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Salman Ahmed Shaikh¹

Abstract

Islamic finance is a set of financial institutions representing a connected financial architecture that works based on prescribed Shari'ah principles. Growth in the industry has been stellar, but, certain principles, the strategic direction and the practices do not warrant celebration yet. This paper while noting the impressive performance of Islamic mutual funds in Pakistan, strives to a) discuss the theoretical problems in screening principles followed in investment policy, b) identifies the problematic and less ideal investment alternatives used in practice, and c) highlights the anomalies in income purification methodology. The paper argues that the vision of leading the establishment of an egalitarian and balanced financial system has taken a backseat and increasingly innovative financial engineering seems to have blurred the distinctive identity of Islamic financial system. The paper concludes with the recommendation that in the short term, Shariah regulators must comprehensively train themselves in prevalent financial reporting standards and understand their implications. In the medium to long term, centralized Shariah board and revised financial reporting standards must be structured taking into account special needs of auditing the fulfillment of Islamic principles in practice.

Keywords Islamic Finance, Islamic Banking, Takaful, Murabaha, Ijarah, Mudarabah, Musharakah, Salam, Istisna

JEL Codes E44, G11, G20

1. Introduction

Islamic Finance industry over the past three decades has diversified itself from banking to other sectors as well and now it comprises institutions such as Islamic banks, Islamic insurance companies and Islamic mutual funds. Growth has been impressive during the last decade despite the crisis that hit global financial markets during the time period.

Islamic mutual fund industry has also enjoyed success in attracting investment funds from Muslim investors and also from non-Muslim investors due to their impressive performance. In a study conducted in Malaysia, Abdullah et al (2007) concluded that Islamic funds performed better than the conventional funds during bearish economic trends. Elfakhani (2005) also noted that Islamic mutual funds might be a good hedging investment for any equity investors, if used to hedge against market downturns and recessions.

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Islamic mutual fund industry has grown by leaps and bounds globally and in Pakistan as well. Mahmud (2011) analyzing the performance of fund types acknowledged that Islamic funds have shown strong growth. Razzaq et al. (2012) investigated 9 Islamic mutual funds in Pakistan and concluded that returns of these funds were according to their levels of risk.

Currently in Pakistan, there are 15 AMCs (Asset Management Companies) managing Islamic mutual funds. There are 29 open ended funds that are Islamic in the open ended funds category. Besides, there are 18 voluntary pension funds and 1 closed ended fund.

In Table 1, we present average annualized return of Islamic and non-Islamic open ended mutual funds in various categories during the last 365 days computed on July 12, 2012.

Table 1: Annualized Return for last 365 Days (%)

Fund Category	Return on Islamic Funds (%)	Return on Non-Islamic Funds (%)
Aggressive Fixed Income	10.94	7.01
Asset Allocation	9.76	8.48
Balanced Funds	18.00	11.59
Capital Protected Funds	14.64	5.68
Equity Funds	24.67	17.67
Income Funds	10.44	9.32
Money Market Funds	10.47	11.25
Average Return	14.13	10.14

Source: MUFAP

It can be seen that apart from money market funds category, Islamic mutual funds have had higher returns than conventional mutual funds.

In Table 2, we present average annualized return of Islamic and non-Islamic voluntary pension funds in various categories during the last 365 days computed on July 12, 2012.

Table 1: Annualized Return for last 365 Days (%)

Fund Category	Return on Islamic Funds (%)	Return on Non-Islamic Funds (%)
Debt Funds	8.86	10.67
Equity Funds	24.10	19.54
Money Market Funds	9.45	10.37

Source: MUFAP

It can be seen that equity funds in Islamic voluntary pension schemes have performed better than their counterparts. But, in debt and money market category, Islamic voluntary pension funds fall behind conventional funds marginally.

Going forward, in section 2, we discuss what are the investment screening principles set for these mutual funds in Pakistan by KSE (Karachi Stock Exchange) & Al-Meezan Investment Management Limited. In section 3, we critically examine these principles. In section 4, we highlight some problematic issues in placement of funds. In section 5, we introduce an anomaly in the dividend purification methodology followed by equity mutual funds in Pakistan. Finally, in section 6, we highlight corporate governance issues in Islamic mutual funds industry.

2. Islamic Screening Principles: KSE & Al-Meezan Criteria

KSE and Al-Meezan Investment Management Limited launched first Islamic Index (KMI-30) in 2008 in Pakistan which tracks 30 most liquid and active Shari'ah compliant stocks. Their screening methodology approved by the Shari'ah Advisors of Al-Meezan Investment Management Limited is explained below.

2.1. Business of Investee Company

The business of the investee company should be Halal. Accordingly, investments in common stocks of conventional banks, insurance companies, leasing companies, companies dealing in alcohol, drugs etc are not permissible and hence they cannot be included in the portfolio.

2.2. Ceiling on Interest Based Debt

Interest based debt must be less than 37% of the consolidated total assets of the investee company. Interest based debt includes issuing corporate bonds, debentures, Term Finance Certificates (TFCs), commercial paper or using conventional bank loans, capital lease, hire purchase agreements, preference shares etc.

Preferred stock guarantees a fixed share in profit while as per Islamic principles, actual profit either in amount or in percentage cannot be fixed. Plus, there shall be no concept of cumulative dividend as per Islamic principles. Profit sharing ratio can be agreed upon at the start of business or at the start of an accounting period. That pre-agreed profit sharing ratio can be used to distribute "actual profits" earned.

In preferred stocks, whatever is the profit level, the preferred dividend remains fixed since it is not a ratio of actual profits, rather it is calculated based on some percentage of par value of preferred stock. Hence, it is not allowable as per Islamic principles.

2.3. Ceiling on Interest Based Investments

Non-Shari'ah compliant investments must be less than 33% of the consolidated total assets of the investee company. Non-Shari'ah compliant investments include investments in conventional mutual funds, conventional money market instruments, corporate bonds, Pakistan Investment Bonds (PIBs), Federal Investment Bonds (FIBs), Certificate of Investments (CoIs), Certificate of Deposits (CoDs), Term Finance Certificates (TFCs), national savings schemes, derivatives etc.

Furthermore, investments in the common stocks of companies that are termed non-compliant due to violation of any of these principles is also termed impermissible and regarded as non-compliant investments.

2.4. Cap on Shari’ah non-Compliant Income

Non-Compliant Income must be less than 5% of the consolidated total revenue of the investee company.

Where,

$$\text{Total Revenue} = \text{Gross Sales} + \text{Total Other Income}$$

Non-compliant income includes bank interest, income from gambling, nightclubs, prostitution, casino, tobacco, alcohol, dividend income from above mentioned businesses or companies which have been declared non-compliant due to non-compliance to any of the mentioned criteria for Shari’ah compliance etc.

2.5. Minimum requirement of Illiquid Assets

Illiquid assets must be at least 20% of the consolidated total assets of the investee company.

Where,

$$\text{Illiquid Assets} = \text{Total Assets} - \text{Liquid Assets}$$

Liquid assets include cash, prepayments, advances, trade receivables etc. Illiquid assets include inventory, all fixed tangible assets such as plant, equipment, machinery, furniture and fixture and also included are intangible assets. In the context of these principles, all assets having some intrinsic value and which can be traded above or below par value are illiquid assets. These exclude things like currency which does not have intrinsic value of its own and it also excludes debt which cannot be traded/re-assigned above or below principal value.

2.6. Minimum Price of Share as per Shari’ah

As per the prescribed rules, the value of the company is worth at least the amount of liquid assets it has. Minimum market price per share is given by net liquid assets per share which is calculated as:

$$\text{Net Liquid Assets Per share} = (\text{TA} - \text{IA} - \text{CL} - \text{LTL}) / \text{No. of shares}$$

Where,

TA = Total Assets,

IA = Illiquid Assets = Total Assets – Liquid Assets

CL = Current Liabilities

LTL = Long Term Liabilities

Besides these, rules of sale in Islamic Fiqh also have to be observed which negate the use of short selling, blank selling, selling before possession of subject matter, sale of rights, options, warrants, future sale, forward sale, margin financing etc.

3. Critical Analysis of Screening Principles

Islamic scholars have put a ceiling on how much interest based debt could be used to finance total assets. In Pakistan, if the ratio of interest based debt to total assets is 37 percent or more, then, Islamic scholars disallow investment in ordinary shares of such a company.

Lamentably, this restriction is mentioned in neither Quran nor Hadith and is referred to as an 'operational restriction' by Islamic scholars. A company which has used an Islamic debt based mode of finance to finance a fixed asset or used an interest based debt to finance the same asset, then, the company will be rendered non-Compliant for investment in its ordinary shares if it has used interest based financing mode. But, from the perspective of leverage, it will have the same nature of liability and same leverage position. It is incorrect to say that this principle discourages leveraging. Fixed installments will be payable in both cases from economic point of view. But, with higher Islamic banking spreads, fixed installments to Islamic banks will be higher than conventional!

Even if the companies all of a sudden shift to Islamic finance and use Islamic debt based modes of finance, then, from the leverage point of view, their riskiness and liquidity will not be any different from the position when they were using conventional financing.

While small investors are deprived of equity investments in such companies, these companies will be provided with finance by Islamic banks with priority. Hubco, Kapco, Nishat Mills, Engro, Fauji Fertilizer Bin Qasim Limited, DGK Cement, Attock Petroleum etc are some of the companies whose shares had performed well in recent past and they had been provided with finance by Islamic banks. But, for small investors, investment in ordinary shares of these companies was not allowed solely due to an 'operational restriction' and on the premise of discouraging 'leverage' and promoting 'Islamic debt based modes of finance'.

Islamic banks would earn exorbitant profits by providing debt based Islamic modes of finance to these companies, but Islamic scholars by way of their self-imposed restriction have deprived small investors to invest in the ordinary shares of these companies.

Small investors already earn negative real interest rate in Pakistan since Islamic banking spreads are 8.80 percent and more than 6.90 percent for the conventional banks (Source: SBP Islamic Banking Bulletin, Apr-Jun 2011). Hence, Islamic financial institutions have not only deprived small investors of a useful way to earn inflation beating returns through equity investments, but with this rent seeking mentality, they have also deprived their depositors by paying them lower profit rates and maintaining world's highest banking spreads among major countries.

4. Issues in Investment Management

To place short term funds, one investment alternative used is known as ‘Commodity Murabaha’ or ‘Tawarruq’. Basing their actions on the opinion of scholars that ‘Murabaha is allowed, even if not ideal’, the Islamic fund managers took the allowance to the extreme whereby in Commodity Murabaha transactions, the subject matter is not genuinely required by both financial institutions, but each of them takes ownership literally for some minutes and execute a complex sale resulting in a profit for one and fulfillment of liquidity requirement for the other.

Through this, the mutual funds invest their surplus liquidity usually with some conventional financial institution. But, the investment with conventional financial institutions leads to some very unfortunate outcomes. Islamic funds take investment funds of customers after convincing them about Islamic principles. But, when they pass on these funds to conventional financial institutions, the conventional financial institutions conduct interest based operations from these funds.

The argument that asset backed nature of financing would ensure effective risk management is also weak as CMOs, MBS, ABS etc were instruments with mortgage loans as their underlying assets. The problem was with excessive leveraging, lax regulation and unbridled pursuit of self-greed and not with securitization per se. Securitization in Islamic finance as in Sukuk also suffered a setback in Dubai Crisis in 2009/10.

Ready buy-future sale is a financial transaction used to circumvent day trading restriction. By taking unilateral undertaking which is binding, a two-leg transaction is executed which enables the fund to invest funds for very short term. This not only encourages shortsightedness and promotes speculation, but also disregards the concept of meaningful long term risk sharing relationship with Investee Company.

To use an alternate of margin financing, Murabaha financing is used. The respected scholar Maulana Mufti Muhammad Taqi Usmani in his article, ‘New Steps in Islamic Finance’ wrote:

“...One must not forget that these instruments are not modes of financing in their origin. They are in fact some forms of trade that have been modified to serve the purpose of financing at initial stage as secondary and transitory measures. Since they are modified versions of certain forms of trade, they are subject to strict conditions and cannot be used as alternatives for interest-based transactions in all respects. And since they are secondary and transitory measures, they cannot be taken as final goal of Islamic Finance on which Islamic Financial Institutions should sit content for all times to come. It is a matter of concern for a student of Islamic finance, like me, that both these points are increasingly neglected by the players in the field, and especially by the new-comers in the industry.”

Furthermore, in his book, ‘Introduction to Islamic Finance’, the respected scholar, Maulana Mufti Muhammad Taqi Usmani sahab wrote:

“It should never be overlooked that, originally, Murabaha is not a mode of financing. It is only a device to escape from “interest” and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where Mudarabah or Musharakah are not practicable.” (p. 72)

It can be seen that Murabaha was initially supposed to be a transitory contract recommended to be used until Islamic finance matures and develops, but now, it along with other debt based modes of financing comprises almost 95% of total financing assets of Islamic banks that are priced using interest based indexes.

5. Anomalies in Income Purification Methodology

Some scholars have given income purification methodologies which try to subtract from the dividend received any non-compliant income portion.

One such method is as follows:

Income to be purified = (Non-Compliant Income / Total Income) x Dividend Received

But, problems with such methods are as follows:

- a) Non-compliant income is earned and reported independently as part of net income. Being a common stockholder, one is part owner in every asset and earning of the company whether it is paid in the form of dividend or retained for reinvestment. This has no relation with dividend policy.
- b) Company may not pay dividend and still have non-compliant income reported in the income statement.
- c) Company may pay dividend, has positive non-compliant income, but negative net income.
- d) The formula assumes that total income and dividend paid has proportional relationship which is not true. Dividend policy may take into account many factors. Dividend payout ratio (DPO) is not necessarily constant overtime.
- e) There is still a lot of inconsistency in international financial reporting standards both across time and space.
- f) By simple mathematics, it can be appreciated that this method does not result in total purification of non-compliant income. Rather, by allowing capital gains to be exempt from purification process, it tilts the preference towards capital gains and it may result in more speculative short term activities in equity markets rather than investing meaningfully in a company with long term horizon.

The second method is given by AAOIFI (Accounting & Auditing Organization for Islamic Financial Institutions). AAOIFI has given the correct purification methodology in its Shari'ah Standard 21. Clause 3/4/6/4 reads as follows:

“The figure, whose elimination is obligatory on the person dealing in shares, is arrived at by dividing the total prohibited income of the corporation whose shares are traded by the number of shares of the corporation; thus, the figure specific to each share is obtained. Thereafter, the result is multiplied by the number of shares owned by the dealer—individual, institution, fund or another—and the result is what is to be eliminated as an obligation.”

Hassan & Michael (2011) have identified one issue with this methodology that if a company is not compliant during a period and if it becomes compliant later on, what will be the status of dividend paid during the period. But, the answer to this is that if a company is non-compliant and pays dividend, Islamic funds will not be having this stock in the portfolio in the first place.

In this methodology, stock dividend and stock splits which change the number of shares outstanding are not potential problems as long as the effect is proportionally felt in stock price at least in the most immediate instance. But, even if it is not proportional and different, there is no way, it systematically benefits or costs the investor. Plus, the most important thing is that it ensures total income purification in all cases and does not leave this matter contingent on dividend policy and particular reporting standards followed to prepare financial statements.

Why it is not used then more often enough despite the ruling of AAOIFI standards? It is because it costs more to the mutual funds and this is one example of where the prioritization of goals comes into question once again.

6. Inconsistencies in Corporate Governance

Shari'ah scholars in Pakistan are in limited supply. Most noted Shari'ah scholars are serving several Shari'ah boards at the same time. It is ironic that some are on the boards of commercial financial institutions as well as on the boards of regulators.

One very easy solution to this is a centralized Shari'ah board which could help in standardization and bringing efficiency to the whole Shari'ah compliance process. While it is acceptable that Shari'ah Advisors be paid for their services and consultancy, but, there should be a natural limit to how effectively and efficiently they can perform multiple tasks for so many multiple organizations. Indeed, as the earlier sections of this paper have shown, too much professional and commercial commitment has led to a big gap between theory and practice.

In this regard, the central bank of Pakistan – which is also entrusted with a secondary goal of Islamizing the financial system – is continuously trying to implement and promote the use of Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) standards.

AAOIFI standards are unique and are of pivotal significance in the sense that they are agreed upon by world renowned scholars from seven major Fiqhs (Schools of Islamic Jurisprudence).

Adopting AAOIFI standards will help in creating standardization which will not only increase the efficiency of transaction execution in Islamic finance industry in Pakistan, but it will also promote it by bringing out a unified ruling on matters. In addition to that, it will also pave way for minimizing the non-compliance errors and improve efficiency of Islamic financial institutions.

Conclusion: The Way Forward

Increase in financial instruments through issuance in primary market does not add to 'Gross Fixed Capital Formation' unless they are used in a way which increases the productive capacity of the economy. Islamic principles compliment the growth in 'Gross Fixed Capital Formation' or productive capacity of the economy by encouraging entrepreneurship in productive sector. Taking on entrepreneurial risk is at the heart of Islamic economics. This risk can only be eliminated at the cost of compromising the basic distinctions of Islamic economic principles. Effective institutions are required to perform financial intermediation that promote entrepreneurial culture rather than circumvent it.

As of now, there is no Islamic investment bank in Pakistan and there is no Islamic venture capital fund. Mudarabah companies that had been in existence since the 1980s have performed in such questionable ways that even the Shari'ah scholars advising Islamic mutual funds regard investment with these companies as non-compliant from Islamic principles standpoint. In voluntary pension funds, there are as many Islamic funds as the number of conventional funds. This just goes onto show that apart from banking, there is so much room in alternate financial institutional structure where Islamic institutions can lead rather than follow. But, their philosophy to mimic and follow the conventional trail as deeply as going towards Islamic derivatives and structured finance disappoints those who expected and hoped for a distinctive and egalitarian financial architecture. Key to that is equity based financial intermediation taking over currently debt based financial intermediation which is circularly linked with banking. But, while Islamic banks maintain higher spreads than conventional banks and have most of their products linked with interest based indexes, there is a long way to go still.

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