

6. Special sectors

6.1 INTRODUCTION

Apart from banks there are specialized financial institutions active in various fields of Islamic finance, in particular insurance, home finance and investment. Banks may also engage in these activities, and in so far as they do, the discussion in this chapter is relevant for them as well. Home finance may even be a major product line for them. This chapter discusses the restrictions sharia imposes on activities in the three areas and the ways financial institutions have found to cope with them.

6.2 INSURANCE

6.2.1 Arguments for Rejecting Conventional Insurance

The advocates of Islamic finance feel that there is a need for Islamic forms of insurance because in their eyes conventional insurance is tainted with *riba* and *gharar* and is therefore to be rejected. Maulana Maududi (1999, p. 288) argued that there are three basic objections to conventional insurance. First, premiums are to a large part invested in interest-bearing assets. Second, paying premiums in order to receive a sum of money in the event of death or a mishap must be seen as a sort of gamble and therefore *gharar* is involved. Modern scholars use similar arguments (El-Gamal 2002). Maududi's third argument concerns life policies. A sum paid at the death of a policy holder, so his argument goes, is a bequest that should be distributed among his legal heirs and not be paid only to the beneficiaries designated in the policy. Conventional life insurance was already declared unacceptable in 1903 by some prominent Islamic scholars in the Arab countries. This was followed in 1978 by a resolution of the Fiqh Council of the World Muslim League and in 1985 by one from the Fiqh Council of the Organization of the Islamic Conference declaring that conventional insurance as presently practised is *haram* (O.C. Fisher 2001).

Though many *fuqaha* reject conventional insurance, views among Muslim scholars differ, on insurance no less than on other subjects. Hardliners reject conventional insurance in no uncertain terms. Sheikh

Omar Bakri Muhammad, who served for a number of years as Principal lecturer at the London School of Sharia, called it 'just one of the filthy and rotten schemes of the Capitalist system' (Bakri Muhammad n.d.).¹ Others accept that if Islamic forms of insurance are not available Muslims may buy conventional insurance, following the principle of *darura*, or necessity. Many Muslim jurists accept the principle of *darura* in case insurance is enforced by law. A much more positive attitude, however, can also be found, even among highly respected Islamic scholars. The Syrian Islamic scholar Professor Mustafa Al-Zarqa (1904–99), for instance, argued that insurance companies gather together the risks of a large number of people and redistribute them in a manner that makes them bearable.² This is a form of lawful cooperation that is compatible with the general objectives of the sharia. Taking the theory of probability into consideration, a conventional insurance contract does not contain any unbearable amount of ambiguity or undue uncertainty. In this view all kinds of insurance, including life, health and property insurance, are permissible. The usual conditions have to be fulfilled, of course. The contract must not contain any *riba* element and the object of insurance must be permissible in the sharia. A casino, for instance, would not be a legitimate object to insure. Mr Al-Zarqa is not alone in his acceptance of conventional insurance (see for Europe, for instance, Fatwa Bank 2000). This does not mean that Muslims should feel free to buy policies from just any conventional insurance firm, if only because these firms usually have a large volume of interest-bearing financial instruments on their balance sheets. Among non-Islamic insurance companies, cooperative or mutual companies would be preferred (Fatwa Bank 2001).

It would appear that those who reject conventional insurance do not follow Frank H. Knight when he made a distinction between risk and uncertainty. In the case of insurable risks the probability distribution of damages and claims is known to a lesser or greater degree. The outcome for the policy holder, and even more so for the insurer, is thus much more predictable than in the case of Knightian uncertainty. Arguably, the concept of *gharar* could be restricted to the class of uncertainty. Scholars such as Mr Al-Zarqa seem to accept that risk can be seen as free from *gharar*.

Muslim scholars opposed to conventional insurance maintain that security or insurance itself cannot be the object of a sale, because that would amount to *gharar* (El-Gamal 2000, p. 7). Even those that do not share this view will be able to understand the point. Other religious arguments on whether some forms of insurance policies are admissible or not, may strike the non-Muslim as rather arcane at times, however. Billah, for instance, notes that some insurers (even Islamic firms) charge lower premiums for life insurance policies for women than for men, as women have a higher

life expectancy. He doubts whether such sex discrimination is justified by sharia principles, as the life expectancy of human beings is determined only by Allah 'regardless of the sex of the creature and, therefore, no creature should overrule the power of Allah' (Billah 2002). One is tempted to retort that Allah's plans may be unknown to man, but that actuarial differences between various groups as regards life expectancy are there for all to see (but of course, as with investment yields, results in the past do not provide any guarantee as to the future).

6.2.2 The Islamic Solution: *Takaful*

The salafi reformists (see Section 2.4) who reopened the debate on insurance had no clear idea how to shape Islamic forms of insurance. Maulana Maududi proposed that a body of experts should try and find out how insurance could be provided on an Islamic basis (Maududi 1999, p. 289) and Qureshi (1991, p. 214) advocated a nationalized form of insurance. In the course of time, Islamic solutions have been found. The Fiqh Councils of the World Muslim League and the Islamic Conference resolved in 1978 and 1985, respectively, that conventional insurance in its existing form is haram, but *takaful*, that is, cooperative or mutual insurance, was declared permissible (O.C. Fisher 2001). The word 'takaful' derives from the verb *kafala*, meaning to help or to take care of one's needs (Billah 2007, p. 403). It was not until the late 1970s that takaful was put into practice. The Islamic Insurance Company of Sudan, established in 1979, seems to have been the pioneer. In Europe, outside Britain, success has so far been elusive. A Luxembourg-based firm, Takafol S.A., owned by Dar Al-Maal Al-Islami Trust, started offering Islamic insurance in 1983 and also made feeble attempts to market their products in other countries, including the Netherlands. In 2003 they were taken over by a Bahrain-based company, Solidarity Company BSC, which signalled the end of their activities as an insurer. It is only in Malaysia and the Arab countries that takaful took off, and even there it has captured no more than a relatively small slice of the market, as far as can be inferred from the scant data (in Malaysia so far much below 20 per cent of the market). In 2006 takaful premium income totalled some \$170 million in Malaysia (Bjelanovic and Willis 2007). For 2001, premium income in Malaysia was \$143 million, so growth has hardly been breathtaking, and in the Arab world it amounted to \$340 million; the two took up 90 per cent of a global total of \$538 million.³

Islamic insurance, or takaful, differs from commercial insurance in that it is a cooperative form of insurance, though the actual business operations may be left to commercial firms, who act as managers, or agents, with the policy holders as their principals. It should be noted that the ideal

of mutuality is hardly ever realized in the real world and insurance firms seldom act as a pure agent, a *wakil*, that contents itself with a fee for its services. Instead of following this *wakala* model, insurance firms often act as a *mudarib*, sharing in the profits but not the losses of the principals, the policy holders. Of course, a sharia supervisory council must be in place before a company can start offering *takaful* products.

One might wonder whether *takaful* insurance does not imply *gharar* too, just like conventional insurance. After all, under *takaful* insurance the insured party may receive a large sum after having paid a low sum in the form of premiums, or receive nothing, though having paid large amounts of premium. Indeed, one commentator brands it as *riba al-fadl*, unequal exchange (Fatwa Bank 2001). However, *takaful* insurance is propagated as a form of mutual cooperation, solidarity and brotherhood in the face of unpredicted risk or catastrophes and insurance premiums are not seen as payments made to reduce insecurity, but as *tabarru*, voluntary contributions made for the good of brothers and sisters that suffer mishaps. *Takaful* is based on the principle of *ta'awun*, mutual assistance. Premiums thus can be seen as gifts and donations and there is no purchase and sale transaction (Fatwa Bank 2000). Payments of claims to the policy holders may also be tagged as *tabarru* (El-Gamal 2005b).

Under a family (life) *takaful* policy, contributions are partly put into an investment account and partly into a *waqf*, a charitable trust. The contribution put into the *waqf* is a donation, and can be used for assisting policy holders who need assistance. Property and casualty insurance have no need for an investment account, a *waqf* suffices. Profits, or surpluses, are returned to participants, the policy holders, but the operator or agent, the insurance firm, also receives a share if a *mudaraba* construction has been chosen. If all profits are distributed among policy holders, no reserves are built up. In case claims exceed contributions over any financial year and funds are insufficient to fully honour them, compensation of damages will be reduced below the full 100 per cent (Al-Suwailem 2006, p. 117). The insurance firm, as agent or *mudarib*, is after all not obliged to shoulder any part of a loss (Billah 2007). Policy holders themselves may make good the deficit and the insurance firm may help them out by providing a loan. This should of course be interest free, but presumably the firm may demand a fee. Voluntary contributions, or gifts, can be donated as well. Some insurance companies at least seem to make binding promises to do so (El-Gamal 2005b). The absence of reserves is not mandatory, policy holders are free to decide to leave part of any surplus in the *waqf* (Ismail n.d.).

It has been argued by *fiqh* scholars that the commercial risks for the insurer under commercial forms of insurance are higher than under a *takaful* construction. This is because a commercial insurer is obliged to

pay claims even if these exceed total premium income. Many would label this as *gharar*. The flip side of the coin of course is that policy holders face increased uncertainty, but that problem is hardly taken seriously in the Islamic literature. On the contrary, it is seen as an incentive to monitor and discipline policy holders not to exploit the system, which, it is piously added, should reduce moral-hazard problems (Al-Suwailem 2006, p. 117).

One factor inhibiting the spread of *takaful* is the dearth of *takaful* reinsurance, or *retakaful*, companies. There seem to be five such companies, among which two are from Malaysia. In line with *darura* principles, *takaful* companies have received dispensation from sharia scholars allowing them to make use of the services of conventional reinsurers, even if not everybody agrees with this leniency (see Billah 2002).

6.3 HOME FINANCE

6.3.1 Introduction

The Islamic character of Islamic home finance is found in the absence of interest payments. Of course, not all Muslims agree that their faith requires them to eschew interest, but even among those that do, there are people who find interest-based home finance for Muslims living in non-Muslim countries acceptable, in particular *fuqaha* who follow the Hanafi madhhab. The European Council for Research and Fatwas and the League of Scholars of Sharia in the USA have pronounced fatwas allowing interest-based borrowing from banks for financing homes, on the basis of *darura* (necessity), in agreement with the Hanafi view (Ramadan 2004, p. 190). Nevertheless, many Muslims in North America and Europe do not seem to be completely happy with such loans, certainly not Ramadan's salafists of different stripes, nor many of his Scholastic traditionalists. Dutch Muslims with a traditional Moroccan background have been cited as saying that an aversion to *riba* is what keeps them from buying a home (*Kiezen voor de stad* 2007, p. 41). Financial institutions, both Muslim and conventional, have been developing sharia-compliant home finance products in response to the demand, or perceived demand, from this segment of the market. These products are available in four forms:

- *murabaha*
- *ijara wa iqtina*
- *musharaka mutanaqisah*
- *istisna* (only during the construction period).

These are discussed successively and the legal hurdles and other disadvantages that may stand in the way of capturing a large share of the market are explained. The section concludes with a recapitulation of the problems common to the various Islamic forms of home finance.

6.3.2 *Murabaha*

Under murabaha finance the home buyer finds a home and approaches the financier, asking him to buy the house and promising to buy it subsequently from the financier. The financier buys the house and resells it to the ultimate buyer with a mark-up against periodic payments. In the UK, for instance, Ahli United Bank (earlier UBK or United Bank of Kuwait) has been offering murabaha finance since 1998. Its customers pay the bank a fixed monthly instalment over a period of 10 to 15 years (www.ihilal.com). The mark-up, or profit margin, included in the purchase price takes the place of periodic interest payments under a conventional mortgage contract. Indeed the mark-up usually equals the present value of future interest payments under such a conventional mortgage. Muslims may be averse to charging or paying interest, there are no objections to using conventional interest as a benchmark. Calculations are often based on LIBOR, but EURIBOR or other rates may figure as well. Ownership first passes to the financier and may then pass immediately to the home buyer. The client makes a down payment and the balance due under the murabaha agreement is secured by a first mortgage.⁴ Transfer of ownership may also wait, possibly until the last instalment has been made.

Murabaha home finance looks simple and straightforward at first sight. However, murabaha is a form of trade finance in the first place and its suitability for home finance may be questioned. Anyone considering murabaha home finance should realize the following points:

- First of all, murabaha replaces interest payments with a mark-up, which puts murabaha finance, like all Islamic forms of home finance, at a disadvantage vis-à-vis conventional interest-based finance in jurisdictions where interest payments on home finance are deductible for income tax purposes.
- Murabaha requires two transfers of property against one in conventional home finance, which brings higher costs with it. The house is first bought by the financier and later resold to the client, the ultimate buyer. Stamp tax or stamp duty must be paid twice, as must registry and solicitor or public notary fees.⁵ On top of that, the inclusion of the mark-up in the price of the home makes for a substantial price increase at the second sales transaction and a proportional increase

in stamp tax. The following numerical example gives an impression of the order of magnitude of the increase.⁶ Consider someone buying a house costing £150 000 with a down payment of £50 000. The financier supplies £100 000 and charges £61 789.09 for a loan period of 15 years. The price paid by the ultimate buyer therefore is £211 789.09, an increase of more than 40 per cent over the original price. The margin above the amount borrowed is more than 60 per cent, and with longer loan periods this percentage would only increase.

In the UK the authorities, in particular the Governor of the Bank of England, Sir Edward George, the Chairman of the Financial Services Authority, Mr Howard Davies, and the Chancellor of the Exchequer at that time, Gordon Brown, were keen to develop an Islamic financial market and they saw to it that the hurdle of double stamp duty was removed (George 2003). Gordon Brown was willing to regard the two sales as part of one financing agreement instead of two unrelated sales and the 2003 Stamp Duty Land Tax requires payment of stamp duty only once.⁷ In the Netherlands no double payment of stamp duty is required if a house is resold within a period of six months. It should be noted that the sharia only requires that ownership should rest with the financier for some period, in order for him to run the risks associated with ownership (such as fire, theft and decay), without stipulating anything about the length of that period.

- Murabaha finance proves extremely inflexible in the sense that selling before the end of the loan period may prove prohibitively expensive. If the buyer/borrower from our numerical example, who was charged with a mark-up of £61 789.09, decides to move house after, say, one year, they are not entitled to a discount on the mark-up and would have to repay the outstanding balance of the loan. This plus the monthly payments made over that year would amount to the full £161 789.09. Whether one keeps the house for one year or for 15 years, the full amount of the loan including the mark-up has to be repaid. In most cases this will come down to a considerable loss to the home owner and they might well be unable to repay the loan. Under a conventional loan one would have repaid the principal in addition to one year's interest only, in total say £105 000 or £106 000. The Islamic financier is free to give a rebate on the mark-up, but this cannot be but a gift and the financier cannot promise beforehand to grant it, as that would imply a time-dependent mark-up, which is tantamount to *riba*. Moreover, even if the financier might be willing to give a discount, if he goes bankrupt or is taken over by another firm, the receivers or the new owners will hardly be inclined to show the same leniency.

- Another problem with murabaha finance is that the loan period cannot be lengthened. The good has been bought and cannot be used again to obtain finance from the financier. This also precludes finance for alterations and reparations (Kranenborg and Talal 2007).
- A feature that makes murabaha home finance unattractive to the financier is that it cannot be securitized. Debt may only be traded at par, otherwise interest and *riba al-fadl* would be involved. A portfolio of murabaha loans therefore is very illiquid.

6.3.3 *Ijara wa iqtina*

Murabaha home finance has some unattractive features. Not surprisingly, therefore, some financiers that started out offering murabaha finance later switched to other forms. The first ‘Islamic mortgage’ written by the Pasadena-based American Finance House – Lariba, for instance, in 1987, was a murabaha mortgage, but they later moved over to *ijara wa iqtina*, lease purchase. Under *ijara wa iqtina*, the client finds a home and asks the financier to buy it. The financier then sells the house to the client against deferred payment, possibly at the same price, but retains title until the last payment has been made. At the same time, parties enter into a lease agreement. This is an agreement separate from the purchase agreement, as the sharia requires a separate contract for each individual transaction. A monthly payment is agreed that includes both rent and amortization of the principal. These monthly lease payments are usually geared to an interest rate and will be periodically revised. Ahli United, for instance, leases a house to its customer for a period of up to 25 years against a monthly instalment which is reviewed every year, using LIBOR as a benchmark. It thus charges a fixed implicit interest within each April–April period, though officially no interest is involved. It is also possible that the house is leased and that the lessor in a separate document unilaterally promises to sell it at the end of the lease period for a nominal amount. This would meet the objections of those who don’t feel comfortable with a sale–purchase agreement to be executed at a future date, as this might reek too much of a forward transaction.

Some Muslim scholars are less than happy with the whole phenomenon of *ijara wa iqtina*, for that matter. El Diwany, noted for his strident criticisms of the existing financial system, including the Islamic variants, notes two dubious points (El Diwany 2003a). First, if rental levels are revised yearly, this introduces uncertainty which might be labelled *gharar*. Second, under the Ahli United model the client bears the risk of a fall in the price of the house. In particular, if the client is no longer able to pay the monthly instalments and the house has to be sold in order to repay the

loan, he is saddled with a loss if house prices have fallen in the meantime. But bearing such risks if you are not the owner (the lessor remains the owner) can hardly be called fair. *Ijara wa iqtina* is neither a full sale nor a full rental, but a mixture that is not necessarily sharia-compliant, according to El Diwany. Sharia boards don't share his negative views however.

Like *murabaha* finance, *ijara wa iqtina* is at a disadvantage vis-à-vis conventional home finance in that two sales transactions and two transports of title are involved, with the associated expenses on taxes and fees. For the financier, *ijara wa iqtina* is, however, much more attractive than *murabaha* because securitization is possible and *ijara wa iqtina* loans therefore are not illiquid (Thomas 2001). After all, *ijara* implies ownership of property, which can be sold to others. In the USA Fannie Mae and Freddie Mac, the institutions that provide a secondary market for mortgage loans, have been buying *ijara wa iqtina* loans from Lariba since 2001 (Maurer 2003; Smith 2005). The downside is that the financier formally owns the house and, if a bank, under the Basel capital adequacy standards has to set aside a higher percentage of own capital than for a mortgage-secured loan (El Diwany 2003a; George 2003). Under both Basel I and Basel II, conventional mortgages and *murabaha* mortgages carry a risk weighting of 50 per cent, but *ijara* mortgages carry a 100 per cent rate. *Ijara* is a lease, with the house treated as a fixed asset on the bank's balance sheet. *Ijara* finance would then be relatively costly for a bank. The European Union's 2006 Capital Requirements Directive, however, allows *ijara* to be risk-weighted in the same way as conventional mortgages (Ainley et al. 2007).

If the financier retains title to the home, unfortunate consequences for the buyer may follow if the financier fails before title is transferred. The buyer is left with empty hands: they are just an ordinary creditor and the property is part of the bankrupt's estate. Also if the buyer is behind on their payments, the financier may decide to sell the home. Websites of UK financiers sport grave warnings like 'Your home is at risk if you do not keep up monthly payments on your home purchase plan' (on Ahli United's website www.iibu.com/).

Selling the home before the end of the financing period should be easier than in the case of *murabaha* finance. Still, the financier must agree, as Islamic contracts cannot be one-sidedly ended. In actual practice this does not seem to be a hurdle; Ahli United adds a standard provision to contracts to the effect that 'You may purchase the property from AUB UK (Ahli United Bank UK) at any time by paying us the balance of the purchase price.' And if you buy the property, you are free to sell it. The only thing required is a tide-me-over loan.

6.3.4 *Musharaka mutanaqisah*

Musharaka mutanaqisah is diminishing musharaka. A home buyer and a financier jointly own a home and over time the financier's share diminishes continuously as the home buyer's share increases. Usually, musharaka mutanaqisah is combined with ijara. In Lariba's home buying scheme, for instance, the client leases the financier's share in the property and agrees to buy that share over a period of up to 30 years. Often, the client buys the home as the financier's agent from the vendor and registers it directly into their own name (Smith 2005). In the UK, however, HSBC Amanah only transfers ownership at the end of the agreed period.⁸

A special case of musharaka mutanaqisah is the cooperative housing finance that was offered in Canada for a number of years by the Islamic Co-operative Housing Corporation Limited in Mississauga, Ontario and was later introduced in the UK by Ansar Housing Ltd.⁹ Prospective clients have to purchase shares and the organization in this way collects funds that are used to finance houses. The bank buys the house and enters into a partnership with the buyer, who occupies the house. The buyer transfers the value of his shares to the partnership and pays rent to the partnership. The rent is distributed among the shareholders in the partnership, that is, the bank and the buyer. In the course of time, the buyer buys the bank's shares in the partnership with the portion of their periodic payments that is meant for amortization, until they own all the shares in the partnership. Finally, title in the property is transferred from the partnership to the buyer, possibly after the buyer has made a special payment reflecting the rise in the value of the house. This payment is made for the benefit of the shareholders of the bank. Instead of a musharaka contract, a mudaraba contract would also be possible.

The attractiveness of musharaka mutanaqisah varies, depending on the legal environment. In the UK there seem to be fewer obstacles than in some other countries, because it is quite easy to set up a limited company for musharaka in a particular project. In other countries musharaka mutanaqisah would probably require setting up a joint venture, which may be relatively expensive. After the Finance Act 2003 replaced stamp duty by the Stamp Duty Land Tax in December 2003, in the UK ownership may pass from the financier to the home buyer in steps without recourse to a notary public and without having to pay stamp duty, if ownership resides with a Third Party Trust. In other countries, such as the Netherlands, every transport of ownership of part of a home requires the services of a notary public, plus payment of stamp duty.

In countries where interest paid on mortgage loans is deductible for income tax purposes, musharaka mutanaqisah, like other Islamic forms of

finance, is at a disadvantage. Selling the home before the end of the agreed financing period, however, should not throw up any particular problems.

6.3.5 Istisna

The fourth type of Islamic home finance contract is istisna. This is a contract under which the bank finances the construction of a house. The customer approaches a contractor and agrees the terms and conditions including costs. The customer then approaches a bank for the financing of the construction. The bank enters into an istisna contract with the customer and adds a profit margin over the cost. It enters into another istisna contract with the contractor to construct the house and will make periodical payments to the contractor as the construction proceeds. The ultimate house buyer, the client of the financier, may act as the financier's agent to monitor the progress of the construction. When completed, the house will be delivered to the client and if the client is unable to fully pay the price of the home, the financier will provide funds under one of the forms discussed above (www.ihilal.com).

6.3.6 Costs and Other Problems

Not much is known about the costs of Islamic home finance, but the few data available suggest that it is more expensive than conventional home finance, quite apart from the question of tax deductibility of interest payments on mortgage loans. Islamic home finance is more complicated than conventional finance and more labour intensive. According to one source, Islamic home finance is 100 to 300 basis points more expensive than conventional finance in Canada, and 40 to 100 basis points more expensive in the USA (*Executive News* 2007, no. 25, IslamicFinance.de). Low transactions volumes possibly play a role and cost differences may diminish when Islamic home finance takes hold and scale economies can be exploited. Still, in many cases there will be the complication of two sales transactions, as the financier has to own the property for a time. This may bring with it not only additional expenses for the services of a notary public, but also double payment of stamp duty, at least outside the UK.

Then there is the question of deductibility of interest on mortgage loans for tax purposes. If no comparable deduction is available for Islamic home finance in countries with such deductibility, it can hardly compete. Introducing tax deductibility of home finance-related costs for Islamic home finance often may be very complicated, as it might require far-reaching reforms of the tax system and of real-estate law (see for the Dutch situation Israël 2006; Kranenborg and Talal 2007). If, for instance,

title of ownership remains with the financier until the end of the contract period, there may be formal objections to claims to tax deductibility for borrowers. For another thing, in the Netherlands the law requires hire or lease purchase contracts to explicitly state which part of regular payments is amortization and which part interest (Israël 2006). The Islamic character of a contract then may be in doubt and Islamic home buyers themselves may have second thoughts (Visser 2007). Still, these difficulties are not always insurmountable. Tax authorities in the USA, for instance, accept deductibility of interest-like costs for consumers (Thomas 2001).

Nor is this all. Other legal obstacles abound. For instance, if the financier buys the property, occupiers may be ineligible for public sector home ownership schemes (sale of council houses). For another thing, Islamic home finance implies that financiers hold real estate for their own account, however briefly in each individual case, and this may lead to higher capital requirements (see Section 6.3.3 for the case of *ijara*) or it may be discouraged by prevalent regulations. In the USA, for instance, banks are restricted from owning real estate property, unless it is related to foreclosure activities or the operations of the bank itself. The rationale is that banks should not become involved in speculative real estate investments. US regulators, in particular the Office of the Comptroller of the Currency (OCC), however, tend to focus on the economic substance of Islamic home finance transactions, rather than the form, and to easily approve applications for licenses to offer Islamic home finance (Shayesteh 2007).

6.4 INVESTMENT

6.4.1 Conditions for Islamic Investments

Fully-fledged Islamic commercial banking may come up against all kinds of practical difficulties, especially in Western countries where the interest-based institutional set-up cannot be fully reconciled with Islamic tenets, but no such impediments stand in the way of Islamic investment. It does not differ markedly from conventional investment, except that the range of admissible assets is more narrow. One site providing information for Islamic investors proudly pronounced: ‘Our goal, in simple terms, can be summarized as: To help Muslims help themselves and each other by getting rich in an Islamically Correct® way.’ This was perhaps a bit too brazen, for a few years later the motto was couched in more suave management talk: ‘Our vision is to help Muslims help themselves, help each other and help others by growing their wealth, and serving their financial needs in an

Islamically Correct® way'.¹⁰ Anyhow, Islamic investment apparently is not a totally different world from conventional investment.

Investment in common stocks makes the investor share in the profits and losses of a firm, it is akin to PLS arrangements. The Council of the Islamic Fiqh Academy at its seventh meeting in 1993 explicitly gave its blessing to investments in shares, provided, of course, that these meet the standards of the sharia. This means that Muslims should not invest in firms that produce, or trade in, forbidden goods and services, such as alcoholic drinks and pork-related products. Investments in entertainment, including not only gambling and pornography, but also movies and music, and even hotels, are seen as haram too. Investments in tobacco and often defence and weapons companies are likewise not admissible. Conventional financial services do not pass muster either, because a large part of income in the financial service sector derives from interest. The same goes for shares in companies whose business practices are considered unethical, such as biotechnology companies that use aborted embryos and resort to human cloning. Muslims can, by contrast, safely invest in industries such as telecommunications, technology and temp agencies. There is no requirement that firms whose shares are bought are of a special Islamic character. It goes without saying that investments in conventional bonds are ruled out. Preferred shares and warrants that promise a definite return to its holder, for instance, during years with poor results, are not acceptable either, as those returns would resemble interest (Ali 2005, p. 24).

The investor should fully share in the profits and losses of the firm. Along with investment in shares, investment in investment funds is considered halal, not only in equity funds, but also in real estate and property funds, Murabaha funds commodity funds and leasing funds.

The restrictions on Islamic investment, if strictly applied, would severely limit the number of shares acceptable for Islamic investment. In countries where the economy is not fully organized according to Islamic principles, there are precious few firms that never borrow money against a predetermined rate of interest, never deposit money at a predetermined rate of interest or never invest in bonds. It seems that the larger Islamic banks saw a huge market and have prodded Islamic scholars to come up with a practical solution, relaxing some of the requirements (McBride 2000). Dow Jones's Sharia Supervisory Board, with heavyweights such as Sheikh Muhammad Taqi Usmani and Sheikh Nizam Yaquby, has developed screens that seem to function as the standard for the investment industry.¹¹ These are quite lenient. Excluded are companies whose:

- Total debt divided by trailing 12-month average market capitalization is 33 per cent or more.

- Cash plus interest-bearing securities divided by trailing 12-month average market capitalization is 33 per cent or more.
- Accounts receivable divided by 12-month average market capitalization is 33 per cent or more.

The criteria appear to be rather arbitrary, it would be difficult to base them on the sunna. The returns on the shares and funds that have received the stamp of approval of sharia boards thus includes interest income. It is a moot point whether this 'impure' or 'contaminated' income should be 'cleansed' or 'purified', that is, be given to a charity. Most scholars allow purification, but some find it unnecessary, as it would be difficult to identify the contribution of a firm's interest payments and receipts to the return on its equities. Purification is either done by a fund manager or by investors themselves, on the basis of information provided by the fund manager (Girard and Hassan 2006). Zakat calculation on investment profits, however, is still controversial.

As in stock investment, the criteria are not too strict in real estate investment either. In the guidelines for Islamic Real Estate Investment Trusts (REITs) issued by the Malaysian government in November 2005 and approved by the Syariah Advisory Council of Malaysia's Securities Commission, up to 20 per cent of the rental incomes that provide the income from the properties in a fund may have been earned on haram activities. One of these REITs is the first Islamic health care REIT in the world, launched in 2006, with its income consisting of rental income from hospitals.

There are people who have a gnawing suspicion that investment in shares, and even more investment in funds, is a form of maysir, gambling. Others may yearn for a stable income stream such as provided by bonds. A solution for such investors is available in the guise of ijara funds. A financial institution in this case sets up a lease company and sells shares of the company to investors. Like money market funds, not an alternative for devout Muslims, these provide a reasonably stable income. In addition, they provide a hedge against inflation. Another way out for those investors is investment in sukuk, which are often themselves based on ijara contracts.

The ban on riba not only restricts the gamut of financial assets that can be included in halal portfolios, but also the way of acquiring them. Margin trading, of course, is out of the question. It is no surprise that the Council of the Islamic Fiqh Academy ruled in 1993 that one may not borrow money against interest with a stockbroker or any other party to buy shares and to deposit them as security for the loan. However, if the purchase of shares can be done without riba being involved the picture changes. One way is

provided by Bank Islam Malaysia Berhad, which offers share financing through *mudaraba* profit sharing contracts (Naughton and Naughton 2000, p. 153).

6.4.2 Performance of Islamic Funds

In 2007 there were said to be more than 250 sharia-compliant mutual funds, managing an estimated \$300 billion (Akhtar Aziz 2007). This is up from some \$800 million in 1996 and between \$5 billion and \$7 billion in 2001 (Gainor 2000). In between, negative stock market developments reduced investments to no more than some \$3.5 billion in 2002, managed by roughly 105 Islamic mutual funds (Iley and Megalli 2002).

Various Islamic indexes are available to give the investor guidance. The first one was launched by RHB Unit Trust Management Bhd. in May 1996 in Malaysia. Financial Times – Stock Exchange (FTSE), in collaboration with International Investor, an Islamic investment bank, launched FTSE Global Islamic Index Series (GIIS) at the end of December 1998. Dow Jones Islamic Market Index (DJI) followed in February 1999 and Kuala Lumpur Shariah Index (KLSI) in April 1999.¹²

The screens applied by Dow Jones's Sharia Supervisory Board and similar bodies favour investments in newer companies that raise money on equity markets rather than through banks. Technology and IT funds have been quite popular. They took a beating around 2000, but seen over longer periods Islamic funds by and large do not seem to perform systematically worse than conventional indexes. Hakim and Rashidian (2002) compared the risk–return profile of the DJI with those of another index, the Wilshire 5000 index, which tracks the performance of the shares of the largest 5000 US companies. They found that, between 12 April 1999 and 4 October 2002, DJI is correlated with neither the Wilshire 5000 index nor the three-month treasury bill (as a proxy for the risk-free interest rate), but they also found that an Islamic basket of stocks, which leaves out many stocks as *haram*, performed not worse than a much larger basket of stocks. In a more recent paper (Hakim and Rashidian 2004), they compared the performance of DJI with that of the Dow Jones World Index (DJW) and of a socially responsible index, the Dow Jones Sustainability World Index (DJS). DJS is the closest substitute for DJI, as it does not invest in stock of companies engaged in gambling, alcohol, tobacco or weaponry. It does not, however, shun interest- or pork-related investments. DJI and DJS are both subsets of DJW and thus, inevitably, less diversified. DJI faces more restrictions than DJS and is consequently also less diversified than DJS. The sample was made up of weekly observations over the 5 January 2000 and 30 August 2004 period. DJI showed a somewhat lower return than

DJS and nearly double its systematic risk (beta). DJW had the highest average return, a full 3 per cent higher than DJI (or rather a full 3 per cent less negative than DJI). Surprisingly, given that it is a subset of DJW, DJI had somewhat lower volatility (beta < 1, with DJW functioning as the market index). Hakim and Rashidian's conclusion that 'we find no evidence that the compliance to sharia, as interpreted by the DJI, has resulted in any discernible costs to investors' is, however, only true in comparison with DJS. Girard and Hassan (2006) found that the Dow Jones Islamic indices outperform their conventional counterparts from 1996 to 2000, underperforming them from 2001 to 2005. Overall, diversification benefits and reward to risk were similar.

Real-world mutual funds do not always track the indexes and may show different characteristics. Hayat (2006) found that Islamic mutual funds that invested globally in the period 17 August 2001 to 25 August 2006 earned higher average returns than DJI and DJW, but funds that restricted themselves to Malaysia underperformed not only these indexes, but also their Kuala Lumpur Islamic and conventional benchmarks. The global Islamic funds had a positive alpha vis-à-vis both the DJI and DJW benchmarks and in both cases a beta < 1.¹³ They have thus been relatively low-risk investments over the period studied.

6.4.3 Some Special Funds

Some special funds call for attention. First, we have pension funds and, second, hedge funds figure prominently on the financial scene.

Pension funds pose no special problems from an Islamic point of view. They simply have to invest in halal assets. Still, Islamic pension funds are few and far between. One was started by HSBC Amanah in 2004 and another by the South African insurer Old Mutual in 2006. Others are slowly following. HSBC's fund invests 95 per cent in equities and the rest in such things as sukuk. Old Mutual sticks to 75 per cent in equities, as it is held by law to invest at least 25 per cent in cash or interest-bearing instruments. Both funds apply the DJI criteria for selecting stocks (Gelderblom 2006).

Hedge funds take long and short positions in securities and borrow for leverage. The knee jerk reaction of fiqh scholars, not unnaturally, is to oppose hedge funds, but financial institutions every now and then try to introduce Islamic versions. Hedge funds could take long positions with the help of murabaha contracts for asset-backed securities such as sukuk or common stock. Banks could provide finance with the securities as collateral. If the price goes down below the level at which the bank would no longer be protected, the murabaha deal would be unwound, with losses for the fund. Leverage for short positions is possible with the help of arbun

contracts. The hedge fund could sell stock for future delivery against a down payment (Gassner 2005). Alternatively, it could sell stocks on a salam basis for future delivery but against immediate payment (Dar 2006). In both cases the stock has to be bought from the market on or just before the agreed delivery date. Such short positions will remain dubious from a sharia point of view, given the ban on selling what one does not own. Some scholars argue that salam should be allowed for all fungible goods, including claims on goods, that is, stocks (see Section 4.3.5). Sharia Standard 21 of the AAOIFI, however, states that salam contracts should not be used for transactions in company shares (see Section 4.2.6). The same standard declares the conventional method of selling short by borrowing stocks and selling these spot not acceptable.

6.5 CONCLUSIONS

The products offered by the specialized institutions, and the similar products offered by banks, all face serious limitations and restrictions when compared with their conventional equivalents. In insurance the prevalent form of takaful often leaves the funds without much reserves and the insured, or rather the participants, cannot be sure that claims will be fully honoured, though managing firms that would be loath to see their clients defect to conventional competitors may come to the rescue in such cases. Islamic home finance is of course seriously handicapped in countries that allow tax deduction of interest paid on mortgage loans. However, in other countries it is no smooth sailing either. Murabaha finance is typically an instrument for short-term trade finance and in the case of home finance severely restricts the freedom of movement, literally, of the home buyer. Ijara wa iqtina and diminishing musharaka may be less problematic in this respect, but will usually be more expensive than conventional home finance, and ijara brings huge risks for the client both if his and if the financier's financial solidity weakens. Investment is restricted to non-interest-bearing securities that furthermore meet the ethical standards of Islam. As there are also non-Muslims that reject interest and/or want their investments to comply with ethical norms, these restrictions may make Islamic funds attractive to them as well. Islamic funds have less scope for diversification than others, but the evidence so far does not point to systematically worse performance. Islamic pensions funds have only just started, but do not seem to face special problems, except that regulators may require them to invest part of their assets in interest-bearing instruments. Hedge funds are an interesting phenomenon in the sense that they can be seen as attempts to stretch the meaning of 'sharia-compliant'.

NOTES

1. Mr Bakri Muhammad is a self-professed salafist who was born in Syria and spent part of his life in Britain, where he was active in the Hizb ut-Tahrir movement before breaking away and setting up his own organization. He has often advocated violence in the Holy War against the non-believers and was not allowed back into Britain after leaving in 2005. There is a Wikipedia entry on him with references to many other sources.
2. Mr Al-Zarqa was a prominent jurist. He wrote an authoritative *Comprehensive Introduction to Islamic Law (Al Madkhal al-Fiqhi al-A'am)* and was involved in the formulation of family law and civil law in Syria after it had gained independence from the French. He also served as Minister of Justice and as Minister of Religious Endowments in Syria and helped draft Jordanian civil law. He was associated with the Islamic Fiqh Council in Mecca and the Islamic University of Medina and supervised the preparation of the encyclopaedia of Islamic Fiqh in Kuwait. His approach to the sharia was characterized by flexibility and practicality, as he thought it should be applicable in all societies and at all times and certainly should not aim at going back to the times of the Prophet. Mr Al-Zarqa is credited with formulating the rule that interest received on bank deposits should be donated for the benefit of the poor (Salahi 2003).
3. From a report by Mohammad Ajmal Bhatti, chief executive of Takaful International, excerpted on the Dutch website www.islamic-commerce.net, 11 June 2002.
4. There are no objections in the sharia to the granting of a mortgage or a deed of trust to secure a creditor in his rights (Thomas 2001). Quran 2:283 says: 'If you are on a journey and cannot find a scribe (to write down the transaction), then transact your business by taking possession of a pledge. If one of you entrust another with a pledge, let the trustee deliver the pledged property to its owner, and let him fear Allah, his Lord. Do not conceal testimony, and whoever conceals it, his heart is surely sinful. Allah is aware of all your actions.'
5. It seems possible to circumvent such double payments by having the home buyer first act as the buying agent of the financier and next as his selling agent. If the home buyer as the financier's agent buys and sells in his own name, double payments can be avoided. This construct was used in Britain before the 2003 Stamp Duty Land Tax made it unnecessary (Sinke 2007, p. 52). One wonders whether all this was really sharia-compliant, as the financier should hold title to the property for a time.
6. Derived from information given to Ms Rachida Talal by a British provider of Islamic home finance. I am indebted to Ms Talal for this information.
7. Below a threshold of £125 000, on 2 September 2008 raised to £175 000 for a year, no stamp duty is due.
8. www.hsbcamanah.co.uk/amanahuk/home-finance, 2007.
9. El Diwany (2003a); www.isnacanada.com/ichc.htm.
10. <http://muslim-investor.com/>, 9 June 2008.
11. www.djindexes.com, 9 June 2008. See for the different norms applied by the Shariah Advisory Council of the Securities and Exchange Commission (SEC) of Malaysia: Ali 2005, pp. 19–20.
12. Dow Jones publishes a great number of Islamic indexes. FTSE's GIIS has been replaced by the FTSE Shariah Global Equity Series, complemented by a number of indexes constructed and published jointly with local stock exchanges, see www.ftse.com/.
13. Alpha and beta are entities that find their place in Michael Jensen's modification of the Capital Asset Pricing Model (CAPM: see Jensen 1968). In his model we may relate the return on an asset or a portfolio to both the return on a risk-free asset and the return on the market portfolio, however defined, as follows:

$$R_{pt} - R_{ft} = \alpha_p + \beta_p (R_{mt} - R_{ft}) + \mu_t,$$

where

R_{pt} = the return on portfolio p at time t

R_{ft} = the return on the risk-free asset at time t

α_p = the intercept of the model, to be estimated using regression analysis

β_p = the systematic risk of portfolio p , to be estimated using regression analysis

R_{mt} = the return of the market portfolio at time t

μ_t = the error term at time t

Alpha is the return on a portfolio over and above that predicted by the CAPM. It reflects pure luck or above average ability of fund managers in picking assets.