Profits Payout to Mudaraba Depositors

(Bangladesh Perspective)

M. Azizul Huq

Since 1989

BANGLADESH INSTITUTE OF ISLAMIC THOUGHT (BIIT)

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Publisher
Bangladesh Institute of Islamic Thought (BIIT)
House # 04, Road # 02, Sector # 09, Uttara, Dhaka – 1230
Phone: 8950227, 8924256
E-mail: *biit_org@yahoo.com, publicationbiit@gmail.com*
Web: www.iiitbd.org

ISBN: 978-984-8471-03-6

First Published
June: 2012

Price
BDT 100 US $: 5

'Profits Payout to *Mudaraba* Depositors (Bangladesh Perspective)' by M. Azizul Huq, published by Bangladesh Institute of Islamic Thought (BIIT). House # 04, Road # 02, Sector # 09, Uttara Model Town, Dhaka-1230. Phone: 8950227, 8924256. E-mail: *biit_org@yahoo.com, publicationbiit@gmail.com Web: www.iiitbd.org* Price: BDT 100 US$: 5

Publisher's Note

Any causal reader who comes in possession of this booklet may ask, 'what this booklet is about?' The answer is 'it is on depositors of Islamic banks - some of their rights and obligations'.

Depositors of Islamic banks, like those of conventional ones, are the biggest stakeholders in the system, resources of the banks are mostly provided by them. The biggest Islamic bank of the country has 7 million depositors, 1 million fund users and 60 thousand equity holders. Similar scenario prevails in all Islamic (as well as conventional) banks. Most of the deposits of Islamic banks are kept under *Mudaraba* principle which means that the depositors will share profit of the fund at pre-agreed ratio. In case the funded income of the bank turns out negative, the entire loss is required to be borne by the depositors. Like equity holders, the depositors of Islamic banks bear certain risk of the bank, though they don't participate in the management of Islamic banks.

Despite this vital position in the system, the depositors of Islamic banks have hardly received due attention from the contemporary *Shari'ah* scholars and Islamic economists, contemporary literature on Islamic finance focuses the asset side of the balance-sheet of an Islamic bank which deals with fund users, not depositors.

'Profits Payout to *Mudaraba* Depositors' written by *M. Azizul Huq*, a distinguished pioneer of Islamic banking in Bangladesh, is an exception to the general trend of writings stated above. The author has rightly focused the critical position of the depositors. He has emphasized the importance of *Shari'ah* compliance; a fair and equitable return for depositors and a transparent and perceivable calculation of profits. He has also emphasized the need for a standard and uniform practice by all bankers of the country.

We believe this booklet will give new insight to the regulators, practitioners, academicians and researchers at home and abroad. We would consider our efforts well-spent if the booklet can promote a wider debate on the issue amongst regulators and top management of Islamic banks and thereby enable them to identify the best practice at the moment.

We congratulate the author and pray for all connected with this publication.

May Allah (SWT) grant us mercy and lead us on the straight path.

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Content

Preface

In Bangladesh, Islamic banking was introduced in 1983 with the establishment of the first Islamic bank of the country, Islami bank Bangladesh Limited. Thereafter, four dedicated Islamic banks were established in quick succession. Soon, two conventional banks were converted to Islamic ones raising the number of dedicated Islamic banks to seven. Besides, 15 conventional banks have launched Islamic operations along with their conventional products. Thus out of 47 banks of the country, 22 have been offering Islamic banking products. Of late, more banks are making in-house preparations to join the Islamic sector. The growth of Islamic banking in the country has been enormous.

The driving forces behind this rapid growth of Islamic banking in the country have been the mass demand, the outstanding success of the first Islamic bank of the country and lavish support of the Islamic Development Bank (IDB) and Arab funds. The entrepreneurial support to the Islamic banking movement came entirely from the private sector. The Bangladeshi professionals also proved their worth. The Islamic banking operations of the country are being managed entirely by local professionals without any foreign technical assistance at any stage. As against this warm popular support, the role of the government and the regulators was half-hearted.

Though Islamic banking has been in place in Bangladesh for 29 years, yet no law has been enacted so far and only a guideline was circulated by the regulators just 3 years back in 2009. Thus Islamic banking in Bangladesh has remained largely a self-regulated system during these years.

This situation was not favorable for growth of standardised and uniform practice of Islamic banking in the country, The operating banks are, of course, conscious of this situation and as remedial measure have come up to co-ordinate their activities with a view to achieving a greater degree of standardization and uniformity. In one such joint project, I had the opportunity to lead an inter bank study team. This exposure gave me an opportunity to gain first-hand knowledge of practices of different banks. This booklet is a product of that experience.

In this booklet, two separate frameworks for profit payout to *Mudaraba* depositors, as practiced in Bangladesh, have been discussed. These frameworks were developed in the country at different periods by two separate teams of dedicated Islamic bankers. Incidentally, I had the unique privilege of leading both the teams and I do not hesitate to bear responsibility for any deficiency that might creep into these frameworks. After a serious study of various applications of *Mudaraba* principle, I am convinced about the superiority of the ISR-based framework over the other one. I feel, it my sacred duty to express my sincere feelings to my professional successors. By writing this booklet, I feel greatly relieved. Now it is the turn of the practitioners to do their part.

May Allah lead us on the straight path.

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CHAPTER I

Shari'ah Principles for Receiving Deposits

Introduction

The Islamic banks in Bangladesh receive deposits under two Shari'ah principles:

i. *Al-Wadeeah* principle and

ii. *Mudaraba* principle.

Al-Wadeeah

Fund which is deposited with Banks by the depositors with clear permission to utilize/ invest the same is called Al-Wadeeah. Islamic banks receive deposits in Current Accounts on the basis of this Al-Wadeeah Principle. Islamic banks obtain permission from the Al-Wadeeah depositors to utilize the Funds at its own responsibility and the depositors would not share any profit or loss earned/incurred out of using of this funds by the banks. The banks have to pay back the deposits received on the principle of Al-Wadeeah on demand of the holders. The depositors have to pay govt. taxes and other charges, if any.

Mudaraba

Mudaraba is a partnership of labour and capital, where one partner provides full capital and the other one manages the business. The capital provider is called *Sahib Al-Maal* and the user of the capital is called *Mudarib*. As per *Shari'ah* principles, the *Mudarib* will conduct the business independently following *Shari'ah* principles. The *Sahib-Al-Maal* may provide advices, if he deems fit but he can not impose any decision over the *Mudarib*. Profit, if any, is divisible between the *Sahib-Al-Maal* and the *Mudarib* at a predetermined ratio, while loss, if any, is borne by the *Sahib-Al-Maal*. *Mudarib* cannot avail of any salary or remuneration against his labour as a manger or conductor of the enterprise/business. The deposits, received by Islamic banks under this principle are called *Mudaraba* Deposits. Here, the depositors are called Sahib-Al-Maal and and the bank is called Mudarib. The *Mudaraba* deposits include:

i. *Mudaraba* Savings Deposits (MSD)

ii. *Mudaraba* Short Notice Deposits (MSND)

iii. *Mudaraba* Term Deposits (MTD)

Different Islamic banks have developed various deposit schemes on the basis of this *Mudaraba* principle such as monthly deposit-based Hajj Scheme, Monthly/One time deposit-based Term Deposit Scheme, Monthly *Mudaraba* Profit Deposit Scheme, Monthly *Mudaraba* Marriage Savings Scheme, *Mudaraba* Savings Bond etc.

Framework for Rate of Return on *Mudaraba* Deposits.

For distribution of profit to *Mudaraba* depositors' two different frameworks of rate of return are in use in Bangladesh, These are:

1. Weightage-based framework and
2. Income Sharing Ratio (ISR) based framework.

The weightage-based framework was introduced in Bangladesh as early as in 1983 and the ISR based framework was introduced in 2008. Naturally banks starting Islamic operations before 2008 adopted the weightage-based framework.

Banks starting Islamic operations after 2008 had the option to choose between the two and they preferred to adopt the ISR based framework. In the following pages, we present both the frameworks in their entirety.

CHAPTER II

Weightage-Based Framework of Return

Introduction

As stated earlier Islamic banks accept various deposits under the principle of *Mudaraba* in which the bank plays the role of entrepreneur (*Mudarib*) and the depositors as fund provider (*Rabb Al-Maal*). Under this principle, profit accrued from investment and financing are shared between the *Mudaraba* depositors and the bank as per pre-agreed profit sharing ratio. Losses, if any, will be borne by the depositors unless the loss is due to the negligence by the banks in managing the depositors' funds.

Given this unique relationship where the depositors would have a direct financial interest over the bank's income, a standard framework for calculation of rate of return is essential that depositors will receive their portion of the investment profits in a fair and equitable manner. The framework of rate of return should also be transparent, perceivable and address all necessary information. Towards these, Bangladesh Bank has prepared a framework of rate of return to standardize the method on the calculation of rate of return for the full- fledged Islamic Banks, Islamic Bank Subsidiaries and Islamic Branches of the Conventional Banks.

Objective

The objective of introducing the framework of rate of return is:

i. To enable the banks under Islamic *Shari'ah* to follow the uniform standard in calculating the rate of return on *Mudarab* deposits.

ii. To clarify the different issues of profit calculation yardstick that often creates ambiguity amongst the Islamic banks.

iii. To ensure the *Mudaraba* Depositors interest that they are getting their portion of investment income in a fair and equitable manner.

iv. To provide a basis for the new Islamic bank that could not yet develop such rate of return framework.

v. To enable the Islamic bank to follow the *Mudaraba* principles on profit calculation for *Mudaraba* depositors as per *Shari'ah* requirement.

vi. To ensure the better level of transparency as well as to disclose the Islamic Banking operations.

Scope

This framework of rate of return on *Mudaraba* deposit is applicable to full-fledged Islamic Banks and Islamic Branches of the Conventional Banks licensed under Bank Companies Act 1991.

Principles

The following principles should be followed by the Islamic banks of all categories in distributing investment income to the *Mudaraba* depositors:

i. *Mudaraba* depositors of the Bank will share income derived from investment activities by deploying the *Mudaraba* funds. Income under this category will mean and include Profit, Dividend, Capital gain, Rent, Exchange Gain and any other income derived from the deployment of fund.

ii. Profit sharing ratio (PSR) between the *Mudaraba* deposits and the bank (*Mudarab*) should be declared before the starting of accounting year/at the time of *Mudaraba* contract and to be duly disclosed to the *Mudaraba* depositors.

iii. The banks may reduce or raise the profit Sharing Ratio before the starting of any accounting year/at the time of *Mudaraba* contract; but it by cannot be reduced after the declaration is done for any accounting year.

iv. The Gross Income derived from investment during the accounting year will, at first, be allocated to *Mudaraba* deposits, as per ratio of participating fund in the outstanding investment. If the *Mudaraba* deposits is higher that total outstanding investment, then participating ratio of *Mudaraba* deposits (as per Annexure – 1) to be considered as 100%. Profit on investment income to be distributed amongst the *Mudaraba* depositors as per pre-agreed ratio taking 100% as the participating fund in the total outstanding investment.

v. Management fee and Investment Loss Off-Setting Reserve, if any, may be deducted from *Mudaraba* depositors' share of investment income subject to prior declaration.of the same before starting of the accounting year/at the time of *Mudaraba* contract.

vi. *Mudaraba* deposits shall get priority in the matters of investment over Bank's Equity and other Cost-Free Fund i.e. Bank's Equity & Cost Free Fund will be deployed only after full investment of *Mudaraba* deposits. Bank's Equity shall mean and include paid up capital, statutory reserve, investment loss off-setting reserve, general reserve and any other reserve or fund created by the bank, Cost Free Fund means any type of funds received by the bank free of cost and not for sharing any income of the bank.

vii. *Mudaraba* fund accepted by the Islamic bank shall be utilized in all sorts of investment activities (i.e. general investment, investment in shares & securities, placement with other banks and financial institutions etc.) approved by the bank's *Shari'ah* Supervisory Board as well as Board of Directors of the Bank.

viii. Income from Exchange Gain derived from buying & selling of foreign currency should be shown separately (in the Annexure – 1) and to be added in the distributable income for the purpose of distribution of profit to depositors.

ix. Islamic Bank's and Islamic Branches of the Conventional Bank's will be required to assign weight-age to all types of *Mudaraba* deposits. The weight-age will represent the importance attached to the holding of each deposit in determination of profit. In this context, the assumption held is that longer the tenure of a *Mudaraba* deposits, the higher the risk.

The weightage and any subsequent change in weight-age of *Mudaraba* deposits should be disclosed to *Mudaraba* depositors before the starting of any accounting year/*Mudaraba* contract.

x. Profit may be calculated on different types of *Mudaraba* deposit accounts as per their respective rules for time & manner of deposit and withdrawal restrictions.

xi. *Mudaraba* deposits shall mean average balance of all types of *Mudaraba* deposit accounts standing in the books of the bank as on last day of each month during the accounting year to which the distribution of income relates after deducting Statutory Liquidity Reserve to be maintained as per Bank Company Act. 1991 (as per Annexure - 1).

Framework

The framework encompasses three types of Tables.

Table 1: Profit Calculation Format-1: Ratio of Participating Fund in the Outstanding Investment for the accounting year (as shown in Annexure-1).

Table 2: Profit Calculation Format-2: Distributable Profit for the accounting year (as shown in Annexure-2).

Table 3: Profit Calculation Format-3: Allocation of Distributable Profit to *Mudaraba* Depositors and the rate of return for the accounting year (as shown in Annexure 3).

Methodology

The methodology in deriving the distributable profit to *Mudaraba* depositors using the three tables described in Para 5 could be better understood from the following example:

Example:

Business information of an Islamic bank as on 31/12/2004 is given below:

			Tk. in Crore
1	Paid up Capital & Reserve		100
2	Total Al-Wadiah and Other Cost Free deposits		120
	Sub Total		220
3	*Mudaraba* Deposits:		
	a.	M. Hajj Deposits above 10 years	5
	b.	M. Special Sabings Scheme up to 10 years	30
	c.	M. Savings Bond for 5 years	5
	d.	M. Savings Bond for 8 years	10
	e.	M. Term Deposits for 3 months	80
	f.	M. Term Deposits for 6 months	100
	g.	M. Term Deposits for 12 months	90
	h.	M. Term Deposits for 24 months	70
	i.	M. Term Deposits for 36 months	100
	J.	M. Savings Deposit	250
	k.	M. Short Notice Deposit (SND)	40
Total *Mudaraba* Deposits			**Tk. 780 Crore**
Total Fund (220 + 780) -------------------------------			**= Tk. 1000 Crore**
Total Outstanding Investment			**800**
(Excluding profit receivable, profit/rent/compensation suspense etc.)			
Gross Investment Income			**96**

Assume that the above figures of all types of funds and investments have been continued in average from January to December 2004 and Profit Sharing Ratio (PSR) between the *Mudaraba* deposits and the hank (*Mudarib*) is 65:3 5 and SLR is 10%

		Other information:	Weightage
		Mudaraba Deposits:	
2	a.	M. Hajj Deposits above 10 years	1.35
	b.	M. Special Saving Scheme up to 10 years	1.30
	c.	M. Saving Bond for 5 years	1.10
	d.	M. Savings Bond for 8 years	1.25
	e.	M. Term Deposits for 3 months	0.88
	f.	M. Term Deposits for 6 months	0.92
	g.	M. Term Deposits for 12 months	0.96
	h.	M. Term Deposits for 24 months	0.98
	i.	M. Term Deposits for 36 months	1.00
	j.	M. Savings Deposit	0.75
	k.	M. Short Notice Deposit (SND)	0.55

Allocate the distributable income for *Mudaraba* depositors and calculate the rate of return for different *Mudaraba* deposits using the Format shown in Annexure 1, 2 and 3.

Solution: Let us fill-up the Table using the data above in the annexure shown in 1, 2 and 3.

Table 1: Ratio of Participating Fund in the Outstanding Investment for the Year 2004

(In Crore Taka)

Month	Outstanding Investment	*Mudaraba* Deposits									Less Liquidity Reserve	Net. M Deposits	Cost Free Fund Deployed
		Mud. Hajj	MSS	M. Muhar	MM Muhar	MS Bond	M. Term	M. Savings	SND	Total			
1	2	3	4	5	6	7	8	9	10	11= (3-10)	12(11×10%)	13(11-12)	14(2-13)
Jan	800	5	30			15	440	250	40	780.00	78.00	702.00	98.00
Feb	800	5	30			15	442	251	42	785.00	78.50	706.50	93.50
Mar	800	5	29			15	441	249	40	779.00	77.90	701.10	98.90
Apr	800	6	31			14.5	441	250	41	783.00	78.35	705.15	94.85
May	800	5	31			15.5	440	250	40	781.00	78.15	703.35	96.65
Jun	800	4	28			15	438	250	38	773.00	77.30	695.70	104.30
Jul	800	5	30			15	439	248	39	776.00	77.60	698.40	101.60
Aug	800	5	29			16	439	250	40	779.00	77.90	701.10	98.90
Sep	800	5	32			15	440	250	40	782.00	78.20	703.80	96.20
Oct	800	7	30			14.5	440	251	41	783.50	78.35	705.15	94.85
Nov	800	5	29			14.5	440	251	40	779.50	77.95	701.55	98.45
Dec	800	3	31			15	440	250	39	778.00	77.80	700.20	99.80
Total Monthly Product	9600	60	360	0	0	180	5280	3000	480	9360.00	936.00	8424.00	1176.00
Total Yearly Product	800	5	30	0	0	15	440	250	40	780	78	702	98
Ratio of Each participating fund												87.75%	12.25%

Note: Outstanding Investment = Total Outstanding Investment – (Credit Balance of Profit Receivable A/C, Unearned Income A/c Profit/ Rent / Compensation Suspense A/C etc.)

Ratio of M. Deposits = $\frac{\text{Net M. Deposits (Col. 13)}}{\text{Outstanding Investment (Col. 2)}} \times 100$

Ratio of C.F.Fund (Including Bank's Equity) = $\frac{\text{Cost Free Fund (Col. 14)}}{\text{Outstanding Investment (Col. 2)}} \times 100$

Table 2: Distributable Profit for the Year 2004.

Sl. No.	Particulars	Amount (In core Taka)
1	Ratio of *Mudaraba* Deposits and Cost Free Fund (Including Bank's Equity) to Total Investment as per Table-1	87.75% : 12.25%
2	Gross Investment Income	96.00
3	Share of Cost Free Fund and Bank's Equity of Gross Investment Income as per Serial no 1	11.76
4	Share of *Mudaraba* Deposits of Gross Investment Income as per ratio at serial no. 1	84.24
5	Less:	
	a. Management Fee (say 20% of serial no 4)	16.848
	b. Investment Loss Off-Setting Reserve (say 15% of serial no. 4)	12.636
	Sub Total (5a+5b) = { (20% +15%) = 35% of serial no. 4}	29.484
6	Total Distributable Profit to *Mudaraba* Depositors (carried over to Table -3) (4-5) (i.e. say 65% of serial no. 4.)	54.756

Table 3: Allocation of Distributable Profit to *Mudaraba* Depositors and the Rate of Return for Year 2004

Distributable Profit (Crore Taka) = 54.756
(From Table 2, serial no. 6)

(Figure in Crore)

Sl. No.		Deposit Type	Total Yearly Product	Weightage	Weighted Product	Share of Distributable Profit	Rate of Return
1		2	3	4	5	6	7
1		*Mudaraba* Hajj Savings					
	a)	Above 10 Years Term	5.00	1.35	6.75	0.535152393	10.70%
2		*Mudaraba* Special Savings (Pension Scheme (MSS)					
	a)	10 Years Term	30.00	1.3	39	3091991602	10.31%
3		*Mudaraba* Savings Bond					
	a)	8 Years Term	10.00	1.25	12.5	0.991022949	9.91%
	b)	5 Years Term	5.00	1.1	5.5	0.436050098	8.72%
	c)	**Sub Total**	**15.00**		**18**	**1.427073047**	**9.51%**
4		*Mudaraba* Term Deposit					
	a)	36 Months Term	100.00	1	100	7.928183595	7.93%
	b)	24 Months Term	70.00	0.98	68.6	5.438733946	7.77%
	c)	12 Months Term	90.00	0.96	8.64	6.849950626	7.61%
	d)	6 Months Term	100.00	0.92	92	7.293928908	7.29%
	e)	3 Months Term	80.00	0.88	70.4	5.581441 51	6.98%
	f)	**Sub Total**	**440.00**		**417.4**	**33.09223833**	**7.52%**
5		*Mudaraba* Savings Deposit	250.00	0.75	187.5	14.86534424	5.95%
6		*Mudaraba* SND	40.00	0.55	22	1.744200391	4.36%
7		Grand Total (1a+2a+3c+4f+5+6+7)	780.00		690.6 5	54.756	

Note:

Weighted Product = Total Yearly Product (Col3) × Weightage (Col 4)

Share of Distributable Profit = $\frac{\text{Total Distributable Profit x Individual Weighted Product}}{\text{Grand To al of Weighted Product (Col. 5 of Sl. No. 7)}}$

Rate of Return = $\frac{\text{Share of Distributable Profit of Individual } \textit{Mudaraba} \text{ Deposit (Col. 6)} \times 100}{\text{Total Yearly Product of Individual } \textit{Mudaraba} \text{ Deposits (Col 3)}}$

Compliance Requirement

Islamic bank and Islamic branches of the conventional banks will preserve the records of cälculation of rate of return for distributing the profit to *Mudaraba* depositors to facilitate to facilitate examination by Bangladesh Bank, Statutory Auditors, *Shari'ah* Supervisory Committee, if any, etc. form time to time. The relevant authority of the Islamic bank of all categories shall endorse such records.

The Islamic banks should also publish a framework of rate of return approved by the Board of Directors from their own perspective in the light of Bangladesh Bank, guideline, This framework of return should be available to all the officials of the relevant department and a copy of the same to he forwarded to Bangladesh Bank for information and necessary action. Any subsequent change, modification of alternation of framework of rate of return duly approved by the Board of Directors of the respective bank should immediately be informed to Bangladesh Bank.

CHAPTER III

Rationale behind the Weightage-Based Framework of Return

In Bangladesh the weightage-based framework of return was first adopted by Islami Bank Bangladesh Limited in 1983. In fact it was specially designed keeping the special needs of the bank in view. The bank being the first Islamic one in the country in the midst of an interest based banking system had a few challanges. It had to be *Shari'ah* compliant and at the same time had to follow the market benchmark set by well-established conventional banks. This was an uphill task. In this context viability and competitiveness were the prime concern of the bank.

All policy tools were geared to address these issues. Naturally on the liability side the framework for distribution of funded income between the banks and the *Mudaraba* depositors was considered crucial. It was structured into two tiers. At the first step the banks management fee was recovered from the funded income on a straightforward calculation with complete certainty and the residues of funded income was left to be distributed to the various groups of *Mudaraba* depositors according to assigned weightage. However, the bank was kept outside this weightage schedule. Any change in weightage schedule or deposit mix does not affect the management fee of the bank. The actual sharing ratio by the bank (30% of funded income for example) was fixed for the bank in line with the ratio of interest expenditure and interest in come of conventional banks operating in the market. Similarly weightage schedule of IBBL was computed keeping the interest rates of several of conventional banks in view. Thus safeguarding the interest of the bank was the cornerstone of the weightage-based framework.

CHAPTER IV

Limitations of Weightage-Based Framework

The weightage-based profit distribution framework as discussed in chapter II provides single/uniform management fee for the bank (*Mudareb*) against all groups *Mudaraba* depositors collectively whereas each group of depositors has different weightage.

The framework consists of a two tier income distribution mechanism. Tier one is for appropriation of Bank's management fee from the funded income as per predetermined share (say 30%) of the distributable funded income. The residue of distributable funded income is left for distribution to the *Mudaraba* depositors.

At Tier Two the rates of profit for each group of *Mudaraba* depositors is computed by applying the weightage assigned to each group. The Bank (*Mudarib*) however, remains outside this weightage schedule.

Thus the depositors' rates of profit are linked with the following three components:

I. Profitability of bank's deposits, i.e., the amount of funded income. This emerges at the end of any accounting period and is calculated ex-post. The Bank (*Mudareb*) in its own interest tries to maximise this income.

II. Bank's management fee, i.e., the share of funded income that bank allocates to itself for managing the funds. Depositor's share of funded income is inversely related to this.

III. The weightage schedule covering the various groups of depositors. Higher the weightage of any group, higher will be its rate of profit.

The second and the third items mentioned above are decided in advance (ex-ante) and are included in the agreement between the bank and the depositor's. The weightage-based framework is structured on the assumption that depositors rate of profit will depend conclusively on the interaction of these three factors, i.e., the distributable funded income, management fee and weightage. But in-depth study of facts reveal that this assumption is wrong. There are two more interlocking factors which affect the rates. These are the schedule of weightage and deposit mix; we have examined this fact in the following pages.

We assume the following data relating to an imaginary Islamic bank for an accounting year:

01.	Daily Product of Deposit	1000m
02.	Investment Product (No fund was kept idle during the period.)	1000m
03.	Total funded income	142.857m
04.	Lending Rate (i.e., Rate on Investments)	14.2857%
05.	Pre-distribution Profit on Deposit ----------	142.857%
06.	Pre-distribution Profit rate on Deposit (ROD)	14.2857m.
07.	Bank's Management Fee (30% of Funded Income)	30%
08.	Amount of Management Fee (30% of Item 5)	42.857%
09.	Rate of Management Fee	4.2857%

10. Depositors' Share of Funded Income ------- 100m.
(70% of Item 5)

11 Depositors' Rate of Funded income 10%

(Item 10 ÷ Item 1 x 100)

10. The Bank collects its funds through the following 4 different products:

Mudaraba SND

Mudaraba 1 Year Term Deposit

Mudaraba 2 Year Term Deposit

Mudaraba 3 Year Term Deposit

In the following Tables all these assumptions have remained unchanged.

Through these Tables we shall examine the impact of deposit mix and change in weightage schedule on profit rates of various groups of depositors.

Table 4.1: Impact of Change in Deposit-mix.

Types of Deposit	Deposit Product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	100m	0.70	0 .70m				7.777%
1 Year- TDR	200m	0.80	16 0m				8.888%
2 Year - TDR	300m	0.90	270m				9.999%
3 Year - TDR	400m	1.00	400m				11.111%
Total	1000m		900m	142.857m	42.857m	100m	

Note:

Column 2 ----- Deposit Product means daily Product of deposit during the period.
Profit rate against 2 year - TDR is arrived at by multiplying 11.111 by 0.90

Column 4 – Weighted Deposit Product: Deposit products bearing different weightages are made homogeneous by converting them into common weightage, i.e., one by multiplying a product by its weightage.

SND Deposit Product of weightage 0.70 is equal to 100m × 0.70

= 70m of Deposit Product One

Example 100m 0.7 = 70m of weightage one.

Table 4.2: Impact of Change in Deposit-mix.

Types of Deposit	Deposit Product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	400m	0.70	280m				8.75%
1 Year- TDR	300m	0.80	240m				10.00%
2 Year - TDR	200m	0.90	180m				11.25%
3 Year - TDR	100m	1.00	100m				12.50%
Total	1000m		800m	142.857m	42.857m	100m	

Table 4.3: Impact of Change in Deposit-mix.

Types of Deposit	Deposit Product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	100m	0.70	70m				8.234%
1 Year- TDR	400m	0.80	320m				9.411%
2 Year - TDR	400m	0.90	360m				10.587%
3 Year - TDR	100m	1.00	100m				11.764%
Total	1000m		850m	142.857m	42.857m	100m	

Table 4.4: Cross Impact of Change in Deposit-mix and Weightage-sehedule.

Types of Deposit	Deposit Product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	100m	0.75	75m				8.196%
1 Year- TDR	200m	0.85	170m				9.288%
2 Year - TDR	300m	0.90	270m				9.836%
3 Year - TDR	400m	1.00	400m				10.928%
Total	1000m		915m	142.857m	42.857m	100m	

Table 4.5: Cross Impact of New Product.

Types of Deposit	Deposit Product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	100m	0.70	70m				7.608%
1 Year- TDR	200m	0.80	160m				8.695%
2 Year - TDR	300m	0.90	270m				9.782%
3 Year - TDR	200m	1.00	200m				10.869%
Hajj Deposit	200m	1.10	2.20m				11.956%
Total	1000m		920m	142.857m	42.857m	100m	

Table 4.6: Deposit Mobilization in a Crisis Situation.

Types of Deposit	Deposit product	Weightage	Weighted Deposit Product	Funded Income	Bank's Management Fee	Distributable Funded Income	Profit Rate for Depositors
1	2	3	4	5	6	7	8
SND	100m	2.00	200m				19.417%
1 Year- TDR	200m	0.80	160m				7.766%
2 Year - TDR	300m	0.90	270m				8.737%
3 Year - TDR	400m	1.00	400m				9.708%
Total	1000m		1030m	142.857m	42.857m	100m	

Table 4.7: Results of All the Six Tables.

Types of Deposit	Profit Rates for Depositors					
	Tab. 4.1	Tab. 4.2	Tab. 4.3	Tab. 4.4	Tab. 4.5	Tab. 4.6
SND	7.777%	8.75%	8.234%	8.196%	7.608%	19.417%
1 Year- TDR	8.888%	10.00%	9.411%	9.288%	8.695%	7.766%
2 Year - TDR	9.999%	11.25%	10.587%	9.836%	9.782%	8.737%
3 Year - TDR	11.111%	12.50%	11.764%	10.928%	10.869%	9.708%
Hajj Deposit					11.956%	

Note:

In all the six tables: Total Deposit Product is - 1000m
Total Funded Income is - 142.857m
Bank's Management Fee is - 42.857m

Comments on the Tables

It may be noted that the bank's total deposit product, funded income and management fee have remained the same in all the six Tables; yet the profit rates to depositors have changed from Table to Table.

A comparison of Table 4.1 and Table 4.2 reveals that profit rates change due to change in deposit-mix. Profit rate of a particular group changes due to change in the volume of deposit by other groups.

Compared to Table 4.1 and Table 4.2 profit rates in Table 4.3 have again changed due to change in deposit mix (Column - 2) although the weightage schedule has remained unchanged.

If we compare the contents of Table 4.1 and Table 4.4 we find that profit rates of 2 year – TDR and 3 year – TDR have changed though their respective balances and weightage have remained unchanged. The change in the weightage of SND and 1 year – TDR has caused change in the profit rates of 2 year – TDR and 3year – TDR.

A comparison of figures of Table 4.5 with those of Table 4.1 reveals that the introduction of a new deposit product, i.e., Hajj Deposit scheme with high weightage, i.e., 1.10 has resulted in reduction of profit of all other existing deposit products.

Table 4.6 indicates that the bank in a crisis situation has mobilized short term deposits thorough SND accounts by offering weightage 2 which resulted in SND profit @ 19.4174%. This rate exceeds even the lending rate and yield on deposits of the bank which is 14.2857%. Interestingly, this operation has not caused any extra cost to the bank. Its management fee has remained unaffected at Tk. 42.857m. The higher rate of the SND account holders has been financed by cross subsidy from the other three groups of depositors.

In brief, it may be stated that changes in the weightage scheldule, deposit-mix and introduction of new deposit scheme with higher weightage as shown in the Tables 4.1 to 4.6 have resulted in gain or loss to the depositors at the cost of each other. Bank's position has remained unaffected though the decisions were taken by the Bank, not by the depositors.

Let us sum up the findings:

1. Bank's profitability remaining the same a depositor's rate of profit is affected by any change in weightage schedule though his own weightage may remain unchanged. Similarly his profit rate is affected by a change in the deposit mix i.e. relative change in the deposits of different groups of the Bank although his deposit amount has remained unchanged.

2. A client's profit rate is adversely affected when his weightage has remained unchanged but others weightages have been revised upward or new product with relatively higher weihtage has been introduced.

3. A client's profit rate is adversely affected when deposit-mix changes to contain higher volume of high weightage deposit.

From the foregoing analysis it is amply clear that from customer's perspective the weightage-based framework, as practiced in Bangladesh, is not a dependable mechanism. It enables an unscrupulous bank to unjustifiably promote its (bank's) interest at the cost of the depositors.

Methodology for Loss Sharing

The weightage-based framework as circulated by Bangladesh Bank does not contain any provision for loss disposal. To make the framework comprehensive it should contain mechanism for dealing with losses, if there be any, along with regulatory safeguards against misuse of such provision.

CHAPTER V.

ISR-Based Framework of Return

Introduction

The detailed framework of rate of return, based on income-sharing ratio, is given hereafter. This framework may be termed as Version 2008 and the version given in the Bangladesh Bank Guidelines for Islamic Banking may be termed as Version 1983 The Version 2008 is based on 25 years experience of Islamic banking in Bangladesh and as such is free from the deficiencies of the former framework.

Islamic banks accept profit-bearing deposits under the principle of *Mudaraba* in which the bank plays the role of entrepreneur (*Mudarib*) and the depositors act as fund-provider (*Rabb Al-Maal*). Under this principle, profit accrued from investment and financing is shared between the *Mudaraba* depositors and the bank as per pre-agreed profit sharing ratio. Losses, if any, are borne by the depositors unless the loss is due to the negligence of the bank in managing the depositors' fund.

Given this unique relationship where the depositors would have a direct financial interest over the bank's income, a standard framework for calculation of rate of return is essential to ensure a fair and equitable return to the depositors. The framework of rate of return should, of necessity, be transparent, perceivable and address all necessary information.

Distinguishing Features of this Framework (Version 2008)

I. The weightage-based framework circulated by the BB provides uniform management fee for an Islamic Bank against various groups of depositors whereas each group of depositors is assigned separate weightage. Increase in the weightage of one group automatically adversely affects the interest of all other groups and the bank's share remains unaffected. This is not fare. It also involves a two-tier calculation, which the clients don't understand.

II. The revised framework (Version 2008) is free from these defects. It is fair to the depositors. It involves one-tire calculation. Under this framework, if the bank decides to offer special benefit to any group it has to do it at bank's cost, not at the cost of other clients of the bank.

III. This framework offers a very, simple process of calculation. The calculation can be dome on month-by month basis. The annual rate can, of course, be calculated from the monthly rates.

IV. The rates can easily be updated throughout the year on a continuing basis. Since the actual rate is available round the year, no provisional rate is used. Needless to mention, provisional rates need frequent adjustments.

V. The framework ensures transparency. The up to date month-by-month rate is displayed in electronic board placed at the lobby of Islamic branches for the information of clients. Bank's clients appreciate this arrangement. They can see through the calculation and need not wait till the close of the financial year to know the result of their investment.

VI. Since the updated rates of various types of accounts are within the knowledge of both the bankers and the clients, they can enter into meaningful negotiation with each other.

Scope

This framework of rates of return on *Mudaraba* deposit is applicable to full-fledged Islamic Banks and Islamic Banking Branches of the conventional Bank. Meanwhile Bank Asia Ltd. has adopted this framework for their Islamic Banking Windows and software has been developed to implement it.

Principles

The following principles should be followed by Islamic Banks m distributing investment income to the *Mudaraba* depositors:

I. *Mudaraba* depositors of the bank will share income derived from investment activities deploying the *Mudaraba* funds. Income under this category will mean and include profit, Dividend, Capital Gains, Rent, Exchange Gain and any other income derived from the deployment of fund investments.

II. Investment Income Sharing Ratio (IISR) for each type of *Mudaraba* depositors and the Bank must be declared before the starting of the accounting year/at the time *Mudaraba* contract (Account Opening) and to be duly disclosed to the *Mudaraba* depositors.

III. The bank may reduce or raise the IISR before the start of any accounting year/at the time to *Mudaraba* contract (Account Opening) but cannot be reduced after the declaration is done for any accounting year.

IV. *Mudaraba* fund accepted by an Islamic bank shall be utilized in all sorts of investment activities (i.e. general investment, investment in share & securities, placement with other banks and financial institutions etc.) approved by the bank's *Shari'ah* Council as well as Board of Directors.

V. Income from Exchange Gain derived from buying and selling of foreign currency is to be added to the funded income for the purpose of distribution..

VI. Profit may be calculated on different types of *Mudaraba* deposit accounts as per their respective rules for period/time and manner of deposit and withdrawal restrictions.

VII. Doubtful Income and unearned Income, if there be any, and Provision for Depositors' Profit Equalization Fund may be deducted from the Funded Income before distribution.

VIII. *Mudaraba* depositors shall not share any non-funded income. Non-funded income means and includes commission and different fees realized by the bank in connection with collection of utility bills, sale & purchase of DD,TT, Issue, amendment and cancellation of L/C, issue of T.C, Bank-Guarantee, rent of Lockers, Postage/Phone/Fax and SWIFT charges recovered etc.

The framework consists of the following

A. Sum of daily products of investable funds for the period i.e., Banks funds, clients' cost-free Deposits and clients *Mudaraba* Deposits,

B. Distributable Investment income / Funded Income for the period less Investment related Provision.

C. Pre-sharing yield Rate for the period.

D. Sharing Ratio of various *Mudaraba* Deposits.

Methodology

The methodology of deriving profit rates for various *Mudaraba* Deposits for any period is illustrated by the following practical example:

A. Figure against Item 12A is 1000m

B. Figure against Item 12B is 142.857m

Investment-related provision is nil.

C. Pre-sharing yield rate per hundred for the period will be:

$$\frac{\text{Funded Income} \times 100}{\text{Sum of Daily Products of Investable Fund}}$$

$$= \frac{142.857m \times 100}{1000m} = 14.2857\%$$

D. **Table 5.1:** Pre-Agreed Income Sharing Ratio between the Bank and Clients.

Types of Deposits	Bank's Share (Management Fee)	Client's Share
SND	50%	50%
1 year Term Deposit	40%	60%
2 year Term Deposit	30%	70%
3 year Term Deposit	20%	80%

Profit rates for the various *Mudaraba* Deposits for the period will be as follows:

Table 5.2: Resultant Profit Rates for the Bank and Clients.

Types of Deposits	**Bank's Rate (Management Fee)**	**Client's Rate**
Special Notice Deposits (SND)	50% × 14.2857 = 7.1429%	50% × 14.2857 = 7.1428%
1 Year Term Deposit	40% × 14.2857 = 5.7143	60% × 14.2857 = 8.5714%
2 Year Term Deposit	30% × 14.2857 = 4.2858%	70% × 14.2857 = 9.9999%
3 Year Term Deposit	20% × 14.2857 =2.8572%	80% × 14.2857 = 11.4285%

Client's rate is derived from the pre-sharing yield rate by applying the client's sharing ratio.

Pre-sharing yield rate on the deposit pool will there fore be distributed between the bank and various groups of depositors as under:

Table 5.2.1: Resultant Profit Rates for the Banks and the Clients.

Types of Deposits	**Pre-distribution yield**	**Bank's Rate of Profit**	**Client's Rate of Profit**
(SND)	14.2857%	7.1428%	7.1428%
1 year Term Deposit	14.2857%	5.7143%	8.5714%
2 year Term Deposit	14.2857%	4.2858%	9.9999%
3 year Term Deposit	14.2857%	2.8572	11.4285%

Since the various types of deposits constitute on pool for the Purpose of investment the yield on the pool, here 14.2857%, is pre-distribution yield for all the groups.

Methodology for Loss-sharing

Let us assume that the same pool of depositors as shown above continued during the subsequent accounting period and the pool incurred as loss of Tk. 20 million. As per rules of *Mudaraba* and *Musharaka* loss to the pool, if any, would be distributed among the pool members according to their capital participation ratio. The various income sharing ratios will be totally ignored. The loss of Tk. 20million to the pool will be shared by all the four types of depositors in the following manner:

A. Figure against Item A is 1000m

B. Figure against Item B is – 20m

Investment related provision is NIL

C. Loss-sharing rate will be

$$\frac{20}{1000} = 2\%$$

The bank (Common *Mudareb* to the entire depositor) will not get any management fee for its services.

CHAPTER VI

Comparison between the Two and Rationale behind the ISR Based Framework

Pre-agreed Profit Sharing Ratio

Every *Mudaraba* depositor of an Islamic bank is a *Saheb-Al-Maal* in his individual capacity and the bank is the common *mudareb* for all the depositors. The account-holders do not have any relationship between themselves nor do they form any corporate group. Bank's relationship with each client in purely a bilateral one. There is no tripartite agreement between the bank and the depositors. The account opening from signed by an individual accountholder is the basis of relationship between that client and the bank. This document and/or any other supplementary document exchanged between the bank and a client must contain a pre-agreed profit sharing ratio. This is mandatory in a *Mudaraba* business. ISR-based framework fulfils this Shari'ah requirement.

The weightage-based framework does not fulfil this requirement. The provision of disclosure in respect of bank's management fee and depositor's weightage does not generate any bilateral profit sharing ratio between the bank and any individual client.

Transparency

The best protection the *Mudarabah* depositors, who undertake to bear the loss if there be any, can get is transparency and full disclosure. This should extend from transparency of the underlying legal contract between bank and customer to transparency and regular and timely disclosure of the relevant profit and performance measures.

To achieve the above stated objectives profit determination by the *mudarabe* bank should be done at short intervals, preferably on monthly basis, if not on daily basis. Calculation of profit should be easy and perceivable by the depositors. At the end of any accounting period every individual depositor (who is a *Saheb Al-Maal*) must be informed about (a) the amount of income generated by his fund (b) the amount retained by the bank from this income as its management fee and (c) the amount of income apportioned to him. The figures (b) and (c) must be derived from figure (a) by applying the pre-agreed sharing ratio.

The ISR-based framework meets all these requirements. Under this framework accounts one updated on continuous basis. Hence the banks do not need any provisional or indicative rate.

The weightage-based mechanism cannot address all the legitimate information. Under this mechanism, a *Mudaraba* depositor is informed only about the amount of profit paid into his account. He does not know what was the total yield from his deposit and what amount has been retained by the bank out of that yield. These two pieces of information are very relevant for satisfaction of a *Saheb Al-Maal*. This situation may be categorized as incomplete disclosure.' or lack of transparency. Besides, the accounting process is round -about and lengthy. Profit calculation is handled exclusively by the head office officials and most of the field-level officials, who are required to interact with the clients, don't understand the calculation and cannot communicate with the clients except stating that it has been fixed by head office. Since the process is lengthy, the profit determination is done at yearly intervals on ground of economy. Throughout the entire accounting year the bank depends on provisional rates which are changed from time to time. The final rate of profit emerges at the end of the year. This scenario is really uncomfortable for the *Mudaraba* depositors who are under obligation to bear the loss, if there be any. To make the transactions fair and equitable the banks (as *mudareb*) must ensure regular and timely disclosure of relevant profit and performance measures.

CHAPTER VII

Conclusion and Recommendations

Islamic banking in the modern world is a very recent phenomenon. Its concepts and practices are still emerging. Through this process the system will achieve standardization and uniformity at national and international level. This fact has to be accepted by all stakeholders. From the preceding discussion it is obvious that the ISR-based framework of return is a definite improvement over the weightage-based framework. This is true in *Shari'ah* as will as in management perspective. Of course the transition to the ISR-based system from weightage-based framework may take some time.

During this transition period Bangladesh Bank (BB), being the regulator, has some responsibility. BB must identify the issues that need regulations. From the preceding discussions it appears that weightage-based framework of return needs regulation on the following two issues:

Banks Management Fee

There should be a cap on it. At one stage Pakistan Govt. announced that any financial institution that limits its management fee within 10% and distributes 90% of its funded income to depositors will get tax incentive. Similar, steps if not the same, may be considered in Bangladesh too.

Band of Weightage

The second issue needing regulation is the band of weightage. It should be kept as short as possible.

Regulatory issue in ISR-based method is the floor level (bottom line) of sharing ratio.

About the Author

Mr. *M. Azizul Huq*, born in 1935, did his post-graduate in Economics at the University of Dhaka in 1958. He started his banking career as Probationary Officer with Habib Bank Ltd. at Karachi, the then capital of Pakistan. Since then he has worked for - (i). Habib Bank Ltd. (ii). National Bank of Pakistan, (iii). Sonali Bank, (iv). Islami Bank Bangladesh Ltd., (v). Social Investment Bank Ltd. (Now Social Islamic Bank Ltd.), and (vi). Islamic Finance and Investment Ltd. Mr. Huq had the rare opportunity of working successively as Founder Chief Executive of Islami Bank Bangladesh Ltd., Social Investment Bank Ltd. and Islamic Finance and Investment Ltd. During 1985-94, Mr. Huq taught Islamic Banking and Finance at the University of Dhaka. He received training in Islamic Banking and Economics under direct supervision of Dr. Ahmed El-Najjar at the Al-Azhar University, Cairo, Egypt. In 2005 when the central *Shari'ah* Board of Islamic Banks of Bangladesh introduced the prestigious annual Islamic Banking Award, Mr. Huq was the first person to be honoured for his outstanding contribution to Islamic Banking in Bangladesh.

Currently he has been working as Chairman of *Shari'ah* Council of City Banks Ltd., Dhaka Bank Ltd. and Pubali Bank Ltd.