Mohd Ma'Sum Billah

Modern Islamic Investment Management

Principles and Practices

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This book is dedicated to the remembrance of my most beloved parents Allamah Mufti Nur Mohammad (r) *and* Ustazah Akhtarun Nisa' (r) *who have nourished me with their love and wisdom. May* Allah (swt) *shower them with His Love and Mercy and grant them* Jannat al-Ferdaus Nuzulah. *I would also like to dedicate this book to my lovely wife, Dr Khamsiah Nawawi, and our heart-touching kids, Dr Ahmad Mu'izz Billah, Ahmad Mu'azz Billah, Ahmad Muniff Billah and Akhtarun Naba' Billah, for their continuous support and sacrifices. May all be blessed with* Muwaddau Wa Rahmah, Qurratu A'yun *and* Mardhaati Allah (swt) *in this life and the next.*

This book is also dedicated to the Ummah, *the whole of humanity and creatures.*

Foreword

It has been observed that Islamic investment activities began in 1963. For the last 55 years this investment has expanded to become a highly valued global platform, accessible to both Muslim and non-Muslim countries. The asset size of Islamic finance has reached almost USD 2.5 trillion, while its annual growth rate is about 18%—a significant achievement compared with conventional finance.

Partly as a result of these developments, people across the world and Muslim communities in particular, are seeking niche Shari'ah-compliant investment products to meet the demands of multi-dimensional markets. Although numerous product developers have claimed to have designed sufficient Shari'ah investment products to cope with this demand, to date this applies only to certain jurisdictions; adequate customer-friendly Islamic investment products are not currently available on a global scale or with effective results.

There are, of course, research works, books, articles and other information on Islamic finance, but no comprehensive discussion of Islamic investment products and their management solutions and structures are available to meet the global demand from academia, industries, professionals, policy makers, investors and students.

The initiative of Prof Dr Mohd Ma'Sum Billah of the Islamic Economics Institute, King Abdulaziz University, in producing this book is therefore timely. I found this book, which addresses the subject with comprehensive analyses, intellectual discussions and empirical solutions as among the pioneer guides and references for academia, researchers, professionals, industrialists, customers, entrepreneurs, decision-makers, promoters, programmers, students and people in general who are involved or have an interest in Shari'ah-compliant investment products and structures. It is my privilege and honour to have been asked to write the foreword for this prestigious title. May we all be blessed with true knowledge and its rightful application.

Acting Dean
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Dr Mohammad A. Naseef

23rd Ramadan, 1440H / 28 May 2019

Preface

No doubt that there are numerous literatures on Islamic finance existing in the market and resource centres, but undesirably it has been observed that there is no comprehensive literature exclusively addressing Islamic investment management, products and their structures. The impact of such a phenomenon is that the industry, customers, promoters, professional and even academia are suffering with confusion. This book is, therefore, timely to contribute with a series of Islamic investment management, products and their structures applicable in the contemporary socio-economic reality. This title ***Modern Islamic Investment Management*** provides specialised treatment focusing on Shari'ah-compliant investment solutions as practised and applicable in the contemporary socio-economic reality. Further, this book contributes to applied Islamic investment product solutions, their policies, structures, mechanisms, management and empirical analyses, which are presented in three parts with 17 chapters besides an introduction, a bibliography and an index.

Part I provides an overview of Islamic investment, which consists of two chapters addressing different core issues of Islamic investment. Chapter 1 contributes to Islamic investment in a nutshell that, Islamic investment is not merely a product with commercial objective, but it is an integrated system with spiritual, moral, economic and humanitarian value benefiting all mankind with a universal character. Chapter 2 provides an analytical model of Islamic fund management.

Part II focuses on the governing principles and policies of Islamic investment management and services, which consists of two chapters contributing different components of the theme. Chapter 3 focuses on Shari'ah frameworks of investment, which covers policies, guidelines and strategies as enshrined in the divine principles. Chapter 4 focuses on Islamic investment policies, which may facilitate an effective operation of *Halal* investment.

Part III contributes to different classes of Islamic investment products and practices along with structures, mechanisms and empirical solutions. The part consists of 13 chapters. Chapter 5 analyses the Islamic personal investment model and mechanisms. Chapter 6 analyses the *Musharakah* venture capital regarding its structure, strategies and practicality. Chapter 7 continues on analysing a model of micro-investment under Shari'ah with an example and experiences of *Tabung Haj* Malaysia. Chapter 8 analyses the Islamic model of investment in stocks within *Maqasid al-Shari'ah*. Chapter 9 provides a comprehensive analytical model of investment in *Sukuk* under Shari'ah. Chapter 10 analyses on the wealth investment mechanisms and strategies under the Shari'ah principles. Chapter 11 discusses the Shari'ah-compliant investment in unit trust to create an opportunity for the low- and middle-income group in particular. Chapter 12 analyses the *Halal* investment mechanisms in the sustainable development goals (SDG) using the doctrine of *Zakat*, *Waqf*, *Hibah* and *Tabarru'at* funds. Chapter 13 contributes to Shari'ah frameworks of investment of *takaful* funds and its mechanisms. Chapter 14 analyses on an empirical experience in investing *takaful* funds within *Maqasid al-Shari'ah*. Chapter 15 discusses the practicality of investing in a *Halal* cryptocurrency platform. Chapter 16 analyses how an Islamic foreign investment model functions in the contemporary reality. Chapter 17 focuses on the technical solution of rate of return in Islamic investment activities.

Essentially, this title, *Modern Islamic Investment Management*, paves the way for an exclusive research on Islamic investment products and its management within the *Maqasid al-Shari'ah*, which is not commonly available yet to meet the demand of academia, researchers, industrialists, investors and professionals with specific solutions. Thus, this title might be among the pioneers of the subject with possible academic, empirical and hypothetical solutions, which may be a guide for the academia, investors, researchers, practitioners, decision makers, programmers, professionals, promoters and students in their future research and development of specific investment products and management under Shari'ah. It is not impossible for the book contains any shortcoming. We are, thus, grateful to all readers should any shortcoming be notified to us for further improvement.

Jeddah, Saudi Arabia Mohd Ma'Sum Billah

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بسم الله الرحمن الرحيم

There is no strength and power except in Allah (swt), To Him comes the praise, the Savant, the Wise, the Omniscient, the most beautiful names belong to Him. May the blessing of Allah (swt) and peace be upon Muhammad (saw) and all the Prophets (aws) from the first to the last.

First of all, I would humbly like to acknowledge King Abdulaziz University, Kingdom of Saudi Arabia, and its prestigious wing, Islamic Economics Institute, for supporting us with every facility in research, academic, human capital and professional development activities outreaching the global *Ummah*. It is also a great honour for me to humbly acknowledge His Excellency Professor Dr Abdulrahman Obaid AI-Youbi, the President of King Abdulaziz University, Professor Dr Yousef Abdul Aziz Al Turki, the Vice President of King Abdulaziz University and Dr Abdullah Qurban Turkistani, the Dean of the Islamic Economics Institute (IEI), King Abdulaziz University (KAU), Dr Mohammad A. Naseef (Vice Dean, IEI-KAU), Dr Marwan G. A. Andejani (Vice Dean, IEI-KAU), Dr Hasan Mohammad Makhethi (Vice Dean, IEI-KAU), Dr Maha Alandejani (Vice Dean, IEI, KAU), Dr Faisal Mahmoud Atbani (Head, Department of Insurance, IEI-KAU), Dr Adnan M. A. Al-Khiary (Head, Department of Finance, IEI-KAU) and Dr Albara Abdullah Abulaban (Head Department of Economics), for their continuous support and encouragements towards dynamic professional development, excellent academic contributions and specialised advanced scientific research activities. Humble acknowledgement is also extended to my respected fellow colleagues from the IEI, King Abdulaziz University, including Dr Yousef Abdullah Basodan (Associate Professor of Accounting, FEA-KAU), Dr Ibrahim M.S. Abolola, Dr Omar Hafiz, Prof Dr Abdulrahim Al-Saati, Sheikh Dr Ali Ahmed Al-Nadwi, Prof Abdul Azim Islahi, Dr Ahmed Mahdi Belouafi, Dr Fadul AbdulKarim Al-Bashir, Dr Abdul Razzaq Belabes, Dr Hichem Salem Hamza and my talented colleague Mr Mohammed Alabdulraheem, Lecturer (Islamic banking and finance), IEI-KAU. Further acknowledgement is extended to Bank Negara Malaysia, Bank Islam, Bank Mu'amalat, RHB, CIMB, HSBC, Standard Chartered, other universities, industries and professional firms including my research assistant Hafiz Akram bin Mohd Ghani, whose direct and indirect support with knowledge, experiences and resources are full-heartedly recorded.

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About the Author

Mohd Ma'Sum Billah Professor of Finance, Insurance, Fintech and Investment, Islamic Economics Institute, King Abdul Aziz University, Kingdom of Saudi Arabia. Billah had been serving and contributing both academic as well as corporate industries for more than 20 years with management, teaching, research, solution proving and sharing of strategic and technical thoughts towards the advancement of Islamic finance and insurance (*Takaful*) besides *Halal* standard. Billah has published 32 books and chapters in books besides more than 200 articles in journals and social media. He has presented in more than 300 conferences, seminars, executive workshops and industrial trainings in different parts of the world. In addition, he has also been affiliated with corporate, academic and financial industries including central banks, international corporate organisations, governments and NGOs in his capacity as a member in boards, advisor, strategic decision maker, transformer and reformer with strategic solutions. Among the areas of his interest and contributions are Islamic finance, insurance (*Takaful*), crowd-funding, investment, capital market (*Sukuk*), social finance, petroleum finance, trade, fintech and cryptocurrency models and standards. (Blog: http://www.drmasumbillah.blogspot.com).

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Introduction

Islamic finance including *Halal* investment is not a new chapter of economy, but in fact began its journey more than half a century ago. Yet it has been observed that Islamic investment products and management techniques are still influenced by conventional technical structures. This may be due to lack of research in designing and structuring niche *Halal* investment products and management techniques with the spirit of *Maqasid al-Shari'ah* to meet the contemporary market demand. The decision-makers are concerned with prioritising commercial goals over Shari'ah normative compliance. Marketers do not really focus on the Shari'ah compliance, but promote what is assigned to them, with commercial objectives and marketability and profitability as the prime goals. This failure to adhere to Shari'ah compliance, ethical concerns or humanitarian care rather is a major concerns for the Islamic investment industry today. Not only does it endanger the industry but could prevent it from growing significantly within the true Islamic spirit. Islamic investment products should not aim only at a commercial goal, but should be an integrated platform for ethical cohesion, offering holistic universal values. Before planning for an Islamic investment product management a target must be established, which includes Shari'ah compliance, ethical standards, smart marketability, *Halal* profitability, socio-humanitarian concern, minimum risk and less competition. The designing of the investment products should be competitive and unique so to attract the market strategically, smartly and promisingly.

In this contemporary era, Islamic finance, including investment, continues to grow with 12–15% p.a. and its total asset size is estimated to touch US$ 2.5 trillion. The Islamic investment industry has not been confined to

Muslim countries alone but has been spreading to important finance centres in Europe, Africa, the United States of America, Russia, Asia Pacific, India and the Far East. The value-orientated ethos has enabled the industry to draw investment from both Muslims and non-Muslims alike. In recent years conventional institutions have also shown growing interest and increasing participation in the sector. This has assisted the Islamic investment industry across the globe in keeping pace with sophisticated financing techniques and in developing investment Shari'ah instruments that are not only profitable, but are also ethically motivated. Despite these significant achievements there is still a lack of realisation, understanding and utilisation of Islamic model of investment and their respective structures. This humble book aims to provide industrialists, professionals, practitioners, academia as well as the students with Shari'ah-justified understanding of investment product management and their structures so to enable them to explore the salient features of Islamic investment product solutions that will help to ensure the continued evolution of the application of Islamic investment product management and services across the world, regardless of religion, gender, status or nationality.

PART I

An Overview of Islamic Investment

CHAPTER 1

An Islamic Investment Paradigm

1.1 Introduction

Savings refer to that part of a person's income that is not spent on consumption. Investment is expenditure that is not for consumption purposes, but aims at the creation of new capital assets such as buildings, land, stocks, mutual funds and so on. Investments are made so as to obtain benefit in the future. When money is kept idle, that is, not invested, it loses its value or purchasing power over time because of inflation. Studies have conclusively proven that uninvested cash has lost over 93% of its purchasing power over the last 200 years. The same studies have also shown that investing in stocks has proven to be more rewarding than investments in securities and bonds with a fixed rate of return. There are basically two categories of assets one can invest in:

- physical assets such as real estate, gold, etc.
- financial assets such as stocks, mutual funds, etc.

Financial assets are usually preferred because they are more liquid than physical assets. This means that they can be bought and sold and cash can be realised at any time, even at short notice. Yet financial assets are also more volatile, meaning that their value can decrease or increase regularly. They offer two types of return: cash income and capital gains.

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1.2 Elements of Islamic Investment

When investing funds, Muslims must take care to follow certain Islamic regulations that are based on the principles of Shari'ah in order to avoid any elements that are prohibited by Islam. Any fund must follow strict procedures to ensure its success and legal approval.

To ensure that things are genuine and to avoid misdirecting funds, various principles must be borne in mind so as to guide investment:

- investment must not involve interest or *Riba*
- investment must not be in unethical or immoral business
- economic reward should be profit or fee based
- investments must not involve prediction, speculation, uncertainty or gambling. They must all be based on Islamic teaching.

Allah (swt) says:

> Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say 'Trade is like usury.' But Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are Companions of the Fire; they will abide therein (forever). (Qur'an 2:275)
>
> O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination of Satan's handiwork: eschew such (abomination) that ye may prosper. (Qur'an 5:90)

Further examples of areas prohibited by the Shari'ah pertain to ethical and ecological issues such as products based on animal testing, human rights abuses and others matters such as tobacco, pork, alcohol and pornography. The involvement of Shari'ah is needed at all stages in order to create and maintain consumer confidence in the genuineness of the application of Islamic principles to funds. For import and export businesses, any practices prohibited according to Shari'ah are not allowed. The operation will not be successful if it is considered unlawful.

1.3 Shari'ah Guidelines for Investment

Islam encourages all the devout to follow Shari'ah in all matters. Hence, in the field of Islamic investment specific stipulations are in place to educate people to obey the ethics that were determined by Allah. In order to follow Islamic principles, investors must follow several rules that are imposed by Islamic scholars. These stipulations are as follows:

- If the main business of a company is *Halal* (permissible), such as being engaged in automobiles, textiles and so forth, but it deposits surplus amounts in an interest-bearing account or borrows money on interest, then the shareholder must express his disapproval of such dealings, preferably by raising his voice against such activities at the annual general meeting of the company.
- If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by him. This is called purification or dividend cleansing. According to many prominent Islamic fund companies, a Muslim investor cannot invest in the shares of a company if non-Shari'ah-compliant sources of income comprise 5% or more of the company's total income.
- The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, that is, in the form of money that cannot be purchased or sold, except on par value, because in this case the share represents money only, then the money cannot be traded in except at par.

1.4 Stocks in Shari'ah Rulings

In conventional practice, ownership of shares is divided into two classes. These are equity stock and preferred stock. The basic difference between the two types of stock are that equity stock does not have a fixed return on dividends to the shareholders, while preferred stock has a fixed return on dividends to shareholders. But this is prohibited in Shari'ah rules. The relevant Shari'ah concept is based on *Riba al-fadl*. Muslims investors may thus trade only in common stock and not in preferred stock.

1.5 Islamic Investment Funds

The term 'Islamic investment fund' commonly refers to a joint pool wherein the investors contribute their surplus money for the purpose of investment to earn *Halal* profits in strict conformity with the precepts of Islamic Shari'ah. The subscribers to the fund may receive a document that certifies their subscription, entitling them to profits after investment in the fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name. Their validity in terms of Shari'ah will require two basic conditions:

- Instead of a fixed return tied up with their face value, they must carry a pro rata profit actually earned by the fund. Therefore, neither the principal nor a set rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the fund. If the fund earns huge profits, the return on their subscription will increase proportionally; however, in case the fund suffers loss, they will have to share it also, unless the loss is caused by negligence or mismanagement, in which case the management, and not the fund, will be liable to compensate it.
- The amounts so pooled must be invested in a business acceptable to Shari'ah. This means that not only the channels of investment but also the terms agreed for them must conform to Islamic principles.

Keeping these basic requisites in view, Islamic investment funds may accommodate a variety of modes of investment, which are discussed in the following subsections.

1.5.1 Equity Funds

In an equity fund, investors' money is invested in shares of joint-stock companies. Profits are achieved in two ways, namely capital gains earned on buying and selling the shares, and also from the dividends distributed by the respective companies. It should be noted that the fund portfolio must comprise of Islamically acceptable companies whose primary business is *Halal*. It is prohibited for the Muslim investor to buy or sell shares of companies dealing in *Haram* activities such as gambling, alcohol, pornography, interest and so on.

Companies' businesses and financial practices must conform to Shari'ah regulations for them to be accepted as legitimate investment avenues. This means that not only should their core business be *Halal*, but the company must not deal in any interest-based activities (i.e. it should neither borrow money on interest nor should it deposit its excess cash in interest-bearing deposits). But evidently such companies are rare, hence the need for certain rules for investment. Contemporary Islamic scholars have unanimously concluded that a company will be considered a *Halal* investment when its primary business is *Halal* and lawful, if its debt to equity ratio is less than 1:3, if its non-operating interest income is less than 5% and lastly if its liquid assets are less than 45% of the total assets.

1.5.2 **Ijarah** ***Funds***

Ijarah literally means 'leasing' or 'renting'. In such a fund, the invested amounts are used to purchase assets such as real estate, motor vehicles, machines and other equipment for the purpose of leasing them out to their ultimate users. The ownership of assets lies with the fund, but the rentals are charged from the users. These rentals form the source of income for the fund and are distributed pro rata among the subscribers. Each subscriber is given a certificate as proof of his subscription, and to ensure his entitlement to the pro rata share in the income. These certificates are called *Sukuk*, a term recognised in traditional Islamic jurisprudence. Since these *Sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be purchased and sold on the secondary market. Anyone who purchases these *Sukuk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these *Sukuk* will be determined on the basis of market forces and are normally based on their profitability. It should be noted that contracts of leasing must conform to Shari'ah principles. Some of the basic principles are summarised below:

- Leased assets must have some usufruct, and rental must be charged only from that point when the usufruct is handed over to the lessee.
- The leased assets must be of a nature that their *Halal* use is possible.
- The lessor must undertake all the responsibilities consequent to the ownership of the assets.

- The rental must be fixed and known to the parties right at the beginning of the contract. In this type of fund, the management should act as an agent of the subscribers and should be paid a fee for his services. The management fee may be a fixed amount or a proportion of the rentals received. Most Muslim jurists are of the view that such a fund cannot be created on the basis of *Mudarabah,* because according to them *Mudarabah* is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali School, *Mudarabah* can apply in services and leases also. This view has been preferred by a number of contemporary scholars.

1.5.3 Commodity Funds

In a commodity fund, the subscription amounts are used in purchasing different commodities for the purpose of resale. Any profits generated by the sale are the income of the fund are distributed pro rata among the subscribers. In order to make this fund acceptable under Shari'ah, it is necessary that all the rules governing the transactions are fully complied with. For example:

- The commodity must be owned by the seller at the time of sale; therefore, short sales where a person sells a commodity before he owns it are not allowed in Shari'ah. Forward sales are not allowed except in the case of *Salam* and *Istisna'.*
- The commodities must be *Halal*; therefore, it is not permissible to deal in alcohol, pork or other Islamically prohibited materials.
- The seller must have physical or constructive possession of the commodity he wants to sell (constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).
- The price of the commodity must be fixed and known to all parties. Any price that is uncertain or is tied up with an uncertain event renders the sale invalid.
- In view of the above and other similar conditions, it may easily be understood that the transactions prevalent in the contemporary commodity markets, especially in the futures commodity markets, do not comply with these conditions. Thus, an Islamic commodity fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shari'ah,

including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

1.5.4 **Al-Murabahah** ***Funds***

Al-Murabahah is a specific kind of sale where the commodities are sold on a cost-plus basis. Contemporary Islamic banks and financial institutions have adopted this kind of sale as a mode of financing. They purchase the commodity for the benefit of their clients, and then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason for this is that in the case of *Murabahah*, as undertaken by present financial institutions, commodities are sold to clients immediately after their purchase from the original supplier, while the price—being on deferred payment basis—becomes a debt payable by the client. Therefore, a portfolio in *Murabahah* does not own any tangible assets; rather, it comprises either cash or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

1.5.5 Mixed Funds

Another type of Islamic fund maybe of a nature where the subscription amount is employed in different types of investments, such as equities, leasing, commodities and so forth. This may be called a mixed Islamic fund. In this case, if the tangible assets of the fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded in, according to the majority of the contemporary scholars. So it must be a closed-end fund.

1.6 Shari'ah Rulings on Investment

Today, there are various methods of easy investment that can be realised in Malaysia. If the investor cannot make an investment at high level, this investor can instead invest small scale in the banking system in Malaysia and this is recognised as legitimate in Islamic Shari'ah. There are several banks that provide appropriate investment for investors who do not want to risk losing their money easily—for example, Maybank, Bank Muamalat, Bank Islam and Ambank.

These banks provide similar products, but the level of profit is different and is based on mutual agreement between bankers and subscribers. There are several types of product in which bankers provide many types of investment account based on Shari'ah rules. The most crucial Shari'ah concepts that bankers use in investment accounts are *Al-Wadiah Yad Dhamanah* and *Al-Mudharabah*.

Al-Wadiah Yad Dhamanah refers to a contract between the owner of funds (account holder) and the bank for safekeeping purposes. In this instance, the account holder places his deposits on the basis of trust. The bank, as trustee, guarantees the repayment of the whole amount of deposits, or any part thereof upon request. *Al-Mudharabah* (profit sharing) refers to a profit-sharing agreement between the bank and the depositors where the bank is responsible for investing depositors' funds to generate profits. The profit will be share equally based on agreement between the bank and the depositors. Ambank Group offers many kinds of investment account and unit trust products that use Shari'ah concepts. These are:

- Al-Wadiah Savings Account
- Al-Wadiah Savers' G.a.n.g
- General Investment Account (GIA)
- Special Investment Account
- Afdhal Investment Account
- GIA Quantum
- Am500Plus GIA
- AmIttikal (Islamic Equities—medium- to long-term investment)
- AmBon Islam (Fixed Income medium- to long-term investment) Islamic Bond Fund
- Am Al-Amin (Fixed Income short- to medium-term investment) Islamic Money Market Fund.

Bank Islam Malaysia Berhad (BIMB) has its own specialised product in the full Islamic banking system in Malaysia that fully complies with Shari'ah precepts. These only involve these investment accounts:

- Al-Mudharabah Concept (BIMB)
- Mudharabah Savings Account
- Wadi Savings Account
- Ijraa Savings Account

- Pewani Savings Account
- Investment Account (Fixed Savings Account)
- Sakinah Investment Account (Fixed Savings Account).

The main bank in Malaysia, Maybank, has provided products that follow these terms of investment. These are:

- Al-Mudharabah Concept (Maybank)
- Premier Mudharabah Account-i
- Mudharabah Investment Account
- Al-Wadiah Yad Dhamanah (Maybank)
- Wadiah Account.

1.7 Treasury Products and Services on the Islamic Money Market

Takaful operators are also sometimes involved in short-term investments, although profits are low compared to long-term investments. An example of such an investment is the fixed deposit fund. This type of investment is low risk and the volatility of interest rate changes is also low and it results in less profit. Other examples are special Islamic accounts (SIA) and general Investment account (GIA). Here, short-term investment in an SIA is of around three months and the GIA investment is around two to three years. However, the type of investment account depends on the financial situation of the particular fund. If a company wants to use money in a short period, it will invest it in an SIA account. But if the company needs money, it will invest in a GIA account. Another aspect of the decision whether to invest in SIA or GIA is the profitability index prediction. If the profitability index looks likely to increase in the future, the company will invest in an SIA account. If the profitability index shows that it faces a decreasing scenario, a *Takaful* operator will make an investment in a GIA account in order to achieve a high return.

1.7.1 **Al-Mudharabah *General Investment Account (GIA)***

This account is based on the Shari'ah principle of *Al-Mudharabah*, in which a contract is made between the provider of capital (depositor) and the entrepreneur of fund (the bank) to enable the bank to carry out business according to Shari'ah principles, whereby both parties agree to share the profits according to pre-agreed profit-sharing ratio.

1.7.2 **Al-Mudharabah** ***Special Investment Account (SIA)***

In addition to a general investment account, the bank may also selectively accept deposits from the government or corporate customers in the form of an SIA. The modes of investment of funds and the ratio of distribution of profit are negotiable. The period of investment is more flexible to suit the investor cash flow position, that is, overnight to one year.

1.7.3 Negotiable Islamic Debt Certificate (NIDC)

NIDC is based on the concept of *Al-Bai Bithaman Ajil* (deferred payment sale) and *Al-Bay' al-Dayn* (debt trading), where:

- an investor purchases assets from the bank on a cash basis;
- the investor re-sells this asset to the bank at a higher price on a credit basis;
- the bank issues NIDC to the investor;
- the bank settles this credit with the investor on an agreed future date;
- NIDC can be traded in the secondary market subject to guidelines for Islamic negotiable instruments issued by Bank Negara Malaysia.

1.7.4 Islamic Negotiable Instrument of Deposit (INID)

The negotiable instrument of deposit (NID) was introduced in Malaysia in 1979. It was designed as an instrument for commercial banks and eligible finance companies and merchant banks to mobilise domestic savings from the public. As the instrument is designed to be marketable and liquid, the NID also promoted the development of the domestic money market. The rapid development of Islamic banking since 1993 and the setting up of an Islamic money market has accelerated the need to create more marketable deposit instruments similar to the NID. In this respect, an Islamic version of the NID has been developed with similar objectives to NID. Thus, the INID has also been approved and endorsed by the National Shari'ah Advisory Council for Islamic banking and *Takaful* of Bank Negara Malaysia.

- The INID is structured according to the concept of *Al-Mudharabah*.
- It refers to the sum of money deposited with the bank and repayable to the bearer on specified future date at the nominal value of INID plus declared dividend.s
- INID may be traded in the secondary market subject to guidelines for Islamic negotiable instruments issued by Bank Negara Malaysia.

1.8 Treasury Products and Services: Islamic Fixed-Income Securities

1.8.1 Government Investment Issue (GII)

- GII is a domestic Ringgit Islamic bond issued by the government of Malaysia to finance development expenditure;
- it is structured based on *Al-Bai Al-Inah*;
- GII qualifies for liquefiable assets for financial institution and can be traded on the secondary market.

1.8.2 Bank Negara Negotiable Notes (BNNN)

- BNNN is an instrument used by Bank Negara Malaysia to mop up any excess liquidity in the system at a fixed profit rate.
- Debt arising out of the buying back of the asset is securitised through the issuance of BNNN.
- BNNN can be traded in the secondary market based on *Al-Bay' al-Dayn*.

1.8.3 Islamic Private Debt Securities (IPDS)

- Subject to Securities Commission and BNM guidelines, the bank may issue Islamic bonds or commercial chapters to finance its project and business activities.
- The IPDS is rated by Rating Agency Malaysia (RAM) or Malaysia Rating Corporation (MARC) and may either be bank guaranteed or stand-alone.
- IPDS may be structured along *Al-Bai' Bithaman Ajil*, *Al-Murabahah*, *Al-Mudharabah* or *Sukuk Al-Ijarah* concepts.
- The debt created is subsequently securitised to enable trading in the secondary market under the concept of *Al-Bay' al-Dayn*.

1.8.4 Sell and Buy-Back Agreements (SBBA)

SBBA is an Islamic money market transaction between the seller (owner) and buyer (investor) of an Islamic money market (IMM) instrument, where:

- the seller of IMM sells the instrument to the buyer for cash to fund his deficit position and the buyer buys the instrument from the seller for investment purposes;

- simultaneously, the buyer promises to sell back the instrument to the seller who agrees to buy back the instrument at a specified price on a specified future date agreed by both parties;
- the difference between the buying and selling price represents the yield to the investors.

1.8.5 Islamic Acceptance Bills (IAB) or Islamic Banker's Acceptance (IBA)

- IAB are investments issued by BIBM. Unlike APL, IAB does not have a fixed tenure; however, it does not normally exceed 90 days;
- the profits are received upon maturity;
- instructions to credit at maturity into the respective bank account must not be made on or before maturity dates;
- IAB/IBA are working capital financing under *Al-Murabahah*, which gives rise to debt or *Al-Deen* and may be securitised;
- in that instance, the bank draws a bill of exchange to be accepted by the customer;
- subject to certain guidelines, BNM allows the bill of exchange referred to IAB to be traded on the secondary market;
- the bank may also trade *Halal* banker's acceptances issued by the conventional banks.

1.9 *Takaful* Funds

Takaful funds fall into three types:

- general *Takaful* funds
- family *Takaful* funds
- shareholder *Takaful* funds.

Takaful Malaysia Berhad is involved in various types of *Takaful* fund, which are based on the principle of *Mudharabah* under general *Takaful* funds. Such schemes provide a short-term yearly coverage, which enable the *Takaful* provider with a good financial standing to cover defined risk. Property, which is owned personally or by corporate bodies, such as stores, factories, houses, vehicles and so forth, can be covered by *Takaful* schemes, which are provided according to the type of property or asset.

Family *Takaful* is divided into two sectors, namely individual and group. For the individual, the product is *Takaful* mortgage plan and *Takaful* plan for education and *Takaful* rawat. For a group, which may comprise a corporate body only, the schemes are a group *Takaful* plan, group hospital relations and the surgical *Takaful* plan. Others are the likes of supplementary contracts to the individual plans, such as the *Takaful* medical and health plan.

A *Takaful* company derives its income from the investment of the shareholders' fund and shares its profit in consideration of the managing of general *Takaful* business and family *Takaful* business under the profit-sharing contract of *Mudharabah.* Under *Takaful* operations, the operating contract must be in line with the principles of *Mudharaba*h.

1.9.1 Types of Takaful *Investment*

Investment is one of the most important components in a *Takaful* operation, as it will result in the company's survival or not. After all premiums are collected, the *Takaful* operator will invest. The Investment Department or Equity Investment and Research in *Takaful* Malaysia are the two departments that play an important role in making decisions as to allocating investments. In order to manage *Takaful* funds, they must deal with several forms of investment from *Takaful* operators. These must be approved by Shari'ah laws and must not contain any un-Islamic subjects. The types of investment involved in *Takaful* funds are investment accounts with BIMB, fixed assets, properties, unit trusts, quoted shares, government investment policies and financing facilities.

1.9.2 Takaful *Investment Policies*

Bank Negara Malaysia, the *Takaful* Act and Shari'ah Supervisory Board determine investment policy for *Takaful*. The *Takaful* operator will examine and research every previous investment they have received and from there will decide whether to continue. This is because every company is not only focused on providing financial security against risk but also on getting a high return on all its investments.

1.10 Conclusion

If some income from interest-bearing accounts is included in the income of a company, the proportion of such income in the dividend paid to the shareholder must be given to charity and must not be retained by him. According to many prominent Islamic fund companies, a Muslim investor cannot invest in the shares of a company if the non-Shari'ah-compliant sources of income contribute 5% or more of the company's total income. The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, that is, in the form of money that cannot be purchased or sold, except on par value, then in this case the share represents money only and the money cannot be traded in except at par. What should be the exact proportion of non-liquid assets of a company for the negotiability of its shares? Some scholars have opined that even if the non-liquid assets of a company are 33%, its shares can be treated as negotiable.

CHAPTER 2

Islamic Fund Management

2.1 Introduction

Islam is a religion that was revealed by Allah (swt) with the creation of human beings. Islam does not separate between *Ibadah*, or ritual, and the method or manner of life. This approach is derived from the meaning of Islam as *Al-Deen*. *Al-Deen* can be defined as a way of life and faithfulness to Allah (swt). The purpose of humanity's creation is to serve Allah (swt). This obligation is not limited by time or place, but covers all aspects of human life. Every human activity which is within the limit of Shari'ah is measured as *Ibadah*. This activity will be rewarded by Allah (swt). Muslims are the second-largest group of religious people after Christians. Some of them have a lot of wealth to invest. However, there is a small group of Muslims who fail to observe proper Islamic practice. This has a negative impact on Muslims because Muslims' daily activities should be within the limits of Shari'ah. Otherwise, they will be rejected by Allah and the doers of such deeds will be considered ignorant.

Islamic fund management is a an option for Muslim investors. This offers a chance for Muslims to invest in accordance with the Shari'ah. This sort of fund is basically similar to the conventional investing except in its compliance with Shari'ah rules and regulations. For an Islamic fund, it is prohibited to invest in companies which are involved in *Haram* activities such as gambling, alcohol, pornography, *Ribawi* institutions and companies financed by *Ribawi* institutions. These strict rules and regulations of Islam is set out purposely to ensure that Muslims operate within the limit

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of Shari'ah. In the Qur'an, Allah (swt) mentions that business is *Halal* for a Muslim but any transaction which is based on *Riba* is considered *Haram*. When an activity is considered *Haram* it will be rejected by Allah and the person will be grouped among sinful people. Of course, these groups of people will be not entitled to rewards. Every investment deals with risk. In Islamic funds, there are risks too. The risks in Islamic funds are various depending on the choices of the investors. Islam accepts risk but rejects any kind of speculation. This is because speculation may bring the *Gharar* and *Maisir*. These two principles are among the *Haram* which are clearly highlighted by Islamic scholars. These concepts also may lead the strong to dominate those who are weak.

As time goes on, Islamic funds are becoming a popular investment opportunity. This is proved by the increasing numbers of Islamic counters (OIC—Organisation of Islamic Cooperation—member countries). The growths of the Islamic counters has occurred in every part of the world. Examples are the Saudi American Bank in Saudi Arabia, Bank Islam Malaysia Berhad in Malaysia and many more.

Finally, an Islamic fund is an option for Muslims in particualar and more generally for the whole population. The fund is used purposely to enhance the economic status of the *Ummah*. At the same time, Muslims believe it will purify them and allow them to get closer to their Creator, avoiding *Haram* activities. In this respect, the activities of Islamic funds are a *Fardhu Kifayah*. Muslims have to support this sacred activity. Allah (swt) encourages Muslims to support good deeds and prohibit bad deeds.

2.2 How to Manage an Islamic Fund?

2.2.1 Investor's Funds

Investment is an activity involving a portion of money allocated to certain types of business and in seeking profit. Investors do not do anything related to the operation of the company. Since investors are not involved in managing the operating of the company, so they are not entitled to any salaries or wages, only the profit gained by the company. Thus, the investors have to have certain expertise in choosing which companies have bright prospects.

This section offers sound tips, or pillars, for investing money. These pillars are taken from the ideas of conventional fund management but are reviewed by the author from an Islamic point of view. These pillars are:

- Successful investing involves doing just a few things right and avoiding serious mistakes. It means an investor has to be aware of potential pitfalls. He has to plan ahead and do his homework regarding the strengths, weaknesses, opportunities and threats of the prospective organisation. He also has to know the activities of the company. He has to know whether the company has any pros or cons vis-à-vis Shari'ah. He has to avoid any serious mistakes that may have a big impact on his investment.
- When there are multiple solutions to a problem, choose the simplest one. Sometimes, an investor will face a serious problem. This sort of problem is usually difficult to solve. Once the problem is clearly defined, there will be multiple possible solutions. So, the investor will again face a problem in choosing the solution. Based on the concept of prudence, the author suggests that the investor chooses the simplest one. As an example, if an investor is confused about whether to invest in a high-risk company or low-risk company, where the high-risk company offers a 5% rate of return but the low-risk company only offers a 2.5% rate of return, based on this principle, the investor should rely on the investment which is more guaranteed.
- Try to earn money every time, even if it is just a small amount. The investor does not leave his money idle. He has to gain something. In Islam the idle money is entitled to *Zakat* if it is over the certain limit or *Nisab* once passed a period of time. The idle funds are *Zakat*able because Islam encourages the *Ummah* to activate his wealth. And later the wealthy people are able to help the poor.
- Today is better than yesterday. This is the principle of all Muslims. A Muslim must be better today than yesterday. Based on this principle, an investor who has been in the investment field for a long time has to be more expert in choosing which companies to invest in. So, Muslim investors are logically able to gain more after spending some time in the investment field.
- An investor has to diversify his investments. In investment, an investor is better investing in various types of business. He has to invest in multiple types of risk businesses because diversification will help the investor balance his risk. In short, an investor who invests in three companies will have more chances to balance the risks than the investor who only invests in one company. The loss of a company can be covered by the profit of the other two companies. However, for a single company the loss will be solely from that company and there is no company available to bring the investor to the equilibrium point or better.

- Cost–benefit analysis is best for determining which companies are the best places to invest. Cost–benefit analysis is prepared by taking into consideration all the costs to be incurred when the investor invests. These costs will be deducted from the expected benefits received after the investment. If the receipt is higher than the expense then the investor may decide to invest, if not it is vice versa.
- Know the operating of the business. Before investing in any business, an investor is required to know at least basic information regarding the activity of the business in which he wants to invest. This is to ensure that the investor will not carry out blind investment. Blind investment may lead to the loss of capital. This loss of capital can be avoided if the investors do their homework in studying the prospects of businesses. He can rely on the current users' behaviours, environments, status of the economy and other financial and non-financial data. He can also rely on his assumptions based on the rating provided by rating agencies such as RAM in Malaysia.
- Investors have to have balanced estimations. It means, not to overestimate or underestimate. Usually, investors will do prior estimation before doing any analysis and later accept or reject an investment chance. This prior estimation is important whether or not investors choose it for further analysis. Overestimates and underestimates will lead the investor to the state of frustration if he failed to achieve his estimations.
- Beware of last year's achievements. The situation and environment are always changing. Therefore, the past year's achievement is not the only basis on which to consider options. It can be used as a rough guide, and we should not totally depend on it. Past achievements are good for checking the reliability of the internal control of the management, but not for measuring future prospects.
- The financial market is related to the fears, hopes, knowledge and greed of all investors everywhere. The environmental situation moulds the feeling of all investors. Sometimes the feeling may boost the market and lead the market be bullish, if not the market will become bearish. For Muslim investors, these feelings should not be there. This is because they will lead to serious speculation, which is *Haram*.
- An investor should use long-term planning in order to be a good investor. Investors should not just grab a chance which is short term only. This is because patience and consistency are valuable assets for intelligent investors.

2.2.2 Types of Investor

The types of funds to invest in depend on the objective of investors. Investors have to decide how big the risks are that they are willing to accept. Of course, the ultimate purpose of investment is increased income.

There are four basic types of investors who deal with the risks of investment: aggressive, moderate, conservative and extremely conservative. An aggressive investor is someone who is not interested in their current income but is interested to capital appreciation; capital appreciation is where the value increases with the company's capital growth in line the impact of the company's business success. This type of person is willing to accept high market risk.

The second group of investors includes those who are willing to accept moderate market risk. They view their current income as a subordinate to capital appreciation.

The third group is conservative. They are only willing to accept limited market risk. For them, current income is more important than capital appreciation. Meanwhile, the extremely conservative are not willing to accept any risk at all. They attempt to greatly reduce the market risk and increase the market return or current income. They are not interested in capital appreciation.

The level of acceptable risk for an investor is referred to as risk tolerance. Risk tolerance differs among investors. Usually, investors will determine their risk tolerance based on the individual's current economic circumstances. The best measurement for risk tolerance is the level of risk that a person finds disturbing. If a person feels that he is not comfortable with a high-risk investment, he may start selling and move to a lower-risk fund or counter.

It is easy to say that investment is the activity most closely comparable with the matter of faith. The fluctuation of the economic situation is determined by environmental factors. No one knows about the future of the economy. Therefore, investors have to be brave in placing their investments.

2.2.3 The Divine Ethical View on Investment

Savings refers to funds that are not spent on consumption. Meanwhile investment refers to the expenditure that is not for consumption but for the purpose of capital appreciation and the creation of new capital. Idle money cannot be considered as an investment. This is because idle money will lose its purchasing power.

Islam encourages Muslims to stream their income into certain areas defined by Islamic priorities. If money is kept idle, it is punished by Allah (swt) through the obligation to pay *Zakat*. This is because in idle money lies the right of the eight *Asnaf* (*Zakat* beneficiaries).

There are two types of investment available for an investor: physical assets or financial assets. The physical assets are gold, coins and other tangible assets. Meanwhile, financial assets are stocks, bonds, mutual fund and so on. Between these two assets, financial assets are preferable for investment. This is the effect of the liquidity of the investment. Investment in financial assets is more liquid than physical assets. An investor can easily pull out his capital from financial assets; he can easily sell his stock certificate to other buyers through investment agents or stockbrokers.

Stocks are the shares of a company that have been apportioned into units. The amount of capital contributed by an investor is determined by the numbers of units of a company's share. The voting power of a company is also determined by the number of shares. The dividend and the disbursement of income are also distributed based on the number of units held by an investor.

Meanwhile, the stocks of a company are divided into two types, one is ordinary and the other preference. The difference between two is that preference holders are entitled to fixed receipt over the years, regardless of whether the company makes a profit or loss. Meanwhile the ordinary stocks are determined by the decisions of the company management.

The fix return receipt from an investment of stock preference is *Haram* according to Islamic scholars. This is because of the concept of justice in Islam. In stock preference, the investor has being promised to receive a certain fix rate annually. In other words, the future dividends are determined prior to the determination of the profit of the year. Therefore, Islam views stock preference as *Haram* since it involves with the uncertainty. The amount receipt from stock preference is considered as *Riba al-Fadl*. As a solution, Muslim may invest in the common stock.

At other points, an investor may reduce the liability of the investment through diversification. Diversification means an investor invests in diverse industries and companies rather than in the related companies and groups. Let us say, if an investor invests in a crude oil company which the company facing the economic downturn in that particular year, at the same time he or she also invests in the motor industry which uses oil as its main power.

As an effect of un-diversification (not diversifying their investments), the investor will face the high-risk problem. However, this kind of problem can be avoided by practising diversification. Diversifying investment in various industries may help the investor to reduce risk. Although he will incur loss in crude oil investment but this loss can be covered by the profit he gains from an investment of the other unrelated industries.

2.2.4 *Islamic Funds versus Mutual Funds*

A mutual fund is a company that pools money to invest in various ways and buys the portfolio of the securities. The managements of the company consist of the investment expert. They have enough knowledge in studying the power of the company and in planning the prospect of the future earnings of the company.

The money that is pooled by the company is invested in buying various portfolios securities on behalf of the whole group. All portfolio securities are eligible for the conventional mutual fund. However, scanning must be done for an Islamic fund. The purpose of the scanning is to check for Shari'ah compliance. The Shari'ah Supervisory Board of the company does the scanning.

In conventional mutual funds, investors will share the profits and losses earned from the investment. The ratio of the profit and loss is based on the amount of shares they invested. Meanwhile, in Islamic fund investment, the profit and shares is distributed based on modes of investment agreed by the investors; among the modes of investment are *Ijarah* fund, equity fund, commodity fund, *Murabahah* fund, mixed funds and many more.

2.2.5 *Risk versus Rate of Return*

Gaining the highest revenue from the investment is the main objective of all investors. They hope that the fund management company will invest properly their money. Although the investment and analysis are done by the company, the investor also may prepare their own analysis.

The academicians, money managers and thoughtful individual investors have drafted some formulas in selecting the best performing fund. They agreed that the assets should be measured based on risk and rate of return.

According to the study, the rate of return is a mix of any change in market value, any dividends, interests and other receive from the investment. All of these are expressed in a percentage gain. After calculating the rate of return, the next task is to measure the level of risk. Based on the same study, the risk could be measured by several different statistics. One of these statistics is beta coefficient. Beta coefficient is a ratio of the average performance of a given stock or mutual fund relative to that of some of market average. As an example, if a beta coefficient of Company A is 2.0, it would indicate that the mutual fund tends to move twice as rapidly as general market.

In viewing to use these statistics, we have to find the company, which offers the Beta coefficient equal to zero, or zero-risk company. Then we have to know the rate of return of the invested company. Let us say the company's rate of return is 5% and the beta is 0. Therefore, an investor may select the other risky fund, which offers the rate of return higher than 5%.

The next step is that an investor has to find the second higher risky than zero risk fund. Let us say the beta is 1 and the rate of return is 10%. An investor may invest is such 10% but he or she has to face one level higher risk in gaining 10% rate of return. If there is a fund which offers higher rate of return than 10% but lower risk (<1), or in other words, the rate of return is more than 10% per unit of risk is described as outperforming the market and as under-performing if the opposite is the case.

2.2.6 Why Should Investors Outsource Investment?

There are a number of investors who pass on the job of investment to an investment company. This kind of investor normally does not care much about the revenue he or she is going to gain. However, there are also investors who are very meticulous about every cent they invest. These groups of people will try to evaluate the performance of their portfolios themselves.

There are a number of reasons why investors try to avoid evaluating their invested portfolio. Here we discuss a few reasons why an investor may prefer to outsource such evaluation to outside advisors. Basically there are four reasons: a desire to avoid fiduciary responsibilities, lack of time, lack of interest or an inability to control emotions, and insufficient knowledge.

2.2.6.1 Fiduciary Responsibilities

Some people have surplus money. They may intend to invest their money but they do not have enough time to do so. They may have expertise in managing the money, but they have other priorities.

People who fall into this category may be a son, daughter, spouse, or other relative who inherits the wealth of a late family member, individuals on the board of directors of a school, mosque, or any foundation, or trustees for retirement plans. None of them have much interest in the activity of investment per se. Therefore, for these people it is better to outsource their investment activities.

2.2.6.2 Lack of Time

A second group of investors who frequently seek outside assistance included people who do not have enough time to manage their investment activities. Although they may do an excellent job, time constraint prevent them from doing so. They realise that their time is better spent focusing upon their business or career.

2.2.6.3 Lack of Interest

This is the third group of investors who simply lack the interest to actively manage their own investments. As an example, upon retiring, many people choose to enjoy life by travelling, recreation and spending time with family, friends and other activities. Their income becomes a secondary motivation in their lives.

2.2.6.4 Inability to Control Emotions

Investors who fail to control their emotions are most in need of an outside advisor. This is because emotion plays an important role in controlling people's activities. Investors may do the wrong thing if they make decisions based on their emotions. In order to avoid such risks, investors may choose outside advisors as their investment agents.

2.2.6.5 Insufficient Knowledge

An investor has surplus money but not necessary sufficient knowledge. Yet knowledge can be a main pillar in investment. This is due to the complexity of transactions. Investors with insufficient knowledge investors can assign the task of investing to external advisors who are the expert in the field.

2.3 Conclusion

An Islamic fund is an alternative option for the Islamic investor. The purpose of this type of fund is to encourage Muslims to activate their wealth and avoid it being idle. It is well known that Islam penalise sidle wealth through the obligation of *Zakat* payment. The biggest question is whether the fund truly complies with the Shari'ah or not.In the twenty-first century, many Muslims have surplus money, available for consumption. However, their wealth is not always properly invested in an Islamic manner. Therefore, the existence of an Islamic fund is the best solution for these investors. Moreover, co-operation between wealthy and knowledgeable Muslims may empower society. A fully developed Muslim society would be the final result of this co-operation.

PART II

Principles of Islamic Investment

CHAPTER 3

Shari'ah Frameworks of Investment

3.1 Introduction

How to be compliant with a Shari'ah model of investment has been an issue of concern worldwide. This chapter is a modest contribution to that debate. It sets out the most important Shari'ah rulings to be fulfilled for those wishing to make an Islamic investment. Investment and production in Islam should take place within the framework of the following concepts and principles:

- The Divine concept is that Allah has created Man to settle on earth blessed, and provided him with considerable natural resources in order to meet his needs and achieve his increase welfare.
- Inevitability of investing funds so that they would not be consumed in paying the legitimately due *Zakat*.
- Prohibiting the accumulation and blocking of funds from circulation through motivating the hidden capacities of individuals.
- Eliminating monopoly which creates more differences among the economic levels of the one society
- All products whether they be commodities or services must lie within the scope of halal (legitimacy) or by granting priority to the principle of the community needs and interests of both the individual and society. (Zaman n.d.)

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3.2 Rational Outlook

Savings refer to that part of one's income that is not spent on consumption. Investment is that part of expenditure that is made not for consumption purposes but on creation of new capital assets such as buildings, land, stocks, mutual funds and so forth. Investments are made for obtaining benefit in the future. When money is kept idle (i.e. not invested) it loses its value or purchasing power over time because of inflation. Studies have conclusively proven that un-invested cash has lost over 93% of its purchasing power over the last 200 years. The same studies have also proven that investing in stocks has proven to be more rewarding than investments in securities and bonds with a fixed rate of return. One invests because of our own consciousness to have a safe future, but it is also commanded by Allah (swt) as evident in the Qur'an and Sunnah.

3.3 Divine Guidance

3.3.1 Wealth Management

Allah blesses those who acquire wealth in good manner, then the wealth is spent accordingly and the remaining is saved for future use when hardship occurs. (Billah, M. M. 2003)

Narrated by Ibn Mas'ud (r), the Holy Prophet (saw) said:

In the day of Judgement, the generation of Adam (a) will not be allowed to escape without being questioned on the following five basic responsibilities:

- How did one spend own life time;
- How did one spend own young life;
- How were the sources of one's income;
- How did one spend own wealth;
- How much did one practises knowledge, which one acquired? (Billah, M. M. 2003)

Verily, Allah! With Him (Alone) is the knowledge of the Hour, He sends down the rain, and knows that which is in the wombs. No person knows what he will earn tomorrow, and no person knows in what land he will die. Verily, Allah is All Knower, All Aware (of things). (Qur'an, 31:34).

There is a Hadith on how to avoid becoming involved in debt:

> O Allah, I seek refuge in thee from sin and debt. He was asked why do you so often seek the protection of Allah (swt) from debt. He replied: One who is in debt tells lies and breaks promises. (Billah, M. M. 2003)
>
> "I seek refuge in thee from unbelief and debt." A man asked him, do you equate debt with unbelief? He replied: "Yes" (Billah, M. M. 2003)

3.3.2 Abstain from Being a Spendthrift

> Verily, spendthrifts are brothers of the Shayatîn [devils], and the Shaitân [Satan] is ever ungrateful to his Lord. (Qur'an, 17:27)
>
> And it is He Who produces gardens trellised and untrellised, and date palms, and crops of different shape and taste (its fruits and its seeds) and olives, and pomegranates, similar (in kind) and different (in taste). Eat of their fruit when they ripen, but pay the due thereof (its zakat, according to Allah's Orders1/10th or 1/20th) on the day of its harvest, and waste not by extravagance. Verily, He likes not Al-Musrifûn [those who waste by extravagance]. (Qur'an, 6:141)

3.3.3 Invest for the Benefit of Others

From investment profit, we can help others by giving away charity and *Sadaqah*. We also may pay *Zakat* from the profits we have from investment, thus it would bring benefits to others.

> The most excellent of men is the believer who strives hard in the way of Allah with his person and property. (Marican, Y. M. 2003)
>
> He who bring forth what is needed will be provided for and he who monopolizes is cursed. (Ibid.)

There are basically two categories of assets one can invest in:

- physical assets: real estate, gold coins;
- financial assets: stocks, mutual funds and unit trust.

Financial assets are the preferred choice because they are more liquid that physical assets. This means that they can be bought and sold with ease, cash can be realised anytime, even at short notice. Financial assets are more volatile, meaning that their values move up and down regularly. Financial assets offer two types of returns—cash income and capital gains.

3.4 The Essence of Shari'ah Compliance

- To ensure acceptance, validity and enforceability from Islamic law point of view.
- The original rationale for having an alternative Islamic system that meets the religious requirements of Muslims in line with their belief and faith.
- The factor that distinguishes Islamic banking and finance from its conventional counterpart.
- Fulfils the goal and objectives of Islamic financial system, that is, to achieve justice and fairness in the distribution of resources.
- In Islamic legal method, the main source of law is the Shari'ah or Islamic Law as contained in the Qur'an and Sunnah.
- Underlying rule: all contracts are deemed permissible except when there is contravention of any established principles of Islamic law or Shari'ah.
- Legal maxim (*A'id al-fiqhiyyah*):

  Al Asl fi al 'Uqud al Ibahah'—the original rule in contracts is permissibility.

- The parameter: Avoidance of any contravention of the established principles and prohibitions in Islamic law.

3.5 Shari'ah Rulings

3.5.1 Investment Shall be Limited to **Halal** *Activities*

The Shari'ah does not permit Muslims to invest in any business or activity that involves the production of items or the pursuit of activities the Shari'ah considers *Haram*, or impermissible. Mufti Taqi Uthmani issued a *Fatwa*, which rules that:

> If the main business of a company is not halal [lawful] in terms of Shari'ah, it is not halal for one to purchase, hold, or sell its shares, because, it will entail the direct involvement of the shareholders in that haram [prohibited] business. (Billah, M. M. 2003)
>
> When Holy Prophet (saw) said: When Allah (swt) prohibits a thing, He prohibits [giving and receiving] the price of it as well. (Billah, M. M. 2003)

3.5.2 Prohibitions

*3.5.2.1 Fixed Interest/Usury (*Riba*)*

Why does Islam prohibit *Riba* or what is the wisdom behind the prohibition of *Riba*? The first wisdom deduced from the Qur'an is the elimination of justice. As the name suggests, *Riba* means excess (*Ziyadah*), augmentation, increase, addition or growth. Thus, by practising *Riba* one party would benefit at the expense of another. The interest earned is without any risk of loss. By removal of the risks altogether, the transaction is no longer one of business and trade, but one of usury.

> And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums). (Qur'an, 2:279)

Another piece of wisdom as evident in the Qur'an is the call for corporation, charity and *Qardh al-Hasan* (interest-free loans). Here the concept of brotherhood prevails, as *Riba* would bring harm to society. The collection of wealth through *Riba* is associated with selfishness, greed, impatience and cruelty. The third wisdom involved in *Riba* is the illegitimacy of charging an extra amount on lent money or commodities because of deferred repayment. Time is not a commercial commodity. Contractual fixed interest derived from loans (risk free) = *Riba*.

> O you who believe! Be afraid of Allah and give up what remains (due to you) from *Riba* (from now onward), if you are (really) believers. (Qur'an, 2:278)

> Those who eat *Riba* will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan leading him to insanity. That is because they say: 'Trading is only like *Riba* ', whereas Allah has permitted trading and forbidden *Riba*. So whosoever receives an admonition from his Lord and stops eating v shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to *Riba*], such are the dwellers of the Fire—they will abide therein. (Qur'an, 2:275)

> For the wrongdoing of the Jews, We made unlawful to them certain good foods which has been lawful to them, and for their hindering many from Allah's Way;
>
> And their taking of *Riba* though they were forbidden from taking it and their devouring of men's substance wrongfully (bribery, etc.). And We have

> prepared for the disbelievers among them a painful torment. (Qur'an, 4:160–161)

> O you who believe! Eat not *Riba* doubled and multiplied, but fear Allah that you may be successful. (Qur'an, 3:130)

> When usury and fornication appear in a community the people of that community render themselves deserving the sanction of Allah (swt). (Billah, M. M. 2003)

3.5.2.2 Gharar *(Uncertainty or Speculation)*

Any transaction entered into should be free from uncertainty and speculation. Contracting parties should have perfect knowledge of the counter-values intended to be exchanged as a result of their transactions.

> O you who believe! Intoxicants [all kinds of alcoholic drinks], gambling, Al-Ansâb, and Al-Azlâm [arrows for seeking luck or a decision] are an abomination from Shaitân's [Satan] handiwork. So avoid (strictly all) that [abomination] in order that you may be successful. (Qur'an, 5:90)

> The Holy Prophet (S.A.W) prohibited any dealing involves uncertainty. (Al-Muwatta)

3.5.2.3 Maisir *(Gambling)*

> Those who believe and do righteous good deeds, there is no sin on them for what they ate (in the past), if they fear Allah (by keeping away from His forbidden things), and believe and do righteous good deeds, and again fear Allah and believe, and once again fear Allah and do good deeds with *Ihsân* (perfection). And Allah loves the good doers. (Qur'an, 5:93)

3.5.2.4 Rishwah *(Corruption)*

Investments should not be involved bribery or misappropriation:

> And eat up not one another's property unjustly (in any illegal way e.g. stealing, robbing, deceiving, etc.), nor give bribery to the rulers (judges before presenting your cases) that you may knowingly eat up a part of the property of others sinfully. (Qur'an, 2:188)

3.5.2.5 Jahl *(Ignorance)*

> There is no poverty worse than ignorance and no wealth more useful than reason. (Marican, Y. M. 2003)

3.6 Every Contractual Party Must Honour the Contractual Terms

O you who believe! Fulfil (your) obligations. Lawful to you (for food) are all the beasts of cattle except that which will be announced to you (herein), game (also) being unlawful when you assume *Ihrâm* for Hajj or *'Umrah* (pilgrimage). Verily, Allah commands that which He wills. (Qur'an, 5:1)

Verily! Allah commands that you should render back the trusts to those, to whom they are due; and that when you judge between men, you judge with justice. Verily, how excellent is the teaching, which He (Allah) gives you! Truly, Allah is Ever All Hearer, All Seer. (Qur'an, 4:58)

And come not near to the orphan's property except to improve it, until he attains the age of full strength. And fulfil (every) covenant. Verily! the covenant, will be questioned about. (Qur'an, 17:34)

3.7 Every Transaction Shall Be Performed with Utmost Good Faith

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is Most Merciful to you. (Qur'an, 4:29)

Woe to Al-Mutaffifin [those who give less in measure and weight (decrease the rights of others]. (Qur'an, 83:1)

Those who, when they have to receive by measure from men, demand full measure (Qur'an, 83:2)

And when they have to give by measure or weight to men, give less than due. (Qur'an, 83:3)

Intention and consent have become the two fundamental principles to any contractual relation. As evident in the Hadith:

The Prophet (saw) said, 'Validity of the acts depends on (doers) intentions'. (Billah, M. M. 2003)

3.8 Preserve the Unity of Mind and Sincerity in Investment

Any investment should be concluded in sincerity between the parties and no one should cause harm to another.

> O you who believe! Why do you say that which you do not do? Most hateful it is with Allah that you say that which you do not do. (Qur'an, 61:2–3)

3.9 Ethical Principles of Islamic Investment

3.9.1 Making Money from Money Is Not Permissible

One of the incorrect presumptions on which all theories of interest are based is that money is a commodity. It is therefore argued that just as a merchant can sell his commodity for a higher price than it cost him, he can also sell his money for a higher price than its face value, or just as he can lease his property and can charge a rent against it, he can also lend his money and can claim interest thereupon. Islamic principles, however, do not subscribe to this presumption. Money and commodity have different characteristics and, therefore, they are treated differently. The basic points of difference between money and commodity are shown in Table 3.1.

But in the case of spot market on foreign exchange, the difference is permissible provided that it is for payment of the management fees.

3.9.2 Profit and Loss Sharing

The basic and foremost characteristic in Islamic investing is, instead of a fixed rate of interest, that it is based on profit and loss sharing. Islam encourages Muslims to invest their money and to become partners in business instead of becoming creditors. This in turn encourages entrepreneurship.

Table 3.1 Making money from money is not permissible

Money/currency	*Commodity/asset*
No intrinsic utility—cannot be utilised directly	Have intrinsic utility—can be utilised directly
No quality except that it is a measure of value or a medium of exchange	Can be of different qualities

Source: Author's own

3.9.3 Segregation of Funds

The funds of investors who are very diligent and anxious to earn lawful income should not be commingled with those of conventional investors who are not observant of the Shari'ah. Therefore, there should be separate accounts, books and computer programs evidencing this complete segregation of funds.

3.9.4 The Existence of a Shari'ah Supervisory Board

There should be a Shari'ah supervisory board for any institutional Islamic investment body, and that Board should consist of trustworthy scholars who are highly qualified to issue *Fatwa* (religious rulings) on financial transactions. In addition, they ought to have considerable experience with knowledge of modern dealings and transactions. The Board should be independent and free to give opinions on proposed contracts and transactions.

3.10 Management Committed to Islamic Financial Concepts

The investment's fund manager should be fully convinced of the Islamic investment precepts and fully committed and dedicated thereto. It should be anxious to implement and comply with the teachings governing it. Unless the entire management is committed and convinced, the business activities and the enterprise will not be foul free or will not escape irregularities and deviation. Regardless of how strict and stringent fatwa and contracts are, this will not ensure sound practices if there is no one sufficiently sincere and committed to implement the principles.

3.11 Compliance with the Standards of the AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has published a number of accounting and auditing standards that all Islamic financial institutions should comply with and implement. The AAOIFI's activities are considered fundamental groundwork that underpins Islamic banking activities by keeping them away from individual, personal reasoning. The collective personal reasoning (*Ijtihad*) of the AAOIFI is highly important in this vital aspect of Islamic economic life.

Therefore, Islamic investment should comply to these standards in order to avoid confusion, misunderstanding and ambiguity, and to seek clarity and sound business activities.

3.12 Shari'ah-Recognised Investment Instruments and Structures

Various Islamic investment concepts are practised today: Figs. 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.7, 3.8, 3.9, and 3.10 show how they are implemented:

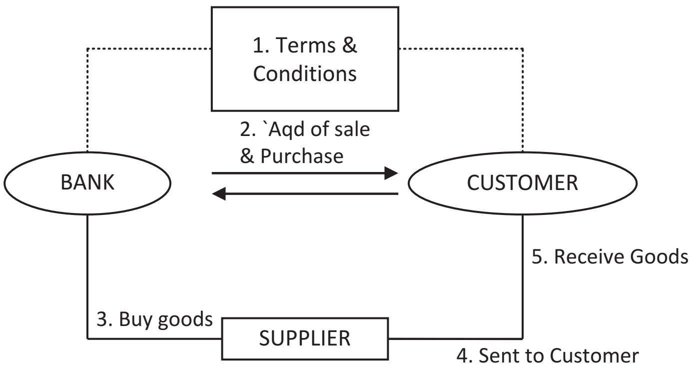

Fig. 3.1 *Bai' al-Murabahah* (Sale by Deferred Payment with Mark-Up). Source: Author's own

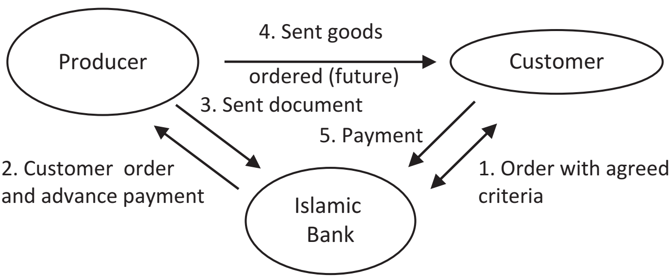

Fig. 3.2 *Bai' al-Salam* (Sale by Deferred Delivery). Source: Author's own

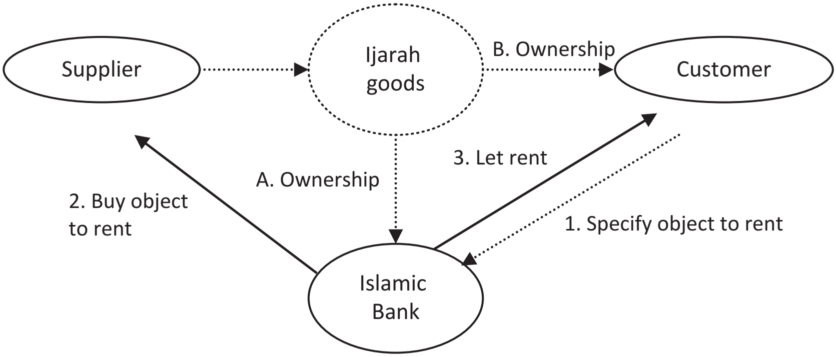

Fig. 3.3 *Al-Ijarah* (Leasing). Source: Author's own

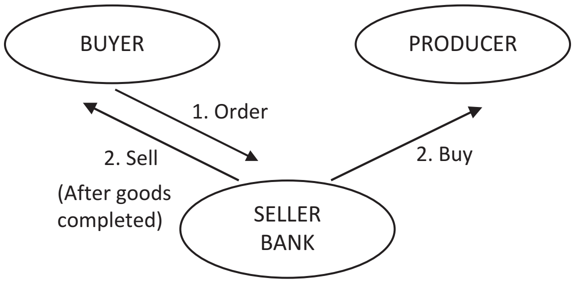

Fig. 3.4 *Al-Istisna'* (Manufacturing). Source: Author's own

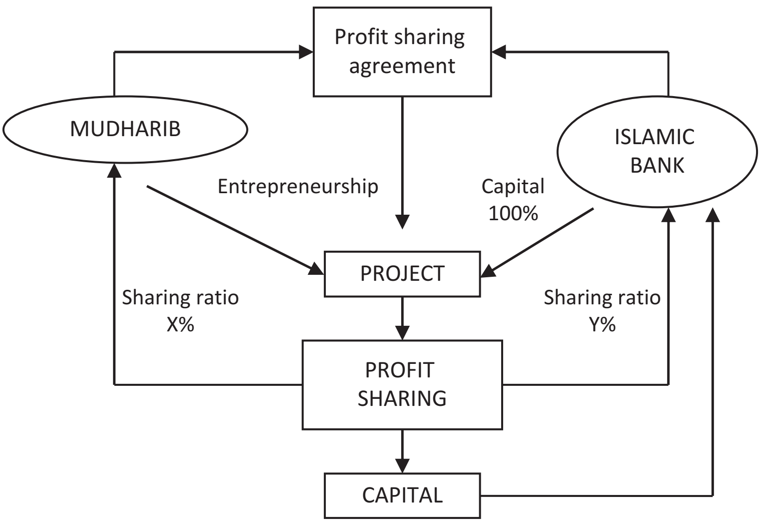

Fig. 3.5 *Al-Mudharabah* (Profit and Loss Sharing). Source: Author's own

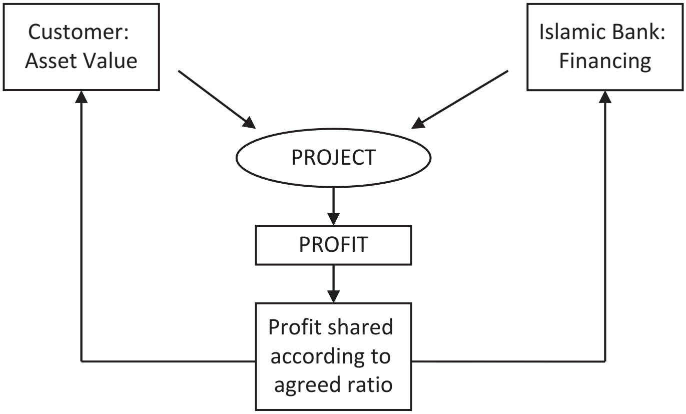

Fig. 3.6 *Al-Musharakah* (Partnership). Source: Author's own

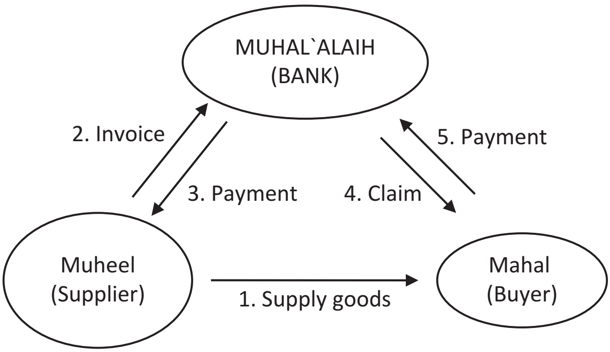

Fig. 3.7 *Al-Hawalah* (Transfer). Source: Author's own

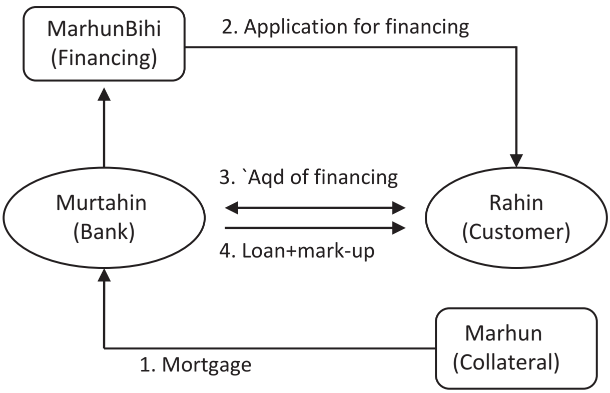

Fig. 3.8 *Al-Rahn* (Mortgage). Source: Author's own

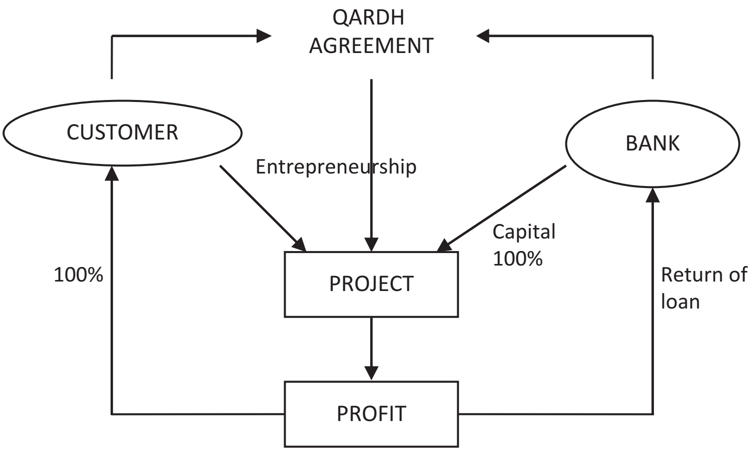

Fig. 3.9 *Al-Qardh* (Loan). Source: Author's own

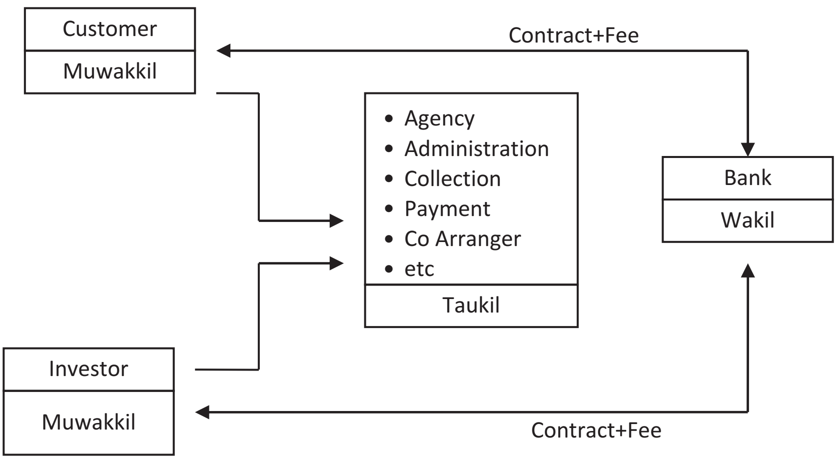

Fig. 3.10 *Al-Wakalah* (Agency). Source: Author's own

3.13 Shari'ah Rulings on Unit Trusts (Micro-investment Plans)

In former times, people automatically thought of keeping savings when they were thinking of performing the Hajj. Although savings kept in the bank has a great advantage of being risk free, it would take many years before they could realise their hopes. Today, many options are available that could make your savings grow. Investment, for example, if wisely planned can bring higher profit whether in the short term or long term. The Malaysian capital market offers an array of investment products in the form of shares, loan stock, bonds, warrants and unit trusts. Furthermore, the rapid growth of the Islamic banking and financial products and services has provided the opportunity for Muslims to actively invest and for Malaysia to play a more significant role in broadening and deepening Islamic financial services. Recently, demand for the Islamic products and instruments that meet the risk–return profile of market participants for various purposes such as liquidity, investment and financing activities necessitates the further expansion of the market in terms of product and services.

The Islamic capital market has grown significantly in terms of the number of new products, size of funds raised and number of market participants. For example, from only three Islamic unit trust funds in its early introduction stage in 1993, the industry now has more than 50, representing almost 25% of the total funds in the country (Economic Report 2003). The Islamic capital market consists of two main sectors—the Islamic equity sector and the Islamic private debt securities (PDS) or bond sector. The Islamic capital products which are available for Muslims to transact in include Commission on Shari'ah-Approved Securities, Islamic Debts Securities, Islamic and Shari'ah Indices, Warrants and Islamic Unit Trust. These products have been guaranteed their permissibility by the Securities Commission's Shari'ah Advisory Council. For the purposes of this chapter, we will focus our discussion on the Islamic Unit Trust.

> Unit Trust fund is an investment scheme that pools money from many investors who shares the same financial objectives. The fund is managed by a group of professional managers who invest the pooled money in the portfolio of securities such as shares, bonds and money market instruments or other authorized securities to achieve the objective of fund. The funds earn income from the investment in term of dividends, interest income and capital gains. The income is then distributed to the unitholders in proportion to their ownership, in form of dividends. (Unit Trusts 2002)

What makes the Islamic Unit Trust different from the above definition is that the activities of the fund are carried out in line with Islamic teachings. In other words, the Islamic Unit Trust represents an assertion of religious of law in capital market transactions where the market should be free from the involvement of activities prohibited by Islam as well as free from the elements of usury, gambling and uncertainty.

The primary objective of Islamic Unit Trust is parallel with the Islamic objective of doing business or investment by participating in halal Shari'ah-based investment portfolio, which complies with the principles of the Shari'ah. Such halal investments will exclude companies involved in activities, products or services related to conventional banking, insurance and financial services, gambling, alcoholic beverages and non-halal food products. The Prophet (saw) said:

> A truthful and trustworthy trader will rise up with the Prophets, the righteous and the Martyred. (Hadith)

Currently there are two types of Islamic Unit Trust funds offered by banks in the market: capital growth and income funds. For the purpose of this chapter, we have chosen RHB Bank Bhd to be the example. The details of the funds are as below.

3.14 An Industrial Experience: RHB Mudharabah Fund

The main objective of the fund is to provide a balanced mix of income and potential for capital growth by investing in stocks listed on the Kuala Lumpur Stock Exchange or on any other stock exchanges, unlisted stocks and Islamic Debt Securities and other non-interest-bearing assets acceptable under principles of Shari'ah. The Fund's activities will be conducted strictly in accordance with the requirement of the Shari'ah principles and shall be monitored by the Shari'ah Panel of the fund (http://www.rhb.com.my).

3.15 Islamic Bond (*Sukuk*) Fund

The main objective of the fund is to provide regular income to investors through investments in Islamic debt securities and bonds which are acceptable investments under the principles of Shari'ah (http://www.rhb.com.my).

3.16 Mechanisms of Investing in the Islamic Unit Trust

3.16.1 Lump Sum Purchases

This is where an investor has a single amount of funds which they want to invest into a unit trust. This may be the only investment the investor wishes to make. Over a period of time (3–20 years), the initial investment will increase as dividends and other income is earned by the fund. When redemption or sale of the unit takes place, the unit-selling price will reflect the accumulation and compounding of capital over the relevant number of periods. It is this compounding effect over time, which makes accumulation type investments, such as unit trusts, so attractive to the investor (The Malaysian Unit Trust Industry 2001).

For example, someone who has recently inherited a sum of money may wish to invest the funds in a unit trust and hold it for an extended period to save for some specific purpose, such as children's education. At the end of the required period, the proceeds of the sale of the units will be the initial investment plus the returns on that amount, accumulated over the relevant period.

3.16.2 Regular Savings

Some people invest in unit trusts by making regular (e.g. monthly) contributions to their fund. This is an ideal, disciplined and useful way to accumulate capital for a future need. By making regular contributions over a period, the sum accumulated at the end of the period will increase at a much quicker pace compared to if one simply makes a single investment at the beginning. At the end of the required period, the redemption (or sale) price of the units held will represent the accumulation of all contributions, plus returns generated from the total contributions since the first purchase was made. The effect is more noticeable the longer the holding and contribution period. This form of saving is the basis of most pension fund accumulation, for instance the Employees Provident Fund.

3.17 Concept of an Islamic Unit Trust Fund

A unit trust is an agreement between the management company, the trustee and fund's investors—who are called unitholders. All parties have their specific rights and obligations that need to be observed. In order to cater the welfare and justice of those parties, the Securities Commission has been given the power to register the deeds of unit trust schemes. The management company is the company that establishes the fund. It handles the marketing and administration of the fund. According to Shari'ah, fund managers can be considered as *Al-Amin* since they manage investors' property in trust. In other words, by putting confidence on their integrity, honesty and sincerity, investors believe that managers will not devour investors' wealth by false or illegal means.

Allah (swt) refers to the *Amanah* (trust) in the following verse of the Qur'an:

> Allah does command you to render back your trusts to those whom they are due; and judge between man and man that you judge with justice. Verily, how excellent is the teaching, which he gives you. For Allah is He who hears and sees all things. (Qur'an, Surah Al-Nisa: 58)

As a safeguard, the management company is not allowed to keep the asset of the fund, such as the share certificates and banks accounts. The trustee's act, as a custodian of these assets and its main responsibility is to look after the interest of the unitholders. This duty of keeping trust is linked with the sanction of the religion of Islam as Allah (swt) warns in the Qur'an:

> And if one of you deposits in trust a thing with another let the trustee (faithfully) discharge his trust, and let him fear his lord. (Qur'an, Surah Al-Baqarah: 283)

A Unit Trust scheme can be illustrated as a tripartite relationship between the managers, the trustee and the unitholders.

3.18 Screening Process Adopted in Evaluating Investments (Fig. 3.11)

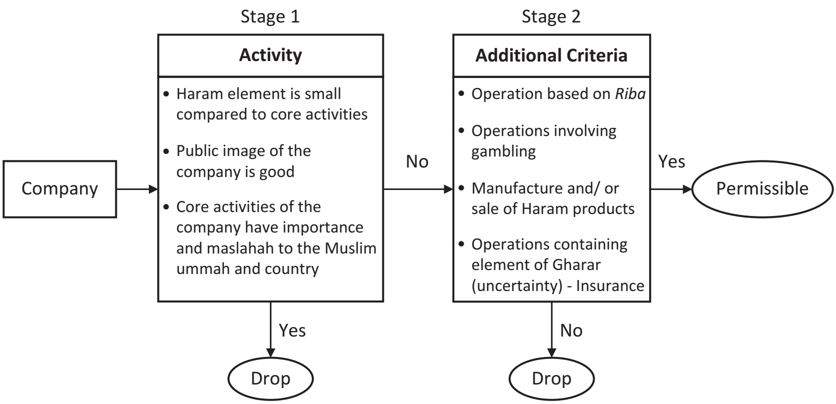

Fig. 3.11 Screening process adopted in evaluating investments. Source: Author's own

3.19 Debate on Islamic Bonds

As mentioned at the beginning of our discussion, Malaysian Islamic capital market consists of two main sectors: the Islamic equity sector and the Islamic private debt securities (PDS) or bond sector. At present, Islamic Private Debt Securities only involve the bond market. It is regulated by the Securities Commission (SC) through the framework provide under the guidelines on the offering of Private Debt Securities. Hence, as stipulated in the guidelines, the structure of Islamic PDS must be confirmed and approved by Shari'ah advisors who are appointed by the issuer. A Shari'ah advisor can be independent, someone who has been approved by the SC or a Shari'ah committee attached to the financial institutions that carry out Islamic banking activities approved by the central bank (Securities Commission n.d.).

The issuance of Islamic bonds began as early as 1992 and a total of $20.5 billion has been invested in Islamic bond since then. However, there are persistent disagreements among Islamic scholars regarding the permissibility of Islamic bond. Basically, the contract is designed based on the principles of *Murabahah*, *Bay' al-'Inah*, *Bay' Al-Dayn* and *Bay' Al-Muzayadah* (Rosli, S. A. and Sanusi, M. M. n.d.). The application of those Islamic principles can be illustrated in the following steps (ibid.).

Step 1:

3.20 Securitisation: The Creation of a *Bay' al-'Inah* Underlying Asset

Asset securitisation is the essence of Islamic bond issues, as the bond must be assumed as a property of value. It is transformed to an object of value in order to qualify it to be sold and purchased in both primary and secondary market. *Bay' al-'Inah* is created when the financier purchases a bond from an issuer and sells it back to the same party at a credit price. This buy-back agreement will ensure that the issuer will receive the money in cash while financier will be paid a prefixed or contracted amount at a future date. Debt payment will be made by instalment through bond issues. The difference between cash and mark-up price will represent the profit due to the financier (*Murabahah* principle applied).

Step 2:

3.21 Issuance of Islamic Debt Certificate (*Shahdah al-Dayn*)

As a consequence of the above transaction, the bond issuer will sell bond pictured in debt certificate to financier or investors. Debt certificates issues are valid when it is backed by an asset. In other words, it should be securitised. In this case the underlying security is the BBA asset (for long-term issues) or *Murabahah* asset (for short- to medium-term issues). In Malaysia, there are two categories of Islamic bond available in the market: the Islamic Coupon Bond and the Islamic Zero-Coupon Bond.

3.21.1 Islamic Coupon Bond

'Coupon' in this context denotes the profit portion gained on Islamic bond issued whether in *Murabahah* notes issuance facilities (MuNif) or *Al-Bai'-Bithaman Ajil* Islamic debt securities (ABBA). Two certificates will be issued to investors where the certificate that represents the capital component is called a primary note while the profit portion is called a secondary note.

3.21.2 Islamic Zero-Coupon Bond

This type of bond is sold at a discount. Although no coupon is given, investors can its profit impliedly through the difference between par value and discount value.

Step 3:

3.22 Trading of Debt Certificate

The secondary market is crucial in order to liquidate bonds. As objects of trade, the bonds can be sold by investors to the issuer or third party if the secondary market for Islamic bond exists. Let us say that Ahmad, an investor, bought a zero-coupon bond at a discount $950. The bond par value is $1000 upon maturity. At maturity, he sells back the bond (debt certificate) to the issuer or third party. Here, we can figure out that Ahmad receives $50 as a profit from the bond. This is how *Bay' Al-Dayn* applied in the contract.

3.23 Application of *Bay' Al-Muzayadah* Principle

Khazanah Zero-Coupon Bond is government-guaranteed bonds. It applies the same process of issuance like other types of zero-coupon bond. However, what makes it different is that the discount price is market determined through a bidding process (*Bay' Al-Muzayadah*). The bidding process allows the bond to be priced according to the forces of demand and supply so as to produce a yield that can be used as a benchmark for the local bond market.

3.24 What Do the Opponents of Malaysian Islamic Unit Trusts Say?

As most of Islamic bonds in Malaysia are structured using *Bay' al-'Inah* and *Bay' Al-Dayn*, many scholars—especially Middle Eastern ones—do not allow them to be traded. A *Bay' al-'Inah* or *Bay' Al-Dayn* contract is seen as something similar to *Riba*-based financing.

3.25 *Bay' Al-'Inah*: Why It Is Not Allowed

Bay' al-'Inah is generally known as sale based on the transaction of *Nasi'ah* (delay). The (prospective) debtor sells to the (prospective) creditor some objects for cash which is payable immediately; the debtor immediately buys the simultaneous the same object for a greater amount for a future date (Schact, J. 1983). The contract involves loans and the difference between the two prices is interest. Such a contract is forbidden because a loan for interest is equivalent to *Riba*.

Based on Shafi'I, Maliki and Hanbali views, Rosli and Sanusi draw the following conclusion (Rosli, S. A. and Sanusi, M. M. n.d.):

1. It is obvious that *Bay' Al-Inah* is a legal device in order to overcome the prohibition of *Riba*, and is not deemed to be an act of sale, as there is clear evidence that such act amounts, in effect, to a contract of loan. Thus, it is forbidden as it is based on unjustified enrichment or "receiving money advantage without giving a counter value".
2. Almost all schools (except *Shafi'i*) prohibit such sale based on a hadith narrated from Ibn Qayyim quoting the Prophet's saying:

> A time is certainty coming to mankind when they legalize [*Yastahillun*] *Riba* under the name of bay. (Ighatha al-Lahfan n.d.) (trade concerning that intending usury by words of a sale)

3.26 *Bay' al-Dayn* for Immediate Payment and Deferred Payment: Are They Allowed?

All schools of scholars agree that *Bay' al-Dayn* (sale of debt either to debtor himself or to any third party) for immediate payment is allowed provided that it is paid in full and no benefit is given to the purchaser. Financial transaction involving debts should never be allowed for a payment relative to the period of loans because it can be regarded as *Riba*. The prophet in one Hadith says: "Do not sell a debt for a debt".

So, here we can conclude that selling debts for deferred payment is not allowed.

As far as sale of debt to a third party, most Hanafis, Hanbalis and some Shafi'is jurists (Al-Zuhili n.d.) agree that it is not allowed to sell *Al-Deen* to non-debtor or a third party at all. Such opinions are based on the forbidden sale of *Gharar*, in which the seller does not have any debt. Otherwise the remaining scholars allow the above selling provided that the following conditions are observed:

- the debt must be confirmed debt. And contract must be performed on the spot;
- the debtor must be financially capable, must accept and recognise the sale in order that he will not deny the sale;
- the sale should be equal in terms of amount of quantity (if the debt is $1000, then its price value should be $1000 too). (Ibid.)

3.27 Conclusion

In our opinion, based on the discussion above, it can be concluded that *Bay' al-'Inah* and *Bay' Al-Dayn* are principles which are still in doubt. However, the evidences presented by most Islamic jurists show that they are not in a position of supporting the application of those principles. Al-Qaradawi states in relation those principles: Why should we practice transaction, which contains elements of devices while we are in position to have a clear and apparent alternative transaction? Furthermore, *Mu'amalat* which contains elements of device deviates the true objective of Shari'ah

(Al-Qaradawi n.d.). The Prophet (saw) reminds Muslims in one of his Hadith to avoid any form doubt (*Shubhah*) in our life.

The above arguments show that the implementation of Islamic bonds in Malaysia is not yet fully supported and agreed by Muslims throughout the world. As Malaysia is going to realise its target of being the centre of Islamic bonds, those disagreements should be taken into consideration. Middle Eastern investors are among those rich people who are interested in Islamic products. However, the principles of *Bay' al-'Inah* and *Bay' Al-Dayn* in bonds certainly will pose a great challenge to the Malaysian to attract investors from rich Gulf countries.

Here we like to propose some alternatives that can be implemented in Malaysia which can support our target to be among the key players in the regional Islamic capital market.

1. Implementation of *Al-Muqaradhah* bond (Rosli, S. A. and Sanusi, M. M. n.d.) as an alternative to the Islamic debt-based bonds. *Al-Muqaradhah* bond is a financial instrument for raising equity capital. It is a conclusion of lawful *Al-Muqaradhah* (the *Mudharabah*) in which one party contributes in term of capital and entrepreneurship for the other, and profits are shared according to predetermined ratio. Its maturity is determined by the tenure or project completion date.
2. Design project finance contracts using *Murabahah* and *Ijarah* financing as being adopted in Middle Eastern Islamic securities (ibid.). These types of financing do not utilise bond instruments. The process simply involves the usual *Murabahah* techniques where financiers will purchase the raw material and equipment from supplier. The goods will be sold to the customer at mark-up price. This type of buying and selling proves suitable in projects involving lumpy items since it term and conditions require most of the characteristics found in traditional debt such as the need for collateral, debentures and guarantees. And it avoids transaction using devices which is still doubtful in Islam.

The Shari'ah has been beautifully gifted by Allah (swt) to be used as guidelines in this worldly life. As the following verse:

> Then We have put you (O Muhammad [saw]) on a plain way of (Our) commandment [like the one which We commanded Our Messengers before you (i.e. legal ways and laws of the Islamic Monotheism)]. So follow (Islamic Monotheism and its laws), and follow not the desires of those who know not.

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CHAPTER 4

Islamic Investment Policies

4.1 Introduction

The state of being wealthy is often highly desired, regardless of the person's religion, race or nationality. Islam, not to be left behind, also encourages its followers to seek wealth, but in doing so it is compulsory to ensure that any activities concerning wealth creation align with Shari'ah principles and guidelines, with the teachings of Islam, as noted in the Qur'an and Hadith of Prophet Muhammad (saw) For instance, Allah (swt) says:

> But seek, with the (wealth) which god has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world. (Qur'an, Al-Qasas: 77)

The above surah indicates that wealth creation is permitted in Islam and it is a gift from Allah (swt) to those whom He wishes to award it to. Nevertheless, wealth should be spent in God's cause, that is, for charity and good works. (Ali, A. Y. 1983) So, how do we create wealth, the Islamic way? There are many means of obtaining wealth, but the most prominent way is to engage in trade and commerce. Prophet Muhammad (saw) said:

> Take to trade and commerce, because nine-tenths of the source of earnings is in trade and commerce. (Fazul-ul-Karim, M. n.d.)

Today, trade and commerce are becoming more complex, and they require knowledge and expertise in order to ensure the continuation of

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businesses over a long period. Hence, not everyone have the time, opportunity and the necessary skills to survive in the business world. Then, how are we to take advantage of the huge potential benefits that trade and commerce offer? One way is for Muslims to invest in businesses that offer future profits, while ensuring compliance with Shari'ah principles.

This chapter focuses on Islamic investment opportunities and some of the issues surrounding investing in Shari'ah-approved counters, as practised in Malaysia. Among other types of investments that we will be looking at are equity and commodity investments, *Ijarah*, *Musharakah* and *Mudharabah* investments. Furthermore, we will also discuss Islamic investment criteria and its future.

4.2 Islamic Investment Paradigm

An independent Shari'ah scholar, Shaykh Yusuf Talal DeLorenzo mentioned that "[i]nvesting is one way in which Muslims can be good stewards of their money, as promoted by the teachings of Islam" (DeLorenzo, Y. T. 2001).

Aligning with the increasing level of awareness and interest in investing in modern financial markets among Muslims worldwide, for the past few years investment strategies that honour Islamic beliefs have apparently been growing in the financial industry. (http://www.lightbulbpress.com/pr_islamic/pressrelease.html) Hence, it was reported in the year 2000 that there were over $150 billion of investments in the Islamic market worldwide. (http://forbes.com/). Before we move on, let us first look at the definition and principle of conventional investments, and compare these with the definition and principle of Islamic investments. Kuala Lumpur Stock Exchange (KLSE) defined conventional investment as the act of putting capital, in the form of time, effort or money into a business or venture, with the aim of obtaining a positive return or profit; while Islamic investment is defined as the act of putting capital, in the form of time, effort or money into a business or venture, which strictly conforms with the tenets of Shari'ah or Islamic Law, for the purpose of getting an Islamically lawful and positive return or profit (Mahmud, M. M. 2001). Thus, the difference here is that an Islamic investment must comply with the Shari'ah principles, in order to ensure that any gains arising from the investment are from halal sources, and thus can be utilised for personal consumption or for charitable purposes.

Conventional investment follows the rules of maximising profits and usage of available capital, while minimising risk and loss; whereas for Islamic investment, the rules goes beyond the conventional investment rules to include divine considerations, meaning that Islamic investment must be guided by Qur'anic and Prophetic injunctions that will maximise benefits (in the form of profits and social welfare) and minimise harms (including losses and social ills) (ibid.). Hence, we can assert here that in Islamic investment, the aim is not just to collect as much wealth as possible for our own personal use, but rather, it specifies that the investments must be align with the teachings of Qur'an and Sunnah, and the investments will give rise to benefits, not only to the investor, but also to the society and ummah as a whole. The Islamic investment thus incorporates within it the sense of brotherhood and wanting to help one another for the benefit of all, as Allah had mentioned in the Qur'an:

> Help ye one another in righteousness and piety, but help ye not one another in sin and rancor. (Ibid.)

How can an Islamic investment benefit t society and reduce social ills? Take, for instance, an executive working for Company XYZ. He has a surplus of income because his salary is more than what he actually needs to cover his expenses. Hence, rather than leaving his money in a conventional bank that offers a low interest rate, he could invest in a project belonging to a friend, who needs capital to pursue his plans. Since the investor has no time to manage the project, both parties could engage in a *Mudharabah* agreement and share the profits and loss that will arise later on. If gains were realised, part of it will be subject to *Zakat* payments. Thus, we can see here that rather than just keeping his surplus of income in the bank all to himself, the investor could earn more from the profit-sharing investment, while at the same time helping a friend in need to also gain some earnings. If many investors were to engage in this activity, wealth creation, circulation and distribution among the participants of investments could be intensified, and at the same time, the poor could also enjoy the positive outcome of the investments through zakat. Consequently, investment activities can bring about benefits to society.

If this is the case, how then does investment minimise social ills? Luqman advised his son thus: "Crush poverty by lawful earnings, because he who is poor earns three habits—laxity in religious actions, weakness in intellect and loss of manliness" (Fazul-ul-Karim, M. n.d.). Furthermore, the state of being poor could also lead to theft, robbery and family abuses. Hence, as mentioned earlier, through investment, wealth can be circulated and distributed among the people in a society; this will lead to a situation whereby everyone in the society will be in a better position financially. As a result, social ills due to poverty could be reduced.

There are several reasons outlined by the KLSE on why we need Shari'ah-compliant investments; the reasons are listed below:

1. Firstly, it says that Islam is a total way of life, whereby the Qur'an and Sunnah embodies the way in which every Muslim should conduct his daily affairs. Therefore, investment activities should also be guided by the Qur'an and Sunnah.
2. Secondly, the general objective of the Shari'ah, in relation to profit making activities, is to maximise benefits and minimise harm, as oppose to merely maximising profits and minimising losses. Hence, through Islamic investment, this objective can be achieved, as mentioned earlier.
3. And finally, there is in excess of 1.9 billion Muslims worldwide, and more than $100 billion of Islamic funds in circulation globally (which is growing at the rate of 20% annually). Since it is a must for Muslims to earn an income from *Halal* sources, the Islamic investment becomes an avenue for fund channelling. (Mahmud, M. M. 2001)

Furthermore, there are a number of principles governing Islamic investment that makes it different from the conventional investment. The principles, as laid down by the KLSE, are:

1. The Islamic investment should conform to the Shari'ah principles, which are based on three sources: the Qur'an, the Sunnah and the consensus of the Islamic scholars.
2. The invested business must participate in halal venture. Therefore, investment involving elements such as *Riba*, gambling, *Gharar* and manufacturing and/or selling of *Haram* products like liquor and pork are prohibited in Islam.
3. The investment should be transparent and certain so as to provide investors with full knowledge about the nature and specifications of the investment. This is crucial in order to ensure that the investment is free from non-halal elements mentioned above. However, when

the non-halal elements are unavoidable, transparent information will assist investors in purifying their income or dividend earned by giving the non-halal portion to charity.

4. The investment should involve a tangible commodity. Hence, commodities, which are not tangible or not backed by assets cannot be invested in.
5. And finally, there is clear ownership of the investment on the part of the investor, regardless of whether or not the investor has fulfilled his/her debt obligation, obtained for the purpose of investment. (Ibid.)

4.3 Types of Islamic Investment

There are a number of avenues for channelling funds in Islamic investments. Some are done privately, meaning that investments are between the contracting parties only like *Ijarah* contracts; while others are pooled or joint investments, which are subject to standardised rules and regulations of authorities in charge like investments in equity. In this section we will discuss a few types of Islamic investments available in Malaysia.

4.3.1 Equity

Investment in equity is a very well-known type of investment whereby investors purchase shares of companies for either capital gains or dividends distributed by the respective companies. This kind of investment can be done on individual basis, whereby a person purchasing shares of a company such as Tenaga Nasional Berhad, or it can be done through an organisation such as a unit trust or mutual fund. To invest in equity shares that are acceptable in Shari'ah, the following conditions need to be fulfilled:

1. The main business of the company is not in violation of Shari'ah – that is, it does not involve *Riba*, gambling, *Gharar*, manufacturing or selling of *Haram* products like liquor and pork (as mentioned above).
2. If the main business is *Halal*, but the company is involved in borrowing money on interest, or depositing its surplus in interest-bearing accounts, Muslim shareholders must express disapproval by raising their voice against such activities in the annual general meeting.

3. If some income from interest-bearing accounts is included as part of the whole income of the company, then the percentage of interest related income to the whole income of the company should be obtained. Then, the same percentage out of the dividend paid to the shareholder must be given to charity.
4. The shares of a company are negotiable only if the company owns some non-liquid assets. Mufti Taqi Usmani reasoned out that if all the asset of a company are in liquid form, i.e. money, hence, the shares represents money only, and the money cannot be traded in except at par. For instance, if one share of a company sells for $100 and it represents $100 of money the company owns, without any non-liquid asset, thus, an investor who wishes to purchase or sell the share must be at the price of $100 only because any disparity in price will lead to *Riba*. (Usmani, M. T. n.d.)

However, in the real world, with regard to the last condition mentioned above, most listed companies do have non-liquid assets like computers, factories or office equipment. Hence, differences in prices of shares can be realised and any capital gains arising from trading of shares can be recognised. However, there are questions arising with regard to the exact proportion of non-liquid assets of a company in order to enable its shares to be negotiated. Some Islamic scholars stated that the non-liquid assets must be at least 51% of the total assets because otherwise, if most of the assets (more than 50%) are in liquid form, the majority deserves to be treated as a whole, thus all of the company's assets should be treated as liquid; other scholars opine that if 33% or more of a company's assets are non-liquid, its shares can be treated as negotiable; while the Hanafi school views that shares of a company can be negotiable regardless of the proportion of its liquid assets, provided that the non-liquid part should be in a considerable proportion and the price of the shares should be more than the price of the liquid amount attributed to each share (ibid.).

4.3.2 Commodity Funds

In this type of fund, the joint pool of funds is used to purchase commodities for the purpose of reselling them; the profits generated from the sale will then be distributed on pro rata basis among the investors. To ensure the alignment of this kind of investment with Shari'ah principles, Mufti Taqi Usmani set out the following rules:

1. The seller must own the commodity at the time of the sale; hence, short selling of commodities are not permissible.
2. Forward sales are not allowed, except in *Istisna'* and *Bai' Salam* contracts.
3. The commodities must be halal, meaning that dealing with pork or wine is impermissible.
4. The seller must have the physical or constructive possession of the commodity he wishes to sell; constructive possession, as mentioned by the Mufti, includes any act in which the risk of the commodity is passed on to the purchaser. For instance, if a seller does not have the physical possession of a commodity, but he bears the risk of declination in price that could lead to an unprofitable reselling of the associated commodity, then the seller is allowed to resell the commodity.
5. The price of the commodity must be fixed and known to the contracting parties; this is to ensure total elimination of *Gharar* elements in the commodity trading. (Ibid.)

4.3.3 **Ijarah** *(Leasing)*

Under this type of investment, the owner or lessor of an asset (a motor vehicle or house) will lease out his assets to a user or lessee for a certain amount of money or rentals; at the same time, the ownership of the asset remains with the lessor. The aim of this kind of investment is for the investor or owner of the asset to recover the capital cost of purchasing the asset, plus a profit margin, which are obtained out of the rental payments (Ahmed, N. 2000). There are basically two types of leases: the first is an operating lease whereby the ownership of an asset remains with the lessor who puts up the asset for rent every time the lease period expires, and the lessor bears the risk of recession or diminishing demand for the asset; the second type of lease is lease purchase whereby the ownership of an asset will be transferred to the lessee at the end of the lease period (ibid.). Just like equity and commodity funds, *Ijarah* contracts must also confirm to the principles of Shari'ah. Some of the principles highlighted by Mufti Taqi Usmani are:

1. The leased assets must have some usufruct and the rentals are charged beginning from the time when the usufruct is handed over to the lessee.

2. The nature of leased assets enables it to be used for *Halal* purposes. Therefore, investing in assets like gambling slot machines are not permissible.
3. The responsibility of the assets lies with the lessor, as the owner of the leased assets during the lease periods. Hence, when there are any problems associated with the leased assets, it is the responsibility of the lessor to get it fixed. For example, a person rents out his house and later got a complaint from the renter, saying that the water tank is leaking. Thus, it is the responsibility of the owner of the house to make sure that the problem is solved.
4. The rental charges must be fixed and known to the contracting parties right at the beginning of the contract. Consequently, the owner of an asset cannot simply alter the rental charges as he pleases because this will make the contract between the parties void; and hence, a new contract need to be drafted and signed. (Usmani, M. T. n.d.)

4.3.4 **Musharakah** ***(Partnership)***

Musharakah or partnership is a type of investment whereby all partners (investors) share profits of a joint venture according to a mutually agreed ratio, while losses are shared exactly in proportion to capital invested by each partner; at the same time, all partners have the right whether or not to participate in the management of the business (Ahmed, N. 2000). In relation to distribution of profits, the ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion of capital invested or fixing of a lump sum amount for any of the partners (http://www.islamiq.com).

For example, if two partners, Y and Z agreed that Z would receive $3000 every month as his share of profit, while the balance would go to Y; or if Y and Z agreed that Y will get 30% of his investment as his share of profits, then both these arrangements are invalid. An example of a valid agreement is: 30% of actual profits of business will go to Y, while the balance of 70% of actual profits will go to Z. As for sharing of losses, if Y and Z invested 45% and 55% of capital respectively, then the same percentage will be used when losses occurred. Hence, Y will have to only bear 45% of losses, while the balance will be borne by Z.

4.3.5 **Mudharabah** ***(Profit and Loss Sharing)***

Just like *Musharakah*, *Mudharabah* is also a partnership, but the difference is that in *Mudharabah*, one partner (investor) gives money for investing, while the other partner is responsible in providing labour and skill to manage the money; the profits generated out of the investment are shared in a predetermined ratio (ibid.). The profit-sharing ratio could be 50:50, 40:60 or 30:70, depending on the contracting parties. *Mudharabah* is one of the most well-known Islamic investments and its principles are widely adopted by Islamic banks (Ahmed, N. 2000). Aside from that, *Takaful* insurance schemes also adopt *Mudharabah* principles when it comes to distribution of profits and losses between the operator and participants of policyholders. Some of the characteristics of *Mudharabah* are:

1. The assets of *Mudharabah* should be easily recognisable and must be realised and liquidated to assist in the distribution of the proceeds between the partners upon termination of operations, completion of deals, or the achievement of the *Mudharabah* objectives.
2. The entrepreneur or manager of the *Mudharabah* funds has no right to mix the funds with his own funds, unless permitted by the investor.
3. If partners wish to renew the *Mudharabah* agreement, a new contract must be negotiated. Prior to that, the old contract must be terminated and the rights and liabilities of both parties have to be recognised and settled. (Ibid)

4.3.6 Other Types of Islamic Investment

Besides the five abovementioned Islamic investments, the KLSE also mentioned several other types of Islamic investments, including:

1. *Bai' Salam*, a forward transaction whereby cash is paid before delivery of commodities, while at the same time the quantity, quality and delivery date of goods and services had been specified clearly. In *Bai' Salam*, the interest of both contracting parties are taken care of: the seller gets the money he wants in advance for the purpose of covering expenses, in exchange of his commitment to deliver the commodity at a fixed future date; and the purchaser benefits from cheap prices (normally *Bai' Salam* sale is cheaper than cash sale) and he is able to hedge his position against fluctuation of commodity prices (Ahmed, N. 2000).

2. *Istisna'*, which is similar to *Bai' Salam*, is an investment whereby the investor provide the needed financing for the production of products or services. The price is determined in advance and the investor need not pay the whole amount in advance, payments can be made in instalments or it can be deferred until the time the desired product or services is delivered (ibid.). An example would be the contract between a person and a housing developer: the investor provides the needed capital for the 'manufacturing' of his house, which will be completed at a future date.
3. *Murabahah*, a mode of financing which is widely used by Islamic banks and financial institutions involves purchasing of commodities for the benefit of clients, and then selling it to them on deferred payment basis at an agreed margin of profits added to the initial cost of purchasing the commodity (Usmani, M. T. n.d.). For example, when a person needs to buy an equipment immediately but does not have enough money to purchase it. He then requests the bank to purchase the specific equipment and agrees to buy back the item in the future at a price, which is more than the cost incurred by the bank. (Mahmud, M. M. 2001)

4.4 Islamic Investment Criteria

For Malaysian Muslims who wish to invest in companies or projects in Malaysia or internationally, qualitative screening, quantitative screening, and trading and investment practices are looked at in order to determine whether an investment qualifies as an Islamic investment.

4.4.1 Qualitative Screening

Under qualitative screening, there are a few questions outlined by the KLSE that need to be answered prior to classifying an investment as an Islamic investment:

1. Firstly, "Is the company involved in an industry or business prohibited in Islam?" For example, Carlsberg involving in alcohol production; Magnum involving in gambling activities, or City Bank involving in interest-based activities. These companies are clear case of companies involved in *Haram* activities, hence making investment in these companies not permissible and non-Islamic.

2. Secondly, "Is the company involved in activities, which are of large benefit to the Muslim community, and the *Haram* element negligible?" For instance, a public utility company like Tenaga Nasional Berhad is involved in interest-based loans and it has interest-bearing accounts. This company provides large benefits to Malaysian, including the Muslim community because it generates and distributes electricity to houses, offices and factories. Hence, in this case, the *Haram* element (interest) is negligible, and thus, Muslim investors can invest in this company.
3. Thirdly, "Is there any element of *Gharar* in the business?" For example, investment in conventional insurance activities involves *Gharar* element because in conventional insurance there is no profit-sharing agreement between operator and policyholders, and it is uncertain whether a misfortune like motor accidents will or will not happen. If accidents do happen, then the participant will get to claim the benefits, and on the other hand, if accidents did not take place, the insurer gets to keep the premiums received.
4. Fourthly, "Is the company involved in exploitative and unethical activities?" For instance, if a Malaysian Muslim investor wants to invest in the Coca-Cola Company in the United States, among other aspects, he will have to make sure that the company does not provide financial aids to the Israeli troops who wishes to get rid of the Palestinians in Palestine. This is to make sure that Muslim investors are free from the involvement, be it direct or indirect, in any activities that could harm other people, particularly Muslims. (Mahmud, M. M. 2001)

4.4.2 Quantitative Screening

An Islamic investment must fulfil the criteria of having non-*Halal* elements that are negligible, which are subject to purification from the profits and dividends received by the investor (ibid.). Thus, investing in conventional banks' shares is impermissible in the eyes of Shari'ah because a significant portion of their earnings is from interest-based sources, which are not negligible. However, in the case of investing in a housing development project, for example, where the only non-*Halal* element is associated with borrowings based on interest, which is unavoidable and insignificant in amount, then, Shari'ah wise, Muslim investors are permitted to invest in the project. Nevertheless, as mentioned earlier, the non-

Halal proportion of the earnings are subject to purification by means of giving it away for charity.

Furthermore, the international criteria for Islamic investment, as stated by the KLSE, revealed four types of quantitative screening that must be fulfilled:

1. Interest related income must not be more than 5% of total income and it must be purified from earnings and dividend obtained. However, there are also some other scholars who perceive that up to 10% of a company's total income can be realised from interest-based sources. (http://ihilal.com)
2. The debt to asset ratio of a company must not be more than 30–33%. The rationale is that nowadays debts are incurred from interest-based borrowings, which are not supported by Shari'ah rulings. But, since interest is unavoidable, a certain level of debt to asset ratio is specified and permitted by Islamic scholars to be in existence in a company. In addition, if the debt level is too high, it could also lead to a financial distress situation, and hence, the future survival of a company could be uncertain in the sense that the future total income might not be sufficient to cover the interest payable on the amount borrowed. This situation, which imposes an increment in the level of uncertainty relating to the future of the company, will result in investment in the company to be impermissible under Shari'ah principles. Therefore, it is a must for companies to maintain the stated debt to asset ratio in order to qualify as an avenue for Islamic investments.
3. Liquid assets must not be more than 33–45% of total assets. This type of quantitative screening is essential to enable the shares of the company to be negotiated at a price different from par value, as mentioned in the equity investment section above.
4. The ratio of accounts receivables to total assets must not be more than 45%. A high level of accounts receivables could indicate that a company is inefficient in its collection, and it could also lead to a high level of bad debt if the receivables are not collectable in the future. Too high a level of accounts receivables could then result in cash flow and financial problems; thus, it is necessary for Islamic investments to adhere to the stated accounts receivables to total assets ratio in order to ensure that Muslim investors will be protected from unfavourable situations, and to make sure that companies are well disciplined and efficient in their day to day operations. (Ibid.)

4.5 Trading and Investment Practices

In the process of selecting securities to invest in, an individual investor and Islamic mutual fund operator must comply with the Shari'ah rulings applicable to trading and investing practices, which are:

1. The fund or money used to invest must be free of interest-based debt; therefore, a Muslim investor is not permitted to borrow on interest in order to finance his investments. For instance, a potential Muslim investor is certain that company ABC's shares will appreciate in the future because the company had won in the bidding of a profitable project. In order to take advantage of the future appreciation of share prices, the person wishes to purchase the shares of ABC now, so that he can sell it in the future at a higher price and thus realise capital gains; however, he does not have enough money to purchase the shares. Therefore, according to Shari'ah rulings, the potential Muslim investor cannot borrow from conventional banks or any other sources that imposes interest on borrowings, for the purpose of financing his investment. On the other hand, he could borrow from Islamic banks or any other institutions or persons who do not require interest on borrowings; or he could engage in a *Mudharabah* contract with a relative, for example, and share the profits at a predetermined ratio.
2. Muslim investors are prohibited from basing investment decisions on short-term speculation without prior knowledge about the fundamental values of the invested companies. Therefore, sound fundamental analyses need to be carried out before making an investment decision (Mahmud, M. M. 2001). Muhamad Obaidullah said that all business decisions involve speculation because businesspersons are required to assume some level of risk, after making proper assessment of risk with the help of knowledge (Obaidullah, M. 2000). Therefore, any investment activity is also a form of speculation; however, the kind of speculation that is impermissible under Shari'ah are speculation without prior knowledge and speculation which involves manipulation and could give rise to one party gaining at the expense of the other party. The Prophet Muhammad (saw) said:

   > Whoever interferes with the prices of Muslims' goods in order to raise them deserves that Allah should make him sit in the Fire on the Day of Resurrection. (al-Qaradawi, Y. 1986)

In relation to the above Hadith, Islamic scholars have deduced that manipulation is prohibited when two conditions exist: firstly, manipulation that could harm the people of a country, and secondly, the manipulator's aim is to make profit (al-Qaradawi, Y. 1986). If these elements are present and known to the Muslim investor, then he should refrain from going on with the investment.

4.6 Misconceptions and the Truth about Islamic Investment

Some critiques of Islamic investments observed that Islamic investment products are rigid and the investment opportunities are limited; Islamic investments give low returns or they are underperform; Islamic investments are not innovative and stagnant; and Islamic investments are merely an alternative to the current conventional investments (Mahmud, M. M. 2001). These criticisms might have been true in the early days of Islamic investments, but now things have changed and the misconceptions need to be corrected.

First of all, the choices of Islamic investments are abound and they are able to fulfil the needs of investors, risk profiles and investment appetites—there are hundreds of Islamic investment products and services available in the market; there are in excess of 200 Islamic banks and financial institutions globally; and there are more than 150 Islamic funds available globally in Malaysia, the Middle East, United States and Europe (ibid.). The many products and avenues of Islamic investments available in the market today clearly remove the first criticism that Islamic investment products are rigid and have limited opportunities. Now, Muslims can invest in Shari'ah-approved investments not only in their respective countries, but they can also do so in other countries, including non-Muslim countries like the United States or the United Kingdom.

Secondly, over the past few years, Islamic investments have actually outperformed conventional investments in terms of yielding higher returns—the average returns on investments on Islamic funds in Malaysia were 20% to 35% on average for the year 1998; 45% to 55% on average, with the highest return being 102.7% in the year 1999; and 81% average, with the highest figure of 116% as at year end March 31st, 2000 (ibid.). This is clear evidence that Islamic investments are much better than conventional investments. By complying with the teachings of Islam, as written in the Qur'an and Sunnah, greater benefits can be realised, compared to following human made policies and regulations, which are subject to injustice and defects. Furthermore, the higher rate of returns offered by Islamic investments serve as the biggest attraction for investing in Shari'ah-approved investments.

Thirdly, Islamic investments are open to non-Muslims and they are also available in non-Islamic nations; for instance, in the United States and Europe investors from all ideologies and religion invest in Islamic funds, and in the United States the Dow Jones Islamic Market Index (DJIM) was established (ibid.). The establishment of DJIM in the United States points to the fact that Islamic investments are widely accepted, even in non-Muslim countries. Moreover, there are no Shari'ah rulings or clauses in the Qur'an and Sunnah, which disallow the non-Muslims to invest in Islamic investments. Hence, everyone is free to participate and become an investor in Islamic investments.

Fourthly, constant Research and Development (R&D) are conducted to develop new and innovative Islamic products and services—in the year 2001, there are over 150 Islamic funds worldwide, which were growing at the rate of 100% per year; Islamic investment principles are being taught in universities in Malaysia, Middle East, Europe and the United States; and there are numerous training centres worldwide like the Islamic Banking and Finance Institute Malaysia (IBFIM) and many others across the world, which aim at training professionals in the field of Islamic finance (ibid.). With the existence of universities and training centres worldwide, more skilled and knowledgeable persons in the area of Islamic finance and investments can be produced. Thus, further development of Islamic products and services can be offered (to the Muslims in particular), which are capable of competing and outnumbering the quantity of the conventional investment products and services offered in the global market today. With the current level of growth in Islamic products and services, it is foreseeable that in the future Islamic products and services are able to capture more market share, be it in Islamic or non-Islamic nations.

And finally, we argue that Islamic investments are not merely an alternative to conventional investments; rather, they can 'hold their own', meaning that Islamic investments can survive without the 'help' of conventional investments—Islamic financial opportunities are currently growing at a high rate, and it is estimated that by 2010, 50% to 60% of the world's savings will be in Islamic institutions (ibid.). Thus, it is evidenced here that Islamic investments are indeed getting more popular, and in a few years' time at least half of the world's savings will be channelled into Islamic investments, as more people gain confidence in Islamic products and services.

4.7 The Future of Islamic Investment

With the ever-growing number of new Islamic investment products and services being offered and accepted in the market, there remains a potential danger that when people are too engross in innovation of new products and services, they might neglect or abandon some Shari'ah rulings just to suit their innovative minds. Therefore, it is necessary to have a global Shari'ah Advisory Council to standardise the rulings relating to Islamic investment products and services innovated, to ensure their alignment with Shari'ah principles (ibid.).

As it is, in Malaysia and other countries, there are several Shari'ah Advisory Councils (SACs) established to monitor and ensure that Islamic products and services developed are Shari'ah compliant. However, since there are several SACs present, there are issues that do not get unanimous consensus from Islamic scholars. For instance, some scholars in Malaysia allowed *Bay' al-dayn* investments, while other scholars outside of Malaysia prohibited it (Usmani, M. T. n.d.). Therefore, establishing a global Shari'ah Advisory Council is needed to solve these kinds of issues. In addition, it is possible that in the future, when Islamic investments are highly preferred to conventional investments, there might be people who are illiterate in Shari'ah rulings, who creates new kind of investments and labels them as Islamic investments just to market them. Hence, if an SAC is set up at the national level, a list of Shari'ah-approved Islamic investments can then be produced and publicised so as to protect Muslims from mistakenly investing in investments that use Islamic labels, but are actually not compliant with Shari'ah rulings.

4.8 Conclusion

Gaining enormous wealth is the basis of all sin (Fazul-ul-Karim, M. n.d.); when we are wealthy, we become arrogant, we tend to forget to fulfil our obligations to God and we forget about our responsibilities because all we care about is to enjoy the money that we have. To a certain extent, some wealthy people might also think that they are equal to god, like the pharaohs during prophetic times. But this does not mean that the beggars are better off in the eyes of Allah compared to rich people. Prophet Muhammad (saw) said:

> God loves one who adopts the path of labour to save himself from depending on others. (Ibid.)

Furthermore, when the prophet Muhammad saw a young man running to his shop and bypassing, without stopping, the mosque of Medina, he said:

> If the young man runs with the object of not depending on others and refraining from begging, he is in the way of god. (Ibid.)

The point here is that being wealthy is not a sin, but a gift from Allah (swt). Consequently, wanting to be rich through investment activities are permitted by Islam. By being wealthy, a Muslim could also help those in need by donating more money, for the course of Islam. What matters here is that wealth created through investments must be from halal sources, based on Shari'ah principles; and wealth must also be spent for good purposes and not to be wasted on unnecessary things.

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PART III

Islamic Investment Products and Practices

CHAPTER 5

Islamic Personal Investment

5.1 Introduction

This chapter concerns personal investment under Shari'ah principles. The main discussion here is about the guidelines or the basic principles for Muslims who want to make any type of investment. This is very important because in daily life we encounter all sorts of financial transactions, including those pertaining to the Islamic banking system. Moreover, we will consider the various types of investment that are granted by Islamic principles, in terms of their rulings and application in daily life. The chapter will also give a brief explanation of each type of investment, its procedures, subject matter and conditions. Then there will be a consideration of the related issue of *Riba*, or interest. The Qur'an (2:275) clearly declares: "And Allah (swt) has made trade lawful and has forbidden interest". The prohibition of interest is so important that all parties connected to any such transaction are sinful, in Islamic law. The Prophet Muhammad (saw) is reported to have said: "Allah Ta'ala has cursed the one who takes interest, the one who gives it, the witness to the transaction and the scribe (who recorded it). All are equal in the sin" (Mishkaat). It is thus clear that one must not take interest in any form.

Nevertheless, at times either due to lack of knowledge or lack of concern, investments are made that apparently are lawful and earn legitimate profits. Yet in reality these profits are nothing but interest. Consuming such "profits" draws the punishments for consuming interest that are mentioned in the Hadith.

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5.2 Types of Personal Investment

5.2.1 Mudarabah *(Profit and Loss Sharing)*

This is a partnership profit-sharing agreement whereby capital is provided by the bank, with assets, management or expertise coming from the client. The terms of profit and risk sharing are planned and customised for each investment. Any loss is borne by the bank, except if carelessness or misconduct can be proven on the part of the client. The maturity period being short to medium term, this instrument is generally suitable for trade activities. In other words, the contract of *Mudarabah* can be accepted for investment account deposits, where customers place funds and investments in order to share the profits of the investment undertaken by the entrepreneur (*Al-Mudarib*). The ratio of profit will be agreed between depositor and entrepreneur and will be spelt out in the contract. The entrepreneur would utilise the deposits in projects that it finances, including trade-related, project-related and equity-related projects.

In *Mudarabah*, individuals can invest their money or assets in a business through issue deposits. The *Al-Mudarib* accepts these deposits on the basis of procedures and periods similar to those for general investment deposits. In the Sunnah of the prophet, His companions (may Allah be pleased with them) transacted in *Mudarabah* and none of them was reported to have adverse opinions about it. There has also been a consensus among the Ummah for generations on the permissibility of *Mudarabah*. Furthermore, it was proved in the historical biography of the Prophet (PBUH), that before prophethood, he travelled to Syria as a *Al-Mudarib* with the capital of Khadeeja (may Allah be pleased with her) and the Messenger of Allah related that afterwards there was a Message approving it.

Some of the conditions are that this capital must not be a liability debt on the *Al-Mudarib*, because the *Al-Mudarib* is a trustee and, in respect to the debt, is a guarantor who can only be absolved after payment. It is permissible for a *Al-Mudarib* to mix their private capital with the capital of the *Mudarabah*. Thus, it becomes a partner, as well, and its disposal of capital on the basis of *Mudarabah* is permissible. So, *Mudarabah* is also suitable for any individual who wishes to make investments in accordance with Shari'ah guidelines.

5.2.2 Mudarabah *(Cost Plus Mark-Up)*

Mudarabah is a sale contract. However, unlike in standard sale contracts, what is negotiated between buyer and seller (in addition to other terms) is not price but the rate of profit of the seller (the mark-up). Price is set as cost plus a mark-up.

Essential requirements for *Mudarabah* are as follows:

- The seller (S) in this contract is the bank, and the buyer (B) is called *Al-Amer bil Shira*.
- Pre-sale order: The pre-sale agreement (the order) is not binding for B, but if he fails to fulfil his promise S is entitled to compensation for actual damages incurred. These may NOT include foregone profit opportunities.
- The agreement must specify the quantity, quality and place of delivery of goods, the mark-up, terms of payment of sale price, items that will be included in the cost, etc.
- Before completing the sale contract, S must have owned and possessed the goods in question.
- Mark-up must be known at least at the time of concluding the sale contract or even before. It may be a fixed percentage of the cost, or a fixed absolute amount.
- To satisfy the requirement of the seller's possession of goods before reselling them, a seller must bear the cost of loss, damage and storage before delivery to B.
- The seller may not increase the outstanding debt in case of misdeed. In such case, it can foreclose on the collateral or go to court.
- The bills of trade arising out of the above transaction cannot be sold, but must be kept until maturity. However, such bills can be transferred at face value.

5.2.3 Ijarah *(Leasing)*

Another type of Islamic fund is an *Ijarah* fund. *Ijarah* means leasing. In this fund the subscription amounts are used to purchase assets such as real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the fund and the rentals are charged to the users. These rentals are the source of income for the fund, which is distributed pro rata to the subscribers.

Each subscriber is given a certificate to evidence his subscription and to ensure his entitlement to the pro rata share in the income. These certificates may be called *Sukuk*, or another name is bond—a term recognised in the traditional Islamic Jurisprudence.

Since these *Sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these sukuk replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these sukuk will be determined on the basis of market forces, and are normally based on their profitability.

As the Prophet (saw) said: "Whoever hires a worker must inform him of his wage" (Bayhaqi).

The most important traits of such a lease operation should be:

- They basically enable the lessee to possess and use the assets they need without pumping in large amounts of money.
- Lease operations do not transfer the ownership of the assets; they only transfer the ownership of the benefits.
- Profit is independent from the corresponding value of the asset; it is a rental that accrues from the renewal of benefit.
- Lease operations are usually not immediate but medium-term operations.

5.2.4 **Musharakah** ***(Partnership/Venture Capital)***

This form of Islamic investment refers to a partnership or joint venture for a specific business with a profit motive, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation. An individual can invest with using this *Musharakah* concept and profit will be allocated fairly according to a ratio agreed by both sides.

Partnership is legal according to the Qur'an and the Sunnah, Ijma.

Allah (swt) says:

> Truly many are partners in business who oppress each other, not so those who believe and work deed of righteousness and how few are they? (Qur'an 38:24)

If one individual wants to joint with someone in a partnership of contract, both of them are involved in commercial activities where the wealth and profits are shared according to their agreed terms. Moreover, when they are involved in partnership of properties, two or more persons can share assets due to certain reason in getting ownership in which no differential can be made between their wealth but not due to contract. When loss is incurred, each partner will bear this in proportion to his/her proportion.

5.2.5 *Investment in Stocks or Shares*

As we know, shares are a form wealth that can help an individual or company to accrue funds. Investment in shares is also known as an equity fund in the capital market. According to Muhammad Taqi, an equity fund describes when the amounts are invested in the shares of joint-stock companies. Profits are mainly achieved through capital gains by purchasing the shares and selling them when their prices increase. Profits are also achieved by the dividends distributed by the relevant companies. It is obvious that if the main business of a company is not lawful in terms of Shari'ah, it is not allowed for an Islamic fund to purchase, hold or sell its shares, because it will entail the direct involvement of the shareholder in that prohibited business. So, investment in shares under Shari'ah principles is very controversial because such practice involves interest, unlawful transaction and conditions of uncertainty.

Today, some Muslims are involved in selling and buying shares, including individuals and large companies. Islam does not prohibit Muslims from growing their wealth but Muslims should follow the Shari'ah guidance because Allah (swt) prohibits *Riba* while allowing trading:

> Allah permitted trading and forbiddeth usury. (Qur'an 2:275)
>
> O ye who believe! Observe your duty to Allah, and give up what remaineth from usury, if ye are in truth believers. (Qur'an 2:278)

However, a large number of contemporary scholars do not support this view. They argue that a joint-stock company is basically different from a simple partnership period. In partnership, any policy decisions are taken with the consensus of all the partners, and each one of them has a power of veto with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. In addition, when a company is financed on the basis of interest, its funds working in the business are impure. Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income, which will be distributed to the shareholders through dividends. Therefore, if a company is engaged in a *Halal* business it keeps its surplus money in an interest-bearing account, wherefrom a small income is received from the interest, but this does not make all the business of the company unlawful.

5.2.6 Wadiah *(Deposit)*

Wadiah means something (valuable) that is kept by someone other than the owner. It can be divided into two types (Shariff, S. n.d.):

1. *Wadiah Yad al-Amanah*—the basis of charity and reward. The hand in keeping is basically a trust.
2. *Wadiah Yad al-Amanah*—usually describes practices in Islamic banking systems. The entire fund must be used for investment activity. It may also be considered as an investment, so as a result bank will give *Hibah* (profit) as was agreed.

Shari'ah basis of *Wadiah*.
Qur'anic Ayat:

> Allah commands you to render back your trusts to those to whom they are due. (Qur'an 4:58)

Sunnah:

> Render trust to who has put his trust to you. Do not betray those who betrayed you.

Al-Ijma:

> *Wadiah* is permissible since people need and it is thus a necessity.

5.2.7 Bay Al-Dayn *(Sale of Debt)*

Bay Al-Dayn means transfer of debt, which actually arises from deferred sale or other exchanges of contract. In the context of the Islamic capital market, *Bay Al-Dayn* is the principle of selling the *Dayn* (debt) which results from an exchange contract such as *Murabahah*, *Ijarah*, *Istin'a* and others.

Conditions:

- expediting the payment of the purchase
- the debtor is present at the place of sale
- the debtor confirms the debt
- the debtor belongs to the group that is bound by law so that he is able to redeem his debt
- payment is not of the same type as *Dayn*, if it is so then the rate should be the same to avoid *Riba*
- the debt cannot be created from the sale of currency (gold and silver) to be delivered in the future.

5.3 Terms and Conditions

In this section, we will analyse and highlight the correct conditions for investment in shares in line with Shari'ah principles. According to Sheikh Muhammad Taqi Usmani (www.albalagh.net/islamic investment/ Shari'ah principle), any business that we want to make must not contradict Shari'ah. Therefore, it is not permissible to acquire shares of companies that are involved in: selling or offering liquor, pork, *Haram* meat, or which are involved in gambling, night club activities, pornography and so forth. Furthermore, if some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given to charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, then 5% of the dividend must be given to charity.

Moreover, the shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, that is, in the form of money that cannot be purchased or sold, except on par value, then a share represents money only and the money cannot be traded in except at par. In the view of Muhammad Elgari (www.elgari.com/islamic banking), investment cannot be made in a company where 30% of the market value of its equity is below the value of cash and interest-bearing securities (wherever the market value of equity is measured by averaging the trailing 12 months' market capitalisation). Besides that, the outstanding total debt must exceed 30% of the market value of equity and receivables from investing must be more than 50% of total assets. In Malaysia, in general investments are only permissible in certain corporations and the list of these permissible corporations is furnished by Bank Negara. Additionally, investments in non-trustee shares are subject to Bank Negara's approval on a case-by-case basis.

The Shari'ah perspective also highlights an aspect of *Riba* that Muslim jurists have defined as usury; the practice was banned to protect poorer classes from exploitative money lenders. But some Islamic scholars and experts in Islamic law have claimed that not all interest should be prohibited except excessive interest. Because of that ambiguity, until fairly recently observant Muslims either financed their businesses and purchases in cash or agreed to pay and receive interest. Those who paid *Riba* could invoke a certain necessity clause in the Qur'an; many who accepted such interest on savings would donate the earnings to charity.

Muslims cannot altogether avoid receiving interest because it is present in all types of business. The important thing is that Muslims and Islamic banking should try to follow the rules and ethics of Islamic transactions. One goal in Islamic finance is to have both partners—the bank and the buyer—share equally in the risk of a transaction. Because Islamic banks invest with their customers rather than lending to them, the risk of losing principal is greater and there is no fixed rate of return. There is much wisdom from Allah to prohibit *Riba* such, as to avoid exploitation of another party which can lead to hostility among Muslims. In certain social conditions, for instance, it can cause individuals to tend towards bad deeds due to eating from unlawful sources of food. Islam teaches us to look for lawful trading and pleasure from Allah (swt) because *Al-Mu'amalat* in Islam is very flexible and appropriate to all circumstances and periods, for the whole of humankind.

5.4 Conclusion

Islamic investment as practised today is approved by Shari'ah scholars and complies reasonably well with sources of Islamic principles as written in the Qur'an and Sunnah. Moreover, with all the fact that we brought into the discussion in this chapter, we can conclude that all considered investments are *Halal* from the Shari'ah point of view, which means that they have fulfilled certain criteria such as being free from *Riba*, cheating and uncertainty. So, it depends on us to choose whatever type of investment that is suitable in order to makes our life better. From the above information, we should understand that Islamic investments have many advantages over conventional (western) types of investment. For example, all Islamic investment has as one of its main criteria the concept of *Ad'l*, or justice. This criterion keeps people away from sinful action, especially when dealing with financial transactions. We hope that all Muslims will be able to take advantage of Islamic investment, in order to achieve *Barakah*, or good reward from Allah, in this world and also so as to have an opportunity to contribute some benefit to ourselves and the whole Muslim community.

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CHAPTER 6

Musharakah Venture Capital

6.1 Introduction

In finance, there are two main methods that any company or organisation can use to raise funds and finance projects. One of those methods is equity financing, through the issuing of shares to the public, especially for listed companies. The second method is debt financing, through the issuing of bonds in the stock market or loans from a bank. As far as Islam is concerned, not all those means of financing are Shari'ah-complaint, or at least there are some restrictions in using the mode of financing specifically in the case of debt financing as far as it involves *Riba* or any other haram elements, such as *Gharar* and gambling. Almost all Muslim scholars are of the opinion that buying, selling or holding shares is lawful given that the company's main business is in line with Islamic law.

Islamic venture capital is a type of equity financing through the use of *musharakah*. In fact, venture capital as a concept is not new. As Sami Al-Suwailem said: "although the concept (venture capital) as such is not new, a formal market for venture capital in the United States started only after World War II. Venture capital institutions currently manage over $30 billion in the United States and another $30 billion in Western Europe." People use venture capital to finance projects which may require a large amount of capital and which may not be available from with project owner. Nowadays, business is using capital venture to finance fully or partially technology-based projects. Form this point of view, it is strongly advisable for the Muslim countries to have mutual contracts or win–win

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strategy to help each other in the era of globalisation, in which those who are stronger will consume the poorest people. On the other hand, most of the Muslim nations have enough resources but they lack skills and expert management teams, while other Muslim countries seem to have highly skilled people, such as Malaysia. Therefore, it will be of great advantage for Muslim countries to have a deal of such a kind. To give one example, the United Arab Emirates and Malaysia built a Technological City together in Dubai in 2018. We need to take the hands of each other to live in the new era of globalisation. In the next section, we need to explain the concept of *Musharakah*, as this is the base for the use of Islamic venture capital.

6.1.1 **Musharakah** *(Venture Capital or Partnership)*

Musharakah literally means sharing. In the context of business and trade is refers to a joint enterprise in which all the partners share profit or loss of the joint venture. It is a contract based on mutual consent, whose validity does not depend on conditions of a valid contract, but the most important aspects in *Musharakah* are that all parties should be capable of entering in to a contract, depending on consents, and that the contract should be free from duress, fraud or misrepresentation.

6.2 Rules of *Musharakah*

There are basic rules which need to be spelt out during implementation of a *Musharakah* contract. The distribution of profit and loss, the nature of capital, management of *Musharakah* and termination of *Musharakah* must be clearly and precisely outlined.

6.2.1 Distribution of Profit

The proportion of profit to be distributed must be determined and agreed upon by contracting parties. If it is not determined, then the contract is invalid. The profit-sharing ratio should be based on actual profit accruing to the business, not on how much each contributed. If the profit is distributed on a capital ratio and at a predetermined rate then such contract is invalid, but the question that arises is: Is it necessary that the ratio of profit of each partner conform to the ratio of capital invested by him? There are differences of opinion among Muslim jurists about this question.

According to Imam Malik and Imam Shafi, a contract is valid if the distribution of profit is based on capital contribution. For instance, if "A" contributed 40% of the capital in *Musharakah*, he is entitled to 40% of the profit that arises from such business. If he receives more or less than the amount he contributed then the contract is invalid. However, in the view of Imam Ahmad the contract is still valid even if the ratio of profit differs from the ratio of capital invested with condition that the partners agreed upon. For example, A may invest 40% of his capital in to the business, but he/she may get above 60% of profit if the partners accept that. Lastly, Imam Abu Hanifah agrees with views of Imam Ahmed that ratio of profit to capital contributed may differ but with condition that all partners are active and not sleeping partners. If there is any sleeping partner, then for such contract to be valid his profit must base on capital that he contributed.

6.2.2 Sharing of Risk (Loss or Liability)

There are no disagreements among jurists in case of sharing a loss. All Muslim jurists unanimously agree that, in case of loss, partners must share it exactly to the amount of capital he invested in to the business. This argument is based on principles of the maxim:

> Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.

6.2.3 Nature of Capital

Most jurists are of the opinion that capital should be in monetary form but not on commodities. However, there are different views in this respect. Imam Malik argues that partners can contribute capital in the form of money since it is not a condition for the validity of *Musharakah* but also permissible to invest in kind with condition that the partner share is subject to market price of that commodity. Imam Abu Hanifah and Imam Ahmad disagree and claim that no contribution in kind is acceptable in a *Musharakah*, Their argument is based on two reasons: the commodities is not the same, even if the same in form but differ in qualities and values, hence *Musharakah* is invalid if the property are distinguished from one another. Secondly, share capital redistribution cannot be possible, since commodities are subject to price fluctuations. But they agree on commodities capital if the commodities are *Dhawat-ul-Amthal*. This means commodities which, if destroyed, can be compensated by similar commodities, such as rice; Imam shafi is also of the same opinion that if the commodities are *Dhawat-ul-Amthal* then it is acceptable on the grounds that it can be mixed with other commodities of the same type, but he disagrees on *Dhawat-ul-Qeemah* (commodities which cannot be compensated with similar commodities like cattle). In conclusion, share capital can be in the form of money or commodities, and the market value of the commodities shall determine the share of the partner in the capital.

6.2.4 Management of **Musharakah**

In the normal practice of partnership, all partners have the right to take part in its management as well as to work for it. However, there are two possibilities that management can be at hand of one partner base on consent of partners, but in this case the sleeping partners will receive his/her profit base on capital he invested. Otherwise, all partners can work as a team and each shall be treated as agent of the other in a matter of the business or any work, and all we have equal rights in day-to-day dealing of the business.

6.2.5 Termination

Musharakah can be terminated in case of the following circumstances:

1. Right to termination. Every partner has right to terminate partnership any time. If the contract is terminated at will, and the asset is in form cash, then it will be distributed according to share each contributed. But if the asset is in form of non-liquid, then there are two options. One to distribute the physical asset base on the value of the asset, in case of dispute, then the physical asset will be sold and cash distributed along the lines of the agreed ratio.
2. In case one of the partner dies, and then partnership can be liquidated. However, if the heirs accept to continue with *Musharakah* then is also permissible.
3. In case of insanity. If one of the parties becomes insane the partnership can be terminated if all partners agree or the other parties will continue with business and pays the share of the insane partner.

These conditions in termination of a *Musharakah* contract are allowed if all parties agreed upon at commencement of the contract. The holy Prophet (saw) said in a Hadith:

> All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

6.3 Modern Operation of the *Musharakah* Model

In a *Musharakah* model, the bank identifies prospective companies with approval subject to due diligence. Companies can issue *Musharakah* preference shares to the bank at discount if the bank wants to buy the chapter through *Wadiah* or discount sale. Incase bank does not intend to buy then the companies can sell it directly to the investors via the *Musharakah* deposits. For example, the bank may require $70 million to finance four short- and medium-term investments projects. The bank will issue $70 million worth of *Musharakah* shares to investors at $1 each. In this case, the bank acts as agent for both investors and the companies and charges some fees for service rendered. When the project arrives at a value of $90 million, the net asset value per unit will increase to $1.50. In this case, investors will enjoy capital gains. However, if the project fails then the investors will lose their capital (Fig. 6.1).

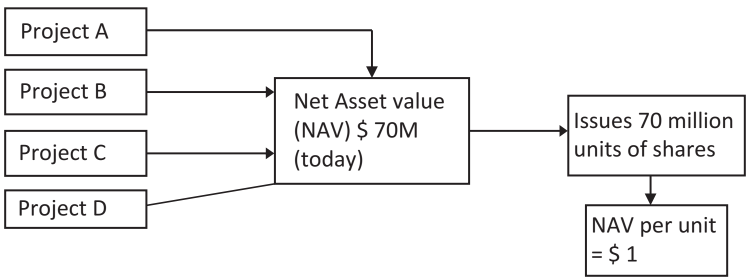

Fig. 6.1 Capital-raising mechanism in a medium-term *Musharakah* capital. Source: Author's own

6.4 The Practical Scenario

In realty, venture capital is a business deal in which both parties, the venture capitalists (the venture capital company) and the financed company, work together and share efforts and returns, because simply there is no gain without pain and from here we could start fighting the concept of *Riba*. At the same time, we could also say: how can we minimise the use of banking services, especially loan services, and establish investments companies that will be based on *Musharakah*. Now we identify some steps that are used in venture capital by looking at the following example:

- The company *Ummah* trades in pharmaceuticals, it has the relevant skills to develop a new type of product but has insufficient capital to finance the project.
- The company founds a venture capital company, to finance about 90% of the total cost based on a *Musharakah* contract, and later on the profit or loss will be divided according to the principle of *Musharakah*.
- After the establishment of the venture capital company, and the investment opportunities identified, the venture capitalist has the right to monitor the investment and analyse it step by step to make sure the project is successful and benefits both parties.
- The contribution of the venture capital company can be converted into common stock, but it is not Islamic to be converted to preference stock which normally its holder receive fixed dividend.
- The full amount of capital will not be provided at once, but each stage of the project has sufficient funds.
- The Board of Directors comprises people from both parties, the recipient company and venture capitalist.
- To minimise risk, the venture capital firm can build a portfolio investment by investing in other companies (diversification).
- After the project materialises the recipient company has the chance to go public.
- The profit earned from the project will be shared between involved parties based on predetermined ratios.

6.5 Conclusion

If we want to survive as a Muslim *Ummah* in the era of globalisation, innovations need to be considered in the Islamic financial sector, Innovations and positive thinking from the side of the Islamic scholars (*Fiqh* Scholars) are our engine to be a civilized *Ummah* in order for us to lead the currently corrupted world—otherwise, we are simply dreaming about being the leaders of the world, and we will just be part of the problem. What is wrong with using others idea if it is in line with the Islamic law? We do not even need to say: Islamic venture capital; we use the venture capital as a mechanism to finance our project using the equity financing. Muslims, especially businesspersons, should know what is wrong and what is right, what is *Haram* and what is *Halal*. From there he can invest using the right mechanism for his investments; the names of things should not be our concern. To conclude, venture capital is a very important mechanism for the raising of funds through the use of the Islamically accepted concept of *Musharakah*. It could help developing Muslim countries to exchange skills and recourses and go further in developing our *Ummah*.

CHAPTER 7

Islamic Micro-Investment: The Experience of Tabung Haji Malaysia

7.1 Background of the Company

Lembaga Tabung Haji was established under the Malaysian Law, Act 535 Tabung Haji Act 1995 which became effective from 1 June 1995. This Act abolished Act 8 and Act A168 Lembaga Urusan Tabung Haji (Amended) 1993.

7.1.1 Objective

- To provide facilities to enable Muslims to save over a period of time free from interests, for the performance of the Hajj/or for meeting any other expenses.
- To provide opportunities to Muslims to participate in a more effective way to invest in industrial, commercial, agrobase and property development through their own savings as permitted by Islam.
- To provide a variety of quality facilities and services for the welfare, health and proper control, as well as overall protection for Muslims in the Holy Land when performing the Hajj.

Acknowledgement is made to Tabung Haji Malaysia (TH) for its corporate information in facilitating this chapter.

Mohd Ma'Sum Billah, *Modern Islamic Investment Management*,
https://doi.org/10.1007/978-3-030-17628-0_7

7.1.2 Goals

- To render the best services to Malaysian Pilgrims throughout the performance of the Hajj.
- To give maximum returns to depositors on their savings. (Tabung Haji 1999)

Shareholding or equity participation, in proportion of Bumiputra/non-Bumiputra or government/private shareholders.

Tabung Haji is an Islamic corporate company and also is known as a government agency. The equity participation of Tabung Haji is 100% and the government only interferes in Hajj matters, which relate to the enhancement of and having a close relationship with the Saudi Arabia government. It is necessary to ensure that all Malaysians pilgrims will have good accommodation and quality facilities while performing the Hajj in the Holy Land.

7.1.3 Core Activities of Tabung Haji

Tabung Haji operates three core businesses (Tabung Haji website), namely:

- Savings: Facilities for the TH Depositors.
- Investment: Accumulated Fund Investment and monitoring of investment functions.
- Hajj: Hajj service in Malaysia and the Holy Land.

7.2 Services Provided by Tabung Haji

7.2.1 Savings

The benefits of saving with Tabung Haji:

- Syiar Islam—Islamic financial system
- *Zakat*—Business *Zakat* is paid for
- *Halal*—Savings invested in activities permitted by Islam
- Bonus—Competitive bonus
- Tax Free—Tax-free bonus
- Guarantee—Savings guaranteed by the government
- Withdrawal Frequency—No limit to number of withdrawals.

Prerequisites for being a Tabung Haji depositor:

- Muslim
- Malaysian citizen
- Permanent resident

Savings account can be opened at any Tabung Haji branch office with a minimum deposit of $10.00. Depositors can increase their savings at the following:

- Tabung Haji branch offices
- Tabung Haji counter, campaign or information session
- Post offices
- Salary deduction for individual and his/her family
- Through Bank Draft/Cheque/Postal Order/Money Order by post to any Tabung Haji branch office.

7.2.2 Withdrawal

Withdrawal can be made at any time at all Tabung Haji offices.

- Cash withdrawal up to $10,000 (a cheque will be issued for withdrawal exceeding $10,000)
- Withdrawal of savings through cheque
- Withdrawal of savings in the Holy Land (Hajj & Umrah) throughout the year
- Telegraphic cash withdrawal and transfer of savings.

7.2.3 Products Offered

7.2.3.1 EPF Member Investment Scheme

Lembaga Tabung Haji has been appointed by the Employees Provident Fund (EPF) as its 24th Fund Management Institution to enable its members to join the EPF Member Investment Scheme. To join the scheme, an EPF member must be a Muslim with a minimum savings of $55,000 in his account be under the age of 55.

7.2.3.2 Savings Scheme for Monthly Allowance

This savings is open to all Tabung Haji depositors with savings of not less than $10,000 and who have been savings for 12 full months. The advantages of this scheme are:

- Fixed monthly income
- Main income not affected
- Monthly expenditure which is *Halal.*

7.2.3.3 Salary Deduction Scheme for the Individual and His or Her Family

A salary deduction scheme for the individual and his/her family is another service provided by Tabung Haji. Under the scheme, a monthly deduction is made from his/her salary, thus save time and energy to go to Tabung Haji office every month to make deposit for self and family. This is a convenient scheme for those with regular income.

7.2.3.4 Incentive Scheme for Malaysian Schools

This scheme is to inculcate the habit of saving among students and attract more students to be Tabung Haji depositors. Incentive is given to schools for the support and co-operation given to Tabung Haji.

7.2.4 Annual Bonus

Savings are utilised for short-term and long-term investment and Tabung Haji has proven itself capable of providing competitive return in the form of annual bonus.

7.2.5 Other Services

7.2.5.1 Fund for Senior Citizens

Lembaga Tabung Haji has set up a fund to help finance part of the cost of performing the Hajj for able senior citizens but not financially, known as Tabung Warga Tua (TWT). Starting the next Hajj season, a Malaysian who is 60 years old but does not have enough savings for the Hajj pilgrimage can still make it with the help of the fund.

The money for the fund comes from donations, the minimum of which is $10, from other depositors with savings of $10,000 and above as well as contributions from companies and individuals.

7.2.5.2 Friendly Counter

In efforts to provide the best service to depositors, Tabung Haji has adopted several new approaches such as opening mini-offices in certain areas, open and friendly counter concept, using numbering system and trained staff. These approaches hopefully will make Tabung Haji depositors accept Tabung Haji as "Pilihan Utamaku" (My Main Choice) for savings and investment.

7.2.5.3 Investment

In line with its objective to provide Muslims in Malaysia with the opportunity to take part in the country's investment and business, Tabung Haji invests its savings in the economic sector such as industries, services and plantation as well as property ownership through short-term and long-term share investment. In carrying out its investment activities, Tabung Haji adopts a prudent investment policy at all times. Every activity carried out by companies concerned is closely monitored to ensure it is *Halal* (permissible to Muslims) as well as profitable and sustainable. Tabung Haji is also active in Islamic financial instruments such as bonds, corporate notes, government investment certificates, mudharabah bank accounts and bill of acceptances. As at 1999, Tabung Haji has invested in 13 subsidiaries involved in various businesses, six of which are in the plantation sector:

- TH Plantation Sdn. Bhd
- TH Indopalms
- Ladang Tabung Haji (Sabah & Sarawak) Sdn.Bhd
- Ladang TH (Estates Holdings) Sdn. Bhd
- TH Agro Sdn. Bhd
- Ladang Sawit Bintulu Sdn. Bhd.

Two committees were set up by Tabung Haji Board of Directors, namely the Investment Review Committee and Fund Management Committee, govern their functions and investment activities. If necessary, reference can be made to the Shari'ah Supervision Council of the Bank Islam Malaysia Berhad or the National Fatwa Council for advice on whether permitted by Islam or otherwise.

7.2.5.4 Hajj (Pilgrimage)
Another major activity of Tabung Haji is managing the Hajj pilgrimage, an activity synonymous with Tabung Haji. It involves careful planning so as to be effective. The facilities and services provided include:

- Providing Hajj Passports
- Hajj matters
- Health service
- Hajj course
- Transport to and from the Holy Land
- Protection, supervision, welfare and safety of Hajj pilgrims in the Holy Land.

Prospective pilgrims with enough money for the Hajj pilgrimage can register themselves at any Tabung Haji office. They can also plan their pilgrimage six years in advance under the open registration system introduced by Tabung Haji in 1993. To facilitate their departure and to avoid congestion at the airports, Tabung Haji has built two Hajj complexes, one in Kelana Jaya (operational in 1982) and the other in Bayan Lepas. Passenger check-in is also done at these complexes; in Kelana Jaya for intending pilgrims departing from KLIA Sepang and Bayan Lepas complex for those departing from LTAB Bayan Lepas. These complexes are equipped with hostels, mosques, canteens and a hall for lectures and briefings. Out of town intending pilgrims are provided free accommodation at these complexes before their departure to the Holy Land. Tabung Haji plans to build more such complexes at all airports that serve as the departure point for pilgrims.

In the Holy Land, Tabung Haji is fully responsible to look after the welfare and safety of Malaysian pilgrims. Two Tabung Haji teams handle these tasks, namely the Welfare Team and Health Team. The Welfare Team will:

- meet the Hajj pilgrims on arrival at the King Abdul Aziz International Airport in Jeddah and also arrange their return flight to Malaysia;
- provide various facilities and look after the welfare of the Malaysia pilgrims through zone offices in Madinah and *Maktab* offices in Makkah;

- co-ordinate Hajj matters with United Agents in Jeddah, Muassasah Adillak in Madinah and Southeast Asia Muassasah in Makkah, Arafah and Mina;
- visit Malaysian pilgrims warded in hospitals;
- provide facilities for Malaysian pilgrims to make withdrawal from their savings in the Holy Land;
- enforce the *Dam* and conduct animal sacrifice;
- register births and deaths;
- provide expert service on Hajj rites and other *ibadat*; and
- provide counseling services.

The Health Team on the other hand is responsible for medical treatment. There are hospitals and clinics in Jeddah, at the *Maktab* in Makkah, zone offices in Madinah as well as clinics in Arafah, Mina Jamrah and Mina Muasim.

7.3 The Development of Tabung Haji

Since its formation, Tabung Haji has gained the confidence of Muslims in Malaysia. It has achieved tremendous growth with large number of depositors and a sizeable investment. This has enabled Tabung Haji to pay out competitive bonus to the depositors every year, after deducting business *Zakat*. Tabung Haji continues to invest actively in the *Halal* economic activities in sectors such as trading industry, plantation and property ownership. Its success has drawn the attention of the Islamic Development Bank (IDB) in Jeddah. A seminar jointly organised by IDB and Tabung Haji in Jeddah after the 1406 Hijrah Hajj season enabled other countries to share the experience gained by Tabung Haji. The excellent Hajj service provided by Tabung Haji also gained international recognition when it was awarded MS ISO 9002 certification on 8 August 1997. The hard work, dedication and honesty of its staff played a significant role in the success of Tabung Haji. Tabung Haji was also the recipient of the Information Technology Innovation Award in 1992 and Public Service Department Director-General Award in 1993. As a result of its quality enhancement programmed, Tabung Haji was selected as the recipient for the Prime Minister Quality Award for the public sector in 1995. This highest award is given to outstanding agencies in the public and private sector.

7.4 Impact of Company Operation to Society and Nation

In line with the concept of Islam as *Addeen*, a way of life in this world and the Hereafter, every *ibadah* commanded by Allah (swt) is of benefit in this world and the next world. To fulfil this desire to perform the Hajj pilgrimage, Muslims have to find enough money for the journey to the Holy Land. To avoid *Riba* (usury), which is *Haram* (forbidden) in Islam, Muslims resort to various traditional methods of saving. Of course, there are those who dispose their animals or inherited properties for cash to cover their Hajj expenses, a practice which ultimately imposes economic burden on themselves and their families while they are on the pilgrimage or when they return. Such practice also does not augur well for the rural economy, besides retarding the country's economic growth. Realising this as well as to help Muslims to save enough money without involving in activities deemed *Haram* in Islam, Perbadanan Wang Simpanan Bakal-Bakal Haji was set up in November 1962, and began its operation on 30 September 1963. The corporation to manage the savings of Muslims, intending to perform the Hajj pilgrimage, was the result of a working chapter entitled "Rancangan Membaiki Ekonomi Bakal-Bakal Haji" presented by Royal Professor Ungku Aziz in 1959 to improve the economy of intending pilgrims. To further enhance the services and facilities to intending pilgrims, the corporation was merged with the Penang-based Pejabat Urusan Hal Ehwal Haji. Subsequently, an Act known as Akta Lembaga Urusan dan Tabung Haji 1969 (or Act 8) was passed by parliament, leading to the formation of Lembaga Urusan dan Tabung Haji or in short 'Tabung Haji' to:

- enable Muslims to gradually save enough money to meet the cost of performing the Hajj or other beneficial expenses;
- enable Muslims, through the use of their savings, to take active part in capital investment in a way, *Halal* to Islam; and
- provide protection, supervision and welfare to Hajj pilgrims.

With these objectives in mind, Tabung Haji strives to provide the best in terms of service to Malaysians performing the Hajj pilgrimage and maximum returns to depositors on their savings. It shows that Tabung Haji was not set up just to manage Hajj pilgrimage to the Holy Land but also to function as an alternative organisation for Muslims in Malaysia in matters relating to savings and investment in a way that is *Halal* and according to Islamic teachings. As a corporate body, Tabung Haji is responsive to developments and changes taking place in the world. To ensure it continues to be competitive in the era of globalisation, a study was carried out in 1995 to widen the scope and role of Tabung Haji. So, on 1 June 1995 a new Act known as the Akta Lembaga Tabung Haji 1995 (or Act 535) came into effect, replacing the old Act. Subsequently, the name 'Lembaga Urusan dan Tabung Haji' was shortened to 'Lembaga Tabung Haji' on 28 August 1997. The letters TH were then introduced for 'Tabung Haji' (Tabung Haji website).

7.5 Function of Divisions

7.5.1 Internal Audit Management Division

- Responsible for monitoring TH financial management according to procedures.
- Assisting the National Audit Department in auditing the TH annual financial statement.
- Auditing financial records and analysing work procedures.
- Analysing the system to ascertain that every system implemented efficiently, effectively and economically.

7.5.2 Corporate Planning Division

- Extending corporate advice on TH group's direction.
- Analyse and evaluate the progress on the implementation of policies and strategies.

7.5.3 Human Resources Division

- Planning and implementing human resources needs through information sources.
- Providing training for TH staff to increase productivity with excellent quality.
- Initiating career advancement of TH staff.

7.5.4 Corporate Communication Division

- Responsible for handling all communication issues both internal and external.
- Responsible for projection of TH image and corporate identity.
- Create friendly relationship among staff, customers and their environment.

7.5.5 Administration Division

- Handling the documentation of official government circulars and general administration to all TH divisions.
- Managing official vehicles and their maintenance.
- Handling parliamentary issues—Dewan Rakyat and Dewan Negara.
- Handling programs and government official functions.
- Storage and printing etc.

7.5.6 Property Development Division

- Planning TH property investment.
- Purchase land for 'land bank' for future development.
- Construct building on TH land.
- Purchase commercial buildings for TH use or long-term investment.

7.5.7 Investment Development Division

- Determining investment opportunities—according to Shari'ah principles and potential growth.
- Analysing proposals on equity investment.
- Conducting economic and sectorial research.

7.5.8 Investment Management Division

- Discovering long term equity investment—potential growth and returns.
- Providing corporate services on TH investment.
- Monitoring return flow on equity investment and subsidiaries defrayal.
- Conducting strategic planning on TH equity investment.

7.5.9 Share Trading Division

- Managing on short-run quoted shares fund investment.
- Monitoring TH fund managers' performance.
- Planning the structure of short-run shares portfolio.

7.5.10 Legal and Secretariat Division

- Advice to TH regarding law situation.
- Preparing and checking contracts.
- Prosecution or court penalties.
- Legislation.

7.5.11 Finance Division

- Preparing TH financial and account statements according to schedule.
- Examining and upgrading TH accounting system.
- Preparing and standardising TH annual budget.

7.5.12 Fund Management Division

- Ensuring maximum return through profit turnover on financial market and capital market investment.

7.5.13 Information Technology Division

- Providing fast, accurate and up-to-date information system services to depositors.
- Ensuring that the transfer on files in the main computer, especially involving depositors' records ran smoothly.
- Co-ordinating the installation of new equipment and supplementing them at the TH offices throughout Malaysia and Saudi Arabia according to the schedule that has been determined.
- Implementing application system such as office automation, OCR, COLD and Imaging in handling data and documentation storage issue.

7.5.14 Property Management Division

- Ensuring all building spaces being rental to the prospective customers.
- Recognising any potential lessee or hirer.

- Collecting data regarding local rental rates.
- Handling on building maintenance effectively and efficiently.

7.5.15 Welfare Division

- Controlling and standardising pilgrims' welfare activities.
- Responsible in providing quality services on management infrastructure to Hajj pilgrims.

7.5.16 Hajj Consul Office

- Responsible in managing stock/logistics of Malaysian pilgrims, especially in residential areas.
- Generating a good relationship between TH staff and Saudi Arabian authorities.

7.5.17 Guidance Division

- Responsible in providing Hajj module to the pilgrims, publishing Hajj articles for their reference in Holy Land and conducting Hajj courses with religious teachers as their guidance.

7.5.18 Private Package Division

- Supervising Hajj pilgrims license organisation under sections 27–36, *TH* Act 1995.
- Enforcing any violation on that sections and increase level of professionalism among *TH* Hajj private package.

7.5.19 Health Division

- Responsible to educate Hajj pilgrims on health aspect before and during performing Hajj.
- Purchasing and delivering of medicine/medical equipment to the Holy Land.
- Giving health advice and guidance at Hajj courses to the pilgrims throughout Malaysia.
- Co-ordinating on health check-ups of pilgrims.

7.5.20 Operational Division

- Responsible for determining the Malaysian Hajj Operational System in Malaysia is being well operated and organised to fulfil Hajj requirement standards.
- Arranging the preparation of pilgrims traveling to the Holy Land according to efficient operational system.

7.5.21 Savings and Withdrawals Division

- Managing and controlling the account of depositors' record.
- Planning/preparing/managing savings and withdrawals system in Malaysia and Holy Land.
- Managing depositors' withdrawal account statement twice a year.
- Preparing and monitoring new depositors target achievement and yearly saving collection.
- Handling on imaging system and Elderly Hajj Subsidised Fund (TWT).

7.5.22 Marketing Division

- Preparing and providing added value to existing and new products.
- Enhancing the effort towards recognised segments.

7.5.23 Branch Office Operational Division

- Managing administration matters towards TH state, district and mini branch offices.

7.6 Sources of Fund

7.6.1 Deposit from Depositors

Condition to be a Tabung Haji depositor:

- Muslim
- Malaysian citizen
- Permanent resident.

A savings account can be opened at any Tabung Haji branch office with a minimum deposit of RM 10.00.

7.7 Terms and Conditions

- A person who is interested to invest in Tabung Haji need to open Tabung Haji account at any Tabung Haji counters, with a minimum of RM 10.
- The investment by the depositors will enable them to save over a period of time, which is free from interest for the performance of the Hajj or for meeting any other expenses.
- By becoming Tabung Haji depositors also will provide an opportunity to them to participate in a more effective way to invest in industrial, commercial, agrobase and property development through their own savings as permitted by Islam.
- Money invested in Tabung Haji is based on Shari'ah principles, which are *Halal* and in accordance with the Islamic financial system. Business *Zakat* also being paid on behalf of the depositors.
- Other advantages and benefits of savings with Tabung Haji are competitive bonus and it is excluded from income tax, savings are guaranteed by the government and money can be withdrawn without time frequent.
- However, the depositors are allowed to withdraw with maximum of $10,000 per day only and it is dependent on them whether to continue saving, withdraw all the money or close their account with Tabung Haji after performing the Hajj—although this is not recommended.
- Beginning 1995, Tabung Haji introduced Open Hajj Registration System commencing from the Hajj season 1414H. With the introduction of this system, prospective pilgrims could now plan and choose when they want to go to the Holy Land without encountering any problem in the administration of registration.
- In view of this easy procedure, it has been extended to 1430H with some deposit payment based on the selected year. With the imposition of the quota system by the Saudi Arabian government, the selection policy was on a first come first served basis. If the prospective pilgrims are not being selected on the year chosen, their Hajj registration will be forwarded to the next year.
- However, if the prospective pilgrims cancel or postpone the Hajj:
- On or after 1st Ramadhan in the current year, $ 1000 will be deducted from their Hajj expense except with the reasons acceptable by Tabung Haji.

- Two to ten days prior to flight schedule, 50% from the flight fees and RM 1000 will be deducted except with the reasons acceptable by Tabung Haji.
- During 48 hours prior to flight schedule or absent as having arrived according to schedule, full flight fees and RM 1000 will be deducted except with the reasons acceptable by Tabung Haji.
- Tabung Haji has the authority to cancel the application for Hajj registration of the prospective pilgrims if they are declared bankrupt.

7.8 Insurance (*Takaful*) Group Division

This division was newly established by Tabung Haji as a subdivision under Administration Division. Before the year 2000, all matters regarding insurance handled by TH Travel and Industry, a subsidiary of Tabung Haji. However, the claiming procedures take time due to many stages involved in processing the information. It also incurred high management cost to Tabung Haji. Due to problems in handling the matter, Tabung Haji takes initiatives to set up a new division for handling insurance matters known as Insurance Group Division. Initially this division helps and manages insurance coverage to:

- all properties of Tabung Haji
- Tabung Haji subsidiaries
- Tabung Haji staff who take housing loans (mortgage and fire)
- Construction contractors and private company which deal with Tabung Haji
- Tabung Haji staff
- Tabung Haji pilgrimages.

The main *Takaful* companies that provide insurance coverage for Tabung Haji are Takaful Nasional and Takaful Malaysia.

*7.8.1 Objective of Insurance (*Takaful*) Group Division*

The objective of this Insurance Group Division is to get a comprehensive insurance coverage to Tabung Haji as well as Tabung Haji subsidiaries, with a competitive premium rate by solving the claim in the short time according to the market practice.

7.8.1.1 Coverage

***Takaful* for Pilgrims**

Tabung Haji continues its *Takaful* services by charging a premium according to claim reserved for a particular year. For instance, in 2003 the premium rate was $7.50 for each pilgrim. The money to pay the premium comes from the Welfare Fund allocation. Among the risk coverage for pilgrims during performing Hajj in the Holy land are death, accident, loss of items (goods or money) and funeral in Masjidil Haram and Masjidil Nabawi.

***Takaful* for Staff**

Under the Tabung Haji Pension System, Tabung Haji staffs were protected under the *Takaful* Group Family Insurance Scheme, which cover death, accident and hospitalised. However, the premium paid is not deducted from staff salary but it is a package and benefit provided to all Tabung Haji employees.

***Takaful* for Construction Contractors and Private Companies**

Those parties that deal with Tabung Haji are obliged to take insurance coverage from Tabung Haji, which cover public liability and all risk during work in progress.

7.9 Conclusion

As a financial institution, Tabung Haji has proven its success. Muslims as a whole should be proud of Tabung Haji as the only model of an Islamic institution with activities covering all aspects of the development of the *Ummah* in this life and the Hereafter. The success is the result of good and positive practices of its management and its employees, working as a team towards the realisation of Tabung Haji objective as Allah (swt) says:

> Help ye one another in righteousness and piety. (Qur'an 5:2)

Reference

Tabung Haji (1999), *Annual Report*.

CHAPTER 8

Islamic Investment in Stocks

8.1 Introduction

The discipline of Islamic finance came into existence decades ago but now it is still present only in the academic sense. Although the guidelines are provided, the level of theories and models still needs the expansion and implementation. In the Islamic financial system, one of its components is financial market, which comprises the money market and the capital market. In the respective market itself are contained the instruments and products available to support ease of the transaction activities. Both aspects of the market play an important role as the means to facilitating economic activities. Via these markets, Muslims may help each other and transact with each other in a comfortable way. In this way the Islamic way of life promotes the welfare of the people by safeguarding their faith, life, intellect, property and their posterity.

Furthermore, there are many responsibilities specific to Muslims, and one of these responsibilities is the management of wealth. Through instruments or products in the financial markets, Muslims may manage their wealth in the proper way. Such business transactions are allowed in Islam as long as the foundations of these dealings do not contradict the Shari'ah and if those transactions are free from prohibited elements such as *Riba* (interest), *Maisir* (gambling) or *Gharar* (uncertainty).

Among the instruments available in the financial market are stock or equity. This chapter discusses Islamic investment in the stock market.

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8.2 Islamic Investment

8.2.1 Central Idea

An investment can be defined as current commitment of resources for a period of time in the expectation of receiving future resources. These future resources will reimburse the investor for the time the resources are committed, compensate for the expected rate of inflation and pay off the risk, which is uncertainty of future payment (Reilly and Norton n.d.). In the context of investment, people or an organisation will put the fund (a sum of money resources) in the financial markets in different form of securities (such as bonds, preferred stock, common stock etc.). Commonly, they make investments due to certain reasons including expecting to generate extra income, to preserve the capital (because of the inflation) and/or to get gain when there is appreciation of capital (ibid.). To obtain extra income, the investors are interested to have the securities that able to give them high rate of return in term of dividend. Meanwhile, investors who would like to preserve their capital or original value of their investment tend to opt for securities with low risk. On the other hand, investors keen to increase their initial investment tend to be attracted to securities with high-risk criteria (risk takers) because their desired returns are based on the growing amount of the price of the securities.

8.2.2 Overview

There are many different types of financial markets developed in the economy. The types of the markets can be divided in terms of physical asset markets, spot markets and future markets, money markets and capital markets, primary markets and secondary market, and so on. In each of the markets, there are different types of instruments offered and the main different exist in each of the instruments is its riskiness (Houston n.d.). For instance, the money market has the treasury bills, banker's acceptance, commercial chapter and the like, and the banker's acceptance is riskier than the treasury bills. In investment there is a direct relationship between risk and return. There is a tradeoff between them, where the security with the high-risk criteria will always give the higher return.

The capital market and the money market are different in terms of the liquidity of the securities where the instruments in the capital market are usually less liquid than the instrument in the money market. Moreover, the capital market offers immediate or long-term debt and corporate stock where it takes long time of maturity as compared to the money market (ibid.). In Islam, making an investment is allowed but it is restricted to certain circumstances. Islamic investment can be defined as investment in financial services and investment products that adhere to principles established by the Shari'ah or Islamic Law as revealed in the Qur'an and Sunnah (http://www.ihilal.com/index.htm). It is required that all investments made shall be from the ethical sectors or in other words, the investment made or the profits gained shall not be in or from the prohibited activities. These prohibited activities include alcohol production, gambling, pornography, interest-based (*Riba*) sector and so on. Instead of having *Halal* securities, the invested funds also should be free from the interest-based debt. The investor does not allowed to borrow on interest to finance his investments. It is stated in the Qur'an:

> and God hath permitted trade and forbidden usury. (Qur'an 2:275)

Before making an investment, the investors should think of certain essential questions: What is the investing 'time horizon'? What type of investments will you make? How much money will you need to reach your goals? Do you have short-term financial needs? Will you need to live off the investment in later years? (http://www.fool.com/school/basics/basics02.htm) By providing answers to these questions, the investors may have a safe investing journey.

8.2.3 Parties

In Islamic investment, the concept of *Mudarabah* can be applied. Under this concept, *Rab-ul-Maal* will provide the fund or investment to the *Al-Mudarib* the management. *Rab-ul-Maal* then will permit the *Al-Mudarib* to organise the investment in appropriate manner with no intervention from his side. However, the *Rab-ul-Maal* has a right to keep an eye on the *Al-Mudarib*'s activities and he may work with *Al-Mudarib* (with the consent from *Al-Mudarib*) (Imran n.d.).

8.3 Stock Market

8.3.1 General Overview

Stock is usually issued by corporations to individuals and institutional investors (Houston n.d.). This stock can be divided into the preferred stock and common stock. Usually, only the common stock is traded at the bulletin board in the stock market. In return of the financing and providing the capital to the corporation, the investor will get the yield, proceeds (if the stock is sold) and becomes part of the owner of the company. In short, the stock or in specialised term is the financial 'securities' may represent the ownership of the company (http://www.fool.com/school/basics/basics.htm). Investors can have stand-alone common stock (only one type of securities) or it can be in their portfolio (collections of investment securities). After possessing the ownership of the common stock, the investors will be the shareholders of the company, which is to be a part of the owner of a business. Being shareholders will allow the investors get one vote per share of stock to elect the board of directors. When the company acquires more assets and generates more cash revenue, the value of the business increases. This increase in the value of the business will drive up the value of the stock in that business. However, if the reverse conditions occur, the shares of stock may decrease in value or even the worst is the company goes bankrupt (ibid.).

8.3.2 Investment in the Stock Market

There are many opinions with regard to Islamic investment in the stock market. Almost all contemporary scholars agreed that that it is permissible to invest in the stock market with the condition that the company invested in does not engaged in a business not permitted by Shari'ah. The forbidden companies include the interest-based companies, conventional insurance companies, and manufacturers of liquors, casinos, nightclubs and so on. Meanwhile, the other view is that investment in any matter even if the nature of business is *Halal* is still not permissible, because these businesses (especially publicly listed joint stock companies) obtain finances on the basis of interest to establish and run their business (http://www.ihilal.com/index.htm). It should be borne in mind that investing in the stock market is the same as in the conventional system except that the Shari'ah prohibits any return on debt and does not consider lending to be a legitimate profitable activity. Investment in the stock market or equity represents an investment exposed to all kinds of business risks and sharing in the profits of the business. It may be in form of permanent nature, that is, redeemable upon liquidation of the business or earlier by mutual agreement but not on demand. Different to conventional investors, Muslims are prohibited from making investment decisions based on short-term speculation. Being a Muslim means using the logic of sound analysis before making an investment decision. As with trading, the market price is also important and these considerations should be kept in mind together with the fundamental value of the companies in before determination of investment in the stock market (ibid.).

8.3.3 Shari'ah Compliance

8.3.3.1 Filtering

Islamic Filters is a tool that can assist an individual to determine whether a company is eligible for investment from the Islamic point of view or not and to identify the reason why it is not eligible. In order to know the qualifications of a company, the most essential criteria are that they must comply with Shari'ah principles which will be discuss later (http://muslim-investor.com). Before discussing Shari'ah principles, a consideration of the role of the Shari'ah Board is provided.

8.3.3.2 Shari'ah Board or Shari'ah Advisor

A Shari'ah Board is a committee of *Ulama* established to make sure that a financial institution's practices and products the institution's offers are in compliance with Shari'ah (http://www.ihilal.com/index.htm). The ulama of Islam have played a crucial role in the contemporary movement of Islamic finance and investment. Their duties are to interpret and analyse the sources of Islamic law and constitute a link with the vast body of work on commerce in the Islamic legal practice. This is important in deriving the principles of Islamic finance and investment. As a group, they also arrive at collective positions on contemporary financial issues in representative bodies such as the OIC Islamic Fiqh Academy (ibid.). The Shari'ah advisors or Shari'ah Boards are in continuous discussion with the bankers and economists in order to develop new financial products in compliance with Shari'ah principles. This is required in so as to ensure that Islamic finance stays abreast of the latest developments in financial markets and also to help Muslim investors have access to proper Shari'ah advice on these markets. Recognising this necessity, all credible Islamic financial institutions today have a Shari'ah advisor or Shari'ah board, for example, BIMB has a Shari'ah Advisory Board.

Islamic scholars refer to the sources of Islamic Law in order to establish new financial products and *Fatwas*. The sources referred to are in sequence as below:

- The Qur'an
- The Hadith texts (the words, actions, recorded statements and practices of Prophet Muhammad (PBUH) and this include Hadith Qudsi)
- Ijma (consensus of the *Ulama*) and qiyas (drawing analogies deduction and reasoning from the Qur'an and Hadith texts)
- Ijtihad (the scholar's own reasoning).

Note that a scholar's ijtihad only comes after the analysis of the other sources, and remains within the parameters established by them (ibid.).

8.3.3.3 Shari'ah Principles

In classifying the stocks as approved stocks, the Shari'ah Advisory Council applies a standard criterion which focuses on the core activities of the companies listed on Board. Hence, companies whose activities are not contrary to the Shari'ah principles will be classified as approved securities/ stocks. Stocks will be excluded from the list of approved stocks based on the following criteria:

- Operations based on *Riba* such as activities of commercial and merchant banks, finance companies, etc.;

> And their taking of *Riba* though they were forbidden from taking it and their devouring of men's substance wrongfully (bribery, etc.). And We have prepared for the disbelievers among them a painful torment. (Qur'an 4:161)

> Those who eat *Riba* will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan [Satan)] leading him to insanity. That is because they say: 'Trading is only like *Riba*,' whereas Allah has permitted trading and forbidden *Riba*. So whosoever receives an admonition from his Lord and stops eating *Riba* shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to *Riba*], such are the dwellers of the Fire—they will abide therein. (Qur'an 2:275)

- Operations involving gambling (Gambling in all its forms is prohibited. This includes casinos, internet gambling outfits, betting, such as horse racing and lottery schemes). These activities have been prohibited by Allah as mentioned in the Qur'an.

They ask you (O Muhammad) concerning alcoholic drink and gambling. Say: 'In them is a great sin and (some) benefit for men, but the sin of them is greater than their benefit.' And they ask you what they ought to spend. Say: 'That which is beyond your needs.' Thus Allah makes clear to you His Laws in order that you may give thought. (Qur'an 2:219)

O you who believe! Intoxicants (all kinds of alcoholic drinks), gambling, Al-Ansâb, and Al-Azlâm (arrows for seeking luck or decision) are an abomination of Shaitân's (Satan) handiwork. So avoid (strictly all) that (abomination) in order that you may be successful. (Qur'an 5:90)

- Activities involving the manufacture and/or sale of *Haram* (forbidden) products such as liquor, non-halal meats and pork;

The likeness of those who spend their wealth in the Way of Allah, is as the likeness of a grain (of corn); it grows seven ears, and each ear has a hundred grains. Allah gives manifold increase to which He pleases. And Allah is All-Sufficient for His creatures' needs, All-Knower. (Qur'an 2:261)

- Operations containing element of *Gharar* (uncertainty) such as conventional insurance business; (www.bursamalaysia.com/website/edcation/smb_Shari'ahindex.htm);
- entertainment activities that are non-permissible according to Shari'ah;
- manufacture or sale of tobacco-based products or related products;
- stockbroking or share trading in Shari'ah non-approved securities; and
- other activities deemed non-permissible according to Shari'ah. (Ibid.)

As for companies whose activities comprise both permissible and non-permissible elements, several additional criteria are applied:

- the core activities of the company must not be counter to the Shari'ah as outlined in the first four criteria;
- public perception or the image of the company must be good; and
- the core activities of the company have importance and *Maslahah* (benefit) to the Muslim *Ummah* (nation) and the country, and the *Haram* element is very small and involves matters such as *'Umum balwa* (common plight), *'Uruf* (custom) and the rights of the non-Muslim community which are accepted by Islam (ibid.). This will be discussed in detail later.

8.3.3.4 Islamic Index

The calculation for Islamic index is as below:

$$\text{Index} = \frac{\text{Current aggregate market value}}{\text{Base aggregate market value}\left(\text{Ibid.}\right)} \times 100$$

Shari'ah-Approved Securities according to sectors as of 1 August 2004.

8.3.3.5 Fatwa *on Investment in the Stock Market*

One of the implications of Islamic investment principles is in the selection of the type of financial instrument among those available in global financial markets today. Interest based securities (e.g. bonds, bank deposits etc.) are not acceptable as Shari'ah-compliant investments, since these securities provide returns that are predetermined, and unrelated to the underlying performance of the asset that is generating the returns. For the same reason, equity securities (shares) are considered permissible by an agreement of contemporary scholars (e.g. the Islamic Fiqh Academy), because the profits an investor makes on equity securities are tied to returns of the underlying company and hence are risk related (http://www.ihilal.com/index.htm). Investment in common stock of companies engaged in permissible activities is allowed under Islamic Shari'ah. However, preferred stocks are prohibited in Islam as they guarantee the amounts paid out as dividends to holders of preferred stock. There are two forms of Islamic screening criteria: qualitative (permissible activities) and quantitative (financial ratios) (ibid.).

8.3.3.6 Qualitative Screens

Qualitative screens are part of the general rules followed by Shari'ah scholars in determining what is *Halal* and what is *Haram* for investment. There are two types of qualitative screens:

- Industry screening: Is the company in an industry prohibited in Islam? Examples of industries that are *Haram* (or are necessarily involved in *Haram* activities) include: alcoholic drinks, *Riba*-based financial institutions, gambling, sales of *Haram* products and entertainment such as pornography.
- Business practices: Is the company biased in its relationship with customers, suppliers and employees or is the company unethical in its trade practices?

8.3.3.7 Quantitative Screens

Quantitative screens are also part of the general rules followed by Shari'ah scholars in determining what is *Halal* and what is *Haram* for investment. There are three types of quantitative screens:

- Debt/asset ratio: Has the company borrowed funds on interest? It is clear that there should ideally 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.
- Interest-related income: Does the company generate any interest or interest-related income? This 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. According to some scholars, however, up to 10% of a company's total income can be derived from interest sources.
- Monetary assets: Items such as accounts receivables and liquid assets such as bank accounts and marketable securities should be review. Various minimums have been set for the ratio of illiquid assets (assets that are not in the form of money) necessary to make an investment permissible. Some set this minimum at 51% (again, according to the principle of "to the majority goes the verdict of the whole"). A few cite 33% as an acceptable ratio of illiquid assets to total assets. (http://muslim-investor.com)

There are also some opinions that classifying the permissibility of transactions of investment into four types:

- The first guidelines is the exclusion of the companies whose activities are totally prohibited. It is necessary that companies which business activities are prohibited should be excluded. This rule also applies to the subsidiaries of such companies if they deal in unlawful activities, such as conventional banks, insurance companies, alcoholic beverages companies and gambling, pork, brothels, pornography-related companies and other similar companies (Yaquby n.d.).
- The second guideline is that to excludes companies in which debt and money form 50% of the existing assets. It is in Islamic Shari'ah

that debt can't be sold to the third party (*Bay' al-dayn*). The contemporary scholars stipulate that the equities of the company which the business activities are lawful may be traded if the total cash and debts do not exceed the total value of other assets that is real assets (fixed assets). Contemporary scholars differ on this percentage, but most of them agreed that it is prohibited if it is exceeds half the assets (50%) as stated in fatwas issued by the 2nd Al Baraka Seminar, *Fatwa* No. 5 (ibid.).

- The third guideline is to exclude companies in which the Debt to Equity Ratio is more than 30–70%.
- This guideline requires that the debt ratio to the shareholders equity should be as low as possible. The Religious Supervisory Board argues that a percentage of not more than 30% is considered to comply with this requirement. The scholars have adapted the rule that what are less than one third are the criteria of a small percentage as what has mentioned by the Prophet (saw): One third and one third is too much.
- The fourth guideline is to exclude equities of companies in which the interest income or unlawful gains exceed 5–15%.
- It is necessary that the ratio between the interest or unlawful earned income (or combined both interest and unlawful income) to the company's total income should be negligible and should be as low as possible for two basic considerations:
  - the lower the percentage, the more company is titled towards producing lawful commodities and services;
  - realising a lawful profit can't be achieved unless the percentage deducted from the dividends is insignificant. (Ibid.)

8.4 Conclusion

The Shari'ah Council has put a lot of effort into making Islamic investment one of the financial products that complies with the Shari'ah. Most Muslim investors will seek Islamic stocks that are approved by the Shari'ah, and these investors rely 100% on the Shari'ah Council to ensure they invest in *Halal* investment. It is hard to separate illegal activities from investment, if the investors want to obtain high profits. For example, with Genting stocks with BIMB stock, Genting have a higher profit than BIMB. Although the activities done in Genting are prohibited, we cannot just see this on profit side; we have to look at the activities they have done in order to get the profit. As stated in the Qur'an;

> They ask you (O Muhammad [saw]) concerning alcoholic drink and gambling. Say: 'In them is a great sin and (some) benefit for men, but the sin of them is greater than their benefit.' And they ask you what they ought to spend. Say: 'That which is beyond your needs.' Thus Allah makes clear to you His Laws in order that you may give thought. (Qur'an 2:219)

In order to support Shari'ah-approved stocks and to strengthen Islamic investment, Muslims need to unite and purchase Shari'ah-approved stocks rather than conventional stocks.

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CHAPTER 9

Investment in *Sukuk*

9.1 Introduction

Sukuk is the Shari'ah alternative to the bond as practised in the modern capital market. It has been significantly expanded for more than a decade by attracting both Muslim and non-Muslim participants with promising results, so that it now occupies more than 70% of the total Islamic financial market across the world. Policies, strategies, instruments, mechanisms, structures, marketing, management and operations are strictly ruled to be in total compliance with the principles of Shari'ah, which are closely monitored by qualified Shari'ah scholars. The Security Commission's guidelines sanction that *Sukuk* refers to certificates of equal value which function as an evidence of undivided ownership or investment in the assets using Shari'ah principles and concepts endorsed by the Shari'ah Advisory Council (Securities Commission Malaysia 2015). Thus, an attempt is made in this chapter to scrutinise the model of *Sukuk* as an investment security by complying with the spirit and standards of Shari'ah as universal values.

9.2 Phenomena

Under modern practices, a bond is a debt security which vests the holder with a right of a financial claim on the issuer. This claim protects the holder in circumstances in which the issuer is unable to pay the amount due. A bond bears certain similarities to a savings account. When an investor

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deposits money in a savings account, in effect, that investor is lending the bank money. The bank pays the investor interest on the deposit. Similarly, the investor who subscribes bonds lends the issuer money in return for interest. When the bonds mature, the investor will receive the principle amount of the bonds back, as he would have if he had withdrawn the amount from the saving account (al-Amine 2001). In this case, the bond functions as a securitisation. The major difference between savings accounts and bonds is that investors can dispose of their bonds in the secondary market before they are mature. Savings accounts, on the other hand, can neither be sold on the secondary market nor be disposed to other investors (Faerber 1993).

The formality for an enforceable bond with relevant documentations is required to specify the terms for both interest and principal payments. Interest can be paid monthly, biannually or yearly. This makes a difference to the compounding of the interest and will affect the trading of a bond. Most bonds are paid with bi-annually with agreed interest. in North America, 'Eurobonds', which trade in Europe, are paid with interest annually. Mortgage-Backed Securities and Asset-Backed Securities are paid with monthly with agreed interest, reflecting the payment terms of the underlying mortgages and loans. The currency of payments is important. Some bonds have the coupon paid in one currency and the principal in another. Bonds which pay part of their principal before maturity are said to 'amortise' their principal, this is the case with many mortgage bonds practiced in North America in particular (ibid.).

The bond market can be categorised into the primary market and the secondary market. The primary bond market is where the bonds are initially issued, while the secondary market where the bonds are resold to other investors. Islamic bonds also share similarities with the modern practices conceptually by adapting primary and secondary markets as well, but practically they are contracting each other as to principles, technicalities, issuance and trading.

Sukuk is a financial instrument (document or certificate), which evidences the undivided pro-rata ownership of underlying assets. *Sukuk* is an Arabic term derived from '*Sak*' (singular of *Sukuk*), which literally means 'freely tradable at par, premium or discount' (ibid.).

The conceptual background of *Sukuk* typically involves the structuring of pools of Shari'ah-compliant assets or without credit enhancement into securities. It is structured based on specific contract of exchange that can be made through sales and purchase of an asset based on deferred payments, leasing of specific assets or participation in joint-venture businesses. The issuance of Islamic bonds requires an exchange of a Shari'ah-compliant underlying assets for a financial consideration through the application of various Shari'ah instruments namely: *Ijarah* (leasing), *Mudharabah* (co-partnership), *Musharakah* (partnership) and or others. The structure of *Sukuk* has to be approved by the Shari'ah advisors to ensure that the structures are in compliance. In addition, the structuring process may also involve the provision of additional protection for investors against late payments, pre-payments, potential write-off and others. Such protection is often provided in the form of credit and/or liquidity enhancement scheme (ibid.).

In the process of *Sukuk* issuance the doctrine of *Tawarruq* (special purpose vehicle) is used to securitise the instrument in the primary market, while in the secondary market, *Bay' al-Dayn* is used in order to legalise reselling of the bonds. Such a process is mostly used in the Malaysian market, while most Middle Eastern countries do not accept it. The proposed alternative is Islamic bonds based on *Al-Muqaradhah* (profit sharing).

9.3 The Modern Bond Market

A bond in the modern economy is treated as a debt security, similar to an IOU when one purchases a bond, he is lending money to a government, municipality, corporation, federal agency or other entity known as an issuer. In return for that money, the issuer provides you with a bond in which it promises to pay a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it matures. Among the types of bonds available for investment are: US government securities, municipal bonds, corporate bonds, mortgage- and asset-backed securities, federal agency securities and foreign government bonds. Bonds can be also called bills, notes, debt securities, or debt obligations. To simplify matters, we will refer to all of these as 'bonds'.

The bond market, namely the primary market, is a financial market in which new issues of a security, such as a bond or a stock, are sold to initial buyers by the corporation or government agency borrowing the funds. The investment bank underwrites securities and then sells them to the public. While the Secondary Market which is also a financial market in which securities, that have been previously issued, can be resold. It could be an organised market, such as KLSE in Malaysia, or over-the-counter market in which dealers at different locations stand ready to buy or sell securities over the counter to whoever accepts their price (ibid.).

Bonds may generally be traded anywhere in the world as long as a buyer and a dealer can strike a deal. There is no central place or exchange for bond trading, as there is for publicly traded stocks. The bond market is known as an over-the-counter market, rather than an exchange market. There are some exceptions to this, however. For example, some corporate bonds in the United States are listed on the exchange. Furthermore, bond futures and some types of bond options are traded on exchanges. But the majority of bonds do not trade on exchanges.

9.4 Market Participants

In a bond market, the following parties are among the lead participants.

9.4.1 Dealers

While investors can trade marketable funds among themselves whenever they want, trading is usually done through bond dealers, more specifically, the bond trading desks of major investment dealers. The dealers occupy centre stage in the vast network of telephone and computer links that connect the interested players. Bond dealers usually make the market for bonds. What this means is that the dealer has traders whose responsibility is to know all about a group of bonds and to be prepared to quote a price to buy and sell them. The role of the dealers is to provide liquidity for bond investors, thereby allowing investors to buy and sell bonds more easily and with a limited concession on the price. Dealers also buy amongst themselves, either directly or anonymously via bond brokers. The aim of trading is to take a spread between the price the bonds are bought at and the price they are sold at. This is the main way that bond dealers make (or lose) money. Dealers often have bond traders located in the major financial centres and are able to trade bonds 24 hours a day (although not usually on weekends).

9.4.2 Brokers

Brokers are agents who match buyers with sellers of securities.

9.4.3 Investors

Bond investors include financial institutions, pension funds, mutual funds and governments from around the world. These bond investors, along with the dealers, comprise the 'institutional market', where large blocks of bonds are traded. A trade of $1 million worth of bonds would be considered a small ticket. There is no size limit, and trades involving $500 million or $1 billion at a time can take place. Similarly, there is no size restriction in the 'retail market', which essentially involves individual investors buying and selling bonds with the bond trading desks of investment dealers. However, the size of trades is usually under $1 million.

9.5 Types of Bond

9.5.1 Convertible Bonds

A convertible bond is a bond that gives the holder the right to convert or exchange the par amount of the bond for common shares of the issuer at some fixed ratio during a particular period. As bonds, they have some characteristics of fixed income securities. Their conversion feature also gives them features of equity securities.

9.5.2 Extendible or Retractable Bonds

Extendible and retractable bonds have more than one maturity date. An extendible bond gives its holder the right to extend the initial maturity to a longer maturity date. A retractable bond gives its holder the right to advance the return of principal to an earlier date than the original maturity. Investors use extendible/retractable bonds to modify the term of their portfolio to take advantage of movements in interest rates. The characteristics of these bonds are a combination of their underlying terms. When interest rates are rising, extendible/retractable bonds act like bonds with their shorter terms when interest rates fall, they act like bonds with their longer terms.

9.5.3 Foreign Currency Bonds

A foreign currency bond is a bond that is issued by an issuer in a currency other than its national currency. Issuers make bond issues in foreign currencies to make them more attractive to buyers and to take advantage of international interest rate differentials. Foreign currency bonds can be 'swapped' or converted in the swap market into the home currency of the issuer. Bonds issued by foreign issuers in the United States market in US dollars are known as 'Yankee' bonds. Bonds issued in British pounds in the British bond market are known as 'Bulldogs'. Yen-denominated bonds by foreign issuers are known as 'Samurai' bonds.

9.5.4 Government Bonds

Governments have the power to print money to pay their debts, as they control the money supply and currency of their countries. This is why most investors consider the national governments of most modern industrial countries to be almost 'risk free' from a default point of view.

9.5.5 Corporate Bonds

A corporate bond is a loan made by a corporation in return for a specified amount of interest and the repayment of the face value of the bond at a specified maturity date. The creditworthiness of corporate bonds is tied to the business prospects and financial capacity of the issuer. The business prospects of companies are dependent on the economy and the competitive situation of industries. Industries with stable revenues and earnings are called 'non-cyclicals', whereas those whose revenues and earnings rise and fall with the economy and commodity prices are called 'cyclicals'. Companies that have financial risk because of high levels of debt and variable revenues and earnings are described as 'below investment grade' or as having 'junk' bonds because of their speculative nature. Higher-quality bonds are considered 'investment grade'.

9.5.6 High-Yield or Junk Bonds

A high-yield, or 'junk', bond is a bond issued by a company that is considered to be a higher credit risk. The credit rating of a high yield bond is considered 'speculative' grade or below 'investment grade'. This means that the chance of default with high yield bonds is higher than for other bonds. Their higher credit risk means that junk bond yields are higher than bonds of better credit quality. Studies have demonstrated that portfolios of high-yield bonds have higher returns than other bond portfolios, suggesting that the higher yields more than compensate for their additional default risk.

9.5.7 Inflation-Linked Bonds

An inflation-linked bond is a bond that provides protection against inflation. Most inflation-linked bonds, the Canadian Real Return Bond, the British "Inflation-linked Gilt" and the new US Treasury "inflation-protected security" are principal indexed. This means their principal is increased by the change in inflation over a period. In most countries, the Consumer Price Index (CPI) or its equivalent is used as an inflation proxy. As the principal amount increases with inflation, the interest rate is applied to this increased amount. This causes the interest payment to increase over time. At maturity, the principal is repaid at the inflated amount. In this fashion, an investor has complete inflation protection, as long as the investor's inflation rate equals the CPI.

9.5.8 Zero-Coupon Bonds

Zero-coupon or strip bonds are fixed income securities that are created from the cash flows that make up a normal bond. Conceptually, a zero-coupon security is just like a Treasury Bill or 'T-Bill'. The investor pays something up front in exchange for a promise to receive $100 on the maturity date.

9.6 Valuation of Bonds

The price of bond like any other financial instrument is equal to the present value of the expected cash flows of that instrument (ibid.). The cash flows, in turn, depend of a bond depends on the size of its coupon payments, the length of time remaining until the bond matures and the current level of interest rates.

9.6.1 Present Value

Present value of a bond is the present value of its cash flows (coupons and principal) discounted at a suitable interest rate(s). One convention used to simplify the calculation procedure is to assume a single rate for all cash flows. This is the known as the yield-to-maturity.

9.6.2 Yield to Maturity (YTM)

YTM is that yield which equates the present value of all the cash flows from a bond to the price of a bond. It is an iterative (trial and error) calculation that accounts for the reinvestment of the coupons as well as any capital gain or loss on the price of the bond (which will be redeemed by the issuer at par, $100). Conversely, given the YTM, a price can be calculated. A rise in the YTM will cause the price calculated to decrease, while a fall in the YTM will cause the price to rise. Although it does simplify the calculations, this convention assumes that all the coupons from a bond can be reinvested at the same rate (which is unlikely). The actual return generated by a bond held until maturity depends on the future reinvestment rates at which the coupon payments received are invested.

9.6.3 Duration

Duration is a measure of the average (cash-weighted) term-to-maturity of a bond. The value of a bond will vary depending on the amount of the cash flows (coupon size), the timing of the cash flows (term to maturity), and the interest rate used for discounting.

9.6.4 Coupon Interest Rate

An interest rate is the cost of borrowing or the price paid for the rental of funds. Consequently, a coupon rate is the interest rate that the issuer of the bond promises to pay the bond holder. If, for example, the coupon rate is 5%, the issuer of the bonds promises to pay $50 in interest on each bond per year (5% × $1000). Many bonds pay interest semiannually, the bond holder would receive $25 per bond every six months (Fabozzi and Fabozzi 1989). There are different coupon interest rates on different types of bonds depending on their riskiness.

9.6.5 Market Interest Rate

Bond's price moves in the opposite direction of the change in market interest rates (Faerber n.d.). As interest rates rise (fall), the price of a bond will fall (rise). For an investor who plans to hold a bond to maturity, the change in the bond's price prior to maturity is not of concern; however, for an investor who may have to sell the bond before the maturity date, an increase in interest rates after the bond was purchased will mean the realisation of a capital loss.

9.7 The *Sukuk* (Islamic Bond) Market

Considering the fact that bond issuance and trading are important means of investment in the modern economic system, Muslim jurists and economists had been trying to find the Shari'ah alternative. However, to meet the various demands of investors Islamic bonds and certificates had been diversified. Resulting from such effort, *Mudarabah* or *Al-Muqaradhah* bonds, *Musharakah* bonds, *Ijarah* bonds, *Istisna'* bonds, *Salam* bonds and *Murabahah* bonds are developed and are significantly appreciated in the global capital markets. However, it is noted that although some of these instruments have been generally accepted as being in compliance with Islamic principles so that they can be traded on the secondary market, the negotiability of some others is still a point of debate and controversy due to their legal acceptability or questionable compliance with Shari'ah. Therefore, some of these bonds can be traded on the secondary market while the trade of others is limited to the primary market because they can be exchanged only at face value.

In Malaysia, almost all of the domestic Islamic debt chapters issued have been based on the principles of *Murabahah*, *Bay'bi al-Thaman al-Ajil*, *Bay' al-'Inah* and *Bay' al-Dayn*, despite the controversy surrounding the issuance of tradable bonds in the secondary market based on the above four contracts. At the same time, there is a perceptible increase in the willingness amongst Malaysian issuers of bonds to explore other Islamic principles of financing, namely the profit-oriented based *Musharakah* as well as the asset-backed mode of *Ijarah*. It had been thus anticipated in the late 1990s that the future issuance of Islamic bonds will focus on the widely accepted bonds such as *Musharakah* bonds, *Mudarabah* bonds and *Ijarah* bonds (Rosly and Sanusi 1999).

However, the problem with Malaysian Islamic bonds has been the application of *Bay' al-'Inah* and *Bay' al-Dayn*, which is not well accepted by the Middle Eastern investors. The contract of *Bay' al-'Inah* and *Bay' al-Dayn* is seen as something similar to *Riba*-based financing. This will certainly pose a great challenge to the Malaysian companies seeking Islamic funds in the Middle East via bond issues.

9.8 Three Main Steps Involved in the Bond Issuance (Supra)

- Securitisation
- Bond Issuance
- Trading of debt certificates.

9.8.1 The Creation of a **Tawarruq** *(Special Purpose Vehicle) Underlying Asset*

Asset securitisation is the essence of Islamic bond issues, as a bond must assume the role of *Al-Maal* or property to qualify as an object of sale. An object of sale in the Islamic law of contract must be a property of value. When a bond certificate is supported by an asset as evidenced via the securitisation process, it is transformed into an object of value and therefore qualifies to become an object of trade whereby it can be purchased and sold in both the primary and secondary market. Investors will then have the right to sell (*Haqq Mali*) these bonds. In the *Tawarruq* asset securitisation, the financier purchases an asset from the issuer and sells it back to the same party at a credit price through *Tawarruq*. This buy-back through *Tawarruq* agreement will ensure that the issuer will receive the money in cash while financier will be paid a fixed or contracted amount at a future date. Debt payments will be made by instalment through bond issues.

The underlying asset is therefore crucial in determining the Islamicity of these bonds. In the Malaysian experience, these assets include factories, equipment, stock and inventory and even intangible assets such as buildings and properties.

*9.8.2 Issuance of Islamic Debt Certificate (***Shahdah al-Dayn***)*

This usually takes place in the primary market where, in settling its debt, the issuing company will sell debt certificates or bonds to investors. As mentioned above, debt certificate issues are valid only when supported by an asset. In other words, the bonds must be securitised. Here the underlying security is the *Buy Bi Than Ajil* (sale by deferred payment in the long term) or *Murabahah* (sale by deferred payment in short term) asset. The underlying asset need not be *Buy Bi Than Ajil* or *Murabahah* alone. If the first stage involves a contract of *Ijarah*, then the debt certificate is called *Sukuk al-Ijarah*. If an *Istisna'* (manufacturing) contract is used, we call it *Sukuk al-Istisna'*. New issues of Islamic bonds can be categorised into two, namely bonds issues with coupons and those with none. The former is known as the Islamic coupon bond while the latter Islamic zero-coupon bond.

9.8.3 Trading of Debt Certificate: Discounted **Bay' al-Dayn**

For liquidity purposes, bond trading in the secondary market is crucial. However, almost all Islamic bonds today were bought for long-term investments. The lack of secondary market, however, should not imply that trading issues is no longer significant. This calls the need to explain the Islamic view of bond trading in the secondary market. As mentioned earlier, when a debt certificate is securitised, it now becomes property (*Al-Maal*) which is also an article of trade. As an article of trade, the bonds can be sold by investors to the issuer or the third party if a secondary market for Islamic bonds exists. The trading or sale and purchase of the debt certificates is called *Bay' al-Dayn*. In Malaysia, the contract is *Bay' al Dayn* at a discount is acceptable while Middle East *Ulama'* consider it invalid even though the debt is supported by underlying assets. Any profit created from the sale and purchase of a debt is *Riba*.

> And whatever *Riba* you give so that it may increase in the wealth of the people, it does not increase with Allah. (Qur'an 30:39)

Al-Maal ruled out to the effect:

> That every loan entailing benefit is usury. (al-Shirazi n.d.)

9.9 The Nature of *Bay' al-Dayn*

The issue of *Bay' al-Dayn* arises when the bonds are traded in the secondary market at a discount. We have to note that buyers in the secondary market are usually speculators, that those who do not intend to keep the bond for long-term investment purposes. Their main objective is to make quick capital gains on the basis of market liquidity and interest rate movement. However, there is no indication that controversies exist in the *Bay' al-Dayn* where bonds are sold or redeemed at par value. We may now discuss *Bay' al-Dayn* to show its nature according to the Islamic view.

According to *al-Majallah, (Majallah al-Ahkam al-Adliyyah*, Art. 158) *Dayn* is defined as the thing due, that is, the amount of money owed by a certain debtor. So a non-existent sum of money is considered a debt, as also a certain sum of money from things which exist or are present, or from a heap of wheat which is present before it is separated from the mass. *Al-Deen* can be either monetary, or a commodity, such as food or metal. Based on the aforementioned of *Al-Deen*, and the literal meaning of *Bay' al-Dayn* we can define it as the sale of payable right either to the debtor himself, or to any third party. This type of sale is usually for immediate payment or for deferred payment (*al Nasi'ah*).

9.10 Sale of *Al-Deen* (Debt) to a Third Party

According to most of Hanafis, Hanbalis and Shafis jurists (Al-Zuhili n.d.), it is not allowed to sell *Al-Deen* to non-debtor or a third party at all. Such opinions are based on the forbidden sale of *al Kali Bil al Kali*, sale of a *Gharar*, sale which the seller does not possess. As an exception Malikis, Hanafis and some Shafis jurists allowed selling *Al-Deen* to a third party. Since the creditor has the right to sell it to the debtor, as well as he has the right to sell it to a third party provided the following rules must be observed:

a. The *Dayn* must be *Mustaqir* (confirmed debt) and the contract must be performed on the spot, not deferred in order to avoid any relationship with the sale of a debt for a debt which is prohibited by Islamic law.
b. The debtor must be a financially capable, and must accept and recognise the sale in order that he will not deny the sale. This condition aims to avoid any dispute between the parties, and the debtor must be easily accessible so that the creditor knows whether he has the capacity to pay his debt or not.
c. The sale should not be based on selling gold with silver or opposite, because any exchanges between these items necessitates the immediate possession, and if the debt is money, its price in another debt should be equal in terms of amount of quantity.

Furthermore, the selling of *Al-Deen* must avoid the occurrence of *Riba* between the two debts, and must also avoid any kinds of *Gharar* which may be raised at the level of inability of the buyer from possessing what he bought, as it is not permitted that the buyer sells before actual receipt of the purchased item.

It is important to note that Muslim scholars have unanimously prohibited the trading of debt at anything other than face value. Where the price paid for a debt is not the same as the face value of that debt, the transaction would be tantamount to *Riba al-Nasi'ah* and is therefore prohibited. It is noteworthy that trading in bonds is a subject of dispute on two counts.

Firstly, the bonds are normally sold at less than their nominal values. Secondly, the state or the issuer would use the mode of *Bay' al-'Inah* and *Bay' al-Dayn* and these both sales transactions are regarded as *Riba* by the majority of Muslim scholars. This is the very reason for the controversy about the legitimacy of Malaysian Islamic bonds which renders it to be unacceptable by individual Islamic jurists and institutions outside Malaysia and the Middle Eastern countries. Islam does not allow the legal devices to be treated as a justification for transactions which Islam regards unjust and against Islamic belief. The bonds would have been acceptable from an Islamic point of view if the application of the mode of financing was based on the legal maxim of *al-Ghunmu bil ghurmi (Majallah al-Ahkam al -Adliyyah*, Art. 158) meaning that no person is allowed to invest in a way that generates profit without exposing himself to the risk of loss. It would expose both parties to the outcome of their deal, be it a profit or a loss, and thus avoid of usury as matter of Islamic principle.

9.11 Types of Islamic Bond (*Sukuk*)

9.11.1 Sukuk al-Ijarah *(Lease Bonds)*

Ijarah is a contract according to which a party purchases and leases out equipment required by the client for a rental fee. The duration of the rental and the fee are agreed in advance and ownership of the asset remains with the lessor. Hence, the relationship between the parties differs from that of a debtor–creditor relationship since it is based on the buyer-seller of an asset. *Ijarah* bonds, on the other hand are securities of equal denomination of each issue, representing physical durable assets that are tied to an *Ijarah* contract as defined by Shari'ah (Kahf 1997).

9.11.2 Sukuk al-Istisna' *(Manufacturing Bonds)*

Istisna' is a contract to sell a manufacturable good with an undertaking by the seller to present it manufactured from his own material, according to specified description and at a determined price. The suitability of *Istisna'* for financial intermediation is based on the permissibility for the contractor in *Istisna'* to enter into a parallel *Istisna'* contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and subcontract the actual construction to a specialised firm (al-Amine 2001).

9.11.3 Sukuk al-Musharakah *(Partnership Bonds)*

Musharakah bonds based on the *Musharakah* contract are similar to *Al-Muqaradhah* bonds. The only major difference is that the intermediary party will be a partner of the group of subscribers represented by a body of *Musharakah* bondholders in a way similar to a joint stock company while in *Mudarabah* the capital is only from one party. It should be noted that almost all the criteria applied to *Mudarabah* bonds are also applicable to the circulation of *Musharakah* bonds.

9.11.4 Difference Between Musharakah *Certificate and a Conventional Bond*

A *Musharakah* certificate represents direct ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. A conventional bond on the other hand, has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest.

9.11.5 Sukuk al-Muqarada *is an Alternative to* Sukuk al-Dayn *(Debt Bonds/Debenture Certificates)*

The Islamic financial system is a set of rules and regulations that govern the flows of funds from the surplus-spending unit to the deficit-spending unit. These rules and regulations are strictly governed by Shari'ah principles where there is neither a possibility nor a need to apply usurious financial instruments such as the debt related bonds. Hence, the solution to the Islamic financial system dilemma lies in the development of financial instruments in which the Shari'ah rulings are not violated. One such instrument is the *Al-Muqaradhah* bond.

A *Al-Muqaradhah* bond is an Islamic bond in which no interest is earned, but whose market value varies with the anticipated or expected profits. It is the product of Muslim scholars and thinkers who developed and designed the financial instrument where interest or similar forms of returns, which Islam has unequivocally prohibited are excluded. The Council of the Islamic Fiqh Academy of the Organisation of Islamic Cooperation during its fourth conference in Jeddah, Saudi Arabia from 18 to 23 Jamadul Akhir 1406H/6 to 11 February 1988, approved the mode of *Al-Muqaradhah* by issuing a Fatwa after having reviewed various studies on *Al-Muqaradhah* bonds. The meaning of *Al-Muqaradhah* bonds and its salient features is given in the following:

Al-Muqaradhah bonds, as the term denotes, are based on the conclusion of lawful '*Al-Muqaradhah*' (the *Mudarabah*) with capital on one hand and labor on the other, and the shares of profit are determined beforehand by a definite proportion of the total. It is called a bond because it is terminal in nature that its maturity is determined by the tenure or project completion date.

9.12 Prospects of *Sukuk* in the Non-Muslim World

By virtue of the announcement on 29 October 2013 by the British Prime Minister that the United Kingdom ought to have been the first country outside the Islamic world to issue *Sukuk* has reaffirmed the increasing interest in this Islamic mode of financing. Over the past decade, Islamic finance has shown a significant growth, with worldwide Islamic financial assets rising from USD 150 billion in the mid-1990s to USD 2.3 trillion by end of 2014. This result is not only in Islamic banking but also by the sustainable development of *Sukuk*. By end of 2012, the value of outstanding *Sukuk* was USD 229.4 billion (with new issues amounting to USD 131.2 billion), representing 14.6% of global Islamic equities. Malaysia accounts for the largest *Sukuk* market with 74% of issues in 2012, but these securities are also usually issued in the Gulf Cooperation Council—GCC (Godlewski et al. 2014).

There are two observations to be made: *Sukuk* structures can either be structured by debt-based or equity-based principles. Debt-based instruments such as *Ijarah* and *Murabahah* pay a predetermined rate of return to investors and are thus less eulogised under Shari'ah compared to equity-based investments. In contrast, equity-based investments by profit-and-loss sharing principles of *Musharakah*, *Mudarabah* and *Qiradh*, which are partnership contracts in which the financier and entrepreneur share profits based on pre-agreed ratios whereas losses are commensurate to their contribution (financial or physical) to the partnership. In light of their Shari'ah compliance questionability and since these instruments are likely to suffer from the adverse selection mechanism described by Godlewski et al., these *Sukuk* may generate a negative stock market reaction in comparison to debt-based instruments (ibid.).

Sukuk structures undergo a strict screening process by religious advisors to ensure their Shari'ah compliance. These instruments must notably be free from prohibitive elements such as *Riba* (interest), *Gharar* (uncertainty), *Maysir* (gambling), but also from non-permissible activities (e.g. investments in pork, pornographic, entertainment, drugs and military activities) (ibid.).

9.13 Process and Issuance of *Sukuk* (*Tawarruq*)

Tawreeq for both issuer and investors are as follows. The issuer shall effect:

- Liberty from the constraints of the balance sheet which provides financial and accounting rules into account the principle of capital adequacy, and management of provision for doubtful debts that would hamper the activities of finance in general, necessarily slow-down of the capital cycle, and reduces the profitability of banks. Therefore, in the *Tawarruq*, the situation is allowed to substitute a large part of the liberalisation of bank funds, which requires her to meet the allotment of such debt.
- Develop the efficiency of the financial cycle, productivity and the rate of rotation through the conversion of non-liquid assets to liquid assets to re-employ them again, thus it would help to expand the size of the facilities without the need to increase the rights of ownership.
- Minimise credit risk through the distribution of financial risk on a wide range of different sectors.
- A *Tawarruq* allows credit rating companies with a low capital base and low capital access to finance small rates obtained by the segments of the excellent. (Al-Maghlouth 2009)

9.14 Investors Shall

- Ignore in risk of the dangers of financial investors, and the recovery of the capital market.
- Analyse some economic sectors of primary markets such as real estate or cars. Moreover, revitalise the capital markets through providing new investment and financing tools, diversify the supply of financial products and stimulate the circulation of market instruments.
- Help to achieve transparency, improve the structure of the information in the market, and the entry of many institutions in the financing process, which provides more information on the market.
- Impress a variety of segments of the *Tawarruq* investors, which leads to the expansion of the size of capital markets and the recovery.

- Facilitate foreign exchange to banks and financial institutions creditors in the case of cross-border *Tawarruq*, since the buyer of the asset in this case is the bank or a foreign financial institution who will pay the local bank the value of the deal by foreign currency, which lead to an increase in domestic bank assets in foreign currency.

9.15 Risk Factors in *Sukuk*

Risks faced by the *Sukuk* industry are market risk, credit and counterparty risk, Shari'ah compliance risk, operational risk and institutional rigidity. There are also challenges facing the management of financial risks of *Sukuk* that are challenge of institutional reorganisation. Furthermore, there is an argument that most *Sukuk* implementation does not follow Shari'ah rules (Al-Maghlouth 2009). Undesirable risks affect the competitiveness of the pricing of assets. Therefore, the innovation of *Sukuk* essentially involves a higher exposure to certain market and financial risks. These risks are market risk, credit and counterparty risk, Shari'ah compliance risk, operational risk, and institutional rigidity. A further illustration is as follows.

9.15.1 Market Risk

Market risks fall into two categories, namely systematic and unsystematic. A systematic risk can arise due to public and economic policies whereas unsystematic risk arises because of different firms' specific instruments are priced out by comparing with other firms' instruments. Market risk comprises profit rate risks, foreign exchange risks, equity price risks and commodity risks. The profit rate risk is rate of return risk upon which *Sukuk* is based on fixed rates that are exposed to this risk in the same manner as fixed-rate bonds are exposed to the profit rate risk. Moreover, an increase in market profit rates leads to a decrease in the fixed-income *Sukuk* values. However, all fixed-return assets either from *Ijarah*, *Istisna'*, *Salam*, *Mudharabah*, *Qiradh* or any other origin will face this risk (ibid.). This also involves reinvestment risk and an opportunity cost of investing at the new rates, particularly if the asset is not liquid as in case of the zero-coupon non-tradable *Sukuk*.

9.15.2 Credit Risk

It is a probability that a bad debt or an asset or loan becomes irrecoverable due to a default or delay in settlements while the counterparty risk is the probability that the counterparty retracts on the conditions of the contract if the relationship involves a contractual arrangement. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inbuilt in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of *Sukuk* asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms, due to Shari'ah considerations (ibid.).

9.15.3 Risks to Shari'ah Compliance

The risk as to Shari'ah compliance is the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with Shari'ah. For example, if the *Sukuk* is based on a hybrid of *Ijarah* and *Istisna'* assets, *Ijarah* must always be more than *Istisna'* in the pool, otherwise the *Sukuk* deed will dissolve. Thus, broadly speaking Shari'ah compliance risk must be defined as a rate of return foregone in comparison to the market rates, as a result of complying with the Shari'ah. Moreover, fixed-rate *Sukuk* faces serious market risks. So, to match the market requirements of *Sukuk* to be floating rate, and the Shari'ah requirements of rents to be fixed rate, the *Ijarah Sukuk* are based on a Master *Ijarah* Agreement with several subordinate *Ijarah* agreements. However, the investors could still face profit rate risk to a certain extent and since the originator can only guarantee the fixed return on the underlying asset pools, the issue of floating rate returns still remains contentious, particularly, in pooled or hybrid *Sukuk*. Therefore, the association of Shari'ah supervisors with *Sukuk* issues will ensure investor confidence.

9.15.4 Management and Operational Risk

Management and operational risks are inherent to the structure of the issuances rather than the underlying Shari'ah principles. The risks related specific to the operation are a mirror to those in conventional bond markets are default risk, coupon payment risk, asset redemption risk, investor-specific risk and risks related to the asset. Default risk is when each party has provisions for the termination of the certificate in the event of a default by the obligor. Coupon payment risk is when the obligor may fail to pay the required coupons on time. Asset redemption risk is when the originator has to buy back the underlying assets from the certificate holder.

Investor-specific risk is when the certificate holder is rendered to several risks relevant to *Sukuk* structures such as liquidity management issues in Islamic finance. Risks related to the asset is when the underlying assets of the *Sukuk* certificates are subject to numerous risks such that the risk of loss of the assets (ibid.).

9.15.5 Organisational Rigidity Risk

The banking and financial infrastructure is weak in most emerging economies despite a significant shift observable in some of these countries such as Bahrain, Saudi Arabia, Malaysia and Brunei and Indonesia among others. However, *Sukuk* require unique Shari'ah-compliant structures which create a state that can be termed as one of institutional rigidity and that cannot be removed in the short run and always increasing the risks of *Sukuk*. Furthermore, the features of this state are lack of hedging and financial engineering processes, nonexistence of inter-bank money markets, lack of best practice uniform regulatory standards and regimes, weaknesses in litigation and legal framework support, particularly in the treatment of default, non-uniform accounting, auditing and income and loss recognition systems, non-robust investment appraisal, promotion and monitoring infrastructure, ineffective external assessment systems, rudimentary state of financial markets, and weak inter-segmental support and linkages (ibid.).

9.16 Managing the *Sukuk* Risks

Sukuk serves to replicate the functions of conventional bonds and tradable securities in resources mobilisation from markets and injecting liquidity into the enterprise or government and in providing stable resource of income for investors. Moreover, investing in *Sukuk* issuances involves the funding of trade or production of tangible assets. So, this section will state the challenges facing the management of financial risks of *Sukuk* that are a challenge of institutional reorganisation (ibid.).

9.16.1 Organisational Challenges

Government debt management of fixed income markets in developing countries is dominated by government bonds. Therefore, the single most important reorganisation of the markets can come from the reorganisation of the public debt management. The introduction of derivative markets has further consequences for market and financing dynamics. Furthermore, markets stabilising role of futures and options markets depends on the speculator's information futures and options markets can also serve to stabilise the value of underlying assets by acting in an insuring role and this can occur if these markets allow investors to pool risks more efficiently and share them. Therefore, in short, the evolutionary changes of financial innovation, deregulation, globalisation of financial services and introduction of novel financing instruments warrants the adoption of supporting risk management mechanisms, viable secondary markets and relevant regulatory bodies (ibid.).

The emergence of the market for asset-backed securities since the early 1990s has permitted banks around the world to free their capital by repackaging and reselling portfolios of loans, assets and other receivables. This adjusts the criteria for lending by forcing financial institutions to meet the market's standards for loan quality and sufficient pricing for risk. It helps decrease funding risk by diversifying funding sources. Financial institutions also employ securitisation to purge profit rate mismatches. Moreover, it creates more complete markets by introducing formerly remote asset classes that better suit investor risk preferences and by increasing the potential for investors to achieve the benefits of diversification. Therefore, by meeting the needs of different market segments, securitisation transactions can generate gains for both originators and investors. The same benefits can be attributed to *Sukuk* certificates. They allow the institution to manage balance sheet mismatches to securitise longer-term assets. Moreover, investors are also given the option to invest in asset grades that are suitable for their investment needs. It is also the case that financial markets are more complete as previously and untapped assets are now available for public-sector resource mobilisation.

The liquidity and secondary markets portray varying risk preferences and a secondary market should be developed to reflect this. *Sukuk* certificates are unique in that the investor becomes an asset holder and is directly tied in to the nature and functioning of the underlying asset pools so *Sukuk* certificate holders carry the burden of these unique risks. The primary concern of an Islamic secondary market is its marketability (ibid.). All things being equal, a certificate holder would rather participate in a well-structured and well-regulated secondary market instead of trading in a poorly run market. However, the challenges remain to provide increased risk management mechanisms, increase market liquidity, create a truer bond yield benchmark as well as expanding the issuer and investor platform.

It is has been observed that the unfavourable risks facing the *Sukuk* industry such as market risk, credit and counterparty risk, Shari'ah compliance risk, operational risk, and institutional rigidity that affect the competitiveness of the pricing of assets which lead to fact that is the innovation of *Sukuk* essentially involves a higher exposure to certain market and financial risks. However, I believe that we should take care most on unsystematic market risk and Shari'ah compliance risk in certain manner because they are related to each other in sense of that market risk will increase if the Shari'ah compliance risks increase (ibid.). Furthermore, the current *Sukuk* margin or profit based on LIBOR (the London Interbank Offered Rate) is an interest rate average calculated from estimates submitted by the leading banks in London. Each bank estimates what it would be charged were it to borrow from other banks. The resulting rate is usually abbreviated to LIBOR, or more officially to ICE LIBOR (for Intercontinental Exchange Libor). It was formerly known as BBA Libor (for British Bankers' Association Libor or the trademark bba libor) before the responsibility for the administration was transferred to Intercontinental Exchange. It is the primary benchmark, along with the Euribor, for short-term interest rates around the world. It is an indictor only but still we depend on it, which leads us to violate the Shari'ah compliance that will cause the market risk increase because most of *Sukuk* holder or investors are Muslims who search for Shari'ah-compliant products to invest and avoid investing in non-compliant product or questionable products, and in our case it could be a questionable product unless we try to avoid this risk.

This can be through fixed percentages not related to anything, even if as indicators. It is true that *Sukuk* issuers in some periods will face problems on their projects due to crises of economy or complexities of their project but they should do and sacrifice in order to avoid violating Shari'ah compliance (ibid.). Moreover, in order to develop the market of *Sukuk* an avoid the risks of Shari'ah compliance, capital authorities of all Muslim countries should establish and create *Sukuk* Authority institutions that report to the Organisation of Islamic Cooperation, and unify the rules and regulations of *Sukuk* issuing, including the price of *Sukuk*.

9.17 *Sukuk* and Its Rating Formula

9.17.1 Credit Rating

The Securities Commission (SC) rules as to the effect of credit rating in *Sukuk* that:

1. All issues, offers or invitations to subscribe or purchase *Sukuk* must be rated by a credit rating agency.
2. The final rating for the *Sukuk* must be made available to the SC at the time when the submission for approval to issue, offer or make an invitation to subscribe or purchase *Sukuk* is made to the SC.
3. Where the final rating is not available, an indicative rating must be submitted to the SC.
4. In the case of a *Sukuk* program where the rating is not assigned for the full amount but for part of the amount (partial rating):
   a. The first issue under the *Sukuk* program must be rated; and
   b. The principal terms and conditions of the *Sukuk* program must include:
      - a disclosure of all the preconditions, relevant risk factors and all material information relating to the partial rating; and
      - a provision that states all subsequent issues of the *Sukuk* program will be rated. (Securities Commission, Malaysia 2014)

9.18 Appointment of Credit Rating Agency

The guidelines further provide that:

1. *Sukuk* rated on a local rating scale must be rated by a credit rating agency registered with the SC.
2. *Sukuk* rated on an international or regional rating scale must be rated by an international credit rating agency.
3. An issuer incorporated in Malaysia may appoint an international credit rating agency to assign a rating for its ringgit-denominated *Sukuk*, provided that;
   a. The issuer had previously issued a foreign currency-denominated *Sukuk* for which an international or regional rating has been assigned;

b. The issuer is appointing the same international credit rating agency; and
c. Any existing international or regional rating of the issuer's *Sukuk* by that international credit rating agency is still valid on the date of submission to the SC. (Ibid.)

9.19 Issuer's Obligations

- An issuer must provide relevant information on a continuous and timely basis to the credit rating agency. This is to ensure that the credit rating agency can continuously make available to investors the rating for the *Sukuk*.
- An issuer must ensure that the rating report is published by the credit rating agency as soon as the rating has been finalised, or at least seven business days prior to the issuance of the *Sukuk*.
- The issuer of the *Sukuk* must not replace the appointed credit rating agency during the tenure of the *Sukuk* unless investors' consent has been obtained. (Ibid.)

9.20 Non-application of Requirements

1. This chapter [nine of the guidelines] does not apply to an issue, offer or invitation to subscribe or purchase the following types of *Sukuk*:
   a. Irredeemable convertible Islamic loan stocks;
   b. Foreign currency-denominated *Sukuk*;
   c. Convertible *Sukuk* or Islamic loan stocks and exchangeable *Sukuk* which fulfil the following requirements:
      - Investors of the *Sukuk* or Islamic loan stocks are given the right to convert or exchange the instruments into the underlying shares at any time or within a reasonable period or periods during the tenure of the *Sukuk* issue; and
      - The underlying shares are listed on a stock exchange;
   d. *Sukuk*:
      - Which are non-transferable and non-tradable; and
      - Whose investors do not require a rating. (Ibid.)

The principal adviser must ensure that both criteria are met prior to the issue, offer or invitation to subscribe or purchase the *Sukuk* and confirm this in writing to the SC.

9.21 Conclusion

The conventional bond market comprises the primary market and secondary market. The primary bond market is where the bonds are initially issued, while the secondary market is where the bonds are resold to other investors. Islamic bonds (*Sukuk*) conceptually share the similar qualities as the conventional model, but not in terms of mechanism, technicality, rules and standards of operation or practicality, thus they also have primary and secondary markets. The main difference, however, is the way the bonds are issued and traded afterwards. In the process of Islamic bond issuance, *Tawarruq* is used to securitise the instrument in the primary market, while in the secondary market, *Bay' al-Dayn* is used in order to legalise reselling of the bonds. Such processes are mostly used in the Malaysian market, while most of the Middle Eastern countries do not accept it. The proposed alternative is Islamic bonds based on *Al-Muqaradhah.*

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CHAPTER 10

Wealth Investment Under Shari'ah

10.1 Introduction

An Islamic wealth investment plan is a new concept being developed and it has a relationship with the definition of Islamic Financial Marketing defined by Ibnu Abu Yusuf and Ibnu Taimiyyah and Ibnu Khaldun. They defined the as the creation, development and delivery of unique customer-satisfying competitive products and services to engender profit for organisations and customers in line with Islamic values and principles. In contrast, conventionally it is defined as the process whereby an individual's personal and financial goals are achieved through the development and implementation of a comprehensive financial plan.

Islam is a comprehensive, integrative and holistic religion that governs all aspects of life, major and minor, personal and social, spiritual and materialistic and relates this worldly life to the Hereafter. This means that we need to practice Islam while we perform our business and economic activities. Muslims are encouraged to plan for their life and put efforts to achieve their goals, asking help from Allah (swt). The final stage is *Tawakal*, which is the result, and takes it as the destiny bestowed by Allah (swt).

The prophet Muhammad (saw) used to supplicate Allah (swt):

> My Lord, help me and do not give help against me, grant me a victory, and do not grant victory over me, plan on my behalf and do not plan against me, guide me and made my right guidance easy for me, grant me victory over those who act wrongfully towards me. (Yusoff, N. M. A. n.d.)

Mohd Ma'Sum Billah, *Modern Islamic Investment Management*,
https://doi.org/10.1007/978-3-030-17628-0_10

In Islam, financial planning is not merely a process of acquisition and accumulating wealth but it has a broad definition which relates to the concept of vicegerent (*Khalifa*).

According to the Qur'an, God created man as his vicegerent (or ambassador) on earth. Allah (swt) says:

> Behold, thy Lord said to the angels: 'I will create a vicegerent on earth.' They said: 'Wilt Thou place therein one who will make mischief therein and shed blood?—Whilst we do celebrate Thy praises and glorify Thy holy (name)?' He said: 'I know what ye know not'. (Qur'an, 2:30)

From the above verse, and others like it, we understand that as the *Khalifah* or vicegerent of God on earth, man is gifted with certain powers, which other creatures of God do not possess. For example, he possesses (within limits of course) intellectual faculties. We also read that God created all things on earth for man.

> He it is who created for you all that is on earth. Then He rose over (Istawa) towards the heaven and made them seven heavens and He is the All-Knower of everything. (Qur'an, 2:29)

The duty of man as God's *Khalifah* is to make use of all the blessings of God on earth to his own benefit. For this, man is given freedom, that is, freedom of choice and action (also within limits). It is because of man's special faculties and his freedom that he becomes the best of God's creatures.

Financial planning is basically a discipline of wealth management that applies to the unique needs and concerns of respective individual. As a Muslim, even though a person does not possess any form of wealth, he still has to commit with financial planning process because either he would leave debt or children to the trusted one. The following discussion focuses on the comprehensive aspects of financial planning whereby an individual should has a balanced approached in order to achieved the golden goal. Financial planning quantifies and manages individual's success in four financial pillars: wealth protection, wealth accumulation, wealth preservation and wealth distribution. Each of these different components is meant to play a different role in addressing unique issues and the objective must in line with Shari'ah principles.

In Islam, we are confined with the concept of Allah's bounty or sustenance. This concept means that Allah is the sole giver of 'bounty' to every living creature in this world. Allah blesses His bounty on those who earn and spend it in compliance with His covenants. He does not bestow His blessing or mercy on those who earn it illegitimately and spend it irresponsibly. Allah (swt) affirms:

> For Allah is He Who Gives (all) sustenance. (Qur'an, 51:58)

The concept of Allah's bounty is considered very important in Islam as a good Muslim is required to have a proper balanced between the fulfillment of his spiritual and worldly obligations (Yusoff n.d.).

The Prophet (saw) stated:

> A Muslim should prepare himself for the next world as if he is going to die tomorrow, but at the same time work hard to improve all his worldly comforts as if he is going to live forever. (Ibid.; narrated by Al-Dailami)

Islam covers the extremes of *Zuhd* (abstinence) and *Bulk* (avarice). A Muslim should not forego wealth. Neither should he be avaricious in the pursuit of wealth. *Zuhd* is not amounting to rejection of pleasure but rather leading a pious life by his ability to life moderate and within his mean. This is why Islam encourages reasonableness and moderation.

As Muslims we are not discouraged from acquiring wealth but we must know how to earn and spend it in accordance with Islamic principles. Wealth should not be abused or misused as Allah (swt) has laid down very clear injunctions on how wealth is to be acquired and spent. All above, wealth is a form of trial by Allah (swt) towards His servants whether they follow His injunctions regarding wealth acquisition and disposal and as such the owners are to be fully accountable on the Day of Judgment for what they do with their wealth. In Islamic financial planning, an individual must understand the discipline of how to protect, to accumulate, to preserve and to distribute wealth according to Shari'ah. These are the components of financial planning that need to be addressed in achieving financial goals.

10.2 Protection in Islam

Wealth protection is the wealth management pillar that identifies and manages various sources of current and future income. This area of financial planning involves cash flow planning, tax planning, family security planning, disability income planning and critical illness income planning. In Islam, the concept of protection is slightly different with the conventional in performing the concept of mutual co-operation or *Takaful* under the umbrella of *Tabarru'* (Donation). *Takaful* is an insurance concept which is grounded in Islamic *Al-Mu'amalat*, observing the rules and regulations of Shari'ah. In fact, this concept has been practised for over 1400 years (Takaful Nasional, http://www.takafulnasional.com.my).

In principle, the *Takaful* system is based on mutual co-operation, responsibility, assurance, protection and assistance between groups of participants. These fundamentals are based on the sayings of Prophet Muhammad (saw) which relate to the takaful:

> Tie the camel first before putting it in the trust of Allah (swt).

10.2.1 Basis of Co-operation

> Help one another in al-Birr and in al-Taqwa (virtue, righteousness and piety): but do not help one another in sin and transgression. (Qur'an, 5:2)
>
> Allah will always help His servant for as long as he helps others. (Narrated by Imam Ahmad bin Hanbal and Imam Abu Daud)

10.2.2 Basis of Responsibility

> The place of relationships and feelings of people with faith, between each other, is just like the body; when one of its parts is afflicted with pain, then the rest of the body will be affected. (Narrated by Imam al-Bukhari and Imam Muslim)

10.2.3 Basis of Mutual Protection

> By my life, which is in Allah's power, nobody will enter Paradise if he does not protect his neighbor who is in distress. (Narrated by Imam Ahmad bin Hanbal)

Thus, through the concept Muslim can plan ahead for any unwanted events which might involve illness, permanent disability or diseases (ibid.).

10.3 Accumulation of Wealth in Islam

The wealth accumulation pillar of wealth management seeks to achieve reasonable capital growth with the primary objective of preserving accumulated wealth. This is the area that balances the risk of losing capital and the risk of losing purchasing power at the same time. Wealth accumulation involves asset allocation strategies, investment policy statement drafting, financial freedom planning and children's tertiary education planning. In Islam, before an individual decides on investment he/she has to check the status of the investment whether the fund approved by the Shari'ah Board. Basically, the Shari'ah way of investing is that it must not be any of the following:

1. Operations must not be based on *Riba* (interest) such as activities of financial institutions like commercial and merchant bank and finance companies which do not comply with the Islamic principle. In Surah Al-Baqarah (275–281) Allah prohibits *Riba*:

> But Allah hath permitted trade and forbidden *Riba*. (Qur'an, 2: 275–281)

Operations involving gambling. This is where one gets something at the expense of the other and the person get suffer of losing asset and dignity.

2. Activities involving the manufacture and/or sale of *Haram* products such as liquor, pork, and meat not slaughtered according to Islamic rites; any other activities against the Islamic teaching such as pornography, operations containing elements of *Gharar* (uncertainty) such as the conventional insurance business.

There are companies with activities comprising both permissible and non-permissible elements. The Shari'ah Council has applied several additional criteria for these companies:

The core activities of the company must be activities that are not against Shari'ah as outlined above and any *Haram* element must be very small compared with the core activities. The public perception or image of the company must be good core activities of the company have importance and *Maslahah* (benefit in general) to the Muslim *Ummah* (nation) and the country and the *Haram* element is very small and involves matters such as *Umum Balwa* (common plight), *Uruf* (custom) and the rights of the non-muslim community which are accepted by Islam. (Shari'ah Advisory Council, Securities Commission of Malaysia)

There are several channels of investment that Muslims can participate in so as to gain some profit, such as *Wadiah* Saving Account, *Mudharabah* Current Account, *Mudharabah* Investment Account, Tabung Haji, Unit Trust, *Takaful* (with saving elements) Islamic Bond via unit Trust Islamic Equity (stock market) Property and others.

10.4 Wealth Preservation

The wealth preservation component aims to protect accumulated wealth against every conceivable financial risk and threat. For an individual who has accumulated reasonable wealth, a bad investment can cause some major discomfort, but still poor investment performance is not debilitating. As far as wealth is concerned, inadequate effort to preserve the accumulated wealth is unrecoverable. The pillar of wealth preservation consists of wealth management, liability containment planning, and business shareholding planning and business succession planning and debt management.

Muslims believe that wealth belongs to them but it is Allah's right to give it to anybody He wants. They are asked to work hard if they want to succeed in gaining wealth. Islam views wealth as a trial and man as a responsible trustee:

> And know you that your properties and your children are but a trial; and that it is Allah with whom lies your highest reward. (Qur'an, 8:28)

10.5 Wealth Distribution

Wealth distribution should involve proper planning so that accumulated wealth can be managed and distributed according to individual wishes with minimum hassle. The discipline of wealth management is important. Death is something that most of us tend to ignore. This area of wealth management is definitely a broader scope than what a will is capable of addressing.

In addressing the issue of wealth Muslims must not forgot that the true owner of wealth is Allah and man is only a trustee. Allah (swt) says:

> But seek, with that (wealth) which Allah has bestowed on you, the home of the Hereafter, and forget not your portion of lawful enjoyment in this world; and do good as Allah has been good to you and seek not mischief I the land. Verily Allah likes not the Mufsidun [those who commit great crimes and sins, oppressors, tyrants, mischief-maker, corrupted]. (Qur'an, Surah A-Qasas: 77)

10.6 The Financial Planning Process

Financial planning is a scientific methodology to manage wealth with a holistic viewpoint. It involves developing co-ordinating and implementing a comprehensive range of strategies to address wealth management challenges. Financial planning is a process that encompasses the following six steps (Hui, Y. M. 2003).

10.6.1 Establish Financial Goal

Goal setting is critical to create a successful wealth management plan. The whole financial planning process starts with establishing and prioritising realistic financial goals and objectives. Appropriate timeframe and risk tolerance levels must be clearly spelt out as well. It is important that the goals be quantifiable so that their attainment can be measured.

10.6.2 Gather Relevant Data

After identifying your financial objectives, you need to gather as much relevant information as possible. This information must be accurate, up-to-date and relevant to the financial objectives. The more complex your situation and the more varied the number of your goals, the more challenging the information gathering risk. This step a requires significant amount of time and patience.

10.6.3 Analysing the Data

Analysing and evaluating the data can start when we have enough information. The objective of this step is to establish where you are now in comparison to the financial goals that were established in step one. This is the step where you determine the strengths and weaknesses of your present financial position.

10.6.4 Develop a Plan for Achieving the Goals

Normally, there will more than one way for a financial objective can be achieved and multiple alternatives should be explored and considered. The plan should be specific in nature, detailing who is to do what, when and with what resources. In order to increase the commitment to the plan, the report describing the plan should be in writing.

10.6.5 Implement the Plan

A financial plan is useful only if it is put into action. The success of a financial plan very much depends on someone's commitment to implementing it. For example, implementation of plan is by writing or updating a will, restructure current asset allocation, reducing debts and mortgages and so on.

10.6.6 Monitor the Plan

The financial planning process is dynamic and requires constant monitoring and review. The plan should be reviewed at least once a year or more frequently if changing circumstances warrant it. The review process should involve tracking the progress and performance of plan implementation (ibid.).

10.7 Recommendations

There are several types of financial products introduced by financial institution and professional bodies to facilitate our needs in managing and improving our financial planning, such Islamic Unit Trust, Family and General *Takaful*, Islamic Bonds and so forth. However, we have chosen the alternative products in our chapter especially in wealth distribution that have been provided and recognised worldwide for their power and effectiveness in their application to our life, in this world and in the Hereafter. The three major instruments that included in our analysis are *Wasiyah*, *Waqf* and *Hibah*.

10.7.1 Wasiyah

Wasiyah is a legal documentation which outlines on how you wish your assets to be distributed upon demise *Wasiyah* or will is one of many acceptable modes of wealth acquisition and disposal in Islam. *Wasiyah* is similar to a gift, though with certain differences. It is executed after demise of the benefactor and takes the form of gift of wealth, useful items [like mosques, estates etc.] or even that of debt etc. The total of *Wasiyah* given cannot be exceeded than one-third of total assets. The eligible or legal heirs are not entitled for *Wasiyah*. (Yaacob, O. n.d.).

Wasiyah should be in writing. It must be signed by the Testator (will maker) and witnessed by at least two persons. In Islam, *Wasiyah* does not necessarily bi in writing but it must be witnessed by two persons. It should comply with the requirement of the Qur'an and Hadith of Prophet (saw).

Actual receipts of willed items are a precondition for legal validity of *Wasiyah*, like gifts, according to Imam Malik, but others like Imam Shafie opined that verbal acceptance alone may suffice.

The recommendation of *Wasiyah* has prescribed by Allah (swt) in the Qur'an and whoever do *Wasiyah* will be rewarded.

> O you believe! When death approaches any of you, and you make a bequest (then take) the testimony of two just men of our own folk or two others from outside, while you are travelling through the land and death befalls on you(Qur'an, 5:106)

Although many scholars believe this verse has been abrogated by the more specific verses enjoining inheritance, still enjoins *Wasiyah* to non-inheriting relations or according to at-Tabari for persons without heirs and for the *Ummah* in general.

Ibn Abbas relates the Hadith of Prophet (saw);

> Prophet (saw) says giving 1/3 of your property by wasiyah is abundance.

Another Hadith related by Saad which was written by Imam Shafie;

> The Prophet (saw) forbids to Wasiyah more than 1/3 of property. (Ismail n.d.)

The person who gives *Wasiyah* has the opportunity to arrange the program for alms or *Sadaqah* and distribution of two-thirds to their legal heirs. In Malaysia, anyone is allowed to make their own *Wasiyah* but must be comply with the rules and conditions of Qur'an and Hadith, and also Will Act 1949.

In the existing practices in financial services in Malaysia, there is huge room for financial planners and government itself to improve and to practice *Wasiyah*. In current practice used by mostly financial institution is to nominate their customers wealth; in government agencies like Employee Provident Fund.

There are differences between *Wasiyah* and nominee according to Islamic laws. Nominee is act as trustee only. According to section 167 Insurance act 1996 acts 553, he is entrusted to claim the policy money from the insurance for payment of claims. Thereafter he has to distribute the money to the rightful heirs or beneficiaries in accordance with Islamic Laws or with consent from them.

10.7.2 Waqf

Waqf in the Arabic language literally means 'hold', 'confinement' or 'prohibition'. The word *Waqf* is used in Islam in the meaning of holding certain property and preserving it for the confined benefit of certain philanthropy and prohibiting any use or disposition of it outside that specific objective. *Waqf* is a religious endowment, a property giving revenues, as regulated by Islamic law. The position of *Waqf* is the same category of *Sadaqah* or *Tabarru'*.

Waqf's legal definition includes two conditions. The first condition is to dedicate one's property rights to any public service and prevention of its re-ownership by others; and the second condition is the perpetuity of this dedication.

The property must be in real or which has some meaning of perpetuity. The property should be given on a permanent basis. Some jurists approve temporary *Waqf* only in the case of family *Waqf*. The example of family *Waqf* is the condition that the fruits and revenues of their *Waqf* are first given to their own children and descendants and only the surplus, if any, should be given to the poor. If a person sets up a *Waqf* for his children, he must treat males and females equally, because he has included all of them in that, which implies that they all have equal share. Just as if he were to give something to them, it should be shared equally among them, so too if he sets up a *Waqf* for them, they should have equal shares.

The *Waqf* founder should be legally fit and able to meet the purpose of *Waqf*. The purpose of the *Waqf* must be in ultimate analysis be an act of charity. Hence the *Waqf* on the rich alone is not permissible because it is not charity.

The revenues from the *Waqf* finance mosques, and another religious institution. Hence, the *Waqf* is considered as a part of the mosque or the institution. According to Ibn Qudama, *Waqf* means bequest the property and dedicating the fruit. As quoted from the Prophet's (saw) words in His advice to Omar Ibn Khattab, when the latter consulted him about a land lot of his:

> Bequest its stock and dedicated its progeny. (Hadith)

10.7.2.1 Advantages of Waqf

There are some points that should be highlighted on why we should include *Waqf* in our financial planning. Usually, when property holders indulge in gathering, developing, managing, protecting and diversifying the source of their wealth, their life, thinking and ambitions become slave to its demand; hence they become trapped in the process of protecting it. For this reason; they are more in need than others of being reminded to pay attention and aspire to the hereafter and to seek its merits. Especially through their money, complying with the Qur'an, we should endeavour towards the Hereafter.

> But seek the abode of the hereafter in that which Allah has given thee. (Qur'an, Surah Al-Qasas: 77)

It can be considered as 'estate planning' for the hereafter. *Faraid* is the rule, *Wasiyah* is the bonus, *Hibah* is the exception; but all for preparing for the legal heirs' provisions in this world. *Waqf* and all in its categories such *Tabarru'* or *Sadaqah* is for all and truly for one's provision in the hereafter. *Waqf* endowment saves the soul from the worries, fear and covetousness surrounding money; and it makes it used to generous spending.

Waqf can also be considered and treated as a way of securing inheritance to the legal heirs. While the benefits from a *Waqf* can be pious and good, the actual establishment of the can have been everything but pious. In Muslim societies, regulations on inheritance have represented a problem for rich families; properties have been considered as belongings only to its owner but not to his descendants. When the owner dies, the property would then be transferred to the ruler. But with *Waqf*, rich families have established *Waqf* and had children put up as trustees. The salary or allowances will be given out at normally practices about 10% of revenues. Through the *Waqf*, the descendants have been secured a part of the fortune or wealth.

10.7.3 Hibah

The transfer of existing properties made voluntarily and without any consideration by the donor to the donee and accepted by or on behalf of the donor during their lifetime.

> and gives his wealth in spite of love for it, to the kinsfolk, to the orphan and to Al-Masakin (the poor), and to the wayfarer and to those who ask. (Qur'an, 2:177)

There will be some issues that arise from applications of *Hibah* in our life. Therefore, the provisions for the implications of *Hibah* transactions must be provided. In Malaysia, Bumiputera-Commerce Trustee Berhad has introduced new product named *Hibah Harta* to facilitate the needs of the whole Islamic community (Bumiputera-Commerce Trustee Berhad).

Property *Hibah* is a private contractual arrangement between three parties; whereby a person (the donor) allocates his property, during his lifetime, to his loved ones (the donees). In doing so, the property allocated thus will be held in trust and managed by Bumiputra-Commerce Trustee Berhad, which known as trustee. This product has been approved by the Majlis Fatwa Wilayah Persekutuan (Yaacob, O. n.d.). Upon the donor's demise, the trustee will then transfer the gifted property to the donee. As *Hibah Harta* is a private contract done during the lifetime of both the donor and the donee, the property will not form part of the donor's estate, and not subjected to the Probate and Administration Act and Will Act 1959 and *Faraid*. Hence, this makes the transfer of the donor's assets smoother and trouble free.

There are two types of *Hibah Harta* introduced by Bumiputera-Commerce Trustee Berhad; *Hibah Umra* and *Hibah Ruqba*. *Hibah Umra* is known as *Hibah* without conditions where the properties will be transferred to donee after death of the donor. Whereas, *Hibah Ruqba* is a *Hibah* with condition where the properties will be transferred depending on who died first. Should the donor die, the properties will be transfer to the donee. If the donee dies first, the property won't be transferred to the legal heirs but will be transferred to the donor.

Hibah Ruqba or *Hibah* with conditions is very important and crucial in today's *Al-Mu'amalat* or transactions. There were few cases which involved in *Hibah* transactions ended with unforeseen and unexpected situation. A similar transaction was *Ruqba* (from *Raqaba*, 'he waited'), by which a man gives a house to another on condition that if the donor died first, the house became the property of the donee, and if the donee died first, the house reverted to the donor, as if each waited for the death of the other. Bukhari does not speak of *Ruqba* which, according to the best opinion, is not allowed in Islam. With regard to *'Umra*, it is agreed that when it is expressly stated that the property shall pass to the heirs of the assignee or when no condition is laid down, it shall be a gift in all respects and shall not revert to the assignor; but when an express condition is laid down that on the death of the assignee it shall revert to the donor or his heirs, there are two opinions; firstly, that the transaction shall take effect in accordance with the condition laid down, as if it were a loan; and secondly, that it shall be looked upon as a gift, the condition being dealt with as illegal and unenforceable.

Another example of *Hibah* is where a couple gives away all their wealth and property to the adopted son as *Hibah* without any conditions. The adopted son has no any legal heirs and met with an accident which cause to his death. Every single penny owned by the late adopted son will be inherited by nobody except *Baitul Mal*. The parent who has *Hibah* all their wealth to the late adopted son has nothing in hand. *Hibah Ruqba* is one of the tools that should be implemented to protect and to hedge from any circumstances may arise in the future. *Hibah* is one of the best alternatives in our financial planning and should ended in a good way. However, based on the illustration given above is related to one of Hadith where Malik related that 'Umar Ibn al-Khattab said,

> What is wrong with men who give their sons gifts and then keep them and if the son dies, they say, 'My property is in my possession and I did not give it to anyone.' But if they themselves are dying, they say, 'It belongs to my son, I gave it to him.' Whosoever gives a gives, and does not hand it over to one to whom it was given, the gifts is invalid, and if he dies it belongs to the heirs in general.

> The Prophet (Pbuh) said: It is not lawful for a man to make a donation or give a gift and then take it back, except a father regarding what he gives his child. One who gives a gives and then takes it back is like a dog which eats and vomits when it is full, then returns to its vomit. (Abdullah Ibn Umar and Abdullah Ibn Abbas)

10.7.3.1 Advantages of Hibah

A *Hibah* property will not be part of the original owner because the contract concluded that the transfer of the property to the beneficiaries is legal. The person who gives his property as *Hibah* will be protected against any legal action from creditors on the particular wealth.

In Malaysia, there are few corporate and professional bodies that provide the consultation on how to manage our financial planning, one of them is Darul Hibah Consultant Sdn. Bhd. The person who deals with *Hibah* will not face any difficulties in completing *Hibah* transaction. It will not take a long time compared to documentation completing *Faraid* matters.

Hibah can eliminate the problem of quarrelling among beneficiaries in claiming ownership of property. The owner of property has full rights to transfer any amount of his wealth to anybody; his legal heirs or not. *Hibah* has no limitation as *Faraid* and *Wasiyah*. *Faraid* is strictly distributed to legal heirs only and *Wasiyah* cannot be distributed to any family member in legal heirs, and at maximum of one-third only.

10.8 Conclusion

In Islam, accumulation of wealth is allowed and in some circumstances mandatory. However, wealth should not be abused and must be managed and be planned properly, as Allah has laid down very clearly injunctions on how wealth should be acquired and spent. Above all, wealth is a form of trial by Allah to His servants; whether they follow His injunctions regarding wealth acquisition and disposal and as such the owners are going to be fully accountable on the day of Hereafter.

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CHAPTER 11

Investment in Islamic Unit Trusts

11.1 Introduction

Currently, the development of the collective investment industry, particularly the unit trusts industry, has become an important factor of growth of the Non-Bank Financial Intermediaries (NBFI) within the Malaysian Financial System. This reflects a significant contribution to the economy as a whole. The percentage of asset holdings in the NBFIs increased from 5.8% in 1992 to 7.0% in 1998 (Malaysian Unit Trusts Industry 2000). Some of the factors that contributed to this growth are robust economic growth, low unemployment and inflation rates, increased population growth, increases in per capita income and so forth. In addition, the introduction of unit trusts packages based on Shari'ah principles plays a significant role in boosting the economy for the nation. So, in this chapter the focus is on the Islamic model of the unit trust, its development, concept within the local market, Shari'ah rulings to support unit trusts, advantages and disadvantages of unit trusts, regulatory bodies related to unit trusts, recommendations to further improve the practice of Islamic unit trusts and the future of the unit trust industry.

11.2 Overview of the Unit Trust Industry

The unit trust industry in Malaysia started early in 1959 when the first unit trust named Malaysian Unit Trust managed by Malayan Unit Trust Limited was introduced. In 1963, the Malayan Unit Trust was transferred

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to the South East Asia Development Corporation Berhad. Later, the Singapore Unit Trust Limited and Asia Unit Trust Berhad were set up as a result of the division of this company. In 1968, Amanah Saham MARA Unit Trust Management was established. The fund aimed to pool bumiputra (Malay origin) savings, mainly from rural areas. The introduction of the funds was very encouraging during that year. Amanah Saham MARA Unit Trust Management Berhad and Asia Unit Trust Berhad largely dominated the industry in 1970s.

The expansion continued on 20 April 1981 when Permodalan Nasional Berhad (PNB) first introduced Sekim Amanah Saham Nasional. It aimed to mobilise savings and increase the corporate wealth of the bumiputra according to the New Economic Policy. The fund from the unit trusts was largely invested in various companies run by bumiputra. As a result, PNB managed to attract about 170,000 bumiputra to participate, just a week after it was launched. Another week after that, about 1 million bumiputra invested in the Amanah Saham Nasional, which was worth $600 million. This is a record for the unit trust industry since its establishment. Later, the government believed unit trust could be a powerful tool to abolish economic differences among races. On the other hand, Malaysian Indians were also introducing their own unit trust to improve the standard of living. They introduced Amanah Saham MIC-TPG Berhad, with the main focus being to promote and mobilise domestic savings among the Malaysian Indians.

The growth in economy in 1990s as a result of growing per capita income, new international ventures, corporatisation, rising consumer affluence, booming stock market and such reflects a greater height of growth for the unit trust industry. The government was very concerned about the growth and development of the industry, so it introduced several regulatory frameworks and a body to monitor the industry. The Securities Commission (SC) was established on 1 March 1993 as a regulatory agency to monitor all the unit trust transaction within the market. Part of its role is to rationalise and strengthen the fragmented regulatory framework in the industry (Malaysian Unit Trusts Industry 2000).

To support this argument, we now summarise the development of unit trust industry in Malaysia from 1992 to 1999 consecutively. The number of government-sponsored funds increased from 19 in 1992 to 30 in 1999. The net asset value for the funds also increases gradually from $15.334 billion to $32.199 billion in 1999. While the development of private funds was also attractive, from 20 in 1992 to 77 in 1999.

The net asset worth also increases, from $0.386 billion in 1992 to $11.058 billion in 1999. All in all, the market capitalisation of the unit trust industry in Malaysia improved year on year, from $6.39 billion in 1992 to $7.827 billion in 1999.

11.3 The Concept of a Unit Trust

11.3.1 Central Idea

A unit trust can be defined as a collective investment scheme which obtains money from pooling the savings from various investors who share the same financial objectives, investment strategy and risk (Desmond Chong, Unit Trust in Malaysia 2000). Next, these funds will be allocated in a diversified portfolio of authorised investments and managed by the professional managers. The Security Commission's guidelines on unit trusts set out the overall regulatory framework of the unit trust such as a 'deed' or an agreement that should be followed by the managers, unitholders and managers. In addition, examples of authorised investments allowed by the Security Commission include approved stocks, bonds, commercial chapters, government securities, treasury bills, foreign securities, direct business ventures, unquoted securities and so forth.

11.3.2 Mechanism of the Unit Trust

A unit trust is based on a trust deed, which is created for the management of fund with trust. It is an agreement between the trustee, fund managers and the fund's investors (unitholders). This agreement is made in alignment with the mutual interests of all parties involved. Again, the unitholder is an individual (s) or institution which invests in the fund. Each of them will receive a certificate or entitlement, which is known as unit trust certificate. They do not directly acquire the securities in the portfolio. Instead, the ownership of the fund is divided into a separate unit of entitlement or right. The decreases or increases in the portfolio will reflect the value of each unit. Normally, unit trust investors are small investors who do not have a time look after a specific portfolio investment. So, they prefer to invest in a secure investment portfolio, incurring minimal costs of administration, marketing and research. The unitholders can buy their units at a selling price. The calculation of price for each of the portfolio is based daily and quoted in the news chapters. They can buy at any time before the fund reaching its maximum approved size. On the other hand, they can also sell the units at a buying price at any time. This can be done through the particular fund management company.

The manager is the professional person appointed to manage the operation of the funds. He will invest the money into authorised investments as approved by the Securities Commission Act 1983—namely, securities of companies listed on recognised stock exchange, Malaysian Government Securities, Treasury Bills, Bank Negara Malaysia Certificates and Government Investment Certificates, Negotiable Certificates of Deposit, Banker's Acceptances and placements of money at call within discount houses, Cagamas Bonds, Unlisted Loan Stocks, Corporate Bonds and so forth. In some exceptional cases, an external investment manager from merchant bank or asset management company is appointed to manage the funds. As a return from services rendered by the managers, some service fees are charged based on the agreement. A different company may charge at different rates to their clients. Usually, the cost of capital of unit trust is reasonable, based on the riskiness of the funds.

A unit trust provides a return on investment in the form of growth (capital appreciation) and dividend income. The dividend income is distributed to the unitholders based on their units held. However, under the unit trust concept this is not guaranteed. It is based on the portfolio performance. In addition, to protect the funds, the fund management company is not allowed to keep assets such as share certificates and bank accounts. So, the trustee is appointed as a custodian to ensure the interests of the unitholders are protected.

11.3.3 Differences Between Unit Trust and Mutual Fund

The main difference for the unit trust and a mutual fund is legal structure. Generally, a mutual fund issues redeemable shares. In contrast, a unit trust issues a unit instead of shares. This difference has a significant impact on the performance of each type of investment. A mutual fund as a closed-end fund is normally traded in a secondary market, unlike the unit trust. The performance of a share price is very much dependent on market demand and supply forces, while a unit trust as an open-end fund can only be traded through the fund management company.

11.3.4 Types of Funds

Unit trust funds can be categorised based on their unique characteristics. Some of these are equity, bond, income, growth, balanced, money market, Islamic funds and so forth. The equity fund is also known as stock fund. The investments are mainly traded on the stock exchange. This fund is made up of local shares, shares of unlisted companies and so on. Next, the bond fund concentrates on investment in bonds and other securities. It is less risky than the equity fund because legally it has first right before the stockholders. Examples of bonds are bank guaranteed, government guaranteed and so on. Meanwhile an income fund concentrates on securities, deriving its income from bonds, utility stocks, money market instruments and so forth. Lastly, the Islamic fund concentrates on investing in businesses that follow Islamic principles. However, this type of funds does not limit to type of investors. It is open to all Malaysians regardless of their race and religion.

11.3.5 Shari'ah Rulings

In Islam, investment under the unit trust concept is in line with the rules of Shari'ah. The concept of risks and rewards shared by the unitholders employing the expertise of professional managers conforms to Islamic principles and is already being applied in within the Islamic financial system. This can be related to specific financial contracts and products, namely *Murabahah* and *Musharakah*.

Firstly, it complies with the concept of *Mudarabah*. This concept is one of the most well-known investments permissible under Shari'ah and widely used by the countries practising Islamic systems of banking, such as Iraq. Generally, *Murabahah* is a concept in profit sharing where one part provides capital and the other party provides labour. Then, the other party will act to manage the money. The profit is shared by both parties according to the agreed ratio (Hasan n.d.); this concept can be implied to the unit trust. In a unit trust, the capital of a venture is provided by the trust and the business expertise and management will be the responsibility of the third party, in this case the unitholders. Then, the profit is divided between the unitholders and the trust according to the agreement. In addition, some unique elements of the *Mudarahah* concept are it is limited to the self-liquidating transactions, the assets must be easily recognisable and must be realised and liquidated so that the profits are easily distributed and its accounts must be recorded properly and be audited.

Next, the concept of *Musharakah* also can be applied in the unit trust. Within this concept, two or more financiers will engage in a new project or participate in an established project. All the partners have a right to share total profits from a venture as in the agreement. The managers who manage a fund will be remunerated in the form of a service charge. This is in line the unit trust concept, in which the mechanisms are the same. The main difference is the avenue of the funds, that is, where the funds are being invested. In an Islamic unit trust, for example, the funds are allocated in the authorised investments approved by the Security Commission as well as the Shari'ah Board. Moreover, the profit is shared after deducting management fees and payment for *Zakat*.

11.3.6 Example of Islamic Unit Trusts

There are many types of unit trust in Malaysia. For the purposes of this chapter, they can be divided into two: namely, Islamic unit trusts and conventional unit trusts. However, the only clear difference is the avenue of the fund, that is, where the funds are being invested. Some examples of unit trust company in Amanah Saham Bank Islam, Arab Malaysian Cumulative Growth Fund, BHLB Pacific Savings, Lifetime Trust Income, Amanah Saham Nasional and so forth. In this section, I discuss one example of an Islamic unit trust as well as the conventional type.

Firstly, Bank Islam Unit Trust Management Berhad (BUTM) introduced Amanah Saham Bank Islam—Islamic Bond Fund on 27 December 2001. This fund has a size of about 400 million units. This fund aimed to invest in a portfolio of '*Halal*' stock, which complies with the principles of Shari'ah. The *Halal* stocks exclude all the companies involved in activities, products or services related to conventional banking, insurance and financial services, gambling, alcoholic beverages and non-*Halal* food products. While this fund also aims to avoid the incidence of *Riba*, or usury interest. One of the ways that this is assured is by direct deduction *Zakat* from each of the proceeds. The Bank of Islam's Shari'ah board advises the fund. The funds can be categorised as the income type. Largely, this type of fund aims to achieve a reasonable return by investing in a moderate risk type of portfolio. Minimum investment for this fund is $1000 and the minimum additional deposit is $100. The service charge is 0% to 5% of the net asset value.

Next, Amanah Saham Nasional 3 (ASN 3) was introduced on 16 October 2001. This fund was introduced by Amanah Saham Nasional Berhad, a wholly owned subsidiary of PNB. This fund's policy is to invest in a prudent portfolio of equities and other capital market instruments, which is in line with the objective to achieve a capital appreciation over the medium to long term. ASN 3 invested 70% of its assets in equities and the remainder in other capital market instruments. The allocation may be reviewed based on market performance. This fund can be categorised as equity and other capital market instruments. In other words, it is a balanced fund. The size of this fund is 1 billion units. In addition, this fund is suitable for investors who expect to gain growth of capital over the medium to long term. The service charge for this fund is 5% to 10% of the net asset value (*Prospectus* 2001).

The difference between ASN 3 and ASBI—Islamic Bond Fund is restriction by the Shari'ah board. Theoretically, the Islamic Fund of ASBI must comply with the Shari'ah qualification as listed below:

- interest-based transactions are prohibited;
- the outcome of the investment will benefit the society;
- capital (*Maal*) should be managed through *Halal* (religiously acceptable) channels. In other words, it cannot be invested in a religiously prohibited activity such as gambling;
- *Zakat* must be deducted from the proceeds and distributed to the needy through the proper channels.

11.3.7 Future of the Islamic Unit Trust Industry

The prospects of Islamic financial product, particularly the unit trust, is bright with further support and encouragement from the government. However, in order to become an international Islamic financial centre, several measures have to be implemented. For example, overcoming consensus among bankers and Islamic jurists, encouraging proactive participation in research and development and education to general public. Firstly, there are problems that occur due to different views between conventional and Islamic practitioners. For example, in the case of unit trusts, some of the company may neglect to deduct *Zakat* from their profits. In contrast, Islam suggests *Zakat* be paid to the needy and poor. In conjunction to this, Shari'ah Advisory Council has to be more proactive to tackle this deficiency. They should re address the matters related to the Shari'ah principles and conduct proper discussions to overcome the issues pertaining in a proper manner. As a result, better co-ordination and consistency of Shari'ah rulings will prevail in the future.

Next, research and development also plays a significant role in shaping the future of the Islamic unit trust. Shari'ah experts and professionals should sit, discuss and develop a versatile Islamic financial product which suits present and future needs. On the other hand, from discussions held by both parties, knowledge gaps can also be diminished over time and this directly reduces resistance and enhances co-operation in promoting any financial products.

Better education on the intricacies of Islamic principles financial product is very important to provide a better understanding of the underlying concepts of Islamic finance. Recently the public has complained that the profits in Islamic products are almost the same as conventional ones. So, the government should take a more proactive role to overcome this. Seminars and information through mass media are means of educating people about the concept of Islamic finance.

As a conclusion, to become a hub of Islamic finance, the government and private sector have to put more effort into Islamic financial subsectors, particularly unit trusts. If this is done, our vision to see a fully Islamic-based country will become reality (Izazee 2002).

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CHAPTER 12

Halal Investment in Sustainable Development Goals

12.1 Introduction

This chapter focuses on financing aimed at growing low-income groups. According to World Bank classification, a number of Muslim countries are categorised as low-income economies. As for Malaysia, due to its stimulated economic development in recent years, it is now categorised as an upper-middle group economy. The discussion here will be based on Malaysian data and statistics. Moreover, it will be noted that no matter how strong an economy is, there are always lower income groups that need to be catered for.

Since 1973, Malaysia has experienced remarkable economic growth. This is shown by an increase in per capita income of 2.5 times from 1973 to 1995. The poverty had shrunk from half of the population to 78% (Data sources: World Bank). This growth has led to increased life expectancy, diminished infant mortality, low public expenditure on health (only about 1.4% of GDP (Gross Domestic Product) (Data is for 1994), as well as high government spending on public education, which has led to secondary school enrolment for both girls and boys increasing rapidly from 34% in 1970 to 58% in 1996. The impressive growth of the Malaysian economy had reduced poverty and reduced in income inequality as well. Table 12.1 shows the reduction in income inequality distribution the context of Malaysia.

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Table 12.1 Income inequality distribution (ibid.)

Economy	*Period*	*Measured variable*	*Gini coefficient (%)*	
			1973	*1989*
Malaysia	1973–1989	I/P (Per Capita Income)	50.1	45.9

Source: Author's own collection

The data has been complied using the Gini coefficient method, where the income inequality distribution among population in Malaysia reduced by 4.2% from 1973 to 1989.

When talking about low-income groups, we always refer to the population in rural areas. However, in this new millennium, to speak of low-income groups does no longer only refers to those who live in rural areas. Due to the pressure of many factors, those who live in urban areas can also often be classified as members of low-income groups. Factors that have made the urban population considered as part of this group are:

- low income received; which it is not enough to support monthly expenditure;
- prices of goods and services are much more expensive than as in rural areas;
- high cost of living; where housing rent, taxes, parking payment and so on is high;
- lack of education;
- higher birth rate also makes some people who live in rural areas fall into the low-income group. Although salaries may be considered high, because of the large family size purchasing power is still low.

In Malaysia, the low-income group is still a major concern for government. To combat the effects of reduced earnings from lost employment or lower wages, the government is expanding income-earning opportunities for the poor by:

- giving low-interest loans to small farmers to increase food production;
- expanding programs run by a local NGO which provide small subsidised loans for income-generation in rural areas;
- supporting a fund for loans to small- and medium-scale industries;

- proposing an employer and employee exemption for contributions to the Employee Pension Fund for all new graduates hired;
- establishing urban micro-credit programs for hawkers, petty traders and small entrepreneurs; and,
- building rural infrastructure to improve access to safe drinking water.

12.2 Low-Income Group

Low- and middle-income economies are sometimes referred to as developing economies—according to World Bank classification. The intention is not to imply that all economies in the group experience similar development or that other economies have reached a preferred or final stage of development. Classification by income does not necessarily reflect development status. The World Bank divides economies according to 2002 GNI per capita, calculated using the Atlas method. The groups are: low income of $735 per month or less; lower middle income, amounting to $736–$2935 per month; upper middle income of $2936–$9075 per month; and high income, amounting $9076 or more. According to the Malaysian Economic Planning Unit, household monthly income of below $1500 is considered low income group whilst households which earn $3500 and lower are classified as part of the middle-income group. The lower income group made up 43.8% of the total population and the middle-income group constituted 37%. These two groups represent 80.8% of the society, almost matching the quantity of houses planned to be built in the Policy period.

12.3 Determinants of the Low-Income Group

In determining the low-income group, all factors list below are considered:

- cash income (includes earnings, workers' compensation, social welfare, public assistance, pension or retirement income, interest, dividends, rents, royalties, income from estates, trusts, educational assistance, alimony, child support, assistance from outside the household, and other miscellaneous sources);
- non-cash benefits (such as food stamps and housing subsidies);
- income calculated before taxes;
- if a person lives with a family, the combined income of all family members is taken into account (non-relatives, such as housemates are not counted).

Poverty thresholds are the dollar amounts used to determine poverty status. Each person or family is assigned one out of 48 possible poverty thresholds. Thresholds vary according to size of the family and ages of its members, and are updated annually in light of inflation using the Consumer Price Index.

Although the thresholds in some sense reflect a family's needs, they are intended for use as a statistical yardstick, not as a complete description of what people and families need to live.

12.4 Poverty: An Islamic Perspective

Poverty is a never-ending problem in the world today. One of the reasons behind the problem might be the unjust economic system practised in a country. History has proved that the system practised during the time of *Jahiliyyah* caused the poor to become poorer and the rich to become richer due to human greed and selfishness through the practice of *Riba*. The same problems exist in the world today. *Riba*, or interest, can be said to be among the major problems in the economy. The world economic superpowers, for instance US government, use their economic might to enforce the poor Islamic countries to be dependent on them through the fiat money system. The more the poor countries borrow from such developed nations, the more the latter gains and the more power they have over the former.

Without a just economic system, poverty can never be eradicated. As Islam comes with its full package for a perfect life, it provides guidelines for every aspect of life—including economic matters.

Islam seriously caters to the welfare of low-income earners (the poor and needy). This can be proved by the provision of *Zakat* in one of the articles of faith which obliges rich people to pay *Zakat* out of their surplus income to those who earn less. This responsibility be cannot taken for granted, since besides helping our poor Muslim brothers, *Zakat* is a medium to purify our wealth. Allah (swt) says:

> Take sadaqah (alms) from their wealth in order to purify them and sanctify them with it, and invoke Allah for them. Verily! Your invocations are a source of security for them, and Allah is All-Hearer, All-Knower. (Qur'an, Al-Taubah: 103)

In other verses, Allah (swt) says:

> And strive hard in Allah's Cause as you ought to strive (with sincerity and with all your efforts that His Name should be superior). He has chosen you (to convey His Message of Islamic Monotheism to mankind by inviting them to His religion, Islam), and has not laid upon you in religion any hardship, it is the religion of your father Ibrahim (Abraham) (Islamic Monotheism). It is He (Allah) Who has named you Muslims both before and in this (the Qur'an), that the Messenger (Muhammad [saw]) may be a witness over you and you be witnesses over mankind! So perform AsSalât (Iqamat-as-Salât), give Zakat and hold fast to Allah [i.e. have confidence in Allah, and depend upon Him in all your affairs] He is your Maula (Patron, Lord, etc.), what an Excellent Maula (Patron, Lord, etc.) and what an Excellent Helper! (Qur'an, Al-Hajj: 78)

> Verily, your Walî (Protector or Helper) is Allah, His Messenger, and the believers—those who perform As-Salât (Iqâmat-as-Salât), and give Zakat, and they bow down (submit themselves with obedience to Allah in prayer). (Qur'an, Al-Maidah: 55)

> And in their properties, there was the right of the beggar, and the Mahrûm (the poor who does not ask the others). (Qur'an, Al-Zariyat: 19)

As far as inequality among human being in this world is concerned, the Qur'an regards it as the result of Divine will (Al-Maududi 1984). However, it is always Islam's objective to eliminate inequality in this world through the Divine teachings that order that everyone should receive equal distribution of wealth. That is why Islam condemns materialism and greed in man. The Qur'an says:

> The mutual rivalry for piling up of worldly things diverts you. Until you visit the graves (i.e. till you die). Nay! You shall come to know! (Qur'an: Al-Takathur: 1–3)

Al-Maududi (1984) stated that one of the basic objectives of the Islamic system is to provide social justice and equitable distribution between the poor and rich. Muslims are not allowed to be greedy and selfish. They have to realise that man is not an absolute owner of what we possess today. Allah (swt) says in the Qur'an:

> His is the kingdom of the heavens and the earth, It is He Who gives life and causes death; and He is Able to do all things. (Qur'an: Al-Hadid: 2)

On the other hand, the Qur'an also condemns any man who spends his wealth to secure luxury (Al-Maududi 1984). The Islamic way of living encouraged by Islam is to spend in a moderate way without wasting money on extravagant spending and neglecting the fulfillment of other Muslims who are suffering from poverty. Allah (swt) says:

> And those, who, when they spend, are neither extravagant nor niggardly, but hold a medium (way) between those (extremes). (Qur'an, Al-Furqan: 67)

> But seek, with that (wealth) which Allah has bestowed on you, the home of the Hereafter, and forget not your portion of legal enjoyment in this world, and do good as Allah has been good to you, and seek not mischief in the land. Verily, Allah likes not the Mufsidûn (those who commit great crimes and sins, oppressors, tyrants, mischief-makers, corrupts). (Qur'an, Al-Qasas: 77)

12.5 Islamic Financial System

The perfect Islamic economic system can be realised at a point when there is no problem of poverty in a country. This perfect system was once attained in the time of caliphate 'Umar ibn 'Abdul 'Aziz (Nadwi 1999). In Islamic history, 'Umar was known to be a very humble and moderate caliphate who succeed in eliminating poverty until there were no more poor and needy who qualified to receive *Zakat* except him. History proved that by implementing Islamic teaching and eliminating greed and selfishness, poverty can be abolished. Taxes imposed by the government are not the only way towards equitable distribution of wealth. During the time of 'Umar (r.a.), it was proved that, without imposing any tax, he was able to return the rights of poor and needy and at the same time develop the country with just governance. In 'Umar's opinion, the abolishment of taxes collections was based on the following verse:

> And O my people! Give full measure and weight in justice and reduce not the things that are due to the people, and do not commit mischief in the land, causing corruption. (Qur'an, Hud: 85)

It may be concluded that poverty is not a problem of the poor and needy alone. It might be caused by spiritual greed and selfishness which ignores the rights of others. Inequality is an aspect of Divine will that requires the spirit of brotherhood, co-operation, responsibility and respect between the rich and the poor to abolish it. As far as Muslims realise their responsibility towards others around them, there must be a time when poverty will cease to exist.

12.6 How Does Islamic Finance Help to Grow the Low-Income Group Towards Sustainable Development?

12.6.1 Musharakah *(Venture Capital)*

Musharakah or *Shirkah* is a valid contract in Islam where the jurist of all schools (*Mazhab*) of thought (Shafie, Hanafi, Hanbali, and Maliki) had agreed on it (Al-Harran n.d.). The Prophet Muhammad (saw) himself also as involved in business on the basis of *Musharakah* and this practice already existed in Arab society, especially in commercial activities in Arabia. *Musharakah* or *Shirkah* can be defined in a very simple way as a form of partnership or joint venture where two or more persons agree to combine either their capital or labour for the purpose of sharing the profits and business risk or liabilities (Fig. 12.1).

The bank and customer agree to join or cooperate in a project suggested by the customer where both parties agree to contribute capital in this particular project. The bank will offer the customer financing based

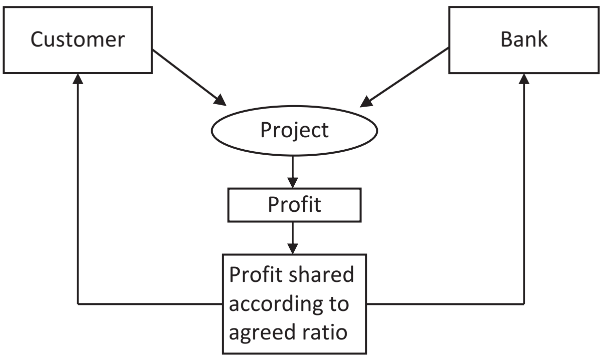

Fig. 12.1 *Musharakah* (venture capital). Source: Author's own

on a profit-sharing basis and the bank will appoint a customer to manage the project. The bank, as a partner, is allowed to be involved in project management. It also has the right to advise its partner on how to manage the project properly based on the experience of the bank. The bank also needs to undertake continual monitoring and to follow-up the project from time to time to make sure it will achieve its objectives on time. If the project is profitable, then both parties will share the profit based on the agreed proportions. If any loss occurs, this will be shared based on the contribution of capital from the partner.

12.6.2 Mudharabah *(Profit and Loss Sharing)*

Mudharabah is similar to *Musharakah* (partnership) principle. The different between *Mudharabah* and *Musharakah* principles is to do with the principle of *Mudharabah*, where capital is to be supplied by one party and another party contributes skills, labour and work. The capital provider is called *Rab-ul-Maal* or *Sahib ul Mal* and the worker called *Mudharib*, who provides the entrepreneurship. Under the *Mudharabah* principle, the bank or financier provides finance and the client (the poor people) provides the labour, management and expertise. In terms of profit and loss sharing, the ratio will be predetermined where if there is a profit, both parties will share it based on pre-arranged proportion (let us say at a ratio of 70:30 or 60:40), where *Rab-ul-Maal* will receive either 30% or 40% of the profit and the *Mudharib* will receive 70% or 60%. When a loss occurs, the *Rab-ul-Maal* (financier) will bear the loss and the *Mudharib* will lose the effort and time that he spent on the project. This system provides the entrepreneur with greater confidence and incentive to undertake such project if they think it is profitable (Fig. 12.2).

The financier as *Rab-ul-Maal* will provide *Mudharib* (entrepreneur) with capital of, say, $100,000 for a particular project. The profit and loss ratio is 70:30. After three years the project is worth $250,000 and so the net profit is $150,000. The profit will be shared between *Rab-ul-Maal* and *Mudharib*, where *Rab-ul-Maal* will receive $45,000 as a return and at the same time compensate the opportunity cost that the financier gave up. *Mudharib* will receive $105,000. In the case of losses occurring after three years, the loss will be borne by the *Rab-ul-Maal* and the *Mudharib* will lose his effort and time.

However, we believe this system will trigger the entrepreneur to undertake any project that they think is profitable due to the incentive provided

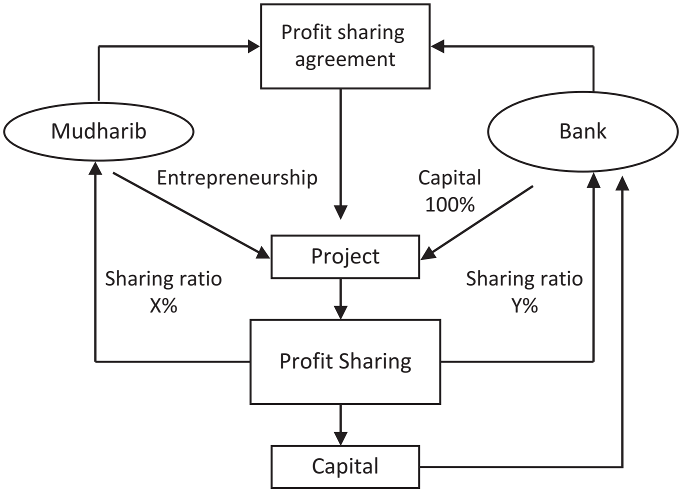

Fig. 12.2 *Mudharabah* (profit and loss sharing). Source: Author's own

by this system and so grow the low-income group economy. We would like to support this statement with a comment from *The Economist*:

> some people in the West have begun to find the idea attractive. It gives the provider of money a strong incentive to be sure he is doing something sensible with it. What a pity the West's bank did not have that incentive in so many of their lending decisions in the 1970s and 1980s. It also emphasizes the sharing of responsibility, by all the users of money. That helps to make the free market system more open; you might say more democratic. (Abdul Gafoor 2003)

12.6.3 Murabahah *(Cost-Plus Financing)*

Murabahah can be defined as the sale of goods or commodities for the price at which vendor has purchased it, with additional profit where the vendor needs to disclose the mark-up price to the purchaser. *Murabahah* is a kind of business participation and is permitted in Shari'ah. "The legality of murabahah is not questioned by any of the schools of law" (Al-Harran n.d.), where Shari'ah assumes that financier will buy the goods or commodity on behalf of his client and then sell it back to the client based on the mark-up price (Abdul Gafoor 2003) (Fig. 12.3).

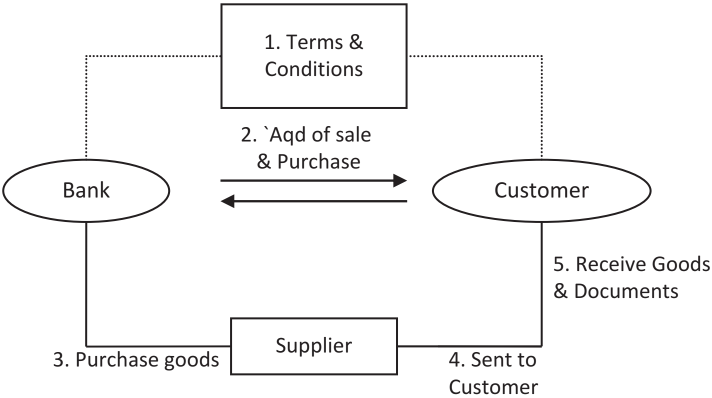

Fig. 12.3 *Murabahah* (cost-plus financing). Source: Author's own

The customer or client will inform the bank of the detail of the goods that he intends to buy or import based on the terms and conditions agreed by both parties. The bank (financier) agrees to buy the goods on behalf of his customer and he will use his own money to purchase the goods and sell them back to the customer at a mark-up price based on the principle of sale. After the supplier receives funds or money from the financier, the supplier will send the goods to the customer. As a return to the bank, the customer will pay cash to the bank or on deferred basis, which is called instalment based on the agreement between financier and customer.

12.6.4 **Ijarah** *(Lease)*

Ijarah is the agreement between two parties, lessor and lessee. The lessee has agreed to pay a certain amount of rental payment to the lessor because of the use of property. It can be divided into two categories:

(a) *Ijarah wa iqtina*;
(b) *Ijarah al-Muntahia Bittamlik.*

Ijarah under (a) is where the lessee agreed; at the end of the lease he is contracted to buy the property that was leased out to him. *Ijarah* under condition (b) is where the lessee is not going to buy the property leased. This means that the lessee will only pay a monthly/yearly rental to the lessor (Fig. 12.4).

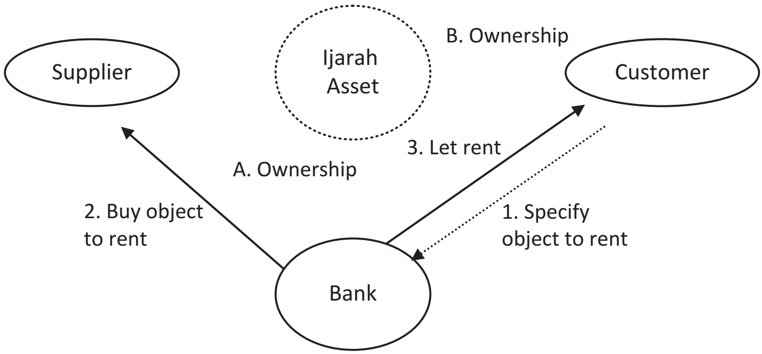

Fig. 12.4 *Al-Ijarah* (lease). Source: Author's own

The above figure best describes how Islamic banking can adopt this concept to help the low-income group. This principle can be applied to the banking system by which an Islamic bank in the first place buys a product (e.g. a photocopier machine) from the supplier and then rents it to the customer. According to this principle, the ownership is in the Islamic bank's hand and the transfer of ownership from the bank to the customer will only take place at the end of the *Ijarah* contract (if it is under condition (a)). Thus, the members of low-income group can, through Islamic banking under *Ijarah* principles, increase their productivity by renting a product that would cost him too much to buy and pay monthly rental. Increase in productivity means increase in household income too.

12.6.5 **Al-Qard** *(Loan)*

Qardh al-Hasan is an agreement between two parties, by which one party acts as a borrower and the other party acts as lender. The lending basis should not involve any collateral or else it is no more *Al-Qard*. It will be under *Ar-Rahn* principle. We can simply say that *Qardh al-Hasan* lending principle is a welfare lending without thinking of taking any return in future (unless the borrower gives the lender *Hibah*) except helping the poor. This is consistent with the brotherhood concept in the Islamic world (Fig. 12.5).

Under this structure, an Islamic bank can help the lower-income group by lending them money. They can then invest in any project that in return gives them profit. The profit, however, does not belong to the bank. It is

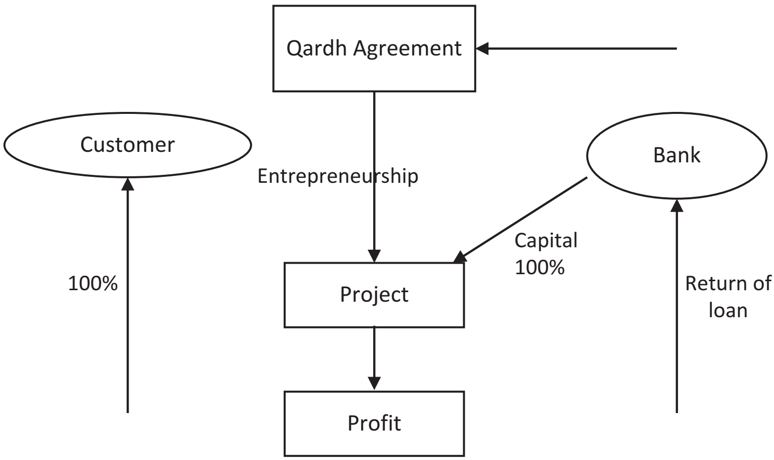

Fig. 12.5 *Al-Qard* (loan). Source: Author's own

100% considered as a profit for the borrower. But the borrower can give the Islamic bank a certain portion of the money as a *Hibah* in the sense that the bank had helped him at the very first stage, so that he would attain profits from the project.

12.6.6 Mode of Financing Through Bailtulmal

Baitulmal has been in existence a long time, since the Prophet Muhammad (saw), with the objective of helping the poor (*Fakir*) and the needy groups such as orphans, *Mualaf*, *Al-Riqab*, *Al-Gharimin*, *Fi-Sabilillah* and *Ibnu Sabil*. People who collect *Zakat* on behalf of *Baitulmal* are called *Amil*. There are two types of *Zakat*: *Zakat Fitrah* and *Zakat* on properties. *Zakat* can be defined as a portion of property (*Mal*) that it is compulsory to spend on others. *Zakat* also can be defined as the process of purification and expansion (Abdul Kader 2001). *Zakat* contribution is compulsory for every Muslim and it is one of the Islamic pillars. The command on *Zakat* contribution in the Qur'an is as follows:

> And those in whose wealth there is a known right. For the beggar who asks, and for the unlucky who has lost his property and wealth, (and his means of living has been straitened). (Qur'an, Al-Ma'ãrij: 24–25)

> Take Sadaqah (alms) from their wealth in order to purify them and sanctify them with it, and invoke Allah for them. Verily! Your invocations are a source of security for them, and Allah is All-Hearer, All-Knower. (Qur'an, Al-Taubah: 103)

These two verses explain that the role of *Zakat* from the Shari'ah point of view is for purification purpose. There are two aspects that we have to purify as below:

- to purify the individual property where Allah had already determined the portion for everyone;
- to purify individual mind from negative characteristic such as selfishness, too much concern about *Ukhrawi* (worldly life) with positive characteristics such as generousness and strengthening of relations (*Silaraturahim*) among the *Ummah.*

12.6.7 Distribution of Income

Zakat can play a very important role and it seems to be an effective tool to ensure the equality of income distribution among the poor and the rich. *Zakat* can be used as a tool to close the income gap to a minimal level in the society, where the richest will contribute a certain percentage of their income as *Zakat* to help the poor. *Zakat* can be paid in the form of money or goods. Even though the *Zakat* contribution from every individual is in small portion, it makes a lot of difference to the poor. With the *Zakat* the poor can fulfill their daily needs and wants to ensure they can survive and live as comfortably as the others.

Zakat will always ensure that society's wealth will be channelled or transferred in such a way that it is not owned by a particular party or person only. Through the *Zakat* system, properties owned by the richest will not only be used for their benefit but also can be used as a channel to transfer wealth the poor.

> What Allah gave as booty (Fai') to His Messenger (Muhammad [saw]) from the people of the townships,—it is for Allah, His Messenger (Muhammad [saw]), the kindred (of Messenger Muhammad [saw]), the orphans, Al-Masâkin (the poor), and the wayfarer, in order that it may not become a fortune used by the rich among you. And whatsoever the Messenger (Muhammad [saw]) gives you, take it, and whatsoever he forbids you, abstain (from it), and fear Allah. Verily, Allah is Severe in punishment. (Qur'an, Al-Hashr: 7)

Continual *Zakat* contributions will stimulate the economy where the purchasing power of the low-income group will increase over time. When purchasing power increases, indirectly the demand on goods also will increase and this will enhance or stimulate the country's economy. As a *Zakat* contributor, a person will receive their rewards in the hereafter and Allah will rewards them in *Dunia* with the increase of their income and profits due to the increments in productivity and national income. This process will ensure that the *Zakat* contributions from society will increase over time as well. Besides paying *Zakat*, the contributor also hopes that their small contribution today not only will help the poor but will have an expectation that this will facilitate the poor to become one of the contributors in the future.

12.7 Conclusion

Since 9/11, negative perceptions of Muslim countries abound, and some Western nations have labelled Muslims as terrorists. Those events were followed by the war between the United States, Great Britain and Iraq, which caused more problems of poverty in Muslim countries. For these reasons now is the right time for Muslim governments to restructure their economic systems so that Muslim countries do not have to depend on Western countries for funds. Restructuring economic systems is essential if governments are to provide solid solutions to help the poor through Islamic modes of financing. Even though there are some criticisms of Islamic modes of financing, we believe this system will be improved and become sustainable in the future and that it will be accepted as a favourable mode of financing not only among the Muslim countries but also in the West.

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CHAPTER 13

Investing *Takaful* Funds

13.1 Introduction

Investment policies for *Takaful* funds strictly adhere to Shari'ah principles. They will, however, be conducted using profitable avenues. As long as Shari'ah principles are practised, Muslims do not mind if returns are marginally lower. The objective of *Takaful* funds, as with all investments, is to raise the value of the investment consistently over time. However, the rate may differ in accordance with some changeable factors, which include: (Billah 2003)

- the nature and amounts of the various *Takaful* funds;
- the local economic environment, such as the country's GDP growth, sectorial growth and monetary policy;
- various regulatory requirements;
- availability and diversity of financial instruments in the banking system capital market.

If we see in any country, Malaysia for example, potential growth in gross domestic product, the concomitant rise in values may be beneficial. On the other hand, large numbers of people in the Muslim community may also encourage the growth of *Takaful* investment development. However, *Takaful* companies will always compete with the various insurance companies that are now increasing rapidly in num-

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bers. In this chapter, we will discuss the brief layout of investment policies of *Takaful* funds whilst among them are the Islamic guidelines of the investment policies, the classifications of the investment policies, its products and also the avenues that enable the investment to takes place according to Shari'ah. Anyhow, there are some aspects of these classifications that are unable to be brought forward because they may be linked to other bodies, such as financial institutions and also security bodies.

13.2 Shari'ah Guidelines

There are three rules that guide investment policies:

- investment should be free from interest;
- there should be no unethical and immoral practices; and
- the economic rewards should be profit of fee based.

As Allah (swt) has enshrined in the Qur'an:

> Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: 'Trade is like usury', but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); But those who repeat (the offence) are Companions of the Fire; they will abide therein (forever). Allah will deprive usury of all blessing but will give increase for deeds of charity; for He loveth not Creatures ungrateful and wicked. (Qur'an 2:275–276)

> O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Messenger: But if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly. If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. (Qur'an 2:278–280)

The investment policies of a *Takaful* company are determined by the Board of Directors. This Board of Directors will select the Shari'ah Committee who will determine all of the investment funds in line with Shari'ah principles.

13.3 Classifications of Investment Policies of a *Takaful* Fund

There is also some identification that makes out the policies that are:

- financing
- miscellaneous income
- owned and leased properties
- foreign investment
- lending and securities
- stock market (shares)
- investment accounts
- unit trusts
- financial instrument
- royalties from franchising
- rental income
- asset leading profit.

Next there are a few examples to briefly explain those avenues.

13.3.1 Financing

An example of a financing product is *Bai' Bithaman Ajil*. This product uses the concept of deferred instalment sale. The underlying steps to using this concept are, firstly, the bank purchase the asset and sell it to customer at an agreed price. The customer can repay by installment within the period and by earlier consent of both parties. Allah (swt) says:

> Help ye one another in righteousness and piety, but help ye not one another in sin and rancor. (Qur'an 5:2)

13.3.2 Financial Instruments

There are another three categories that fall under financial instruments. The financial instruments are *Mudharabah* Bonds, IAB and securities. *Mudharabah*, as we know, is an Islamic concept that takes care of profit-sharing practice. As for *Mudharabah* Bonds, it lies under debt-financing instruments. For instance, Cagamas will issue this debt-financing to be shared with the bondholders. Then, it uses the concept of *Bai' Bithaman*

Ajil, (deferred installment sale), for the purpose of the Islamic bank's financing debt of the purchased asset by their customers.

13.3.3 Government Investment Certificates (GIC)

GIC holders have the opportunity to hold the certificate until its maturity. As a temporary measure and until new GICs are issued, *Takaful* operators have been allowed to invest in government-guaranteed bonds.

13.3.4 Investment Accounts

A *Takaful* company has investment accounts that operate with Islamic banks and other Islamic banking divisions of financial institutions. For example, Takaful Malaysia has investment accounts with BIMB and a special investment account with BIMB. A special investment account is on a short-term/medium-term basis. However, an investment account can be divided into short-/medium-term and medium-/long-term periods.

13.3.5 Unit Trust

Islamic funds are growing at a rapid rate nowadays. A *Takaful* company introduces its Islamic unit trust as an alternative to the conventional one. The principle of this Unit Trust is accordance with Shari'ah principles. Therefore, the choices of the portfolios of this unit trust must be in the line with Shari'ah guidelines. Each stock is considered lawful if the activities does not involve any un-Islamic elements, such as *Riba* (interest), *Gharar* (uncertainty) and no trading and production of the prohibited products (Alhabshi n.d.). Unit trusts also concern the management of funds which are usually placed in interest-bearing deposits. The company will pay insurance bonuses as an incentive to unitholders in the Islamic nature.

13.3.6 Foreign Investment

Takaful has expanded its investment to the foreign countries as well. The company has invested to several countries, especially in the Middle East. The practices of foreign investment made by *Takaful* company will give a good return to the company itself for the long term.

13.4 Investment Process (Fig. 13.1)

13.4.1 How Does It Function?

- Contribution received

Firstly, participant will give payment to Takaful Malaysia, which is the operator. The contribution is paid in accordance with the agreed contract between both parties.

- Maintain participants' database

Takaful Malaysia will ensure that the participants' database being kept as to ease them as well as for the safety of the participants' information.

- Maintenance of bonds/equities account
- Settlement of transaction
- Investment activities

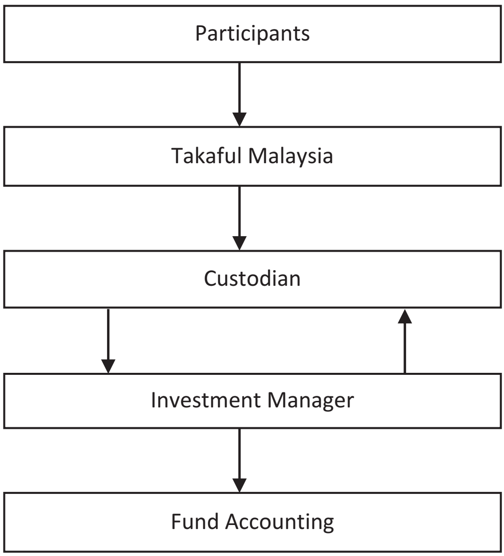

Fig. 13.1 Investment process. Source: Author's own

Cash collected, profits from investment and so forth will be credited to the fund to increase the net asset value (NAV).

- Calculation of NAV

NAV formula = Assets (MV) – Liabilities (including custodian and management fees.

- Maintenance of balance sheet/profit and loss account

13.5 Products for Investment

Takaful Malaysia Berhad (TMB) has its newest product called Dana Saham, which comes under the umbrella of an investment-linked product (ILP). In ILP, all participants will enjoy investment returns and *Takaful* protection at the same time. Basically, all products by TMB will have some investment purpose. However, it will only conduct such business indirectly. The operation of the ILP will be done by Takaful Malaysia, but external fund manager will manage the investment activities. TMB can guarantee good returns for their participants because professional fund managers will be in charge on the investment task. Essentially, the fund manager will conduct extensive research and analysis, so as to gather massive financial and market situation information. There is only one fund manager at this point in time.

13.5.1 Types of ILP

There are three types of ILP:

- Growth Funds
- Stability Funds
- Balanced Funds.

13.5.1.1 Growth Fund

The asset allocation for growth fund is up to 100% in equities. There will be balance allocation if any in bond and money market. It aims for high return that is expected to be 9% or more per annum under normal market conditions. However, the risk with this type of fund is high.

13.5.1.2 Stability Fund

For a stability fund, there is up to 35% of asset allocation in equities. There are between 65% and 100% to be allocated in bond and money market. Primary objective of this fund is to make a stable return over a long-term period (secured) which is at least 3% per annum. Besides, the goal is to avoid negative returns. The risk is low.

13.5.1.3 Balanced Fund

Between 30% and 70% of the allocation will be in equities. Likewise growth fund, it also will be allocating balance asset in bond and money market. The objective is to have medium return that is 7% to 9% p.a. it also have a goal to at least outperform KLSI levels. This type of fund will have medium risk.

13.6 *Takaful* Dana Saham: Investment-Based Product of Takaful Malaysia

As the motto of the product itself is that investment that is protected, we can know clearly that this product the participant's contribution will be invested and apart from the risk coverage that is also serving to the participants. It is conducted under the principle of *Wakalah*, where the participant will entrust Takaful Malaysia as the agent to manage money contributed as well as the investment activities. This management cost for the agent is called *Al-Ujrah*. *Takaful* Dana Saham has two investment packages, the Istiqrar Fund and the Ittizan Fund.

13.7 Avenues for Investment of *Takaful* Funds

The investment of *Takaful* funds is divided into two terms that are short-/medium-term and also medium-/long-term. Those terms are subject to the rules as stated before (Billah 2003).

Short-/Medium-Term

- Special Investment Account with BIMB
- Investment Account with BIMB
- Governments Investment Certificates (GIG)
- Islamic Accepted Bills (under BNM regulatories).

Medium-/Long-Term

- Investment Account With BIMB
- Financing Facilities
- Quoted Shares
- Unit/Property Trust
- Properties.

13.8 Examples of Islamic Investment Instruments

13.8.1 Short-Term

For short-term, the period will be less than 1 year only. The return is between 2% to 4% per annum.

Under short term, the instruments are:

- Bank Negara Negotiable Notes
- Islamic Banker Acceptance and Commercial Chapters
- Deposits (*Murabahah* placements, Negotiable Instruments of Deposits Certificates, MGIA)
- *Wadiah* deposits
- Shari'ah approved, etc.

13.8.2 Medium- to Long-Term

The return for this type of instrument is 4% or higher. Listed below are samples of the instruments:

- Government Investment Instrument
- Cagamas Sanadat Murabaha Bonds
- Corporate bonds (ABBA)
- Deposits (Negotiable Instruments of Deposits Certificates (NIDC), Sale and buy-back Agreements.

13.9 Functions of the Investment Department

Basically, this department is responsible for investing *Takaful* funds that will give profit to the *Takaful* company. There are various responsibilities of department of Takaful Malaysia, such as the following:

- Liaison with Fund Manager
- Manage the calculation of Net Asset Value (NAV). Fund manager will provide total Net Asset Value of the fund
- Responsible to insert the NAV per unit into the system
- Authorised personnel that approve the price
- Monitor the performance of ILPS and fund managers
- Responsible to transfer the fund from bank account maintained by Takaful Malaysia to/from bank account maintained by fund manager
- Monitor fund manager's compliance with the Shari'ah principles and the portfolio mandate.

13.10 Future Role and Prospect of Takaful Investment

The investment of *Takaful* has its role, not only here in this world but also in the Hereafter, InsyaAllah. Rationally, this is because whatever that we contribute here, that is for the sake of our welfare, and in the path of Islam, it shall be counted as *Ibadah* and always has the reward from Allah (swt). Nowadays though, not many Muslim in Malaysia have a deeper knowledge of *Takaful* itself and the scope is always narrowed to the concept of insurance and they get confused by this conventional concept of risk coverage. However, many non-Muslims have realised the benefits of *Takaful* investment and many have also adapted to this concept instead of the conventional ones. If the concept of *Takaful* would be more widely explained, there is no doubt that the prospect will be bright. As we can see nowadays, many people, especially Muslims, are begging for helps in the news and on television to cover their medical treatment costs. This phenomenon is driven by the lack of information of this Islamic Investment concept. Therefore, as for TMB, they will broaden their business prospect to attract more Muslims as well as non-Muslims. Moreover, this investment is not only focused on life coverage (Family *Takaful*) but also on more general purposes by adding more products under these two scopes.

13.11 Conclusion

In conclusion, the investment policies of *Takaful* funds are the best way to maintain the development of *Takaful* operations. Its policy is in line with Shari'ah that emphasise many aspects, such as: security part of its returns, the certainties of its process, plus it also eliminates all kind of forbidden un-Islamic elements, as well as reducing risk while throughout the investment practice. A *Takaful* company can improve the long-term values of its asset and products under these policies as well. Moreover, the return in the investment of *Takaful* fund is competitive in comparison with other conventional insurance companies. As far as Islamic ways of investment are concerned, we can ensure the security of our investment returns because Islam clearly stresses virtue in all dealings in our life. In *Takaful*, for example, the participant can claim some portion of their money back if it is unclaimed after a certain period—unlike in conventional practice. Besides, Takaful Malaysia for example points towards the wellbeing of Muslim in its operation. This is practiced under the concept of mutual cooperation among each other. There are Qur'anic verses and Hadith which put this fact in a nutshell.

> The attitude of the believer and feeling of brotherhood to one another is like that of the single body. When one member of the body is hurt, it will have an effect on the whole body. (Sahih al-Bukhary and Muslim)

> One is not judged as righteous until he cares for his brother as much as he cares for himself. (Sahih al-Bukhary)

> It is not righteousness that you turn your faces towards east or west but righteousness is whoever believes in God and the Last Day and the angels and the Book and the messengers; and spending out of his wealth for His love towards kin, and orphans and the poor and the wayfarer and those who ask and the freeing of slaves and those in debt; to be steadfast in prayer and practice regular charity; to fulfil the contracts, which you have made; and to be firm and patient in pain or suffering and adversity and throughout all periods of panic. Such are the people of the truth, the God-fearing. (Qur'an 2:177)

The newly introduced product of Takaful Malaysia (TMB) encompasses any investment in one's life. Not many Muslims been exposed to this kind of future planning. They maybe get confused about the Islamic type of insurance (*Takaful*) because insurance (conventional approach) is the one that has precedence, especially in Malaysia. So, we would like to recommend that *Takaful* company will step forward to attract more in the Muslim community to register for their own *Takaful* policy. They should also be properly informed about the concept of *Tabarru'*, which is applied in the procedures as to ensure their understanding in the concept and make them realise that they may help themselves and others too.

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CHAPTER 14

Experiencing in Investing of *Takaful* Funds

14.1 An Overview

Takaful operations can be divided into two principal activities. On the one hand, they act as the conduit for providing financial benefits in the event of a misfortune through the various types of *Takaful* product that may be participated in by both individuals as well as corporate bodies. Technically, the product is similar to insurance. From straightforward personal lines such as motor vehicle cover to the very complex requirements of the corporate sector, *Takaful* products can fulfil the demands of all. A long-term family *Takaful* plan would one way or another satisfy the life insurance need of an individual, whilst the industrial risks scheme would meet the insurance needs of a sophisticated manufacturing plant belonging to a huge conglomerate.

In all, as consideration for using these products, *Takaful* participants whether individuals or corporate bodies, shall pay a certain sum of *Takaful* contributions to the *Takaful* funds managed by the *Takaful* operator. Depending upon the types of product, contributions in respect of family products shall be credited into the Family Takaful Fund, whilst contributions for general products shall be paid into the General Takaful Fund. Essentially, these *Takaful* funds belong to all participants. The basic function of the funds is to provide financial assistance, in the form of claim benefits to any participant who suffers a loss due to a defined misfortune. In this sense, *Takaful* assumes the role of helping one another at times of

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need by participants. Proceeds from the claim benefits would come from the pooled contributions accumulated in the respective *Takaful* funds and not from any other fund.

As an Islamic system, all aspects of the *Takaful* operation must therefore comply with Shari'ah principles, including investment. Shari'ah compliance here covers not only how but where the fund is invested but whether the return and the purpose of the investment are permitted by Shari'ah. Over and above this, the investment must also comply with the regulations and guidelines of the relevant authorities. It has been acknowledged that the rejection by Shari'ah of conventional insurance is due partly to the non-Shari'ah manner of the investment of premiums. On this note, it is worth mentioning that Muslims generally tend to be profoundly sensitive to concerned about matters related to investment. As long as they can be assured of Shari'ah compliance, they will not mind even if returns are marginally lower.

14.2 Investment in Property

Investment in property, especially commercial buildings that would generate a steady and reasonable return to the operator, would be another attractive avenue. But it is crucial for these properties to have tenancy because the rental income would be critical to ensure a steady flow of return to the funds. Furthermore, ownership of properties is an investment permitted in Islam. In the case of Takaful National Malaysia, for example, it has properties in practically all major towns in the country. Being part of Bank Islam group tenancy normally would not pose a major problem.

14.3 Investment in the Equity Market

The *Takaful* operator may also invest in the equity market. Buying and selling of shares and any gains secured thereof is permissible in Islam as long as the equity concerned is a Shari'ah-approved counter. There are more than 600 Shari'ah-compliant counters in the Malaysian bourse that Islamic financial institutions have the option to deal with. The list is published from time to time by regulatory bodies such as the Securities Commission.

14.4 Investment in Credit Facility

It is also possible for the *Takaful* operator to utilise part of the *Takaful* funds for the purpose of providing credit facility to selected clients as long as it is undertaken prudently. The financing transaction must certainly be on Islamic basis. Usually, financing of this nature is granted to a borrower to enable him to acquire or purchase fixed assets of which the repayment shall be made over a certain fixed period. By this transaction, the party that provides the facility shall purchase the assets required and resell it to the borrower at a price plus profit. It is usually structured based on the principle of *Al-Bai Bithaman Ajil.* Granting of such financing facility ought to have appropriate collateral as security. This is part of the steps taken to protect the participants' money in case of default. Investment of this nature usually would be in the form of syndication with Islamic banking. The 'Islamicness' of *Takaful* must not only be in terms of its operation but also its investment. To oversee this requirement there is the Shari'ah Supervisory Council at the operator's level as well at the regulatory agencies.

14.5 Online Investment

To retain a dominant position in a dynamic business environment, such as Internet transactions, requires huge amounts of effort, innovation and, most importantly, a deep commitment to customer service. That we received the 2002 award for "Best Internet transactions for Customers in Takaful Nasional" from *Global Finance Magazine* bears witness to our pre-eminence in creating and delivering such services in Malaysia. This year, we have introduced a "Business e-Insurance" package for the corporate and commercial sectors. "Business e-Insurance", with its highly secure and easy to use applications, brings a far greater degree of control and efficiency for our customers, which can be delivered by direct line to their back-office systems. With such a flexible package, we can incorporate our own systems and procedures into our business partners' operating processes. While appearances may suggest that we have concentrated on our corporate and commercial customer base, our policyholders have received no less attention. Our Business e-dealing and service, Takaful Nasional, has been developed further to give additional features and even greater levels of security. Our Takaful Nasional service has also been upgraded to send even more message types, such as premium payment reminders in English and Malay. We believe that transparency and accessibility are keys for building real partnerships. As a result, the National Insurance has launched a dynamic new website, which allows visitors to access a large amount of information about the company's products and services, as well as other related topics. The visitor can also customise the site's content and functionality according to his or her preferences. In short, we are committed to providing our partners with e-financial solutions that make a difference.

14.6 Investment in IT

Information Technology (IT) in the recent years has been moving to improve service to company customers and increase the customer's sense of confidence and security in the insurance. Security and availability of customer information, protection of company assets and continuity of service to the customer under adverse circumstances are our primary objectives. Addressing the issue of asset and information security, IT has deployed multiple layers of security measures such as different types of intrusion detection devices and software. Technology such as this helps us to protect information and assets from the many disruptive forces that now exist. The development of a full-fledged disaster recovery facility enables the bank to continue to service customers in all circumstances. Activities such as these will continue next year and additional steps will be introduced to provide and maintain a safe, secure and accessible service for our customers.

14.7 Investment in Professional Development

Some corporate sectors' human resources divisions recognise their own staff as stakeholders in the business and continue to treat them equitably and with dignity and professionalism. They are encouraged to make an increasing contribution to the achievement of the company's business goals and objectives. Such contributions are acknowledged and rewarded through a process of individual assessment and career planning. As part of the process, we continually refine the staff selection and recruitment process and actively encourage better communications throughout the company. Malaysian remains an ongoing priority. By the end of 2002, the ratio of Malaysian to total staff stood at 81%. The role of the Training

Centre is to develop the necessary strategic capabilities through learning. In the last year, a major initiative has been introduced to support the company's shift in focus from transactions to relationships. An intensive training and certification program has allowed staff to upgrade their product knowledge and customer service skills to ensure that our customers receive the full benefit of the many new products and services that have been developed.

For example, Takaful Nasional controls and risk management training have helped keep our staff focused on the importance of disciplined growth in all areas of the business. Overall management expertise has been developed and strengthened by extensive effectiveness training, as ongoing career development programs allow staff at all levels to assume significant additional responsibilities. In essence, the company's commitment to individual career development has opened up many exciting opportunities within the company.

14.8 Market Participants' View

One of the important areas in this chapter was the floor of question and answer session which has given us really useful information about not only the project but also enhance our own knowledge about the investment systems in Takaful Nasional which is one the most successful *Takaful* companies in the world today. And we have given the questions with the answers together in order to make the job of the readers of our project easy. Therefore, the questions and answers are as follows.

14.8.1 Issue 1 Takaful Nasional

Answer: Takaful Nasional is a collective effort, consistent with Shari'ah guidelines, by members of a group to share any harm or loss that may befall any member of the group. Takaful Nasional emerged from an ancient practice on the Arabian peninsula of mutual cooperation and assistance among members of a tribe. The root word "Kafala" means to guarantee and *Takaful* (a noun) is derived from the verb "Takafala" which means committing one's self to avert the loss of somebody. It also refers to "Ta'awun", which is considered as mutual assistance—helping our fellow Muslims, either by aid, support or monetary help. Therefore, a *Takaful* system is a group of individuals who contribute collectively in order to share the harm or loss that may fall upon any member of the group.

14.8.2 Issue 2 Shari'ah View

Human action changes the Will of Allah (swt) for our destiny. Whether a person has insurance or not has no effect on future events. However, we are urged to take precautions … just as we make provisions prior to starting our journey.

> "Narrated by Anas bin Malik when an Arab Bedouin asked Prophet Muhammed (PBUH), Shall I leave my camel untied and seek Allah's protection on it, or should I tie it?" The Holy Prophet replied, "Tie your camel and then depend upon Allah (swt)." (Sunan al-Tirmizi)

14.8.3 Issue 3 Elements of Takaful Nasional

A *Takaful* system of risk protection consists of the following elements:

- Shari'ah compliance in *Takaful* operations and investments
- Financial and risk sharing under the principle of *Ta'awun*
- Contract holders are owners of the "common risk pool"
- Contributions include *Tabarru'*, or donations for mutual assistance to the needy members of the group
- Application of ethics and full disclosure.

14.8.4 Issue 4 **Takaful** *Differs in Terms of Insurance*

Major differences include:

- Application of mutual or cooperative risk-sharing principles incorporated into the *Ne'aa*, or intentions, of the *Takaful* participant.
- Participants bear the risk of loss rather than a stock company
- Participants gain from any surplus from annual operations eliminates *Gharar*, or uncertainty
- Motivation is not a commercial transaction with a profit-maximising motive; rather mutual assistance for the community well-being and to achieve a self-sustaining *Takaful* operations
- Investment of premiums into Shari'ah-approved securities
- Charitable donation from surplus, if any, can be elected.

14.8.5 Issue 5 Central Bank Participation in **Takaful** *Investment*

All investment instruments and funds are Shari'ah compliant and approved by both the Central Bank's Permanent Shari'ah Advisory Committee and Malaysian Monetary Agency. Contributions to a Takaful Nasional Plan that consists of an investment component [such as Education Plan, Retirement Plan, *Waqf* Plan, etc.] are directed into either an Investment Strategy or an individual Investment Fund. Clients may select from three Investment Strategies: (a) Conservative, (b) Balanced and (c) Growth, that suits their long-term financial goals. Alternatively, clients may choose to place funds into one of Central Bank's four equity mutual funds, or its *murabahah* fund. These funds are professionally managed by either Takaful Nasional or well-respected investment managers.

14.8.6 Issue 6 Ownership of **Takaful** *Fund*

Takaful fund or 'pool' of funds is actually owned by the participants who join in one of several plans on offer. Under a contractual arrangement, Central Bank acts as a *Wakeel* or agent on behalf of the participants to manage the *Takaful* 'pool' and business operations. Whilst the Central bank provides both insurance, operational and investment expertise in the management of *Takaful* operations, it does not assume any risk resulting from *Takaful* operations.

14.8.7 Issue 7 Payment in **Takaful** *Plan*

To initiate a *Takaful* Plan, you may arrange for a convenient automatic payment deduction from your bank account or pay by cheque. Instalments for your *Takaful* Plan may be made monthly, quarterly, semi-annually, annually or in one lump sum in order to match your financial resources.

14.8.8 Issue 8 **Takaful** *Model Function*

A participant's contribution is handled by Bank Negara in one of two ways: (a) contribution to a participant's Individual Reserve Investment Account in the case of Risk-only Protection products, or (b) contribution to a participant's Individual Investment Account in the case of savings and investment products which also consist of a chosen level of protection. As funds are needed on a monthly basis to cover risk charges, *Wakalah* fees and/or for investment purposes, a participant's account is debited and monies are transferred to a *Takaful* account, a major portion of which is a *Tabarr'u* (donation), to the operator as *Wakalah* fees or to the investment funds selected by the participant, as appropriate.

14.8.9 Issue 9 **Takaful** *Plan's Contribution in Needs*

There are a range of Takaful Investment Plans to assist you—Retirement Plan, Ladies Savings Plan, Marriage Savings Plan, and Capital Plan. For example, the Takaful Retirement Plan is an ideal and convenient way to set aside savings on a regular basis, which is invested, long-term to assist you in achieving financial independence. Based upon your current earnings and your financial goals for retirement, a plan can be designed that includes growth for the funds committed to investment as well as risk protection for your family throughout the plan period, in the event of death or disability.

14.8.10 Issue 10 **Takaful** *Plan's Contribution in Family Needs*

There are ranges of Risk-only Plans (Level Term, Increasing Term and Decreasing Term) to assist you with a fixed or variable level of protection in the event of death or disability that can be provided to your family or Beneficiary. Risk-only protection for a fixed term is ideally suited to match a temporary indebtedness or substantial financial obligation that can be fully paid rather than become a burden on your family. Contributions can be made on a level, an increasing or decreasing basis to match your financial resources or your risk protection requirements.

14.8.11 Issue 11 **Takaful** *is Complemented by the General Organisation for Social Insurance (GOSI)*

GOSI is a mandatory social insurance program sponsored by the Central Bank of Malaysia, which is funded by deductions from wages of expatriates and Malaysian nationals. GOSI mandatory payments are 2% of gross wages for occupational hazards and 15% of gross wages (divided 6% for insured and 9% for employers). GOSI's compensation relates only to injuries, illnesses or death directly linked to employment. Hence, compensation for death by natural causes is excluded. Compensation by GOSI for occupational hazards on the job is an allowance of 75% of monthly wages for injuries or temporary/permanent disability, and for old-age Annuities an amount which is 2% of the average monthly wages multiplied by the number of years insured by GOSI (viz. pay in over 20 years, last average monthly salary of 10,000, then GOSI stipend per month is 4000). When the Annuitant dies, the GOSI payments cease. The key features of each program are:

- Compensation by GOSI is geared to a person's average monthly salary. *Takaful* Plan pays the sum assured and/or the accumulated savings as established by the Plan Holder.
- Compensation by GOSI is paid to wage earner and ends with his death. *Takaful* Plan pays the Plan Holder at the time of Maturity or pays the heirs or Beneficiary in the event of death [God forbid] as a lump sum or continuing annuity until funds are exhausted.
- Funds contributed to Takaful Nasional are owned by the Plan Holder at all times and may be directed into funds chosen by the participant.
- GOSI contributions belong to the state authority.
- GOSI contribution is fixed and compulsory.
- GOSI is compulsory and important social insurance system operated by the Central Bank of Malaysia. *Takaful* is flexible and discretionary system, which complements GOSI and provides additional benefits to its members.

14.8.12 Issue 12 Additional Benefits of **Takaful** *Funds*

Takaful is a long-term financial plan. Most probably a participant will live to cash in the net asset value of his plan, which is value-added to your existing investment, besides the additional protection that your customised plan can provide to your family and loved ones.

14.8.13 Issue 13 Participation in **Takaful** *Schemes*

Anyone may join the *Takaful* program—youth or adult, Malaysia national or expatriate. Participation begins with completion of an Application form and submission to *Takaful* or to one of our friendly *Takaful* financial consultants available at the headquarters or through the Branch office. There is no special membership fee. Interested persons can contact us through many channels. According to the CEO of Takaful Nasional the company's investment is not based on just one single area or one single product but it considers many factors while operating in today's business world, to him in order to be successful the company should focus on the investment from shareholders as well as from the other co-companies in the business (partners or stakeholders) and also the company should make another investment in its employees and its products in order to thrive in today's competitive market.

14.9 Effort in Marketing Family *Takaful* Products

The experiences related here are those of Takaful Nasional, which had been hiring more people to sell Islamic life insurance to Muslims, of whom 95% are still uninsured. The company has appointed Insist Amilat Sdn Bhd to recruit and train 300 representatives to sell *Takaful* products. Chief executive said Takaful Nasional has set itself an eight-year plan to achieve at least 6% of the total insurance market share by 2010 through its *Takaful* products. He said Muslims in Malaysia continue to shy away from *Takaful* insurance products, with only 5% of the population or about 600,000 estimated to be policyholders. Under a Central Bank of Malaysia directive, the five *Takaful* companies in operation are expected to command a 20% share of the total insurance market by 2010. "We aim to be the biggest" he said, speaking to reporters after a signing ceremony on Tuesday to mark the collaboration of Takaful Nasional with Insist Amilat, which is a subsidiary of Johor Islamic Economic Development Board. "We need a corporate agent manager if we want to develop fast. However, we will iron out existing teething problems before considering extending the recruitment and training project to other companies." "We presently have 7000 registered agents in our stable, but about 80% are part timers", he remarked, adding that the group needs to aggressively mobilise its agents in order to achieve its goals. Aminuddin said Takaful Nasional will also improve the quality of its customer service, introduce new products and provide attractive commission in order to turn the company into a 'one-stop *Takaful* provider'.

14.10 Conclusion

The drive for transparency and accessibility during 2002 has been an exciting and rewarding journey, which Takaful Nasional intends to continue in the years to come—for the benefit of our customers, staff and shareholders. And investing credit facility, which is being accepted by the Shari'ah code of business, the company also considers investment in equity market as one of the most important elements of investment in today's business world. According to a statement by the CEO of Takaful Nasional, human capital is one of the factors that they take account—thus, the company is providing fruitful training to their staffs in order to permit them acquire the real and accurate knowledge about the product and services of the company. Through our interview we have realised that the company's target is of course making profits but the most and important target for them is to serve the community and to promote mutual cooperation between people in today's material world. Therefore, the annual report of the company showed satisfactory results from the investments made by the Takaful Nasional in the year 2002.

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CHAPTER 15

Investment in *Halal* Cryptocurrency

15.1 Introduction

A cryptocurrency management platform is a digital financial platform operated in the borderless realm of cyberspace, but it still requires to be established as a registered company with a separate legal entity. Among the prerequisites of a Shari'ah alternative cryptocurrency model is to be formalised under the company's rules, either onshore or offshore, as a separate legal entity. It should be managed based on an acceptable system, operational mechanism, standard planning and strategies, legitimate objectives and manifesto, documentations and manuals, policies and guidelines, which must all comply with Shari'ah law and policies within the *Maqasid al-Shari'ah* (divine objectives) (Vejzagic and Smolo 2011).

The brainchild of the idea for every strategic and business model of Shari'ah cryptocurrency management was first discovered and initiated with intellectual discussions, writings and designations by my humble initiative (Mohd Ma'Sum Billah) in early 2017. The idea has been shared among interested parties, presented in forums and written in periodicals and promoted on social media. Subsequently some initiated to establish a Shari'ah-compliant cryptocurrency (Oziev and Yandiev 2017) model with global operations. A Shari'ah-compliant cryptocurrency is a cryptocurrency platform initiated by cryptography and operated based on a blockchain technology. Its objective, operational mechanisms, board before one's operation takes place. It shall be treated as a commercial entity,

Mohd Ma'Sum Billah, *Modern Islamic Investment Management*,
https://doi.org/10.1007/978-3-030-17628-0_15

offering cryptocurrency globally based on Shari'ah standards (Shari'ah compliance) within the *Maqasid al-Shari'ah*. For a Shari'ah cryptocurrency, it is among the prerequisites to ensure that, the entity and its total operations are backed by valued asset. In other word, a Shari'ah cryptocurrency shall be on asset-backed operation within the ambit of Shari'ah.

Cryptocurrency generally means a virtual, digital or cyber-complimentary money with intrinsic commercial value, which takes the form of tokens or coins. Some digital currencies have ventured into the physical world with debit or credit cards or other instruments, the large majority remains entirely intangible or virtual existence in cyberspace. The term 'crypto' in digital currencies refers to sophisticated cryptography, which allows for a particular e-coin or e-token to be generated, stored and transacted anonymously typically, securely and smartly by digital encryption. The essence of 'crypto' feature of these digital currencies is, a common undertaking to decentralisation; all digital currencies are typically designed and developed as a specific hash code by teams who build in mechanisms for issuance through a process called 'mining' in most cases and other virtual devices. In the contemporary practices, digital currencies are commonly designed to be free from government manipulation, control and influence, despite their (digital currencies) having grown rapidly with global market appreciation. Digital currencies, which are modelled after Bitcoin, are collectively known as altcoins and have tried to appear in the cybermarket as hybrid versions of Bitcoin. Some of those digital currencies are easier to be managed than Bitcoin with complexity. Today, there are more than 1600 digital currencies in existence, which are offered in cyberspace through blockchain technology (*Fintechnews* Singapore, November 01, 2017), and many of those tokens or coins are popular in their micro-capacities or attributes among the virtual communities of investors and traders in cyberspace (https://www.investopedia.com/tech/most-important-DigitalCurrencies-other-than-bitcoin).

Numerous players are in the market globally to offer different categories of digital currencies, but with many shortcomings such as the lack of regulatory support, poor strategic planning, uncertainty and mostly with no backing asset, but on virtual assumption. A Shari'ah model of cryptocurrency on the other hand is Shari'ah-compliant. As noted by Oziev and Yandiev (2017) such a model is backed by valued asset, operated based on valued assets (coins or tokens), Shari'ah instruments such as *Al-Bay Wa Al-Shira'* (trading), *Musharakah* (partnership), *Mudharabah* (copartnership), *Shuftaja* (exchange), *Bai' al-Sarf* (money exchange), *Wakalah* (agency), *Ujrah* (service charge), *Ju'alah* (reward), *Wadiyah* (deposit), *Amanah* (trust), *Tabarru'at* (charity) and *Zakat* (alms), concerns about humanitarian wellbeing, regulated by the standard Shari'ah principles, opposed to uncertainty (*Gharar*) in any component and liberty in enjoying with legitimate (Shari'ah) investment return. Thus, the Shari'ah cryptocurrency model has the greater opportunity to attract the global cryptocurrency market with sustainable existence in the emergence of blockchain technology.

The prime objective of a Shari'ah cryptocurrency model is to create an enterprising and entrepreneurial community across the world through Shari'ah cryptocurrency management and participation therein globally. This may ultimately fight poverty, joblessness, domestic economic crisis and world eco-catastrophe. Shari'ah cryptocurrency management is, with its universal character, welcoming, encouraging and benefiting of all humankind regardless of one's religion, race, status, gender, colour or even nationality. Its operation does not concern only money making, but part of its income with 2.5% in each transaction shall be deducted for the humanitarian or charitable causes based on the holistic principles of *Zakat*. Additionally, it is also recommended that all gross income in every transaction, account, management, activities, income and services shall be subjected to a reasonable deduction as *Tabarru'at* for the noble causes of charity and solidarity.

A Shari'ah cryptocurrency model should be based on the following dimensions and philosophy: The model shall be operated based on the principles of Shari'ah. The total operation of the model shall be facilitated by a Shari'ah-compliant hybrid structure. It evolves as both an asset-backed and also an asset-based operation within the Shari'ah frameworks. The company shall be backed by a valued asset equivalent to the value of the initial coin offering (ICO) at least, while its products and services (business operations) are based on asset (valued coins/tokens). The total operation shall be facilitated by Shari'ah-justified instruments and divine principles outlined above. The structure of a Shari'ah model is thus a Shari'ah-compliant hybrid platform of cryptocurrency backed by valued asset.

The operation of a Shari'ah cryptocurrency model is facilitated and dully operated with the concept of "issuer coin or token" or of an "exchange platform". An operation based on "Issuer Coin or Token" shall primarily be executed by trading platform, a decentralised direct (one-to-one) buying and selling (*Bai' wa al-Shira'*) mechanisms. However, It may exceptionally be operated through exchange platform based on a Shari'ah hybrid mechanism, facilitated by the doctrines already outlined.

15.2 Objectives

Among the objectives of a Shari'ah cryptocurrency (Bangash 2018) are:

- Offering and managing Shari'ah cryptocurrency with the rules of Shari'ah compliance.
- To create a legitimate income opportunity for all mankind (regardless of one's religion, race, status, gender, colour or nationality) within the *Maqasid al-Shari'ah*.
- To create a micro-investment platform for all humankind with holistic approach of universal character (regardless of one's religion, race, status, gender, colour or nationality) through Shari'ah cryptocurrency management.
- To create an economic wellbeing for all mankind through Shari'ah cryptocurrency platform based on the holistic principles of mutual co-operation and solidarity.
- To care about the poor and helpless ones by segregating a part of the income over the Shari'ah cryptocurrency operation within the Divine principles of humanity.

15.3 Governing Principles

The governing principles (Ahmat and Bashir 2017) of a Shari'ah cryptocurrency are as follows:

- All levels of products and services of a Shari'ah cryptocurrency management shall be designed, regulated and operated in accordance with the principles of Shari'ah.
- All activities, policies, technicalities and mechanisms of a Shari'ah cryptocurrency management shall be in conformity with Shari'ah standards and within the *Maqasid al-Shari'ah*.
- All activities, policies, technicalities, mechanisms, products and services of a Shari'ah cryptocurrency shall be closely monitored, screened and approved by the SAB of a Shari'ah cryptocurrency management to ensure every aspect of Shari'ah compliance (Noordin 2018) is strictly observed.

- The Shari'ah cryptocurrency management's board of advisors shall also play a vital role to advise the company, to ensure its policies, products and services are in conformity with the Shari'ah principles within the *Maqasid al-Shari'ah*.
- Shari'ah cryptocurrency management shall also strictly observe and duly comply with other applicable national or international laws and policies.

15.4 Ethical Principles

Among the ethical principles of a Shari'ah cryptocurrency management are:

- All levels of decisionmakers, advisors, operators and facilitators of a Shari'ah cryptocurrency management shall observe the principles of Shari'ah (Shari'ah standard) in their activities with relation to a Shari'ah cryptocurrency management in view of *Maqasid al-Shari'ah*.
- Anyone involves in a Shari'ah cryptocurrency management directly or indirectly shall observe the divine principles of honesty, transparency, rights and obligations while strictly opposing and avoiding the unlawful culture or unethical gain at the expense of others.
- None of the parties involved in a Shari'ah cryptocurrency management directly or indirectly shall be allowed to practice undue influence, misrepresentation, duress, malpractices, falsehood, manipulation, selfishness, deceit and or other unethical action.

15.5 Model and Structure

A Shari'ah cryptocurrency management shall be based on the following model and structure:

- A Shari'ah cryptocurrency management is a cryptocurrency model based on the principles of Shari'ah.
- The total operation of a Shari'ah cryptocurrency management is a Shari'ah-compliant hybrid model.
- It evolves as both an asset-back and also an asset-based operation within the Shari'ah frameworks.
- The company is backed by a valued asset, while its products and services (business operations) are based on asset (valued coins/tokens).

- A Shari'ah cryptocurrency management's total operation are facilitated by the Shari'ah justified instruments and Divine principles given above.
- The structure of a Shari'ah Cryptocurrency management is thus, it is a Shari'ah hybrid platform of Cryptocurrency backed by valued asset and, facilitated and dully operated mainly based on the Shari'ah principles of *Musharakah* and others such as *Wakalah*.
- A Shari'ah cryptocurrency operation shall be based on "Issuer Coin or Token" by trading platform by decentralised direct (one-to-one) buying and selling.
- Shari'ah cryptocurrency management can also be operated through an exchange platform based on a Shari'ah hybrid mechanism, facilitated by the doctrines mentioned above.

15.6 Operational Mechanism

The operational mechanisms of a Shari'ah cryptocurrency management are as follows:

- The operation adapts its prime operational tool based on valued coin or token offering through the issuance of the ICO justified and duly screened through by the general principles of Shari'ah and divine ethical standard.
- The offered coins or tokens through the ICO may also be effectively transacted (buying-selling) further in the secondary market within the Shari'ah ambit.
- A Shari'ah cryptocurrency management may also provide a platform for the international *Waqf* co-operation and contribution through cryptocurrency.

15.7 Technological Model

- The products and services under a Shari'ah cryptocurrency management (Shari'ah cryptocurrency in coins or tokens) shall be operated based on a Shari'ah-screened blockchain technology.
- The blockchain technology is cyber-space platform provider with a reliable blockchain solution to systemise, manage, operate and function all activities of a Shari'ah cryptocurrency management within the *Maqasid al-Shari'ah*.

- The blockchain technology for a Shari'ah cryptocurrency management is closely monitored by the Shari'ah experts to ensure all technological supports for a Shari'ah Cryptocurrency platform are with Shari'ah compliance (Alexandre 2018).

15.8 Scope and Limitations

Among the scope and limitations of a Shari'ah cryptocurrency management are:

- A Shari'ah cryptocurrency management shall be operated within the principles of *Maqasid al-Shari'ah*.
- All its policies, activities, structures, systems, products and services shall be in conformity with the Shari'ah principles.
- The culture shall generally be, in compliance with the divine ethical standards and Shari'ah principles.

15.9 Products and Services

Among the products and services of a Shari'ah cryptocurrency management are:

- *Halal* cryptocurrency with valued coins or tokens commercialised by trading platform through blockchain technology or exchange platform or through halving exercise or mark-up through the global payment innovation.
- In order to create a cashless society, a cashless payment through cryptocurrency model may be introduced to ease the society in their day to day payment activities. It is a hybrid cashless or cardless digital debit account backed by cryptocurrency, to be maintained in the blockchain platform and be operated through mobile phone, iPad or laptop application like currently available in China. This may have dual benefits namely:
  - having an investment return through currency inflation;
  - creating a cashless purchasing power by simply maintaining an image (barcode) with a digital credit capacity appearing in the mobile, iPad or laptop screen enabling the creditor or seller to appreciate the payment by digital swap.

- *Waqf* management through cryptocurrency.
- Investment through Shari'ah cryptocurrency.
- Trading platform through Shari'ah cryptocurrency.
- Humanitarian concern through Shari'ah cryptocurrency management.
- Global *Tabarru'at* foundation through Shari'ah cryptocurrency management.

15.10 Backing Assets

The company, its products and services shall be backed by valued assets as a backing asset. Thus, a certified proof of product (POP) shall be prerequisite to ensure that, the total operation of a Shari'ah cryptocurrency management is backed by commercially valued asset. Backing asset for a Shari'ah cryptocurrency management and its operation refers to a certified POP carrying the commercial value of a legitimate asset, product, property, intellectual property, IT, solutions, program and or others recognised by the Shari'ah principles. The POP shall carry the value at least the equivalent of the initial coin offering (ICO). For the valid operation of a Shari'ah cryptocurrency, the backing asset is prerequisite to ensure that, the total products and services or business activities of the entity are an asset-backed operation. The backing asset shall only be treated as the backing Asset of the company, its activities, products and services. The backing asset is just for the purpose of supporting and facilitating the company's capacity.

15.11 Decision-makers

The decision-making in Shari'ah cryptocurrency management shall be empowered to the following authorities:

- Board of Directors (general decisionmaking)
- SAB (Shari'ah compliance, screening and approval)
- In-house Advisor or Consultant (technical advice)
- Board of Advisors (overall advice).

15.12 Shari'ah Advisory Board

The SAB of a Shari'ah cryptocurrency management shall comprise of qualified Shari'ah scholars including Mufti, Shari'ah judge, Shari'ah lawyer, Islamic finance expert, Islamic finance researcher, Shari'ah scholars in cryptocurrency and others.

Among the functions (Wardhani 2012) of the SAB are:

- To advise, supervise, monitor and approve a Shari'ah cryptocurrency management and all its policies, systems, activities, operations and mechanisms to ensure the company and its operation are generally compliance with the Shari'ah principles.
- The SAB shall also screen and approve all activities of a Shari'ah cryptocurrency management to ensure all are compliant with the Shari'ah principles (Shari'ah standard).
- The SAB shall also contribute to a Shari'ah cryptocurrency management in training its employees and also the public as per required with Shari'ah-compliant cryptocurrency model.

15.13 Board of Advisors

The Board of Advisors of a Shari'ah cryptocurrency management may comprise of renowned scholars including academia, financial experts, business operators and other key people in the Islamic financial industry.

- Among the functions of the Board of Advisors are: To advise the Shari'ah cryptocurrency management to ensure that the company is moving forward dynamically within the *Maqasid al-Shari'ah*.
- The Board of Advisors shall also contribute to a Shari'ah cryptocurrency management in training its employees and also the public as per required with Shari'ah-compliant cryptocurrency model.

15.14 Management

A Shari'ah cryptocurrency management shall be managed by a qualified management team by complying the business dynamism, quality management and smart strategies within the holistic spirit of Shari'ah ethical principles. The management team shall be headed by a well experienced with corporate personality and Islamic finance expert Managing Director or Chief Executive Director.

15.15 The Public Statement

In every operation of Shari'ah-compliant cryptocurrency, it is recommended to make a public statement through social media, soft-launching or organising a summit prior to the actual operation takes place by ICO or initial product offering (IPO) or initial token offering (ITO). Thus, a model of a public statement may be as follows:

A Shari'ah cryptocurrency management is a Shari'ah-compliant cryptocurrency. It is backed by valued asset with legal authentic proof of property (POP). Its establishment, policies, management, operation, activities and general culture are compliant to the spirit of Shari'ah standard and within the *Maqasid al-Shari'ah*.

Its blockchain technology, ledger system and operational mechanisms are designed as a Shari'ah hybrid model based on the Shari'ah doctrines of *Silsalat al-Katl*, *Ta'awun*, *Musharakah*, *Al-Bai' wa al-Shira'*, *Wakalah*, *Fudhuli*, *Ju'alah* and *Tabarru'at*.

The total activities of Shari'ah Cryptocurrency management are generally screened through by Islamic finance and Shari'ah Cryptocurrency expert, supervised by an SAB comprising of a team of renowned Shari'ah scholars and further advised by a Board of Advisers (BoA) comprising of a group of academia, economists and industrialists, to ensure the activities and operation of Shari'ah Cryptocurrency management are compliance to the spirit of Shari'ah standard.

Among the prime objectives of a Shari'ah Cryptocurrency management are: to create an economic and entrepreneurial opportunities for all mankind (particularly those of with less fortunate), embracing with the universal character (regardless of one's religion, colour, status, gender or nationality) and within the holistic spirit of *Maqasid al-Shari'ah*.

It is also the strict policy of a Shari'ah Cryptocurrency management with a special provision to segregate part of all levels of its income for the humanitarian causes within the broad principles of *Zakat* and *Tabarru'at*.

15.16 The White Paper

A white paper for a *Halal* cryptocurrency operation may include the following information:

15.16.1 Introduction to Shari'ah Coin

15.16.1.1 Shari'ah Coin

It is a Shari'ah compliant (Shari'ah) cryptocurrency management platform with global prospect. Its blockchain system, technology, model, objective, operational mechanisms, technicalities, culture and all activities shall be in total compliance with the Shari'ah principles (Shari'ah standard), which shall regularly be advised by the company's Board of Advisors, screened through by the company's in-house adviser prior to the approval by the SAB of the company and thereafter shall be operated or executed globally.

15.16.1.2 Emergence of Blockchain

The cryptocurrency through the blockchain technology (Bank Negara Malaysia) is a cyberspace economic revolution in the twenty-first century. Numerous players are in the market globally to offer cryptocurrency platforms but with many shortcomings like, lack of regulatory supports, poor strategic planning, uncertainty and mostly with no backing asset, but only on virtual assumption. Whereas a Shari'ah model of cryptocurrency is a Shari'ah-compliant cryptocurrency model is a timely to fill the gap of the ongoing shortcomings in the cryptocurrency market. The Shari'ah cryptocurrency model is thus backed by valued asset (POP), operated based on valued assets (coins), transactions are based on Shari'ah instruments outlined already, as well as concerns about humanitarian wellbeing, regulated by the standard Shari'ah principles, opposes to uncertainty in any component and liberty in enjoying with legitimate (Shari'ah) investment return. Thus, in the Shari'ah cryptocurrency model has the greater opportunity to attract the global cryptocurrency market with sustainable existence in the emergence of blockchain technology.

15.16.1.3 Background of Shari'ah Coin

The idea of a Shari'ah cryptocurrency model was initiated with strategic structure in early 2007 on how a Shari'ah cryptocurrency model can be developed and duly operated globally with a unique model to meet the contemporary demand as to cryptocurrency operation in accordance with Shari'ah standards within the *Maqasid al-Shari'ah*. It was initiated with grassroots ideas, strategies, mechanisms and structures. It has been continued by sharing in different occasions and countries around the world both in Muslim and non-Muslim environments outreaching through social media in particular. To strengthen the idea further, this book project on Shari'ah cryptocurrency management undertaken has been by focusing on numerous specialist issues as among the pioneering and leading works on Shari'ah cryptocurrency model in the contemporary world of cryptocurrency.

15.16.1.4 How Shari'ah Coin Could Help to Solve Certain Problems

The prime objective of a Shari'ah cryptocurrency model is to create an enterprising and entrepreneuring based community across the world through Shari'ah cryptocurrency management and participation globally. This may ultimately fight the poverties, jobless, domestic economic crisis and world eco-catastrophe. A Shari'ah cryptocurrency management is with universal character welcoming, encouraging and benefiting to all mankind regardless of one's religion, race, status, gender, colour or even nationality. The operation does not concern only money making, but part of its income (2.5%) is mandatorily deductible as *Zakat* for the charitable causes. Furthermore, all gross income in every transaction, account, management, activities, income and services may be encouraged to be subjected a reasonable deduction as Tabarru'at for the humanitarian causes within the *Maqasid al-Shari'ah*.

15.16.1.5 The Meaning of Shari'ah Coin

A Shari'ah Coin refers to a Shari'ah cryptocurrency model, to be operated based on the Shari'ah principles. It is a coin or token-based offering and activated by transactions based on a Shari'ah trading mechanisms through Shari'ah-screened blockchain technology.

15.16.2 Shari'ah Coin Branding and Definition

The basic features of Shari'ah cryptocurrency model is that, it shall be operated based on the Shari'ah standard (compliant with the Shari'ah principles) closely supervised by a world class SAB, advised by team of scholars as a board of advisors and further monitored and screened through in-house Shari'ah expert. The management of Shari'ah cryptocurrency management is to abide by the standard Shari'ah guidelines and ethical standard. All investors (token-holders) are protected by transparent transactions and are formalised based on the Shari'ah doctrines of *Musharakah*, *Shuftaja*, *Bai' al-sarf*, *Ju'alah* and *Wakalah*.

15.16.2.1 Shari'ah Coin Structural Analysis

A Shari'ah cryptocurrency management shall be based on the following model and structure:

The model shall be based on the principles of Shari'ah (Shari'ah standard).
The total operation shall be based on a Shari'ah compliant hybrid model.
It evolves as both an asset-backed and also an asset-based operation within the Shari'ah frameworks.
The company is backed by a valued asset, while its products and services (business operations) are based on asset (valued coins or tokens).
The total operation is facilitated by Shari'ah justified instruments and divine principles. Among those doctrines are: *mudarabah* (co-partnership), *Musharakah* (partnership or joint-venture), *Shuftaja* (exchange), *Bai' al-Sarf* (money exchange), *Wakalah* (agency with commission), *Wadiyah* (deposit), al-*Ju'alah* (reward or service charge), *Amanah* (trust), *Ijarah* (charge), *Tabarru'at* (donation) and *al-Zakat* (alms or compulsory tax).
The structure of the model is thus, it is a Shari'ah hybrid platform of Cryptocurrency backed by valued asset and, facilitated and dully operated mainly based on the Shari'ah principles within *Maqasid al-Shari'ah*.
The operation shall be based on "Issuer Coin or Token", but exceptionally it can be based on exchange platform subject to strict Shari'ah ethical guidelines.
A Shari'ah Cryptocurrency operation shall primarily be based on "Issuer Coin or Token" by trading platform, a decentralised direct (one-to-one) buying and selling (*Bai' wa al-Shira'*). However, it may exceptionally be operated through exchange platform based on a Shari'ah hybrid mechanism, facilitated by the doctrines of *Shuftaja* (exchange), *Bai' al-Sarf* (money exchange), *Al-Hewalah* (transfer), *Kafalah* (custodianship), *Al-Amanah* (trust), *Al-Wakalah* (agency by commission), *Al-Ju'alah* (reward for services) and *Al-Ujrah* (service charge) within the Shari'ah frameworks.

15.16.3 Application of a Shari'ah Cryptocurrency

15.16.3.1 Financial Assets Exchange (Backing Asset)

The company, its products and services are strictly backed by valued asset as a backing asset. Backing asset for Shari'ah cryptocurrency management and its operation refers to certified POP with an approved value equivalent to the value of the ICO at least.

15.16.4 Pass-up Plan

15.16.4.1 Total Volume

Total volume with ICO may rationally be recommended not to exceed 1,000,000,000 coins or tokens with roaring value may not exceed USD 1 each. Thus, total value with all phases of the ICO may not exceed USD 1,000,000,000.

15.16.4.2 Digital Asset Ratio

Total value of the offered coins or tokens.

15.16.4.3 Shari'ah Cryptocurrency Appreciation Logic

No competitive model of Shari'ah cryptocurrency has been launched yet. Huge demand globally, but no supply (available model) yet it is timely for the Shari'ah cryptocurrency to grab the global market with utmost appreciation.

15.16.5 Project Progress and Team

The Project of Shari'ah cryptocurrency model shall be ready in hand with all modelling, strategic and structural solutions, required documentations, backing asset, decisionmakers, advisory panel, supervisory panel, marketing teams, audit (compliance), procedure, mechanisms, technological supports, logistic supports and management team shall also be ready before the ICO takes place (Rahajeng 2013).

15.16.6 Operation

A Shari'ah cryptocurrency management may maintain its operating office in any offshore or in any other suitable location. It may maintain its corporate offices or branches in different locations or jurisdictions, as may time to time be decided by the Board of Directors.

15.16.7 Market

A Shari'ah cryptocurrency management shall be in liberty to create its marketplace across the cyberworld within the legitimate frameworks, but within the spirit of *Maqasid al-Shari'ah*. The customers and investors are not limited, but open to anyone regardless of one's religion, race, status, gender or nationality.

15.16.8 Accounts

A Shari'ah cryptocurrency management may maintain the following accounts:

- Customer's or Investor's Account (coinholders)
- Board of Directors' Accounts
- Company's Management Account
- *Waqf* Co-operation Account
- Humanitarian Account
- *Tabarru'at* Account.

15.16.9 Significant Results

Among the significant results of a Shari'ah cryptocurrency operation are:

- To create an atmosphere for all humankind to participate with investment opportunities through Shari'ah cryptocurrency within the *Maqasid al-Shari'ah*.
- To help everyone generally and particularly those who are poor and in the low-income group to create an economic opportunity by participating in the Shari'ah cryptocurrency management.
- To create a global awareness among all with an encouragement to enjoy with entrepreneuring and enterprising opportunities through Shari'ah cryptocurrency management.
- To create an economic empowerment with basic rights for all mankind through Shari'ah cryptocurrency management.

15.16.10 Humanitarian Concern Through **Tabarru'at**

A Shari'ah cryptocurrency management may aim at creating a *Tabarru'at* fund through the partial contribution from the income to care and concern about those who are poor, helpless, destitute, orphans and other underprivileged ones in any society to meet their basic needs and natural rights of well-beings within the holistic spirit of *Maqasid al-Shari'ah*.

15.17 Conclusion

In the contemporary digital space, there are numerous types of cryptocurrency in operation, but with no standard system, operational mechanisms or compliance to legal requirements. This may be a negative feature for those wishing to participate in cryptocurrency and also for the system in general. To be sustainable, cryptocurrency should observe all legal requirements. A Shari'ah cryptocurrency model (Asif 2018) is no exception, and should be accepted only if it is Shari'ah-compliant in its establishment, system, operation and code of ethics within the ambit of *Maqasid al-Shari'ah*.

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CHAPTER 16

Foreign Investment Under Shari'ah

16.1 Introduction

Islamic principles regarding foreign investment, and the reason for the importance of foreign investment, with particular regard to Malaysia, are the focus of this chapter. The definition of foreign investment is the employment of foreign capital in a new or existing economic enterprise after obtaining an investment license. Various types of foreign capital, either in cash or kind, may be imported into a country by foreign investors. There are the likes of cash funds in the form of convertible currency, imported into the country via banking system or other methods. Besides, the capital can be in the form of equipment or machinery. Some foreign capital, such as transferable dividends of foreign investors and other permissible items, have been approved by the Council of Ministers. What, then, is Islamic return? Islamic return is return that gives benefit to Muslims and Muslim countries and does not carry involve deception.

Today, the Islamic economy has been noted by some economists for its system, which emphasises the needs of human beings and not just the calculation of profit. The relationship between the Islamic economy and foreign investment aims to strengthen these links, with the intention to support each other to bring benefits to the investor and Muslim countries. The reason for Islamic return on foreign investment is important lies in its potentiality to help people and gain benefit and profit in accordance with Shari'ah guidelines.

Mohd Ma'Sum Billah, *Modern Islamic Investment Management*,
https://doi.org/10.1007/978-3-030-17628-0_16

16.2 Foreign Investment Policy Under Shari'ah

First of all, foreign investment in Islamic perspectives is very hard to understand unless we practise it in our own business life. When a foreign investor come to certain country to invest, they should follow the rules and acts pertaining to foreign investment. According to the foreign investment policy of the Islamic Cooperation for the Insurance of Investment and Export Credit, there are 20 articles which explain these policies:

- Article 1: Losses covered
- Article 2: Exclusions
- Article 3: Policy cancellation
- Article 4: Renewal procedure
- Article 5: Changes in premium rates
- Article 6: Loss minimisation and notification
- Article 7: Claims
- Article 8: Rates of exchange
- Article 9: Other insurance
- Article 10: Recoveries
- Article 11: Chapter
- Article 12: Uninsured percentage
- Article 13: Proposal
- Article 14: Declaration
- Article 15: Observance of stipulation
- Article 16: Misrepresentation
- Article 17: Joint and several obligations
- Article 18: Arbitration
- Article 19: Relevance Law
- Article 20: Definition

These articles instruct what an investor should do and not to do vis-à-vis foreign investment policy. Article 19 states that the policy shall be governed by the principles of Shari'ah in all respects. It shows that Shari'ah rulings also included in foreign investment policy to ensure that the Islamic return can be obtained by Muslim investors and Muslim countries. Islamic return in foreign investment is very important to make sure the needs of Muslim countries and their people are fulfilled. So, it is the obligation of government of Muslim country to be concerned about this matter. At the same time, foreign investment must not bring harmful and bad impacts to the particular country when they invest in certain country. Absolutely, Islamic law was a relevance law of the guideline for foreign investor to make sure their goods, equipment, cash fund and so forth, not contradicting Shari'ah rules, such as no excess interest payment, hoarding, cheating, corrupt and involve with gambling. Allah (swt) prohibits in Qur'an:

> they ask you concerning wine and gambling (maisir), say in them is great sin and some profit for men, but the sin is greater than the profit. (Qur'an 2:219)

Another verse which is concerned with the the same:

> O you, who believe, intoxicants and gambling, dedication of stones and divination by arrows are abomination of Satan's handiwork, eschew such abomination that you may prosper. Satan's plans are to excite enmity and hatred between you with intoxicants and gambling, and hinder you from the remembrance of Allah and from prayer, will you not then abstain? (Qur'an 5:90–91)

In Muslim countries such as Saudi Arabia, they make restriction for foreign investor with creates one authority called Saudi Arabian General Investment Authority (SAGIA). SAGIA is expected to serve as a one-stop shop for business licensing as well, replacing the multiple permits from a variety of Saudi government bodies are currently required for new ventures. This authority will make creation of a 'negatives list' of foreign investment, widely considered by investors to be an improvement on the current 'positives list'. SAGIA will probably assume the lead role in licensing. It means that they only accept permissible foreign investment and disallowed prohibited investment which not approved by Saudi government.

In addition, there are privileges and preferences in Saudi Arabia that favour Saudi companies and joint ventures with Saudi participation. For instance, only firms with at least 25% of Saudi ownership are eligible for interest-free loans from government credit institutions such as the Saudi Industrial Development Fund. Meanwhile, the Saudi Arabian legal system is derived from the legal rules of Islam, known as the Shari'ah. The Ministry of Justice oversees the Shari'ah-based judicial system, but most ministries have committees to rule on matters under their jurisdiction. Generally, the board of grievances has jurisdiction over disputes with the government and commercial disputes. The Saudi legal system protects and facilitates acquisition and disposition of private property, consistent with strong Islamic teaching respecting private property. In the Sunnah it is stated: "Render trust to whom has pit his trust to you, do not betray those betrayed you". Non-Saudis are not allowed, however, to purchase real estate in Saudi Arabia, though this will likely change under the new regulations. Other foreign-owned corporate and personal property is protected.

Islamic return is for concerns especially of the Muslim community because it develops strong relationship with other country and cooperation to promote the kindness of Islam. As we know, Islam is the perfect religion and its teachings cover all aspects of life including the economy and trade. From foreign investment a Muslim country can increase its economic growth and help other Muslim people who need help in poor countries. For this purpose, the way of making the investment is lawful and get blessing from Allah (swt) is by following the Qur'an and Sunnah and the bounties (*Ni'mah*) from Allah must not make Muslims forget the responsibility to the *Deen* and Allah (swt). As Allah (swt) says:

> O you who believe, when the call is proclaimed on Friday for prayer, hasten earnestly to the remembrance of Allah and leave off business and traffic that is best for you if you but knew. (Qur'an 62:9)

In the time of Prophet Muhammad (saw), Madinah is the state of Islam and many traders come to Madinah and make business peacefully and the companions of prophet deal with them and not to cheat, gamble or commit bad actions to the traders outside of Madinah. It is because the good *Akhlaq* of Sahabah which they follow the teachings of the Qur'an and Sunnah. The important part is the traders were affected by the beauty of Islam and then embraced this religion because Islamic teaching is easy and not burden people even in the economic system.

16.3 Experience of Foreign Investment in Malaysia

At a glance, the Malaysian government encourages foreign direct investment (FDI), particularly in export-oriented manufacturing and hi-tech industries, but retains considerable discretionary authority in approving individual investment projects. Outside the export sector, in keeping with long-standing public policies designed to increase bumiputra (ethnic Malay) participation in the economy, the Malaysian government encourages or requires joint ventures between Malaysian and foreign companies, limiting foreign equity and employment. Foreign investment in Malaysia is very broad. Many foreign investors come to Malaysia to invest due to Malaysia's foreign policy which is reliable, and for the stability of its economy. Malaysia's foreign policy is no exception. Various geographical, historical, social and political determinants contribute to shaping the nature of Malaysia's foreign policy and the conduct of the country's international relations.

Moreover, Malaysia has given many opportunities to foreign investor as well as to increase the Malaysia economic growth. According to a news article (*New Strait Times*, 26 June 2004), Malaysia will ease procedures for foreigners to buy property and major stakes in local companies as part of efforts to boost the country's competitiveness. It means that Malaysia government want aim to be more investor friendly. Besides that, even Malaysia has sufficient domestic liquidity, foreign investment is input to ensuring technology transfer in its quest to become a knowledge-based economy by 2020 and reduce a serious budget deficit. Malaysia's initiatives at various regional and international levels have put the country on the world map too. Increased economic prosperity and political stability has enabled Malaysia to carve its own niche in the international scene. Making its presence felt has allowed this country to exercise some influence in setting the international agenda.

In the international area, the United States is currently Malaysia's largest trading partner and biggest foreign investor. Malaysia possesses abundant resources and land, a well-educated workforce, adequate infrastructure and a relatively stable political environment. Meanwhile, bilateral relations with other Asian, African, Middle Eastern and Latin American countries would continue to be pursued without neglecting our traditional economic partners in Europe and America. Japan, the European Union, the United States, Australia and the Republic of Korea, would remain Malaysia's major trading partners as well as the source of investment and technology, particularly in connection with the establishment of Malaysia's multimedia super-corridor. Then, the years ahead therefore would see Malaysia's foreign policy specially oriented towards not only ensuring Malaysia's economic recovery internally, but also the government's effective role as an influential geopolitical player in this field at the global level (Table 16.1).

Table 16.1 Foreign investment by countries (million US $)

Countries	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
I. OECD Countries	3632.3	1409.9	1562.5	1541	2568	1047.4
EU Countries	3272.4	1030	1085.3	1166	1950	769.8
Germany	226.4	281.6	329.8	407	583	153.4
Belgium	70.2	7.6	17.8	23	72	4.4
Luxembourg	43.2	23.1	23.9	32	32	20.7
Finland	9	90.1	1.6	69	696	0.5
Denmark	0.4	13.7	4.2	11	11	9.7
France	2370.3	103.9	135.5	147	38	71.4
Netherlands	338.6	206.1	352.1	235	696	402.5
United Kingdom	164.8	122.2	44.4	88	167	74.6
Ireland	1.9	36.2	12.2	1	0	0.3
Italy	43.2	124.5	128.7	95	272	26.2
Greece	1.2	2	0.2	3	33	2.2
Spain	8.2	2.9	9.2	31	6	1.2
Austria	11.2	8.4	6.1	16	29	0.9
Sweden	22.1	7.5	19.2	95	9	1.8
Other OECD countries	359.9	379.9	477.2	375	618	277.2
USA	179.4	174.5	297.2	293	296	99.6
Japan	21.1	126.7	17.5	14	192	162.5
Switzerland	156.8	50.3	101.6	51	35	12.5
Others	2.5	28.5	60.9	18	94	2.6
II. Eastern European countries	3.1	12.2	1.9	1	7	3.3
Bulgaria	0.4	0.6	0.3	0	1	0.6
Hungary	0.1	0.3	0.6	0	0	0.0
CIS			1.1	9	5	2.5
Others	0.3	11.1	0.6	0	1	0.2
III. Islamic countries	83.4	56.5	56.8	26	49	6.3
Middle Eastern countries	72.4	46.9	53.1	25	47	4.6
Iran	5.4	9.6	5	2	2	1.8
Iraq	5.5	3.2	3.2	1	2	1.2
Saudi Arabia	9	10.1	17.1	15	9	0.0
Kuwait	0.5	0.7	0.4	0	0	
Lebanon	5.1	2.9	0.2	2	0	0.6
Syrian Arab Republic	10.5	4.6	0.7	2	1	0.2
Jordan	1.1	0.6	0.4	1	1	0.3
Turkish Republic of Northern Cyprus	10.2	8.5	0.4	3	29	
Yemen	0	0.1	0.1	0	2	0.1
Islamic Development Bank	6.2	1.4	0	0	0	0.1
North African countries	9.7	7.3	0.3	1	2	1.0
Algeria				0	0	
Morocco				0	1	
Egypt				0	0	0.2
Other Islamic countries	1.3	2.2	3.4	1	1	0.7
IV. Other countries	103.1	195.2	17	123	435	139.1
Grand total	3821.9	1673.8	1646	1700	3060	1196.0

Source: Author's own collection. Ref: Website: http://www.dtmtokyo.org/foreigninvestmentbycountries.htm

16.4 Foreign Direct Investment

FDI is viewed as a major stimulus to economic growth in developing countries. Its ability to deal with two major obstacles, namely, shortages of financial resources and technology and skills, has made it the centre of attention for policymakers in low-income countries in particular. From FDI, we can figure out the growth for the country, because this is one of the determinants for calculating GDP (gross domestic product) in each country. Muslim countries were not actively generating income from FDI. This may be due to the politics, high labour costs, lack of infrastructure and size of the market. In order to start business, foreign investors must accept the rules and regulation as what have done or stated by that particular Islamic country. Here we bring in an example for further understanding: the Islamic Republic of Iran.

16.5 The Experience of the Islamic Republic of Iran

16.5.1 General Overview

FDI in Iran is allowed only through participation of foreign persons in the equity capital of existing and new Iranian companies. Maximum foreign participation in the joint companies is 49%; however, this proportion will be determined on merits of each project. The Law for the Attraction and protection of Foreign investments of 1995 (the Law) provides the legal framework for the approval of all foreign investments in Iran. In accordance with Article I of the Law, foreign natural or legal persons importing capital, either in cash or in the form of machinery, etc. into Iran with the permission of the government of Iran for the purpose of development and productive activities in industry, mining, agriculture and transport shall enjoy the facilities provided in the Law. Such facilities shall be granted to those investors who obtain the required approval. In general, the facilities referred to, among other things, are the annual transfer of net profits in the currency of the original investment, repatriation of the original capital and the accrued profits derived there from and proceeds of the sale of capital or shares and the remaining portion of capital in the event of liquidation government guarantee of fair compensation in the event of expropriation pursuant to law, all at the exchange rate of the Central Bank's selling rate on the day of actual transfer, and the legal facilities accorded to domestic investors.

16.5.2 Procedure

The procedure to be followed by prospective foreign investor to get his investment approved involves different stages:

16.5.2.1 Finding a Suitable Iranian Partner

The foreign investor may approach the search in the following ways:

By referring to or direct correspondence with the relevant ministries. The relevant ministry, with regard to its sanctioned projects, is in a position to introduce holders of an 'agreement in principle' issued by the ministry and/or introduce potential Iranian investors interested to establish industrial firms, to the foreign side:

By referring to or direct correspondence with different banks, financial institutions and or Iran Chamber of Commerce, Industries and Mines:

By referring to or direct correspondence with the Organization for Investment, Economic and Technical Assistance of Iran (OIETAI) Foreign investment Dept. Ministry of Economic Affairs and Finance:

16.5.2.2 Obtaining an Agreement in Principle

As the second step in initiating the investment process, the local partner (together with the foreign investor) should apply to the concerned ministry for sanctioning the industrial project. The application should be supported by the following:

- the special prescribed questionnaire for setting up an industry, and
- a copy of the project feasibility study.

Should the concerned ministry, after necessary investigation and examination, be in agreement in principle with the proposed industry, it will issue an agreement in principle. Based on the above agreement the investor(s) is (are) permitted to start practical measures for construction of plant, import of machinery and arrangement for infrastructural utilities.

16.5.2.3 Application for Participation

Simultaneous, the foreign investor may apply to OIETAI for participation in the realisation of the sanctioned project.

His application should be submitted along with the following documents:

- properly filled-in "Application for import of Capital (1)"
- copy of project possibility study

- copies of draft Joint Venture Agreement, and Articles of Association of the Joint Company
- copies of other draft Agreements, if any, in case the foreign investor is the supplier of services and know-how etc.
- power of Attorney given to person(s) for signing the application and other contractual texts confirmed by the Islamic Republic Consulate in the county of investor
- copies of Articles of Association and financial reports of the foreign investor including balance sheet and profit and loss account of at least last three years
- other information which is deemed helpful.

16.5.2.4 Review of Application by Supervisory Board for Attraction and Protection of Foreign Investments (The Board)

Foreign Investment Dept. (formerly CAPFI), after necessary co-ordination with the relevant ministries and examination of the Application and supporting documents, prepares a comprehensive report and submits it to the Board for a decision. Should the application meet the countries' overall interests, the Board will present its positive decision through the Minister of Economic Affairs and Finance for approval and issue of a decree.

16.5.2.5 Issuance of Decree of Council of Ministers

The decree so issued is the permission that officially authorises the foreign investor to begin operations by importing the required capital into the country. Once officially registered, the imported capital shall be covered by the Law.

16.5.2.6 Formation of the Joint Company

Upon issuance of the Board's positive decision or after issuance of the decree, the local and foreign investors may form joint company for commencement of operations.

16.6 Financial Mechanisms and Instruments Facilitate Foreign Investment

Islamic return depends on a set of rules and laws collectively referred to as Shari'ah. Shari'ah governs not only financial aspects of Islamic society but also the social, political and cultural ones. The following basic principles characterise the Islamic financial system:

- The prohibition of interest; prohibition of *Riba* as it is called is justified on arguments of social justice against speculation. Profits from labor and entrepreneurship are encouraged, whereas interest fixed or predetermined, irrespective of the performance of the business venture, distorts wealth creation and productivity.
- Risk sharing: the role of investor is emphasised as opposed to that of lender/creditor; both the provider of capital and the entrepreneur share risks and profits.
- Money is 'potential' capital until it becomes actual capital in joining in a productive activity. The time value of money is admitted by Shari'ah but only when employed not as potential capital.
- Speculative behaviour is strictly prohibited especially in extreme uncertain transactions.
- Sanctity of contracts; upholding contractual obligations and disclosure of information are essential to reduce the risk of asymmetric information and moral hazard.
- Only Shari'ah-approved activities qualify for investment, that is, no business dealings in alcohol, gambling or pork.

16.6.1 Instruments

16.6.1.1 Mudarabah

A partnership with profit-sharing agreement whereby capital is provided by the bank and assets, management or expertise by the client. The terms of profit and risk sharing are predetermined and customised for each investment. Any loss is borne by the bank except if negligence or misconduct can be proven on the part of the client. The maturity period being short to medium term, this instrument is generally suitable for trade activities.

16.6.1.2 Musharakah

A profit-sharing joint venture between the bank and the client with both parties providing capital in equal or varying degrees and sharing the profits and losses in proportion to their investment. This form of equity participation is used for financing working capital of medium- to long-term duration and fixed assets.

16.6.1.3 Murabahah

A short-term commercial finance agreement with the bank buying the goods on behalf of the client and then reselling them to the client who becomes owner, on a predetermined date and at a price that includes an agreed mark-up.

16.6.1.4 Ijarah

Ijarah is a leasing structure based on risk sharing. High cost assets such as industrial equipment, aircraft, ships, can be leased without bearing the full capital costs. The bank purchases the equipment for the client and retains ownership. Ownership is transferred to the client at the end of lease period according to pre-agreed terms.

16.6.1.5 Istisna'a

Istisna'a is a supplier credit or preproduction facility. Through this mode of financing, the bank undertakes to supply equipment, industrial products or raw materials to meet the client's orders for goods. *Istisna'a* is particularly suitable for financing buildings, construction, manufacture or plants. Once completed, the title is passed to the client on a predetermined deferred-payment basis.

16.6.1.6 Al-Bay'mu'ajjal

Al-Bay'mu'ajjal is a deferred-payment sale where delivery of the goods is taken on the spot, but payment is delayed for an agreed period. Payments can be made in a lump sum or in instalments.

16.6.1.7 Bay' al-Salam

Bay' al-Salam is a deferred delivery sale, which is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

16.6.1.8 Qardh al-Hasan *and* Zakat

Qardh al-Hasan is a benevolent loan and *Zakat* (alms). Funds advanced under *Qardh al-Hasan* are for humanitarian and welfare purposes. Repayments are made over a period agreed upon by both parties at no profit to the bank. Most Islamic banks include these charitable activities in their operations.

16.7 Conclusion

In conclusion, foreign investment with Islamic return can only happen if the investors applied or used Islamic financial product, as mentioned before. This is because only these products are allowed to be used in Islam, in order to get the *Halal* rate of return (profit or loss). Nevertheless, Islamic rate of return is governed by Shari'ah, which is fixed and approved by majority of Muslim scholars. It is suitable beyond any place and time. Muslims should encourage non-Muslims to use it as a medium of financial instrument and try to convince them that these Islamic rates of return are fair and just. If this mission succeeds, Islam will be revealed as a comprehensive religion, because it teaches people not only in religious matter but also how to gain profit according to the will of Allah (swt). We must show a good morality to the non-Muslim, in terms of daily financial transaction, so they can believe that it was not just a theory but a reality which can attract them to change from conventional to Islamic financial product. Indeed, in order to apply this concept, we should be united and support the Islamic financial product—because nowadays, many people across the world appreciate the impact of the capitalist (conventional) system, which seems to make the rich get richer and the poor remain poor. So, the solution for this problem is to change from conventional to Islamic product which is free from *Riba* and fair to all parties.

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CHAPTER 17

Rate of Return in Islamic Investment

17.1 Introduction

According to Brigham (Eugene n.d.), rate of return is how much an investor can earn from an investment over time. Firstly, rate of return includes interest payments or dividend payments as well as the difference between an investment's starting price and its ending price. In Islamic investment, *Riba* or interest is not allowed. But nowadays many Islamic banks apply interest payment to gain more profit. The nature of Islamic banking principles is that they must be social banks, not just banks performing some special social functions. No doubt the social nature of banking can be seen from the rate of return, which must be higher than the prevailing rate of interest. This will require more effort from the taskforce which will be assigned the responsibility of preparing sound feasibility studies for the Islamic bank to enable it to finance various viable projects.

Islamic principles have shown how rate of return can be used to reduce some confusion in application of it. The challenges that face Islamic banks today require major changes in their perception and attitude. Further to this, we will look at glance on the distinctive between rate of return in Islamic investment and conventional investment. Although there are some similarities between both Islamic and conventional approaches, the distinctiveness of Islamic finance remains. Moreover, the benefit that we can gain from an applied rate or return in Islamic investment is promoting Islamic finance as a new phenomenon in international investment. In a world currently dominated by Western capitalism, Islamic finance may

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appear as a beginner, although in fact it has a rich history as a facilitator of trade and economic transactions in the past. Finally, without a doubt, Islam has both contributed to and benefited from financing based on Islamic investment and money market.

17.2 Shari'ah Principles Governing Rate of Return

Basically, rate of return is given in investment when investor involve in investment trading. As we know, rate of return includes interest payments or dividend payments as well as the difference between an investment's starting price and its ending price. Furthermore, rates of return are typically calculated as a percentage, which is the growth in value of an investment over a time period compared to its starting value. An investment does not need to be purchased or sold to make this calculation. The market price is used to measure a rate of return. Muslim investors should not disobey the commandment of Allah (swt) even in business transactions. But many Muslim investors choose to get more profit by taking interest which is clearly prohibited. The Qur'an declares:

> And Allah (swt) has made trade lawful and has forbidden interest. (Qur'an 2:275)

The prohibition of interest is so severe that all the parties connected to the transaction are sinful.

Moreover, they still in dilemma either to choose profit base on Shari'ah rules or based on excess interest payment. The Prophet Muhammad (saw) is reported to have said:

> Allah Ta'ala has cursed the one who takes interest, the one who gives it, the witness to the transaction and the scribe (who recorded it). All are equal in sin. (Al-Mishkat)

It is thus clear that one must totally shun interest in every form.

Nevertheless, at times, either due to lack of knowledge or lack of concern such 'investments' are made that are apparently lawful and earn legitimate 'profits'. Yet in reality these 'profits' are nothing but interest. Consuming such 'profits' draws the punishments that have been mentioned in the Hadith for consuming interest. Rate of return in Islamic investment is more fairly and not burdened investors. The objective of it is to make justice between human being and focus on helping each other especially among Muslim investors. In addition, it is also the objective of the Islamic capital market to ensure that there exists a means of attracting surplus funds for worthwhile investments in accordance with the owners' preferences in terms of the extent of risk involvement, rate of return as well as the period of investment preferred.

The example of payment rate of return in conventional investment:

Among common unlawful investments is the investment in running business for a fixed return. For example, Zaid has a thriving business in which his friend, Ahmad, wishes to invest $10,000. The agreement is that Zaid will pay Ahmad 20% on the $10,000 which amounts to $2000 annually. While they agree to share the profits in the above manner, they also agree to share the losses. For instance, if the business was destroyed, Ahmad would lose his investment and he will have no claim over Zaid. In many cases, it is also agreed that if the partnership is dissolved, Ahmad will take back his investment of $10,000 and Zaid will retain the business. This agreement is not valid. The amount of $2000 which Ahmad is paid is simply interest, and thus haram.

An example of actual profit in return in Islamic investment:

The basic principle in an investment of this nature is that one shares a percentage of actual profits or losses. When Ahmad invests the $10,000, he will become a shareholder in Zaid's entire business to the proportion of his investment, hence if the business was worth $90,000. Before Ahmad joined, Ahmad will become a 10% shareholder after his investment. The partners may mutually decide what Ahmad's share of the actual profits will be. If it was agreed that Ahmad will share 20% of the profits, therefore the total net profit for that year was only $1000. Ahmad will receive $200 only as his share of the profit. If the partnership is dissolved, each partner will receive his share of his actual worth in the business. In the above example Ahmad was a 10% shareholder and Zaid owned 90%. Upon dissolution of the partnership, the net value of the business will be ascertained. This will then be proportionately distributed. For instance, if the net value of the above business at the time of dissolution was $300,000. Ahmad will take 10% which amounts to $30,000.

Moreover, because of the ban on interest (*Riba*), an Islamic bank cannot charge any fixed return in advance, but rather participates in the yield resulting from the use of funds. In an Islamic framework, the incentive for the firm to invest will solely depend on prospective profitability. A profit-maximising firm will continue investing until the marginal productivity of capital becomes equal to the opportunity cost of capital; therefore, the 'cost of capital' in the Islamic system can be represented by the rate of return on alternative opportunities for investment of comparable risk. It has also been demonstrated that there is a rate of return in Islamic capital markets serving the opportunity cost of capital, and this rate of return is also closely related to the rate of return in the real sector of the economy.

In other words, in the Islamic financial system determination of prospective profitability and the rate of return on investments of the same risk class plays an essential role in determining the relative cost of capital. Moreover, the irrespective of various justifications provided for the practice, obviously the use of any interest rate as part of a mark-up (pricing or performance) is not acceptable because interest rate does not represent real rate of return in the economy as intended by Islamic principles.

According to Ahmad Kaleem in his journal *International Journal of Islamic Financial Services* (vol. 4, no. 4), in Malaysia, Bank Negara Malaysia (BNM) formulated a standard framework for the computation of the rate of return for Islamic banking institutions, aimed at providing a level playing field and terms of reference for the Islamic banking players in deriving the rate of returns. BNM uses this to assess the efficiency, profitability and fairness of Islamic banking institutions by using this framework more effectively.

Furthermore, the standardisation of the calculation of the rate of return would serve to address the information asymmetry between the bank and its depositors, by enhancing transparency and ensuring the depositors receive the fair share of the rate of return on investment, in conformity with Shari'ah principles.

In addition, the Islamic financial system recognises that investment decision-making will have to be based on the concept of rate of return on capital as it participates in real sector activities and not on the opportunity cost of capital as represented by the interest rate. Thus far, the literature on Islamic economics and finance has not developed techniques to determine a rate of return at the firm (micro) or economy (macro) level so that investments can be compared for efficient allocation of capital. In the western perspective of rate of return, there is more emphasis on how much an investor can profit based on interest charged on investment. In contrast to Islamic investment, the financing on the basis of an estimated rate of return, the bank estimates the expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. It is possible that this rate is negotiable, if the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered, the bank will take a share in it.

A recent model presented by Mirakhor utilises this concept of q in deriving the cost of equity capital of a firm in the Islamic financial system. In its simple form the model states:

$$r = (Y / V)(1 - d + dq)$$

where:

r = Firm's cost of capital or shareholder's required rate of return.

Y = Value of expected earnings for the next year.

V = Present value of the firm's stock of capital. Since there is no debt financing in the Islamic system, it is equal to value of the firm.

d = Sum of fraction of expected earnings retained by the firm and the expected rate of stock financing expressed as ratio of firm's expected earnings.

q = Firm's q ratio.

From the above equations, it means that a firm's cost of capital (r) is a function of a firm's q ratio and the firm's market value (V), stream of expected future earnings (Y), ratio of retained earnings, and new stock financing. The q ratio can be simply derived by dividing the value of the firm (V) determined by the market price of the firm's stock by the replacement costs of firm's assets such as equipment, land, receivables and marketable securities. The cost of capital will fluctuate with the fluctuations in the q ratio, thus signalling the prospects of an investment project. For example, we are interested in finding the cost of capital for a firm with future expected earnings for next year (Y) of $1,000,000 and equity value of $10,000,000 (since there is no debt financing, value of the firm is equal to equity value).

In conclusion, many examples that involve rate of return in Islamic investment recently and previously which its application always up to date and based on financing conditions and situation. Finding a practical solution for a benchmark compatible with Islamic principles requires an understanding of the concept of cost of capital in the context of an Islamic financial system and obviously the use of any interest rate as part of a mark-up (pricing or performance) is not acceptable because interest rates do not represent the real rate of return in the economy as intended by Islamic principles.

17.3 Socio-economic Benefits

In order to understand this concept, we need to know why it is very important to be applied in Muslim society, especially for the long-term period. The Islamic concept of development has a comprehensive character. It includes moral, spiritual and material aspects. Development becomes a goal- and value-oriented activity, devoted to the optimisation of human well-being in all dimensions—moral and material, economic and social, spiritual and physical—which are inseparable. The Islamic bank has a multi-dimensional approach based on Islamic principles for the benefit of mankind and gives serious consideration to the total development requirement of the community. Therefore, the Islamic bank should take responsibility in the use of funds available. The investment strategy should directly relate to the development of mankind according to Islamic norms. This will require that investments should be to serve long-term development objectives rather than short-term ones. Islam came to show the right path for a good life. It must tackle the problem of developing man in his relationship with God, in his relationship with other human beings, not only in his personal life but in business as well.

The most important consideration here is how to create linkages between all Islamic countries in terms of investment, financing and also banking systems, to strengthen the economy as well as *Ukhuwwah* (relationships among Muslims). This also would result to increment in export and import between us, and this can reduced our relation of using dollars, in addition we can replaced it with Islamic Dinar. All transactions in Islam should be balanced, in accordance to social benefit as its objective, therefore when it is involved an investment, it must take into account society as a whole not the needs of the individual only. For instance, when there is a new project by the government to be developed, such as a new factory in certain area, government must consider its benefits to the society, such as, employment opportunity, increase people salary, and also for the betterment of their life. In addition, the disadvantages or possible bad impacts must also be considered. But if the project can create more benefits than hazards, it can go ahead.

If all Muslim countries can be united as a one *Ummah*, certain benefits will arise, such as there being no borders between them, which will facilitate investment across the Islamic world, which in turn can help to generate an income for the needy countries like Afghanistan, Iraq, Bosnia and so on. When this happens, we can combine our resources and construct it as a shield to maintain our survivor as one *Ummah* in order to face the future. Many Muslim countries have resources such as petroleum and this is one of the most important assets that can be used wisely for controlling our economy. Nowadays, Muslims all over the world need to regain their status as the best *Ummah* in this world. Investment not only enables people to gain more profit; it can also be used as a way for the improvement of our relations with others.

17.4 Rate of Return: Profit Sharing Versus Interest

It has been pointed out by Islamic economists that the profit-sharing system was not only feasible; it was also more efficient than the system based on interest. The interest-based system is inefficient insofar as productive enterprise is financed by interest-bearing credit where the suppliers of invertible funds (the banks) are mainly concerned with the creditworthiness of the borrower. The prospective productivity of the venture for which the funds are intended is not their major concern. By contrast, in the projected interest-free system, the banks as suppliers of invertible funds would be guided solely by the prospective profitability of the ventures since their returns, as well as repayment of capital, would depend on the productivity of the venture, the creditworthiness of the entrepreneur concerned not being at all directly relevant for this purpose. Since there is no reason why the ventures which carry the largest prospective profitability should be the ones sponsored by those with highest creditworthiness, the interest-based system of financing production fails to allocate resources to the most productive uses which the profit-sharing system always does.

It was also pointed out that the profit-sharing arrangement would result in a just and equitable sharing of the social surplus, whereas the system based on interest is unjust for it guarantees a definite positive return to the financier whereas the value productivity of investment is uncertain. It transfers additional wealth to owners of capital even when no additional wealth has been created through the employment of capital in productive enterprise. The system results in a constant transfer of existing wealth from loss-incurring entrepreneurs to wealth owners, which makes the distribution of wealth more inequitable with the passage of time. By contrast, profit-sharing, ensures justice both at the micro and macro level. As happens in the interest-based system, the banks get back what remains of the capital supplied.

A policy of pooling of deposits and diversification of investment can ensure that the banks do not sustain a loss on the totality of their investments and. Hence, the depositors do not get a negative return, except in the case of a deep recession. In the profit-sharing system, wealth will bring more wealth to its owners only to the extent the employment of their wealth results in the creation of more wealth, in which case the entrepreneurs will also have received a share. Thus, the profit-sharing arrangement results in a sharing of social surplus which is just and equitable. The arrangement harmonises the interest of the financiers with that of the entrepreneurs which contributes to the efficiency of the system. Besides being superior to the interest-based system when judged on the criteria of justice and efficiency, the profit-sharing system has the unique advantage of not being level to inflation.

This characteristic follows from the way money capital is supplied for business. The banks as suppliers of invertible funds examine the projects presented to them and supply invertible funds only when they are fully satisfied that the project will result in the production of a value larger than that invested, since the banks' own returns depend on it. In a partial reserve system supply of invertible funds by banks involves creation of new money. This applies to the profit-sharing system also. But the creation of new money in the profit-sharing system is effectively linked with genuine possibilities of creating additional value. It may not be so in the interest-based system where creditworthiness of the borrower is more important than the prospective productivity of the project. Furthermore, the system automatically curtails the money supply to the extent that investment of funds fails to be productive of value.

This happens when, in the possibility of a loss of productive enterprise, the banks back an amount less than they had supplied. This reduced amount of money capital corresponds to the value of the goods and services produced. The part of money capital that failed to result in production of goods and services is simply annihilated. There is no counterpart to this unusual mechanism in the interest-based system which makes that system level to inflation.

17.5 Conclusion

The philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behaviour. Whereas conventional financial systems focus primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state. An Islamic financial system can play a vital role in the economic development of Islamic countries by mobilising inactive savings that are being intentionally kept out of interest-based financial channels and by facilitating the development of capital markets. At the same time, the development of such systems enables savers and borrowers to choose financial instruments compatible with their business needs, social values and religious beliefs.

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