

## PROFIT AND LOSS DISTRIBUTION POLICY FRAMEWORK

Memorandum to  
Central Management Committee  
**BANK ALFALAH LTD.**

### 6.2. Profit Equalization Reserve

- 6.2.1. Definition of Profit Equalization Reserve (PER) as per AAOIFI's Financial Accounting Standard 11 – Provisions and Reserves is as follows:

*"This is the amount appropriated by the Islamic Bank out of the Mudaraba income, before allocating the Mudarib share, in order to maintain a certain level of return in investment for investment account holders and increase owners' equity."<sup>3</sup>*

- 6.2.2. According to the Risk Management Guidelines for Islamic Banking Institutions (IBIs) issued by SBP and Islamic Financial Services Board (IFSB) Standard:

*"PER is the amount appropriated by Islamic Financial Institutions (IFS) out of their total profit before allocating the working partner share, in order to compensate for Displaced Commercial Risk and smoothen out the return on investments"<sup>4</sup>*

- 6.2.3. According to the Capital Adequacy Standard issued by the IFSB Standard Displaced Commercial Risk (DCR) has been defined as:

*"The risk arising from assets managed on behalf of IAH which is effectively transferred to the IFS's own capital because the IFS follows the practice of foregoing part or all of its Mudarib share of profit on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to the IAH."<sup>5</sup>*

- 6.2.4. The peculiar relationship of Mudaraba where income earned by BAFL-IBG through financings, investments and placements has a direct impact on depositors' return entails the DCR and to mitigate the same, BAFL-IBG may be under pressure to pay a return that is higher than the rate earned by such depositors under normal working for profit and loss.

- 6.2.5. In order to mitigate the DCR, PER is one of the tools suggested by IFSB for risk management purposes to maintain an equilibrium between the actual rate earned and the rate of return expected by the depositors. In addition, AAOIFI's standards also permit to set aside periodically, a certain ratio of reserve for meeting the risk due to lower return on assets than expected as PER.

