Mudarabah and expected credit loss under IFRS 9

Background

In classical texts, Mudarabah is a type of partnership where one party contributes capital, and another contributes entrepreneurship towards a commercial venture. Any profits made on the venture are shared between the partners in a pre-agreed ratio, but any losses would be borne by the capital contributor. In modern Islamic finance, a customer (being the capital contributor) may place amounts in a Mudarabah account which would be managed by the bank (as the entrepreneur). Profits made through the arrangement would be shared between the accountholder and the bank.

From the bank's point of view, the placement from customer represents a financial asset or an investment in the underlying asset, depending on the nature of the transaction. Assuming that it is a financial asset measured at amortised cost[1] (whereby returns of the financial asset represents solely "interest"), it will be subjected to impairment test under IFRS 9.

Issue

Although the general principle of Mudarabah is that losses are borne by the accountholder, in practice there may be a mechanism of loss transfer from the bank to the accountholder resulting in the reduction of the carrying amount of the financial asset and a corresponding reduction of the amount due to the accountholder when this loss is transferred. There is a debate whether it is allowable under Shariah to charge impairment loss over the life of the Mudarabah contract when profits are yet to be realised to the Mudarabah partners (the bank and the accountholder). The issue arises mainly because the impairment under IFRS 9 is based on expected credit loss (ECL) as opposed to an incurred loss model. Consequently, there is a view that the ECL model might deprive the right of the Mudarabah partners of the "actual" profit.

Preliminary assessment

From our preliminary discussion with the Central Bank (Bank Negara Malaysia, BNM), the BNM staff view is that they do not foresee any Shariah prohibition in applying the ECL principle as long as it does not in any way deprive the rights of the Mudarabah partners.

In addition, Shariah recognises acceptable practices or 'urf in business and financial reporting hence ECL model should be regarded as an acceptable practice which is widely used.

It is also worth noting that in the BNM Policy Document on Mudarabah, there are 2 methods of profit[2] distribution i.e. realised and constructive, whereby the latter refers to "acceptable profit recognition method". Consequently, if ECL is considered in the determination of the amount of net profit distributable to the partners, we believe this would not pose an issue from a Shariah perspective.

Question to Members

Do you have any observations pertaining to the above issue?

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[1] This paper does not discuss whether a Mudarabah meets or fails amortised cost measurement criteria under IFRS 9.

[2] Paragraph 16.2 of the Mudarabah Policy Document states: A mudarabah profit (the profit) is the value created over and above the capital which is determined based on a methodology acceptable by market conventions or practices.