



ISLAMIC FINANCIAL SERVICES BOARD

**GUIDANCE NOTE ON THE PRACTICE OF
SMOOTHING THE PROFITS PAYOUT TO
INVESTMENT ACCOUNT HOLDERS**

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The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ACRONYMS

BOD	Board of directors
CAR	Capital adequacy ratio
DCR	Displaced commercial risk
ECAI	External credit assessment institution
GN	Guidance Note
IAH	Investment account holder
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services (excluding Islamic insurance/ <i>Takāful</i> institutions and Islamic mutual funds)
IRR	Investment risk reserve
PER	Profit equalisation reserve
PSIA	Profit-sharing investment account
RIA	Restricted investment account
SSB	<i>Shari`ah</i> Supervisory Board
UIA	Unrestricted investment account
UIAH	Unrestricted investment account holder

SECTION 1: BACKGROUND

1.1 Introduction

1. The existence of the practice of smoothing the profit payout to investment account holders (IAH) by institutions offering Islamic financial services (IIFS) is well acknowledged in the Islamic finance literature. Since the practice is reminiscent of “income smoothing”, an accounting technique which has been described and examined in the literature on financial accounting and reporting, this Guidance Note (GN) does not aim to determine the technical meaning of the practice. Rather, it will focus on:

- (i) identifying the causes and effects of the practice as far as the Islamic financial services industry (IFSI) is concerned, including verifying how it is put into operation by IIFS; and
- (ii) further refining the best practices in dealing with the subject, especially from the perspective of supervisory authorities and their prudential concerns.

2. For ease of reference, from this paragraph onwards the practice of smoothing the profits payout to IAH shall be referred as “Smoothing”, unless specified otherwise in the respective paragraphs.

3. Earlier Islamic Financial Services Board (IFSB) standards and guiding principles – namely, the Guiding Principles of Risk Management for IIFS (hereinafter “IFSB-1”) and Capital Adequacy Standard (hereinafter “IFSB-2”) issued in 2005, the Guiding Principles on Corporate Governance for IIFS (hereinafter “IFSB-3”) issued in 2006, Disclosures to Promote Transparency and Market Discipline for IIFS (hereinafter “IFSB-4”) issued in 2007, and the IFSB Guiding Principles on Governance for Islamic Collective Investment Schemes (hereinafter “IFSB-6”) issued in 2009 – have thoroughly analysed Smoothing from their respective points of view, be it risk management, capital adequacy, corporate governance or disclosures. This GN benefits from the publication of these earlier documents and will attempt to complement them by providing a more holistic perspective on Smoothing. As is made clear in the IFSB publications just mentioned, the practice of Smoothing raises a number of issues, especially with regard to corporate governance and transparency. To make any endorsement of Smoothing would in any case be outside the remit of the IFSB, and the issuance of this GN should not be considered as an endorsement of the practice.

1.2 Objectives

4. It follows that, specifically, the GN will aim at:

- (i) complementing other prudential standards issued by the IFSB by highlighting in more detail, to the supervisory authorities in particular and the industry’s other stakeholders in general, various issues related to Smoothing triggered by various methods, including forfeiting of the *Mudārib* share of profits, transfer of profits from shareholders to IAH, maintenance of a profit equalisation reserve (PER) by the IIFS, etc. These issues, *inter alia*, accentuate various transparency, corporate governance and harmonisation concerns;

- (ii) recommending to national supervisory authorities a number of “best practices” for the regulation and standardisation of techniques for Smoothing by IIFS in their jurisdiction; and
- (ii) promoting a wider debate on key points with regard to Smoothing practices adopted by IIFS.

1.3 Scope and Application

5. This GN shall be read together with the other applicable IFSB standards and guidelines dealing with the subject of displaced commercial risk (DCR).¹ As IIFS may be present in jurisdictions either with a full-fledged Islamic banking environment or with a dual banking environment² (in which both IIFS and conventional financial institutions co-exist), it is envisaged that IIFS may resort to different types of Smoothing depending on the level of competitive pressures posed by their market competitors.³ Broadly speaking, this GN endeavours to provide a framework whereby national supervisory authorities will be able to evaluate and standardise Smoothing in their jurisdiction, keeping in view the DCR faced by the individual IIFS and the Islamic financial services sector as a whole.

1.4 Rationale for Smoothing

6. A preponderant portion of investment funds raised by IIFS is based on the *Muḍārabah* contract, which is a partnership between work and capital in which the capital provider (*Rabb-ul-Māl*) is exposed to losses of his capital, while the provider of work (*Muḍārib*) is exposed to losing his time and effort. The contract thus involves profit-sharing for both partners and loss-bearing for the provider of capital. Under the *Muḍārabah* contract, the IAH agree to participate as *Rabb-ul-Māl* in the financial activities undertaken by the IIFS as *Muḍārib* and to share the profits generated from financing and investment activities⁴ based on a predetermined profit-sharing ratio. As capital owners, IAH are liable to bear the losses arising from the assets funded under the *Muḍārabah* contract, except in the case of fraud, misconduct, negligence, or breach of contracted terms and conditions by the IIFS.

7. Under the *Muḍārabah* contract, the IAH therefore bear the commercial risk associated with the assets financed by the funds provided by them. Concurrently, the IIFS are responsible for managing the investment of assets and are under a fiduciary obligation⁵ to safeguard the interests of the IAH through the establishment of sound and prudent policies in the management of the assets funded by IAH.

8. However, IIFS are faced with a number of limitations while managing funds provided by the IAH. It has been documented in the Technical Note on Issues in Strengthening Liquidity Management of IIFS: The Development of Islamic Money Markets (hereinafter “TN-1”), issued by the IFSB in 2008, that in most countries, efficient money and interbank markets for Islamic financial instruments have not yet been developed. In most jurisdictions, the major limitations

¹ See paragraphs 10–11 of this GN for an explanation of displaced commercial risk.

² The term “dual banking environment” refers to a financial system wherein both types of institutions – Islamic and conventional – are operating in the same jurisdiction. This system is prevalent in most of the jurisdictions where IIFS are operating.

³ This competitive pressure may arise from conventional banks, other full-fledged IIFS, Islamic banking subsidiaries, Islamic branches or Islamic window operations of conventional banks.

⁴ Refer to paragraphs 19 and 28 of IFSB-2 for details of financing and investment activities which may be undertaken by IIFS. Paragraphs 55–56 of IFSB-7 also provide a differentiation between financing and investment activities of IIFS in the real estate sector.

⁵ This fiduciary obligation implies that an IIFS as *Muḍārib* is expected to act as a trustworthy and faithful party with respect to the capital entrusted to it, and therefore is not liable for any loss occurring in the normal course of business. The *Muḍārib*, however, becomes liable for any losses in respect of the assets in its care in the case of any failure to act in accordance with this fiduciary obligation.

have been the non-existence or limited availability of *Sharī`ah*-compliant instruments for managing liquidity, the absence of a *Sharī`ah*-compliant interbank money market, and the non-availability of a *Sharī`ah*-compliant lender of last resort facility provided by the central banks/monetary authorities. Equally important is the non-availability of a safety net in the form of a *Sharī`ah*-compliant deposit insurance scheme for profit-sharing investment accounts (PSIA). Despite the issuance of *Sharī`ah*-compliant instruments called *Sukūk* in a number of jurisdictions in recent years, the development of active secondary capital markets in these issues remains elusive. TN-1 also underlines an insufficient utilisation of securitisation techniques and the non-availability of alternative tools of risk management based on hedging instruments as some of the major reasons for underdeveloped money and capital markets in the IFSI.

9. The unavailability or limited supply of the aforementioned instruments or market mechanisms in many jurisdictions impacts on an IIFS's liquidity management (typically, the holding of significant amounts of cash or other assets with zero or very low rates of return) and thus profitability. This may result, at times, in the returns earned on its IAH funds being uncompetitive compared to those being offered by its competitors, whether other IIFS or conventional institutions, and hence to those expected by its unrestricted investment account holders (UIAH). This leads to *rate of return risk*, which is a particular problem with respect to funds of UIAH, who typically may withdraw their funds at short notice subject to loss of profit share. In such a scenario, rate of return risk exposes the IIFS to *withdrawal risk* – namely, the risk that their UIAH may withdraw their funds at short notice and place them with other financial institutions (IIFS or conventional) that offer better expected or actual rates of return. If unmitigated, UIAH withdrawals can reach systemic proportions and become a cause for concern on the part of supervisory authorities.

10. As explained in IFSB-2,⁶ DCR refers to the risk (i.e. volatility of the stream of profits) arising from assets managed on behalf of IAH (and, in particular, UIAH) which is effectively transferred to the IIFS's own capital because the IIFS follows the practice of forgoing part or all of its *Muḍārib* share of profit on such funds, and/or making a transfer to UIAH out of the shareholders' investment profit as a *hibāh*, when it considers this necessary as a result of commercial and/or supervisory pressure.⁷ The rate of return paid to the UIAH is thus "smoothed" at the expense of the profits attributable to the IIFS's shareholders.

11. In addition to the effects on profitability of the limitations on liquidity management mentioned in paragraphs 8–9, a major cause of DCR is rate-of-return risk. Rate-of-return risk is the risk of facing a lower rate of return on assets than that currently expected on unrestricted investment accounts. For instance, IIFS may have invested UIAH funds into relatively long-maturity assets such as long-maturity *Murābahah*, *Murābahah* for the purchase orderer, *Ijārah* or *Ijārah Muntahia Bittamleek*, and thereby have locked in lower rates of return on assets than those currently on offer in the market. DCR results when there is pressure on the IIFS to match the market expectations of UIAH.⁸

1.4.1 *Classes of Investors and Investment Accounts*

12. As noted above, two main types of investment accounts may be offered by IIFS: unrestricted investment accounts (UIA) and restricted investment accounts (RIA). In managing UIA, an IIFS has full discretion to utilise the funds for the provision of finance and/or investments, as UIAH provide funds without specifying any restrictions as to where, how or for what purpose the funds should be invested, provided that they are *Sharī`ah* compliant. For RIA, on the other

⁶ Refer to paragraph 76 of IFSB-2 for details.

⁷ DCR as defined here does not include the covering of IAH losses using shareholders' funds. This is because an IIFS in its capacity as *Muḍārib* in a *Muḍārabah* contract does not bear losses unless they are attributable to misconduct and negligence. In principle, IAH losses may be covered by using an investment risk reserve (IRR) which is formed using only IAH funds.

⁸ See Appendix 1 of this GN for illustration.

hand, the mandate is confined to finance and/or investment activities agreed between the IIFS and IAH as to where, how and for what purpose the funds are to be invested.

13. In principle, Smoothing may apply to both types of accounts, but in practice it is more generally found in connection with UIA since they are considered a *Shari'ah*-compliant substitute for conventional deposits. IIFS usually maintain separate reserves (PERs and/or IRRs) for each type of account for risk management and segregation purposes.

14. Another categorisation of PSIA can be made by distinguishing (i) funds invested with an IIFS on what may be termed a “retail” basis by individuals from (ii) those invested on what may be termed an “institutional” basis by other IIFSs either in the interbank market, by *Takāful* institutions or by big corporates. This distinction is relevant because the “retail” IAH are likely to be seeking a *Shari'ah*-compliant substitute for conventional retail deposits, whereas the “institutional” UIAH are likely to be knowledgeable market players who are fully aware of the economic characteristics of PSIA. The focus of this GN has been mainly on the perspective of the “retail” IAH, whether unrestricted or restricted (but especially the former), as they face many of the disclosure and governance problems highlighted in section 4 of this GN. This GN acknowledges that issues highlighted in section 4 may be fundamentally different for a financial institution or a corporate investing liquid funds with an IIFS on a *Muḍārabah* basis. Most importantly, the interbank *Muḍārabah* investments are usually short-term placements and, unlike the case of “retail” investment accounts where the profit-sharing ratio is laid down by the IIFS in the *Muḍārabah* contract, for these placements the profit-sharing ratio is usually negotiated between the parties. The negotiated profit-sharing ratio is commonly fixed to achieve the target return which the investing IIFS is seeking from its investments, keeping in view the income generated in previous periods by various investment pools (general or specific) maintained by the IIFS receiving the funds. Further, an IIFS investing its funds with another is likely to have a clearer appreciation of the risks it is assuming and of the contractual terms on which it is doing so. The investing IIFS may well have the commercial strength to secure the disclosures it needs without supervisory intervention. Owing to these differences, the motivation to apply Smoothing techniques is largely absent in the case of “institutional” *Muḍārabah*-based investment accounts, whether as interbank transactions or as placements of liquid funds by *Takāful* institutions or corporates, and the related issues of transparency and governance are correspondingly of much less significance.

15. The risk and return profile of UIAH can be compared in certain ways with another important stakeholder in the IIFS – i.e. shareholders. Despite both UIAH and shareholders contractually agreeing to invest their funds with the IIFS and to bear any genuine loss of their capital, they will typically have different risk appetites. Retail UIAH are “defensive” investors seeking low-risk investments with steady but modest returns, whereas shareholders are likely to be more “aggressive” investors having a greater risk appetite in the expectation of higher returns. When funds from both UIAH and shareholders are commingled, a conflict of interest may arise due to their broadly different risk and return expectations. The conflict of interest can be mitigated by Smoothing, but this does not fundamentally address the nature of the problem. Moreover, shareholders may be receiving dividends that are subject to variation over time and may suffer capital loss as well as generate gains from the behaviour of the share price. On the other hand, returns to UIAH may be exposed to less volatility, but due to the very nature of UIA they cannot enjoy any benefit from capital gains through an increase in the share price. *Shari'ah* also stipulates that the nominal value of *Muḍārabah* accounts cannot be guaranteed by the IIFS, but from a practical point of view it is the shareholders’ dividend which is at stake when an IIFS engages in Smoothing.

16. Theoretically, there should be a positive correlation between an IIFS’s rate of return on assets/return on equity and the rate of return paid on UIA. In order to verify this, some empirical

studies have compared returns paid to UIAH with net return on assets and return on equity of IIFS in various jurisdictions. One such study pointed out that:⁹

- The rate of return on investment accounts is uncorrelated with the net rate of return on assets, as well as with the rate of return on equity, in contrast to the significant positive relationship that would be expected if the returns on assets were shared between investment accounts and IIFS shareholders, without adjustments in various reserves.
- The rate of return on investment accounts is significantly positively correlated with the general market return on deposits, suggesting a significant reliance on Smoothing (including maintenance of reserves) in order to align the returns on investment accounts with market rates.

This evidence is consistent with the general perception that, in a number of jurisdictions, IIFS resort to Smoothing.

1.4.2 Categorisation of Smoothing Techniques

17. In order to mitigate withdrawal risk, IIFS resort to various Smoothing techniques, each taking different forms and therefore entailing different legal and governance consequences for the IIFS. Some Smoothing techniques may be more prevalent in some jurisdictions than in others. The basic purpose of Smoothing is to give better rates of payout to UIAH in periods when assets financed from UIAH funds fail to generate competitive returns vis-à-vis competitors' asset portfolios. In addition, some IIFS are also involved in the practice of building separate reserves for covering losses on the UIAHs' investment.

18. The Smoothing methods used by IIFS in various jurisdictions may entail DCR without mitigation, or mitigation of DCR by the use of reserves. DCR occurs when IIFS effectively transfer risk (i.e. volatility of the income stream) arising from the assets managed on behalf of UIAH to their own capital, by forgoing a part or all of (a) the *Muḍārib* share of profit, and/or (b) the shareholders' portion of profit in the joint investments, in order to increase the rate of return payable to UIAH.

19. Methods which entail DCR without mitigation include the following:

- An IIFS may forgo or give up part or all of the *Muḍārib* share of profit earned on UIAH funds. Normally, in this case, the contractual percentage *Muḍārib* share is established at a high level, so as to provide flexibility in setting the percentage share for any particular year.
- An IIFS may make a transfer from shareholders' current or retained profits to a UIAH on the basis of a *Hibāh*.

20. Methods in which DCR is mitigated include the following:

- An IIFS may establish a reserve called a profit equalisation reserve (PER)¹⁰ by setting aside amounts from the investment profits before allocation between the shareholders and the UIAH and the calculation of the IIFS's *Muḍārib* share of profits.
- An IIFS may also maintain a reserve called an investment risk reserve (IRR) by setting aside amounts from the investment profits attributable to the UIAH, after deducting the IIFS's *Muḍārib* share of profits. The IRR can be used only to cover losses on the investments of UIAH funds. To be precise, the use of an IRR does

⁹ V. Sundararajan, *Risk Measurement and Disclosure in Islamic Finance and the Implications of Profit Sharing Investment Accounts*. These relationships were analysed empirically using data from a sample of 14 IIFS in eight countries, taking two time periods for each IIFS.

¹⁰ The term "profit equalisation reserve" is misleading, as what is "equalised" is not the profit but the profit distribution or payout. However, the term may reflect an intention to present the stream of profits as being more stable than is in fact the case.

not mitigate DCR, since the IIFS as *Muḍārib* may not accept a loss attributable to IAH as *Rabb-ul-Māl*. However, use of an IRR may mitigate withdrawal risk and reinforce the effect of the PER.

SECTION 2: FEATURES OF VARIOUS SMOOTHING TECHNIQUES

21. Techniques commonly used by IIFS for Smoothing and compensating for inadequacy of investment returns have been set out in the previous sub-section. In addition, as noted above, investment losses may be covered, or partially covered, by the use of an IRR. While the fundamental purpose of these techniques is Smoothing, their mechanisms and implications are clearly distinguishable. Features of these techniques are discussed in the following paragraphs.

2.1 Forgoing Part or All of the *Muḍārib* Share of Profit

22. A recent IFSB survey¹¹ indicates that this is the most widely practised Smoothing method among the IIFS. With this method, the IIFS varies the percentage of profit taken as the *Muḍārib* share in order to increase the share attributed to the IAH so as to maintain a competitive rate of payout¹² to them. Thus the *Muḍārib* share of profits stated in the contract is actually a maximum amount, while the precise percentage may vary from year to year.¹³

23. Reducing the *Muḍārib* share of profits to give competitive returns to IAH remains a management decision. Under the *Muḍārabah* contract, an IIFS is eligible for a *Muḍārib* share of profits in the form of a pre-agreed profit-sharing ratio. At the end of the financial period, the management team of IIFS, in line with the formal approval of the board of directors (BOD), can reduce the *Muḍārib* share of profits *ex-post* to a percentage below the contractual level.

2.2 Making Transfers from Shareholders' Current or Retained Profits

24. In this method, an IIFS makes a transfer of profit to IAHS out of current or retained shareholders' profits on the basis of *Hibāh*. The shareholders' decision to agree¹⁴ to give up part or all of their profits to enhance IAHS' returns means that the shareholders accept that the risk attaching to the returns of a portfolio of assets financed partly or wholly by IAH funds is "displaced" so that it is borne disproportionately by the shareholders.

2.3 Profit Equalisation Reserve

25. Another Smoothing method used by the IIFS involves establishing a profit equalisation reserve. A PER is created by appropriating to a reserve (the PER) amounts out of the profits earned on the commingled pool of assets before the allocation to shareholders and UIAH. The amounts appropriated to the PER reduce the profits available for distribution to both categories of investors – shareholders and IAHS. There is also a further effect on the shareholders' share of profits, because the reduction in the amount of profit available to the UIAH also reduces the amount of the *Muḍārib* share of the latter. The PER allows IIFS to mitigate considerably their exposure to DCR and related problems of asset–liability management.

26. The PER collectively belongs to IAH and shareholders for Smoothing their profit payouts. In other words, conceptually, one part of the PER belongs to the shareholders and the other part

¹¹ Refer to paragraphs 28, 30 and 31 of the GN for further details of this survey.

¹² This GN makes a reference to paragraph 76 of IFSB-2, where it is explained that the IIFS as *Muḍārib* is not permitted to absorb losses incurred on the IAHS' investment as this is not *Shari'ah* compliant, except in the case of misconduct or negligence by the former.

¹³ A unilateral increase of the *Muḍārib* share of profits above the (maximum) percentage stated in the contract is not permitted.

¹⁴ Obtaining the shareholders' approval to give up their profits is a *Shari'ah* requirement.

belongs to the IAH (although they have no say in its disposition). While the purpose of these reserves is to enhance the profit payout to IAH in periods when the assets in an IIFS's asset pool have underperformed, so that the returns to IAH may be lower for that IIFS than for its Islamic and conventional peers,¹⁵ it is also the case that a PER can be used for Smoothing or enhancing dividend payouts to shareholders if so desired by the management. It should be noted, however, that while shareholders benefit from the PER, it is less clear that UIAH do so, as they have no choice as to the amounts of their profits that are withheld, and may not even be aware that the profit performance of their investment is more risky than is apparent from the (smoothed) profit payouts. There is also an "inter-generational" problem in that appropriations to the PER which have reduced the profit payout to UIAH in one year may be used to enhance the payout to a different set of UIAH in a later year.¹⁶ Unlike shareholders, IAH have no say in the disposition of the balance of the PER.

2.4 Investment Risk Reserve

27. An IRR is created by setting aside amounts out of the profit attributable to IAH, after deducting the IIFS's *Muḍārib* share, in order to cushion the effects of future investment losses on IAH. This reserve is created in the equity of IAH. The IRR enables the IIFS to cover, fully or partially, unexpected losses on investments of IAH funds. Where the losses are fully covered, use of the PER may enable a profit payout to be made to the IAH notwithstanding the loss.¹⁷

28. With regard to both the PER and the IRR, IAH agree in advance, in the contract that regulates their relationship with the IIFS, on the proportion of their income that may be appropriated to each of these reserves.¹⁸ This amount is determined by the management of the IIFS at their own discretion. In the same contract, IAH also agree to give up any right they have to these reserves when they terminate their contractual relationship with the IIFS. This aggravates the inter-generational problem mentioned above.

SECTION 3: IDENTIFIED INDUSTRY PRACTICES

29. To analyse current industry practices across jurisdictions regarding Smoothing, the IFSB has undertaken a study of regulations and guidelines issued by the banking supervisors, as well as of the disclosures made by the IIFS in their annual reports. However, there are limitations to such studies, since the supervisory authorities in most of the jurisdictions where IIFS operate have not laid down any disclosure requirements for Smoothing practices by IIFS within their jurisdiction. To address such limitations, the IFSB also conducted a survey regarding Smoothing practices in a number of member countries in 2009, some of the findings from which are highlighted in this GN. It may be pointed out that Smoothing through forgoing part or all of the IIFS's *Muḍārib* share of profits, and transfers from shareholders' profits to IAH, usually remain undisclosed in annual reports. The only disclosure made in most of the annual reports, if any, is regarding PER and/or IRR. It was noted that various IIFS across the jurisdictions maintain a PER and disclose its use in their annual report. However, except in a few jurisdictions, IIFS either do not maintain an IRR or do not disclose its use in their annual report. We also observed that some IIFS maintain just one reserve, either a PER or an IRR. This may be due either to regulatory requirements or to a decision by the IIFS based on its own circumstances.

30. Whereas the generally accepted practice is to make appropriations to PER out of profits before division between the IIFS as *Muḍārib* and the IAH, a number of divergences from this practice were observed, including the following:

¹⁵ See Appendix 2 of this GN for illustration.

¹⁶ This inter-generational problem is discussed at greater length in IFSB-3.

¹⁷ See Appendix 3 of this GN for illustration.

¹⁸ The principle of *Mubāra'at* will be applicable in this case whereby the IIFS and IAH agree that the latter will allow the former to appropriate amounts out of the IAH share of profit, up to specified maximum percentages, to PER and IRR, made during the investment period.

- From their annual reports, it was evident that some IIFS were not making appropriations to the PER out of profits before allocation between shareholders and IAH and before deducting the *Muḍārib* share of profits; instead, they were making appropriations to the PER only out of the IAH share of profits after deducting the *Muḍārib* share (which is the normal procedure for the IRR, but not for the PER). This is obviously advantageous to the shareholders, since their profits available for dividends are not reduced by such appropriations.
- Moreover, some IIFS were found to be creating a profit equalisation provision,¹⁹ instead of a reserve.
- In one jurisdiction where the supervisory authority requires that IIFS maintain a PER, one IIFS reported that it did not, in fact, maintain a PER as it had been utilising profits attributable to shareholders to stabilise the rate of return to IAH.
- It was also noted that some IIFS are using the same method for creating both an IRR and a PER – that is, appropriating amounts to both of these reserves out of the total profit from UIAH funds *before* allocating the *Muḍārib* share of profits.

Some IIFS have adopted the more orthodox policy of appropriating to an IRR on a regular basis a certain percentage (usually in the range of 5–10%) of the profits attributable to unrestricted IAH, after allocating the *Muḍārib* share.

One IIFS disclosed in its annual report that, on liquidation, the balance of its IRR would devolve to the *Zakat* fund after covering all expenses and losses and would not be made available to its IAH. It was also mentioned in some reports that in the event that an IIFS went into liquidation, the balance of the PER (including the appropriations out of shareholders' profits) would revert to UIAs as per the terms and conditions of the *Muḍārabah* contract.

31. The industry practices identified from a recently conducted IFSB survey, as mentioned in paragraph 28, indicate that the great majority of IIFS offering PSIA are involved in Smoothing. At the institution level, the most common method of Smoothing consists of the IIFS forgoing their rights to some or all of the *Muḍārib* share of profits in order to offer their IAH a more competitive rate of return on their funds. Transfer of profits from shareholders to IAH in the form of a *hibāh* is the second most commonly used Smoothing method. Maintenance of a PER as a cushion for Smoothing and a mitigant of DCR is also a fairly common practice, notably in jurisdictions where the supervisory authority makes it compulsory for IIFS to maintain such a reserve. Some IIFS are also using an IRR as a Smoothing method, but this is generally limited to jurisdictions where IIFS are not allowed to establish any reserve other than an IRR.

32. When asked whether losses from assets financed by IAH funds have been covered by the IIFS (i.e. shareholders), less than half of the respondents replied in the affirmative. The most common methods for covering losses from assets financed by IAH funds were the same as those used for Smoothing of profits – that is, adjusting the IIFS's share of profits as *Muḍārib*²⁰ and transferring profits from shareholders to IAH.²¹ The next most common practice is maintenance of a PER. Although IRR is specifically meant for covering such losses from assets financed from IAH funds, there is little indication that many IIFS were maintaining such a reserve. The survey

¹⁹ According to applicable international accounting standards, a provision is either a contra-asset or a liability and is constituted by charges made as an expense against income, whereas a reserve is a component of equity and is constituted by appropriations made out of income.

²⁰ This result from the survey highlights an important variance between the principle and practice of many IIFS. If a *Muḍārabah* pool of assets suffers from a loss, then there will be no profit for the IIFS as *Muḍārib*, hence IIFS cannot cover losses for IAH from their profit as *Muḍārib*. Nevertheless, survey results show that some IIFS are using this practice to cover the losses of the IAH. What we assume here is that, essentially, these IIFS may be adjusting profits from some other pool of *Muḍārabah* or non-*Muḍārabah* assets in order to cover the losses attributable to the IAH.

²¹ As referred to earlier in footnote 12, the IIFS as *Muḍārib* is not permitted to absorb losses incurred on the IAHs' investment, as this is not *Sharī'ah* compliant, except in the case of misconduct or negligence by the former.

also highlighted that Smoothing is not limited to jurisdictions with a dual banking environment, because many IIFS in jurisdictions with a full-fledged Islamic banking system are also involved in Smoothing.

33. At the regulatory level, some supervisory authorities have prescribed certain requirements for the maintenance of reserves for Smoothing purposes. Usually these supervisory authorities have specified an upper limit for the balance of these accounts, commonly specified as a percentage of capital. One supervisory authority has fixed a maximum amount of the monthly appropriation to be credited to the PER. Another authority has specified a minimum amount as a percentage of net investment earnings that is to be credited to the “risk reserve account” until the maximum limit is attained. Some other regulatory authorities have prescribed disclosure requirements for PER and IRR. However, no supervisory authority has comprehensively addressed the subject of Smoothing by IIFS in its jurisdiction, covering all possible methods and/or reserves, as highlighted in sub-section 1.4.2 of this GN.

34. The IFSB also conducted a survey in 2004 to evaluate the Smoothing practices of IIFS, the findings of which were used in developing IFSB-3²² (Guiding Principles on Corporate Governance). That survey indicated that IIFS which operate a PER and/or an IRR generally do not inform their IAH that part of their share of profits will be set aside for these reserve accounts. One of the respondents even indicated that it had resorted to Smoothing every year for the five years prior to the survey. In this respect, the IFSB has correctly highlighted the concern that reliance on reserves, without proper disclosures, can lead to misconceptions on the part of IAH in particular, and the public in general, as to the actual performance of investment accounts managed by the IIFS.

35. It is observed from surveys and the annual reports of IIFS in a number of jurisdictions that IRR is yet to be widely adopted as an industry practice. It can be argued that the minimal use of IRR could be due to the availability of *Sharī`ah*-compliant deposit insurance as a safety net for the IAH. However, given that a *Sharī`ah*-compliant deposit insurance scheme is available in only a few jurisdictions, this may not be the reason for the widespread non-usage of IRR. Possibly, IIFS not maintaining an IRR may consider that it is very unlikely that losses would be incurred on the assets financed from investment accounts on a pool-wide basis, because of risk diversification, and that, in the rare case that they might have negative returns, they might offer better returns to IAH by using some other Smoothing measure (although this would raise *Sharī`ah* compliance issues). Moreover, some supervisory authorities have required IIFS in their jurisdiction to maintain only a PER (and not an IRR) as a measure for managing the DCR.

36. Nevertheless, the IFSB is concerned that, despite evidence of extensive Smoothing across several jurisdictions, many supervisory authorities have not taken any initiative to address the prudential and risk issues associated with such practices. This may leave too much room for inconsistent and conflicting practices and conventions, thus causing confusion and eroding public confidence in the long-term soundness and stability of the industry. The longer such uncertainty is left unattended, the more difficult it will be to harmonise and standardise the practices among the market players. As indicated above, issues of *Sharī`ah* compliance may also arise.

SECTION 4: ISSUES RELATED TO SMOOTHING PRACTICES

4.1 Disclosure and Transparency Issues

37. It has been highlighted in IFSB-4 (Disclosures to Promote Transparency and Market Discipline for IIFS) that Smoothing, if unchecked, is a significant obstacle to transparency. By maintaining stable returns to UIAH regardless of whether it rains or shines, an IIFS (as *Muḍārib*) automatically sends the signal that the IIFS has a sustainable and low-risk earnings stream for its

²² See paragraph 98 of IFSB-3 for details.

UIAH, while the reality may be quite different.²³ Smoothing therefore introduces a veil of opacity between UIAH in particular and the public in general, and the IIFS competing for their funds. Without appropriate disclosure to investors and other stakeholders, this opacity can only lead to a false impression that an IIFS is performing better than it actually has performed. There are also issues of providing a true and fair view in accounting and financial reporting. This problem is further aggravated by the very limited transparency regarding the use, size and allocation of these funds. Limited disclosure does not necessarily provide comfort to UIAH regarding their fair treatment, as it may lead them to suspect the possibility of abuse and manipulation on the part of the IIFS since it has absolute control over their funds. It is also a matter of concern that no option is granted to UIAH to withhold consent for their investment returns being smoothed (although Smoothing may not be to their benefit), since the investment contracts that they sign give them no choice in the matter.

38. IFSB-4 acknowledged that, in some circumstances, Smoothing might be arguably consistent with the preferences of risk-averse UIAH, who may be willing to forgo part of the profit payout in some years in order to have a reduced volatility of the expected level of payout (just as dividends to shareholders are normally less volatile than profits). However, unlike shareholders, the UIAH have no opportunity to approve or disapprove the IIFS management's decisions on the use of such reserves, and in some cases they are not even informed that the IIFS in which their funds are invested maintains such reserves. In contrast, the shareholders of an IIFS have control over its dividend policy and the maintenance and use of reserves by management, which must be approved by them in the annual general meeting. Accordingly, the argument that Smoothing and the creation of reserves are in the best interests of the UIAH can hardly be sustained. This raises the corporate governance issues which are discussed below.

39. A major transparency issue arises, because other stakeholders and outside observers simply have no means of being aware of and evaluating the management decisions involved in Smoothing, especially as the financial statements typically provide minimal disclosure of such matters. In these circumstances, it is not possible for outsiders to evaluate the sustainability of a given level of return on PSIA.

4.2 Corporate Governance Issues

40. It would seem that the shareholders of IIFS are generally willing to sacrifice part or all of the *Muḍārib* share of profits in the short term, in order to pay UIAH a competitive rate of return on their funds, and so to retain the UIAH as providers of funds. This is very much in the interest of the shareholders in most IIFS, since UIAH funds represent the preponderant portion of the funding side of the IIFS's balance sheet.

41. A PER provides an IIFS with a mechanism to tap a pool of funds to relieve shareholders of the burden of Smoothing – that is, to mitigate DCR as well as rate-of-return risk and the attendant problems of asset-liability management. However, as noted above, a PER does not necessarily operate to the benefit of the UIAH, since they are obliged to forgo profit payouts in good years so that the payouts in bad years may be enhanced. As the riskiness of the underlying profit stream is not reduced, this has the effect of reducing the present value of the stream of payouts to the UIAH. This reduction in present value represents a cost borne by the UIAH. In contrast, shareholders benefit from the mitigation of DCR and rate-of-return risk, and management benefit from the opacity, which may hide decisions on their part that are not in the interests of the UIAH. Hence, from a corporate governance point of view, there is a clear risk of potential abuse.

²³ Though UIAH may be seeking stable returns on their funds like conventional depositors, there is a fundamental legal difference between the two. Whereas the returns on funds provided by conventional depositors are contractually fixed or tied to a benchmark, this is not the case for funds provided by UIAH. In principle, while IIFS may pay stabilised returns to UIAH over a period of time, they have no legal obligation to stabilise the returns paid out.

42. Risk-sharing between UIAH who invest on a *Muḍārabah* basis and the IIFS as *Muḍārib* is reduced or even eliminated by a PER, which is used to smooth out the volatility of profit payouts on PSIA and to offer payouts that are aligned to market rates of return on conventional deposits or other benchmarks. Consequently, the volatility of payouts to UIAH is absorbed largely or entirely by the use of a PER (together with an IRR where the latter is present). Movements on the PER are found to be strongly positively correlated with the IIFS's net return on assets – that is, the appropriations to the PER are raised or lowered when the return on assets rises or falls. Thus, the precise relationship between the risk to UIAH and the aggregate risk for the IIFS as a whole arising from the variability of net return on assets depends upon the policies toward PER (and IRR, when applicable).

43. As noted above, UIAH lack the right to influence the use of reserves such as PER and IRR. UIAHs may not opt out of their participation in the accumulation of these reserves. Reserves such as the PER and IRR are a form of retained profits, similar to retained profits for shareholders, which are intended to be reinvested in profit-earning activities. An IAH who withdraws his funds loses his claim on the accumulated reserves and is in effect contributing to the future profits of other IAH. The building of reserves through profit retention, which is normally intended to finance the growth of assets and profits over time, rather than just to facilitate the Smoothing of payouts, is thus long-term in nature, and may be viewed differently by different types of investors. An investor with a long-term investment perspective might find it useful for management to retain profits in order to finance the growth of assets and profits. However, an IAH with a short-term investment perspective is likely to be negatively affected by the building of reserves which will likely be used for the benefit of someone else. Most IAH, including restricted investment account holders but especially UIAH, are essentially short- to medium-term investors with no interest in forgoing current payouts in order to finance long-term growth.

44. The portion of the PER that is attributable to the IAH, and all of the IRR, are invested in assets that produce returns for the IAH as a pool; however, the IIFS as *Muḍārib* will also receive a percentage of these returns. As appropriations to the PER are made before the deduction of the *Muḍārib* share of profits, the IIFS may be considered to forgo part of the potential *Muḍārib* share in one year in the hope of receiving greater *Muḍārib* shares in future years. The fact that the *Muḍārib* percentage share may in practice be variable rather than fixed, being larger in the more profitable years, can provide a further incentive for management to build a PER, in addition to the practice of Smoothing.

45. The use of an IRR may also give rise to moral hazard problems similar to those arising from deposit insurance schemes, since the existence of an IRR in an IIFS may encourage the management to engage in excessive risk-taking. This is because losses can be covered, at least in part, by this reserve, which is financed only from the funds of IAH and not those of shareholders. Therefore, this is likely to increase the management's risk appetite to a higher level than that of the IAH, especially as the IRR is appropriated from profits after the calculation of the *Muḍārib* share, which means the IIFS is unaffected, while in the case of a loss the *Muḍārib* share is zero irrespective of the size of the loss. Even if a loss absorbed by the IRR were due to misconduct, negligence or a breach of contractual conditions by the IIFS, it would be difficult for IAH to be aware of – and even more difficult to prove – such violations, due to the absence of either adequate disclosure or an appropriate monitoring mechanism to detect such a loss. In addition, it is largely uncertain as to what extent the legal system in the countries in which IIFS operate would support the rights of IAH to be recompensed for such losses in such cases. The burden of proving misconduct or negligence on the part of the IIFS surely has to be satisfied, but it seems the IAH face severe and possibly insuperable difficulties in proving that any such act has been committed by the IIFS.²⁴

²⁴ The supervisory authority, or *Sharī'ah* Supervisory Board (SSB), of the IIFS may be involved in verifying the existence of any misconduct, negligence or breach of contractual conditions by the IIFS.

46. Furthermore, an IRR (together with a PER) reduces the ability, if not the incentives, of IAH and shareholders to monitor the IIFS's performance, and thus may negatively affect market discipline. This is similar to an effect of deposit insurance schemes in conventional banking, which is to reduce the incentives of depositors to monitor banks,²⁵ while subordinated debt holders, to the extent that they believe the existence of central banks as lenders of last resort might protect them, also have their incentive to monitor the banks curtailed.

47. One economic result of Smoothing through reserves such as PER is, effectively, making the returns on UIAH behave more like those on conventional deposits – that is, a debt instrument. This effect will likely continue as long as there are adequate balances in the reserves to reduce the volatility of the payouts to the UIAH before they are seen to erode the equity of UIAH. Such a situation contributes to both weak market discipline and a lack of transparency. Another implication of the use of a PER and IRR together with a lack of transparency is that it would distort competition among IIFS, in that UIAH would not see the need to withdraw their funds, which is the only means available to them to signal dissatisfaction with the performance of the IIFS as a *Muḍārib*, thus disciplining the IIFS. As long as UIAH receive a smoothed rate of payout on their investment that is commensurate with the going market rate, and they cannot observe the underlying profit stream which may be showing a downward trend, they will not be aware of any reason to withdraw their funds until the IIFS finally runs out of the means to “smooth”.

48. If Smoothing continues over a long period during which the rate of payout on IAH is effectively kept in line with benchmark interest rates, this may not be to the advantage of the IAH who, contractually, bear a higher risk than their conventional counterparts.

49. Finally, the use of reserves such as the PER and IRR to emulate the rate of payout on conventional deposits could enable an IIFS to emulate a conventional institution by investing in riskier assets than is consistent with the risk appetite of the UIAH and skimming off the excess returns for the benefit of the shareholders. Such a practice is highly undesirable because, unlike conventional depositors, UIAH bear the risk of losses, having no claim as creditors for the return of their invested capital.

50. IFSB-3 has discussed in detail the inter-generational problem with respect to reserves such as PER and IRR.²⁶ If one considers the shorter periods, it is apparent that the practice of Smoothing through appropriations to or from reserves has the effect that UIAH do not fully participate in the profit generated by the investment of their funds. This is a kind of “inter-generational” shift of portions of profit to be shared. This problem may also arise in cases where new UIAH, who have not contributed to the reserves (PER and/or IRR), get the benefit from them due to the closure of the accounts by those UIAH who have contributed to the building up of the reserves.

51. In the case of reserves attributable to shareholders, their magnitude is normally reflected in the market value of their shares in the IIFS itself. There is no such effect on the value of investment accounts of amounts held in PER and IRR. Further, it may be pointed out that, instead of resorting to Smoothing through the creation of reserves, IIFS could achieve similar results – that is, achieve stable returns for their UIAH – by adopting a more conservative investment strategy for the UIAH funds. However, where UIAH funds are fully or largely commingled with those of shareholders, such a strategy is unlikely to be consistent with the risk-return appetite of the latter. For the reason suggested above, the use of reserves such as PER and IRR enables the management of an IIFS to satisfy the risk-return appetite of the shareholders while *appearing* to satisfy simultaneously the more defensive risk-return appetite of the UIAH. Moreover, this is

²⁵ An effective deposit insurance scheme is able to protect retail depositors who do not have the capacity to monitor the performance of IIFS. The limit of coverage provided by the scheme will ensure the protection for retail depositors and inculcate market discipline among non-retail depositors for whom the deposits are not protected in full.

²⁶ See paragraphs 37, 39 and 102 of IFSB-3 for details.

carried out in a way that exposes the UIAH to a risk of losses unrecompensed by a corresponding level of return.

52. The practice of Smoothing has the effect of blurring a key distinction between the Islamic and the conventional financial sectors. If UIAH are aware of Smoothing practices in the past, which kept the payouts to UIAH roughly in line with the prevailing market rates of interest on conventional deposits, and if they expect the same practices to continue into the future, this implies that they will form expectations of future returns which are based on the same interest rates. However, the *Shari'ah*-compliant assets in which their funds are invested will not necessarily produce the same rates of return as the assets of conventional financial institutions, which consist largely of interest-bearing loan portfolios together with financial assets held for trading. Given the same level of competence in asset management, there is no reason why the rates of return of IIFS should be lower than those of conventional institutions with a similar risk appetite. However, in conventional institutions the shareholders bear all of the risk of losses (except in insolvency), whereas in IIFS the IAH bear the risk of losses on assets financed by their funds. This has implications for the risk appetite that is appropriate for IIFS in investing UIAH funds. As noted above, where UIAH funds are commingled with those of shareholders, the practice of Smoothing appears to be intended to permit an IIFS to adopt a greater risk appetite than is appropriate for the UIAH, in the search for higher returns for shareholders.

4.3 Issues Arising on Liquidation

53. A critical question with respect to reserves such as PER and IRR is their treatment in the event of a voluntary liquidation of an IIFS.²⁷ IFSB-3 notes that in such an event, the outstanding PER should be disposed of in accordance with what was agreed upon at the time of establishing the reserves, which commonly would be either: (i) the reserves should be disposed of to those parties who “own” them – that is, existing IAH and shareholders; or (ii) the funds corresponding to the balances of these reserves should be donated to charity. Therefore, the IIFS should have in place practices, procedures and entitlements that adequately address any undesirable ambiguity in this area which could be ethically questionable with regard to the PER. IIFS are expected to disclose appropriately whether the PER will or will not be distributed to the IAH in the event of liquidation. In the case of a “forced” (involuntary) liquidation,²⁸ however, the court that is involved might not recognise ownership of reserves as per the initial contract made by the IIFS and IAH at the time of the establishment of the relationship. In other instances, the supervisory authority might play a role and, based on circumstances, may decide that the outstanding balance of reserves should be distributed differently from what was initially agreed between the parties.

4.4 Capital Adequacy Issues

54. For IAH, the capital amount is not guaranteed by the IIFS. Therefore, in case of any loss arising from investments financed by IAH, the consequences are borne solely by IAH except in the case of fraud, misconduct, negligence or breach of contract by the IIFS. Consequently, in principle, no regulatory capital requirement would need to be imposed in respect of assets financed by IAH, since risks on these assets do not represent risks for the IIFS's own capital. This implies that assets funded by either unrestricted or restricted IAH would be excluded from the calculation of the denominator of the capital adequacy ratio (CAR).²⁹ Nevertheless, IIFS may resort to various types of Smoothing practices in order to afford its IAH a more competitive rate of return on their funds, which often result in DCR. This Smoothing may be performed by way of IIFS forgoing its rights to some of or its entire *Mudārib* share of profits, transferring current or retained profits from shareholders to IAHs, or by creating reserves such as PER.

²⁷ A voluntary liquidation is one that is decided voluntarily between the shareholders and creditors, on application to the court. IAH, being neither shareholders nor creditors, have no say in the matter. However, the court will not normally grant permission for a shareholders' voluntary liquidation if the applicant is insolvent

²⁸ An involuntary liquidation occurs in the case of insolvency.

²⁹ See Appendix A of IFSB-2 for the formula.

55. The existence of DCR entails a requirement for an IIFS to allocate adequate capital to cover at least some of the credit and market risk exposures arising from the assets funded by the IAH that would otherwise be absorbed by the IAH. The proportion of the credit and market risk exposures on assets financed by IAH funds which is considered to be borne by the IIFS's shareholders because of Smoothing and the resultant DCR is represented by a parameter alpha (α) in the alternative (Supervisory Discretion) formula of the CAR calculation under IFSB-2.

56. More specifically, IFSB-2 stipulates that, where DCR exists, the supervisory authority has discretion to require the IIFS to include a specified percentage of assets financed by IAH in the denominator of the CAR in the Supervisory Discretion formula. This would apply in principle to risk-weighted assets financed by both unrestricted and restricted IAH; however, the practice of income Smoothing for IAH by the IIFS is normally confined to UIAH.

57. The percentage of risk-weighted assets funded by UIAH subject to DCR, indicated by " α ", is left to the individual supervisory authorities to decide in their own jurisdictions. While in principle " α " is to be determined at the level of each IIFS, in practice supervisors may apply a country-wide percentage. For example, if a supervisory authority decides on an " α " parameter of 35% for IIFS in its jurisdiction, it would mean that 35% of risk-weighted assets of the IAH of those IIFS will be included in the CAR denominator, implying that the IAH will bear up to 65% of the volatility of the profit stream on their investments, while the other 35% will be borne by the shareholders of the IIFS.

58. Many factors must be taken into account by the supervisory authorities when determining the level of " α " for their jurisdiction. They include, in particular, IIFS industry Smoothing practices and resultant exposures to DCR, and the risk mitigation techniques used. The IFSB will issue a separate Guidance Note on the determination of the alpha as a guideline to the supervisory bodies in this regard.

4.5 Harmonisation/Standardisation Issues

59. As mentioned in sections 1 and 2, various Smoothing techniques are used by IIFS. They usually perform Smoothing as a prudent practice on their own initiative, to mitigate withdrawal risk and DCR, but may be constructively obliged to do so by the supervisory authority as a measure of investor protection and in order to mitigate potential systemic risk resulting from massive withdrawals of funds by unsatisfied IAH. It should, however, be taken into account that some IIFS may not be involved in any type of Smoothing practices, especially in countries where DCR is low due to markets being less competitive or those applying a fully Islamic model in their banking industry. Nevertheless, as highlighted in paragraph 31, the IFSB survey has also found evidence of IIFS resorting to Smoothing practices even in jurisdictions applying a fully Islamic model.

60. A small number of supervisory authorities have prescribed different Smoothing practices in their jurisdictions. Whereas some have required IIFS in their jurisdiction to maintain only a PER, others have chosen to maintain only IRR, while still others have allowed both types of reserves to be maintained without making it a requirement.

61. It is evident from the discussion in section 3 that many IIFS resort to different Smoothing practices within and across jurisdictions. However, it might be preferable for such practices to be harmonised, at least within the same jurisdiction. The main reason is that the use of different practices militates against transparency among both market players and, above all, current and potential IAH. If a supervisory authority decides that in principle it will permit the IIFS in its jurisdiction to practise Smoothing, the question arises as to what types of Smoothing techniques and/or associated reserves should it allow. Arguably, if a safety net for UIAH in the form of a *Shari'ah*-compliant deposit insurance scheme exists in the system, the need for IIFS to set up an IRR will be reduced but not necessarily eliminated. For example, the deposit insurance scheme may not cover 100% of the UIAH investments, or there may be an upper limit to the cover.

Further, an IRR will be used to cover the losses attributable to IAH in the normal course of business, whereas a *Shari`ah*-compliant deposit insurance scheme will be usually triggered in special circumstances such as liquidation of the IIFS. This means an IRR can not be considered as an alternative to a *Shari`ah*-compliant deposit insurance scheme in the normal course of an IIFS's operations.

62. On the other hand, irrespective of whether a *Shari`ah*-compliant deposit insurance is available in the system or not, the supervisory authority may take the view that it should be compulsory for all IIFS in its jurisdiction to maintain an IRR to cushion any potential losses of capital. The advantage for the supervisor is that, if the individual IIFS has an IRR, the "implicit" regulatory oversight cost for the supervisor, as well as its own lender of last resort insurance "cost", is reduced. Moreover, supervisory authorities may also evaluate the level of DCR being faced by IIFS individually and as an industry, and may evaluate whether PER should be prescribed in IIFS under their jurisdiction. In doing so, however, they need to bear in mind the undesirable aspects of Smoothing generally, and of reserves such as PER and IRR in particular. These undesirable aspects include (as mentioned above) the loss of transparency, especially when financial reporting is less than adequate, the corporate governance problems raised by the lack of any control by IAH over management's use of these reserves, and the fact that the use of the reserves tends to benefit shareholders at the expense of IAH.

63. Bearing in mind the considerations just mentioned, supervisory authorities need to develop and make public an explicit policy as regards Smoothing in general and the use of reserves such as PER and IRR in particular. If they decide to permit the use of such reserves, they should also ensure that the relevant IFSB standards on corporate governance and transparency and market discipline are properly implemented in their jurisdiction. They may also wish to consider placing some constraints on the permissible practices, such as the following:

- i. a maximum deduction in terms of the percentage of earnings to be transferred to PER and/or IRR;
- ii. maximum balances of these reserves – for example, in terms of the percentage of the total balance of UIA. It is implicit that if the balance on one of the reserves has reached the maximum laid down by the supervisory authority, the IIFS in question should refrain from making further appropriations to that reserve until such time as the balance is once again below the limit; and
- iii. the treatment of unused balances of the reserves at the end of the relevant *Muḍārabah* contract (in case of the liquidation of IIFS or withdrawal of funds by PSIA).

SECTION 5: ECAIs' PERSPECTIVE ON SMOOTHING PRACTICES

64. From the point of view of external credit assessment institutions (ECAIs), the earnings of an IIFS are reflective of its capability to support operations, achieve strategic asset growth and strengthen capital. In a dual banking environment, IIFS commonly adopt a market-driven approach in applying the profit-sharing and loss-bearing principle in respect of their UIAH. As far as possible, an IIFS will offer its UIAH a sufficiently attractive rate of return, considered to be competitive with the benchmark market rate, in order to retain customers' investment accounts. If the benchmark market rate is higher than that offered to the UIAH at the end of the term, the IIFS may resort to Smoothing returns to this class of fund providers, by resorting to the various practices discussed in earlier paragraphs. From an ECAI's perspective, creation of reserves such as PER and IRR with the express objective of providing cushions to IAH and Smoothing returns may give significant strength to ratings once these reserves are large enough to be meaningful in the institutional context. The existence, or non-existence, of such reserves may therefore have a significant impact on the ECAI assessment of an IIFS, and ECAIs should explain in their methodologies how these issues are factored into their ratings. There is evidence, however, that ECAIs do not necessarily recognise or attach importance to the less desirable aspects of reserves such as PER and IRR from a corporate governance and transparency standpoint. While they should be able to distinguish between the Smoothing of profit payouts and the stability of the

underlying profit stream, they tend to regard reserves such as PER and IRR simply as cushions against DCR and withdrawal risk. They thus tend to overlook the fact that the efficacy of these reserves in mitigating these risks depends to a considerable extent on the lack of transparency, as a result of which the underlying profit stream is made to look more sustainable than it may be in reality.

SECTION 6: CONCLUSIONS

65. This section is primarily intended as guidance to IIFS regarding their management of profit payouts to IAH and to the supervisory authorities with respect to their supervision of the Smoothing practices of the IIFS in their jurisdiction. Reference is made to the relevant IFSB standards, proper implementation of which is a matter to which particular attention should be paid.

6.1 Board of Directors³⁰

66. Considering the fiduciary duty of the IIFS towards the IAH under the *Muḍārabah* contract, an IIFS is obliged to safeguard the rights and interests of the IAH whose investment accounts are exposed to credit and market risks arising from the IIFS's financing and investment activities. Under the existing legal and regulatory framework, it is the responsibility of the BOD to provide a robust oversight and sound monitoring function to ensure that investment accounts are managed in the best interests of IAH.

67. IFSB-1 (Guiding Principles of Risk Management for IIFS) has stipulated that for PER, the basis for computing the amounts to be so appropriated should be pre-defined and applied in accordance with the contractual terms and conditions accepted by the IAH and after formal review and approval by the IIFS's BOD. Similarly, the terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the BOD.³¹

68. As set out in IFSB-1, the BOD should review and approve the policies and strategies of the investments and strategies for the management of DCR, and conduct regular reviews of the investment policies and the performance of the asset portfolio in which UIAH funds are invested. The broad policies and strategies should include, *inter alia*, the following areas:

- (i) the management of DCR, including the limits to and tolerance level of DCR, the policies regarding and the mechanisms used in respect of the IIFS forgoing its share of profits in favour of the IAH; and
- (ii) appropriations to reserves and provisioning in accordance with the agreed contractual terms and conditions for IAH.

69. As proposed in IFSB-3, to safeguard the interests of IAH, the BOD or its Governance Committee (see also below) should ensure rigorous and diligent oversight policy, process and procedures over the following: (i) the financing and investment activities undertaken by the IIFS on behalf of its IAH; (ii) the fiduciary duties performed by the IIFS, which must be in accordance with the terms and conditions of the *Muḍārabah* contracts between the IIFS and its IAH; and (iii) the level of reserves allocation, ensuring that it is appropriate and as fair as possible to both existing and new IAH. Further, as a part of systems and controls, internal audit or internal *Shari'ah* review of the IIFS should verify the conformity of the IIFS to approved policies and procedures relating to profit calculation and Smoothing, and this may also be within the scope of external audit.

³⁰ The term "board of directors" has been used in this GN not to identify legal constructs but rather to label a decision-making function within an IIFS. In jurisdictions that adopt a two-tier system, this term shall refer to the "supervisory board" rather than the "management board" of an IIFS. In addition, references to the "board of directors" shall be understood to include a committee, properly constituted under the firm's charter and applicable law, to which relevant authority has been delegated by the full board.

³¹ Refer to paragraphs 105 and 106 of IFSB-1 for details.

6.2 Governance Committee

70. Although the management of IIFS owe IAH a fiduciary duty similar to that owed to shareholders, there is a concern that the rights of the former could be compromised as a result of their weak governance rights and structure as compared to the shareholders, although both are equity holders and residual claimants in the IIFS.³² Moreover, keeping in view the fact that there is no defined process regulating how an independent organ of governance scrutinises and oversees any Smoothing, it is envisaged that the practice could be subject to potential abuse. To overcome this problem, an independent governance structure in the form of a Governance Committee has been recommended in IFSB-3, which shall comprise at least three members³³ and shall coordinate and integrate the implementation of the governance policy framework, with the primary objective of protecting the interests of stakeholders other than the shareholders.

71. In order to ensure that Smoothing, including utilisation of reserves such as PER and IRR, is appropriately checked and monitored,³⁴ the Governance Committee³⁵ should be mandated to scrutinise the utilisation of such reserves and to make appropriate recommendations to the BOD. The Governance Committee should ensure that the interests of IAH are taken into account when the profits are appropriated to such reserves or reserves are drawn down, in order to enhance the profit distribution to IAH. The Governance Committee shall also evaluate the disclosures made by the IIFS regarding its asset allocation and investment strategies in respect of investment accounts in order to monitor closely the performance of IIFS as managers of such accounts.

6.3 Disclosure and Transparency

72. IIFS should have in place a policy and framework for managing the expectations of their shareholders and IAH. IIFS need to develop and maintain an informed judgment about the appropriate level of balances for PER and IRR, bearing in mind that their essential function is to provide mitigation of DCR and not to “window-dress” their profit performance. The appropriateness of the reserves level can be as specified by the supervisory authorities; otherwise, IIFS may establish their own policy on the maximum levels for annual appropriations to and balances of these reserves, which should be specified in their investment contracts with UIAH.

73. An IIFS should be transparent to the IAH in respect of any Smoothing practices. This is in due recognition of the rights of IAH as *Rabb-ul-Māl* to monitor the performance of IIFS as *Muḍārib*, which is crucial in preserving equitable treatment of investors and enhancing market discipline. As much as shareholders must be informed when a company utilises reserves to maintain a certain level of dividends distributions to them, similarly the IAH have a right to know when profits distributed to them are affected by appropriations to or releases from reserves. Indeed, a good track record of profit distribution is aimed not only at retaining IAH but also at enticing potential new investors. Smoothing should thus be treated as an issue of public concern.

³² UIAH are a form of “puttable instrument” that has equity-like characteristics but is not classifiable as equity under international accounting standards because the funds may be withdrawn (a “put” of the instrument) and there is another class of equity holders (the shareholders) who do not have such a right.

³³ IFSB-3 suggests that the Governance Committee may comprise three members, such as: (i) a member of the Audit Committee; (ii) a *Shari’ah* scholar (possibly from the IIFS’s SSB); and (iii) a non-executive director (preferably chairing the meeting). Any increase of membership in the Governance Committee should preferably be filled by independent non-executive directors, rather than non-independent directors.

³⁴ Since a member of the SSB of the IIFS will already be present in the Governance Committee, as suggested in IFSB-3, this will ensure that *Shari’ah* issues, if any, related to Smoothing practices are taken into account by the Governance Committee.

³⁵ While highly recommending the establishment of a separate Governance Committee, as suggested in IFSB-3, depending on the organisational framework of an individual IIFS, the suggested role can be performed by some other BOD committee provided it is chaired by an independent BOD member and is explicitly mandated to monitor the governance policy framework of the IIFS and safeguard the interests of IAH.

Therefore, it is reasonable for IIFS to publicise information about the aforementioned reserves in major media organs as well as in their annual reports.

74. In addition, as a part of the best practices mentioned in IFSB-3, IIFS are recommended to disclose, through appropriate media, policies in respect of profit calculation, asset allocation and investment strategies regarding the investment accounts maintained by them. Further, IIFS should also make an adequate and timely public announcement using appropriate media if there is a material change in any of the aforementioned policies. Adequate and appropriate disclosure regarding asset allocation and investment strategies of IIFS in respect of PSIA and the utilisation of PER and IRR would allow organs of governance such as Governance and Audit Committees to check and monitor the performance of IIFS as managers of investment accounts. Similarly, such disclosures would enable other information intermediaries for consumers, such as financial analysts and the media, to play a more effective role in promoting market discipline. While disclosing the returns to IAH, the IIFS should also distinguish between “distribution rate” and “profit rate” – that is, the rate of profit distributed to IIFS versus the actual profit rate earned from investments made on behalf of IAH.

75. IFSB-4 (Disclosures to Promote Transparency and Market Discipline for IIFS) has elaborated in great detail on the disclosure requirements with respect to Smoothing. Among others, IAH should be given special focus, and supervisors should encourage IIFS to provide to IAH simplified disclosures regarding Smoothing, written in plain language so that they are reasonably easy for a majority of them, who may not be finance professionals, to understand. IFSB-4 recommends IIFS to disclose, *inter alia*, their policies towards managing DCR, the extent to which the IIFS’s *Muḍārib* share of profits is subject to a partial or total waiver to pay a competitive rate of return to IAH, the extent of management’s right to build a PER and/or an IRR, and their utilisation and disposition, etc. Further, disclosure of a five-year comparison of the historic rates of return of UIAH in relation to the market benchmark rates has been suggested. A similar five-year comparison has been suggested between the percentage rate of return to IAH³⁶ and the percentage rate of return to shareholders from *Muḍārabah* profits. It has also been suggested to disclose the previous five years’ historical data with respect to *Muḍārabah* profits earned and paid out before and after Smoothing, balances of PER and IRR, and movements on these reserves, as well as variations in the *Muḍārib*’s actual annual profit-sharing ratio from the contractually agreed (presumably maximum) ratio.

76. As explained earlier, currently in most jurisdictions, supervisory authorities have not specified any guidelines for the management of DCR and applying Smoothing practices. In the absence of any guidance, some IIFS may wish to refer to relevant international financial reporting standards in respect of disclosures relating to investment accounts. It would be helpful if supervisory authorities were to carry out a study of Smoothing practices within their own jurisdictions and set out adequate guidelines and regulations on the subject. Such guidelines may cover:

- i. the definition of permitted Smoothing practices so that all the stakeholders are presented with a uniform meaning of these terms;
- ii. calculation and management of the permitted Smoothing practices;³⁷
- iii. the constraints discussed in paragraph 63;
- iv. various disclosure requirements discussed in this section, as well as any additional disclosure requirements needed by the supervisory authorities; and

³⁶ In some jurisdictions, IIFS maintain more than one pool of assets. Each pool may earn a different return depending on the yield of the allocated/tagged portfolio of assets. IIFS are encouraged to take appropriate measures to disclose the rate of return on each pool separately. IIFS need to ensure that maintenance of separate pools does not affect/dilute the stake of other pools.

³⁷ The attention of supervisory authorities is drawn to the “rate of return framework” issued by supervisors in some jurisdictions, a reference to which is made in paragraph 148 of IFSB-1. Such a framework may include, *inter alia*, methods of calculation and distribution of profits; permitted Smoothing practices and their treatment; applicable periods; recognisable income and expenses that are applicable to IAH funds; range of weightages and profit-sharing ratios applicable to various tenors of IAH funds and comingled funds of the IIFS, etc.

- v. the role of the SSB, via internal *Shari'ah* review, in reviewing the Smoothing practices of the IIFS,³⁸ if any.

6.4 Terms and Conditions of a PSIA Contract

77. For effective management of DCR and other risks, administration of the terms and conditions of the *Muḍārabah* contract between IAHs and IIFS is of the utmost importance. At the time of establishing the relationship with IAH, IIFS should ensure that the terms and conditions of the *Muḍārabah* contract between them are in accordance with *Shari'ah* principles and the relevant laws, regulations and contracts governing the product. IIFS should also ensure that prohibited and imprudent activities are not undertaken in breach of the terms and conditions of the contract. IIFS shall ensure that the IAH are fully aware of and agreeable to the terms and conditions stipulated under the PSIA contract. The PSIA's contractual terms and conditions must be transparent, concise and written in a simple manner that can be easily understood by the IAH.

78. IIFS should disclose relevant details to the IAH, such as the type, purpose, terms or period of the contract and the profit-sharing ratio initially agreed by the contracted parties at the time of opening the investment account. The basis of profit distribution and allocation shall be clearly stated to the IAH. A statement of the contractual profit-sharing ratio and weightings assigned to invested funds is crucial, keeping in view that the underlying contract is a *Muḍārabah* contract in which these items must be declared before inception of the contract. Subsequent changes in the profit-sharing ratios and the weights assigned to the relevant category of investment accounts should be adequately disclosed to the IAH on a timely basis by using available media, including display in the branches, posting on the websites, or directly informing the IAH by post or through email, etc.

79. IIFS should clearly state in the investment contract and make clear to IAH any Smoothing practices that they employ – in particular, if they expect the IAH to forgo their rights to that portion of income which is appropriated for building up reserves such as PER and IRR. In addition to the general requirements of the PSIA contracts, the following details should be explicitly disclosed in the contract:

- the rights and liabilities of both parties – in particular, with respect to the circumstances where losses are to be borne by the IAH and the implications for the IAH contractual rights with regard to early withdrawal and early redemption;
- the accountability and responsibility of the IIFS to disclose accurate, relevant and timely information to the IAH on the investment of their funds, including its performance, investment policies, valuation, and frequency of valuation of the IAH-funded assets; and
- the rights of IAH in the event that the IIFS fails to perform its fiduciary obligations in accordance with the applicable PSIA contract – that is, in the event of proven negligence or misconduct by the IIFS whereby the IIFS will have to recompense the IAH for any loss.

³⁸ The SSB of the IIFS may have a role to play in ensuring that IIFS's practices relating to Smoothing and assigning profit-sharing ratios/weightages to IAH funds on a periodical basis are justified and take into account the legitimate rights of the IAH. In some IIFS, the role of the SSB is limited to approving the product structure of the PSIA, which can be extended to reviewing Smoothing practices and changes in the profit-sharing ratios/weightings assigned to the IAH and commingled funds of the IIFS by the management on a periodic basis.

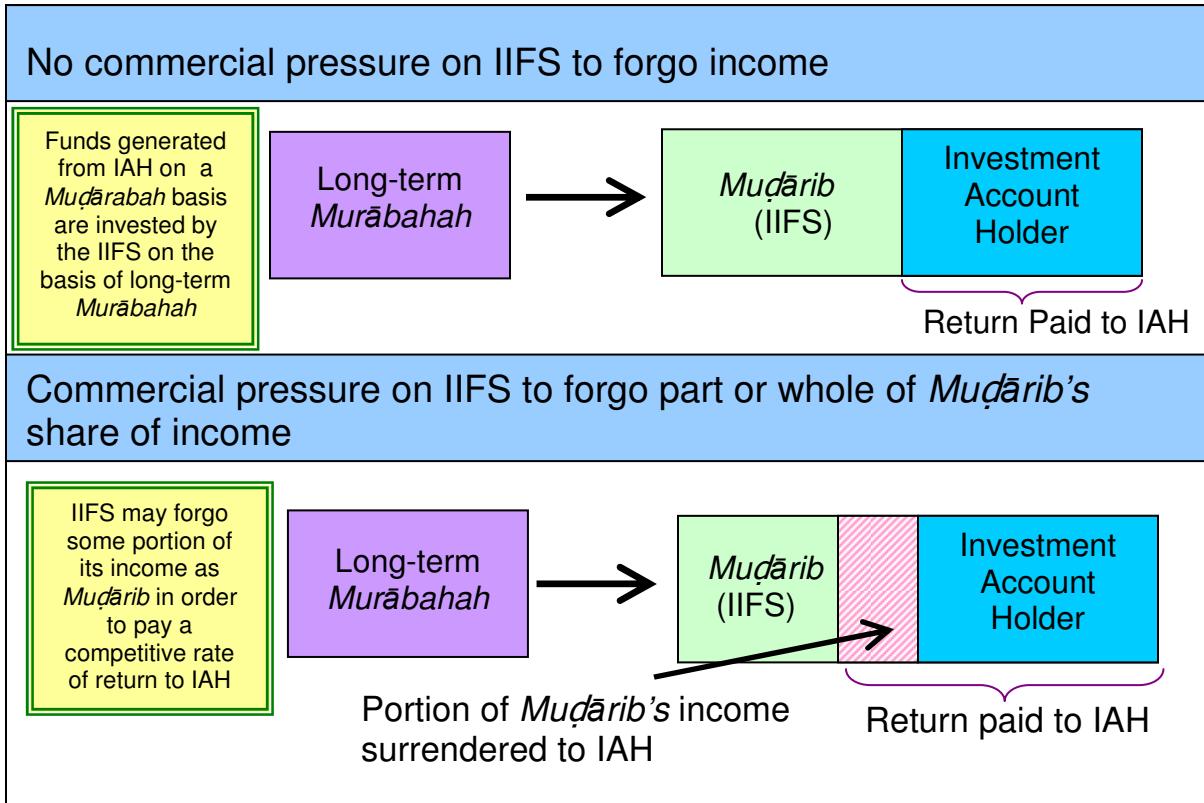
DEFINITIONS

The following definitions are intended to assist readers in their general understanding of the terms used in the Guidance Note. The list is by no means exhaustive.

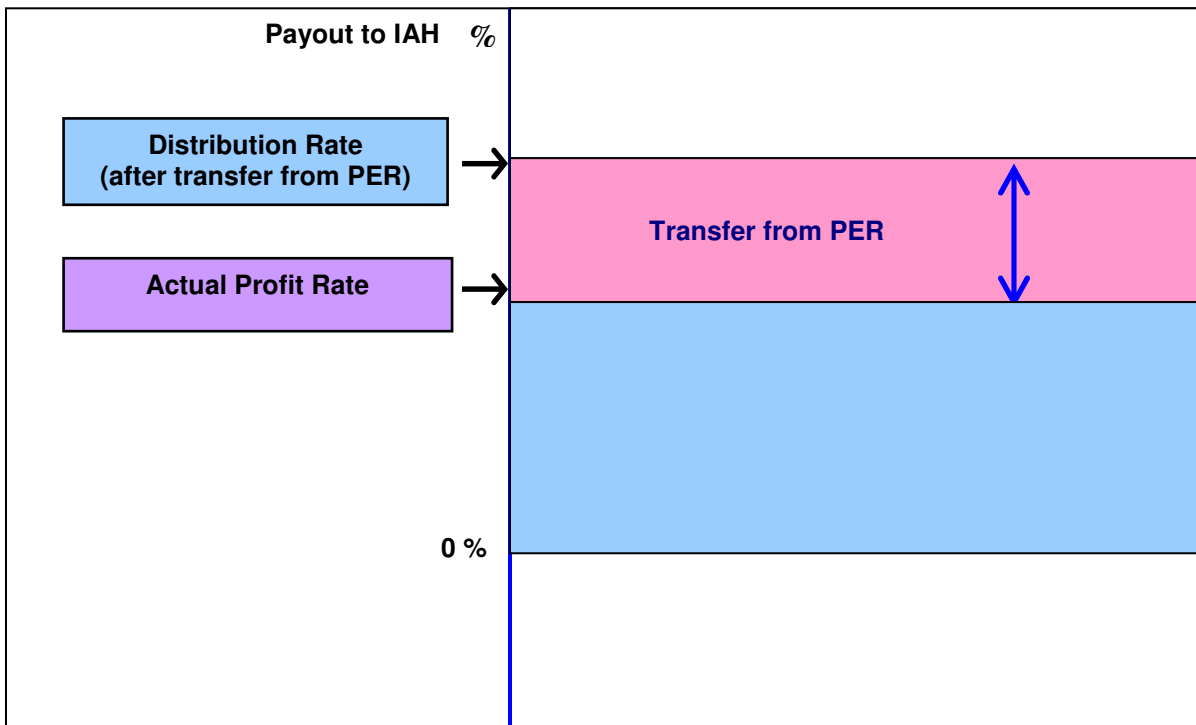
<i>Hibāh</i>	A unilateral transfer of ownership of a property or its benefit to another without any counter-value from the recipient.
<i>Ijārah</i>	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An <i>Ijārah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijārah</i> contract.
<i>Ijārah Muntahia Bittamlīk</i> (or <i>Ijārah wa Iqtina'</i>)	A form of lease contract that offers the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value, or by means of a <i>Hibāh</i> contract.
Investment Risk Reserve (IRR)	The amount appropriated by the institution offering Islamic financial services out of the income of investment account holders (IAH), after allocating the <i>Muḍārib's</i> share, in order to cushion against future investment losses for the IAH.
<i>Mubāra'at</i>	An agreement between the institution offering Islamic financial services and its customer whereby the customer will waive a certain portion of his profits earned during the investment period.
<i>Muḍārabah</i>	A contract between the capital provider (<i>Rabb-ul-Māl</i>) and a skilled entrepreneur (<i>Muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the <i>Rabb-ul-Māl</i> unless the losses are due to the <i>Muḍārib's</i> misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution offering Islamic financial services sells to a customer at an agreed profit margin plus cost (selling price) a specified kind of asset that is already in their possession.
<i>Murābahah</i> for the Purchase Orderer (MPO)	A sale contract whereby the institution offering Islamic financial services (IIFS) sells to a customer at cost plus an agreed profit margin (selling price) a specified kind of asset that has been purchased and acquired by the IIFS based on a promise to purchase from the customer, which can be binding or non-binding.
Profit Equalisation Reserve (PER)	The amount appropriated by the institution offering Islamic financial services out of the <i>Muḍārabah</i> income, before allocating the <i>Muḍārib's</i> share, in order to maintain a certain level of return on investment for investment account holders and to increase owners' equity.
Restricted Investment Accounts	The account holders authorise the institution offering Islamic financial services to invest their funds based on <i>Muḍārabah</i> or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
<i>Sukūk</i> (sing. <i>Sakk</i>)	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of assets that are <i>Sharī'ah</i> compliant.
Unrestricted Investment Accounts	The account holders authorise the institution offering Islamic financial services (IIFS) to invest their funds based on <i>Muḍārabah</i> or <i>Wakālah</i> (agency) contracts without imposing any restrictions. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.

APPENDICES

Appendix 1: Forgoing part or all of the *Muḍārib* share of income to pay a competitive return to IAH



Appendix 2: Smoothing using PER



Appendix 3: Coverage of loss and smoothing of returns using IRR and PER

