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JUSTIFYING THE NEED FOR SMOOTHING TOOLS BY ISLAMIC FINANCIAL INSTITUTIONS

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Abstract: This paper focuses on the positive impacts of using smoothing tools such as Profit Equalisation Reserve or PER and Investment Risk Reserve or IRR to smoothen the rate of return or profit on investments to investment account holders (IAH) of Islamic financial institutions (IFIs). Since the goal of introducing PER and IRR into Islamic banks is to compete with the conventional banking industry, it is a shield used by Islamic banks to protect their risks such as displaced commercial risk (DCR), withdrawal risk (WR), and reputation risk. This is a qualitative review of the positive impacts of using smoothing tools in Islamic financial institutions. One of the major issues highlighted is Islamic banks' sensitivity to the conventional interest rate changes because many Islamic banking products are benchmarked against the conventional interest rate. Moreover, the limited techniques and instruments available to mitigate the rate of return risk also need the regulators' serious attention. Before the use of smoothing, tools were restricted by BNM, Islamic banks were allowed to save up until 15% from profit gain. However, in certain circumstances, BNM has allowed IB's to save up to 30% from profit gains. Hence, smoothing tools like PER and IRR enabled Islamic banks to be competitive and manage their unique risks. This research is focused on the positive aspects of using smoothing tools (STs) and does not cover the negative aspects from the Shari'ah, legal or corporate governance point of view. Since the abandonment of smoothing tools by IFI's after the instructions of Bank Negara Malaysia (BNM) in 2014, there has not been much debate about the benefits of using STs. Therefore, this paper might provide a spark required to re-ignite the whole debate once again.

Keywords: Smoothing Tools; Islamic Investment Account; Profit Equalization Reserve (PER); Investment Risk Reserve (IRR)

Abstrak: Penelitian ini fokus pada dampak positif dari penggunaan alat penstabil seperti Profit Equalization Reserve (PER) dan Investment Risk Reserve (IRR) untuk memperlancar tingkat pengembalian atau keuntungan investasi kepada investment account holders (IAH) dari Islamic financial institutions (IFIs). Karena tujuan memperkenalkan PER dan IRR ke bank syariah adalah untuk bersaing dengan industri perbankan konvensional, itu adalah perisai yang digunakan oleh bank syariah untuk melindungi risiko mereka seperti displaced commercial risk (DCR), withdrawal risk (WR), dan reputation risk. Penelitian Ini menggunakan tinjauan kualitatif tentang dampak positif penggunaan alat penstabil di lembaga keuangan Islam. Salah satu isu utama yang disoroti adalah sensitivitas bank syariah terhadap perubahan suku bunga konvensional karena banyak produk perbankan syariah yang dibandingkan dengan suku bunga konvensional. Selain itu, keterbatasan teknik dan instrumen yang tersedia untuk memitigasi risiko tingkat pengembalian juga perlu mendapat perhatian serius dari regulator. Sebelum penggunaan alat penstabil dibatasi oleh BNM, bank syariah diperbolehkan menabung hingga 15% dari perolehan keuntungan. Namun, dalam keadaan tertentu, BNM mengizinkan IB untuk menghemat hingga 30% dari perolehan keuntungan. Oleh karena itu, alat penstabil seperti PER dan IRR memungkinkan bank syariah menjadi kompetitif dan mengelola risiko unik mereka. Penelitian ini difokuskan pada aspek positif dari penggunaan smoothing tools (STs) dan tidak mencakup aspek negatif dari sudut pandang syari'ah, hukum atau tata kelola perusahaan. Sejak ditinggalkannya alat pemulusan oleh IFI setelah instruksi Bank Negara Malaysia (BNM) pada tahun 2014, tidak banyak perdebatan tentang manfaat penggunaan STs. Oleh karena itu, tulisan ini bisa memberikan masukan yang penting dalam menanggapi isu yang sedang diperbincangkan.

INTRODUCTION

Islamic banks typically operate in a dual banking system where conventional banking has existed for many years. While conventional banks are leading the market and can easily offer products with a fixed rate of return, Islamic banks, on the other hand, are deterred from acting the same way as their counterparts and are encouraged to offer products with profit and loss sharing principles. Therefore, it is difficult for Islamic banks to compete with their counterparts and become exposed to several risks. One of the many risks is displaced commercial risk (DCR), leading to the withdrawal risk and liquidity risk (Faouzi M.H, 2013). For instance, this risk may emerge when returns from Investment Account Holders (IAHs) fund are lower than the market rate of return. In this scenario, IAH may withdraw his funds from the bank's Investment account on short notice and place them with other conventional or Islamic banks. This withdrawal risk consequently affects the bank's liquidity position and expose it to the liquidity risk. As these risks can reach systemic proportions and can put barriers for Islamic banks in competing with conventional banks, some Islamic institutions such as Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI), Islamic Financial Services Board (IFSB), and Bank Negara Malaysia (BNM) advised Islamic banks to use smoothing tools, such as Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR). They also point out that the primary role of these reserves is to mitigate volatility in rates of return and reduce the risk of paying dividends in times when actual profits are lesser than expected (Salman S. & Htay, 2013). Due to the fluctuations in the rate of return and risks associated to Islamic banks and investment account holders, BNM introduced the guidelines for these two reserves in 2004 that Islamic banks are allowed to save up to 15% from profit gain. However, in certain circumstances, BNM has allowed save up amount to be up to 30% (Bank Negara Malaysia, 2010). This practice was common before the Bank Negara Malaysia (BNM) made amendments in the Islamic Financial Services Act (IFSA) in 2013, post which the use of PER and IRR has been completely discontinued.

Bank Negara Malaysia (BNM), in its guidelines on Islamic investment account dated 14th March 2014, directed Islamic banks (IBs) not to use the profit smoothing tools or Displaced Commercial Risk (DCR) techniques (Bank Negara Malaysia, Investment Account, 2014).

DCR is the risk faced by Islamic banks, and this risk further intensifies in a dual banking system scenario like Malaysia. However, DCR is also faced by conventional banks, but because they do not have the restrictions of investing in Shari'ah-compliant assets and businesses, conventional banks have a very diversified investment asset portfolio and higher chances of maximizing their profit on investment returns (Juliza, 20th March 2019).

Therefore, keeping in view the Islamic banking system's essentiality, especially for the Muslim ummah, it is important to highlight the issues that might affect Islamic banks' performance, pushing customers or investors away from these banks. Hence, this paper focuses on the positive side of smoothing tools that could be essential for the Islamic finance industry's growth.

LITERATURE REVIEW

A. Shari'ah Perspective and rulings related to the usage of Smoothing Tools.

The supervision provided for PER can be attained from BNM guidelines. Ideally, the reserves protect Islamic banks from DCR and stabilize the rate of return to investors. In this regard, the SAC, in its 14th meeting dated 8th June 2000, has resolved that the proposal to implement PER is permissible (Bank Negara Malaysia, 2010).

1. Basis of the Ruling

According to the general method of investment in Islam, the distribution of profit between the Islamic financial institution and the investors shall be based on an agreed ratio. Notwithstanding that, in order to ensure the sustainability of the Islamic financial system and market stability, the PER mechanism may be implemented on the condition that transparency shall be considered.

This is considered a fair mechanism as both the Islamic financial institution and investors/depositors jointly contribute and share the benefits of PER. This is also in line with the concept of waiving of right *(mubara'ah*) allowed by the Shari'ah, which means waiving a portion of right to receive profit for the purpose of achieving market stability in the future (Bank Negara Malaysia, 2010).

2. BNM resolution on transferring *Mudarabah* Investment Profit by Islamic Financial Institutions (IFIs) to Customers to Avoid DCR

In a dual banking system, where the market rate of return fluctuates and when there is an increase in the market rate of return the customer of Islamic financial institution would also expect the same rate of return. In the context of the *Mudarabah* investment account, the institution will transfer its *Mudarabah* investment profit to the account holder to avoid DCR so that the declared rate will be competitive with the prevailing market rate of return. In this regard the SAC, in its 82nd meeting dated 17th February 2009, has resolved that the practice of Islamic financial institutions to forgo part of their profits to the customers to avoid displaced commercial risk in the context of *Mudarabah* investment is permissible (Bank Negara Malaysia, 2010).

3. Basis of the Ruling

The profit in a *Mudarabah* contract is an exclusive right of the contracting parties. A mutual agreement to review the pre-agreed profit-sharing ratio will not affect the entitlement of either the *rabbul* mal or the *mudarib* to the profit. In addition, the profit will remain as the rights shared between them.

Furthermore, the customers will receive more profit than the pre-agreed profit-sharing ratio (Bank Negara Malaysia, 2010).

4. Shari'ah Resolution by Securities Commission (SC) Malaysia and the Organisation of Islamic Cooperation (OIC)

SC, in its 14^{th} meeting dated 8th June 2000, has resolved that the proposal to implement PER is permissible (Bank Negara Malaysia, Shari'ah Resolution in Islamic Finance, 2010). Although this mechanism of smoothing may lessen the return to depositors during the peak time but it is fair and reasonable in a situation of lower return faced by Islamic Institution. This is also in line with waiving of the right concept *(Mubara'ah)*, which is allowed by Shari'ah which means "waiving a portion of right to receive profits for the purpose of achieving market stability in the future" (Bank Negara Malaysia, 2010).

According to OIC Fiqh Academy, PER is permissible based on the concept of waiving of right known as *mubara'ah* that is referred to waive a portion of right to receive profit for the purpose of achieving market stability in the future (OIC Fiqh Academy, 2000).

Islamic Financial Services Board's (IFSB) Recommendations for Smoothing Tools

a. IIFS must safeguard the rights and interests of the IAH whose investment accounts are exposed to credit and market risks arising from the IIFS's financing and investment activities. Under the existing legal and regulatory framework, it is the responsibility of the BOD to ensure that investment accounts are managed in the best interests of IAHs.

b. IFSB no. 1 "Guiding Principles of Risk Management for IIFS" has stipulated that for PER, the basis for computing the amounts to be so appropriated should be pre-defined and applied in accordance with the contractual terms and conditions accepted by the IAH and after formal review and approval by the IIFS's BOD. Similarly, the terms and conditions whereby IRR can be set aside and utilized should be determined and approved by the BOD.

c. IIFS should have in place a policy and framework for managing the expectations of their shareholders and IAH. IIFS needs to develop and maintain an informed judgment about the appropriate level of balances for PER and IRR, bearing in mind that their essential function is to provide mitigation of DCR and not to "window-dress" their profit performance. The appropriateness of the reserves level can be as specified by the supervisory authorities; otherwise, IIFS may establish their own policy on the maximum levels for annual appropriations to and balances of these reserves, which should be specified in their investment contracts with Unrestricted Investment Account Holders (UIAH).

IIFS should clearly state in the investment contract and make clear to IAH any Smoothing practices that they employ – in particular if they expect the IAH to forgo their rights to that portion of income which is appropriated for building up reserves such as PER and IRR. In addition to the general requirements of the Profit-Sharing Investment Account (PSIA) contracts, the following details should be explicitly disclosed in the contract:

The rights and liabilities of both parties – in particular, with respect to the circumstances where losses are to be borne by the IAH and the implications for the IAH contractual rights with regard to the early withdrawal and early redemption;

The accountability and responsibility of the IIFS to disclose accurate, relevant, and timely information to the IAH on the investment of their funds, including its performance, investment policies, valuation, and frequency of valuation of the IAH funded assets; and

The rights of IAH in the event that the IIFS fails to perform its fiduciary obligations in accordance with the applicable PSIA contract that is in the event of proven negligence or misconduct by the IIFS whereby the IIFS will have to recompense the IAH for any loss (IFSB, 2010).

5. Accounting and Auditing Organization for Islamic Financial Institution's (AAOIFI) Recommendation for PER and IRR

The AAOIFI had put together the new conceptual framework guiding the important consideration relevant to financial statement treatment of investment accounts that stem from Shari'ah point of view. AAOIFI also promotes the ability of IFIs to exercise free authority regarding decisions that affect investment and deployment of 'the investment account holders' fund.

AAOIFI had provided in its consultation paper certain elements that must be disclosed in the notes to the accounts of financial statement regarding the IAHs as follows:

- Accounting policy being under practice and basis for charging provision.
- Total administrative expenses charged to investment accounts with a brief description.
- Percentage of profit allocation between owner's equity and various investment account holder.
- Percentage earmarked to be deducted for PER and IRR.

It will help in injecting transparency into the system and promote peoples' trust in the Islamic banks (AAOIFI, 2012).

B. The application of Smoothing tools in Islamic banks

Sundararajan (2005) found that for Malaysian banks, PER is a determinant of net income before provisions. The IRR is also created to cover eventual negative asset returns pay out to the IAH. These reserves allow them to absorb losses if the benchmark rate goes up. They also prevent Islamic banks' customers from switching to conventional banks if the benchmark rate declines. A suitable combination of the PER and the IRR to reach the target return is decided by Islamic bank managers based on their expectations of the way these reserves will be used in the future (Sundararajan, 2005).

Archer and Karim (2006) suggest that Islamic banks can invest a proportion of unremunerated assets whose return is certain but with a lower risk form. This approach allows banks to produce more returns, which favours a stable income and promotes income smoothing practices. As long as the "Shari'ah-compliant products" are based on the principle of cost-plus margin, they offer an opportunity for managers to use their latitude, especially in setting the selling price, which in turn may affect the gross revenue for Islamic banks (Karim, 2009).

However, it can be stated that smoothing tools are practiced in Islamic banks to smooth the return of IAH and stakeholders of IBs. Sundararajan (2008) has pointed out that the provision of PER is practiced by the Islamic banks of eight nations globally. Thus, it should be considered that the provision of PER and IRR by Islamic banks shall be fair and impartial as it is built up in good times to cater to the need in bad times.

Usually, smoothing tools have been used in investment account of IFI's in order to mitigate withdrawal risk. The basic purpose of using smoothing techniques is to give a better pay out to the unrestricted investment account holder (UIAH) in periods when assets financed from UIAH fail to meet the competitive return as its conventional counterpart. There are essentially two ways in which income smoothing conducts: Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR) (Juliza, 20th March 2019).

C. Types of Smoothing Tools

Techniques that are used commonly by IFI's for smoothing and compensating for the inadequacy of investment pay out are divided into two groups:

1. Without mitigation:
   a. IFI forgo its share of profit partially or completely; Forgoing completely or partially share of profit of the IFI as an entrepreneur *(Mudarib):* in this method, IB's forgo their part of profit share completely or partially in order to increase the share attributed to UIAH and to maintain the competitive rate of return in the market. For instance, if the indicative rate of return is higher than the actual rate of profit so in this case bank forgoes its share of profit in order to retain its customers.
   b. Transfer from current or retained shareholder's fund; Making the transfer from shareholders' current or retained profit: an IFI makes the transfer of profit to Investment Account Holder out of current or retained shareholder's profit based on *Hibah.*
2. With mitigation:
   a. Profit Equalisation Reserve (PER); IB's establish a profit equalization reserve. In this method, before the generated income divided between IB as Mudarib and Customer as Investor or Rabb-ul-mal, a pre-agreed portion of income is deducted and transferred to PER account. If the actual profit rate does not meet the indicative rate, IB transfers the remaining amount from PER account to UIAH account based on Hibah. On the other hand, if the actual profit rate exceeds the indicative rate, so Mudarib forgoes the exceeded amount based on Tanazul.

b. Investment Risk Reserve (IRR): an IRR is created by setting aside an amount out of the profit attributed to IAH after deducting the entrepreneur (Mudarib) share of profit. IFI's use this technique to protect IAH's from future investment losses and enable IB's to cover fully or partially unexpected losses to IAH's funds.

(IFSB, December 2010).

c. Frequency of usage of smoothing tools in IFI's

The following figure shows the distribution of the responses obtained from the surveyed Islamic banks regarding the frequency of usage of the smoothing techniques by them while dealing with Unrestricted Profit-Sharing Investment Account holders. The scores shown are the weighted mean scores "1" represents "never" and "5" represents "always".

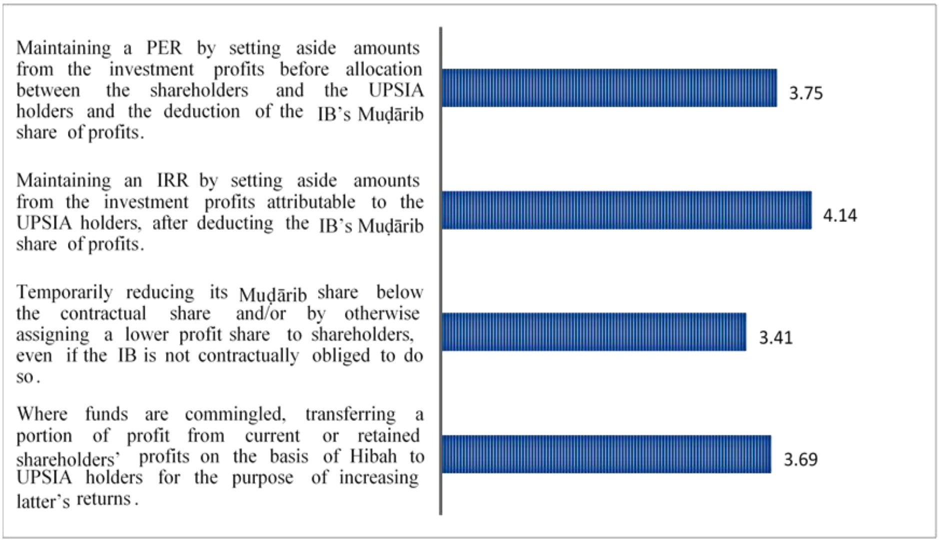

Fig 1. Frequency of usage of PER and IRR by IFI's
Source: (Sheila N.N. H, 2013)**.**

METHODOLOGY

This study has adopted a qualitative approach, as this research paper justifies the need for smoothing tools by IFIs to mitigate the displaced commercial risk (DCR), liquidity risk, and withdrawal risk and also to provide a competitive rate of return to IFIs account holders. Content analysis method of qualitative study is applied in this research. The method is applied to obtain theoretical secondary data from various sources such as articles and research papers, journals etc., on the practice of PER and IRR as smoothing tools for investment accounts, particularly pertaining to displaced commercial risk (DCR).

RESULT AND DISCUSSION

A. Rationale for the Use of Smoothing Tools

Islamic banks in Malaysia raised investment funds under the contract of Mudarabah, and as Mudarabah is a partnership-based contract where the capital providers or Rabb-ul-mal are the investors or depositors, and banks act as Mudarib or manager of the investment account on behalf of the Investment Account Holders (IAH). Due to the nature of the Mudharabah contract, capital providers or investors are exposed to the risk of losing their capital as the loss has to be borne by the capital provider, while Mudarib is exposed to losing all of his time and effort. But, in a dual banking scenario where investors have various options for investments and when the market rate of return is matched by conventional banks, if Islamic banks return a lower rate of profit or investors incur losses, it would expose the Islamic banks to Withdrawal risk, which means the investors and depositors will withdraw their investments from the Islamic banks and invest it elsewhere to gain a higher rate of profit that is matched with the market rate of return, which usually reflects a rate based on the conventional indexed rate such as LIBOR (IFSB, December 2010).

IFI's are under a fiduciary obligation to safeguard the interests of IAH and manage the investment account with all honesty. In case of losses due to breach of any terms of the contract or negligence by Mudarib, he is responsible for bearing the losses because the IAH as rabb-ul-mal or capital providers bear the commercial risk associated with the assets financed by the funds provided by them (IFSB, December 2010)

Islamic banks face a serious problem of choice or variations while investing in the assets due to the limitation of halal portfolio availability. Unlike conventional financial institutions, IFI's have to invest funds into halal portfolios, and this makes it even more difficult for Islamic banks to maintain a healthy rate of return while investing only in halal asset portfolios.

IFSB explains DCR as the risk of volatility in the rate of returns faced by Islamic banks. Rather, this risk is faced by both Islamic and commercial banks but, in the case of IB's, it intensifies due to the restriction on IB's for investing only in halal assets (IFSB, December 2010)

One of the major causes of DCR is the rate-of-return risk. It is the risk of facing a lower rate of return from investments than expected on unrestricted investment accounts. For example, it is possible that IFI's may have invested UIAH funds into relatively long-maturity assets such as long-maturity Murabahah or Murabahah to the purchase orderer, Ijarah or Ijarah Muntahia Bittamleek, and thereby have locked in lower rates of return on assets than compared to the current market rates (IFSB, December 2010).

B. Positive Impacts of Using Smoothing Tools

1. Displaced Commercial Risk:

The prohibition of guaranteed return in the form of interest and the inability of the Islamic financial intuitions to invest in Shari'ah non-compliant instruments make the investment approach of Islamic banks quite unique. According to AAOIFI FAS 6," profits of an investment jointly financed by the Islamic Bank and investment account holders should be allocated between them according to the contribution of each of the two parties in the jointly financed investment". Based on this standard, Islamic banks face a unique risk known as "Displaced commercial risk" vis-à-vis with their unrestricted investment accounts holders who rely on the banks' expertise to invest their funds and generate their returns. This unique risk will compel Islamic banks to increase the pay outs to investment accounts holders during times when returns from investing the funds of investment account holders fall short of the prevailing market rate of return. Considering this cyclicality in the returns of investment and its catastrophic consequence for Islamic banks if this volatility were to be shared or transferred to the investment accounts holders, Islamic banks use smoothing tools to manage volatility caused by displaced commercial risk. This allows Islamic banks to avoid the displaced commercial risk that will result in a massive withdrawal of funds and, therefore, trigger a potential bank run. The PER allows the Islamic banks to save up to 15 per cent monthly of the total gross profits in a separate provision before distribution during the month and ensure that the maximum accumulation of PER does not exceed 30 per cent of shareholders' fund. The use of smoothing tools to manage this risk enables Islamic banks to compete and hence attract customers.

2. Provision of Competitive Rate of Return

Islamic banks perform the same essential functions as banks do in the conventional system, except for the need for them to carry out their transactions in accordance with the rules and principles of Islam (Iqbal, 2007)**.** Islamic banking has emerged to be a viable alternative to the long-standing conventional riba-based banking system, however with similarity in purpose; both banks provide similar services as commercial or profit-driven entities. This similarity of purpose creates the same departing point for both Islamic as well as conventional banks. However, the parting of the ways sets in as Islamic banks being Shari'ah governed institutions will need to fulfill certain Shari'ah requirements in their internal operational processes as well as external relations and economic undertakings, which are completely open and unrestricted for their counterparts. Keeping their purpose in mind as commercial entities, Islamic banks are restrained in their relationships (i.e., no direct lending at interest) with their customers as well as the approved or permissible economic activities they could possibly undertake to generate returns for onward distribution to their depositors/investors. These restrictions place the Islamic banks at a disadvantage, especially in a dual banking system like Malaysia. This natural characteristic of Islamic banks quite evidently does not put them at a level playing field with their conventional counterparts. For this and many other reasons, smoothing tools such as PER and IRR allow Islamic banks to give similar and equal rates of returns as provided by the conventional banks in order to avoid excessive withdrawal of funds by customers, which could trigger a bank run.

3. Attract potential and maintain existing customer:

As one of the most important players in the service industry today, Islamic banking is no longer regarded as a business entity striving only to fulfil the religious obligations of the Muslim community, but more significantly, as a business that is ineluctably in need for winning over customers whilst retaining the old ones. A study conducted by Asyraf & Nurdianawati (2006) revealed that "Islamic bankers can no longer depend on marketing strategy of attracting pious and religious customers who might only concern about Islamicity of financial products. The important insights identified on the ranking of various banking selection criteria implies the need for an Islamic bank to enhance its service quality which is now considered a critical success factor that affects an organization's competitiveness", and study also revealed that there is a need to intensify public education and awareness towards the distinctive characteristics of Islamic banks and how it may profitably suit the interest of customers in their financial dealings. Islamic banks have the potential of being marketed to various segments of customers extending beyond those who are concerned with the legitimacy of the facility from the Islamic point of view and those who seek service quality, convenience, and efficient transactions. Consumer education programmes are therefore crucial if they are to increase the level of consumer awareness about the unique characteristics of Islamic banking and its wide-range of financial products offered (Nurdianawati, 2006).

From the above discussions, it could be argued that there are several criteria for the patronage of Islamic banking products by customers, including costs and benefits, service delivery, confidentiality, religiosity, size, and reputation of the bank etc. However, among these very many criteria, the one most important criterium which exerts greater influence is the cost and benefit from a customer perspective. As such, to attract and maintain the existing customers, Islamic banks should endeavour to provide competitively or even products and services than their conventional counterparts, hence be able to attract new customers and retain existing ones.

4. For Maintaining Liquidity

The performance of an investment asset is not guaranteed in any type of investment account as it does not remain the same from one financial year to another. On top of that, regional and global financial crises or instability in the financial markets also affect the return on investments as they fluctuate quite frequently, and since an Islamic investment account is an integrated part of the Islamic banking system, if it underperforms or runs in losses, the effect of it will be seen in the performance of the Islamic banks, and if these losses are passed on to the investment account holders of Islamic banks or IFI's, eventually it will affect the business of IB's negatively in the form of loss of investors and therefore capital.

On the contrary, Shari’ah's stance is that the real essence of Mudarabah is in sharing profit, and loss is to be borne by Rabb ul mal or the investor. However, if the loss is due to the negligence of mudarib, then mudarib has to share the loss with rabb ul mal. However, opposed to this stance, according to the OIC Fiqh Academy (2000), PER of smoothing of return/profit is permissible based on the concept of waiving of right known as "*Mubara'ah*" which means to waive a portion of right to receive profit for the purpose of achieving market stability in the future.

5. Reduce Volatility in the Rate of Return:

Using smoothing tools such as PER and IRR, volatility in the returns in times of financial instability in the market or an economy can be smoothed. Since investors are crucial for any business and its growth and no investor wants to receive a loss or fluctuated returns on his/her investment. However, loss on the investment is inevitable, and it is part and parcel of any business and risk that an investor has to bear. That been said, it cannot be denied that if an investor invests money in another business, he/she hopes to receive profit most of the times, and if instead loss is passed onto him/her often or occasionally, then there is a high chance that the investor will withdraw its capital or deposit from the IB and invest it elsewhere. Moreover, IFI's face fierce competition, especially from the conventional fixed deposit schemes of conventional banks where principal and return are guaranteed, which makes it even more important for Islamic banks to be competitive in order to retain their business.

6. Nurture and Grow Investors' Confidence

It is quite evident that most of the investors that invest in IFI's or Islamic investment account of IB's want their money to be invested in *Shari'ah*-compliant assets or businesses at first so that they can get a return from *halal (permissible)* ways. Therefore, it is of utmost importance for the IFI's to keep the faith of investors intact in the business by reflecting financial and operational stability. Therefore, in case when the financial market is not stable, or there is temporary a regional financial crisis, if the IB takes care of its investors by giving them stable returns on their investments and saving them from incurring losses, it wins its customers'/investors' loyalty by doing so and it increases investors' confidence in Islamic banks and encourages them to invest more as they believe the IFI's to be more reliable. This encouragement goes a long way in the promotion of IFI's as it will attract more investors to invest in IFI's, which in turn helps the Islamic finance industry grow. If we consider the opposite of it by supposing that IFI's incur losses on their multiple investment asset portfolios and these losses are passed onto the investors, according to the principle of Mudarabah contract, then it will leave a bitter impression on the minds of investors, which will restrict them from further investing in IFI's and also encourages them to look for other alternatives for a better return (Amin, 5th June, 2017).

7. To Grow Islamic Finance Industry

All the above points explain the importance and positive impacts of using the smoothing tools. One thing that justifies the use of these tools is that no matter what the principle of Mudarabah says, but it is inevitable that at the end of the day, investors want to benefit from their invested funds, and if they are not satisfied, IFI's will suffer from losses in the form massive withdrawals or capital loss since their competition is with the age-old and well-established practice of conventional banking where the capital and a fixed percentage of return is guaranteed by the bank such as in fixed deposits. Therefore, if the Islamic finance industry needs to grow, it must take into consideration all the possible ways to give good competition to the conventional banking system.

Apart from this, a few Shari'ah issues due to which the use of smoothing tools was discouraged and stopped can be rectified by making clear declarations about the use of smoothing tools in IB's product disclosure sheets (PDS). One such example can be found in the study conducted to examine the provisioning behaviour of PER. It focused on the underlying determinants of PER in Malaysian Islamic banks (Ismail, 2006). This study found that the banking regulators in Malaysia view PER as a reserve that is built up in good times to cater to the need during bad times. Thus, the actual estimates of PER are determined by each bank's management. This issue can be resolved by providing a guideline according to which the maximum and minimum limits of PER must be followed by all Islamic banks. Also, the use of smoothing tools can be re-initiated based on the concept of *Maslahah (beneficial),* which says if something does more good than harm, then it can be allowed for the *maslahah* of the ummah.

CONCLUSION

It has been well-established in the literature that despite the fact that Islamic bank transactions are free from interest, movements in the interest rate have significant effects on Islamic banks' performance. From the review of the literature, the development of Islamic banking side-by-side with the conventional banking system poses several problems. First, the reliance on the conventional market interest rate as a benchmark due to the absence of an Islamic index rate of return increases the sensitivity of Islamic banks to the changes in the interest rate.

These findings reveal that generally, Islamic banks do not exercise their discretions to smooth their results. Instead, this smoothing originates from a stable and steady activity mainly due to the nature of Islamic financial products. Also, the fact that the pay out revenues to IAH are more variable than others suggests that Islamic banks could strengthen the use of smoothing techniques through the use of PER and the IRR. This implies that the supervisory authority should exert greater control over the accounting practices applied by Islamic banks.

In short, Islamic banks can adopt various mechanisms to smooth their net income, and the revenues paid out to IAH. In fact, they may use their accounting discretion to move their net income closer to the target values and stabilize the rate of return to depositors, meaning they are expected to smooth their results intentionally.

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