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Market Movements

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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.

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 customers, specifically the PSIA’s features, related management practices, and the rights of retail bank customers 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.

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

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The foundational dual-partner-based structure of PSIAs is, in most cases, the modarabah, a form of Islamic partnership wherein a capital-depositing party (generally, a customer) and a provider of services (moderab, the bank) (To a lesser extent, agencies) enter into a relationship wherein (i) the bank receives customer funds as trust property, and (ii) gains 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 PSIAs customer funds are typically invested jointly (contingent) with shareholder funds in a common investment pool.

- PSIAs are an important funding vehicle for Islamic banks. According to fairly recent data, modarabah-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)). The IFSB’s findings are consistent with other estimates. (See, eg, Abdelhady, Specialized Insolvency Regimes for Islamic Banks: Regulatory Interventions and Process Design, World Bank Legal Review, Volume 5 137 (2013) (Abdelhady) (discussing findings that “PSIA-sourced funds accounted for just over 60% ...fund (and separately), unrestricted modarabah accounts represented nearly zero to 80% of the total deposits of some Islamic banks.”) (The author is aware of indications that PSIAs and funding levels have dropped remarkably in recent years. In any case, current empirical data on Islamic banking is not abundant, which creates impediments for regulators to decide whether to regulate the PSIA according to profit nature or according to entity type, or take a third way. (See, eg, Abdelhady at 136 & n. 41) discussing the former UK PSIA’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 in 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 realization 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 a danger 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) thresholds.

The question, and its regulatory and insolvency-related implications, becomes more nuanced 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.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Expected practices (based on nature of PSIA)</th>
<th>Observed practices/IFSB “identified industry practices”</th>
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| 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 facilities 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 overhead.

**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 (eg, 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 characterized as Mudarib in Gifts (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...

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

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| 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. |
CONSUMER-ORIENTED INSOLVENCY RISK ALLOCATION IN ISLAMIC RETAIL PROFIT SHARING INVESTMENT ACCOUNTS

Feature

The creation of a statutory claim, while inconsistent with the retail PSIAs underlying structure, would likely be acceptable from the shari’ah perspective

Creation of statutory claim
Assuming PSIAs assets (capital, profits and or-PER/IRR funds) are available at the point of insolvency (or early regulatory intervention), retail PSIAs 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 PSIAs funds (in proportions 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 PSIAs customers claims (and thus 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 PSIAs underlying structure (in principle, not as often implemented) would likely be acceptable from the shari’ah perspective, as also of jurisprudential approaches allow courts (or their equivalent) to weigh, against other factors, the public interest (notably). 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 PSIAs assets
PSIAs assets should be isolated from others, to preserve funds potentially claimable by PSIAs customers. Unlike situations in which ring-fencing is demonstrated 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 PSIAs assets would serve another purpose: it would remove PSIAs funds from the reach of other elements while determinations of any mudaraba-based claims are made (see below).

Mudaraba PSIAs claims
PSIAs 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 PSIAs assets are ring-fenced or otherwise removed from the reach of other claims, specific procedures and timelines should be in place to allow for determination of the validity of any mudaraba-based claims. Where the same bank conducts both mudaraba and gross receipt to mudaraba-based claims. Follow-on issues for regulator determination would include: whether PSIAs customers should be treated as judgment (or similar) claimants or as PSIAs customers with statutorily-created standing; and, as between them, their relative standing.

Adjust claims to gross profitability claims
In the case of proved mudaraba-based claims for negligence, breach of contract,
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 in insolvency, as customers of closely held banks would, in principle, have the potential for greater recovery relative to customers of widely held banks.

**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 assurance of fixed returns should, for example, incentivise financially responsible investment decisions in well-understood and varied 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.

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**Biog box**

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