

BANK OF KHYBER ISLAMIC BANKING

MUDARABAH

Profit and Loss Distribution Policy Framework



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Mudarabah (Profit and Loss Distribution Policy Framework)

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Overview

1.1. Preamble

- 1.1.1. Profit and losses sharing (PLS) deposits constitute major part of sources of funds for Islamic banking institutions (IBIs) wherein profit on financing and investments made through such deposits are shared between the IBI and PLS depositors as per pre-agreed profit sharing ratio. In case of loss, the same is borne by the partners in proportion of their investments unless such loss is proved to be due to the negligence by bank in managing depositors' funds. Considering this unique relationship where income earned by the IBI through financing and investment has direct impact on depositors return, there is need to have profit and loss sharing and pool management policy.
- 1.1.2. This document – titled “Profit and Loss Distribution Policy Framework” (the Policy) is to establish a well-defined policy for the purpose of profit and loss distribution to the saving and deposit account holders and holders of Riba Free Certificates (Certificates of Investments). Further, the purpose behind documenting the policy for profit and loss distribution mechanism is to bring harmony, transparency and authenticity in the overall process of profit and loss distribution in line with Shariah principles, regulatory requirements, as well as, with market discipline. This policy has been developed by Islamic Banking Group (IBG) of the Bank of Khyber (BOK), in line with the rules and regulations as applicable to Islamic Banking Institutions (IBIs) and the Shariah rules and principles defined by the Shariah Board of BOK and Islamic Banking Division of SBP, as well as, the industry accepted practices.

1.2. The Policy Framework

- 1.2.1. The Policy is meant to provide the basic structure and specification of Profit and loss Distribution Mechanism (PLS) and to describe the policies and procedures for carrying out the functions related to it. This Policy also highlights the Shariah principles and guidelines and the regulatory requirements which should be strictly complied with.
- 1.2.2. Monitoring and updating of the Policy:
- a. The basic responsibility for monitoring of the Policy rests with the Board of Directors (BOD) as well as the Shariah Board of the Bank.
 - b. Responsibility for regularly updating the Policy shall be of the Head IBG. The review and update of this Policy shall be an ongoing process to ensure continuous alignment of the Policy with the developments, changes and trends in profit and loss sharing whether required by law or by generally accepted market practices within the Islamic financial market.
 - c. Head IBG shall initiate, the RSBM of the Bank validates and the Board of Directors of the Bank and Shariah Board of the Bank shall approve any modifications to this Policy. However, in any case no amendments shall be accepted in violation of any Shariah rules and principles or in contradiction to the rules and regulations prescribed by the State

Bank of Pakistan (SBP). Guidance will also be sought from standards issued by Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI).

- d. As a guiding principle, this Policy, in its entirety, shall be reviewed at least annually and updated, if required, in order to keep this Policy in line with significant changes in internal and external environment. Further, Shariah Board of the Bank shall report on the profit and loss distribution management in his report to be published in the Bank's annual report.

1.2.3. **Responsibility for implementation**

- a. Primary responsibility for overseeing implementation of the Policy rests with the Head IBG. The Head IBG is also responsible for continuous monitoring and reviewing of all the policies.

1.2.4. **Responsibility for Shariah Compliance**

- a. The management of the Islamic Banking Division and Shariah Compliance Division shall be responsible to ensure that all activities are in accordance with the guidelines defined in this Policy and the procedures to be defined according to such Policy.

1.3. **Basic Structure of Profit and Loss Distribution Pool**

- 1.3.1. The operation of fixed deposits and savings account in Islamic Banks is different from conventional Banks because the deposits with Islamic Banks are based on Mudarabah in which people invest by opening their account in fixed deposit and savings accounts. They are not the owners or shareholders of the Bank and are partners in profit and loss pool, meaning that they have contract of Mudarabah with the owners of the Bank.

1.4. **Basic Shariah Rules**

- 1.4.1. The status of the Bank or the shareholders is of a Mudarib and the account holders are Rab-ul-mal. The contract is known as Mudarabah or Profit and Loss Sharing (PLS) Scheme.
- 1.4.2. It is permissible for the Mudarib (Bank representing the shareholders) to merge his assets with the assets of depositor with the prior consent of the depositors, and in that case they are regarded as owner of their respective shares of assets.
- 1.4.3. The Bank and the depositor have a partnership through a contract of Musharakah or Mudarabah in which case the depositor's capital is not regarded as loan. The shareholders act as Rab-ul-mal as well as Mudarib. The depositor acts only in the position of Rab-ul-mal.
- 1.4.4. The Bank plays different roles for which there are different rules. These roles and related responsibilities are:
 - a. Ameen (Trustee), where the Bank holds money as trustee and is responsible for management of funds within the framework of mandate given in the Mudarabah agreement. However, the Bank is not responsible in case of actual loss.

- b. Wakeel (Agent), where the Bank manages funds as an agent of capital provider. Actual loss is to be borne by Rab-ul-mal unless Mudarib has been found guilty of misconduct of the agreement.
 - c. Shareek (Partner), where the Bank becomes partner in the profit that the Mudarabah generates.
 - d. Zamin (Liable / Guarantor), where, in case of loss due to negligence or misconduct, the Bank has to bear that loss.
 - e. Ajeer (Employee), where, if the agreement becomes void due to any reason, the Bank is entitled to receive fee for its services.
- 1.4.5. Relationship between the Bank and depositors is that of Mudarabah because they have invested without participating in labor/management. Whereas, relationship between shareholders is through Musharakah because they are participating in labor / entrepreneurship / management as well as investment.
- 1.4.6. As per Shariah, the profit and loss is calculated on the basis of evaluation of assets. In case of loss, each partner shall suffer the loss exactly according to the ratio of their investment. In case of profit, the same is distributed according to the agreed ratio between the partners. Mudarib is free to determine any ratio of profit of the Bank as manager (Mudarib), therefore, it can be agreed mutually that Rab-ul-Mal will have a higher profit margin while the profit margin of Mudarib can be comparatively lower. However, the share of profit of the Mudarib cannot be less than the ratio of his investment since he is the sole provider of labor. However, profit distribution in the Bank shall be subject to limitation prescribed by SBP from time to time.
- 1.4.7. The Bank may offer incentives to its holders of savings accounts without informing them in advance, and by whatever means the Bank decides to offer them, so long as these are several and differ each time that they are offered. A further condition for such incentives is that they should not be offered regularly, lest they become the only reason for saving. Any monetary incentive shall be subject to limitation prescribed by SBP from time to time.
- 1.4.8. It is permissible for the Bank to allow anyone with a regular savings account to specify a certain percentage of the balance for transfer to a short-term investment account in accordance with the conditions specified in the contract.
- 1.4.9. It is impermissible to insert any condition in contract for savings accounts that if the balance falls below certain limit, the account will be treated like an ordinary current account because a Mudarabah gets dissolved by means of such a condition.
- 1.4.10. Profit or balances that cannot be delivered to the clients or which the clients do not claim i.e. amounts in paisas, may be donated in charity. In case, the clients return to claim their profit, the bank will have to return the profit to them in their entirety. Accordingly, it is better to manage separate fund of the same with reasonable balance available for any future demands.

Therefore, such funds shall be managed subject to the limitations prescribed by SBP from time to time.

- 1.4.11. Return on saving accounts and deposit should be paid on the basis of daily products and weighted average system. Different weightages may be arranged to different types of accounts. For example, investments of major amounts or a longer-term account may be given relatively higher weightages. According to the principles of Islamic finance, a sleeping partner cannot take a share in the profit which is more than his share in the investment. In case the Bank also provides funds, it would be entitled to get profit on his own capital in proportion, which such capital has, to the total capital of Mudarabah. In addition to such share in the profit, the Bank shall also be entitled to share the remaining profit in an agreed proportion.

2. Introduction to Pool Management

2.1. Introduction

2.1.1. IBG of BOK will initially maintain a single pool, however, at a later stage the Bank may create different pools. Each pool to be created shall be a virtual enterprise having demarcated sources of funds, ownership of specific assets and income and expenses. As such, pools may sell assets between them or to / from the owners of other pools.

2.1.2. Creating and maintaining pools is a strategic decision. As such, new pools would be created and / or existing pools would be dissolved or maintained based on the future strategies and available opportunities of the Bank.

The pools may be created on the basis of:

- a. Musharaka;
- b. Mudaraba;
- c. Combination of Musharaka and Mudaraba; and
- d. Wakalah.

2.2. General Pool

2.2.1. General pool is the basket in which all the deposits from depositors will be placed along with the Bank's own equity and funds from other financial institutions.

2.2.2. The general pool will be based on the principle of unrestricted Mudarabah.

2.2.3. An unrestricted Mudarabah contract is a contract in which the depositor permits the Bank to administer the funds without any restrictions. In this case, the Bank has a wide range of trade or business freedom on the basis of trust and the business expertise the Bank has acquired.

2.2.4. However, such unrestricted business freedom in an unrestricted Mudarabah must be exercised only in accordance with Shariah rules and the interests of the parties and the objectives of the Mudarabah contract, which is making profit. Therefore, the actions of the Bank must be in accordance with the business customs relating to the Banking operations.

2.3. Special Pool(s)

2.3.1. The Bank may, depend upon its need, the prevailing circumstances and / or the opportunities available opt to create special pool(s).

2.3.2. Special pools will be created from time to time based on the following reasons:

- a. To minimize the risks i.e. to manage different types of assets, having different risk characteristics;
- b. To reach the expected results in order to achieve the desired goals;
- c. In case of a restricted Mudarabah is to be initiated on the demand of a specific depositor;
- d. To separate the Bank's own assets and strategic investments; and
- e. Against regulatory requirements e.g. IERS.

2.3.3. The Bank shall transfer matching asset(s) to special deposit pool from general pool, or this could be done through fresh deployments.

2.4. **Treasury Pool(s)**

2.4.1. Treasury pool(s) may be created from time to time by obtaining funds from financial institutions (preferably Islamic financial institutions only). However, they may be created by obtaining funds from conventional financial institution in exceptional circumstances with the approval of the RSBM of the Bank.

2.4.2. Treasury pool may be created for one or more of the following reasons:

- a. Major withdrawals by existing depositors;
- b. New disbursement / financing requirement; and
- c. Meeting general liquidity requirement.

2.4.3. In case a major withdrawal has been requested from any depositor in an existing pool, the Bank may arrange funds from financial institution by creating a separate pool.

2.4.4. The Bank will transfer matching assets(s) from the pool in which the withdrawal request has been made, to the treasury pool.

2.4.5. These pools need to be maintained separately due to its peculiar nature (i.e. liquidity management).

2.5. **Foreign Currency pool(s)**

2.5.1. The Bank will accept saving deposits based on foreign currency. As preferable a separate pool will be created for foreign currency deposits.

2.5.2. As required by the Shariah Standard No. 12 on “Sharika (Musharaka) and Modern Corporations”, the currencies must be translated into the currency of the Sharika at current exchange rates so as to determine the shares and liabilities of each partner.¹

2.5.3. Further, the foreign currency deposits will be managed as per existing instructions of SBP Foreign Exchange Manual.

¹ Shariah Standard No. 12 – Sharika (Musharaka) and Modern Corporations, Paragraph No. 3/1/2/2

3. **Creation of Pools**

3.1. **Introduction**

3.1.1. Each pool to be created and managed by the Bank would be treated as a virtual enterprise having its own demarcated assets, liabilities, income and expenses, which would be identifiable, balanced and verifiable at all time.

3.1.2. In addition, transaction records for each pool would be maintained separately. It would also be ensured that the Bank's equity in different pools is reconciled with the total equity appearing in accounting records.

3.2. **Basis of Creation of Pools**

3.2.1. The creation of pools would be based on the specific conditions prevailing during the specific circumstances.

3.2.2. Creation of new pools i.e. special pools may be for any of the reason that are mentioned in *Section 2* above. Further, as preferable, a separate pool for each foreign currency will be created.

3.3. **Objectives of the Pool**

3.3.1. The overall primary objective of any pool is to earn return for the participants.

3.3.2. However, the specific objectives of the pools created by the Bank would mainly be based on the basis of creation of the pool.

3.4. **Investment Strategy of the Pool**

3.4.1. The deposits from depositors would be invested in any profitable venture or avenue as identified by the Bank and which conform to Shariah rules and principles. All the business arrangements and agreements would be in accordance with those approved by the Shariah Board of the Bank.

3.4.2. None of the business undertaken by the Bank, financing arrangements and transactions would involve directly or indirectly any element of Riba, Gharar, Qimar or any other Shariah non-compliant element.

3.4.3. Assets will be acquired by investing total pool's funds into corporate and consumer sectors and other permissible investment opportunities, such that the assets acquired are not which fall under the negative / watch list of businesses / sectors approved by the Shariah Board of the Bank.

3.4.4. **Illustration for Investment Strategy of different pools**

The categories, in which the funds mobilized by the Bank would be deployed, will differ as per the investment strategy of the Pool. The table below illustrates such categories and investment strategies on an example basis:

Type of Pool	Investment Strategy
General Pool	The depositors of general pool generally expect a consistent and moderate level of return in addition to long term preservation of capital in a Shariah compliant way. Therefore, the investment strategy of the pool would be to invest in such assets and investment that may give a stable and moderate return over the period of time. However, most of the assets will be directed to General pool.
Treasury Pool – Financial Institution (FI)	Deposits from FI are obtained for a short tenure and these depositors expect comparatively higher return as compared to depositors of general pool. Therefore, the deposits obtained from such depositors will be deployed in highly solid assets which give a higher return to meet their expectations. Mainly Sukuk will be used for this purpose.

- 3.4.5. Examples of the categories in which the funds mobilized by the Bank shall be deployed include:
- Murabaha;
 - Ijarah;
 - Diminishing Musharaka;
 - Salam;
 - Istisna;
 - Running Musharakah;
 - Any other Islamic modes of financing; and / or
 - Investment.
- 3.4.6. In addition to the above, the Bank would also deploy the funds in maintaining reserves to meet the regulatory requirements.
- 3.4.7. Murabaha (if any) shall be restricted to a certain maximum limit of the total assets of the pool, in order to be able to pay monthly profit to depositors as approved by Shariah Board/RSBM of the Bank from time to time.
- 3.4.8. All placements of the funds by the Islamic Treasury will be in the companies which fulfill the criteria of KSE's KMI or as may be approved by the Shariah Board.
- 3.4.9. A list of companies approved by the Investment Committee of the BOD shall be maintained in which the Islamic Treasury shall be allowed to invest, however approval of the Shariah Board/RSBM shall be a prerequisite.
- 3.4.10. Similarly, a list of Islamic Banks approved by the Investment Committee of the BOD shall be maintained where Islamic Treasury can place its idle funds however approval of the Shariah Board/RSBM shall be a prerequisite.

3.5. **Risk Characteristics of the Pool**

- 3.5.1. The risks related to any pool depend upon the nature of the pool and the purpose for which the pool has been created. Considering the low risk tolerance of the investors of the profit and loss distribution pool, the key objective will be to earn competitive returns while containing the risk (volatility) of the returns to a minimum i.e. providing higher risk adjusted returns.
- 3.5.2. Significant risks may be categorized in accordance with the risks to the financing assets and to the profit and loss distribution pool.
- 3.5.3. Risks to which the financing assets of the Bank may be exposed to are:
- a. Credit Risk which is generally defined as the potential that a counter party fails to meet its obligations in accordance with agreed terms. Therefore, the Bank should have sound credit risk management policies to protect the depositors' / IAH from loss due to credit risk.
 - b. Market risk is generally defined as defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leasable assets (including Sukuk) and in off-balance sheet individual portfolios (for example restricted investment accounts). The risks relate to the current and future volatility of market values of specific assets and of foreign exchange rates.
 - c. Equity Investment Risk is generally defined as risk associated with holding equity investments during unfavorable situations, where decline in investment caused by market conditions in turn gives volatility of earnings of Musharakah and Mudarabah investments.
- 3.5.4. Risks to which the profit and loss distribution pool may be exposed to are:
- a. Liquidity Risk which is the potential loss to the Bank arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses. In order to mitigate the liquidity risk the Bank should invest in a combination of liquid and illiquid assets to be able to meet their obligations towards the depositors' / IAH.
 - b. Rate of return Risk to which the Bank may be exposed to in the context of its overall balance sheet exposures. An increase in benchmark rates may result in saving account holders having expectations of a higher rate of return. A consequence of rate of return risk may be displaced commercial risk. Therefore, the Bank should employ a gapping method for allocating positions into time bands with remaining maturities or re-pricing dates, whichever is earlier. Moreover, Profit Equalization and other reserves may be created to mitigate the rate of return risk to an acceptable level.

3.6. **Comingling the Bank's Fund with the Deposits**

- 3.6.1. AAOIFI's Shariah Standard No. 13 on Mudarabah paragraph 8/9 states that:
"If the Mudarib has commingled his own funds with the Mudarabah funds, the Mudarib becomes a partner in respect of his funds and a Mudarib in respect of the funds of the capital

provider. The profit earned on the two commingled funds will be divided proportionately to the amounts of the two funds, in which case the Mudarib takes the profit attributable to his own funds, while the remaining profit is to be distributed between the Mudarib and the capital provider according to the provisions of the Mudarabah contract.”²

Keeping in view the aforementioned, if the Bank invests its own equity in the pool, the distributable income will be first proportionately divided between the two funds and then the Mudarib fee will be charged on the income distributed income to the depositors.

3.6.2. As the Bank assumes all the risks of non-remunerative current deposits mobilized on Qard basis. Therefore, if the funds from non-remunerative current deposits are commingled with the funds of remunerative depositors such deposits will be treated as equity for the purpose of profit and loss computation and distribution.

3.6.3. The Bank would obtain explicit permission from the remunerative depositors of the Bank to commingle the depositors’ funds with that of the Bank and / or the funds of other depositors including the current deposits within the Mudarabah pool as and when required.

3.7. **Allocation of Different Types of Deposits to Pool**

3.7.1. The allocation of deposits to a particular pool would, again, depend upon the primary reason of creation of the pool.

3.7.2. The nature of deposits would be matched with the assets of the pool and then allocated to the relevant pool.

3.7.3. The pool to which a deposit is to be allocated shall be identified at the time of accepting the deposit and allocation of such deposit to the respective pool on the same day shall be ensured.

3.7.4. Illustration:

a. The deposits by depositors in foreign currency would be allocated to foreign currency pool.

b. The deposits by more than one high net worth individuals all of whom demand the same rate of return (which is not in-line with the Bank’s customary rate of return) would be allocated to a special pool.

3.7.5. Subsidized financing facilities extended to the Bank’s employees would be funded from bank’s own resources including current deposits. Mudarabah based deposits other than non-remunerative current account deposits would not be used for extending any subsidized financing to employees i.e. staff loans and other funded facilities given to staff under the Bank’s Human Resource policies. In addition, whatever income generated on subsidized financing will not be part of general pool.

² AAOIFI’s Shariah Standard No. 13 – Mudarabah Paragraph No. 8/9

3.8. **Profit Sharing Ratio (PSR) / Mudarib Fee**

- 3.8.1. Profit Sharing Ratio (PSR) is the ratio of profit distribution among the depositors (the pool participants) and the bank.
- 3.8.2. The Bank will declare the PSR at least 5 days before the beginning of the month, which must be available to all constituents. However, the Bank will declare such PSR at least 3 days before the beginning of the month as required by SBP, in exceptional circumstances, provided approval of the RSBM of the Bank is obtained.
- 3.8.3. The PSR will be available on website of the Bank and the statement declaring the PSR would be displayed in all branches of the Islamic Banking Division (IBD). Further, at a minimum the statement will contain:
- a. date of declaration;
 - b. period for which they remain effective;
 - c. all categories / pools and Bank's equity share and their types, sizes and tiers of accounts; and
- 3.8.4. The Bank may, on its sole discretion opt a similar PSR for all the depositors in a pool or may vary the PSR among the depositors with respect to tenure and / or slab of deposit.

3.9. **Assigning Weightages to Each Category of Deposit**

- 3.9.1. The weightages will be calculated and declared monthly as the Pool is constructively liquidated at end of each month and created simultaneously.
- 3.9.2. The Bank will declare the weightages at least 5 days before the beginning of the month, after the approval of the RSBM of the Bank and it will be available to all the constituents of each pool. However, the Bank will declare such weightages at least 3 days before the beginning of the month as required by SBP, in exceptional circumstances, provided approval of the RSBM of the Bank is obtained.
- 3.9.3. Weightages will be available on website of the Bank and the statement declaring the weightages would be displayed in all branches of the IBD. At a minimum, the statement will contain:
- a. date of declaration;
 - b. period for which they remain effective; and
 - c. The weightages assigned to all categories / pools, PER, IRR (if part of pool) and Bank's additional profit ratios.
- 3.9.4. The weightages to different categories of deposits in a pool would be assigned uniformly on a consistent basis, based on the following, but not limited to, parameters / criteria:
- a. Contracted period of deposits;
 - b. Frequency of profit distribution, monthly, quarterly or on maturity; and
 - c. Volume of the deposit.

- 3.9.5. The maximum weightage to the Mudarabah based deposit of any nature, tenor and amount would not exceed 3 times of the weightages assigned to basic PLS accounts.
- 3.9.6. In case of Musharakah pool, weightages assigned to equity cannot be more than the highest weightage of any class of deposit or Riba Free Certificates (RFCs).
- 3.9.7. In case Bank cannot contribute its equity as declared by the Bank at start of a period, its weightages shall have to be reduced in proportion to the shortfall in required equity at the time of applying the equity. While declaring minimum equity contribution of the bank in the Pool, the words “up to” should be used to cover forced reduction in equity at any point of time.
- 3.9.8. Special weightages shall not be allowed to any particular customer (specifically government accounts) to shift more profit to that customer.
- 3.9.9. Weightages and other terms of a pool, once declared and / or accepted by the customer, cannot be changed before liquidation of a pool.
- 3.10. **Use of Daily Product Balance / Weighted Average Daily Balance**
- 3.10.1. As depositors continually open and close their accounts or increase or decrease their balances during a month; the return paid to the depositors would be based on the average daily balances at the day end.
- 3.10.2. The profit is calculated during the tenure of the pool (i.e. from start till its constructive or actual liquidation whichever is earlier).
- 3.11. **Pool Creation Documentation and Approvals**
- a. Creation of pool is a strategic decision as mentioned above, therefore new pool will be created through a “*Memorandum of creation of pool*”. Creation of new pools may be initiated by the Head of Finance, Head of treasury, Head of Product development department or the Head of Liabilities as per the requirements of the Bank. Pools created will be approved by the Head IBG and the RSBM of the Bank.
- 3.11.2. Memorandum of creation of pool would at a minimum include:
- a. process / procedures relating to sources and utilization of Special Pools funds;
- b. fixation of PSR and weightages;
- c. segregation / allocation of income / expenses;
- d. profit declaration;
- e. description of equity of the pool and proportions;
- f. characteristics of assets to be taken to such pool; and
- g. any other related process / procedure.
- 3.11.3. Refer *Annexure – I* to the document for sample “*Memorandum of creation of pool*”.

3.12. **Ratio of Illiquid Assets and its Determination**

- 3.12.1. To honor redemption / withdrawal requests, each pool shall constitute at least 20% tangible / tradable assets such as Ijarah assets, Ijarah Sukuk, Diminishing Musharakah assets, etc.
- 3.12.2. However, this benchmark may be brought down to a minimum of 10% of the pool's assets subject to approval of the RSBM of the Bank.
- 3.12.3. The above benchmark is set to avoid the possibility of sale of debt (dayn).

3.13. **IT System**

- 3.13.1. Currently, the Bank will use a modified version of the deposit / PLS module being used by the conventional counterpart. However, later on the Bank will maintain an adequate IT based system which would inter-alia suitably cater to the requirements of allocation of:
 - a. deposits;
 - b. financing, investments and placements;
 - c. income and expenses; and
 - d. Movement of assets to / from different pools.
- 3.13.2. In case separate pool(s) is / are created by the Bank for a special purpose; then proper allocation of assets for the pools would be followed to maintain transparency, followed by a centralized and proper system based tagging of allocated assets.
- 3.13.3. The system would be secured by proper supervision and authorization controls.
- 3.13.4. The system would eliminate all such terminologies and words unique to the conventional (interest based) banking system.
- 3.13.5. The Mudarabah based deposits will not be invested in non-trading fixed and other assets like land, building, furniture fixtures, computers and IT systems *etc.* The Bank as Mudarib is responsible to finance all such costs / assets from its own sources / equity.

3.14. **Cash Reserve Requirements (CRR)**

- 3.14.1. The Bank will keep aside a certain percentage liquid in the pool to meet need for cash in hand, contingencies, and Cash Reserve Requirement (CRR). This amount shall be considered as part of pool. Preferably the customer will be informed at the time of the contract.
- 3.14.2. As per the circulars issued by SBP from time to time, the CRR would be maintained as required.
- 3.14.3. The above CRR as prescribed by SBP would be part of the pool financed through deposits attracting CRR. Accordingly, higher weightages will be assigned considering this fact.

3.15. **Statutory Liquidity Requirement (SLR)**

- 3.15.1. As per the regulations of SBP; the SLR would be maintained at the required percentage announced by SBP from time to time of Total Demand Liabilities (including Time Deposits with tenors of less than 1 year). It is to be noted that the Time Liabilities (including Time Deposits with tenor of 1 year and above) will not require any SLR.
- 3.15.2. The Bank will invest the funds to finance the SLR and the return on such SLR will be credited as income of the pool from which it is financed.

3.16. **Inter Pool Transfer of Assets**

- 3.16.1. In case separate pool(s) is / are created by Mudarib for a special purpose; then proper allocation of assets for the pools should be followed to maintain transparency, followed by a centralized and proper system based tagging of allocated assets.
- 3.16.2. Assets of the special pools (if any) will be properly assigned to a specific pool in General Ledger or Sub-Ledger.
- 3.16.3. Assets once allocated to special pool shall remain intact till the liquidation of the pool.
- a. The inter pool transfers of assets would be made through a memorandum (Deal Ticket) which would inter-alia include the need and objective of inter pool sale / purchase of assets and would be authorized by the committee including Head IBG. Moreover, for a counter check purpose the RSBM of the Bank will also approve such inter pool transfer of assets.
- 3.16.4. Receivables (Dayn) should not be transferred from one pool to another pool, unless some exceptional circumstances arise and the approval of the Shariah Board/RSBM of the Bank is obtained.
- 3.16.5. To facilitate, if the asset to be transferred is a Dayn, then it shall be transferred at the face value. Similarly, assets on the basis of Salam and Istisna shall be transferred at outstanding amount of the assets without any accruals.
- 3.16.6. In addition, assets against Murabaha can only be transferred if it is a part of a set of assets containing Murabaha and either or both, Ijarah and Diminishing Musharakah with the clearance of the Shariah Board/RSBM. As such, assets against Murabaha alone cannot be transferred from one pool to another pool.
- 3.16.7. While allocation of assets, the Bank should comply with the requirement of maintaining at least 20% illiquid assets in each pool.
- 3.16.8. Kindly refer *Annexure – 2* to the Policy framework for Sample of Deal Ticket.

4. **Identification and Allocation of Pool Related Income**

4.1. **Introduction**

4.1.1. The allocation of income and expenses to different pools shall be made based on pre-defined basis and accounting principles / standards.

Keeping the importance of operating costs and expenses in view, the policy for charging expenses should be documented and preferably be shared with the depositors.

4.2. **Allocation of Income**

4.2.1. All income pertaining to specific assets for specific periods should be allocated to the pool to which the assets are tagged during the period. Due care should be taken while recognizing revenue from assets.

4.2.2. Revenue recognition for each type / class of assets should be in-line with the respective Shariah principles. Further, the financing will be diversified across different sectors and in compliance with the prudential regulation for exposure of individual and corporate clients.

4.2.3. Profit shall be distributed at gross income level. As such, the gross income of the pool is defined as net income from financings and investments activities before provisions, and indirect expenses.

4.2.4. Income generated from non-financing activities (fee / commission / service charges) should not be credited to the pool.

4.3. **Direct Expenses**

4.3.1. According to Shariah rules and principles, all direct expenses shall be expensed out of the total profit i.e. always charged to the pool.

4.3.2. The direct expenses will be charged to respective pool(s).

4.3.3. The direct expenses to be charged to the pool shall include all the direct cost of transaction including the following:

- a. depreciation of Ijarah assets;
- b. cost of sales of inventories;
- c. takaful expenses of pool assets;
- d. taxes (sales tax and service tax levied by the provincial government);
- e. stamp fee or documentation charges;
- f. other costs / foreign exchange losses (if ascertainable);
- g. brokerage fee for purchase of securities/commodities etc;
- h. Impairment / losses due to physical damages to specific assets in pools etc.

4.3.4. Write-offs of financings and loss on sale of investments shall be charged to respective pool along with other direct expenses.

4.4. **Indirect Expenses**

- 4.4.1. Indirect expenses can be categorized as those which are agreed with the saving and deposit account holders to be borne by the Mudarib.
- 4.4.2. Indirect expenses including the establishment cost which will be borne by the Bank as Mudarib are summarized as follows:
- a. other costs / foreign exchange losses (if not ascertainable);
 - b. penalties by regulators;
 - c. provisions / write-off against assets owned by equity fund;
 - d. provisions / write-off against assets not owned by equity fund but due to misconduct / negligence / breach of contract by the Bank;
 - e. depreciation / amortization of material items of PPE (considering these assets owned by the Bank and built in Mudarib fee);
 - f. operating and maintenance expenses;
 - g. costs of meals and other general expenses;
 - h. staff cost;
 - i. administration expenses; and
 - j. Business and marketing expenses.

4.5. **General and Specific Provisions**

- 4.5.1. The general and specific provisions created against non-performing financings and diminution in the value of investments as under prudential regulations and other SBP directives will be borne by the Bank as Mudarib. However, write-offs of financings and loss on sale of investments shall be charged to respective pool along with other direct expenses.
- 4.5.2. The losses on financings and investments due to misconduct / negligence / breach of contract by Bank shall not be charged to the pool; the Bank as Mudarib shall be responsible for absorbing such losses.
- 4.5.3. In case of write-offs of financings and loss on sale of investments, Investment Risk Reserve (IRR), if any, shall be utilized. For details regarding the utilization and working of IRR refer section 7 of the Policy.
- 4.5.4. For the above purpose, the financing approved and disbursed and investment made in contravention to the prudential regulations or the Bank's own policies, procedures and processes as determined by internal auditor, external auditor and / or SBP inspection team will be treated as the negligence on the part of the Bank.
- 4.5.5. 5% of all dividend and capital gain on shares income shall be transferred to Dividend Income provisioning and Capital Gain/Loss provisioning respectively at the time of liquidation of the pool, part of the provisioning corresponding to interest income of the company's total income during that period as declared in published accounts (whether audited or unaudited) shall be paid in charity and remaining income, if any shall be reversed so as to

become part of net income of the pool. The remaining portion thus reversed shall be based on Tabarru from the pool contributors at the time of creation of such provisioning.

5. **Sources of Fund**

5.1. **Islamic Banking Fund (Equity)**

5.1.1. This is the interest free amount invested by the conventional Bank into its Islamic Banking business as seed money according to SBP regulations.

5.1.2. Bank will at all times ensure that the Islamic Banking Fund / Capital Adequacy Ratio requirement for Islamic Banking is fulfilled as per the applicable regulations.

5.1.3. The equity for this purpose may include the non-remunerative current accounts, paid up capital, the Islamic Banking Fund and Sundry.

5.2. **Additional Head Office funds**

5.2.1. The deposits will be obtained from head office, if required by the Bank. These deposits will be treated like other PLS deposits. However, separate pools may also be created for such deposits.

5.3. **Remunerative / Profit and Loss Saving Deposits**

5.3.1. Remunerative deposits are accepted on the basis of Mudarabah, or combination of Musharakah and Mudarabah or any Shariah compliant mode deemed feasible by the IBG. As such, the depositors participate in the uncertainties of business of the Bank, bearing the risk of loss and reaping the reward of profit.

5.4. **Non-remunerative Deposits (Current Account Holders)**

5.4.1. Non-remunerative deposits are received on the basis of Qard and such depositors do not participate in the profits and loss of the Bank. Repayment of the principal amounts deposited by the current account holders is guaranteed by the Bank. Bank will obtain permission from the current account holders explicitly in the account opening form to utilize their deposits as equity share of the Bank in the profit and loss distribution pool.

5.5. **Islamic Financial Institution's Fund**

5.5.1. Bank may obtain funds from Islamic financial institutions to invest in the deposit products of the Bank. Further, the Bank may obtain funds from the conventional financial institutions as well, subject to the approval of the Shariah Board/RSBM of the Bank. The Bank can take placement and deposit in the general pool or create separate pools made specifically to address the requirements of this type of deposits.

6. **Profit Smoothing**

6.1. **Profit Equalization Reserve**

6.1.1. Definition of Profit Equalization Reserve (PER) as per AAOIFI's Financial Accounting Standard 11 – Provisions and Reserves is as follows:

“This is the amount appropriated by the Islamic bank out of the Mudarabah income, before allocating the Mudarib share, in order to maintain a certain level of return in investment for investment account holders and increase owners' equity.”³

6.1.2. According to the Risk Management Guidelines for Islamic Banking Institutions (IBIs) issued by State Bank of Pakistan and Islamic Financial Services Board (IFSB) Standard:

“PER is the amount appropriated by Islamic Financial Institutions (IFS) out of their total profit before allocating the working partner share, in order to compensate for Displaced Commercial Risk and smoothen out the return on investments”.⁴

6.1.3. According to the Capital Adequacy Standard issued by the IFSB Standard Displaced Commercial Risk (DCR) has been defined as:

“The risk arising from assets managed on behalf of IAH which is effectively transferred to the IIFS's own capital because the IIFS follows the practice of foregoing part or all of its Mudarib share of profit on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to the IAH.”⁵

6.1.4. The peculiar relationship of Mudarabah where income earned by the Bank through financings, investments and placements has a direct impact on depositors' return entails the DCR and to mitigate the same, the Bank may be under pressure to pay a return that is higher than the rate earned by such depositors under normal working for profit and loss.

6.1.5. In order to mitigate the DCR, PER is one of the tools suggested by IFSB for risk management purposes to maintain an equilibrium between the actual rate earned and the rate of return expected by the depositors. In addition, AAOIFI's standards also permit to set aside periodically, a certain ratio of reserve for meeting the risk due to lower return on assets than expected as PER.

³ AAOIFI's Financial Accounting Standard 11 – Provisions and Reserves

⁴ Risk Management Guidelines for IBIs issued by SBP

⁵ Capital adequacy standard for institutions (other than insurance institutions) offering only Islamic financial services

6.1.6. There can be different methods for the maintenance and utilization of PER. These methods can be based on a Structured, Interim, Judgmental, or a Hybrid approach. A brief summary of these approaches is summarized in the table below:

Approach	Definition
Structured Approach	This is a statistical method for calculating the rate of return risk and displaced commercial risk and based on these statistical methods a pricing mechanism is made to maintain and utilize the reserves.
Interim (Provisional) Approach	This is the approach where, either there are no defined principles and rules, or the defined principles and / or specific rules are in its provisional stage and not finalized because of the lack of the surety to apply those.
Judgmental (Principle Based) Approach	This is the approach where the principles of maintaining and utilizing PER are defined and the Islamic Financial Institutions (IFIs) are at liberty to maintain and utilize the PER within the limits of the principles.
Hybrid Approach	This is the approach where maintaining and utilizing the PER would be based partly on the defined principles and partly on the specific rules.

6.1.7. Until the Bank establishes itself and have enough experience of the prevailing market conditions, the expectations of the depositors, the actual versus the earned return on investments & advances and the behavior of the customers; the Bank would follow the interim approach. Once the Bank has established itself and has obtained enough experience of the prevailing market conditions, the expectations and the behavior of the depositors, the actual versus the earned return on investments & advances and the behavior of the customers; the Bank would phase out the interim approach with the structured and judgmental approach. This would however not take more than 3-4 years from the commencement of business.

6.1.8. The approach to be followed by the Bank as an interim approach is depicted in detail in the table below:

Approach	How we will calculate and apply
Maintenance	<p>The Bank will maintain PER by deducting an amount from 'net income of the pool'</p> <p>The Bank will maintain a separate pool for management of PER. The management of the Bank shall obtain the approval from Head Islamic banking and RSBM of the Bank (Refer Annexure - 5 for scale of authorities) and depositors shall be informed (via statement of declaration of weightages and PSR) before making such deductions.</p> <p>The monthly contribution into PER pool shall not exceed 2% of Net Income, and the accumulated balance of PER shall not exceed 30% of the Islamic Banking Fund of the Bank.</p> <p>Balance of PER pool will be reflected as liability and equity as per the ratio of share of the Bank and the deposit account holders.⁶</p> <p>The funds of PER pool shall only be invested in Shariah compliant SLR eligible securities as a separate pool and the returns earned on these funds will also be credited into the PER account. The profit sharing ratio for the Bank as Mudarib shall not be more than 10% for managing PER pool.</p>
Utilization	<p>The Bank may fully or partly utilize the amount of PER to improve the returns to the depositors during periods when the pool's profits are below market expectations.</p> <p>Amount transferred from PER to Mudaraba pool will be based upon Tabarru (gift) concept.</p> <p>It is recommended that month wise account of PER (for example PER for January 2013, PER for February 2013 and etc.) may be maintained and these accounts may be reversed as per the average maturity and withdrawal limits of depositors not higher than 24 – 30 months. This will ensure that:</p> <ul style="list-style-type: none"> • Depositors are not deprived of the return and of their share of PER; and • the write back of liability as per the Income Tax Ordinance, 2001 would be avoided.⁷

⁶ As per the Profit & Loss Distribution and Pool Management for IBIs issued by SBP, 50% of the balance of PER pool shall be reflected as liability and 50% as equity, however, as per the policy of the Bank the same shall be reflected as equity and liability as per the respective contributions made by the Bank and depositors towards the PER.

⁷ Income Tax Ordinance, 2001 Section 34(5) Accrual-basis accounting

6.1.9. The structured approach as mentioned to be followed by the Bank for PER is depicted in detail in the table below:

Approach	How we will calculate and apply
Maintenance	<p>The Bank will maintain PER by deducting an amount from ‘net income of the pool’ before allocating the profit between the Bank (Mudarib) and the depositors in a separate pool to be created.</p> <p>The amount appropriated to the pool will be based on the statistical / quantitative methods of risk calculation based on a consistent pricing mechanism. Other factors which shall be considered while deducting PER will be:</p> <ul style="list-style-type: none"> • the limits to and tolerance level of DCR; • maturity profiles of depositors; • the expected versus the earned return on investments and advances; • the behavior of the depositors; and • the credit risk and uncertainty. <p>The funds of PER pool shall only be invested in Shariah compliant SLR eligible securities and the returns earned on these funds will also be credited into the PER account. The profit sharing ratio for the Bank as Mudarib shall not be more than 10% for managing PER pool.</p>
Utilization	<p>The Bank based on the factors mentioned above and the statistical calculations will release an amount from PER in each period on a rolling basis.</p> <p>The size of PER to be maintained will be the main factor to decide whether to utilize the amount of PER or not and based on judgments and statistical calculation the amount will be utilized accordingly in each period.</p> <p>Amount transferred from PER to Mudarabah pool will be based upon Tabarru (gift) concept.</p> <p>It is recommended that month wise account of PER (for example PER for January 2013, PER for February 2013 and etc.) may be maintained and these accounts may be reversed as per the average maturity and withdrawal limits of depositors not higher than 24 – 30 months. This will ensure that:</p> <ul style="list-style-type: none"> • Depositors are not deprived of the return and of their share of PER; and • The write back of liability as per the Income Tax Ordinance, 2001 would be avoided.

- 6.1.10. The depositor should be made aware of the clauses related to PER (if any). As such, it shall be made part of account opening form or any other document for this purpose.
- 6.2. **Hiba**
- 6.2.1. According to AAOIFI's Standard, a partner may relinquish, on the date of distribution, a part of the profit that is due to him in favor of another party.⁸
- 6.2.2. The compensation (Hiba) in the shortfall of the expected profit rate from working partner's share is generally allowed in Shariah rules and principles which results in meeting expected profit rates. According to the Shariah principle "Al Maroof Kal Mashroot" anything which becomes common becomes implied. Issue arises as to whether such practice of contributing returns from Bank's fund to the depositors' fund each period makes it implied that the investors will get the same rate of return as expected rate of profit.
- 6.2.3. For the above mentioned reasons, the Bank should not exercise the practice of Hiba on a permanent basis.
- 6.2.4. To address the displaced commercial risk, in addition to maintaining and utilizing the PER, the Bank may forego up to 60% (refer table below) of its Mudarib share as Hiba to meet the market expectation in case of lower than expected market returns earned by the pool. It is to be emphasized that if the Bank is maintaining PER, it will reduce its Mudarib share only if the PER is insufficient to improve the profit payouts to the depositors.
- 6.2.5. The Bank will follow the SBP instruction in respect of HIBA for phasing out the practice of HIBA by 2015 Hiba if any, to be offered shall not be more than 2% over and above the actual return earned by the depositor based on performance of the pool and respective weightages and the reasons for allowing such special Hiba shall be documented, and shall be subject to specific and explicit approval of the RSBM of the Bank.
- 6.2.6. No Hiba shall be allowed in favor of any particular customer or a particular class or category of customers / investors. As such, Hiba by the Bank shall be distributed across the board to all the deposit categories in a pool.

⁸ AAOIFI's Shariah Standard No.12 – Shirka Paragraph No. 3/1/5/2

7. Investment Risk Reserve (IRR)

7.1.1. Definition of Investment Risk Reserve (IRR) as per AAOIFI's Financial Accounting Standard 11 – Provisions and Reserves:

“This is the amount appropriated by the Islamic Bank out of the income of investment account holders, after allocating the Mudarib share, in order to cater against future losses for investment account holders.”⁹

7.1.2. According to the Risk Management Guidelines for Islamic Banking Institutions (IBIs) issued by SBP and IFSB, IRR is the amount appropriated by Islamic Financial Institute out of total profit after allocating the working partner share, in order to reduce the risk of future investment losses.

7.1.3. As the credit and market risk of the financing and investment portfolio is to be borne by depositors being Rab-ul-mal in the Mudarabah arrangement with the Bank, there may be scenarios where the pool may incur losses primarily due to unusually large write-offs and / or significant losses on sale of the pool's investments. Thus to absorb / off-set such losses, the Bank may create the IRR to cover the future investment losses and develop models and basis to determine the size of the IRR and the periodic contributions to be made to build up the IRR.

7.1.4. For the measurement of IRR the Bank may use the Value at Risk model, which is a statistical technique used to measure and quantify the level of financial risk within the financing and investment portfolio of the Bank over a specific time frame.

7.1.5. The method adopted by the Bank to maintain and utilize IRR will be based on an interim approach. Further, the Bank will also take measures to calculate the maintenance and utilization of IRR on a structured approach based on the value at risk model to be followed at the later stage. This would however not take more than 3-4 years from commencement of business.

7.1.6. The approach to be followed by the Bank as an interim approach is depicted in detail in the table below:

Approach	How we will calculate and apply
Maintenance	<p>The Bank will set-up a different pool for management of IRR and it is entirely upon the discretion of management of the Bank whether to deduct amount for IRR or not.</p> <p>The Bank may contribute towards IRR an amount up to 1% of the profit available for distribution amongst the pool's depositors after deduction of Mudarib share in every profit period.</p>

⁹ AAOIFI's Financial Accounting Standard 11 – Provisions and Reserves

	The funds of IRR shall only be invested in Shariah compliant SLR eligible securities to be maintained as a separate pool and the returns earned on these funds will also be credited in the IRR account. The profit sharing ratio for the Bank as Mudarib for the pool shall not be more than 10% for managing IRR.
Utilization	<p>Funds of IRR will be released mainly when there are financial losses on financing and investments or it is no more required. Therefore, the Bank may, at its liberty, utilize the funds in IRR for smoothening profits.</p> <ul style="list-style-type: none"> • It is recommended that month wise account of IRR (for example IRR for January 2013, IRR for February 2013 and etc.) may be maintained and these accounts may be reversed as per the average maturity and withdrawal limits of depositors not higher than 24 – 30 months. This will ensure that: Depositors are not deprived of the return and of their share of IRR; and • The write back of liability as per the Income Tax Ordinance, 2001 would be avoided.

7.1.7. The structured approach as mentioned to be followed by the Bank for IRR is depicted in detail in the table below:

Approach	How we will calculate and apply
Maintenance	<p>The Bank will maintain IRR by deducting an amount from ‘Depositors’ Profit after Mudarib share’ based on the determination of credit market and equity investment (if any) risk factors.</p> <p>The amount appropriated to the pool will be based on the statistical / quantitative methods of risk calculation based on a consistent pricing mechanism. Such appropriation to the IRR pool may even be based on judgmental approach of the management of IBD considering the credit, market and equity investment (if any) risk factors. Other factor which may be considered while deducting IRR will be the maturity profile of the depositors and the maturity profile of assets.</p> <p>The funds of IRR pool shall only be invested in Shariah compliant SLR eligible securities to be maintained as a separate pool and the returns earned on these funds will also be credited into the IRR account. The profit sharing ratio for the Bank as Mudarib for the pool shall not be more than 10% for managing IRR.</p>
Utilization	<p>Funds of IRR will be released mainly when there are financial losses on financing and investments or it is no more required. Therefore, the Bank may, at its liberty, utilize the funds in IRR for smoothening profits.</p> <p>Month wise account of IRR (for example IRR for January 2016, IRR for February 2017 and etc.) will be maintained and these accounts will be reversed</p>

	<p>as per the average maturity and withdrawal limits of depositors not higher than 24 – 30 months. This will ensure that:</p> <ul style="list-style-type: none">• Depositors are not deprived of the return and of their share of IRR; and• The write back of liability as per the Income Tax Ordinance, 2001 would be avoided. Already
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7.1.8. The pool for IRR (if any) created and maintained shall be reflected as liability by the Bank.

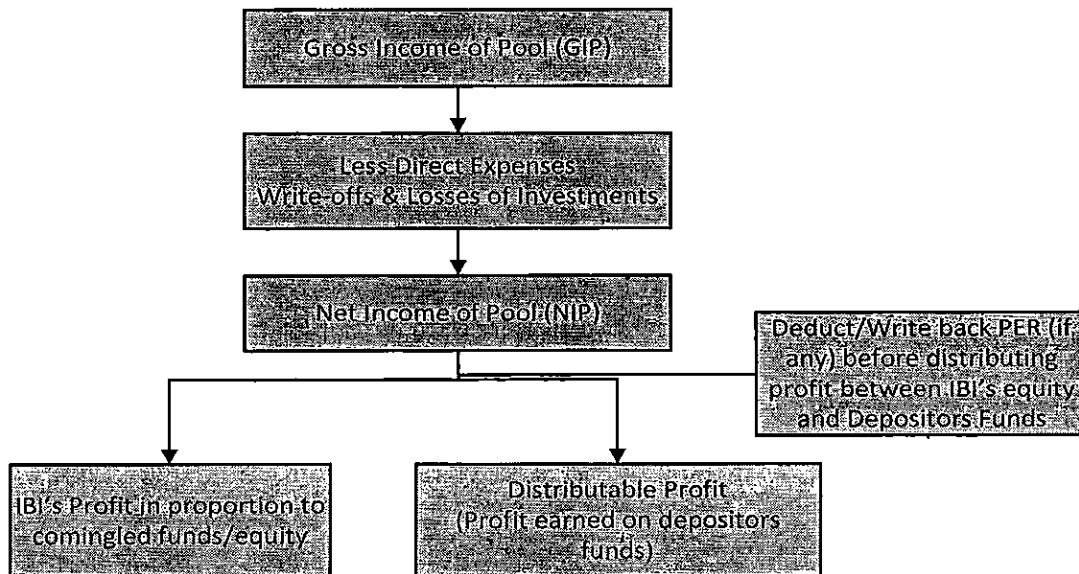
7.1.9. The depositor should be made aware of the clauses related to IRR (if any). As such, it shall be made part of account opening form or any other document for this purpose.

8. Profit and Loss Distribution

8.1. Distributable Profit

8.1.1. Distributable profit is the Net Income of Pool (Gross Income of Pool less direct expenses, write-offs and losses) less the Bank's share in profit in proportion to comingled funds / equity.

The following chart summarizes the overall profit computation and distributable process flow:



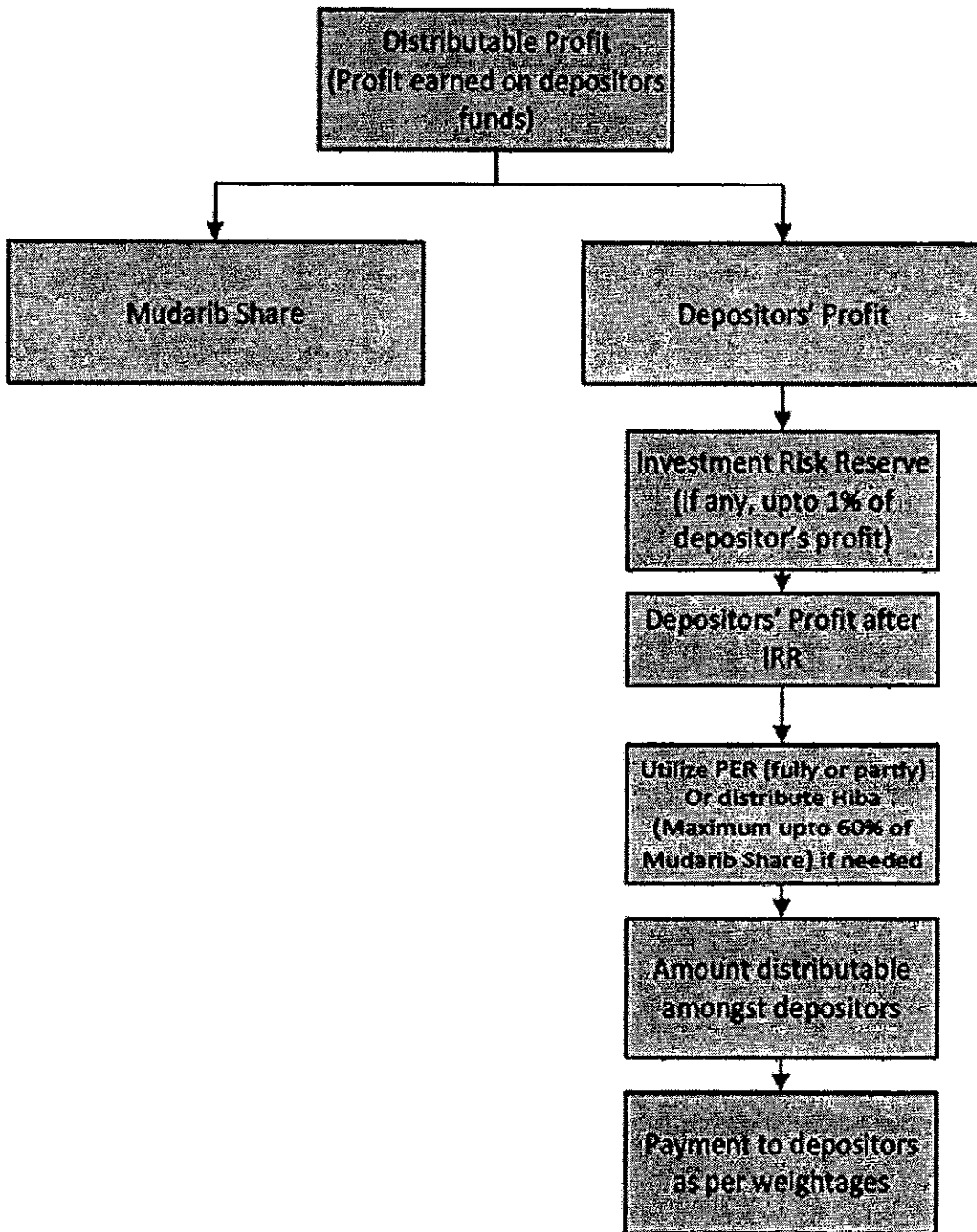
8.1.2. The collection of Mudarib share by the Bank would be in-line with the rate declared by the Bank. The PSR would be applied to the Distributable Profit. Further, the Mudarib share will not exceed 50% of the Distributable Profit.

8.1.3. The depositors' share of total profits shall be distributed at each month end for saving deposits and categories / types of RFCs to which profit is to be paid on monthly basis , provided the applicable RFCs have not been earlier redeemed or matured.

8.2. Distribution of Profit

8.2.1. The calculation of profit distribution shall be performed at the end of each month.

8.2.2. The remaining amount of Distributable profit after deducting Mudarib share is termed as depositors' profit. Following chart summarizes the flow for the calculation of payment of profit to the depositors from the depositors' profit:



8.2.3. The profit shall be announced within six (6) working days after the end of each calendar month.

8.3. **Distribution of Loss**

8.3.1. In case of loss, following policy will be followed by the Bank:

- a. PER and IRR shall be used to meet the specific loss causing the declaration of loss;

- b. Even after utilizing PER and IRR, if the loss is not eliminated; then the Weightages shall be ignored for and the loss should be distributed among the depositors and the Bank (in the capacity of provider of the funds) proportionate to their respective investments in the pool;
 - c. Loss shall be calculated and after vetting by the Shariah Board of the Bank, shall be declared with approval of the Managing Director;
 - d. In case, a depositor desires to close his account after declaration of loss, he will be allowed to close as per rules of the Bank *i.e.* a Notice period may be required as per term and conditions of the Account; and
 - e. Full detail of the loss shall be provided to a customer on demand and the reasons for incurring such loss shall be declared in the press note, circular to branches and declared on website.
- 8.3.2. In case if loss is due to breach of the requirements of trust, such as misconduct in respect to the Mudarabah fund, negligence and breach of the terms of Mudarabah contract, loss shall be borne by the Bank.
- 8.4. **Ad hoc Profit**
- 8.4.1. In case a depositor(s) deposits during a month, he shall be paid due proportionate share in profit, based on daily average balance during the month. If a depositor divests during a month, the “ad hoc profit” for the number of days for which the balance remains invested, during such month, shall be paid at the profit rate for the preceding month
- 8.4.2. In case the ad hoc profit, principle of Takharuj will be applied *i.e.* such calculation and payment to the customer shall be in full and final discharge of the Bank's obligations to the customer and no further claim whatsoever shall be made or entertained.

9. **Liquidation of the Pool**

9.1. **Constructive Liquidation**

- 9.1.1. In order to effect investment and withdrawal from the respective investment pool in a Shariah compliant manner, constructive liquidation concept will be applied.
- 9.1.2. Deposit into the respective pool will be deemed as the purchase of investment share in the investment pool.
- 9.1.3. Account holders may withdraw part or all of their balances, which be deemed as sale of investment share of the investment pool at an agreed value which may be below or above the actual deposit plus profit in case of interim withdrawals. Remunerative depositors may withdraw full amount of the account on maturity or prematurely as per terms and conditions applicable.
- 9.1.4. The concept of constructive liquidation will be applied for giving profit as final settlement to closed / matured accounts that close or mature between profit calculation points.

9.2. **Actual Liquidation**

- 9.2.1. According to AAOIFI's Shariah Standard No. 13 - Mudarabah, actual liquidation (winding-up or dissolution) of the pool can take place in the following scenarios:
- with the agreement of both parties;
 - on the date of maturity if the two parties had earlier agreed to set a time limit for it;
 - when the funds of Mudarabah contract have been exhausted or have suffered losses; and
 - The liquidation of the institution that acts as Mudarib.
- 9.2.2. In case of actual liquidation, Bank may calculate actual profit and loss and distribute profit in reasonable time period.
- 9.2.3. Term of liquidation of the Pool shall be specifically stated at time of creation of any Pool.
- 9.2.4. In case of actual liquidation of Pool, only the existing depositor(s) and the Bank shall have their share in PER and IRR as per their contributions.
- 9.2.5. A depositor shall not share any profit or be liable for any loss if he closes his account before liquidation of the Pool.

10. **Pre-mature Encashment of Riba Free Certificates (RFCs)**

- 10.1.1. In case of pre-mature termination, the profit will be distributed according to the schedule for premature encashment.
- 10.1.2. In case of early /premature encashment of RFC's the applicable weightages on such RFC shall be that of the RFC of the nearest completed period.
- 10.1.3. The schedule for premature encashment is summarized in *Annexure – 3* to the profit and loss distribution policy framework.

11. **Taxes and Zakat**

- 11.1.1. The payment of profits, shall be subject to deduction of Zakat and withholding tax, if applicable, in accordance with the provisions of the law.
- 11.1.2. Any depositor or holder of RFCs entitled to compulsory exemption from deduction of Zakat must submit such evidence proforma (CZ-50) in the prescribed manner one month preceding the valuation date except in the case of newly opened accounts
- 11.1.3. Withholding Tax at the rate notified by the Government of Pakistan from time to time will be deducted out of profits payable to the account holders.
- 11.1.4. There might arise certain taxation issues in establishing PER and / or IRR. Accordingly, advice from the consultant shall be sought before establishing PER and / or IRR.
- 11.1.5. As such, the Bank will not obtain any prior permission from the depositors for debiting their account for arising any Zakat and / or tax payable to the Government (or what so ever).

12. **Accounting Treatment and Presentation & Disclosure Requirements for Pool in the Financial Statements**

12.1. **Accounting Treatment**

12.1.1. The accounting treatment of PLS saving account and RFCs shall be based on Islamic Financial Accounting Standard on Profit and Loss Sharing on Deposits (Exposure Draft – as soon as it is finalized) as issued by ICAP. However, till the time such standard is issued, the accounting treatment will be in line with Industry practice and SBP’s instructions and guidelines.

12.1.2. Equity of depositors’ and their equivalent (RFCs) are not considered a liability for the purpose of financial accounting and reporting. This is because the Bank is not obligated in case of loss to return the original amount of funds received from the depositors’ unless the loss is due to negligence or breach of contract. Likewise, equity of depositors’ / PLS deposit account holders and their equivalent are not considered part of the owner’s equity.

12.2. **Presentation & Disclosure Requirements**

12.2.1. Contribution of depositors’ will be presented as an independent category in the statement of financial position / balance sheet of the Bank distinguishing it from liabilities and owners’ equity or as a liability according to SBP’s guidelines / disclosure requirements.

12.2.2. Current account will continue to be disclosed as similar to the conventional counterpart as required by SBP’s requirement for financial statements.

12.2.3. The financial statement will disclose in the note on significant policies of:

- a. The number and nature of pools maintained by the Bank along with their key features and risk & reward characteristics;
- b. Avenues / sectors of economy / business where Mudarabah based deposits have been deployed;
- c. Parameters used for allocation of profit, charging expenses and provisions etc. along with a brief description of their major components;
- d. Mudarib Share (in amount and Percentage of Distributable income);
- e. Amount and percentage of Mudarib share transferred to the depositors through Hiba (if any);
- f. The bases applied by the Bank in the allocation of profits between its own funds and funds of depositors’; and
- g. Profit rate earned vs. profit rate distributed to the depositors during the year.

12.2.4. Following disclosures will be made of the bases and the aggregate amounts, where applicable:

- a. for determining the incentive profits which the Bank receives from the profits of unrestricted / PLS deposit accounts; and

- b. for determining the incentive profits which the Bank pays from its profits to unrestricted investment/ PLS deposit accounts.

12.2.5. Disclosure will be made in the financial statements of the magnitude of balances of all unrestricted investment / PLS deposit accounts and their equivalent and other accounts by type in foreign currencies.

12.2.6. Disclosure will be made in the financial statements of the distribution of unrestricted investment / PLS deposit accounts and their equivalent and other accounts:

- a. by type,
- b. with respect to maturity, from the date of the statement of financial position / balance sheet.

The Bank's disclosure should differentiate between demand accounts and other accounts. With respect to accounts other than demand accounts, the IIFS should use for the purpose of this disclosure, maturity periods designed to disclose liquidity requirements immediately and in the following period(s). Maturity periods should be consistently used and changes in the maturity periods used by the Bank should be disclosed.

12.2.7. Disclosure will be made in the notes to the financial statements in respect of significant assets showing separately assets:

- a. exclusively financed by unrestricted investments / PLS deposit account holders;
- b. exclusively financed by the Bank; and
- c. jointly financed by the Bank and unrestricted investments / PLS deposit account holders.

The rights, conditions and obligations of each type of unrestricted investment accounts / PLS deposit accounts and its equivalent and other deposit accounts shown in the statement of financial position / balance sheet should be disclosed in the notes to the accounts.

12.2.8. Separate disclosures will be made of all material items of revenues, expenses, gains and losses classified under the headings appropriate to the IIFS distinguishing as regard to:

- a. exclusively financed by unrestricted investments / PLS deposit account holders;
- b. exclusively financed by the Bank; and
- c. Jointly financed by the Bank and unrestricted investments / PLS deposit account holders.

ANNEXURES TO THE POLICYMemorandum of Creation of New Pool(s)

Pool Identification Number: _____

date of creation of pool

Objective: _____

Mudarib Share / PSR: _____

Structure of Pool:

Tenor of Pool:

Particulars	Expected Amount (Rs.)	Expected Percentage of Pool	Weightages
Equity			
Deposit Category 1 (Type and Tenor)			
Deposit Category 2 (Type and Tenor)			
Deposit Category 3 (Type and Tenor)			
Deposit Category 4 (Type and Tenor)			

Description of Assets	Amount (Rs.)	Percentage	Maturity date
Asset – 1			
Asset – 2			
Asset – 3			
Asset – 4			

Authorizations:

RSBM

[Relevant personnel]

[Relevant personnel]

[Relevant personnel]

Deal Ticket
(For transfer of Assets)

Deal Ticket #: _____

Deal Ticket Date: _____

Asset(s) with particulars mentioned below in Schedule – A is transferred:

Sr. No.	Particulars	System Deal #	Asset Identification Number	Contract	Amount Outstanding (A)	Accrual / Receivable (B)	Total (A+B)

Transferred from the following Pool(s):

Sr. No.	Pool Identification Number	Allocation Date	Allocation Amount	Face Value	Fair Value Gain / (Loss)	Authorized By

Sr. No.	Pool Identification Number	Allocation Date	Allocation Amount	Face Value	Fair Value Gain / (Loss)	Authorized By

Transferred to the following Pool(s):

Sr. No.	Pool Identification Number	Allocation Date	Allocation Amount	Face Value	Fair Value Gain / (Loss)	Authorized By

[Attach details of assets if necessary]

Schedule for Profit Rate on Pre-Mature Encashment

Premature encashment schedule for RFCs								
RFC's	Within 1 Month	1-3 Months	3-6 Months	6-12 Months	1-2 Years	2-3 Years	3-4 Years	5 Years
3 Months	No Profit	Saving Account Rate						
6 Months	No Profit	Saving Account Rate	3 Months RFC					
1 Year Quarterly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC				
1 Year Half Yearly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC				
1 Year Maturity	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC				
2 Year Quarterly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Quarterly RFC			
2 Year Half Yearly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Half Yearly RFC			
2 Year Maturity	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Maturity RFC			
3 Year Quarterly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Quarterly RFC	2 Year Quarterly RFC		
3 Year Half Yearly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Half Yearly RFC	2 Year Half Yearly RFC		

3 Year Maturity	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Maturity RFC	2 Year Maturity RFC		
5 Year Quarterly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Quarterly RFC	2 Year Quarterly RFC	3 Year Quarterly RFC	3 Year Quarterly RFC
5 Year Half Yearly	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Half Yearly RFC	2 Year Half Yearly RFC	3 Year Half yearly RFC	3 Year Half yearly RFC
5 Year Maturity	No Profit	Saving Account Rate	3 Months RFC	6 Months RFC	1 Year Maturity RFC	2 Year Maturity RFC	3 Year Maturity RFC	3 Year Maturity RFC