

**CENTRAL BANK OF NIGERIA**



**GUIDELINES ON THE PRACTICE OF  
SMOOTHING THE PROFIT PAYOUT TO  
INVESTMENT ACCOUNT HOLDERS FOR NON-  
INTEREST FINANCIAL INSTITUTIONS IN  
NIGERIA**

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## **DEFINITION OF TERMS**

<i>Hibah</i> (Gift)	A unilateral transfer of ownership of a property or its benefit to another party without any counter-value from the recipient.
<i>Ijarah</i> (Leasing)	An <i>Ijarah</i> contract refers to an agreement made by Non-Interest Islamic Financial Institutions (NIFIs) to lease to a customer an asset specified by the customer for an agreed period against specified installments of lease rentals. An <i>Ijarah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijarah</i> contract.
Income Smoothing	The practice of levelling out the profit pay-out to investment account holders (IAH) by NIFIs.
Investment Risk Reserve (IRR)	Investment Risk Reserve is the amount appropriated by the NIFIs out of the income of Investment Account Holders (IAH), after allocating the <i>Mudarib's</i> share, in order to cushion against future investment losses for IAH.
Islamic Financial Services Board (IFSB)	The IFSB is an international standard-setting organization, which promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The Malaysia-based institution complements the efforts of Basel Committee on Banking Supervision (BCBS) and other international standard setting organization on prudential regulation that focus on conventional financial institutions.
<i>Mubara'at</i> (Waiver)	An agreement between a NIFI and its customer whereby the customer waives a certain portion of his profits earned during the investment period.
<i>Mudarabah</i> (Trust Partnership)	A contract between the capital provider ( <i>Rabb-ul-Mal</i> ) and a skilled entrepreneur ( <i>Mudarib</i> ) whereby the capital provider contributes capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>Mudarib</i> (or labor provider). Profits generated by the enterprise or activity are shared in accordance with the terms of the <i>Mudarabah</i> agreement while losses are borne solely by the capital provider, unless the losses are due to the <i>Mudarib's</i> misconduct, negligence or breach of contractual terms.
<i>Murabahah</i> (Cost Plus Mark-up Sale)	A <i>Murabahah</i> contract refers to a sale contract whereby the NIFIs sell to a customer at an agreed profit margin plus cost, a specified kind of asset that is already in their ownership and possession.

Non-Interest Financial Institutions	Means banks and other financial institutions under the regulatory purview of the Central Bank of Nigeria that provide banking and other financial services on the basis of Islamic Commercial Jurisprudence.
Profit Sharing Investment Accounts (PSIA)	These are accounts on the liability side of NIFIs' balance sheet that share in the profit and bear the losses generated from the investment of their funds. The owners of these accounts are called Investment Account Holders (IAHs).
Profit Equalization Reserve (PER)	PER is the amount appropriated by the NIFIs out of the <i>Mudarabah</i> income, before allocating the <i>Mudarib's</i> share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
Restricted Investment Account (RIA)	An account in which the holder authorizes a NIFI to invest funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
<i>Sukuk</i> (Islamic Investment Certificates)	<i>Sukuk</i> are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership) of assets of particular projects or special investment activity.
Unrestricted Investment Accounts (URIA)	The account holders authorize the NIFI to invest their funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts without imposing any restrictions. The NIFI can commingle these funds with their own funds and invest them in a pooled portfolio.

## **1.0 BACKGROUND**

### **1.1 Introduction**

1. In the exercise of the powers conferred on the Central Bank of Nigeria (CBN) by Section 55(2) of the CBN Act 2007, which is to make rules and regulations for the operation and control of all institutions under its supervision, the provisions herein are made as Guidelines on the Practice of Smoothing the Profit Payout to Investment Account Holders for Non-Interest Financial Institutions in Nigeria (NIFIs), herein after referred to as “income smoothing” or “smoothing”.
2. Section 11.3 of the Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria issued by the CBN permits NIFIs under its regulatory purview to practice income smoothing.
3. Income smoothing is defined as a Shariah-compliant technique employed by NIFIs to pay a certain level of competitive returns to Profit Sharing Investment Account Holders (PSIAHs). Various factors necessitate smoothing and are explained in Section 1.4 of this Guidelines.
4. This Guidelines complements relevant CBN Guidelines that deal with the subject. These include Guidelines on Corporate Governance for Non-interest Banks and Other Financial Institutions; various Guidance Notes on Calculation of Capital Requirements for Non-Interest Financial Institutions; Guidance Notes on Disclosure Requirements to Promote Market Discipline for Non-Interest Financial Institutions; Guidance Notes on Supervisory Review Process for Non-Interest Financial Institutions; and Guidelines on the Management of Investment Accounts.

### **1.2 Scope of Application**

5. This Guidelines shall apply to the following NIFIs:
  - Full-fledged non-interest bank or full-fledged non-interest banking subsidiary<sup>1</sup> of a conventional bank;
  - Full-fledged non-interest merchant bank or full-fledged non-interest banking subsidiary of a conventional merchant bank;
  - Full-fledged non-interest microfinance bank;
  - Non-interest Window of a conventional bank;
  - Non-interest subsidiary, branch or window of a non-bank financial institution;
  - A development bank regulated by the CBN offering non-interest financial services;

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<sup>1</sup>Conventional banks can only have a NIFI subsidiary under a Holding Company structure arrangement in line with the Guidelines for Licensing and Regulation of Financial Holding Companies in Nigeria issued by the CBN.

- A primary mortgage bank licensed by the CBN to offer non-interest financial services either full-fledged or as a subsidiary; and
- A Finance Company licensed by the CBN to provide non-interest financial services, either full-fledged or as a subsidiary.

### 1.3 Objectives of the Guidelines

6. The Guidelines is intended to achieve the following objectives:
- To explain the rationale for income smoothing;
  - To regulate and standardize income smoothing practices by NIFIs in Nigeria;
  - To specify and explain the techniques of income smoothing permitted for NIFIs in Nigeria;
  - To highlight some specific requirements relating to income smoothing; and
  - To state the role of Advisory Committee of Experts (ACE), Board of Directors (BOD), Governance Committee and Internal Audit/Shariah Review on income smoothing.

### 1.4 Rationale for Income Smoothing

7. NIFIs obtain a significant portion of their funds for financing and investment from Investment Account Holders (IAHs) based on *Mudarabah* and *Wakalah* contracts. Under the *Mudarabah* contract, the IAHs agree to participate as *Rabb-ul-Mal* in the financing and investment activities undertaken by the NIFIs as *Mudarib* and to share the profits generated from such activities based on a predetermined profit-sharing ratio. As capital owners, IAHs are liable to bear the losses arising from the assets funded under the *Mudarabah* contract, except in the case of fraud, misconduct, negligence, or breach of contracted terms and conditions by the NIFIs.
8. Under the *Mudarabah* contract, the IAHs therefore bear the commercial risk associated with the assets financed by the funds provided by them. At the same time, the NIFIs have a fiduciary obligation to manage the investment assets in a profitable manner and to safeguard the interests of the IAHs through the establishment of sound and prudent policies in the management of the assets funded by them.
9. However, NIFIs in Nigeria, like most of their counterparts in other jurisdictions, face a number of challenges while managing funds provided by the IAHs. Unlike their conventional counterparts that have readily available liquidity management instruments for investment of surplus funds and an efficient money and inter-bank markets including lender of last resort facilities, such infrastructures and instruments are not yet fully developed for NIFIs in Nigeria. This situation is not helped by the limited availability of

long-term but liquid investment instruments called *Sukuk*, which operates like a conventional bond.

10. The unavailability or limited supply of the aforementioned instruments or market mechanisms in Nigeria impacts on NIFIs' liquidity management as result of the holding of significant amounts of cash or other assets with zero or very low rates of return, and these have negative consequences on profitability. This situation results, at times, in the returns earned on IAHS funds being uncompetitive compared to those being offered by its competitors, whether other NIFIs or conventional institutions, and hence to those expected by its unrestricted investment account holders (UIAHs). This leads to *rate of return risk*, which is a particular problem with respect to funds of UIAHs, who typically may withdraw their funds at short notice as a result of low profit share thereby resulting to *withdrawal risk*. This, if unmitigated can ignite systemic risk which is a concern to supervisory authorities.
11. The scenarios painted in paragraphs 9 and 10 lead to Displaced Commercial Risk (DCR) which refers to the risk (i.e. volatility of the stream of income) arising from assets managed on behalf of IAHS that is effectively transferred to the NIFI's own capital because it follows the practice of forgoing part or all of its *Mudarib* share of profit on such funds, and/or making a transfer to UIAHs out of the shareholders' retained profit as a *hibah* when it considers this necessary as a result of commercial pressure. The rate of return paid to the UIAHs is thus "smoothed" at the expense of the profits attributable to the NIFI's shareholders.
12. DCR is caused principally by low income due to the limitations on liquidity management and rate-of-return risk. Rate-of-return risk is the risk of facing a lower rate of return on assets than that currently expected by UIAHs. For instance, a NIFI may have invested UIAHs' funds into relatively long-maturity assets such as long-maturity *Murabahah* and *Ijarah* and thereby have locked in lower rates of return on assets than those currently on offer in the market. DCR results when there is pressure on the NIFIs to match the market expectations of UIAHs.

## **1.5 Types of Investors and Investment Accounts**

13. Two main types of investment accounts may be offered by NIFIs: Unrestricted Investment Accounts (UIAs) and Restricted Investment Accounts (RIAs). In managing UIAs, a NIFI has full discretion to utilize the funds for financing and investments, as UIAHs provide funds without specifying any restrictions as to where, how or for what purpose the funds should be invested, provided that they are *Shari'ah* compliant. For RIA, on the other hand, the mandate is confined to financing and investment activities

agreed between the NIFI and the account holders as to where, how and for what purpose the funds are to be invested.

14. Smoothing may apply to both types of accounts, but in practice it is more generally applied to UIAs since they are considered as *Shari`ah*-compliant substitutes for conventional term deposits. NIFIs usually maintain separate reserves, such as Profit Equalization Reserve (PER) and/or Investment Risk Reserves (IRR) for each type of account for risk management and segregation purposes.

## **1.6 Categorization of Smoothing Techniques**

15. In order to prevent withdrawal risk emanating from IAHs due to low returns, Islamic Financial Institutions (IFIs), in many jurisdictions, resorts to various income smoothing techniques all of which have varying degrees of legal and governance implications to the institutions. The basic purpose of Smoothing is to give better rates of payout to UIAH in periods when assets financed from their funds fail to generate competitive returns vis-à-vis competitors' asset portfolios. In addition, some IFIs are also involved in the practice of building separate reserves for covering losses on the UIAHs' investments.
16. The smoothing methods used by IFIs in various jurisdictions may entail DCR without mitigation, or mitigation of DCR by the use of reserves (PER & IRR). DCR occurs when IFIs, as *Mudarib*, effectively transfer risk (i.e. volatility of income stream) arising from the assets managed on behalf of UIAHs to their own capital, by forgoing a part or all of (a) the *Mudarib*'s share of profit and/or (b) the shareholders' portion of profit in the joint investments in order to increase the rate of return payable to UIAHs.

## **2.0 PERMISSIBLE INCOME SMOOTHING TECHNIQUES FOR NIFIs IN NIGERIA**

### **2.1 Profit Equalization Reserve**

17. NIFIs shall create PER and appropriate to the reserve amount out of the profits earned from the commingled pool of assets before the allocation to UIAHs and *Mudarib* (the NIFI). The amounts appropriated to the PER has the implication of reducing the profits available for distribution to both categories of investors – shareholders and IAHs. The PER allows NIFIs to mitigate considerably their exposure to DCR.
18. The internal policy of using PER as a smoothing technique shall be subject to approval of ACE and the BOD. The actual transfers to and from the PER shall be subject to ACE and executive management committee's approval. The consent of IAHs shall also be obtained who shall agree to give up any portion of the reserve as *hibah* on the basis of *Mubara`at* when the *Mudarabah* contracts terminate.

19. The condition that triggers a transfer to PER shall be determined by executive management and approved by the BOD. This should usually be signified when the aggregate rate of return from *Mudarabah* assets exceeds a certain expected level of rate of return payable to IAHs at the end of any given profit calculation period adopted by the NIFI, after deducting the *Mudarib's* share. This rate (expected rate of return) should typically be a benchmark rate of return. There shall not be any transfer to PER once this rate is not met or exceeded.
20. The maximum amount of transfer to PER at any point shall be set by the BOD and endorsed by the ACE, subject to CBN approval
21. The balance in PER shall be utilized within a maximum period to be set by the BOD and endorsed by the ACE after which it shall be transferred back to income for distribution to existing IAHs and the shareholders.
22. The IAH's portion of PER shall be added to their equity in the liability side of the balance sheet while that of the *Mudarib's* shall be reported under shareholders' funds.

### **2.2 Forgoing Part or All of the *Mudarib's* Share of Profit**

23. A NIFI may forgo or give up part or the entire *Mudarib's* share of profit earned on UIAHs funds. The contractual profit sharing ratio for the *Mudarib* shall be seen as the maximum which can be reduced to zero. However, a NIFI shall not unilaterally increase its profit sharing ratio without obtaining the consent of the IAHs.
24. The overall decision to reduce the profit share for *Mudarib* shall be subject to the consent of the BOD, while a formal approval of executive management committee is required for any reduction of *Mudarib's* share at the time of each profit distribution.

### **2.3 Transfers from Shareholders' Current or Retained Profit**

25. NIFIs may make transfer from current or Retained Profit/General Reserve for distribution to IAHs on the basis of *Hibah*. The use of this smoothing technique shall be subject to BOD approval and shareholders' consent at annual general meeting.
26. The actual amount to be transferred from current profit and/or Retained Profit/General Reserve for distribution to IAHs at any time shall be subject to the decision of executive management committee. The amount of each transfer from current or Retained Profit/General Reserve shall be determined by the BOD subject to the approval of the CBN.

27. Both practices of foregoing part or *Mudarib's* entire share of profits, and transfer from shareholders' amount of retained profits, shall only occur at the point of profit realisation and distribution, but not a condition precedent to the *Mudarabah* agreement.

#### **2.4 Investment Risk Reserve**

28. NIFIs shall create IRR and transfer to the reserve amounts out of the profit attributable to IAHs after deducting the *Mudarib's* share in order to cushion the effects of future investment losses on IAHs. This reserve is added to the equity of IAHs. The IRR enables the NIFIs to cover, fully or partially, unexpected losses from the investments of IAHs' funds. It should be noted that the NIFIs do not guarantee the investment losses for IAHs as the reserve is appropriated from their income.
29. The internal policy of using IRR as a smoothing technique shall be subject to the approval of and the BOD. The consent of IAHs shall also be obtained who shall agree to give up any right they have to the reserve when the *Mudarabah* contract terminates.
30. The maximum amount of transfer to IRR at any point shall be determined by the BOD and endorsed by the ACE subject to CBN approval. IRR complements Shariah-compliant deposit insurance even though the latter is useful only in the event of liquidation.
31. Transfer to IRR shall be made after each profit calculation period whenever the NIFI recorded a positive rate of return on investment of assets funded with PSIA funds.
32. The balance in IRR shall be utilized within a maximum period to be determined by the BOD after which it shall be transferred back to income for distribution to IAHs.

### **3.0 SPECIFIC REQUIREMENTS ON INCOME SMOOTHING**

#### **3.1 Disclosure and Transparency**

33. NIFIs shall inform the IAHs that they practice income smoothing, indicating the nature of the smoothing and the types of reserve it maintains.
34. NIFIs shall make relevant disclosures regarding income smoothing in appropriate media as contained in the Guidance Notes on Disclosure Requirements to Promote Market Discipline for Non-Interest Financial Institutions in Nigeria issued by the CBN.
35. NIFIs shall disclose the analysis of the proportion of the RWA funded by IAHs that should be considered in arriving at the total RWA (as specified in the Guidance Notes on Regulatory Capital for Non-Interest Financial Institutions in Nigeria issued by the CBN).

36. NIFIs shall appropriately disclose the process of disposal of PER and IRR in the event of liquidation or termination of contractual relationship.

### **3.2 Liquidation of Non-Interest Financial Institutions**

37. At the time of creating the PER and/or IRR, NIFIs shall have a provision that in the event of their voluntary liquidation, the outstanding PER and/or IRR shall be disposed of either: (i) to those parties who “own” them – that is, existing IAHs and shareholders in the case of PER; or IAHs alone in the case of IRR; or (ii) the funds corresponding to the balances of these reserves should be donated to charity.
38. Notwithstanding paragraph 37, the CBN may decide that the outstanding balance of the reserves should be distributed differently from what was initially agreed between NIFIs and IAHs.

### **3.3 Capital Adequacy Ratio Computation**

39. Where DCR exists, NIFIs are required to allocate capital to cover some of the credit and market risks exposures arising from the assets funded by the IAHs that would otherwise be absorbed by the IAHs. The proportion of the credit and market risks exposures on assets financed by IAH funds, which is to be borne by the NIFI’s shareholders because DCR and the resultant Smoothing, is represented by a parameter alpha ( $\alpha$ ) in the Supervisory Discretion formula of the CAR calculation as specified in the Guidance Notes on Regulatory Capital for Non-Interest Financial Institutions in Nigeria issued by the CBN.

### **3.4 Terms and Conditions of a PSIA Contract**

40. At the time of establishing the relationship with IAHs, NIFIs shall ensure that the terms and conditions of the *Mudarabah* contracts are in accordance with *Shari`ah* principles and the relevant laws and regulations issued by the CBN and contracts governing the product.
41. NIFIs shall ensure that prohibited and imprudent activities are not undertaken in breach of the terms and conditions of the contract.
42. NIFIs shall ensure that the IAHs are fully aware of and agreeable to the terms and conditions stipulated under the PSIA contract. The terms and conditions shall include profit sharing ratio and basis of profit distribution and allocation. The PSIAs’ contractual terms and conditions shall be transparent, concise and written in a simple language that can be easily understood by the IAHs.

43. NIFIs shall clearly state in the investment contract any smoothing practices that they employ – in particular, if they expect the IAHs to forgo their rights to any portion of income which is appropriated for building up reserves such as PER and IRR.

#### **4.0 GOVERNANCE OF INCOME SMOOTHING**

##### **4.1 Internal Policy on Income Smoothing**

44. NIFIs are required to develop an internal policy on income smoothing to address the requirements of this Guidelines. The policy shall be commensurate to the size and complexity of each institution's operations.
45. The policy shall be subject to ACE's concurrence and the approval of the BOD.

##### **4.2 Board of Directors**

46. Considering the importance of IAHs and their peculiar position in NIFIs, the latter have a fiduciary duty towards the IAHs under the *Mudarabah* contract to safeguard the rights and interests of the IAHs whose investment accounts are exposed to credit and market risks arising from the NIFIs' financing and investment activities. Under the existing legal and regulatory framework, it is the responsibility of the BOD to provide a robust oversight and sound monitoring to ensure that investment accounts are managed in the best interests of IAHs.
47. For PER, the basis for computing the amounts to be so appropriated shall be pre-defined and applied in accordance with the contractual terms and conditions accepted by the IAHs and after formal review and approval by the NIFI's BOD. Similarly, the terms and conditions whereby IRR can be set aside and utilized shall be determined and approved by the NIFI's ACE and BOD.
48. The BOD shall review and approve the policies and strategies of the investments and for the management of DCR, and conduct regular reviews of the investment policies and the performance of the asset portfolio in which UIAHs funds are invested.

##### **4.3 Governance Committee**

49. IAHs occupy a special place in NIFIs. They provide the bulk of the funds for investment in income-earning assets on the basis of profit-sharing and loss-bearing *Mudarabah* contract. They are similar in many respects to shareholders as their return is not fixed while they bear any loss from the assets invested with their funds. However, unlike shareholders, IAHs are in a weak position to monitor management decisions regarding the profitable management of their funds.

50. Following from paragraph 49, NIFIs shall form a Governance Committee which shall comprise of at least three members one of whom shall be a member of the NIFI's ACE, which shall coordinate and integrate the implementation of the NIFI's Income Smoothing Policy, with the primary objective of protecting the interests of IAHs and other stakeholders. Depending on the size and complexity of the NIFI, an appropriate Board committee such as Board Audit Committee or Board Finance & General Purpose Committee may perform this role.
51. If the function of Governance Committee is performed by any other Board Committee, the Committee's mandate shall include the protection of the interest of IAHs as outlined in paragraphs 49-50 of this Guidelines. The Committee shall be chaired by an independent director.
52. In order to ensure that smoothing, including utilization of reserves such as PER and IRR is appropriately checked and monitored, the Governance Committee shall be mandated to scrutinize the utilization of such reserves and to make appropriate recommendations to the BOD.
53. The Governance Committee shall ensure that the interests of IAHs are taken into account when the profits are appropriated to such reserves or when reserves are drawn down, in order to enhance the profit distribution to IAHs.
54. The Governance Committee shall also evaluate the disclosures made by the NIFI regarding its asset allocation and investment strategies in respect of investment accounts in order to monitor closely the performance of NIFIs as managers of such accounts.

#### **4.4 Advisory Committee of Experts**

55. The ACE shall monitor effective management of investment accounts and ensure compliance with internal policy on income smoothing.

#### **4.5 Internal Audit/Shariah Review & External Audit**

56. As part of systems and controls, the NIFI's Internal Audit or Internal *Shari'ah* Review shall verify the conformity to the approved policies and procedures relating to profit calculation and Smoothing. This review shall also be within the scope of External Audit.