

## ISWGNA Task Force on Islamic Banking

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### Classification of property income associated with Islamic financial services

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## Diversity of Islamic financial instruments

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- Islamic financial instruments use a variety of cash flows to produce income for investors and banks. Potentially, each type of instrument must be tracked in order to compile data on property income generated.
- Also, country-by-country differences exist for each instrument.
- *For conventional banks*, the income statement top line is Net interest income, equal to gross receipts less payments.
- *For Islamic banks* (next slide), income receipts (**line 3a in red**) must be calculated on an instrument-by-instrument basis; payments to account holders (**line 6a in red**) also must be calculated instrument-by-instrument.
  - Lines 3a and 6a both include diverse types of SNA income and other flows – trading profits, rents, fees, capital gains, etc.
  - Rates of return and their volatility can differ by type of instrument
  - Types of income must be handled separately for SNA purposes

## Islamic bank revenue from jointly funded assets per *PSIFI Compilation Guide*

Components of Revenue from Jointly Funded Assets		
Line		Formula
1	<b>Net Income from Jointly Funded Assets</b>	2 – 6a + 7
2	Revenue from Jointly Funded Assets (UPSIA)	3 – 4– 5
3	<b>Revenues by type of income</b>	3a – 3b
3a	<b>By type of income</b>	
3b	<i>less</i> Provisions for accrued income on non-performing assets	
4	<i>less</i> Financing and nonfinancing costs	4a + 4b
4a	Provisions for sub-standard or bad financing	
4b	Other costs	
5	<i>less</i> Transfer to Profit Equalization Reserve (PER)	
6	<i>Memo: Income available to IAH and bank (UPSIA)</i>	6a + 6b
6a	<b>Income distributable to IAH*</b>	
6b	Income available to bank from unrestricted revenues*	
7	Bank share in restricted investment income (RPSIA) *	

## Line 3a – PSIFI Enumerated financing instruments

### ST07 - Total financing (Type of revenue generated)

Murābahah (Sales based)
Commodity Murābahah / Tawwaruq (Sales based)
Salam (Sales based)
Istisnā` (Sales based)
Ijārah / Ijārah Muntahia Bittamlīk (Leasing/Leasing concluding with sale)
Muḍārabah (Profit and loss sharing between bank and depositor)
Mushārah (Profit and loss sharing partnership)
Diminishing Mushārah (Profit and loss sharing with amortizing partnership)
Wakālah (Fees for agent or fiduciary)
Qarḍ Hassan (Benevolent loan with no remuneration)
Others (Often variations of above with different names)
Amanah (Deposits in trust with no remuneration – used for current accounts)
Wadiah (Deposits for safekeeping with no remuneration)

## Line 6a – Types of funding

### ST04 – Total funding/liabilities and equities

Profit-sharing investment accounts (PSIA)

Other remunerative funding (Murābahah, Commodity Murābahah etc.)

Nonremunerative funding (current account, Wadī'ah)

Sukūk issued

Other Sharī'ah-compliant securities issued

Interbank funding/liabilities

All other liabilities

Capital and reserves

## Profit-sharing investment accounts (PSIA)\*

- Classic form of funding of Islamic banks - Mudarabah and Musharakah
- Funds placed in PSIA are considered to involve a mix of deposits and investment-type sharing of financing, rewards, and risk. Those placing the funds are called Investment Account Holders (IAH).
- Funds in PSIA accounts are managed by the Islamic bank and receive returns based on the income generated by the funds.
- PSIA are important and their special features must be handled in SNA methodology, but other funding instruments must also be covered.
  - PSIA are widely used, but extent varies considerably by country - PSIFI survey shows rates of 77% of funding down to 0%.
  - Recent shift toward use of less risky remunerated accounts, such as Murabahah – these are more used than PSIA in at least 5 countries.
  - Current accounts and other non-remunerated funding typically provides ¼ to 1/3 of total funding

## Payments made on PSIA

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- Returns on PSIA are based on the type of financial instrument in which they are invested.
- Returns are not guaranteed – funds placed are at risk of loss – thus they have character of risky investments.
- Payments to IAH are not considered as interest liabilities, but as quasi-equity returns.
  - Because IAH bear some risk and the bank does not have a liability to repay deposits and to pay interest, IFSB supervisory capital adequacy standard permits adjustments to capital adequacy ratio to lower the amount of risk to be covered by the bank's own supervisory capital.

## Types of PSIA

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- Unrestricted PSIA – Funds are intermixed with other IAH and the bank. Recorded as on-balance-sheet. (UPSIA)
- Restricted PSIA – IAH instruct the bank on how the funds may be used. Accounts are segregated. The IFI provides asset management investment services and receives fee income in exchange for its services and expertise. (RPSIA)
  - The funds and income they generate have traditionally been treated off-balance-sheet.
  - *However, per AAOIFI FAS 27 some funds are required to be treated on-balance-sheet.*

## Property income for PSIA

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- Musharakah
  - Appears to be a true joint venture for which returns should be treated as investment gain or loss
  - Separate data on Musharakah accounts are not usually available for statistical purposes → Statistical treatment likely to cover PSIA as a whole
- Mudarabah
  - Actual returns are based on the specific instruments financed by the funds
  - Often have effective characteristics of deposits
    - Public considers them like deposits
    - Often have returns equivalent to deposits
    - Mechanisms exist to smooth returns to make them deposit-like

## PSIA distributions to IAH

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- Rather than offer interest returns on deposits, PSIA provide “indicative rates of return” based on recent history that IAH might expect but which are not guaranteed; legal/ethical requirements exist to not misrepresent likely returns.
  - Usually close to deposit rates, but often with a slight premium due to additional risk
- Bank calculates the return to each IAH based on instruments used and length of time funds are used
  - Returns could be more or less than indicative rate; capital not guaranteed.
- For competitive reasons, Islamic banks’ distributions need to be comparable to regular deposits
  - Research has verified this is often the case
- Smoothing techniques are used to provide competitive returns

## PSIA Smoothing Techniques

- *Displaced commercial risk (DCR)*. For competitive reasons, IFI owners can forgo part of their own profit share in order to smooth returns to IAH. This can be directly out of profits (empirically the most common form of smoothing) or by creating special reserves for smoothing purposes.
- *Profit Equalization Reserve (PER)* sets aside profits for distribution to IAH to smooth the returns paid. Funds are set aside from profits prior to calculating the bank's share of profits and the distribution between IAH and shareholders. Shifts rewards between generations of IAH.
  - Because PER is *allocated before deducting the IFI share*, in effect it has a superior status
  - Funds for the PER are allocated based on estimated monthly income, or by topping up a desired level of the reserve from annual earnings.
- *Investment Return Reserve (IRR)* is set up from the net income of IAH in order to avoid investment losses to IAH. Funding for the IRR is after deducting the IFI's profit share, and thus is solely owned by the PSIA. It is typically used to cover losses to IAH capital and not to smooth profits.

## Economic flows of PSIA

- PER and IRR data for statistical purposes are enumerated on the balance sheet
- Applying economic concepts to smoothed PSIA returns defines economic flows that parallel treatment to interest within an expanded concept of returns on funding/deposits.
- Moreover, the specific characteristics of certain Islamic financial instruments result in payments flows very similar to interest payments on deposits – for analytical and statistical purposes it is useful to treat these flows as similar to interest paid by conventional banks.
- *Defines a new term "interest and similar investment returns"*
  - No time value of money nor discounting of future returns is implied.

## Estimating PSIA payments in National Accounts

- For *PSIA accounts*, the payments stream should be measured by Slide 2 line 6a "Income distributable to IAH". On an accrual basis these are treated as distributed to IAH (any amounts not actually disbursed are treated as reinvestment in a separate transaction) *plus* line 5 "Transfer to Profit Equalization Reserve (PER)" which shows amounts transferred into reserves from the current accrued income of IAH.
- In contrast, *on a cash basis* actual payments to IAH must reflect additions to PER or IRR or withdrawals from PER or IRR reserves built up from earlier returns. Funds withdrawn from reserves were previously recorded in the SNA as part of current income that has been reinvested, and thus withdrawals should be recorded as transactions in financial assets, which reduces the IAH claim on the bank.
- Rates of payment for PSIA accounts can be calculated as total payments divided by total amounts in the account, or by weighting rates of payments by type of account by their outstanding amounts. This is a rate of profit parallel to the rate of interest on conventional deposits.

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## Final Question – Accrual of income flows prior to expiration of underlying contract?

- One country accrues a current rate of profit *for the bank* as a fee paid by IAH calculated as a percentage of outstanding PSIA accounts, subject to reconciliation between Bank and IAH at the expiry of the contract.
  - Implies that the assets held by the bank are engaged in current productive activity (at a rate  $\geq$  fee), which is recorded as generating earnings that in turn generate dividends for stockholders and build capital through reinvested earnings.
  - This raises supervisory concerns because the fee rate is rather high and the reconciliation *de facto* favors the bank – the financial strength of the bank might be overestimated and are the rights of IAH being protected?
- Are similar accrual practices followed in other countries, and how are they handled in national accounts?

## Conclusions

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- As shown on slide 4, Islamic financial instruments do not earn interest, but generate all other types of financial flows.
- Table 4 lists most common instruments and types of returns – profit on sales, leasing, partnership returns, fees, or implicit FISIM type services in the case of non-remunerated deposit accounts.
- This list can be supplemented by returns from Islamic Capital Markets (sukuk and other securities – not discussed here) in the form of revenues from projects, capital gains, revaluations, etc.
- Many of the instruments have rates of profit or other returns that can be readily calculated if underlying data are available.
- *Rates of profit parallel to interest can be calculated on substantial portions of PSIA. These can be incorporated into the SNA under an expanded concept of interest-like returns.*
- However, some PSIA are financial positions that generate investment returns rather than generate current SNA income.