

The Framework Of The Rate Of Return

Bank Negara Malaysia introduced the Framework of the Rate of Return to standardise the methodology on the calculation of distributable profits and the derivation of the rates of return to the depositors. The objectives of the framework, among others are to: -

- (i) Set the minimum standard in calculating the rates of return;
- (ii) Provide the same playing level and term 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 are genuine that 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 that led to the distortion of rates of return in the retail and inter-bank markets.

The standardisation of the rates of return would serve to address the information asymmetry between the IBIs and the depositors by enhancing the level of transparency and ensuring that depositors receive a fair share of return on their investment. This is carried out through the framework that detailed out 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 prescribed 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* (profits-sharing) contract in the Islamic banking deposit taking activities. Unlike conventional banking where it is based on lender-borrower relationship, the *mudharabah* contract is based on investor-entrepreneur relationship whereby the depositor assumes the role as capital provider while the bank assumes the role of the entrepreneur. The depositors' funds are utilised for financing and investment activities and profits generated from these activities are shared between the depositor and the bank based on the pre-agreed profits sharing ratio. In the event of a loss, it will be borne by the depositors. As the bulk of 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, while profits generated from the financing and investments are distributed to the depositors in the most equitable manner. Towards this end, the Framework of

the Rate of Return was introduced, not only to standardise the methodology of the calculation but also to ascertain the actual and fair distribution of income to the depositors.

The Framework

The framework comprises two main components i.e. the calculation table and the distribution table. 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) are provided by the conventional banking operations. However, under the framework, the IBS banks are required to provide separate general provision and specific provision. This is in accordance with the *mudharabah* contract whereby the provisions in Islamic banking operations are shared by both the depositors and the bank, unlike conventional banking operations where the provisions are solely borne by the bank.

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 Fund/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 of income, provisioning and total deposits and to 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 posted from the calculation table among demand, savings and general investment deposits according to their structures (*mudharabah* or non-*mudharabah*), maturities and the pre-agreed profits

sharing ratios between the bank and depositors. For the purpose of 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.

Distribution Table

Types 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 ADA denotes Average Daily Amount of each type of deposit

² WADA denotes Weighted Average Daily Amount

³ PSR denotes Profit Sharing Ratio agreed by the bank and depositors

⁴ GIA denotes General Investment Account

⁵ NDI denotes the amount of Net Distributable Income transferred from Calculation Table

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 subsequent one 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 prior to the introduction of the framework. 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 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 being managed under a consolidated funds or being managed separately between shareholders' and depositors' funds. The review will provide greater flexibility to the IBIs in managing their portfolios as to remain competitive in the market place.