Charity account in Islamic financial institutions: creating a defined Sharī‘ah standard

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Abstract

Purpose – This article seeks to propose a defined set of Sharī‘ah standards and guidelines for the charity account in order to provide clear guidance to Islamic financial institutions (IFIs) and eventually create a standardised practice in the management of the charity account by IFIs worldwide.

Design/methodology/approach – This article is based on a literature review regarding the origin and concept of the charity account for IFIs. It makes reference to various primary Sharī‘ah sources and contemporary Sharī‘ah standards pertaining to impermissible income as it relates to the charity account. It also analyses secondary sources of reference, in particular research papers and case studies on the same subject matter.

Findings – This article proposes relevant Sharī‘ah standards required for the better functioning and standardisation of the charity account application by IFIs.

Research limitations/implications – This article will help IFIs, standard-setting bodies and regulators to develop a defined charity account framework. It also addresses the gaps discussed in past research and case studies that have not been resolved to date, particularly on the determination and management of charity accounts at the level of IFIs.

Practical implications – The charity account will be better controlled and thus eliminating potential reputational issues arising from collecting and disbursing commitment to donate amounts (CDA).

Social implications – The charity account distribution will be better managed and thus of more benefit to the society and recipients.

Originality/value – This article promotes the idea of standardisation in the practices of charity accounts, especially in terms of sources and disbursement.

Keywords Charity account, Donation, Islamic banks, Islamic finance, Late payment penalty, Sharī‘ah compliance, Sharī‘ah non-compliant earnings

Paper type Research paper

Introduction

Sharī‘ah compliance is a fundamental requirement of Islamic financial institutions (IFIs). Under the current practices of IFIs, it is the duty of Sharī‘ah departments along with the Sharī‘ah Supervisory Board (SSB) to monitor, audit, check, certify and approve financial products and services offered according to the requirements of Islamic financial laws (Wardhany and Arshad, 2012; Laldin and Furgani, 2018). When a financial transaction is found to be in violation of the Sharī‘ah (Islamic law), the SSB will accordingly need to decide whether the financial transaction is void; or needs to be rectified; or its cost shall be borne by the IFI and/or the profit earned represents Sharī‘ah non-compliant (SNC) earnings.

The SSB treats a financial transaction that involves SNC earnings seriously. Accordingly, two consequences shall arise: the IFI is not allowed to benefit from SNC earnings; and the IFI
shall deal with SNC earnings in a prescribed manner as approved by its SSB’s resolutions. Here, the Shari’ah-compliant solution which has been formulated is to utilise such SNC for charitable purposes; hence, the establishment of a charity account.

Central to the creation of a viable Islamic finance industry is the principle of earning *halāl* (permissible) income. Despite that, IFIs are still inevitably subject to receiving some SNC earnings. Accordingly, the following issues arise: how such funds are being managed in practice; how they are being spent; whether there are regulations in place governing such funds; and whether IFIs may benefit from such funds. These considerations substantially differentiate IFIs from their conventional counterparts which do not maintain a charity account for such purposes.

The discussion of SNC income is not new in Islamic law. It revolves around a *hadith* which says: “O people, Allah is pure, and He only accepts that which is pure” (Muslim, n.d., *hadith* no. 1015). It is inferred that for *sadaqah* (charity) to be accepted, it must come from *halāl* income. Classical Shari’ah scholars disagreed whether it is acceptable for *harām* (impermissible) income to be given as charity. This is relevant to the current practice of IFIs putting aside *harām* income to be channelled to charity. Some scholars opined that it should be directed to charity since that would be better than wasting it, while others said that it is prohibited to direct it to charity and that it should be wasted and thrown into the sea (Ibn Rajab, 2008). The classical Shari’ah views indicate that *harām* income is a serious issue.

It should be noted that significant gaps exist in the existing literature and legal frameworks of most jurisdictions regarding the law and practice of charity accounts in the context of IFIs. In addition, there remain unresolved Shari’ah, legal and regulatory issues concerning the charity accounts of IFIs, and no comprehensive Shari’ah standard or guidelines on it has yet been issued by leading regulatory bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). Other important issues that impact charity accounts relate to money laundering and the financing of terrorism. In 2019, the IFSB published a working paper on the risks of money laundering and financing of terrorism in Islamic banking. It examined, among others, risks emanating from the intrinsic characteristics of arrangements used in Islamic banking. It highlighted the risk related to usage of donations and moving funds to criminal activity.

Based on this backdrop, this article aims to address the above-mentioned gaps in the concept and application of the charity account in the Islamic finance industry. It is structured as follows: it begins by providing an overview of the charity account, its origin and underlying concept. Then, the discussion sheds light on the Shari’ah basis for the income flow of charity accounts. It then explains the relevant regulatory issues applicable to charity accounts and the proposed solutions. Based on this information, it proposes the suitable Shari’ah standard and guidelines for charity accounts. Finally, the conclusion summarises the article and presents important findings.

The origin and concept of the charity account

The idea of disposing SNC earnings to charity is not new. In 1986, the Islamic Fiqh Academy (IFA) issued a resolution regarding the interest amounts generated from the deposits of the Islamic Development Bank (IsDB) in foreign banks, requiring the IsDB to channel them for general welfare purposes (IsDB and IFA, 2000). This may be deemed the initial step towards formation of the charity account by IFIs as a Shari’ah-compliant resolution.

The notion of charity account is strongly linked with the credit risk encountered by IFIs. Conventional financial institutions resolve such risk by stipulating in the loan agreement that the customer shall be charged an extra amount, defined as: “a penalty charge imposed due to
late payment by the debtor without the financier or the banker needing to show the actual loss suffered” (Zulkipli, 2010, p. 194)—which is the essence of interest. This penalty amount is the absolute right of conventional financial institutions and is treated as income or assets.

Constituents of the charity account

As the Islamic finance industry works on different underlying principles from its conventional counterpart, the above-mentioned practice by conventional financial institutions cannot be adopted by IFIs as one of their credit risk mitigation techniques. Shari’ah considers charging a sum of money in addition to the amount of the debt to be riba (interest), and thus IFIs cannot use such a solution to prevent or mitigate risks arising in cases of late payment by their customers (Hatta and Samah, 2015; Abdullah, 2018). AAOIFI Shari’ah Standard No. 3, Article 2/1/2, states:

It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of a loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt.

The above standard is similarly upheld by the IFA (IsDB and IFA, 2000). As a result, IFIs must apply necessary modifications in their underlying contracts and treatments to address such late payment issues. These amounts gathered from late payment penalties will be combined with other amounts generated from other SNC earnings or sources broadly categorised within the following three categories and will form part of the charity account which is to be treated as per the prescribed Shari’ah rules:

1. **Late payment penalty (LPP) or commitment to donate amount (CDA):** This is a typical clause as can be seen in any Islamic financing contract. LPP is charged to a customer as a result of late payment of its financing facility to the IFI; for example, in an ijarah (lease) agreement in home financing and murabahah (mark-up sale) agreement in personal financing. The purpose of such a clause is to serve as a deterrence mechanism to prevent customers from defaulting on their payment obligations; it is not to be viewed as a retribution mechanism. A standard calculation formula of charging such amount, found in the ijarah agreement of Abu Dhabi Islamic Bank, is:

   \[ LPA = US \times PR \times AP / Y \]

   where LPA = Late payment amount.

   US = Unpaid sum

   PR = Aggregate of the quotation rate and 1 per cent, expressed as a percentage

   AP = Duration of the applicable period, expressed in days

   Y = Number of days in a year in accordance with the day count convention prevailing in the relevant market.

2. **SNC income from SNC investments such as interest payments and voidable transactions subject to purification:** An example of such a case is interest payments received by IFIs due to deposits with conventional financial institutions in some situations. Another instance is elimination of prohibited income due to investing in
shares of corporations whose primary activity is permissible, but they have borrowings based on interest. Such eliminated amount shall be calculated in accordance with the formula, as provided for by AAOIFI Shari‘ah Standard No. 21, Article 3/4/6/4.

\[ EA = \left( \frac{TPI}{NSC} \right) \times NS \]

where EA = Eliminated amount.

TPI = Total prohibited income of the corporation
NSC = Number of shares of the corporation
NS = Number of shares owned by the IFIs

(3) Amounts from dormant accounts and funds belonging to unknown customers:
Dormant accounts comprise another element that should arguably form part of a charity account. In general, dormant accounts exist where no customer-originated account activity has occurred within some defined period. Since the dormant account might end up with unclaimed amounts after setting-off against any outstanding liabilities, the IFI transfers such amounts to the charity account after it tried to contact the customer after a specified period of inactivity but received no response. As shall be discussed below, dormant accounts here refer to investment accounts rather than current accounts.

The above can be seen in the current practices of IFIs where, for example, the address of a murābahah-based investment account holder (IAH) changed or the customer becomes unreachable, which would result in failure to transfer funds and profits. It has been the practice of IFIs to keep such funds in “a suspended account for the specified period before being added to the Charity Account” in accordance with AAOIFI Shari‘ah Standard No. 40, Article 2/2/7. If the IAH eventually reappears, the IFI shall pay the relevant funds to the IAH from this charity account. In addition to the above-mentioned, there are situations in which an IFI is unable to identify the customer to whom the money belongs. This case is different from a dormant account where the customer is known but unreachable. Here, the customer is unknown and no information is available to track the customer. For example, a walk-in customer visits the bank for a certain inquiry and then forgets a sum of money at the IFI’s premises. Also, the IFI might fail to identify the customer in case something goes wrong with the ATM during the depositing process. Although unknown customer cases are unusual, they need to be addressed. Therefore, it has been the practice of some IFIs to direct funds of unknown customers to the charity account.

Determining funds contributing to the charity account
From the operational perspective, the determination of the inflow of funds contributing to the charity account is rather subjective; i.e. whether to use a fixed or variable method of calculation. For instance, amounts generated from dormant accounts and funds belonging to unknown customers will, and should, at all times be on a fixed basis; i.e. representing whatever amounts are identified by the IFI. The full amount gathered shall be transferred automatically to the charity account, and the IFI should not be at liberty to create any formula with regard to such amounts.

In contrast, amounts generated from CDA are subject to a variable method of determination depending on the client type, whether retail or corporate. For instance, some IFIs use a pre-determined formula that will result in deducting certain amount from
CDA. Following this, in some IFIs, the SSB intervenes by setting a maximum threshold of what cost deduction can be applied. For example, the maximum amount that can be deducted on the basis of the IFI recovering its costs and expenses is 49%. The balance, representing at least 51%, shall at all times be allocated to the charity account to maintain the underlying Shari’ah basis for such account establishment in the first place; i.e. for charitable purposes and not to confer benefits to the IFI. Some other SSBs of IFIs take an even stricter approach by requiring the full amount under these categories to be channelled automatically to the charity account without any deduction of costs or expenses. It is noted that such differences of opinion in theory and practice arise due to the lack of standardised practice within the IF industry.

**Defining the charity account**

Unstandardised practice is also reflected in the lack of a common name for the account within the industry. There are three terms generally used in the literature to name the account in which funds are pooled and transferred by the IFI for such charitable contributions. These are: charity funds (Hussain, 2011), charity account (AAOIFI, 2020) and welfare account (IsDB and IFA, 2000; Noor and Haron, 2016). For the purpose of this article, the term charity account is preferred as it is believed that this term reflects the most accurate definition of it. The AAOIFI and IFSB have also opted for the term charity account in their respective published standards.

Hussain (2011) and Mansuri (2019) described the charity account based on sources of income, and they have mentioned only two: CDA and SNC income. They did not address dormant accounts and funds of unknown customers, which this article attempts to include together, and their definitions also do not address how the inflows of funds would be dealt with.

It must be understood that the charity account of an IFI is not concerned with the shareholders’ funds allocated for the purpose of corporate social responsibility activities, which is the prevalent practice of conventional financial institutions. Thus, the perception that charity account is created by the IFI to donate part of its income to charity channels is inaccurate. The figure below demonstrates the funds contributing to the charity accounts (see Figure 1).
IJIF

Sharī‘ah basis for the inflow funds of the charity account under Islamic financial laws
Having explained the origin of charity accounts and its meaning in the context of IFIs, this section investigates its legality under Islamic law. The Sharī‘ah bases for the inflow of funds of the charity account vary depending on the sources of funds contributing to the charity account.

Donation commitment (iltizam bi al-tabarru‘) vis-à-vis undertaking (wa‘d)
The Sharī‘ah basis for CDA charge is the self-imposition clause in the agreement. Accordingly, customers would undertake to penalize themselves by making a certain self-imposed payment for charitable purposes in the event they default in their contractual obligations. Technically, the customer himself willingly undertakes to make such a payment which can be seen as a self-discipline mechanism and in the context of IFIs takes the form of a “donation commitment”.

The Sharī‘ah principles of donation commitment are adopted from the opinion of a minority of classical Sharī‘ah scholars which provides for the permissibility of such an action (Albayan, 2020). Some contemporary Sharī‘ah scholars, on the other hand, propose other alternatives such as imposing a condition in the agreement for balance instalments to become immediately due (IsDB and IFA, 2000) and applying for a judicial demand (Albayan, 2020). It is also worth noting how the charity (tabarru‘) concept, which involves giving something to others without wanting anything in exchange (Bashier, 1993), has been adopted as a means of punishment and credit risk mitigation. Further, the principle of commitment to pay donations falls under the category of donations in which a certain level of uncertainty is tolerated (IFSB and ISRA, 2020).

This principle of donation commitment given by the customer to the IFI is also widely established in the form of an “undertaking” (wa‘d) given by the customer in the event that they breach their own agreed obligations. Therefore, AAOIFI Sharī‘ah Standard No. 8, Article 5/6, has permitted the debtor in a murābahah contract to undertake to donate a certain amount for charitable causes in the case of procrastination of payment. Hence, the CDA amount is based on the donation commitment, which is different in form and substance from the conventional finance LPP that is treated as another source of income for the institutions.

Purification (tathīr, tanqiyyah, tajnīb)
The Sharī‘ah basis for purifying SNC income such as interest payments and voidable transactions is based on the practice of purification (tathīr, tanqiyyah or tajnīb). An IFI may be involved in international business that inevitably exposes itself to contractual agreements that contain elements of interest and impermissible income. An example illustrating purification of SNC income would occur if an IFI invests in the shares of corporations whose primary activity is permissible, but they have deposits and borrowings based on interest, which is permissible with certain conditions according to AAOIFI Sharī‘ah Standard No. 21, Article 3/4/3. Article 3/4/6/1 of the same Sharī‘ah Standard provides that an IFI is obliged to eliminate the prohibited income at the end of the financial period. AAOIFI adds that it is the responsibility of the IFI in this case to dispose of such prohibited income for charitable purposes. Some Sharī‘ah scholars argue that it is permissible to retain the impermissible income on the basis of necessity and the difficulty of avoiding such earnings in inevitable situations (Sahih al-Bukhari, Vol. 3, Book 34, ḥadīth no. 275). An example of such situations is adhesion contracts in which the contract has uniform details and only the offering party has the rights to dictate the terms, as explained in AAOIFI Sharī‘ah Standard No. 38, Article 8/3.

Another instance occurs in court judgements. Courts in various jurisdictions vary in their handling of disputed Islamic financial transactions, and most judges are unfamiliar with the
concepts that govern them (Foster, 2006; Hasan and Asutay, 2011). Given the underdeveloped laws and legislations of the industry in most jurisdictions, there is a high tendency that courts will interpret Islamic financial transactions as commercial loans due to the similar economic behaviour. This inevitably entails provisions for interest payment in court judgements.

As for SNC earnings from voidable transactions, any violation of the Shari'ah requirements for the contract elements would lead to an SNC earning (Bakar and Ali, 2008; Nawawi, 2009) and not only prohibited activities. It is mandatory that income which is later discovered to be Shari'ah impermissible be donated to charity on the basis of “purification of mistakes” (Rider, 2011).

Amounts from dormant accounts and funds belonging to unknown customers (luqatāh)
The rule of luqatāh in Islamic law shall be applied to funds belonging to unknown customers that are found by the IFI. Luqatāh literally means picking up something from the ground, intentionally or unintentionally (Ibn Fāris, 2019, Vol. 5, p. 262). Technically, it refers to “property lost by its owner that someone else picks up as a trust” (Ministry of Awqaf and Islamic Affairs, 1983, Vol. 35, p. 295). The IFI must make every effort to search for the owner of such found items for at least one year (Muslim, n.d., hadith no. 1722). Only if it failed to find the owner, after exhausting all efforts, would the finder be entitled to benefit from such funds. If an IFI fails to find the owner within the stipulated period, as acknowledged by the SSB, some IFIs may decide to keep the amount while others transfer it to the charity account. These differences of opinion reflect the absence of a collective Shari'ah standard pertaining to charity accounts which, if it existed, would have clearly defined the composition of such accounts and whether or not the charity account would include funds belonging to unknown customers.

Included in the same category is the inter-related issue of dormant accounts. The only difference is that the account holder in this case is known; however, all communication attempts to connect with them failed after a certain prescribed period of time. Accordingly, the question that arises is what should be done with such funds after the prescribed timeframe. It has been argued by some SSBs that such funds be transferred to the charity account, by analogy with the Shari'ah principles that govern luqatāh. Despite knowing the identity of the account holder, the inability to contact him requires a decision. Naturally, using it for charitable purposes would be the best solution; hence, funds related to dormant accounts would form part of the charity account.

Another important point that affects the determination is the different underlying Shari'ah contract of such dormant accounts; for example, whether they are a current account or investment account. It would be difficult to establish that dormant money in a current account has to be transferred to charity accounts since such current accounts are typically based on the Shari'ah contract of qard (benevolent loan). Accordingly, as the borrower, the bank reserves the right to utilise the funds as it wishes provided that it returns the funds to the lender upon demand as per AAOIFI Shari'ah Standard No. 40, Article 2/2/1. Based on this, there is no Shari'ah requirement to direct dormant money to the charity account. As for an investment account, AAOIFI Shari'ah Standard No. 40, Article 2/2/7, requires such funds to be firstly held within a suspense account for a prescribed period. Only after no claims have been made during that period the funds could be transferred to the charity account. An investment account is typically based on the Shari'ah contract of mudarabah, wakalah or murābahah. Therefore, the dormant money in an investment account should be channelled to the charity account since it is technically owned by the customer. It also can be argued that dormant money in an investment account can be used and benefited by the IFI on the condition that the principal amount plus profit (if any) shall be made available to the customer in case such an account is claimed later. This is because IFIs maintain investment accounts
based on trust. Here, one finds the difference between this scenario and the scenario in which the original owner comes back after the completion of the search period in the case of *luqatat*.

There is little contention about the Shari’ah legitimacy of channelling dormant accounts and funds belonging to unknown customers to the charity account. There is, however, ongoing debate about the Shari’ah legitimacy of the doctrine of donation commitment. The researcher holds that there should be no hesitation about considering the principle of donation commitment in the absence of any viable alternatives to deal with the credit risk faced by the IFI. Moreover, there is no harm to base Islamic financial transactions on weak (minority) opinions, particularly when a situation of necessity exists and adoption of such opinion ensures the financial stability of IFIs. Further, it has been argued that not charging anything for the failure of customers to pay on time would amount to moral hazard. Therefore, the Shari’ah legitimacy on donation commitment in the context of IFIs should be analysed not only from the perspective of Islamic law of contract but also from the wider perspective of Shari’ah objectives (Abdullah, 2018).

**Regulatory issues pertaining to charity accounts and proposed solutions**

Having set out the Shari’ah bases for inflow funds contributing to charity accounts of IFIs, this section shall broaden the discussion by looking at the applicable regulatory perspective on these accounts.

The existence of a charity account would necessitate specific guidelines and treatments by respective regulatory authorities regarding the management of the account by the IFI. Existing regulations, laws and guidelines; for example, on accounting treatment, should pay attention to the operational aspects of such accounts. There should also be disclosure requirements pertaining to these accounts to ensure transparency regarding Shari’ah compliance by the IFI. Unfortunately, there is yet to be an international regulatory framework for charity accounts. This section will propose the key regulatory aspects required with emphasis on preserving the Shari’ah-compliant nature of the charity account. The regulatory framework of a country should clarify the type of funds forming constituents of a charity account. In this context, IFSB (2005) stated that some jurisdictions disallow any contractual impositions of CDA except in cases of deliberate procrastination and that the IFI is prohibited from utilising such funds for its own benefit and, accordingly, must channel them to charity.

Regulatory authorities should not underestimate the relevance of regulating charity accounts. CDA have been identified by IFSB (2005) as one of the remedial actions in the case of financial distress of a counterparty. Therefore, the regulatory authority should facilitate a mechanism that deals with late payments and default in a Shari’ah-compliant manner. The practices related to charity accounts differ from one jurisdiction to another depending on the presence of a relevant regulation and the view adopted by the SSB in case such regulations are absent. One can find below charity account practices in three jurisdictions, notably Malaysia, the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA).

**Malaysia**

Bank Negara Malaysia (BNM) was arguably the first regulator in the world to issue a specific regulation on donation commitment amounts. BNM issued “Guidelines on Late Payment Charges for Islamic Banking Institutions” in 2012. The guidelines are quite lengthy, detailed and comprehensive. Late payment charges are divided into two elements: compensation (*ta’wid*) and penalty (*gharamah*). The following principles are laid down:

1. IFIs may impose a combined late payment charge up to a prescribed limit.
(2) IFIs shall be compensated up to the actual loss.

(3) The penalty shall be channelled to charitable organisations approved by the Shari’ah board.

(4) IFIs shall ensure that governance is in place to ensure the implementation of the guidelines, including Board of Directors’ undertaking, Shari’ah board undertaking and information system capability.

(5) IFIs shall recognise compensation as “non-profit income” and penalty as “other liabilities”.

**United Arab Emirates**

The Central Bank of the UAE (CBUAE) issued a regulation in 2020 governing deduction of costs from donation commitment amounts (Alyoum, 2020). It includes, among others, the following requirements:

(1) Such amounts shall not be collected unless the customer is requested to pay the due debt and the customer is notified that failure would result in debiting the account.

(2) Payment of such amounts has to be reflected in the contract.

(3) Such amounts are not part of the IFI’s profits and shall be directed to charity purposes under the supervision of Shari’ah boards.

(4) Such amounts shall be imposed only in case the customer is procrastinating and not due to insolvency.

(5) IFIs shall not deduct any direct costs unless this is reflected in a clause within the contract that is separate from the clause related to donation commitment amounts.

(6) The deduction process shall be done under direct supervision of the SSB.

Although the application of AAOIFI standards has become compulsory on IFIs regulated by the CBUAE, the regulator has provided room and flexibility for them to deduct actual costs. It is to be noted that AAOIFI asks for the entire donation commitment amounts to be channeled to charitable purposes as per AAOIFI Shari’ah Standard No. 8, Article 6/5.

**Kingdom of Saudi Arabia**

The Saudi Arabian Monetary Agency has not issued a specific regulation concerning charity accounts or donation commitment amounts. It is left to individual SSBs to decide on the matter. Based on information gathered in an interview conducted on 10 October 2021 with the Internal Shari’ah Control Department of Emirates NBD–KSA, current practices relating to charity accounts can be divided into four groups:

(1) IFIs that do not impose any donation commitment amounts at all.

(2) IFIs that impose donation commitment amounts and direct the entire amounts to charitable purposes.

(3) IFIs that impose donation commitment amounts and deduct “actual costs” before disposing of such amounts to charitable purposes.

(4) IFIs that impose donation commitment amounts and deduct “expected costs” before disposing of such amounts to charitable purposes.
Disclosure requirements in financial statements are also another important aspect of charity accounts. For example, if an IFI opts to differentiate between compensation and fines, the compensation amount received shall be recognised as non-profit income in the income statement. As for fines, they have to be recognised as other liabilities. Accordingly, IFIs shall disclose the utilisation of donation commitment amounts as fines for charitable purposes in the accounting notes (BNM, 2010). The above-mentioned accounting rules on fines shall also be applicable to other charity account inflow types, namely SNC earnings and dormant accounts and funds belonging to unknown customers.

An added aspect is related to the treatment of the charity account in case an IFI becomes insolvent (Hussain, 2011). There is a concern whether the legal framework in a given jurisdiction clarifies that the charity account is not part of the bankruptcy estate and therefore does not belong to the insolvent IFI. It is only managed, controlled and disposed of by the IFI after obtaining approval from the SSB of the concerned institution. Therefore, there should be legal provisions under financial laws or bankruptcy laws that provide for the legal status of the charity account in line with Islamic financial laws in case an IFI becomes insolvent. Perhaps a rather more important issue in regard to the disclosure requirements is the various inflow funds that add to the size of the charity account. Accordingly, the following points should be considered from a regulatory point of view:

**Disclosure requirements**

1. Each IFI shall be required to disclose the actual proportion of inflow funds forming the components of the charity account total amount. This information should be clarified in the form of numbers and percentages that show, for example, the ratio of donation commitment amount compared to other inflow sources. Further, the issue of whether the IFI shall disclose the amount of SNC earnings and/or their nature requires further regulatory attention (Rosman et al., 2017). This will ensure proper management of the charity account, including for distribution purposes.

2. Each IFI should disclose to the regulatory authorities the list of beneficiaries or the way the charity account is being spent. IFSB (2007) considers that social and charitable contributions disclosures are among the general governance disclosures that should be made by IFIs. Since customers also contribute to the charity account in the form of donation commitment amounts, they should be assured that such money is directed properly for legitimate charitable purposes and neither for dubious activities nor indirectly for the IFI’s own benefit.

3. Disclosures should include all relevant aspects related to the charity account. IFSB (2017) in the context of *ṣukūk*, stated the following: ‘Disclosure should state whether or not there are arrangements made in the *ṣukūk* contracts for *ta’āwidh* or other compensation payments to be made on overdue amounts under the *ṣukūk*, and if so under what circumstances such a payment is imposed, on which party it is imposed, and the rate and manner of payment and how it will be utilised (to the extent mentioned in the *ṣukūk* documentation)” (p. 13). For instance, the customer should be informed about whether the IFI combines the elements of compensation and fine on the donation amount in their respective calculation formula. Accordingly, IFSB (2009) emphasised the need to make any penalty imposed on customers perfectly clear by: “being spelled out in the contract and brought to the customer’s attention prior to signature of the contract” (p. 12).

**Other requirements**

4. There should also be specific regulatory treatment for dormant investment accounts. For example, money transferred to the charity account and already distributed to
charity should be refunded to the customer upon their request, regardless of the timeframe. The customer may be compensated by the IFI from the future inflow of charity account funds of that IFI as a mechanism to address this potential issue. In this regard, CBUAE has made it mandatory on all banks to enable segregation of dormant funds in order to allow customers or their legal heirs to receive the balance amount from the dormant account, including any profits attached to it, at any given time; i.e. without any defined time period. In the event that it exceeds five years, such amount should be transferred to the dormant account held by the Central Bank, but the right of the customer to reclaim the amount still subsists and will still be the liability of the same bank. This is to safeguard customers’ interest while affording enhanced protection.

(5) Another issue relates to the Shari'ah governance framework whether at the regulatory or institutional level whereby the requirement of referring to the SSB prior to any charity account distribution should be stated. In this regard, IFSB (2009) emphasised that the duties of the SSB shall cover, amongst others, the monitoring of SNC income disposal and charitable activities. Therefore, there should exist a requirement under the Shari'ah governance framework that the SSB of the IFI shall disclose in its annual Shari'ah report its observation of the management and the distribution process of the charity account.

(6) Conflict of interest is another delicate issue that needs to be discussed with regard to the management of the charity account. Mansuri (2019) argued that there is a conflict of interest in the context of charity accounts that requires regulatory attention and there has been strong rejection by some IFIs for assigning the responsibility of managing charity accounts to someone else such as the SSB or regulator. To illustrate, concerns arise where an IFI may use the charity account for its own benefit as those managing it are employed by the IFI and thus may delay distribution on grounds of business growth. Building on this issue, it is subject to debate whether the IFI should be allowed to continue managing the charity account, or has the time come to consider the creation of an independent entity or account at the national level to manage charity account funds in a more prudent and effective manner? An example is by letting a more specialist organisation to manage the charity account, such as a waqf foundation which has more experience in managing social contribution funds and, most importantly, which acts as an independent organisation.

(7) Adequate attention to the tax treatment of charity accounts is also a point for consideration. Regulators need to provide guidance on the tax treatment of such accounts. Since the charity account is not part of an IFI’s assets, the IFI ideally should not be charged tax on such an account. Currently, IFIs direct the donation commitment amount to the charity account after deducting taxes and other expenses. Charging tax in this situation would add costs to IFIs. However, regulators have recently become aware of the practice of IFIs in the way which they may potentially benefit from the donation commitment amount before being directed to the charity account, e.g. by the deduction of costs and expenses. In this regard, it is uncertain whether regulators may turn to charge tax on the charity account on a total account amount basis or to a specific component of it; i.e. specific to the donation amount component only. Accordingly, there should be clear guidance by regulators concerning this tax treatment issue.

(8) Finally, doubts may arise due to the potential unnecessary delays in the charity account distribution process (Mansuri, 2019). It is essential for regulators to fix a
defined period for charity account funds to be distributed. The longer the timeframe, the greater the possibility that the IFI will benefit from such funds, especially during times of financial distress. Therefore, setting a clearly defined timeframe would be beneficial to all stakeholders.

**Proposed Shari’ah standard and guidelines for charity accounts**

Some IFIs’ policies on charity accounts, in particular the donation commitment, pose concerns from an Islamic financial law standpoint. For example, some Islamic banks are allowed by their SSBs to deduct expenses as long as they are below 50% of the total donation commitment collected. If the IFI is not able to accurately ascertain the actual costs or expenses involved, it can apply an automatic formula by deducting the maximum which is below 50% of the donation commitment against these costs. This view is based on the permission to deduct “expected” expenses rather than “actual” expenses. This forms a great shift from the original rule as discussed in the earlier sections whereby charging a donation commitment is allowed on the basis that the entire amount be directed to the charity account and eventually fully used for charitable purposes. This also raises Shari’ah questions regarding the permissibility of such deduction concept; i.e. the definition of “actual cost” and its substance.

This section will propose, among others, the relevant Shari’ah standard and guidelines for charity account management and Shari’ah practice as this remains the gap to date.

**Scope of the standard**

This standard shall cover the rules and management process of a charity account owned by an IFI, which is an account established for the purpose of accumulating funds that the IFI cannot as income. As a general rule, such funds in the charity account shall be utilised for charitable channels only, however, subject to the relevant rules and standards as applicable herein.

**Applicable Shari’ah standard on charity account**

1. **Determination of CDA:** If an IFI wishes to impose a CDA on the customer, it must clearly state this in the contract from which the debt arose as a certain defined formula. A sample of the formula is as follows:

   - The donation commitment represents a fixed amount for each due unpaid installment; or
   - The donation commitment is equal to a certain percentage (for example 3 per cent) of the outstanding amount for each day of delay beyond the due date for the payment.

   Either of the above options is permissible provided that the formula is clearly defined and fixed at the contract execution stage by the parties and provided the IFI will not economically benefit from the donated amount.

2. **The practice of deducting the CDA:** The entire amount generated from donation commitments should be entirely transferred to the charity account as per the position held by AAOIFI (2020) and IFSB (2005, 2009). However, in the event that the SSB of the IFI permits, deduction of actual costs from donation commitments is allowed with the following conditions:

   - It is not allowed for the IFI to benefit either directly or indirectly from the CDA;
- CDA is to be separated into two categories: compensation and fine. The compensation component can be treated as income of the IFI in order to compensate itself for the actual costs suffered by the IFI. Such income can be used by the IFI at its free will and disposal. However, the fine component, which is intended as a deterrent penalty, shall be directed entirely to the charity account;

- Alternatively, the IFI may combine the compensation and the fine in the donation commitment but with clear treatment for calculation of actual cost. The latter amount can be deducted for recovery purposes only, while the balance will go to the charity account (Noor and Haron, 2016).

(3) **Use of interest and impermissible earnings by the IFI**: An IFI might receive interest and other SNC earnings in its business activities; however, the total amount generated from these sources must be directed to the charity account for charitable distribution. The amount shall not be subject to any possible deduction as opposed to sources from donation commitment and dormant accounts. The IFI is not allowed to utilise the funds for its own benefit whether directly or indirectly. Any exception must require the SSB's approval in line with the AAOIFI Shari'ah Standard No. 6, which requires that the management of the funds be under the guidance and supervision of the bank’s SSB.

(4) **Determination of cost**: Recovering the actual cost from a defaulting customer is acceptable provided that the institution’s SSB allows it to be compensated for the costs suffered in cases of default or late payment. The practice of determining any actual costs shall be as follows (Noor and Haron, 2016):

- Charging compensation according to a certain fixed rate determined by the IFI as approved by the SSB or the regulator.

- Charging compensation equivalent to the actual costs (as per AAOIFI standard) borne by the IFI such as phone calls, IT system, man-hours costs and taxes. Third party provider costs incurred such as from a debt collection agency shall be accepted only with the approval of the SSB. These shall be direct costs which do not bring any additional benefit that can be categorised as **riba**.

- Charging compensation from indirect costs such as “salaries of the employees, the rentals of space, assets and means of transport as well as other management and general expenses of the institution” are not allowed as per AAOIFI Shari'ah Standard No. 19, Article 9/2.

- Charging compensation based on opportunity loss, which means future profit and benefit arising from receiving debt on time, is not allowed as it involves the concept of time value of money.

- Charging compensation based on cost of funds, which means cost of capital or what is equivalent to interbank borrowing rate, is not allowed since cost of fund in itself is not allowed to be imposed in Islamic law (Al Dawudi, 2017).

(5) **Definition of charitable channels**: A clear definition and description of a charitable channel must be made by the IFI as approved by the management and the SSB. This should be in line with the AAOIFI Shari'ah Standard No. 6, Article 10/2. Charitable channels should be distinguished from the eight zakat channels that are specifically identified in the Qur’an.
(6) **Conditions for spending from the charity account on charitable channels:** IFIs must use the funds available in the charity account for charitable channels. To ensure that the charity account is channelled to charitable channels in a Sharī‘ah-compliant manner, the SSB must consider certain conditions for any approval pertaining to distribution of charity account funds, which are as follows:

- There is no advertisement which benefits the IFI in terms of its publicity and business reputation, whether directly or indirectly (Mansuri, 2019).
- In case there is a regulatory requirement to announce the IFI’s name, it must be clearly disclosed that the money used for such channels is from the charity account.
- The money shall be directed to certified governmental-related institutions that have been screened and pre-approved by the IFI management and SSB. This is important to avoid channelling charity account funds to suspicious financial activities.

(7) **Receiving consideration for supplying impermissible assets or services:** If an IFI receives any consideration for supplying Sharī‘ah-impermissible assets or services, it must transfer them to the charity account. For example, this is necessary in a conversion exercise from a conventional financial institution to an IFI. An IFI should not reject receiving such consideration, and the customer should continue paying out such consideration as per AAOIFI Sharī‘ah Standard No. 6, Article 8/1/4, which states: “Otherwise, such a customer would end up being entitled to two counter-values of the same transaction: the good or service supplied and the price payable for it”.

(8) **Acquiring income from impermissible assets:** An IFI that is entitled by contract to income from an impermissible asset shall continue collecting such income but shall direct it to the charity account (AAOIFI, 2020). However, the IFI may, at the specific approval of its SSB, retain such income following AAOIFI Sharī‘ah Standard No. 6, which allows for the retention of impermissible earnings; i.e. it is not to be paid out to the charity account, on the condition that: “complete disposal promptly will lead to the collapse of the bank or bankruptcy” (AAOIFI, 2020). This is justified based on the doctrine of public interest in Islamic financial law.

(9) **Funds failed to be transferred to IAHs due to address change:** In the event a customer cannot be traced, the IFI shall take the following actions:

- Keep the funds in a suspended account for a specified period pursuant to the Sharī‘ah principles of *luqatah*;
- Direct the funds to the charity account once the specified period as determined by the SSB is over and the address continues to be unknown;
- Pay out the funds from the charity account whenever the IAH returns and reclaims the amount;
- Add a clause to the conditions of an account opening “indicating that the holders of the accounts agree to donate for charitable purposes (donation commitment) any amounts which could not be transferred to them within a specific period as determined by the SSB due to change of address” (AAOIFI, 2020).
10) **Deduction of certificate holders’ funds and profits in takāful:** If there is an accumulated balance in the takāful account and reserve account in cases of liquidation, it is not permitted for the takāful company to use the accumulated balance for its own benefit. This is because the certificate holders make the takāful contributions to the takāful company based on the principle of donation commitment; therefore, the takāful contributions made do not belong to the takāful company. As such, any accumulated balance shall be directed to the charity account in cases of liquidation (AAOIFI, 2020). Alternatively, the takāful company may distribute the proceeds amongst certificate holders.

11) **Waiving of CDA:** A donor (defaulting customer) is not allowed to reclaim what he has given as a donation as such donation contract involves transfer of ownership. The IFI is also not allowed to waive such CDA once the customer fails to make the due payments unless it is stated in the contract that such CDA is due upon the IFI request and notification.

12) **Incapable debtor or negligent defaulter:** It is permissible for an IFI to receive a donation commitment regardless of the financial position of the customer, whether he is genuinely incapable (Abdullah, 2018) or he is a negligent defaulter. This is owing to the self-imposition nature of the doctrine of donation commitment where the customer has committed to donate in the event of late payment (AAOIFI Shari‘ah Standard No. 3, Article 2/6). IFI is strongly encouraged not to make the CDA clause effective unless the customer is solvent. The contract may state that the customer is considered a procrastinator unless the customer proves otherwise.

13) **Investing the charity funds:** The IFI shall immediately, or as soon as possible, dispose of all the charity account funds to charitable channels, regardless of their sources since impermissible income does not constitute the IFI’s own income. However, the IFI may invest such funds provided that it is not prohibited by the local regulatory laws and regulations (BNM, 2012), and with the condition that the whole invested principal amount plus any future profits generated shall collectively be transferred back to the charity account for charitable purposes. The IFI shall not be allowed to benefit from any of the profit generated from this investment activity, and the SSB’s approval is required for such activity. This Shari‘ah rule is clear in case of amounts received based on donation commitment and purification. However, the question arises in case of untraceable money that is analogous to luqatah as to whether the IFI can invest it and whether the return of such investment can belong to the IFI. As per the luqatah rules, it is understood that the IFI is allowed to invest luqatah after the completion of the search period (during which the collector has to look for the original owner of the luqatah) (Ministry of Awqaf and Islamic Affairs, 1983). However, investing the luqatah during the search period is not allowed since the IFI shall maintain such amount collected on a trust basis. If despite this rule, the IFI does invest the amount during the search period, the amount plus the profit shall be returned whenever the original owner asks for it. This is followed by another valid question as to whether the IFI can return only the principal amount since this might look fair and just to the IFI. According to the majority view, luqatah is allowed to be considered part of the IFI assets after the completion of the search period, and it is described as ownership with account (Ministry of Awqaf and Islamic Affairs, 1983). This means that if the original owner came back at any time later, the ownership of the collector would come to an end. One can establish that the IFI is allowed to enjoy the return over the investment period since the right of the original owner is
associated with the *lugāṭah* amount. This is also, from a Shari’ah perspective, supported by the fact that the collector is required to maintain the *lugāṭah* on a trust basis as long as the search period is still ongoing.

The above-mentioned proposed Shari’ah standard includes the key parameters for the management of the charity account by the IFI supported by the relevant Shari’ah basis for each. The development of such clear standard and guidance will enable IFIs to have better clarity on the various issues surrounding charity accounts and to avoid potential misuse or controversies associated with the charity account. The adoption of the above standard would also create a standardised and harmonised practice amongst IFIs worldwide and eventually facilitate a robust framework based on international Shari’ah best market practices.

**Conclusion**

This article provided important insights about charity accounts of IFIs. The charity account is fundamentally founded to tackle the issue of inflow funds that are not allowed to be used by the IFI for its own benefit. Recently, the practice of the charity account has been subject to appraisals and criticisms. It would be no exaggeration to say that the charity account is in fact a creative Shari’ah-compliant solution by IFIs to address the issue of SNC funds, a feature that distinguishes it from the conventional finance industry, which does have to deal with such a situation. However, the Islamic finance industry lacks a clear and defined Shari’ah standard dealing with matters pertaining to charity accounts, either from international Shari’ah standard-setting bodies or national regulators. In order to protect the integrity of the charity account and uphold its underlying Shari’ah objectives, the charity account must be managed according to strict rules and governance requirements.

In summary, this article has laid down the following suggestions supported with relevant arguments:

1. To protect the charity account from being mismanaged or misappropriated, regulators and the management of the IFI must put in place effective measures—such as seeking approval from concerned authorities before disbursing charity account funds, and establishing a solid control, audit and reporting system under a robust regulatory and Shari’ah governance framework.

2. There should be a proper management process in relation to the distribution of charity account funds to enable full accountability and transparency. The establishment of a separate entity or fund by the government or regulatory bodies in the respective jurisdiction is a solution that may ensure proper management and strategic distribution of funds to benefit the whole society.

3. To address the specifications of the charity account, regulatory authorities need to introduce specific laws and regulations.

4. International standard-setting bodies of the Islamic finance industry urgently need to issue a global standard and guiding principles that focus on prudential aspects of the charity account of IFIs. Needless to say, they have to provide particular attention to relevant Shari’ah issues surrounding charity accounts, as have been highlighted in this article.

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