mechanism, another variable rate financing product based on the concept of *ijarah muntahia bittamleek* (leasing ending with ownership) is being explored.

Enhancing Regulatory Framework

The growing significance of the Islamic banking industry requires the development of an effective regulatory framework to provide the enabling environment to support the development of the industry.

- In 2003, Bank Negara Malaysia conducted a review on the Framework of the Rate of Return. The purpose was to further strengthen the methodology for deriving the rate of return to depositors, whereby the revised framework is to provide a greater degree of flexibility in the implementation of the framework.

- The Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i) was issued in August 2003. The objective was to promote consistency and standardisation amongst the Islamic banks in complying with the provisions of the IBA and approved accounting standards, specifically MASB *i*-1 and the Shariah requirements. The Guidelines prescribed the minimum requirements of the financial statements that the Islamic banks need to disclose.

- In the development of accounting standards for Islamic financial business, the Malaysian Accounting Standards Board has embarked on the preparation of standards on leasing *(ijarah)*, deferred payment sale (BBA) and cost-plus *(murabahah)* in relation to the recognition, measurement and disclosure of these Islamic financial transactions.

The Framework of the Rate of Return

Towards standardising the methodology on the calculation of distributable profits and the derivation of the rates of return to depositors in Islamic banks, Bank Negara Malaysia introduced the "Framework of the Rate of Return". Among others, the objectives of the framework are to: -

(i) Set the minimum standard in calculating the rates of return;
(ii) Level the playing field and provide the terms of reference for the Islamic banking institutions (IBIs) in deriving the rates of return; and
(iii) Provide Bank Negara Malaysia with an effective yardstick to assess the level of efficiency of the IBIs.

Prior to the introduction of the framework, the IBIs adopted various methods in deriving the rates of return. Such practice has led to large variations in the results and implications. For example, some IBIs include all types of income in their computation while some exclude certain type of incomes. These variations have led to the following impediments in terms of: -

(i) Assessment of the rates of return by Bank Negara Malaysia specifically to ascertain whether the rates genuinely reflect the true performance of the IBIs or otherwise;
(ii) Regulation and supervision by Bank Negara Malaysia, particularly in assessing the prudence and fairness in the distribution of profits to the depositors; and
(iii) Assessment by the IBIs of their funding cost, which in turn led to the distortion of rates of return in the retail and inter-bank markets.

The standardisation of the rates of return was also aimed at addressing the information asymmetry between the IBIs and the depositors by enhancing the level of transparency and ensuring that depositors would receive fair returns on their investment. The framework would detail the items, for example, the income and expense items that need to be reported and incorporated for the purpose of the calculation. In particular, the calculation table lists the expense items that need to be shared by the depositors and the bank; and items that are to be solely borne by the bank.

The introduction of the framework is also to effectively support the application of *mudharabah* (profit-sharing) contract in Islamic banking deposit-taking activities. Unlike conventional banking, which is based on a lender-borrower relationship, the *mudharabah* contract is based on an investor-entrepreneur relationship. In this system, the depositor assumes the role of capital provider while the bank assumes the role of the entrepreneur. The depositors' funds are utilised for financing and investment activities, and the profits generated from these activities are shared between the depositor and the bank based on the pre-agreed profit sharing ratio. In the event of a loss, it will be borne by the depositors. As the bulk of the deposits in Islamic banking are in the form of *mudharabah* deposits, it places a higher degree of fiduciary risk on the management of the IBIs to ensure that the funds are utilised in the most efficient manner, as profits generated from the financing and investments are distributed to the depositors in the most equitable manner. Towards this end, the framework was introduced, not only to standardise the methodology for the calculation of returns, but also to ascertain the actual and fair distribution of income to the depositors.

The Framework

The Framework of the Rate of Return comprises two main components, that is, the calculation and distribution tables. The **calculation table** prescribes the income and expense items that need to be reported and sets out the standard calculation in deriving the net distributable income. Among the important items in the calculation table is the provisions. Prior to the issuance of the framework, the provisions of the banking institutions participating in the Islamic Banking Scheme (IBS banks) were provided by the conventional banking operations. Under conventional banking operations, the provisions are solely borne by the bank. However, under the framework, the IBS banks are required to distinguish their general and specific provisions, in accordance with the *mudharabah* contract, whereby the provisions in Islamic banking operations are shared by both the depositors and the bank.

Table 1
Calculation Table

	RM million
Income generated from asset items	
(+) Net trading income	
(+) Other income	
Total gross income	
(-) Provisions and income-in-suspense	
(-) Profit equalisation reserve	
(-) Direct expenses	
Net gross income	
(-) Income attributable to:	
Specific investment account	
IBCF/SHF[1]	
Net income	
(-) Income attributable to:	
Amount due to designated FIs	
Islamic negotiable instruments	
Net distributable income	

[1] Islamic banking capital funds/ shareholders' funds.

The calculation table also introduced a new item known as **Profit Equalisation Reserve (PER)**. The PER is an item that acts as a mechanism to mitigate the fluctuation of rates of return arising from the flux in income, provisioning and total deposits. This would ensure that the rates of return of the IBIs remained competitive and stable. The PER is appropriated out of the total gross income and is shared by both the depositors and the bank.

The second component of the framework is the **distribution table**. The table sets out the distribution of the net distributable income, derived from the calculation table among demand, savings and general investment deposits according to their structures (*mudharabah* or non-

Table 2
Distribution Table

Type of deposit	ADA[1]	Weightage	WADA[2]	Distributable profits		Depositors' portion		
				RM	%	PSR[3]	RM	%
Current account								
Savings account								
GIA[4]								
1-month								
3-month								
6-month								
9-month								
12-month								
Above 12-month								
				NDI[5]				

[1] Average daily amount of each type of deposit.
[2] Weighted average daily amount.
[3] Profit sharing ratio agreed by the bank and depositors.
[4] General investment account.
[5] Net distributable income transferred from Calculation Table.

mudharabah), maturities and the pre-agreed profit sharing ratios between the bank and depositors. Under the framework, Bank Negara Malaysia allowed the IBIs to adopt either the weightage or without the weightage method, primarily to accord the system capacity of the IBIs.

The IBIs are required to calculate their rates of return on a monthly basis and to declare their monthly rates of return on a specified date. The following month would be the effective period of the declared rates of return.

The introduction of the framework has provided the IBIs with a standard approach in deriving the rates of return and has enhanced the level of transparency. The framework has also improved the efficiency level of the IBIs given that the rates of return are now reflective of the business acumen of the IBIs rather than the methodology of deriving the rates of return. The introduction of the PER has also reduced the volatility of the rates of return of the Islamic banking industry and enabled the IBIs to manage their portfolio more efficiently. In tandem with the introduction of the framework, the scope of the statistical submission has been broadened further to provide Bank Negara Malaysia with an effective measurement tool to assess the efficiency of the IBIs in terms of profitability, prudent management and fairness.

Bank Negara Malaysia has also undertaken a review of the framework in 2003 to promote capacity enhancement and efficiency among the IBIs in managing their business operations. While the foundation of the framework remained unchanged, the revised framework will provide, among others, flexibility in determining the weightage assigned to each group of deposits, the profit sharing ratio of investment deposits, the provisioning of PER and the segregation of income from the funds that are managed under a consolidated fund or managed separately between shareholders' and depositors' funds. The reviewed framework will provide greater flexibility to the IBIs in managing their portfolios and remain competitive in the market place.

Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i)

The Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks or GP8-i was issued to the Islamic banks (IBs) in August 2003. It sets out the minimum requirements for the presentation and disclosure of reports and financial statements of IBs. The GP8-i is to be adopted by the IBs for annual accounts commencing 2004.

The objective of the GP8-i is to provide the basis for presentation and disclosure of reports and financial statements of the IBs. GP8-i is also aimed at ensuring consistency and comparability of the reports and financial statements amongst the IBs in complying with the provisions of the Islamic Banking Act 1983, Companies Act 1965, Shariah requirements and other Bank Negara Malaysia guidelines. As a comprehensive guideline, GP8-i also incorporated the new requirements of MASB standards, specifically the MASB *i*-1: Presentation of Financial Statements of Islamic Financial Institutions. The standard, which came into effect in 2003, was issued to streamline the disclosure and presentation of financial statements of the IBs and the conventional banks that participate in the Islamic Banking Scheme (IBS banks).

Prior to the issuance of the GP8-i, the IBs observed the various provisions of the Companies Act 1965, the applicable accounting standards and the Guidelines on the Specimen Financial Statement for the Banking Industry (GP8) which was formulated to facilitate the conventional banking operations. Some of the requirements have been modified for the IBs, particularly those under the GP8, to reflect the Islamic banking operations such as the disclosure on the various Shariah concepts applied in financing.

Salient Features of GP8-i

The salient features of the GP8-i, amongst others, are as follows:

a) ***Performance Overview and Statement of Corporate Governance***
In promoting good corporate governance, IBs are required to report their performance overview and corporate governance practices. The performance overview requires the IBs to disclose their review on performance, measures, business plans and strategies, whilst the statement of corporate governance requires IBs, among others, to disclose the composition and responsibilities of the Board, internal audit and control activities and risk management strategies and policies. These report requirements are important in providing additional information to users in evaluating the performance and conduct of an IB.

b) ***Disclosure of Shariah Advisory Board/ Committee and Zakat Obligations***
The Shariah Advisory Board or Committee plays an important role in monitoring the compliance of Islamic banking activities with the Shariah requirements. Given its importance, the IBs are required to disclose the functions and duties of their Shariah Advisory Board or Committee in monitoring the activities pertaining to Shariah matters under the Directors' Report. With respect to the *zakat* obligations disclosure, IBs are required to disclose the responsibility towards payment of *zakat* either on the business or shareholders or on behalf of depositors.

c) ***Report of the Shariah Advisory Board/ Committee***
The IBs are required to report the conformity of the IB's operations with the Shariah principles under the Report of the Shariah Advisory Board/Committee. The Report, which is akin to the Auditors' Report, will enhance the credibility of the IB's operation in complying with the Shariah principles.

d) ***Profit Equalisation Reserves (PER)***
PER is a mechanism introduced in the Framework of the Rate of Return to stabilise the rate of return to depositors. Disclosure of PER would reflect the capability of the IBs in managing the level of profit distribution to the *mudharabah* depositors. The IBs are required to disclose their policy on PER as well as its movement (provision and write-back) during the financial year.

e) Classification of Deposits from Customers and Placements from Banks and Other Financial Institutions

The IBs are required to disclose their deposits into two categories i.e. *mudharabah* and non-*mudharabah* deposits. As the manager of public funds, the disclosure would provide additional information on the risk profile of the IBs' deposits portfolio to the public.

f) Presentation of the Income Statement

Presentation of the Income Statement of the IBs is structured to reflect the nature of the Islamic banking operation, mainly on the application of *mudharabah* concept in the deposit-taking activities. The statement discloses the incomes and expenses that are either shared by the bank and depositors or solely belonged to the bank.

Product Approval

- In tandem with the gradual progression towards a market-driven regulatory environment, Bank Negara Malaysia issued the Guidelines on New Product Approval Requirements for Islamic Banking Institutions (the Guidelines). These replace the existing product pre-approval requirements and came into effect on 2 January 2004. The Guidelines outline the notification and specific approval process for new products submitted by Islamic banking institutions.

  In formulating the Guidelines, Bank Negara Malaysia adopted the approach that "what is not prohibited is allowed" on new Islamic banking products. This was to provide greater clarity, transparency and speedy product approval. For a new product to qualify for automatic approval (under notification process), the submission to Bank Negara Malaysia must be made at least 21 days before its launch date. The definition of a new product has also been widened to include an existing approved product or service that is applying a different or a new combination of Shariah concepts. In addition, the Islamic banking institutions are required to submit a detailed explanation on the Shariah concepts used in the product as endorsed by their Shariah committee. This is to ensure that a thorough research on the product has been carried out by the Islamic banking institutions and thus, would not lead to any detrimental effect on the customers and on the stability of the financial system. A new product that does not qualify for automatic approval would require specific approval from Bank Negara Malaysia and may require, among others, the deliberation of the Shariah Advisory Council of Bank Negara Malaysia. The Guidelines place significant emphasis on self-regulation, where the Islamic banking institutions are required to ensure consistency of the products introduced with the Guidelines.

- In line with efforts to streamline the regulatory framework of the credit card industry, Bank Negara Malaysia issued the Credit Card-i Guideline (the Guideline) in January 2004. This was an extension to the Credit Card Guideline issued to the conventional banks in March 2003. Under the Guideline, the credit card-i can apply either *bai' inah* (sell and buy back arrangement) or BBA (deferred payment sale) Shariah concept. Under the *bai' inah* concept, the fund for the cardholder's spending limit is created upon the bank buying back the asset from the cardholder for cash which it previously sold to the cardholder on deferred terms. Under the BBA concept, the fund is created upon the bank purchasing the asset from the cardholder for cash which will be sold back to the cardholder on deferred basis.

  The Guideline also prescribes the treatment on penalty and fee structure according to the Shariah principles. In terms of late payment charges, issuers of credit card-i are allowed to impose a compensation fee on the defaulters subject to specific terms and conditions imposed by Bank Negara Malaysia. The terms and conditions, among others, prohibit the Islamic banking institutions from compounding the compensation fee for late payment and monthly charges. This provision was intended to protect the customers as well as to streamline the penalty structure of credit card-i.

Strengthening Shariah and Legal Infrastructure

One of the pre-requisites for a strong and stable Islamic banking system is the existence of a