

# Profit Equalization Reserve and Investment Risk Reserve: Issues and its Application

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## Abstract

*The Islamic Financial Institution (IFI) is a unique financial institution which has special characteristics, maqāsīd, worldview, risk, and opportunity. One of the methods used to mitigate the unique risk of Islamic banks is the Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR). However, there are some issues related to PER and IRR. Some issues have been identified in the Islamic Financial Services Board (IFSB) guidance note, including profit smoothing and other issues yet to be discussed. This paper tries to observe issues related to PER and IRR and their application in some Islamic banks using content analysis method on their annual reports and/or financial statements. The paper concludes that PER and IRR will bring bigger issues and risks to Islamic banks. This leads the writer to suggest that the regulator reconsider its permissibility. In addition, the paper also finds that the concept of PER and IRR has low acceptance among Islamic banks.*

*Keywords: Profit Equalization Reserve (PER), Investment Risk Reserve (IRR), Risk Management, Islamic Banking.*

## Abstrak

*Islamic Financial Institution (IFI) adalah lembaga keuangan yang unik yang memiliki karakteristik khusus, maqāsīd, pandangan dunia, risiko, dan peluang. Salah satu metode yang digunakan untuk memitigasi risiko unik bank Islam adalah Profit Equalization Reserve (PER) dan Investment Risk Reserve (IRR). Namun, ada beberapa masalah terkait PER dan IRR. Beberapa masalah telah diidentifikasi dalam catatan panduan Islamic Financial Services Board (IFSB), termasuk peraturan laba dan masalah lain yang belum dibahas. Makalah ini*

*mencoba mengamati masalah terkait dengan PER dan IRR serta penerapannya di beberapa bank Islam menggunakan metode analisis konten pada laporan tahunan dan / atau laporan keuangan mereka. Makalah ini menyimpulkan bahwa PER dan IRR akan membawa masalah dan risiko yang lebih besar ke bank syariah. Hal ini mengarahkan penulis untuk menyarankan bahwa regulator mempertimbangkan kembali izinnya. Selain itu, makalah ini juga menemukan bahwa konsep PER dan IRR memiliki penerimaan yang rendah di antara bank Islam.*

*Kata kunci: Profit Equalization Reserve (PER), Investment Risk Reserve (IRR), Manajemen Risiko, Perbankan Islam.*

## Introduction.

The Islamic Financial Institution (IFI) is a unique financial institution which has special characteristics, *maqāsid* (objective), worldview, risk, and opportunity. Based on that premise, in order to manage the IFI, it needs unique treatments of risk management, governance, and accounting. According to Hameed,<sup>1</sup> in order to handle the Islamic Financial Institutional, we need a special accounting system that can accommodate the worldview and values of Islam.

One of the topics that has strong relation to Islamic accounting is the profit smoothing of *mudhārabah* by Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR). The rationale behind using the two reserves is to avoid Displaced Commercial Risk (DCR) rising from the shareholders' attempts to mitigate the withdrawal risk that rises from the low profit Islamic banks' distribution to their depositors. In more detail, Displaced Commercial Risk (DCR) refers to the risk that rises from assets managed on the behalf of Profit Sharing Investment Account Holders (PSIAH), which is effectively transferred to the bank's own capital because it forgoes part or all of its *mudhārib's* share (profit) of on such funds. It considers this necessary due to commercial pressure to increase the return that would otherwise be payable to PSIAH's. In other words, DCR refers to the risk of losses that the bank absorbs in order to make sure that the PSIAH are paid at a rate of return (ROR) that exceeds the actual return supposedly earned by the Investment Account Holders (IAH) based on their contractual profit sharing ratio.<sup>2</sup>

1 Shahul Hameed Mohamed Ibrahim, "Nurtured By Kurf: The Western Philosophical Assumptions Underlying Conventional (Anglo-American) Accounting," *International Journal of Islamic Financial Services* 2, No. 2 (2000), p. 1-19.

2 BIMB Holdings Berhard, "Annual Report and Financial Statements 2012," <http://bimb.irplc.com/docs.htm?filepath=BIMB/BIMB-AR2012-31122012.pdf>, (2012), p. 164.

According to the IFSB Guidance Note on the practice of smoothing the profit's payout to investment account holders,<sup>3</sup> a PER is created by appropriation to a reserve (the PER) of the amounts out of profits earned from the commingled pool of assets before the allocation to shareholders and the Unrestricted Investment Account Holder (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 *mudhārib* share.

An IRR is created by setting aside amounts of the profit attributable to IAH, after deducting the IIFS's *mudhārib* share, in order to cushion the effects of future investment losses on the 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 these losses are fully covered, use of the PER may enable a profit payout to be made to the IAH, notwithstanding the loss.<sup>4</sup>

However, there are some issues related to PER and IRR. Some issues have been identified in the IFSB Guidance Note on profit smoothing, and other issues are yet to be discussed. In addition, it is also important to know how banks utilize and disclose PER and IRR because that reflects the banks' acceptance of the ideas of PER and IRR. Thus, this paper will try to observe those issues related to PER and IRR and their application in some Islamic banks based on the information they provided in their annual reports from 2008 to 2013.

### Issues Related to PER and IRR.

The IFSB Guidance Note identifies four issues related to smoothing practices.<sup>5</sup> They are: disclosure and transparency issues, corporate governance issues, issues arising from liquidation, and capital adequacy issues. In addition, we observed four additional issues related to PER and IRR: risk management issues, bank

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3 Islamic Financial Services Board (IFSB), "Guidance Note on The Practice of Smoothing The Profits Payout to Investment Account Holders," <https://www.ifsb.org/download.php?id=4388&lang=English&pg=/published.php>. (2010), p. 6.

4 IFSB, "Guidance Note on The Practice of Smoothing The Profits Payout...", p. 7.

5 *Ibid.*, p. 9.

stability issues, valuation issues, and substance over form principal issues. Below we shall discuss those eight issues.

- Disclosure and transparency issues.

The IFSB Guidance Note opens discussion on these issues related to profit smoothing by stating that by maintaining stable returns to unrestricted investment account holders, regardless of whether it rains or shines, an Islamic bank automatically sends a signal that (it) has a sustainable and low-risk earnings stream (for those account holders)—while the reality may be quite different.<sup>6</sup>

This situation eliminates one of the most important characteristics of Islamic finance: transparency. Although transparency is not a unique requirement for Islamic banking, transparency is needed more in Islamic banking because it is not a secular institution with a concentration on only profit maximization. Islamic banking has a worldview and values that do not separate between the worldly and hereafter life.<sup>7</sup> In a capitalist worldview, a capitalist can maximize profit as long as the law cannot catch him; but in the life of a Muslim, he knows that he is responsible for what he has done in this world. In the case of the bank, he cannot keep the reality of the bank only to gain more profit.

The transparency issues related with PER and IRR also come in other forms. At the initial stage, when a depositor is opening his account in an Islamic bank, he has to be aware that some portion of profit generated from his money will be deducted in order to form a reserve from which he may not enjoy its benefit. The depositor must understand how this reserve works and must give his legal consent to it. However, only on very rare occasions, if at all, the depositor's consent may be requested during the opening of his investment account. This suggests an issue of cheating and stealing money, because the depositor does not know and thus, does not permit his money to be taken.

Another lack of transparency can be found in the disclosure of the PER and IRR in financial statements. Hameed stressed that disclosure of PER and IRR is crucial, but unfortunately,

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6 IFSB, "Guidance Note on The Practice of Smoothing The Profits Payout...", p. 9.

7 Shahul Hameed Mohamed Ibrahim, "Nurtured By Kurf: The Western...", p. 15.

most of the banks that use PER and IRR do not disclose these reserves properly.<sup>8</sup>

- Corporate governance issues.

One of the major corporate governance issues of PER and IRR is that the unrestricted Investment Account Holders (UIAH) lack the right to influence the use of reserves such as PER and IRR, and UIAH's 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 the 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's.<sup>9</sup>

Cunningham observes that in the case of the PER, the reserve belongs to the IAH and the shareholders jointly, but the IAH have no say in how the reserves are accumulated and distributed.<sup>10</sup> There is also the issue of inter-generational fairness. A short-term investor is disadvantaged when some of today's robust profits are squirreled away into a reserve fund and then used during the future years (after the short-term investor has left the fund) to make up for lower returns prevailing at that time.

Still related to the corporate governance issue, the IFSB (2010) added that 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. 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 that lack of transparency is that it would distort competition among IIFS, in that UIAH's 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 *mudhārib*

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8 Shahul Hameed Mohamed Ibrahim, *IE 2002: Reporting of Islamic Financial Transactions* (Kuala Lumpur: International Centre for Education Islamic Finance, 2012), unit. 6, p. 38.

9 IFSB, "Guidance Note on The Practice of Smoothing The Profits Payout...", p. 11.

10 Andrew Cunningham, "New Guidance on How Islamic Banks May "Smooth" Returns to Investors," <https://www.darienniddleeast.com/hidden/new-guidance-on-how-islamic-banks-may-smooth-returns-to-investors-2/>, (2012).

and in turn, disciplining the IIFS.

- Issues arising on liquidation.

A critical question discussed by IFSB<sup>11</sup> with respect to reserves such as PER and IRR is how they are treated in the event of a voluntary liquidation of an IIFS. 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, the existing IAH and shareholders – or (ii) the funds corresponding to the balances of these reserves should be donated to charity.

- Capital adequacy issues.

One capital adequacy issue discussed by the IFSB Guidance Note is in the determination of the alpha ( $\alpha$ ) factor. The IFSB<sup>12</sup> found that the percentage of risk-weighted assets funded by UIAH subjects to DCR, indicated by “ $\alpha$ ”, is left to the individual supervisory authorities to decide in their own jurisdictions. While in principle, “ $\alpha$ ” 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 “ $\alpha$ ” parameter of 35% for IIFS in its jurisdiction, it would mean that 35% of risk-weighted assets of the IAH in those IIFS will be included in the Capital Adequacy Ratio (CAR) denominator. This further implies 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.

Another capital adequacy issue arises when banks differ in how they treat PER and IRR. In the Bank Nasional Malaysia BNM guideline on PER and IRR,<sup>13</sup> PER should be treated as equity. Thus, it can be treated as Tier 2 capital. However, from

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11 IFSB, "Guidance Note on The Practice of Smoothing The Profits Payout...," p. 13.

12 *Ibid.*," p. 14..

13 Maybank Islamic Berhad (MIB), "Directors Report and Audited Financial Statements," [https://www.maybank.com/iwov-resources/corporate\\_new/document/my/en/pdf/subsidiary-reports/2014/Maybank\\_Islamic\\_Fin\\_Statment\\_FY2013.pdf](https://www.maybank.com/iwov-resources/corporate_new/document/my/en/pdf/subsidiary-reports/2014/Maybank_Islamic_Fin_Statment_FY2013.pdf), (2013), p. 64.

our findings we observed that the Islamic banks which use PER list this reserve as liability. This causes confusion when calculating the capital adequacy ratio of the bank.

- Risk management issue.

In addition to the four issues which are discussed by the IFSB in its guidance notes, we also observed that PER and IRR come with some risk management issues. While PER and IRR are aimed to mitigate DCR, they can also cause a fiduciary risk, which can lead to a withdrawal risk as well. According to The Accounting and Auditing Organization for Islamic Financial Institutions, AAOIFI in Ahmed,<sup>14</sup> fiduciary risk can be caused by breaches of contract by Islamic banks. For example, a bank may not be able to comply fully with the *shari'a* requirements of various contracts. That inability to comply fully with Islamic *shari'a*, either knowingly or unknowingly, leads to a lack of confidence among the depositors and hence, causes their withdrawal of deposits. Similarly, a rate of return lower than the market's rate can also introduce fiduciary risk, when depositors/investors interpret a low rate of return as a breach in their investment contract or a mismanagement of funds by the bank.

In the case of PER and IRR, the practice of profit smoothing gives the consumer the impression that Islamic bank practices are similar to those of conventional banks. The majority of Islamic banks' most loyal customers are people who have an understanding of the basic principle of the *mudhārabah* transaction. These loyal customers deposit their money in Islamic banks because they expect that Islamic banks, as *mudhārib*, will act according to what they understand from *mudhārabah* contracts. When they perceive that their bank acts similarly to conventional banks, they may see no advantage in saving at an Islamic bank. In this situation, they may prefer to shift to more a mature bank, such as a conventional bank.

This discussion leads to another discussion about the main ideas behind PER and IRR itself. One rationale supporting PER and IRR is to give Islamic Banks a chance to grow during its early stage, during which they are a price takers and co-exist

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<sup>14</sup> Habib Ahmed and Tariqullah Khan, "Risk Management in Islamic Banking," edited by M. Kabir Hassan and Mervyn K. Lewis, *Handbook of Islamic Banking* (Massachusetts: Edward Elgar Publishing, Inc, 2009), p. 146.

with conventional banks. It is perceived that PER and IRR are needed to pass through this stage in order to give enough time for Islamic Banks to become big players and to have influence in pricing decisions. However, this situation will give Islamic banks additional risks, such as an interest rate risk. Benchmarking its return to interest rate risk and competing in rate of return risk will bring more difficulty than opportunity during the development stage of Islamic banks. In the scope of strategic management, Islamic banks have a differentiation strategy, and they do not need to involve themselves in cost leadership strategy, because it will be disastrous for Islamic banks in its infancy.

Thus, it can be argued, that while Islamic banks can mitigate DCR in the short run by using PER and IRR, it may also cause Islamic banks to face other risks that are of bigger magnitude and have a longer impact: fiduciary risk and withdrawal risk.

- Valuation issue.

Cunningham explained that the PER is owned in part by the shareholders of the bank and in theory may be entirely appropriated by them.<sup>15</sup> At a minimum, that needs to be disclosed in the accounts. Beyond that, some judgment must be made as to how much value PER adds to the bank (since in practice, it is unlikely that all of it will be appropriated by the shareholders). Even the IRR, over which the shareholders have no claim, may add to the value of the bank by reducing losses to investors and in turn, helping the bank to maintain its customer base.

- Bank stability issue.

Another rationale to justify PER and IRR is it that they avoid withdrawal risk. A massive withdrawal is called a bank run, and it can bring a big bank to ruin in a short period of time. However, the rate of return is not a depositor's only consideration for saving or withdrawing their money. Another consideration, related to depositors' decision to save or withdraw their money, is bank stability. According

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<sup>15</sup> Andrew Cunningham, "New Guidance on How Islamic Banks May "Smooth" Returns to Investors," <https://www.darienmiddleeast.com/hidden/new-guidance-on-how-islamic-banks-may-smooth-returns-to-investors-2/>, (2012).

to economic law, a higher return indicates higher risk. Risk-averse depositors may remain in relatively lower profit banks because they give more stability guarantee. Due to a trade-off between stability and efficiency, the depositor who prefers higher efficiency and risk may deposit in a bank with higher profit, and vice-versa. Thus, we can argue that the rate of return is not the only means to keep the depositor saving their money in a bank. In fact, one's confidence in the stability of a bank is a bigger factor.

Knowing their Islamic banks use their reserve to pay higher returns, depositors may perceive this action as one that signals bad banking performance. Then depositors may withdraw their money from those banks and save in another. This might be one of the reasons why some banks do not properly disclose their PER and IRR movements.

Should depositors choose to keep their savings, regardless of the signal of bad performance he received, this may lead to a bigger catastrophe in the economy, in the long run. The bank keeps operating in bad performance with no direct and immediate incentive to reform, depositor keeps adding more investment, banks tries to keep the depositor staying in the bank by giving competitive return, the cycle goes on and on, and suddenly the bank has no more fund to be used from its PER and IRR, and the shareholders also dissatisfied with bank performance. In the end, both depositors and shareholders may leave their banks.

In addition, the existences of PER and IRR remove the cushion effect of natural withdrawing. Withdrawing, when it is based on the natural evaluation of bank performance, is good for banks, depositors, and the economy as a whole. To stop natural withdrawing would be similar to drinking painkillers that disable the body from sensing reality. Continuous usage of this painkiller would cause sensory processing disorder, which creates inefficiency and instability within the banking sector and in the economy as a whole.

- Substance over form principal issue.

One important characteristic of Islamic accounting is the adherence to the "substance over form" principal.<sup>16</sup> This

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16 Shahul Hameed Mohamed Ibrahim, *IE 2002: Reporting of Islamic...*, unit. 3, p. 18.

principal gives guidelines that, in order to be Islamic, an accounting system not only has to pass a “formal” form test but also has to prove that its substance is compliant with Islamic teachings, its worldview, and *maqāsid sharia* (objective of Islamic rulings) of the contract and transaction. As we know, PER and IRR have been approved by IFSB. The acceptance of PER and IRR was judged by their structure of contracts. PER is taken from the profits of shareholders and depositors in the form of *hibah* (gift). So far, in our observations, there is no writing that examines whether the mixing of *hibah* and *mudarabah* is prohibited according to the *qiyās* (analogy) of prohibition on mixing *hibah* and sales.

Regardless of that acceptance by the IFSB, we try to observe the effects that might be caused by PER and IRR. We try to create a reverse situation in order to see this phenomenon more clearly. Now, let’s put ourselves in the position of a bank: We are a *rabbu al-māl* (capital provider). We give finance to someone so that they may become our *mudhārib*. Unfortunately, the *mudhārib* does not perform well. Furthermore, instead of admitting loss and letting the *rabbu al-māl* lose the money, the *mudhārib* returns the capital in full, plus an additional sum of return. At that point, we know that the *mudhārib* is losing but still gives back capital plus profit because we know that the *mudhārib* does not want to lose our trust when presenting their future financing proposals.

The question is: Are we still going to give him more financing in the future? If yes, that may be because we have been strongly affected by a materialistic worldview in conventional financing where the quality of investment is not an important consideration. In conventional finance, the major consideration is credit risk, and the biggest component of credit risk is one’s ability to repay their loan. In Islamic economics, while credit risk is considered, what matters more is investment risk. In making financing decision, Islamic finance will concentrate more on a project’s feasibility rather than the creditor’s rating. Islamic finance, in this way, creates Pareto efficiency, because the fund flows to the most productive project, not to someone who has proven able to pay their loan despite their failing project. Thus, we can suggest that overriding ‘form’ over ‘substance’ may cause Islamic finance fail to achieve one of its biggest *maqāsid*; creating efficiency in economy.

## Its Application.

To understand how Islamic banks accept the permissibility of profit smoothing and how they apply it, below we will analyze the application of PER and its disclosure in seven major Islamic banks in six Muslim majority countries. From each country, we pick one prominent, full-fledged Islamic bank to serve as a sample in our observations—except for Malaysia, in which we take two banks as samples, because the Maybank Islamic Bank, the biggest Islamic bank in term of capital, is not a full-fledged Islamic Bank. Thus, we also observe Bank Islam Malaysia Berhad to make our sample better represent the situation of industry in that country.

- Qatar Islamic Bank (QIB).

According to the Balance Sheet of QIB (appendix 1), we can see that it does not use PER as part of its risk management. Instead, it uses another type of reserve called “risk reserve”. According to a QIB statement:

In accordance with QCB regulations, a risk reserve should be created to cover contingencies on both the public and private sector financing assets, with a minimum requirement of 2.5 % of the total private sector exposure granted by the Group inside and outside Qatar after the exclusion of the specific provisions and profit in suspense. The finance provided to / or secured by the Ministry of Finance – Qatar or finance against cash guarantees is excluded from the gross direct finance. The total amount transferred to the risk reserve amounted to QAR 321.3 million (2012: QAR 334.7 million).<sup>17</sup>

Notably, the minimum requirement regulated by QCB in 2012 was 2% of the total private sector exposure granted by the Group inside and outside Qatar after the exclusion of the specific provisions and profit in suspense. It turns to be 2.5% in 2013.

The QIB statement of changes in equity (appendix 2) clearly shows that the risk reserve is taken from retained earnings. In other words, it is only shareholders who fund the risk reserve. Thus, QIB’s risk reserve is similar enough to PER and IRR that we may observe it. Additionally, QIB does not admit the existence of displaced commercial risk (DCR). Thus, the risk

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<sup>17</sup> Qatar Islamic Bank (QIB), "Annual Report 2012," <https://www.qib.com.qa/en/images/QIB-Annual-Report-2012.pdf>, (2012), p. 123.

reserve is not intended to smooth the return to the IAH. It is instead created to cover contingencies on loans and advances, and it is applied to both conventional and Islamic banks.<sup>18</sup>

- Bahrain Islamic Bank (BIsB).

Like QIB, the Bahrain Islamic Bank (BIsB) prepares its financial statements accounting in accordance with the requirements of AAOIFI. For matters for which no AAOIFI standard exists, the Group uses the relevant International Financial Reporting Standards ('the IFRS') issued by the International Accounting Standards Board. However, unlike QIB which does not recognize PER and IRR, BIsB utilizes PER and IRR as its risk mitigation method. In their "significant accounting policies" section, BIsB explains:

Profit equalization reserve: The Group appropriates a certain amount in excess of the profit to be distributed to equity of investment accountholders after taking into consideration the *mudarib* share of income. This is used to maintain a certain level of return on investment for equity of investment accountholders.<sup>19</sup>

However, since 2009, BIsB no longer collects funds to form PER and IRR. The last time BIsB deducted profit to them was in 2008. In 2009, BIsB closed PER accounts by transferring to income from jointly financed sales, and it closed IRR by allocating it to unrestricted investment account holders—as can be seen in the BIsB 2010 notes on consolidated financial statements (appendix 3). In 2012, BIsB started using IRR again, but not PER. The amount is BND 63,000 and regarded as part of Tier 2 capital, as can be seen in the BIsB capital classification (appendix 4).

- Bank Islam Malaysia Berhad (BIMB).

Bank Islam Malaysia Berhad is the biggest full-fledged Islamic bank in Malaysia, established in 1983. It describes itself as Malaysia's maiden *shariah*-based institution. Since its inception, it has emerged as the symbol of Islamic banking

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18 Raghavan Seetharaman, "Banking on Corporate Governance," <https://www.gulf-times.com/story/343285/Banking-on-corporate-governance>. (2013)

19 Bahrain Islamic Bank (BIsB), "Annual Report 2012," <https://www.bisb.com/en/our-financials/Downloads/Annual-2012.pdf>. (2012), p. 44.

in Malaysia and its vision to be “A Global Leader in Islamic Banking” illustrates the Bank’s status as the flag bearer of the country’s financial services industry.

In relation to financial risk management policies, BIMB does recognize DCR. However, as stated in its Reports and Financial Statements for the Financial Year Ended 31 December 2012, BIMB does not use or maintain PER to manage DCR. The Bank instead uses the following approaches to manage DCR:

- a. Forgo part or all of the Bank’s profit share as *mudhārib* to the PSIAH, by way of varying the profit percentage taken as the *mudhārib* share, in order to increase the share attributed to the PSIAH in any particular year;
- b. Transfer the Bank’s current profits or retained earnings to the PSIAH on the basis of *hibah* (gift); and
- c. Utilize the Waiver of Entitlement Clause based on the *tanāzul* (waiver) principle. In this context, a partner who has agreed to a certain profit sharing ratio waives the rights to profits to be given to another partner on the basis of *tanāzul* at the time of profit realization and distribution, as well as at the time of the contract.<sup>20</sup>

The bank also does not use or maintain IRR to manage DCR. To make sure, we checked the details in the “Other Reserve” section of the financial statement, and we find that the bank only maintains three types of reserve under “other reserves”. They are statutory reserve, fair value reserve, and translation reserve (appendix 5).

- Maybank Islamic Bank (MIB).

In its summary of significant accounting policies, regarding PER, the Maybank Islamic Bank stated:

Since 1 July 2012, the Bank has adopted BNM’s Revised Guidelines for PER (“the Revised Guideline”). In managing the displaced commercial risk, the Bank will use its current profits to be transferred to depositors on the basis of *hibah* in the event that there is a shortfall in the actual return on *mudharabah* deposits as compared to the published rate of return. The payment of *hibah* is recognized as cost in the income statement.<sup>21</sup>

20 BIMB Holdings Berhad, "Annual Report 2012...", p. 164.

21 Maybank Islamic Berhad (MIB), "Directors Report and Audited...", p. 38.

In 2013, the bank did not transfer any amount from its income to PER, (appendix 6). However, in 2013, it distributed MYR 42.8 million from PER to IAH (appendix 7). It is interesting the way MIB treats PER, because under the BNM PER Guideline, PER is to be classified as a separate reserve in equity. However, MIB classifies PER under liabilities (appendix 8). On the other hand, regarding IRR, MIB did not use IRR to manage DCR.

- Abu Dhabi Islamic Bank (ADIB).

In its "Significant Accounting Policies" section, under profit distribution, ADIB states:

A part of the deserved profits relating to the *mudarabah* based investment accounts profit can be reserved as "Profit Equalization Reserve" and shall be subsequently utilized in order to maintain certain level of profit distribution to the account holders.<sup>22</sup>

In 2013, ADIB transferred AED 52.4 million to PER, which made the total of AED 276 million in its PER. ADIB also treated the whole amount of PER as liability (appendix 9).

- Bank Muamalat Indonesia (BMI).

Based on its annual report,<sup>23</sup> BMI does not recognize DCR in its risk management. There are eight types of risk mentioned in BMI's financial statements:

They are financing risk, market risk, liquidity risk, operational risk, legal risk, reputation risk, strategic risk, and compliance risk. Based on these stances, BMI does not use or maintain PER and IRR as part of its risk management.<sup>24</sup>

- Kuwait Finance House (KFH).

The Kuwait Finance House (KFH) is considered a pioneer in the banking phenomenon known as Islamic Finance or *Shari'a* Compliant Banking. KFH is one of the first Islamic banks, established in 1977, in the State of Kuwait; and today it is one of the foremost Islamic financial institutions in the world. By analyzing the KFH Financial statement of 2013, we

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22 Abu Dhabi Islamic Bank, "Annual Report 2013," <https://www.adib eg/ADIB%20Annual%20Report%202013%20En.pdf>. (2013), p. 72.

23 Bank Muamalat Indonesia (BMI), "Annual Report 2013," [https://www.bankmuamalat.co.id/uploads/hubungan\\_investor/1\\_laporan-tahun-2013\\_20160225132602.pdf](https://www.bankmuamalat.co.id/uploads/hubungan_investor/1_laporan-tahun-2013_20160225132602.pdf). (2013), p. 172.

24 *Ibid.*, p. 152.

find that KFH did not recognize DCR in its risk management. As a result, KFH did not form and maintain any PER or IRR.<sup>25</sup>

To summarize our findings from the seven Islamic banks in six countries, we present the table below:

No	Islamic Bank	Country	Reporting Standard	Recognize DCR	Using PER	Using IRR	Classification of PER	Classification of IRR
1	QIB	Qatar	AAOIFI	No	No	No	N/A	N/A
2	BIsB	Bahrain	AAOIFI	Yes	No *	Yes**	N/A	Equity
3	BIMB	Malaysia	MFRS	Yes	No	No	N/A	N/A
4	MIB	Malaysia	MFRS	Yes	Yes	No	Liabilities	N/A
5	ADIB	UAE	IFRS	In indirect way	Yes	No	Liabilities	N/A
6	BMI	Indonesia	IFAS	No	No	No	N/A	N/A
7	KFH	Kuwait	IFRS	No	No	No	N/A	N/A
	* Stopped using PER from 2009							
	** Stopped using IRR from 2009, and started again in 2012							

As we see in table above, we find only two banks use PER and one bank uses IRR. These low figures show that the idea of PER and IRR has a low acceptance rate among Islamic banks. We also find that two banks present PER under liabilities, which is “clearly wrong.”<sup>26</sup>

### Conclusion and Suggestion.

Based on our observations on issues and current application, we find that the PER and IRR that are initiated to smooth return and mitigate DCR and withdrawal risk, may result in bigger issues and risks. This leads us to suggest the regulator to reconsider its permissibility.

From the seven banks we analyze, the author find only two banks use PER and one bank uses IRR. From that figure, we infer that the idea of profit smoothing by PER and IRR, although it is permitted by IFSB, is not widely accepted nor applied by Islamic banks. The reason those banks do not use PER and IRR is beyond the main discussion of this paper. Any further research to find that reason behind low acceptance can yield valuable contribution to study in this field.

25 Kuwait Finance House (KFH), "Annual Report 2013," <https://www.kfh.bh/bahrain/reports/bahrain/Annual-Reports/Annual-Report-2013/document/KFH-Annual-Report-2013-Ar.pdf>,

26 Shahul Hameed Mohamed Ibrahim, *IE 2002: Reporting of Islamic...*, unit. 6, p. 18.

For further research the author suggest a comprehensive acid test to be conducted in order to compare the strength between banks using PER and IRR and banks which do not use these reserves. Other valuable research could be conducted on the *fiqh* review, on the permission of combining *hibah* and *mudhārabah*; observing its similarity with combination of *hibah* and sale; and deciding whether or not both combinations are comparable (in term of *qiyās*). Since this research is based on information provided by banks from 2008 to 2013, further research on more recent years will give sharper insight into the current applications of PER and IRR in Islamic banks.

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## Appendix 1. A Snapshot of the Qatar Islamic Bank's (QIB) Balance Sheet

QATAR ISLAMIC BANK (S.A.Q)			
CONSOLIDATED STATEMENT OF FINANCIAL POSITION		QAR '000s	
As at 31 December		2013	2012
	<i>Notes</i>		
<b>Assets</b>			
Cash and balances with central banks	9	2,992,762	3,643,735
Due from banks	10	6,348,139	8,757,963
Financing assets	11	47,139,466	43,137,334
Investment securities	12	14,851,841	13,355,758
Investment in associates	13	741,660	875,311
Investment properties	14	792,533	774,232
Assets of a subsidiary held for sale	15	303,133	293,638
Fixed assets	16	436,181	377,366
Intangible assets	17	318,819	249,819
Other assets	18	3,429,710	1,726,906
<b>Total assets</b>		<b>77,354,244</b>	<b>73,192,062</b>
<b>Liabilities, equity of unrestricted investment account holders and equity</b>			
<b>Liabilities</b>			
Due to banks	19	6,490,703	10,371,518
Customers' current accounts	20	12,469,798	9,081,880
Sukuk financing	21	5,444,077	5,415,628
Liabilities of a subsidiary held for sale	15	5,267	205,182
Other liabilities	22	1,378,530	1,001,367
<b>Total liabilities</b>		<b>25,788,375</b>	<b>26,075,575</b>
<b>Equity of unrestricted investment account holders</b>	23	<b>37,893,209</b>	<b>34,065,482</b>
<b>Equity</b>			
Share capital	24(a)	2,362,932	2,362,932
Legal reserve	24(b)	6,370,016	6,370,016
Risk reserve	24(c)	1,084,566	763,213
General reserve	24(d)	81,935	81,935
Fair value reserve	24(e)	94,896	86,074
Foreign currency translation reserve	24(f)	(49,974)	(31,078)
Other reserves	24(g)	212,058	289,080
Proposed cash dividends	24(h)	945,172	886,100
Retained earnings		758,113	665,603
<b>Total equity attributable to shareholders of the Bank</b>		<b>11,859,714</b>	<b>11,473,875</b>
Non-controlling interests	25	1,812,946	1,577,130
<b>Total equity</b>		<b>13,672,660</b>	<b>13,051,005</b>
<b>Total liabilities, equity of unrestricted investment account holders and equity</b>		<b>77,354,244</b>	<b>73,192,062</b>

These consolidated financial statements were approved by the Board of Directors on 19 January 2014 and were signed on its behalf by:

## Appendix 2.

**To see the source of this risk reserve, we can see the QIB's statement on changes in equity.**

QATAR ISLAMIC BANK (S.A.Q)



**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**

QAR '000s

For the year ended 31 December 2013

	Share capital	Legal reserve	Risk reserve	General reserve	Fair value reserve	Foreign currency translation reserve	Other reserves	Proposed cash dividends	Retained earnings	Total equity attributable to the shareholders of the Bank	Non-controlling interests	Total equity
Balance at 1 January 2013	2,362,932	6,370,016	763,213	81,935	86,074	(31,078)	289,080	886,100	665,603	11,473,875	1,577,130	13,051,005
Change in foreign currency translation reserve	-	-	-	-	-	(18,896)	-	-	-	(18,896)	-	(18,896)
Fair value reserve movement	-	-	-	-	8,822	-	-	-	-	8,822	-	8,822
Net profit for the year	-	-	-	-	-	-	-	-	1,335,400	1,335,400	(9,797)	1,325,603
Total recognised income and expense for the year	2,362,932	6,370,016	763,213	81,935	94,896	(49,974)	289,080	886,100	2,001,003	12,799,201	1,567,333	14,366,534
Transfer from other reserves	-	-	-	-	-	-	(77,022)	-	77,022	-	-	-
Cash dividends paid to shareholders	-	-	-	-	-	-	-	(886,100)	-	(886,100)	-	(886,100)
Transfer to risk reserve	-	-	321,353	-	-	-	-	(321,353)	-	-	-	-
Proposed cash dividends	-	-	-	-	-	-	-	945,172	(945,172)	-	-	-
Social and Sports Fund appropriation	-	-	-	-	-	-	-	-	(33,385)	(33,385)	-	(33,385)
Loss on acquisition of non-controlling interests	-	-	-	-	-	-	-	-	(20,002)	(20,002)	-	(20,002)
Movement in non-controlling interests	-	-	-	-	-	-	-	-	-	-	245,613	245,613
Balance at 31 December 2013	2,362,932	6,370,016	1,084,566	81,935	94,896	(49,974)	212,058	945,172	758,113	11,859,714	1,812,946	13,672,660

## Appendix 3.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

31 December 2010

**14. UNRESTRICTED INVESTMENT ACCOUNTS**

	2010 BD'000	2009 BD'000
Customers	600,024	522,379
Profit equalisation reserve (note 14.1)	-	-
Investment risk reserve (note 14.2)	-	-
<b>Customers' investment accounts</b>	<b>600,024</b>	<b>522,379</b>
Financial institutions' investment accounts	141,358	157,914

**14.1 Movement in profit equalisation reserve**

	2010 BD'000	2009 BD'000
Balance at 1 January	-	2,368
Transferred to income from jointly financed sales	-	(2,368)
<b>Balance at 31 December</b>	<b>-</b>	<b>-</b>

**14.2 Movement in investment risk reserve**

	2010 BD'000	2009 BD'000
Balance at 1 January	-	167
Amounts apportioned from income allocable to unrestricted investment account holders	-	(167)
<b>Balance at 31 December</b>	<b>-</b>	<b>-</b>

The profit equalisation reserve reverts to unrestricted investment accounts as per terms and conditions of the Mudaraba contract.

## Appendix 4

The classification of the Group's capital in accordance with the regulatory requirements is as follows:

	2012 BD'000	2011 BD'000
<b>Core capital - Tier 1:</b>		
Issued and fully paid ordinary shares	93,404	93,404
General reserves	1,000	1,000
Legal / statutory reserves	10,267	10,268
Share premium	-	43,936
Retained earnings / losses (excluding current year net income/loss)	-	(25,000)
Less:		
Net loss for the year	(36,195)	(17,100)
Unrealised gross losses arising from fair valuing equity securities	(638)	(4,611)
Tier 1 Capital before deductions	67,838	101,897
<b>Supplementary capital - Tier 2:</b>		
Asset revaluation reserve (45% only)	-	-
Unrealised gains arising from fair valuing equities (45% only)	593	315
Investment risk reserve	63	315
Other reserve	2,688	-
Tier 2 Capital before deductions	3,344	630
Total available capital	71,182	102,527
<b>Deductions</b>		
Significant minority interest in banking, securities and financial entities	(5,493)	(5,321)
Excess amount over materiality threshold	-	(10,741)
Investment in insurance entity greater than or equal to 20%	(1,650)	(1,830)
Excess amount over maximum permitted large exposure limit	-	(12,057)
Total eligible capital	64,039	72,578

## Appendix 5

### Bank Islam Malaysia Berhad

(Company No. 98127-X)  
(Incorporated in Malaysia)

#### 21. Other reserves

Group	Statutory reserve RM'000	Fair value reserve RM'000	Translation reserve RM'000	Total RM'000
At 1 January 2011	795,013	83,426	76,461	954,900
Effect in change in accounting policy (Note 45.5(a))	-	-	(76,461)	(76,461)
At 1 January 2011, restated	795,013	83,426	-	878,439
Foreign exchange translation differences	-	-	(9,451)	(9,451)
Unrealised net gain on revaluation of financial assets available-for-sale	-	34,034	-	34,034
Transfer from current year profit	179,581	-	-	179,581
At 31 December 2011	974,594	117,460	(9,451)	1,082,603
Zerorisation of accumulated losses	(684,335)	-	-	(684,335)
Foreign exchange translation differences	-	-	10,543	10,543
Unrealised net gain on revaluation of financial assets available-for-sale	-	3,954	-	3,954
Transfer from current year profit	215,392	-	-	215,392
<b>At 31 December 2012</b>	<b>505,651</b>	<b>121,414</b>	<b>1,092</b>	<b>628,157</b>

## Appendix 6

Maybank Islamic Berhad  
(Incorporated in Malaysia)

Statement of changes in equity  
For the year ended 31 December 2013

	Non-distributable					Distributable		
	Share capital RM'000 (Note 20)	Share premium RM'000 (Note 21)	contribution from the holding company RM'000 (Note 21)	Statutory reserve RM'000 (Note 21)	Unrealised holding reserve/ reserve/ (deficit) RM'000 (Note 21)	Profit equalisation reserve RM'000 (Note 21)	Retained profits RM'000 (Note 21)	Total equity RM'000
At 1 January 2013	132,720	2,687,480	1,697	147,338	31,274	34,456	1,510,406	4,545,371
Profit for the year	-	-	-	-	-	-	1,049,337	1,049,337
Other comprehensive income	-	-	-	-	(159,153)	-	-	(159,153)
<b>Total comprehensive income for the year</b>	-	-	-	-	(159,153)	-	1,049,337	890,184
Issue of ordinary shares	86,268	1,038,489	-	-	-	-	-	1,124,757
Dividend on ordinary shares (Note 31)	-	-	-	-	-	-	(124,757)	(124,757)
Transfer to statutory reserve	-	-	-	262,334	-	-	(262,334)	-
<b>Total transactions with shareholder</b>	<b>86,268</b>	<b>1,038,489</b>	<b>-</b>	<b>262,334</b>	<b>-</b>	<b>-</b>	<b>(387,091)</b>	<b>1,000,000</b>
<b>At 31 December 2013</b>	<b>218,988</b>	<b>3,725,969</b>	<b>1,697</b>	<b>409,672</b>	<b>(127,879)</b>	<b>34,456</b>	<b>2,172,652</b>	<b>6,435,555</b>

## Appendix 7

### 15. Profit Equalisation Reserve ("PER")

	2013 RM'000	2012 RM'000
At beginning of the year	54,695	54,695
Distribution to Investment Account Holder	(42,875)	-
At end of the year	<u>11,820</u>	<u>54,695</u>

Under the BNM PER Guideline, the PER of the Bank is to be classified as a separate reserve in equity.

## Appendix 8

### 14. Other liabilities

	Note	2013 RM'000	2012 RM'000
Profit equalisation reserve	15	11,820	54,695
Sundry creditors		41,459	83,408
Deposit on trade financing		22,585	13,983
Provisions and accruals	(a)	17,698	12,035
Others		4,353	21,219
		<u>97,915</u>	<u>185,340</u>

## Appendix 9

### 27 DEPOSITORS' ACCOUNTS

	2013 AED'000	2012 AED'000
Current accounts	20,920,478	16,963,281
Investment accounts	54,327,154	44,139,272
Profit equalisation reserve	276,073	223,594
	<u>75,523,705</u>	<u>61,326,147</u>