Albalagh

"Our duty is only to deliver the message"

بسم الله الرحمن الرحيم

"Give brief directions; directions that are too long are likely to be forgotten." (Sayyidna Abu Bakr, Radi-Allahu anhu)

Principles of Shariah Governing Islamic Investment Funds

By Mufti Taqi Usmani

The term "Islamic Investment Fund" in this article means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profits 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-rated profits actually accrued to 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:

First, instead of a fixed return tied up with their face value, they must carry a pro-rated 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 in 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.

Second, 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 briefly in the following paragraphs.

Equity Fund

In an equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly achieved through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also achieved by the dividends distributed by the relevant companies.

It is obvious that if the main business of a company is not lawful in terms of Shariah, it is not allowed for an Islamic Fund to purchase, hold or sell its shares, because it will entail the direct involvement of the share holder in that prohibited business.

Similarly the contemporary Shariah experts are almost unanimous on the point that if all the transactions of a company are in full conformity with Shariah, which includes that the company neither borrows money on interest nor keeps its surplus in an interest bearing account, its shares can be purchased, held and sold without any hindrance from the Shariah side. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock market or in some way involved in an activity which violates the injunctions of Shariah.

Even if the main business of a company is halal, its borrowings are based on interest". On the other hand, they keep their surplus money in an interest bearing account or purchase interest bearing bonds or securities.

The case of such companies has been a matter of debate between the Shariah experts in the present century. A group of the Shariah experts is of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is halal. Their basic argument is that every share-holder of a company is a sharik (partner) of the company, and every sharik, according to the Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the share-holder to the company to carry on its business in whatever manner the management deems fit. If it is known to the share-holder that the company is involved in an un-Islamic transaction, still, he holds 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.

Moreover, when a company is financed on the basis of interest, its funds employed in the business are impure. Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income which will be distributed to the share-holders through dividends.

However, a large number of the present day scholars do not endorse this view. They argue that a joint stock company is basically different from a simple partnership period. In partnership, all the policy decisions are taken by the consensus of all the partners, and each one of them has a veto power with regard to the policy of business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the policy decisions in a joint stock company are taken by the majority. Being composed of a large number of share-holders, a company cannot give a veto power to each share-holder. The opinions of individual share-holders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every share-holder in his individual capacity. If a share-holder 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 the transaction in his individual capacity, specially when he intends to withdraw from the income attributable to that transaction.

Therefore, if a company is engaged in a halal business, however, it 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 the incidental transaction also, and will not use that proportion of the dividend for his own benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

The other aspect of the dealings of such a company that it sometimes borrows money from financial institutions. These borrowings are mostly based on interest. Here again the same principal is relevant. If a share-holder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

Moreover, according to the principals of Islamic jurisprudence borrowing on interest is a grave sinful act for which the borrower is responsible in the Hereafter; however, this sinful act does not render the whole business of the borrower as haram impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange of that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who willfully indulged in a transaction of interest, but this fact does not render the whole business of a company as un-lawful.

Conditions for Investment in Shares

In the light of the forgoing discussion, dealing in equity shares can be acceptable in Shariah subject to the following conditions:

1. The main business of the company is not in violation of 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, such as the companies manufacturing, selling or offering liquors, pork, haram meat, or involved in gambling, night club activities, pornography etc.

2. If the main business of the companies is halal, like automobiles, textile, etc. but they deposit there surplus amounts in a 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 is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given 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.

4. The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, i.e. in the form of money that cannot be purchased or sold, except on 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 non-liquid assets of a company for the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of non-liquid assets must be 51% at the least. They argue that if such assets are less than 50%, the most of the assets are in liquid form, 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 of a thing. Some other scholars have opined that even if the non-liquid asset of a company or 33%, its shares can be treated as negotiable.

The third view is based on the Hanafi jurisprudence. The principle of the Hanafi school is that whenever an asset is a mixture of a liquid and non-liquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

First, the non-liquid part of the mixture must not be in a negligible quantity. It means that it should be in a considerable proportion. Second, the price of the mixture should be more than the price 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 as 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the rest of 30 dollars are in exchange of the fixed asset. Conversely, if the price of that share fixed as 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 as 75 dollars, it will not be permissible, because if we presume that 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 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 a price of the share goes lower than its liquid assets.

Subject to these 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 Shariah 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 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."

The Shariah scholars have different views about whether the "purification" is necessary where the profits are made through capital gains (i.e. by purchasing the shares at a lower price and selling them at a higher price). 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 other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of price can be allocated for the interest received by the company. It is obvious if all the above requirements of the halal shares are observed, the most of the assets of the company are halal, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also a negligible as compared to the bulk of the assets of the company. Therefore, the price of the share, in fact, is against the bulk of the assets, and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the halal assets only.

Although this second view is not without force, yet the first view is more cautious and far from doubts. Particularly, it is more equitable in an open-ended equity fund because if the purification is not carried out on the appreciation and a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his unit after some dividends have been received in the fund and the amount of purification has been deducted therefrom, reducing the net asset value per unit, he will get a lesser price compared to the first person.

On the contrary, if purification is carried out both on dividend and capital gains, all the unit-holders will be treated at par with the regard to the deduction of the amounts of purification. Therefore, it is not only free from doubts but also more equitable for all the unit-holders to carry out purification in the capital gains. This purification may be carried out on the basis of an average percentage of the interest earned by the companies included in the portfolio.

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as mudaribs for the subscriber. 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, but the share of the management will increase with the increase of profits.

The second option of 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 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 on what basis 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 on all the subscribers.

Ijarah Fund

Another type of Islamic Fund may be an ijarah fund. Ijarah means leasing. 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 rated to the subscribers. Each subscriber is given a certificate to evidence his subscription and to ensure his entitlement to the pro rated share in the income. These certificates may be preferably called "sukuk" -- a term recognized in the traditional Islamic jurisprudence. Since these sukuk represent the pro rated 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 rated 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 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 the conventional financial leases. The points of reference are explained in detail in my book

"Islamic Finance." 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 his 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 affected 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 the resale. The profits generated by the sale are the income of the fund which is distributed pro rated among the subscribers. In order to make this fund acceptable to Shariah, it is necessary that all the rules governing the transactions and fully complied with. For example:

1. The commodity must be owned by the seller at the time of sale, therefore, short sales where 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 my book "Islamic Finance" may be consulted).

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 or 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, 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 fund can also be traded in with the condition that the portfolio owns some commodities at all times.

Murabahah Fund

"Murabahah" is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. 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 can not be negotiable in a secondary market. The reason is that in the in the case Murabahah, 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 Murabahah does not own any tangible assets, rather it comprises of either cash 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 bill of exchange, it is termed in Shariah as Bai'-al-dain. The traditional Muslim jurists (fuqaha') are unanimous on the point that Bai'-al-dain 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 Shaf'ite school wherein it is held that the sale of debt is allowed, but they do not pay attention to the facts that the Shaf'ite jurists have allowed it only in a case where a debt is sold on 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 from 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 a sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as a sale of the commodity. The arguments, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer commodity of the seller. What the seller owns is nothing other than money, therefore if he sells the debt, it is no more than a sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity. That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic Fiqh Academy of Jeddah which is the largest representative body of the Shariah scholars and is represented by all the Muslim countries, including Malaysia, has approved the prohibition of Bai'-al-dain unanimously without a single decent.

Mixed Fund

Another type of Islamic Fund maybe 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 in according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.

Taken from: http://www.albalagh.net/Islamic_economics/finance.shtml