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Hedging Against Capital Depreciation: A Case Study of BIMB Malaysia Berhad

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Abstract

This case study focuses on study of Islamic hedging mechanism instruments. Hedging is a conservative and prudent approach to manage risk in the market through specific financial instruments. Swap is one of the effectively and efficiently used financial instruments for the purpose of hedging or minimizing risk faced by financial institutions. This case discusses BIMB Malaysia Berhad (BIMB) which is facing heavy losses due to higher provisioning on the huge write-off of Net Performing Finances (NPFs). After the losses in October 2006, Lembaga Tabung Haji (LTH) and Dubai Investment Group (Dubai Financial LLC) emerged as BIMB's direct shareholders' through a recapitalization exercise. Following a period of losses, BIMB was recapitalized in October 2006 through a RM1.01 billion capital injection. This case allows students to evaluate BIMB performance since the establishment on July, 1983. Besides that, students can identify on the types of risk management and how to mitigate them in Islamic perspective. This study encourages students to know the purpose of using Islamic hedging to achieve *shariah* compliance by full filling the requirements of *shariah* including principles and objectives.

Keywords: Bank Islam Malaysia Berhad (BIMB), capital depreciation, capital injection, Islamic hedging, non-performing financings (NPFs)

1. Introduction

1.1 Swap as an instruments for hedging

Swap is one of the effectively and efficiently financial instruments used for the purpose of hedging or minimizing risk faced by financial institutions. Scholars such as Dusuki and Mokhtar (2010) and Ramasamy et. al, 2011It can be defined as a bilateral contractual agreement between two parties in which both parties agree to do periodic payment in exchange for two different streams of cash flow (Asyraf Wajdi Dusuki and Shabnam Mokhtar, 2010; Ravindran et. al, 2011). This agreement of swap can be executed by replacing assets or liability in the same or different currencies or a floating interest rate streams with another of fixed rate or vice versa.

Generally, swap used to protect the value of the asset from exposure to volatility or market fluctuation. The potential fluctuations of interest rate markets is the value of currencies that is usually managed through swap instrument related to interest rate and currency swaps. Banks and multinational companies use the swap facility in managing their balance sheet.

1.2 Islamic Profit Rate Swap (IPRS) is the alternative for Islamic hedging

The Islamic swap instrument follows the structure of conventional swap agreement. However, the instrument should avoid the elements of *riba* (usury), *maisir* (gambling) and *gharar* (uncertainty). Therefore, the market introduce the Islamic profit rate swap (IPRS). An IPRS is basically an agreement to exchange profit rates between a fixed rate party and a floating rate party and vice versa, implemented through the execution of a series of underlying *Shariah* contracts. In the current market an additional contract called *wa'ad* (promise) is introduced so as

to facilitate the smoothness transaction of IPRS. The IPRS also involves a series of *murabaha* transactions.

The commodity murabahah transaction, as discussed in Ismail (2010), is a trade transaction designed for investment purposes as well as to mobilize depositors' fund. It is introduced as an alternative innovation to liquidity management instruments in the broader Islamic money market spectrum. It is carried out based on spot purchase (immediate delivery) and forward sale on deferred payment term (cost plus mark-up basis). All the commodities should be approved by *Shariah*.

2. Background

2.1 Brief History of Islamic Banking in Malaysia and BIMB Malaysia Berhad

Islamic banking has emerged as ompetitive and viable alternative system for the conventional banking system during the last three decades. Islamic banking refers to a financial system which is consistent with principles of *Shariah* (Islamic law) called *fiqh muamalat* (Islamic rules on transactions). *Shariah* prohibits the fixed or floating payment or acceptance of specific *riba* or *usury* (interest or fees) for lending of money. Investing in businesses that provide goods or services considered contrary to Islamic principles and values is also *haram* (forbidden). In recent years, a number of Islamic banks have been created to cater to the growing demand, driven by globalization and the vast wealth of some Muslim as well as capture a larger market share. Islamic banking industry today is capable in providing complete banking solutions in fulfilling requirement people and has moved from a niche position to become a mainstream component of the global banking system.

Islamic banking in Malaysia began in the early 1963 when the government established Pilgrims Management and Fund Board (Lembaga Urusan Tabung Haji) (Ahasanul Haque, 2007, 2010). The main objectives of the Board are facilitated and manage annual pilgrims in Makkah as well as, encourage and persuading local Muslims to participate investment opportunity and economic activity. Additionally, the Board also maximize the return of saving by invest the saving of the through investment in *Shariah* compliant vehicles in varied business venture (interest free place).

Malaysian government introduced a synchronized, methodical, systematic and efficient process of implementing the Islamic financial system based on the experience of established Pilgrims Management and Fund Board. The long-term objective of the Central Bank of Malaysia (CBM) was to create Islamic banking system operations as an initiative to familiarize the process. The BIMB commenced operations as Malaysia's first Islamic bank on July 1983 following Central Bank of Malaysia introduced the Islamic Banking Act (IBA) at the same year under the Companies Act 1965. The IBA was officially enacted on 1983 aimed to regulate Islamic banking activities. BIMB operated as the sole Islamic bank and the operations were initiated in accordance with *Shariah* principles until 1993. At 1993, more conducive environment for competition among the banks while the government of Malaysia allowed other conventional banks to setting up Islamic banking services through the operation of "Islamic windows" as referred to in the "Islamic banking scheme (IBS)" in March, 1993. The scheme allowed conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches. Instead of conventional banks operating their Islamic banking activities alongside the conventional ones, they in fact have physically

separate entities that operate these Islamic banking schemes. Malaysia has emerged as the first country to implement a dual banking system with the implementation of the interest free banking scheme whereby an Islamic banking system functions on a parallel basis with the conventional banking system (The Central Bank of Malaysia Annual Report, 1993, pp. 57). Bank Muamalat Malaysia Berhad (BMMB) is the other full-fledged Islamic bank was established after restructuring and consolidation of the banking system.

The establishment of BIMB and BMMB marked a milestone for the development of the Islamic financial system in Malaysia. BIMB has not only become the symbol of Islamic banking in Malaysia, it has also played an integral role in setting the stage for a robust growth of the country's Islamic financial services industry. BIMB is committed to its role as a leading vehicle in transforming Malaysia into a global Islamic financial hub. To this end, BIMB continuously develops and introduces trend-setting financial solutions, some of which are the first-of –its-kind in the world or at least in the region in widening the breadth of its innovative end-to-end *Shariah* based financial products and services, comparable to that offered by its conventional counterparts. Today, BIMB parades a wide ranging list of more than 50 innovative and sophisticated Islamic financial products and services as well as a fast growing network of 113 branches and more than 900 self-service terminals nationwide. The increasing number of Islamic financial products, services and players in Malaysia and abroad, BIMB play its role as a pioneer-leader in enhancing its first-mover advantage and unique value propositions while reinforcing Malaysia distinctive competitive advantages as a leading international centre for Islamic finance (BIMB Annual Report, 2010).

3. BIMB Malaysia Berhad

3.1 Overview of BIMB operational performance – Profitability, Funding and Liquidity[1]

The bank has grown from strength to strength over the years. Initially, the seed capital of only RM80 million, BIMB's shareholder funds swelled to RM2.5 billion as at December 2010, a testament to its successful long-run growth plan. An asset base of RM30.3 billion at end-Disember 2010, BIMB is the third largest commercial Islamic bank in Malaysia, accounting for approximately 12% of the Islamic banking industry's assets. As the same date, the Bank accounted for 7.5% and 12.7% of the Malaysian Islamic banking industry's financing and deposits, respectively.

BIMB continued to achieve remarkable performance for the period performance for the period under review as it embarked on its new three-year Sustainable Growth Plan (2010-2012). For the 18-month financial period, BIMB achieved a Profit before Zakat and Tax (PBZT) of RM503.4 million (Table 1 and Figure 1). FY 2007 up to FY 2010, BIMB's pre-provision profits has been trending upwards. The pre-tax profit had continued increasing except in FY June 2009. The profit is driven by strong financing growth which was matched by an impressive improvement in asset quality, growing contribution from non-fund based income, decline in cost-to-income ratio and continued increase in deposits through current and savings accounts (CASA).

The Bank's capital position remained healthy with its Tier 1 capital ratio and risk-weighted capital ratio ("RWCR") standing at 15.7% and 16.8% respectively as at end December 2010. The

[1] Refer BIMB Annual Reports (2003-20010) available on BIMB website http://www.bankislam.com.my and RAM Rating Services (2010)

bank takes cognizance of Basel 3 recommendations and is confident that the capital position will remain favourable to support its business expansion whilst maximizing shareholder value. BIMB seeks to proactively manage its capital structure to maximize efficiency and drive return on equity while maintaining a delicate balance between the needs of capital to support strong organic growth strategies and shareholder expectations. Given the significant improvement in performance, BIMB proposed a dividend of 4.75% amounting to RM80.7 million net of tax for the period under review.

In the performance of a bank can be understood by analysis the performance of financial ratios to assess bank's performance (Mohamad Abdul Hamid & Shaza Marina Azmi, 2011). BIMB has strong performance, and was able to sustain an annualized Return on Equity (ROE) of 19.92% (Table 2 and Figure 3) for FY2010. This is despite the increase in equity from the issuance of Islamic Convertible Redeemable Non Cumulative Preference Shares (ICRNCPS) amounting to RM540.0 million during the financial period. The ICRNCPS were subsequently converted to ordinary shares on 29 September 2010. Despite the increase in equity, Return on Assets (ROA) on the other hand increased to 0.81% from the 0.85% recorded in June 2009 (Table 2 and Figure 2), reflecting the on-going exercise of balance sheet reshaping that focuses on better yielding assets and lower cost funding to maximize returns. The ROA and ROE declined until -3.02% and -65.76% respectively in FY 2005 while the FY 2006 ROA and ROE -8.74% and -459.67 (Table 2, Figure 2 and 3).

BIMB have a robust funding and liquidity profile and maintains a very liquid balance sheet in the past 3 year (Table 3). Its liquid-asset ratio is around 60% (end-June 2009: 67%) with its average deposit growth (of 16%) outpacing its financing growth (of 4%) in the past 5 years. The Bank's financing to deposits ratio only came up to 42% as at end June 2010. The Bank's financing to deposits ratio is expected to improve to a still-comfortable 60%.

Deposits grew by RM1.7 billion or 6.7%, of which low cost deposits comprising of CASA growth accounted for RM1.6 billion or more than 95%. BIMB's depositors are mainly corporate and government-related entities; these accounted for approximately 70% of the bank's deposit base as at end-June 2010. While this gives rise to concentration risk, the bank's long standing relationships with its depositors help to maintain the stability of its deposit base. One of BIMB's largest depositors is Tabung Haji, which has historically maintained sizeable deposits. BIMB's deposits build on its long-standing relationships with *zakat* collecting institutions and universities, where it has a first-mover advantage as Malaysia's first Islamic bank. BIMB's deposits make up 98% of its profit-bearing funding. CASA deposits constituted 39.7% of the Bank's total deposits as at end-June 2010; CASA deposits have featured prominently in its deposit base, making up at least a third of its total deposits. The Bank's large proportion of CASA deposits, in contrast to the industry average of some 25%, is viewed positively its broader net financing margins.

3.2 First Loss and weak financing practices surfaced[2].

BIMB in FY 30 June 2005 (FY 2005) and FY 2006, BIMB recorded an aggregate RM1.7 billion of losses that had wiped out its shareholders' fund and capital base. Table 2 had shown the financial ratio pre and post of the losses from 2003 until 2010. Table 4 had shown the Gross Non Performing Finance (NPF) ratio and Net NPF. BIMB's NPF had risen, peaking in 2006. BIMB suffered hefty pre-tax losses of RM479 million and RM1.2 billion in FY June 2005 and FY 2006 respectively, due to sizeable financing-loss charges (Table 4). The huge losses had arisen from the conversion of its Labuan offshore subsidiary, BIMB (L) Ltd. to a branch. The losses were attributed to large non-performing finances of the Labuan branch. The entity of BIMB (Labuan) Ltd (BIL) had extended cross-border foreign currency advances to financing, with large exposures in Bosnia, Indonesia and the Middle East. BIL's operations were subsequently wound up, and its assets and liabilities vested to BIMB's Labuan offshore branch (BILOB). BILOB accounted for 13% (or RM1.4 billion) of BIMB's RM10.5 billion financing portfolio.

3.3 Restructuring and Recapitalized in 2006 after Heavy Losses

During the FY 30 June 2006, BIMB focused on two major initiatives. The first is a recapitalization and balance sheet restructuring exercise to strengthen the capital base. Second was to introduce strategic reforms at all levels of operations. These initiatives are part of a turnaround plan implemented during the year to return the Bank to profitability and enable it to play a significant role in the Government's pursuit of the Malaysian International Financial Centre (MIFC).

BIMB was subsequently recapitalized in October 2006. The restructuring involved a substantial amount of capital injection to cover the equity deficit. Exhibit 7 had shown the shareholders' structure in 2010. After the losses in October 2006, Tabung Haji and Dubai Investment Group (Dubai Financial LLC) emerged as BIMB's direct shareholders' through a recapitalization exercise. The whole process after the recapitalization resulted in BIMB Holdings having a 51% stake, while Dubai Financial LLC and Tabung Haji owned a respective of 40% and 9% due to the losses (Figure 8). The new shareholders' bring extensive experiences in the financial services industry and committed to help the bank become a dominant player in the global Islamic industry. BIMB has a balance sheet that has been strengthened by the RM1.01 billion capital injection which raised the risk-weighted capital ratio (RWCR) way above the 8% minimum regulatory requirement. After the conversion, Tabung Haji's stake in BIMB has now been increased by 9.5% (to 18.5%) while Dubai Financial LLC's shareholding has declined by the same quantum (to 30.5%). BIMB's 51% equity has stayed unchanged (Figure 9).

4. Recapitalization

Following a period of losses, BIMB was recapitalized in October 2006 through a RM1.01 billion capital injection. The investors ask the bank to hedge against currency fluctuation. What is the mechanism used by investors to inject fresh and cash capital to the BIMB? In this case, the Islamic hedging mechanisms were used to show how the investors (Dubai Financial Group LLC) inject the capital to BIMB from USD to MYR. The investor would hedge the investment against many fluctuation rates. In Islam, the volatility of *riba* (interest rate), *maisir* (gambling) *and gharar* (uncertainty) are prohibited. Islamic Profit Rate Swap (IPRS) is one of the alternatives

[2] Refer BIMB Annual Reports (2003-20010) available on BIMB website http://www.bankislam.com.my and RAM Rating Services (2010).

used by investor to inject capital because the mechanism used seeks to achieve *Shariah* compliance by using a series of *murabaha* transactions (Sidney Yankson, 2011; Asyraf Wajdi, 2009).

Figure 10 shows the flow how the investor inject the capital from USD to MYR. In this case, the party involved are investor (Dubai Financial Group LLC) and Bank A (Islamic Bank). The investor injected the capital from USD to BIMB in MYR (RM 1.01 billion) via Bank A. Bank A as counterparty to protect investors from currency fluctuation risk and ensure that the Bank A squares off its position regarding its transaction with the investor and BIMB. This situation exist the important element feature to put in the structure of transaction which is *wa'ad* (promise). The use of *wa'ad* ensures no party will withdraw from the transaction. In this situation, what are the probably implication if at the first stage, both parties not applied *wa'ad* during transaction which is one of the party withdraw from the transaction?

Figure 11 shows how the Islamic hedging (IPRS) assist the transaction from investor to BIMB. This situation illustrated how Bank A converted the capital from USD into MYR by using a series of commodity *murabaha*. Bank A will purchase a commodity from Commodity House A (CH A) (spot) and pays cost of commodity in USD. After that, Bank A sell the commodity for differed payment cost plus profit in USD (assumed LIBOR as reference price) to a client. Client will converts USD into MYR at foreign exchange spot rate at inception and places MYR cash as collateral with Commodity House B (CH B).

Figure 12 shows that CH B will purchase commodity with MYR collateral from converted USD commodity *murabaha* from CH A upon clients instruction. CH B on behalf of clients pays the cost of commodity in MYR. Then, CH B on behalf of client sells commodity for differed payment at cost plus profit in MYR (KLIBOR as reference price) and MYR collateral converted from USD commodity *murabaha.* Now, Bank A has MYR collateral and can inject the capital to BIMB. In this situation, was the transaction by using commodity *murabaha* success to inject the capital? Is investor and Bank A (counterparty) protected from the possibility of an increase in the floating rate, which cause the operating cost increase? Is there any fixed reference price to minimize the risk (i.e LIBOR or KLIBOR). What is the implication if use only one reference price or both? Is the hedge structure in this case (used IPRS as a tools) matched with *Shariah* principles and objectives? Is there any tools besides IPRS to inject the capital? (i.e. Islamic Foreign Exchange Swap, or Islamic Cross-Currency Swap, etc). Is the Islamic bank is a good place to invest and why?

5. Case Discussion

a. Discuss the structure of Islamic profit swap.

b. Why do the Islamic banks get involved in cross currency swaps? What are the benefits to clients?

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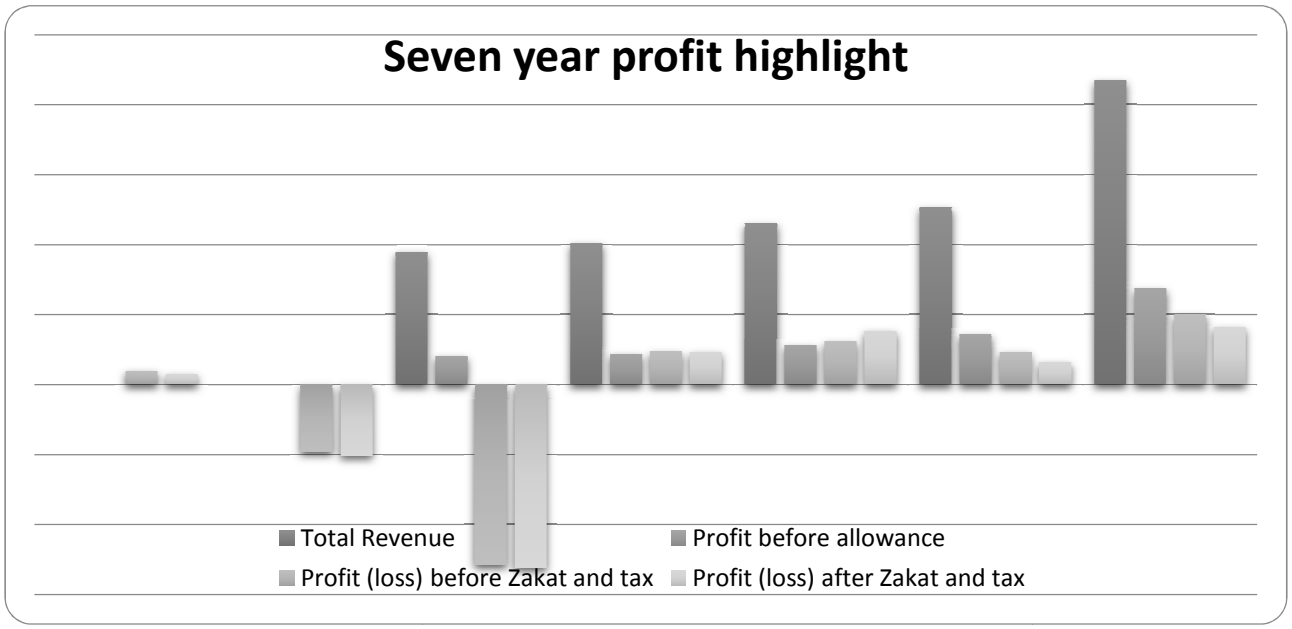
Appendices

Table 1: Seven year profit highlight

Year	Total Revenue (RM '000)	Profit before allowance (RM '000)	Profit (loss) before Zakat and tax (RM '000)	Profit (loss) after Zakat and tax (RM '000)
FY June 2004	N/A	N/A	98,298	75,262
FY June 2005	N/A	N/A	-479,778	-507,807
FY June 2006	949,459	202,925	-1,288,334	-1,307,963
FY June 2007	1,010,493	218,637	236,660	232,460
FY June 2008	1,152,041	280,240	308,267	384,117
FY June 2009	1,267,087	359,154	233,096	160,607
FY December 2010	2,174,184	684,460	503,400	411,778

Sources: Bank Islam Malaysia Berhad (Annual Report 2004-2010)



Sources: Bank Islam Malaysia Berhad

Figure 1: Seven year profit highlight

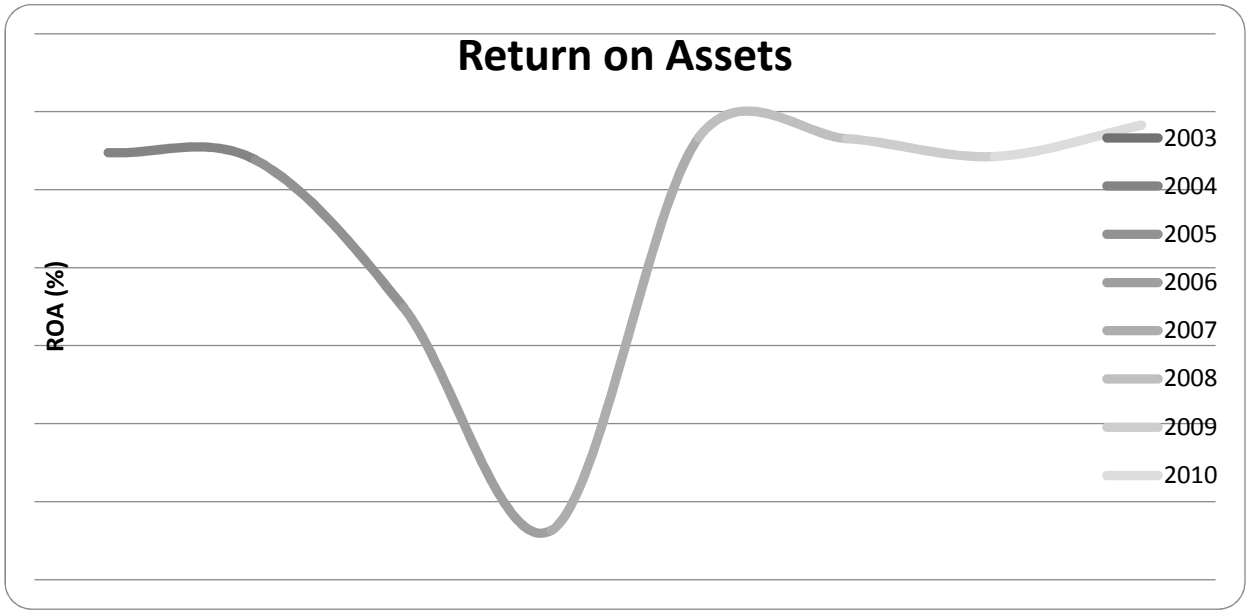
Return on Assets (ROA): $\frac{Profit\ before\ zakat\ and\ tax}{Total\ Assets}$ x 100

Return on Equity (ROE): $\frac{Profit\ before\ zakat\ and\ tax}{Total\ Equity}$ x 100

Table 2: Financial ratio of BIMB performance from 2003 until 2010

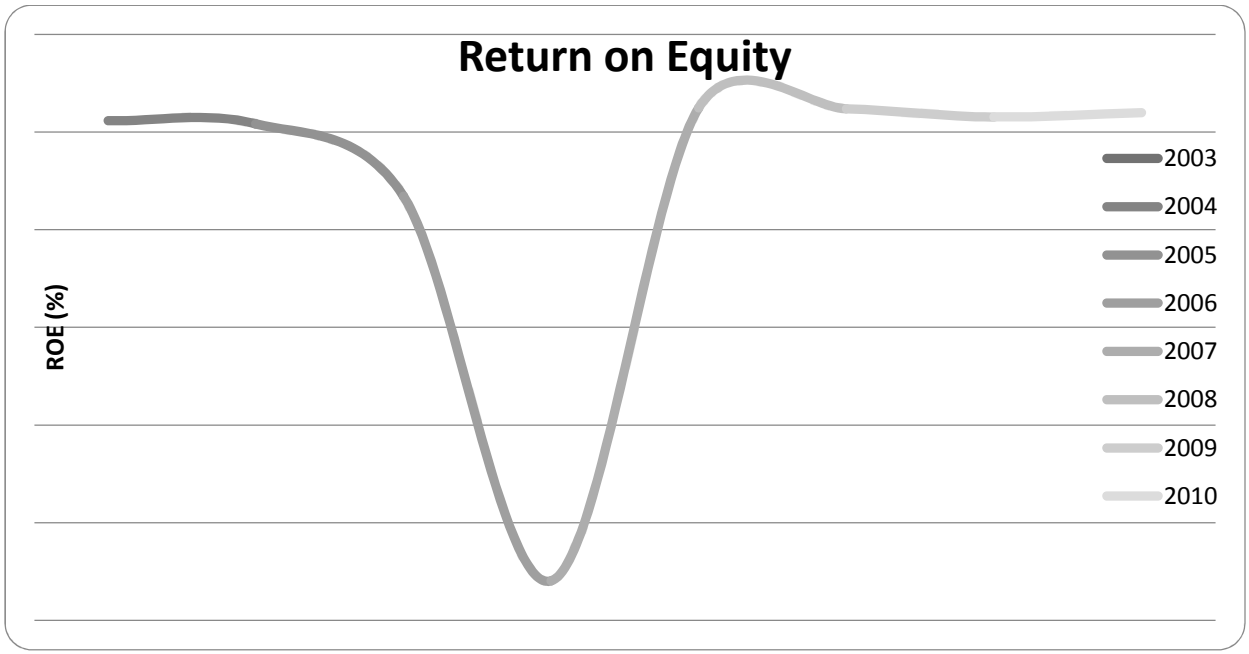
Year	Profit or loss Before Zakat and Tax (PBZT) (RM '000)	Total Assets (RM '000)	Total equity (Shareholders' base) (RM '000)	Return on Assets (ROA) (%)	Return on Equity (ROE) (%)
FY June 2003	130,331	13,717,155	1,113,126	0.95013	11.70856
FY June 2004	98,298	12,958,514	1,163,188	0.75856	8.45074
FY June 2005	-479,778	15,848,906	730,181	-3.02720	-65.70672
FY June 2006	-1,277,160	14,608,884	-277,840	-8.74235	-459.67463
FY June 2007	255,488	19,121,177	1,044,214	1.33615	24.46702
FY June 2008	308,267	23,559,424	1,308,950	1.30847	23.55071
FY June 2009	233,096	27,488,204	1,519,553	0.84799	15.33977
FY December 2010	503,400	30,364,166	2,526,968	1.65788	19.92111

Sources: Bank Islam Malaysia Berhad Annual Report (2003-2010)



Sources: Bank Islam Malaysia Berhad

Figure 2: Return on Assets (ROA %) from FY 2003 until FY 2010



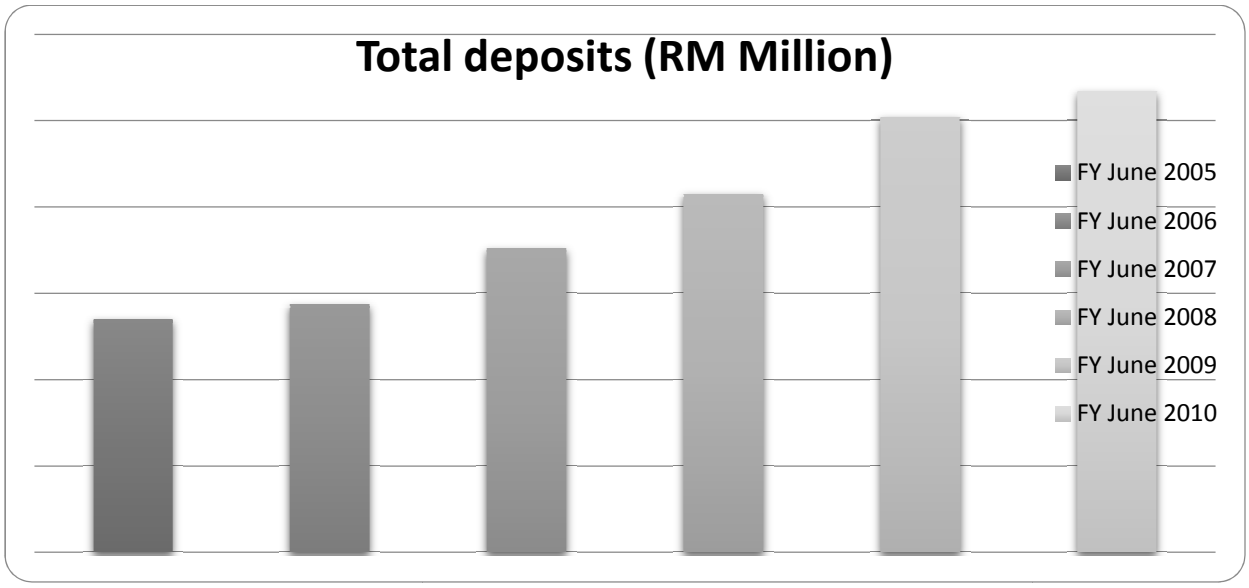
Sources: Bank Islam Malaysia Berhad

Figure 3: Return on Equity (ROE %) from FY 2003 until FY 2010

Table 3: Bank Islam funding and liquidity positions

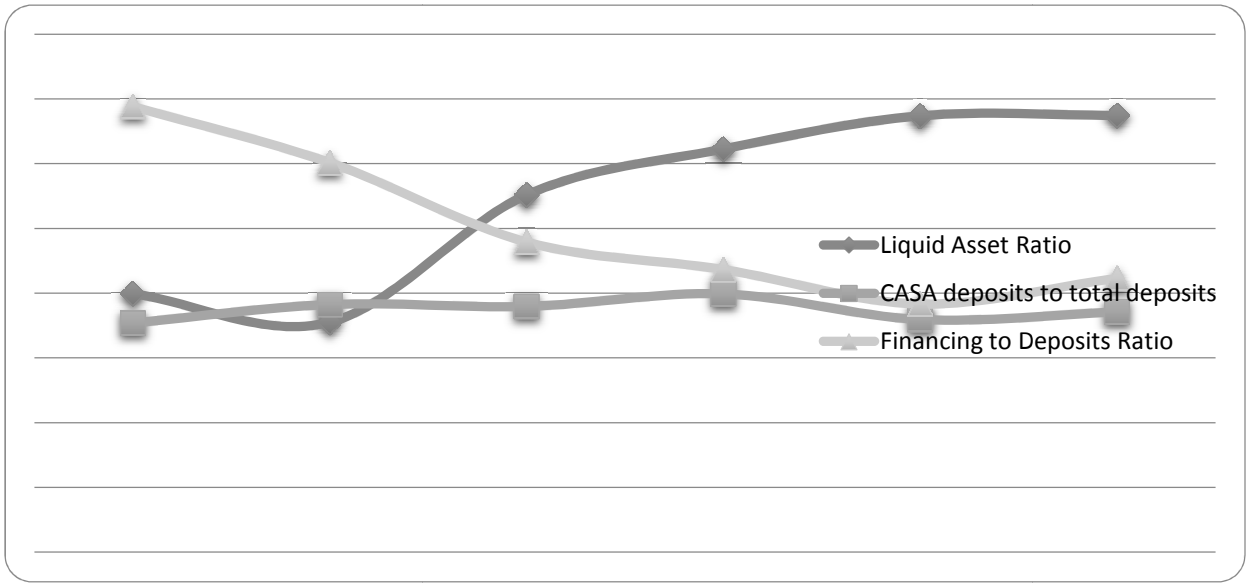
	FY June 2005	FY June 2006	FY June 2007	FY June 2008	FY June 2009	FY June 2010
Total deposits (RM Million)	13,483.20	14,340.40	17,577.70	20,754.30	25,204.60	26,686.70
Liquid Asset Ratio	39.94%	35.52%	55.16%	62.26%	67.37%	67.45%
CASA deposits to total deposits	35.40%	38.26%	37.97%	39.89%	35.95%	39.7%
Financing to Deposits Ratio	68.86%	60.17%	47.91%	43.66%	38.33%	42.30%

Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)



Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)

Figure 4: Total deposits from FY 2005 until FY 2010



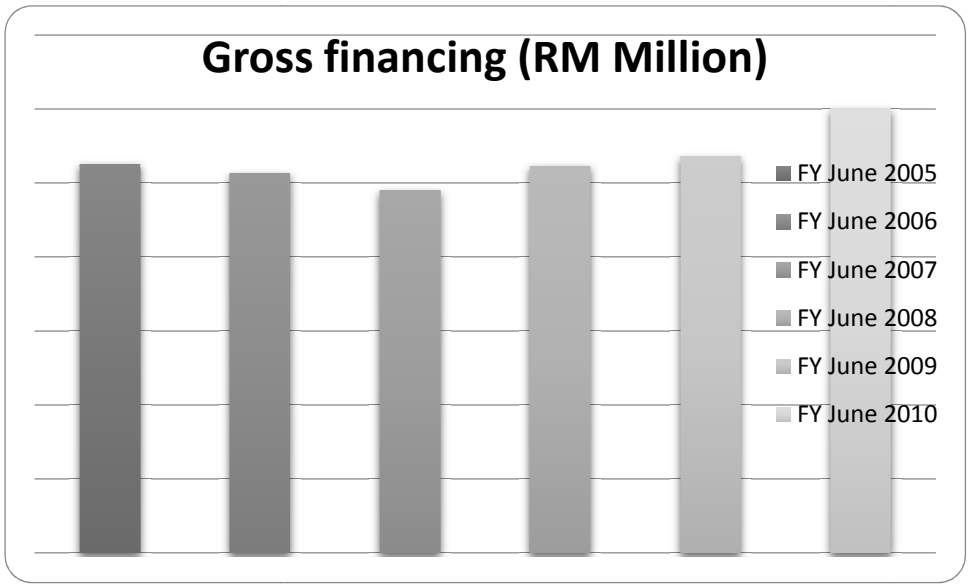
Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)

Figure 5: Liquidity assets ratio from FY 2005 until FY 2010

Table 4: Historical profitability indicators

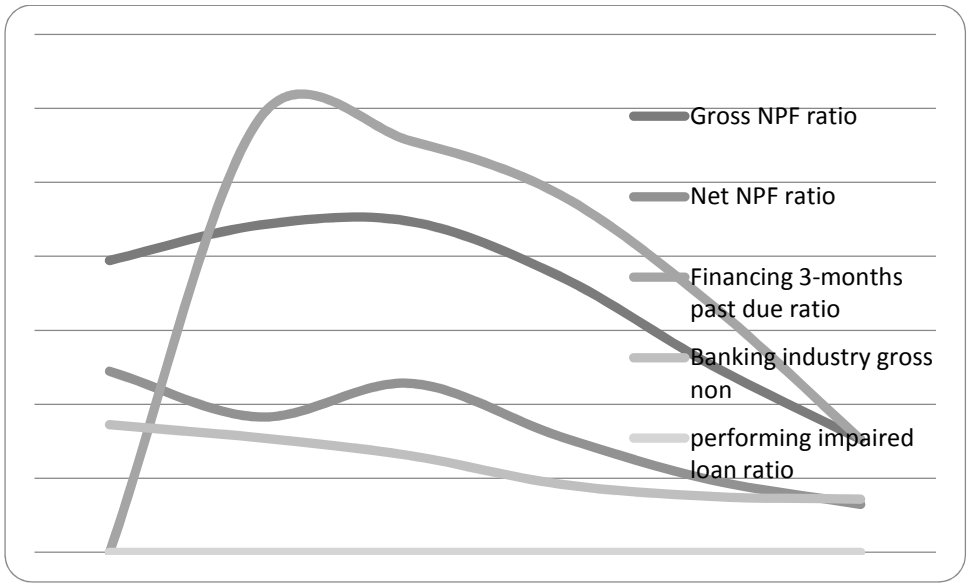
	FY June 2005	FY June 2006	FY June 2007	FY June 2008	FY June 2009	FY June 2010
Gross financing (RM Million)	10,518.24	10,261.59	9,803.74	10,458.83	10,711.00	12,008.28
Gross NPF ratio	19.72%	22.11%	22.36%	18.64%	12.70%	7.64%
Net NPF ratio	12.24%	9.15%	11.42%	7.82%	4.90%	3.24%
Financing 3-months past due ratio	N/A	29.33%	27.81%	24.16%	16.81%	7.64%
Banking industry gross non performing impaired loan ratio	8.63%	7.74%	6.54%	4.61%	3.78%	3.59%

Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)



Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)

Figure 6: Gross financing from FY 2005 until FY 2010



Sources: Bank Islam Malaysia Berhad and RAM Rating (2010)

Figure 7: Financing and NPFs ratio from FY 2005 until FY 2010

Figure 8: Shareholders' Structure in 2007 (BIMB Annual Report, 2007; pp. 5)

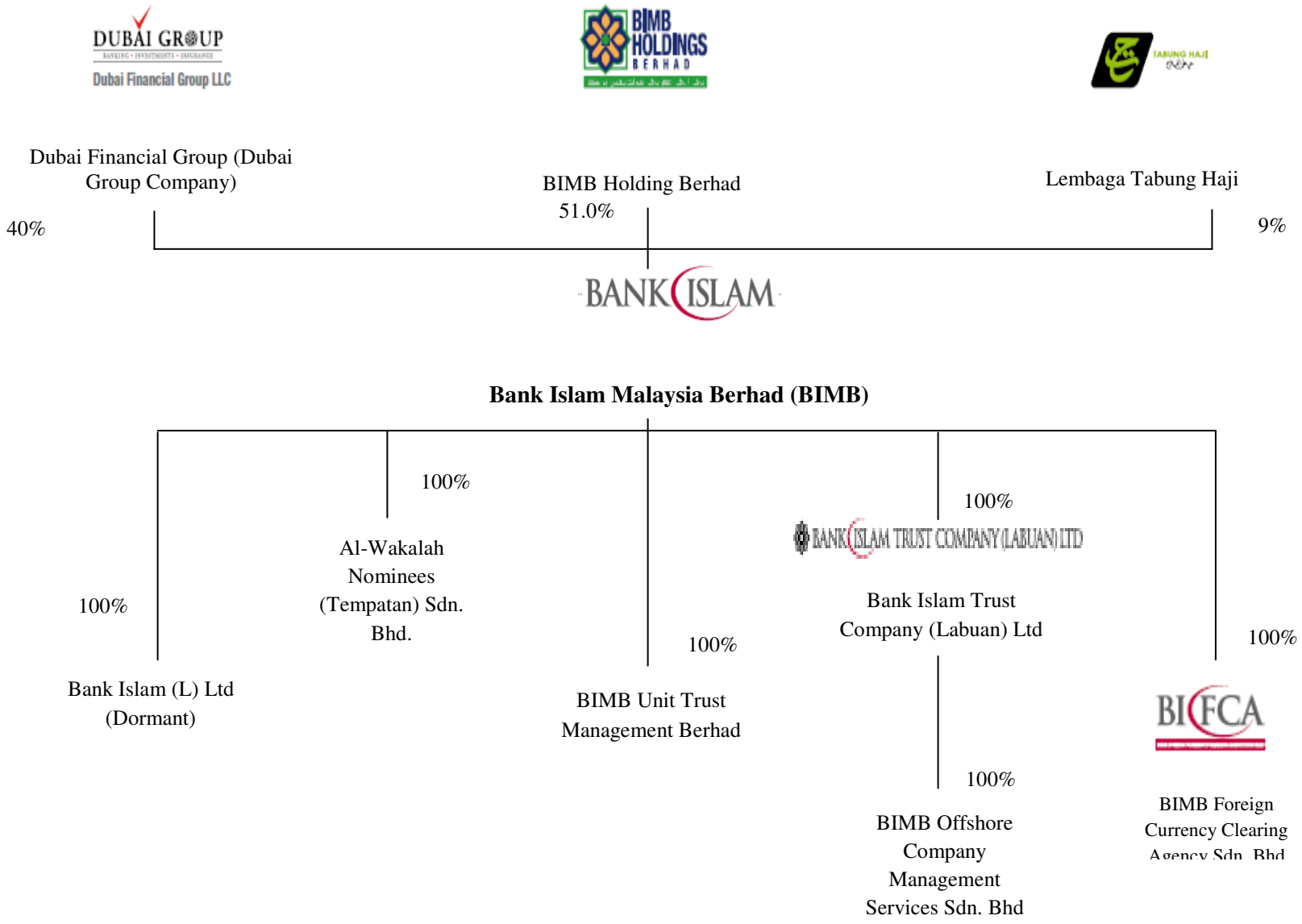
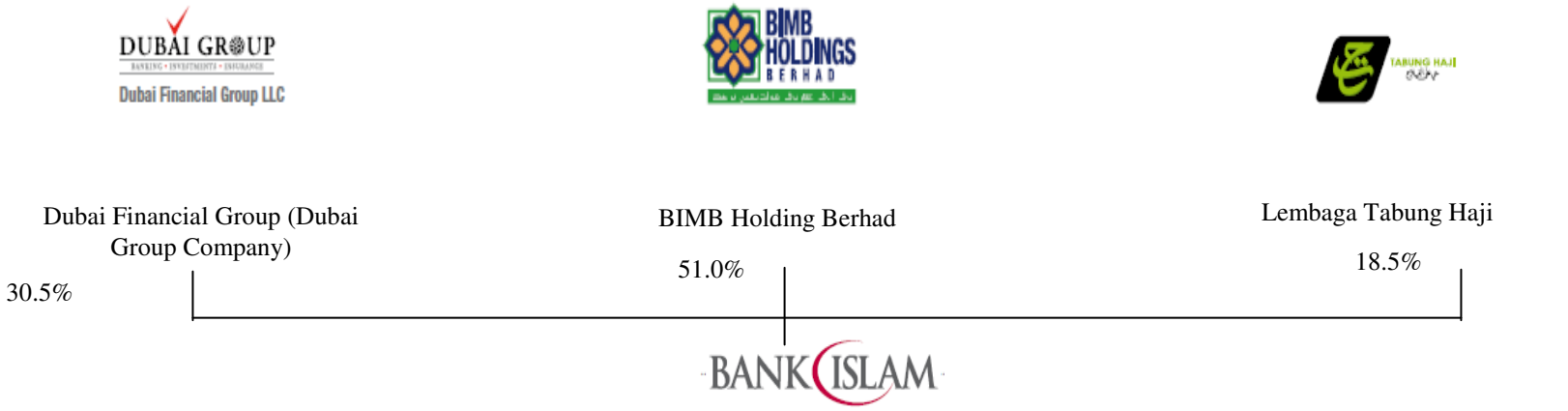
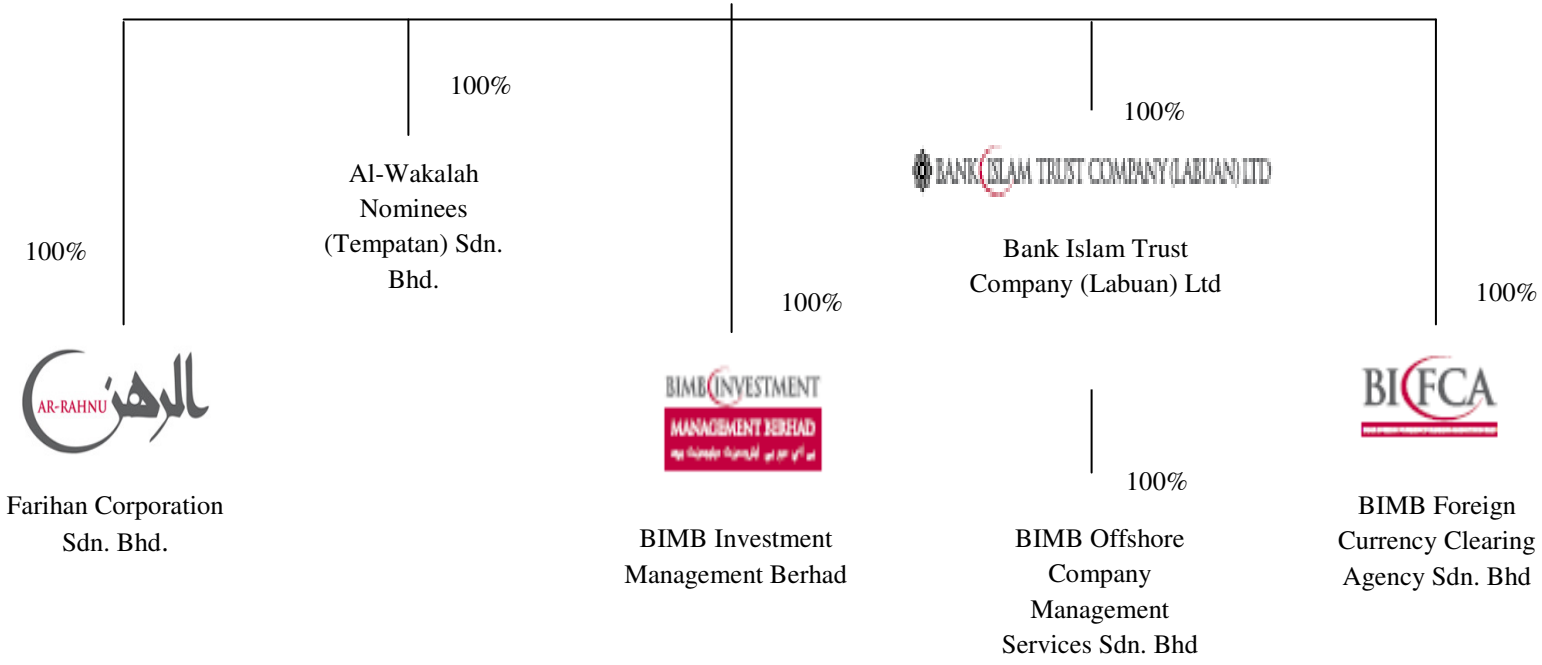


Figure 9: Shareholders' Structure on 2010 (BIMB Annual Report, 2010; p.p 29)



Bank Islam Malaysia Berhad (BIMB)



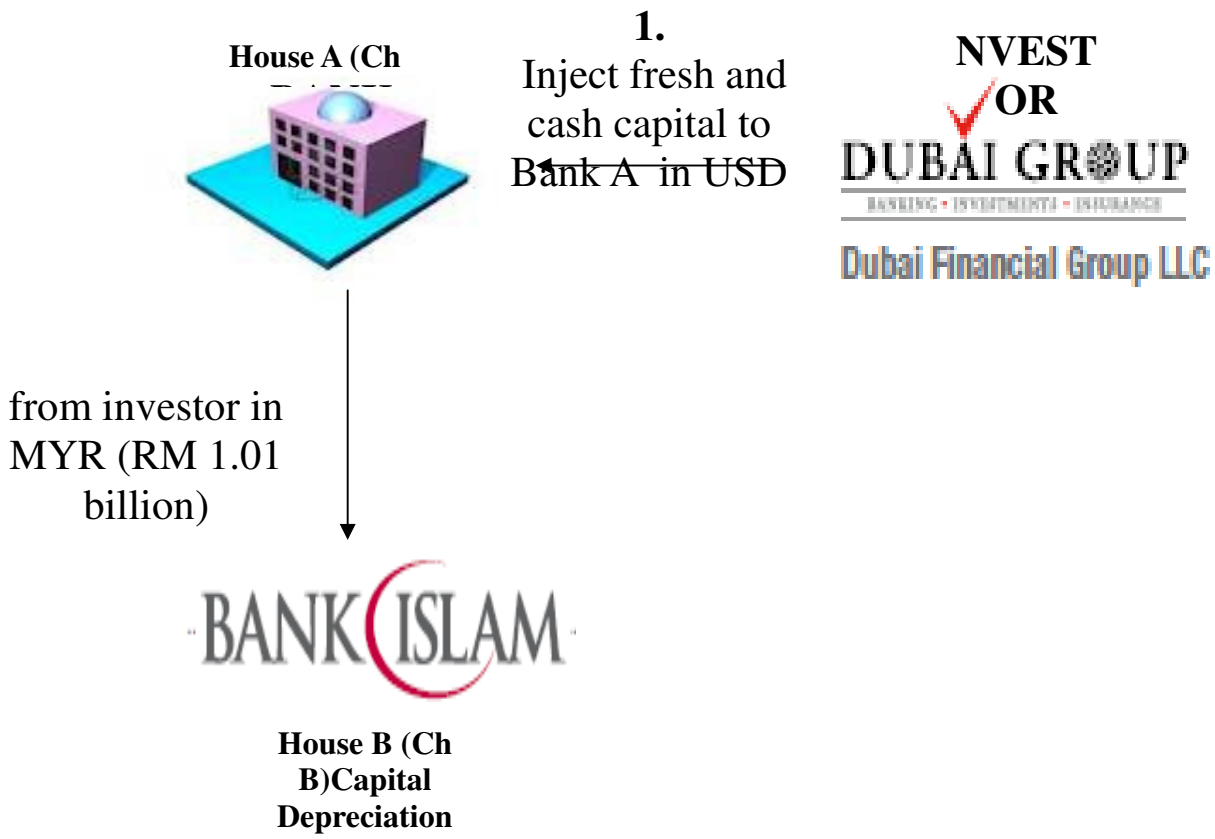


Figure 10: Flow of the capital injection from Dubai Financial Group to Bank Islam Malaysia Berhad

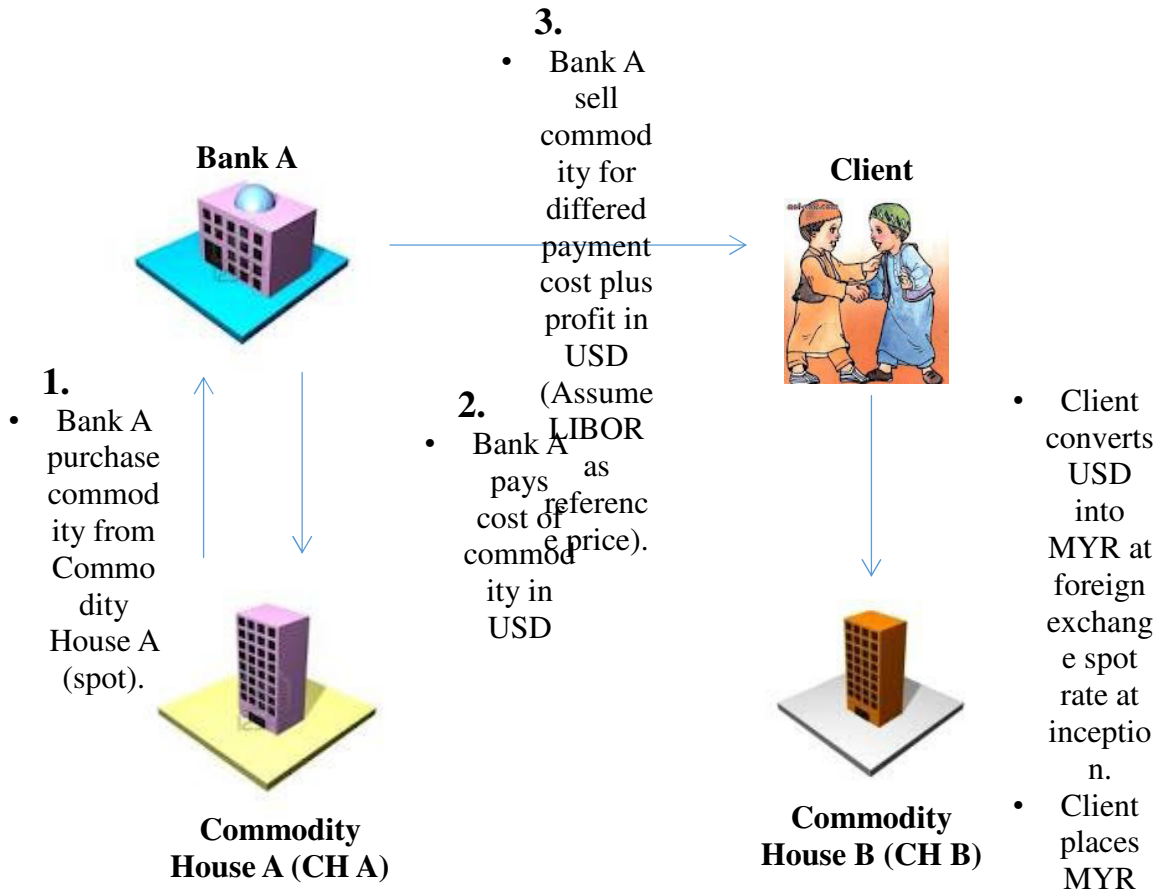


Figure 11: Flow of transaction in commodity *murabaha* by Bank A to convert capital USD to MYR

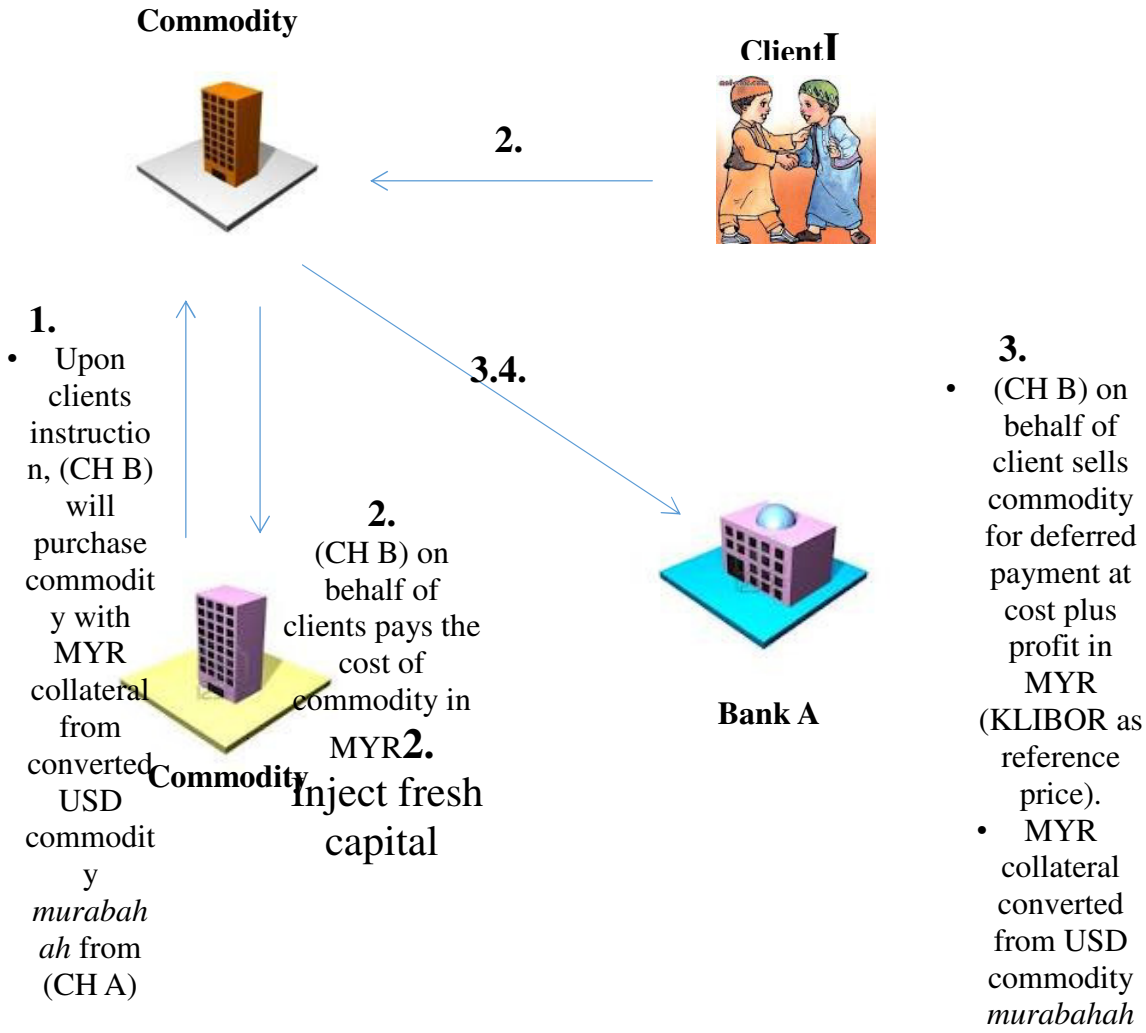


Figure 12: Flow of Bank B converted the USD by purchase MYR collateral