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Importance of Transparency in Islamic Finance

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Abstract

Islamic finance is being practiced in over 75 countries around the world with about 550 Islamic financial institutions in the field. This study analyzes the importance of transparency in different aspects for the Islamic financial institutions and clients/savers in the Islamic finance market. The work suggests ways of establishing transparency in the Islamic finance market. It is also discussed in the study that the establishment of these transparency aspects will strengthen the confidence of clients/savers in the Islamic finance market, while bringing some new contributions to the Islamic financial institutions.

Keywords: establishing transparency, Islamic finance, standards of Islamic finance, transparency, uncertainty in Islamic finance

JEL: G20, G21

Introduction

Islamic financial system is based on a set of rules and laws referred to as Shariah. Shariah is governing economics, political, and cultural aspects of Islamic societies. Shariah originates from the rules dictated by the Quran and its practices and explanations by the Prophet Muhammad known as Sunnah.

In general we can say that Islamic finance contains any financing activities that should not be prohibited by Sharia and these activities must not involve interest (riba) and should avoid uncertainty, risk, and speculation (in Arabic Gharar). Islamic finance does not allow trading in alcoholic beverages, gambling and products that contain pork.

Islamic finance has a short history on the other hand from a small base it reaches a very huge size in the market when its short history is concerned. History of Islamic financing industry is very young. According to many authorities in Islamic finance, Islamic financial institutions really took off in the 1960s with the launch of the first Islamic bank in Egypt.

Islamic assets under management stand at around $700 billion and are growing faster than conventional finance assets (Islamic Financial Services Board).

'The concept of transparency is wide-ranging and covers the notions of accountability as well as the legal and accounting infrastructure for economic decisions. However, from an operational perspective of a central bank or supervisory authority, -transparency of an IIFS (Institutions offering Islamic financial services) - refers to an environment where material and reliable information about the IIFS is made available in a timely and accessible manner to the market at large and to all stakeholders.' (IFSB, Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services, December 2007). Transparency simply can be defined as the condition in which nothing is hidden and all information is available to all clients/depositors. Any client or depositor must have chance to see and check financial operations done by Islamic financial institutions.

There are doubts about possible differences between financial theories and operational practices due to the lack of transparency in the Islamic finance market. The parallelism between return rates and interest rates is seemed the source of the deep doubts and questions about Islamic finance (Sekreter and et al., 2012). The root of the problems is the lack of transparency in contemporary Islamic finance. Introducing transparency in Islamic finance market will ensure depositors/savers and establishing transparency in Islamic financial institutions will remove possible differences between theory and practice.

This study explores the affects of transparency in Islamic finance. The purpose of this thesis is to remove doubts about Islamic finance by analyzing importance of transparency for the market, to show that creating Islamic financial institutions that fully Sharia-compliant Islamic financial institutions can be possible by establishing real transparency and to prove importance of it from many different point of views such as for the Islamic Institutions, clients or savers, and the problems in contemporary Islamic finance and some discussable solutions by introducing more transparency are also included in this thesis project.

Islamic financial products and importance of transparency in Islamic finance

Islamic financial products refer to financial market transactions, any operations and services that comply with Sharia that is Islamic laws, rules and principles. All these instruments, operations and products can be summarized as in the following table.

Generally, transparency refers to accountability as

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well as the legal and accounting infrastructure for economic decisions. The common property of all these financial instruments and operations is that they all have to conform to the norms of Sharia and Islamic ethics. Hence the norms of Sharia and Islamic ethics must be understood correctly. The instruments, operations and products must be defined very clearly to be checked for the compliance of Sharia and Islamic ethics.

From operational perspective of a supervisory authority, transparency is characterized by an environment in which the information disclosed is; Comprehensive, Material, Reliable, Comparable, Relevant & Timely, and Accessible to all stakeholders and to the market at large (IFSB'TMD 2006). Transparency for Islamic financial institutions can be defined –additionally- as follow; reporting information on operational practices as reporting information on financial performance. The reliable information about the status of the agreed Islamic contracts, investments, or operations that are been practicing is another definition of transparency from another point of view of Islamic finance. Maximizing reporting of documents about transactions, activities and practicing contracts is included in the meaning of transparency. Another definition of transparency in Islamic finance is no difference between financial theories and operational practices, no hidden agendas, and the reliable information about the distributed profit by Islamic financial institutions, contracts, investments, and all financial activities for the clients and savers (Sekreter, 2011).

Table 1
Istamic Financial Products

sale-murabahah	sale-debt & currency	ijarah
• BBA (deferred payment sale) • tawarruq(tripartte sale) • Inah(sell with immediate purchase) • Istijrar(supply contract) • Musawamah(sale at bargained price) • Tawliyah(sale at cost price) • Wafa(sale and buy back) • Bay bima yanqati bihi si'r(recurring sale) • Murabahah lil amir bi shira(murabahah to the purchase orderer) • Wadi'ah(discount sale)	• Istisna(manufacture sale) • Salam(forward sale) • Bay dayn(sale of debt) • Sarf(sale of currency) • Tawriq(securitisation)	• Ijarah muntahia bittamlik(financial lease) • Ijarah thumma al bai(leasing and subsequently purchase) • Ju'alah(commision) • Ujr(fee) • Ijarah mawfusah fi zimmah(forward lease)
partnership	**bilateral supporting contracts**	**unilateral supporting contracts**
• Mudharabah(profit-sahring) • Musharakah(partnership) • Musharakah mutanaqisah(diminishing partnership) • Muzara'ah(share-cropping) • Musaqah(agricultural contract)	• wadiah(safekeepings) • Rahn(collateral/pledge) • Kafalah(gurantee) • Wakalah(agency) • Muqasah(setting off)	• Waqf(endowment) • Ibra'(forgoing of right) • Hibah(gift) • Wasiah(will) • Wa'd(promise)

Source: Natt, 2010

Islamic finance is the most developed branch of economics. It has been developing exponentially. There are many new concepts and tools introduced as an Islamic finance products in recent years. However Muslim community is not sure that what are admissible and what are forbidden. In the Medieval time the church declared decisions about the discussed topics, like Vatican in these days. When we look at the all Muslims all around the world, we see that there is no final authority which involves the discussions and gives final decisions especially in Sunni Muslims.

There are some independent advisory institutions but they represent some parts of the community.

The root of the problems faced by Islamic finance today is based on lack or absence of transparency. Interest based system is replaced by PLS (profit-loss sharing system). End of the maturities, clients/depositors of Islamic banks are informed just about distributed profit rates.

Any client/depositor does not have chance the types of investments or how the money that saves in the bank returned them as a profit. Clients/depositors cannot have documents supplied from

Islamic banks, so they do not have any idea about the implementation process. Like reporting financial performance, operational performance must be reported by Islamic banks. The financial performance of Islamic banks is always similar to interest rates. There is no difference in the mean of profit rates in Islamic banks and interest rates in conventional banks. "Unfortunately what is happening is that Islamic finance in some ways is moving more and more closely to the conventional finance," says Prof.Dr. Habib Ahmed, a world authority on Islamic finance.

Therefore it can be concluded that the parallelism between Islamic finance and conventional finance in financial performance and also the criticizing about similarities of Islamic finance with conventional one from the world authorities are pointing the lack of transparency in the Islamic finance market.

Islam is designed to supply everything what is needed and to bring solutions of human beings. So if we search we can find our answer. The issue is the problem or the situation is not clearly stated. To decide an Islamic tool or product complies with Shariah or not it must defined very well and the process of the activities must be clear in every steps. Transparency will help to eliminate the differences between theory of Islamic finance and practice of Islamic finance.

Islamic financial products refer to financial market transactions, any operations and services that comply with Shariah that is Islamic laws, rules and principles. All these instruments, operations and products can be summarized as in the following tables.

Establishing transparency

Transparency gives depositors reassurance that stocks in which they are investing is not only screened through internet with web pages that show percentage of return rates. Transparency that is real transparency means that investors must be informed about size of investment, liquidity, type of the chosen product as an Islamic.

Absence of unity is causing problems to establish Sharia standards in Islamic finance. Another problem is that Islamic banks are approved by different authorities as government or non government institutions. ''Investors want to see the same degree of responsibility and professionalism going into Shariah compliance as they expect from Moody's for credit ratings and S.&P. for market information,'' said John Sandwick, an Islamic asset and wealth manager based in Geneva. The lack of uniform reporting standards followed by the Islamic financial institutions causes the difficulties for analysts to collect useful information (Iqbal & Mirakhor, 2011).

There are some attempts to establish Sharia standards; the most successful attempt according to some authorities is the publication of Sharia standards by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). "There are 68 standards include recommendations on Tawarruq (monetization), indices and banking services; accounting standards on consolidation; governance standards on the independence of the Shariah supervisory board and governance principles for Islamic financial institutions," said Dr Mohamad Nedal Alchaar, secretary general of AAOIFI. This financial institution helps the market to improve itself and to establish standards for fully Sharia-compliant institutions. This board was chaired by Sheikh Muhammad Taqi Usmani, vice president of Islamic seminary Darul Uloom Karachi and a permanent member of the OIC Fiqh Academy. In 2007 Taqi Usmani declared that about 85% of Sukuk issued globally were not Shariah compliant because of repurchase agreements.

Determining the standards and establishing the authority for checking the determined standards are seemed to be primary issues for establishing transparency in Islamic Finance. Investors need to have greater information to monitor their investments (Ariffin, Archer, & Karim, 2007). Ayub (2009) also indicated that Islamic finance needs transparency more than conventional finance.

Conclusion

Islamic finance should be transparent as possible as it ensures predictability and confidence in the processes, says Raja Dr Nazrin Shah, crown prince of the northern Malaysin state of Perak. "For all its successors, Islamic finance still accounts for less than 1.0 per cent of global financial instrument," he noted (Kuala Lumpur, March 17, NNN-Bernama).

For all Islamic financial products there should have offices like offices between clients/depositors and Islamic financial institutions to monitor check and analyze all transactions, contracts, operational and practical financial activities. These offices should also report these financial activities and operations to inform clients/depositors. What does the bank invest in? These investments should be screened for Sharia compliance. The contemporary Islamic banks do not have any filtering system that checks the financial activities whether are prohibited or permitted. Accounting & auditing standards have important effect on establishing transparency. These standards must be defined. After defining these standards then implementation of transparency will be clearer and establishing transparency will be realistic for the market and product providers.

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