CHAPTER 2

Profit distribution in common mudaraba pools

2.1 Introduction

Islamic banks accept hundreds and thousands of deposits on a mudaraba basis and pool them together in a common pool for investment. Normally, these banks commingle their own equity, or a significant portion of it, in the same pool, turning it into a unique investment pool. Since the pool is based on an innovative weightage system with a hybrid of mudaraba cum musharaka structure, and because new depository products are constantly introduced, issues that require Shari'a solutions and guidance surface from time to time. To address these issues in line with Shari'a rules and principles and establish universal practices, detailed policies, Shari'a compliant solutions and guidelines should be developed by these banks and their regulators.

How can scores of depositor classes, with thousands of customers, pool their funds together on the basis of unrestricted mudaraba for investment? How will they share the profit and loss of their investments under the innovative weightage system? How is a constructive liquidation carried out? How is the profit calculated and distributed and who bears the expenses of the Islamic Banks and those of the pool? These and many other issues that need Shari'a solutions should be addressed in detail in comprehensive profit distribution policies. It ensure that the profit allocation and distribution are carried out in line with these policies, it should be ensured that the profit distribution module has been developed in conformity with these policies.

This chapter will discuss the basic parameters of the profit distribution mechanism in the mudaraba pool of an Islamic Bank, (the "IB"), and highlight some of the issues and current practices that need Shari'a solutions or refinement. Since a proper understanding of the profit distribution mechanism in IB's Common Mudaraba Pool (the "CMP") is not possible unless the nature of the investment deposits in the IBs, vis a vis those of conventional banks, is properly understood, the chapter will briefly touch upon this issue before proceeding further.

The following are the main points that this chapter will attempt to cover:

- Mudaraba and its basic terms in an IB;
- Multiple mudarabas, and commingling of mudarib's own funds with mudaraba capital;
- The need to maintain separate balance sheets for the IB and for the CMP, and calculation of the expenses of the mudarib and mudaraba;
- How to calculate the net profit in the CMP;
- Issues in the constructive liquidation of the CMP;
- Creation and reversal of provisions in the CMP;
- Calculation of the shareholders' funds in the CMP;
- Calculation of the depositors' funds in the CMP;
- Weightage system, the rules and rationale;
- Profit smoothing techniques; and
- Profit for broken period and premature withdrawal.

2.2 The nature of investment deposits in an Islamic bank

An IB, primarily, has two different relationships with its customers:

- **IB as a Service Provider or Agent:** An IB provides various Shari'a compliant banking services such as remittance of funds, lockers, safe-keeping of funds, ATM services, mobile banking service, etc., to its clients against agreed fees and commissions. It carries out such services in its capacity as a service provider or an agent against a fee or commission; but unlike conventional banks, it provides only Shari'a compliant services against agreed-upon fees and commissions that are permitted by Shari'a.

- **IB as a Fund Manager:** Another role of an IB is that it manages, against a fee or a share in the profit, the funds of its depositors. It may receive investment deposits on the basis of the following three contracts:

  a. Unrestricted mudaraba: the IB manages funds against an expected reward which is an agreed share in the profit to be generated from deployment of those funds, and pool these funds together for investment in the CMP.

  b. Wakala: The IB will receive a lump sum amount, or a percentage of the invested amount, as its agency fee. As a Wakil, the IB is not responsible for any loss of the invested amount unless the loss is attributable to its negligence, misconduct or breach of Wakala terms.

  c. Musharaka: The IB shall become the managing partner with one or more depositors in specific investments or transactions.

It is quite evident from the above that IBs, by receiving investment deposits for deployment at the fund providers' risk against a share in the profit, are different from conventional banks which guarantee their deposits received on the basis of interest bearing loan contracts.

The nature and the main features of a Shari'a compliant mudaraba contract, through which the IBs get their deposits in the CMPs, are as follows:

- The deposits (the balances of the savings accounts and the term deposits) are received on the basis of an unrestricted mudaraba. The depositors are Arbabul Amwal or fund providers, and the IB manages those funds against a pre-agreed share in the generated profit.

- In an unrestricted mudaraba, the IB as fund manager has the permission to invest the funds in any Shari'a compliant and commercially viable transaction without being restricted to any specific area of business or particular trade.

- The arabul amwal and the mudarib are entitled to their respective pre-agreed shares in the profit that is generated from deployment of the funds, while in a loss or no-loss-no-profit situation, the mudarib will not receive the expected reward.

- Since in an IB there are many fund providers with a single mudarib, the fund providers are considered as partners amongst themselves. They share the profit as per agreement on the basis of a weightage system, while the loss is borne pro-rata.

- Any agreement for profit distribution amongst the depositors is acceptable as long as it does not deprive any partner from a share in the profit. Based on this principle and certain objective criteria such as size and tenure of the fund, different tiers and classes of the depositors are given different weightages.

- Based on this principle, IBs have launched various savings products. For instance, the profit of the regular or simple savings is calculated on the monthly minimum balance, rather than on the average balance, to discourage fund withdrawals by the depositors unnecessarily. However, there may not be any restrictions on the number of transactions. In a special type of savings account that normally targets High Net Worth customers, giving them a higher weightage, the profit is calculated on the basis of monthly average balance, but usually there are certain restrictions in addition to the requirement to have higher balances in the CMP. Restrictions on withdrawals and applying transaction charges beyond a certain limit are meant to justify the higher weightage. It could be argued that a savings product whose profit is calculated on the basis of minimum balance of the month should be considered to have been allocated, in this way, a lower weightage than a product whose profit is paid on the basis of the average balance, but it must be ensured that there should be real differences between the products justifying the different treatment. Some IBs have other savings products where the profit is calculated on the basis of daily weightages or the weightage differs due to a variety of reasons which may not be fully justified at times.

- Although AAOIFI Standards have allowed agreement of mudarib with different classes and tiers on different profit sharing formulas (e.g. 40/60 or 30/70), since it is assumed that the mudarib is entering into a mudaraba with several fund providers who have formed, or accepted to form, a partnership, the profit sharing ratio between the mudarib and all the depositors ought to be the same e.g. 40/60 or 50/50. Further, an IB should avoid any practices which may lead to any kind of discrimination without any valid justification, as it may tarnish the image of the Islamic banking industry.

- The IB may stipulate a minimum capital for each depositor to allow him to enter into the mudaraba; and hence any balance below that limit should be considered as current account/qard even if it is deposited into a savings account by the customer.

- The risk of loss, damage or destruction of the mudaraba assets is borne by the fund providers, while the mudarib shall not get the expected reward, unless the loss is attributable to negligence, misconduct or breach of the terms of the contract by the mudarib, in which case the mudarib has to bear the loss.

2.3 Multiple mudarabas & commingling of mudarib's own funds with mudaraba capital

In principle, a mudarib should work with a single fund provider; or even if he accepts funds from more than one fund provider, he should keep the mudarabas, along with their transactions and profit & loss accounts, separate. However, if the fund providers agree, the mudarib may pool their funds together, provided an actual or constructive liquidation of the first mudaraba is conducted to determine its loss or profit before new funds from the second provider are accepted. For instance, if the first fund provider has invested a sum of 10 million with the mudarib, and after a passage of time a second mudarib wants to invest a similar amount in that business, the two fund providers should not be treated as equal partners automatically. Rather, an actual or constructive liquidation of the first mudaraba should be carried out to determine the worth of its proceeds, and accordingly, the share of the second fund provider in the business.

Some IBs initially followed this rule by accepting new funds only at the beginning of a new profit distribution period; but with the profit distributions occurring annually or quarterly, it delayed the investment of customer funds into IBs for several weeks or even months until the commencement of the new profit distribution period. However, if they decided to move their funds to an IB before such a date, they had to park the same in a current account without any profit. This process made it impracticable and highly discouraging for potential customers and as such hampered their smooth transition into Islamic banking, putting the IBs at an obvious disadvantage vis a vis conventional banking, where the depositors could easily move their funds on a daily basis. With technological progress and the advent of innovative IT solutions which simplified and automated the process of constructive liquidation and profit calculation of investments, the permission to calculate the profit of Islamic investments such as murabaha and other deferred payment contracts on accrual basis spread over the period of the investment, it became easier to calculate, at the end of the period, the profit of each unit of money invested in a common pool on a daily product basis.

The weightage system allowed allocating higher profits to bigger amounts committed for longer periods, on account of the size and tenure of the funds, and the application of the principle of takharuj (where a depositor settles his right in the CMP with the payment he receives and is absolved of any liability that may befall the other depositors later in lieu of absolving them of any benefit that he would have been entitled to had he remained in the CMP) allowed for waiver of small differences in calculation and distribution of profit. This enabled IBs to accept funds of different sizes and periods in a single pool, and allow withdrawals and premature encashment on a daily basis.

An IB, in its capacity as a mudarib, may follow a policy of total segregation between its own funds and those of the investment depositors, which it receives to invest on behalf of the Arbabul Amwal at their own risk.

However, many IBs follow the policy of a CMP where they invest all the funds received under an unrestricted mudaraba as well as their own equity and funds obtained through qard or guaranteed by them in any manner, on the basis of permission of the Arbabul Mal obtained in the mudaraba contact, in order to ensure that all funds are given equal chance of deployment without any priority or discrimination. Another reason for adopting this policy may be the fact that management of a single pool is easier than managing multiple pools. However, this does not preclude the IB from entering into specific transactions with certain customers or creating other pools.

2.4 Separate balance sheet and account statement for the CMP

The CMP, being a fund under the management of the IB, should have a separate balance sheet and P&L statement from those of the IB, as a company and legal entity, in the following manner:

- The balance sheets and account statements of the CMP and the IB should be fully independent and completely segregated, with each one reflecting the liabilities, funds and assets of each one as a separate entity. The assets and liabilities of each entity should be properly tagged and identified in a manner that makes them fully distinct from the assets and liabilities of the other entity.

- The account of the CMP should maintain the record of the invested amounts, direct costs and expenses of investment, and the profit and loss account. There must be a system to draw a clear line of demarcation between transactions executed by the CMP, whether they are trade transactions or foreign currency deals, financings or investments, and those entered into on behalf of the IB's shareholders. The profit and loss of all transactions in which the funds of the CMP are used shall be for the account of the CMP. However, if there is any transaction, in which only funds of the shareholders duly marked and segregated for that purpose have been used, the profit and loss of such transaction would be for the account of the shareholders only.

- In the CMP, all the deposits, including the funds of the IB invested in the CMP, would be entitled to the profit in accordance with the weightages allocated to them, while the losses should be borne pro rata by all the depositors in proportion to their invested amounts.

- The IB's own account shall include the IB's income from the fees and commissions that it gets for the banking services that it provides to its customers, other than the mudaraba service provided to the investors in the CMP for which it gets a share of the generated profit, if any. The profit of any direct investment of the shareholders' funds would be added to these incomes.

- A very important factor in this regard is to maintain a clear distinction between the expenses of the mudarib and those of the mudaraba. The following guidelines should be followed in this regard:

  a. All pre-operative expenses should be borne by the shareholders in their capacity as a mudarib. This is because Shari'a requires the mudarib to establish itself as an entity capable of delivering its services with the care and prudence required from such a mudarib. To that end, the IB needs to equip itself with all the necessary skills, infrastructure, manpower and systems in compliance with the requirements of the licensing and regulatory authorities, before it launches its operations and starts receiving deposits from the public on mudaraba basis. Therefore, the fixed assets including IT system of the IB are owned by the shareholders and must be purchased with their funds, and their depreciation costs charged on them.

  b. All the indirect expenses, or the general expenses of the IB, its administrative expenses (including staff salaries, perks and other expenses) should be borne by the IB (the shareholders), as the IB shall, in any case, have to incur these expenses as a bank capable of providing services against fees and commissions, or for deployment of its funds in the CMP or separately, or to obtain license for marketing its fund-management skills.

  c. Undesired income relating to Shari'a repugnant transactions, and segregated by the Shari'a Board on the basis of Shari'a audit reports, should be deducted from the shareholders' funds and credited to the account of the charity fund in which all the late payment penalties and Shari'a repugnant income of the IB is credited in order to be released for charitable purposes.

  d. An IB's sources of income would be as follows:

    i. It gets fees & commissions against the services it provides to its customers.

    ii. It is also entitled to a share of the profit from the mudaraba funds at a pre-agreed ratio (e.g. 50/50 or 40/60) with the depositors.

    iii. Another source of income for the IB would be the return on its invested funds in the CMP.

    iv. At times the IB may directly invest a part of its equity in certain specific projects which are totally segregated from the CMP. The income generated from these direct investments made out of the shareholders' funds should also be added to the shareholders' income.

    v. The IB may also get wakala fee from any wakala fund or transaction, or the mudarib's share of profit from any other mudaraba fund, pool or specific transaction.

2.5 Calculation of net profit of the CMP

The following basic principles should be taken into consideration while determining the net profit of the CMP:

- Profit or loss account of any investment pool can be ascertained through liquidation of pool.

- Since actual liquidation of the CMP is not possible, Shari'a allows a constructive liquidation of the pool by following proper accounting policies and standards.

- No profit can be realized unless the capital deployed for investment remains intact, as profit is the surplus generated through investment of the mudaraba capital.

- Through constructive liquidation of the CMP, the net profit, if any, can be ascertained in the following manner:

  a. Total income from the CMP's Shari'a compliant financing and investment activities in which the funds of the CMP have been used should be calculated.

  b. The following items should then be deducted from (a).

    i. Direct expenses relating to financing & investment activities of the CMP such as taxes, transportation expenses of the goods, insurance of the goods and leased assets etc.;

    ii. Provisions for bad and doubtful transactions/ investments; and

    iii. Depreciation of the fixed assets in the CMP such as assets leased on operating lease basis, if any.

    The result of the above equation will be the net profit of the CMP available for distribution between the shareholders and the depositors.

2.6 Issues in constructive liquidation of the CMP

It must be borne in mind that constructive liquidation does not result in arriving at the exact figure of profit or loss as actual liquidation does. This is because the former is based on a number of policies, assumptions and guesstimates that may not correspond with the factual position at any given moment. The results of the constructive liquidation, at best, may be close to that of actual liquidation, and at worst, it may be off the mark by a large margin. This is true for conventional interest based companies and funds as well as for the Islamic ones; however, the IBs face a number of additional issues in this regard, some of which are as follows:

- Although, the IBs are allowed to calculate the profit of the deposits as well as the assets on an accrual basis, since the actual profit would differ in many cases, especially in case of mudaraba and musharaka and other non-fixed income products, the actual profit would be different from the accrued figures. Therefore, if the profit of an asset is calculated and distributed on an accrual basis, while the actual profit turns to be higher or lower, the profit account would need adjustment.

- Similarly, an IB cannot start accruing profit immediately upon disbursing funds for acquisition of an asset for murabaha or ijara financing, unless the asset has been received and delivered to the customer. This process may take, at times, a few weeks or even months, and the profit of this period is either spread over the entire financing period by way of charging a higher rate of profit or realised at the profit distribution period in which the finance is booked. This limitation, no doubt, leads to disturbing the basis of constructive liquidation and results in generating a higher or lower profit to the investors in a certain period, especially if the amount of the financing in question is significant, and the overall size of the CMP is small, which in turn forces the IB to resort to profit smoothing techniques.

- Since the recognition of profit would be based on constructive liquidation, the CMP may not have enough cash for payment of the profit at a certain period. In that case, it should liquidate some of its short term investments for profit payment. Similarly, the profit declared for deposits with maturity, annual or semi-annual profit pay out options should remain invested in the CMP under a payable account, so that the higher weightage for such deposits is justified.

- The accounting policies and standards followed by the IB would have a significant impact on the results of pool's constructive liquidation. Measurement of the receivables on gross basis or at amortized cost, valuation of the assets at book value or market value, the quality of valuation reports if assets have to be recorded at marked-to-market price will tilt the results of constructive liquidation one way or the other. Similarly, the policies adopted for depreciation of the CMP's fixed assets (whose expense has to be borne by the CMP, being their owner) can have a significant impact on the results. Creation of provisions and reserves is another factor which would affect the outcome of a constructive liquidation.

- Therefore, the IB should have a clear policy regarding all these issues so that it can carry out the constructive liquidation of the CMP in a professional and objective manner, without giving the IB any undue leverage, enabling it to change the results through unnecessary subjective provisioning, or moving the goal posts as per its own whims.

2.7 Creation and reversal of provisions in the CMP

The profit and loss of the CMP, as a separate entity from the IB, are borne by the investors (depositors and the IB when it invests its own funds in the CMP) pro rata as per their share in the investments, with the IB getting the entire profit of its own funds invested in the CMP as well as the mudarib share from the profit of the depositors' funds, while the depositors get the agreed percentage of the profit of their funds.

If a provision is created in the CMP, it has to remain invested in it, with its profit being added to it continuously, till the time its fate is decided by either compensating for the envisaged loss or being reversed to the CMP revenue account, if it transpires that the provision is not required any more.

How should a provision that is not required anymore be reversed? Some may argue that since the provision was created from the profit generated by the funds of the old depositors, it should be returned to them. This view would not only be impossible to implement but it would also be inconsistent with the dynamics of the CMP where the funds are pooled together, without any tagging or linking of any fund with any particular asset or specific transaction. This opinion also likens a provision to a reserve, whereas they are different in nature, as the former is an expense which has to be booked even if there is no profit; and hence, it is excluded from the profit calculation in constructive liquidation of the pool. Based on this, since the amount segregated for the provision was not part of the profit recognized or distributed, it never belonged to the old depositors in the first place; and hence no question of returning the same to them would arise.

Even if it is accepted, just for the sake of argument, that a provision has been created from the profit of the old depositors, it must be noted that it has been created from an amount segregated, as per the rules of profit calculation, for the account of provision, where the depositors waive their rights in those amounts for the benefit of the entire pool. As such, it no longer belongs to them; and hence there is no obligation on the IB to return the same to those depositors. Further, since many of the old depositors may have left the CMP, it would be impossible to trace them in order to return to them the exact amount that had been taken from them for creation of the provision. Therefore, the only viable option is to return the provision to the CMP.

Since most of the provisions are created and developed in a phased manner, the reversal could be also made in a phased manner or immediately (in case an outstanding liability against which the provision was created is settled/paid off). At times, such an immediate reversal may inflate the profit of a certain profit distribution period unrealistically. To avoid paying inflated profits for the profit distribution period in which such a provision is reversed, IB can create a profit equalization reserve (the "PER") or an investment risk reserve (the "IRR") as per the profit distribution policy.

However, since the balance sheets and profit & loss accounts of the CMP and the IB have to be totally independent from each other, it is not allowed under any circumstances to reverse a provision created out of the income of the CMP to the balance sheet of the IB or vice versa.

2.8 Determination of the shareholders' funds

In case the IB is commingling its own funds with the mudaraba funds in the CMP, it has to determine its exact investment in the CMP. For determination of the shareholders' funds in the CMP the following mechanism should be adopted:

The daily average balances for the following accounts would constitute the aggregate investment by the shareholders in the CMP:

- Shareholders' equity funds which comprise the paid up capital, statutory reserve, general reserve and retained earnings, if any.

- Funds belonging to customers and other parties but guaranteed for repayment by the shareholders such as the average balance of the current accounts, margin accounts or any other accounts, under any name, if they are in the form and nature of current accounts. On the basis of the Shari'a maxim that says, "He who has taken the risk of an asset is entitled to its profit" the shareholders would be entitled to the return generated by investing these funds in the CMP.

- The following would be deducted from the total product of the above two:

  a. Current accounts and reserves with the Central Bank of the country;

  b. Cash in hand, including the cash in the ATMs;

  c. Current accounts with the other banks within and outside the country;

  d. Fixed Assets of the IB;

  e. Investments made by the IB as an entity (subsidiaries, overseas branches etc, if any);

  f. Investments made by the IB, in its capacity as an independent entity from mudaraba and not as a mudarib, in restricted accounts or activities (e.g. funds, sukuk etc);

  g. Average balances of any amounts extended as qard hasan to certain customers (credit cards, overdrawn current accounts etc) or to the employees of the IB or any other party.

The net average balance of the above shall be the Shareholders' funds invested in the CMP.

2.9 Determination of the depositors' funds

Broadly speaking, there are two types of deposits in an IB:

- Current accounts: the holders of which deposit their funds with the IB for safekeeping but since the depositor permits the IB to use the money at the IB's risk and the IB guarantees to pay back a similar amount, the current deposits are considered as qard, and consequently their averages are added to the equity of the shareholders and invested on their behalf in the CMP.

- Investment deposit: it would be based on mudaraba if it is received for investment in the CMP. There could be wakala or musharaka based deposits also, but they should be invested, in principle, separately and not with mudaraba-based funds in the CMP. However, exceptions to that rule could be made under special circumstances provided the rules and terms for such exceptions are strictly adhered to.

The investment deposits in the CMP are either savings accounts of various types and features or term deposits; and both are obtained on the basis of unrestricted mudaraba. The major difference between the two is that the funds in a savings account may be withdrawn at any time (in certain cases after serving a notice period), while the funds in a term deposit are committed for a specific time limit to be entitled to a better weightage for profit distribution, and as such, cannot be cashed prematurely unless the IB consents to that.

In case of term deposits, the profit is paid on the amount of the deposit which has to remain constant, while in case of savings deposits, there could be more than one kind of product, with the rules and terms of each product differing in line with the differences in the features of the products.

2.10 The weightage system

The basic rationale behind allocation of weightages is that the bigger the size of the fund and the longer the term for which it is committed, the better would be the possibility of its deployment in more profitable businesses. Accordingly, savings deposits, being demand deposits, get lower weightages because the IBs have to keep some of the funds either idle or invest them in short-term and low-yield investments to cater to the liquidity requirements. Further, if the profit is paid on each profit distribution date, only the principal gets invested in the subsequent profit distribution, while in case of profit payout at maturity or after more than one profit distribution dates (quarterly or annually for instance), the declared profit of the deposit in every profit distribution period, by remaining in the pool, is added notionally to the principal, and hence such a deposit deserves a higher weightage.

The following parameters should be followed while allocating or changing the weightages:

- The depositors are partners, and Shari'a allows distribution of profit in proportion to the capital of each partner, or on the basis of any agreement that may allocate a higher share of profit to one partner or segment of partners, provided the formula is known and agreed to by all, and it does not deprive any partner from a share in the generated profit.

- This transparency and agreement of the partners on the formula is essential because if a higher weightage is allocated to any tier, it means that a higher percentage or share of profit will go to that tier, decreasing the share of the profit of other tiers or some of them proportionately. Therefore, the weightages for every tier should be allocated on the basis of the formula agreed upon by all the depositors at the time of depositing their funds in the CMP. in line with the rationale given above and reflecting that logic in a just manner.

- The weightages cannot be allocated in an arbitrary manner; nor is it allowed to allocate higher or lower weightages for any reasons other than the objective criteria mentioned above. For instance, no specific weightage can be given to deposits for children or old people or for the staff deposits. Similarly, higher weightage for smaller funds should not be allowed.

- Since prior knowledge and agreement of the partners on the profit distribution formula is a pre-requisite of a Shari'a compliant partnership, the weightages cannot be changed without their knowledge and consent which requires announcement of the new weightages well before commencement of the profit distribution period in which the new weightages would be applied. A notice period of at least 2-3 weeks should be given to the depositors, providing them with an opportunity to withdraw their funds if they do not accept the new weightages. Since obtaining written acceptance of thousands of customers would not be possible, if the customers do not approach the IB for withdrawal of the funds within the notice period, this is considered, under the terms of the mudaraba contract signed by the depositor, as a tacit approval of the new weightages. Hence, the new weightages could be applied in the next profit distribution. Unfortunately, some IBs change the weightages frequently without going through the due process of serving notices to the depositors to give them the option of withdrawal. This practice should be stopped by the Shari'a boards of these IBs or the regulators.

- Any change in the weightages should be based on a proper study and analysis of the market dynamics and supply of funds in the market, and it should be made only after the Shari'a board of the IB has reviewed the study and has approved the new weightages based on it. Further, since the majority of the customers do not understand the dynamics of the weightages, a chart explaining the positive or negative impact of the new weightages on each tier should also accompany the announcement of the new weightages on the website of the bank and its branches.

- If a customer objects to the new weightages and consequently wants to withdraw his funds before maturity, such a deposit should get the profit of a similar amount in the tier/period for which it has remained invested in the CMP, and should not be penalised by downgrading it further even if the terms and conditions so stipulate.

- An increase in the weightage of a tier would benefit that tier at the expense of the other tiers/depositors of the CMP, while a decrease in its weightage would have an opposite effect, and as such the allocation of weightages should be based on this logic, where an increase in weightage could be justified as beneficial for the entire pool. However, many IBs raise or lower weightages of certain tiers or products due to the fact that they package certain services provided by the Bank in a service provider capacity different from that of the mudarib within a certain product. For instance, if a customer accesses his deposit through internet, he would be given a higher weightage, or if he executes more than a certain number of transactions in his savings account, he would get a lower weightage or forgo the profit of that period. These features or products have been copied from conventional banks where the benefit of a lower weightage would compensate the conventional bank for the services it provides, while this is not the case in the CMP. The mudarib has no right to burden the entire CMP by allocating a higher weightage to a tier while the benefit is reaped by the mudarib alone. Similarly, it should be understood that allocating lower weightages to a tier which avails such free services from the mudarib that are not related to mudaraba, or waiver by depositor of his share in profit would benefit the entire CMP. As such only a portion of the waived profit will go to the mudarib as mudarib's share in the profit as well as through the profit of its own funds invested in the CMP; and hence allocation of lower weightage to such a deposit would not be justified.

- Weighted average balance should be worked out by multiplying the average balances into the assigned weightage percentages. In case the IB has to keep a particular percentage of certain types of deposits as a cash reserve with the central bank of the country, the same should be deducted from the averages and the remaining funds multiplied by the weightages to arrive at the amounts which were invested in the CMP as adjusted average balances.

2.11 Profit smoothing techniques

The income of the CMP usually remains stable when the asset quality is good and the pool grows in size. However, at times, the income of certain profit distribution periods may drop in case provisions need to be created for losses and bad assets, or because of delays in acquisition of assets for which the IB has made the disbursement, but the investment is yet to be made. The problem could be exacerbated if a large asset of a small CMP goes bad, while in case of large-sized CMPs the impact may not be that severe. In such cases, normally the IBs try to compensate the depositors through passing on a share of their own profit to the depositors in order to retain them.

Conversely, an IB may have extraordinary profit in a certain profit distribution period as a result of booking the profit of the acquisition period of a certain asset that it has recently financed, or settlement of a bad asset which requires reversal of the provision created earlier, etc.

The techniques used for smoothing of the profit are either by creation of profit equalization reserve or an investment risk reserve in such cases where the generated profit is higher than returns on similar investments, while the mudarib may give away a share of its profit to the depositors in case the generated profit is lower than competitive rates of return on such investments.

However, to safeguard the interests of the depositors and ensure Shari'a compliance, creation of PER or IRR, or the mechanism of forgoing a share of the mudarib's profit in favour of the depositors must have prior approval of the Shari'a board of the IB.

2.11.1 Creation of the profit equalisation reserve

If there is an extraordinary stream of income which has resulted in an unusual increase in the profit which is substantially higher than the normal market rates of return on such funds for a certain profit distribution period, the IB may decide to create a PER after taking permission from the Shari'a board. The IB can rely on this reserve for the interest of all the fund providers/investors in the CMP as well as the shareholders in case of unfavorable or competitive market environment where the returns are below the anticipated or desired level.

a) In that case, before distributing the net profit of the CMP amongst the shareholders and depositors, an equalization reserve may be established by transferring a suitable percentage of the overall net profit to it.

b) The reserve amount should be invested in the CMP as a deposit in the relevant tier getting appropriate weightage and its profit should be added to the same account.

2.11.2 Creation of investment risk reserve

a) In case the IB wants to get its share in the extraordinary profit for any profit distribution period, but the rate of return on the deposits are substantially higher than the market rate on similar funds, the IB may decide to create an IRR, with prior permission from the Shari'a board, by transferring a portion of the depositors' profit to the IRR account.

b) In case the rate of return to the depositors in a certain profit distribution period is lower than the market rates or there is a loss, the IB's management may decide to compensate the depositors by transferring the required amount from the IRR account to increase the depositors' return.

c) The balance of this reserve account should be invested in the CMP, and given appropriate weightage as approved by the Shari'a board, and profit thereon should also be added to the same account.

2.11.3 Shareholders may forgo a portion of their profit to their depositors

The shareholders may decide to give up a portion of their own profit to the depositors or to a specific category of depositors. Should the shareholders decide to do so, proper disclosure about it should be made in the profit distribution sheets and/or accounts of the IB.

However, it has been observed that the practice of hiba (gift) is used by some IBs for two purposes: first, to be able to give a fixed rate of return to corporate or rate-conscious customers, and second to be able to manage the cost of the mudaraba funds. To remedy the first misuse of this principle, the Shari'a board of the IB should not allow hiba for specific customers; rather if the IB desires to forgo a share of its profit for the depositors, it should do so for the benefit of all the depositors by deducting a lesser percentage of profit than what it deserves from the profit of their funds, or by giving a share of its profit to those tiers whose profit is lower than the expected rate of profit.
To tackle the second issue, the weightage system in the profit distribution model should be prepared after a thorough analysis of the impact that the product features may have on the profit rates of various tiers, and in a manner that would eliminate or minimize the need for raising the rate of profit through forgoing a share of the shareholders' profit in favour of the depositors or certain tiers of them.

Further, an IB should not create an IRR and at the same time give hiba from its own share of profit to some tiers, as by creation of IRR, it claims that the profit is higher than the market rates or the expected rate of return from the CMP, while by giving hiba to some tiers it says that the profit in those categories are lower. Such situations may arise at times, but this should not be allowed as a practice.

2.12 Profit for broken period and pre-mature encashment/withdrawal from mudaraba

Profit for Broken Period: If a deposit matures in the middle of a profit distribution period, one of the following two methods may be followed:

a) The principal amount and profit accrued till the last declared rate is credited to the customer at maturity. The profit for the broken period, the number of days in the period in which the deposit has completed its tenure, is paid at the end of the profit distribution period after its profit is calculated and the rate declared.

b) The IB pays to the depositor, on the maturity date, the principal amount and the profit declared till the last declared rate, in addition to an amount equal to profit at the declared rate for the same tier in the last profit declaration. However, in this case, the profit for the broken period would not be the actual profit, but would be an amount paid on account of the profit which means that it would be subject to adjustment and settlement once the actual profit is determined. Therefore, once the actual profit for that month is declared, the amount paid on account of the profit should be adjusted against the actual profit, by paying to the customer the extra profit amount if the actual profit is more than the amount paid on account of the profit, or deducting from the customer's account any excess amount should the actual profit be less than the amount paid on account of profit.

Although mudaraba is not a binding contract, once the mudarib commences the business and deploys the funds, the fund provider may terminate the mudaraba, but he cannot ask for immediate withdrawal of his funds. Rather, he would have to wait till liquidation of the mudaraba assets takes place, or somebody else is willing to purchase his share in the mudaraba assets. Further, if a period has been defined for mudaraba, as is the case between the IBs and the customers who agree on a time-bound mudaraba such as a term deposit, the contract becomes binding for the committed period, and hence no pre-mature encashment request should be made.

It may also be noted that since the profit sharing mechanism is based on a weightage system which gives the period of the investment a weightage, it is normal to require the customer to maintain his funds in the CMP for its full tenure to be eligible to enjoy all applicable weightages. However, the IB may accept a request by the customer for pre-mature withdrawals within certain parameters approved by the Shari'a board. In this case, the deposit would be given revised weightages, considering the actual period for which the deposit has remained with the IB and the terms announced for premature withdrawal or agreed upon at the time of settlement.

To safeguard the benefit of other depositors and stop misuse of the weightage system, when a deposit is en-cashed prematurely, the profit paid to the customer would get adjusted on the basis of the new weightage, and this would result in reversal of a portion of the profit allocated to the depositor or accrued for his account. Such reversed profit should go to the PER for the benefit of the entire pool as the higher accrual or payment of the profit to the customer in question on the basis of the initial weightage has affected the profit share of other tiers in the pool.

2.13 Conclusion

To sum up, the article is an attempt to highlight the evolving nature of the products and dynamics of the CMP in the Islamic banking industry. It emphasizes the need for developing a comprehensive profit allocation and distribution policy to ensure complete Shari'a compliance and transparency. The rules related to the expenses of the mudarib and mudaraba, calculation of the funds invested in the CMP and constructive liquidation of the CMP such as accounting policies, valuation methods, creation and reversal of provisions etc. have been discussed in some detail. After highlighting the rationale of the weightage system, apprehensions with regard to arbitrary allocation of weightages and their amendment without the consent of the customers have also been highlighted. At the end, some basic parameters on profit smoothing techniques, premature encashment and profit for broken period, the period between the last profit declaration date and deposit's maturity, have been discussed.