

PRACTICE OF PROFIT EQUALIZATION RESERVE AND INVESTMENT RISK RESERVE BY ISLAMIC BANKS

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ABSTRACT

Stability of banking system is backbone of any country's economy. Conventional banking is a prominent banking system and it is well established in both Muslim and non-Muslim countries. Recently, Muslim scholars have suggested Islamic banking which has been widely practiced all over the world. All the Islamic banks except in Sudan are operating in the environment whereby the conventional banking has been dominating since a few decades. Although a few countries like Malaysia are facilitating Islamic banks, they are still influenced by the dominated conventional banking. In some scenarios, there are no rules and regulation governing Islamic banks. Islamic institutions such as AAOIFI and IFSB and regulatory bodies like Bank Negara Malaysia come out with some guidelines to ensure that Islamic banks are competitive with conventional banks and the former ones are able to attract the investment account holders (IAHs) as well as to stabilize the whole country banking system. Among the guidelines, the most important guideline is related to the practice of profit equalization reserve and investment risk reserve. Thus, the aim of this paper is to highlight the important role of these reserves and the recommendations provided by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and Bank Negara Malaysia (BNM) on their practices. The guidelines cover how much percentage of profit can be allocated for reserves and the transparent disclosure on this matter. Finally, the Shari'ah resolution by BNM is highlighted. It is expected that this paper will widen the knowledge of all interested parties on Islamic banking practices, especially on these reserves.

Key Words: Profit Equalization Reserve, Investment Risk Reserve, AAOIFI, IFSB and Bank Negara Malaysia.

1.0 INTRODUCTION

Banking business is full of different types of risks. Among the risks faced by the Islamic banks, rate of return risk and displaced commercial risk (DCR) are the unique risks and they are given attention by the IAHs, industrial players and regulators. The main cause of the problem is that Islamic banks are operating together with the conventional banks in the dual banking system. Islamic banks are prohibited to provide fixed rate of return while conventional banks are providing it. In addition, the Islamic banks are encouraged to

involve in the profit and loss sharing type of investment with IAHs. As a result, the IAHs will be receiving the return based on the profitability of the investments, rather than fixed amount of return. IAHs as rational decision makers might decide to withdraw the deposits if rate of return is lower, compared to the conventional banks. This will cause Islamic banking unstable and it will affect the country's economy as a whole.

Due to that, the Islamic institutions such as by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and regulators like Bank Negara

Malaysia (BNM) have recommended and allowed the Islamic banks to set aside some portion of the profit under two special types of reserves, namely, profit equalisation reserve and investment risk reserve. According to AAOIFI, IFSB and BNM, PER is an amount appropriated by the Islamic bank out of the *mudaraba* (profit and loss sharing contract) income, before allocating the *mudarib* (entrepreneur) share and its purpose is to ensure that the market rate of return able to pay to IAHs and increase owner's equity. It is mainly intend for protection of a financial firm against the risk of ruin due to existence of systematic risk that is prevalent in the industry and issue of adequate capital and cost of raising it to mitigate the risk. Similarly, IRR is an amount appropriated by the Islamic bank after allocating the *mudarib* share, in order to cater against future losses for the IAHs.

It can be said that these reserves are intended to protect the Islamic banks not to lose the IAHs in the case of misfortune. This paper is organized in five sections. The second section explains the current practice of Islamic banks regarding PER and IRR. The third section focuses on the guidelines of AAOIFI, IFSB and BNM related to these reserves. Fourth section elaborates on the *Shari'ah* resolution on them and the last section concludes.

2.0 CURRENT PRACTICES OF ISLAMIC BANKS IN PER AND IRR

Since the aim of introducing PER and IRR in Islamic banks is to compete with conventional banking industry, it is a shield used by the Islamic banks to protect their risks such displaced commercial risk, withdrawal risk (WR) and reputational risks [1, 2, 3, 4, 5]. They further state that the main role of these reserves is to mitigate the fluctuation of rates of return and to reduce the risk of paying profits out of equity in periods when actual profits are lower than expected.

According to the prevailing standards, DCR is defined as a risk and a pressure faced by the Islamic banks to pay its investors-depositors a rate of return higher than what should be payable under the "actual" terms of the investment contract. Therefore, it forces the Islamic banks when they underperform and are incapable to generate enough profits for distribution to account holders. Therefore, in reality, most of Islamic banks decide to waive

their profit portion to pay the IAHs in order to prevent the withdrawal of the IAHs. Due to significant experience gained by Islamic banks from attempt to mitigate DCR and WR has led to development of standard practices in Islamic banking industry regarding PER and IRR.

In the case of Islamic banks in Malaysia, BNM has introduced the guidelines for these two reserves in the beginning of 2004. Islamic banks are allowed to save up until 15% from profit gain. However, in certain circumstances, BNM has allowed save up amount to be up to 30%. The differences between PER and IRR is the latter is retention only from profits of IAHs and after deduction of *mudarib* share. Meanwhile, PER is the reserve made by bank for certain portion of profits calculated from gross income before distribute the profit between the shareholder and Investment Account Holder and the calculation of *mudarib* share. It is a need because it assists to smooth a low rate of return and reduce the volatility in return of IAHs. Meanwhile, IRR is use to cover potential losses on assets invested with IAHs' Funds [6]. In addition, Islamic banks are encouraged to provide the transparent information relating these reserves.

3.0 RECOMMENDATIONS FOR PER AND IRR BY AAOIFI, IFSB AND BNM

3.1 AAOIFI's Recommendation for PER and IRR

AAOIFI is an international not-for-profit organization that was founded on 26th February 1990. It was established solely for maintaining and promoting *Shari'ah* standards for Islamic financial institutions (IFIs). One of the objectives of AAOIFI is to define and set certain acceptable standard for various aspects of Islamic finance which are accounting, governance, ethics, transactions and investment. These standards must be in conformity with the principles of *Shari'ah*.

The AAOIFI had put together the new conceptual framework guiding the important consideration that is relevant to financial statement treatment of investment accounts which stem from *Shari'ah* point view. AAOIFI also promotes ability of IFIs to exercise free authority regarding decisions which affect investment and deployment of 'the investment account holders' fund. This kind of *Shari'ah* worldview is related to the "*maslaha* (public

interest)’’ which is a secondary source of *Shari’ah* that denotes public interest that imparts the lives of people.

According to [7] revenue should be recognized when realized. Based on the professional standard recommended by AAOIFI, realization of revenue takes place when IFI has the right to receive the revenue, there is an obligation from the end of another party to remit and the amount of revenue to be collected should be known with reasonable degree of certainty. IFI should recognize the investment account in cash as cash equivalent value or fair value. If the *mudarabah* is profit sharing based that takes part in the utilization of fund, it is treated as equity of investment account and as an on-balance sheet item. On the other hand, if the *mudarabah* is the type that provides no authority in the fund utilization, it is still treated as equity of investment account but as an off-balance sheet item. AAOIFI FAS 17 provides that at the end of accounting period, investment held for trading purposes shall be measured at their fair value. The realized profits or losses accrued as a result of sale of any investment should be measured at the difference between the book value and the net cash proceeds from the sale of investment.

Generally speaking, there are four objectives of accounting disclosure. Two are *Shari’ah* based while the other two are inferred general requirement. The *Shari’ah* based is to avoid interest and to pay zakat (religious tax). These two objectives are social accountability as well as full disclosure. The financial statement should contain all material information necessary to make them useful to the users. The AAOIFI also provided in its consultation paper [8] certain elements that must be disclosed in the notes to the accounts of financial statement regarding the IAHs as follows:

- i) Accounting policy being under practice and basis for charging provision
- ii) Total administrative expenses charged to investment accounts with a brief description
- iii) Percentage of profit allocation between owner’s equity and various investment account holders
- iv) Percentage earmarked to be deducted for PER and IRR.

All of these are in the best interest of all the stakeholders involved such as the IAHs, the shareholders and the public. It will help in injecting transparency in the system and promote peoples’ trust in the Islamic banks.

3.2 IFSB’s Recommendation for PER and IRR

IFSB is one of outstanding supervision boards which provide guidelines to IFIs to manage PER and IRR. As for the board, PER is appropriate account created from *mudarabah* contract income. The reserve functioned as to support necessary level of return for the investment activities which have been made before apportion the income for *mudarib*. This specific account is believed can provide security for investment account holder (IAH) while increase owner’s equity. In comparison, the income will be transfer from investment account holder after proportion *mudarib* share in IRR. The reason of the process is expected to mitigate risk from future losses from investment activities. This will enhance existing and potential investment account holders’ trust to participate in investment portfolio offered by the Islamic banks. These accounting treatment and disclosure for both reserves should be enforced upon engaged with investment account holders’ consent and Board of Directors’ resolution.

The practice of creating the reserves must include analysis of risk profile of IAH. Based on IFSB no. 12 [9] “Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services Excluding Islamic Insurance and Islamic Collective Schemes”, Islamic banks must manage IAHs’ liquidity risk. IFSB proposes IFIs to perform stress testing including scenario analysis to test and study the possible returns from the investment activities. By doing that, Islamic banks can forecast the expected return from investment. IFSB also sets guideline to perform additional cash flow analysis periodically. By carefully managing IRR, management should alert on its ability to share the profit with investors.

3.3 BNM’s Recommendation for PER and IRR

The supervision provided for PER and IRR can be attained from BNM guideline. The guideline has assisted Islamic banking to

maintain rate of returns given to the IAHs in order to compete with conventional banking system which mainly based on interest rates. The reserves function ideally is to protect Islamic banks from DCR. BNM has proposed number of procedures can be taken to handle these reserves. In "Guideline on Profit Equalization Reserve", if necessary, Islamic banks are required to transfer shareholders' investment profit or banks' share as *mudarib* to IAHs in order to provide sufficient profit to IAHs. Several treatments to solve DCR issue are to provide the market rate of return to investors are (a) Islamic banks' current profit or retained earnings as *hibah* (gift), (b) create PER and (c) IRR. BNM has issued Framework of Rate of Return to aid Islamic banking sector to mitigate risk of income erosion by sustains comparable rates of return for fund depositors.

According to BNM, PER is the amount given out to preserve adequate level of return to IAHs. Before such reserve can be established, the Islamic banks should gain first agreement from IAHs regarding PER application on mitigation process for DCR. IAHs must be informed on PER disclosure and systems used to manage the reserve. The reporting on the management of PER shall cover DCR implication by utilizing suitable approaches which can mitigate the risk. It is essential for Islamic bank to perform timely comprehensive analysis for current balance of assets and liabilities in the investment accounts. Normally, management should incorporate factors of industry status, economic position and political issues which can contribute upon affecting investment performance. By following practice of corporation, the bank may carry out complete analyses of trends on the expected return by utilizing historical data. As a result, the forecasting activities can be used as tool to measure the degree of DCR to be apportioned to PER.

It is expected that corporate governance structure can help Islamic bank to avoid window dressing activities by management. This unethical practice commonly takes place to show attractive financial position despite disclosing real overall economic position of the liquidity standing. The reserves should not be used as a tool not to pay the deserved profit return to the IAHs. The management must aware of the reserve requirement is to maintain in timely manner as to guarantee the bank provide adequate funds to lessen DCR by using accumulated pool of profits.

In consistent with issues raised by accounting practitioners whom argued the framework on Rate of Return August 2002 did not comply with International Financial Reporting Standard (IFRS), BNM has revised the issues in March 2010. The recommendation made is to debit PER transaction into statement of comprehensive account rather than bank's income statement. The portions will be segregate as section separately for customers' fund deposits. The reason for the proposed revision is due to PER is not acquire nature of normal expenses. Therefore, the transaction should not be included in normal income statement. As for Malaysian Accounting Standard Board (MASB), the board proposes another accounting treatment can be taken into consideration instead of open PER to meet repayment obligation to IAHs. The treatment is by transfer payment amount from retained earnings compared to pool of accumulated profit. Such extraordinary transactions should follow strictly BNM guidelines and observe General Accepted Accounting Principles (GAAP).

From *Shari'ah* perspective, PER of IAH should be classified as liability and recognized at cost. The distribution of PER will be account as funds outflow upon settlement process. Islamic banks must submit the regulatory report on PER amount to BNM in monthly basis. This can help supervision activities by BNM to monitor relevant PER management by respective Islamic banks. All the necessary disclosures on changes in accounting policy shall be presented annual financial statements in the notes to accounts.

4.0 SHARIAH RESOLUTION BY SECURITY COMMISSION (SC) MALAYSIA

Based on the SC from 14th meeting dated 8 June 2000, has resolved that the proposal to implement PER is permissible [10]. According to general method of investment in Islam, the profit segregation in Islamic institution to the depositors must be based on agreed ratio. However, to ensure there is no cheating and poor satisfaction among the customers, transparency aspects must be taken into consideration. Although this mechanism can reduce the return to depositors during high return, the depositor is protected during poor bank performance. Hence, it is fair

and reasonable in a situation of lower return faced by Islamic Institution.

This is also in line with waiving of right concepts (*Mubara'ah*) which is allowed by *Shari'ah* which means "waiving a portion of right to receive profits for the purpose of achieving market stability in the future" [10]. In certain research stated that ruling for the PER and IRR are under the basis of *maslahah mafsadah* [11] and the profit portion save by Islamic institution is based on *Hibah* [12]. It has being agreed by the contemporary scholars.

5.0 CONCLUSION

Islamic banks have emerged as an alternating banking system to conventional one. Unfortunately, since the conventional banking has been well established and dominating the banking sector a few decades ago, it is difficult for the Islamic banks to compete and penetrate the market. The situation becomes more difficult for the Islamic banks in the case of profit and loss sharing with the IAHs. During the booming period, there is no issue since Islamic banks will be able to pay the competitive rate of return to the investors. However, in the case of loss from investing, if the Islamic banks cannot pay same rate given by the conventional banks, IAHs might withdraw their deposits and it will consequently lead to DCR. In order to protect the Islamic banks from WR and DCR, international organizations such as AAOIFI and IFSB as well as some countries like Malaysia have provided the guidelines. These guidelines are regarding how to appropriate PER and IRR as well as what should be accounting recognition and disclosure. It is expected that this paper will be the interests of investors, bankers and the society. In addition, *Shari'ah* scholars and researchers will be able to further investigate how these reserves can be fair to all the involved parties.

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