Purification in Islamic Equity Investment Concept and Methodology

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Introduction

The basic model of limited-liability-publicly traded company is a contemporary one going back in Muslim countries to no more than 100 years. This form of company presents a momentous departure from the simple form of partnership. Such model has never been rejected by contemporary Shari'ah scholars who saw in it a modern form of the *Anan* company, well known in Islamic jurisprudence[1].

Except for a minor dissent, the majority of today's Shari'ah scholars accept company shares as exemplifying an undivided ownership over the assets of the company as well as the basic transferability of ownership through purchase and sale of company shares (negotiability). It remained, however, that the prototype of public company on which all the jurisprudent application (up to the 1980's) was based, is one that is free from every prohibited activity or questionable source of income,

[1]Ofcourse, there are those who say that such acceptance was not the product of rigorous scholarship but mostly based on *Istishab Al-hal*.

including borrowing and lending on the basis of interest. However, the business environment and the state of economic affairs in contemporary world makes such model of company beyond reach, not existing anywhere, not even in Muslim countries, the problem is to do with *Riba*. It may not be impossible for a company to refrain from prohibited activities such as production of *Haram* goods. However, it is not possible for a modern corporation to survive with no access to capital and money markets as well as basic banking services. Even companies that maintain a large liquid assets, can hardly do without a regular overdraft account with the local bank. In most cases this is not the only facility such companies need and can't arrange on Islamic basis. If such transactions are based on interest then purport to borrowing on the basis of *Riba*. Unfortunately Islamic banks are yet to develop a substitute for regular overdraft account, This effectively meant that public companies no matter how dedicated their management is to

Islamic *Shari'ah*, will not be able to fully refrain completely from interest based transaction.

Many Muslims started shunning equities all together as this appeared to them to be the best thing to do from religious point of view.

The OIC *figh* academy[2] took in 1991 a monumental and decisive ruling about “what is a company share” and what exactly is the object of the sale contract when such share is sold. Only then that these scholars were able to revisit the issue related to investing in companies that are not *so pure* because, such issue is now articulated in a manner that affords a Shari'ah discourse.

Shari'ah scholars succeeded in the last few years in developing an equity investment program that lends itself to implementation by professional investment managers, of which, purification was

[2]Figh Academy session of the Year 1412 H.

a pivotal element. Islamic equity funds were then born[3]. Today, the market for such funds is quite sizable. In the author’s estimate, it may have already passed the $ 20 billion mark worldwide, affording two market indexes (and a third on the way).

While the study of the Shari'ah basis for Islamic equity funds is important it is the subject of a different paper. The present paper doesn’t attempt to cover this part. Rather, it takes such aspects as given and concentrate on the issue of purification.

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

[3]There are now over 55 Public Islamic Equity Funds world wide and two Islamic market indexes.

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 a 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.

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 issue as will be described below.

The Issues:

1- What is to be purified?

a) 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.

b) Capital gain

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.

c) Assets or Liabilities:

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 maxim 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>Profit from lent funds:</u>

Others, go further to say that we need to purify our income from the profit generated from borrowing.

So far we have assumed that tainted income emanates from the assets side of the company's balance sheet, and that the

liability side is ignored since the Shari'ah criteria we applied assumes that the judgement is based on the 2/3 not the 1/3. Under this view, we further need to treat this debt as if it was a separate venture. They assume that such debt generated part of the profit equal to its ratio to total liability. Since the profit would not here been made with the mixture of capital and labor then we would assign only half that portion of profit to capital. We then dispose of this half since it is generated through impermissible means. Needless to say that they assume that labor is provided by the company and it hence deserves half the profit.

2- Net or Gross:

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.

3- 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 befitness. 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.

4- 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*"[4]. 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.

Methods of purification

We have deducted in the practice of Islamic equity fund management several methods of purification, which will be presented below. Each method is based on assumptions the

[4]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

purpose of which is to embody Shari'ah requirements in a formula that lends itself easily to implementation by fund managers. All the methods presented here are already in practice, and are used by one or more fund managers. However, these, I am sure, are not the only methods, albeit the most common.

In each methodology a formula is set-up to find factor P, through which interest income can be estimated.

First method:

Let us assume that we have a portfolio of company shares. On January 1 (t_1) we have n investee companies (c) each earning interest equal to ί .

Hence, we have interest income equal

$ί_{c1} + \dots + ί_{cn} = a$

Let us assume that the net operating income for any company in the portfolio is y.

Hence the total net operating income for the portfolio is =

$y_{c1} + ----- + y_{cn} = b$

$$\text{Then} \quad H = \frac{a}{b}$$

Let us assume that the net asset value of the fund on Jan 1 is equal to $NAV_{t1.}$

Then calculate Z which equals $NAV_{t2} - NAV_{t1.}$

The purification factor P will then equal ZH = P.

Hence for every dollar invested, the investor must multiply by P and donate this amount to charity.

If for example, P = .007 and the investors Z = $ 2000 then he must dispose of the amount of $ 14.00

Second method:

Let us assume that we have n companies in the portfolio:C_1, C_2 …C_n

$$\text{Then calculate dividend yield (d) where d equals} = \frac{\text{dividend}}{\text{market value}} = d$$

Therefore, the annual portfolio dividend yield will be = $d_{c1} + d_{c2} + \ldots.. + d_{cn}$

calculate interest income ratio for each company (ɩ) which equals =

$$ɩ = \frac{\text{interest income}}{\text{net operating income}}$$

for the portfolio it will be = $ɩ_{c1} + ɩ_{c2} + \ldots.. + ɩ_{cn}$

Hence, purification factor is = (d) (ɩ) = P

This means that for every dollar invested the amount of $ P must be donated annually to charity.

<u>Third method:</u>

Let us assume that reported interest income for each company in the portfolio is X, we will then have X_1 to X_n where 1 and n denotes investee companies.

Let us assume that: T is equal to each company's tax rate and that there is a tax rate for each investee company.

A equals the percentage of the total company shares owned by the fund.

M equals the number of months the share is held in the portfolio.

Then we have interest income in the portfolio ip equals S X (1-T) (X) (a) (M).

$\sum$ x (I-T) (X) (A) (M)

Our recommendation:

In designing a purification formula we have to take into consideration the following:

1- That it is simple and requires data that is standard and available from every company.

2- That it satisfies the requirement of "prudence" from Shari'ah point of view which means that if we are to err, we prefer to err on the side of more purification not less.

Hence, the purification suggested by the writer, for purifying in a portfolio of stock proceeds as follows:

Step 1: We find the amount of interest and other non-permissible earning in each company in the portfolio. Let say company A earned during the year 2000, $500 from interest and sale of liquor.

If company A paid a tax on its income for the year 2000, then interest earning should be netted. If tax was, say 10% then only $450 should considered for purification purpose.

Step 2: We divide this amount on the total number of shares of this company, lets assume company A has 10,000 shares outstanding in the market. The outcome is $.045 for each share.

Step 3: We multiply this number by the shares of company A, we hold in the portfolio. If for example we hold 50 shares, then the amount for investment in this company is $2.25.

If the share is held in the portfolio for less than one year, then we divide 2.25 over 12. Let us say we held it for only 9 months. Then only $ 1.69 needs to be disposed off out of our investment in this company.

Step 4: We do the same exercise for all the companies in the portfolio. Suppose we ended up with an amount equal to $36.5. This would be the amount we need to dispose of to charity.

We mentioned earlier the view of those who say that only dividend need to purify. We also mentioned the view of those who believe that even capital gain need to be purified. This formula actually steers away from such dispute. It aims at purifying the investment itself. The company in which we own a share, has attained income which needs to be purified even if they made a loss during the year. Therefore, whether the company paid dividend or not, or that we made a capital gain or loss, the formula should be applied to the total investment.