Understanding PER and IRR in Islamic Investment Accounts

The Borneo Post (Sabah), 5th June 2017

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INCOME smoothing for Islamic investment accounts is broken down into Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR). According to Bank Negara Malaysia (2011), PER refers to the amount appropriated out of the total gross income before distribution for Islamic banking institutions to maintain an acceptable level of return for investment account holders. Instead, IRR is defined as amounts of profit attributable to the account holders, after deducting the banks share of profits. PER and IRR are two techniques in the management of Displaced Commercial Risk (DCR). DCR is a risk in which an Islamic bank is exposed to the commercial pressure to pay a competitive return rate to investment account holders (IAHs).

This week, I intend to write on three issues pertinent to PER and IRR. Issue #1 – Why Islamic banks need PER and IRR? Issue #2 – What are *Shariah* issues in PER and IRR? Issue #3 – Do the PER and IRR still relevant?

Three (3) reasons explained why PER and IRR used but are not restricted to: **(1) MAINTAINING THE COMPETITIVE PROFIT PAY OUT** – Islamic banks have a limited scale of banking businesses that expose the banks to the fierce competition from their conventional peers. To remain competitive, the banks need to use income smoothing approach to provide competitive returns to IAHs to reflect the market rate. Conventional fixed deposits are the challengers for Islamic investment accounts. Practically, the returns for the fixed deposits are guaranteed while the latter is not. **(2) PROTECTING THE LARGE STAKEHOLDERS** – In a dual banking framework, it is worth mentioning that bank customers are a large stakeholders. The customers are of retail investors or capital contributors. Hence, the greater the stability of the return offered the better is the customers' confidence and loyalty to the facility. **(3) ENHANCED BANK LIQUIDITY MANAGEMENT** – The performance of investment products is somewhat erratic from one year to another. Regional and global financial crises have contributed to the fluctuation in returns. In fact, Islamic banks' investment is an integrated industry that causes the spill over effect to the banks' performance. The income smoothing tools are an enabler that assist to smooth a low rate of return by reducing the return's volatility earned by investors.

In terms of *Shariah's* stance, the practice of both PER and IRR are inconsistent with the theory of *mudarabah* or local slang pronounced it as "*mudah rebah*". The profit sharing in the case of this contract must be shared by both parties while loss is borne by the *rabbulmal* but *mudarib* should the loss is caused by him. Taking some portion of profit from *mudarabah* profit without informing the investors can lead nothing but to a deception where *gharar* matters. Thus, the product should communicate the PER and IRR policies clearly in the product disclosure sheet to benefit consumers at the expense of *gharar.*

I believe that the act of guaranteeing a profit for *mudarabah* investors is violating the profit and loss sharing principle. In this principle, however, profit is shared, loss is considered as far as a trading is brought into play. In a business, being in loss and profit is an evidence that explains why the act of guaranteeing a profit is forbidden.

Yet, PER should be viewed as liability that recognises at cost. Islamic banks are required to submit the report on their practice of PER amount to Bank Negara Malaysia on a monthly basis for better supervision and monitoring of the Bank Negara Malaysia. In addition, PER is permissible given the Securities Commission resolution at the 14th meeting dated back on the 8th June 2000. Less attention is given to IRR perhaps out of similar role to PER and equity factor. According to OIC Fiqh Academy (2000), PER is permissible based on the concept of waiving of right known as *mubara'ah* that is referred to waive a portion of right to receive profit for the purpose of achieving market stability in the future.

To comprehend better PER and IRR, I provide a simple calculation for "educational purposes" as follows: *Mudarabah* profit is MYR1,000,000: less PER 5% (MYR50,000): Balance is MYR950,000: less the bank's share 25% (MYR237,500): investor share of profits is MYR712,500: less IRR (MYR35,625): investor actual profit is MYR676,875. Without PER and IRR, the investor and the bank will earn MYR750,000 and MYR250,000, respectively. Do PER and IRR better?

Indeed, some growing issues need to tap. The first issue is about "Going concern" of the investment made by the customers. Does the practice of PER and IRR fair enough for customers who leave Islamic banks? Assume the customers already invested for 12 months, in which some portions of their profit earned through *mudarabah* investment is allocated for PER and IRR. If they leave after the months, the portions contributed for the income smoothing will not benefit them but for new customers. Does this fair? The second issue is about "Reserve amounts" of PER and IRR. A question to ponder. Does an Islamic bank allocate consistent amounts of PER and IRR should the bank consistently earn profits? Is there any mechanism to determine the reserves amounts? To capture these questions, Islamic banks have relied on the BNM's guideline in which the banks can save up to 15 percent from profit and somewhat can reach up to 30 percent. The question further, however, does this rate realistic to small banks? Many Islamic banks have a superb approach to address this issue effectively and efficiently.

The practice of PER and IRR is viewed to be faded given the advent of Islamic Financial Services Act 2013 (IFSA) that creates a significant transition for *mudarabah* deposits. I discuss only PER as it is captured in many Islamic banks. Changing *mudarabah* deposits takes two forms, viz., **(1) CHANGING THE GOVERNING *SHARIAH* PRINCIPLE** (from *mudarabah* "deposit" to *tawarruq* "deposit") and **(2) CHANGING THE PRODUCT TYPES** (from *mudarabah* "deposit" to *mudarabah* "investment"). Islamic banks have mixed view regarding the continuity of PER. Maybank Islamic and Bank Islam Malaysia Berhad, for example, opt to cease the practice of PER since 2011 and 2012, respectively. Both banks offer *mudarabah* products. Public Islamic and Hong Leong Islamic, for instance, still consider the use of PER as far as they are offering a so-called Islamic term deposits.

To sum it up, both PER and IRR theoretically serve as an additional liquidity injector that offers an improved an Islamic bank's liquidity management to boost returns for IAHs. Practically, however, their appearance is somewhat defeating the true purpose of investment in Islam. As such, banks that promote PER and IRR must put forward the accountability and transparency to strengthen the usefulness of PER and IRR for enhanced liquidity and return for IAHs, at least.

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