be a generalization of 'hostage posting' as the Islamic banks would be induced to invest non-trivial proportions of shareholders' funds in all *Mudarabah,* as a bonding measure to extend 'vicarious monitoring'. Monitoring capabilities can be strengthened by active involvement of IAHs in the governance structure, by granting of some representation of IAHs on the board or the audit committee of the board, and/or at the annual general meeting of Islamic banks. Their participation might be restricted to only approving the bank's financial statements and the appointment of external auditors and members of the SSB, since the *Mudarabah* contract does not permit interference by investors in management, but gives a clear signal to the bank management that the concerns of IAH would be the utmost priority.

AAOIFI Financial Accounting Standard No. 3 provides basic guidelines to the accepted method of recording the accounting entries for a *Mudarabah* transaction and delves deeper into information risk and how to mitigate moral hazard through proper accounting methods. Similarly, AAOIFI Shari'ah Standard No. 13 sheds some light in terms of accounting disclosure by requiring the parties of the contract to reach an agreement through a Memorandum of Understanding, which should indicate the intention of parties to use either *Restricted* or *Unrestricted* Mudarabah, pre-agreed profit sharing ratio and the type of guarantees which shall be presented by *Mudarib* to cover misconduct, negligence or breach of contract or other relevant issues in this regard (Latiff, 2010).

Archer and Karim (2007) criticize the current regulation of IAHs from depositor protection perspective. They propose that IAHs should be treated as investors and the securities regulators rather than banking regulator should do monitoring and supervision. Archer and Karim (2007) do not propose the role of securities regulator in making market discipline possible. One possibility might be that, the securities regulator teams up local credit rating agency, after taking into account riskiness of Islamic bank's portfolio, assign a rating to Islamic banks. In this regard, Standards & Poors Raring Services launched a new service in 2007 that gives their customers a useful opinion about their profit-sharing investment accounts by providing Stability Ratings for Islamic banks offering PSIAs (Al Bawaba, 2007). These ratings are Standards & Poors opinion about the expected stability of cash flow distributable to PSIA holders of Islamic financial institutions on scale running from, SR-1 (highest) to 'SR-7' (lowest). Though it is a good innovation, but the critics might argue that it has major problems i.e., *Mudarabah* is equity investment and *Mudarabah* investments are not tradable. Ratings can be assigned easily to the debt instruments, which are tradable in the capital market.

Another forthcoming solution is to give high valued restricted IAHs privy to detailed qualitative information. On the other hand, for the unrestricted investment accounts holders, quantitative information should be accompanied by qualitative information gathered by the fund managers (Latiff, 2010). Such reports should be prepared regularly, and made accessible to all interested investors. Transparency must be enhanced in the compliance and financial reporting and external audit functions covering all types of *Mudarabah* investments, whether reported on or off the bank's balance sheet. In some countries, where compliance with IAS is mandatory without any room for AAOIFI standard, some Islamic banks might have PSIA that are off-balance sheet (Abdul-Aziz, 2011). We propose that our checklist of items would provide Islamic banks self-assessment toolkit to address current shortcomings. It will enhance transparency, timeliness and appropriateness in disclosure related to PSIAs. BNM introduced a new Shari'ah governance framework for Islamic Financial Institutions (IFIs) which became effective starting 1 January 2011. BNM required each IFI to confirm the status of compliance with this framework at the end of six month period however it is was not still mandatory (at the time of writing of this paper). We propose that PSIA should be regulated through a stringer set of disclosure requirements by securities commission and not by the banking sector regulators, which would force the non-compliant bank to improve its deficiencies in disclosure related to PSIA. In case of non-compliance, such banks should not be allowed to offer such products and in the extreme case of non-compliance, such bank licence should be suspended.

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Appendix

Survey questionnaire

Instructions

This survey is about the disclosures of Profit Sharing Investment Accounts (PSIA) in the annual reports of the Islamic banks. The survey is divided into two sections:

Section A: Investment Account Holders Disclosures focuses on the PSIA - unrestricted and restricted investment account holder disclosures. It has three parts A-1, A-2 and A-3.

Section B: General Governance and Shariah Governance Disclosures focuses on the governance practices in a Islamic bank.

Please tick "√" under "Yes" to indicate that your bank has such disclosure practice. If your bank currently does not disclose but Plan to implement please indicate the proposed date (if known). If your bank currently **does not** provide the required disclosure in its annual report as per statements in each section, please provide reasons in the space given.

Name of the Bank:______________________

Respondent's job title:__________________________

Date of incorporation of the Bank:__________________________________

Total number of branches in Malaysia:______________________________________

A. Investment Account Holder (IAH) Disclosures

A.1 General Disclosure

Statements	Yes	Plan to implement. Please indicate the proposed date (if known)	If No, and do not plan to include. Please provide reasons (for example, not a requirement, not important etc)
Bank states range of investment products available for investors.			
Bank states profile of investors for whom investment products may be suitable.			
Bank provides details of procedures involving purchase distribution and redemption of investment products.			
Bank reports educational qualification of investment advisors, portfolio managers, and trustees.			
Bank reports experience of investment advisors, portfolio managers and trustees.			
Bank explains duties and responsibilities of investment advisors.			
Bank explains duties and responsibilities of portfolio managers.			
Bank reports Profit distributed by type (unrestricted and restricted IAHs) (in RM).			
Bank reports computation and amount of Profit Equalization Reserve (PER) (in RM).			
Bank reports computation and amount of Investment Risk Reserves (IRR) (in RM).			
Bank reports Total assets financed by IAHs (in RM).			
Bank reports Total assets financed by type (unrestricted and restricted IAHs) (in RM).			
Bank reports changes in PER and IRR during the year.			
Bank reports total profit available for sharing between IAH and shareholders.			

A.2 Disclosure on Unrestricted Investment Account Holders (IAHs)

Statements	Yes	Plan to implement. Please indicate the proposed date (if known)	If No, and does not plan to include. Please provide reasons (for example, not a requirement, not important etc)
Bank explains its general investment objectives and risk-sharing policies when offering investment products under unrestricted PSIA.			
Bank reports concentration of its investment in industrial sectors.			
Bank reports economic, business, or political developments or changes that may affect that industry or group of industries in which it has invested IAHs funds.			
Bank reports total investment of unrestricted IAHs (in RM).			
Bank reports description of assets in which it invests IAHs funds.			
Bank reports its degree of exposure to any securities or other assets which have liquidity risk.			
Bank reports actual allocation of IAHs funds by type of assets and as percentage of total invested funds.			
Bank reports total expenses incurred on unrestricted IAHs (in RM).			
Bank reports details administrative expenses charged to unrestricted IAHs (in RM).			
Bank reports proportion of profit earned by unrestricted IAHs before transfer to or from reserves (amount and as percentage of funds invested).			
Bank reports profit earned and paid out over past 5 years to IAHs (amount and as percentage of funds invested).			
Bank reports profit rate on unrestricted IAH by maturity- 3 months, 6 months, 1 year, 2 years, 3 years, and 5 years.			

A.3 Disclosure on Restricted Investment Account Holders (IAHs)

Statements	**Yes**	**Plan to implement. Please indicate the proposed date (if known)**	**If No, and does not plan to include. Please provide reasons (for example, not a requirement, not important etc)**
Bank explains its investment objectives and risk-sharing policies when offering investment products under restricted PSIA.			
Bank clearly states limit on the amount that can be invested on any asset type.			
Bank reports concentration of its investment in industrial sectors of more than 20%.			
Bank reports economic, business, or political developments or changes that may affect that industry or group of industries in which it has invested IAHs funds.			
Bank states historical returns over the past 5 years according to asset type.			
Bank reports total investment of restricted IAHs (in RM).			
Bank provides description and actual allocation of funds by type of assets and as percentage of total invested funds.			
Bank reports administrative expenses incurred on restricted IAHs (in RM).			
Bank discloses changes in asset allocation in the last 6 months.			
Bank reports profit rate on restricted IAH by maturity- 3 months, 6 months, 1 year, 2 years, 3 years, and 5 years.			
Bank reports proportion of profit earned by restricted IAHs before transfer to or from reserves (amount and as percentage of funds invested).			
Bank reports profit earned and paid out over past 5 years to IAHs (amount and as percentage of funds invested).			

B. Governance Disclosures

B.1 General Disclosure

Statements	Yes	Plan to implement. Please indicate the proposed date (if known)	If No, and does not plan to include. Please provide reasons (for example, not a requirement, not important etc)
Bank provides a list of Fatwa(s) supporting its new or existing products.			
Bank reports nature, size, and number of violations of Shariah compliance during the year.			
Bank reports its internal procedures for the monitoring and reporting of risk factors that could potentially affect PSIA.			
Bank reports when and why it has employed guarantors to mitigate risk exposure in PSIA.			
Bank provides information on mediation and advice for IAHs set up by Bank Negara Malaysia including procedures for lodging complaints.			
Bank describes the monitoring and auditing procedures specific to investment projects to ensure that shares of profit are fairly calculated.			
Bank provides reliable information on progress and performance of the invested entities.			
Bank provides details of actions that could be taken against incompetent entrepreneur who deliberately caused loss to bank.			
If there is a breach in the contract by invested entities, bank discloses the type of breach and time period allowed to the invested entities to settle the issue.			
Bank reports exit mechanism including the conditions that it shall immediately relinquish its board representativeness in the invested entities.			

B.2 Shariah Governance Disclosure

Statements	Yes	Plan to implement. Please indicate the proposed date (if known)	If No, and does not plan to include. Please provide reasons (for example, not a requirement, not important etc)
Bank reports procedures for screening and selection of Shariah board members.			
Bank explains duties and responsibilities of Shariah board members.			
Bank reports remuneration of Shariah board members (in RM).			
Bank reports expenses on external Shariah auditors and consultants (in RM).			
Bank reports that Shariah Supervisory Board (SSB) members are not sitting on more than one SSB in Malaysia.			
Bank reports on SSB members' verification of the contractual documents and terms and conditions observed by the invested entities.			
Bank reports on SSB work with management to ensure that everything about the financial product is in compliance with the principles and precepts of the Shariah.			
Banks discloses that SSB members verify transactions that they comply with issued Fatwa(s).			
Bank discloses that SSB members are involved in the calculation and payment of Zakat as well as disposing of non-Shariah compliant earnings.			
Bank states that SSB members are required to submit an unbiased opinion in all matters.			

Thank you for your participation. If you would like to have a copy of results of this study, please provide your email: ____.