Frequently Asked Questions (FAQ) on:

GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders

Q1. What are the types of Smoothing Profits Payout techniques?

Answer: There are two smoothing methods used by IIFS in various jurisdictions. The first method entails the Displaced Commercial Risk (DCR) without mitigation, whereas the second method considers DCR with mitigation by the use of reserves.

(i) For the first method, an IIFS may forgo or give up part or all of the Mudarib (entrepreneur) share of profit earned on UIAH funds. Normally, in this case, the contractual percentage Mudarib share is established at a high level 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* (gift).

(ii) With regards to the second method, an IIFS may establish a reserve called a profit equalisation reserve (PER) by setting aside amounts from the investment profits before allocation between the shareholders and the UIAH and the calculation of the IIFS's Mudārib 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 Mudārib 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 not mitigate DCR, since the IIFS as Mudārib may not accept a loss attributable to IAH as Rabb-ul-Māl (capital provider). However, the use of an IRR may mitigate withdrawal risk and reinforce the effect of the PER.

Q2. What motivates Islamic banks to smooth their profits payout?

Answer: When the returns earned on PSIA is uncompetitive compared to those being offered by IIFS`s competitors, IAHs tend to withdraw their funds in order to seek for other investment opportunities with higher return rates. This may trigger the Displaced Commercial Risk (DCR), which may have an adverse impact on IIFS liquidity position and competitiveness. If unmitigated, UIAH withdrawals can reach systemic proportions and become a cause for concern on the part of supervisory authorities.

Q3. What is DCR (Displaced Commercial Risk)? And how is it different from Rate of Return Risk and Withdrawal Risk?

Answer: The Rate-of-return risk is the risk of facing a lower rate of return on assets than that currently expected on unrestricted investment account holders (UIAHs), 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. Intuitively, this will trigger the Displaced Commercial Risk. As explained in IFSB-2, 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 Mudārib 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.

Q4. Why smoothing profits is more related to UIA (unrestricted investment accounts) compared to RIA (restricted investment accounts)?

Answer: In principle, Smoothing may apply to both types of accounts, but in practice it is more generally found in connection with UIA for two raisons: First, UIA are considered a Sharī`ah-compliant substitute for conventional deposits. Thus, IIFS usually maintain separate reserves (PERs and/or IRRs) for each type of account for risk management and segregation purposes. Second, UIAHs have the right to withdraw their funds in short notice, which may lead to DCR.

Q5. What are the main differences between PER and IRR?

Answer: 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. An IRR is created by setting aside amounts out of the profit attributable to IAH, after deducting the IIFS's Mudārib share to cushion the effects of future investment losses on IAH. The PER allows IIFS to mitigate considerably their exposure to DCR and related problems of asset–liability management. The PER collectively belongs to IAH and shareholders for Smoothing their profit payouts. The IRR, however, represents a reserve to protect the capital positions of IAHs in an event of loss. This is a reserve created by appropriating Mudarabah profits before distribution of profit shares to IAH and after deducting the Mudarib's share.

Q6. What is the Inter-generational problem that might arise in Profit Equalization Reserve (PER)? And how can IIFS mitigate such problem?

Answer: The "inter-generational" problem is defined by the fact that 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 UIAHs in a later year. Unlike shareholders, IAH have no say in the disposition of the balance of the PER. In fact, the management of IIFS owe IAHs 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. 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 members 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. In order to ensure that Smoothing, including utilisation of reserves such as PER and IRR, is appropriately checked and monitored, the Governance Committee should be mandated to scrutinise the utilisation of such reserves and to make appropriate recommendations to the Board of Directors (BOD).

The Governance Committee should ensure that the interests of IAHs 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 IAHs. The Governance Committee shall also evaluate the disclosures made by the IIFS regarding its asset allocation and investment strategies in respect of investment accounts to monitor closely the performance of IIFS as managers of such accounts.

Q7. What would be the motivation for the shareholders to approve any smoothing technique since it will negatively affect the amounts of their dividend payouts?

Answer: Shareholders are motivated to approve the adoption of the smoothing techniques to ensure IAHs` retention by providing a relatively stable rate of return over a specific period of time. In other words, it enables the mudarib (IIFS) to enhance the profit payout to IAHs when the expected rate of return is less than the rates proposed by other Islamic and conventional peers. Providing a rate of return below market rates shall motivate IAHs to withdraw their funds and seek for other investment opportunities with higher profit. This, therefore, will lead to DCR.

Q8. What are the undesirable aspects of Smoothing Profits Payouts?

Answer: Five main issues are related to the smoothing practices as defined in GN 3, such us (i) Disclosure and Transparency Issues; (ii) Corporate Governance issues; (iii) Issues Arising on Liquidation; (iv) Capital Adequacy Issues; and (v) Harmonisation/Standardisation Issues.

Q9. What are the constraints that can be imposed by the supervisory authorities on the Smoothing practices such as PER and IRR?

Answer: 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.

Q10. What is the difference between “profit rate” and “distribution rate”?

Answer: The rate of profit is the difference between total revenues and total costs (if any), divided by the capital invested. The Distribution Rate however, represents the Fund's last regular distribution per share in a specific period divided by the market price at the end of the period.