

Profit and Loss Distribution and Pool Management Framework for IBIs in Pakistan: Progress, Issues and Implications

Muhammad Ayub¹ and Shahul Hameed bin Mohamed Ibrahim²

Abstract

Pakistan is among the three countries that opted for economy-wide transformation to Islamic financial system in 1980s, the other two being Iran and Sudan. But the ‘non-interest based’ banking system introduced in mid-eighties was declared un-Islamic by the ‘Federal Shariat Court’ because the same was largely based on ‘buy-back’ (*bai‘ al-‘Inah*) and sale of debt instruments (*bai‘ al-dayn*). In the new system introduced since December 2002, Islamic banking institutions (IBIs) operating in parallel with the conventional banks are using *mudārabah* as the major mode to raise investment deposits from individuals as also the corporate sector. But based on the assumption that depositors’ risk tolerance level is close to zero, they have been giving profit to the investment depositors comparable with their conventional counterparts by way of discretionary *hibah* without proper disclosure. The rules of *mudārabah* were not being followed in letter and spirit. The main issue was to give arbitrary gifts to priority depositors. The State Bank of Pakistan recently issued a comprehensive profit distribution and pool management framework in order to improve transparency and bring standardization in the IBIs’ practices while taking care for stability of the system. This paper analyses the new framework and finds that the SBP has taken a step in right direction to replace the indiscriminate use of *hibah* with a well thought-out profit distribution and allocation procedure along with provisions for specific reserves necessary for sustainability of the system.

Keywords: Investment deposits; Pool management; *Hibah*, PER, IRR, Transparency, Weightages System, PSR.

¹ The Editor of the JIBM and Director Research & Training at the Riphah Centre of Islamic Business, Riphah International University, Islamabad, Pakistan.

² Associate Professor, International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur, Malaysia.

1. Introduction

The State Bank of Pakistan (central bank), announced the much awaited standardized framework on distribution of profit and pool management mechanism for the Islamic banking institutions (IBIs) in Pakistan on 19th November, 2012. The *mudārabah* based deposits constitute a major part of IBIs deposit mix. The pool management refers to systematic creation of one or more pools for different categories of *mudārabah* deposits, as per risk and reward expectations of such depositors. The new framework is comprehensive which is also crucial in enhancing the level of Sharī‘ah compliance, doing justice to all major stake holders and streamlining the procedure of financial reporting and general disclosure. While the academia and the investors in general have appreciated the move, the IBIs deem it too strict to be implemented and managed easily in the competitive conventional and Islamic banks’ operations and the level of competencies of the personnel responsible for pool management. The objective of this paper is to highlight the salient features of the framework and discuss and analyze the value addition it could make, the issues and the implications for development of Islamic banking and finance in Pakistan with its spill-over effect on Islamic finance around the globe.

2. What Prompted the SBP to take the Initiative?

Since the policy shift in Pakistan in 2002 from transformation of the whole economy to interest free basis to the parallel functioning of the conventional and Islamic banking systems³ (Janjua: 2002), IBIs had been following different procedures for deposit management and profit allocation and distribution. They have not been consistent with regard to the profit sharing ratio between the banks and the IAHs, weightages assigned to various categories of deposits in terms of size and allocation of assets to various pools. To remain competitive in the market and to manage the displaced commercial risk (DCR), the tool they have been using indiscriminately was the *hibah* in case the profit realized by any pool was less than the market benchmark. Further, they have not been making disclosures as required for valid *mudārabah* based business⁴. It

³ Previously, the policy was to eliminate ‘*riba*’; now conventional & Islamic banking systems will operate side by side. In the long run, let people ‘vote through their wallets’ (SBP Strategic Plan- 2009). However, it is against the provisions of the Constitution of Pakistan (1973) that still requires ‘elimination’ of *riba*.

⁴ Besides disclosure required with regard to profit sharing ratio (PSR), weightages assigned to various categories of deposits, nature of business conducted with funds from the pools, the process of income allocation (to various reserves) and distribution of

resulted in injustice to small depositors in particular, a number of Sharī'ah compliance related issues and, in turn, integrity risk for the Islamic finance discipline which could be a serious cause of concern in a country like Pakistan where the general public is perceived to be faith sensitive on such issues. SBP in its Financial Stability Review (2012) observed that the profit and loss computation and distribution policies of the Islamic banking institutions lacked uniformity. The review also underlined that the IBIs are contractually obliged to share profits and losses with the PLS depositors; however, at the same time, IBIs were obliged to pay a minimum (5%) rate of return to the depositors (SBP, BPRD Circular No 7 of 2008), which is not in line with the Sharī'ah principles.⁵ Even the IBIs themselves were of the view that there was no formal policy by the central bank about the financial disclosure and sharing P/L information with the saving depositors (Farhan, 2013). Hence, streamlining the disclosure and the reporting systems and procedure was also an aspect to be taken care of on priority basis.

3. *Muḍārabah* as a Basis for Financial Intermediation

Muḍārabah is the main contract useable for intermediation between the investors and the entrepreneurs. While S.M. Hasanuz Zaman and a few other scholars are not in favour of using *muḍārabah*⁶ on assets side for non-trade operations⁷, a vast majority of scholars has recommended its extensive use. Nejatullah Siddiqi has discussed thoroughly the extended

income between the bank and the pool, and among the depositors as pool members, any *hibah* made by the banks for smoothing the profit payouts, etc., the classical fiqh literature requires some strict conditions with regard to *muḍārabah* operations and profit distributions (Shariah scholars have raised a number of issues in this regard, e.g. see Hafiz Zulfiqar Ali, 2011). For application of the system in present world, adjustment in the form of all partners' agreement and their consent was needed that the framework under review has amicably fulfilled.

⁵ Consequently, this restriction regarding minimum rate of return on savings deposits is no more applicable on Islamic banking institutions, vide SBP's IBD Circular No. 03 dated November 19, 2012.

⁶ Alternatively, he recommends the use of *mushārah*. As the combination of *muḍārabah* and *mushārah* is also accepted by Sharī'ah scholar, the bank could use profit/loss sharing as a technique encompassing both modes subject to fulfillment of relevant conditions.

⁷ Hasanuz Zaman, S.M. '*muḍārabah* in Non-Trade Operations' in Islamic Economics', Journal of King Abdul Aziz University, Jeddah, Vol.2, 1990 (1410 AH), pp: 69-88.

scope of *muḍārabah*.⁸ The main relationship between depositors and Islamic banks is that of financiers and entrepreneurs (the IBIs). Out of the three main categories of contracts that could be used by banks and financial institutions namely, *amānah* / *wadi'ah*, *wakālah* and the *muḍārabah*, the last one is the most suitable mode for seeking deposits from investment account holders (IAHs) and the savers who want to get return on their savings and investments. While the deposits held under *wadi'ah* / *amānah* cannot seek any return, *wakālah* based deposits allow the fund managers / banks a fixed fee for managing the investors portfolios.

Banks normally put a part of their equity as well in the deposits pools. There is a slight difference of opinion whether this combined investment should be treated as *mushārah* or *muḍārabah*. In terms of the rules, the relationship is that of *mushārah* if they put their part in the pool at the time of pool creation with a *mushārah* provision in the contract and that of *muḍārabah* if there was no provision for *mushārah* and the fund were provided subsequently. In latter case, which is sometime termed as pooled *muḍārabah*, the bank will be investor just like other depositors getting profit on its share in the pool's capital and the weightage assigned to it. All pool members will be partners among themselves and the bank will serve as *muḍārib*. The overall relationship will remain of *muḍārib* and *rab al-māl* because in case of *mushārah* all partners would have the right to participate in the appreciation of the business assets as a whole, which is not in case of the banks' depositors. Further, depositors are like sleeping partners and normally have no right in management and business decisions. All deposits are pooled, banks invest the pooled amount in business, all direct expenses are charged to the pool while expenses related to the general management or Head Office expenses are borne by the bank (*muḍārib*) itself, and the net proceeds are distributed among depositors according to the stipulated ratios.

3.1 Essentials of *Muḍārabah*

In *muḍārabah*, an investor or a group of investors provides capital to an agent or manager who has to do business with it; the profit is shared according to the pre-agreed proportion while the loss has to be borne

⁸ Siddiqui, M. Nejatullah ; 'Some Economic Aspects of *muḍārabah* : Review of Islamic Economics', Journal of International Association For Islamic Economics, Vol.1, No.2, 1991, pp.21-34.

exclusively by the investor.⁹ The loss means shortfall in the capital or investment of the investor / account holder. The loss of the bank (*muḍārib*) is by way of expended time and effort for which he will not be given any remuneration. Any ambiguity or ignorance regarding capital or ratio of profit makes the contract invalid. By allowing *muḍārabah*, Islam has intended to fulfill an important economic function by way of encouraging the hiring of capital and that of trade skills on judicious terms of risk sharing leading to benefit of the society and the concerned parties (Ayub, 2007). A number of investors may enter into *muḍārabah* contract with a single person / institution to do the business or with more than one business managers severally or jointly. The classical jurists generally restricted the use of *muḍārabah* to the act of trade (buying / selling)¹⁰, but an overwhelming majority of contemporary jurists and scholars allow the use of *muḍārabah* with a wider scope for use by Islamic banks as an alternative to interest based financing.

Muḍārabah may be restricted and un-restricted, and conditional or unconditional. The conditions may pertain to the nature of the work, the place of work and the period of the work. Conditions binding the worker to trade with a particular person or in a particular commodity etc. are, according to Hanafi and Hanbali jurists permissible but these make the contract a special *muḍārabah*. The financier has a right to impose conditions on *muḍārib* provided they are not prejudicial to the interest of the business and are not counter productive to the purpose of the *muḍārabah*. After transfer of the capital by the financier, the *muḍārib* needs to be given independence for normal conduct of business. However, financier can impose restrictions on the *muḍārib* in terms of place, object and method of trade. He may also want to have a quick and direct access to his capital and may, for instance, stipulate that the *muḍārib* may trade within a certain marketing zone.¹¹

The profits realized from *muḍārabah* cannot be finally distributed until all expenses have been paid, in accordance with custom and original agreement. Accrual of profit does not mean transaction-wise calculation of the profits; it means the overall adjustment of profits and losses over a

⁹ Ibn e Qudāma, op. cit, P.33.

¹⁰ This is particularly the view of Shafie jurists (Al Jaziri, Kitābul Fiqh..., Vol. 2: 847-48; See also relevant chapter in Badai lil Kāsāni. Among the contemporary jurists S. M. Hasanuzzaman, an IDB laureate in Islamic economics, is in favour of limited role of *muḍārabah* (1990).

¹¹ For details: see Ayub, 2007, Chapter 12.

particular period of time, which is treated as closing of the accounts but not necessarily as winding up of the business. The profit sharing ratio between the depositor (financier) and the bank (*muḍārib*) has to be decided at the time the contract is concluded. They can agree on equal sharing or allocate different proportions. Parties can change the ratio for profit distribution at any time, but that ratio will remain effective for the period for which it has been mutually fixed. A lump sum amount as profit/return on investment for any of the parties cannot be allowed or agreed upon. In other words, they can agree on, for example, that 50, 40 or 60 percent of profit will be for financier and the remaining 50, 60 or 40 percent respectively shall go to *muḍārib*. The loss means erosion of capital; no profit can be recognized or claimed unless the capital of *muḍārabah* is maintained intact.¹² As provided by AAOIFI in standard on *muḍārabah*, reserves can be created with mutual consent and if a *muḍārabah* incurs a loss, the loss can be compensated by the profit of the future operation of the joint business or the reserves created in the past. At the time of profit allocation, one partner can donate a part of his profit to the other partner(s). Profit becomes an absolute right of the parties only after distribution takes place. For valuation, receivables should be measured at the cash equivalent, or net realizable, value, i.e. after the deduction of a provision for doubtful debts. In measuring receivables, neither time value nor discount on current value for extension of period of payment shall be taken into consideration.¹³

In *muḍārabah*, distribution of profit has to be done after liquidation of *muḍārabah* business. However, 'on account payment of profit' is possible subject to ultimate adjustment.¹⁴ To avoid problems in perpetual *muḍārabah*, as the banking business is, the contemporary jurists have accepted the concept of constructive liquidation of assets by determining market value of non-liquid assets.¹⁵

If the bank as *muḍārib* has also contributed the capital, which it can do with mutual consent, it would bear the pro-rata loss. In case profit has been distributed upon constructive or actual liquidation of business, it cannot be withdrawn¹⁶ in order to make up for a later loss or for any other purpose. If loss has occurred in some transactions and profit realized in

¹² See for its basis: AAOIFI, Sharī'ah Standard, 2004-05; P. 243.

¹³ AAOIFI, Sharī'ah Standard on *muḍārabah*, Clause, 8/8.

¹⁴ Jaziri, Abdur Rehman, Kitābul Fiqh ..., Vol.3, P.61.

¹⁵ Ashraf, Imran Usmani (April, 2000), Pp.276-283.

¹⁶ Al-Jaziri, Kitābul Fiqh....., Vol. 2, Pp. 862-65.

some others, the profit can be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

Profit allocation between banks' equity and investment account holders is important because it deals with fundamental and ethical aspects relating to the concept of fairness in the alternative that Islamic banks offer as opposed to interest-based banks. It requires disclosure of information regarding the business and the profit sharing formula. The principles of fairness and trust emphasize the importance of the individuals' confidence in the Islamic banks' ability to achieve their investment goals. Disclosure should be made about significant accounting policies, weightages assigned on the bases of the tenor and the size of accounts, expenses to be charged and the bases applied by the Islamic Bank in the allocation of profits between owners' equity and unrestricted investment account holders.

3.2 *Muḍārabah* and the Weightages System

Depositors in any banking system continue to deposit and withdraw the funds with the result that their balances with the bank increase or decrease during any accounting period. Similarly, they open and close their accounts at their will and banks are not in position to stop any account holder. To resolve the issue, the concepts of daily / average product and the weightages have been evolved by way of *ijtihād*. These concepts are approved by OIC Fiqh Council, AAOIFI, and Sharī'ah scholars in general. The basic rationale behind different weightages is that Sharī'ah does not mandate an equal return to all partners, and instead allows a "just" and "equitable" method of distribution of profit. Investors who provide funds for longer period, facilitate the banks to do the business with more confidence than the providers of short term funds. Dormant partner should not have higher proportionate return as compared to the working partner. Hence, the longer the period of a deposit, the more could be weight assigned to it. Different weightages can be assigned to different depositors depending upon their tenure and size subject to condition of sufficient disclosure to all depositors. The longer the tenor of deposits greater would be the weightage to be assigned to them. As a general rule, equity is given the highest weightage due to its being perpetual. For the purpose of profit distribution among partners, there is constructive liquidation after a tenure or accounting period and then joint relationship starts afresh for the next accounting period.

All *muḍārabah* accounts have to be linked to respective pools containing more than 50 % *ijārah* or other fixed assets to allow premature withdrawal. This is because, in case there are no fixed assets, it could be treated as transfer of liquid assets covered under *bai‘al- dayn*. As *ijārah* represents physical assets leased out by the bank, *ijārah* assets serve the best purpose for this provision. However, if Hanafi view is adopted, early withdrawal will be allowed even if the non-liquid assets are more than 10% of its total worth.

3.3 Why Separate Pools?

Banks manage different pools keeping in view different risk appetite of the savers / IAHs. Mainly, the pools may have categories based on the tenor of the deposit or the risk profile of the accountholders. Following could be the purposes of managing multiple deposit pools:

- To mitigate the risks or to manage different types of assets having different risk characteristics;
- To separate Bank’s own assets and strategic investments;
- Against regulatory requirements e.g. IERS in Pakistan¹⁷;
- To raise financings e.g. through financial institutions (liquidity management);
- To issue *ṣukuk* or Units of *mushārah* / Certificates of Investment;
- To manage assets in different currencies;
- To cater to different types of depositors needs;
- To get the expected results for specific investors – not desirable;
- To separate certain assets for a few days – not desirable.

Each pool is a “virtual” commercial venture and owns certain assets and is represented by the bank’s equity and /or the customers’ money. To make the periodic redemption of investment and profit payment to pool participants possible, at any stage, the assets of the pool should constitute at least 10% illiquid assets (like *ijārah* assets, fixed assets, or inventory). Related risk and reward of the asset have to be clearly linked to a specific pool, so that identification may be determinable at any time the assets are transferred. To avoid assets-liability mismatch it is better that longer term

¹⁷Under the Islamic Export Refinance Scheme (IERS), SBP provides refinancing to banks on the basis of *mushārah* with IBIs who provide export finance for the specified items. IBIs have to maintain *mushārah* pools and the both parties shares in the actual profit of the pool maintained by the Islamic bank (see for details: Ayub, 2007, chapter 14).

assets are financed by equity and / or longer term investment deposits creating separate pool (s) for the same.

4. New SBP Instructions

The State Bank of Pakistan issued detailed instructions for P & L distribution and pool management by IBIs in order to improve transparency and disclosures and bring standardization in their policies and practices in this regard. With the issuance of these instructions, applicable with immediate effect, the provisions of BPRD Circular No 7 of 2008 regarding minimum rate of return on savings deposits as amended from time to time shall no more be applicable on IBIs. Failure to comply with SBP instructions shall invoke penal action under the relevant banking law. As per new instructions, each deposit pool would act like a virtual enterprise having explicitly demarcated sources of funds, ownership of specific assets and income and expenses. The profit earned on the financing and investments made through any such pool will be shared between IBIs and the depositors as per pre-agreed profit sharing ratio. In case of loss, the same will be borne by the depositors in proportion of their investments unless caused by the negligence and misconduct by the IBIs in managing the depositors' funds. Salient parts of the SBP's instructions are as hereunder:

4.1 Creation of Pools

IBIs shall have a well-defined profit and loss distribution and pool management framework for creation of one or more pools of assets to be financed by different types of *muḍārabah* -based deposits. The framework shall, *inter alia*, specify the objectives, investment strategy, and risk characteristics of each pool akin to different types of investment funds. It shall also explicitly define the basis for allocating different types of deposits to different pools, and assigning weightages to each deposit category of a particular pool. It is preferable to create separate pools for foreign currency deposits. The framework shall be approved by the Sharī'ah Advisor and BOD of the IBI and a duly approved copy of the same shall be submitted to the SBP within three months of issuance of these instructions. Further, changes (if any), warranted in the framework shall also be approved by Sharī'ah Advisor and BOD under intimation to SBP within 15 days of such change(s).

IBIs may create treasury pools for interbank transactions through necessary authorisation level as defined in the pool management

framework. Such pools however need to be maintained separately due to peculiar nature of short term liquidity placements by the banks.

All pools shall be created through a memorandum signed by the authorised senior executive to be defined in the framework documenting the objectives, investment strategy, tenor (if any), the risk and reward features, Profit Sharing Ratio (PSR), weightages and the basis thereof. The pool to which a deposit is to be allocated shall be identified at the time of accepting the deposit and allocation of such deposit to the respective pool on the same day shall be ensured. While the IBIs will be getting permission for this from the depositors at the time of account opening, this instruction seems to ensure that banks do not make transfers of assets to different pools arbitrarily.

To honour redemption/withdrawal requests, the pool(s) shall constitute at least 20% tangible/tradable assets such as *ijārah* assets, *ijārah šukuk*, Diminishing *mushārah* assets, etc. However, this benchmark may be brought down to a minimum of 10% of the pool's assets subject to approval of the Sharī'ah Advisor of the IBI.

IBIs shall explicitly mention in their profit distribution and pool management framework, the treatment and remuneration basis for premature/early encashment of term deposits during the period concerned. This shall however be ensured that the profits distributed and allocated as a result of constructive liquidation of the pool shall not be called back/forfeited in any situation.

The IBIs shall have in place an adequate IT based system which *inter alia* suitably caters to the requirements of allocation of (a) deposits, (b) financing, investments and placements, (c) income and expenses and (d) movement of assets to/from different pools. The system limitations, if any, shall be addressed within one year of issuance of these instructions. The pools till such time shall be managed through proper chart of accounts or cost centers. The relatively smaller sized IBIs may however approach SBP for relaxation/extension in time frame for development of the IT system.

4.1.1 Weightages

The weightages to different categories of deposits in a pool shall be assigned based on parameters/criteria defined in the pool management framework and announced at least 3 working days before the beginning of period concerned and shall not be changed during the period. The maximum weightage to the *muḍārabah* based deposit of any nature, tenor and amount shall not exceed 3 times of the weightage assigned to saving

deposits (general deposits with checking facility at discretion of the depositor). Seemingly, it is not fair, but IBIs may be required to do that in order to encourage the longer term deposits. So long as the weightages do not differ with regard to size of deposits of a particular tenure, this treatment has been accepted by all Shari'ah bodies. (Previously, the banks sometime exceeded the 3 times while assigning weightage to respective categories).

4.1.2 Investment of Pools' Funds

The *muḍārabah* based deposits shall be invested in earning assets like financing, investment, etc. Such deposits shall not be invested in non-trading fixed and other assets like land, building, furniture fixtures, computers and IT systems etc. An IBI as *muḍārib* is responsible to finance all such costs/assets from its own sources/equity. The cash reserve requirement (CRR) as prescribed by SBP from time to time shall be part of the pool financed through deposits attracting CRR¹⁸.

The IBIs may commingle their own funds from their equity with the depositor's funds in a pool. As an IBI assumes all the risks of current deposits (mobilised on *qard* basis), it can use such deposits as its equity for the purpose of profit and loss computation and distribution. For this the account opening form for *muḍārabah* based deposits shall include depositor's explicit permission to IBI to commingle its funds or the funds of other depositors including the current deposits within the *muḍārabah* pool as and when required.

Subsidised financing facilities extended to IBIs employees shall be funded from bank's own resources including current deposits. *Muḍārabah* based deposits shall not be used for extending any subsidised financing to employees i.e. staff loans and other funded facilities given to staff under IBIs' HR policies.

4.1.3 Pool as a Separate Enterprise

Each pool to be created and managed by an IBI shall be treated as a virtual enterprise having its own assets, liabilities, income and expenses, which are identifiable, balanced and verifiable at all times. Further, transaction records for each pool shall be maintained separately. It shall also be ensured that IBIs equity in different pools is reconciled with the total

¹⁸ In order to provide a liquidity cushion, any central bank requires all commercial banks to deposit with it a certain part, say 5 %, of their demand and time liabilities / deposits. SBP, like other central banks does not pay any return on such CRR deposits.

equity appearing in accounting records. The inter pool transfers of assets shall be made through a memorandum which shall, *inter alia*, include the need and objective of inter pool sale/purchase of assets and shall be authorised by committee of least two relevant senior executives.

4.2 Identification and Allocation of Pools Related Income & Expenses

The accrual / allocation of income and expenses to different pools shall be made based on pre-defined basis and accounting principles/standards. Direct expenses shall be charged to respective pool, while indirect expenses including the establishment cost shall be borne by IBIs as *muḍārib*. The direct expenses to be charged to the pool may include depreciation of *ijārah* assets, cost of sales of inventories, insurance/*takāful* expenses of pool assets, stamp fee or documentation charges, brokerage fee for purchase of securities/commodities etc, impairment/losses due to physical damages to specific assets in pools etc. IBI's pool management framework and the respective pool creation memo may identify and specify these and any other similar expenses to be charged to the pool. Only income from the investment of the pool assets goes to the pool and there should be no transfer of income or expenses from other pools or other earnings/expenses of the bank.

4.3 Treatment of Investment & Financing Losses

The SBP's frameworks provides that the general and specific provisions created against NPFs and diminution in the value of investments as under prudential regulations and other SBP directives shall be borne by the IBIs as *muḍārib*, although this seems to be in contravention of Sharī'ah principles. However, write-offs of financings and loss on sale of investments shall be charged to respective pool along with other direct expenses. The losses on financings and investments due to misconduct / negligence / breach of contract by IBI shall not be charged to the pool; the IBI as *muḍārib* shall be responsible for absorbing such losses¹⁹. The financing approved and disbursed and investment made in contravention to the prudential regulations or the IBIs own policies, procedures and processes as determined by internal auditor, external auditor and/or SBP inspection team will be treated as the negligence on the part of the IBI.

¹⁹ Negligence generally refers to doing any unauthorized act, any act against the accepted norms of a prudent business, and any dishonesty or misconduct that is proved. It could be identified by the central bank's auditors / inspectors which they do periodically.

4.4 Profit/Loss Allocation Between Depositors' Fund and Bank's Equity

In case of commingling of IBIs equity with depositors' fund in a pool, the net Income/loss of Pool shall be allocated between IBIs equity and the depositors' fund in proportion to their respective share in pool.

4.5 Profit Sharing Ratio and Deposits' Balances

The Profit Sharing Ratio (PSR) between depositors and IBIs shall be decided and announced at least 3 working days before the beginning of period concerned. Further, no downward revision in the PSR agreed with the depositors (particularly the term depositors) at the time of acceptance of deposit shall be made during the deposit tenor. In case such a revision is necessary, the depositors shall be allowed to withdraw their investments without any deduction/forfeiture of profits/penalties, etc. Profit and loss on the *muḍārabah* based deposits shall be computed and distributed on the basis of average balance in the depositor's account during the profit computation period. The *muḍārib* share shall be admissible only on profit allocated to depositors' funds from the pool's net income. Further, the *muḍārib* share shall not exceed 50% of the distributable profit.

4.6 Profit Smoothing

In the present scenario wherein the share of IFIs in the national as well as global financial systems is low, functioning of the IBIs in competitive environment is really a challenge. They cannot give rates to the depositors significantly different from the conventional benchmark rates because of regulatory requirements or the forces of demand and supply in the money and capital markets. Banks have been using the tool of changing the PSR or giving *hibah* indiscriminately that spoiled the whole spirit of the *muḍārabah* principle. In order to meet this challenge, some cushion has been provided by way of *maṣlahah* and *ḍarūra* (by way of *ijtihād*) and the banks have been allowed to keep some reserves from the profits to be used for smoothing the profit payouts in the long run.

4.6.1 Profit Equalization Reserve (PER)

In order to avoid volatility in the profit payouts to IAHs, the SBP has suggested, in line with the IFSB Capital Adequacy Standard (2005) and the guiding notes on capital adequacy and corporate governance, to create reserves out of the realized profits. The first is the PER kept from the net income of the pool (prior to distribution between the bank and the pool), i.e. the gross income less direct expenses and losses if any. The monthly

contribution into PER will not exceed 2% of Net Income, and the accumulated balance of PER shall not exceed 30% of Islamic Bank's Equity or Islamic Banking Fund (IBF) of IBD of Conventional banks. In the books of the IBI, 50% of the balance in PER will be considered as liability and the remaining 50% as reserve.²⁰ Sharī'ah scholars may have reservations on this provision, but it may be because, bank's / *mudārib* share cannot be more than 50% of the distributable profit. Going forward, it could be discussed further by the Sharī'ah Board of the SBP to make any decision in consultation with Sharī'ah scholars of the IBIs. For managing PER the profit sharing ratio for IBI as *mudārib* should not be more than 10% and the remaining shall go to the PER. It implies that the reserved amount and the profit accrued on that amount will belong both to the depositors and the bank and could be used for smoothing the profit pay-outs. The IBIs may fully or partly utilise/the amount of PER to improve the returns to the depositors during periods when the pool's profits are below market expectations. The funds of PER shall only be invested in Sharī'ah compliant Statutory Liquidity Reserves (SLR)²¹ eligible securities and the returns earned on these funds will also be credited into the PER account.

4.6.2 Investment Risk Reserve (IRR)

As the credit and market risk of the financing and investment portfolio is to be borne by depositors being *rab al-māl* in the *mudārabah* arrangement with the IBI, there may be scenarios where the pool may incur losses primarily due to unusually large write-offs and/or significant losses on sale of the pool's investments. Thus the IBIs may create IRR from the pool's share in profit to cover the future investment losses. They have to develop model and basis to determine the size of the IRR and the periodic contributions to be made to build up the IRR. Till the development of the model, IBIs may contribute towards IRR an amount up to 1.0 percent of the profit available for distribution amongst the pool's depositors after deduction of *mudārib* share in every profit period. The clauses related to

²⁰ There are two issues here, the first is that the PER should be allocated to equity and Investment Account Holders in the same proportion as their profit sharing ratio and secondly it should be respectively classified to equity and Investment Account Holders equity, not liability.

²¹ All banks are required to invest a certain part of the deposits, known as SLR (statutory liquidity reserves), of their deposits / liabilities base into tradable instruments / securities as approved by the regulators from time to time. Islamic banks are allowed to invest only in Sharī'ah compliant instruments like *ṣukuk* or approved mutual funds, and not in interest based government or corporate securities.

IRR shall be made part of account opening form or any other document for this purpose.

The IRR, if any created and maintained, shall be reflected as liability by IBIs. The funds of IRR shall be invested in Sharī'ah compliant SLR eligible securities only and the returns earned on these funds will also be credited in the IRR account (it cannot be part of the IBB's equity). The profit sharing ratio for IBI as *mudārib* shall not be more than 10% for managing IRR. The losses, if any, incurred by the pool shall be covered from the balance available in IRR.

4.6.3 Bank's *Hibah* from its Profit Share

An IBI may forego up to 60 percent of its *mudārib* share as *hibah* to meet the market expectation in case of lower than expected/market returns earned by the pool. However, they could do so only if the PER is insufficient to improve the profit payouts to the depositors. This *hibah* by the IBI shall however, be distributed across the board to all the deposit categories in a pool. IBIs will gradually phase-out the practice of offering special or individual *hibah* to the priority customers from the actual amount of special or individual *hibah* given during 2011 (100 %) to 0% in 2015. Further, special *hibah* if any, to be offered shall not be more than 2% over and above the actual return earned by the depositor based on performance of the pool and respective weightages and the reasons for allowing such special *hibah* shall be documented, and shall be subject to specific and explicit approval of the Sharī'ah Advisor.

4.7 Sharī'ah Audit and Disclosure

The distribution of profit and loss to the depositors on the basis of these instructions shall be subject to verification/audit jointly by the Sharī'ah advisors and external auditors. For knowledge of the public and the account holders IBIs shall make disclosure on their websites and notice board of each branch regarding the PSR, weightages assigned to each category of deposits, PER and IRR and the actual periodic profit/loss distributed to each category of deposits for the period concerned and at least two previous periods / years. They shall also make following disclosures in Notes to Financial Statements:

- The number and nature of pools maintained by the IBI along with their key features and risk & reward characteristics.
- Avenues/sectors of economy/business where *mudārabah* based deposits have been deployed.

- Parameters used for allocation of profit, charging expenses and provisions etc along with a brief description of their major components.
- *Muḍārib* Share (in amount and percentage of distributable income).
- Amount and percentage of *muḍārib* share transferred to the depositors through *hibah* (if any).
- Profit rate earned vs. profit rate distributed to the depositors during the year.

5. Issues and Implications

The recent instructions of the SBP needs to be acclaimed as the same are expected to develop the deposit management framework on professional basis and also improve Sharī'ah compliance level possibly leading to just treatment with banks and the depositors. The balances in PER and IRR will be used only for the purpose of profit smoothing and loss bearing respectively, while 90 % of income earned from such balance will also belong to the respective heads. But, the practitioners in the IBIs have expressed following reservations in this regard:²²

- Too strict guidelines as compared to other regulators and supervisors. This might have adverse impact on IBIs efficiency and competitiveness compared to conventional banks;
- The weightages and the assets allocation system to various pools will reduce flexibility available to the IBIs;
- It calls for Sharī'ah advisors and external auditors to work together in verifying profit/loss distributions ... such a collaboration may not be conveniently possible;
- Sharī'ah advisors adequately qualified to understand the accounting/financial reporting standards might not be available;
- Special *hibah* to individual depositors that makes the system akin to the conventional system should have been stopped forthwith;

²² See, for example, the on-line journal, Islamic Finance Pakistan (IFP), Volume 3, issue 11 December 2012.

- Some instructions were also needed for recognition of the profits on pools investments in respect of various modes which have not been given yet;
- It is fine that the losses on financings and investments due to negligence / breach of contract by IBI shall not be charged to the pool, but the instruction that provisions created against NPFs and diminution in the value of investments as under prudential regulations and other SBP directives shall be borne by the IBIs as *mudārib* may cause some objections as, in principle, such losses, if any have to be borne by the investor / pools.

Despite the above reservations, the regulatory instructions were really needed to streamline the system on sustainable grounds. The package that has taken into account the Sharī'ah as also the risk management requirements, has covered the relevant guidelines of the IFSB as well. In the long run, higher level of Sharī'ah compliance is in the interest of the banks themselves. It can generally be concluded that if they follow the instructions in letter and spirit, they may face some difficulties in the initial periods, but the evolved system would be more stable and sustainable by dint of better Sharī'ah compliance and risk management framework. The reservations could be removed or managed in some way or the other. The problem is that banks have to work in competitive environment while their size is much smaller than their conventional counterparts. Awareness level of both the depositors and the fund users is also low and any cyclical movements in the profit pay-outs may cause instability in the system through contagion effect. In order to avoid DCR, IBIs may resort to a systematic way of smoothing profit or covering the losses, if any, rather than giving *hibah* arbitrarily. In case of lower than market returns earned by any pool, IBIs are still allowed to forego up to 60% of their *mudārib* share as *hibah* to meet the market expectation. In this perspective, banks should not take it as harsh and must apply the new instructions wholeheartedly.

As a whole, it will result in improved internal controls and better mechanism of pool creation, asset transfers and earmarking and allocation and distribution of the profits. Every pool will have its own segregated sources of funds, income, expenses and rights of particular assets. The losses on financings and investments due to negligence / breach of contract by IBI shall not be charged to the pool. It may lead to just and fairer treatment to the general categories of investment account holders. While no such framework can ever be termed as perfect, yet this seems to

be an earnest attempt towards taking a balanced approach from a Sharī'ah and the risk management perspective. The disclosure and the transparency requirements are of special importance fulfilling the *muḍārabah* principles. However some instructions relating to pool allocation seem to be harsh. Similarly, banks may need sufficient time to properly train their personnel and update their IT systems. In this regard, they can approach SBP for extension in time frame for development of the IT system. In case any Sharī'ah advisor is not conversant with the accounting and auditing practices, any Sharī'ah auditors may be associated with them.

Hence, we can say that keeping aside some minor issues, there would be positive implications in terms of further strengthening the overall regulatory and the Sharī'ah compliance frameworks, particularly in terms of the fairer treatment with various categories of IAHs and disclosure requirements:

- Liabilities side disclosure of *muḍārabah* based pools: Now the IBIs will be required to make detailed disclosure and reporting with regard to allocation of deposits of IAHs to various pools, assets transfer(s) and earmarking to various pools and various kinds of reserves, etc;
- To match financing (assets) and sources of funds for all deposit pools, even the statutory Cash Reserve Requirement (CRR) shall be part of the respective pool;
- Prudential CAR requirements through the treatment of 50% of PER as liability;
- Prudential CAR requirements through the treatment of IRR as liability;
- Preparation of detailed Notes to the financial statements to disclose the PSR, weightages, number and nature of pools along with their key features and risk & reward characteristics.

6. Conclusion

On account of the peculiar nature of relationship between the depositors and IBIs where income earned by the IBI has a direct impact on depositors' return(s), there was a need for IBIs to have well-defined, transparent and standardised policies and practices for profit & loss computation and distribution. The recent instructions by the SBP have fulfilled the need to a large extent. It is a positive step towards enhancing Sharī'ah compliance level and to protect the interests of the IAHs. Joint

audit of profit / loss distribution procedure by Sharī'ah advisors / external auditors could enhance the proficiency of the Sharī'ah scholars that might go a long way in developing Islamic banking on a sustainable basis. The central bank is gradually moving towards achieving enhanced levels of Sharī'ah compliance through improved transparency, disclosures and better profit / loss distribution policies. Omar Mustafa Ansari, head of Islamic finance at EYFRSH (Ernst & Young Ford Rhodes Sidat Hyder), Pakistan observed in this regard that once the Islamic Financial Accounting Standards – 3 (on *muḍārabah*) is approved by ICAP's council and notified by SECP, it will add relevant accounting and disclosure requirements and the combined effect is expected to improve the overall system in many ways (IFP; Dec. 12). As a divine system, Islamic finance has to present a new identity based on the *maqāṣid al-Sharī'ah*. It is possible only if the regulators all over the world take increasingly effective measures to remove deficiencies in the application and procedures of Islamic banking and the informal practices like giving *hibah* indiscriminately is replaced by the well thought-out profit distribution and allocation procedures.

Bibliography:

1. AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions), Bahrain; (a) Sharī'ah *Standards* (1425-6 H / 2004-5; (b) *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*; 1425-6 H / 2004-5.
2. Al Jaziri, Abdur Rahman, *Kitabul Fiqh Alā Mazāib-e-Arba'a*, Urdu Translation, Lahore 1973, Vol. 2.
3. Ashraf, Muhammad Imran Usmani (April, 2000), '*Shirkat wa Muḍarabat*, '*Asr-e-Hazir Mein*' Idaratul Maaraf, Karachi, April.
4. Ayub, Muhammad; (a) *Understanding Islamic Finance*, John Wiley and Sons, 2007; (b) *Islamic Banking and Finance: Theory and Practice*, State Bank of Pakistan, Karachi; December, 2002.
5. Chapra, M. Umer and Tariqullah, *Regulation and Supervision of Islamic Banks*; IRTI Occasional paper # 3, 2000.
6. Farhan Iqbal; *Islamonline.com* 16th Jan 2013;
<http://www.islamonline.com/news/articles/80/Islamic-banks-in-Pakistan-anxiously-wait-for-stand.html>

7. Hasanuz Zaman, S.M. '*Muḍārabah in Non-Trade Operations*' in *Islamic Economics*', Journal of King Abdul Aziz University, Jeddah, Vol.2, 1990 (1410 AH), Pp: 69-88.
8. Hennie van Greuning and Zamir Iqbal; "*Risk Analysis for Islamic Banks*" THE WORLD BANK, Washington, D.C. 2008.
9. Islamic Finance Pakistan (IFP); Volume 3, issue 11 December 2012.
10. Islamic Financial Services Board (IFSB); Capital Adequacy Standard, December, 2005; Guiding principles on corporate Governance, December, 2006; Capital Adequacy Guidance Note, March, 2008.
11. Janjua, M. Ashraf; *History of the State Bank of Pakistan* (1988-2003); Chapter on Islamisation.
12. Siddiqi, M. Nejatullah; '*Some Economic Aspects of muḍārabah: Review of Islamic Economics*', Journal of International Association For Islamic Economics, Vol.1, No.2, 1991, pp.21-34.
13. State Bank of Pakistan (SBP) IBD Circular No. 03 of 2012 Dated November 19, 2012. www.sbp.org.pk
