# Instructions for Profit & Loss Distribution and Pool Management for Islamic Banking Institutions (IBIs)

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## INTRODUCTION

The Mudaraba based deposits constitute a major part of Islamic banking institutions' (IBIs) deposit mix. The contractual arrangement of such deposits with the IBI requires sharing of profits in financings, investments and placements etc. funded by such deposits between the IBI as Mudarib and the depositors as Rabbulmal, as per pre-agreed profit-sharing ratio. In case of loss, the same is borne by the depositors in proportion of their investments unless caused by the negligence and misconduct by the IBI in managing the depositors' funds. Considering this peculiar relationship where income earned by the IBI through financing investment and placement has a direct impact on depositors' return; there is a need to have well defined, transparent and standardized policies and practices for profit & loss computation and distribution across the Islamic banking industry.

As the depositors' funds are deployed in one or more pools, each having distinct risk and reward features, the IBIs' pool management[1] policies and practices significantly impact the profit and loss distribution. Each pool is like a virtual enterprise having explicitly demarcated sources of funds, ownership of specific assets and income and expenses. At present, different pool management practices are prevalent in the industry, which coupled with limited disclosures on the practices give rise to reputational risk for the Islamic banking industry. Considering the need to bring standardization and improve transparency in profit & loss distribution and pool management practices, the following instructions have been developed, which are applicable on IBIs with immediate effect.

## 1. <u>CREATION OF POOLS</u>

1.1. 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 Mudaraba-based (individual, corporate or financial institutions) deposits. The framework shall interalia specify the objectives, investment strategy, and risk characteristics of each pool. It shall also explicitly define the basis for (i) allocating different types of deposits to different pools (ii) assigning weightages to each deposit category of a particular pool. The framework shall be approved by the Shariah Advisor and Board of Directors (BOD) of the IBI and a duly approved copy of the same shall be submitted to Islamic Banking Department, SBP within three months of issuance of these instructions. Further, changes (if any), warranted in the framework shall also be approved by Shariah Advisor and BOD under intimation to SBP within 15 days of such change(s).

1.2. All the pools to be created by the IBI shall be in conformity with the aforementioned framework and shall be created through a memorandum signed by the authorized senior executive to be defined in the framework documenting the objectives, investment startegy, tenor (if any), the risk and reward features, Profit Sharing Ratio (PSR), weihgtages and basis thereof. Till the finalization of the framework in light of these instructions, the pools may be created through the memo with the approval of the president or relevant senior executive authorized by him/ her. In case of Islamic Banking Division (IBD) of conventional banks, the memo may be approved by Head IBD in the interim period.

1.3. 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.

[1] The pool management in IBIs refers to systematic creation of one or more pools for different categories of Mudaraba deposits, as per risk and reward expectations of such depositors.

1.4. The IBIs shall have in place an adequate IT based system which interalia 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.

1.5. The Mudaraba 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. The IBI as Mudarib is responsible to finance all such costs/assets from its own sources/equity.

1.6. The Cash Reserve Requirement (CRR) as prescribed by SBP from time to time shall be part of the pool financed through deposits attracting CRR.

1.7. The IBIs may comingle its own equity (available in liquid/cash form) with the depositor’s funds in a pool. As IBI assumes all the risks of current deposits (mobilized on Qarz basis), it can use such deposits as its equity for the purpose of profit and loss computation and distribution.

1.8. The account opening form for Mudaraba based deposits or any other document for the purpose shall include depositor’s explicit permission to IBI to commingle its funds or the funds of other depositors including the current deposits within the Mudaraba pool as and when required.

1.9. To honor redemption/withdrawal requests, the pool(s) shall constitute at least 20% tangible/tradable assets such as Ijarah assets, Ijarah Sukuk, Diminishing Musharaka assets, etc. However, this benchmark may be brought down to a minimum of 10% of the pool’s assets subject to approval of the Shariah Advisor of the IBI.

1.10. 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 time. Further, transaction records for each pool shall be maintained separately. It shall also be ensured that IBI’s equity in different pools is reconciled with the total equity appearing in accounting records.

1.11. The inter pool transfers of assets shall be made through a memorandum which shall interalia include the need and objective of inter pool sale/purchase of assets and shall be authorized by committee of least two relevant senior executives.

1.12. IBIs may create treasury pools for interbank transactions through necessary authorization level as defined in the pool management framework. These pools however need to be maintained separately due to its peculiar nature i.e. liquidity management.

1.13. Subsidized financing facilities extended to IBI’s employees shall be funded from bank’s own resources including current deposits. Mudaraba based deposits other then remunerative current account deposits shall not be used for extending any subsidized financing to employees i.e. staff loans and other funded facilities given to staff under IBIs’ HR policies.

1.14. It is preferable to create separate pools for Foreign Currency (FCY) deposits. The FCY deposits will be managed as per existing instructions of SBP Foreign Exchange Manual.

## 2. IDENTIFICATION AND ALLOCATION OF POOL RELATED INCOME & EXPENSES

2.1. The allocation of income and expenses to different pools shall be made based on pre-defined basis and accounting principles / standards.

2.2. The direct expenses shall be charged to respective pool, while indirect expenses including the establishment cost shall be borne by IBIs as Mudarib. The direct expenses to be charged to the pool may include depreciation of Ijarah assets, cost of sales of inventories, insurance / Takaful 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. However, this is not an exhaustive list; IBI 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.

2.3. **Investment & Financing Losses:**

2.3.1. The general and specific provisions created against non-performing financings and diminution in the value of investments as under prudential regulations and other SBP directives shall be borne by the IBIs as Mudarib. However, write-offs of financings and loss on sale of investments shall be charged to respective pool along with other direct expenses.

2.3.2. 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 Mudarib shall be responsible for absorbing such losses. The financing approved and disbursed and investment made in contravention to the prudential regulations or the IBI’s 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.

## 3. PROFIT/LOSS ALLOCATION BETWEEN DEPOSITORS’ FUND AND IBI’S EQUITY

3.1. In case of comingling of IBI’s equity with depositors’ fund in a pool, the Net Income/ loss of Pool shall be allocated between IBI’s equity and the depositors’ fund in proportion to their respective share in pool.

3.2. Profit and loss on the Mudaraba based deposits shall be computed and distributed on the basis of average balance in the depositor’s account during the profit computation period.

## 4. PROFIT SHARING RATIO & WEIGHTAGES

4.1. **Profit Sharing Ratio (PSR)**

4.1.1. The Profit Sharing Ratio (PSR) between depositors (Rabbulmal) and IBIs (Mudarib) 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.

4.1.2. The Mudarib share shall be admissible only on profit allocated to depositors’ funds from the pool’s net income (please see the Profit Computation and Distribution Process Flow at Annexure-I). Further, the Mudarib share shall not exceed 50% of the Distributable Profit.

### 4.2. Weightages

4.2.1. The weightages to different categories of deposits in a pool shall be assigned based on parameters / criteria defined in the pool management framework.

4.2.2. The weightages shall be announced at least 3 working days before the beginning of period concerned and shall not be changed during the period.

4.2.3. The maximum weightage to the Mudaraba based deposit of any nature, tenor and amount shall not exceed 3 times of the weightages assigned to saving deposits.[2] The remunerative current accounts shall not form part of Mudaraba based deposits for the purpose of this clause.

4.2.4. 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.

## 5. PROFIT SMOOTHENING

### 5.1. Profit Equalization Reserve (PER):

5.1.1. IBIs may maintain Profit Equalization Reserve (PER) from Net Income of Pool i.e. the gross income less direct expenses and losses if any.

5.1.2. 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 Islamic Banking Division of Conventional banks

5.1.3. 50% of the balance available in PER shall be reflected as liability and remaining 50 % as reserve in the books of the IBI.

5.1.4. The funds of PER shall only be invested in Shariah compliant SLR eligible securities and the returns earned on these funds will also be credited into the PER account. The profit sharing ratio for IBI as Mudarib shall not be more than 10% for managing PER.

5.1.5. The IBIs may fully or partly utilize/the amount of PER to improve the returns to the depositors during periods when the pool's profits are below market expectations.

5.1.6. The clauses related to PER (if any) shall be made part of account opening form or any other document for this purpose.

### 5.2. Transfers from Mudarib Share:

5.2.1. IBI may forego up to 60 percent of its Mudarib share as Hiba to meet the market expectation in case of lower than expected/market returns earned by the pool. However, the IBIs maintaining PER will reduce their Mudarib share only if the PER is insufficient to improve the profit payouts to the depositors.

[2] The deposits that used to attract SBP instructions for payment of minimum returns

5.2.2. This Hiba by the IBI shall however, be distributed across the board to all the deposit categories in a pool.

5.3. IBIs will gradually phase-out the practice of offering special or individual Hiba to the priority customers. Therefore, special or individual Hiba for CY 2012 will be frozen to previous year's level in absolute terms i.e. upto the actual amount of special or individual Hiba during CY 2011, upto 50% in 2013, upto 25% in 2014 and 0% in 2015. Further, special Hiba 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 Hiba shall be documented, and shall be subject to specific and explicit approval of the Shariah Advisor . The actual amount of special or individual Hiba given during CY 2011 shall be submitted to Islamic Banking Department along with the Shariah Advisor and BoD approved Framework as required in clause (1.1).

## 6. INVESTMENT RISK RESERVE (IRR)

6.1. As the credit and market risk of the financing and investment portfolio is to be borne by depositors being Rabbulmal in the Mudaraba 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 to absorb/off-set such losses IBIs may create the Investment Risk Reserve (IRR) to cover the future investment losses and develop models 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 mudarib share in every profit period.

6.2. The IRR, if any created and maintained shall be reflected as liability by IBIs.

6.3. The funds of IRR shall only be invested in Shariah compliant SLR eligible securities and the returns earned on these funds will also be credited in the IRR account. The profit sharing ratio for IBI as Mudarib shall not be more than 10% for managing IRR.

6.4. The losses, if any, incurred by the pool shall be covered from the balance available in IRR.

6.5. The clauses related to IRR shall be made part of account opening form or any other document for this purpose.

## 7. VERIFICATION/AUDIT

The distribution of profit and loss to the depositors on the basis of these instructions shall be subject to verification/audit jointly by the Shariah Advisor and External Auditor.

## 8. DISCLOSURES

8.1. **Disclosures in Notes to Financial Statements:**

8.1.1. The number and nature of pools maintained by the IBI along with their key features and risk & reward characteristics.

8.1.2. Avenues/sectors of economy/business where Mudaraba based deposits have been deployed.

8.1.3. Parameters used for allocation of profit, charging expenses and provisions etc. along with a brief description of their major components.

8.1.4. Mudarib Share (in amount and Percentage of Distributable income).

8.1.5. Amount and percentage of Mudarib share transferred to the depositors through Hiba (if any).

8.1.6. Profit rate earned vs. profit rate distributed to the depositors during the year.

8.2. **Disclosures on IBI's website and notice board of each branch:**

8.2.1. Percentage of Mudarib Share for period concerned and at least two previous periods in each category of deposits.

8.2.2. Weightages assigned to each category of deposits for period concerned and at least two previous periods.

8.2.3. The actual monthly/periodic profit/loss distributed to each category of deposits during last 2 years.

8.2.4. PER and IRR policies (if in place).

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**Profit Computation and Distrirbution Process Flow:** **Appendix-I**