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KEY POINTS

- The retail Profit Sharing Investment Account (PSIA) exemplifies the need for more robust regulation of Islamic banking.
- Observed Islamic bank practices related to PSIAs are inconsistent with applicable principles.
- A consumer-oriented approach to PSIA customer claims at insolvency is justified in the absence of quality disclosure, management and regulation.

Author Hdeel Abdelhady

Consumer-oriented insolvency risk allocation in Islamic retail profit sharing investment accounts

This article discusses the Profit Sharing Investment Account (PSIA), an investment product that entails capital loss and is offered by Islamic banks to retail and wholesale consumers. Specifically, the PSIA's features, related management practices, and the rights of retail bank consumers at bank insolvency are addressed, concluding with a proposal for a consumer-oriented statutory approach to PSIA customer claims in the event of bank insolvency or other financial distress worthy of regulatory intervention. The discussion of PSIA-related practices and the state of Islamic banking regulation provide a composite picture – no specific jurisdictions or institutions are discussed.

A member of the United Arab Emirates' Federal National Council recently stated that: "banking laws should be revised to match the growing number of banks operating in the [UAE]...'[L]aws should set out improved rights for bank customers...[t]hey should set the standards for fairness, transparency, behaviour and accountability that customers can expect from their banks.'" (Samir Salama, "UAE bank customers need more protection", *Gulf News*, January 18, 2014). The UAE official is right, and the sentiment expressed is as applicable to Islamic banking as it is to banking generally, in the UAE and other jurisdictions that host Islamic banks.

STATE OF ISLAMIC BANKING REGULATION

Financial intermediation by Islamic and conventional banks serves the same economic function: to match funding deficits with funding surpluses. Unlike conventional banks, however, Islamic banks must comply with Islamic law (*shari'ah*), which prohibits them from, *inter alia*, engaging in highly speculative or otherwise unduly risky transactions or accepting or charging monetary interest. Consequently, the techniques employed by Islamic banks to raise and disburse funds, manage liquidity risk and self-govern should and do differ from those employed by conventional banks to achieve similar ends.

Despite the uniqueness of Islamic banking, its regulation, including in majority-Muslim jurisdictions, is sparse. Even in jurisdictions in which *shari'ah* is a source of law, Islamic banking (and Islamic finance) is, with few exceptions, governed by laws and legal processes applicable to conventional banking, and often by default in the absence of clear indications of applicable legal processes. Important legal rules, such as insolvency rules for Islamic financial and banking transactions, are insufficiently clear or comprehensive.

Where legal issues pertaining to prevalent Islamic banking products and practices have been addressed, approaches have been too privately driven and narrowly tailored to specific products, services, institutions, and commercial objectives. Existing *shari'ah* standards and rulings, which comprise the bulk of contemporary Islamic financial "law," rarely explain (or evidence consideration of) the foundational *shari'ah* principles on which they are, or should be, based.

For example, a *shari'ah* ruling might explain, for the narrow purpose of bringing a product to market, the product's validity or mechanics, without reference to underlying rules of contract, policy, or interaction with non-*shari'ah*-based financial laws and regulations in dual jurisdictions.

This is not surprising. Many *shari'ah* rulings are produced by private *shari'ah* scholars on behalf of financial institutions that recruit and remunerate them to do so (particularly in the Middle East, where authorities have taken a comparatively laissez-faire approach to Islamic finance). Proprietary to the financial institutions that procure them, these rulings rarely enter the public domain. With origins in a privately driven, fit-for-commercial purpose environment, the Islamic banking (and Islamic finance) legal framework lacks rule and policy depth.

The problem is compounded by gaps in regulation. Many regulators have been slow to proactively implement clear and tailored rules. The status quo may, perhaps, be due to the still-evolving nature of modern Islamic banking (too early for robust regulation); the comparatively small (but rapidly growing) market share held by Islamic banks; an assumption that Islamic banks face and pose fewer risks (particularly systemic risk); reluctance to regulate too rigorously because Islamic banks are special; or, a belief that governments (particularly in majority-Muslim jurisdictions) will bail out Islamic banks if needed.

Whatever the causes of anemic regulation, structural integrity and industry growth justify amelioration. Islamic banking has grown rapidly, but remains a comparatively nascent and fragile banking segment. Clear and comprehensive regulation will bolster its credibility and prospects for sustainable growth. Where specific products are concerned, outstanding questions pertaining to, *inter alia*, the marketing, documentation, and management of products and consumer rights, including at insolvency or other financial distress, require regulatory resolution. The Profit Sharing Investment Account (PSIA) exemplifies the need for more vigorous regulation.

THE PROFIT SHARING INVESTMENT ACCOUNT (PSIA)

The PSIA is an investment product offered to retail and wholesale consumers of Islamic banks. PSIAs resemble savings or investment deposit accounts in conventional terms, except that, importantly, neither capital (deposited funds) nor profits are guaranteed by Islamic banks. The risk of capital loss is, in principle, borne entirely by customers. However, customers may raise claims for negligence, breach of contract, fraud, other misconduct, or breach of fiduciary duty. No reserve requirement attaches to PSIA deposits. Other core characteristics of PSIAs include:

- The foundational *shari'ah*-based structure of PSIAs is, in most cases, the *mudaraba*, a form of Islamic partnership between a capital provider (*rab al maal*, the customer), and a provider of services (*mudarib*, the bank). (To a lesser extent, agency (*wakalah*)-based PSIAs are used, but only the *mudaraba*-based PSIAs are discussed here).
- The customer and bank are participating partners in the profit of the partnership, if any, according to pre-agreed percentages. As *mudarib*, the bank receives customer funds as trustee (*amin*), and thus owes a fiduciary duty to the customer.
- PSIAs are of two kinds:
  - restricted, where the bank's investment authority and conduct are limited by the customer (eg, to specific target assets); and
  - unrestricted, where the bank may invest customer funds at its discretion. (Only unrestricted PSIAs are of concern here).
- Unrestricted PSIA customer funds are typically invested jointly (commingled) with shareholder funds in a common investment pool.
- PSIAs are an important funding vehicle for Islamic banks. According to fairly recent data, *mudaraba*-based PSIAs accounted for a "preponderant portion of investment funds raised by [Islamic Financial Institutions]". (Islamic Financial Services Board (IFSB) Guidance Note on the Practice of Return Smoothing the Profits Payout to Investment Account Holders 2, IFSB, December 2010) (IFSB GN). The IFSB's findings are consistent with other estimates. (See, eg, Hdeel Abdelhady, "Specialized Insolvency Regimes for Islamic Banks: Regulatory Prerogative and Process Design", *World Bank Legal Review*, Volume 5 137 (2013) (Abdelhady) (discussing findings that "PSIA-sourced funds accounted for just over 60% …funding [and, separately]…unrestricted *mudaraba* accounts represented 'nearly zero to 80%' of the total deposits of some Islamic banks"). (The author is not aware of indications that PSIA-tied funding levels have dropped remarkably in recent years. In any case, current empirical data on Islamic banking is not abundant, which creates impediments generally for regulation).

PSIA MANAGEMENT: RETURN SMOOTHING

Where regulation and insolvency are concerned, the PSIA presents a paradox. As an investment product offered by deposit-taking banks, the PSIA requires regulators to decide whether to regulate the PSIA according to product nature or according to entity type, or take a third way. (See, eg, *Abdelhady* at 136 & n. 41) (discussing the former UK FSA's approach with the Islamic Bank of Britain and the Dubai Financial Services Authority's (DFSA) special classification of PSIAs). Questions of regulatory treatment and customer rights at insolvency are further complicated by the practice of "return smoothing."

Islamic banks engage in return smoothing to avoid customer withdrawals where actual returns (or losses) could lead to the realisation by customers of capital losses or below market profits (the market being returns offered by other Islamic banks and conventional banks). According to the IFSB, return smoothing is also necessitated by the absence of a developed Islamic financial ecosystem: eg, money and interbank markets, lender of last resort facilities, deposit insurance, and platforms for diversification, such as secondary markets for trading of Islamic investment products, eg, *sukuk* (Islamic "bonds"). (IFSB GN at 2-3). (Without an ecosystem, there is an absence of private market participants capable of imposing market discipline (theoretically at least, assuming proper functioning of the market). The lack of private checks and balances in Islamic banking makes the case for healthy regulation more compelling).

The use of return smoothing to achieve parity with market rates gives rise to a threshold question: whether, from the customer perspective, the PSIA, owing to smoothing, resembles capital- and return-guaranteed products and, therefore, creates a reasonable expectation interest in capital certainty and guaranteed profit (fixed, minimum, or average). The question, and its regulatory and insolvency-related implications, becomes more textured when one considers the variance between expected (and mostly accepted) return smoothing practices and observed practices that diverge from expectations.

UNRESTRICTED PROFIT SHARING INVESTMENT ACCOUNTS IN ISLAMIC RETAIL BANKING: COMPARISON OF EXPECTED AND OBSERVED PRACTICES

"Supervisory authorities in most of the jurisdictions where [Islamic Financial Institutions] operate ha[d] not laid down any disclosure requirements for smoothing practices." (IFSB GN at 7). The Dubai Financial Services Authority, which has adopted clear and detailed PSIA regulations addressing, eg, PSIA marketing, contract terms, and management, is a notable exception.

Issue	Expected practices (based on nature of PSIA)	Observed practices/ IFSB "identified industry practices"
Marketing of PSIAs	➨ Clear statement in all marketing or PSIA related literature that capital loss is possible and borne entirely by customers. ➨ Clear statement that profits are not guaranteed. ➨ Absence of indications – express or implicit – of expected profit, such as by advertising past profit rate. ➨ No facilities or features typically associated with "deposit" accounts, eg, bill payments, direct salary or wage deposit, etc.	➨ Often marketed to the public through various channels (eg, internet, etc) without clear, unmistakable statement that risk of capital loss is inherent to the product and borne entirely by the customer. ➨ Some banks indicate that profit rates are announced in advance of investment periods, others advertise past rates of return. ➨ Some banks offer facilitates or features typically associated with "deposit" accounts.
Contract formation and terms	➨ Clear disclosure of capital loss risk and lack of profit guarantee; existence and mechanics of PER and IRR (if applicable); customer rights to PER and IRR funds generally, at account termination, and in the case of bank insolvency; explanation that funds are commingled with shareholder and other funds (if applicable).	➨ Adhesion contract. No symmetry of bargaining power between retail consumer and bank. (In contrast, wholesale unrestricted PSIA depositors (eg, corporates, takaful operators) negotiate profit-sharing ratios which are "commonly fixed to achieve the target return" desired by the customer "keeping in view the income generated in previous periods by various investment pools." (IFSB GN at 4)). ➨ Existence of PER and IRR not uniformly stated and/or adequately explained. ➨ Commingling with shareholder and other funds not uniformly stated and/or adequately explained.
Transfers of *mudarib* and shareholder profits to customers	➨ Should be disclosed in the contract, specifically or as part of a general description of PSIA management. ➨ Disclose transfers in annual reports and/or in shareholder dividend distributions/periodic reports (for shareholder informational purposes and to create a record in case needed in connection with future claims or regulatory inspection).	➨ Generally not disclosed to customers. ➨ Insufficient information to know if disclosures are made to shareholders in non-public statements or reports. ➨ Transfers from *mudarib* and/or shareholder profit "usually remain undisclosed in annual reports". (IFSB GN at 7).

Expected and observed practices are described above and overleaf.

RETURN SMOOTHING: EXPECTED PRACTICES

Three primary methods of return smoothing are known to be common.

- The transfer to customers of some or all of current or retained profits owing to the bank (as *mudarib*) and/or bank shareholders, to bolster customer returns (and achieve parity with market rates offered by other Islamic or conventional banks). In connection with transfers from the *mudarib* share, it is noteworthy that Islamic banks set their "contractual percentage [of *mudarib* profit]...at a high level...to provide flexibility in setting the percentage share for any particular year". (IFSB GN at 5).
- Where transfers of shareholder profits are made, the transfers are outright or characterised as *hibah* (a gift, or, as the IFSB explains, a unilateral transfer of ownership without consideration). (IFSB GN at 20).
- The maintenance of a Profit Equalization Reserve (PER), an internally created and maintained fund to which profits earned on the entire commingled investment pool are allocated, prior to profit allocations to shareholders and customers and after deduction of the bank's (*mudarib*) share. Expressly or implicitly, most regulators permit the maintenance of PERs.
- The maintenance of an Investment Risk Reserve (IRR), an internally

UNRESTRICTED PROFIT SHARING INVESTMENT ACCOUNTS IN ISLAMIC RETAIL BANKING: COMPARISON OF EXPECTED AND OBSERVED PRACTICES (CONTINUED)

Issue	Expected practices (based on nature of PSIA)	Observed practices/ IFSB "identified industry practices"
PER practices, disclosures, rights.	➨ The PER "collectively belongs to [PSIA customers] and shareholders". (IFSB GN at 7). ➨ PER should be in place where required by regulation. ➨ Should conform to standard PER practices (described above in text). ➨ PER should not be used to bolster shareholder returns. ➨ Existence and mechanics should be disclosed in PSIA. ➨ Disclose actual deductions from customer profit or payment to customer from PER on a periodic basis, preferably in periodic statement. ➨ Disclose PER status and transactions in PER in annual reports. ➨ PSIA customers have rights to PER funds proportionate to their investment, while the investment relationship exists, when it is terminated and at insolvency.	➨ No ownership claim can be asserted where the existence of the PER and its mechanics are not disclosed and documented. ➨ PSIA customers "agree to give up any right they have to [PER and IRR] when they terminate their contractual relationship with the" Islamic Financial Institution. ➨ In one jurisdiction where the PER was required, one institution reported that it did not maintain a PER and was "utilising profits attributable to shareholders to stabilise the rate of return to IAH". (IFSB GN at 8). ➨ Some institutions were found to be deducting all PER funds from customer profits only, after deducting the mudarib share. (IFSB GN at 8). ➨ One study found that the return on PSIAs was "uncorrelated with the net rate of return on [shareholder] equity" (shareholder returns were higher than PSIA returns). However, PSIA rates of return were "significantly positively correlated with the general market return on deposits, suggesting a significant reliance on [s]moothing...to align the returns...with market rates." (IFSB GN 4-5). ➨ Usually disclosed in annual report. (IFSB GN at 7). (However, a review of available annual reports suggests that some significant/well-known Islamic banks do not disclose PER in annual reports). ➨ Rights to PER cannot be asserted where their existence, mechanics, and respective rights to funds are not disclosed or documented in contracts. ➨ PSIA customers are effectively subsidising future PSIA investors (customers and shareholders) where they do not benefit from prior contributions owing to closure of the PSIA account.
IRR practices, disclosures	➨ Conform to IRR practices (described above), where IRRs are permitted by applicable regulation. ➨ Disclose existence and mechanics of IRR (where applicable). ➨ PSIA customers have rights to IRR funds proportionate to their investment, while the investment relationship exists, when it is terminated and at insolvency.	➨ Some institutions applied the PER deduction method to source and allocate IRR funds (ie, they deducted from gross profits before allocating the *mudarib* share). ➨ Some institutions appropriated "to an IRR on a regular basis a certain percentage (usually 5-10%) of the profits...after allocating their share of profits as *mudarib*." (IFSB GN at 8). ➨ One Islamic financial institution "disclosed in its annual report that, on liquidation, the balance of its IRR would devolve to the *zakat* [charity] fund after covering all expenses and losses". (IFSB GN at 8). ➨ Rights to IRR cannot be asserted where their existence, mechanics, and respective rights to funds are more often than not undisclosed or not documented.

created and maintained fund designed to "cushion the effects of future investment losses". (IFSB GN at 7). The IRR is funded by deductions from profits attributable only to customers (and not shareholders), with the deductions made after allocation of the bank's (*mudarib*) share. (IFSB GN at 7). IRRs are not as widely accepted or used (or acknowledged) by Islamic banks.

RETURN SMOOTHING: DIVERGENCE FROM EXPECTATIONS

The IFSB reported in 2010 that "supervisory authorities in most of the jurisdictions where [Islamic financial institutions] operate ha[d] not laid down any disclosure requirements for smoothing practices". (IFSB GN at 7). A notable number of Islamic banks' observed return smoothing practices have deviated from expectations. Some of these observed practices are set forth in the table above, alongside practices that are expected or should be followed, with the latter being faithful to *mudaraba* principles and appropriate for the context in which retail PSIAs are offered.

PRO-CONSUMER INSOLVENCY RISK ALLOCATION

If the regulation of retail PSIAs was sufficiently clear, comprehensive, and effectively enforced to achieve, *inter alia*, uniformity of practice and adequate disclosure, issues of customer standing at insolvency would require little discussion: contractual risk allocations should carry over into insolvency. The realities of how (and how inconsistently) PSIAs are marketed, documented in contracts, and managed without consistently observed and effectively disclosed smoothing practices, require a pro-consumer outcome at insolvency. A statutory approach favouring retail PSIA customers is suggested here as an option, assuming the status quo remains intact.

(Return smoothing, as practised, impedes effective regulation and informed investment decisions. Particularly where unrestricted PSIA funds are used to finance activities on the asset side of a bank's operations, information reflecting the true performance of PSIAs would indicate a bank's asset and governance quality. Return smoothing practices effectively obscure evidence of a bank's overall financial health and governance quality).

> "The creation of a statutory claim, while inconsistent with the retail PSIA's underlying structure...would likely be acceptable from the *shari'ah* perspective"

Creation of statutory claim

Assuming PSIA assets (capital, profits, and or PER/IRR funds) are available at the point of insolvency (or early regulatory intervention), retail PSIA customers of Islamic banks that have failed to put customers on notice of their risk and rights should be vested with a statutory claim to PSIA funds (in proportion to their investment). This statutory claim can be absolute or rebuttable (administrative, time, and cost considerations, among others, will be relevant). In the latter case, the presumption of a consumer claim can be rebutted with evidence that an insolvent bank put customers on notice. In the interest of judicial economy, retail PSIA customers' claims (and their rebuttability, in the case of a presumption) could be administered on a class basis (eg, according to investment periods, contract(s) or disclosure(s) made, etc).

The creation of a statutory claim, while inconsistent with the retail PSIA's underlying structure (in principle, not as often implemented), would likely be acceptable from the *shari'ah* perspective, as *shari'ah* jurisprudential approaches allow courts (or their equivalent) to weigh, against other factors, the public interest (*istislah*). The public interest in protecting retail bank customers' funds from losses attributable to poorly disclosed and regulated practices that run counter to a product's nature is compelling.

Ring-fence PSIA assets

PSIA assets should be isolated from others, to preserve funds potentially claimable by PSIA customers. Unlike situations in which ring-fencing is demarcated along legal entity lines (eg, to achieve bankruptcy remoteness or protect retail deposits held by conventional banks), delineations based on asset type are appropriate in the Islamic banking context (most Islamic banks operate as a single entity). The isolation of PSIA assets would serve another purpose: it would remove PSIA funds from the reach of other claimants while determinations of any mudaraba-based claims are made (see below).

Classify PSIA claims

PSIA customers could, at insolvency or early regulatory intervention, have separate, *mudaraba*-based claims for breach of contract, negligence, fraud, other misconduct; or for breach of fiduciary duty. Assuming that PSIA assets are ring-fenced or otherwise removed from the reach of other claimants, specific procedures and timetables should be in place to allow for determination of the validity of any *mudaraba*-based claims. Where the same bank conduct causes both insolvency and gives rise to *mudaraba*-based claims, follow-on issues for regulator determination would include: whether PSIA customers should be treated as judgement (or similar) claimants or as PSIA customers with statutorily-created standing; and, as between them, their relative standing.

Adjust claims to gross profits; clawback

In the case of proved *mudaraba*-based claims for negligence, breach of contract,

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fraud, other misconduct; or for breach of fiduciary duty, the assets within the potential reach of PSIA claimants should be expanded (if supported by evidence and consistent with other applicable law and policy) to include prior profit distributions to the *mudarib* and to bank shareholders, where the *mudarib* realised profit improperly or shareholder returns in one or more relevant investment periods were effectively subsidised by unrestricted PSIA customers without their knowledge. (See table above, PER practices, disclosures, rights, known practices). Shareholders' inside knowledge and power to influence bank practices (in closely held banks, see below) would justify this outcome.

In addition, gains of *mudarib* profits (which flow to shareholders) or direct shareholder profits attributable to, eg, misconduct or breach of fiduciary duty, could be made subject to clawback as ill-gotten /misappropriated (or similarly categorised) gains. Providing for a clawback mechanism might retroactively alleviate (but likely not cure) the consequences for unrestricted PSIA customers of conflicts of interest that arise when shareholder and PSIA customer funds are commingled in a common investment pool and managed by shareholder-aligned personnel.

The prospect of clawback might also induce shareholders and management to better align their interests with those of unrestricted PSIA customers in the ordinary course of business.

Of course, in the case of widely held banks, a clawback mechanism would be impracticable and unfair to small shareholders. To counter this, clawbacks could be made applicable only to closely held banks. But the downside of the latter approach would be inequality between PSIA customers at insolvency, as customers of closely held banks would, in principle, have the potential for greater recovery, relative to customers of widely held banks.

> "Of course, in the case of widely held banks, a clawback mechanism would be impracticable and unfair to small shareholders"

CLOSING THOUGHTS

The PSIA, when *shari'ah*-compliant in practice, illustrates the potential role that Islamic banks can play in financial intermediation with a discernable impact on the real economy. In principle, the investment of consumer funds without capital certainty or guarantee of fixed returns should, for example, incentivise financially responsible investment decisions in well-understood and vetted assets, with short, medium, and long-term balancing.

At the same time, the PSIA and the regulatory confusion it creates are emblematic of the state of Islamic banks – institutions that, in significant aspects of their operations and based on *shari'ah*, should function like asset managers and investment advisers – but which are "return smoothing" to compete with conventional, interest-based products. Whether a more authentic form of Islamic banking will emerge is an open question; the absence of appropriate regulation will stunt, rather than facilitate healthy growth in the long-term. In the meantime, as Islamic banks continue to cope with the commercial pressures and legal constraints that shape (in part) present conditions, they and their regulators should ensure that retail consumers do not unfairly bear the risk or cost of the status quo. ■