

Management of Investment Risks Fund (IRF) In Islamic Banks *In The Light of The Decisions of The Shariah Supervisory Board, law and AAOIFI Standards*

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Abstract

This study aims at revealing the administrative and accounting aspects of the investment risks fund in Islamic banks through the study of the reality of the management of these funds and accountability in the Jordanian Islamic banks, where they were put up important questions relating to the administration of the Fund and its accounting and investment amount accumulated in it. The researcher found that the establishment of such funds needs arising from the nature of Islamic banks and subject to the supervision and control by the central banks. Also, the researcher revealed that there is a difference in the foundations of this fund truncated and accountable between accounting Islamic standard number (11) and the advisory opinion of the Jordanian Fatwa Board. The study revealed that the investment of this fund is forbidden .

Key words: Investment risks, Islamic banks, Investment risks fund, Mudarabah, Warranty Donation.

1. Introduction

Islamic banks are distinguished from traditional Banks in working in more risky field especially in operating risks in addition to other risks. These banks are supervised by the central banks, which consider protecting the depositors` funds as its main priority. Accordingly, Islamic banks are forced to search for solutions are compatible with Islamic law (Shari`ah) to protect investment process and make participants feeling safety ,increase investment accounts and its stability and taking in to consideration the response to the requirements of banking supervision. Subsequently, the idea of accomplishing investment risks fund is existed by Islamic banks management.

2.General framework

2.1 Research significance

The importance of this study arise from discussing important issues related to the big wealth which gathered in Islamic banks as account which called "Risks **Fund**", such as, the unison between the fund and the Islamic controls from the practical aspect, Zakah¹ of this fund and the impact of all this on the rights of unrestricted investment accounts holders (unrestricted Mudarabah accounts)².

2.2 Research Objectives:

The study aims at identifying the reality of risk fund in Jordanian Islamic banks and its compatibility with the provisions of Islamic controls. As this study aims at releasing all matters relating to the risk fund management of practice, religion, Zakah , and the impact of this tool on the distribution of profits among the owners of unrestricted investment accounts and Islamic Banks.

2.3 Research Statement:

This study could be limited to answer the following questions:

1. Are Islamic banks committed to apply the provisions of Islamic controls regarding the establishment and management of the risk fund?
2. How to fund truncated and its impact on the distribution of profits between the Islamic bank and unrestricted investment accounts holders?
3. Are Islamic banks paying Zakah related to this Fund ?
4. Are Islamic banks investing this fund? Is that permissible? If yes;Who is responsible about such investment?

2.4 Methodology

The researcher will Follow the inductive analytical approach to get investigate the views of the Jurists and standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in this area and to access to the reality of this fund management in some of the Jordanian Islamic banks to answer the research questions.

2.5 Literature Review

¹ Zakat is the estimated share of money imposed by God in the wealthy money to the beneficiaries (specific parties in the quran).

²Unrestricted Investment Accounts: These accounts opened by the Islamic Bank for its clients on the basis of Mudarabah contract so that the account holders are "Rabualmal" the Islamic Bank is the "Mudareb"

1. Osman Ahmed Babiker study (2001), entitled: "The deposit protection system in Islamic banks"(in Arabic): The study discussed the traditional and Islamic banks systems to protect deposits and their adequacy between their own actions. It also clarified the Sharia`ah aspects to guarantee deposits of Islamic banks where the researcher proposed a system of deposit insurance. The most important findings of this study is the validity of the traditional systems of system deposits as a framework to ensure the ongoing deposits with Islamic banks as long as they are taken as a loan (current accounts) and proposed a system to protect the investment deposits on the basis of Takaful insurance.
2. Monzer Kahf study (2005): "guarantee deposits in Islamic banks in Jordan"" (in Arabic):The study argued the risks of deposits in Islamic banks and guarantee of Sharia`ah. It compared the risk of deposits in Islamic banks with deposits in conventional banks. The researcher explained the need of evaluating the interest guarantee deposits in Islamic banks in Jordan. The researcher discussed the possibility of deposits guarantee in Islamic banks through the deposit insurance corporation provided that the Islamic Bank shall bear all expenses of guarantee deposits in current accounts and excluded from the investment accounts.
3. Abdullah Al-Saif study (2013):" Insurance on Bank Deposits in Islamic Banks" (in Arabic):This study attempts to shed the light on the side of financial transactions, banking, insurance, Islamic banks and deposits with the Takaful companies or institutions that guarantee deposits. Deposits form most of the fund of the bank through which projects are funded and are worked in the market. On the other hand, there are many risks facing the bank as; how can the bank save the deposits of its customers? This study was conducted to present the Islamic rule in saving the bank deposits. The study showed that insurance on bank deposits to the Takaful insurance companies or to the institutions is accepted and permissible under special conditions based on Shariaah rules.

3. Investment Risks Fund(IRF) In Islamic Banks

3.1 Investment risk fund as a concept

The investment risks fund represents the amount, which is allocated by the Islamic banks, from investments accounts holders profit after the distribution of Islamic banks share to mitigate the future investment risks on the investment account holders (IAH). It aims at covering the IAH losses as occur (Khuwaylidi 0.2011).

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard (11) defined IRF referring to the definition of **reserve investment risk** ;"the amount that is appropriated by the bank from the investment account holders dividend, after the share of Mudarib¹ deduction to protect the owners of investment accounts from future loss."

The Hashemite kingdom of Jordan forced Islamic banks to establish the investment risk fund, in article (55) of the Jordanian Banking Law 2000, where the Jordanian Islamic banks are forced to maintain an account in a fund to cope with the investment risks to cover any losses in excess of the total investment profits during a specific financial period at least (10%) of net realized investment gains on the various operations carried out during the period. (Jordanian Banks Law No. 28 of 2000).

It is important to note the difference in the concept of IRF " investment reserve " in the Jordanian Islamic banks point of view from the concept of this reserve in AAOIFI which based on this difference that these amounts are deducted from the share of each of the Islamic Bank and unrestricted investment accounts as defined by Jordanian banking law. While this amounts are deducted from the share of unrestricted investment account holders only according to AAOIFI.

3.2 The reasons of establishing an investment risk fund

The problem of Mudarabah funds (IAH) guarantee made Islamic banks encourage depositors to keep their deposits by finding alternatives to legitimize the idea of guarantee deposits. One of these alternatives is IRF, which contributed to configure a variety of reasons and factors: (kuhf, 2005, p. 61; Abu Zeid, 1996 , p. 61; Babacar, 1421, p. 56):

1. The continued expansion in the Islamic banking business even outside the scope of the Muslim world. This expansion is subjected to the fulfillment of certain conditions laid down by the financial and banking systems in countries where the Islamic banks work is applied. For example, some central banks such as the Bank of England are asking expressly to mention that in the rules of operation of any bank or any entity interested in collecting deposits

¹Al-Mudarabah : A contract between two parties in which one party pays money to the other party to invest it for profit. This must be the distribution of profits between the two parties proportions agreed between them, while the loss is borne by the owner of the money and the investor loses his efforts if he didn't cheat or betraying the money owner .

Money owner called " RABUALMAL"

Investor called " Al-Mudareb"

Money called " Mudarabah Capital"

from the public that states guarantee these deposits. Of courses, the Bank of England will not grant a license to the Bank does not guarantee deposits.

2. The nature of the contemporary investment includes new risk types were not familiar in the past which has necessitated the introduction of a specific fund to address these risks.

3. The requirement of the Central Bank of the Islamic banks composition of reserves for investment like legal reserve and to protect Mudaraba money(IAH).

4. Islam forbids Mudarib (Islamic Bank) to guarantee unrestricted investment accounts (Mudaraba capital). So it is necessary to find an alternative acceptable to Islam to protect the investments accounts. Note that competition with traditional banks makes it necessary to find an alternative to guarantee the investments accounts in Islamic banks

4. Investment risks Fund from Shariah perspective

Jurists have more than one point of view regarding to the IRF in Islamic banks. The idea of IRF in Islamic banks based on the principle of guarantee and how far is this idea applied. Researchers refer to the old books of fiqh¹ in similar issues, but this study will mention the most important statement in this area in order to serve the purposes of research as follows:

4.1 Guarantee Donation

Tijani mentioned that it is permissible to include the Islamic Bank on the grounds that this guarantee based on donations and volunteering, but it shall not be binding on the Islamic Bank to guarantee investment accounts because that is considered as a guarantee of Mudarabah capital which is forbidden in Islam (Tijani ,2001):

The researcher believes that what Al Tijani said is unacceptable because it contrasts with the base " Algunmu Belgurm" which means that the party who worth profit should bear the loss. In addition to that it includes a return to the interest under other names because the interest system (RIBA) means to guarantee the capital and guarantee an increase on it.

On the other hand, the guarantee donation of any party does not permit her/him to participate in the profits because -in Islam- it is not permissible that the bank donates to guarantee the IAH funds then accept banks` participation in the profits.

4.2 The third party guarantee

What is meant by the third party here is a separate person in his/her personality and financial discharged from the parties to the contract and not as an agent or broker for one of the parties or of one of them guaranteed. It may be natural or legal persons (Nashmi 0.2010.)

The third party guarantee in fact is binding commitment to provide a gift equivalent to the nominal value of the assets in the event of the loss of whatever was caused by- If the loss were not a result of bad bank management- (Abu Goddah 2010),

Here, a question arises; Is there in fact a third party not related to the parties of the contract (IAH " Rabualmal" and Islamic bank "Mudareb")? And what is the benefit of this party from Muadarabah capital guarantee?

Looking at the matter fairly makes the researcher recognizing that the third party -who is conditioned to not have a relationship with both parties of the contract -is not existed unless the state. However, when the state enters as a third party , it have its own objectives which are the economic stability situation and giving safety to depositors.

4.3 IRF as a kind of Tkaful Insurance

The issue of donation itself agreed upon by jurists as desirable in Islam. And the meaning of insurance Takaful: " the Cooperation of a group of people who are exposed to the type of risk to compensate for the loss that may infect someone through their contribution amounts of cash to lead them compensation to any shareholder of them If actually signed the danger that was insurance against it." (Zoheily 0.2010, p. 147).

The bases of cooperation here are donated by all means, whether it is an urgent need or to prepare for the risk or expected disaster. The goal of cooperative insurance contracts is the fragmentation of the dangers and to participate and take responsibility when disasters occur (Zoheily ,2004).

The Council of Shariaah of AAOIFI was likely conditioner cooperative insurance on the commitment of donation (Nashmi 2010). Scientists, Shariaah Boards of Islamic financial institutions and fatwa bodies agreed on the permissibility of Takaful insurance (the Islamic Fiqh Council 9 (9/2); Jordan Ifta House No. 45).

Modern scholars also discussed about the controls of IRF that should shed the lights on IAH's rights, These controls can be summarized as follows (Sharif ,2011: p. 24):

1.To inform depositors about this deduction from profits and its importance in the prevention process of their capital. In addition to that, Mudarabah contract - that is signed with IAH's- must contain condition to deduct a percentage of profits to IRF.

¹Fiqh: knowledge about Islamic rulings derived from detailed evidence

2. The amounts to be deducted to IRF from the revenue according to how much the ownership of the funds invested. If the money belongs to depositors and shareholders shall be deducted of all their earnings as they represent the funds owners (Rabualmal).

2. The deduction rate must be reasonable, so that the ratio will not be exaggerated to affect the impact on the investors` profit and estimate it based on the experts of Shariaah committee and economics.

5. Accounting of IRF in Jordanian Islamic Banks

The balance of IRF in Jordan Islamic Bank reached 76 million dinars in 2013, and this fund balance at Islamic International Arab Bank reached 12 million dinars (annual Report Jordan Islamic Bank, Islamic International Arab Bank, 2013).

These figures indicate the magnitude of this fund. We have observed that all Jordanian Islamic banks adhere to what has mentioned in Article 55 of the Jordanian banks Law No. (28) in the year of 2000 that we have mentioned previously. Through our analysis of what is stated in the financial statements for Islamic Banks of Jordan in 2013, we note that an amount has been deducted from IRF reached to 10% of the total balance of the joint investment earnings account, which means the resolution of this amount from IAHs (*RABUALMAL*) and Islamic banks (*AL-MUDAREB*) shares . This contrary match to what mentioned in Standard No. (11) of AAOIFI standards which allowed deducting this amount from IAHs share to protect unrestricted investment accounts only.

This difference between the definition of the Jordanian banks law and AAOIFI standards resulted from the difference that we have mentioned above with respect to the legitimate adaptation to IRF, and to clarify that consideration could be given to the following simplified example that captures this difference:

If we assume that the Jordanian Islamic banks distributed profits by 60% of owners money and 10% of IRF. where you will have to resolve the Fund's share from the total quota. If the mutual earning net profit reached 100 million dinars, for example, the fund's share in this case would be 10 million dinars and the Bank's share (Mudarib) 30 million dinars and the share of the IAH of 60 million dinars .

But if Islamic banks committed to the AAOIFI standards, bank's share (Mudarib)will be (40) million dinars ,IAHs share will be (60) million dinars, and the share of IRF will be (6) million dinars .

The researcher believes that the method of Jordan commensurate with the nature of the work of Islamic banks if it was permissible to Islamic Bank (Al-Mudareb) and unrestricted investment accounts holders (IAHs) to donate with a part of their share to IRF. Jordanian Islamic banks allow that it is permissible to Islamic Bank (Al-Mudareb) and (IAHs) to donate with part of Mudarabah profits to a third party and that according to the Resolution No. (45) of the Jordanian Fatwa Council resolutions on: April,25th 2000 with respect by virtue of the IRF in Islamic banks.

This difference impact will not stand on the income statement, but also affects the way of disclosure in the financial statements, the Jordanian Islamic banks are committed to the Jordanian bank law which does not comply with the standard No. 11,they will show the balance of this fund somewhere in the credit side of the balance sheet, but not as a liability nor owners equity and unrestricted investment account holders rights, it is not an obligation on the Bank –from accounting perspective - because liabilities must be paid to others in the future on a specific or on-demand, and this does not apply to this fund balance in the Jordanian Islamic banks because it comes out of ownership of the donors , and this makes it imperative for Islamic banks to disclose in their financial reports that this fund devolves to the Zakat Fund in the event of liquidation of the bank (the annual report of Jordan Islamic Bank, Islamic International Arab Bank, 2013).

6. Management, Investment, and Zakat of IRF

6.1Management of IRF

The practical aspect indicates that Islamic banks manage this fund through a committee of bank's employees as well as some members of the Shariah Committee in the Bank. In the case of a loss as a result of Mudarabah investment funds are loaded to the IRF ,if the Sharia Supervisory Board issued a decision to do so on the recommendation of the Fund Management Committee and inform the Central Bank (provided that they are loss without any default or infringement of the bank). This is what the Jordanian Islamic banks do, but they use this Fund also to bear the expected losses from investment and financing operations which are determined based on the Central Bank of Jordan instructions in addition to the accounting principles known (annual report of Jordan Islamic Bank (JIB) 2013).

The researcher sees that forming an independent committee made up of specialists in economics and law under the supervision of the central bank to oversee IRF in Islamic banks is a must. It is oddly enough that "Mudareb"(Islamic bank) is the part who is managing the IRF, and at the same time, its Shariaah board decided that the

Mudareb exceeded or failed to manage IRF and allow the Mudareb (Islamic Bank) to use the IRF to compensate losses.

The way in which the IRF is managed in Islamic banks raises suspicions and questions. So, those who are in charge of Islamic banking should reconsider the method of administration and increased explanations about IRF.

6.2 Investment of IRF

The premise, for which the IRF was established, is to protect Mudarabah money from losses. Here, the question is: Since this fund was established to meet future risks from operations of Mudarabah investment; Is it permissible to invest IRF fund?.

Islamic scholars differed in this matter. The Jordanian Fatwa Department said that it is not permissible to invest IRF, and if the Islamic Bank has not committed to do so it shall bear any loss arising from the investment, and if the result is a profit, Islamic bank takes nothing and turning all the earnings of the Fund (Jordan Dar al-Ifta, resolution No. 45).

Other scientists said that this account may be invested funds because the money here as an annual basis are taken separately on each investment from the previous year and the following year, and thus the amounts allocations that are not needed may be invested. Investment earnings in this case shall transfer the party who has the money in this fund (Hassan, 2011, p: 32).

Such an opinion is difficult to be applied by the Islamic banks because of the withdrawal of some holders of unrestricted investment accounts and the difficulty in estimating the investment for each individual because the bank mixes his money with unrestricted investment account holders' money. In addition to that, some Islamic banks imposed by the Central Bank to compose this fund and not invest it.

The researcher believes that the investment of IRF is not valid because there is no owner of these funds. Subsequently, the Islamic banks are delegated to be responsible about the investment process. As it is not appropriate for the Islamic Bank staff that are at the same time managing the IRF because they will act with money they do not own.

6.3 Pay Zakat for IRF

Zakat -in Islam- should be about the money that has an owner not about the money that has no owner. It is noted that the fund's money came from property owners by donating - in the opinion of the Jordanian Fatwa committee - and therefore, the Jordanian Islamic banks do not pay Zakat of these funds.

7.Result and recommendation

7.1 Results

1. To establish a fund to face the investment risks in the Islamic banks to protect/save the investment money which is gained from the unrestricted investment accounts holders or the shareholders in the Islamic banks. It is a necessity that imposed by the work nature of the Islamic banks and the importance of being commitment with the directions of the supervisory and regulatory authorities and the banks laws that the Islamic banks are worked depending on.
2. The jurists agreed on the permissibility of establishing the fund to face the investment risks and that it is not allowed to deduct from the Islamic bank share of profit because it will be as an guarantee of Mudaraba capital. The Jordanian Mufti council premises the deduction from the bank and the unrestricted investment accounts holders to donate to the IRF. Accordingly, the IRF is not owned by any of the parties and is given to the needed people in the case of bank's liquidation.
3. There is a clear difference between the point of view of the banks in Jordan and the central Jordanian banks and the point of view of AAOIFI to this fund. Accordingly, that affect on the accounting of this fund from the respect of calculating the deductions and showing it in the balance sheet of the Islamic bank.
4. The jurists differed in the investment of the IRF money where the Jordanian Mufti council forbids the investment of IRF. Others issued the opposite. And the first Fatwa is more appropriate to the work nature of the Islamic banks which is the best and the most secure from the practical approach.
5. The Islamic banks which treat the fund money don't pay Zakkah from the IRF considering that there is no owner for it.

7.2 Recommendations

1. The importance of tighten the censorship on establishing the IRF and the way of moderating it. This processed through the regulatory and supervisory bodies in moderating this fund in the case of following the donation principle. While in the case of deducting it from the holders of the unrestricted investment accounts and the continuity of owning it, a participation of them or voicing someone else instead of them must be imposed in moderating the IRF.
2. Shedding the lights on principle No.11 which is related to the reserve investment risks and adjusting it to involve this donated money in the opinion, the matter which will affect the way of establishing this IRF and the way of showing it in the financial statement.
3. More research must be investigated in this field especially from the Islamic point of view.

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