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CLASSIFICATION AND MANAGEMENT OF NON-PERFORMING LOANS OF ISLAMIC BANKS AND CONVENTIONAL BANKS: A COMPARATIVE STUDY

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Abstract. This paper compares the classification and management of non-performing loans between Islamic banks in Malaysia and conventional banks in the UK and Japan. The objective of this paper is to investigate if there are differences in the classification and management of non-performing loans in Islamic banks as a result of the existence of the Investment Account Depositors (IADs). The nature of profit and sharing loss agreement has made the position of IADs in an Islamic bank unique. This uniqueness, however, has posed some degree of risk where in case the bank incurs a loss, the IADs are liable to share this loss. This has made the investment of IADs very risky and is subject to the potential problem of asymmetric information. This paper finds that the Islamic banks define and manage their non-performing loans differently from the conventional banks in the UK and Japan. The analysis shows that even though Islamic banks have special characteristics, the classification and management of its non-performing loans are quite lenient. This is evidenced in the way non-performing loans are defined, the way loss provision is made and the level of disclosure made by an Islamic bank.

Keywords: Islamic banks; non-performing loans; loss provision; level of disclosure

Abstrak. Artikel ini membandingkan klasifikasi dan pengurusan pinjaman tak-berbayar antara bank Islam di Malaysia dengan bank-bank konvensional di United Kingdom (UK) dan Jepun. Objektif kajian adalah untuk menyelidik sama ada terdapat perbezaan dalam klasifikasi dan pengurusan pinjaman tak-berbayar yang dipratikkan oleh bank Islam hasil dari kewujudan Akaun Deposit Pelaburan (IAD) di bank berkenaan. Peruntukan perkongsian untung rugi seperti mana yang terdapat dalam IAD di bank Islam adalah sesuatu yang unik. Keunikan ini, walau bagaimanapun mempunyai risiko di mana dalam kes bank mengalami kerugian, maka IAD akan turut sama menanggung kerugian tersebut. Ini menjadikan pelaburan dalam IAD sangat berisiko dan tertakluk kepada maklumat asimetri. Kertas ini mendapati bank Islam mendefinisikan dan mengurus pinjaman tak-berbayarnya secara berbeza berbanding dengan bank-bank konvensional di UK dan Jepun. Analisis menunjukkan walaupun bank Islam mempunyai ciri-ciri khas tapi klasifikasi dan pengurusan pinjaman tak-berbayarnya adalah lebih longgar. Ini dibuktikan melalui cara di mana pinjaman tak-berbayar dan cara peruntukan kerugiannya didefinisikan dan juga tahap pendedahan maklumat kewangan yang dilakukan oleh bank Islam.

Kata kunci: Bank Islam; pinjaman tak-berbayar; peruntukan kerugian; tahap pendedahan maklumat kewangan

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1.0 INTRODUCTION

In a conventional banking system, the bank obtains fund by borrowing from its depositors at an interest rate. The bank uses the funds to make profits by extending loans and also by investing in securities. The profit made by the bank is through the differences between the borrowing interest rate and the lending interest rate. Unlike conventional banks, Islamic banks do not operate on an interest rate system. Thus, to make a profit, Islamic bank must invest the funds by extending financing. Since they are not able to charge interest, Islamic banks use various types of contract like cost plus, and profit and loss sharing (PLS), which are consistent with Islamic principles. The funds for the financing comes from the Islamic bank's own equity, customers' deposits in current accounts, customers' deposit in saving accounts and customers' deposit in investment accounts (hereafter referred to as Investment Account Depositors – IAD).

Funds from the depositors mingle with shareholders' funds and the bank use the funds in the same investment portfolio. However, the shareholders' fund would be used to fulfil legal requirements while most of the deposits will be used for extending financing. Current Accounts and Saving Accounts are guaranteed whereas Investment Accounts do not guarantee capital because they are based on the profit and loss sharing agreement. The IADs are entitled to share in the bank's net profit or loss and this is based on a profit sharing ratio of a certain pre agreed percentage. In case of loss from the activities of giving out financing, the IADs can lose all of their investments. Since deposits other than IADSs are guaranteed, the loss flows to the IADs first, with any remaining flowing to the shareholders of the bank. Only when the loss is major that it will finally flow to the rest of the depositors. The IADs actually act as a cushion for the bank in case of a loss. The position of IADs in an Islamic bank is quite unique. This is because even though the IADs have invested in the bank and may suffer losses, they are not shareholders. Since they are not shareholders the IADs do not have special rights like voting rights and therefore cannot influence the investment decision of the Islamic bank. The nature of profit and sharing loss agreement has made the position of IADs in an Islamic bank unique. However, this uniqueness has posed some degree of risk for the IADs. In case where the bank incurs a loss, the IADs are liable to share this loss. This has made the investment of IADs very risky and is subject to the potential problem of asymmetric information.

The objective of this paper is to investigate the policy on classification and management of non-performing loans in Islamic banks in Malaysia. It will compare the policy in the classification and management of non-performing loans with the policy adopted in the UK and Japan. Specifically, this paper investigates whether or not the existence of IADs has resulted in a stricter approach to the classification and management of non-performing loans in Islamic banks in Malaysia. The unique position of IADs in Islamic banks has lead to several questions. Firstly, are there any differences in the policy pertaining to non-performing financing in an Islamic bank so that the IADs will be protected from any loss? What are the differences between the approaches

used by Islamic banks in Malaysia and conventional banks in UK and Japan in classifying and managing their non-performing loans? Secondly, are there adequate disclosures to the IADs on the situation of non-performing loans that the bank has?

2.0 LITERATURE REVIEW

Fama (1970) introduces a model of efficient capital markets. An ideal market is a market where prices provide accurate signals for resource allocation. He divided the markets into three categories depending on the nature of the information subset of interest. They are the strong-form, semi-strong-form and weak form. A strong-form efficient market model is where the prices are assumed to fully reflect all available information. A semi-strong-form is where the prices are assumed to fully reflect the publicly available information and the weak-form where the prices are reflected from available historical information. According to Abalkhail and Presley (2001), the lack of information transfer between investors and entrepreneur exposes the investors to the risk of adverse selection and moral hazard. Information seems to be a very important element in a financial market. Stiglitz (1985) suggested that a capital market is informationally efficient when the prices reflect the available information.

In relation to the importance of information, the most important information for the IADs would be on the non-performing financing of the bank that they invested in. As suggested by Beattie *et al*. (1995) bad debs are by far the most common cause of bank failures. Bank failures are always viewed to be more damaging than any other types of business failures because it is feared that the failure might be contagious and as a result, the whole financial system might collapse. Kaufman (1996) suggested that the reason for this is because banks are closely entwined financially with each other through lending and borrowing from each other, payments clearing system that the failure of one bank is likely to spill to other banks more quickly. The best example of the adverse effects of uncontrolled classification and management of non-performing loans is Japan. Insufficient provisioning and public disclosure have been identified as factors that concealed the actual levels of the non-performing loans in Japan (Nakaso, 2001). With regard to the issue of non-performing loans in Islamic banks, in September 2000, Pakistan has set up the "Corporate and Industrial Restructuring Corporation" (CIRC) to address the issue of non-performing loans and risk aversion (State Bank of Pakistan, 2002). A second committee on Revival of Sick Units (RSU) was established to restructure and revived problematic loans. Pakistan has also promulgated the Financial Institution (Recovery of Finance) Ordinance to expedite recovery of non-performing loans by foreclosure. In Bangladesh, the amount of bad debts of the Islamic banks grew from 18% in 1996 to 20% in 1997 (Sarker, 1999).

In order for the IADs to be protected, there should be an adequate classification and management of non-performing loans and adequate disclosure on the level of the non-performing loans of the banks to the IADs. This is important because the nature of the relationship between the IADs and the bank entail the sharing of losses. Hence if

these two are inadequate, it may lead to potential bank failure and the IADs may risk losing their investments. Therefore, a transparent approach in the management of non-performing loans in Islamic banks is very crucial as it may reduce the probability of IADs losing their investments.

3.0 CLASSIFICATION AND MANAGEMENT OF NON-PERFORMING LOANS

The regulations in each country differ and as a result the classification and management of non-performing loans differ from one jurisdiction to another. The treatment of non-performing loans, loss provision and disclosure are different as well. In general, however different the regulations are in every country, the objective of regulation in the end is to ensure the bank's soundness. In this section, an analysis is made of the classification and management of loss provision in Malaysia, Japan and the United Kingdom.

3.1 Definition of Non-Performing Loans

The Basle Committee on Banking Supervision does not have an exact definition of non-performing loans, but in the Consultative Documents, January 2001, under Rules for Corporate Exposures for minimum requirements for corporate exposures, section 272, it is mentioned that:

> *A default is considered to have occurred with regard to a particular obligor when one or more of the following events have taken place:*
>
> - *It is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;*
> - *A credit loss event associated with any obligation of the obligor, such as a charge off, specific provision, or distressed restructuring involving forgiveness or postponement of principal, interest or fees;*
> - *The obligor is past due more than 90 days on any credit obligation; or*
> - *The obligor has filed for bankruptcy or similar protection from creditors*
>
> *This definition however is not intended to affect the bank's legal rights and remedies should a borrower fail to meet his or her obligations under a credit agreement. It is also not intended to establish or alter accepted accounting standards.*

The Accounting, Auditing and Governance Standards for Islamic Financial Institutions (AAOIFI) does not define doubtful receivables. AAOIFI was established in 1991, led by four major Islamic banking groups and the Islamic Development Bank (IDB). Its objective was to promulgate international accounting and auditing standards to be used by Islamic financial institutions internationally (AAOIFI, 2004).

The Central Bank of Malaysia (BNM) defines a loan as non-performing when the principal or interest is due and unpaid for six months or more from the first day of default. The same definition is also applicable to Islamic financing. Even though Islamic banks have special characteristics in which it operates on the basis of profit and loss sharing and extend different modes of financing than conventional banks, they still share the same guidelines for the classification and management of its non-performing loans. Both conventional and Islamic banks use the same guidelines known as the *Garis Panduan 3* (GP3) for the definition and treatment of non-performing loans or non-performing finance. However, not all of the contents of the GP3 can be applied. For example, there are financing products that are not applicable to the Islamic banks like for example, overdraft facilities.

Other than the GP3, Islamic banks in Malaysia are allowed to use the accounting methods suggested by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) for the provision of losses. However, this paper will only focus on GP3 as the standard guidelines in the classification and management of non-performing loans for Islamic banks in Malaysia. The guidelines in GP3 given by BNM on the classification of non-performing loans set the minimum standards. Financial institutions are responsible for establishing reliable systems of policies, standard procedures and independent units to review the non-performing loans and the provisions required.

Other than the general classification of non-performing loans, there are various categories that have their own non-performing classification.

(1) Bankers' acceptances (BA), trust receipts, bills of exchange and other instruments of similar nature will be classified as non-performing loans when the instrument is due and unpaid for 1 month after the maturity date.
(2) Credit Cards will be classified as non-performing when the holder fails to settle his minimum monthly repayments for 3 months or more from the first day of default.
(3) Term financing, revolving credit facilities, leasing, hire-purchase and other financing is classified as non-performing when it is unpaid for 6 months or more from the first day of default.

In respect of the treatment of financing with quarterly, semi annual, annual or bullet repayments where repayments are scheduled on intervals of 3 months or longer, the loan is classified as non-performing when a repayment is due and unpaid for 3 months or more from the first day of default. If a loan is fully secured by cash or cash substitutes as to principal and interest and cost of collection, the loan will be classified as non-performing if it is due and unpaid for 12 months or more from the first day of default. Cash or cash substitutes are fixed deposits or sinking funds with set-off rights, securities issued by the Federal Government or irrevocable guarantees or step-in rights by the

Federal Government. Where financing is partially secured by the above then split application applies whereby the unsecured portion will be subject to the normal classification of 6 months and above.

In ascertaining the period in arrears, each repayment must be made in full. If the monthly repayment is made partially, the repayment is still deemed to be in arrears. According to the GP3, a non-performing loan can be reclassified as performing once total instalments in arrears falls below 6 months. For example, if a loan is 8 months in arrears and the borrower pays 3 monthly instalments, the non-performing loan can be reclassified as performing as the total period in arrears is below 6 months.

Similar to Malaysia, Japan's definition of non-performing loans is past due loans in arrears 180 days or more and loans to borrowers in legal bankruptcy (Annual Report on Japan's Economy and Public Finance, 2002). Since the crisis, the definition of non-performing loans was expanded to include loans where the interest was reduced and later to include loans in arrears by three months or more and restructured loans. In the United Kingdom (UK), the definition of non-performing loans based on Securities and Exchange Commission (SEC) are loans accounted for on a non-accrual basis, accrual loans which are past due 90 days or more and loans not included in the previous two that are troubled debt restructurings or reduced rate loans (Beattie *et al.* 1995).

3.2 Loss Provision for Bad and Doubtful Debts

Provision for bad and doubtful debts is profit set aside to cover possible loan losses. In a paper by the Basle Committee on Banking Supervision (1999) on sound practices for loan accounting and disclosure, the aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio. A bank should not understate or overstate loan losses in order to achieve a desired level of earnings in the current or future reporting periods.

AAOIFI (2000) defines provision as a contra-asset and is constituted by charges made as expenses against income. The provisions are of two types: specific and general. A specific provision is an amount set aside to reflect an estimated impairment of value of a specific type of asset. The specific provision shall be deducted from its related receivables assets so that their financial position is at their cash equivalent value. The specific provision related to each of financing and investment assets are also deducted from these assets so that their value is reported at the lower of cost and cash equivalent value. A general provision is an amount set aside to reflect a potential loss that may occur as a result of currently unidentifiable risks in relation to receivables, financing or investment assets that have already occurred. The general provision shall be deducted from the total value of receivables, financing and investment assets. The Islamic bank must disclose in the notes to the financial statements the total amount of the specific provision and general provision related to receivables, financing and investment assets.

In Malaysia, the BNM requires the banking institutions to make two types of provisions for bad and doubtful debts. The two types of provisions are general provision

and a specific provision. Specific provision as defined by the BNM is an amount set aside out of profit to cover losses expected for a specific loan that has been classified as bad or doubtful although the exact amount of loss cannot be confirmed. A general provision is an amount set aside out of profits to meet possible loan losses which are not identifiable to any loan account or known to exist as at the financial reporting date. This is because some losses may arise from loans that are performing as at the financial reporting date. The general provision required is at least at 1.5% of total outstanding loans net of specific provisions for substandard, bad and doubtful debts.

According to the GP3, financial institutions in Malaysia are required to observe the following minimum parameters in respect of specific provisions as outline in Table 1.

The substandard accounts are credit facilities that involve more than normal risk of loss due to certain factors. These factors could include delays in the servicing of financing, unfavourable financial conditions, insufficient security or other factors that give rise to some doubts in the capacity of the borrower to make repayment. Doubtful accounts are credit facilities or a portion thereof where collection in full is improbable and there is a high risk of ultimate default. Bad accounts are credit facilities that are deemed not collectible on the basis of relevant circumstances.

In determining the specific provision for bad and doubtful debts required for a particular financing, consideration must be given to the collateral taken as security.

Table 1 Guidelines in respect of specific provisions

Period of Default	**Classification**	**Specific Provision on the Shortfall in Security Value over the Amount Outstanding**
6 months but less than 9 months	Substandard	20% provisioning unless overall loan loss provisions are adequate
9 months but less than 12 months	Doubtful	50%
12 months and above	Bad	100%

Source: GP3, Bank Negara Malaysia

The BNM provides guidelines on the valuation of security. There are guidelines for collaterals in the form of property, deed of assignment, debenture, and shares, quoted or unquoted, plant, machinery and equipment and guarantees. Other collateral will be considered on case-to-case basis.

There is no specific rule on provision for banks in the UK but in the Interim Prudential Sourcebook For Banks, 2002 (IPRU) item 3.3.17 R, issued by the Financial Services Authority (FSA) in the United Kingdom stated that *a UK bank and an overseas bank must maintain adequate provisions for the depreciation or diminution in the value of its assets (including provisions for bad and doubtful debts), for liabilities which will or may fall to be met by it and for losses which it will or may incur*. In item 3.4.5 R of the IPRU there

is also a provisioning policy statement whereby *(1) A UK bank and an overseas bank must also set out its policy on making provisions in a written statement and (2) The policy statement must be such that compliance with it would enable the bank to comply with IPRU (Bank) 3.3.17R except that an overseas bank need only cover such provisions as made in the accounts of its operations in the UK.* The FSA provide guidance on what a bank's policy statement should contain. A bank must provide a statement on issues relating to provisioning for credit exposures and other liabilities, issues relating to provisioning for credit exposures only and issues relating to provisioning for other liabilities. Examples of issues relating to provisioning for credit exposures and other liabilities given in the IPRU include, *who in the bank has responsibility for drawing up and monitoring the policy?; Who is responsible for reviewing and updating the policies and how often is this done and what are the review processes?* Issues relating to provisioning for credit exposures include the non-performance exposure for the different types of business that the bank undertakes and how they are identified. The reason for having this explicitly stated is that banks having different views as to what constitutes a non performing exposure must explain clearly and concisely the definition that they uses. With regard to provisioning for other liabilities only, a bank must state which accounting standards the bank complies with in terms of providing for other liabilities. Table 2 illustrates the provisioning practices in the UK in terms of criteria, basis and level of provisioning.

In Japan, before the crisis, the specific provisions may be recorded but subject to the approval from the Ministry of Finance (MoF). The financial institutions are expected to set aside provision for expected losses over a period of three years. Even though the new provisioning policy is in the right direction, it created a financial disruption as it is done in a short period of time. It squeezes banks' profit and banks' capacity to give out loans. Table 3 shows the policy on loss provisioning in Japan before such changes were made in response to the crisis.

In response to the crisis, a new policy on loss provision was introduced. The specific provisions are based on self-assessment of the loan portfolio using the Tracing Method

Table 2 Provisioning in the UK

(i)	**What criteria must be met before the following provisions are made:**	
	(a) Specific Provision	There are no specific rules and the decision is left to management's discretion, based on the financial condition of the borrower, guarantor, security etc. Guidance is given in the Statement of Recommended Accounting Practice (SORP) on Advances published by the British Bankers' Association. Maintenance of adequate debt provision is a requirement for authorisation under the Banking Act. Specific

Table 2 (*Continued*)

		provisions should be made against loans where the creditworthiness of the borrower has undergone a significant deterioration and recovery of the advance is in serious doubt.
	(b) General provision	The SORP on advances requires a general provision to be made to cover impaired advances not yet identified.
(ii)	**What basis is used when assessing loans for the following provisions:**	
	(a) Specific provision	Commercial loans are normally assessed on an individual basis. Retail loans are generally assessed on a pooled basis.
	(b) General provision	Assessment of level of general provision is made with reference to the residual risks in the total loan portfolio, normally after accounting for specific provision.
(iii)	**Level of provisioning:**	
	(a) Specific provision (except for provisions for country risk)	Loans assessed on an individual basis, where practical. Statistical techniques used on large portfolios of small value loans. No official guidance on calculation of level of provision. The SORP requires that the specific provision should be the bank's estimate of the amount needed to reduce the carrying value to the expected ultimate realisable amount. Banks should consider at least five factors: • the amount of the loan and the bank's other commitments to that borrower; • the borrower's(business) prospects and ability to repay; • the security for the loan (if any) and how it could be realised; • the costs that would be incurred in obtaining repayment if security or other rights had to be enforced; and • the income from the loan
	(b) General provision	Level of general provision is left to the bank's discretion. Normally management has regard to: • identification of usually large, loans for which it is not clear that a specific provision is needed but where sufficient doubt exists for some general provision to be appropriate; • the application of varying percentages to the different categories of loan portfolio and other exposures, weighted towards those industrial and geographical segments that are considered to be particularly at risk;

Table 2 (*Continued*)

		• the application of an absolute percentage to the total risk portfolio, based on past experience of the incidence of bad and doubtful debts, and the current economic climate; • both on and off balance sheet exposures, sometimes using the weighted risk asset data required by the Bank of England.
(iv)	**What other provisions are made and how are they determined?**	Sovereign and country risk. Setting levels of provision using Bank of England "matrix" to objectively measure the extent of each country's difficulties do the provision. Consideration factors for the provision are country's economic management, activity, political stability, controls over companies and the characteristics of their own portfolio.
(v)	**Are discounted values used in determining the probable loss and the provision required?**	No official guidelines but is often used by banks to help determine provisions.
(vi)	**What are the rules to prevent capitalisation of interest on non-performing loans? Are there any procedures (other than annual external audit) to prevent circumvention of these rules?**	The crediting of interest to the suspense account should cease when there is no longer any realistic prospect of recovering it.
(vii)	**What are the policies on the valuation of collateral**	No official guidance. It is based on banking industry practice. The value of any security is usually taken at its current realisable value, less any prior charges and costs of realisation. Enforceable of the security will also be taken into account. For listed securities, valuation is at lowest "bid price" allowing for a discount if the shareholding is substantial. For unlisted securities, value is determined based on the financial information. As for guarantees, the reliance on guarantees is only to the extent that the guarantor has the resources and the intention to honour it and the bank is willing to exercise it.
(viii)	**Taxation**	• General provisions are not tax-deductible. Specific provisions are tax deductible, provided management has reasonable evidence that the portion of the loan provided is irrecoverable. Tax deductions on country risk provisions are based on the Inland Revenue matrix. This matrix allows lower provisions for tax deductions than those recommended by the Bank of England matrix.

Table 2 (*Continued*)

(ix)	**What factors determine whether a deferred tax asset is recognised for differences between the tax and accounting treatment of loan losses?**	Deferred tax assets are not generally recognised unless they are expected to be recoverable and will not be replaced by equivalent debit balances.

Source: Beattie *et al.* (1995)

(Bank of Japan, 1998). This approach allows flexible provisioning policy based on the actual quality of the borrower. It observes changes in the condition of individual assets in a time series analysis. Financial institutions classify borrowers into five categories-normal borrowers, borrowers requiring caution, borrowers threatened with bankruptcy, potentially bankrupt borrowers and substantially bankrupt.

Table 3 Loss provisioning in Japan before financial crisis

(i)	**What criteria must be met before the following provisions is made?**	
	(a) Specific provision	Under the Ministry of Finance (MoF) regulations, specific provisions may be recorded at the management discretion but subjected to the approval of MoF.
	(b) General provision	Mandatory.
(ii)	**What basis is used when assessing loans for the following provisions?**	
	(a) Specific provision	Commercial loans and retail loans are generally assessed on individual basis.
	(b) General provision	Based on total receivable balance.
(iii)	**Level of provisioning**	
	(a) Specific provision (except for provisions for country risk)	The following “tax deductible” provisioning may be approved by MoF: • Up to 100% of uncovered portion of loan if the borrower is insolvent, for more than one year and, at the same time, more than 40% of face value of loan is reckoned unrecoverable. • 50% of uncovered portion of loan once filing has been made for the borrower’s bankruptcy or restructuring. At the management’s discretion, “non tax-deductible” provisioning may be made for up to 100% of face value of loan on MoF’s consent.
	(b) General provision	A general tax deductible provision may be set up using 0.3% of total receivable balance, the statutory basis, or by using the “actual percentage” based upon

Table 3 (*Continued*)

		prior debt experience in the past three years and the level of the loan portfolio.
(iv)	**What other provisions are made and how are they determined?**	• For sovereign debt, banks are currently maintaining 30% level (previous ceiling level for sovereign debt provisions). However, they can determine the justified level of provisioning subject to the approval of MoF. Some banks however, have moved from 30% to 35%. • Other loan related provisions. It is recorded for book purposes only and after discussion with MoF and the national tax authorities. Formal approval is usually not given and the purpose of this is to enable banks to provide additional reserves due to uncertainty in provisioning.
(v)	**Are discounted values used in determining the probable loss and the provision required?**	Not used in determining provision.
(vi)	**What are the rules to prevent capitalisation of interest on non-performing loans? Are there any procedures (other than annual external audit) to prevent circumvention of these rules?**	Management decision on methodology to prevent income recognition non-performing loans, but may be driven by specific rules for tax purposes. MoF must approve the capitalisation of interest in the case of customer liquidation. The retail trust banks account for all interest on a cash basis.
(vii)	**What are the policies on the valuation of collateral**	No specific rules or guidance. It is subject to management's discretion and is usually discussed with MoF representatives when determining loan provision.
(viii)	**Taxation**	
(i)	**Is there conformity between book and tax accounting?**	Book and tax accounting in conformity, except for; • Portion of sovereign debt that is tax deductible is limited to 1% of the increase in loan balance for total outstanding to those countries where a specific reserve is allowable.
(ix)	**What factors determine whether a deferred tax asset is recognised for differences between the tax and accounting treatment of loan losses?**	Deferred tax are not recorded under Japanese Generally Accepted Accounting Practise (GAAP) in unconsolidated accounts; it is permitted in consolidated accounts.

Source: Beattie *et al.* (1995)

3.3 Write-off of Non-Performing Loans

Regulations by BNM warrant that accounts or portions thereof that are classified as bad or deemed not collectible and worthless should be written-off. To ensure that the health of the institution is not distorted by writing off loan accounts those are deemed still collectible as a guise to suppress the true level of non-performing loans it is the management's responsibility to ensure that prudent and proper monitoring of loans is enforced. Before a loan can be written off, the financial institution should seek the approval of the Board of Directors. The Board staff may delegate these powers to a management committee comprising senior management subject to specified limits.

Partial write-offs are permitted under the following circumstances:

(1) The value of security is less than the balance outstanding (including principal and other charges) and topping up of the security deficiency is not forthcoming;
(2) The shortfall in security value over the outstanding balance (including principal and other charges) is not collectible and worthless;
(3) The financial institution is now in the final stage of realising the security/collateral; or
(4) The amount is written down to the value of security i.e. the shortfall in security over the outstanding balance is written off.

In the UK, write-off is up to the discretion of each individual bank. In Japan the write off of a non-performing loan that is irrecoverable would depend on the category of the borrower with respect to asset assessment. Previously, decisions to write-off were made mainly between the Ministry of Finance and the financial institutions. Under the new regulation, the responsibility of the auditor is increased. In Japan, after the financial crisis, the Japanese Certified Public Accountants (CPA) is given more responsibility. Audits made by the CPAs are on a professional form. An example given by Abiko (1997), whereby immediately after an audit a financial institution fails and the cause is traced to tardy disposal of a bad loan, then not only the institution but also the auditor who overlooked it most likely will be blamed. The main guidelines issued by the Japanese Institute of Certified Public Accountants with respect to asset assessment for proper write-off are (Abiko, 1997):

(1) For claims against failing or virtually failing companies, bookings for write-off or reserve for loan losses are after deducting the amount likely to be collected from collateral foreclosure or from the guarantor.
(2) Claims against firms that may fail, booking the necessary amount is after deducting the amount to be collected through collateral foreclosure or from the guarantor.
(3) Claims against firms requiring caution, booking based on possible loan losses on the bad loan write-off ratio (The amount less the sum that can be collected by foreclosure on collateral.

(4) A claim against normal borrowers, booking is based on the bad loan write-off ratio.

Two types of accounting methods are used in writing off; they are direct write-off where the amount of non-performing loan is removed from the balance sheet assets column and indirect write-off to prepare for potential loss where a book entry is made in a specific reserve for possible loans losses to off set bad claim. Currently, Japanese banks are asked to write-off loans from the bank's balance sheets within 2 years for existing bad loans and within 3 years for newly created bad loans (Zenginkyo, 2002).

3.4 The Level of Disclosure of Non-Performing Loans

The Basle Committee on Banking Supervision (1998) recommends that banks provide timely information that can facilitates the market participants' assessment of them. It identifies six categories of information that must be addressed in clear terms and relevant details to achieve transparency in banks. These categories are:

(1) Financial performance
(2) Financial position (including capital, solvency and liquidity
(3) Risk management strategies and practices
(4) Risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks)
(5) Accounting policies; and
(6) Basic business, management and corporate governance information.

Under credit quality, Basle recommends that;

(1) A bank disclose impaired loans and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category
(2) A bank should disclose geographic information about impaired and past due loans including specific and general allowances
(3) A bank should disclose a reconciliation of changes in the allowances for loan impairment
(4) A bank should disclose balances of loans on which the accrual of interest- in accordance with the terms of the original loan agreement-has eased because of deterioration in credit quality
(5) A bank should disclose summary information about troubled loans that have been restructured during the year.

The BNM provides guidelines called "Guidelines on the Specimen Financial Statements for the Banking Industry" in December 1988. This guideline is referred to

as GP8 or *Garis Panduan 8*. The GP8 prescribes a standard format for financial reports of banks and financial companies. In October 1996, the GP8 was revised to incorporate the interest-free banking activities. For this section, Bank Islam Malaysia Berhad's (BIMB) financial report will be taken as an example on disclosure of non-performing loans in financial report of Islamic banks in Malaysia. In the director's report section there are two separate sections on bad and doubtful financing and provisions for bad and doubtful financing and diminution in value of investment. In the first section the public is informed that the directors have taken reasonable steps to ascertain that action has been taken in relation to writing-off and making provision for doubtful financing. They are satisfied that all known bad debts have been written-off and adequate provisions have been made. It is also mentioned in the section, that at the date of the report, the directors are not aware of any circumstances that would render the amount written off for bad financing or the amount provided for doubtful financing in the financial statements be inadequate.

In the second section, the treatment on providing provision is set out. As BIMB's provision is made in accordance to the AAOIFI financial accounting standards, the provision during the year is charged against the Profit Payable to Depositors and the balance is shared between the Mudarabah Depositors (IAD) and Shareholders' Fund. The basis of apportionment between these two is the proportion of total deposits in Mudarabah Funds in relation to the total deposits from customers. In respect of the disclosure of non-performing financing not much information can be derived from the financial statements. The information with regard to this are the percentage of non-performing finance to total financing, the movements in the non-performing finance and movements in the provision for bad and doubtful debts and financing. Table 4 and Table 5 show an example of the report on the movements in the non-performing finance and provision for bad and doubtful debts.

In contrast, the disclosure of non-performing loans in the UK is very different. In the Reporting Requirement, Chapter 16 (Financial Services Authority, 2001) clear guidelines are given on the reporting of provisions against bad and doubtful debts and investments.

Table 4 Movements in non-performing loans

Current Year and Previous Year
Balance brought forward from previous year
Non-performing during the year
Amount sold to Danaharta
Amount reclassified as performing
Balance as at current year

% of non-performing financing to total financing
Table Adapted From the Financial Statement of Bank Islam Malaysia Berhad, 2001

Table 5 Movements in the provision for bad and doubtful debts

Current Year and Previous Year
General Provision; brought forward from previous year
Provisions made during the year
% Of general provision to total financing net of specific provision
Specific provision: brought forward from previous year
Provision made during the year
Amount write back in respect of recovery
Balance as at current year

Table Adapted From the Financial Statement of Bank Islam Malaysia Berhad, 2001

The guidance given is on how to report previous balance of specific and general provisions, adjustments for acquisitions or disposals, adjustments for exchange rate movements, and charge or credit to profit and loss account. It also provides guidelines on how to report for the amount written off, recoveries of amounts previously written off and any other items including exceptional provisions and transfers between general and specific provision. Banks in the UK are also required to show the assets (by risk weights) against which specific provisions have been made. The provision for diminution in value of investments other than trading investments should also be shown. An example of disclosure is a specimen of financial statement of HSBC, an international bank with its headquarters in England. Generally a financial report of a bank in the UK would include a section on its risk management policy. In the case of HSBC, this section provides detailed information on the bank's policy in managing risk. The information is on the design of the policy such that it is able to identify and analyze credit risk, liquidity, market risk, operational risk and other risks. This section also provides detailed description of the bank's policy on the appropriate risk limits and how the risks are monitored and limited by using reliable and up to date administrative and information systems. There is also an explanation of credit risk and how it arises. In HSBC, a special unit is mandated to manage the credit risk and its function is described clearly in the financial statement. As HSBC is an international bank, HSBC has a 5-year analysis of its loans. The analysis is by industry sector and by the location of the principal operations of its lending subsidiary. Refer to Table 6.

As for provisions for bad and doubtful debts, they are disclosed in respect of the type of customers. HSBC outlines its policy that each operating company will make provisions for non-performing loans promptly on a prudent and consistent basis to ensure that the provisioning matches or exceeds the requirements of relevant regulators. It also stated its definition of non-performing debts, as debts that management has doubts as to the ultimate collectability of principal or interest are 90 days overdue (HSBC's Financial Report 2001).

Table 6 Loans and advances to customers by geographical region and by type of customer, by type of customer and provisions for bad and doubtful debts by type of customers

Personal:
Residential Mortgage
Other Personal
Total Personal
Corporate and Commercial
Commercial, industrial and international trade
Commercial real estate
Other property-related
Government
Other commercial
Total corporate and commercial
Financial:
Non-bank financial institutions
Settlement accounts

Table Adapted From HSBC's Financial Report, 2001

Explanations of what specific provisions, general provisions, loans on which interest is suspended, non-accrual loans, outstanding provisions are also given in the financial report in order for the public to understand. A 5-year analysis is made on the movements for provisions for bad and doubtful debts. The analysis is by location and the information analyzed are as in Table 7.

The information on the movements of the provision is provided by region and type of customers and is based on a 5-year analysis. The analysis is on the amount written off, recoveries from the amount written off in previous years and provisions for the year.

HSBC classifies loans in accordance with the UK accounting practice as follows:

(1) Suspended interest
(2) Assets acquired in exchange for advances
(3) Troubled debt restructurings
(4) Potential problem loans

HSBC also provides a 5-year analysis of risk elements in loan portfolios in accordance to geographical location. The essentials information that are analysed are as shown in Table 8. The table shows if there is adequate provision in relation to the total risk elements in HSBC.

Barclays reporting on its provisions and doubtful debts is also based on geographical analysis even though it does not provide a 5-year analysis in its financial statement.

Table 7 The movements in HSBC's provisions for bad and doubtful debts by region: Europe, Hong Kong, and the rest of Asia Pacific, North America and Latin America

Provisions brought forward
Amounts written off:
Banks
Commercial, industrial and international trade
Real Estate
Non-bank financial institutions
Governments
Other commercial
Residential mortgages
Other personal
Total amounts written off
Recoveries of amounts written off in previous years:
Commercial, industrial and international trade
Real Estate
Non-bank financial institutions
Governments
Other commercial
Residential mortgages
Other personal
Total recoveries
Charge to profit and loss account:
Banks
Commercial, industrial and international trade
Real Estate
Non-bank financial institutions
Governments
Other commercial
Residential mortgages
Other personal
General provisions
Total Charge
Foreign exchange and other movements
Provisions at current year
Provisions against banks:
Specific provisions
General Provisions
Provisions at current year
Provisions against customers as a % of gross loans and advances to customers:
Specific provisions
General provisions
Total Provision

Table Adapted from HSBC's Financial Report, 2001

Table 8 Risk elements in the loan portfolio by region

Loans accounted for on a non-accrual basis
Loans on which interest has been accrued but suspended
Assets acquired in exchange for advances
Troubled debt restructurings
Accruing loans contractually past due 90 days or more as to principal or interest
Total risk elements
Provisions for bad and doubtful debts as a % of total risk elements

Table Adapted from HSBC's Financial Report, 2001

However, it provides a 5-year analysis for its shareholders and the information is available on its website where everybody can see. There is also a section on potential credit risk lending in accordance to the United States Securities Commission guidelines. This section contains information on non–performing lending that are divided into non-accrual lending, accruing lending where interest is being suspended, other accruing lending against which provisions have been made, accruing lending 90 days overdue against which no provisions have been made and reduced rate lending. Other than that information, there is also information on potential problem lending, percentage of provision coverage of non-performing lending and percentage of provision coverage of total potential credit risk lending. Another disclosure is on the interest forgone on non-performing lending.

In Japan, the disclosure of non-performing loans became compulsory beginning March 1993. The standards of disclosure on non-performing loans for major banks under the Federation of Bankers Associations of Japan (Zenkoku Ginko Kyokai Rengokai), herein called Zenginkyo are based on four types of asset claims. They are; claims to failing companies, claims regarding delayed interest payments and claims when interest payment is totally or partially waived (Abiko, 1997). Refer to Table 9. The Zengkiyo standards are for major banks.

In addition to the major banks, Shinkin banks and other financial institutions have been asked to disclose the amounts of loans to failing companies. The MoF in Japan classify debt according to assets assessment method (Abiko, 1997). This system classifies financial institutions assets, including loans and securities, following an itemised review based on the risk of recovery or based on depreciation. Evaluation is in terms of representing deposited amounts whether total assets are large enough to cover withdrawal of deposits. The evaluation also probes to the extent to which individual assets are exposed to deterioration. Assets are sorted into four different categories in terms of the degree of risk in value of loss. Table 10 illustrates this.

The process of listing assets in the above categories is called classification. Assets under Category II to IV are called classified assets and are loans that require attention,

Table 9 Zenginkyo uniform disclosure standards (summary)

Type	Outline
Loans to failing companies	Loans to firms subjected to the Corporate Reorganization Law, those in bankruptcy, those subject to composition, those subject to arrangement, or those firms whose settlement by banks is suspended at clearing house.
Loans on which interest payment is delayed	Loans on which interest payment is in arrears six months or more (excluding those to failing companies and those to which interest payment is partially or totally waived)
Loans on which interest payment is partially or totally waived	Loans on which interest rate is reduced to a level equal to or lower than the official discount rate at the time of revision of the loan agreement, those officially approved as loans on which interest payment is totally waived, etc.
Loans to firms whose management includes lending bank participation	Loans to companies in whose management lending institutions take part in a way officially approved by tax authorities and/or in the form of disclaimer as a means to assists restructuring or provide support.

Source: Abiko (1997)

are in danger of bankruptcy or are already bankrupt (Zenginkyo, 2002). Assets under Category I are non- classified and they include all loans to normal borrowers (Zinginkyo, 2002). The procedures of loan classification with respect to assets are based on the status of borrowers, status of collateral and status of write-off. The status of the borrowers is classified based on the capacity for repayment in terms of financial status, fundraising capability, profitability and others. Table 11 illustrates the categories of borrowers.

In addition, the National Association of Shinkins Banks also established a uniform disclosure standard for Shinkin banks. The Shinkin banks in Japan have been obliged

Table 10 The categorisation in assets assessment

Category	Description
Category IV	Basically, assets whose recovery is impossible or judged as worthless as of the date of evaluation (relative assets automatically included even if future partial recovery might be possible)
Category III	Assets whose recoverability or eventual value merits serious concern, posing a potential loss the amount which is hard to determine
Category II	Assets such as loans whose recoverability poses greater than average risk (owing to such factors as improper fulfilling of conditions to secure the loan or grave concern about the borrower credit)
Category I	Assets which do not belong to any of the above categories (those which do not entail any risk regarding recovery or loss of value)

Source: Abiko (1997)

Table 11 Categories of borrowers

Type	Description
Failing company	Firm wherein legal or formal management has occurred (bankruptcy, liquidation, corporate rearrangement or reorganization, composition, suspension of clearing house bill handling, etc.)
Virtually failing company	Firm whose business is in dire straits and there is little chance of recovery, etc., and management it is all but incompetent (long state of insolvency or loan repayment is long overdue)
Company apt to fail	Firm whose business is in trouble and may well go bankrupt (business performance is very poor and there is little hope of recovery; there is no lender intention to lend support or to reduce loan to the minimum, etc.)
Company requiring caution	Firm with problematic lending condition (interest partially or totally waived), whose payment record is poor (delays, etc.), whose business performance is bad or unstable, whose financial statement is not good, or whose loan management foreseeable will demand caution.
Normal borrower	Company having good business performance and no specific financial statement problems

Source: Abiko (1997)

to reveal their loans to failing enterprises, the amount of loans on which interest payments are in arrears, loans on which payment is partially or totally waived and loans to firms whose management includes lending bank participation.

4.0 CROSS COMPARISON ANALYSIS

Despite having the common objectives of controlling non-performing loans, there are significant differences in the policy of the classification and management of non-performing loans in Islamic banks in Malaysia, Japan and the United Kingdom. This section analyses and compares these differences.

Even though the Basle suggested that loans over 90 days are considered to be in default, the BNM definition's of non-performing loans as loans that have been in default for over 180 days. Since the financial crisis, Japan expanded its definition of non-performing loans from loans past due in arrears by 180 days or more and loans to bankrupt customers, to include loans where interest has been reduced, loans in arrears by three months or more and restructured loans. The UK financial sector, a highly developed financial system (Hall, 1993) defines its non-performing loans as loans that have been in default for over 90 days.

The reclassification of non-performing loans to performing in Malaysian Islamic banks is quite lenient whereby as long as the installment arrears falls below 6 months or 180 days, the non-performing financing will be reclassified as performing. This is in contrast to the Basle requirement whereby a non-performing loan would only be classified as performing when all arrears have been paid (Basle, 1999).

In Malaysia, the loss provision made is based on the percentage specified by the BNM in accordance to their period of default and classification. A loan that has been in default for 6 months but less than 9 months is classified as substandard and is given a 20% provision after deducting its security value. A loan that has been in default for 9 months but less than 12 months is classified as doubtful and the amount of specific provision is 50% after deducting the security value and for loan that has been in default 12 months or more is classified as bad loan and is given a 100% specific provision. The percentage of provision is regardless of the type of loans. General provision is fixed at 1.5% after deducting the amount of specific provision for the purpose of unidentified losses.

In the UK, the decision on how much to provide for specific provision is left to the discretion of the banking institution based on several conditions like the financial condition of the borrower, guarantor and security plus guidance from the Statement of Recommended Accounting Practise (SORP) and for general provision it must be enough to cover the losses not yet identified. Banks in the UK are given the freedom to decide the total amount of provision. However, banks in the UK need to follow the reporting requirement of the Financial Services Authority. Even though loss provisioning is left to the discretion of the management of the banks, the UK appears to have a more stringent system for the loss provisioning. This is based on the basis of assessing loans for provision. For example, assessments for specific provision for commercial loans are assessed on individual basis and only retail loans are assessed on a pooled basis.

Banks in the UK estimate the amount needed to reduce the risk using whatever statistical techniques. This is however subjected to consideration being made by the bank on the amount of loan and the bank's other commitments to the borrower, the borrower's business prospects and the ability to repay, the security, the costs incurred in obtaining repayment if rights of the bank are enforced. As for general provision, in the UK, the management of banking institutions would have to identify the loans that are not clear if specific provision is needed but they are still doubtful. Not only that, consideration for general provision is also based on the industrial and geographical risk, past experiences, current economic climate and on and off balance sheet exposures. The percentage also varies according to the different categories of loan portfolio and other exposures and also weighted towards the degree of risk that are particularly at risk.

Looking at the Japan's policy before the crisis, Japan's loss provision was very rigid, as the financial institutions have to satisfy certain criteria such as a high probability of default and to refer to the MoF before provision can be made on non-performing loans.

However, after the crisis, loss provision is made using the self-assessment method. With the self-assessment method, banks can now carry out assessment on their own assets and make provisions or write off for possible loan losses.

In the UK, specific provisions are tax deductible, while general provision is not. In Japan, specific provision and general provision is tax deductible but the level of

provisioning is intended to cater for the tax deduction. In other words, the levels of provision for both specific and general provision are little since the amounts that are tax deductible are little too. The tax rules are likely to be the reason behind the lack of provision in Japan (Yamawaki, 1996). As a result Japanese banks were faced with large amount of write-off and provisioning during the economic downturn. Specific and general provisions are tax deductible in Malaysia. In the profit and loss statement, both provisions are treated as other expenses and are deducted from the revenue of the bank.

In Malaysia, the BNM gives guidelines on the valuation of security for the purpose of provision. While in the UK and Japan no official guidance is given. In the UK the policies on the valuation security is based on the banking industry practice. However, in Japan, the management usually discuss with the representatives of the MoF.

The level of disclosure of non-performing loans by financial institutions in Islamic banks in Malaysia is limited compared to the information on non-performing loans that are disclosed in HSBC's or Barclays's financial statement. This can be seen from the limited information on non-performing loans that can be obtained from the annual report of BIMB as compared to the information provided by HSBC (UK) and Barclays.

In the BIMB report one can only see the movement of non-performing loans and movement of provision for the non-performing loans in the past 12 months. There is a section on the percentage of non-performing loans to performing loans but there is no detailed information on this. The only information one can get is on the amount of non-performing loans for the year. There is no breakdown of the non-performing loans and it is not analysed by either the type of loans or customers. This information is only understood by professional and does not disclose pertinent information for stakeholders like depositors.

Unlike the method of disclosure by some banks in the UK where the policy on risk management of the financial institution is made known to the public in a special section in the annual report, a person reading the financial report of an Islamic bank in Malaysia would not be provided with such information. There is no information on the bank's policy on analysing credit risk, liquidity risk, market risk and other related risk. There is also no information on how these risks are managed by the bank. The limit of risk that the bank is taking and how these risks are monitored is also not mentioned. This is quite unusual considering that the IADs share with the Islamic banks the profit and loss; they have limited information on the risks to which they are exposed. This lack of transparency creates moral hazard in such an institution.

Looking at the financial report of HSBC (UK), the total loans are broken down by the type of customers and geographical region. Analysis is for the past 5 years. The types of customer are personal, corporate and commercial, and financial. Each type is further broken down into the type of loans like residential, mortgage and etc. Information on amount of recoveries written off is broken down into the type of customers and also for the period of 5 years. One can see clearly if the amount of non-performing loans and recoveries are increasing or decreasing for the past 5 years. There are detailed

explanations on what specific provisions, general provision and other related items on non-performing loans are. The analyses of risk management are comprehensive.

As an international bank, the movement of loss provision reported by HSBC (UK) is by region and is also broken down by the type of customers. Therefore, one can see which type of customers that has a large amount of loss provision and how much has been recovered in the past 5 years. Furthermore, there is also information on loans that might be at risk of becoming non-performing loans in the future. This sort of information is accessible to the public. By doing this, not only do the depositors know but it would also encourage the bank to take action, so that these loans will be monitored. Barclays also undertakes the same method of disclosure even though the analysis is only for the past 12 months.

As for Japan, there is good progress in terms of disclosure by financial institutions after the economic crisis. In the case of major banks under Zenginkyo, they must disclose the following information: loans to failing companies, loans on which interest payment is delayed, loans on which interest payment is partially or totally waived and loans to firms whose management includes the participation of the lending bank

In addition, the MoF in Japan also provides a classification of debt for disclosure to the public. The information that must be disclosed under the MoF is based on 4 categories of assets. Even though there are two different sets of disclosure, this shows that the Japanese authorities realised the importance of disclosure and is now requesting banks in Japan to disclose information of non-performing loans to the public.

The policy on loss provision that is not applicable to Islamic banks is related to the capitalisation of interest. While conventional banks can capitalise on the interest of non-performing loans by crediting them to the interest in suspense, Islamic banks are not allowed to capitalise on the profit they are supposed to make if the loan is performing. Profit of Islamic banks can only be recognised as income when it is received.

5.0 CONCLUSION AND RECOMMENDATION

The study of the classification and management of non-performing loans in Islamic banks in Malaysia finds that the Islamic banks define and manage their non-performing loans differently from the conventional banks in the UK and Japan. However, applying the same guidelines designed for conventional banks would make it difficult for Islamic banks to determine the timing to declare the financing as non-performing. For example, a loan is considered non-performing when the loan has been in default for six months or more. The same classification may be suitable for Murabahah (cost-plus) financing, but for profit and loss sharing activities this definition may not be suitable. A more appropriate definition is needed to determine their classification as non-performing. Project under the profit and loss sharing provide uncertain return as they depend on the profitability of the project. The return may be less than expected or even fails. As different projects give different timing of return to investment, a standard definition of

non-performing should not be applied. Therefore a suitable regulatory framework is necessary to avoid the unwanted implications of non-performing loans.

In respect of the level of disclosure, IADs share very little knowledge of the non-performing loans faced by the bank. There is little information that can be derived from the annual report of the Islamic banks in Malaysia. They do not know what actions are undertaken by the Islamic banks to control or reduce the amount of non-performing loans. When little information is given, the IADs may not be aware that their investments or savings can be affected by the percentage of non-performing loans. They may not be aware that uncontrolled non-performing loans would lead to the failure of a financial institution. It is only when they are given no return to their investments or when they are informed that their investments are making losses that they will realise the repercussion of non-performing loans. By that time it will be too late to do anything other than face the losses. Lessons must be learned from Japan's forbearance policy in their classification and management of non-performing loans.

Information disclosure is very important in an Islamic banking system because of the risk sharing characteristics and the absence of protection for IADs. The more reliable is the disclosure, the more are IADs or other users able to make an accurate assessment of the Islamic bank's financial position. A clear information disclosure will allow depositors especially IADs to decide which bank they want to deposit their funds into. Important information, particularly on the non-performing loans is very important because investors would like to know the risks that their investments are exposed to. This will allow depositors to monitor the bank and as a result could help to discipline the bank.

The special characteristic of an Islamic bank calls for an appropriate regulatory framework specially designed to accommodate its characteristics in addition to what has been designed for conventional banks. Appropriate information disclosure will help regulators understand the objectives, strategies and the risks that a bank is exposed to. This will prevent misleading information that can cause the instability of the financial system. Regulators or policymaker should be concerned if there is lack of control or disclosure from a bank because they act as representative of depositors. There is a need to protect the IADs from potential moral hazards and adverse selection arising from asymmetric information. The IADs do not have voting rights because they do not own the equity of the Islamic bank and therefore cannot participate in the investment decisions. The objectives of regulating banks are to ensure that there is no moral hazard, depositors' protection, avoid systemic risk and investors' protection (Dale and Wolfe, 1998). Therefore, regulators should be concern when any of this is absent. Regulations of Islamic banks must emphasize the classification and management of non-performing loans. Therefore, BNM should tighten its supervision and regulation of Islamic financial institutions; to ensure their level of supervision is equivalent to that of the conventional banks, albeit taking into account its compliance with Islamic laws. Study by Demirguc-Kunt *et al.* (2006) show that sound banking is associated with

compliance with principles related to information provision. The study suggests that transparency enhances the effectiveness of the supervisory process and strengthens market discipline. This is to ensure that the risk of failure can be avoided and the welfare of depositors is protected.

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