



Legal composition of investment accounts in Islamic law: An appraisal

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Abstract

Investment accounts offered by Islamic financial institutions manifest features developed through a convergence of the principles of equity partnership and fund management. 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. 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. A number of partners pooling their funds together for running a business operation is possible under a contract of equity partnership. In the case of fund management, schools of Islamic law have recognised the validity of several parties jointly investing funds with a common manager/entrepreneur through a single contract. The position of the Hanafi school of Islamic law appears to provide some leeway for mixing of funds belonging to different investors, which is the practice adopted in modern equity accounts. When funds are deposited with a company on *mudārabah*, the contract is held to take place between the company as a juridical person and the investors.

Keywords: *mudārabah*, capital, investment accounts, multiple investors

Introduction

In the contemporary arena of Islamic banking, joint investment accounts replace interest-based deposit accounts found in the conventional banking system. 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, a vital function expected of Islamic banks that could be of great economic import. 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. 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. In the conventional system, a wide variety of deposit accounts offers interest at different rates to clients.

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. Usually offered under the name of *mudārabah* 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 *mudārabah* 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. Many Islamic banks allow investment accounts in the name of minors, where the parent or guardian is required to represent their interests. Each depositor is treated as a financier (*rabb 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 *mudārabah* capital, the liability of which is borne by the depositors / investors. The bank represents the fund manager (*mudārib*) who receives funds from each depositor under a separate contract of *mudārabah* 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 and to make fresh deposits without major restrictions, except in the case of deposits 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 / 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.

In *sharī'ah*, deposit of funds into deposit accounts of conventional banks, similar to current deposits, falls under extending a loan (*qard*) to the bank. 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 in these accounts, being a stipulated excess on monetary capital, is *ribā*, and is impermissible. 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.

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 *mudārabah* investment accounts, the *modus operandi* here comprises an admixture of *shirkah* and *mudārabah* both, as the bank's own funds too are activated along with deposits in these accounts. In most types of equity accounts, profit / loss is distributed periodically, at the end of a stipulated cycle such as six months or one year.

Joint Equity Accounts and Mudārabah/Shirkah Contracts

Although termed *mudārabah* investment accounts generally, joint equity accounts offered by Islamic banks do not totally conform to the fundamental *mudārabah* contract as put forth by jurists. Equity accounts as generally offered today by many Islamic banks manifest features that have been developed through a convergence of, as well as various additions to, the principles of both *shirkah* and *mudārabah*. 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 *mudārabah* 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 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 *mudārabah* investment accounts from a depositor's position is made essentially similar to maintaining a conventional deposit account.

In view of the diverse areas of *sharī'ah* importance relating to joint equity accounts, they remain a subject frequently taken up for consideration in conferences and forums on Islamic finance. Numerous *fatāwā* and resolutions have been issued on various aspects on the operation of such accounts. Collections of *fatāwā* issued by the *sharī'ah* boards of various Islamic banks and other bodies such as the Albaraka conference contain many relating to them. The Jeddah based Islamic Fiqh Academy had 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. The *Sharī'a* Standards of AAOIFI as well as their Accounting Standards are seen to have elaborated on guidelines concerning joint investment accounts, 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.

Due to various aspects of *sharī'ah* importance pertaining to investment accounts offered on the basis of *shirkah* / *mudārabah* by Islamic banks, it would be pertinent here to evaluate the concept of joint equity accounts, the role played by the bank as *mudārib*, the nature of the relationship between the depositors and the bank.

Sharī'Ah Perspective of the Concept of Joint Investment

As far as joint investment on the basis of *shirkah* is concerned, the possibility of a multiparty *shirkah* where a number of partners pool their funds together for running a business operation appears well supported by accepted texts of Islamic law. Since the concept of partnership refers in general to sharing of capital and profits, participation of even a large number of people for this purpose does not appear to be extraordinary. Thus, frequent mention of such multiparty relationships is found in Islamic texts. However, in the case of *mudārabah*, where capital is contributed by one party to another for investment and management, the usual format discussed is noted to be that of a two party relationship. However, rulings pertaining to *mudārabah* relationships involving a number of parties, is to be found in Islamic legal literature, which amply indicates that the such multiparty relationships are permissible in *mudārabah* in principle. The Hanafī jurist al-Sarkhasī, the Mālikī jurist Ibn 'Abd al-Barr, the Hanbali jurist Ibn Qudāmah, the Shāfi'ī

jurist al-Nawawi, among others, have discussed instances where mudārabah involves more than two parties. The Shāfi'i jurist al-Māwardi has discussed in detail different variations of profit sharing when two individuals invest their funds with two mudārib. Extending the same principle, there should be no bar to the contract involving a number of participants in both sides.

In spite of this, mention of an instance where the funds of a large number of people are pooled together for being invested in business ventures by another body of individuals or an organisation acting as mudārib is not to be found in the treatment of the topic. However, it may not be inferred from this that such an arrangement would be unacceptable or illegal, and that mudārabah could not be structured in this manner. Islamic jurists had devoted their texts to analyse and illustrate the basic concepts and rulings pertaining to different types of business relationships, based on which any form of activity could be carried out involving any number of people, as long as the fundamental principles expounded are not violated. The number of participants itself would not be treated as a factor affecting the contract adversely except in instances where the number of participants is specifically restricted, such as in the contract of marriage. Where this is not the case, a contract could be formulated with the association of any number of participants.

Simultaneous Investment by All Investors

According to the recognised norms of mudārabah, where several parties invest with a single mudārib, such investment is understood to take place on a single occasion, so that the tenure of mudārabah could commence with regard to all deposits at the same time. Juristic rulings on the topic indicate that although several parties were allowed to invest with a single mudārib, all of them were perceived to invest on the same occasion under a single contract, which requires the parties having agreed beforehand to invest their funds on mudārabah. Apart from the Hanafi school, there appears little room for merging of different investments made on different occasions. The Māliki position suggests the possibility of the mudārib combining funds received from different individuals under separate contracts, which need not have commenced at the same time. However, Māliki texts imply that in this instance, involvement of the funds in trade would take place after combining them, which ensures simultaneous commencement of operations with regard to all capital. As far as combining two investments made on different occasions in a single mudārabah is concerned, i.e. to combine a capital invested later to an existing mudārabah that is active, this has been held impermissible by Māliki jurists. Similarly, Shāfi'i and Hanbali jurists have indicated its unacceptability. The least restrictive on this issue appears to be the position adopted by the Hanafi school, which indicates that it is permitted for the mudārib to mix the mudārabah funds with his own or with the funds of another, when the investor grants overall permission to the mudārib to transact using the mudārabah funds as he wishes, or when such mixing is customary. This could mean that simultaneous commencement of mudārabah by all investors is not considered mandatory in the Hanafi school.

With regard to modern investment accounts, if the majority position were to be adopted, observance of this aspect would demand that deposits for investment be taken at the same time. The mudārabah investment taking would have to be programmed in such a way that instead of a single cycle

for all investors that accepts deposits at any point of time during its tenure, different cycles that run more or less concurrently are commenced at intervals, facilitating a group of investors to invest together in a single cycle that commences on a date convenient to them. Once an investment cycle had commenced with a defined group of investors, additional investment by fresh investors would not be possible. Thus, this could dictate the inception of multiple mudārabahs, which could partially resemble closed-end investment funds due to non-acceptance an increase in the original investors. However, this process could involve various difficulties with regard to managing each mudārabah investment portfolio separately, in addition to restricting the opportunity to invest anytime as found in conventional bank accounts, as those wishing to invest would need to wait until the date of commencement of a cycle, and would have to forgo the opportunity of involving their funds in business for that duration. Thus, this is an aspect that has been cited as a reason for identifying joint equity accounts as a novel variety of mudārabah where restrictions necessitating simultaneous investment have been relaxed, as shall be discussed subsequently. However, it can be noted that the Hanafi position indicated above provides some leeway for mixing of funds belonging to different investors, which could justify the practice adopted in modern equity accounts within the parameters of traditional mudārabah as far as this aspect is concerned.

The Nature of the Mudārib (Fund Manager)

If investment on mudārabah is to materialise on a large scale, appointment of a single individual or a group of individuals as mudārib may involve unnecessary restrictions with regard to functionality and operations. Although a group of individuals acting as mudārib could be sufficient in operations of a relatively smaller scale, it would prove inadequate with regard to mass scale fund accumulation as is done in the course of commercial banking. Raising and management of such funds usually takes place through modern companies, which are identified as juridical personalities. In the case of investments on mudārabah basis involving a juridical person such as a limited company, it is necessary to verify the identity of the mudārib. Consequent to incorporation, a limited company becomes a legal person distinct from its members, i.e. the shareholders who, apart from a right to their shares, do not have any direct rights to the property of the company. The board of directors are entrusted with the management of the company. The legal title to the company's property is vested in the company and not in the directors, who are servants of the company only if they have a separate contract of service. However, due to the fact that the company is represented by its board of directors, some contemporary scholars hold them in the position of mudārib for the funds of mudārabah. In this case the responsibility of managing the funds devolves on them clearly. Even if the shareholders or the juridical entity of the bank itself is identified as mudārib, in either situation, for practical purposes, the board of directors are seen to act on behalf of them in a representative capacity.

In the view of some other contemporary scholars, the Islamic bank itself, as a legal person, is the mudārib. Some scholarly bodies concerned with Islamic banking have supported this opinion in their resolutions. Although the shareholders are the owners of the company, it is difficult to regard them as the mudārib in this instance, due to the

distinction brought about by the involvement of the juridical person, which, on the whole, limits the relationship of the shareholders with the venture to ownership of their shares and entitlement to dividends. As far as the directors are concerned, their capacity is not seen to exceed management of the company. As such, the involvement of the directors in the mudārabah agreement is only for the purpose of representation. On this basis, the mudārib is held to be the juridical person involved, i.e. the company itself.

As the entity of mudārib as discussed in Islamic legal texts is invariably portrayed as a single individual or several individuals, it would be necessary to examine whether a juridical entity could be appointed as mudārib. The sharī'ah perspective of the concept of legal personality being a subject requiring a separate discussion, it would not be feasible to cover this issue adequately within the scope of the current research. However, the topic has been studied by contemporary sharī'ah scholars at some length, and despite of some objections, it appears to be accepted by many that the concept of juridical personality is recognised in sharī'ah, and that business institutions that are juridical persons could be formulated in a valid manner, with certain restrictions. This research would proceed based on this postulation.

Accordingly, when funds are deposited with a company on mudārabah, the contract takes place between the company as a juridical person and the investors. Based on this, it has been held that changes occurring in the owners of the entity or the board of directors would not affect the relationship between the investors and the mudārib, i.e. the institution. Consequent to identifying the juridical entity as the mudārib, the relevant rights and liabilities would necessarily be associated with this entity.

Conclusion

Equity accounts manifest features developed through convergence of the principles of shirkah and mudārabah. When funds are deposited with a company on mudārabah, the contract is held by some contemporary scholars to take place between the company as a juridical person and the investors. A number of partners pooling their funds together for running a business operation is possible under shirkah. In the case of mudārabah, schools of Islamic law have recognised the validity of several parties jointly investing funds with a common mudārib through a single contract. In the position adopted by the Hanafī school, which indicates that it is permitted for the mudārib to mix the mudārabah funds with his own or with the funds of another, when the investor grants overall permission to the mudārib to transact using the mudārabah funds as he wishes, or when such mixing is customary. This could mean that simultaneous commencement of mudārabah by all investors is not considered mandatory in the Hanafī school.

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