Introduction to Islamic Investing

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Overview

Assets of Islamic financial institutions have grown by an average of 15% per annum* over the past five years to reach over $1 trillion in March 2011, suggesting robust demand for Islamic investing. It is expected Islamic finance will continue to grow at this rate for the next few years and that total assets in Islamic finance could reach US$4 trillion to US$5 trillion by 2015*.

The demand for Islamic banking and Islamic products is increasing and these products and services are being introduced by well-known financial institutions. As more non-Islamic markets show increased interest in Islamic finance, a growing number of new Islamic financial institutions are being introduced internationally.

This is an industry that is still evolving, developing and growing. The industry has also grown from retail banking to commercial banking and, more recently, into investment banking. Its sophistication and product offering have developed along with this change. Islamic financial institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, and financial service companies.

Amongst the various asset classes on offer, the most common forms of Shariah compliant funds are equity funds, real estate funds and commodity funds. But the significant portion of Islamic funds is concentrated in equity investments. However, Islamic finance has also recently developed a wide range of products in the area of private equity and where there were significant product gaps in fixed income, these have since been mostly filled by sukuk (Islamic equivalent of a bond).

With a large expanding and untapped Muslim population, there are likely to be investment opportunities in the future. Islamic finance has come a long way. It is easy to forget how young the sector is and its modest beginnings, but the rate of growth, fuelled by petrodollars and community needs, remains steady. We expect Islamic finance to continue to evolve. There will be a drive towards product sophistication and innovation to cater for the increasing business complexity of investors. As companies and corporates grow in size, their business needs will become more complex. Consequently, Islamic products will need to become more sophisticated to fulfil those needs.

But while continuing growth seems likely, and a wider range of products is now available to investors, legitimate challenges and concerns over the mechanics and regulation of Islamic finance remain. If Islamic finance is to move deeper into mainstream global finance, the industry needs to foster innovation, with gaps across asset classes (sector specific, fixed income, hedge funds), but also credibility by harmonising standards and practices. Not least, Shariah interpretation varies between regions and even institutions. These measures, among others, could be critical in broadening the appeal of Islamic finance.

While Islamic finance was developed for the Muslim community, there is a genuine socio-economic component that renders it equally attractive to investors of all faiths. Ethical investment and Islamic investment products share some common ground and the recent surge in demand for ethical products could provide a lift for Shariah investments, notwithstanding Islamic finance’s transparent and rigorous risk management platform.

*Source: Ernst & Young May 2011 and Cerulli research August 2011.
About Shariah Compliant Investments

Financial markets are witnessing the growing success story of Islamic finance, a unique form of investment which corresponds with the values of socially responsible investing. Islamic finance is an equitable mode of finance that derives its principles from the Shariah, the Islamic law. The Shariah is based on the Quran, the sacred text of Islam, and it governs all aspects of personal and collective life of Muslims. The most distinctive element of Islamic finance is the prohibition of interest, whether nominal or excessive, simple or compound, fixed or floating. To comply with Shariah, investment must not involve interest (also known as ‘Riba’).

Islamic financial institutions work on a philosophy of prohibiting transactions considered immoral and promoting greater social justice by sharing risk and reward. The customer and the Islamic bank share the risk of any investment on agreed terms, and divide any profits between them. Islamic finance does not allow creating new financial risks in order to gain profit; it is about protecting society from trickery, fraud and social tensions. Shariah products also stress accountability, fairness and transparency.

In addition to risk sharing and the prohibition of interest, under the principles of Shariah, investment is also disallowed in businesses that deal with alcohol, pork, gambling, weapons, tobacco, media, ‘conventional’ financial institutions, pornography and anything else which it deems ‘Haraam’ (unlawful). It is also ensured that not only the underlying investments but also the contractual terms agreed between the investors and the investment manager conform to Islamic principles. Islam also disallows certain contracts due to inherent elements which render them ‘Haraam’ (unlawful). This concept covers particular types of uncertainty or contingency in contracts such as short selling, futures, derivatives and conventional insurance.

Shariah compliant investments must all be certified by experts, generally through a panel or board comprised of respected Shariah scholars who are highly qualified to issue “Fatwas” (religious rulings) on financial transactions. This panel of Shariah experts ensures full compliance of the investments and transactions with Islamic principles. All Islamic investment fund companies have appointed Shariah boards which not only provide approvals on individual investments on a regular basis but also conduct a Shariah audit annually to ensure all activities of the investment funds are fully compliant.

When Shariah compliant investments receive company dividends generated as part of a company’s normal business operations, a purification process takes place. A large diversified corporation may be Shariah compliant but may own a small finance subsidiary deemed non-compliant so any proportion of income received from non-compliant activities are paid to Charity and thereby ‘purified’. 
Please note that the above mentioned screenings apply only to funds managed using the Dow Jones Islamic Market indices. For funds using the MSCI indices different financial screenings will be used.

For illustration, the Central Shariah Committee of HSBC Amanah has determined that investment funds investing in equities as an asset class will not invest in companies whose primary business activity is shown in Figure 1 (sectoral screens), or in companies which exhibit characteristics shown in Figure 2 (financial screens). Islam has disallowed certain contracts due to inherent elements which render them Haraam:

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<tr>
<th>Figure 1: Sectors</th>
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<tr>
<td>Alcohol</td>
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<td>Weapons</td>
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<td>Tobacco</td>
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<td>Pork</td>
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<td>Financial services</td>
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<td>Gambling</td>
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<td>Pornography</td>
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<td>Leisure/media</td>
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<th>Figure 2: Financial</th>
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<td>Total debt/12 month trailing market capitalisation</td>
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<td>Cash &amp; interest bearing securities/12 month trailing market capitalisation</td>
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<tr>
<td>Accounts receivable/12 month trailing market capitalisation</td>
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Central Shariah Committee

All Shariah compliant investments must be certified by experts in Shariah, generally through a panel or board comprised of respected Shariah scholars who are qualified to issue “Fatwas” (religious rulings) on financial transactions. This panel of Shariah experts ensure full compliance of all Shariah compliant investment funds.

Three scholars of international repute, well versed in both Islamic law and modern finance, serve on the HSBC Amanah Shariah Committee. The Committee not only provides initial approvals on investment objectives and investment strategy of all funds, but also reviews the investments periodically to ensure the continuous compliance of the investments of the funds to Islamic principles. Moreover, the Committee conducts annual audits of all funds to ensure adherence to their rulings during the year.

Sheikh Nizam Yaquby

Is a graduate in economics and comparative religion from McGill University and is an internationally acclaimed scholar in the Islamic banking industry. He has been a teacher of Tafsir since 1976. He advises a number of banks and financial institutions including BNP Paribas, Dow Jones, Lloyds TSB and Standard Chartered on Islamic banking and finance.

Sheikh Dr Mohamed Elgari

Holds a PhD in economics from the University of California. He is a Professor of Islamic Economics and the director of the Centre for Research in Islamic Economics at King Abdulaziz University in Saudi Arabia. He is an expert at the Islamic Jurisprudence Academy (OIC), Jeddah. Dr Elgari is the editor of the Review of Islamic Economics. He is also an adviser to several Islamic financial institutions worldwide and the author of many books on Islamic banking.

Dr Mohamed Imran Ashraf Usmani

Holds a PhD in Islamic Finance. He also obtained degrees of Alimiyyah and Takhassus (specialisation in Islamic Jurisprudence) from Jamia Darul Uloom, Karachi. His area of expertise is Islamic Finance in which he has carried out extensive research. Dr. Usmani is a faculty member/teacher of Jamia Darul Uloom, Karachi and Institute of Business Administration (IBA), Karachi. He is the author of various books on Shariah (Islamic law from Jamia Darul Uloom, Karachi.) His area of expertise is Islamic Finance in which he has carried out extensive research. Dr. Usmani is a faculty member/teacher of Jamia Darul Uloom, Karachi and Institute of Business Administration (IBA), Karachi. He is the author of various books on Shariah (Islamic law).
Financial Instruments

The most common forms of Shariah compliant investment funds are equity funds, real estate funds and money market funds. These investment funds employ Islamic contracts which ensure that the terms and rights of all parties are safeguarded in conformity with Islamic principles (examples and definitions are given below).

**Musharakah:** A partnership where profits are shared according to a pre-agreed ratio while losses are shared in proportion to the capital investment of each partner. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

**Mudarabah:** An investment partnership under which the investor (the “Rab-ul-Mal”) provides capital to the investment manager (the “Mudarib”) in order to undertake a business or an investment activity. While profits are shared on a pre-agreed ratio, losses are borne only by the investor.

**Ijarah:** An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the investor to earn profits by charging rentals on the asset leased to the user.

**Murabaha:** Purchase and resale of an asset. Instead of lending money, the investor purchases the desired asset from a third party and resells it at a predetermined higher price to the user. By paying this higher price over instalments, the user of the asset has effectively obtained credit without paying interest.

The classical equity instruments in Islamic commercial law (musharakah and mudarabah) require partnership and profit sharing. In financial markets, investing in stocks and equity funds is permitted but must conform to certain guidelines. Conventional interest-based lending or bonds are ruled out in Islamic finance because it relies on interest. Instead, asset-backed financing is encouraged with the risk being shared by the provider and the user of the asset.
**Glossary**

**Amanah:** Trust, with associated meanings of trustworthiness, faithfulness and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another’s funds or property in trust. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. By extension, the term can also be used to describe different financial or commercial activities such as deposit taking, custody or goods on consignment.

**Arbun:** Earnest money/Down payment; a non-refundable deposit paid by the client (buyer) to the seller upon concluding a contract of sale, with the provision that the contract will be completed during the prescribed period.

**Gharar:** Uncertainty. One of three fundamental prohibitions in Islamic finance (the other two being riba and maysir). Gharar is a sophisticated concept that covers certain types of uncertainty or contingency in a contract. The prohibition on gharar is the basis for disallowing practices such as short selling, speculation and derivatives.

**Ijarah:** An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer. Ijarah wa iqtinah extends the concept of ijarah to a hire and purchase agreement.

**Islamic banking:** Financial services that meet the requirements of the Shariah, or Islamic law. While designed to meet the specific religious requirements of Muslim customers, Islamic banking is not restricted to Muslims: both the financial services provider and the customer can be non-Muslim as well as Muslim. Also called Islamic finance or Islamic financial services.

**Istisna:** A contractual agreement for manufacturing goods (commodities), allowing cash payment in advance and future delivery or future payment and future delivery (based on agreed terms).

**Maysir:** Gambling. An ancient Arabian game of chance played with arrows for sake of slaughtered and quartered camels. It came to be identified with all types of gambling and is one of three fundamental prohibitions in Islamic finance (the other two being riba and gharar). The prohibition on maysir is the basis for disallowing practices such as speculation, conventional insurance and derivatives.

**Mudarabah:** A Mudarabah is an Investment partnership, whereby the investor (the Rab ul Mal) provides capital to another party/entrepreneur (the Mudarib) in order to undertake a business/investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The mudarib loses its share of the expected income.

**Mudarib:** The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investor’s funds in a project or portfolio in exchange for a share of the profits. For example, a mudarabah is essentially similar to a diversified pool of assets held in a Discretionary Asset Management Portfolio.

**Murabaha:** Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over installments, the capital user has effectively obtained credit without paying interest.

**Musharakah:** Profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner. In a Musharakah, all partners to a business
undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

**Riba:** Interest. The legal notion extends beyond just interest, but in simple terms riba covers any return of money on money - whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in accordance with the Islamic tradition.

**Shariah:** Shariah or Islamic refers to divine guidance as given by the Holy Quran and the Sunnah (practice) of the Prophet Muhammad (Peace Be Upon Him) and embodies all aspects of the Islamic Faith, including beliefs and practice.

**Shariah compliant:** An act or activity that complies with the requirements of the Shariah, or Islamic law. The term is often used in the Islamic banking industry as a synonym for “Islamic” for example, Shariah compliant financing or Shariah compliant investment.

**Sukuk:** Similar characteristics to that of a conventional bond with the difference being that they are asset-backed, a sukuk represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the sukuk.

**Takaful:** Islamic insurance. Structured as a charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of conventional insurance (interest and gambling).
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