BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA



Value-based Intermediation Scorecard

Consultative Document

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About the Discussion Paper

The discussion paper provides an overview of Value-based Intermediation (VBI) Scorecard that covers purposes, key components of assessment and proposed measurement methodology. The Bank acknowledges that currently there is no single common measurement framework to assess performance of Islamic banking institutions (IBIs) in delivering the Shariah propositions. For the purpose of developing this document, the Bank has referenced relevant academic research, local and international index and listing standards. This document does not intend to describe the technical details of the VBI Scorecard but instead aims to briefly elaborate the key aspects, which require further inputs and feedback from other stakeholders. Objective of this public consultation is to obtain feedback on several aspects of VBI Scorecard (as elaborated in this document) from relevant stakeholders. In this regard, the Bank invites written feedback on this document, particularly on the specific questions raised throughout this document. Responses may include suggestions on issues or areas to be clarified or alternatives that the Bank should consider. To facilitate an effective consultation process, the written feedback should be supported with clear reasons, including accompanying evidence or illustrations where appropriate.

Responses must be submitted to the Bank by 30 November 2018 to –

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Electronic submission is encouraged. Submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

In the course of providing your feedback, you may direct queries to the following officers at 03-26988044:
Azren Rizuani Aziz ext. 7855 or azren@bnm.gov.my
Siti Nurul Ain Zakaria ext. 8332 or ain@bnm.gov.my

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EXECUTIVE SUMMARY : VBI SCORECARD

What is VBI Scorecard?

VBI Scorecard is a strategic management tool that captures the commitment, implementation strategies (including practices) and key performance indicators (results) of an Islamic banking institution in advancing VBI agenda

Purposes of VBI Scorecard

Strategic Planning Process

Facilitate IBIs in realigning their current business priorities and practices with key underpinning thrusts of VBI

Performance Assessment

Compile relevant information and data that can measure progression of IBIs in advancing VBI

Effective Communication

Enhance understanding and instill greater appreciation among wider stakeholders on IBIs' impact and value creation to economy, community and environment

Key Components of VBI Scorecard

VBI Scorecard produces a score that reflects comprehensive performance of IBIs, which is computed based on two key components :

Perfomances

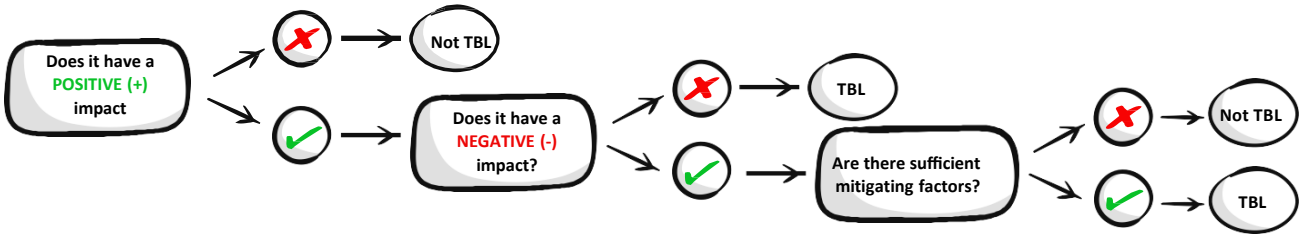
- Financial Sustainability
- Level of Support to Real Economy
- Value creation to wider stakeholders

Efforts

Integration of key underpinning thrusts of VBI into six aspects

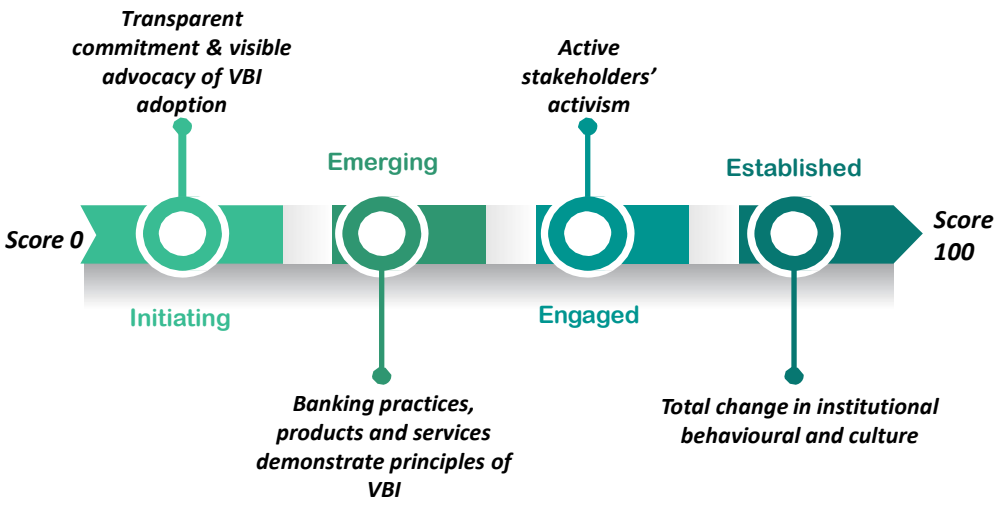
- Products and Services
- Leadership
- Human Resource Tools
- Organisational Structure
- Performance Reporting
- Management Systems

Triple Bottom Line (TBL) Decision Tree



What does score of VBI Scorecard signify?

- Score of VBI Scorecard reflects progression of an Islamic banking institution in advancing the VBI agenda from '*Initiating*' to '*Established*' phases.
- The lowest score does not denote that such institution create zero or less values to wider stakeholders, but merely classifying the institution as at the initiating phase of VBI implementation.



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Overview: Overall Framework of Value-based Intermediation (VBI)

- In March 2018, a Strategy Paper on VBI (Strategy Paper) was finalised and issued by Bank Negara Malaysia (the Bank), in collaboration with the members of the VBI Community of Practitioners (CoP)[1].
- VBI is defined as an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests[2].
- The Strategy Paper has provided a broad articulation of the underpinning thrusts of VBI as well as the implementation approach and strategies in advancing VBI as the next strategic direction for the Islamic banking industry.
- The Bank facilitates the implementation of VBI by establishing key enablers such as the CoP, VBI Network, VBI Scorecard and series of Guidance. In addition, the Bank promotes proactive transparency on the optimal set of information that aims to trigger intended reaction (market discipline) from relevant stakeholders towards existing banking practices & offerings.

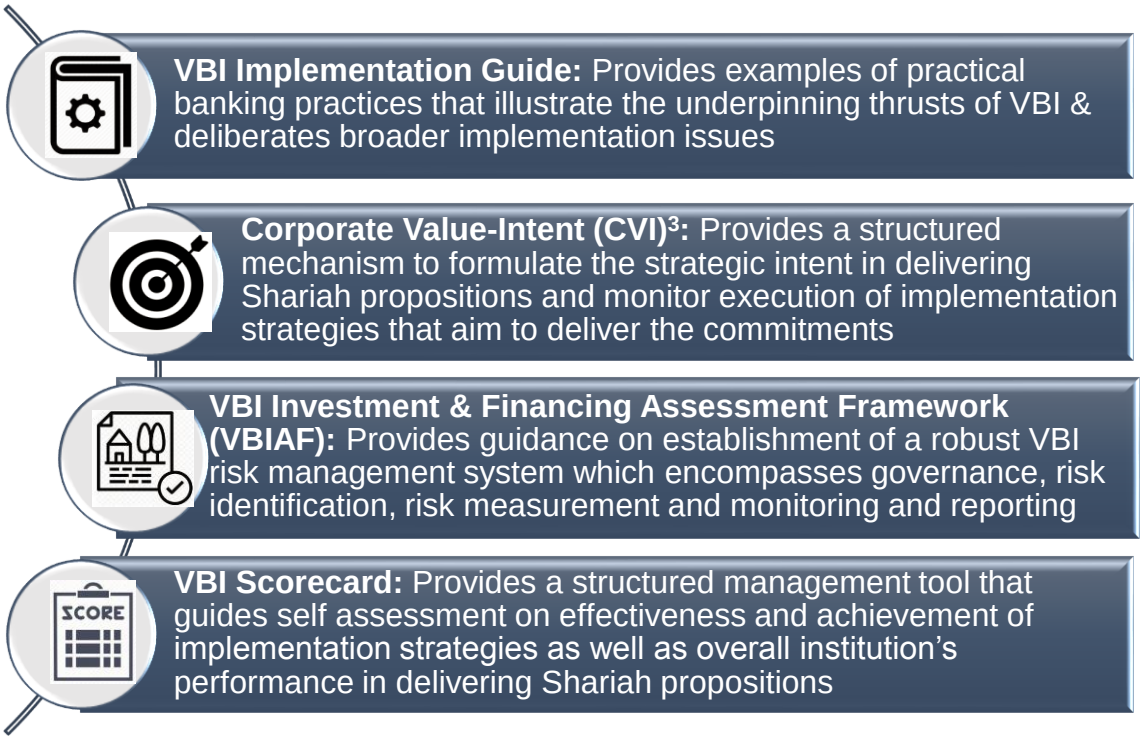
Two–pronged approach in facilitating VBI adoption by industry players

1) Creating an enabling environment through regulatory guidance

- In addition to the establishment of the VBI CoP (including its strategic network), the following documents are produced to provide guidance on how to translate articulation of VBI in the Strategy Paper into **real** banking practices & offerings:

[1] Comprising of 9 Islamic banking institutions (Bank Islam, Bank Muamalat, Agrobank, Maybank Islamic, CIMB Islamic, AmBank Islamic, Alliance Islamic, HSBC Amanah & Standard Chartered Saadiq)

[2] Strategy Paper on Value-based Intermediation: Strengthening the roles & impact of Islamic finance (12 March 2018)



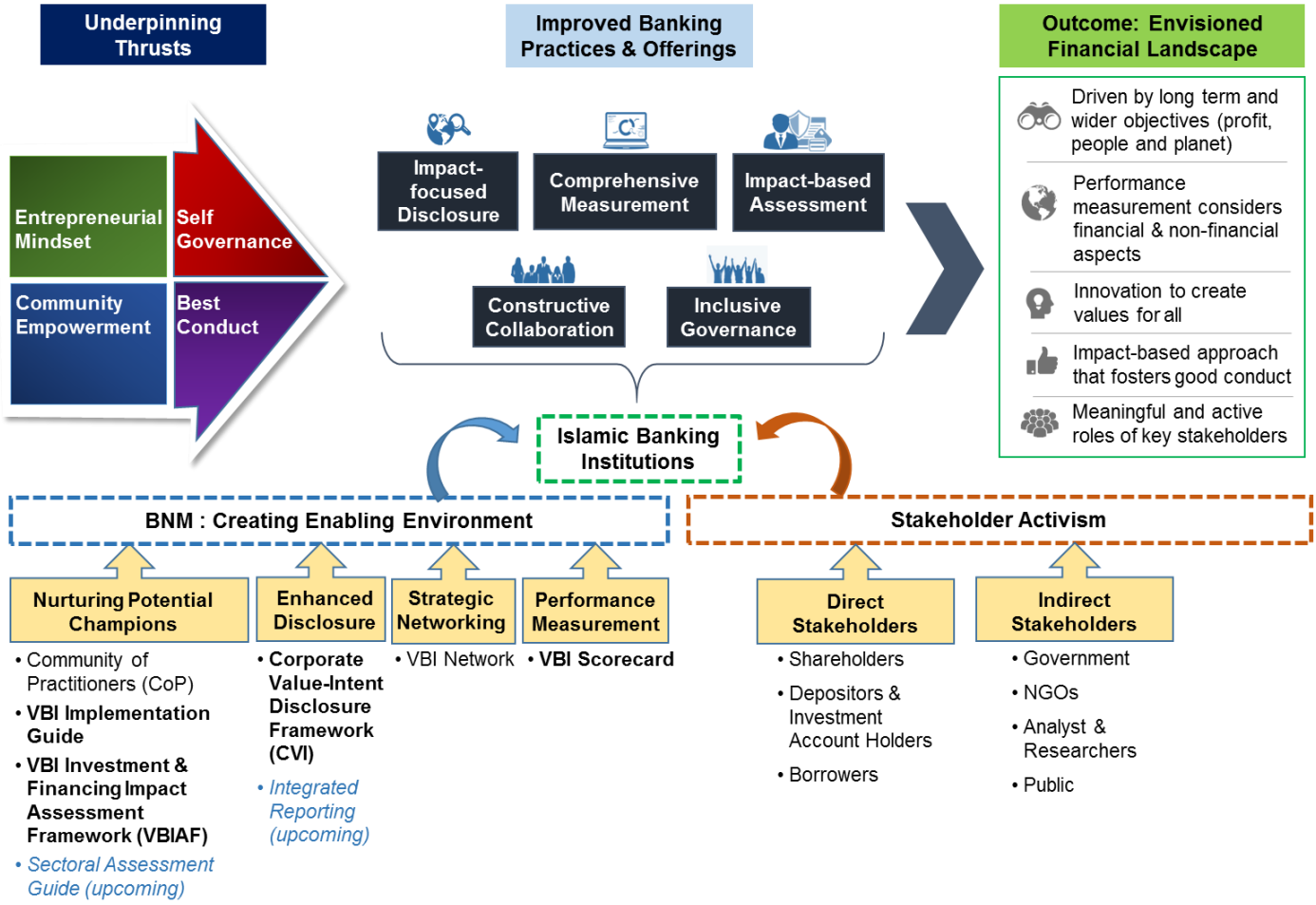
- These documents are developed in collaboration with the members of the VBI CoP and relevant stakeholders. These guidance are meant to facilitate the design process and make extensive use of examples to provide ideas of best practices evidenced globally. As such, these guidance are robust documents and rather be enhanced further in the future. Beyond these documents, other guidance may also be produced as and when necessary.

2) Enhancing quality of transparency to trigger intended stakeholder activism

- It is crucial to promote disclosure of the optimal set of information to key stakeholders such as financial consumer, investor, government, non-governmental organisations (NGOs) with an objective to generate the intended **market discipline** that encourages Islamic banking institutions (IBIs) to sharpen their focus on delivering Shariah propositions.
- At this juncture, VBI transparency expectations focus on intent/ commitment (mission statement), implementation strategies and comprehensive performance reporting (which eventually will cover **impact** of financial intermediation).

[3] Further explanation on the Corporate Value-Intent is embedded in the *Implementation Guide for VBI*. There will be no separate document issued on this aspect.

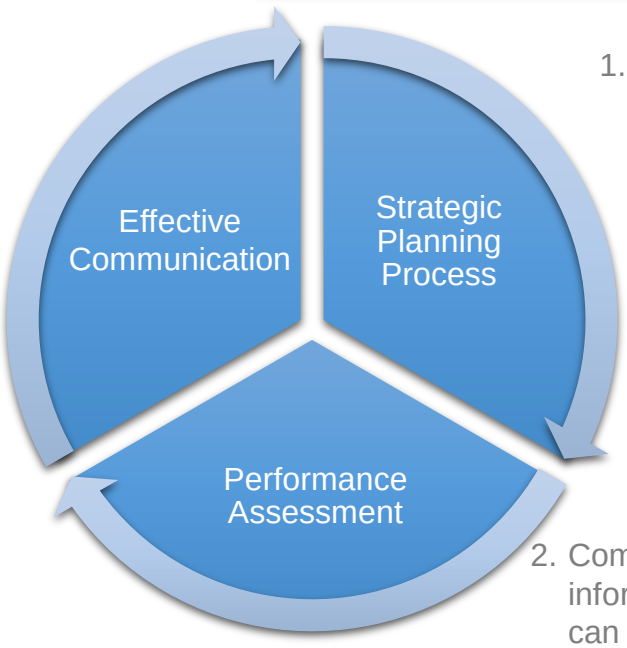
Diagram 1: Overall Framework of Value-based Intermediation



Introduction: Definition and Implementation Approach

1.1 VBI Scorecard is one of the key enablers in facilitating the implementation of VBI. The Strategy Paper articulates that VBI Scorecard provides a strategic management tool that captures the commitment, implementation strategy (including practices) and key performance indicators (results) of an Islamic banking institution, specifically in advancing VBI agenda.

Diagram 2: Purposes of VBI Scorecard



3. Enhance understanding and instill greater appreciation among wider stakeholders on IBIs' impact and value creation to economy, community and environment.

1. Facilitate IBIs in realigning their current business priorities and practices with key underpinning thrusts of VBI

2. Compile relevant information and data that can measure progression of IBIs in advancing VBI

1.2 VBI Scorecard will be adopted by IBIs in a staggered manner:

i. **Phase 1 (Internal Use)**: VBI Scorecard is used as a strategic management tool that facilitate strategic planning process and self assessment of performance and progression in advancing VBI agenda.

ii. **Phase 2 (External Use)**: Data and information captured in the VBI Scorecard will be made publicly available for wider stakeholders to analyse and compare performance of IBIs. The implementation of Phase 2 will be determined by the Bank and members of the CoP at a later stage, contingent upon the level of readiness among the industry players as well as feedback from other stakeholders.

What is VBI Scorecard?

Definition

1.3 Assessment of VBI Scorecard will categorise IBIs into a classification that reflects comprehensive performance of IBIs. Such assessment is based on two key components:

i. Assessment of performance (**outcomes**) of IBIs from three key aspects:
   a) financial sustainability – measures of profitability, asset quality, capital strength and liquidity position of IBIs;
   b) level of support to real economy – measures of financial intermediation activities that directly support the real sectors as well as proportion of IBIs' income generated from such activities; and
   c) values creation for wider stakeholders – measures of impacts (values) resulted from financial intermediation activities to wider stakeholders (economy, community and environment).

ii. Review of existing and future **efforts** of IBIs in developing and executing relevant strategies or action plans that aim to deliver the strategic intent (commitment) on VBI agenda. Assessment focuses on the degree of integrating the key underpinning thrusts of VBI into six aspects, namely leadership, organisational structure, management systems, products and services, human resource tools and performance reporting.

These components will be further elaborated in the following chapters.

1.4 VBI Scorecard considers quantitative and qualitative information in assessing both the performance (outcomes and impacts) as well as the efforts of IBIs, specifically in regards to delivering the intended outcomes of Shariah to wider stakeholders through the financial intermediation activities.

1.5 An effective adoption of VBI Scorecard (under Phase 1 and Phase 2) is expected to give rise to the following:

i. Enhance focus on delivering the Shariah propositions through a more structured and comprehensive performance measurement approach, which analyse the link between the actual outcomes of financial intermediation and the IBIs' predetermined Corporate Value-Intent (CVI); and

ii. Promote proactive behaviour and adoption of value based practices among the IBIs through greater transparency that advocates inclusive and collaborative stakeholder engagement.

Development and Implementation Approach

1.6 The development of a pilot VBI Scorecard is a **collaborative initiative** between the Bank, IBIs (led by members of the VBI CoP) and the Global Alliance for Banking on Values (GABV), hereafter referred to as "the collaborators".

1.7 Currently, all nine members of the VBI CoP have conducted an initial assessment based on the pilot scorecard.

1.8 The collaborators are aware of a separate initiative under the Bank on developing a Performance Measurement Framework (PMF) for development financial institutions (DFIs). Where applicable, specific questions have been posed to facilitate deliberation on streamlining the two initiatives. However, the collaborators agree that the specific mandate and structure of DFIs may warrant some degree of differentiation.

1.9 Notwithstanding, the development of the VBI Scorecard is not contingent upon the approach of the PMF initiative.

1.10 Throughout the development phase, it is observed that effectiveness of VBI Scorecard will be subjected to the following (non-exhaustive list):

i. Granular data mining capability of individual IBI;
ii. Availability of publicly available related analysis of real sectors and IBIs' awareness on such references; and
iii. Integration of overall VBI implementation with existing banking operations.

Questions:

1. To what extent would reporting of VBI Scorecard facilitate better-informed decision making of relevant stakeholders (shareholders, investors, financial consumers, civil society, regulators , etc.)?
2. Kindly suggest key indicators that should be considered under the non-financial aspects and why do you think such indicators are important?
3. Who else should be involved in either the development or the review the VBI Scorecard and why should they be involved?
4. Kindly highlight any concerns or issues with the disclosure of data and information captured by the VBI Scorecard?

Assessment Framework: Performance (outcomes) of Islamic Finance

How VBI Scorecard assess and measure outcomes of IF?

1) Financial Sustainability

2.1 In order to sharpen the IBIs' focus on delivering the Shariah propositions, performance yardstick should not only focus on the profitability but should also assess IBIs' contribution and values creation to wider stakeholders (beyond shareholders).

2.2 Consistent with the articulation of VBI where such values (impacts) to wider stakeholders should be created through the IBIs' financial intermediation activities[4], VBI Scorecard evaluates IBIs' performance from the following three critical components, which cover beyond the generic financial indicators:

i. Financial sustainability;
ii. Level of support to Real Economy; and
iii. Values creation for wider stakeholders.

2.3 Financial sustainability component focuses on the long term outlook of IBIs, where capacity and capability to face disruptions are assessed from the following aspects:

i. Profitability: return on assets;
ii. Capital strength: equity to total assets;
iii. Asset quality: impairment ratio; and
iv. Liquidity position: client funding to total assets ratio.

2.4 In essence, it is important for IBIs to generate sustainable profits for the shareholders as well as for relevant investments to enhance the institution's resiliency and long term capacity and capability to generate positive values to wider stakeholders.

2.5 In relation to paragraph 2.3, current assessment uses "**lagging**" indicators – in the sense that they provide post-event evidence of risks or vulnerabilities. For instance, tracking of impaired financing provides after-the-fact evidence of a credit quality issue[5]. VBI Scorecard explores the use of "**leading**" indicators that can provide indication of future performance and focus on good practices, which **proactively** identify and manage risks e.g. tracking of credit policy **exceptions** and trends in underwriting.

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[4] VBI is different from corporate social responsibility (CSR), specifically from the perspective of positive values or impact creation is created through and fully integrated within the IBIs' operations, offerings and business conduct.

[5] Supervisory Insights, Federal Deposit Insurance Corporation (Winter 2017), Credit Management Information Systems: A Forward Looking Approach

2) Level of support to Real Economy

2.6 Consistent with key universal values that aim to protect humanity from harm and attain benefit to all, Shariah prohibits *riba*, uncertainties in economic activities and any transaction that has element of gambling, excessive speculation and immoral activities[6].

2.7 Based on such premise, VBI is expected to directly support to the real economy through innovative applications of Shariah contracts that boost productivity and promote prosperity of overall economy and community at large. VBI Scorecard attempts to measure the following:

i. Proportion of total financial intermediation (asset-side) that directly support the real economy activities; and
ii. Level of income generated from such financial intermediation activities. Consistent with the Shariah principle of no-risks no-gain that emphasises the need to take some risks in order to realise any gain.

2.8 Review of these indicators will assess to what extent, IBIs **prioritise** sectors or activities, which are considered important in the current **national economic agenda** (e.g. affordable housing, digital economy, renewable energy, etc.).

2.9 For the purpose of this consultative document, IBIs' support to real economic activities can be in the form of the following activities:

i. Direct involvement in production of goods and services e.g. manufacturing, health care services, warehousing, logistics, property development and investment;
ii. Provision of capital or funding to **production** of goods and services through various financial instruments e.g. financing, investment in Sukuk (held to maturity) and equity investment;
iii. Other forms of support that facilitate the production of goods and services e.g. trade-related guarantee and derivative transaction that manages risks of businesses;
iv. Provision of funding to direct **consumption** of goods and services e.g. home financing, car financing and education financing.

2.10 Assessment focuses on the **purpose** of transaction, not the type of financial instruments used for the transaction. VBI Scorecard recognises innovative financial instruments that are designed to further facilitate real economic activities.

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[6] Prohibition of *riba* is mainly due to **injustice** that is caused by allowing a creditor to generate easy income from loan transaction and hence, lack of motivation to invest in real economy activities. Reference: Islamic finance: A Real Alternatives?, Dr. Mohamad Akram Laldin, International Shari'ah Research Academy for Islamic Finance.

2.11 Intermediation activities that do not directly support the real economic activities or expose IBIs to the volatility of financial markets will be excluded from this indicator. For example:

i. personal financing that is disbursed to individuals for debt consolidation purpose i.e. settlement of another debt; and
ii. investment in Sukuk or other financial instruments for trading purpose.

2.12 Nonetheless, VBI Scorecard recognises the importance of liquidity management and hedging transaction for bank's own risk exposures.

2.13 In relation to sub-bullet (iv) of paragraph 2.9, VBI Scorecard also explores practical application of *maqasid* Shariah framework, specifically in assessing the purpose of intermediation activities that support consumption of goods and services. In principle, consumption-based intermediation should not promote destructive behaviour[7] such as *israf* (unnecessary spending), *itraf* (self-indulgence) and *tabdhir* (spending on unlawful activities).

Questions:

5. In addition to quality of credit underwriting practices, what are other "leading" indicators that should be considered by the VBI Scorecard, specifically in assessing proactive behaviour of Islamic banking institutions in identifying and managing potential vulnerabilities, which may eventually affect institution's sustainability?
6. What is the proportion (%) of a banking institution's total assets currently used for liquidity management and hedging of own risk exposures?
7. What do you think on the proposed parameter of intermediation for real economic activities as described in paragraph 2.9? What is the optimum % of intermediation for real economy activities that is reflective of the nation's economic needs? Kindly support your answer with relevant analysis and information.
8. Discuss on the examples of activities that may not fall within the intermediation for real economic activities and the importance of these activities.

[7] Developing Islamic finance in the framework of *maqasid al-Shari'ah*: Understanding the ends (*maqasid*) and the means (*wasa'il*), Mohamad Akram Laldin and Hafas Furqani, International Shari'ah Research Academy for Islamic Finance (ISRA).

3) Values Creation for Wider Stakeholders

2.14 Given that one of the Shariah propositions emphasises on prevention and minimisation of harm (negative impacts) as well as advocates attainment of benefit (positive impacts) for wider stakeholders, VBI Scorecard assesses to what extent financial intermediation of IBIs has created positive and sustainable values or impacts to wider stakeholders (beyond shareholders).

2.15 This component of performance will be evaluated from the following aspects:

i. proportion of total intermediation (asset-side) that has created the intended values (impacts) to wider stakeholders i.e. economy, environment and community, consistent with the strategic commitment of the IBIs' in delivering Shariah propositions; and
ii. efforts of an IBI, specifically in identifying, measuring and monitoring positive and negative impacts of the proposed transaction as well as mitigating negative impacts arising from such transaction.

2.16 This assessment focuses on the impact of intermediation activities to **wider stakeholders** (beyond shareholders) i.e. community, environment and economy. Such "impact" can be reported in the form of financial (e.g. targeted segment's income growth) and non-financial indicators (e.g. improved productivity & enhanced standard of living). There are references on "**triple bottom line**" (TBL) which focuses on the following three aspects[8]:

i. Social empowerment – education, health care, social inclusion, affordable house
ii. Environmental Regeneration – renewable energy, sustainable agriculture, green building, energy and water efficiency
iii. Economic Resiliency – micro financing and economic inclusion.

Diagram 3 summarises a simple decision tree that can be used to determine whether each exposure qualifies as TBL or not.

2.17 Unlike financial sustainability, this assessment on the impact of financial intermediation to wider stakeholders involves subjective elements. VBI Scorecard explores the use of related references of real sectors issued by either local or international authorities. For instance, the Sustainable Development Goals (SDGs) set by the United Nations General assembly and the environmental and social risk by industry sector from the International Finance Corporation (IFC).

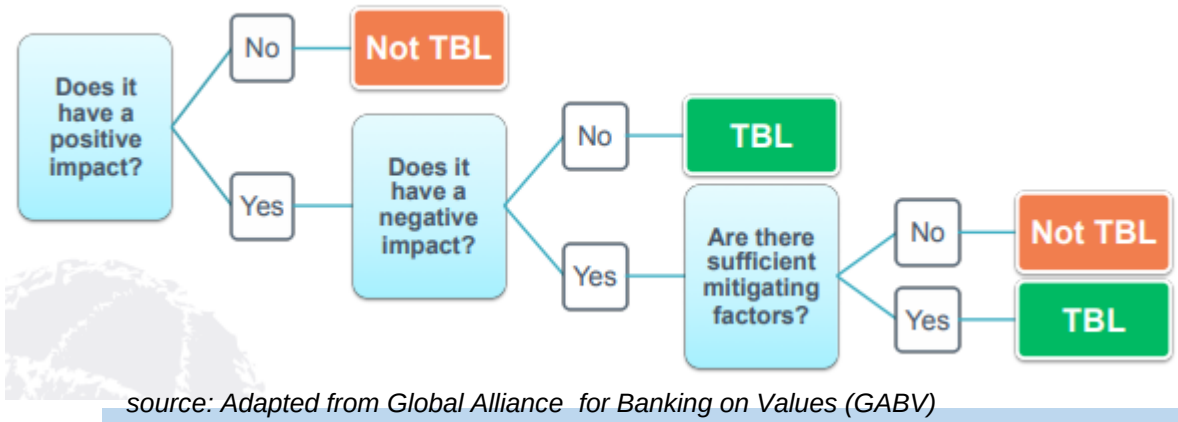
8 Assessing Banks: Delivering a Triple Bottom Line in the Real Economy, the Global Alliance for Banking on Values.

2.18 For transactions that result in significant negative impacts, the assessment will consider availability of effective **mitigation** that manage or address the negative externalities. Without the effective mitigation in place, those transactions that result in negative impacts will be excluded from the assessment.

2.19 VBI Scorecard also analyses degree of consistency between the actual impacts of intermediation activities with the strategic commitments (intent) of an IBI.

2.20 In relation to paragraph 2.17, VBI Scorecard does not expect IBIs to immediately reject proposed transaction or exit from existing transaction, which results in significant negative externalities. Focus of VBI Scorecard will be on the **proactive** efforts by IBIs in **nurturing** their clients to adopt sustainable practices and over time growing the proportion of intermediation that results in positive TBL.

Diagram 3: Triple Bottom Line Decision Tree



source: Adapted from Global Alliance for Banking on Values (GABV)

Questions:

9. Discuss on any unintended consequences of such assessment on access to financing for specific sector or segment?
10. Should the VBI Scorecard consider specific indicator on intermediation that results in negative TBL and why?
11. Kindly share your views on the proposed triple bottom line decision tree. Is there an alternative framework that can enhance analysis on externalities of financial intermediation?
12. Suggest common indicators that can consistently reflect impacts of financial intermediation across the industry.

Assessment Framework: Efforts of IBIs

How does VBI Scorecard capture efforts of IBIs?

3.1 To facilitate assessment on the "efforts", IBIs are expected to capture the following information:

i. **Strategy** - explanation on formulation of specific strategies and translation of such strategies into relevant policies.

ii. **Process** - deliberation on implementation approach or specific action plans undertaken to execute the strategies.

iii. **Results** - provide meaningful and concrete results (e.g. impact to clients, amount of financing for affordable housing, range of supports & services for entrepreneurs).

3.2 VBI Scorecard will assess IBIs' efforts in **integrating** the key underpinning thrusts of VBI within the overall banking operations as well as offerings.

3.3 Assessment on "efforts" also consider relevant **forward looking information** such as products or projects in the pipeline.

3.4 IBIs need to provide relevant information (as specified in paragraph 3.2) for the following six operational aspects:

i. Leadership

- Level of advocacy and support by the institution's leaders (Board of Directors and Senior Management) in actively advancing VBI within the institution (internal) as well as to external stakeholders

ii. Organisational Structure

- Commitment from key shareholders (based on the strategic mandate or nature of institutional investors) and proactive role of Shariah committees and affiliated entities in driving implementation of VBI related strategies.
- Discussion on the effect of current institutional structure (i.e. a full-fledged bank, subsidiaries or windows) to effectiveness of VBI strategies implementation.

iii. Products & Services

- Distinct features of Islamic banking products and services that demonstrate key underpinning thrusts of VBI.
- Adoption of best practices throughout product development, marketing, sales, product delivery and after-sales services, which aim to create better values to customers.

iv. Management Systems

- **Resources allocation** (capital, risk appetite, funding and human resources) that considers **impact** of proposed transactions to wider stakeholders.
- **Risk management framework** that explicitly identifies positive impacts resulting from an exposure (transaction) as well as addresses negative externalities arising from transactions.
- Development of innovative funding instruments that can match the maturity and expected returns of VBI-related assets (**asset-liability management**)

v. Human Resource Tools

- Application of human resource tools that instill the right culture and shape the right staff behaviour e.g. staff performance management and remuneration practices that are linked to factors such as customer wellbeing (in addition to profits or sales volume).

vi. Performance Reporting

- Proactive transparency on impact of intermediation to facilitate better informed decision making of relevant stakeholders.
- Internal performance tracking and reporting.

Questions:

13. Suggest common indicators that can be made applicable across industry players for measurement of “efforts”.
14. Suggest a way to incorporate future plans and goals into VBI Scorecard.

Chapter 4: Score and Disclosure

What does score of VBI Scorecard signify?

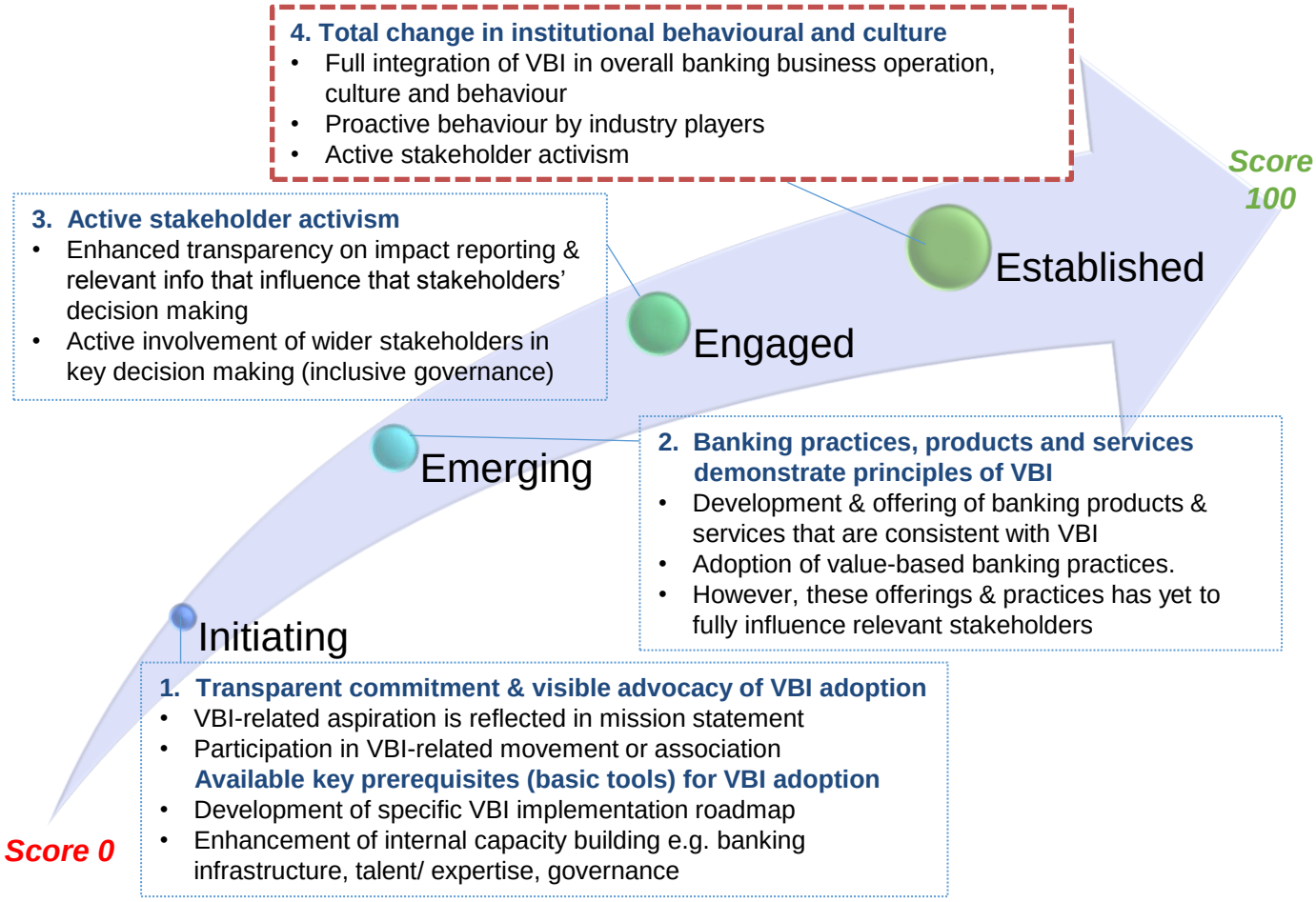
4.1 Score of VBI Scorecard aims to reflect progression of an IBI in advancing the VBI agenda.

4.2 The lowest score does not denote that such institution create zero or less values to wider stakeholders, but merely classifying the institution as at the early phase of VBI implementation phases.

4.3 Deliberation of the score focuses on identification of potential areas of improvement and appreciation of best practices adopted by IBI by sharing with other industry players for reference and benchmark.

4.4 There are four classifications under the VBI Scorecard: Initiating, Emerging, Engaged and Established. Diagram 4 summarises key parameters under each classification.

Diagram 4: VBI Score signifies phases of VBI implementation



source: Adapted from Sustainable Banking Network (SBN) Global Progress Report (Feb 2018) & Global Alliance for Banking on Values (GABV)

4.5 VBI Scorecard assessment will be done annually. At this juncture, such exercise only involves nine IBIs who have volunteered and committed to adopt this practice.

4.6 Moving forward, VBI Scorecard aims to compile and collect relevant information and data that are useful and meaningful for overall assessment on effectiveness of VBI agenda, in achieving its underlying objective i.e. to strengthen the roles and impacts of Islamic financial institutions.

Disclosure Expectation

4.7 Subject to the IBIs' level of readiness, the score and the content of VBI Scorecard's submission will be disclosed to the public. Objective of such transparency is to equip relevant stakeholders with the right set of information that further facilitate financial decision making process.

Question:

15. In addition to regulator and individual IBI, who else do you think should be involved in the deliberation of the score? Kindly articulate rationale of your answer.