UNDERSTANDING OF ISLAMIC BANK’s BALANCE SHEET

Presentation to Dr. Ruqaia, Member of Iraq House of Representative
15 March 2012
A SNAPSHOT

✓ Malaysia’s **Pioneer Islamic Bank** – 1983

✓ 3rd Largest Islamic Bank in Malaysia
  ➢ Total Assets of about RM32 billion

✓ Total customer base of more than 3.5 mil.

✓ **Best Islamic Bank** in Malaysia 2011 – IFN Award

✓ Rated A1/P1 with stable outlook by Rating Agency Malaysia

✓ Rated 4th Strongest Bank in Malaysia by The Asian Banker (Part of Financial Times Group)

✓ Ranked 53 – Asia Pacific 500 Strongest Bank by The Asian Banker
“BUILDING STRENGTHS TO STRENGTHS”
MARKET SHARE AS AT DEC 2011

Total Assets

<table>
<thead>
<tr>
<th>Bank</th>
<th>Market Share</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maybank Islamic</td>
<td>22.5%</td>
<td>RM75.5b</td>
</tr>
<tr>
<td>CIMB ISLAMIC</td>
<td>14.3%</td>
<td>RM47.9b</td>
</tr>
<tr>
<td>BANK ISLAM</td>
<td>9.6%</td>
<td>RM32.2b</td>
</tr>
<tr>
<td>Public Islamic Bank</td>
<td>8.8%</td>
<td>RM29.4b</td>
</tr>
<tr>
<td>AmIslamic Bank</td>
<td>6.7%</td>
<td>RM22.4b</td>
</tr>
</tbody>
</table>

Islamic Banking Assets – RM334.9 billion
MARKET SHARE AS AT DEC 2011

Net Financing

25.4% 14.7% 9.6% 7.6% 7.0%

RM50.9b RM29.5b RM19.2b RM15.3b RM14.1b

Islamic Banking Net Financing – RM200.3 billion
MARKET SHARE AS AT DEC 2011

Deposits

22.1%  11.8%  10.6%  7.5%  6.4%

RM59.1  RM31.6b  RM28.3b  RM20.0b  RM17.0b

Islamic Banking Deposits – RM267.0 billion
MARKET SHARE AS AT DEC 2011

CASA Deposits

25.0% 18.4% 11.1% 10.0% 5.2%

RM16.7b RM12.3b RM7.4b RM6.7b RM3.5b

Islamic Banking CASA Deposits – RM66.7billion
Profit before Zakat and Tax for 12 months to Dec 2010 = RM 344.5 m

* 18 months Financial Period Ended Dec 2010
...Accounting is like ‘the language of businesses’ or ‘a doctor’s health prescription’ of a business entity
Ensures compliance with Shariah rules & principles

Liabilities

- To safeguard interest of Investment Account Holders (IAH) – profit sharing contracts
  - IBI’s fiduciary responsibilities in protecting depositors (profit sharing investment account)
  - Sound investment & financing strategies – to align with IAH risk & return expectations
  - Proper disclosure & transparency

Assets

- To manage risks associated with Mudharabah (profit-sharing) & Musharakah (partnership) contracts: equity-based transactions
  - Board to ensure IBIs have sufficient expertise & capability
  - Allow appointment of Board representatives on entities involved in such transactions as monitoring mechanism
  - Establishment of dedicated oversight function e.g. in-house property development/research department for property investment & development activities

Strict compliance with corporate & Shariah governance promotes financial stability...

Source: BNM
The accountancy profession in Malaysia is regulated by the Malaysian Institute of Accountants (MIA) through the powers conferred by the Accountants Act, 1967.

The MIA is an agency under the Ministry of Finance and reports directly to the Accountant General Office.

MIA sets the By-Laws (On Professional Conduct & Ethic) and auditing standards for the accountancy profession in Malaysia, which are in line with the standards issued by the International Federation of Accountants (IFAC) and the International Auditing and Assurance Standards Board (IAASB).

Accounting standards are issued by the Malaysian Accounting Standards Board (MASB) by virtue of the power conferred by the Financial Reporting Act, 1997.

The MASB had announced the effort to bring Malaysia to be in full convergence with the International Financial Reporting Standards (IFRS) by 2012.
The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and the industry.

The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings.

The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders.
The Central Bank of Malaysia had issued a Guidelines on Financial Reporting for Licensed Islamic Banks (GP8-i) is to provide the basis for presentation and disclosure of reports and financial statements of Islamic banks in carrying out its banking and finance activities.

This is to ensure consistency and comparability of these statements among the Islamic banks in complying with the provisions of the Companies Act 1965, applicable approved accounting standards and Shariah requirements, and to facilitate users in their evaluation and assessment of the financial position and performance of an Islamic bank.

With respect to accounting, some standard-setters such as the Malaysian Accounting Standard Board (MASB) have concluded that it would not be in conflict with Shari’ah to apply conventional accounting standards, namely the International Financial Reporting Standards (IFRSs), to Islamic financial transactions.

Conversely, others such as the AAOIFI believe that not all IFRS principles can be applied, and have formulated alternative accounting standards for certain transaction

– Chapter 18, Islamic Financial System by ISRA
DEFINITION OF A BANK – MALAYSIA’s PERSPECTIVE

- Governed by Banking and Financial Institutions Act 1989 (BAFIA)

- Banking business means:
  
  (a) The business of;
      
      (i) Receiving deposits on current account, deposit account, savings account or other similar account;
      
      (ii) Paying and collecting cheques drawn by or paid in by customers; and,
      
      (iii) Provision of finance; or
      
  (b) Such other business as the bank (BNM), with the approval of the Minister may prescribe
Section 2, IBA 1983:

“Islamic banking business” means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam.
ISLAMIC BANKING ACTIVITIES

- **Islamic bank main activities:**
  - structure of mobilising and investing capital;
  - profit sharing institution that invests investment account holders money in Shari’ah based financing activities;
  - investment account holders and their unique position in Islamic financial institutions;
  - principles and practical operations of current accounts and savings accounts (mudaraba, wakala and wadiah);
  - financing through leasing ( ijarah), sale based contracts (murabaha, istisna’a, salam) or profit sharing modes (musharaka/mudaraba);
  - mechanism of profit and loss sharing with investment account holders
BASIC PRINCIPLES OF ISLAMIC FINANCE

- **Prohibition of interest (riba’).** Prohibition of riba – a term literally “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales”.

- **Money as “potential” capital.** Money is not a commodity, but a medium of exchange, a store value and a unit of measurement. Money represents purchasing power and cannot be utilised to increase the purchasing power without any productive activity. Islamic finance advocates the creation of wealth through trade and commerce.

- **Risk sharing.** Because interest is prohibited, suppliers of funds become investors, rather than creditors.

- **Prohibition of speculative behaviour.** Islamic finance discourages hoarding and prohibits transactions featuring extreme uncertainties (gharar), and gambling (maysir).

- **Sanctity of contracts.** Islamic finance upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

- **Shari’ah approved activities.** Only those business activities that do not violate the rules of the Shari’ah qualify for investment. For example, any investment in a business dealing with alcohol or gambling is prohibited.

- **Social justice.** Any transaction leading to injustice and exploitation is prohibited.  

*Source: IFGFS*
KEY THRUST OF ISLAMIC FINANCIAL TRANSACTIONS

- Islamic banking to have high degree of transparency and disclosure in preserving the rights and responsibilities of the parties to a contract.

- Islamic financial institutions to undertake the appropriate due diligence on the viability of business proposals and to meet the requirement for transparency and disclosure. Market conduct disclosure and customer relationship management form the core of these principles. Addressing the information asymmetry between Islamic banking institutions and the depositors/investors is of vital importance.

- Disclosure of the true and fair value of the Islamic banking operations in the financial statements is also essential for depositors to undertake an informed assessment of the bank’s performance. Please refer to Bank Islam’s Annual Report.

- Non-commingling of funds is essential and should be enshrined and expressly stated in the statutes.

- The role of the Shariah Board in ensuring that all aspects of the business operations of Islamic financial institutions are in accordance with the Shariah principles, adds another level of oversight which inherently safeguards against irresponsible practices.

- These inbuilt dimensions of governance and risk management contribute to safeguarding Islamic finance from the potential risks of financial stress arising from excessive leverage or speculative activities.

Source: IFGFS
SHARIAH CONTRACT DEVELOPMENT MILESTONES

1983 - 1990
- Wadiah Current a/c
- Wadiah Savings a/c
- Mudharabah Investment a/c
- Mudharabah Financing
- Ijarah Financing
- BBA Financing
- Murabahah LC
- Musharakah LC
- Wakalah LC
- Bai’ Dayn Trade Finance
- Murabahah Working Capital Financing

1991 - 2000
- Sarf Forex
- Mudharabah Interbank Investment
- Musharakah Financing
- Bai Inah Credit Card
- Ar Rahn

2001 - 2005
- Bai Dayn, Musharakah, Mudharabah ICDO
- Wadiah Debit Card
- Bai Inah Overdraft
- Bai Inah Commercial Credit Card
- Bai Inah Personal Financing
- Bai Inah Negotiable Instrument of Deposit (NID)

2006 - 2008
- Commodity Murabahah Profit Rate Swap
- Commodity Murabahah Forward Rate Agreement
- Ijarah Rental Swaps-I
- BBA Floating Rate
- Murabahah Floating Rate
- Istisna’ Floating Rate
- Mudharabah Capital Protected Structured Investment
- Bai Inah Floating Rate NID
- Mudharahah Savings Multiplier Deposit
- Tawarruq
- Commodity Undertaking

2009 Onwards
- Tawarruq Business Financing
- Tawarruq Personal Financing
- Murabahah with Novation Agreement
- Istisna’ convertible to Ijarah
- Bai and Ijarah (Sale & Lease Back)
- Musharakah Mutanaqisah
- Istisna’ with Parallel Istisna’
- Wakalah Deposit
- Waqf
- Tawarruq Revolving Credit-I
- etc

Note – This listing is far from being exhaustive. Although they have been developed and/or approved, some products have yet to be rolled out at the time of publication of this document.
Various features have been identified in classifying contracts as follows:

- **Price**
  - Cost Price (Tawliya)/ Mark up price with disclosure (Murabaha)
  - Negotiated price (Musawamma)
  - Discounted Price (Wadhi’)

- **Payment**
  - Cash Payment
  - Deferred Payment (Muajjal)

- **Delivery**
  - Immediate delivery/Deferred delivery (Salam)
  - Piecemeal Delivery (Istisna’a)

These features also influence classification and reporting of types IFI Financing assets.
GENERIC BUSINESS MODEL

VALUE PROPOSITIONS

- Competitive Pricing
- Excellent Services (Turnaround Time, Hassle Free)
- Innovative Offerings

ASSETS
- (Fixed vs Float Rates)

LIABILITIES
- (Profit Sharing vs CASA)

REVENUE – COST = PROFIT
Profit levels are dependent on the ability to manage risks and price according to expected returns.

RISK SHARING
Risks associated with the use of funds to finance customers or to invest in marketable securities. Risk premium should be factored into the price.

CUSTOMERS & ASSETS
- (Debt based Financing vs Equity based Financing)

INVESTORS VS DEPOSITORS

SUPPORT FUNCTIONS
Product development and innovation will be key aspect in developing successful offerings.
Mega Islamic Banks (Paid Up Capital of US$1 bil)

17 Commercial Islamic Banks, 6 FB windows, 6 DFIs & 4 IIBs.
ISLAMIC FINANCE SYSTEM AS AT DEC 2010

**Assets**
- 20.8% of total banking system
- Total IB asset: RM351 bil (USD116.2 bil)

**Financing**
- Market share – 22.7%
- Total financing: RM222.3 bil (USD73.6 bil)

**Deposits**
- Market share – 22.6%
- Total deposit: RM277.5 bil (USD91.9 bil)

**Capital Market**
- 57% of the outstanding PDS
The GP8-i sets out the minimum disclosure requirements that should be observed by the reporting institutions. The reporting institutions are encouraged to disclose additional information on the accounting policies, new financial instruments and other material activities of the reporting institutions. This is to ensure that all the above activities are reported and well understood by readers of the financial statements.

The financial reports must be prepared in accordance with the provisions of the Companies Act 1965 and approved accounting standards issued by the Malaysian Accounting Standards Board. In addition, the listed reporting institutions are required to comply with the disclosure requirements of the Bursa Malaysia Securities Berhad.

To further enhance the disclosure and presentation of reports and financial statements, reporting institutions are required to disclose the overview of performance and corporate governance. As for the Board committees established, the disclosure on the activities of the committees and their assessment should be presented in the Statement of Corporate Governance of the reporting institution.
Islamic accounting has been described as the “accounting process” which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity, to ensure that the entity is continuously operating within the bounds of Islamic Shari’ah and delivering its socio-economic objectives.

The importance of accounting is stressed in the Qur’an, in Surah Al-Baqarah verse 282, which read:

“Oh you who believe! When you deal with each other in transaction involving future obligations in a fixed period of time, reduce them in writing. Let a scribe write down faithfully as between parties. Let not the scribe refuse to write: as God has taught him, so let him write. Let him who incurs the liability (debtor) dictate, but let him fear his Lord God, and not diminish aught of what he owes. If the party liable (debtor) is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully, and get two witnesses, out of your own men, and if they are not two men, then a man and two women, so that if one of them errs, the other can remind him....”

– Chapter 18, Islamic Financial System by ISRA
ISLAMIC ACCOUNTABILITY

- Transcendental accountability to Allah SWT (*Hablumminallah*)
- Social accountability to the society (*Hablumminan-nass*)
- Individuals as trustees or *khalifah*
- Success in this world and in the hereafter (*al-falah*)
- Economic goals beyond purely wealth but include *tazkiyah* (purification of self and wealth)

It is conceded that both Islamic and traditional accounting refer to the same process of providing information to the stakeholders or financial statement users. However, proponents expound the Islamic accounting aims to create greater transparency and accountability of the institution to abide by the principles of Shari’ah in dealings and assess whether the strategic intent of the institution are being met.
<table>
<thead>
<tr>
<th><strong>KEY DEFINITIONS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital</strong></td>
</tr>
<tr>
<td>Capital derives its value from real assets in lawful economic activities.</td>
</tr>
<tr>
<td>Equity capital - financial claims recognized based on profit &amp; loss sharing contracts for an expected return derived from exchange transactions involving real assets.</td>
</tr>
<tr>
<td><strong>Shareholders’ Equity</strong></td>
</tr>
<tr>
<td>It is the amount remaining at the date of the statement of financial position, from the Islamic bank’s assets after deducting the bank’s liabilities, equity of unrestricted investments and their equivalents.</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>“Capable of generating positive cash flows or other economic benefits in the future either by itself or in combination with other assets which the bank has acquired the right to hold (rightful ownership of maal), use of dispose (rights on manfaat) as a result of past transactions or events” (AAOIFI)</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
</tr>
<tr>
<td>A liability is a measurable present bank’s obligation to another party to transfer assets, extend the use of an asset, or provide services to that party in the future as a result of past transactions or events.</td>
</tr>
<tr>
<td>Islamic bank’s obligation must not be a reciprocal to an obligation of the other party to the bank.</td>
</tr>
</tbody>
</table>
**KEY TERMS – “COMPARABLE BUT NOT THE SAME”**

**Islamic Banking**
- Total Financing (Qard is the only loan)
- Profit Rate
- Fund-based Income
- Non Fund-based Income (Fee-based)
- Net Income Margin (NIM)
- Financing Loss Coverage
- Impaired Financing Ratio
- Financing-to-deposit ratio
- Profit Sharing Ratio
- Profit Sharing Investment Account (with risk absorbent capability)
- Profit Attributable to Depositors
- Zakat
- Profit After Tax & Zakat
- Sukuk

**Conventional Banking**
- Total Loans
- Interest Rate
- Interest Income
- Non Interest Income
- Net Interest Margin
- Loan Loss Coverage
- Impaired Loan Ratio
- Loans-to-deposit ratio
- Not Available
- Not Available
- Interest Expense
- Not Available
- Profit After Tax (without zakat)
- Bonds
ISLAMIC BANKING OPERATION IN A NUTSHELL

**Sources of funds**
- Non-mudharabah deposits
- Mudharabah deposits
- Shareholders’ Fund

**Application of funds**
- General Pool
- Specific account I
- Specific account II

**Profit**

**Distribution of profit**
- Depositors
- Bank
- Depositors
INCOME STATEMENT : GP8-i

- Finance income is recognized on an accrual basis. Income on cash line, house and term financing is accounted for on a straight-line basis by reference to the rest periods as stipulated in the financing agreement.

- Where an account is classified as non-performing, income is suspended until it is realized on a cash basis. Financing income recognized prior to the non BNM/RH/GL/002-2 JPIT Guidelines on Financial Reporting for Licensed Islamic Banks (Page 47/111) performing classification is not clawed-back to the first day of default in conformity with Bank Negara Malaysia guidelines.

- Customers’ accounts are classified as non-performing where repayments are in arrears for more than six months (or based on internal policy i.e. 3 months) from the first day of default for financing, cash line and advances; and three months from the first day of default for trade bills, bankers acceptances, trust receipts and other instruments of similar nature.

- Financing arrangement, management and participation fees, underwriting commissions and brokerage fees are recognized as income based on contractual arrangements.

- Guarantee fee is recognized as income upon issuance of the guarantee.

- Fees from advisory and corporate finance activities are recognized net of service taxes and discounts on completion of each stage of the assignment.

- Dividend income from subsidiary and associated companies and other investments are recognized when the Bank’s right to receive payment is established.
Zakat - This represents business zakat. It is an obligatory amount payable by the Bank to comply with the principles of Shari’ah. Zakat provision is calculated based on xx% of the net asset method.

Income tax on the profit or loss for the financial year comprises current and deferred tax. Current tax is the expected amount of income taxes payable in respect of the taxable profit for the financial year and is measured using the tax rates that have been enacted at the balance sheet date.

Deferred tax is provided for, using the liability method, on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

Deferred tax liabilities are recognized for all taxable temporary differences and deferred tax assets are recognized for all deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, unused tax losses and unused tax credits can be utilized.

Deferred tax is measured at the tax rates that are expected to apply in the period when the asset is realized or the liability is settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date.

*Source: BNM GP8i*
## PRESENTATION OF INCOME STATEMENT

<table>
<thead>
<tr>
<th>Bahrain Islamic Bank B.S.C</th>
<th>Bank Islam Malaysia Berhad (GP8-i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Islamic finance</td>
<td>Income derived from investment of depositors’ funds</td>
</tr>
<tr>
<td>Income from Sukuk &amp; Commodities</td>
<td>Income derived from investment of shareholders’ funds</td>
</tr>
<tr>
<td>Gross return to unrestricted inv. acc.</td>
<td>Allowance for losses on financing</td>
</tr>
<tr>
<td>Bank’s share as Mudarib</td>
<td>Reversal of impairment loss</td>
</tr>
<tr>
<td>Return on unrestricted inv. acc.</td>
<td>Profit Equalization Reserve</td>
</tr>
<tr>
<td>Bank’s share of income from joint financing and investment accounts</td>
<td>Direct Expenses</td>
</tr>
<tr>
<td>Net income from investments</td>
<td>Total distributable income</td>
</tr>
<tr>
<td>(Loss)Gain on sale of available for sale</td>
<td>Income distributable to the depositors</td>
</tr>
<tr>
<td>Gain on fair value adjustment - properties</td>
<td>Total net income</td>
</tr>
<tr>
<td>Share of results of associates</td>
<td>Personnel expenses</td>
</tr>
<tr>
<td>Fee &amp; commission income</td>
<td>Other overhead expenses</td>
</tr>
<tr>
<td>Other Income</td>
<td>Impairment loss from property &amp; equipment</td>
</tr>
<tr>
<td>Expenses (Staff costs, Depreciation, etc)</td>
<td>Finance cost</td>
</tr>
<tr>
<td>Income before provision</td>
<td>Profit before zakat and tax</td>
</tr>
<tr>
<td>Provision for impairment</td>
<td></td>
</tr>
</tbody>
</table>
BALANCE SHEET OF AN ISLAMIC BANK
MALAYSIA’s PERSPECTIVE

...snap shot of stocks at a given point of time – financial position
### ISLAMIC BANKING BALANCE SHEET

**ASSETS**

<table>
<thead>
<tr>
<th>Inventory (Real Estates, Automobiles, etc)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset-backed Transactions</td>
</tr>
<tr>
<td>- Murabahah (cost plus)/ Ijarah (leasing)/ Istisna’ (manufacture)/ Salam (forward delivery)</td>
</tr>
<tr>
<td>Profit Sharing Transactions</td>
</tr>
<tr>
<td>- Mudharabah (profit sharing &amp; loss bearing) / Musharakah (profit &amp; loss sharing)</td>
</tr>
<tr>
<td>Fee Based Transactions</td>
</tr>
<tr>
<td>- (Ujr, Sarf, Wakalah, etc) i.e. for Trade Financing</td>
</tr>
</tbody>
</table>

**LIABILITIES**

<table>
<thead>
<tr>
<th>Current/Demand Deposits (Wadiah (Safe Custody), Wakalah)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted Investment Accounts (Mudharabah-based GIA, SIA)</td>
</tr>
<tr>
<td>Restricted Investment Accounts (Mudharabah PSIA)</td>
</tr>
<tr>
<td>Profit Equalization Reserves</td>
</tr>
<tr>
<td>Shareholders’ Equity</td>
</tr>
</tbody>
</table>

- **Return on Assets**
  - Distinct characteristic – ownership of assets
  - Akin to loans but legal position of lender and borrower is replaced by different contractual relationship
  - Investor – entrepreneur relationship

- **Investment Returns**
  - Akin to demand deposit
  - Akin to fixed deposit but uses profit sharing basis where return based on performance of assets
  - Distinct characteristic as prudential tools
  - Partly used to set up infrastructure to undertake the business

- **Return on Financing**
  - Cost of Funds
### SOURCE & APPLICATION OF FUNDS – BALANCE SHEET’s PERSPECTIVE

<table>
<thead>
<tr>
<th>Application of Funding</th>
<th>Source of Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (@ branches/placement @ BNM/etc)</td>
<td>Demands Deposit</td>
</tr>
<tr>
<td>Financing Assets (Inah, Murabaha, Salam, Ijarah, Istisna’)</td>
<td>Investment Account (Mudarabah)</td>
</tr>
<tr>
<td>Investment Assets (Mudharabah, Musharakah)</td>
<td>Special Investment Account (PSIA, Mudarabah, Musharakah)</td>
</tr>
<tr>
<td>Fee-based services (ju’ala, kafala, and so forth)</td>
<td>Reserves</td>
</tr>
<tr>
<td>Non-banking assets (property, building for branches, etc)</td>
<td>Equity</td>
</tr>
</tbody>
</table>

- For Islamic banks, the mudarabah contract is the cornerstone of financial intermediation and thus of banking.
- The basic concept is that both the mobilisation and (in theory) the use of funds are based on some form of profit sharing among the depositors, the bank, and the entrepreneurs (users of funds).
- The financial intermediation is merely a ‘pass-through’ arrangement similar to funds management, with the difference that there are multiple portfolios on the asset side.
CAPITAL MANAGEMENT

- Regulatory Capital
  - RWCR - 8%

- Capital Buffer
  - Take into account stress test

- Capital Allocation
  - Allocated to business lines for organic growth and for inorganic growth

- Capital for Infra & Marketing
  - To act as Mudarib

- Capital Reserves
  - Allocation for Profit Equalization Reserves
Financing are recognized when cash is disbursed to customers. They are initially stated at cost including any transaction cost and are subsequently measured at amortized cost using the effective profit rate method.

Reporting institution should refer to BNM guidelines on classification of non-performing and provisioning for financing. Impaired financing shall be measured at their estimated recoverable amount. Reporting institution should provide additional allowance if the recoverable amount (present value of estimated future cash flows discounted at original effective profit rate) is lower than the net book value of the financing (outstanding amount of financing, advances and other loans, net of specific allowance).

A general allowance based on a percentage of the financing portfolio is also made. The percentage is reviewed annually in light of past experiences and BNM/RH/GL/002-2 Islamic Banking and Takaful Department Guidelines on Financial Reporting for Licensed Islamic Banks (Page 43/111) prevailing circumstances and an adjustment is made to the overall general allowance, if necessary. Specific allowance provided for impaired financing had been made in full compliance with the BNM/GP3. Additional allowances for impaired financing are provided when the recoverable amount is lower than the net book value of the financing (outstanding amount of financing, net of specific allowances). Any allowances made during the year are charged to the income statement. An uncollectible financing or portion of a financing classified as bad is written off after taking into consideration the realizable value of collateral, if any, when in the judgment of the management, there is no prospect of recovery.
## PRESENTATION OF BALANCE SHEET - ASSETS

<table>
<thead>
<tr>
<th>Bahrain Islamic Bank B.S.C</th>
<th>Bank Islam Malaysia Bhd (GP8-i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (including deposit with Central Bank)</td>
<td>Cash and short term funds</td>
</tr>
<tr>
<td>Murabaha Receivables</td>
<td>Deposits &amp; placement with banks and other financial institutions</td>
</tr>
<tr>
<td>Mudaraba Investments</td>
<td>Securities held-for-trading</td>
</tr>
<tr>
<td>Musharaka Investment</td>
<td>Securities available-for-sale</td>
</tr>
<tr>
<td>Investments</td>
<td>Securities held-to-maturity</td>
</tr>
<tr>
<td>Investment in associates</td>
<td>Financing, advances and others</td>
</tr>
<tr>
<td>Investment in Ijarah assets</td>
<td>Other assets</td>
</tr>
<tr>
<td>Ijarah Muntahia Bittamleek</td>
<td>Statutory deposits with the Central Bank</td>
</tr>
<tr>
<td>Investment in properties</td>
<td>Current tax asset</td>
</tr>
<tr>
<td>Ijarah rental receivables</td>
<td>Deferred tax asset</td>
</tr>
<tr>
<td>Other assets</td>
<td>Investment in subsidiary</td>
</tr>
<tr>
<td></td>
<td>Property &amp; equipment</td>
</tr>
<tr>
<td></td>
<td>Prepaid lease payments</td>
</tr>
</tbody>
</table>
**PRESENTATION OF BALANCE SHEET - LIABILITIES**

<table>
<thead>
<tr>
<th>Bahrain Islamic Bank B.S.C</th>
<th>Bank Islam Malaysia Bhd (GP8-i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer’s Current Account</td>
<td>Deposits from Customers</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>Deposits and placements of banks</td>
</tr>
<tr>
<td>Unrestricted Investment Accounts</td>
<td>Bills and acceptance payable</td>
</tr>
<tr>
<td>Financial Institutional Investment Accounts</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>Customers’ Investment Accounts</td>
<td>Zakat</td>
</tr>
<tr>
<td></td>
<td>Subordinated financing</td>
</tr>
</tbody>
</table>
The structure of a typical balance sheet has demand deposits and investment accounts from customers on the liability side and Islamic financing and investing accounts (the equivalent of conventional banks’ loans to customers) on the asset side.

Types of liabilities present in an Islamic bank’s balance sheet are nearly universal, their exact composition varies greatly depending on a particular bank’s business and market orientation, as well as the prices and supply characteristics of different types of liabilities at any given point in time.

When compared with conventional banks, balance sheet risk profile of Islamic banks is different. First, the foremost feature of an Islamic bank is the ‘pass-through’ nature of the balance sheet. This feature removes the typical asset-liability mismatch exposure of a conventional bank, as the Islamic bank’s depositors’ return is linked to the return on the assets of the bank.

Second, the nature of assets of two institutions is different. Whereas a conventional bank tends to stay with fixed income very low credit risk debt securities, an Islamic bank’s assets are concentrated on the asset-based investments which has credit risk but are also backed by a real asset. As a result, the lending capacity of the Islamic banking sector (at least for commercial banks) is bound by the availability of real assets in the economy.

- *Source:* Balance Sheet Analysis - Hennie van Greuning and Zamir Iqbal, senior advisor and lead investment officer respectively at The World Bank Treasury in the US.
Third, the assets of Islamic banks contain financing assets where tangible goods and commodities are purchased and sold to the customers. This practice creates distinct exposures.

For example, in case of conventional banking, the asset is financed by a loan from the bank to the customer whereas in case of an Islamic bank, the asset and the financing are coupled together. The bank is not limited to the exposure as a financier but can develop additional exposures resulting from dealing with physical assets.

Another feature which distinguishes the risks of an Islamic bank from a conventional bank is the general lack of liquid securities on the asset side. This feature is not a design issue but is a temporal phenomenon until a well-functioning securities market for Shari’ah-based instruments is developed.

Finally, due to prohibition of interest, Islamic banks cannot issue debt to finance the assets which consequently discourages creation of leverage. Due to the lack of leverage, Islamic banks can be considered less risky during a time of financial crisis.

The current financial crisis was precipitated by excessive leverage and complexity in the financial system, which had developed multiple layers of intermediaries. Hence, the financing – or the claims on assets – became remote from the underlying assets.

Source: Balance Sheet Analysis - Hennie van Greuning and Zamir Iqbal, senior advisor and lead investment officer respectively at The World Bank Treasury in the US.
CUSTOMER DEPOSITS

Deposits as at Dec 2010
RM million

<table>
<thead>
<tr>
<th>Deposits</th>
<th>RM Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 06</td>
<td>14,443</td>
</tr>
<tr>
<td>June 07</td>
<td>17,617</td>
</tr>
<tr>
<td>June 08</td>
<td>20,763</td>
</tr>
<tr>
<td>June 09</td>
<td>25,212</td>
</tr>
<tr>
<td>Dec 10</td>
<td>26,888</td>
</tr>
<tr>
<td>Dec 11</td>
<td>28,305</td>
</tr>
</tbody>
</table>

Growth + 5.3%

Deposits as at Dec 2011
RM million

<table>
<thead>
<tr>
<th>Deposits</th>
<th>RM Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>NIDC</td>
<td>1,690</td>
</tr>
<tr>
<td>An Najah</td>
<td>414</td>
</tr>
<tr>
<td>Ziyad</td>
<td>81</td>
</tr>
<tr>
<td>SIA</td>
<td>7,875</td>
</tr>
<tr>
<td>Waheed</td>
<td>3,564</td>
</tr>
<tr>
<td>GfA</td>
<td>2,529</td>
</tr>
<tr>
<td>Demand</td>
<td>7,100</td>
</tr>
<tr>
<td>Savings</td>
<td>3,564</td>
</tr>
<tr>
<td>of which Al-Awfar</td>
<td>414</td>
</tr>
<tr>
<td>Demand</td>
<td>8,420</td>
</tr>
<tr>
<td>Savings</td>
<td>3,863</td>
</tr>
<tr>
<td>of which Al-Awfar</td>
<td>703</td>
</tr>
<tr>
<td>Demand</td>
<td>8,444</td>
</tr>
<tr>
<td>Savings</td>
<td>3,863</td>
</tr>
<tr>
<td>of which Al-Awfar</td>
<td>112</td>
</tr>
</tbody>
</table>
CUSTOMER DEPOSITS - CASA

<table>
<thead>
<tr>
<th>RM million</th>
<th>Dec 2010</th>
<th>Dec 2011</th>
<th>Islamic Banking Industry as at Dec 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total CASA</td>
<td>10,664</td>
<td>12,283</td>
<td>66,700</td>
</tr>
<tr>
<td>% of Total Deposits</td>
<td>39.7%</td>
<td>43.4%</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

Total Deposits at Dec 2010
- Non CASA RM16,224m
- CASA RM10,664m

Total Deposits at Dec 2011
- Non CASA RM16,022m
- CASA RM12,283m

CASA Deposits at Dec 2010
- Demand RM7,100m
- Saving Non-Mudharabah RM2,577m
- Saving Mudharabah RM987m

CASA Deposits at Dec 2011
- Demand RM8,420m
- Saving Non-Mudharabah RM2,599m
- Saving Mudharabah RM1,264m
WHAT RISKS ARE INEVITABLE?

- In trade transactions, the seller is entitled to the profit from the sales price because he has to bear the risk of ownership and assume the liability for loss when the subject matter has actually moved into his possession before selling it to customer.

- Similarly, to ijarah or leasing, the lessor is entitled to rent only when he keeps the asset in usable form by incurring ownership-related expenses and undertakes the risks associated with the asset.

- In Mudharabah and Musyarakah-based investments, investors earnings depend on the result of economic activity undertaken by the venture and they will share the profits as per agreed ratios and bear the loss as per the share in the capital of the business.

- Therefore, risk is legitimate when it is necessary for value creation.

- In fact, this type of risk is inevitable since it is inseparable from real and value adding transaction.

- In this regards, any attempts to deliberately separate risk from ownership and thus from real economic activities, may appear in direct opposition to Shariah principles.

*Source: ISRA – Dr. Asyraf Wajdi Dusuki*
## KEY FINANCIAL INDICATORS

<table>
<thead>
<tr>
<th></th>
<th>Audited FY June 07</th>
<th>Audited FY June 08</th>
<th>Audited FY June 09</th>
<th>Actual FYE Dec 2010 (12 months)</th>
<th>Audited FY Dec 11</th>
<th>Islamic Banking System</th>
<th>Banking System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity – Gross</td>
<td>23.3%</td>
<td>26.5%</td>
<td>16.5%</td>
<td>14.5%</td>
<td>17.7%</td>
<td>14.5%</td>
<td>16.5%</td>
</tr>
<tr>
<td>Return on Assets - Gross</td>
<td>1.4%</td>
<td>1.45%</td>
<td>0.91%</td>
<td>1.2%</td>
<td>1.5%</td>
<td>1.2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Cost Income Ratio</td>
<td>68.2%</td>
<td>60.8%</td>
<td>56.7%</td>
<td>55.4%</td>
<td>53.8%</td>
<td>44.9%</td>
<td>46.7%</td>
</tr>
<tr>
<td>Non-Fund Based Income Ratio</td>
<td>9.0%</td>
<td>7.8%</td>
<td>10.3%</td>
<td>10.1%</td>
<td>13.8%</td>
<td>8.6%</td>
<td>20.1%</td>
</tr>
<tr>
<td>Gross Non-Performing/Impaired Financing Ratio (%)</td>
<td>24.7%</td>
<td>21.2%</td>
<td>16.4%</td>
<td>4.5%</td>
<td>2.6%</td>
<td>2.5%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Net Non-Performing/ Impaired Financing Ratio - Less IA &amp; CA (%)</td>
<td>11.4%</td>
<td>7.8%</td>
<td>6.7%</td>
<td>1.1%</td>
<td>-0.3%</td>
<td>-0.05%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Financing Loss Coverage Ratio (%)</td>
<td>67.7%</td>
<td>75.8%</td>
<td>80.8%</td>
<td>76.8%</td>
<td>111.7%</td>
<td>101.8%</td>
<td>96.3%</td>
</tr>
<tr>
<td>Financing to Deposits (%)</td>
<td>55.9%</td>
<td>50.4%</td>
<td>42.5%</td>
<td>45.7%</td>
<td>51.5%</td>
<td>76.0%</td>
<td>78.4%</td>
</tr>
<tr>
<td>RWCR / CAFIB (%)</td>
<td>12.0%</td>
<td>12.9%</td>
<td>13.6%</td>
<td>16.8%</td>
<td>16.3%</td>
<td>14.7%</td>
<td>14.8%</td>
</tr>
</tbody>
</table>

^ Annualised (Net is calculated based on profit after tax and before zakat)
* Bank Negara Malaysia Annual Report 2010
# Bank Negara Malaysia Monthly Statistical Bulletin @ Dec 2011
### Key Ratios

<table>
<thead>
<tr>
<th>Key Ratios</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Average Equity (ROE)</td>
<td>Pre-tax profits/Average Equity (Presented on annualized basis)</td>
</tr>
<tr>
<td>Return on Average Assets (ROA)</td>
<td>Pre-tax profits/Average Assets</td>
</tr>
<tr>
<td>Net Financing Margin</td>
<td>Net Finance Income/Average Assets</td>
</tr>
<tr>
<td>Gross Impaired Financing Ratio</td>
<td>Gross Impaired Assets/Gross Financing</td>
</tr>
<tr>
<td>Net Impaired Financing Ratio</td>
<td>Net Impaired Assets/(Gross Financing-Collective Assessment – Individual Assessment )</td>
</tr>
<tr>
<td>Financing Loss Coverage</td>
<td>(General provision + Specific Provision + Income In Suspense)/Gross Financing</td>
</tr>
<tr>
<td></td>
<td>Under FRS : (Collective Assessment + Individual Assessment + General Provision)/Gross Financing</td>
</tr>
<tr>
<td>Risk Weighted Capital Ratio</td>
<td>Capital base/Risk-weighted assets</td>
</tr>
<tr>
<td>Core Capital Ratio</td>
<td>Core Capital/Risk-weighted assets</td>
</tr>
</tbody>
</table>
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