1 April 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG Islamic Finance Working Group Comments on Amortised Cost and Impairment

The AOSSG's Islamic Finance Working Group ("AOSSG IF WG") was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia.

When IASB ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* was issued in November 2009, AOSSG IF WG was yet to be established. As such, the AOSSG had not forwarded any views on how the proposals would impact Islamic transactions and events.

Given that the IASB is now seeking comments on a Supplement to ED/2009/12, we would like to take this opportunity to advise the IASB how we think the ED could potentially affect the Islamic finance industry. In particular, the proposed expected loss model may have consequences for transactions and events based on the profit-sharing contract of *mudarabah*.

These comments are additional to the AOSSG Financial Instruments Working Group's comments on the Supplement to IASB ED/2009/12 dated 1 April 2011, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and none of those members have expressed significant disagreements.

Mudarabah

Mudarabah is a type of partnership where one party provides capital, and another provides management, to a profit-seeking endeavour. Profits are shared at a pre-agreed ratio, but losses are borne solely by the capital provider.

In modern Islamic finance, *mudarabah* arrangements between a customer and a financial institution can be structured to closely resemble either customer 'deposits' in a banking environment, or accounts placed with an investment management entity. In capital markets,

mudarabah can also be used to structure *sukuk*, which are colloquially known as 'Islamic bonds'.

Although strictly-speaking any losses should be borne solely by the capital provider, some banks may implement 'smoothing' mechanisms to protect the account holder against losses, e.g. regardless of the actual performance of the enterprise, the bank would pay account holders returns consistent with market rates; any relevant share of excess account holders' profits would be put into a reserve and disbursed in times of lower profitability. In some cases, this could involve the bank's foregoing all or part of its own share of the returns from the enterprise to support the account holders[1].

In an investment management relationship, there may or may not be a smoothing mechanism in place; and the customer could be exposed to risk on both profits and principal.

***Mudarabah*, the expected loss model, and inter-generational inequity**

Some Working Group members think that an expected loss model won't impact on the profit or loss generated by a given portfolio of loans over the life of those loans, as the outcome will be determined by the cash flows actually associated with those loans.

However, the expected loss model can impact the time at which profits or losses are recognised. Thus, some Working Group members are concerned that applying the expected loss model could exacerbate 'inter-generational' inequity in an open-ended 'investment management-type' *mudarabah* accounts without a smoothing mechanism. As the expected loss model would load losses up-front (potentially at an amount greater than that in an incurred loss model), if the computation of profit to be distributed includes a deduction for expected losses, then the first generation of account holders could potentially be paid 'less' than the amount of 'actual' profit they are entitled to due to the expected losses recognised. Conversely, the next generation of account holders could get 'more' than the 'actual' profit they deserve. This is because the earlier generation of accountholders would have borne the up-front losses.

When pay-outs are based on estimates, some regulators / *shariah* authorities may require a final reconciliation at maturity to arrive at the actual profit for distribution. While this may work for a close-ended fixed term arrangement (such as *sukuk mudarabah*), it may not help in an open-ended arrangement where numerous account holders continually enter and exit. In an open-ended arrangement, account holders who cash out of their positions are unlikely to receive any true-up payments if the actual losses are less than expected losses, as of the date they exit the investment.

In contrast, some Working Group members see that inter-generational equity depends more on the accuracy of estimates, rather than on the impairment model used. They opine that even under another model, e.g. an incurred loss model, any over- or under-estimate amount of loss

[1] According to the Islamic Financial Services Board (IFSB) there are four types of smoothing techniques, (1) the financial institution may forgo part or all of its share of profit; (2) the financial institution may transfer amounts from its shareholders' retained earnings to the account holders; (3) the financial institution may maintain a Profit Equalisation Reserve (PER) by setting aside amounts from both the financial institution's and account holders' profits; or (4) the financial institution maintains an Investment Risk Reserve (IRR) by setting aside amounts solely from the account holders' profits.

in one generation would affect that generation's 'actual profit' as well the subsequent generations of account holders. Thus, they do not think that expected losses, *per se*, would exacerbate inter-generational inequity. They add that the problem is not exclusive to Islamic structures.

***Shariah* authorities' acceptance of expected losses in arriving at profit for distribution**

Some *shariah* authorities specify what constitutes permissible deductions in arriving at the profit to be shared by *mudarabah* partners. While incurred losses have traditionally been accepted as permissible deductions, the Working Group has not established whether expected losses would be as well. Incurred losses (including incurred but not reported (IBNR) losses) have been accepted because the estimates are usually based on some trigger event, and hence deemed to have 'actually' occurred and are 'actual' losses. The proposed expected loss model, however, requires factoring in "supportable forecasts of future events and economic conditions" which have not yet happened. Some industry practitioners believe that if *shariah* authorities currently accept general loss provisions based on an arbitrary percentage of a portfolio, then surely they would accept a 'statistically-based' impairment estimate. Conversely, others counter that these general provisions are usually small (e.g. in Malaysia, typically 1.5% of total outstanding loans) and hence its effect on 'actual profit' is minimal, and is tolerated by *shariah* authorities. They further opine that estimates of expected loss over the lifetime of an asset may not be deemed as 'actual loss', and the amounts can be large such that on initial recognition they can materially skew the 'actual profit'. This could result in *shariah* authorities being hesitant about accepting profit distributions based on expected losses, particularly for *mudarabah* arrangements without a smoothing mechanism.

The working group plans to keep abreast of any *shariah* pronouncements on the application of the expected loss model in deriving *mudarabah* profit for distribution, and will advise the IASB accordingly.

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group