Transfer of assets between internal stakeholders

Presentation for IASB Islamic Finance Consultative Group (IFCG)
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Agenda: discussion points

1. Overview
2. Examples of internal transfers
3. Challenges related to transfers between internal stakeholders
4. Accounting challenges
5. Classification challenges
6. Way forward: possible solutions

Overview

- The unique business models of Islamic financial institutions (IFIs) and internal transfers between different sets of stakeholders

- IFIs have specific types of stakeholders and operate under unique business models.
- For each investment pool / virtual reporting entity which comprises of distinct assets held under the ownership of and on behalf of the multiple stakeholders (e.g., owners' equity, quasi-equity (instruments with characteristics of both equity and liability) and off-balance-sheet assets under management).
- At times, there is internal transfer of assets between the respective investment pools.
- Such transfer necessitates a distinct set of financial reporting requirements in line with Shari'ah principles and rules, including disclosures for the purpose of transparency for each virtual reporting entity.

Overview (contd.)

- What constitutes transfer of assets between different sets of stakeholders / investment pools?

- Transfer of assets from one investment pool to another (whether on-balance-sheet or off-balance-sheet) occurs by way of either
  - sale;
  - exchange;
  - investment;
  - clearing;
  - others (e.g., Hiba) in line with a contractual arrangement; or
  - through reconstitution of multiple investment pools immediately following their constructive liquidation.

Overview (contd.)

- Why transfer of asset between investment pools is necessary?

- Transfer of asset between investment pools is at times necessary because of:
  - maturity of assets;
  - sale / disposal of assets;
  - creation of new investment pools;
  - increase in investment accounts accumulated balances in investment pool(s);
  - encashment / withdrawals from investment accounts or maturity of term investments; and / or
  - decrease in owners’ equity in investment pool.

Overview (contd.)

- Why pools are created?

To limit the risks, i.e., to manage different types of assets, having different risk characteristics	To reach the expected results	To separate assets for a few days
To separate bank's own assets and strategic investments	To raise financings, e.g., through financial institutions	To issue Sukuk

Overview (contd.)

- The financing assets of the IFIs are grouped in different investment pools with respect to:
  - the source of funds; and / or
  - the purpose of investment of funds.

- Types of investment pools include:
  - general IAH pool (LCY & FCY);
  - treasury / financial institutions (FI) pools;
  - equity pool; and
  - specific / special pools.
- Investment pools include, e.g.,:
  - URIA / on-balance sheet IAH pools;
  - off-balance sheet pools; and
  - Sukuk investment pools.

Overview (contd.)

- Example of general pool (example only)

Equity		Assets	
Customer deposit / IAH	75%	Murabaha	30%
Bank equity	25%	Diminishing Musharaka	30%
		Corporate Ijarah	40 %

Overview (contd.)

- Example of treasury pool (example only)

Equity		Assets	
Financial institution deposit / borrowing on Mudaraba basis	90 %	Consumer Ijarah	50%
Bank equity	10%	Housing gradual transfer Ijarah / Diminishing Musharaka	50%

Examples of internal transfers

- Examples of internal transfers between investment pools

From owners' equity to a category or investment pool within quasi-equity / on-balance-sheet investment accounts, and vice versa

From owners' equity to a category or investment pool within off-balance-sheet assets under management, and vice versa

Transfers between owners' equity and participants' Takaful fund and / or participants' investment fund

Challenges related to transfers between internal stakeholders

- The issues encountered during transfer of assets between internal stakeholders

- Internal transfers between different types of stakeholders, e.g., between shareholders and investment accountholders or between different sets of investment accountholders shall be considered carefully.
- The valuation of such transfers shall be just and fair as per Shari’ah principles and rules. Hence, generally, all transfers shall take place at fair value.
- Consequent to such transfers, if they take place at a value different than the fair value, issues related to the recognition of valuation gains and losses, as well as, changes in classification arise.

Challenges related to transfers between internal stakeholders (contd.)

- Shari’ah requirements

- Tangibility requirements – whereby a debt directly or through bundling with tangible assets, unless comprising a legal entity, may not be exchanged against cash / debt / monetary assets.
- Buy-back transactions shall be avoided in short-term transfers of assets.
- Any restrictions, and any specific valuation approaches applied on transfers of any monetary assets.
- There shall be justifiable bases and reasons that govern the transfer of assets between various investment pools and the bases applied in valuing these assets shall be just and based on fair valuation.

Accounting challenges

- Examples of different accounting challenges which emanate as a result of internal transfer of assets

- The transfer of instruments such as Sukuk between investment pools with identical investment objectives, such as available-for-sale or held-to-maturity, does not pose any accounting challenges.
- Accounting challenges may arise if instruments are transferred between investment pools with different objectives, i.e., the transfer of an instrument from an investment pool whose objective is to hold instrument for trading to an investment pool whose objective is to keep instruments available-for-sale.

Accounting challenges (contd.)

- Examples of different accounting challenges which emanate as a result of internal transfer of assets

- If there was a gain directly allocated to other comprehensive income, what treatment would be required? And would it be necessary to reverse it?
- When held-to-maturity instruments are transferred between investment pools, it is essential to address the treatment of gain in one pool and the loss in the other pool. This is essential to ensure compliance with the principles of just and fairness of the transfer, which mandates that the instruments be transferred at their fair values.

Classification challenges

- Examples of different classification challenges which emanate as a result of internal transfer of assets

- How held-to-maturity instruments shall be classified when transferred between investment pools?
- How would strategic investments, such as investments in subsidiaries accounted for using the equity method, be classified when transferred between investment pools? And what would be the classification if they were being consolidated?
- How would classification of instruments be impacted by the fact there are different investment pools with different investment motives and periods?

Way forward: possible solutions

- Transparency through presentation and disclosures

* AAOIFI FAS 47 has tried to address most of these challenges

- Commitments and restrictions applied by the mutual contractual relationship between investors of various investment pools.
- The cumulative amounts of transfers between (or, where material, between significant categories of) owners' equity, quasi-equity and / or off-balance-sheet assets under management) at net transfer value.
- Respective gains or losses recognised in the respective categories, where applicable.
- Difference between the net transfer value and the fair value of such assets, if the net transfer value is different from the fair value.
- The valuation differences resulting from the transfer of assets in foreign currencies and the financial effect of these transfers.

Way forward: possible solutions (contd.)

- Transparency through presentation and disclosures

- The nature and terms of the significant assets transferred.
- Whether these assets are divisible / separable.
- Any related Shari'ah principles and rules applied.
- Significant assets proportionately divided between (or, where material, between significant categories of) owners' equity, quasi-equity or off-balance-sheet assets under management. and
- Transfer of assets transactions conducted with related parties, indicating the nature of the relationship, type of transactions, the total value of these transactions at beginning and end of the financial period and the financial effect, whether recognised or unrecognised, in line with the respective accounting policy(ies) and relevant Shari'ah principles and rules.

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Thank you!