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Investing in Stock Market: The Shariah Way

Shariq Nisar

Islamic economists and financial experts agree that if certain conditions are met, it is lawful to invest in the stock market. Any earnings that result from such investments will be *halal*. The logic behind this argument is that when one purchases shares in a company he actually becomes a shareholder and thus becomes a partner in the business. Thus, this arrangement is akin to the Islamic concept of *mudarabah*. However, there are a host of conditions that must be satisfied before one is allowed to invest in stocks. To start with, one must be sure that the business of the corporation/company offering the stock must be *halal*. Over and above this, *shariah* scholars have developed certain financial parameters for stocks selection. These are mainly related to the capital structure of the company. The purpose of these criteria is to determine the level of involvement of *riba* (interest) and *gharar* (uncertainty) in the overall business of the company.

One should keep in mind that these criteria are the results of modern *fiqh* scholarship (*ijtihad*) and therefore, should be seen to represent the current state of thinking on the issue. In that way, they represent the maximum tolerance levels and not the last word on the subject. In short, if a Muslim investor is contemplating investment in the stock market, he must not only be careful about the profitability but also about the *shariah* compliance. These can be done by looking at the nature of business, percentage of income from interest and the financial soundness of the company. While there are a number of tools available to help understand the financial soundness of a company there are not many that can guide an investor in determining the *shariah* compliance of a stock. Following screening patterns may be helpful in determining the *shariah* compliance of stocks.

Islamic Investment Criteria:

Qualitative Screens:

There are two types of qualitative screens:

- i. Industry screening: Is the company in a business that is prohibited or abhorred in Islam? Apart from investment in banking and finance there are a number of business activities that are considered to be prohibited in Islam, and thus investing in these kinds of businesses is not something a Muslim would like to undertake such as alcoholic beverages, pork and pork products, tobacco products, gambling, lottery, pornography and adult oriented material, prostitution and drugs etc.
- ii. Business practices: Following *shariah* principles are applicable to investing and trading practices applicable to individual investors as well as Islamic financial institutions:

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

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

b. Prohibition of speculation:

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

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Prof. Ausaf Ahmad Delivers Lecture on Islamic Banking

At a select gathering of professional economists at Jamia Millia Islamia, New Delhi, Prof. Ausaf Ahmad of the Islamic Development Bank (IDB) Jeddah, focused on the efficiency, stability and equity financing of Islamic banking currently operating both in Muslim and non-Muslim countries but its major concentration is in the Arabian Gulf. The growth of Islamic banking and finance in the academic fields and its researches in the academic institutions, particularly in the western universities has aroused further interest among the academics and finance experts.

About 30 years of experiments, Islamic banking has achieved a distinguished position as an alternative interest-free financial intermediation, accepted by the world bodies such as IMF and World Bank. Despite the controversies on *riba* and interest as well the operational shortcomings in comparison to the conventional commercial banks, Islamic banks are receiving credibility and their investment and deposits based is expanding rapidly. At present, Islamic finance industry is running under some \$200 billion around the globe. He said, the relevance of this profit and loss sharing system is now more when the world finance is crossing the international boundaries.

Prof. Ausaf's lecture drew much interest among the audience and the questions on the viability of Islamic modes of finance, various Islamic instruments and current research trends in this area were raised.

He was delivering an extension lecture at the Department of Economics, at Jamia Millia Islamia, on the 'Relevance of Islamic Banking' on March 28 2005. The programme was presided over by the Dean, Faculty of Social Sciences, Prof. Naushad Ali Azad.

CALL FOR PAPERS:

Seventh Harvard University Forum on Islamic Finance, "Integrating Islamic Finance in the Mainstream: Regulation, Standardization and Transparency"

The Seventh Harvard University Forum on Islamic Finance is scheduled to be held at Harvard Law School in Cambridge, Massachusetts on April 22 and 23, 2006. The theme of the conference will be "Integrating Islamic Finance in the Mainstream: Regulation, Standardization and Transparency."

The Harvard University Forum on Islamic Finance provides a venue for the critical and objective examination of the purposes, theory, practice, structure, and institutions of the rapidly developing field of Islamic finance. Building on previous forums, the Seventh Harvard University Forum will focus on a variety of challenges facing this industry: regulation, standardization, transparency, and related issues of Shari'a compliance. The industry's response to challenges in these areas will no doubt go far in determining the shape of its future expansions, and the degree to which it becomes part of the global financial mainstream.

From the Sixth Forum onwards, the Project has changed its policy from one of publishing the full conference proceedings to publishing a book of selected papers. *Islamic Finance: Current Legal and Regulatory Issues* (ISBN 0-9702835-5-5), based on the Sixth Forum, is due for publication in Spring 2005.

In view of the new policy, prospective authors are recommended to put as much time as possible into developing their topics and editing their papers in order to have a better chance of inclusion in the final publication. For reference, kindly refer to the standards as set out by Harvard University's official publications, such as the proceedings from past forums which can be purchased online at <http://www.ifp.harvard.edu>.

Papers are sought in the following areas:

Regulation, Advancements, Challenges, And Implementation

Advancements in the principles, rules, or laws designed to control and govern the conduct of Islamic financial institutions. The challenges faced in formulating and implementing such regulation of financial institutions (bank and non-bank alike), and how these were overcome.

Standardization and Transparency

Efforts to establish commonly agreed upon standards of practice by Islamic financial institutions, including product development, accounting, corporate governance and Shari'a compliance challenges, pitfalls, and shortcomings in the pursuit of such standardization and transparency.

Shari'a Compliance

The latest advancements in the understanding of Shari'a with regards to financial products, services, their regulations and implementation.

Current Academic Research

As in the Sixth Forum, a section will be devoted to advanced graduate students in Islamic finance, economics, and law. They are encouraged to submit their work for consideration. Preference shall be given to those falling within the themes of this year's conference.

Guidelines

Potential presenters are requested to e-mail, in a Word document or as PDF, the following to ifp@law.harvard.edu:
 -Biographical sketch up to 200 words
 -Single-page list of related publications
 -150-word abstract of the proposed paper

Papers must be original and written exclusively for presentation at the Seventh Harvard University Forum on Islamic Finance; papers substantially similar to those already presented elsewhere shall not be accepted.

Papers on issues not listed above but relevant to other issues in shari'a and conventional law in Islamic finance or governance and regulation in Islamic finance may be submitted for review.

All papers, abstracts, and supporting material accepted for the Forum become the property of the Islamic Legal Studies Program at Harvard Law School and may not be reproduced in any form or submitted elsewhere without prior written permission. No submissions will be returned.

Deadlines

Paper title, 150-word abstract, and bio: August 1, 2005
 Draft of Paper: October 15, 2005
 Final Paper: January 15, 2006

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New Books and Articles

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Books:

1. KHAROF A, Ala' Eddin, *The Loan Contract: in Islamic Law (Shariah) – A Comparison with Positive Law*, Tr. By Abdul-Wahid Lulua, Kuala Lumpur, Malaysia: International Islamic University, Malaysia, 2003, 229pp.
2. MOHAMMAD, Jigar, *Revenue Free Land Grants in Mughal India: Awadh Region in the 17th and 18th Centuries*, New Delhi, India: Manohar Publication 2003, 281pp.
3. QARDAWI, Yusuf al-, *Poverty: Its Solution in Islam*, New Delhi, India: Adam Publishers, 2004, 228pp.
RAHMAN, Mushfiqur, *Zakah Calculation*, Leicester, UK: The Islamic Foundation, 2003, 128pp.

Articles:

1. AMINE, Muhammad Al-Bashir, 'The Development of the Institution of Hisbah and its Relation with Khilafah', *Hamdard Islamicism* (Karachi, Pakistan), Vol.25, No.4, 2002, pp.49-58.
2. BAIG, Khalid, 'Seeking Halal Earning', *Journal of Islamic Banking and Finance* (Karachi, Pakistan), Vol.20, No.3, 2003, pp.63-4.
3. DUDOIGNON, Stephane A., 'Status, Strategies and Discourses of Muslim 'Clergy' Under a Christian Law: Polemics About the Collection of the Zakah in Late Imperial Russia', In: A. Dudoignon and K. Hisao (eds.), *Islam in Politics in Russia and Central Asia* (Early Eighteenth to Late Twentieth Centuries), London: Kegan Paul, 2001, pp.43-73.
4. METWALLY, M.M., 'Consumer Equilibrium in an Islamic Economy', *Journal of Islamic Banking and Finance* (Karachi, Pakistan), Vol.20, No.2, 2003, pp.17-23.
5. OMER, Spahic, 'The role of the Madinah Market at the time of the Prophet Mohammad', *Al-Shajarah* (Kuala Lumpur, Malaysia), Vol.8, No.2, 2003, pp.213-38.
6. OSMAN, Jamil Bin, 'The Development and Growth of Islamic Financial Institution in Malaysia', *Journal of Islamic Banking and Finance* (Karachi, Pakistan), Vol.20, No.3, 2003, pp.32-62.
7. OWEISS, Ibrahim M., 'Ibn Khaldun: Father of Economics', *Al-Mashriq* (Victoria, Australia) Vol.1, No. 1, 2003, pp.65-78.
8. PRAMANIK, Ataul Haq, 'Development Strategy and Its Implications for Unity in the Muslim World', *American Journal of Islamic Social Sciences* (Herndon, VA), Vol.20, No.1, 2003, pp.63-87.
9. SIDDIQUI, S. Hasan, 'Islamic Banking: True Models of Financing', *Journal of Islamic Banking and Finance* (Karachi, Pakistan), Vol. 19, No.1, 2002, pp.11-24.
10. UTHMAN, Usamah A., 'Money, Interest and an Alternative Macroeconomic System', *IJUM Journal of Economics and Management* (Kuala Lumpur, Malaysia), Vol.9, No.1, 2001, pp.101-14.
11. WERENFELS, Isabelle, 'Obstacles to Privatization of State-Owned Industries in Algeria: The Political Economy of a Distributive Conflict', *Journal of North African Studies* (London), Vol.7, No.1, 2002, pp.1-28.

A. Quantitative Screens:

There are three types of quantitative screens:

- i. **Debt/Asset Ratio:**
Has the company borrowed funds on interest? Ideally there should be no interest-based debt, but based on the Islamic legal principle "li al-akthar hukm al-kul" (to the majority goes the verdict of the whole) and subsequent scholarly opinions, a company is not a permissible investment if debt financing is more than 33% of its capital. This could be calculated as Total Debt divided by Trailing 12-Month Average Market Capitalization (where Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).
 - ii. **Interest-related Income:**
Does the company generate any interest or interest-related income? This only includes those companies who do not make earning interest their business, but place their surplus funds in investments that yield interest income. As in the previous case, ideally no income should come from interest-related sources. However, looking at the current situation *shariah* scholars have permitted to invest in stocks of companies whose income from interest forms less than 5% of a company's total income. Some scholars have fixed that ceiling up to 10% of a company's total income.
 - iii. **Monetary Assets:**
To invest in *shariah* compliant companies, one has to be very careful about company's monetary assets. Accounts receivables and liquid assets such as bank accounts and marketable securities have to be below the limits fixed by *shariah* scholars for the investment to be permissible. Some scholars have set this minimum at 51% whereas the majority of *shariah* scholars agree that "Accounts Receivables" should not be over 45% of company's total assets (where Accounts Receivables = Current Receivables + Long-Term Receivables).
- B. Trading Practices:**
- i. **Day Trading**
Day trading has little to do with actual investing. Usually day traders watch the market and buy and sell on short-term price fluctuation (normally within one day). For this reason, a numbers of Islamic scholars have termed this as closer to gambling and thus prohibited.
 - ii. **Margin Trading**
Margin trading is buying stocks using money loaned from the broker. Interest is paid for this loan, and therefore it is prohibited. Moreover this is a very risky (and complicated) practice, as one can lose more than what he has borrowed.
 - iii. **Derivatives - Options and Futures:**
Option is purchasing the right to buy or sell a stock or a commodity at a future date for a fixed price (regardless of the then prevailing price in the market). Exercising this option means buying at the price set in the past. Not exercising the option results in the investor paying the option fee. A great majority of scholars are of the opinion that Futures trading is not permitted in Islam.
 - iv. **Short Selling**
Short selling is borrowing a stock from the brokerage firm and selling it in prediction that the stock price will further go down. Once the prices are bit stabilized the stock is purchased back to square up the sale transaction. Thus, the investor as a shorter keeps the difference. This transaction involves huge risk that almost has no upper limits. Moreover, from *shariah* point of view you cannot sell what you do not possess.

Seminar Report:**Economy Stability and Growth**

A one-day seminar on Islamic concept of money, currency, interest, and riba was held on 20th March at Allahabad, U.P. where a number of scholars both Muslims and Non-Muslim deliberated on the issues of prevailing Economic System, and the relevance Islamic economics as an alternative system. The event was attended by over 150 persons from different walks of life. The main speakers were Mr. Hifzur Rab, and a senior High Court advocate Mr. Abdul Qadeer presided the programme.

Mr. Hifzur Rab, the well-known Islamic economist, highlighted on the drawbacks of interest based capitalist system with the following arguments:

- (a) The prevailing interest based system cannot survive without manipulating (consistently reducing) the Yardstick of Measurement of Wealth i.e., Currency. Manipulation of measure is a clear case of fraud, an integral part of the system of interest.
- (b) There do not exist any rate of interest that can form a just basis of sharing of profits. 10% is low for an industry making 45% profit but even 3% is high for one that fails to make more than 2.5% profit. Thus, many resources remain un-employed and therefore many people remain un-employed.
- (c) Prevailing economic system is a tool to enslave the human race and it cannot coexist with freedom, human dignity and justice.
- (d) Currency is a share in national product. Increase in number of shares reduces quantity of product (wealth) that one share. Thus, value of currency falls because the quantity of national product that it is, is reduced.
- (e) Price depends upon quantity. Market value of 2 kg sugar is twice that the market value a kg of sugar. It applies to everything and it has nothing to do with supply and demand. Similarly value of fiat money (prevailing currency) falls because the quantity of national product that it really is, is reduced.

- (f) Economists define nominal interest as interest in terms of currency i.e., a share of national product that is becoming consistently smaller (in terms of quantity) because number of shares is increased faster than the quantity of the product. Thus, what is nominally equal is not equal in quantity.
- (g) Economists define real interest in terms of market value. Suppose market value of currency falls to half then there is no real interest is one who has lent 10 number of currencies gets 20 numbers in return.
- (h) Ar-Riba-the interest that Islam has prohibited is interest in terms of quantity that may be called true or REAL interest. Assume that np is a standard measure/unit of national product. Suppose today the share of national product that is equal to currency measures $10np$. Suppose after 10 years currency measures $5np$. Then the reality is that in the said 10 years the quantity of wealth that currency is has fallen to half of what it previously was. Now suppose you have lent 10 number of currencies to someone and when the borrower pays back the loan the quantity of national product that currency is has fallen to half. Then in terms of quantity there is no interest if borrower returns 20 numbers of currencies in lieu of 10 that was borrowed. Thus, interest prohibited by Islam is a real excess in terms of quantity and it is neither nominal interest nor real interest as defined by economists.
 - (i) It was felt that it is neither desirable nor practical to protect ourselves from nominal or real interest, rather there is no need to use these terms. However we must not deal in true/ REAL interest that is a real excess in terms of quantity.
 - (j) It was felt that if people could be informed, most of them could be persuaded not to deal in true/REAL interest. Dealings free from true/REAL interest are not only practical but also bring efficiency.

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