A COMPARATIVE INVESTIGATION OF THE IMPACT OF FINANCIAL DISCLOSURE IN CONVENTIONAL AND ISLAMIC BANKS ON STOCK RETURNS IN SELECTED GCC COUNTRIES

BY

TAWFIK AZRAK

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ABSTRACT

Diverse attempts have been made to analyse the impact of financial disclosure on the stock returns volatility of banking sector. In light of theoretical and empirical results available in this domain, two contradictory views have emerged. Some researchers are of the opinion that financial disclosure will enhance the banking stock returns stability since it will increase the trust between the shareholders, while others have opposite viewpoint and they argue that enhancing the financial disclosure will lead to inject more data into the market which will be misunderstood by the investors and therefore it will increase the stock return volatility. This thesis provides empirical evidence of a linear relationship between financial disclosure and stock returns volatility, which shed light on the conflicting results of previous theoretical and experimental studies. In our study, we are exploring the financial disclosure levels of Islamic and conventional banks in five Gulf Cooperation Council (GCC) countries which have dual banking system with a significant share of Islamic banking for the period of 2005 until 2015 and find which banks is more transparent to the market. Furthermore, we are studying the disclosure – stock return volatility relationship and we are exploring whether or not bank types affect this relationship and which banks have higher stock return volatility effects. Using fixed or random effect technique on panel data covering the GCC countries with dual banking system, this thesis finds and affirms that the disclosure levels in conventional banks were better than Islamic banks in GCC region during the studied period, but interestingly at the same time we find that the gap between the financial disclosure levels in these two banking system was decreased from 13.96% in 2005 to become 5.51% in 2015, and this indicate the efforts and enhancement done to improve Islamic banking system during the last few years. Additionally, the empirical finding confirms that increasing the financial disclosure level will lead to increase the stock returns volatility for both banking system in a different ratio. Analysis of the differences among Islamic and conventional banks verified that the effect of the financial disclosure will be higher for stock returns volatility of Islamic banks. These results have significant policy implications, as it suggests that policymakers should encourage the banks to have clear guidance on the required information to be disclosed on multiple criteria. Instead of recommending for injecting more information in the market, the focus should be made on the dissemination of reliable, adequate, relevant, and timely information. Furthermore, results derived in this thesis have direct implications for managers and policymakers in GCC banking system, who can use this information to design better disclosure policies to influence investors.

ملخص البحث

تم إجراء العديد من المحاولات لتحليل أثر الإفصاح المالي في تقلبات عوائد الأسهم في قطاع المصارف بشكل عام. وفي ضوء النتائج النظرية والعملية المتوفرة في هذا المجال، فقد ظهرت وجهتا نظرٍ متناقضتان. حيث يرى الفريق الأول من الباحثين أن تحسين مستوى الإفصاح المالي سيؤدّي إلى استقرار عوائد الأسهم المصرفية، حيث إنها تزيد الثقة بين المساهمين. بينما يرى الفريق الثاني عكس ذلك، حيث يقول إن تحسين مستوى الإفصاح المالي سيؤدّي إلى ضخ مزيد من المعلومات للسوق، والتي سوف يساء فهمها من قبل المستثمرين، وبناءً عليه سوف تؤدّي إلى زيادة تقلبات عوائد الأسهم. تقدّم هذه الأطروحة دليلاً عملياً على وجود علاقة خطية بين الإفصاح المالي وتقلبات عوائد الأسهم، والتي بدورها سلطّت الضوء على النتائج المتضاربة للدراسات النظرية والعملية السابقة. فقد تمت دراسة مستويات الإفصاح المالي للمصارف التقليدية والإسلامية لدول مجلس التعاون الخليجي التي تمتلك نظاماً مصرفياً مزدوجاً وللمصارف الإسلامية فيها حصة كبيرة، خلال الفترة الممتدة من عامي 2005م، وحتى 2015م، و إيجاد أي المصارف لديها مستويات شفافية أكبر للسوق. وعلاوة على ذلك، فقد تمت دراسة العلاقة بين الإفصاح وتقلبات عوائد الأسهم وإيجاد في ما إذا كان هناك أي اختلاف في هذه العلاقة بين نوعي المصارف، وأي منهما سيكون لديه تأثير أكبر في تقلبات عوائد الأسهم. باستخدام تقنية التأثير الثابت أو المتغير في بيانات تشمل النظام المصرفي المزدوج في دول مجلس التعاون الخليجي، فقد وجدت وأكدت هذه الدراسة أن مستويات الإفصاح المالي للبنوك التقليدية كانت أفضل من مستويات الإفصاح المالي لنظيرتها الإسلامية خلال الفترة المدروسة، ولكن من المثير للانتباه أن الفجوة بين مستويات الإفصاح المالي في هذه الأنظمة المصرفية قد انخفض من 13.96٪ في عام 2005م، ليصبح 5.51٪ في عام 2015م، وهذا يشير إلى الجهود المبذولة لتحسين النظام المصرفي الإسلامي خلال السنوات القليلة الماضية. بالإضافة إلى ذلك، تؤكّد النتائج العملية أن زيادة مستويات الإفصاح المالي سيؤدّي إلى زيادة تقلبات عوائد الأسهم لكلا الأنظمة المصرفية بنسب مختلفة. حيث أكد تحليل الفروق بين البنوك الإسلامية والتقليدية على أن تأثير الإفصاح المالي سيكون أكبر بالنسبة لتقلبات أسعار الأسهم في البنوك الإسلامية. ولهذه النتائج آثار مهمّة في السياسات المطبقّة، حيث تقترح أن يشجّع أصحاب القرار جميع المصارف في الحصول على إرشادات واضحة ودقيقة بشأن المعلومات المطلوبة التي يتعيّن الإفصاح عنها بناءً على معايير متعددة، حيث ينبغي التركيز على نشر معلومات موثوقة، كافية، ملائمة، وفي الوقت المناسب.

APPROVAL PAGE

The thesis of Tawfik Azrak has been approved by the following:

____
Buerhan Saiti
Supervisor

____
Engku Rabiah Adawiah Bt Engku Ali
Co-Supervisor

____
Adewale Abideen Adeyemi
Internal Examiner

____
Abdul Ghafar Ismail
External Examiner

____
Amir Shaharuddin
External Examiner

____
Radwan Jamal Yousef Elatrash
Chairman

DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This Thesis is dedicated to my beloved parents; Khaldoun and Hazami for their endless love, support and encouragement

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LIST OF ABBREVIATION

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
CIFAR	Centre for International Financial Analysis Research
CTI	Cost-to-income ratio
DI	Discourse Index
DJIA	Dow Jones Industrial Average
EMH	Efficient Market Hypothesis
FE	Fixed Effects
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GOB	Government of Bahrain
IAHs	Investment Account Holders
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
KSA	Kingdom of Saudi Arabia
OLS	Ordinary Least Squares
RE	Random Effects
ROA	Return on assets
SD	Standard Deviation
SEC	Securities and Exchange Commission
UAE	United Arab Emirates

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Many economists like Ben Bernanke (Former Chairman, Federal Reserve, United States) and Eigner & Umlauft (2014) consider the 2008 financial crisis as the worst financial crisis since the great depression of the 1930s. The crisis impelled a global awareness to enhance disclosure in the financial reporting related to risks. It has been widely accepted that the proper disclosure helps to enhance the stability of banking financial system in general and the stock returns in particular. A lack of disclosure about banks' risk exposures prevented markets from correctly pricing risk that leads to the financial crisis in 2007-2008 (Hyytinen & Takalo, 2003; Nier, 2004).

The concept of improving the disclosure in the banking sector is relatively new; it has emerged after the recent global financial crises of Asian financial crisis and the US sub-prime crisis in 2008, where many banks were asked to increase their disclosure in the financial statements (Lahrech *et al.*, 2014). Furthermore, it became more prevalent, when the official bodies including the Basel Committee on Banking Supervision (2003) and the International Monetary Fund (IMF) recommended increasing the transparency and disclosure in banking firms. These appeals came simultaneously with the suspicion that recent crises owe to a lack of disclosure about both borrowers and lenders. However, a publicly available practice and policies could have restricted the intensity of the last few crises (Fischer, 1999). As a policy response, the stated aim of the Pillar 3 disclosures introduced by the revised Basel Accord III is to provide incentives for banks to manage their risks more prudently.

The issue of disclosure is crucial in the banking sector in general, and even more relevant in the Islamic banking (Lahrech *et al.,* 2014). Because like other conventional banks or financial institutions, Islamic banks also deal with money in different forms of business, such as collecting deposits, lending and investing. However, the fact which distinguishes Islamic banks is the way they deal with the depositors by non-predetermined sharing of profit and loss. This factor implies the Islamic banking’s' fiduciary role in maintaining trust among depositors and investment account holders to achieve investment goals (to record profit) and a fair distribution of the revenues between banks and the investment account holders (according to the *Mudaraba* agreement). Such a functioning becomes per-eminent in the continuity of the Islamic banking business.

Based on the discussion made above, Islamic banking holds more responsibility than conventional banks to give higher disclosure to their investment account holders, not only about their financial conditions but concerning to the management of the trust money also. Additionally, they must explore the most appropriate measures to develop accounting standards that could deliver adequate, reliable and relevant information to financial statement users.

In such a context, Islamic banks will emerge as a favourable alternative to conventional banks because their functioning is naturally less volatile, and features only moderate risk. For example, it was argued by Saiti *et al.,* (2014) that Islamic stocks would be less exposed to the leverage effect due to an upper limit of debt financing imposed by *Shari’ah* screening. Therefore, Islamic banking results in the lower volatility and higher diversification level among the mix of all Islamic equities, especially during the market downturn.

Indeed, Islamic banks prohibit speculation, uncertainty and any form of the interest rate on credit *(riba)* that is assimilated with illicit usury practice. Therefore, Islamic banking investments are a priori more likely to reduce financial risk and excess volatility and provide a more stable financial industry. They also advocate sharing profits and losses with investors. For example, in Islamic banks, during the *Mudarabah* contract, the bank will act as *Mudarib* while the investor will be *rab-Almaal*, who will provide the capital and they will share the profits or losses based on their agreement. In such cases, Islamic banks are expected to invest in the sectors that comply with the *Shari'ah* requirements with fewer volatility features in nature, and to disclose all the relevant information to the stakeholders.

To this end, it is worth investigating to analyse the reporting of Islamic banks about their transactions and activities. Because, under the *Shari'ah*, Islamic banks are responsible for investing the investors and depositor's money in viable projects. These projects could be the debt-based financing like *Murabaha*, *Salam*, *Ijarah* and (or) profit and loss sharing like *Mudarabah* and *Musharaka*. In these projects, the investors and the bank will enter into an agreement that requires both parties to have full access to their transactions information as covered by the agreement, thereby assisting to stable their stock returns.

The need for disclosure is essential *Shari`ah* elements also. Any form of hiding the information, cheating or attempt to distort the reality will violate the principles of justice and fairness in *Shari`ah*. As mentioned in the Qur'an in the following verse:

> "O you who believe! When you contract a debtor for a fixed period, write it down. Let a scribe write it down injustice between you. Let not the scribe refuse to write as Allah has taught him, so let him write …" (Al-Baqarah 282).

This verse emphasizes the value of transparency in Islam declaring that every transaction must be written to avoid injustice and ambiguity (*gharar*).

The paragraph as mentioned above emphasizes the importance of transparency in Islam. However, the question arises, to what extent we should disclose information? Alternatively, do we have to disclose complete information to the market? At the same time, someone may think of some reasons what could be the negative effects of increasing the disclosure, for example, increasing the disclosure to a certain level might increase the market volatility to the stock returns or to the market in general, and at the same time it will increase the cost of the bank. As such, increasing the disclosure requirements will provide the markets with lots of data with a possibility of getting misconstrued. Also, by enhancing the disclosure beyond a certain level may lead to the inefficient liquidation of the bank. It is because of the characteristics of a standard deposit contract; its payoff scheme possesses limited upside gains (cap) but omits the depositor with the downside risk. Accordingly, investors will not consider possible future upside gains of the bank when choosing whether or not to withdraw their deposits (Allenspach, 2009).

Therefore, common knowledge would perceive that increasing disclosure typically enhances the stability of the financial system. However, it is still debatable to predict a positive impact of the increased disclosure in the banking sector on stock returns volatility.

Alternatively, it has been argued by Sowerbutts *et al.,* (2013) that inappropriate public disclosure by banks may lead to the financial crisis. Because investors are incapable of judging the risks that banks are taking and withdraw lending in times of systemic stress. Therefore, an increased disclosure will improve financial stability and reduce market volatility. Though, another conceptual work suggests that an increased disclosure may not improve the welfare and therefore may increase stock returns volatility for the banking industry.

Owing to the interests towards Islamic banking, we found this issue of "Increasing financial disclosure by Islamic banks" as facilitating many more questions about its potential impact on the GCC banking system. For example, Are Islamic banks prepared for increasing their financial disclosure? Do they have higher levels of financial disclosure compared to the conventional ones? Is the stock returns volatility of Islamic banks affected by increasing financial disclosure? Does financial disclosure necessarily lead to a positive impact on the stability of stock returns in the banking system in GCC?

This research addresses these relevant policymaking questions through investigating the evolution of increasing financial disclosure under GCC banking system and its effect on stock returns volatility. Understanding the conditions under which more financial disclosure may improve or worsen outcomes will enhance our understanding and assist us in building a better policy.

1.2 PROBLEM STATEMENT

A discussion paper issued by the Euro-currency Standing Committee of G10 Central Banks in September 1994 (The 'Fisher Report') was one of the clearest statements to date on the importance of and the rationale for improved levels of financial disclosure by institutions.

Starting from that time, there were many research papers, conferences, and articles discussed the importance of transparency and disclosure in financial system in general and in banking industry in particular.

For example, (Patel, Balic, & Bwakira, 2002) find that micro-level transparency is integral to effective corporate governance, and the higher transparency and better disclosure will reduce the information asymmetry between a firm's management and financial stakeholders, equity and bond holders, which will lead to mitigate the agency problem in corporate governance. At the same time, Herdman (2001) argues that it is critical for all public companies to provide an understandable, comprehensive and reliable portrayal of their financial condition and performance in order to maximize investor confidence.

Based on the previous discussions, we found that, it is very important for both conventional and Islamic banks to have an adequate level of financial disclosure of the information to the stakeholders; and these disclosures must reveal enough and reliable information to enable the assessment of its financial achievements, profitability and risk exposure.

Although disclosure is an important aspect in the financial and banking sector, but at the same time disclosing intensive information which contain the details of the financial institutions is not something preferred in banking industry, since increasing the disclosure may affect the banks in negative way.

For example, it has been argued by Rajni and Maliendra, (2007) that stock prices volatility tends to rise when new information is released into the market, however the extent to which it rises is determined by the relevance of that new information as well as the degree in which the news surprise investors.

To date, the existing literature has exhaustively discussed the various aspects of disclosure and its main effects on banking system and stock return in conventional banks. Conversely, empirical studies have rarely been directed towards disclosure in Islamic banking system and their multifaceted impact in GCC area. In more particular, it is yet not clear that what could be the multifaceted effects of increasing the financial disclosure in conventional and Islamic banking system in GCC, and whether increasing the financial disclosure level to a certain level will affect the volatility of stock returns in GCC banking system or not. To the best of our knowledge, no empirical study has been found to investigate and compare the disclosure level of conventional and Islamic banks in GCC area and study the effects and relationship between the financial disclosure and its impacts on stock returns and whether it has positive or negative effects towards it's volatility during the last eleven years at banking system of Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates.

In other words, a stock returns volatility is a major issue in both theory and practice and has attracted the attention of researchers. An increase in stock returns volatility leads to a perception of higher risk of a firm; therefore the cost of capital of companies rises (Bushee & Noe, 2000). These authors also affirm that volatility adversely affects the firm value by making stock returns compensation less efficient (costlier). The increase of stock returns volatility in recent years and the expected impact of information asymmetries on stock returns have raised questions about whether financial reporting can decrease stock returns volatility or not (Rajgopal & Venkatachalam, 2011).

Therefore, based on the previous explanation, this study estimates and compare the financial disclosure level in conventional and Islamic banking institutions in five GCC countries, and examine the relationship between this financial disclosure level and stock returns volatility in the GCC selected countries during the last eleven years.

1.3 RESEARCH OBJECTIVES

In the banking industry, financial statements disclosure reduces the volatility of stock returns by decreasing the information asymmetry. With insufficient or unclear information, investor act erratically in the confusion that creates volatility in stock returns (Jayasree, 2013). The investigation, therefore, attempts to identify any existing correlation between financial disclosure and stock returns volatility. Although there are other factors also, which may lead to the stock returns volatility, this study concentrates on the financial disclosures aspect.

Based on the problem statement, this study has three objectives:

1. To measure the financial disclosure level of conventional and Islamic banking institutions in five GCC banking system.
2. To investigate that whether the Disclosure Index affects the stock returns volatility of both conventional and Islamic Banks in GCC countries.
3. To examine the relationship between the Disclosure Index, bank-specific variables, macroeconomic variables and stock returns volatility in the conventional and Islamic banks of the selected GCC countries.

1.4 RESEARCH QUESTIONS

Diverse issues arise concerning the research objectives above. This study endeavors to answer the following questions specifically:

RQ1. Is there a difference between the financial disclosure levels of Islamic vs. conventional banks in GCC banking system? Which one is more transparent to the market?

RQ2. Does the disclosure level negatively affect banks stock returns volatility in GCC countries? And does this relationship differ between Islamic and conventional banks?

RQ3. What will be the relationships among the Disclosure Index, bank-specific variables, macroeconomic variables and stock returns volatility in conventional and Islamic banks in GCC countries?

1.5 RESEARCH HYPOTHESIS

To answer the research questions, the following hypotheses are formulated:

The first hypothesis addresses the first research question of the study: Is there a difference between the disclosure levels of Islamic vs. conventional banks in GCC banking system? Which banks are more transparent to the market?

H0: There are no differences between the disclosure level of Islamic and conventional banks in GCC region.

H1: There are differences between the disclosure level of Islamic and conventional banks in GCC region.

The following hypothesis addresses the sub-questions, in the case that there are differences between the disclosure levels;

H0: The disclosure level in Islamic banking is higher than conventional banks.

H1: The disclosure level in Islamic banking is lower than conventional banks.

The second hypothesis addresses the second research question of the study, does the disclosure level negatively affects banks stock returns volatility in GCC countries? Moreover, does this relationship differ between Islamic and conventional banks?

H0: Enhancing the disclosure will not affect the stock returns volatility.

H1: Enhancing the disclosure will affect the stock returns volatility.

The following hypothesis addresses the sub-questions, in the case that enhancing the disclosure will affect the stock returns volatility;

H0: Enhancing the disclosure will decrease the stock returns volatility.

H1: Enhancing the disclosure will increase the stock returns volatility.

Finally, the third hypothesis considers the third research question of the study, what will be the relationships among the Disclosure Index, bank-specific variables, macroeconomic variables and stock returns volatility in Conventional and Islamic banks in GCC countries?

H0: There will be no association between the independent variables and stock returns volatility.

H1: There is a relationship between the independent variables and stock returns volatility.

The following hypothesis addresses the sub-questions, in the case that, there is relationship between the independent variables and stock returns volatility;

H0: Disclosure index, bank-specific variables, macroeconomic variables have a positive effect on the stock returns volatility.

H1: Disclosure index, bank-specific variables, macroeconomic variables have a negative effect on the stock returns volatility.

1.6 SIGNIFICANCE OF THE STUDY

Accounting disclosure is raised to a particularly high level of importance for banking organizations relative to non-financial firms, because banks are inherently more opaque (Huang, 2006). This importance encourage and urges the banks to do more research studies on their disclosure levels and its multifaceted impact, and in particular they were trying to analyse and understand the effects of increasing their disclosure levels to the