Regulation on Profit Distribution

Accountable Executive & Custodian	Islamic Banking Division
Policy Owner	Head of Islamic Banking Division

Approved by DAB Governor:	Date	DAB Board Secretary ....

Contents

ISLAMIC REPUBLIC OF AFGHANISTAN,

DA AFGHANISTAN BANK, REGULATION ON PROFIT DISTRIBUTION

PART A: PREAMBLE

1. Background

1.1 This Regulation on Profit Distribution Guideline (hereinafter referred to as "the Guideline") is issued by the Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be adopted and become the Profit Distribution guideline for Islamic Financial Banks, Financial Banks operating with an Islamic Window and Financial Banks operating with an Islamic Unit (collectively referred to as "the Bank") in the Islamic Republic of Afghanistan offering Islamic financial products.

1.2 Islamic banking institutions mobilise a large proportion of their deposits, of which a preponderant portion of investment funds raised by the Bank in the form of mudharabah (profit-sharing and loss-bearing) contract. Under the mudharabah contract, depositors (hereinafter known as investment account holders or IAH) agree to participate in the financial activities undertaken by the Islamic banking institutions (as mudharib) and share the profit generated from financing and/or investment activities based on an agreed profit-sharing ratio. The IAH shall bear the losses arising from the assets funded under the mudharabah contract or commonly known as profit-sharing investment account (PSIA), except in the case of fraud, misconduct, negligence or breach of contracted terms by the Banks. The contract thus involves profit-sharing for both partners and loss-bearing for the provider of capital.

1.3 An important element in the risk management capability of the Banks is managing risks that are peculiar to Islamic finance transactions. A dominant contractual relationship in Islamic banking, the case of mudharabah contract is an example of the distinct risk in Islamic finance that would require adherence to strong risk management governance and a high degree of transparency. Unlike conventional deposits where the interest rate is fixed at the point of placement of the deposits, the return of the mudharabah contract can only be ascertained at the end of the investment period.

Consequently the mudharabah contract exposes the Banks to the impact of cyclicality of returns generated from assets funded by the IAH, the stability of the rates of return to the IAH and the level of the Bank's competitiveness within the Islamic finance industry .

1.4 In order to maintain comparable rates of return, the Banks are exposed to Displaced Commercial Risk (DCR). DCR refers to the risk arising from the assets managed on behalf of the IAH which may be borne by the Bank's own capital, when the Banks foregoes part or all of its share of profits on the IAH funds, and/or make transfer to IAH out of the shareholders' fund investment profits as a result of commercial and/or supervisory concerns in order to increase the return to the IAH.

1.5 The application of DCR requires the Banks to displace the credit and market risk losses to themselves by paying a return that exceeds the actual return that was supposedly to be earned by the IAH on the assets based on the contractual profit sharing ratio. The rate of return paid to the IAH is thus given at the expense of the profits belonging to the Bank's shareholders. Hence, under this arrangement, the Bank would be expected to manage DCR in order to safeguard the Bank's own capital and to mitigate potential withdrawals and inflow of funds by the IAHs.

1.6 Given the unique relationship where the depositors would have a direct financial interest in the Banks, a standard calculation of the profit distribution is imperative to ensure that depositors will receive their portion of the investment profits in a fair and equitable manner. It will also address the information asymmetry between the Bank and its depositor by enhancing the level of transparency of Islamic banking operations.

1.7 The broad concept of the framework is based on the return on assets (ROA) approach, which calculates the income of the balance sheet assets. The framework prescribes the methodology in calculating income generated from the balance sheet assets, including other income such as trading income. It also incorporates the type of expenses to be deducted from the total income such as impairment loss, income-in-suspense and profit distributable to other related partier i.e. specific investment deposit holders, bank capital and interbank placements.

2. Purpose

2.1 The purpose of this Guideline contained in this document is to provide a framework of Profit Distribution principles as part of the effort to standardised the method on the calculation on the profit distribution in terms of rate of return and the approached, practices and processes to guide for the Banks. The purposes of introducing this guideline are to:

a) set the minimum standard in calculating the rate of return;
b) serve as a tool for the Banks to assess and monitor their business strategies and financial performance; and
c) provide the Banks with better means of assessing the efficiency of the Banks as well as their profitability; prudent management and fairness.

2.2 The framework includes the prohibition of application of weightage in the allocation of income, introduction of principal recognition of eligible income and expenditure with a negative list for direct expenses. The fundamental objective of the framework aims to promote a higher level of capacity and efficiency of the Banks in managing their Islamic Banking operations while strengthening Shariah application in mudharabah contract.

3. Scope of the Guideline

3.1 This Guideline is issued pursuant to Article 2.2 of the Afghanistan Bank Law gazetted on 12/17/2003 (corresponding to 30/10/1382) in relation to the powers of DAB to regulate and supervise Banks in the Islamic Republic of Afghanistan and any amendments thereto.

3.2 The policy and guiding principles provided under this document are applicable to all Banks. Banks are expected to apply these principles taking into account the size, complexity, risk profile and nature of their activities.

PART B: POLICY REQUIREMENT

4. The Framework of Profit Distribution

4.1 The underlying principle of the framework is that all deposits accepted by the Banks shall only be utilised in the provision of finance (financing, advances and loans), investment in securities, inter-bank placements and other business prescribed by DAB that complies with Shariah.

In other words, the deposits cannot be used or utilised in other than these activities such as acquisition of fixed assets and investment in subsidiary or associate companies.

4.2 The framework encompasses two types of tables:

4.2.1 CALCULATION TABLE (CT)

Objective:

To guide the Banks in deriving the net distributable income to the depositors and the Banks by incorporating the income generated from the assets, the relevant shared expenses and allowances between the Banks and the depositors, and income attributable to the various types of depositors. Income generated is to be recognised on an accrual basis.

Features:

Comprises income generated from balance sheet assets; trading and other income; provisions; profit equalisation reserves; other expenses; income attributable to Islamic banking capital funds/ shareholders' funds (IBCF/SHF); specific investment deposits (SID); amount due to designated financial institutions; Islamic negotiable instruments and other deposits.

4.2.2 DISTRIBUTION TABLE (OT)

Objective:

To guide the Banks on the proper distribution of the net distributable income posted from CT among other deposits or funds not included in the CT i.e. current, savings and general investment deposits. It requires the Banks to segregate between mudharabah and non-mudharabah deposits to reflect the different risk profiles and to ensure fair distribution of profit between these two categories of deposits.

Features:

Reports the respective weightage, profit sharing ratio and distributable profit to depositors and the Banks for each type of deposits, tenures and agreed profit sharing ratios.

5.0 CALCULATION TABLE (CT)

The methodology in deriving the net distributable income in the CT comprises two levels:

5.1 First Level

5.1.1 Reports the income generated by all Islamic banking assets and calculates the weighted average rate of return (WAR) of each asset.

5.1.2 The WAR reflects the percentage of income generated by each asset in a specific month. It also serves as a tool to evaluate the performance of the assets and to assist the Banks in strategising their future activities. For example, a lower WAR for the current month as compared to the previous month implies that efforts should be intensified to enhance the performance of the assets.

5.1.3 The WAR per annum of each asset is derived as below:

$$\text{WAR} = \frac{\text{Income}}{\text{Average daily amount of asset}} \times \frac{365}{\text{Number of days for the month}} \times 100\%$$

5.2 Second Level

5.2.1 This level prescribes the relevant allowances (such as general allowance, specific allowance, impairment loss and provisions for commitment and contingencies), profit equalisation reserves, direct expenses, other expenses and income attributable to the Banks and various depositors in arriving at the net distributable income.

5.2.2 In terms of direct expenses, handling fee for hire-purchase financing and brokerage fee for trading of securities are eligible to form part of direct expenses for the purpose of deduction from total gross income.

5.2.3 In addition, commission payable to sales officers for introducing new financing activities approved to the customers are also recognised as an eligible direct expense subject to the following conditions:

a) The commission is to be recognised after the new financing agreement has been completed by both the customer and the Banks and

b) Each payment of commission to the sales person must be documented.

5.2.4 Other direct expenses shall be specified by DAB from time to time.

5.2.5 The WAR of net income represents the percentage of income attributable to funds other than SID and IBCF/SHF and is derived as follows:

WAR of net income

$$= \frac{\text{Net income}}{\text{Average daily amount of (Total funds 1 - SID - IBCF/SHF)}} \times \frac{365}{\text{Number of days for the month}} \times 100\%$$

5.3 The WAR of the net distributable income reflects the percentage of income over other deposits or funds not included in the CT. Normally, the deposits include current, savings and general investment deposits (inclusive of special general investment deposits (SGID) if any).

6.0 DISTRIBUTION TABLE (DT)

6.1 The Banks are required to classify the current, savings and general investment deposits into mudharabah or non-mudharabah deposits.

6.2 For each current, savings, and general investment deposit, the Banks are required to report the followings:

- Average daily amount of deposit;
- Distributable profit (amount and percentage); and
- Depositors' and IBI's portion of distributable profit (amount and percentage)

6.3 SGID, if any, shall be reported in the DT under a separate itemif such deposit is not reported in any tenure of general investment deposits (GID).

6.4 Weighted is Not Permitted.

The application of weightage (to represent the varying risk reward attached to the different tenures) in determining the allocation of the net income to the different tenures of the deposits in **not permitted**. Profit sharing ratio (PSR) shall be the sole determinant of the distributable profit to depositor and the Banks.

6.5 Distributable Profit

6.5.1 In arriving at the distributable profit for Mudharabah and non-mudharabah deposits, the total average daily amount of each category of deposits is divided by the total average daily amount and multiplied by the total distributable profit.

6.5.2 The distributable profit of each category of deposit (Mudharabah and non-mudharabah) shall be used to determine the distributable profit of each type of deposits (current, savings, and general investment). The average daily amount of a type of deposit is divided by the total average daily amount of each category of deposits and multiplied by the distributable profit of each category.

6.5.3 Percentage of distributable profit for each type of deposits per annum (referred as gross rate of return) is derived as follows:

Gross rate of return

$$= \frac{\text{Distributable Profit}}{\text{Average daily amount of Deposits}} \times \frac{365}{\text{Number of days for the month}} \times 100\%$$

6.6 Profit Distributable to depositor and the Bank

6.6.1 The distributable profit is apportioned to the depositors and the Banks according to the PSR of the respective deposit types and tenures. The total amount of depositors' and the Banks's profit portions must be equal to the total distributable profit.

6.6.2 The percentage of profit distributable profit to depositors and the Banks per annum (net rate of return) is derived as follows:

Net Rate of return = Gross Rate x PSR

7.0 GENERAL AND COMPLIANCE REQUIREMENTS

7.1 ***Management of Funds*** - The funds of Islamic banking operations are classified into two categories i.e. restricted and unrestricted funds.

7.2 ***Income and Expenses*** – Income and expenses of the Islamic banking operation are categorised based on the management of funds in relations to the restricted and unrestricted funds. The classification of the Trading income, Fee-based income, Direct expenses will be guided by the general principles to be circulated by DAB.

7.3 ***Provisioning*** – The Banks are required to observe the relevant guidelines and circulars issued by DAB on the classification and provisioning of non-performing financing and securities.

7.4 ***Profit Sharing Ratio (PSR)*** - PSR refers to the portion of profit distributable to depositors and the Banks. For example, PSR of 70:30 refers to 70% of profit distributable to the depositors and the remaining 30% distributable to the Bank.

7.5 ***Dividend/Hibah*** – An accurate calculation of dividend/hibah is imperative to ensure that the mudharabah depositors receive a fair portion of their investment profit. The calculation based on the average rate of each investment deposit reflects the risk exposure of each deposit to the yield of the bank's assets.

7.6 ***Declaration of Rates of Return (ROR) and Board Rates*** – As a minimum requirement, the Banks are required to prominently display the effective period, types of deposits, PSR and ROR (in percentage) for respective deposits at their premises:, and notice to the depositors that other information not displayed on the board is available at the counters.

7.7 The Banks are required to declare their monthly ROR on a specified date and the subsequent one month will be the effective period of the declared ROR.

7.8 The framework is to regulate and monitor the prudence and fairness of the Banks in deriving their ROR to depositors. The Banks are required to maintain the records of both tables to facilitate examination by DAB from time to time. The relevant authority of the Banks shall endorse such records, at least the Head of Islamic Banking Division or the relevant department such as Finance or Treasury Department.

8. Custodian of the Profit Distribution Guideline

8.1 This Guideline shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Guideline shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council.

8.2 Banks may further refine the Guideline to suit their particular structure and policies. Such amendments shall be approved by the Bank's Board of Directors

9. Effective Date of the Document

The Effective date of this Guideline is the ______ day of ___________ 20___