ISLAMIC FINANCE IN NATIONAL ACCOUNTS STATISTICS

2. ISLAMIC BANK INCOME STATEMENT AND BALANCE SHEET

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INTRODUCTION

This lecture extends the discussion of Islamic finance indicators to examine the sectoral income statement and balance sheet of Islamic banks.

The income statement shows key differences between the economic structures of Islamic and conventional banks and helps clarify why special treatments might be needed in compiling the SNA.

The IFSB has created “Detailed Financial Statements” (DFS) for Islamic banks (which is AAOIFI-based) which contrast to similar accounts for conventional banks (which is IFRS-based).

Compilers need to be aware of the differences when they incorporate data on Islamic banks into the SNA or compile data on the structure and condition of the Islamic banking sector *per se*.

IFSB INDICATORS COMPILED IN THE GCC

- IFSB's indicators are called PSIFIs – Prudential and Structural Indicators for Islamic Financial Institutions

- All GCC countries compile PSIFIs and submit them to IFSB for publication.

- A second set of accounts covering the income statements and balance sheets for the Islamic banking sector have been compiled by the IFSB. Currently, only Bahrain and Saudi Arabia compile the IFSB's "Detailed Financial Accounts" (DFS).

- Compilation of data on Islamic banking;
  - In each GCC country, data operations covering indicators for Islamic banks already exist.
  - Compilation of Islamic banking data for the SNA can also be an opportunity to compile parallel data for the DFS.
  - Collaboration between national accounts compilers (in national statistical offices), financial supervisors (in central bank or supervisory organizations), accountants, and information technology specialists might be needed to draw on local expertise, share data, and compile statistics. Sometimes legal or confidentiality barriers need to be addressed.

DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC FINANCE

- Key differences between conventional and Islamic financial statistics are revealed in the underlying income statements and balance sheets.
- The next slides show the aggregate income statements for conventional banks and Islamic banks. (Only major lines are shown.)
    - Conventional bank statement from IMF *Compilation Guide on Financial Soundness Indicators* (2019)
    - Islamic bank statement from Islamic Financial Soundness Board (IFSB) *Compilation Guide on Prudential and Structural Indicators for Islamic Financial Institutions (PSIFIs)* (2019)

REPRESENTATIVE INCOME STATEMENT OF A ***CONVENTIONAL*** BANK

Revenue
Total Revenues
Net interest income
Interest income
Interest expenses
Noninterest income
[1] Expense
Total Expense
Noninterest expense
Provisions for loan loss
Income
Income before income tax (Operating income)
Income tax
Net Income
Dividends
Retained Earnings

Based on IMF Compilation Guide on Financial Soundness Indicators. (2019) Table 5.1.

KEY FEATURES

- *Net interest income* is the top line series. (Component of “FISIM” in SNA)
  - Interest receipts and payments are shown gross, then netted to *net interest income*
  - Interest payments are shown separately from other expenses
- *Other revenues (such as fees and commissions)* and *Net interest income* are added to get *Total revenues*
- *Expenses (which exclude interest)* are subtracted from *Total revenues* to get *Net income before taxes*
- The income statement is not limited to transactions – it includes holding gains and losses, write downs, and catastrophic losses, which are not part of SNA production of banks.

REPRESENTATIVE INCOME STATEMENT OF AN *ISLAMIC* BANK

PER IFSB "DETAILED FINANCIAL STATEMENTS" (DFS)

FS01	**Gross financing and investment income**
FS01(i)	Income from financing
FS01(ii)	Income from investments
FS02(iii)	Less provisions for accrued income on nonperforming assets
	Distribution of financing and investment income (FS01 – FS02(iii))
FS02(i)	Income distributed to unrestricted depositors/investors
FS02(ii)	Distribution to Profit Equalization Reserve (PER)
FS03 = (FS01 – FS02)	**Net financing and investment income available to bank**
	Other bank income (FS04 + ….. + FS07)
FS04	Bank share in RPSIA
FS05	Fee-based income
FS06 + FS07	Other Income
FS08	**Total Gross Income**
FS09	Expenses
FS10	Personnel expenses
FS11	Other expenses
FS12	Provisions
FS13	**Net income before taxes and zakah**
FS16	Taxes
FS15	Zakah
FS17	Net income after taxes and zakah
FS20	Dividends
FS21	**Retained Earnings**

ISLAMIC BANK INCOME STATEMENT

- The Islamic bank accounts are broadly analogous to those of conventional banks
- Income is reflected in three ways
  - *Net financing and investment income available to the bank* parallels net interest income for conventional banks. Covers income generated from funds coinvested by bank and depositors, less distributions of returns to depositors.
    - *Unrestricted PSIA* (unrestricted profit sharing investment accounts) in which depositors' and banks funds are commingled and the bank and depositors share income.
    - *Restricted PSIA* are generally treated off-balance-sheet for which the bank earns fee income (but beginning in 2021 *some restricted PSIA can be on-balance-sheet).*
  - Other revenues and expenses parallel revenues and expenses of conventional banks.
- Next slide shows component detail of *Net financing and investment income*

COMPONENTS OF NET FINANCING AND INVESTMENT INCOME

1	**FS01**	**Gross Financing and Investment Income**
2	FS01(i)	Income from financing (less operational costs of financing)
3	FS01(i.i)	Sales-based
4	FS01(i.ii)	Lease-based
5	FS01(i.iii)	Equity-based
6	FS01(i.iv)	Other
7	FS01(ii)	Income from investments (less operational costs of investments)
8	*less* FS02(iii)	*less* Provisions for accrued income on nonperforming assets
9 = 1 - 8	**FS01 - FS02(iii)**	**Income available to depositors (IAH) and bank**
10	FS02(i)	Income distributable to IAH
11	FS02(ii)	Transfer to Profit Equalization Reserve (PER)
12 = 9 -10 - 11	**FS03 = FS01 – FS02**	**Net Financing and Investment Income of bank**

INCOME GENERATED BY ISLAMIC FINANCIAL INSTRUMENTS

	Instrument	Type of income generated
1	Murābahah	Sales contract - Embedded profit
2	Commodity Murābahah / Tawwaruq	Sales contract - Embedded profit
3	Salam	Sales contract - Embedded profit
4	Istisnā	Sales contract - Embedded profit
5	Bai al Ajel	Sales contract - Embedded profit
6	Ijārah / Ijārah Muntahia Bittamlīk	Leasing/Leasing with delivery
7	Muḍārabah	Profit/Loss sharing
8	Mushārakah	Partnership
9	Diminishing Mushārakah	Partnership
10	Wakālah	Fee
11	Qarḍ Hassan	Nonremunerated benevolent loan
12	Amanah	Nonremunerated deposit
13	Wadiah	Nonremunerated deposit
14	Sukuk	Investment security
15	Participation Term Certificate	Investment security

IMPLICATIONS

- Net financing and investment income is a net concept broadly analogous to net interest income for conventional banks.

2011 PSIFI Compilation Guide "Conventional interest income earned is replaced with profit/rent from each financing type" (Table 4.1, p. 39)

- Calculation is parallel for net interest income (conventional) and Net financing and investment income,
  - For Islamic banks, it is customary to subdivide income from jointly funded assets by type of income (sales, leases, fees, etc.). The types and amounts of income, and income distribution, will differ for each type of Islamic financial instrument.
  - Distributions (interest paid for conventional banks; profit distributions for IFIs) are subtracted in a similar manner.

HOW TO TREAT DIFFERENT ISLAMIC FINANCIAL INSTRUMENTS

- Different economic flows are associated with each type of Islamic financial instrument and distributions between bank and customers differ by instrument.
- "Slotting-in Approach" – Classify each Islamic financial instrument by its closest SNA equivalent based on similar underlying financial flows. This is the main thrust of Guidance Note.
  - In the revised SNA, all Islamic financial instruments will be classified in such manner to compile GDP, balance of payments, and other accounts.
- "Islamic financial accounts approach" or "instrument-by-instrument approach" – Compile accounts based on instrument-by-instrument features and behavior, *per* AAOIFI or local Shariah-compliant standards.
  - The IFSB's "Detailed Financial Statements" (DFS) is on this basis, from which an "Islamic finance satellite account" might be built.

IMPLICATIONS

- The accounts and financial structure of Islamic banks differ from conventional banks.
  - Economic behavior and monetary policies could differ.
  - Information on the differences is just beginning to become available.
- Returns to depositors (for some instruments) can vary based on the results of banks’ investments.
  - Depositors face more risk on returns on their deposits. Raises issues of consumer protection and corporate governance.
  - Calculations of income and distributions to depositors are more complex than for conventional banks. Calculations are instrument-by-instrument.
- In many countries, regulations and accounting rules for Islamic banks are based on those for conventional banks (for example, IFRS rules might be mandated for all banks); Separate information on Islamic finance-based transactions of Islamic banks might not be available; Data for Islamic banks can be distorted in the process

BALANCE SHEET

- The balance sheet of an Islamic bank closely parallels conventional balance sheets with some notable differences. A key difference is ownership of nonfinancial assets underlying Islamic financial assets.

- *Nonfinancial assets* – Islamic financial instruments often generate income through sale or lease of underlying goods.
  - The Islamic bank must have legal ownership of the underlying assets even if for only an instant – during which time the bank incurs all risks and rewards of holding the asset. These can be referred to as "nonfinancial assets related to sales, lease, and equity financing". These assets could be volatile and behave differently from other nonfinancial assets
  - "Ijara and Istisnaa financing" includes are lease-based financial assets that effectively include the value of the underlying non-financial assets. (The IFSB Task Force on PSIFIs concluded it is impractical to separate the financial value of Ijara from the value of the underlying nonfinancial asset.)
  - "Other nonfinancial assets" records all other types of nonfinancial assets such as property, plant, and equipment and inventories.

- These two items sum to Nonfinancial assets as reported in the SNA balance sheet framework; it is recommended an "*of which*" line Ijara and Istisnaa financing be added as a financial asset that *de facto* encompasses the value of its underlying nonfinancial assets.

IFSB’S DFS BALANCE SHEET: ASSETS

FS22	Total assets (= FS23 + .. + FS31 = FS32)
FS23	Cash in hand
FS24	Total Sharī`ah-compliant financing (excluding interbank financing)
	Of which, Ijara and istisnaa financing***
FS25	Interbank financing
FS26	Sukūk holdings
FS27	Other Sharī`ah-compliant securities
FS28	Investment funds, shares and other equity
FS29	Shariah-compliant hedging instruments
FS30	Plant, property, and equipment***
FS31	All other assets

*** Line FS24 includes the amount of financing against Ijara and Istisnaa' in line with AAOIFI standards that explain that “leased assets shall be presented in the lessor’s statement of financial position under investments in Ijarah Assets.” Thus, the value of physical assets leased under these instruments is included in line FS24, not line FS30. Islamic banks that follow IFRS are requested to report the amount of Ijara and Istisnaa' financing in line FS24 rather than in FS30 for the shake of cross-country comparability.

DFS: LIABILITIES AND EQUITY

FS32	**Total funding/liabilities and equities (= FS33 + … + FS41)**
FS33	Current accounts (Nonremunerative funding)
	(i) Current accounts of banks and other financial institutions
	(ii) Nonremunerative (qard and wadī`ah) funding from customers
	(iii) Other nonremunerative funding from customers
FS34	Remunerative funding
	(i) Profit Sharing Investment Accounts (Mudarabah, Musharakah basis)
	(i.i) PSIA by banks (unrestricted + restricted)
	(i.ii) All other unrestricted PSIA
	(i.iii) All other restricted PSIA (on-balance sheet)
	(ii) Other Remunerative Funding
	(ii.i) Wakalah funding by banks
	(ii.ii) All other wakalah funding
	(ii.iii) Tawwaruq/Commodity Murabahah funding by banks
	(ii.iv) All other Tawwaruq/Commodity Murabahah funding
	(ii.v) Other, not indicated elsewhere
FS35	Other Interbank funding/liabilities
FS36	Sukūk issued
FS37	Other Sharī`ah-compliant securities issued
FS38	Payables
FS39	All other liabilities
FS40	Equity of Unrestricted Investment Account Holders (If AAOIFI)
FS41	Shareholders' equity
	(i) Paid-up share capital
	(ii) Retained earnings
	(iii) Accumulated other comprehensive income
	(iv) General and other reserves

SAMPLE OF SNA-DERIVED BALANCE SHEET
PER IMF FSI TEMPLATE

14. Total assets (= 15+16 = 31)
15. Non-financial assets
16. Financial assets (=17 to 22)
17. Currency and deposits
18. Loans (after specific provisions)
(i) Gross loans
(i.i) Interbank loans
(i.i.i) Resident
(i.i.ii) Nonresident
(i.ii) Non-interbank loans
(i.ii.i) Central bank
(i.ii.ii) General government
(i.ii.iii) Other financial corporations
(i.ii.iv) Nonfinancial corporations
(i.ii.v) Other domestic sectors
(i.ii.vi) Nonresidents
(ii) Specific provisions
19. Debt securities
20. Shares and other equity
21. Financial derivatives
22. Other assets

23. Liabilities (= 28 +29)
24. Currency and deposits
(i) Customer deposits
(ii) Interbank deposits
(ii.i) Resident
(ii.ii) Nonresident
(iii) Other currency and deposits
25. Loans
26. Debt securities
27. Other liabilities
28. Debt (= 24+25+26+27)
29. Financial derivatives
30. Capital and reserves
31. Balance sheet total (=23+30 = 14)

FINAL NOTE:

- The DFS can be a foundation for compiling a SNA “satellite account” for Islamic finance, but there are challenges.
  - The DFS covers the global consolidated banking entity (although most Islamic banks are domestic only), whereas the SNA focuses on domestic production (GDP).
  - The DFS does not cover the sectoral distribution of funding and financing.
  - If national financial reporting standards are based on IFRS, information on Islamic finance transactions and positions might not be readily available.
  - The DFS does not separately cover transactions and positions with the rest of the world.
  - The treatment of Ijara differs, is significantly large, and affects data on nonfinancial assets.
  - Deconsolidating data on Islamic windows from their conventional parents.
  - Accounting for Hibah, Zakat, and Profit smoothing could be tricky.