

The Board of Directors of Bank Islam (“the Board”) recognises the importance of corporate governance and is fully committed to the recommendations of the Malaysian Code of Corporate Governance. In this respect, the Board constantly strives to ensure high standards of corporate governance, internal control and risk management are practised throughout Bank Islam and its subsidiaries.

Further to this, the Board also considers for adoption where appropriate, recommendations as outlined under respective guidelines by Bank Negara Malaysia (“BNM”).

1.0 The Board of Directors

1.1 Composition of the Board

The Board has eleven (11) members, comprising one (1) Managing Director and ten (10) non-executive directors, of which four (4) are independent. * The current composition of the Board is in compliance with BNM Guideline on Corporate Governance for Licensed Islamic Banks (BNM/ GP1-i) which requires at least one-third of its directors to be independent directors.

The Board comprises members from diverse professional background and experience such as banking, finance and accounting, bringing with them invaluable knowledge, expertise and perspective to achieve Bank Islam’s objectives and vision.

* Dato’ Mohd Bakke, an independent director, was appointed as the Chairman on 1 April 2008. Following the appointment, he was re-designated as a non-independent director.

1.2 Roles of the Chairman and Managing Director

The roles of the Chairman and Managing Director are clearly defined and differentiated. This distinction is to ensure a balance of power and authority for better understanding and distribution of responsibilities and accountabilities. The Chairman together with the rest of the Board are responsible for setting the policy framework within which the Management is to operate. The Chairman also leads the Board in monitoring the performance of the Management in meeting the corporate goals and objectives of Bank Islam.

The Managing Director has overall executive responsibility for the day-to-day operations of Bank Islam which includes implementing the policies and strategies adopted by the Board. The Managing Director also carries the primary responsibilities for ensuring management competency including the placement of an effective succession plan to sustain continuity.

1.3 Board Meetings

Board meetings are scheduled at the beginning of the year where meetings are held at least once every two months with additional meetings convened as and when important decisions are required to be taken between the scheduled meetings. Nine (9) Board Meetings were held during FY 2008.

Details of attendance of each director during the FY 2008 are as follows:

Directors	Designation	Attendance at Meetings*
Tan Sri Dato’ Dr. Abdullah Mohd Tahir	Chairman/ Non-Independent Non-Executive Director	0/6**
Dato’ Mohd Bakke Salleh	Chairman / Non-Independent Non-Executive Director	8/9***
Dato’ Zukri Samat	Member/Managing Director	8/9
Datuk Ismee Ismail	Member/Non-Independent Non-Executive Director	7/9



1.3 Board Meetings (continued)

Directors	Designation	Attendance at Meetings*
Salaam Said Salim Al-Shakysy	Member/ Non-Independent Non-Executive Director	5/9
Fadhel Abdulbaqi Abu Al-Hasan Al-Qaed	Member/ Non-Independent Non-Executive Director	7/9
Hashim Abdulla Ahmad Al-Dabal (or his alternate - Marwan Hassan Ali Al-Khatib)	Member/ Non-Independent Non-Executive Director	7/9
Zahari @ Mohd Zin Idris	Member/ Independent Non-Executive Director	9/9
Zaiton Mohd Hassan	Member/ Independent Non-Executive Director	9/9
Ahmed Saeed Sultan Bin Braik	Member/ Independent Non-Executive Director	5/9
Dato' Noorazman A. Aziz	Member/ Non-Independent Non-Executive Director	3/4****

* Reflects the number of meetings held during the time the directors held office.

** Tan Sri Dato' Dr. Abdullah Mohd Tahir was hospitalised and unfit to attend the Board meetings since December 2006 and resigned from the Board on 1 April 2008.

*** Dato' Mohd Bakke Salleh was appointed as the Chairman on 1 April 2008 following the resignation of Tan Sri Dato' Dr. Abdullah Mohd Tahir from the Board.

**** Dato' Noorazman A. Aziz resigned from the Board on 1 November 2007 and his successor, Johan Abdullah was appointed to the Board on 1 August 2008.

1.4 Access to Information

The directors have full and unrestricted access to all information pertaining to Bank Islam's business and affairs to enable them to discharge their duties effectively. All directors have access to the Management and to the advice and services of the Company Secretary and they may also seek independent professional advice where necessary.

Reports providing updates on operational, financial and corporate developments are circulated prior to Board meetings to enable the directors to obtain further clarification or explanation where necessary in order to be adequately apprised before the meeting.

1.5 Appointment to the Board

The Board through the Nomination and Assessment Committee's recommendations ensure that the level and make-up of its members are of the necessary credibility, integrity and calibre with the required skills and knowledge. There is a formal and transparent procedure for the appointment of new members to the Board.

1.6 Re-Election of Directors

In accordance with Bank Islam's Articles of Association, all directors other than the Managing Director are subject to retirement from office at due intervals by rotation. Being eligible, they may offer themselves for re-election, a process that enables shareholders or proxy holders to vote them back into office.

Directors who are appointed as additional directors or to fill casual vacancies during the year are subject to re-election by the shareholders at the next Annual General Meeting following their appointment.

The office of Managing Director is exempted from retirement by rotation so as not to expose his office to vagaries of discontinuity.

All appointment of directors is subject to the approval of BNM.



2.0 Board Committees

The Board has delegated certain responsibilities to Board Committees, which operate within clearly defined terms of reference. These Committees are:

2.1 Nomination and Assessment Committee (“Committee or NAC”)

The Board delegates to this Committee the process for election and appointment of directors, assessing existing directors and identifying, nominating and thereafter making the necessary recommendation to the Board. This function extends to the recommendations on the appointment of key senior management within Bank Islam.

Members of the Committee are:

Name of Member	Designation	Attendance at Meetings*
Zaiton Mohd Hassan	Chairman/ Independent Non-Executive Director	8/8
Zahari @ Mohd Zin Idris	Member/ Independent Non-Executive Director	8/8
Datuk Ismee Ismail	Member/ Non-Independent Non-Executive Director	5/8
Hashim Abdulla Ahmad Al-Dabal (or his alternate - Marwan Hassan Ali Al-Khatib)	Member/ Non-Independent Non-Executive Director	7/8

* Reflects the number of meetings held during the time the directors held office.

2.2 Remuneration Committee (“Committee or RC”)

The Committee has a broad responsibility of recommending to the Board the remuneration of all directors including Shariah Council members, the Managing Director and Senior Management. The Board is ultimately responsible for the approval of the remuneration package.

Members of the Committee are:

Name of Member	Designation	Attendance at Meetings*
Zaiton Mohd Hassan	Chairman/ Independent Non-Executive Director	8/8
Zahari @ Mohd Zin Idris	Member/ Independent Non-Executive Director	8/8
Hashim Abdulla Ahmad Al-Dabal (or his alternate - Marwan Hassan Ali Al-Khatib)	Member/ Non-Independent Non-Executive Director	6/8
Datuk Ismee Ismail	Member/ Non- Independent Non-Executive Director	3/4**

* Reflects the number of meetings held during the time the directors held office.

** Datuk Ismee Ismail was appointed as a member to the Committee on 29 November 2007.



Bank Islam Malaysia Berhad and Its Subsidiaries

(Company No. 98127-X) (Incorporated in Malaysia) | Annual Report 2008

2.3 Board Financing Review Committee (“Committee or BFRC”)

This Committee is responsible for the review of financing and/or investment proposals approved by the Financing Committee ‘A’ (“FCA”) and/or Underwriting & Investment Committee (“UIC”) of the Management based on the limits determined by the Board. BFRC may overrule any decision of FCA and/or UIC, where appropriate.

Members of the Committee are:

Name of Member	Designation	Attendance at Meetings*
Dato’ Mohd Bakke Salleh	Chairman/ Non-Independent Non-Executive Director	7/7**
Zaiton Mohd Hassan	Vice Chairman/ Independent Non-Executive Director	7/7
Zahari @ Mohd Zin Idris	Member/ Independent Non-Executive Director	7/7***
Fadhel Abdulbaqi Abu Al-Hasan Al-Qaed	Member/ Non-Independent Non-Executive Director	6/7****
Salaam Said Salim Al-Shaksy	Member/ Non Independent Non-Executive Director	4/7****

* Reflects the number of meetings held during the time the directors held office.

** Dato’ Mohd Bakke Salleh resigned as Chairman of BFRC on 27 August 2008.

*** Zahari @ Mohd Zin Idris was appointed as Chairman of BFRC on 27 August 2008.

**** Fadhel Abdulbaqi Abu Al-Hasan Al-Qaed and Salaam Said Salim Al-Shaksy resigned as members of BFRC on 27 August 2008 and subsequently Datuk Ismee Ismail was appointed as member of BFRC on the same date.

2.3.1 Primary Duties and Responsibilities of the Committee

The following are the primary duties and responsibilities of the Committee:

- To deliberate, review and if necessary exercise the right to overrule FCA’s or UIC’s approvals/decisions on all financing/credit or investment related proposals including its proposed terms and conditions or any variations thereof.
- In the discharge of the above duties, the Committee shall exercise credit prudence in approving or deciding on the investment or financing proposals in line with the directives and guiding principles as approved by the Management, Board and all other relevant authorities.



2.4 Board Risk Committee (“Committee or BRC”)

The BRC is established to assist the Board in discharging its functions by having a focused forum that deliberates on risk management issues to ensure effective management of risks and enforcement of risk tolerance within Bank Islam. In addition, the Committee is responsible to review and assess the adequacy of the existing risk management framework in addressing the various risk factors by Bank Islam.

Members of the Committee are:

Name of Member	Designation	Attendance at Meetings*
Zaiton Mohd Hassan	Chairman/ Independent Non-Executive Director	8/8
Zahari @ Mohd Zin Idris	Member/ Independent Non-Executive Director	8/8
Fadhel Abdulbaqi Abu Al-Hasan Al-Qaed	Member/Non-Independent Non-Executive Director	7/8
Salaam Said Salim Al-Shakysy	Member/Non-Independent Non-Executive Director	5/8

* Reflects the number of meetings held during the time the directors held office.

2.4.1 Primary Duties and Responsibilities of the Committee

The following are the primary duties and responsibilities of the Committee:

(a) Strategy / Policy

- (i) Reviewing and recommending risk management strategy and policies for Board’s approval.
- (ii) Reviewing and proposing the setting of the risk appetite/tolerance of Bank Islam at enterprise and strategic business unit levels.
- (iii) Reviewing new products and services to be submitted for Board’s approval and highlighting the risk aspects to the Board.

(b) Organisation / Structure

- (i) Overseeing the overall management of all risks covering market, credit and operational.
- (ii) Ensuring that there are clear and independent reporting lines and responsibilities for the overall business activities and risk management functions.
- (iii) Inculcating risk management culture within Bank Islam.
- (iv) Instituting independent review of Bank Islam’s risk management infrastructure, capabilities, environment and processes.



2.4.1 Primary Duties and Responsibilities of the Committee (continued)**(c) Measurement / Tools**

- (i) Approving risk methodologies for measuring and managing risks arising from Bank Islam's business and operational activities.
- (ii) Endorsing the engagement of external and independent reviewers for the validation of risk measurement methodologies and outputs.
- (iii) Reviewing the allocation of risk-adjusted capital and broad-based limits across Bank Islam covering market, credit and operational risk.

(d) System / Processes

- (i) Reviewing the risk management processes, systems and internal controls throughout Bank Islam.
- (ii) Reviewing on periodic basis, risk exposures of Bank Islam in line with the risk management strategy.
- (iii) Reviewing the adequacy of tools, systems and resources for the successful execution of risk functions within Bank Islam.
- (iv) Reviewing contingency plans for dealing with various extreme internal/external events and disasters.

2.5 Audit and Examination Committee ("Committee or AEC")

The Committee comprises of three (3) non-executive directors, the majority of whom are independent non-executive directors. The Chairman is an independent non-executive director.

Members of the Committee are:

Name of Member	Designation	Attendance at Meetings*
Zahari @ Mohd Zin Idris	Chairman/ Independent Non-Executive Director	9/9
Zaiton Mohd Hassan	Member/Independent Non-Executive Director	9/9
Hashim Abdulla Ahmad Al-Dabal (or his alternate - Marwan Hassan Ali Al-Khatib)	Member/Non-Independent Non-Executive Director	6/9

* Reflects the number of meetings held during the time the directors held office.



2.5.1 Primary Duties and Responsibilities of the Committee

The duties and responsibilities of the AEC amongst others are to:

- (a) Ensure fair and transparent reporting and prompt publication of financial accounts.
- (b) Oversee the effectiveness of the internal audit function and ensure compliance with BNM/GP10 requirements such as:
 - (i) Review of the scope of audit plan, audit programme and processes.
 - (ii) Ensure adequate and technically competent resources for effective discharge of responsibilities.
 - (iii) Review the effectiveness of infrastructure for ensuring Shariah compliance.
 - (iv) To ensure appropriate actions have been taken by the Management on the recommendations made by the internal auditors.
 - (v) To appoint, evaluate the performance and decide on the transfer or dismissal of the Chief Internal Auditor.
 - (vi) To determine the remuneration package of the internal auditors.
- (c) Ensure that the internal audit function is well placed to undertake investigations on behalf of the AEC.
- (d) Review the effectiveness of internal controls and risk management processes.
- (e) External Auditors
 - (i) Recommend to the board for the external auditors' appointment and audit fee payable including any decision on removal.
 - (ii) Review the external auditors' management letter and the management's response on weaknesses of internal accounting procedures and controls.
 - (iii) Assess objectivity, performance and independence of external auditors.
 - (iv) Approve provision of non-audit services by external auditors and ensure adequacy of proper checks and balances such that the provision of non-audit services does not interfere with the external auditors' exercise of independent judgement.
 - (v) The Committee shall meet with the external auditors without the presence of the Management, at least annually. The Committee shall review any significant transactions that are not within the normal course of business and where potential conflict of interest may arise between related parties.

2.5.2 Authority

The Committee has the explicit authority to investigate any matter within its terms of reference. To enable it to discharge its function properly, the Committee has full access to and co-operation from the management and full discretion to invite any director or officer to attend its meetings. The Committee has full and unrestricted access to information and the authority to obtain independent professional advice.



3.0 Shariah Supervisory Council (“Council or SSC”)

As an Islamic bank, a Shariah governance framework is put in place as a distinct feature in the organisational structure of the Bank, which includes establishment of the Council in line with the requirement of Section 3 (5)(b) of Islamic Banking Act 1983. The Council serves to advise the Board and Management in ensuring that the Bank’s operations are in line with Shariah requirements. Structurally, the Council reports to the Board, but functionally, it is independent of the Board and Management of the Bank.

3.1 Composition of the Council

Members of the Council are scholars who have qualification and necessary knowledge, expertise and experience in the areas of Islamic jurisprudence (*usul al-fiqh*) and Islamic commercial laws (*fiqh al-mu’amalat*). Currently, the Council members are:

Name of Member	Designation	Attendance at Meetings*
Ustaz Mohd Bakir Hj Mansor	Chairman	6/6
Dr. Abdullah Hj Ibrahim	Member	1/6**
Dr. Ahmad Shahbari @ Sobri Salamon	Member	6/6
YAA Dato’ Daud Muhammad	Member	6/6
Associate Professor Dr. Yusof Ramli	Member	6/6
Dr. Asmak Ab. Rahman	Member	5/6

* Reflects the number of meetings held during the time the members held office.

** Dr. Abdullah Hj Ibrahim was unfit to attend the Council meetings due to his poor health condition.

3.2 Primary Duties and Responsibilities of the Council

The duties and responsibilities of the Council are principally based on the BNM Guidelines on the Governance of Shariah Committee for Islamic Financial Institutions (BNM/GPS1). The duties and responsibilities of the Council are:

- (a) Advising the Board and Management on Shariah related matters.
- (b) Reviewing and endorsing Shariah related policies and guidelines.
- (c) Endorsing and validating relevant documentations in the proposal of new products and services including contracts, agreements or other legal documentations used in executing banking transactions.
- (d) Endorsing and validating product guidelines, marketing advertisements, sales illustrations and brochures related to the Bank’s products, services and activities.
- (e) Advising the Bank on the computation and distribution of Zakat.
- (f) Assisting and advising related parties such as the Bank’s legal counsels, auditors and consultants on Shariah matters upon request.
- (g) Advising the Bank in consultation with the Shariah Advisory Council of Bank Negara Malaysia (“SAC”) on any Shariah matters which have not been resolved or endorsed by the SAC.
- (h) Recording any opinion given on Shariah related issues. In particular, the Council shall prepare written Shariah opinions in the following circumstances:
 - (i) Where the Bank makes references to the SAC for advice; or
 - (ii) Where the Bank submits applications to BNM for new product approval in accordance with guidelines on product approval issued by BNM.



3.2 Primary Duties and Responsibilities of the Council (continued)

- (i) Assisting the SAC on reference for advice. In such event, the SSC must explain the Shariah issues involved and recommend decision supported by relevant Shariah jurisprudential literature from relevant and established sources.
- (j) Monitoring that all SAC's decisions are properly implemented by the Bank.

In addition to the above, the Head of Shariah Department is empowered by the Council to execute its duties and responsibilities to endorse and validate product guidelines, marketing advertisements, sales illustrations and brochures used to describe particular products subject to precedents of Council decisions. However, in the event that there is no precedents of the Council decisions, the marketing advertisements and product illustrations shall be tabled to the Council for approval.

3.3 Responsibilities of the Bank Towards the Council and Shariah Compliance

It is the responsibilities of the Bank to perform the following with regard to the Council and Shariah compliance:

- (a) To comply with all the Council decisions and established Shariah requirements in its entire products, services, legal documentations and activities.
- (b) The Bank shall not change its allegiance and obedience to the Council decisions to suit its convenience. Such a practice could impair the independence of the Council members and have a damaging impact on the integrity and credibility of the Bank, in particular, and on the Islamic banking industry as a whole.
- (c) While the Council is responsible for forming and expressing decisions on the extent of the Bank's compliance with the Shariah, the responsibility for compliance therewith rests with the Management of the Bank.
- (d) To provide to the Council access to all relevant records, transactions, manuals and relevant information, as required by its members in performing their duties.

4.0 Risk Management Structure**4.1 Structural Management of Risk**

The responsibilities of the Board include establishing of policies on the management of all risk categories. The Board is also accountable for ensuring effective management of internal control mechanisms. Assisting the Board in discharging these roles are the two (2) board committees, i.e. BRC and AEC.

In addition, Bank Islam has also established a main risk committee at the management level known as the Management Risk Control Committee ("MRCC"). In addition, four sub-committees of the MRCC were established as follows:

- (a) Asset and Liability Management Committee ("ALCO").
- (b) Operational Risk Control Committee ("ORCC").
- (c) Credit Risk Control Committee ("CRCC").
- (d) Recovery Management Committee ("RMC").

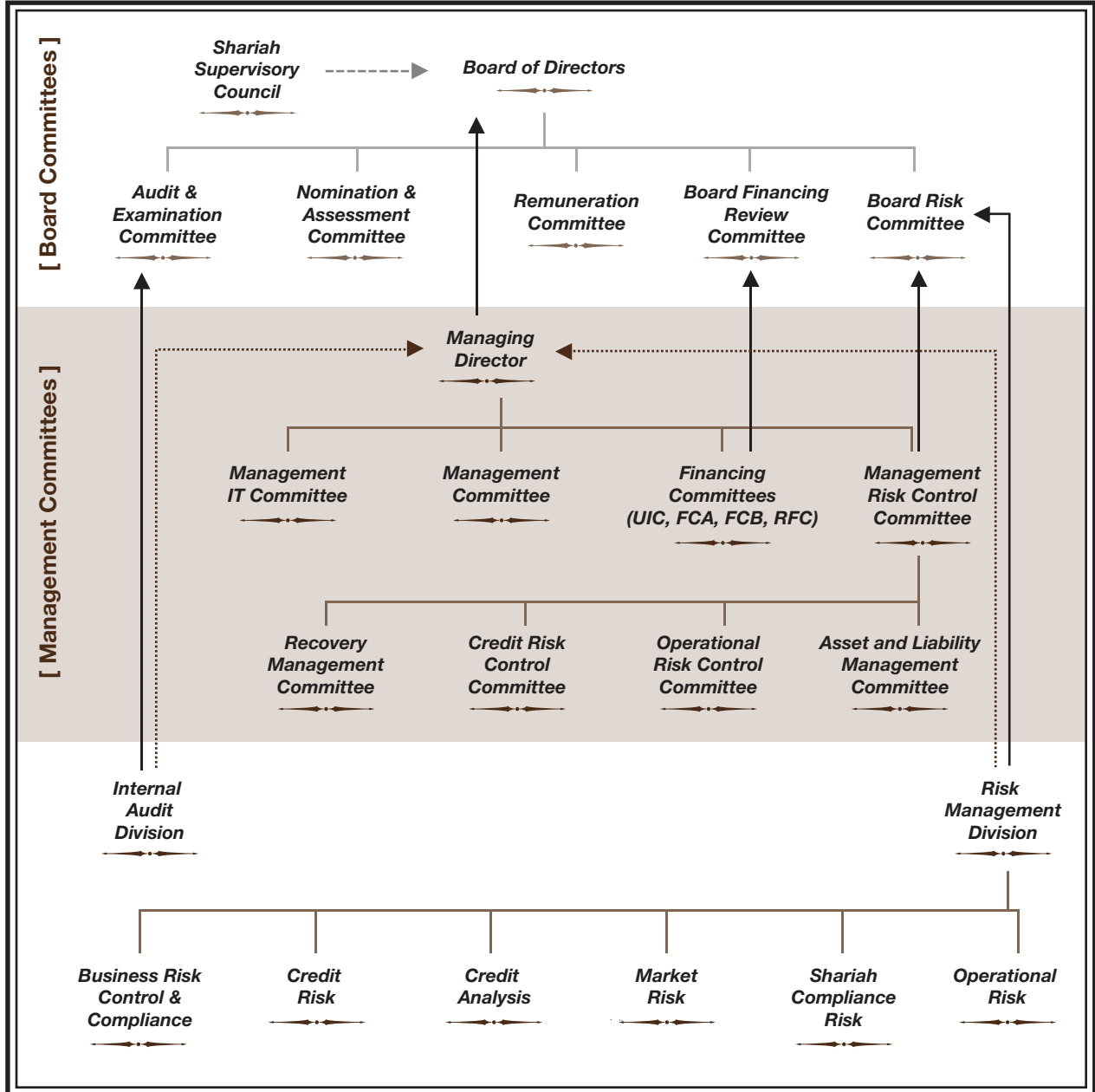
The main responsibilities of the MRCC are to ensure proper implementation of policies approved by the Board and effective management of operational issues.

Financing and credit decisions are made at four (4) different layers of credit authorities according to their respective approval limits as determined by the Board – the regional, middle management, upper management and Board levels with the establishment of Regional Financing Committee ("RFC"), Financing Committee 'B' ("FCB"), FCA, UIC and BFRC. The above is illustrated as follows:

Bank Islam Malaysia Berhad and Its Subsidiaries

(Company No. 98127-X) (Incorporated in Malaysia) | Annual Report 2008

4.1 Structural Management of Risk (continued)



4.2 Holistic Management of Risk

Bank Islam has formulated a Risk Management Framework (“RMF”) aimed to set the tone for the philosophical and practical approaches in managing risks holistically in the Bank. It also acts as a foundation for the management of risk to be conducted in the most effective manner in line with the industry’s best practices. The framework methodology is based on the concept of solah which is the most important constituent of the Muslim’s faith and one of the essential elements of Islam, as depicted in the following diagram:

SOLAH – THE PILLAR OF ISLAM	PHILOSOPHY OF SOLAH IN LIFE	BANK ISLAM’ S RMF
<p>NIYYAH</p> <p>Pronouncement/ Statement of Solah</p>	<p>MISSION STATEMENT</p>	<p>MISSION & OBJECTIVES</p>
<p>JAMA’AH</p> <p>Implementation Structure of Solah</p>	<p>STRUCTURE</p>	<p>FUNCTIONAL STRUCTURE</p>
<p>SYARAT</p> <p>Necessary Elements of Solah</p>	<p>RULE OF LAW</p>	<p>POLICIES & GUIDELINES</p>
<p>RUKUN</p> <p>Essential Activities of Solah</p>	<p>PROCEDURE</p>	<p>PROCESSES</p>
<p>QAEDAH</p> <p>Facilities Required for Solah</p>	<p>TOOLS</p>	<p>ENABLERS</p>

The basis of solah is built upon five important elements, namely Niyah, Jama’ah, Syarat, Rukun and Qaedah. In this regard, the framework is developed by focusing on five (5) basic and core areas of managing risks, i.e., Mission and Objectives, Functional Structure, Policies and Guidelines, Processes, and Enablers. All these five (5) elements are adopted in managing the key risk areas of Bank Islam namely, credit, market, strategic, Shariah compliance, liquidity and operational which are briefly described as follows:

4.2.1 Credit Risk

Credit risk is risk arising from loss of revenue, principal and capital as a result of defaults in the inability to meet the terms of a contract by the customers or counter parties through financing, dealing and investment activities.

The primary exposure to credit risk arises from financing activities. The credit policy and the related guidelines governing the Bank’s credit activities have been established and continuously enhanced with the objective of continuously improving the quality of assets as Bank Islam recognises the need for proper credit risk management which encompasses identification, measurement, controlling and monitoring of credit risk to ensure that Bank Islam is adequately compensated for taking such measured risk and managing it in a portfolio as well as on an individual basis.

For the purpose of determining the capital requirements under the credit risk standardised approach, the Bank applies the ratings assigned by the approved External Credit Assessment Institutions (“ECAIs”) which include the Rating Agency Malaysia (“RAM”), Malaysian Rating Agency Corporation (“MARC”), Standard and Poor’s Rating Services (“S&P”), Moody’s Investor Service and Fitch Rating.



4.2.1 Credit Risk (continued)

As at June 2008, financing exposures were mostly unrated while banking book fixed income portfolio comprised mainly rated sovereign, AAA and AA papers, accounting for 95% of total portfolio.

The management of credit risk is aimed to achieve a high quality credit portfolio in line with Bank Islam's risk appetite and strategy as well as balancing the risk reward undertaken by Bank Islam to optimise the stakeholders' value. Credit risk processes and practices have been established to enable Bank Islam to manage credit risks in a manner that complies with all required principles, practices and prudence, including Shariah requirement. To deliberate specifically credit risk related matters, Bank Islam has established CRCC, a sub-committee to MRCC.

In order to improve individual credit, Risk Management Division ("RMD") is involved in conducting independent pre-approval credit analysis and credit assessment on all corporate and commercial accounts. RMD also conducts post mortem review on all new financing that turned delinquent or non-performing and report its observations to CRCC.

Going forward, the Bank is planning to adopt the Internal Ratings Based Approach under Basel II, and in preparation, the Bank has engaged Messrs Oliver Wyman to assist in enhancing our internal rating models.

4.2.2 Market Risk

Market Risk is the risk of loss arising from the adverse movement in the level of market prices or rates. Market risk components are foreign exchange risk, rate of return risk, displaced commercial risk, equity investment risk and commodity risk.

(a) Foreign Exchange Risk

This risk refers to the impact of adverse exchange rate movements on foreign currency positions taken by Bank Islam. Foreign currency open positions are marked-to-market on a regular basis and are monitored against pre-determined position limits and cut-loss limits.

(b) Rate of Return Risk

Rate of return risk refers to the potential impact on Bank Islam's net income margin or economic value of equity caused by unexpected changes in rate of returns. Rate of return risk arises when there are structural mismatches or gaps between the Bank's rate sensitive assets and liabilities.

Bank Islam's policy is to measure and manage its rate sensitive positions to ensure that Bank Islam's profits are optimised and its long run earning power sustained. Bank Islam will continuously assess the sensitivity of its assets and liabilities portfolio to market and price volatility using appropriate measurement tools and techniques.

(c) Displaced Commercial Risk

Displaced commercial risk refers to the risk that Bank Islam is not able to pay its mudharabah depositors/investors a rate of return which is competitive vis-à-vis the market. Bank Islam addresses its displaced commercial risk by ensuring that the investments or use of the mudharabah funds are managed with the objectives of maximising and sustaining returns. Sustainability of returns is addressed by setting up a prudential reserve account known as Profit Equalisation Reserve which comprises amounts appropriated out of the gross income from mudharabah.



4.2.2 Market Risk (continued)

(d) Equity Investment Risk

Equity investment risk refers to the impact of adverse movements in the price of equities (“shares”) on equity positions. Equity open positions are marked-to-market against prevailing market prices on a regular basis to reflect changes in market value due to changing market conditions.

Such risk also applies to risks inherent when Bank Islam assumes an equity stake as part of a mudharabah or musyarakah investment/financing arrangement where Bank Islam shares in the profit and loss of the investment/financing.

In addition, equity risk arises when Bank Islam enters into an operating ijarah or a non-binding murabahah purchase order contract where Bank Islam at any point during the life of the investment/financing, owns the asset. This type of equity risk is sometimes termed as inventory risk.

(e) Commodity Risk

Commodity risk refers to the risk of loss arising from movements in commodity prices. The commodity portfolio will be revalued on a regular basis to capture the changes in market value due to changing economic conditions. Market risk associated with holding commodity positions are managed by pre-determined transaction and other risk limits.

Risks arising from dealing and investment activities are managed by the establishment of limits that include trading limits, counter party limits as well as product and sub-product limits.

4.2.3 Shariah Compliance Risk

Shariah Compliance Risk (“SCR”) is one of the unique risks for Islamic banks in addition to rate of return risk, displaced commercial risk and equity investment risk. This means that Shariah compliance considerations are taken into account in all Islamic banks’ activities. Essentially, the Islamic banks are required to comply with Shariah requirements prescribed in the Quran and Sunnah as well as *fatwa*/decision of Shariah scholars resulting from their exercise of *ijtihad*. From Bank Islam’s perspective, SCR refers to risks arising from Bank Islam’s failure to comply with Shariah rules and principles determined by the Shariah regulatory councils i.e. SAC of BNM, SAC of Securities Commission and SSC of Bank Islam.

In managing SCR, consistent with Bank Islam’s aims and goals to expand to new markets and services in line with Shariah requirements, clear responsibilities are assigned to various functions, which are responsible for developing strategies to identify, assess, monitor and control/mitigate SCR, codifying bank-level policies, procedures and controls concerning SCR Management (“SCRM”) and designing and implementing the SCRM methodology and reporting system in the Bank. These include Board of Directors (including BRC), SSC, MRCC, Shariah Compliance Risk Working Group (“SCRWG”), Shariah Department (“SD”), Shariah audit function of Internal Audit Division (“IAD”) as well as line managers and all staff of Bank Islam. The above is guided by a SCRM Policy and the policy is supplemented by several Shariah contract guidelines and Shariah Compliance Manual.



4.2.3 Shariah Compliance Risk (continued)

As part of Bank Islam's efforts to improve the oversight on the SCRМ at the Board level, the Bank has implemented "cross attendance" in the BRC and SSC meetings whereby two of the SSC members to attend the BRC meeting and vice versa. At management level, Bank Islam has established the SCRWG, which deliberates all Shariah non-compliances tracked by the SD and its rectification plans and recommends acceptable standards of internal control and appropriate mechanism(s) to ensure effective and efficient SCRМ across the Bank.

In order to streamline its Shariah governance, the Shariah Department was merged with Shariah Compliance Risk Management Department with effect from 28 April 2008. The merged department is responsible to support the SSC in providing day-to-day Shariah advice to the business and support units based on the decisions of the Shariah regulatory councils, as well as to work independently of the business and support units in facilitating the process of identifying, measuring, controlling and monitoring SCRs inherent in the Bank's operations and activities. The department also participates in conducting Shariah assessment, audit and other activities together with other relevant business and risk management units, financing committees and IAD.

4.2.4 Liquidity Risk

Liquidity risk refers to the potential inability of Bank Islam to meet its funding requirements arising from cash flow mismatches at a reasonable cost. In managing this, Bank Islam adopts the liquidity framework introduced by BNM that ascertains liquidity based on the contractual and behavioural assumptions of cash flows derived from Bank Islam's assets, liabilities and off balance sheet commitments. In addition, Bank Islam has instituted internal controls and limits to complement the regulatory framework in managing liquidity risk in the Bank.

4.2.5 Operational Risk

This risk is defined as the risk of loss arising from inadequate or failure of internal processes, people, systems and external events. In managing operational risk, a dedicated team has been established within the RMD to enhance awareness and facilitate the identification, assessment and measurement, to recommend mitigation and control measures, and provide a platform for monitoring and reporting of operational risk issues.

As part of Bank Islam's effort to improve its operational risk management, risk assessment using Management Awareness Self Assessment ("MASA") was introduced in mid 2005. The main objective is to create a risk awareness culture throughout Bank Islam at all levels. This would enable and facilitate line managers to identify, assess, manage and report on a quarterly basis to RMD, operational risks inherent in their day to day activities.

In addition, Bank Islam has formed an Operational Risk Working Group Committee ("ORWG"), which focuses on deliberating all operational issues, in particular those submitted through the MASA and to propose appropriate remedial actions. Besides ORWG, Bank Islam has established ORCC, sub-committee of MRCC, to deliberate operational risk matters such as operational risk loss events in order to ensure controls are adequate and effective.

To keep the Board updated on the overall risk level of the Bank, RMD has introduced the Key Risk Indicators ("KRIs") comprising of 44 parameters grouped by the CAMEL components. These KRIs are tabled to MRCC and BRC on regular basis.



5.0 Internal Audit Function

Bank Islam's IAD undertakes the audit of entities within Bank Islam and subsidiaries of the Bank based on an annual Audit Plan approved by the AEC. The Audit Plan that adopts a risk-based approach to audit, covers the review of adequacy of risk management and operational controls, compliance with laws and regulations, quality of assets and management efficacy. Internal audit highlights control and process weaknesses and makes appropriate recommendations for improvement to Management.

Its authority is provided in the Audit Charter, which formally documents the roles, duties and responsibilities of IAD and relationship with the Board, AEC, Management, external auditors and regulators.

IAD is committed to enhancing its audit processes such as adopting the risk-based audit techniques, upgrading staff competencies and benchmarking itself to industry best practices in internal auditing. Overall, IAD has served Bank Islam in maintaining a sound internal control environment and promoting a compliant culture within the Bank and its subsidiaries.

6.0 Accountability and Audit

6.1 Financial Reporting

The Board takes responsibility for presenting a balanced and comprehensive assessment of Bank Islam's operations and prospects each time it releases its quarterly and annual financial statements to its shareholders. The Board ensures financial statements are properly drawn up in accordance with the provision of the Companies Act 1965, approved accounting standards in Malaysia, BNM Guidelines and Shariah requirements. The Board is assisted by the AEC in scrutinising information to be disclosed to ensure accuracy, adequacy, completeness and transparency.

6.2 Statement on Internal Control

The Board recognises the importance of maintaining a sound system of internal controls and risk management practices as well as good corporate governance. The Board exercises overall responsibility in identifying, evaluating and reviewing the adequacy and integrity of Bank Islam's internal controls and its effectiveness. The Board recognises that risks cannot be eliminated completely. As such, systems and processes have been put in place to provide reasonable assurance and not absolute assurance of effectiveness against material misstatement of management and financial information or against any losses and fraud.

The Board is of the view that the internal control framework that has been instituted throughout Bank Islam is sufficient to safeguard shareholders' investment, customers' interest and Bank Islam's assets. Nevertheless, reviews are continuously carried out to ensure the effectiveness of the system.

BRC was established to further strengthen Bank Islam's risk management process, where it meets regularly with the objective of assisting the Board in managing Bank Islam's range of inter-related risks in an integrated manner.

The key processes that the Board has established in reviewing the integrity of the system of internal controls are as follows:



6.2 Statement on Internal Control (continued)

- (a) The management of Bank Islam is delegated to the Managing Director, whose role and responsibilities, and authority limits are set by the Board. The appointment of the Managing Director requires the approval of the Board.
- (b) Specific responsibilities have been delegated to the relevant Board Committees, based on their respective terms of reference. These Committees have the authority to examine all matters within their scope of responsibility and submit their recommendations to the Board. The ultimate responsibility for the final decision on all matters, however, lies with the entire Board.
- (c) Delegation of authority, including limits at various levels of management and those requiring the Board's approval, are documented and designed to ensure accountability and responsibility.
- (d) Policies and procedure manuals for key processes are documented and regularly reviewed and updated for application across Bank Islam.
- (e) The Board regularly reviews reports on the adequacy and integrity of Bank Islam's internal control systems and management information system including systems for compliance with applicable laws, regulations, rules, directives and guidelines.
- (f) Bank Islam's annual business plan and budget are submitted to the Board for approval. In addition, variances between actual and targeted results are also presented on a monthly basis. This allow for timely responses and corrective actions to be taken to mitigate risks.
- (g) IAD reports to the AEC, performs regular reviews of the processes to assess their effectiveness and highlight any significant risks affecting Bank Islam. The AEC reviews the IAD's scope of work and resources annually via the Audit Plan and budget submitted.
- (h) The AEC regularly reviews and holds discussions with Management on actions taken to address lapses in internal controls and issues identified in reports prepared by the internal auditors, external auditors and regulatory authorities.
- (i) The BRC regularly reviews risk profiles based on a range of key risk indicators, as well as other risk assessment tools.

6.3 Relationship with External Auditors

Bank Islam through the AEC has established an appropriate and transparent relationship with the external auditors, where they meet at least once a year when the annual audited accounts and reports are presented to the Board for approval.