An Introduction to Islamic Shari'ah

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Meaning of *Shari'ah*

Shari'ah is the body of Laws which *Allah* prescribed for His servants through Prophet *Muhammad* (PBUH). *Figh* is the knowledge of the rules of *Shari'ah*. A "*Fagih*" is the one who is knowledgeable to these rules and their relevance to changing circumstances.

Shari'ah is a much wider concept than the term "Law" in English or "Droit" in French. This is because Shari'ah is actually the worlderly side of the religion Islam.

Rules of *Shari'ah* relate to beliefs and to acts.

A Muslim is required to obey and adhere to the rules of *Shari'ah*, as part of the faith.

This body of laws contain rules about actions (conduct and behavior) of the believers. These rules are in the form of:

1- obligation
2- recommendation
3- prohibition
4- disapproval
5- permission.

Rules of *Shari'ah* and Rules of Law.

Positive law is a body of rules and precedents which lay to the people a specific conduct, and prescribes punishment to those who violate, awarded by the authorities responsible for the protection of law.

Rules of *Shari'ah* differ significantly from rules of law:

a) The source of the rules of *Shari'ah* is divine. It is the judgment of *Allah* conveyed by the Messenger (PBUH)) and expounded by the great learned jurists who derived (and do derive) from the texts of *Shari'ah* and its sources. These sources are the *Kuran*, *Sunnah*, Consensus and Analogy.

Rules of *Shari'ah* are settled, can't be changed. Their application to contemporary incidents and events may change. The *Fatwa* (legal opinion) may change and vary from time to time and from place to place and from jurist to jurist, yet *Shari'ah* remains the same. Human effort doesn't create new law but only reveal from the texts and sources the rules of *Shari'ah*.

b) The subject matter of the rules of *Shari'ah* is not confined to rules regulating the relations between human beings such as sale and partnership, but also includes acts and deeds required from the believers as symbols of devotion and submission to *ALLAH* such as prayer and fasting. These two branches of *Shari'ah* are not necessary separate.

Man made law doesn't concern itself with the relationship between people and their lord.

c) Punishment for disobeying the rules of *Shari'ah* will be inflicted in times only in the hereafter, in others in both now and the hereafter.

Punishments for violating man made laws are in this world only. Obedience to *Shari'ah* is a devotion to *ALLAH*, a firm belief in the just rules of *Shari'ah* and a hope for great rewards in the hereafter.

Divisions of *Shari'ah*

The rules of *Shari'ah* are divided into two major divisions, religious observance and transactions.

The division of transaction bears great similarity to positive law. These rules of transaction fall into three types: regulating relations between individuals, rules relating to relations between individuals and governors and rules relating to relationship between Muslim society and other states and communities.

It is clear that these divisions resemble those of positive law. The first, is similar to private law which includes civil, commercial, family and private international law. Except that *Shari'ah* doesn't make special laws for merchants (commercial law). The second have the same subject matter of constitutional law.

Major Schools

There are five major schools of *Figh* (jurisprudence), which constitute two "sect-like" (not sect) divisions of *Islam*: *Sunni* and *Shia*. The Sunni branch of *Islam* consists of four major schools, *Hanafi*, *Maliki*, *Shafie* and *Hanbali*. The *Shia* branch consists of one major school (the *lthna-ashariah*) and several other smaller ones. These divisions have their roots in history and methodology.

Sunni-Shia

The origins of the division between *Shia* and *Sunni* go back to the early part of the 7th century.

The *Sunni* maintain that the first four Caliphs, which are called the rightly guided (*Abybaker*, *Omer*, *Othman* and *Ali*) are the rightful successors of the Prophet (PBUH) as they were chosen by the leaders of community then.

Shia believe that only *Ali* (who is the cousin and son in law of the Prophet) is the legitimate heir (*Ali* himself was agreeable to the governance of the three), and his siblings. (The *Sunnis* have more egalitarian methodology for selecting the leaders). In methodology, the *Shia* only recognize narrations by the blood relation of the Prophet as a source of *Shari'ah*.

The four major *Sunni* schools:

It is the firm belief of the *Sunni Muslims* that all four schools are correct and the difference between them is methodological. Yet, the basic approach of these schools can be identified to have two main patterns vis sources of law those who are more inclined toward the "*Hadith*" (traditions of the Prophet (*PBHU*)), and those who have a more "rationalist" inclinations.

The four schools formed in less than two centuries. *Abu Hanifa* died in 767, *Ahmed bin Hanbal* died in 855.

Primary sources of Islamic Shari'ah

The primary sources of Shari'ah are:

1) The Kuran

The Kuran is Allah word revealed to Prophet Mohammad (PBHU). It has been recorded and transmitted through the centuries word by word and letter by letter. Believing in every word in Kuran is a basic requirement for being a believer in Islam. Reciting is itself a prayer. The Kuran is in Arabic, but it is beyond any Arab to do like it. Kuran is the primary source from which rules are deducted directly or by inference. Other sources are subordinate. This as well as the supremacy of the Kuran are laid down in the Kuran. While the words and letters of the Kuran is certain and definitive, the meaning of these words is sometimes definite and sometimes presumptive. When the meaning is definitive, there is no room for Ijtihad. When the words signify several meaning, then other sources may reveal the correct ones.

2) The Sunnah

Sunnah means the words, deeds and tacit concurrence to the words and deeds of others of the Prophet (PBHU). The Sunnah is transmitted through narration. The authority of each narration is the subject matter of the science of Hadith. Hence, Sunnah varies in respect of its establishment and transmission, and have authority. The Sunnah is the second source of Shari'ah. It is the expounder of the Kuran, where specific meaning are given to general statements of the Kuran. Not only this, but Sunnah lays down rules for matters not attended to in the Kuran, or extension of rules laid down in the Kuran.

3) Ijma

Ijma in Arabic is consensus. Ijma refers to the unanimous convergence of the views of reputable jurists at one time on certain issue. Ijma takes place when there is no specific authority on a given point from the first two sources. Clearly Ijma doesn’t mean the consensus of all and every scholar at the time, but only the major ones.

Secondary Sources

a) Al-Qiyas, or analogy.

This is where a rule is applied to a particular situation because of its analogy to one with a preset rule from Kuran and Sunnah. The analogy is based on what is called “illah”, i.e. the logic or the effective case of the rule. This effective case of the rule. This effective cause is sometimes mentioned explicitly in the first two primary sources, or arrived to at by consensus of jurists.

ISLAMIC EQUITY FUNDS

What is an Islamic Equity Fund?

An Islamic equity fund is a portfolio of shares of companies, selected on the basis of certain Islamic principles, and managed with a consideration of pre-set Shari'ah parameters. An Islamic equity fund is basically “ethical investing”.

Ethical Investing is not new. It goes back to the 1920’s. They became popular, however, in the 1970’s and thereafter.

Islamic Equity Funds are, therefore, part of a larger group of ethical investment programs. They address the needs of a class of investors, who are concerned about public issues, social justice or certain individual preferences. However, the main concern of Islamic “ethical” investor is the sources of his income. He is obliged religiously to make sure his earnings always come from “clean” sources. Therefore, there is no share holder’s activism in Islamic equity funds. Islamic investors don’t attempt to make a statement Vs corporate management, and feel no duty to influence corporate action.

THE RELIGIOUS FOUNDATION OF THE ISLAMIC EQUITY FUND DESIGN:

Like any legal system, Shari’ah is a set of do’s & don’ts. The difference, however, is that Shari’ah is not just worldly, but a part of a system of beliefs that relates life to the hereafter. Therefore, a believer is supposed to internalize in his method of judgment and “cost-benefit” analysis this aspect of heaven & hell. This means that, through Shari’ah, the now and the hereafter are united into one spectrum. Because of this, believers are keen to make sure that their investment decisions are in tune with religious requirements by abiding by Shari’ah rules. As a result Shari’ah approval of structure & operation is the most important element of the working of equity funds.

SHARI’AH ASPECTS OF ISLAMIC EQUITY FUNDS:

Investment funds are created when investors pool their money for a shared investment goal. Collective power affords an opportunity to participate in a well-diversified, professionally managed investment portfolio. To be acceptable from Shari'ah point of view, it is essential to examine certain aspects of investment funds. In particular we will evaluate the contractual relationships between the parties involved in the working of a fund, choice of portfolio holdings as well as some operational elements of such funds.

A. <u>Contractual Relationships:</u>

Shari'ah is the Islamic Law. Contractual relationships in any transaction are the most relevant aspects to Shari'ah scrutiny.

The most visible is the relationship between investors and the manager of the fund. Fund management may be based on *Mudarabah*, where the manager, either individual or institution, the *Mudarib* (agent) and the investors are rub-ul-mal (providers of funds). In such a case, manager will only share in the profits generated. Sharing of profit must be in accordance with the ratio spelled-out in the prospectus which constitutes, from Shari'ah point of view, a contractual relationship. His income will be based on the difference between the initial NAV and the NAV at the pricing date which represent profit in such arrangement. Pricing date represents the accounting liquidation of the Mudarabah.

Many managers would not like their compensation to be tied to profit, but rather prefer to get a fixed remuneration. In such case, the relationship can be based on the Ijara (hire) contract. The manager in this case is hired by the fund which inturn represents the collective will of the Investors. The manager is, then entitled to an income linked to his managerial effort. Most investment funds management is based on such arrangement. In this case, the manager charges a percentage of the NAV at the pricing date. Ijara is a permissible contract. However, compensation in the Ijara contract, like any exchange contract in *Shari'ah,* must be known at the beginning of the period (time of contracting) not the end (time of liquidation). Otherwise *gharar* will be present which may void the contract. Such compensation will not be known exactly at the time of contracting (since it is based on end-of-the-term NAV), but only known in approximate amount, which reduces such *gharar,* though by no means eliminate it. Although the writer is of the view that such Ijara is permissible, there are some contemporary scholars who think otherwise. Making compensation for the next period depend on last period's NAV is a straight forward solution. In a lot of cases many institutions participate in the "management" of the fund. Some of them may handle the marketing leg of the operations and one takes care of the custodianship and actual execution of transactions. They will all be contractors to the manager and get fees for their services.

B. <u>Restrictions on the types of equities in the fund:</u>

This could be the most important aspect of Islamic Equity Funds. We can classify the Shari'ah restrictions on the types of equities in the fund in two categories:

(a) Restrictions related to the area or the core business of the company whose equities are to be held by the fund: Any company whose business activities are basically in the non-permissibles is not suitable for an Islamic equity fund. The list is not very long and it includes financial services banking, insurance companies, gambling, liquor, port, pornography . . . etc. Notice here that we are talking about the "core" of the business activities of the company. Borderline cases, however, can only be resolved by a Shari'ah board on a case by case basis.

(b) Restriction related to the finances of the company. This is an operational restriction. A Company that is already short-listed through our first screen may still be unsuitable for an Islamic equity fund. It is important that such companies are not engaged in non-permissible financial transactions. Certainly it would be preferable if one can find companies so pure that they depend completely on their own income, and always rely on self-financing. But this is hardly possible. The question becomes, then, how to set parameters that guarantee selection of companies with minimal involvement in such non-permissible financial transactions. These parameters are:

1- **Debt to equity ratio:** The problem with debt in the capital structure of a company, from an Islamic point of view is that it is interest based. A Company indebted through Murabaha, for instance, need not have any such restriction. Borrowing on interest is not permitted, therefore it is necessary that such borrowing is limited to a tolerable level. In certain situations Shari'ah treats minute and insignificant amount of non-permissibles as negligible having no effect on the permissibility. But what is the cut off-point? There are many indications in Shari'ah which points out to the "one third" as "plenty", and that anything less than one third is "trifle". Though such distinction came in a different context, many contemporary Shari'ah scholars thought it relevant and assumed that a debt to equity ratio of less than 1/3 is tolerable. It is extremely important to note that such criteria will never be suitable for wine production for example. This because, as we mentioned above, hardly any company can do without some debt. Our objective here is, therefore, to measure the extent of the firms financing with debt. Debt to equity ratio represent the relationship between funds supplied by creditors (debt) and investors (equity).

2- **Interest earning:** Companies whose core business is production of goods and services draw their income from profits generated from sale of such goods or services. It is not likely for any such company to earn any significant percentage of income from interest. It does happen, however, that excess cash is deposited in interest-bearing account or invested in money market instruments. This amount must be identified and investors should be advised to set aside what ever such percentage constitute out of the portfolio returns on investment. The investor may then donate the same to a charity of his selection. Such amounts are usually very limited.

3- **Cash and Receivables:** Shari'ah distinguishes between sale of real goods and that of money and debt. In the latter such sale can only be done at par value. The share of any company don’t actually have an existence of its own but its value comes from the undivided portion of the assets of the company it represent. Therefore, when one buys a share he is actually buying these assets. If the latter are primarily cash and receivables then the share must not be sold at a price different from the face value of these assets. Any thing more (or less) may be considered usurious from Shari’ah point of view. Because such pricing is not possible in practice, a restriction is imposed to eliminate the likelihood of such thing. This could be done by, again, putting a cap on the size of such class of assets.

C. Gearing:

One of the most important advantages of investment funds in conventional setting is gearing, i.e., the possibility of pledging the assets in the fund for borrowing and re-investing to enhance the earning in the fund. This is clearly not acceptable from *Shari’ah* point of view since these borrowings are interest based.

The rationale behind this approach, is to have some resources in the fund that receive fixed return. Because the fund can generate higher earnings than that fixed return, then participants will have their return on investment improved. It is not wholly unlikely that an Islamically acceptable design to the same effect. For example, the fund can purchase some assets on Murabaha basis using the rest of assets in the fund as collateral.

D. Hedging market risks:

Equity markets are volatile, which exposes the invested funds to significant risks. It is customary that fund management engage in certain transactions for the purpose of hedging these risks. The most used means for this purpose are to sell index futures, write call options on stock indices or purchase put options. In investment funds that cover different markets and take cross-border risks, currency hedging may be necessary. Managers may engage in currency forward contracts, put and call options to hedge currency risk. Unfortunately, most of these transactions are not permissible from Shari'ah point of view. Hence non-of the above can be practiced by the Funds management.

E. Other transactions:

For the purpose of efficient portfolio management, manager may go into certain transaction such as securities lending and repurchase agreement. As for the latter, repurchase agreements are not permitted for the sale of any item, from Shari'ah point of view, must not include a repurchase. While lending is permitted from Shari'ah point of view no increase is allowed. Therefore, lending of securities can be done free. However because this is not likely to happen, then this is not affective.

F. The Process of “Cleansing”:

The basic concept of an Islamic equity fund is based on the idea that the Investor will be able to rid his earnings from the portion that is coming from interest, and that such procedure will be attainable to him through the assistance of the manager.

It is essential, therefore, to adopt procedures and designs measures that correctly estimate the non permissible income for each company in the portfolio, and how much such income constitutes out of the investment earnings of each subscriber.

How to estimate the “usurious” income:

The funds portfolio consists of tens of companies each having the probability of interest earning. However, the investor will not be receiving income directly from any company. Rather, he will receive income from the Investment Company. i.e. the fund. How would the manager then calculate the portion of each investors income that need to be purified.

There are many possibilities that differ significantly in terms of accuracy and practicality. It is important, however, that we know exactly what needs to be estimated. We want to know how much of the increase in the net asset value of the fund was coming from interest earning of the companies in the portfolio holdings. We, therefore start with each company and see what is the ratio of interest earning to the net revenue of that company. This percentage is totaled and divided by the number of companies to get the average. This average will then be applied to all the dividend income earned by the fund.

Why “net revenue” and not “net income” ?

One may wonder why did we apply the company’s interest earnings to net revenue and not to net income. The reason is two fold: Firstly, because net income is not a very reliable variable. In a lot of cases, net income depends mere on company’s accounting procedures that is reality. On the other hand revenue is not. Secondly, by relating interest earning to income, we assure that this part of company’s revenue should not be charged with any operational expenses, which is not reasonable. interest earning is a revenue and therefore, it should be related to revenue items.

The process of cleansing then should include calculating interest earning as a percentage of net revenue for every company and then averaging out for the whole portfolio holdings. The result should be included in the cleansing formula that is advised to the subscribers in the fund.

Market or Book Value:

Since we are dealing, in both the selection of stock as well as purification of earning with ratios, then we need to refer to either book or market value of the company in question. Some fund managers use total assets, others use market capitalization. It is the view of this writer that market capitalization is more relevant because it represents the actual value of the investment.

I. The Role of the Shari'ah Supervisory:

To give assurance to subscribers about managers commitment to Shari'ah parameters, it is becoming customary that fund managers appoint a Shari'ah advisor (or advisors). Not all Islamic equity funds have Shari'ah advisors. Atypical Shari'ah advisors functions may be:

a- Provide opinion on matters referred to it from the manager relating to funds operations particularly initial screening and the cleansing process.

b- Issuing an annual declaration attesting to the managers adherence to the parameters set by the Shari'ah advisor and informing subscribers about the percentage of their annual income that they rid themselves of to cleanse their earnings.

Furthermore, a Shari'ah advisor is always a consultant. While may seek the opinion of the Shari'ah advisor on a continuing basis, he (or they) will never interfere in the day-to-day business of the fund. No Shari'ah advisor, for example, will be involved in the buy or sell orders of an equity fund, non in an “managerial” decision in its operations. He may voice his reservations on the managers decisions, but will never “pre empt” the manager.