Islamic Equity Investment

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Shari'ah and its place in the life of a Muslim:

Islam is a religion that governs the life of Muslims in totality. Islamic law which is called Shari'ah in Arabic, governs both one’s relationship with God and with fellow man. Shari'ah is a very rich and amply detailed legal system. One of the most distinct phenomenon in Muslim world today is that Muslims are more keen to adjust all aspects of their life to the commands of Shari'ah. This includes economy and finance.

The basic concept of Modern Corporation has never been rejected by contemporary Shari'ah scholars since it was introduced in Muslim world less than 100 years ago. They saw in it a modern form of a well-known Shari'ah acceptable form of partnership called “*Anan partnership*”.

However, the Model Company on which all jurisprudent probing was based, is one that is free of every prohibited activity, including borrowing on the basis of interest. Such company actually does not exist even in Muslim countries. In-fact, almost all major business enterprises resort to borrowing if only to match spending to cash flow. This means that contemporary form of company is a far cry from the original model upon which Shari'ah scholars based their judgment.

The prohibition of usury in Islam is very firm and uncompromising. In the classification of “sinful acts” it is at the top of the list. Therefore, the direct effect of realizing the fact that interest based transactions are inescapable by public companies was for Muslims to shun investment in shares since income from such companies will be tainted with interest. This tendency was even strengthened by the view of contemporary Shari'ah scholars which got firmer and more resolute that interest is usurious at any percentage.

In 1992, The Islamic Jurisprudence Academy of the OIC The most authoritative jurisprudence body in Muslim world adopted a decision on the definition of “company share” it stated that the subject in the sale of shares is an “undivided portion of company assets”. This is clearly different from the conventional legal definition where a share represents a right to future earning and liquidation proceeds.

This meant that it is possible now to a new approach at looking at companies. This is because the definition made it possible to apply analogy to the case of equity investment. If the problem is the mixture of permissible and non permissible, then we can rely on the rich heritage of Shari'ah jurisprudence. This is because the case of permissible and prohibited elements getting mixed is neither new or novel. It is well covered in the annals of Shari'ah written by classical scholars who adopted clear-cut position such cases.

The first attempt to design an Islamic Investment Program goes back to the last year of the decade of the 1980’s. Unfortunately the project soon collapsed to unfavorable investment environment created by the Gulf war in 1990. Participants with-draw their investment soon after launch of that equity fund. Though the investment criteria then was not as sophisticated as Islamic equity funds are today, that attempt clearly paved the way to the revelation that it is to take place in the decade of 1990's.

In 1993, the real take-off of Islamic equity investment took place.

Now, there are close to 100 Islamic equity funds and the Islamic equity investment program is used by hundreds of thousands of investors worldwide.

The “plain-Vanilla” of investment portfolio built and managed on the criteria of Islamic investment, is still the staple form.

However, innovation is abound. Index based funds, capital protected, specialized funds as well as Internet portals especially designed for Islamic equity investment are now a main stay in the world of Islamic equity investment. Nevertheless, the basic concept of Islamic equity investment is not new. It finds roots in the idea of ethical investing.

Ethical Investing is not new. It goes back to the 1920’s. They became popular, however, in the 1970’s and thereafter. In 1971 a group of Methodist clergy in the USA discovered that their church regularly received letters from individuals asking how to invest in companies not manufacturing weaponry. After finding that no organization specializes in this kind of investment, the ministers went to Wall Street firms asking for assistance in setting up a fund for this purpose. Pax World Fund may be the first equity fund to adopt a full set of ethical issues in its screens. The pioneer fund which excluded companies producing alcohol & tobacco from its portfolio holding was available to investors in 1928. Then the environmental movement and the equal employment opportunities programs in the 1970's produced a number of equity funds tailored to the preferences of investors who are concerned about these issues, and want their money to help influence the business sector into more compliance. Dreyfus third century fund was pioneering in this regard. Such funds do exist now in USA & Europe.

The Islamic Equity Investment Criteria

The Islamic equity investment criteria consists of selection screens, if applied will yield a choice of companies, upon which investment may be based. Periodically, a process of purification must also be applied. The most important screen is the debt to equity ratio.

a) Outstanding total debt doesn't exceed 33%.

This is the most important screen and the main financial ratio in the Islamic equity investment program. Shari'ah is concerned about the financial resources from which the company generates income. If the sources are permissible, then such income is also permissible (assuming they are used for permissible purposes). There are two major sources for such resources for a company: debt and equity. It is rare that a company confines itself to the capital subscribed by its shareholders. In almost all cases, a company is leveraged. Because interest based transactions are prohibited in Shari'ah, then portion of the capital structure is not acceptable.

Established Shari'ah rules cover cases of the mixer of permissible and non-permissible, and ways to deal with such situations. This is exemplified by the statements on the classical book of jurisprudence on such mixture in the case of clean and non-clean water for purpose of ablution, in cases of co-mingled *halal* and *non-halal* earned income…etc.

Several Shari'ah maxims cover incidents of such mixture; most prominent is the one that states:

"Judgment is based on majority not minority".

In other words, to make a judgment on the permissibility or otherwise of a mixture, we will rely on the majority not the minority. We therefore need to define majority and minority. Another, Shari'ah maxim covers this. "The dividing line between majority and minority is one third". This is narrated in an authentic saying of the Prophet (PBUH). Hence, contemporary Fuguha ruled that as long as the non-permissible sources of income for the company are less than 1/3, then we rule on the majority which a permissible 2/3rds.

b) <u>Cash and interest-bearing securities don’t exceed 33%.</u>

This is a new parameter. In the past the investment program includes a percentage of interest earning. This ranges between 5% to 15%.

Unfortunately, it can’t be defended from Shari'ah point of view. This is because it can’t be said that 5% interest is not allowed but anything lower is. The fact of the matter is that any interest earning is prohibited. Originally the *fatwa* that supported this investment program stated that interest earning should be minimal and insignificant. However, it is difficult for fund managers to apply such vague parameters. On the other hand, there are cases of good companies, which would pass all the screens except this one because of the fact that it is a new venture developing an invention in technology or biological sciences. Because it only has its capital and don’t yet generate any income (except interest earning) such interest will constitute a higher percentage if related to its assets.

Although such company is in line with the Shari'ah objectives in investment, it will not pass the screen. The new formula states that total cash held by company combined with interest bearing securities should not exceed one third of the market volume of the company. This would indirectly screen interest earning. If the interest earning are high then the cause can only be too much cash and interest bearing securities at hand. We know that equity investment is a long-term type of investment. Hence, if the company does hold too much cash, but the potential for its growth in the long run (over 3years) are high, then we should give the Islamic investor the opportunity to benefit by not excluding such companies just because their interest earning increased beyond a set percentage. Remember that we will apply the purification formula at any rate.

Furthermore, since this 33% is related to market volume of the company, those companies, which have patents, or new formulas that are worth something, should not be excluded just because they are in the process of developing their assets.

Moreover, if the rate of interest is very low, an interest earning of the company will be low despite the fact that most of its assets are cash.

Having said all that, it is important to state that the reason for the new formula is to put the Islamic equity investment program on a more solid Shari'ah grounds. The rule of one third is on solid Shari'ah ground as we made clear earlier. A company that operates on cash and interest bearing securities of more than one third of its market value is not suitable for our Islamic investor.

c) <u>Receivables are less than 50%:</u>

Receivables are, in general, funds owed to the company by others. Companies create receivables when they sell on deferred payment basis. However we differentiate between receivables created by permissible transactions like deferred payment sale of goods and services and those created by transactions contrary to requirements of Shari'ah such as lending. Hence, it is assumed that receivables in the companies which are included in Islamic equity funds are all created through sale of goods and services on deferred payment and not lending. Therefore, we apply the Shari'ah rules concerning debt. Financial companies whose assets are only receivables are excluded.

Since the Shari'ah position concerning company shares is that a share is an undivided ownership of the assets of the company, then, sale of share is effectively sale of this undivided ownership of these assets.

Shari'ah doesn't permit sale of debt except to the debtor and even then only at nominal value. Hence, if the company has only assets in the form of receivables, then sale and purchase of shares of this company would not be permissible this would amount to will sale of debt to a third party at a price different from the nominal value. This is not permitted. The selection criteria states that receivables in the investee company should be less than 50%. The purpose is to make sure that a share represents assets the majority of which is not debt so as not boil down to sale of debt.

One may wonder why did we adopt a 33% for debt in the company liabilities while we say here less than 50%. The answer is: borrowing on the basis of interest is not permitted. Hence the Shari'ah basis for the rule relates to the mixture of permissible and non-permissible. In the case of receivables, the foundation is different because selling on deferred price basis is permitted. This pertains to a different percepts.

d) <u>Business of the company</u>

The restrictions on the business of the company are straightforward. Although such restrictions founded on Islamic Shari'ah, the ethical aspects of which are quite apparent, except for gold and silver. Purchase and sale of gold and silver are not impermissible in Shari'ah. Nevertheless, Shari'ah distinguishes between sale of goods and commodities in general and that of money in which gold and silver are included. While goods can be sold spot or on differed payment basis, money can only be exchanged spot and at nominal value only. Because the whole criteria is built on the assumption that a company share is an undivided portion of its assets, sale of a share of a company whose assets are gold effectively means, sale of this undivided portion. While it is possible to make it spot, it is difficult to guarantee that it is exchanged at nominal value. The narration from the prophet (PBUH) states gold and silver. This is why majority of scholars adhered to the letter of the narration.

There is some debate on the matter to the effect that gold and silver should be treated as commodities not money as they no longer are mediums of exchange. It remains, however, that the majority of Shari'ah scholars, even contemporary ones, find it too daring to go otherwise.

e) <u>Prohibition of Financial instruments:</u>

It is not permitted for the manager in an Islamic equity fund to use the financial instruments:

- **<u>Futures:</u>**

  The Figh academy of the OIC ruled that Futures contracts as practiced in financial and commodity markets are not permitted in Shari'ah. Future contracts are standardized forward contracts traded in organized markets. The problem is that offer and acceptance are made today however, the effect happens in the future. In exchange contracts Shari'ah permits the deferment of either price or the sold item but not both. In a futures contract, price and sold item are put off to a future date. It is not sufficient that a margin is paid. *Salam* contract is similar to futures, except for the requirement that total price is paid at the time of contracting.

- **<u>Options:</u>**

  Not everything can be subject to sale in Shari'ah. Goods, commodities, services, usufructs can all be objects for sale contracts. However, pure rights and obligations can't. If we look at the financial option contract, we find that it is a sale contract where one party pays a price to another so that the latter is legally committed to either sell or buy something at a future date for a set price. The subject of the contract is actually this commitment not the underlying asset, since this will be the subject of another separate contract. Pure rights and obligation are not negotiable from Shari'ah point of view. It is because of this The Figh Academy of the OIC rule that financial options are not permitted.

- **<u>Preference Shares:</u>**

  We mentioned earlier that the whole jurisprudence of equity investment is derived from that of the *Anan* Company in Shari'ah. The rules governing partnerships in Shari'ah including *Anan* demand in earnest that fairness and equity is to be maintained by partners. It is apparent that the holder of a preference share is not equal in his rights and obligations to the holder of ordinary share. It is because of this the *Figh* Academy of the OIC ruled that preference shares are not permitted.

- **Short Sales:**

  Selling short means, that vendor sells things that he doesn't own at the time of sale. To be in line with Shari'ah requirements, sold items must be owned by the seller at the time of sale. It is permitted to sell items on basis of description only i.e. items not owned by seller at the time of sale. In this case, however, they have to be "fungible" in nature and price must be paid in full at time of sale. Short sales are, therefore, in violation of Shari'ah requirements.

The Process of Purification.

a) Meaning of purification:

Purification simply means: deducting from one's investment those earning the source of which is not acceptable from Shari'ah point of view. In the case of equity investment, this refers primarily to interest earning and incidental income from other non-permissible sources of income to the investee company such as sale of alcoholic beverages or pork, estimating earning from sale of pork and alcoholic beverages, is not easy. It is interest that is quite arduous. The basic idea looks simple, but it is not. A Company is a going concern. It is a living entity with far-reaching enterprise and widely stretched activities. It is also very complex from accounting and financial point of view, a far cry from the single partnership of the *Anan* form of company. Therefore, estimating such income is a formidable task. One that require an excellent knowledge of accounting and corporate finance and exceptional ability to handle Shari'ah issues, a combination that is not always within reach.

b) Shari'ah basis for purification

Although the Islamic equity investment program gains more and more acceptance everyday from an increasing number of Shari'ah scholars and the Muslim public at large, an opinion is still held by some, that the Shari'ah basis for such program are speculative to say the least. However, no part of this program is on more solid ground from Shari'ah point of view, than that of purification. This is because the issue of purification is not new and hence it finds clear Shari'ah foundation, exemplified in the classical annals of *figh* and statements of major learned scholars of the early centuries based on their understanding of the texts (*Quran and Sunnah*), from which principles for such procedures were epitomized.

However, articulating these Shari'ah principles into a formal procedure for purification in portfolio investment is quite a heroic task and one with a number of unsettled issues as will be described below.

c) What is to be purified?

- Dividend

There are those who think that non-permissible earnings of a company (such as interest) will transpire into investor's returns only if such investor collects a direct receipt from the company in the form of dividend. Hence what is to be purified is only that part. Return derived from capital gain, as most of the returns accruing to equity investors; need no purification according to this viewpoint. This is because capital again is a market element, the argument goes. The main consequence of this approach is that no cleansing will need to be applied if the dividend is distributed, even if the company did earn interest income.

- <u>Capital gain</u>

Others differentiate between investing in a single company, and being a subscriber in an investment fund. While it makes sense to only purify dividend income in the first case, in the second, the fund itself should be treated as a company, where the investment units are akin to company shares. In this case the investment returns one derives from such fund (which is primarily capital gain) must be all purified as they are not dissimilar to company shares and dividend. This is because no capital gain is realized from sale of fund units, and hence any income therefore is similar to dividend. A third view holds that, the increase in share prices in the market (capital gain) is a complex phenomenon. Such increase can be attributed to a multifarious of factor, from which cash and debt securities (the source of interest earning) can’t be excluded. Hence, even capital gain ought to be purified.

- **<u>Assets or Liabilities</u>:**

Current thinking is that only company assets need to be purified. This is because the Islamic equity investment program is based among other considerations, on the *Shari'ah* maxim that *"Lilkatheer Hukm Alkull"* (rule is based on the majority not minority). Since the bulk of the sources of funds for the company is coming from permissible sources (2 thirds), then the minority source is ignored and hence should not be of any consequence on purification. However, there are those who believe that the above mentioned maxims only permit us to invest in the company and that composition of the liability side should be considered for purification. In this case we need to assign a portion of the income of the company to the debt source of funds and dispose of it.

d) <u>Net or Gross:</u>

A Company deposits some money in a time deposit (or holds government bonds) and earns interest. Such interest will be part of that company's income for the year. But, should such interest earning be a net income or just revenue. In other words, when we transpose the interest earning of a company to the return on investment received by a participant in an equity fund, we need to relate such interest earning to either net income of the revenue of the Investee Company. It appears that income is not a very reliable element, while revenue is less influenced by such factors. By counting interest as revenue we indirectly allow charging operational expenses to such source of income, like any other source. This is not the case when we relate interest to net income.

e) Purification v/s Screening

It is important to distinguish the method of handling interest as well all incidental non-permissible earning in the screening phase of the Islamic investment program as compared to that at the purification phase. There is no basis in Shari'ah for saying that a 5% is acceptable while 6% is not. In other words, screens that permit investing in a company if its interest earning is 5% or less of its income are clearly founded on expedience not Shari'ah be fitness. It is because of this many Shari'ah boards are now moving to a more strict criteria. It is different at the stage of purification as every interest earning must be dispensed off.

f) Deduct or Inform:

Investors in most equity investment funds are advised on quarterly basis of the percentage of their investment they need to dispose off to purify their return. It is the duty of every subscriber to, himself, purify. In other funds, such burden is entrusted to the fund manager. He is not only required to calculate but also to dispose off the tainted amounts. The first method is clearly more practicable. Because no deduction from the net asset value of the portfolio is done, hence fund appears more profitable. Furthermore, they attracts strict Muslim investors (who would be keen to dispose off this amount every quarter), and the not so strict and non-Muslims to invest in the fund.

On the other hand, some Shari'ah scholars think an equity fund will not be truly Islamic unless all returns to investors are “pure”. Hence the manager must himself deduct such amount and dispose off to charity.

In the writer’s view, money itself is neither pure nor tainted. Such things can only take place in the “*dhimma*”[1]. If one earns an unpermissible income, he will be cleared if he disposed of the same from other sources. In the final analysis, those who subscribed to the fund with the intention of earning pure and clean return will purify.

[1]If one becomes obliged from payment of Zakah, for instance it suffices if he pays the due amount from funds other than the one on which Zakah is due. The same thing can

Glossary of Terms for Islamic Equity Investment Criteria

Debt: Bonds, Notes, Mortgages and Loans borrowed from banks on interest basis.

Equity: Ownership interest possessed by shareholders in a corporation by stock (not bond) of such corporation.

Interest bearing securities: Bonds, Notes issued by companies or governments.

Market capitalization: Value of a corporation determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of shares by the current market price. For the purpose of screening, the average of daily or monthly closing market values over the previous six months.

Receivables: Money owed to the investee company for merchandise or service sold to its clients.

Preferred Stock: The class of preference shares that are prohibited in Shari'ah are the ones entailing certain rights beyond those attached to common stock in the payment of divided and priority in the distribution of assets in the event of dissolution of the corporation.

Futures: Same as forward except that futures are dealt in organized markets.

Swap: A contract in which two parties agree to make payments to one another on specific dates.

Interest: The charge on money borrowed. Interest in installment sale or leasing is not included in the Shari'ah prohibited interest.

Forward Contract: Contractual agreements to buy or sell specific amounts of currencies, commodities or shares at certain dates in the future for specific price. A forward contract in commodities or company shares (not currencies) would be permitted from Shari'ah point of view if the full price is paid at time of contracting and that parties intend to deliver and receive delivery of the sold items and hence form contracts that offer the possibility of such delivery.

Option: A binding promise in which one party agrees, for a consideration that another shall have the privilege of buying a property at a fixed price within a stated period of time or at a specific date. If such option contract is formed without monetary consideration it would be permitted from Shari'ah point of view. Furthermore, if the property is owned by promiser when contract is formed, and consideration is a small down payment, which, if option is exercised, made a part of the price. Then such option is permitted from Shari'ah point of view.

Pork: The flesh, skin, hair and bones of hog used for any purpose.

Short Sales: To sell stock that seller didn’t own presently but is borrowed to make delivery.