

Some Issues In *Shari'ah* Compliance & Regulation of Islamic Funds

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The number of players in the Islamic funds industry has already crossed three-digit mark with a variety of funds appearing on the scene, such as, equity funds, lease or *ijara* funds, real estate funds, commodity funds and the like. Of these, equity funds seem to have caught the fancy of the Muslim investor. This presentation mostly focuses on the criteria for *Shariah* acceptability of assets for inclusion in such equity funds.

Criteria for screening of stocks to be included in the universe could be positive or negative. Positive criteria imply that a company may be given greater weight in portfolio construction for factors, such as, a good record for quality products, safety, staff management and customer relations; involvement in environment improvement, pollution control, sustainable woodland management and energy conservation and the like. Negative criteria means the exclusion of companies from the universe based on certain criteria. Islamic funds have generally used negative criteria and excluded producers of alcohol and pork-related products, providers of conventional financial services (banking, insurance, etc.) and providers of entertainment services (hotels, casinos /gambling, cinema, pornography, music, etc.). Tobacco manufacturers and defense and weapons companies although not strictly forbidden for investment under Islamic Law, are excluded as well. Apart from the main line of activity that must not be forbidden in the eyes of *Shariah*, Islamic funds have also been using a financial screen to exclude a company that rely on excessive interest-based debt and derive a significant portion of their income from interest. However, the nature of such screens have also undergone changes over time and the criteria used in such screens are often not free from controversy.

Let us take the example of the DOW-JONES Islamic Market Index screen. The screen in its current form appears as follows:

Exclude companies that have unacceptable lines of business;

Exclude companies if;

Total Debt divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).

The sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%.

Accounts Receivables divided by Total Assets is greater than or equal to 45%. (Note: Accounts Receivables = Current Receivables + Long-Term Receivables).

Major changes that have taken place in the screen over recent past. One of the financial criteria initially was:

“Exclude a company if interest income is more than 9% of their operating income”;

This was subsequently changed to:

“Exclude a company if non-operating interest income / revenue = or > 5%”

Apparently, this was called for considering the anomaly that if a company has non-operating interest income but the net income is negative, it is excluded. However, a company with negative net income while there is no non-operating interest income may still be included.

This criterion was again replaced subsequently with:

“Exclude a company if the sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%.”

This naturally implies that the DJIM screen or the DJIM criteria or other similar ones are a subject matter of continuous change in the light of new insights and that these should not be taken as “divine” rules of *Shariah* compliance. To cite an example, the one-third rule used in the screen seems to be based on the hadith:

The Prophet PBUH advised Abu Bakr RAA not to donate more than One-Third of his wealth, and commented that "One Third is too much (*Al Thuluth Katheer*)".

Is it an out-of-context use of the hadith? Or does it involve an out-of-context use of the following *fiqhi* rule?

“Whether a commodity that is part gold and part brass qualifies as gold for purposes of applying the rules of *riba* is resolved by the percentage of gold in the commodity, *i.e.*, if greater than a third, it is "gold."

Arguably, the one-third rule could be applied to other ratios as well. There is indeed arbitrariness over applying the one-third rule (even if it is a correct application) to a specific ratio.

It may also be argued that replacement value of assets, and not market capitalization may be a better denominator to determine the nature of a mix.

Another point that needs to be emphasized is that practical implications of the DJIM ratios may not be very ideal for Muslim investors. A blind application of the rule would provide the following trading strategy:

Buy High as Share Prices Rise
Sell Low as Share Prices Fall

This obviously would not be very healthy. Rules must therefore, be different for good times and bad times.

Some *Shariah* scholars would like to offer these as “interim” solutions. We would like to add a qualifier to these. The “interim” solutions must not be “arbitrary” solutions involving a great degree of “subjectivity.” For example, consider the subjectivity involved in the screen prescribed by the Malaysian Securities Commission Shariah Council. The screen requires inclusion when;

public perception or the image of the company must be good; and the core activities of the company have importance and *maslahah* to the Muslim *Ummah* and the country, and the *haram* element is very small and involves matters such as *uruf* and the rights of the non-Muslim community which are accepted by Islam.

Last, but not the least, is the issue of purification. *Shariah* scholars associated with many of the funds suggest that it is impossible to identify a stock where the company has zero leverage or (pays or receives) zero interest. Therefore, they suggest that a fund can invest in companies with less than one-third leverage-related ratios and purify its income by donating the interest income received to a charity. An issue related to this suggestion is that such donations to charity do not fall in the category of *zakah* or *sadaqa*. Therefore, is it a “convenient” solution to a major *fiqhi* problem? Needless to say, there must be no interest income “by intention.”