INVESTMENT ACCOUNTS AMONG CONVENTIONAL BANKING ACCOUNTS: SIMULATION OR INNOVATION

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ABSTRACT

Initiation of joint investment accounts operating on a profit and loss sharing basis could be regarded as a major innovation by Islamic banks in the practice of Islamic finance. Provided as an alternative to conventional interest based accounts such as fixed deposit accounts and saving accounts, these facilitate clients to invest their surplus resources through the mediation of the bank for realising profits. Operation of equity accounts where investment is done by the public at varying points of time for jointly sharing in profit and loss periodically involves several aspects of Islamic legal importance concerning joint investment. While the modus operandi of investment accounts appear to have gained market acceptance, theoretical and Shari’ah aspects continue to demand the interest of academics. Whether these accounts differ from conventional bank accounts in substance and outcome as well as Shari’ah validity may vary depending on diverse factors, and requires careful individual scrutiny.

Field of research: Islamic commercial law, Islamic banking and finance

1. Introduction

Investment accounts based on joint equity serve the purpose of supplying capital needed by the bank for investment profit making ventures, in addition to acting as the primary means of distributing earnings of the bank among the public, a vital function expected of Islamic banks that could be of great economic import. Ordinary members of the society who are averse to earning interest income and are not inclined to invest their funds in private trading enterprises and other forms of direct investment, find in these accounts a ready avenue for involving their funds profitably. Operation of joint investment accounts where investment is done by the public at varying points of time for jointly sharing in profit and loss periodically involves several aspects of Shari’ah importance concerning joint investment, withdrawal of funds, and the mechanism adopted for allocation of profit and loss among the collective body of investors. Correlation of the profit share of the investor to the period of investment is a significant change introduced by Islamic banks that requires further Shari’ah elaboration. Whether the share of a potential loss should be made dependant on the same is a question yet to be answered satisfactorily. An overview of the position of investment accounts vis-à-vis conventional deposit accounts together with some of the questions facing investment accounts is undertaken in this paper, as a prelude to a specific study of the individual issues.

2. Equity accounts among conventional deposit accounts

In the contemporary arena of Islamic banking, joint investment accounts replace interest-based deposit accounts found in the conventional banking system. In conventional banking, consumer deposits form a major source of funds for the bank, that are cheaper than “bought-in” funds from the money markets.

1 Mohammed Obaidullah, Islamic Financial Services, 52.
The term ‘deposits’ is often used to describe the money which customers leave with the banks on current, deposit, and other accounts. If a current account is defined as an account which is opened so that cheques may be drawn on it, then a deposit account can be defined as an account which is opened to earn interest.\(^3\) In the conventional system, a wide variety of deposit accounts offers interest at different rates to clients. Some important aspects of these accounts are discussed below.

Current accounts were historically non-interest bearing and have formed a major source of cheap funding for the banking sector over a considerable number of years. This position has now changed with the majority of banks offering at least an interest rate option on an account. Current accounts allow a customer to withdraw money on demand, or to instruct the bank to pay funds to a third party. These are the shortest of term deposits, with the customer being able to withdraw the totality of the funds without notice.\(^2\) The client could be required to pay a service fee for the privilege to operate a current account. The bank is required to maintain sufficient liquidity for the purpose of meeting demands for withdrawal according to guidelines stipulated by central banking authorities. The clients aim at the safety coupled with the possibility of easy withdrawal provided by these accounts and the facility they provide in money related transactions through cheques. The Islamic basis of these accounts is ‘aqd al-‘qarāl or the contract of lending, free of any stipulated return from the receiver of funds tantamount to ribā.\(^5\) Shari‘ah rules pertaining to loan transactions are fully applicable here. The bank here is in the position of a borrower (mustaqār) liable to repay the money borrowed whenever the lenders, i.e. the depositors, demand.

In addition to current accounts, banks offer a range of other deposit accounts at various terms and interest rates. Deposit terms range from overnight to periods up to one year.\(^6\) Accounts may include some form of interest rate step function so that a higher rate is paid on balances above a stipulated sum. The deposit may have a notice period, requiring up to 90 days’ notice for withdrawal from the account without an interest penalty being extracted. For this loss of flexibility, the customer will receive an increased interest rate. The bank, in return, obtains assurance that the customer will, in all probability, not require the funds in the short term.\(^7\) Deposit interest is paid at a rate determined by the bank’s base rate, usually up to 3 per cent below it. Withdrawals are nominally at seven days’ notice, but can be obtained on demand, although in such a case seven days’ interest on the sum withdrawn will be foregone. Interest is credited to the current account, if there is one, half yearly; otherwise, it is added to the balance of the deposit account. Fixed deposits are sometimes arranged for a fixed sum at a fixed rate. Rates of about 2 per cent over normal deposit rates are quoted for terms of one, two, three or six months.\(^8\) Bonus savings accounts are for regular savers who are able to commit themselves for a period. Personal customers who can put aside a stipulated minimum amount regularly each month for a minimum period of twelve months are offered a rate of interest paid at a margin above seven-day deposit rate. Various types of savings schemes include facility to borrow when desired, sometimes at a twenty-one day notice, and additional offers such as life insurance, in an attempt to attract personal savings.\(^9\)

In Shari‘ah, deposit of funds into deposit accounts of conventional banks, similar to current deposits, falls under extending a loan (qarāl) to the bank.\(^10\) The major objection to such deposit accounts from an Islamic perspective is, of course, the interest element. As conclusively borne out by various individual scholars as well as a number of academic bodies and also the historic judgement delivered by the supreme court of Pakistan in December 1999, interest paid by the bank periodically on deposits

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\(^6\) Cox, 183.

\(^7\) Ibid, 181.

\(^8\) Perry, 323.

\(^9\) Ibid, 354.

in these accounts, being a stipulated excess on monetary capital, is ribā, and is impermissible.\textsuperscript{11} Therefore, deposit of funds into such accounts entail entering an interest based loan transaction. A minority of contemporary scholars have argued for the permissibility of bank interest, which, however, is negated by the overwhelming majority of contemporary Islamic jurists. This research does not intend to analyse the said debate as it falls outside the scope adopted, and instead follows the conclusion as upheld by the majority in its subsequent discussion.\textsuperscript{12}

In their quest to offer an account similar to deposit accounts offered by conventional banks where clients could deposit funds for varying periods without forgoing the opportunity of availing of a return, Islamic banks have succeeded in introducing joint equity investment accounts. Instead of the platform of lending coupled with fixed interest adopted in conventional bank accounts, equity investment accounts are expected to operate on a profit and loss sharing basis. Although called muḍārabah investment accounts, the modus operandi here comprises an admixture of shirkah and muḍārabah both, as the bank’s own funds too are activated along with deposits in these accounts. In most types of equity accounts, profit is distributed periodically, at the end of a stipulated cycle such as six months or one year.

3. Mechanism of equity accounts

Prior to embarking on a detailed analysis of individual issues, it would be relevant here to present a brief survey of the operational mechanism adopted by Islamic banks in general in joint investment accounts.\textsuperscript{13} Deposit mobilisation techniques of Islamic banks are almost uniform.\textsuperscript{14} Usually offered under the name of muḍārabah accounts, these allow clients to make capital deposits at any point of time, subsequent to opening the account by signing the agreement with the bank, often referred to as a muḍārabah agreement, and placing an initial deposit. These accounts could be opened in the name of individuals as well as joint investors such as husbands and wives, business firms and societies, and in some instances, legal entities such as companies and trusts. Sometimes investment accounts in the name of minors are allowed, where the parent or guardian is required to represent their interests. Each depositor is treated as a financier (rābb al-māl) who hands over funds to the bank for investment in profitable activities against a share of the profits. The deposits are treated as muḍārabah capital, the liability of which is borne by the depositors / investors. The bank represents the fund manager (muḍārib) who receives funds from each depositor under a separate contract of muḍārabah with each, and involves the funds in business ventures in an unrestricted or restricted form as agreed with the depositors. Although the funds are received separately, they are converged into a common pool for investment purposes, which fact is usually highlighted in the initial agreement. A ratio is agreed at the inception for distribution of profits between the bank and the joint pool of investors, such as 30 : 70 and 40 : 60. The agreements usually provide that loss affecting the pool would be solely borne by the depositors. There could be different investment pools created for different investment purposes.

In many accounts, depositors are allowed to make withdrawals of the capital during the tenure of the contract\textsuperscript{15} and to make fresh deposits without major restrictions, except in the case of deposits

\textsuperscript{11} See Resolutions No. 10(10/2), 2\textsuperscript{nd} Session of the Islamic Fiqh Academy, Jeddah, 1985, Resolution Nos. 1, 2, 2\textsuperscript{nd} Conference on Islamic Banking, Kuwait, 1983, Muhammad Taqi Usmani, The Historic Judgement on Interest: The Supreme Court of Pakistan 23 December 1999 (2000).


\textsuperscript{13} See Mohammed Obaidullah, Islamic Financial Services, 51-54, Nik Norzrul Thani, Law and Practice of Islamic Banking and Finance, 85.

\textsuperscript{14} Tariqullah Khan, Redeemable Islamic financial Instruments and capital participation in enterprises, Research paper No. 29, Jiddah, Islamic Research and Training Institute-IDB, 1995, 34.

\textsuperscript{15} Tariqullah Khan, Redeemable Islamic financial Instruments and capital participation in enterprises, IRTI Research paper No. 29, 34. Withdrawals may be allowed under special circumstances with the depositor forfeiting
involving some specific investment projects. At the end of the designated cycle, usually consisting of three months to one year, which could extend in some long term specific investment projects up to three years, the profit or loss situation of the joint pool is assessed. Any profits realised are divided between the bank and the pool of investors according to the agreed ratio. There could be different ratios applicable to different types of investment. Thereafter, profits accruing to the pool of investors is divided among individual investors taking into consideration the aggregate amounts invested by them during the cycle and the duration each deposit had remained in the pool, through a process known as the daily product method. Profits accruing to investors are usually credited to their accounts and are reinvested with the capital, unless if the depositors choose to withdraw them or had advised otherwise.

4. Joint equity accounts and *muālārabah* / *shirkah* contracts

Although termed *muālārabah* investment accounts generally, joint equity accounts offered by Islamic banks do not totally conform to the fundamental *muālārabah* contract as put forth by jurists. Equity accounts as generally offered today by Islamic banks manifest features that have been developed through a convergence of, as well as various additions to, the principles of both *shirkah* and *muālārabah*. These variations have been introduced in order to overcome issues faced in management of deposits from a large number of depositors at the same time and to face competition offered by the conventional banking industry. Thus, maturity of deposits is subject to a cycle common to all deposits in a category and the determination of profit and loss is carried out with regard to most assets by constructive liquidation, rather than actual liquidation. Some banks uphold the practice of holding reserves in order to meet potential losses. Investors are not allowed to provide guidelines concerning the particular avenues of investment favoured by them and are required to accept investment decisions made by the bank, except in the case of restricted or special *muālārabah* accounts, where they are allowed to do so. Deposits in joint equity accounts are usually involved in business ventures together with a part of the share capital of the bank.

It is evident that in operational details, Islamic banks are pressured to mimic conventional interest based banks in order to survive, due to the prevailing environment comprising the expectations of depositors, entrepreneurs and regulators, as well as the pre-existing legal and regulatory system. Thus, joint investment accounts are designed in general to facilitate deposit and investment by the public

his share of the profit for the withdrawn amount. Ahmad Ausaf, *Contemporary Practices of Some Islamic Financing Techniques*, Jiddah, Islamic Research and Training Institute-IDB, 1993, Research Paper No. 20; Mohammed Obaidullah, *Islamic financial Services*, 51. In general investment accounts offered by Bank Islam Malaysia Berhad (BIMB) which operate on a somewhat different basis, while it is required that the deposits will have to be for a specified period, the stated rules and regulations imply that early withdrawal is possible, which, however, may affect the profit share of the investor. See Islamic Banking Practice from the Practitioner’s Perspective, Kuala Lumpur, Bank Islam Malaysia Berhad, 1994, 65, 85.

16 See sections under distribution of profit and loss in equity accounts below. In investment accounts offered by Bank Islam Malaysia Berhad, profit division is carried out based on applying the rate determined by the bank from time to time on the principal and the duration of investment. Specific weightages allocated to different types of accounts play a role in the distribution. See Islamic Banking Practice from the Practitioner’s Perspective, Bank Islam Malaysia Berhad, 67, 85, 145.

17 Tariqullah Khan, *Redeemable Islamic financial Instruments and capital participation in enterprises*, IRTI Research paper No. 29, 35.

18 Ibid.


20 Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Risk, Religion and Return*, London, Kluwer Law International, 1998, 134. Vogel has discussed some of the issues where the Islamic banking model, which to a large extent involves deposit taking on the basis of *muālārabah*, has to elaborate its functions from an Islamic point of view. He has grouped these under three headings, namely, problems in managing deposits, problems in organizing the Islamic bank using conventional legal forms and practices and problems arising from pressure on Islamic banks to frame deposits and investments to have risk and liquidity characteristics similar to those of conventional banks in order to compete.
along the lines of deposit accounts offered by conventional banks. The elementary reasoning appears to be that an Islamic investment account functioning drastically different from conventional deposit accounts would not be favoured by a public accustomed to the convenience of the latter, and thus would fail to attract sufficient capital for investment purposes. Due to this reason, operation of **muḥārabah** investment accounts from a depositor’s position is made essentially similar to maintaining a conventional deposit account. Deposit is freely allowed at any point of time. Withdrawal of capital, too, is freely allowed in most cases, even exceeding the facility granted in this respect in conventional fixed and saving accounts, where various restrictions are imposed as to the time and nature of withdrawal.21 Thus, it could be observed that **muḥārabah** investment accounts have come to resemble conventional current accounts as far as withdrawals are concerned, in spite of the marked difference between the fundamental natures of the two accounts.

A major feature common to many equity investment accounts offered by Islamic banks is that withdrawal of funds from the account, when allowed, plays a crucial role in determining the profit share entitled to by the depositor.22 Since withdrawal is allowed, and the amount of funds invested is permitted to fluctuate without restriction, it is impractical and inconceivable to structure profit allocation on the basis of the amount initially invested. During the investment cycle as decided and publicised by the bank, the amount of funds remaining in the account at different points of time could vary drastically. The account could reflect a high balance at one point of time for a short period, and a small balance in the rest of the cycle, or *vice versa*. The account could even have alternating peaks and lows in balance. As pointed out earlier, this phenomenon, which is a marked difference from the investment procedure familiar to **muḥārabah**, is due to the facility granted to the depositors to invest additional amounts and make withdrawals according to their wish. While the Shari‘ah perspective of this aspect itself has to be ascertained, it has led to another factor which is more critical, namely, the allocation of profit and possible loss in this situation. Since the profit is to be distributed among the investors proportionate to their respective investments, identifying the amount of investment made by each is vital. The investment of each varying at different points of time, allocation of profit becomes a complex issue.

As a solution to this problem, many Islamic banks have adopted the daily product method of profit allocation for distribution of profit among the pool of depositors.23 Here, as shall be described later, profit allocation is done by taking the twin factors of money and period both into consideration. The amount of funds invested by a depositor as well as the duration of time each unit of currency remained in the investment, i.e., with the bank, is allowed to influence the profit calculation process. Thus, the factor that determines the amount of profit of a depositor is not the magnitude of his investment alone. The time factor is also allowed to play a role in increasing or decreasing his profit share. Therefore, the profit share claimed by a person investing a large amount of funds for a short period could be equal to that of a person who invests a relatively smaller amount for a longer duration.

This provision is seen to be based on the surmise that withdrawal of funds from an investment account is tantamount to removal of one’s capital, resulting in the reduction of his capital engaged in the on-going project. On this basis, it is justified that the profit share should also suffer commensurately. However, a concern relevant here is that while the capital is engaged in the business, it cannot be conclusively established that the capital of the pool remains intact, so as to allow withdrawal. Until liquidation and profit identification at the end of the tenure, profitability of the venture cannot be known with certainty. Thus, the possibility of treating the withdrawal as a portion of the capital invested requires verification. In addition, unlike conventional deposit accounts that only call for distribution of fixed interest, Islamic investment accounts need to have a ready mechanism for allocation of possible loss, as in an eventuality of loss befalling the venture, the capitals of the depositors would be made to bear the whole of it directly. In spite of adoption of methods such as the accrual basis of accounting

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21 See section on equity investment accounts among conventional deposit accounts above.

22 See sections on general withdrawals below. In investment accounts offered by BIMB, in case of early withdrawals, profit is payable proportionately for the completed months the funds have been on deposit at the rate applicable to the completed period. The relevant rates of profit are based on the corporate or bank-wide performance. See *Islamic Banking Practice from the Practitioner’s Perspective*, BIMB, 85, 129.

23 See sections under distribution of profit and loss in equity accounts below.
that lead to identification of profit even before it is realised and maintenance of adequate reserves to offset possible decline in profits, allocation of loss may not be left totally un-provided for. In the current scenario, however, allocation of loss among depositors could pose an interesting problem, in view of the fact that the investments had not remained equal throughout the tenure, but had been fluctuating. The adequacy of the daily product method in loss allocation remains to be analysed satisfactorily.

In view of the diverse areas of Shari’ah importance relating to joint equity accounts, they have been frequently taken up for consideration in conferences and forums on Islamic finance, from the early days. Numerous fatāwā and resolutions have been issued on various aspects on the operation of such accounts. Collections of fatāwā issued by the Shari’ah boards of various Islamic banks and other bodies such as the Albaraka conference contain many relating to them.24 The Jeddah based Islamic Fiqh Academy held a session (i.e. the 13th session held in Dec. 2001 in Kuwait) where the subject of joint investment accounts of Islamic banks was discussed extensively.25 The Shari’a Standards of AAOIFI as well as their Accounting Standards have elaborated on guidelines concerning joint investment accounts26, where it has been attempted to regulate some of the anomalies inherent to their operation by providing specific rulings on the procedure to be followed in various instances. With the provision of some favourable fatāwā and industry standards issued by recognised bodies such as the AAOIFI, while the modus operandi of investment accounts appears to have gained popular acceptance, theoretical and Shari’ah aspects continue to demand the lively interest of academics.

5. Conclusion

Initiation of joint investment accounts operating on a profit and loss sharing basis could be regarded as a major innovation by Islamic banks in the practice of Islamic finance. Provided as an alternative to conventional interest based accounts such as fixed deposit accounts and saving accounts, these facilitate clients to invest their surplus resources through the mediation of the bank for realising profits. Investment accounts serve the dual purpose of supplying necessary capital for investment by the bank in various projects, in addition to acting as the primary means through which the earnings of the bank are distributed among the public who do not happen to be shareholders of the bank. Operation of equity accounts where investment is done by the public and loss periodically involves several aspects of Shari’ah importance concerning joint investment. Whether these accounts differ from conventional bank accounts such as fixed deposit accounts and saving accounts, these facilitate clients to invest their surplus resources through the mediation of the bank for realising profits.

6. References


24 E.g. al-Fatāwā al-Sharʿīyyah fī al-Masāʾil al-Iqtiṣādiyyah of the Shariʿah Board of Kuwait Finance House, Fatāwā Sharʿīyyah Fī al-Aʾmāl al-Masrafīyyah of Dubai Islamic Bank, A Compendium of Legal Opinions on the Operations of Islamic Banks of the Institute of Islamic Banking and Insurance. The Albaraka conferences on Islamic Economics that had issued resolutions on the subject include the 7th, 8th, 9th, 10th and 11th sessions. See Fatāwā Nadwāt al-Barakah, Jeddah, Albaraka Bank.


