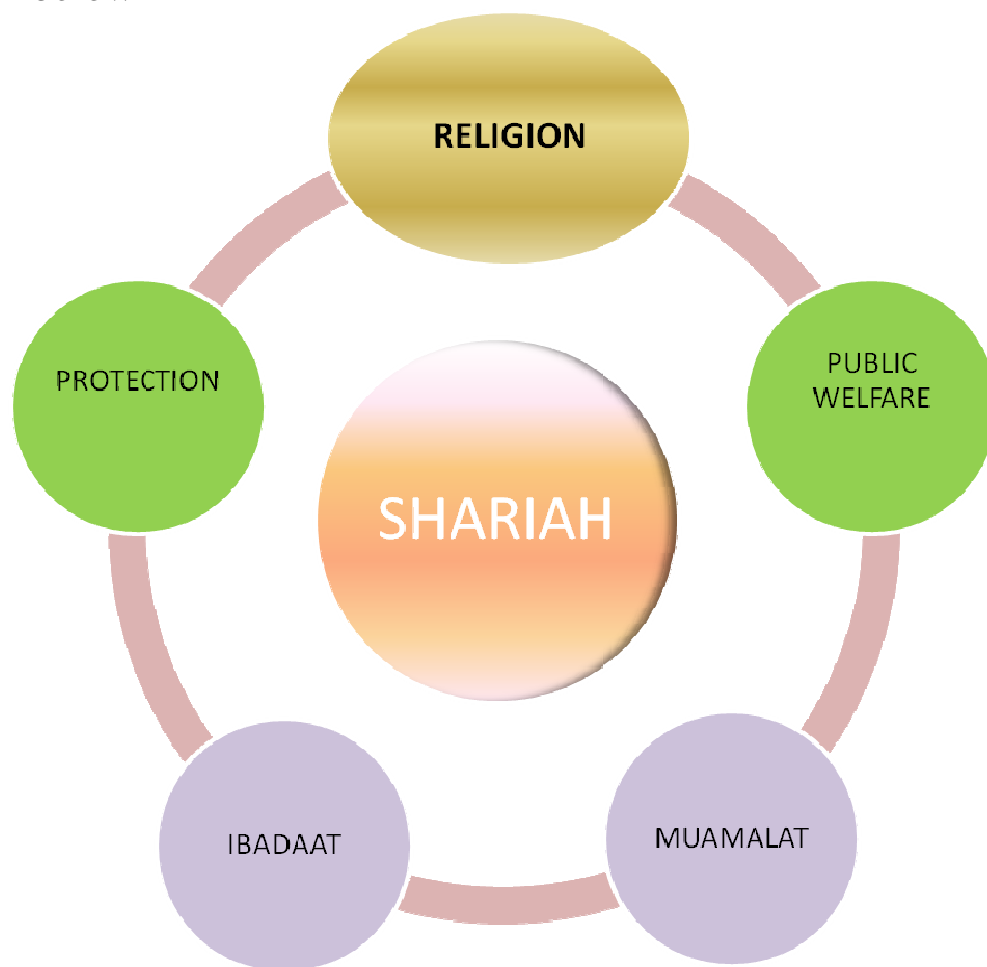


1. What is *Shariah* ?

A brief Overview:

SHARIAH:

Sharia' a is the divine Law as revealed in the Quran (Book of Allah) and Sunnah (words or acts) of his prophet Muhammad (SAW) Without wishing to demean the importance of Sharia' a to devout Muslims, in commerce, Sharia' a is often viewed as an important choice of business style and indicates a desire to comply with ethical principles that are deeply meaningful to investors and financial consumers such that they have no desire to pursue an alternative. This can be illustrated by the diagram below



The Sharia' governing the practical aspects of a Muslim's daily life is divided into two bodies of rules:

- **Ibadaat**
- **Muamalat**

Ibadah is concerned with the obligatory worship of God. The law for *Ibadaat* is that "everything except what is prescribed is considered prohibited."

Muamalaat relates to daily life outside of the context of obligatory worship. The law for *Muamalaat* is that "everything is permissible except what is prohibited". Part of Muamalat determines the conduct of commerce, including banking and finance.

Shariah basically means path towards the source. Islamic shariah actually means path of Islamic law. Islamic laws are derived from two sources:

- 1) **Primary sources** which is from Quran and Sunnah.
- 2) **Secondary Sources** which is through Ijma, Qiyas, and Ijtihad.

Holy Quran: The Quran is the primary source for discerning the laws of God. It is a concise book which mostly talks about principles and parameters.

Sunnah: The word Sunnah literally means "well known path". In its technical sense it means "what was transmitted from the prophet of his words, acts, and approvals". This is because often people used to ask the Prophet about certain aspects which they could not find in or understand from the Quran.

Ijma: It literally means agreement on a matter. It is a consensus of the religious scholars.

Qiyas: It literally means deductive reasoning. It is defined as the assignment of the legal rule of an existing case found in the texts of the Quran and Sunnah to a new case whose legal rule is not found in these

sources on the basis of a common underlying attribute called the illah of the legal rule.

Ijtihad: It is independent scholarly opinion. Some scholars focused on certain aspects and applied certain principles whereas others did it differently. This is how different Islamic schools of jurisprudence emerged.

OBJECTIVES OF SHARIAH

- Securing Benefits (*manfa'a*)
- Protecting from Haram (*madarra*)

FUNDAMENTAL PRINCIPLES OF SHARIAH:

- **Justice:** Neither party to a contract may exploit the other.
- **Transparency:** Those concerned must share all available information bearing on the transaction could render the contract invalid.
- **Maslaha:** Common interest will take precedence over individual or particular interest. On the basis of maslaha a particular form of transaction may be exempted from a general rule because it has been showing in common practice to facilitate business.

2. What is different in Shariah Finance???

FUNDAMENTALS OF SHARIAH FINANCE:

Prohibitions:

- 1) Riba
- 2) Gharar
- 3) Maysir
- 4) Prohibited sectors
- 5) Conditionality

Promotions:

- 1) Encouragement of profit and loss sharing.
- 2) Public need or necessity.

PROHIBITIONS EXPLAINED:

Riba: “The Kind of loan where a specified repayment period and an amount in excess of capital is predetermined.” In Islam it is religiously, socially and economically unjust practices. Riba is of two types:-

Riba al Naseeyah: - Riba al Naseeyah is defined as excess, resulting from predetermined interest which a lender receives over and above the principal amount it has lent out.

Riba al-Fadl: - Riba al fadl is defined as excess compensation without any consideration (e.g., monies passing between the parties) resulting from an exchange or sale of goods.

Gharar: It literally means to deceive, cheat, delude, lure, entice. The sale of probable items whose existence or characteristics are not certain due to the risky nature that makes it similar to gambling. The gharar that invalidates a sale is that which pertains to the existence of the object of sale, which may or may not exist. As for gharar pertaining to the attributes of the object of sale it corrupts the sale.

Maysir: It is gambling, bets and wager where whatever one profits, is at the cost of others.

Prohibited sectors:

Pork

Pornography

Financial services (conventional)

Arms or ammunitions

Cinema

Tobacco

Gambling

Alcoholic Liquor

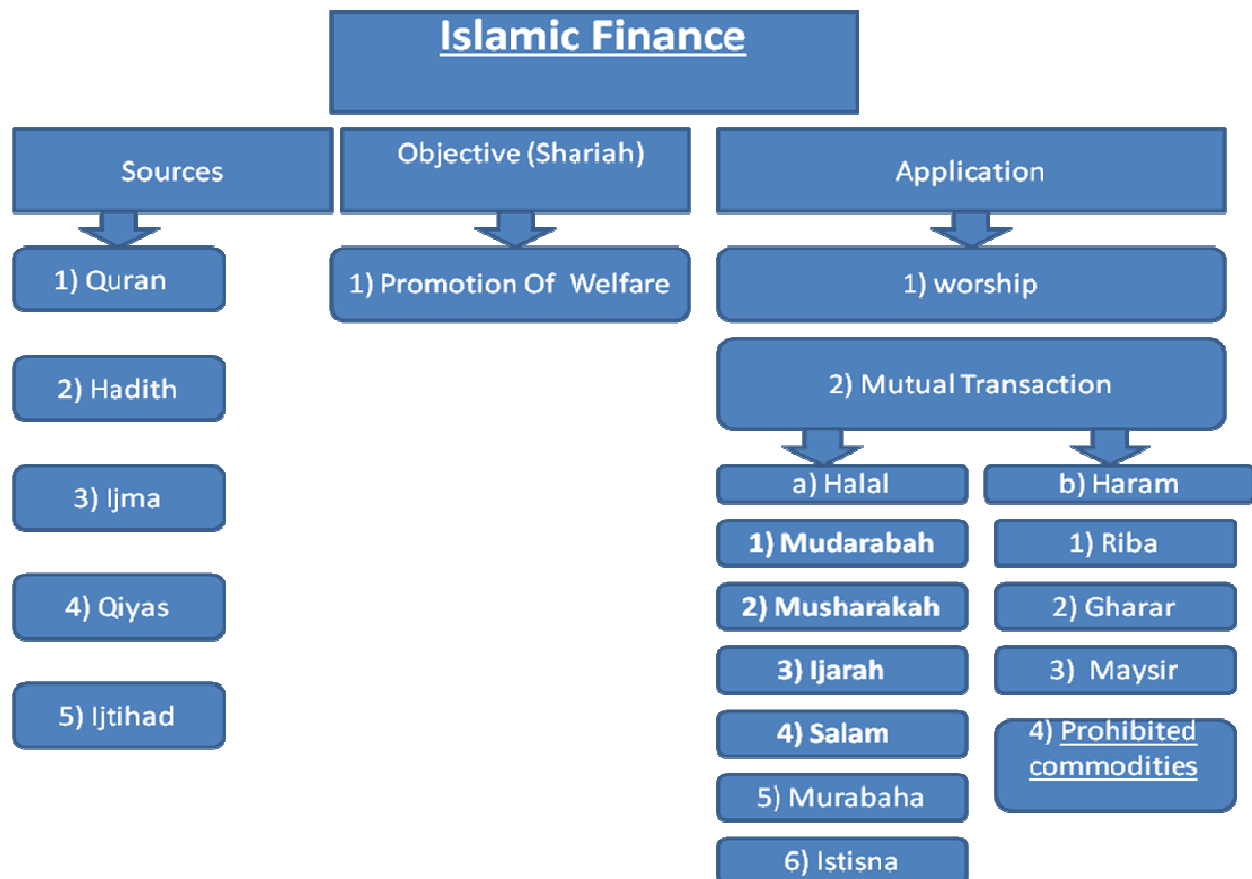
3. Islamic Finance

INTRODUCTION

Islamic finance has assumed an increasing significance both in the Islamic world and in the Western world since the mid-1970s. There has been vast increase in national as well as personal wealth.

In the Middle East over the past 20 year has coincided with a renaissance in the influence of Islamic beliefs in various parts of the world. This has created a strong demand for system of finance which enables Muslims to make use of their wealth in a manner which is consistent with their beliefs.

A diagrammatic representation of Islamic Finance:



SOURCES OF SHARIAH IN ISLAMIC FINANCE

- 1) Quran**
- 2) Hadith**
- 3) Ijma**
- 4) Qiyas**
- 5) Ijtihad**

Quran:-

The Quran is the primary source for discerning the laws of God. It is binding on jurists to have the first recourse to the Quran in their attempts to find answers. The evidence found in other sources is subject to the Quran.

Hadith: - (WORDS OR ACTS OF THE PROPHET)

Hadith is the collection of the Prophet Muhammad's statements and actions coupled with the statements and actions of his companions. It is the basis of jurisprudence for Islamic law, or *Shariah* law.

Sunnah:-

The word Sunnah literally means 'well-known path'. In its technical sense it means "What was transmitted from the prophet (Messenger of ALLAH) of his words, acts, (tacit) approvals."

Ijma: - (CONSENSUS)

Literally *ijma* means 'agreement on a matter', in its technical sense it means "the consensus of mujtahids (independent jurists) from the Ummah of the prophet Muhammad (SAW), after his death, in a determined period upon a rule of Islamic law."

Qiyas: - (ANALOGY)

The word *Qiyas* literally means measuring or estimating one thing in terms of another. In technical sense it has been defined as "the assignment of the legal rule of an existing case found in the texts of the Quran, the Sunnah, or *ijma* to new case whose legal rule is not found in

these sources on the basis of a common underlying attribute called the illah (underlying rationale) of the legal rule.”

Ijtihad: - (INTERPRETATION)

There are a number of meanings of Ijtihad. For instance, Islamic Scholars take into account the customs of place that address a problem, but are not offensive to the shariah. In some cases, Islamic scholars develop their own personal preference from a solution to an apparently unique problem. Often scholars examine the question of public welfare. Ijtihad is fundamentally a personal exercise until other scholars are able to agree with the solution proposed by the innovator.

OBJECTIVE (SHARIAH):-

A. Promotion of Welfare:-

The core objective behind Shariah is the promotion of welfare. As Islam is not a religion but the way how to live life peacefully. As Shariah is an important part of Islam and it guides muamalat and ibadaat of an individual to promote welfare and peace in the society.

APPLICATION

A. Worship:

B. Mutual Transaction:

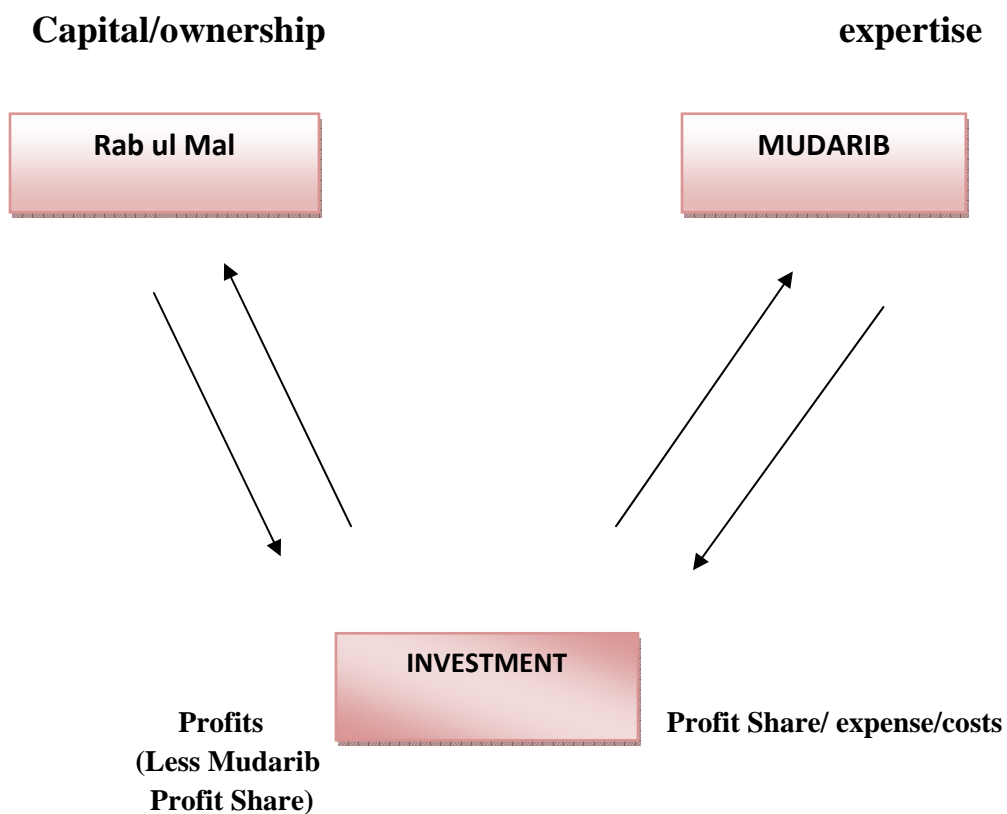
1) Halaal

a) MUDARABAH:-

Mudarabah is the type of partnership where one partner act as Rab ul Mal and invests his capital (financing partner) and other partner called Mudarib (manager) contributes his knowledge and

entrepreneurial skills to the project. The Rab ul Mal is not involved in the actual management of the partnership.

The profit from the project is shared according to predetermined ratio. In case of loss, Rab ul Mal loses his capital whereas Mudarib losses his opportunity cost. If the loss occurred due to negligence of Mudarib, he will also have to bear loss. The Mudarib cannot draw money for his personal expenses; he can only share in profit.



b) MUSHARAKAH:- (Joint venture or partnership financing)

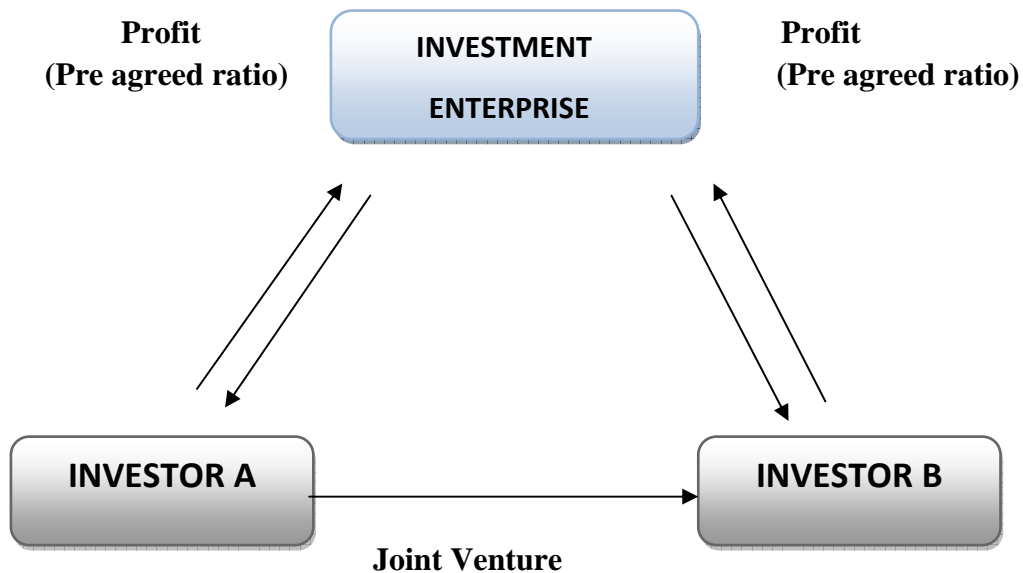
Musharakah is the kind of partnership between two or more parties (called Musharik), where each party have to contribute capital in cash or in form of fixed assets. Each partner has right in the management of the business; they may take active participation in the management of the business. The partner who took part in management is called working partner, and who is not involved in management is called sleeping partner.

Profit is shared according to predetermined ratio, but sleeping partner won't get more than his ratio of share in the capital. Losses are borne by each partner according to each party's equity participation.

There are two basic types of Musharakah:

Shirkah al milk: partnership based on joint ownership. This may be voluntary, e.g. in the purchase of a ship, or involuntary, e.g. as a result of inheritance.

Shirkah al uqud: partnership based on a contractual relationship.



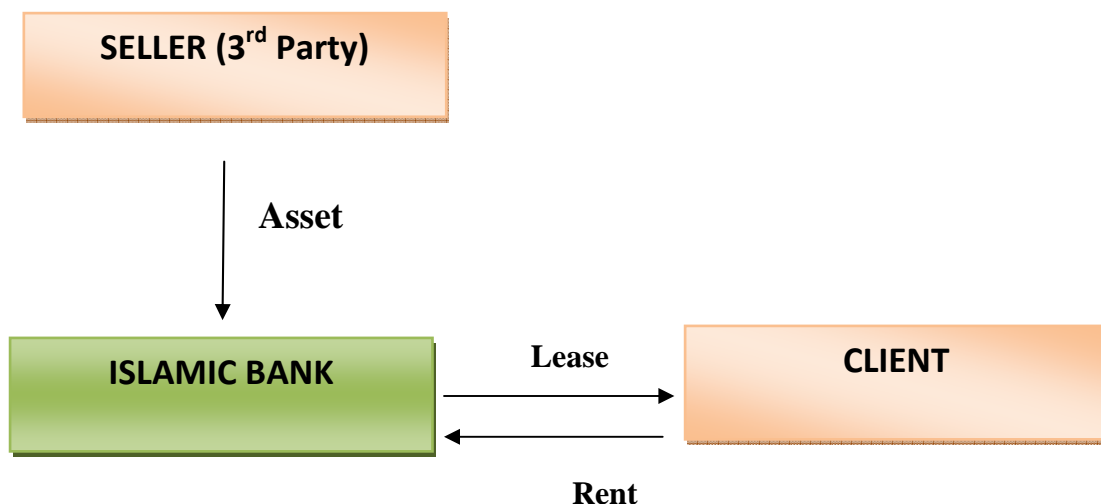
c) IJARAH:-

Ijarah is a kind of lease. In this transaction the lessor would purchase the asset and lease it to the lessee, for an agreed period of time and for an agreed fee set in advance. During this period the ownership of the underlying asset remains with the lessor and only its usufruct is transferred to the lessee. During this period the lessee will pay rentals to the lessor determined mutually between the parties. During the life of the asset the risk of ownership remains with the lessor, while the lessee is responsible for use of the asset. It is the responsibility of the lessor to maintain and repair the assets.

Lease may be of two types:

Operating lease: the title of the ownership is not transferred to the lessee at the end of lease period.

Financial lease: the title of the ownership is transferred to the lessee at the end of lease period.



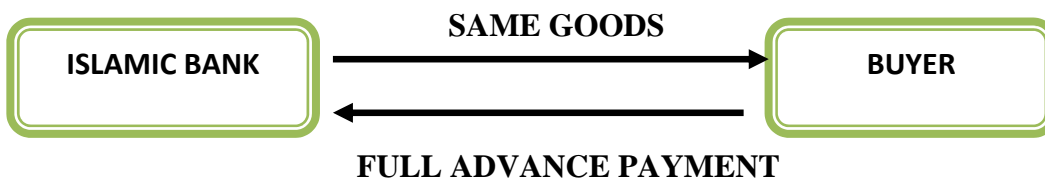
d) SALAM:-

Salam may be defined simply as a contract executed with spot payment in full for the purchase of assets which have commodity-like characteristics and must be fungible like base metals, e.g., copper and zinc, and grain promised for future delivery in a Salam transaction, the goods purchased must be commodities freely available in the market. The goods which are the object of a Salam sale must be of specified quality and quantity without ambiguity. Although one might envisage that the goodwill is a specific commodity from a specific farm or producer; the Salam contract specifies the quality, the date and place of delivery.

SALAM SALE 1

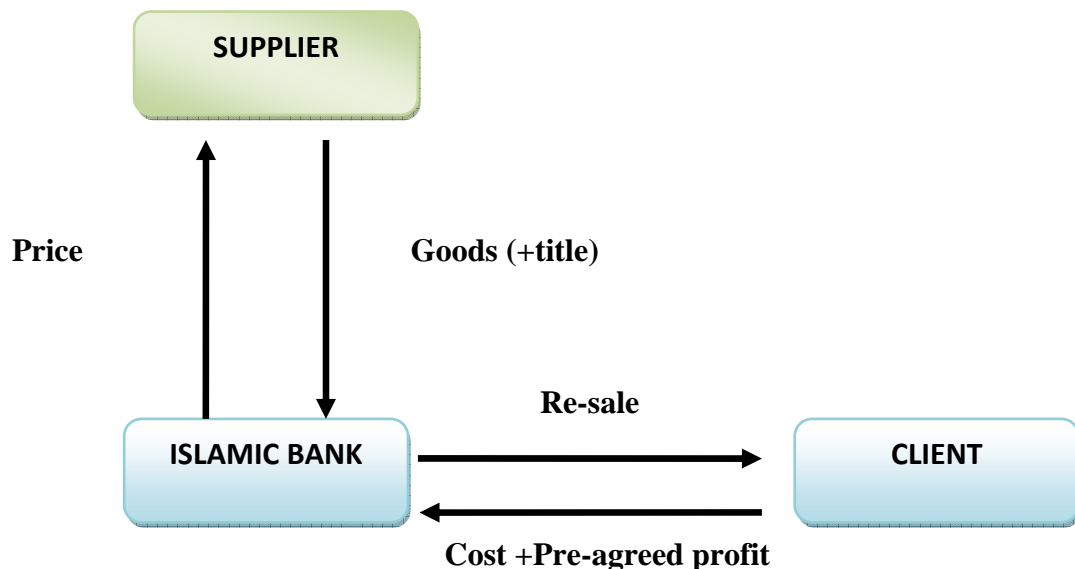


SALAM SALE 2



e) MURABAHA:- (mark up or cost plus financing)

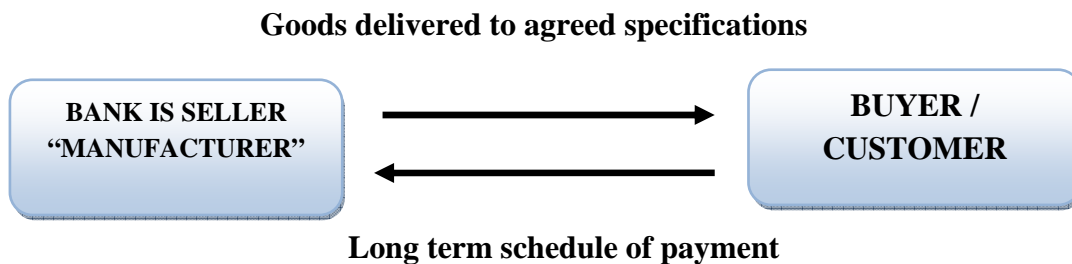
The Murabaha contract is very popular form, Islamic short-to-intermediate- term debt contract. A Murabaha financing transaction can be defined, most simply, as a cost-plus-profit financing. Murabaha transaction can be structured in a vendor for the price at which the core of each transaction involves the sale of tangible property by a vendor for the price at which the property was purchased by the vendor, plus a profit element agreed upon by the vendor and the purchaser at the time when the contract is entered into. Payment by the purchaser can be immediate, but the parties often agree that payment will be made in installments over a period of time. In a Murabaha transaction the Islamic financial institution does not share in the profit and losses of its customer, the purchaser. Instead the Islamic financial institution's compensation is the fixed and agreed profit and agreed profit element of the price paid by the purchaser.



f) ISTISNA:-

Istisna is a contract for the acquisition of manufactured goods by specification or order, where the price is paid gradually in accordance with the progress of the job. The specification in an istisna sale have to be very clear as to type, size, materials used, delivery date and place.

An istisna is the second kind of sale (bai' salam being another) where a commodity is transacted before it comes into existence. An example would be a contract made with the manufacture where by the manufacturer agrees to make something for a purchaser; the staged payments are made to the developer or builder according to the stage of work completed. The contract of istisna creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving a notice to the other. However after the manufacturer has started the work, the contract cannot be cancelled unilaterally.



BACK TO BACK ISTISNA



2) HARAM

a) **INTEREST (RIBA):-**

Interest is generally understood to mean any return for the use of money. The basic principle is that within Islamic banking, it is not permissible to charge for the mere use of money. Whereas conventional financial institutions "trade" in money (buying money from depositors and selling money in the form of loans), Islamic financial institutions must "trade" in real assets or services.

b) **UNCERTAINTY (GHARAR):-**

Any contract based on the occurrence or the non occurrence of a future uncertain event, within Islamic banking, is not generally allowable, e.g. hedging, dealing in derivatives, etc.

c) **SPECULATION OR GAMBLING (MAYSIR):-**

Any transaction undertaken for purely speculative purposes are not allowable within Islamic banking. Allowable trading or investment transactions which involve the risk of incurring losses as well as earning profits are not included in this definition of speculation.

d) **PROHIBITED ACTIVITIES/ COMMODITIES:-**

Sharia'a (Islamic law) prohibits using or dealing in certain commodities or activities. Islamic financing will therefore be inappropriate in financing any enterprise involved in any of the following types of activities/commodities:

- Pork
- Pornography
- Financial services (conventional)
- Arms or munitions

- Cinema
- Tobacco
- Gambling
- Alcoholic liquor

4. Role of Shariah in Financial Services

Introduction:

The idea of organizing business and finance according to Shariah requires that business institutions and their clients modeled their entire business transaction on shariah lines. Muslim scholars are engaged in a serious and deep process of *ijtihad* in order to assist Muslims in general, financial players, lawyers and business people in particular to develop interest free solutions to financial problems.

With the emergence of Accounting & Auditing Organization for Islamic Financial Institutions (“AAOIFI”) and the Islamic Financial Services Board (“IFSB”) the shariah process relating to method and problem solving has become more scientific and transparent. Unlike in the past there is now broad consensus, across regions and madhahib relating to key concepts and structures. As a matter of fact Islamic scholars are now hybridizing solutions based upon prior rulings in all relevant schools of thought. This trend requires scholars to return to original, core Shariah sources in order to achieve cutting edge solutions for modern business challenges. This more open Ijtihad means that scholars are going beyond their traditional madhahib.

Constitution of Shariah Board:

Shariah board is composed of respected Islamic scholars who are appointed as independent advisors to an institution wishing to seek their advice. The nature of their appointment is similar both to the engagement of an independent auditor and legal counsel. This dualistic character reflects both the absolute independence of the scholars from their client, and the juristic style of their advice and opinion.

The Shariah board is constituted to assist the client to primarily comply with Shariah and not to affirm the actions of management. Therefore, the board will involve itself in product development at the client's request, and then perform periodic audits to assure ongoing Shariah compliance. As a result, the role of the board means that the company cannot direct the scholars to a desired result. Instead, the company must adapt, adjust, or terminate projects and products according to the opinions and advice offered by the scholars.

A well managed Shariah board has a constitution or set of by-laws which define the board's relationship with its client, the costs, and process to issue or renew fatwa. A number of organizations have no internal shariah board, but they must be governed by Shariah. They mostly consult a third party body to provide Shariah advisory.

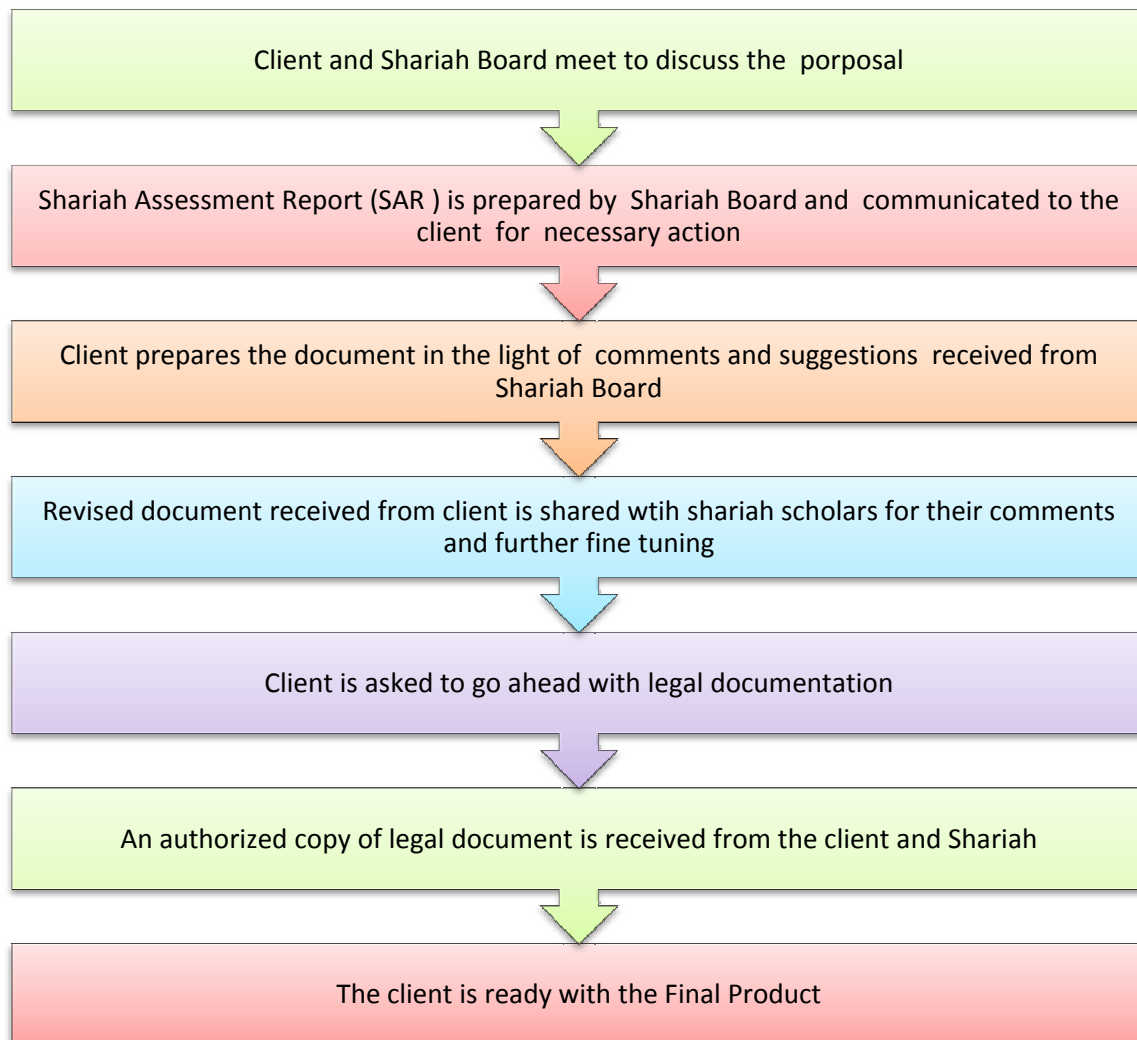
The most important pillars embedded in Shariah advisory are:

- ***Independence;***
- ***Shariah Audit;***

The first is the independence of the scholars and the fatwa process. One engages the scholars for their advice, whether one is pleased with the advice or not. There is never an obligation to provide a specific fatwa or any fatwa at all. The second is that the business processes and products of the client are subject to two levels of audit. The first is Shariah compliance; the second is good moral standing.

5. SHARIAH APPROVAL PROCESS

A flowchart representing Shariah Approval Process:



The Shariah approval process is typically an iterative process. For the process to work correctly, the business people have to correctly describe their objectives, the business idea and process, and the regulatory and legal issues.

If the process or fund represents a widely accepted practice, then the Shariah review process may be rather quick and result in a simple affirmative fatwa. But, should the process or fund require unique

innovations, or less well understood adaptations of Islamic concepts, then the Shariah process may take longer times. The more complicated or innovative the proposal, the more iterative the process; and, ultimately, the more detailed the fatwa.

Actually, the fatwa is the beginning, not the end. A successful Shariah compliance program means that the business and processes are submitted to periodic Shariah audit. The best shariah audit process entails a regular shariah audits which may be carried out by a Shariah specialist representing the Shariah board. Following the audit, the Shariah auditor will submit a report to the board indicating errors, problems, issues or compliance. The board and the auditor, jointly or the board alone, will advise the client, inform the client of corrective actions that may be required, or certification of compliance.

In some cases the Shariah review process is undertaken by national shariah standard boards like that in Pakistan and Malaysia. In most other cases Shariah scholars take the help of shariah guidance and standards prepared by international Shariah standard bodies such as AAOIFI and IFSB.

Regarding Shariah Board AAOIFI has this to say:

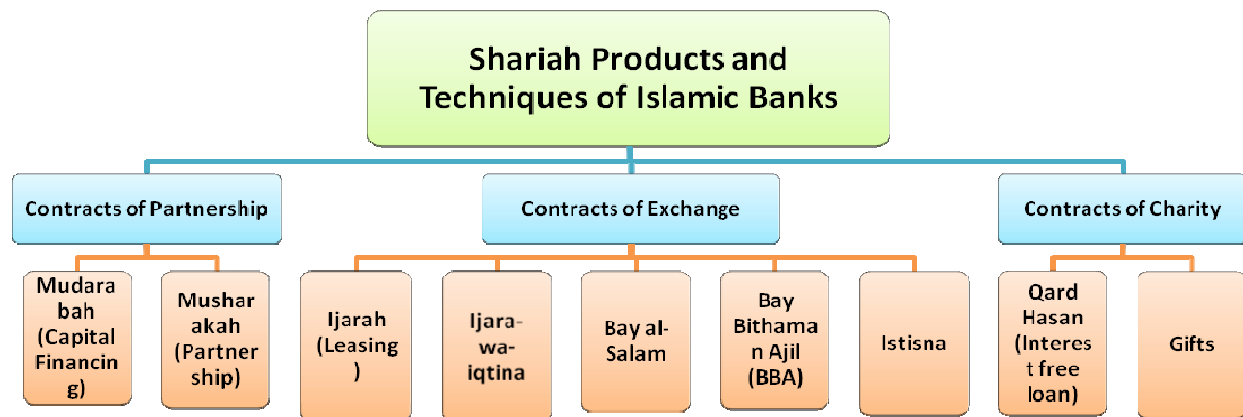
“A Sharia’a supervisory board is an independent body of specialized jurists in fiqh al mu’amalat (Islamic commercial jurisprudence). However the Sharia’a supervisory board may include a member other than those specialized in fiqh al mu’amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh al-mu’amalat. The Sharia’a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution to ensure that they are in compliance with Islamic Shariah rules and principles. The fatwas and rulings of the Board shall be binding on the Islamic financial institutions.”

What is a Fatwa?

A fatwa (fatawa, plural) is a certification of Shariah validity or ongoing Shariah compliance. By definition, a fatwa is issued by an Islamic scholar who is typically called a mufti. The fatwa is a certificate representing a formal opinion of Shariah compliance or non-compliance, permissibility or non-permissibility. The majority of fatawa relating to Islamic finance advise the readers that the signatories to the fatwa have formally examined the product, business, service or process and made a specific finding or opinion relating to the Shariah compliance of the subject matter.

6. THE INSTRUMENTS OF SHARIAH FINANCE

A flowchart representing basic shariah products



Keeping in view the Shariah considerations, Islamic banks around the world have devised many financial techniques that are basically derived from Islamic contract of partnerships, exchange, and the loans (Charity). For day-to-day banking activities, Islamic banks resort to these financial instruments that have been devised to satisfy the Islamic doctrine and provide acceptable financial returns to the investors. These are basic techniques, however, a certain degree of variance in their practices may be observed from county to country and region-to-region. Sometimes the same techniques are called, pronounced or spelt differently in different regions as they all are derived from the Arabic sources. Following section gives a brief account of the Islamic financial techniques adopted by the Islamic banks worldwide. These can be grouped under three broad categories.

A. CONTRACTS OF PARTNERSHIP

Mudarabah (Capital Financing):

Also known as trust financing, this is an agreement between two parties one provides the capital and the other known as 'Mudarib' uses his entrepreneurial capabilities and manages the fund and the project. The profit arising from the project is distributed according to a predetermined formula. Any losses accruing are borne by the provider of the capital. The provider of the capital has no control over the management of the project.

Under Islamic banking, the bank acts as a manager of customers' funds. The depositors on the other hand are known as 'Rab-ul-Mal', meaning the owner of the fund. The bank on its own risk invests deposits accepted on savings under the profit sharing and loss absorbing agreement. Customers give authorization to the bank to invest funds and share profit or absorb loss on agreed proportions. Account holders of this type of account are required to maintain a minimum balance in the account.

Capital Trust financing is a contract between at least two parties in which the bank as the investor supplies the entire capital of the business forming a relationship between the supplier of capital and the user of capital. These two parties work together and share profits and bear the losses. A notable point of this agreement is attachment of the liability of loss to the financier only; the working party i.e. the user of the capital bears no part of the loss accruing to the capital extended by the financier. His only loss will be his labor, which will get no reward.

Musharakah (Partnership):

This technique involves a partnership between two parties who both provide capital towards the financing of a project, both parties share profit on a pre agreed ratio, but losses are shared on the basis of equity

participation. Either both or any one of them may carry management of the project.

In this case the bank and the customer jointly contribute capital. They also contribute managerial expertise and other essential services at agreed proportions. Profits are shared according to the contract agreed upon while losses will be shared according to capital contribution. An individual partner does not become liable for the losses caused by others.

B. CONTRACTS OF EXCHANGE

Murabaha (Cost plus profit):

This is a contract sale between the bank and its client for the sale of goods at a price which includes a profit margin agreed by both the parties. As a financing technique it involves the purchase of goods by the bank as requested by its client. The goods are then resold to the client with a markup usually received in specified installments.

Ijarah (Leasing):

A contract under which, a bank buys and leases out for rental fee equipment required by its client. The duration and the rental fees of the lease are agreed in advance. Ownership of the equipment remains with the bank. This is similar to the conventional leasing. However, in the conventional leasing system the lessee pays specific rentals and a fixed rate of interest over a given period for the use of specific asset. But in the Islamic banking system of leasing the risk related to leasing has to be shared between the bank and the lessee, in case of any damage to the leased assets.

Ijara-wa-iqtina:

Very similar to Ijarah except that there is commitment from the client to buy the equipment at a pre agreed price at the end of the lease. In this case rental also includes the costs of the equipment.

Bay al-Salam:

It is a contract for sale of goods where the price of the said item is paid in advance. In this system a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique is similar to a future or forward-purchase contract and is particularly applicable to seasonal agricultural purchases. Under Islamic banking this technique is generally used to buy the goods particularly raw materials in cases where seller needs working capital before he could deliver.

Bay Bithaman Ajil (BBA):

This contract refers to the sale of goods on deferred payment. In this system the Islamic bank buys the item requested by the client and sells it to the client on pre agreed installment including the cost of the equipment and the markup. This is very similar to Murabaha except the payment is made in installments some time after delivery of the underlying goods.

Istisna:

It is a contract of acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of a job completion. This is practiced for purchase of an item that is yet to be completed or produced, for example, a house to be constructed where payments are made to the developer or the builder according to the stage of work completed. Istisna differs from Ijarah; in this the manufacturer must procure his own raw materials. Otherwise the contract would amount to a hiring of the seller's wage labor as occurs under Ijarah. Istisna also differs from bay salam in a sense that (a) the subject matter of the contract is always a made-to-order item, (b) the delivery date need

not be fixed in advance, (c) full advance payment is not required and (d) the Istisna contract can be canceled but only before the seller commences manufacture of the agreed item(s).

C. CONTRACTS OF CHARITY

Qard Hasan (Interest free loan):

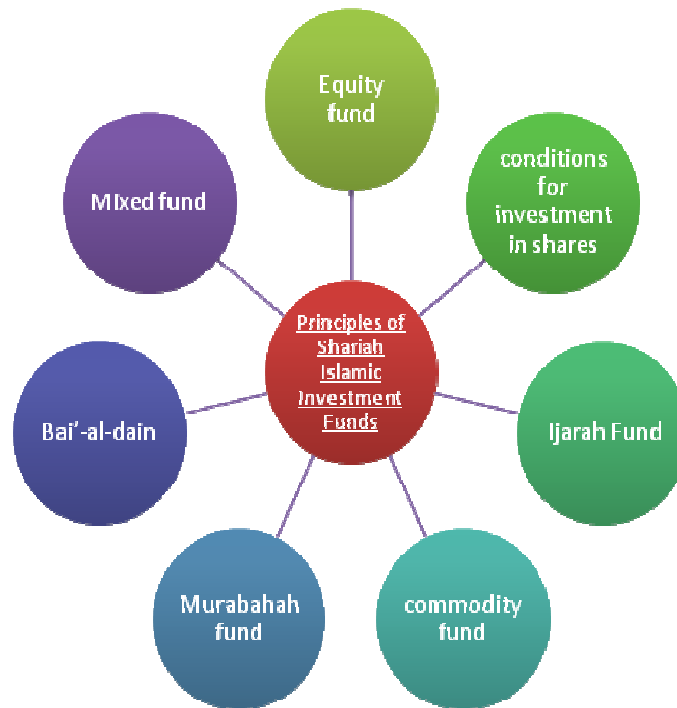
Qard Hasan means an interest-free loan, given by the Islamic bank to the needy people in a society. The practice of dealing with this sort of investment differs from bank to bank. Qard Hasan is normally given to needy students, small producers, farmers, entrepreneurs and economically weaker sections of the society, who are not in a position to obtain loan or any financial assistance from any other institutional sources. The main aim of this loan is to help needy people in a society in order to make them self-sufficient and to raise their income and standards of living.

This principle is also practiced in case of Islamic banks accepting deposits from public. Depositors of this account do not receive any return, however, if Islamic bank wishes it might grant some financial or non-financial benefits to its depositors.

Gifts (HIBAH):

Actually a form of voluntary charity encouraged under Islam. In Islamic banking this is used to oblige the depositors who have kept their money in Islamic bank without hoping any return. These cases are especially noticed in Malaysia and Iran where Islamic banks offer some gifts to the depositors to compensate for any losses they might have incurred by choosing to deposit in an Islamic bank. This is often commensurate with the conventional banks interest rate. In Malaysia, for example, 'Government Investment Certificates' (GIC' s), which do not carry any interest to the lender, is compensated by offering gift at the end of each loan period.

7. DIFFERENT TYPES OF ISLAMIC INVESTMENT FUNDS



1. Equity fund.
2. Conditions for investment in shares.
3. Ijarah fund.
4. Commodity fund.
5. Murabaha fund.
6. Bai'-al-dain
7. Mixed fund.

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.

Conditions for investment in shares:-

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 halaal, like automobiles, textile, etc. but they deposit there 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 is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given to 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.

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 halaal shares are observed, the most of the assets of the company are halaal, 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 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 halaal assets only.

Although this second view is not without force, 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 from there, 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.

2) 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. 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 halaal (permissible) use is possible.
3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.

3) 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 sale 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.
3. The commodities must be halaal therefore; it is not allowed to deal in wines, pork, or other prohibited materials.

In view of the above and similar other conditions, it may easily be understood that the transactions prevalent in the contemporary commodity markets, especially 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.

4) Murabaha fund:-

"Murabaha" 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, and 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 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, 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.

5) 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.

6) Mixed fund:-

Another type of Islamic Fund maybe of a nature where the subscription amounts is 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.

8. Investments in Stock Market:The Shariah Way

Shariah scholars associated with financial matters agree that if certain conditions are met, it is permissible to invest in the stock market. The logic behind this argument is that when one purchases shares in a company he actually becomes a shareholder or a partner in the business. Thus, this arrangement is akin to the Islamic concept of *musharakah* (partnership). However, there are certain conditions that must be satisfied before investment is considered permissible. To start with, the first and foremost issue is to ensure that the business of the corporation/company of which one is willing to buy the equity, is purely halaal or permissible from the Islamic point of view. Shariah scholars say, “Objective of the company should be shariah lawful”. Consequently one is not permitted to buy equity of businesses involving interest-based activities (banking, financial services, stock broking, insurance etc), non-halaal foods (pork, alcohol, and tobacco), vulgar, entertainment (porn videos, games, programs, promiscuity etc), gambling (all kinds of games of chance), and all kinds of illegal armaments. In India, sugar companies are also excluded because of their heavy focus on molasses which are used for production of potable alcohol. Similarly any other business activities that are by and large injurious to society are excluded from the permissible investment category.

Over and above, shariah scholars have developed certain financial parameters for stocks selection because even if the business is halaal, companies are invariably engaged in activities that are not permissible under shariah. For example companies borrow and lend on interest. Companies also engage themselves in a number of unethical and illegal practices like selling alcohol to clients in hotels or airlines. Companies raise financial resources through instruments which are not permissible from the shariah point of view. For example, financial instruments giving more capital protection and profit to one set of investors at the cost of others. Similarly there are a number of practices which are very

common but not permitted under shariah. The best examples of these in the stock market are short selling, margin trading, dealing in derivatives, etc. (more details on these will follow)

In a nutshell, it can be argued that investment in the capital market is permissible. However, a lot of care needs to be taken with regard to the business of the company in which the investment is desired and also about the level of shariah non-compliant activities of the company. Shariah scholars have designed tools to determine the level of involvement of companies in shariah impermissible activities such as *riba* (interest), *gharar* (excessive uncertainty, contractual ambiguity) and other prohibitions.

One should keep in mind that these criteria are the results of modern fiqh scholarship (*ijtihad*) and therefore, should be seen to represent the current state of thinking on the issue. In that way, they represent the maximum tolerance levels and not the final word on the subject. In short, if a Muslim investor is contemplating investment in the stock market, he must not only be careful about the profitability but also about the shariah compliances. These can be done by looking at the nature of business, percentage of income from impermissible sources apart from the financial soundness of the company. While there is near unanimity among shariah scholars that the main or core business of the company in which the investment is desired has to be fully shariah compliant. There are differences among shariah scholars when the company is occasionally involved in shariah repugnant activities. While one set of shariah scholars do not permit investment if the company is engaged in un-Islamic activities to any extent. There are others who allow it on various conditions such as:

- If only a minor portion of the company's income is *haram*;
- If the company is engaged in activities that are considered *maslaha* (public welfare) under shariah;

- If the company is engaged in un-Islamic practices because of either lack of shariah compliant options or pervasiveness of un-Islamic practices (which are considered very difficult to avoid)

Thanks to spread Islamic finance knowledge across the globe in the last few years. There are a number of institutions active in providing information on shariah compliance (more appropriately, tolerance) of a stock. In some countries it is the stock market index service providers like Dow Jones, S&P, FTSE, MSCI, etc who screen stocks based on the norms given by their shariah boards. In the Middle East most of the institutions follow AAI OFI norm, which is a composite body representing Islamic financial institutions across the world.

In India shariah norms and stocks screening are conducted by Taqwaa Advisory and Shariah Investment Solutions (TASIS). TASIS headquartered in Bombay is India's first professional shariah advisory, product structuring and certification agency. TASIS, which is a Shariah advisory board, is a member of prestigious AAOIFI and also consults Indian shariah scholars who are reputed in the area of business and finance apart from being qualified muftis. Some stock broking firms in the country also follow Dow Jones and S&P criteria for serving their shariah conscious clientele. Here a question may be posed. When the Shariah is one why are there so many norms for investment in the same kind of market?

The question is very genuine and warrants an elaboration. We have seen in the above paragraph that there are a number of institutions (mostly index service providers) engaged in these services. These institutions compete with each other in all areas of their businesses including the most recent: shariah screening. Despite the fact that most of these institutions have common shariah scholars on their boards, their norms differ somewhat, for various reasons including the copyright. If you look closely at their norms, you will find hardly any difference in them.

In the following section we mention shariah norms developed by TESIS. After about 7 years of research on Indian capital market TESIS has come up with shariah norms which is most conservative – in terms of compromise with shariah at the same time it gives investors sufficiently good stocks to choose from.

Islamic Investment Criteria:

A. Qualitative Screens:

There are two types of qualitative screens:

i. Industry screening: Is the company in a business that is prohibited or abhorred in Islam? Apart from investment in banking and finance, there are a number of business activities that are considered to be prohibited in Islam and thus investing in these kinds of businesses is not something a Muslim would like to undertake. Examples of these are alcoholic beverages, pork and pork products, tobacco products, gambling, lottery, pornography and adult oriented material, prostitution and drugs etc.

ii. Business practices: Following shariah principles are applicable to investing and trading practices applicable to individual investors as well as Islamic financial institutions:

a. Investment funds must be free of interest based debt:

The investor cannot borrow on interest to finance his investments, and therefore cannot trade on margin i.e., borrow to purchase shares. Conventional hedge funds, arbitrage funds, and leveraged buy-out (LBO) funds are prohibited for Islamic investors as they all borrow heavily in order to finance their investment practices.

b. Prohibition of speculation:

Unlike conventional investors Muslims cannot base their investment decisions on short-term speculation. They cannot enter the market as speculators but only as investors.

B. Quantitative Screens:

There are three types of quantitative screens:

i. Debt/Total Assets Ratio:

Has the company borrowed funds on interest? Ideally there should be no interest-based debt, but based on the Islamic legal principle of necessity and subsequent scholarly opinions, investment in a company is not permissible if the interest-based debt taken by the company is more than 20% of its total assets max of 33% of market cap of the company (generally 12 month average market cap).

ii. Interest-related Income:

Does the company generate any interest or interest-related income? This only includes those companies who do not make earning interest their primary business, but they have excess cash at certain points of time which they place in interest yielding assets. As in the previous case, ideally no income should come from interest-related sources. However, looking at the current situation shariah scholars have permitted to invest in stocks of companies whose income from interest varies up to 5% or 10% of the company's total income.

Whatever the percentage of income a company may earn from shariah point of view, it is important to filter that income by donating that percentage of income to a charity without any intention of "Sawab".

iii. Monetary Assets:

To invest in shariah compliant companies, one has to be very careful about the company's monetary assets. Account receivables and liquid assets such as bank accounts and marketable securities have to be below the limits fixed by shariah scholars for investment in them to be permissible. Some scholars have set this maximum at 90% whereas the majority of shariah scholars agree that "Account Receivables + Cash" should not be over 49% of company's total assets.

C. Trading Practices:

i. Day Trading:

Theoretically shariah does not require any minimum time limit for selling one's ownership. One can sell immediately on acquiring ownership. But when it comes to trading in stock market it is very clear that the day trader has no intention of becoming the owner of the stock, rather he aims to benefit from the short term fluctuations in the price of his stocks. Consequently many shariah scholars treat this form of investment as gambling or speculation, thus prohibiting the activity. Those who permit, argue that shariah does not stipulate any time limit on ownership and intentions whatsoever cannot be a basis for a legal ruling.

ii. Margin Trading:

In this case generally an investor/trader gets a limit fixed by his broker based on the deposit he has with his broker. Suppose an investor has kept Rs 1 lakh as a deposit with his broker and he has a 10% margin. In this case the investor can purchase and sell shares up to the value of Rs. 10 lakhs. Normally the intention is not to buy the stock but to profit from the fluctuations in its price. If the call is right then he makes the profit or else the losses are adjusted from his deposit with the broker. Here again shariah is not against buying with partial payment but the way margin trading activities are conducted in Stock Market, there are many things which make it Shariah impermissible such as borrowing stock at interest or borrowing stock for speculative purposes. In case of carry forward the

investor is charged the prevailing rate of interest. This is not permitted in shariah as interest is an inherent part of this kind of trade and also because this is a highly risky practice. One can lose more than what he has borrowed.

iii. Derivatives - Options and Futures:

Derivatives, more precisely are options and futures contracts. An option is purchasing the right to buy or sell a stock or a commodity at a future date for a fixed price (regardless of the prevailing price in the market). Exercising the option means buying or selling at the price set in the past. Not exercising the option results in the investor losing the option fee. Futures are standard contracts wherein one is buying or selling a stock at a future date. In futures contracts; the settlement date, quantity and prices are fixed in advance but final settlement takes place by squaring off the trade or by booking profit or loss. According to shariah both aspects, i.e. delivery and payment, cannot be postponed to a future date.

iv. Short Selling:

Short selling is selling the stock without prior ownership of it. This happens when a trader or investor or a speculator expects the price of a particular stock to go down. He starts selling as immediate delivery is not required to be made. At the time of delivery he buys the stocks and squares off the trade. If his expectations turn out to be correct then he makes money because he has sold higher and bought lower. If he goes wrong then he ends up paying the difference in price. In any case the intention was not to have the ownership of the stock but to profit from its price fluctuations. This transaction involves huge risk that almost has no upper limits. Moreover, from shariah point of view you cannot sell what you do not possess. In case you own the stocks then you can sale it for short term and buy it again, it is Shariah permissible.

9. SHARIAH ISSUES IN COMMODITY MARKET

In commodity market, 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 are fully complied with.

For example:-

1. The commodity must be owned by the seller at the time of sale, therefore, short sale where a person sells a commodity before he owns it are not allowed in shariah. But in commodity market there is no actual delivery of goods, infact only difference in price is square off to book profit or loss which is purely speculative in nature.
2. Forward sales are not allowed as it is a well recognized principle of Shariah, that purchase or sale cannot be affected for a future rate and future date. Future rate with future date is not permitted in shariah along with no guarantee of delivery of goods. Therefore, all forward and futures contracts are invalid in shariah.
3. The commodities must be halaal therefore; it is not allowed to deal in wines, pork, or other prohibited materials.

SPOT COMMODITIES: SHARIAH PERMISSIBLE COMMODITIES

Investors, who refrain from trading in commodities on stock exchanges due to Shariah (Islamic jurisprudence) restrictions, can now actively buy and sell precious commodities like gold and silver and other commodities in the spot market at real-time prices.

National Spot Exchange (NSEL) has introduced E-series products like E-Gold and E-Silver, etc. wherein retail investors can buy a minimum of 1 unit of gold equivalent to 1 gram of gold and 1 unit of silver equivalent to 100 grams of silver in demat form at real-time Indian prices, which tracks the international gold prices.

If a buyer wants to take delivery of E-Gold in physical form then he can do so in units of 8gm, 10 gm, 100 gm and 1 Kg and any combination thereof. Similarly, E-silver can be taken delivery of in units of 100 gm, 1 kg and 5 Kg, or any combination thereof.

The reasons that make the spot market attractive to investors is that the transactions are delivery-based; don't involve speculation as in Futures & Option market and unlike gold exchanged traded funds (ETFs), money is not parked in debt instruments.

There are lots of people who want to invest in gold and silver but stay away from speculative futures market. Spot exchange is an amazing platform for such investors, as it gives them full control over their assets. They also have convenience of demat account and other overheads are also taken care of.

Most transactions on commodities exchanges are forward contracts like futures & options which are against Shariah principles. Islam prohibits

investors from speculating and also from selling something that one doesn't own in the first place (read short selling).

E Series products has been designed and developed by NSEL keeping in mind the convenience of the client to buy and sell the commodities in a transparent manner at a single price across the nation which is accessible to all. For buying and selling E gold, the impact cost is nearly zero. It can be traded throughout the day from 10 am to 11.30 pm. There is no risk pertaining to impurity or weight difference. Hence, E Gold combines the benefits of holding physical gold, demat records and seamless entry-exit process.

NSEL is also working on non-perishable commodities like zinc, copper, nickel, etc. Within one year, NSEL plans to launch 15 commodities under E series.

Trading Practices:

Day Trading:

Theoretically shariah does not require any minimum time limit for buying or selling one's ownership. One can sell immediately on acquiring ownership.

In shariah it is permissible to buy and sell commodities in the same day, provided in case of selling it is permissible to sell to the extent to which one owns but not more than the ownership of the commodity.

Margin Trading:

In this case generally an investor/trader gets a limit fixed by his broker based on the deposit he has with his broker. Suppose an investor has kept Rs 1 lakh as a deposit with his broker and he has a 10% margin. In this case the investor can purchase up to the value of Rs. 10 lakhs.

Normally the intention is not to buy the commodity but to profit from the fluctuations in its price. If the call is right then he makes the profit or else the losses are adjusted from his deposit with the broker. Here again shariah is not against buying with partial payment so margin trading is permissible but the way margin trading activities are conducted in commodity market, there are many things which make it Shariah impermissible such as borrowing commodity at interest or borrowing commodity for speculative purposes. In case of carry forward the investor is charged the prevailing rate of interest. This is not permitted in shariah as interest is an inherent part of this kind of trade and also because this is a highly risky practice. One can lose more than what he has borrowed.

Derivatives - Options and Futures:

Derivatives, more precisely are options and futures contracts. An option is purchasing the right to buy or sell a stock or a commodity at a future date for a fixed price (regardless of the then prevailing price in the market). Exercising the option means buying or selling at the price set in the past. Not exercising the option results in the investor losing the option fee. Futures are standard contracts wherein one is buying or selling a stock at a future date. In futures contracts; the settlement date, quantity and prices are fixed in advance but final settlement takes place by squaring off the trade or by booking profit or loss. According to shariah both aspects, i.e. delivery and payment, cannot be postponed to a future date.

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he buys the stocks and squares off the trade. If his expectations turn out to be correct then he makes money because he has sold higher and bought lower. If he goes wrong then he ends up paying the difference in price. In any case the intention was not to have the ownership of the stock but to profit from its price fluctuations. This transaction involves huge risk that almost has no upper limits. Moreover, from shariah point of view you cannot sell what you do not possess. In case you own the commodity then you can sell it for short term and buy it again, it is Shariah permissible to that extent to which one owns commodity.

In spot commodity exchange like National Spot Exchange Ltd. Short sell is not allowed, one cannot sell more than the ownership.