

## 7

# Partnerships and Equity Investment

As one can readily infer from the case studies at the end of Chapter 6, equity investment in the forms of stock- and mutual-fund ownership, as well as index participations with or without principal protection and the like, have been among the more successful areas in Islamic finance. Indeed, it is easier to explain to Muslims and non-Muslims alike the virtues of investing only in certain types of stocks, excluding those of companies that produce, for example, alcoholic beverages or weapons. The links between the “Islamic” brand name, on the one hand, and ethical and economic considerations, on the other, are more direct in those areas.

On the other hand, many Muslims did not accept stock ownership as permissible until recently, and some continue to argue that Islamic jurisprudence recognizes only simple partnership styles, to the exclusion of contemporary corporate structures. At the other extreme, many contemporary jurists have allowed ownership of legal constructs such as stocks, mutual funds, index participations, and the like, albeit under slightly inaccurate legal interpretations of those structures. In this chapter we shall review classical jurisprudence on partnerships of various types, as well as contemporary juristic analyses of limited-liability corporations and corporate stocks.

### 7.1 Classical Types of Partnership

Simple partnership forms existed in Arabia prior to the advent of Islam and were recognized and legalized both in the Qur’an and in Prophetic traditions.<sup>1</sup> In this regard, a number of simple partnership types were recognized by classical jurists.<sup>2</sup>

The most familiar form of classical partnerships was limited partnerships, which were generally classified under the Arabic name “*sharikat al-‘inan*.”<sup>3</sup> Limited

(*‘inan*) partners need not contribute equal amounts of capital to the partnership and consequently may have different degrees of control over partnership assets, even to the extent of giving only one partner exclusive control over capital and assets. Because of those varying degrees of control, each partner is responsible only for dealings that he himself makes. Profits may be distributed according to any agreed-upon formula, but losses must be distributed in proportion to capital contributions, a rule that is extensively applied today in Islamic finance.

Unlimited partnerships were generally known as “*sharikat al-mufawada*” (literally delegated partnerships), wherein each partner allowed the other to deal in his property. Hanafi and Zaydi jurists imposed a peculiar condition that all partners must have equal amounts of wealth to justify this rule of equal and unlimited liability. Of course, this condition was virtually impossible to satisfy and – as Al-Shafi‘i correctly pointed out – resulted in considerable *gharar* exposure, since knowledge of another party’s net worth is very difficult. Consequently, other schools of jurisprudence allowed partners to contribute only part of their wealth to this type of partnership. However, they maintained that partners must contribute equal amounts to the partnership and thus have equal rights for dealing in the capital they contributed.

A third type of recognized partnerships were so-called credit partnerships, generally known as “*sharikat al-wujub*” (literally reputation partnerships), wherein a number of partners joined in credit purchases, followed by spot-market sales of the same properties. Profits and losses are distributed among the partners according to their ownership shares in the objects of the initial credit purchases. Jurists of the Hanafi, Hanbali, and Zaydi schools permitted this type of partnership, whereas jurists of the Maliki, Shafi‘i, Zahiri, and Imami schools deemed it invalid. Jurists of the latter schools based their objection to this type of partnership on the view that partnership capital must be physical property. Contemporary jurists have argued that following the joint credit purchase of property, property may be established as the partnership capital.

A fourth recognized classical partnership form was called labor partnerships (known variously as *sharikat al-‘mal*, *sharikat al-abdan*, and *sharikat al-sana’i*’), wherein a group of workers collaborated on projects (e.g., building some structure) by contributing labor of various types. The partners thus shared the wages paid for that work. Hanafis, Malikis, Hanbalis, and Zaydis allowed those types of partnerships, although Malikis allowed them only when all workers contributed the same type of work and collected equal profit/wage shares. On the other hand, Shafi‘i and Imami jurists, and the Hanafi jurist Zufar, disallowed this type of partnership based on the view that partnership capital must be physical property, and based as well on the perceived difficulty of ensuring that profit shares justly reflect labor contributions of the various partners.

Those classical partnership forms were of very limited use for a number of reasons. First, jurists of most schools deemed partnership contracts nonbinding and thus allowed each partner unilaterally to dissolve a partnership. The Maliki school was an exception, since it deemed partnerships binding and thus allowed their dissolution only by mutual consent of all partners. However, that school has not had a significant following in recent centuries and was superseded by codified Hanafi jurisprudence in regions under Ottoman control. A second and more important reason why classical partnership forms did not thrive in the industrial age is the ruling by jurists of all classical schools that partnerships are automatically dissolved on the death of any partner, whether or not the other partners know of that death.

This made classical partnership forms unreliable and unstable – instability increasing monotonically with the number of partners. Hence classical partnership forms were ill-equipped to take advantage of economies of scale in the pre-industrial and industrial ages. Even if heirs to one partner wished to continue the business, the first partnership – in which the deceased took part – was dissolved, and a new partnership needed to be formed. In part building on the seminal historical work of Abraham Udovitch (1970), contemporary economists such as Avner Greif and Timur Kuran have argued that this fundamental characteristic of Islamic partnerships limited them severely, in terms of both size and longevity, in comparison to Western-style limited-liability corporations that retain their own legal personality.<sup>4</sup>

As we shall see later in this chapter, contemporary jurists found little difficulty in adapting classical *‘inan* (limited) partnerships and *mudaraba* or *qirad* (silent) partnerships to justify Western corporate structures. Indeed, the basic elements of limited liability and legal personality were already developed in classical jurisprudence, for example, within the contexts of *‘inan* partnerships and the legal status of a deceased individual, respectively. Whether or not corporate structures could have evolved indigenously in Islamic jurisprudence is a fascinating topic in institutional economics. Indeed, the institutional limitations imposed by classical partnership forms clearly impeded economic growth in the premodern Islamic world.

A full counterfactual analysis – to understand whether indigenous development of such corporate institutions, or earlier adoption thereof by Muslim jurists in the pre-industrial era, was possible – requires fully understanding the dynamics of juristic institutions, which is beyond the scope of this book. Restricting our attention to the observed historical path of Islamic jurisprudence and finance, we shall proceed to discussing classical views on silent partnerships and then to reviewing contemporary juristic views on, among various topics, corporations, stock ownership, and mutual funds.

***Silent Partnership: Theoretical Workhorse of Islamic Finance***

The classical partnership form that contemporary Islamic practice has adopted most extensively, albeit in modified form, is the classical silent partnership form known in Iraq as *mudaraba* and in Hijaz (western Arabia) as *qirad*. The model of silent partnership was originally envisioned in Islamic economics and finance as the cornerstone of the prospective Islamic financial industry. In this type of partnership, one party (the silent partner, investor, or *rabb al-mal*) contributes his property as partnership capital, while the other party (entrepreneur or *mudarib*) contributes his labor, expertise, and so on.

One reason that this contract was viewed favorably by Islamic economists and early architects of Islamic finance as a potential building block for the latter is its prominence in medieval Mediterranean trade, in part under the Italian name *commenda*. We shall turn to contemporary utilization of silent partnerships in the next section and later chapters. First, however, we need to summarize the classical conditions of silent partnerships, especially since the contract has significant similarities to labor hiring (*ijara*, wherein the entrepreneur would be characterized as a hired worker) as well as agency (*wakala*, wherein the entrepreneur as agent is paid a flat fee rather than a profit share). Of course, the ruling based on analogy to either of those contracts would have been problematic based on the prohibition of *gharar* (since the profit share characterized as wage or agency fee is uncertain). Thus, classical jurists had to rely on prophetic tradition to legitimize the contract under a separate name (as they had done, for instance, for *salam*) despite that *gharar*. As we shall see in Chapter 8, one of the most significant controversies regarding conventional versus Islamic bank structures revolves around silent partnership conditions related to profit sharing. The agency problem introduced by silent partnership conditions (viewing the silent partner or investor as principal and the entrepreneur as agent) also has significant effects on the regulation of Islamic banking structure as currently envisioned, to which we turn in Chapter 9.

In a classical silent partnership, the investor forwarded his capital to the entrepreneur, most often to trade on his behalf. Profits were shared between the investor and the entrepreneur according to any agreed-upon formula, but all financial losses were borne by the investor. Nevertheless, the silent partnership is still characterized as a profit-and-loss-sharing arrangement, wherein the investor loses his labor and effort if no profits were generated. If, at one extreme, the profit-sharing rule assigned all profits to the investor, then the contract is deemed one of *mubadā'a*, wherein the entrepreneur is characterized as a volunteering agent. At the other extreme, if the contract assigns all profits to the entrepreneur, then the contract is characterized as a loan, with significant ramifications for the entrepreneur's liability as a guarantor borrower rather than trustee agent.

*Types of Silent Partnership*

Silent partnerships were very common in pre-Islamic Arabia. Indeed, the Prophet first met his wife Khadija when he traded with her capital, most likely in a *mudaraba* arrangement. He thus implicitly approved of the contract through both his own actions and by continuing to approve of his companions' utilization of that contract after his Prophetic mission commenced. It appears that the contract may have evolved in Arabia based on sharecropping agreements, wherein those with property and those with labor and skills can collaborate to generate mutually beneficial profits.<sup>5</sup>

Classical jurists recognized two main types of silent partnerships, which gave rise to two types of investment accounts in contemporary Islamic banks. The first type of silent partnerships was restricted. Thus, the entrepreneur's activities were limited to a particular timeframe (starting time as well as duration), location, line of business, and the like. Restricted silent partnerships were permitted by Hanafi and Hanbali jurists. In contrast, Maliki and Shafi'i jurists ruled that all valid *mudarabas* must be fully unrestricted. Unrestricted silent partnerships, which are accepted by all jurists, required only specification of the profit-sharing rule. Otherwise, the entrepreneur receives the investor's capital and is free to invest it in any manner or timeframe that he deems fit.

Jurists of all schools agreed that silent partnerships are not binding on either party as long as the entrepreneur had not commenced working. Moreover, Abu Hanifa, Al-Shafi'i, and Ibn Hanbal ruled that silent partnerships remain non-binding at all times and may thus be dissolved unilaterally by either party. On the other hand, Malik ruled that the contract becomes binding once the entrepreneur begins working. One consequence of this difference in opinion is that the majority opinion does not allow inheritance of rights and responsibilities under silent partnerships, whereas Malik's opinion does allow for such inheritance.

Classical jurists of all schools allowed silent partnerships to be formed with multiple investors and/or multiple entrepreneurs, thus paving the way for reinterpretation of contemporary joint-stock companies. In this context contemporary jurists have approved the practice of mixing attributes of limited partnerships, silent partnerships, and labor hiring conditions to justify various management structures of joint-stock companies. In his seminal work *Al-Sharikat fi Al-Fiqh Al-Islami*, the prominent Azhari jurist and professor Dr. Ali Al-Khafif characterized all limited-liability companies with fewer than fifty partners as silent partnerships, with managers viewed as entrepreneurs. However, the contemporary jurist Dr. Wahba Al-Zuhayli argued that the manager may at times be more appropriately characterized as a hired worker. To the extent that the manager may also own stocks, he may be viewed as one of the silent partners by virtue of owning stocks,

and as a hired worker to the extent that he works for the company and collects a fixed wage or fee accordingly.<sup>6</sup>

### ***Valid and Defective Silent Partnerships***

Some discussions in Chapter 8 regarding contemporary banking and Islamic banking practices revolve around the nature of the contract if one or more of the silent partnership conditions are violated. Since the majority of jurists viewed silent partnerships as nonbinding, violations of their conditions merely converted them into other contracts. The vast majority of jurists ruled that if conditions of silent partnership are violated, then all profits are assigned to the capitalist, and the entrepreneur should be paid the prevalent market wage for his efforts. The Malikis, on the other hand, developed a complicated “standard silent partnership” format to which the contract reverted if one or more of the contract conditions were violated. We shall revisit the implications of those rules for synthesizing debt instruments directly from defective *mudarabas*.

### ***Conditions on Partnership Capital***

The most important silent partnership conditions pertained either to the nature of capital invested in the partnership or to profit-sharing rules. In this regard, most jurists agreed that it is best to invest capital in monetary form, to avoid disputes regarding the value of nonmonetary capital. More recently, AAOIFI standards stipulated that if *mudaraba* capital is provided in nonmonetary form, then it should be booked based on fair market value, whereby any difference between that fair market value and accounting value is considered a profit or loss, depending on sign.<sup>7</sup> Although AAOIFI did not specify the grounds of this rule, it seems to be based on the classical opinions of Abu Hanifa, Malik, and Ibn Hanbal, all of whom permitted listing the prevalent market prices of nonmonetary properties as the capitals of silent partnerships.

Most classical jurists also ruled that silent partnership capital must be present at contract time and thus may not be legally constructed from a liability on the entrepreneur. On the other hand, the majority of jurists also allowed the silent partner or investor to appoint an agent to collect his debts and then invest them on his behalf. Similarly, they allowed an investor to ask a depository to invest his deposited property on his behalf. Those rulings follow from the rules of trust versus guaranty in possession, which we shall revisit in Chapter 8. Briefly, the entrepreneur’s possession is one of trust, as are the possessions of a depository and an agent (for debt collection or otherwise). In contract, the possession of a debtor is a possession of guaranty, which is stronger. Thus, the majority of jurists require the debtor first to pay off his debt, and only then allow the investor to

give the property back to the debtor in trust as a silent partnership investment agent (entrepreneur or *mudarib*). For the same reason, the majority of jurists also required the investor to deliver the partnership capital to the entrepreneur, otherwise the latter's possession of trust would not have been established.

### *Profit-Sharing Conditions*

Most jurists, classical and contemporary, insisted that returns to the investor and entrepreneur must be specified as unidentified shares in profits. Some leniency was allowed if the shares were not known explicitly, in which case most jurists reverted to a default rule of equal sharing in realized profits (recall that all financial losses are borne by the investor). We have also noted that if profit shares were specified, but at extreme values, the contract is deemed a loan if the entire profit was assigned to the entrepreneur, and a voluntary agency if it was all assigned to the investor. On the other hand, the vast majority of classical and contemporary jurists unequivocally rejected silent partnerships wherein one party is promised a fixed amount of money, including as a percentage of provided capital (interest).

The vast majority of classical and contemporary jurists claimed that the rules for profit sharing must be strictly followed in silent partnership. Thus, debtlike instruments such as corporate bonds, which promise a fixed amount of money equal to the invested capital plus interest, were forbidden. Moreover, hybrid equity instruments such as preferred shares were deemed impermissible. However, as we shall see in Chapter 8, some contemporary jurists have argued that classical consensus over the rules of silent partnership may not be very relevant for contemporary practice. They alluded to rules of defective silent partnerships, which entail recharacterization of the contract in terms of other permissible ones. They also argued that contemporary practices need not be limited to classical contract forms, and classical conditions thereof. We shall rejoin this discussion in Chapter 8, within the context of conventional banking practice. However, for the remainder of this chapter, we shall focus on simple common stock equity investments and Islamic finance products that have been structured thereof in recent years.

## **7.2 Common-Stock Ownership**

Equity investments in Islamic finance started with simple mutual funds that applied standard portfolio management techniques to a limited universe of stocks, which excluded, for example, companies with Islamically illegitimate lines of business. In recent years managers have begun to use more advanced trading techniques, including trading on margin and short sales, to boost investor returns in an increasingly competitive Islamic finance market. We begin by listing the

most widely held contemporary juristic opinions on equity investment vehicles and trading techniques thereof.

#### *Characterization of Stocks and Mutual Funds*

In its seventh session the Fiqh Academy of OIC ruled that the object of sale when a common stock is traded is an unspecified share in the assets of the issuing corporation. In that regard, they ruled that the stock certificate is a documentation of the legal right to that unspecified share. According to that characterization, the academy ruled in the same session that it is not permissible to issue preferred stocks that give their owners priority claims to the company's assets, a guaranteed amount of profit, and the like. Conventional bonds were seen as interest-based loans to corporations and thus impermissible for ownership and trading. However, juristic councils recognized that bonds (characterized as *sukuk* or debt certificates) may in fact be structured from premodern Islamic contracts (e.g., through *ijara* financing or *salam* trading, as discussed in Chapter 6). Legal opinions at Al-Baraka symposia (e.g., *fatwa* #17/2) and other juristic councils regulated the potential convertibility of conventional bonds into common shares and encouraged companies that had issued conventional bonds also to convert them into common shares in the same manner.

Based on this characterization, numerous juristic councils permitted trading common stocks of corporations that have permissible primary businesses. This view followed since ownership of the stock was deemed to imply partial ownership of the company's assets as a silent partner. Under this characterization, a stock owner would be deemed a partner in the company and thus responsible for its operations. Furthermore, mutual funds were allowed by various juristic councils, characterizing the mutual fund provider as an agent for fund shareholders, who were seen as investors in the underlying stocks. In other words, jurists characterized ownership of mutual fund shares as ownership of the underlying stocks, which were in turn characterized as documentations of ownership of unspecified shares in the assets of the various underlying companies.

Needless to say, mutual fund managers in reality promise to pay fund shareholders only the monetary value of the portfolio of underlying stocks but do not promise to deliver the actual stocks to shareholders if they demand that delivery. Indeed, segregated physical storage of stock certificates for mutual fund holders would present substantial logistical difficulties to fund managers and reduce their competitiveness considerably. Fortunately for Islamic finance providers, jurists seem to be satisfied with the fiction of a sequential ownership structure that ultimately leads to ownership of the underlying companies' assets.

Unfortunately for those providers, continuation of that fiction – under which Islamic mutual funds were allowed to be traded – means that index participations

have not been generally acceptable in most juristic circles. Most jurists continue to argue that an index is merely a number, which does not represent any real underlying assets. It would seem logical to explain to jurists that in fact an index reflects the value of underlying assets no less (and no more) than the value of a mutual fund reflects the value of the physical assets of its constituent stocks' issuing companies. Nevertheless, as we have seen in the previous chapter, some index participation products have in fact been structured by treating the index as a mutual fund and maintaining the fiction that investors own the underlying companies' physical assets.

### *“Islamic Screens” and Their Shortcomings*

To date, the central “Islamic” focus in Islamic mutual fund management has been on the screening criteria used to exclude certain stocks from the universe of permissibility. Most industry participants have dubbed stocks that survive various screens “Shari‘a compliant,” despite the fact that a number of compromises are generally adopted, which result in noncompliance to strict Shari‘a standards. Moreover, Shari‘a compliance would require adherence to positive proscriptions (e.g., “help the poor”) as well as negative prohibitions (“do not ferment alcoholic beverages”). In contrast, “Shari‘a-compliance” criteria used by various providers of financial products and services primarily take the form of negative screens.

#### *Line-of-Business Screens*

The first set of screens is qualitative, based on the corporation's line of business. Those screens are easier to define in the abstract but more difficult to implement, requiring constant monitoring of company activities by Shari‘a supervisors. For instance, it is easy to say that businesses that serve alcoholic drinks should be excluded (possibly excluding certain hotel chains, airlines, restaurant chains, etc.). However, the issue of degrees of separation, which we have raised repeatedly throughout the book, allows jurists many degrees of freedom.

For instance, *fatwa* #18 by the Shari‘a board of the Dallah Al-Baraka group stipulated that leasing airplanes to airlines that are known to serve alcoholic drinks is permitted. Their reasoning was that the primary business of the airline is transportation of passengers, rather than serving or transportation of alcoholic beverages, and hence any sin for serving those beverages would accrue to the operator of the planes and not to their lessor. The Shari‘a board of Kuwait Finance House issued a similar opinion in their ruling #384, within the context of leasing real estate to embassies of foreign countries, wherein alcoholic beverages will be served.<sup>8</sup> The list of activities that lead to exclusions of various companies vary significantly from one Shari‘a board to another. Some may exclude companies that engage

in certain types of genetic research, depending, for instance, on their potential contribution to human-cloning programs, while others may not. The issue in all cases is whether an activity is forbidden and the extent to which it is a primary activity of the company under consideration.<sup>9</sup>

This approach allows for a number of Shari‘a-arbitrage opportunities. For instance, instead of purchasing a restaurant chain, one can create an SPV that buys all the assets of the chain, excluding their wine cellars, wine bottles and glasses for serving wine, and the like. Then shares in the newly created company would be permissible, since the primary usage of its capital (e.g., real estate, tables, chairs, kitchens) is serving food rather than alcoholic beverages. With sufficient accounting acumen, one can thus separate ownership of the impermissible part from ownership of the permissible part and sell the latter as “Shari‘a-compliant” securities. Later in this chapter we shall discuss in greater detail one particular application of this separation principle to Real Estate Investment Trusts (REITs), which would normally fail the standard financial ratio screens applied in the industry, to which we now turn.

#### *Financial Ratio Screens*

In addition to the qualitative screens discussed above, industry practitioners have also developed a set of financial screening rules that exclude companies with excessive debt or excessive interest income. The origins of this idea seem to have germinated at the Al-Baraka Investment and Development Company, which pioneered some of the Islamic mutual fund methodologies later utilized more effectively by the Saudi National Commercial Bank and others. The idea was quite simple: If we exclude all companies that deal in *riba* (viewed excessively generally as any payment or collection of interest), we would be left with a very small universe of permissible equity instruments, leading to massive inefficiency relative to the overall universe of such instruments tapped by conventional fund managers. However, it might be possible to approach the efficiency frontier of risk-return tradeoffs between efficient portfolios, none of which can be dominated by ones that yield the same return with less risk, or higher return with the same risk exposure.

Thus, pioneers of this area sought *fatawa* from jurists, to allow them to include in their portfolios stocks of companies with small or negligible amounts of interest expense or interest income. Early opinions were relatively strict, allowing only for investment in companies with total debts-to-assets ratios of 5 percent, then 10 percent. Over the years those ratios were relaxed, while striving to maintain some notion of retaining only companies with minor debt or interest income. The most common set of financial screens currently used are those of the Dow Jones Islamic Index.<sup>10</sup> Those screens or filters exclude the following:

1. Companies with total debt accounting for 33 percent or more of monthly moving average (over the previous year) of market capitalization.
2. Companies with monetary (cash plus interest-bearing securities) accounting for 33 percent or more of the same monthly moving average (over the previous year) of market capitalization.
3. Companies whose accounts receivables account for 45 percent or more of total assets.

The third screen is interpreted as a yardstick for characterizing the “main business” of companies in question. In this regard, if the majority (more than 50 percent) of a company’s assets are financial, rather than real, the main business of the company is deemed to be financial dealings, and it is thus excluded. The basis of this screen is the classical juristic principle that majority determines the genus and characterization of the total.<sup>11</sup> Because of fluctuations in asset values, a cutoff point of 45 percent was selected, instead of 50 percent.

The second screen similarly aims to limit companies that deal in financial instruments or receive substantial amounts of interest income.<sup>12</sup> The one-third rule in the second screen (as well as the first one) is derived from a juristic principle that “one-third is significant,” based on a Prophetic tradition restricting voluntary distribution of estate in a will to one-third of the estate. The first screen uses the one-third rule to exclude companies with too much debt and hence significant payment of interest.

#### *Incoherence and Dangers of Financial Ratio Screens*

The last two screens create a dilemma for the permissibility of owning shares in Islamic banks, more than 90 percent of whose assets may indeed be in the forms of cash, government and corporate *sukuk*, and accounts receivables from *murabaha* and *ijara*. Similarly, the first screen does not distinguish explicitly between “Islamic debt” (arising from *murabaha* or *ijara*, for instance) and other types of debt. Those two paradoxes have not been discussed widely within the industry for an interesting reason: The bulk of investment of “Shari‘a-compliant” funds are in securities listed on the New York Stock Exchange and other major Western exchanges, none of which have listed Islamic banks or companies that seek Islamic financing. This curious fact puts in focus the Shari‘a-arbitrage nature of the industry, which has made only symbolic gestures toward investing in compliant shares in Malaysia, Turkey, and other majority Muslim countries. However, even in those few initiatives there has not been to date any serious discussion of the rule in those terms. We shall return to this issue in our case study discussion of REITs below.

Other curious paradoxes pertain to the use of moving averages of market capitalization in the denominator of debt and receivable ratios. Initially, the ratios used total assets in the denominator. However, it was deemed advantageous to the size of “Shari‘a-compliant” universe of stocks to switch to a restriction on the ratio of debts to market capitalizations around late 1999, when U.S. stock markets were in the middle of a speculative bubble that inflated those market capitalizations (especially for information technology stocks, which passed other screens). Shortly thereafter, when it became clear that market capitalizations were not particularly stable month to month, the standard moved to a ratio of debts to moving average of market capitalizations, first for three months and then twelve months.

There are in fact two paradoxes in this screening based on ratios of debts to market capitalization. The first paradox comes from the fact that, at any given time, the same effect of enlarging the permissible universe could have been achieved by changing the cutoff ratio (currently set at 33 percent), instead of changing the denominator from assets to market capitalization. The second paradox arises from the use of any fixed ratio, together with a denominator that reflects market capitalization or a moving average thereof. Any such rule is bound to include more securities as market capitalizations rise, thus potentially including some securities in Islamic fund portfolios when their prices are higher than their long-term historical averages under similar economic conditions (i.e., when they are overpriced). Conversely, when prices fall, many stocks (including those that were bought at excessive prices) may be forcibly excluded from the portfolio, because of failing one or more of the listed financial screens (even if their prices are lower than long-term averages under similar economic conditions). In other words, any fixed-ratio screening rule, with market capitalization as the denominator, forces abnormal purchases at high prices and sales at low prices. Needless to say, such artificial “buy high, sell low” strategies can have catastrophic consequences.

Combining this analysis with the fact that *riba* is forbidden regardless of amount or percentage puts in question the wisdom of imposing any fixed financial ratio screen. Although the rule of one-third has a relatively unrelated origin (in inheritance law), it has indeed been used by jurists in many other contexts. However, if the rule could be applied to *riba*, then we would in effect be able to impose a Western-style (post-Calvinist) usury law that limits interest rates to 33 percent or lower. Moreover, although the rule allows Muslim investors to buy equity shares in Western companies that have 33 percent or less (interest-bearing) debt-to-market capitalization, the same jurists who devised that rule forbid Muslim investors to obtain the same level of interest-based leverage in their own direct investments. In other words, this rule encourages investment in non-Muslim-based business, as it discriminates against Muslims by depriving them of leverage opportunities that make their competitors more profitable.

Finally, if the goal is to meet a particular debt ratio, we have seen in Chapter 6 how debt can easily be taken off-balance-sheet through sale-lease-back transactions. Curiously, the latter procedure has in fact been a popular one in Islamic finance and hailed as converting companies from Shari'a noncompliance to Shari'a compliance, when the substance and structure of their financing had hardly changed. Finally, fixing any ratio such as one-third without fixing its numerator and denominator (as evidenced by the switch from assets to market capitalizations) gives the appearance of rigidity of the rule, when in fact the rule is too flexible.

Returning to the historical roots of this one-third rule, we recall that it was justified on the grounds that the universe of permissible securities would be too small if we did not allow any level of debt or interest income. The need (*haja*) to be able to track market averages was viewed as sufficiently acute to invoke the rule of necessity (*darura*), according to which a license is given to the extent of need. In this regard, it would be much more coherent to fix the numerator and denominator of financial ratios (e.g., debt/market capitalizations and receivables/market capitalization) and vary the cutoff ratio rule according to market conditions. When stock prices are generally high, a high degree of efficiency can be obtained with a lower ratio cutoff (e.g., 10 percent), and when they are low, efficiency would dictate using a higher cutoff (e.g., 50 percent). An even better procedure would dictate excluding companies that are, say, in the top 20 percent for those ratios, thus automatically adjusting for overall secular market trends.

In fact, there appears to be a trend toward changing the old Dow Jones Islamic Index ratios. In a recent article on [www.zawya.com](http://www.zawya.com), Yusuf DeLorenzo stated that five of the six jurists serving on the Dow Jones Islamic Market Indices Shari'a board have approved different screening rules for Meyer's Shari'a Funds (an Islamic Hedge Fund pioneer). The new screens remain proprietary, but the characterization given by Mr. DeLorenzo suggests that they are more flexible than their fixed-ratio predecessors. The CEO of Shari'a Funds, for which those new screens were developed, suggested that they were based on actual interest income and interest expense, rather than levels of debt, but has not given further details.<sup>13</sup>

### *Case Study on Debt Screens: REITs*

In recent years a number of different "Islamic REITs" (Real Estate Investment Trusts) have been marketed to GCC investors, who remain the main source of funds for much of Islamic finance. Indeed, this is not a surprising development, since equity REITs (those that own real estate directly, rather than owning mortgages) fundamentally engage in acceptable business, which is buying, maintain-

ing, and leasing real estate. A typical equity REIT holds the overwhelming majority of its assets in the form of real estate (as shown in Table 7.1) and derives most of its income from rent.<sup>14</sup>

Table 7.1. *REIT Investments, End of 2001*

REIT Name	Total Assets (\$1,000s)	Real Estate Assets (\$1,000s)	% Real Estate
AMLI Res. Prop. Tr.	919,002	879,545	95.71
Avalonbay Comm.	4,664,289	4,390,843	94.14
BRE Prop.	1,875,981	1,818,795	96.95
Equity Res. Prop. Tr.	12,235,625	11,300,709	92.36
Essex Prop. Tr.	1,329,458	1,207,647	90.84
Home Prop. of NY	2,063,789	1,933,514	93.69
Archstone Smith Tr.	8,549,915	7,869,220	92.04
Glenborough Re. Tr.	1,388,403	1,289,929	92.91
Camden Prop. Tr.	2,449,665	2,410,299	98.39
Cornerstone Re. Tr.	980,691	942,712	96.13
United Dominion Re.	3,348,091	3,261,301	97.41
Town & Country Tr.	499,370	483,924	96.91
Apartm. Inv. & Man.	8,316,761	8,261,651	99.34

Moreover, REITs are required in the United States to distribute the bulk of their net income in the form of dividends, and thus they tend to attract long-term investors who are looking for reliable sources of fixed income. Finally, REITs have traditionally exhibited low correlations with other asset classes, and thus – as an asset class – they add a significant diversification opportunity to many stock investors. However, REITs as an asset class are at a fundamental disadvantage under Dow Jones Islamic Index and similar screening rules, since the “sweet spot” or optimal range for the debt-to-assets (leverage) ratio for REITs is considered to be 40 percent to 60 percent. This range is clearly illustrated in Table 7.2 (second column from the right), wherein twelve out of thirteen of the largest equity REITs clearly had debt-to-assets ratios in that range, which exceeds the 33 percent cutoff rule.

As we see in Table 7.2, all REITs in the sample failed the debt-to-assets 33 percent screen. It is interesting to note in this context that changing the benchmark to a ratio of debt to floating market capitalization makes the ratios significantly higher, as shown in Table 7.3 (second column from right). In this regard, low growth in market capitalizations of REITs is not viewed negatively by their typical buyers, as we have discussed earlier, since the main attraction for them is dividend collection, rather than capital gain.

Table 7.2. *Debt-to-Assets Ratios for Various REITs, End of 2001*

REIT Name	Total Debt (\$1,000s)	Mortg. Debt (\$1,000s)	Total Assets (\$1,000s)	Debt/ Assets (%)	% Non- Mortg. Debt/ Assets
AMLI Res. Prop. Tr.	405,126	300,876	919,002	<b>44.08</b>	11.34
Avalonbay Comm.	2,082,769	447,769	4,664,289	<b>44.65</b>	<b>35.05</b>
BRE Prop.	1,008,431	210,431	1,875,981	<b>53.75</b>	<b>42.54</b>
Equity Res. Prop. Tr.	5,742,758	3,286,814	12,235,625	<b>46.93</b>	20.07
Essex Prop. Tr.	638,660	564,201	1,329,458	<b>48.04</b>	5.60
Home Prop. of NY	992,858	960,358	2,063,789	<b>48.11</b>	1.57
Archstone Smith Tr.	3,853,012	2,330,533	8,549,915	<b>45.06</b>	17.81
Glenborough Re. Tr.	653,014	588,420	1,388,403	<b>47.03</b>	4.65
		Secured Debt			Non- Secured Debt/ Assets
Camden Prop. Tr.	1,207,047	283,157	2,449,665	<b>49.27</b>	<b>37.71</b>
Cornerstone Re. Tr.	609,600	554,600	980,691	<b>62.16</b>	5.61
United Dominion Re.	2,064,197	974,177	3,348,091	<b>61.65</b>	32.56
Town & Country Tr.	475,403	459,403	499,370	<b>95.20</b>	3.20
Apartm. Inv. & Man.	4,637,661	3,433,034	8,316,761	<b>55.76</b>	14.48

*Note:* Debt ratios exceeding the commonly used 33% screen shown in bold.

Despite numerous questions by various participants at Islamic finance conferences, providers of Islamic REITs have not to date revealed the methodologies that allow them to include stocks of such companies in their Islamic portfolios. Nonetheless, one can think of two ways to include desirable REITs, such as the ones presented in these tables, in an Islamic portfolio. The first approach is to use the argument provided in the previous section, based on the general principle of need and necessity: that the extent of the license is dictated by the extent of the need. Since the case can be made for REITs as a very useful asset class for investors (especially in light of its low correlations with other classes), the case can also be made – as has been made by Mr. DeLorenzo and others – that as a different asset class, REITs merit a different screening benchmark. As most REITs that are considered good buys on conventional grounds have debt-to-assets ratios around 50 percent, the argument goes, a screening ratio in that neighborhood would be warranted.

An alternative approach is illustrated in the extreme right-hand column of Tables 7.2 and 7.3. In those tables we list the nonmortgage or unsecured (depending on reporting by various REITs) debt-to-assets and debt-to-market capitalization

Table 7.3. *Debt-to-Market Capitalization Ratios for Various REITs, End of 2001*

REIT Name	Debt/Full Mkt. Cap. (%)	Non-Mortg. Debt/Full Mkt.Cap.(%)	Debt/Float Mkt.Cap. (%)	Non-Mortg. Debt/Float Mkt.Cap.(%)
AMLI Res. Prop. Tr.	<b>90.10</b>	23.19	<b>90.10</b>	23.19
Avalonbay Comm.	<b>63.26</b>	<b>49.66</b>	<b>67.01</b>	<b>52.60</b>
BRE Prop.	<b>71.42</b>	<b>56.51</b>	<b>71.42</b>	<b>56.51</b>
Equity Res. Prop. Tr.	<b>73.86</b>	31.59	<b>73.86</b>	31.59
Essex Prop. Tr.	<b>69.29</b>	8.08	<b>76.90</b>	8.97
Home Prop. of NY	<b>141.82</b>	4.64	<b>172.20</b>	5.64
Archstone Smith Tr.	<b>88.49</b>	<b>34.97</b>	<b>88.49</b>	<b>34.97</b>
Glenborough Re. Tr.	<b>124.72</b>	12.34	<b>134.18</b>	13.27
		Non- Secured Debt/Full Mkt.Cap.(%)		Non- Secured Debt/Float Mkt.Cap.(%)
Camden Prop. Tr.	<b>81.03</b>	<b>62.02</b>	<b>81.03</b>	<b>62.02</b>
Cornerstone Re. Tr.	<b>113.64</b>	10.25	<b>120.18</b>	10.84
United Dominion Re.	<b>144.67</b>	<b>76.40</b>	<b>144.67</b>	<b>76.40</b>
Town & CountryTr.	<b>142.29</b>	4.79	<b>142.29</b>	4.79
Apartm. Inv. & Man.	<b>136.53</b>	<b>35.46</b>	<b>136.53</b>	<b>35.46</b>

*Note:* Debt ratios exceeding the commonly used 33% screen shown in bold.

ratios. Focusing on the unsecured debt-to-assets ratios, we can see that ten of the thirteen REITs under consideration would pass the traditional 33 percent screen. The logic behind looking at unsecured debt is quite simple: All secured debt, most of which is mortgage debt, can easily be “Islamized,” for instance, through sale lease-back. Even if that secured debt is not Islamized, it is still possible to sell shares in the equity component of the REITs’ assets, albeit through the utilization of SPVs, possibly including UPREITs or DownREITs, that can strip the equity component from the rest. Of course, Islamizing the debt or isolating it would add unnecessary transactions costs, with no change in the substance of ownership of REIT shares (sharing in the company’s equity in real estate).

Consequently, applying the conventional screening ratio rules (taking into account the previous section’s arguments for flexibility therein) to unsecured debt rather than total debt seems to be significantly more cost effective. Unfortunately, the Shari‘a-arbitrage approach likely to be followed by Islamic finance jurists and practitioners would be precisely to build the costly structures to Islamize the secured debts of equity REITs, or to separate those debts from the equity portions through various structured products. In fact, the insistence on incurring those

transaction costs serves as a barrier to entry, giving the larger financial institutions involved in that field a decided size advantage, because of, for example, economies of scale in creating SPVs and retaining appropriate jurists' services.

### *Cleansing Returns*

For stocks of companies deemed “Shari‘a compliant,” jurists have imposed a rule that stock returns (theoretically covering both dividends and capital gains) due to company income from unlawful interest should be cleansed. The method of cleansing unlawful gains has been explicitly discussed by classical jurists: The unlawful income must be given to charity.<sup>15</sup> Islamic mutual fund and other financial providers usually provide customers with a list of approved Islamic or other charities to whom unlawful income will be forwarded.

A number of paradoxes arise from return-cleansing rules as currently applied. First, although jurists insist on cleansing the returns caused by interest income, they have not given a rule on how to compute the portion of dividends and capital gains attributed to interest income. For instance, high-interest income indicates that a company has large amounts of cash (e.g., Microsoft) and therefore can move quickly to make profitable acquisitions, engage in research and development, and so on. Investors generally value such flexibility and therefore will bid up the stock price, resulting in capital gains. However, computing the percentage of capital gains due to that psychological effect is virtually impossible.

Another interesting paradox arises from the fact that jurists do not require similar cleansing of returns caused by higher debt ratios. Obviously, a higher level of debt (especially at lower interest rates) can lead to significantly higher returns on equity and consequently higher dividends and/or capital gains. However, those gains caused by interest-based borrowing are not cleansed. Third, while cleansing for interest income is required, cleansing for income from other (secondary) impermissible activities (such as serving alcohol) is not. Finally, it is not clear how “Islamized” interest (e.g., collected or paid through *murabaha* or *ijara* transactions) should be treated.

Some of those concerns can be addressed in the short to medium term by proposing some internally coherent set of rules for cleansing unlawful returns from a variety of sources. The long-term challenge in developing coherent and meaningful cleansing rules is far from minor, however, since designers of those cleansing rules should ensure that they do not introduce unwarranted distortions in optimal portfolio selection rules (comparing precleansing and postcleansing returns). Of course, distortions that serve normative Islamic objectives are welcome, as discussed below in the context of positive screens.

***Positive Screens and the Islamic Brand Name***

The focus on negative screens reflects the general prohibition-driven nature of Islamic finance more generally. In this regard, providing unequivocally permissible mutual funds was not quite possible, since the universe of companies with, for example, zero interest expense, zero interest income, and no business that is disallowed in Islam would be extremely small. When jurists and financial professionals looked for a compromise, they sought it in the form of screening out companies with significant interest income and interest expense. However, very little effort has been undertaken to apply positive screens as well, such as ones that would favor investment in pollution abatement or community development.

Some positive steps have been taken recently to rectify this situation. For instance, some recent proposals have been made to introduce rating strategies that would combine both negative and positive attributes of a company, as well as measuring the degree of severity of forbidden activity, thus reaching an overall "Islamicity" or "Shari'a-compliance" score. Other recent steps in the right direction include selective regional preference for stocks in countries with significant Muslim populations, such as by issuing region-specific Dow Jones Islamic Indexes. However, the emphasis in selecting stocks in those regions remains a negative one of "avoiding prohibitions."

As we shall argue more generally in Chapter 10, Islamic finance needs to outgrow its current mode of operation, which aims to serve a captive market of customers who are not sufficiently served by conventional finance. In this regard, if the industry is to succeed in reaching the fast-growing educated Muslim middle class, it will have to outgrow this prohibition-driven mentality and demonstrate positive ethical and religious values that it serves. Of course, it is much easier for fund managers simply to work with a smaller universe of permissible securities, within which they can apply their standard portfolio management techniques, rather than incorporate a weighting scheme that trades off risk-return performance, degrees of violation of legalistic Islamic rules, and degrees of serving the ethical goals of Muslims. On the other hand, if and when the industry grows to the point where such tradeoffs are being made in a more sophisticated manner, resulting investment vehicles will be much more appropriately marketed in terms of "Islamic" or ethical investing (where many non-Muslim investors may share the same normative negative and positive screen preferences). In contrast, the ones currently marketed as "Shari'a compliant" can at best be described as "avoiding explicit and major violations of legal prohibitions."