مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

معيار معادلة الأرباح في المصارف الإسلامية

STANDARD REGARDING PROFIT EQUALIZATION FOR ISLAMIC BANKS

Article (1)
Introduction

1.1 This Standard Regarding Profit Equalization for Islamic Banks ("the Standard") constitutes additional requirements to the Standards Re Risk Management Requirements for Islamic Banks issued by the Central Bank. This Standard is mandatory and enforceable.

1.2 This Standard is issued by virtue of the powers conferred by the Central Bank under the provisions of Decretal Federal Law No. (14) of 2018 Regarding the Central Bank & Organization of Financial Institutions and Activities and its amendments ("the Central Bank Law").

1.3 This Standard elaborates on the supervisory expectations of the Central Bank with respect to profit equalization in Islamic Banks and it must be read in conjunction with the regulations, standards and resolutions issued by the Central Bank and the Higher Shari'ah Authority ("HSA").

1.4 For the Shari'ah aspects related to profit equalization, all Islamic Banks and banks housing an Islamic Window operating in the UAE ("Islamic Banks or "IBs") are required to comply with the Shari'ah requirements issued by the HSA.

Article (2)
Scope of Application

2.1 This Standard applies to all IBs. Islamic Banks established in the UAE with Group relationships, including Subsidiaries, Affiliates, or international branches, must ensure that the Standard is adhered to on a solo and group-wide basis.

2.2 Islamic Banks may maintain more than one investment pool for different Investment Account Holders ("IAHs"). Each investment pool may earn a different return depending on the yield of the allocated and/or tagged portfolio of assets. The IBs must maintain the separation of accounts for each investment pool.

Article (3)
Profit Equalization Techniques

3.1 The preponderant portion of the profit-generating funds raised by IBs is based on Mudaraba and Wakala contracts. The funds raised are further deployed into the pool that the IB manages in its capacity as Mudarib or Wakil ("Fund Manager"), for both of which the IB enjoys certain rights and undertakes certain responsibilities. IAHs bear the commercial risk associated with the underlying investments made using their funds unless there is negligence, misconduct or breach of contract from the IB. Nevertheless, the return to be distributed to the IAHs can only be ascertained at the end of the investment period. Contractually, IAHs are only entitled to profits or returns if the pool's underlying assets perform. The profit sharing and loss bearing contracts expose IBs to different risks, which require adherence to strong risk management governance and a high degree of transparency.

3.2 Therefore, one of the key risks IBs are exposed to is Displaced Commercial Risk ("DCR") whereby the IB may be under market pressure to voluntarily pay a return that exceeds the rate that has been earned on the assets financed by IAHs' funds, when the return on assets is under-performing when compared with competitors' returns.

3.3 IBs are expected to develop and implement a sound methodology to identify, monitor, measure and report the impact of DCR and the amount needed to mitigate the exposure. The methodology must be applied systematically and reviewed regularly. Any changes to the adopted methodology must be justified and approved at the appropriate management level and the Board, if applicable.

3.4 In managing this risk, IBs may adopt the following profit equalization techniques:

i. Establish an Investment Risk Reserve ("IRR"). This reserve represents the amount appropriated by the IBs out of the income of IAHs, after allocating the Mudarib's profit, in order to cushion IAHs against future investment losses. IBs must develop models to determine the size of the IRR and the periodic contributions to be made to build up the IRR over time.

ii. Establish a Profit Equalization Reserve (PER) by setting aside amounts from the profits before allocation between the IAH and IB. IBs may fully or partly utilize the amount of the PER to improve the returns for IAHs during periods when the investment pool's profits are below market expectations.

iii. Unconditionally, and based on the IB's absolute discretion:

a. Forgo part of or its entire profit as the Mudarib, in favor of the IAH in order to increase the profit attributed to the IAH; and/or

b. Transfer the IB's current profits or retained earnings to the IAH on the basis of Hibah / gift.

3.5 IBs may combine more than one technique in order to equalize the profit payout to IAH so as to match the current market returns. The techniques applied must be duly disclosed and compliant with the applicable laws and regulations, including HSA resolutions.

3.6 Subject to 3.1, the IRR and PER must be reflected in the audited financial statements in accordance with the appropriate accounting treatment and must be invested in Shari'ah compliant activities only. Any return from such investment must be credited back to the IRR and PER as applicable.

3.7 IBs must set limits for the amounts transferred to the IRR and PER and must distribute the rest to the IAHs.

3.8 If the IB has various Investment Accounts ("IA") (with different categories/types/tiers), the IB must ensure that any accumulated reserve (appropriated from a specific category/type/tier) will benefit only the respective IAs, avoiding, in the process, any cross funding.

Article (4)
Governance Requirements

4.1 The Board is responsible for providing robust oversight and a sound monitoring function to ensure that IAs are managed in the best interests of IAH.

4.2 The Board must ensure that profit equalization internal policies, procedures and controls are developed and periodically updated in order to ensure adequate and prudent profit equalization. The Board must ensure that the internal policies, procedures and controls are adequate and duly approved by the Internal Shari'ah Supervision Committee ("ISSC").

4.3 The Board must review and approve the policies and strategies of the investments, and strategies for the management of DCR, and conduct regular reviews of the investment policies and the performance of the asset portfolio in which IAHs funds are invested.
The broad policies and strategies must address, *inter alia*, the following areas:
- i. The management of DCR, including the limits to and tolerance level of DCR;
- ii. the policies and mechanisms used in respect of the IB forgoing its share of profits in favor of the IAH; and
- iii. appropriations to reserves and provisioning, in accordance with the agreed contractual terms and conditions for IAH.

4.4 In order to ensure that profit equalization, including utilization of reserves such as PER and IRR, are appropriately checked and monitored, the Board must form an independent committee ("the Committee") mandated to scrutinize the utilization of such reserves and to make appropriate recommendations to the Board. The Committee 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 line with the HSA and ISSC resolutions.

4.5 The Committee shall comprise of at least three members:
- i. an independent non-executive director (preferably chairing the Committee);
- ii. a member of the Board; and
- iii. a member of the ISSC.

Any increase of membership in the Committee must be filled by independent non-executive directors.

4.6 The Board or its committees must ensure rigorous and diligent oversight policy, process and procedures over the following:
- i. the financing and investment activities undertaken by the IB using IAH's funds;
- ii. the fiduciary duties performed by the IB, which must be in accordance with the terms and conditions of the Mudarabah and Wakala contracts between the IB and its IAH; and
- iii. the level of reserve allocation, ensuring that it is appropriate and fair to both existing and new IAHs.

Further, as a part of systems and controls, compliance, internal Shari'ah compliance, internal audit and internal Shari'ah audit functions of the IB must verify the compliance of the IB to approved policies and procedures relating to profit calculation and equalization.

4.7 The Committee shall also evaluate the disclosures made by the IB regarding its asset allocation and investment strategies in respect of IA, in order to monitor closely the performance of IB as managers of such accounts.

4.8 The ISSC must ensure that all IB's practices related to profit equalization are Shari'ah compliant. This includes reviewing and approving the establishment and any changes to:

i. the internal policies and procedures related to profit equalization,
ii. the contractual arrangements between IAHs and the IB, including terms and conditions and the profit equalization arrangements,
iii. the profit distribution mechanisms as well as the profit distributed, including appropriation to the PER and IRR,
iv. the maintenance of the PER and IRR and their deployment, and
v. the policy regarding liquidation of PER and IRR.

Article (5)
Disclosure Requirements

5.1 IBs must clearly demonstrate, in IA related contracts and agreements to IAH, any equalization practices that are employed by the IB, including the approach towards allocating a portion of income which is appropriated for building up reserves such as PER and IRR.

5.2 IBs must explicitly disclose the following requirements within IA contracts entered with IAH:

- the rights and liabilities of both parties – in particular, with respect to the circumstances where losses are to be borne by the IAH and the implications on contractual rights of the IAHs with regard to early withdrawal and early redemption;
- the extent of management's right to appropriate IAH's share of investment profits in order to build up PER and/or IRR, to use these reserves to equalize profit payouts to IAH, and the deployment of unused balances on these accounts when the relevant Mudarabah contract matures;
- the accountability and responsibility of the IB to disclose accurate, relevant and timely information to the IAH on the investment of their funds, including its performance, investment policies, valuation, and frequency of valuation of the IAH funded assets; and
- the rights of IAH in the event that the IB fails to perform its fiduciary obligations in accordance with the applicable IA contract, that is, in the event of proven negligence or misconduct or breach of contract by the IBs whereby the IBs will have to compensate the IAH for any loss.

5.3 IBs must make adequate and timely public disclosures in their annual report, website and any other means used by the IBs, of any material changes to their policies regarding profit calculation, asset allocation, investment strategies and mechanics of equalization of the returns (if any) in respect of the IAs that they manage. The IB must allocate appropriate time between the announcement and the changes being effective.

5.4 The utilization of PER for equalizing the returns to IAH and shareholders, as well as the use of IRR for covering losses (if any), is an issue of public interest and must be publicized via the usual means used by the IB as well as in the annual report of the IB.

5.5 IBs must disclose information on policies, procedures, product design/type, profit allocation basis and differences between restricted and unrestricted IAH in addition to the clarity and transparency regarding the rates of return and associated risks that are applicable to IA.

5.6 Disclosures on the IBs' websites and notice boards in branches / client-facing offices must include:
   i. Percentage of Mudarib Share for the concerned period and at least two previous financial periods in each category of IA.
   ii. Weightages assigned to each category of IAs for the concerned period and at least two previous financial periods.
   iii. The actual monthly/periodic profit/loss distributed to each category of IA during the last 2 years.
   iv. Key highlights of PER and IRR policies.

5.7 IAH disclosures must contain information to reflect, with the appropriate level of detail, the direct and indirect fees, expenses, taxes deducted and the net amount received by the IAH based on the profit calculation and allocation methods adopted by the IB.

5.8 The IB shall be encouraged to provide simplified disclosures, using simple language, and easy-to-understand measures of risk and risk-sharing.

Article (6)
Liquidation Requirements

6.1 In the event of voluntary liquidation, the IBs must dispose the outstanding IRR and PER in accordance with the agreed terms and conditions at the time of establishing the reserves.

6.2 The ownership over the profit equalization reserves, including the IAHs', must be clearly stated and publicized.

Article (7)
Reporting

Periodic reports must be shared by the Board with the Board committees, ISSC and the Central Bank, stating the current state of the reserve, amount used for the equalization of the profit, and the amount allocated for investment.

Article (8)
Compliance with the Standard

8.1 The IBs must comply fully with the requirements stated in this Standard within 180 days from publishing this Standard.

8.2 The Regulatory Development Division of the Central Bank shall be the reference for the interpretation of the provisions of this Standard.

Appendix: List of disclosures

The disclosures indicated may be made as part of the periodic financial reporting (marked "**F**" in Tables 1, and 2), or as part of product information published in connection with new products or changes in existing products – for example, prospectuses and offer documents (marked "**P**" in Tables 1, and 2). Some disclosures may be made under both headings.

Table 1: Investment Accounts (both Unrestricted and Restricted IAH)

			F	P
General Qualitative Disclosures	1.	Written procedures and policies applicable to the IAs, including a synopsis of the following: • range of investment products available from the IB; • characteristics of investors for whom various investment accounts may be appropriate; • purchase, redemption and distribution procedures; • experience of portfolio managers, investment advisors and trustees; • governance arrangements for the IAH funds; and • procedures for trading and origination of assets.		√
	2.	Disclosure that IAH funds are invested and managed in accordance with Shari'ah requirements.	√	√
	3.	Product information and the manner in which the products are made available to investors.		√
	4.	Bases of allocation of assets, expenses and profit in relation to IAH funds.	√	
	5.	Disclosure on the policies governing the management of both unrestricted and restricted IAH funds, which covers the approaches to the management of the investment portfolio, establishment of reserves, and the calculation, allocation and distribution of profits.	√	√
General Quantitative Disclosures	6.	PER-to-IA ratio – that is: Amount of total PER / Amount of IA by type of IAH.	√	
	7.	IRR-to-IA ratio – that is: Amount of total IRR / Amount of IA by type of IAH.	√	
	8.	Return on Assets (**ROA**) – that is: Amount of total net income (before distribution of profit to unrestricted IAH) / Total amount of assets financed by shareholders' equity and minority interests, unrestricted IAH, and current accounts and other liabilities.	√	
	9.	Return on Equity (**ROE**) – that is, Amount of total net income (after distribution of profit to IAH) / Amount of shareholders' equity.	√	
	10.	Ratios of profit distributed to IA by type of IAH.	√	√
	11.	Ratios of financing to IA by type of IAH.	√	

Table 2: Unrestricted Investment Accounts

			F	P
Additional Qualitative Disclosures	1.	General investment objectives and policies that are offered to the unrestricted IAH based on the general business strategy and risk-sharing policies of the IB (including commingling of funds).		√
	2.	Disclosure on the major changes in the investment strategies that affect the investment accounts (including commingling of funds).	√	√
	3.	Method for calculation and distribution of profits.		√
	4.	Rules governing the transfer of funds to or from PER and IRR.	√	√
	5.	Bases applied for charging expenses to unrestricted IAH.	√	√
	6.	Description of total administrative expenses charged to unrestricted IAH.		√
Additional Quantitative Disclosures	7.	Total amount of unrestricted IAH funds, and sub-totals by asset category.	√	
	8.	Share of profits earned by unrestricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested).	√	
	9.	Share of profits paid out to unrestricted IAH, after transfers to or from reserves (amount and as a percentage of funds invested).	√	
	10.	Changes on PER during the year.	√	
	11.	Changes on IRR during the year.	√	
	12.	Disclosure of the utilization of PER and/or IRR during the period.	√	
	13.	Profits earned and profits paid out over the past three to five years (amounts and as a percentage of funds invested).	√	
	14.	Amount of total administrative expenses charged to unrestricted IAH.	√	
	15.	Average declared rate of return or profit rate on unrestricted IA by maturity (3-month, 6-month, 12-month, 36-month).		√
	16.	Changes in asset allocation in the last six months.	√	
	17.	Off-balance sheet exposures arising from investment decisions, such as commitments and contingencies.	√	
	18.	Disclosure of limits imposed on the amount that can be invested in any one type of asset.	√	√