SIMPLIFIED ILLUSTRATION OF MUDHARABAH INVESTMENT ACCOUNTS

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INTRODUCTION

- This presentation is aimed at illustrating how unrestricted Mudharabah investment accounts work in principle.
- The flow of funds and profit distribution will be clarified for the fullest understanding.
Features of a Mudharabah Investment Account

- The investors-cum-depositors (customers) are the *rabbiul-mal*, sometimes also called *sahibul-mal*
- They deposit their money in a *Mudharabah* investment account at a bank (as the *mudharib*), with the profit ratio agreed up front (standard contracts in Islamic banks mean that there is usually no negotiation for normal account holders)
- The customers’ funds will then be separated according to whether they have an UNRESTRICTED or RESTRICTED account
FEATURES (CONT’D)

- Unrestricted accounts are where investors’ deposits are commingled into a common investment pool.
- The common investment pool will include equity or shareholders’ capital.
- Restricted accounts are where investors have specified the types of investments they want, and this means that the bank as *mudharib* cannot go beyond the constraints set; restricted accounts go off the balance sheet as they do not become part of the bank’s assets/liabilities, but are instead considered as being ‘managed’ by the bank.
ILLUSTRATION

- Let’s go through an example of how an unrestricted Mudharabah investment account (MIA) works in principle.
- Say there are deposits from investors/rabbiul-mal totalling $300m.
- Assume that $30m goes to restricted accounts, while the remaining $270m goes to the unrestricted accounts.
- The investment account holders (IAH) and the bank are now in the 1st mudharabah, and the profit sharing ratio between the investors and the bank/mudharib has been agreed as 60:40 in the investors’ favour.
- The investors’ deposits will be placed in a common investment pool, commingled with bank shareholders’ equity, say $30m.
- The total size of the pool will then be $300m.
Investors = $300m deposits

Unrestricted accounts = $270m

Common investment pool = $300m

Bank

Bank manages investment pool

Equity = $30m

Restricted accounts = $30m (off balance sheet)

1st mudharabah
The bank then enters into a 2\textsuperscript{nd} mudharabah with a fund manager, so the bank is now the rabbiul-mal and the fund manager is the new mudharib

The new profit sharing ratio between the bank and fund manager is agreed at 80:20 in the bank’s favour

The fund manager invests the pool of $300m, and manages to acquire profits of $100m

So the FIRST distribution of profits is between the fund manager and the bank:

- $100m at 80:20 $\rightarrow$ $80m$ to bank, $20m$ to fund manager
ILLUSTRATION (CONT’D)

Bank

Fund manager

Common investment pool = $300m

Profit = $100m

$80m profit share

$20m profit share

2nd mudharabah

Investment
The SECOND distribution of profits (Profit A) is to the shareholders in proportion to pool contribution:
- $80m at 90:10 → $72m remaining profits, $8m to shareholders

From the remaining $72m (Profit B), let’s assume 5% will be taken for the Profit Equalization Reserve (PER), which is used for income smoothing:
- $72m x 5% PER = $3.6m, with balance of $68.4m

The THIRD distribution of profits (Profit C) is now between the bank and investors (IAH):
- $68.4m at 60:40 → $41.04m to IAH, $27.36m to bank
ILLUSTRATION (CONT’D)

Profit A = $80m
$8m profit share
Shareholders

Profit B = $80m
PER = $3.6m

Profit C = $68.4m
$27.36m profit share
Bank

$41.04m profit share
IAH
The process does not end here as part of the investors’ share of $41.04m in profits is put into the Investment Risk Reserve (IRR), which is a mechanism for capital protection.

Let’s assume that from the profits, 2.5% is taken for IRR:
- $41.04m x 2.5% = $1.026m, with balance of $ 40.014m

This leaves a net profit of $40.014m for the IAH as "Rabbiul-mal"
ILLUSTRATION (CONT’D)

Profit = $41.04m

IRR = $1.026m

Net Profit = $40.014m

IAH
PER AND IRR

- Why do we have PER and IRR?
  - PER is for income smoothing. If profits from investments dip during a certain period, then the bank can ‘top up’ the profits using the PER to ensure that investors do not experience volatile fluctuations in their income stream.
  - IRR is for capital protection, and since capital (i.e. deposits) belongs to the IAH, the IRR is only taken AFTER the distribution of profits between the IAH and bank.
  - In situations where investments make losses, the IRR is used to help ‘protect’ the capital (i.e. deposits).
ISSUES WITH PER AND IRR

- When an IAH leaves the bank, he/she may not claim the PER or IRR taken from his/her share of profits
- The justification is that the bank has to look at the IAH as a whole, and not individually
- Moreover, if that IAH becomes a new customer at a different bank, that customer will be taking advantage of that bank’s previous customers whose profit shares would have undergone similar PER and IRR treatment
- Therefore, we give some and we lose some, and if we take the broader view of the situation and understand that we are ‘covering’ each other in this manner, it becomes easier to accept that this system of PER and IRR makes practical business sense
ISSUES WITH PER AND IRR (CONTD’)

- However, is that justification good enough?
- Shouldn’t the IAH be allowed to reclaim his/her profits? After all, it is his/her property....
- Furthermore, should capital be protected at all through the IRR mechanism? Is this not the same as capital guarantee, which is not allowed in Mudharabah?
- Furthermore, how are the PER and IRR accounts treated? Do the banks use them in anyway?
- In practice, Mudharabah investment accounts mimic conventional FD accounts, in that the IAH is paid the same amount in profit as the interest payment for conventional FD accounts, and this ‘profit share’ is the same throughout the life of the account
- Is this a case of form over substance?
CONCLUSION

- There are many issues regarding *Mudharabah* investment accounts, of this there are no doubts
- The next step is to tackle these issues and find out what exactly the possible remedies are

Thank you!