**Original Article**

# Profit-sharing investment accounts in Islamic banks: Regulatory problems and possible solutions


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**ABSTRACT** As interest-bearing deposits are not permitted by the rules and principles of the *Islamic Shari'ah*, Islamic banks typically raise deposits in the form of profit-sharing investment accounts. These accounts differ from conventional deposits not merely by virtue of the profit-sharing nature of the returns they offer, but also because the contact between the depositors and the bank is not a debt contract, and the deposits are in consequence not 'capital certain' (that is, the depositors are required to accept negative returns or losses). This latter characteristic leads to serious regulatory problems in jurisdictions where bank deposits are required *by legal definition* to be 'capital certain'. More generally, the presence of such 'puttable instruments' in the capital structure of Islamic banks leads to complications in assessing their capital adequacy. In addition, the fact that the profit-sharing investment account holders are a type of equity investor without the governance rights of either creditors or shareholders raises a major problem of supervision. This article explains these problems in further detail, and proposes a solution in the form of a structural distinction between the Islamic *bank* in the narrow sense on the one hand, and the entity that *manages the profit-sharing investment accounts* on the other hand.
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## INTRODUCTION

The aim of this article is to examine the regulatory and supervisory problems arising from the use of profit-sharing investment accounts (PSIAs) by Islamic banks, and to suggest a solution to the main regulatory problem, which will also greatly reduce other problems, including those of supervision.

The section 'The nature of PSIAs' of this article provides an analysis of the nature of PSIAs, their contractual basis and its implications for profit and loss as regards the bank and its customers holding PSIAs. The main regulatory problem and the related problems of supervision to which these give rise are then examined in the 'The main regulatory problem and other related problems' section. A possible solution to the main regulatory problem, which may also mitigate the supervisory problems, is described in the 'A possible solution' section, and the final section sets out some concluding remarks.

## THE NATURE OF PSIAs

### The contractual basis of PSIAs and their implications for profit and loss sharing

One of the key differences between Islamic and conventional banks is that the former do not offer interest-bearing deposit accounts, as payment or receipt of interest are forbidden by the *Shari'ah*. Instead, Islamic banks offer profit-sharing and loss-bearing investment accounts, usually based on a *Mudarabah* partnership contract between the bank and the customer; alternatively, a *Wakalah* agency contract may be used as the basis.

A *Mudarabah* partnership is a 'partnership between work and capital', in which one partner, the *mudarib*, provides the work in the venture, while the other partner, the *rabb al mal*, provides the capital as a 'sleeping partner'. The partners share profits according to an agreed ratio, but subject to the exception noted below the *rabb al mal* bears any losses (the *mudarib* having no capital in the partnership to absorb losses). The share of profits received by the *mudarib* (the *mudarib* share) is that partner's remuneration for managing the funds invested by the *rabb al mal*.

It is also possible for the partner that is the *mudarib* to invest in the venture as a capital-providing partner or *Musharik* (in which case the venture is a *Musharakah* partnership), and that partner will receive the profits and bear any losses proportionately to its share of the total capital in the venture, as well as being entitled to the agreed *mudarib* share of the profits on the *rabb al mal*'s share of the capital. Such an arrangement is known as a *bilateral Mudarabah* or *Mudarabah-Musharakah*. Note that (again subject to the exception noted below) the *mudarib* does not share in any losses on the *rabb al mal*'s share of the capital. Not merely would this be inconsistent with the contractual logic of a *Mudarabah-Musharakah*, but it is expressly forbidden by the *Shari'ah* for the *mudarib* as such to bear losses attributable to the *rabb al mal*. The *mudarib* may, however, waive part or all of its *mudarib* share in order to improve the return to the *rabb al mal*. As *musharik*, it may also donate part or all of the profit on its share of the total capital in the venture to the other partner. It cannot 'donate' to cover a loss of the other partner, for in case of such a loss it too would be faced with a loss on its own share of the venture.

If the bank accepts PSIAs on the basis of a *Wakalah* contract, according to which it acts as *wakeel* or agent, it receives a management fee for managing the customer's funds. Again (subject to the exception noted below), the *wakeel* does not bear any loss arising from the investment of these funds.

The exception mentioned above, namely, the only circumstance in which either a *mudarib* or a *wakeel* may be held liable for losses on funds under its management, is a case of misconduct or (gross) negligence on its part. Misconduct would include fraud and other illegal conduct, and also wilful investment of funds in breach of *Shari'ah* prohibitions, or in breach of the investment mandate stated in the contract. Negligence would include a gross failure of due diligence, resulting in losses or in prohibited income (which would have to be given away to charitable causes).

### Restricted and unrestricted PSIAs

PSIAs may be either restricted or unrestricted. Restrictions on the investment of the funds are set out in the offer documents for products, as with mutual funds, and may thus concern asset class or type of activity, geographical area and so forth. Restricted investment accounts are thus somewhat similar to mutual funds, but unlike the latter they are not vested in a separate legal entity but are managed by the Islamic bank under a contractual *(Mudarabah or Wakalah)* umbrella. Probably a closer similarity is to the non-discretionary wealth management accounts offered by private banks. They are normally treated by Islamic banks for financial reporting purposes as 'off balance sheet funds under management'.

Unrestricted investment accounts likewise have similarities to the discretionary wealth management accounts offered by private banks. However, there are also key differences, as follows:

(a) Unrestricted PSIAs are intended not for a clientele of 'high net worth' individuals, but for typical high street retail customers seeking a low-risk savings account that is *Shari'ah* compliant;
(b) In many cases, the bank invests the unrestricted PSIA funds in a 'commingled' asset pool, together with funds from (unremunerated) current accounts and shareholders' funds. This is the 'bilateral *Mudarabah*' described in 'The contractual basis of PSIAs and their implications for profit and loss sharing' section. The bank is entitled to the profits, and liable for the losses, from investing the current account funds.
(c) Normally, unrestricted PSIAs are reported on the balance sheet of an Islamic bank.

It will be seen from points a to c that unrestricted PSIAs are treated by both the bank and its customers as a *Shari'ah* compliant substitute for conventional retail deposit accounts. They occupy a position in an Islamic bank's balance sheet somewhat similar to that which, in a conventional bank, would be taken by that bank's deposit liabilities. In fact, the revised IAS 32 classifies instruments such as unrestricted PSIAs as 'puttable instruments', and requires them to be classified (under a separate heading) among the liabilities in the balance sheet of the Islamic bank. A descriptor for such instruments is 'Equity of Unrestricted Investment Account Holders'.[1] However, unlike deposits, unrestricted PSIAs are not debt obligations of the Islamic bank. The bank's obligation is to pay holders of unrestricted PSIAs (a) their contractual shares of any profit from the investment of their funds; and (b) upon withdrawal, the balance of their investment accounts, after deduction of any losses (the right of withdrawal by their holders is what makes unrestricted PSIAs as 'puttable instruments').

## THE MAIN REGULATORY PROBLEM AND OTHER RELATED PROBLEMS

### The main regulatory problem

The main regulatory problem arising from the use of PSIAs is that they do not meet the legal definition of *deposits*. Neither the customers' capital nor any return on it is guaranteed by the bank. Hence, PSIAs are not 'capital certain' and are, essentially, investment products. Islamic banks, therefore, do not meet the criteria to be classified as depositary institutions as required by banking regulations in the majority of countries.

This has proven to be a severe problem when the issue of authorising Islamic banks in countries such as the United Kingdom has had to be addressed. In the case of the Islamic Bank of Britain (IBB), which proposed to offer retail banking services, the UK Financial Services Authority (FSA) would not authorise IBB to operate if it used unrestricted PSIAs as its substitute for conventional deposits. Instead, IBB was obliged to offer a product that was contractually 'capital certain', so that although the returns were based on profit sharing, the PSIA holders were not required to accept shares of losses provided the bank remained solvent, *but could (if they so chose, for religious reasons) volunteer to accept them*. This arrangement allowed the bank's customers (or those who so wished) to be *Shari'ah* compliant, but the bank's unrestricted investment accounts (being contractually 'capital certain') were not themselves *Shari'ah* compliant, and hence neither was the bank, even though it was permitted to call itself the 'Islamic Bank of Britain'.

Such a stultifying outcome suggests that authorising an Islamic bank in a jurisdiction such as the United Kingdom, or that of most if not all Western countries, is comparable to squaring the circle. However, as indicated below, there is a solution to this problem.

## Other related problems

The related problems concern (1) the market perception of unrestricted PSIAs by retail customers as close substitutes for conventional deposits, and the issues that this perception may raise for industry supervisors, with potentially negative consequences for market discipline; and (2) the issue of corporate governance raised by the fact that the holders of PSIAs are exposed to the risks of equity investors, but have no governance rights, either in the form of voting rights or even of rights to adequate information about financial performance.

### *Market perception of PSIAs and related supervisory problems*

With regard to the first set of problems, in the case of the IBB, the FSA avoided these (at the expense of *Shari'ah* compliance) by making the unrestricted investment accounts contractually 'capital certain', although there was no requirement to 'smooth' profit payouts. In the Middle East and Asia, other approaches that can have undesirable consequences may be found, while less questionable from a *Shari'ah* perspective.

In Jordan, Malaysia and Qatar, the industry supervisor (the central bank) requires Islamic banks to manage unrestricted PSIAs in such a way as to avoid passing losses onto the holders of such accounts, and also to 'smooth' the periodic returns paid to them. These desired outcomes have generally been achieved by a combination of conservative investment strategies and the use of reserve accounts formed out of profits attributable to PSIA holders to smooth profit payouts (so-called profit equalisation reserve (PER)) and to cover periodic losses (so-called investment risk reserve (IRR)). There is also a portion of the PER that is formed out of profits attributable to shareholders that can be used to 'donate' amounts to PSIA holders. Another technique is to reduce voluntarily the *mudarib* share of profits for the period so as to increase that of the PSIA holders.

In Bahrain, the industry supervisor (the central bank) does not impose any such requirement, but Islamic banks in that country use some or all of these techniques.[2]

As a consequence of the use of these techniques, the 'profit share' paid to unrestricted PSIA holders is the outcome of a process of earnings management and accounting manipulation that seeks to shadow the rates of return paid by conventional banks on their retail deposits. These practices, and notably reduction of the *mudarib* share and 'donation' to PSIA holders of profits attributable to shareholders, reflect the existence of *displaced commercial risk* (DCR) that results from pressure by the supervisor, the market or both, on Islamic banks to emulate rates of return on conventional deposits. The use of the PER is intended to mitigate DCR by reducing the need for reduction of the *mudarib* share and 'donation' to PSIA holders of profits attributable to shareholders.[3]

A major problem arising from these cosmetic practices is the resultant lack of transparency with regard to the underlying profit performance of the investments of unrestricted PSIA funds. This lack of transparency makes it very difficult for unrestricted PSIA holders to monitor the performance of their funds under the management of a given fund manager and to make a timely switch to a better fund manager; it is thus highly inimical to market discipline.[4]

### *Corporate governance*

As Williamson[5] points out, equity may be expected to entail transaction costs of governance, as equity investors need to have a governance structure that provides them with monitoring of their investment. The board of directors is designed to fulfil this role, and shareholders typically have the right to appoint and dismiss its members. However, as pointed out by Archer *et al*[6] and Archer and Karim,[7] PSIA holders have no such right or any other 'voice' in governance. This is a particular problem for unrestricted PSIA holders who have no choice in deciding the types and risk-return characteristics of the assets in which their funds are invested. In order to mitigate this problem, the Islamic Financial Services Board (IFSB) in its *Guiding Principles on Corporate Governance for Islamic Financial Institutions*[8] proposed that Islamic banks should have, as part of their governance structure, a Governance Committee that would provide such a voice. The structure proposed below would provide a means of further mitigating this problem.

## A POSSIBLE SOLUTION

### Structure

One notable difference between Islamic banks and conventional 'universal' banks is that the latter conduct fund management activities through subsidiaries and not on their own balance sheet. The term 'universal' banks was coined to express the fact that such banks combine retail banking (including deposit taking), investment banking and fund management in the same banking group, something that was forbidden until recently in the United States by the now repealed Glass–Steagal Act, but was and is common in Europe. However, as noted above, the banking groups in question conduct fund management activities and retail banking through separate subsidiaries.

In contrast, Islamic banks use contractual structures (most commonly based on *Mudarabah*) for fund management activities, and, because of the practice of commingling funds of unrestricted PSIAs with current account and shareholders' funds in a bilateral *Mudarabah*, unrestricted PSIAs appear on the banks' own balance sheets. This use of contractual structures rather than separate legal entities for fund management leads to the main regulatory problem described above, as well as to other related problems. As noted above, the latter include (1) complications in supervision, as the same legal entity requires supervision both as a bank and as an investment company, which are typically the tasks of different supervisors and in any case require different supervisory approaches; and (2) corporate governance problems, especially for the unrestricted PSIAs.

It is not clear why Islamic banks use contractual structures in place of separate legal entities for their fund management activities. One reason may be the practice of 'commingling' in a bilateral *Mudarabah*, which is facilitated by using a single legal entity. Another reason may be the sheer flexibility that comes from using a single legal entity, as well as the attractions of the avoidance of transparency that this may afford, facilitating the profit manipulations described in the 'Other related problem' section.

In any event, it would seem that if Islamic banks are to develop retail banking activities in Western markets, they will need to find a solution to the main regulatory problem. Fortunately, a relatively simple solution exists: the use of a separate legal entity for fund management activities. Subject to regulatory requirements, this entity could be either a subsidiary of the retail bank or a fellow subsidiary of a holding company. The retail bank would take current accounts, offer chequebook facilities and carry out related banking activities such as issuing letters of credit. It could place current account holders' funds in relatively short-maturity assets, such as *Murabahah* or *Salam*, as well as marketable *Sukūk,* placing any surplus funds with the fund management company (for example, as *rabb al mal* in PSIAs). In addition to these funds, the fund management company would take PSIAs (restricted as well as unrestricted) from the public, and could use *Mudarabah* or *Wakalah* contracts for this purpose. These funds would be invested in *Shari'ah* compliant assets, including longer maturity assets, such as *Ijarah* and *Istisna'a*.

Insofar as Islamic retail banks (and their customers) use unrestricted PSIAs as a substitute for conventional deposits, this solution will result in removing from the retail bank's balance sheet the greater part of the funds at its disposal and the assets financed by these funds. These items will appear on the balance sheet of the fund management subsidiary, but will of course reappear on the consolidated balance sheet. 'Commingling' would still be possible, insofar as the retail bank would be able to place funds as *rabb al mal* in PSIAs managed by the fund management company as *mudarib*.

With regard to supervision, the proposed structure will enable the banking activities and the fund management activities to be separately supervised, with the latter being supervised by the investment industry supervisor if it is separate from the banking supervisor. Supervision at the consolidated level will still fall to the banking supervisor. This raises the issue of capital adequacy, which we discuss below.

With regard to corporate governance, notwithstanding any use of the *Mudarabah* contract as a vehicle, the funds management company would be required to give all of its IAH the sort of protection that is normal for investors in mutual funds.

## Capital adequacy

Fund management activities *per se* do not raise the issues of capital adequacy that are typical of banking, where banking assets are financed largely by liabilities that are not expected to absorb losses on such assets, so that the bank needs adequate capital for this purpose. In fund management, the owners of the funds are expected to absorb such losses, unless they result from fraud or gross negligence on the part of the fund manager. The fund managers are thus not required to hold capital to absorb such losses. This has resulted in some complications with regard to the capital adequacy of 'universal' banks at the consolidated level,[9] but at least the structure of such banking groups separates fund management from retail banking, making the situation transparent.

The calculation of the capital adequacy ratio for the retail bank would be straightforward, being based on the standard formula set out in the IFSB standard.[10] In the case of the fund management company, its capital requirement would depend on whether it used PSIAs and, if so, on the extent to which it is subject to DCR, as described in the 'Other related problem' section. The extent of any such DCR would be reflected in the value assigned to the parameter $\alpha$ (alpha) in the 'Supervisory Discretion Formula' set out in the IFSB's capital adequacy standard.[3,10] At the consolidated level, DCR in the fund management company would be reflected in the use of the supervisory discretion formula.

## Division of activities between the retail bank and the fund management company

As noted in the 'Structure' section, in our proposed structure for Islamic banks the retail bank would offer current account and chequebook facilities, as well as letters of credit, and would place the current account funds either in short-maturity assets or in appropriate funds with the fund management company. This placement could be made either as *rabb al mal* in PSIAs or as an investor in Islamic mutual funds, managed by the fund management company.

The latter would also receive funds from the public in the form of either PSIAs or Islamic mutual funds. The choice between PSIA and mutual funds would be made either on the basis of supervisory requirements (for example, in the Kingdom of Saudi Arabia, the supervisor does not permit PSIAs but allows mutual funds), or as a matter of management policy. Likewise, the division of asset-side financing activities between the retail bank and the fund management company would be based on group management policy, but would reflect supervisory preferences. A major consideration for the retail bank would be liquidity and the avoidance of asset-liability mismatching. Hence, it is not expected that the retail bank would place funds in assets with maturities exceeding three months. This would clearly constrain its profitability, but, by placing funds with the fund management company, it could earn substantial profits if the latter were run successfully.

## CONCLUDING REMARKS

Perhaps the most (or only) surprising aspect of the solution proposed above is that it has not been proposed and adopted before. In fact, it has to some extent been implicitly adopted in the Kingdom of Saudi Arabia, as the supervisory authority, the Saudi Arabian Monetary Agency (SAMA), does not permit PSIAs, but Islamic mutual funds are widely used. In a number of other jurisdictions in the Middle East and Asia, PSIAs are permitted and constitute by far the largest source of funds for Islamic banks. The flexibility offered by the use of PSIAs, and especially of unrestricted PSIAs, makes them attractive to Islamic banks for which in various respects they take the place of conventional deposits.

However, the regulatory problem that arose in the setting up of the IBB in the United Kingdom and the unsatisfactory nature of the solution that was adopted to deal with it lead to the conclusion that for Islamic retail banking to develop in Europe and North America, such a problem will need a genuine solution. Such a solution is one that does not result in an 'Islamic' retail bank being obliged to offer a 'capital certain' (and hence not *Shari'ah* compliant) type of retail deposit account in order to satisfy regulatory requirements. The structural solution that we propose in this article meets this criterion. Given the large potential demand for Islamic retail banking from the millions of Muslim citizens in Western Europe and North America, we believe that such a structural solution will need to be adopted.

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