



# *Meezan Bank's Guide to Islamic Banking*



The Premier Islamic Bank



*Meezan Bank's Guide to*  
**Islamic Banking**

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The Premier Islamic Bank

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## **SECTION VII**

### **ISLAMIC INVESTMENT**

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### ISLAMIC INVESTMENT FUNDS

The term 'Islamic Investment Fund' means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profit in strict conformity with the precepts of Islamic Shariah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profit actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Shariah, will always be subject to two basic conditions:

1. Instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Fund, will be liable to compensate it.
2. The amounts so pooled together must be invested in a business acceptable to Shariah. It means that not only the

channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment, which are discussed here briefly.

### ***Equity Fund***

In an equity or mutual fund (unit trust) the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

From this angle, dealing in equity shares can be acceptable in Shari'ah subject to the following conditions:

1. The main business of the company does not violate Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, eg. companies manufacturing, selling or offering liquor, pork, haram meat, or involved in gambling, night club activities, pornography, prostitution, or involved in the business of hire purchase or interest etc.
2. If the main business of these companies is halal, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts or non-Halal activities is included in the income of the company, the proportion of such income should not exceed 5% of the total income. If it exceeds 5%, it is not permissible to invest in that company. However, if it does not exceed 5%, it must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity. Moreover, the company's total short term and long term investment in non-permissible business should not exceed 30% of the company's total market capitalization.

It may be questioned "What is the basic rationale of this limitation of 5%?" Infact, there is no specific basis derived from the Holy Quran or Sunnah for the 5% rule of non halal (impermissible) income. However, this is only the collective outcome (consensus) or *ijtihad* of contemporary Shariah Scholars. To explain this consensus of their ruling, we shall have to go back to the origin or basis of company on Shariah perspective. As mentioned in the books and research papers of Islamic jurists, companies come under the ruling of *Shirkatul Ainan*. But if the rule of partnership is truly applied in a company, there is no possibility for any kind of impermissible activity or income. Because every shareholder of a company is a *sharik* (partner) of the company, and every *sharik*, according to the Islamic jurisprudence, is an agent of the other partners in matters of joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the shareholder to the company to carry on its business in whatever manner the management deems fit. If it is known to the shareholder that the company is involved in an un-Islamic transaction, and he continues to hold the shares of that company, it means that he has authorized the management to proceed with that un-Islamic transaction. In this case, he will not only be responsible for giving his consent to an un-

Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

However, a large number of Shariah Scholars say that Joint Stock Company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the majority takes the policy decisions in a joint stock company. Being composed of a large number of shareholders, a company cannot give a veto power to each shareholder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a halal (permissible) business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, then it cannot be said that he has approved the transaction of interest and hence that transaction should not be attributed to him.

In short, the matter of traditional partnership is different from the partnership of company in this aspect. Therefore if a very small amount of income is earned through these means despite of his disapproval, then his trade in shares would be permissible with the condition that, he shall have to purify that proportion of income by giving it to charity. Now a question could be raised as to what extent or what limit that income would be forgone. Definitely, this matter could not be left on decisions or opinions of lay men, therefore, it was resolved through the consensus of proficient Shariah Scholars that the limit of impermissible income should not exceed 5% of the total income.

4. The leverage or debt to equity ratio of the company should not exceed 30%. To explain the rationale behind this condition, it should be kept in mind that, such companies sometimes borrow money from financial institutions that are mostly based on interest. Here again the aforementioned principle applies i.e. if a shareholder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as Haram (impermissible). It is explained in the conventional books of Islamic jurisprudence that the contract of loan is among those, that are called "Uqood Ghair Muawadha" (Non compensatory contracts), therefore, no void condition such as condition of interest can be stipulated. However, if such a condition has been stipulated, the condition itself is void, but it will not invalidate the contract. Since, the contract remains valid despite of void condition, the borrowed amount would be permissible to use and it

would be recognized as owned by the borrower. Hence, anything purchased in exchange for that money would not be unlawful. However, the responsibility of committing the sinful act of borrowing on interest rests on the person who willfully indulges in such a transaction but this does not render his entire business as unlawful. But it should also be remembered that the extent of investment in shares of companies, that involve borrowing should be limited. Can this limit be the same as the 5% limit that is applied to interest income? No, because in this case this activity does not affect the income of the company, it is less severe than interest based income, therefore, Shariah scholars and Islamic jurists extended the limit (from 5% which is limit of interest/impermissible income) to 30%. The basis of 30% is that the 30% is less than one third ( $1/3^{\text{rd}}$ ) of the total asset of the company and one third has been considered abundant by the following Hadith of the Holy prophet (SAW) "One third is big or abundant" (Tirmizy). Hence whatever is less than one third, would be insignificant. Therefore to avoid the majority or abundance specified in the hadith, such limit is fixed at less than one third of the total asset of the company.

5. The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of illiquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are

in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

***The majority deserves to be treated as the whole thing.***

Some other scholars are of the view that even if the illiquid asset of a company is 33%, its shares can be treated as negotiable. The basis of this view is a well-known Hadith that means "One third is big or abundant" (Tirmizy).

They say that according to the Hadith one-third illiquid assets will be considered as sufficient or abundant for this purpose. The third view (of the scholars of the sub continent of Pakistan and India) is based on the Hanafi jurisprudence. The principle of the Hanafi School is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

1. The illiquid part of the combination must not be in insignificant quantity. It means that it should be in a considerable proportion.
2. The price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed at 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed at 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed at 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of

the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Among the three different views mentioned above, the most conservative view is the first one. Therefore, nowadays that has been adopted by the majority of Shariah boards of Islamic mutual funds or in screening of the Islamic stocks methodology.

Subject to aforesaid conditions, the purchase and sale of shares is permissible in Shariah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in shari'ah as partners inter se. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The method of purification adopted by Dow Jones Islamic market Index and Islmiqstocks.com are in favor of this view.

As we have discussed above for the negotiability of the share, it is essential for the share or securities that they represent more than 55% illiquid assets. If a mutual fund has 10% cash and 90% shares, we shall have to see how much of these shares represent fixed assets. Fixed assets include land, equipment, machinery and leased assets. If these shares represent more than 55% of fixed or illiquid assets, such shares or Musharkah certificates of mutual fund can be negotiated at other than par value as well.

Sale of option short sale, future sale and forward sale where some principles of Shariah are lacking are not permissible.

***Management of the fund:***

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as *mudaribs* for the subscribers. In this case, a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary Shariah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year.

However, it is necessary in Shariah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management

will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

### ***Ijarah Fund***

Another type of Islamic Fund may be an Ijarah fund. Ijarah means leasing the detailed rules of which have already been discussed in chapter 23 this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund, which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called '*sukuk*' - a term recognized in the traditional Islamic jurisprudence. Since these *sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these *sukuk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these *sukuk* certificates will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of *Shariah* which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
2. The leased assets must be of a nature that their *halal* (permissible) use is possible.
3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.
4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund, the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of Mudarabah, because Mudarabah, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali School, Mudarabah can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

### ***Commodity Fund***

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund, which is distributed pro rata among the subscribers.

In order to make this fund acceptable to *Shariah*, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The seller must own the commodity at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in *Shariah*.

2. Forward sales are not allowed except in the case of *Salam* and *Istisna* (For their full details, see chapters 17 & 20 respectively).
3. The commodities must be *halal*. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.
4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).
5. The price of the commodity must be fixed and known to the parties. Any price, which is uncertain or is tied up with an uncertain event, renders the sale invalid.

In view of the above and similar other conditions, more fully described in the previous chapters of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shariah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

### ***Murabaha Fund***

'Murabaha' is a specific kind of sale where the commodities are sold on a cost-plus basis. The contemporary Islamic banks and financial institutions as a mode of financing have adopted this kind of sale. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of murabaha, as undertaken by the present financial

institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabaha does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

### ***Bai-Al-Dain***

Here comes the question whether or not bai-al-dain is allowed in Shariah. Dain means 'debt' and Bai means sale. Bai-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in Shariah as Bai-al-dain. The traditional Muslim jurists (fuqah) are unanimous on the point that bai-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafai school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shafai jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of bai-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same

denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shariah.

Some scholars argue that the permissibility of bai-al-dain is restricted to a case where the debt is created through the sale

of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why the overwhelming majority of the contemporary scholars have not accepted this view. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shariah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of bai-al-dain unanimously without a single dissent.

### ***Mixed Fund***

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.