In the name of Allah, Most Gracious, Most Merciful. It has become an undeniable fact that Islamic finance is here to stay. The industry is already making its mark in the global financial sphere as a viable alternative to conventional finance. The International Monetary Fund recently expressed proactive support for the promotion of financial stability in countries with Islamic banking; meanwhile, the World Bank Group also expressed interest in leveraging on Islamic finance for economic development in Muslim countries. These global initiatives indicate that the potential of Islamic finance is receiving more and more recognition day by day. On the other hand, the expectations of the masses from Islamic finance are rising as well. People would like to know what Islamic finance can offer them beyond a commercially viable solution. As the ethical and social aspects of finance have been severely questioned in the post-crisis era, people expect Islamic finance to answer the need of the hour.

Islamic teachings consist of the best moral and ethical practices. By virtue of the same, Islamic finance is expected to represent an intrinsically socially responsible and ethical way of finance. It should not only address but also promote the best environmental, social and governance practices. Recognising its role and responsibility in this regard, the Islamic finance industry should move at a faster pace toward ethical and socially responsible finance. For all the participants in the industry, it is high time for a paradigm shift to elevate Islamic finance from the mere level of permissibility/impermissibility (ḥalāl/harām) to the level of permissible and good (ḥalāl and tayyib). In that paradigm, it would more actively seek to achieve common welfare (falāḥ) and public good (maslahah). The industry will achieve more if it positions itself to endorse ethical, social, environmental, sustainable and good governance dimensions in its practice.

This June 2017 issue of the ISRA International Journal of Islamic Finance covers a number of topics that are of relevance to the different stakeholders of the industry. The subjects discussed include both socially oriented concepts such as ʿwaqf, cash ʿwaqf, zakāh, qardaḥ hasan, takāfūd and microfinance as well as practically oriented areas such as stock screening and income purification methodologies, country experience of Islamic banking and Shariʿah risk rating. Four academic articles, one practitioner article and five research notes are published.

The first academic article, “Application of ʿWaqf for Social and Development Finance”, by Salman Ahmed Shaikh, Abdul Ghafer Ismail and Muhammad Hakimi Mohd Shafii, discusses the important topic of ʿwaqf (endowment) which has played a crucial role in the promotion of welfare of Muslim communities in Islamic history. The article is conceptual in nature and explains how the social institution of ʿwaqf can harness charitable giving in an effective way to foster social and economic development in contemporary societies. Among its recommendations is increasing social awareness for developing the right kind of ʿwaqf to meet the specific needs of particular societies. For instance, in societies requiring educational services, it suggests the establishment
of waqf-based training and vocational centres to increase opportunities for self-employment and upward mobility of beneficiaries.

The second article, “The Optimum Size of Rotating Qard Hasan Savings and Credit Associations”, by Seyed Kazem Sadr, examines another viable model that has been established in different parts of the world, rotating savings and credit associations (ROSCAs) and their Sharīʿah-compliant equivalent called qard hasan associations (QHAs). The article considers QHAs as an important informal, interest-free model to meet the microfinance needs of beneficiaries across societies. It further discusses a few issues associated with ROSCAs and QHAs, notably their optimum size and their determining factors as well as conformity with the practices of QHAs with Sharīʿah rules.

The third article, “ISRA-Bloomberg Sharīʿah Stock Screening and Income Cleansing Methodologies: A Conceptual Paper”, by Ashraf Md. Hashim, Farrukh Habib, Ziyaat Isaacs and Mohamed Anouar Gadhoum, furnishes a comprehensive discussion on Sharīʿah stock screening criteria and the cleansing process for income generated from stocks. It mainly focuses on the approach proposed by ISRA-Bloomberg, which is unique in terms of screening criteria for stocks, income purification method and coverage of the universe of stocks. The ISRA-Bloomberg platform provides users (i.e. investors) more detailed information by a simpler and more intuitive technique using a novel color-coding scheme to indicate the Sharīʿah compliance of a stock. It also shows the exact ratios of the Sharīʿah compliance criteria to the users so they can closely observe changes in the trend of ratios and decide beforehand whether a company is likely to remain within the Sharīʿah-compliant list. It further explains the challenges in the screening and cleansing practices faced by the industry.

The fourth academic article, “Causes and Solutions for the Stagnation of Islamic Banking in Turkey”, by Halit Yanıkkaya and Yaşar Üğur Pabuççu, offers a critical analysis of the evolution of the Islamic banking sector in Turkey. It specifically evaluates the Turkish Islamic banking experience in terms of governance and regulations aspects, instruments, financial and efficiency ratios, and long-term growth strategy of Islamic banks. Among its recommendations are:

- setting up of a sound Sharīʿah governance framework for Islamic banks in Turkey;
- increasing the variety of instruments offered;
- improving the perception of Islamic banking in society;
- increasing research to address the issues faced by Islamic banks; and
- improving the business models, operational efficiencies and information technology infrastructure to boost the growth of the Islamic banking sector.

The practitioner article, “Purging of Impure Income: A Comparative Study of the Existing Purging Methodologies”, by Wasiullah Shaik Mohammed, Mufti Abdul Kader Barkatulla, Mohammed Husain Khathkatay and Zaffar Abbas, offers a practical perspective on the process of cleansing impure income realised from an investment. The article presents a comparative study of the existing purging methodologies prevailing in the market. To illustrate the discussion, it also includes a case study of purging based on numerical examples. Its arguments are then supported with empirical data related to the universe of Sharīʿah-compliant stocks listed on Indian stock exchanges. In conclusion, the authors highlight the lacunae pertaining to the existing purging methodologies and propose changes to the current methodology of purging set by the Accounting and Auditing Organization for Islamic Financial Institutions.

The research notes published in the ISRA International Journal of Islamic Finance are short articles summarising the research endeavours at the level of ISRA and other institutions. A summary of these research notes is provided as follows:
• “Towards the Establishment of Cash Waqf Microfinance Fund for Refugees” by Omar Ahmad Kachkar utilises the concept of waqf to develop a sustainable model to promote the economic engagement of refugees in refugee camps and urban areas. It proposes the setting up of a cash waqf microfinance fund to provide Islamic microfinance and microcredit facilities to refugee entrepreneurs having the potential to develop viable businesses.

• “Proposal for a New Shar’ī Risk Rating Approach for Islamic Banks” by Muhammad Adeel Ashraf and Ahcene Lahsasna proposes a Shar’ī risk rating model to measure the Shar’ī risk of Islamic banks. In the process, it provides an overall risk score that represents the Shar’ī and financial risk of an Islamic bank. This score would assist customers to better gauge the level of Shar’ī compliance of Islamic banks and for the banks to determine the adequate amount of capital that should be allocated to mitigate this risk.

• “Challenges of Developing a Takāful Retirement Annuity Plan in Malaysia” by Younes Soualhi explores the potential market for a takāful retirement annuity plan in Malaysia. It capitalizes on previous practices of takāful retirement plans and research conducted on the subject to highlight the key operational challenges in launching the product in Malaysia. Among its preliminary recommendations is that takāful retirement annuity plans should have diversified investment portfolios, both in terms of maturity and asset quality.

• “Utilisation of Zakāh and Waqf Funds in Micro-Takāful Models in Malaysia: An Exploratory Study” by Said Adekunle Mikail, Muhammad Ali Jinnah Ahmad and Salami Saheed Adekunle examines how the concepts of zakāh and waqf can be utilised in micro-takāful models to provide social security and uplift the economic conditions of underserved communities. It also delves into the key Shar’ī issues related to the use of these two concepts as part of the micro-takāful model.

• “Fiqhı Views on Bay’wa Salaf and Qarḍ-Based Islamic Banking Deposit Accounts in Malaysia” by Mahadi Ahmad and Riaz Ansary undertakes a theoretical study on the prohibition of bay’wa salaf (combination of a sale contract and a loan) and its link to the qarḍ (loan) policy relating to Malaysian Islamic banking deposit products. One of its findings is that there is no violation of Shar’ī if qarḍ-based Islamic deposits are used by Islamic financial institutions to carry out tawarruq transactions.

This issue of ISRA International Journal of Islamic Finance marks a new beginning with the collaboration developed between the International Shari’ah Research Academy for Islamic Finance (ISRA) and Emerald Publishing Limited for the latter to publish, host and distribute the Journal. ISRA International Journal of Islamic Finance has been published since December 2009 and it has always sought to publish articles of superior quality to meet the needs of the different stakeholders of the Islamic finance industry. It is hoped that this recent collaboration will further raise the journal to greater heights to better serve the community.

As always, we thank all the contributors for submitting their work to ISRA International Journal of Islamic Finance and wish a pleasant read to our readers.

Allah (SWT) is the Bestower of success, and He knows best.

Ashraf Md. Hashim
Editor-in-Chief
ISRA, Kuala Lumpur, Malaysia
Abstract

Purpose – This paper aims to discuss the application of *waqf* (endowment) in the social finance sector for funding social and development projects and services.

Design/methodology/approach – The study is qualitative. It reviews literature and provides descriptive data to present its main idea.

Findings – Most Muslim-majority countries are generally income-poor, and the governments are generally weak in their tax collection, effective governance and capacity for development spending. Private sector financial institutions are scarce and mostly cater to the people who can meet the income-based lending criteria. Thus, the institution of _waqf_ can fill the gap as a social finance institution by providing intermediation services for effectively utilising perpetual social savings. Flexibility in the rules of _waqf_ enables it to serve beneficiaries directly or through financial institutions and to provide a wide range of social services.

Research limitations/implications – This conceptual research highlights the need and potential of _waqf_ without discussing the regulatory and operational details of how to effectively institutionalize it in different regions.

Practical implications – The institution of _waqf_ can harness the potential of selfless charitable giving in an effective way for better economic impact in the targeted social segments of society.

Originality value – The paper suggests the establishment of _waqf_-based training and vocational centres which will increase opportunities of self-employment and contribute in upward social mobility of beneficiaries.

Keywords _Waqf_, Charitable giving, Selfless behaviour

Paper type Research paper

Introduction

According to The World Bank (2016), 767 million people are estimated to be living below the international poverty line of US$1.90 per person per day. On the other hand, there has been an unprecedented change in income disparity between the poor and the rich during the past
half century. According to Oxfam (2017), the richest eight people own as much wealth as half of the world’s population. The question is: Do we really have scarcity of resources because of which we cannot end poverty, hunger and famine? Nobel laureate Sen (1981) did research on famine in Bengal and argued that the famine was not caused by lack of resources. Interestingly, according to the Food and Agriculture Organization (2013), for the world as a whole, per capita food supply rose from about 2,200 kcal a day in the early 1960s to more than 2,800 kcal a day by 2009.

The world has enough resources to feed everyone, but the resources are not equitably distributed. The level of inequality has increased tremendously in the past 50 years. Piketty (2014) writes that 60 per cent of the increase in US’s gross domestic product (GDP) since 1977 has accrued to the richest 1 per cent of the population. Similarly, countries in the Organisation for Economic Cooperation and Development in general also experience higher levels of income inequality today. People in the top 10 per cent of the income distribution get almost 10 times as much average income as people in the bottom 10 per cent of the income distribution (OECD, 2011).

While the developed world needs to find answers for egalitarian distribution of income, the developing world has to achieve both a decline in poverty as well as egalitarian distribution of income. Most of the Muslim-majority countries are generally poorer than other countries on average. Most of world poverty resides in Africa and Asia, and the bulk of Muslim-majority countries are located in these continents. Alpay and Haneef (2015) note that in the 57 Organisation of Islamic Cooperation (OIC) member countries, 31 per cent of the total population lives in poverty with average incomes below US$1.25 per day. In Pakistan, Naveed and Ali (2012) conclude that around 59 million people are living in multidimensional poverty. Other Muslim-majority countries like Bangladesh and Nigeria have poverty headcount ratios of 43 and 62 per cent, respectively (The World Bank, 2015a).

Thus, in a largely income-poor Muslim world, there is enormous need for development spending and infrastructure. However, the size and scope of formal-sector financial institutions is small and concentrated. On the other hand, governments are also weak in effective governance and have limited revenue collection to instigate any meaningful long-term development plans. In this scenario, the role of the third sector becomes highly important. The institution of waqf in the Islamic social finance framework provides a useful vehicle to fill the gap in social intermediation. This study explores the potential and application of the institution of waqf in social and development finance through effective social intermediation between philanthropists and the needy.

The remainder of the paper is divided into five subsections. The second section presents some descriptive statistics on the economic underdevelopment in Muslim-majority countries which highlights the need for scaling up social and development finance. The third section then gives a relative comparison of motives in charitable spending in the mainstream and Islamic economic theoretical framework. The fourth section discusses the importance of waqf in the Islamic redistributive framework. The fifth section presents the contemporary applications of waqf in instigating development finance and projects which are geared to enhance skills, capacity and employability of the intended beneficiaries. The sixth section finally concludes the discussion and proposes steps to increase the effectiveness of waqf.

**Waqf as a social and development finance institution**

Because of high levels of poverty and weak governments, most of the Muslim-majority countries are behind in spending on schooling and health services. Hence, the level of human capital, productivity and national income remain at lower levels. Muslim-majority countries on average have lower literacy rates and primary school enrolment rates when we compare
them against the high-income and middle-income countries as shown in Table I. Similarly, in health infrastructure, life expectancy and basic facilities like sanitation and water, it is observed that Muslim countries are far behind the high-income and middle-income countries.

Despite the fact that Muslim countries have higher average per capita income than the middle-income countries, the socio-economic performance of Muslim countries is still lower. This presents a case for effective financial and social intermediation to enable the surplus households who want to engage in continued philanthropic spending to help resource-deficient households who require income and social assistance. However, financial intermediation in Muslim-majority countries focuses on commercially viable target markets and offers financing products which have income-based lending criteria for eligibility. The majority of income-poor households do not have sufficient or stable sources of income, and they lack asset ownership to qualify as bankable clients.

Could government instead scale up development spending and provide a wide range of welfare services as is the practice in the West? The fact is that welfare states in Europe usually have high tax collection. On the other hand, the governments in Muslim-majority countries have weak tax collection, and the public institutions are generally poorly governed. The World Bank (2015b) reveal that OIC countries have very poor governance performance. None of the OIC countries features in the top 50 countries with strong governance in 2015 on a composite index which includes voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.

In this scenario, third sector social finance institutions could fill the gap in providing effective social intermediation within the country. In addition to that, across countries, we know that there is huge disparity in economic conditions between oil-rich and industrializing countries in the Gulf Cooperation Council and East Asia, respectively, and the rest of the OIC member countries in Africa and South Asia. With transnational waqf and country-to-country support programmes among the Muslim-majority countries, waqf-based social intermediation can help to improve the underdevelopment problems of the Muslim ummah (community).

<table>
<thead>
<tr>
<th>Indicators</th>
<th>High-income countries</th>
<th>Middle-income countries</th>
<th>Muslim countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP per person employed (Constant 2011 PPP, USD)</td>
<td>76,507</td>
<td>29,631</td>
<td>40,341</td>
</tr>
<tr>
<td>Poverty ratio at PPP US$1.90 a day (% of population)</td>
<td>0.56</td>
<td>5.95</td>
<td>24.58</td>
</tr>
<tr>
<td>Gross fixed capital formation (% of GDP)</td>
<td>21.95</td>
<td>24.50</td>
<td>22.87</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Literacy rate (% of adult population)</td>
<td>98.46</td>
<td>93.22</td>
<td>73.46</td>
</tr>
<tr>
<td>Net enrolment ratio in primary (%)</td>
<td>96.92</td>
<td>92.34</td>
<td>85.55</td>
</tr>
<tr>
<td>Government expenditure on education (% of GDP)</td>
<td>5.19</td>
<td>4.67</td>
<td>3.69</td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health expenditure (% of GDP)</td>
<td>8.75</td>
<td>6.20</td>
<td>5.18</td>
</tr>
<tr>
<td>Hospital beds (per 1,000 people)</td>
<td>5.18</td>
<td>3.37</td>
<td>1.98</td>
</tr>
<tr>
<td>Improved sanitation facilities (% people with access)</td>
<td>97.14</td>
<td>81.85</td>
<td>64.53</td>
</tr>
<tr>
<td>Improved water source (% people with access)</td>
<td>99.28</td>
<td>91.89</td>
<td>82.04</td>
</tr>
<tr>
<td>Life expectancy (years)</td>
<td>79.06</td>
<td>71.69</td>
<td>66.53</td>
</tr>
</tbody>
</table>

Source: The World Bank (2015a)

Table I. Comparison of socio-economic indicators across country groups
Motives of charitable giving in mainstream and Islamic framework

This section discusses the significance of charitable giving and how mainstream and Islamic economics explain the motivation to spend in charitable causes. Charitable giving poses a unique challenge to the self-interested microeconomic agent that is known by the name of homo-economicus in neo-classical economics. Charitable spending exceeds 2 per cent of GDP in the USA alone (List, 2011). Alam (2010) contends that the annual philanthropic giving in Muslim communities could be as high as US$1tn. A national level study by the Aga Khan Foundation in Pakistan reveals that private charitable giving is four times as much as the amount of the foreign aid received by the country (Alam, 2010).

The question that arises is: How can philanthropic behaviour be explained? In neoclassical literature on utility maximisation stream, social interactions were first explored by Becker (1974, 1976). Later on, Andreoni (1989, 1990) argued that people engage in impure altruism when they contribute in charity or donate for public goods. These charitable acts also emanate from self-interest, i.e. to gain fame, satisfy the ego or change the living environment to improve one’s own social experience and relations. Other motives identified in the literature include moral satisfaction generated by contributing (Crumpler and Grossman, 2008), peer pressure which triggers reluctant altruism (DellaVigna et al., 2009), redeeming one’s public image and avoiding the guilt of saying no (Andreoni and Bernheim, 2009) and public prestige (Harbaugh, 1998).

From this discussion, it appears that the empirical literature in neo-classical economics confines socially empathetic behaviour within a materialist and self-interested paradigm. Nonetheless, strengthening a person’s moral commitment towards social needs should not be ignored as altruistic behaviour is also learnt like other behaviours (Mayr et al., 2009). Hence, to promote charitable spending, the right form of learning, as well as reinforcement and permanent incentives, are required.

Now, we attempt to explain the reinforcing incentives in the Islamic two-world framework for charitable spending. In the theoretical literature on Islamic economics, Sadeq (1987) explains that the Islamic concept of human welfare is more comprehensive than economic welfare alone. In line with this, Chapra (1999) contends that economic development is one part of human wellbeing. Economic development on its own is insufficient to actualize all-encompassing human wellbeing. After the rise in income inequality which followed economic growth in the post-Second World War era and the subsequent ecological and environmental challenges which appeared as a result of the capitalist growth model, the Western concept of development has also given way to wider dimensions of human development and recognition of the role of institutions (Mirakhor and Askari, 2010).

In the Islamic worldview, human welfare is only complete when it is achieved in both worlds, i.e. the temporal worldly life and the everlasting afterlife. The Islamic worldview provides a larger perspective and incentive structure for righteous actions in the two-world framework of life. This has the potential to result in comparatively higher willingness for social actions, affirmative participation in social causes, higher charitable giving and exhibition of more selfless behaviour in social relations and in the marketplace.

The Qur’an says, “By no means shall you attain righteousness unless you give [freely] of that which you love” (3: 92). The Prophet (peace be upon him) once said:

When a man dies, all his acts come to an end, except three: recurring charity (ṣadaqah jariyah), or knowledge by which [people] benefit, or a pious offspring who prays for him (Salih Muslim, Book of Wills, Ḥadīth No. 4005).

Hence, in the Islamic framework, the incentives for socially empathetic behaviour come from a distinct worldview and comprehensive notion of social responsibility and ethical
behaviour. These are ingrained in faith-consciousness which ultimately affects preferences and economic and non-economic choices.

The importance of *waqf* in the Islamic redistribution framework

*Waqf* is an important institution in the Islamic social framework. It can harness the potential of selfless charitable giving in an effective way for better economic impact in the targeted social segments of society.

Under *waqf*, an owner donates and dedicates an asset (movable or immovable) for permanent societal benefit. The beneficiaries enjoy its usufruct and/or income perpetually. In the contemporary application of *waqf*, it can be established either by dedicating real estate, furniture or fixtures, other movable assets and liquid forms of money and wealth like cash and shares.

The cash *waqf* is usually formed where the pooled donations are used to build institutions, such as schools, hospitals and orpanages (Sadeq, 2002). Aziz et al. (2013), argue that cash *waqf* can pool more resources and ensure wider participation of individual donors.

One of the important features of *waqf* is that it provides flexibility in fund utilisation as compared to *zakāh* (almsgiving). *Zakāh* funds must be utilised for specific categories of recipients. On the other hand, the institution of *waqf* can be used to provide a wide range of welfare services to Muslims as well as non-Muslims, and the beneficiaries could also be other living beings. For instance, animal protection programmes and environmental preservation expenditures can be provided more flexibly through *waqf*. The institution of *waqf* can transform social capital into social and public infrastructure. It provides a permanent social safety net in the case of perpetual *waqf* to the beneficiaries.

The institution of *waqf* complements the institution of *zakāh* because the government cannot take more than a prescribed portion of wealth as *zakāh*. Hence, the private establishment of *waqf* helps in sharing the burden of the exchequer and also provides a source of contentment for the faithful donor in following the Islamic directives on charitable spending. The institution of *waqf* is also an excellent source of building religious infrastructure for Muslims in Europe, America and Australia where non-Muslims are the majority and governments are mostly secular and not interested in providing funds for religious infrastructure like mosques. In such countries, Muslims can share infrastructure like schools and hospitals built by the government for all citizens. However, they cannot share the religious infrastructure with non-Muslims, and the government is unlikely to pay attention to the religious needs of minority Muslims in such secular-oriented countries.

As compared to individual charity, the institution of *waqf* is more effective in matching right targets with objective screening and providing sustainable sources of funds to the beneficiaries. In individual charity, rich people often face difficulty in finding the right targets because their extended families and social circle normally comprise people like themselves.

Besides income support and cash transfers, poor people need training, capacity building and skills improvement to get out of poverty and achieve social mobility. Haneef et al. (2014) argue that lack of finance and business training requires institutional support to unleash the potentials of micro-entrepreneurs and to establish viable micro-enterprises. Obaidullah (2008) explains that growth-oriented micro-finance programmes also need to provide training, insurance, and skills enhancement facilities. In this regard, the institution of *waqf* can improve the chances of socio-economic mobility by providing a rather permanent, effective and efficient funding source for the health and education infrastructure. The increased and improved provision of education and health infrastructure funded through *waqf* can enhance the income-earning potential of beneficiaries.
In Muslim history, *awqāf* (pl. of *waqf*) provided public utilities (roads, water and sewage), educational institutions and hospitals. Even staunch critics of Islamic economics, such as Kuran (2001) concede that the institution of *waqf* delivered public goods in a decentralised manner in Muslim economies for a long period of time. Even in contemporary times, *awqāf* can also directly affect entitlements by providing educational scholarships and health services for the poor. Hence, the institution of *waqf* can help in capacity building and wealth creation through building human, physical and financial capital.

**Application of *waqf* in a contemporary policy framework**

In the contemporary application of *waqf*, it can be established either by dedicating movable or immovable asset(s). This provision enables people to contribute in establishing a *waqf* even if they do not personally own any real estate. Mohammad *et al.* (2006) suggest that if we keep a distinction between the perpetuity of the object itself and its “dedication” of benefits, then we can effectively use the institution of *waqf* in contemporary economies. They argue that only the value capital is to be preserved perpetually, whereas the investment capital may be transformed into different types of assets as deemed fit for maximizing the benefits from the *waqf*.

With regards to the management, administration and governance aspect of *waqf* in contemporary times, many scholars also highlight the importance of professional management and transparent administration of *waqf* for effective results. Alpay and Haneef (2015) recommend that there must be transparency and accountability between funding and implementing agencies for achieving the ultimate goal of poverty reduction. In the same line of thought, Hassan and Shahid (2010) argue that professional business management will improve institutional quality, service delivery and effective delegation of responsibility so as to ensure and ease accountability. Hence, corporate structure is suitable for professional management and perpetuity. Sulaiman *et al.* (2009) argue that transparency is vital in operations as well as in reporting so that the trust deficit is reduced between the donors and the *waqf* administration.

Another important aspect in the application of *waqf* in contemporary times is the sustainability of *waqf* institutions. Dafterdar (2011) argues that sustainability is complimented by profitability. Thus, seeking profits could create surplus which can help in expanding or at least sustaining the net of social services adequately. Otherwise, if we rely solely on cash donations and do not hedge against declining purchasing power of money in a cash *waqf*, the risk of non-sustainability could increase. Obaidullah (2016) emphasizes that preservation of benefits for the intended beneficiaries requires prudent management of the assets and efficiency in their development and investment. Sulaiman and Zakari (2013) emphasize the importance of diversity in income sources for *waqf* institutions. In making investments, it is better to engage quality investment management specialists to protect and achieve growth in the pooled funds over time.

The permissibility of making *waqf* with contemporary forms of wealth like cash and shares increases flexibility and widens participation. Mohammad (2011) explains that *waqf* can be used to establish new financial, commercial and social sector institutions. *Waqf* with large funds can also become a superstructure under which other commercial and welfare institutions can be established. In this regard, Habib (2007) proposes a *waqf*-based Islamic microfinance institution. Habib (2007) suggests that Islamic banks can use income derived from late-payment penalties and other proceeds to establish these institutions. Mohammad (2011) argues that because commercial banks usually miss the poorer clients, cash *waqf*-based Islamic banks can provide more compassionate and egalitarian services. Because the people establishing cash *waqf* will not have as much target profit in mind as the investors in
commercial banks, the *waqf* management can use the funds in a more flexible way in financing social needs as well as providing benevolent loans to the ultra-poor. Mohammad (2011) suggests that the cash *waqf* model can be used to provide capital for the *waqf* bank.

In developing countries, the masses of poor people do not have access to financial services either because of supply-side sluggishness or unavailability of supporting services. Saad and Anuar (2009) argue that, for commercial reasons, microfinance programmes usually miss the ultra-poor and hence commercial microfinance is ineffective in reducing poverty. The evidence from countries with high penetration of microfinance reveals that poverty has not been reduced by much there. The ultra-poor severely lack access to complementary services, which reduces the marginal benefit of access to finance relative to the moderately poor. That is where the institution of *waqf* could support microfinance beneficiaries in enhancing the non-income aspects of their human capital potential.

Rahman and Dean (2013) highlight that it is important to utilise the institutions of *waqf* and *zakāh* for capacity building of the poor so that they can build skills for income generation and subsequently become marketable clients for microfinance. The *waqf* model can be used to fund the establishment of training and business support centres. The recurring costs can be managed by taking a fee-in-kind in terms of requiring the trained person to further train some fixed number of clients. Hence, no monetary fee would be charged for training facilities, but the person provided with training shall further train other people so that the model becomes financially sustainable. In turn, maximum leverage can be obtained from the funds that are used to establish these centres and for training the first few groups of people.

These training centres would complement the financing functions of microfinance institutions as the people with required human capital are expected to be more productive and, hence, earn income levels that can cover the cost of financing and leave some surplus for the client.

It is an empirical reality that people want to donate both time and money. Hence, professionals like doctors and academicians can donate voluntary time to be part of such training centres. Such non-monetary donation will enable them to contribute to social causes without having to become a permanent part of the institutions and leave their primary bread-earning occupation. It will also enable them to be part of social projects without having to worry about administration, necessary infrastructure and finding suitable targets. This would also reduce their cost of donation by reducing transaction costs, and it would help them to donate more time in actual service delivery than in incurring transaction costs of matching the right targets.

Lastly, the institution of *waqf* can also be used to finance public infrastructure and public goods like roads, schools and hospitals. Such complimentary public investments are one of the prime sources of continuous economic growth (Romer, 1986).

**Conclusion and recommendations**

This paper argues that the motives and incentive structures for charitable giving in Muslim societies are different from secular societies. This difference arises because of the distinct Islamic worldview and inspiration from Islamic sources of knowledge for social and moral attitudes to life. It is argued that the institution of *waqf* is an important institution in the Islamic social framework and that it can harness the potential of selfless charitable giving in an effective way for better economic impact in the targeted social segments of society.

In light of various economic indicators, the paper presented how *waqf* can contribute in social finance as a complementary alternative to governments and private-sector financial institutions which cannot undertake all socially desirable projects because of lack of funds or commercial non-viability.
Some recommendations for increasing the effectiveness of the institution of waqf in contemporary applications are listed below:

- It is vital to improve the matching technology. Charitable spending can be seasonal and impulsive. Hence, there is a need for accessible avenues to match targets and mobilise resources efficiently.
- Sourcing philanthropic contributions online in cash waqf can be more efficient and bring more participation, especially in the case of emergencies (Yusof et al., 2014). It can also help in capitalizing on short-term impulsive empathetic spending on special occasions and events.
- In soliciting waqf contributions or investments in waqf certificates, it is necessary to highlight the positive externalities as suggested in the experimental economics literature (Andreoni, 1995). For instance, it is important to highlight how much difference a contribution of RM 1,000 will make in funding one year schooling of a certain number of children.
- It is important to provide tax incentives to engage more people and corporations in establishing awqaf. Shirazi (2014) urges the Islamic Development Bank (IDB) to encourage cash awqaf with tax incentives to the endowers. Tax deductibility for corporations can be one such incentive that should be allowed by countries where tax incentives are yet to be allowed. Furthermore, tax rebates on income deducted at source of waqf investments shall be allowed to reduce the tax burden on waqf.
- It is important to create social awareness for creating the right kind of waqf at the right place. For instance, in many Muslim countries, only mosques are built as waqf, and often very close to each other, whereas the majority of Muslims often face shortages of basic medical and educational services.
- The laws related to waqf must be simplified and standardised, especially for trans-national awqaf. In the past, the abrupt nationalisation of awqaf dented the confidence of people. Thus, it is vital to ensure the independent status and operations of waqf.

References


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Abstract

Purpose – Several indigenous credit and savings schemes have been accredited recently in developing countries for the benefit of households and entrepreneurs alike. Famous among them are the Rotating Savings and Credit Associations (ROSCAs) that exist in almost all continents currently. The rapid development of ROSCAs and their varied structures in many countries have been the subject of numerous studies. What has not been thoroughly analysed is the optimum size of these associations and the fact that lending and borrowing is without interest. The aim of this paper is to present a model that would determine the optimum size of ROSCAs and deal with the following issues: how the group size varies with changes in the income level of the members, the demand for the loan, the size of the collected loan and its duration. Further, the question of whether or not lending to the association in return for obtaining larger sums is a violation of the qarḍ (loan) contract is dealt with, and several Sharīʿah compatible formulations are provided.

Design/methodology/approach – Economic analysis has been applied to show the optimum size of Qarḍ Ḥasan Associations (QHAs), which are the Sharīʿah-compliant equivalent of ROSCAs, and the Sharīʿah rules of the qarḍ contract to illustrate the legitimacy of group lending.

Findings – The major findings of this study are determination of the optimum size of QHAs, the factors that affect the size and suggestion of alternative legal forms for group financing.

Research limitations/implications – Inaccessibility to sources of data to test the hypothesis that has been put forth is the main difficulty encountered when conducting research on the subject.

Practical implications – The paper concludes that the development of informal interest-free ROSCAs in both Muslim and non-Muslim countries is an efficient informal microfinance scheme and that it is compatible with Sharīʿah rules.

Originality/value – The optimum size of ROSCAs and QHAs has been presented in this paper.

Keywords Microfinance, ROSCA, QHA, Optimum size, Qarḍ contract

Introduction

The relative success of the microfinance industry in providing financial services and saving opportunities to the poor and its proliferation throughout the developing world have promoted the creation and development of Islamic microfinance institutions in many Muslim countries. A number of microfinance schemes that are compatible with Islamic rules...
have been innovated (Obaidullah and Abdul Latif, 2008). They are largely based on institutions such as zakāh (almsgiving), khums (alternative Sharīʿah financial obligations), waqf (endowment) and qarḍ hasan (QH) (bona fide loan). In light of this revived interest and these efforts, the global Islamic microfinance industry is estimated to have grown at a five-year cumulative average growth rate of 19.7 per cent from 2013 to 2018 (Kustin, 2015). In addition, the Islamic Social Finance Report (2014) indicates that zakāh collections have grown steadily over time. They have increased by 32 times over the past 10 years in Indonesia and by 27 times over the past 20 years in Malaysia. Hassan (2014) highlights the role of Islamic microfinance in alleviating poverty in his study of the Andaman Islands in India. He reports that cash waqf and zakāh funds were distributed to the poor, and microfinance loans were offered to low-income farmers provided that they observe the Islamic rules of environmental preservation and waste avoidance.

Despite recognition of Islamic microfinance as a valuable and novel tool for poverty alleviation, great challenges remain in Muslim communities, where a high portion of global poverty is concentrated. Over half a billion individuals live on under US$2 per day in Indonesia, India, Pakistan, Bangladesh, Egypt and Nigeria, many of whom struggle to access sufficient liquidity and manage their small savings. Moreover, the total financing gap for micro, small and medium enterprises in developing countries is almost US$2.4tn, according to a World Bank-Islamic Development Bank Policy Report (World Bank, 2015). Further, 55-68 per cent of small- and medium-sized enterprises (SMEs) in these countries are either financially underserved or not served at all.

Several indigenous credit and savings schemes have been accredited recently in developing countries for the benefit of households and entrepreneurs alike. Famous among them are the Rotating Savings and Credit Associations (ROSCAs) that exist in almost all continents currently and their Sharīʿah-compliant equivalent, called Qarḍ Ḥasan Associations (QHAs), that have been established in many Muslim countries. The rapid development of ROSCAs and their varied structures in many countries have been the subject of numerous studies (Adams, 1978; Besley et al., 1992, 1994; Bouman, 1995; Levenson and Besley, 1996; Calomiris and Rajaraman, 1998; Handa and Kirton, 1999; Kovsted and Lyk-Jensen, 1999; Kimuyu, 1999; Anderson and Baland, 2002; Anderson et al., 2009; Gugerty, 2007; Stefan and Nicolas, 2007; Armendariz de Aghion and Morduch, 2010). What has not been thoroughly analysed, however, is the optimum size of these associations and the factors that affect their efficiency. An optimum economic scale of operation will arguably ensure the efficiency of the association’s financial intermediation services and also its stability and resilience.

This paper is composed of three parts. The first part shows that QHAs are universal structures for informal saving and financing services. It also reviews different types of ROSCAs and the motivation for joining them. The second part discusses the optimum size of QHAs and factors that affect it. The final part discusses the compatibility of QHA financial contracts with Sharīʿah standards. The study concludes with recommendations for the development of informal interest-free Savings and Credit Associations in both Muslim and non-Muslim countries.

**Qard hasan as a universal mode of saving and finance**

QH lending and borrowing is not foreign to people’s conventions. In fact, it is common in most parts of the world as a group type of financial services that reduces the cost of lending, mobilises savings, facilitates monitoring and deploys community-based enforcement mechanisms.
QHA is formed by a number of volunteers who are closely associated with each other. They are either members of a family or workers in a public or private organisation or are residents of small communities. They decide collectively that each member contributes a fixed amount of cash to the association periodically, so that the collected sum will be distributed among them, one at a time, for a predetermined period. The order of distribution is usually determined by drawing lots. The member who receives the money will be excluded from the lot in future periods until all participants have received the loan. Alternatively, the order may be determined by the priority of some members’ demand for the loan. Sometimes, the order of loan distribution is kept the same in the following rotations, particularly in associations that continue over time. It may also be determined anew at each subsequent round. The latter is the practice when some members leave or new ones are added. The length of the period may vary from one week to a few months. Members continue to contribute periodically, but the instalments for loan repayment may or may not be on the same periods (Armendariz de Aghion and Morduch, 2010).

This type of mutual group lending and borrowing is known as ROSCAs in the conventional microfinance literature. It has almost identical structure, management scheme and membership as QHAs. ROSCAs are institutions that mediate funds between participants, where financial resources are transferred to meet lifestyle needs such as consumption, school fees, weddings, durable consumer goods and ensuring survival and improving the quality of life (Bouman, 1995). The interesting practice in ROSCAs is not only contribution to a pot and its random distribution but also the fact that the lending and borrowing operation is free of any interest charge. This feature makes it identical to QHAs and may imply that the QH contract is an intrinsic universal mode of loan exchange. As such, QHAs and ROSCAs furnish platforms for households to save and to finance their durable consumption goods (Besley et al., 1993) and for entrepreneurs to finance SMEs (Bouman, 1995; Khan and Lightfoot, 2013). Because QHAs and ROSCAs are essentially similar structures, they will be mentioned interchangeably from now on, unless otherwise indicated.

As mentioned previously, ROSCAs exist in at least three continents (Africa, Asia and Latin America) and within very different communities (Bouman, 1977). They involve between 50 and 95 per cent of the adult population in several African countries and mobilise about one-half of national savings in Cameroon (Bouman, 1995). The particular characteristics of ROSCAs probably depend on the needs of the population living in these countries. In a survey of households with steady access to microfinance through Bank Rakyat Indonesia, it was found that 40 per cent of them also participate in ROSCAs (Armendariz de Aghion and Morduch, 2010, p. 59). In Ethiopia, 8-10 per cent of GDP in the early 1970s and 20 per cent of all bank deposits in Kerala State of India were ROSCAs participants’ deposits (Bouman, 1977). At least half the rural residents in Cameroon, Cote d’Ivoire, Congo, Liberia, Togo and Nigeria participate in ROSCAs (Bouman, 1995). Between 1977 and 1991, researchers found that roughly one-fifth of the Taiwanese population participated in ROSCAs (Levenson and Besley, 1996). Among the 95 ROSCAs called “lotri samilies” in Bangladesh, it was found that 70 per cent of members were residents in the same neighbourhood and the others shared a workplace (Rutherford, 1997).

Being an indigenous informal financial intermediary, ROSCAs have different names in various parts of the world. They are named “hui” in Taipei, “tanda” and “polla” in Mexico and Chile, respectively. They are known as “chit funds” in India, “committee” in Pakistan, “lotri samilies” in Bangladesh, “arisans” in Indonesia, “kuttu” in Malaysia and “kye” in Korea. In African countries, they are called “susu” in Ghana, “ensusu” in Nigeria, “upatu” or “mchezo” in Tanzania, “totimes” in rural Cameroon and “chilemba” or “chiperegani” in
Malawi and “iqqub” in Ethiopia (Armendariz de Aghion and Morduch, 2010, pp. 68-69). The form is called “jamʿiyyah” in Persian Gulf countries and “Qarzul Hasaneh” in Iran (Sadr and Torabi, 2015).

ROSCAs have very flexible structures. The size of the group, the amount of the contribution and the rotation period vary in accord with local economic conditions (Bouman, 1995). The number of members in ROSCAs ranges from 5 to 100 and the pots from US$25 to 400 in Bangladesh. About two-thirds of the ROSCAs have daily collections as small as 5 to 25 cents and about one-fourth collect payments daily (Armendariz de Aghion and Morduch, 2010, p. 70). According to Gugerty (2007), in western rural Kenya where people are dependent on small-scale farming, most ROSCAs comprise groups of friends and neighbours. The average pot is about US$25 and is usually disbursed monthly, whereas the average wage is less than $1 a day. The typical ROSCA lasts for one year. The pot is about one-quarter of the average monthly expenditure of a household.

ROSCAs are not only found in areas where formal financial systems are less developed. In fact, their prevalence is also documented in well-developed financial systems with financially literate populations. They have been found among bank employees in Bolivia (Adams and Canavesi de Sahonero, 1978) and Ghana (Bortei-Doku and Aryeetey, 1995). Another study carried out in urban Zimbabwe found 76 per cent of urban market traders participate in ROSCAs and about 77 per cent of these traders also have bank accounts (Chamlee-Wright, 2002). A study in Indonesia shows that 40 per cent of households with steady access to microfinance services provided by Bank Rakyat Indonesia also participate in ROSCAs (Armendariz de Aghion and Morduch, 2010, p. 59). ROSCAs are moreover found in countries such as Taiwan, Malaysia and GCC countries that have well-functioning credit markets and among South Asian communities in Oxford in the UK (Srinivasan, 1995). The prevalence of ROSCAs as an interest-free scheme of finance reinforces the conjecture that QH might be the global efficient and equitable contractual form of lending and borrowing.

ROSCA’s structure has not remained fixed and limited to contributing members. In more modified structures, some members may mainly save, whereas some others only borrow. In this new form, the association is called an Accumulating Savings and Credit Association (ASCA) as described by many authors (Bouman, 1995; Rutherford, 2000; Collins et al., 2009; Armendariz de Aghion and Morduch, 2010). The chief advantage of ASCAs is that borrowers are not required to deposit their savings in advance and members who have surplus income can save there, that is, members who save may be different from those who borrow and the fund distribution is based on demand not on drawing lots. “There are ROSCAs and ASCAs with a history of over 20 years, adapting the society’s financial technology to such changes as an economic boom, a depression, an inflation […]” (Bouman, 1995).

In this new direction of transformation of ROSCAs into ASCAs, I notice conformity with QHAs and also QH funds (Sadr and Torabi, 2015) where the initiation has been financing consumption and production demands. The characteristics of the QH funds in Iran, Pakistan and Malaysia have been described by some researchers (Sadr and Torabi, 2015; Zada and Saba, 2013; Saad, 2011). The modification of the structure of QHAs from ROSCAs into ASCAs is also observable in the structural change of consumption-type QH (i.e. where the funds are used for consumption purposes) into a business type, which will be described below. This structural development implies that this type of informal group associations is the most efficient organisational form for voluntary interest-free saving and financing activities. Therefore, Islamic microfinance institutions can both learn from the worldwide experience of ROSCAs and ASCAs and share their achievements with them. As such, dealing with the performance of QHAs is beneficial not only to the Islamic but also to the global microfinance industry.
An interesting form of QHA, called Committee, which resembles a kind of ASCA, is formed among businessmen in Pakistan (Khan and Lightfoot, 2013). These committees usually have a small number of members and shorter cycles as compared to those organised by salaried people and housewives. There are, however, varieties of committees in the market with larger and smaller number of members, size of pot and rotation period. If an entrepreneur wants to raise an amount but cannot contribute the agreed instalment, he can join two committees of half that instalment. For example, if an entrepreneur wants to raise Rs 2m but cannot contribute the agreed instalment, he can join two committees of one million each or enter twice in the same committee. He may also put in half of the instalment, whereas the other half can be paid by another member (Khan and Lightfoot, 2013). Thus, businessmen join the committee that suits their business profile.

In these investment QHAs, lots are drawn every 15 days. Members make frequent payments, often daily, weekly or fortnightly. Investment ROSCAs or QHAs have a short cycle length – typically six months because investment into the business can be made two or three times in a year (Khan and Lightfoot, 2013).

Khan and Lightfoot (2013) report that investment committees are markedly different from those organised by salaried employees or housewives, which typically run over one or two years. The longer committee is not favourable for the businessmen because of inflation and the opportunity cost of capital. Interestingly, contribution of gold (coins) is the norm in committees operated by wholesalers and gold sellers to avoid inflation cost.

These committees are organised by well-known businessmen who take the first pot but also manage the association and perform all bookkeeping and accounting jobs. They also cover any shortfall to the pot because of a member’s delayed payment. Consequently, organizers exert effort to select creditworthy members and, reciprocally, members seek a committee whose director has management talents and is trustworthy. Committees are observed to last for five years although they are often renewed every six months (Khan and Lightfoot, 2013). Handa and Kirton (1999) note the same role for a director in Jamaican ROSCAs, who initiates the scheme, selects the members, collects contributions and pays into the pot if any member fails to pay.

It is remarkable that these ASCA-type of associations operate the business without any interest charge. In contrast, in some African ASCAs, interest is charged and the first pot is allotted to the member who bids the highest interest rate and the rest of the members who pay lower interest receive the pot later on a random basis (Bouman, 1977). Although the formation of ASCAs shows the flexibility of ROSCAs to adapt to new market conditions and satisfy the business financial demands, the allocation of the pot on the interest bidding method is a drift from the principle of balanced reciprocity and genuine universal ROSCA model.

Alternative motives for joining Rotating Savings and Credit Associations
Besley et al. (1993) considered ROSCA as representing an institution for mediating funds between individuals who do not have access to the credit market. These associations transfer funds to meet life cycle needs and to purchase indivisible goods. Like all other microfinance groups, ROSCAs circumvent default problems by social sanctions on defaulting members as well as preventing them from further participation. Ambec and Treich (2007) report that the economic literature has been mostly driven by the durable good hypothesis that is put forth by the former authors. This literature asserts that the main benefit of ROSCAs is to allow an early purchase of a durable good. They further comment that the economic literature has recently complemented the durable good motive by a self-control commitment to save. A number of researchers have argued that at certain economic conditions individuals suffer from lack of self-control and time-inconsistency problems.
Economic environment and social obligations impose impediments for households to adhere to a consumption budget which was originally planned. Ambec and Treich (2007) developed a new analytical model based on this hypothesis and derived verifiable propositions. They showed that ROSCAs mostly attract average-income individuals, as opposed to the very poor or very rich. Members are homogeneous within ROSCAs and the contribution increases with the income of members. Furthermore, they emphasize that these predictions are consistent with findings of many empirical studies.

Aliber (2001) found that the type of occupation has an impact on the frequency of ROSCAs’ meetings in his South African sample. There are daily, weekly and monthly meetings. However, those working in the formal sector prefer monthly meetings to coincide with the end-of-the-month pay schedule. Others who are in the private sector and receive their wages on a daily or weekly basis prefer meetings that coincide with their payment date. The above observation indicates that consumers at all income levels have strong motives to save. They may further have the same average propensity to save. The individual’s income, profession, duration and size of ROSCAs are all interrelated.

The optimum size of qard hasan associations
The focus of studies so far has been on the income and saving motivation in ROSCAs. The effect of group size on the efficiency of saving behaviour in these informal financial intermediaries has not been carefully analysed by researchers. One important factor that facilitates access to ROSCAs is the openness of these institutions to new members. A new participant is welcome to the ROSCA if he can add more benefit than burden to the group and enhance the saving formation process; otherwise, he is denied acceptance. Therefore, it is crucial to find out how the members of ROSCAs determine their group size. It is most likely that homogeneous members form the group, but what is not clear is the number of them who do so. Furthermore, how the group size varies with changes in the income level of the members, the size of the pot and its duration remains to be analysed. These are the issues that will be dealt with in the following membership model, and a number of testable hypotheses will be put forth.

Members in QHAs will encounter two opposing benefit and cost streams. Each member will have the privilege of receiving an interest-free loan at some future period, on the one hand, and bear the opportunity cost of waiting for this transfer, on the other hand. As membership in QHA increases, the size of loanable capital increases because of the contribution of new members. On the other hand, the expected waiting time for getting the loan is further prolonged. The marginal benefit (MB) of adding a new member to the QHA remains constant for incumbent members because the new member contributes an a priori fixed membership share. But the marginal cost (MC) increases because the expected opportunity cost of obtaining the loan increases. The addition of new members will increase the number of rotations if the rotation period is fixed or it may necessitate an extension of the rotation period. For example, in a seven-member association the loan may be delivered every week, so that every member will receive the collected loan at most in seven weeks; but, if a member is added, the maximum time that each has to wait is eight weeks or the rotation period may be extended to eight days for each member to receive the loan at least once in eight days. Either way, the maximum waiting time will be extended from 49 to 56 days.

If the aggregate loan is distributed by the intensity of the demand expressed by members, rather than casting lots, a monitoring cost will be added. This new cost will, in turn, increase the MC of obtaining the loan as the size of the group increases. The optimum size is that number of participants at which the MC of joining or leaving the Association for each member is equal to its MB. At this size of membership the net benefit to the association is
maximised if there are no associated external costs or benefits. Thus, there will be no incentive for new members to enter or be allowed entry or an old member to leave the association. This explains the fact that the size of associations remains unchanged over time.

Factors that have impact on the optimum size of qard hasan associations
Many factors affect the benefit and cost of membership in QHAs. Suppose a member’s income increases and he decides to start a new venture. If the initial capital needed for investment is greater than the aggregate loan that is distributed in the association, he would leave the group and seek alternative sources of fund. It is reported in fact that as the income of ROSCA members increases they leave the group (Armendariz de Aghion and Morduch, 2010, p. 71).

If all members demand larger loans, they increase the membership due. The MB curve would shift upward, and the optimum size of the group would increase. New members would be added to the group if they are homogeneous with the incumbents. Thus, the size of the group and that of the individual contribution and the lump-sum distributed are directly related. Alternatively, the rotation period may be prolonged.

In those associations that are formed for a short period but are constantly reconstituted, risky members may join the group because of adverse selection problems. The MC of membership would then increase, and the optimum size of the association would diminish. Consequently, when the adverse selection problem is present, membership will be confined to incumbent safe members and the size of association would diminish. Besley et al. (1993) state that individuals insensitive to social sanctions have stronger incentives to bid to obtain the pot early, which may create an adverse selection problem for the group. This explains the formation of associations among family members who trust each other and also in small communities where people have either full knowledge of each other’s conduct or can easily acquire it in the community. Further, family ties and social reputation are such important social assets that no member would ever risk losing them. This attribute has been considered as the essential trait of all types of microfinance schemes.

If higher income members have access to a QH fund, they would leave the association and obtain the loan from the fund. Alternatively, they may keep their association and use the smaller loan for short-term consumption and that from the QH fund for long-term business investment. If on the other hand, no source of fund is accessible, either because of distance or lack of collateral or high interest charges, the members keep their association and encourage new entries. Subsequently, the rotating period extends and some members will be required to wait up to a year to receive a loan. Thus, there is a direct relationship between the size of the aggregate loan and the expected rotation cycle.

At the dire level of poverty, individuals can hardly become eligible for membership for the poor have nothing to share. The QHAs are thus formed by individuals who have surpassed the poverty level and not only are able to satisfy their customary consumption expenditures but also, in addition, can save part of their income. Hence, QHAs are not formed at the poverty level or at low levels of family income. The zakāh and waqf funds are very effective in rescuing poor individuals and supporting them until they become eligible for membership in a QHA (Cizakca, 2000). Mosques, too, play a very important role for promotion of benevolent behaviours among participants. A multitude of motives for alternative forms of giving are offered in Islam. Mosques provide a platform for enunciating them and reminding community members about them. The propensity for donation and QH loan extension increases as the average family income in the community exceeds the level needed to finance a decent livelihood and also as social interaction enhances among members of the community, both in the mosques and in the market place.
Therefore, individuals are not likely to join QHAs at low and at high levels of income; that is, the size of the group has an inverted U-shape relationship with members’ income levels. In Taiwan, the likelihood of participation in ROSCAs rises with income level up to a certain limit and then starts to fall. ROSCAs become less important as households income increases and they become rich (Armendariz de Aghion and Morduch, 2010, p. 71).

The model that is presented can also determine the optimum size of investment QHAs and show that it is less than that of the consumption type in Pakistan (Khan and Lightfoot, 2013). Here, the MB of membership is higher because the lump-sum loan received is a multiple of the consumption loan. However, the MC is much higher; first because of the fact that the first allotment goes to the director, and, therefore, the chance of early attainment of the pot is less for any member and the opportunity cost of capital is higher. Second, management, monitoring and late payments by some members comprise additional costs for the group though the particular burdens vary for the director and the other members. Consequently, the net benefit is maximised at a lower number of members, and investment committees are smaller than the consumers’ associations. Khan and Lightfoot (2013) report that committees with all different pot sizes, instalment periods and cycle lengths can be found in the market. These committees usually have a small number of members and shorter cycles as compared to the committees organised by salaried people and housewives. There are large and small committees in the market; thus, people who cannot afford to put aside big amounts usually participate in smaller ROSCAs.

The conformity of gird hasan associations lending with the gird contract

The extension of QH is very much praised in the Qur’ān (Farooq, 2011; Sadr, 2014). Interest-free loans are, in fact, an example of this practice. However, QH in the Qur’ān includes any decent value-creating activity in the form of charity, waqf, or contribution to enhancement of the poor’s income, education, health or lodging. On the other hand, the gird contract like other stipulated contracts by the Sharīʿah prescribes a set of privileges and obligations for the contracting parties. Privileges include the guarantee of the principal loaned and the ability to recall it at any time if the borrowing period is not specified beforehand. The creditor is not entitled to any contractually stipulated pecuniary or non-pecuniary benefit other than repayment of the principal. Based on these terms and conditions of the gird contract, the question is whether the lending to the association in return for obtaining a larger sum, sooner or later, is a violation of the gird contract or not?

Aliero (2014) has argued extensively that the practices of QHAs are perfectly compatible with the Sharīʿah rules because all contractual agreements are permissible unless they violate a rule or precondition. In this respect, he cites cases when collateral is taken and interest is charged. He points out that a QHA requiring a pledge or collateral does not violate canonical rules but that charging interest is not allowed. Although the latter is followed in some conventional ASCAs and microfinance units, it is not practiced in Islamic ASCAs as reported by Khan and Lightfoot (2013) in Pakistan. Aliero (2014) examines thoroughly the compatibility of all QHA practices with Sharīʿah standards but leaves out the contractual basis of distributing the fund among the members in the association. Two issues need to be clarified: first, do members consider the contribution that they make to be a gird or do they intend another contractual arrangement? Second, if it is a gird contract, does it not violate the terms of it because it is paid by each member on the expectation of receiving a larger lump-sum later?

One interpretation is that each member’s contribution to the group is out of good will and a gift. The lump-sum that the group transfers to him is also a gift or prize, without any contractual obligation. Both transfers are made out of benevolence and ta’awun (cooperation). The configuration is thus that of hibah muʿawadah (reciprocal gift). Another
formulation is to envisage that all transfers in QHA are carried out on the basis of the *wakālah* (agency) contract. Each member delivers his choice to the group or to a moderator selected by the group and binds himself freely to their or his decisions. Because there is no debt or *qard* relationship, the constraints of the *qard* contract do not apply. Alternatively, it can be presumed that members consider the director of the association to be their attorney and deliver to him the right of distributing the collected funds. The latter will then lend the funds to the members randomly or on any other agreed basis. Thus, the transfer of contributions to the director will be on the basis of *wakālah*, but the distribution of the collected pool to the members will be on the basis of the *qard* contract. In any of the suggested formulations, the violation of *qard* terms and conditions is precluded. In the first and second configurations, the transfer of funds is either on the basis of benevolence and *taʿāum* or *wakālah*. The *qard* contract is not used and its terms do not apply. In the third formulation, where a combination of both *wakālah* and *qard* contracts are used, the members do not commit any violation because their contributions are made on the basis of *wakālah* and not *qard*. In fact, this third alternative arguably represents the intention and practice of the members of QHAs better than the others. Members freely choose the association, and they either elect the director or know him in advance. Unless they have trust in the director and his management capabilities, they will not join the group. The latter lends the fund to the members through the *qard* contract to benefit from the attributes of this contract, which ensures the security of the loan repayment on time. Thus, the operation of QHAs and the participation of the members are fully compatible with Sharīʿah rules as Aliero (2014) has concluded.

In all the presented formulations, the legitimacy of the QHA practices is secured, but the virtue of reward that is associated with any QH deed is obscured because *wakālah* contracts do not embed this trait. This virtue is captured if the whole operation is carried out on a QH basis. To embrace this end as well as to secure the authenticity of QHA practices, some scholars have argued that a *qard* contract will be invalidated if the access to the lump-sum money is stipulated as a term of the contract. As long as any gain, definite or expected, is not specified and made a condition of the *qard* transaction, the contract is valid and conforms to the rules of the Sharīʿah. In a comprehensive study of juristic opinions on the *qard* contract, Abozaid and Saleem (2014) argue that the financial arrangement in QHAs is different from conditional reciprocal lending. A member offers a loan to another on the condition that other members, not the borrower, provide him a loan. No obligation is imposed on the borrower. Furthermore, the lenders at each rotation do not receive benefit from the borrower rather from other members in the future rotations.

An analogy is the milk distribution associations that were in place in Iranian rural villages in the past. Every household having a cow used to contribute one or two specific measures of milk to a common pot which used to be distributed among contributors in turn for making dairy products. The practice was perceived genuine by *fuqahāʾ* (scholars) at the time for not violating the requirements of valid lending and borrowing. Similarly, lending to a QHA and borrowing from it is not accompanied by any binding condition that will obligate the participating parties to fulfil it. Therefore, the operation is perfectly valid from the Sharīʿah standpoint and may also be accompanied with the spiritual reward of exchanging a QH loan. This new version that considers financial transactions in QHAs to be *qard* and not *wakālah* legitimizes the bidding proposals for obtaining earlier receipt, a practice which is common in some Malaysian QHAs. One member bids to transfer part of the lump-sum loan to the group if he receives it earlier. In a *qard* contract, the borrower will own the principal lent and is free to allocate it to any legitimate use. Therefore, the group that is lent by each member has the right to lend back the principal that it owns to any
individual member. If bidding is considered beforehand as a legitimate practice by the group, then it is not a violation of a promise or of fair distribution. The important requirement is that bidding would not be done on an interest payment.

Conclusion

ROSCA is a universally recognised microfinance scheme. Its indigenous equivalent in Muslim countries is QHA. The practice of interest-free financing in ROSCAs all over the Muslim and non-Muslim world manifests that the QH contract is an efficient and viable mode of finance. QHAs are financial intermediaries which promote rural and urban households’ savings and channel them to the purchase of durable consumer goods and to investment projects. By pursuing this function, they constitute an essential part of the financial sector in both developing and developed economies and contribute to a steady process of economic development. Therefore, financial authorities should adopt all measures that facilitate formation of these associations and reduce the risk of their financial services. They also have the potential to become partners with formal financial institutions and provide financial services at very low cost to households in rural and urban areas. Being microfinance vehicles, they embed all the attributes of their conventional counterparts such as screening and monitoring of clients. They are thus capable of alleviating all problems of information asymmetry, both for formal and informal institutions.

One attribute of ROSCAs that ensures their efficient operation is their optimum scale of operation. The addition of a member increases the size of the pot being distributed, but it also extends the expected queuing time for each member to receive the pot. The maximum net benefit of the number of members participating in any ROSCA determines its optimum size. Factors that affect the benefit and cost of membership in the QHAs are the demand for the loan, either for consumption or investment purposes, family or kinship relationship, supply of alternative sources of finance and the period of pot distribution. Individuals are not likely to join QHAs at low and higher levels of income; that is, the size of the group has an inverted U-shape relationship with the member’s income level.

Decisions by individuals to join QHAs can also be interpreted by alternative Sharī‘ah compatible schemes. The contractual form that seems to preserve both the reward of a QH loan and the terms and requirement of the qard contract was presented. As stated, the contract is valid and conforms to the rules of the Sharī‘ah if no gain or benefit is specified and made a condition of the qard transaction.

The QHAs are viable informal financial intermediaries in all economies regardless of their income levels. It is, therefore, incumbent upon financial authorities to undertake legislative and regulatory measures to support these associations and enhance their development in both rural and urban locations. The spread and persistent development of this form of interest-free financing, both in Muslim and non-Muslim countries, are indications of the robustness of Islamic finance and the role that it can play to foster social welfare and economic growth all over the world.

References


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ISRA-Bloomberg Sharīʿah stock screening and income cleansing methodologies: a conceptual paper

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Abstract

Purpose – The purpose of this paper is to explain and critically analyse the Sharīʿah screening criteria and cleansing process for income generated from stocks with a special focus on a newly developed ISRA-Bloomberg methodology.

Design/methodology/approach – The paper focuses on the methodology of ISRA-Bloomberg in terms of Sharīʿah screening of stocks and the income cleansing process. To achieve this objective, this paper adopts a descriptive approach.

Findings – The methodology of ISRA-Bloomberg is unique in terms of its criterion for screening stocks, the cleansing process and coverage of the universe of stocks. It facilitates the investors by offering a novel colour-coding scheme to indicate the Sharīʿah compliance of a stock. It also provides the exact ratios of the Sharīʿah-compliance criteria to the investors so they can closely observe changes in the trend of ratios and decide beforehand whether or not a company is likely to remain within the Sharīʿah-compliant list. The paper further discusses the issues in the screening and cleansing practices faced by the industry.

Research limitations/implications – This research is limited to the criteria of screening and income purification of stocks which have been used by ISRA-Bloomberg from a Sharīʿah perspective.

Practical/implications – The robust screening criteria and comprehensive analysis of the stocks will enhance the confidence of Islamic capital market participants. The investors, regulators and index providers will be equally able to benefit from this initiative.

Originality/value – The paper focuses on the recently established methodology of ISRA-Bloomberg, which has not been discussed in the literature until now. The methodology, because of its exceptionality, may add a new dimension to Sharīʿah screening and cleansing of stocks.

Keywords Islamic finance, Sharīʿah-compliant shares, Islamic equity, Screening criteria, Income purification

Paper type Research paper
Introduction
A vibrant equity market is one of the most crucial elements of a market economy. It offers a
dynamic and efficient platform to companies to gain easy access to capital and to investors
to acquire ownership of a company with promising future performance. In this way, it
contributes to the growth of real economic activity and development.

An Islamic equity market is also an essential element of the Islamic financial system.
However, to develop a comprehensive Islamic equity market, a robust supporting
infrastructure is needed. Keeping this in view, it is important, on the one hand, to have
devout Muslim investors who are keen on investing in Sharīʿah-compliant stocks and, on
the other hand, to make available a large group of Sharīʿah-compliant stocks to them. It is
important that they know about any stock if it is Sharīʿah-compliant and how much of the
income generated from a Sharīʿah-compliant stock is actually Sharīʿah-compliant. This is to
ensure that they can avoid Sharīʿah non-compliant stocks and avoid the impermissible
portion of the income from those that pass the Sharīʿah-compliance screening. The issues
here are how a stock can be determined to be Sharīʿah-compliant; how much income is
permissible from it; and how the impermissible income is treated.

Many regulatory and Sharīʿah authorities, standard-setting bodies, Islamic financial
organisations and individual scholars have deliberated on these issues and proposed viable
solutions. Based on those solutions, various equity index providers such as Dow Jones,
FTSE, MSCI and S&P have developed their own criteria for determining the Sharīʿah
compliance of a company’s shares. They also offer a complete list of Sharīʿah-compliant
shares based on their own databases.

This paper explains the Sharīʿah screening criteria of stocks in general, with a special
focus on the newly developed ISRA-Bloomberg Sharīʿah screening methodology. In
addition, it discusses in detail the cleansing methodology proposed by ISRA-Bloomberg
for the income generated from stocks. The methodology proposed by ISRA-Bloomberg is
unique from many aspects that will be made clearer in the following sections of this
paper. In doing so, Sharīʿah justifications and rationale of the methodology are also
discussed, and comparison of the methodology with other criteria is furnished wherever
needed.

After the introduction, the paper explains the concept of Sharīʿah-compliant shares and
the need for them. Following this discussion, the importance of screening stocks is
highlighted. It explains the criteria of Sharīʿah screening of stocks and the rationale behind
such criteria and then discusses the screening methodology of ISRA-Bloomberg. After that,
it furnishes the cleansing methodology for the income generated from stocks. It delves into
the problems faced in the screening and cleansing processes in the subsequent section,
followed by the conclusion.

Investing in common shares
The common stock of a company represents ownership interest in the company apportioned
to the number of stocks bought by an investor (Investopedia, 2016). Therefore, investors
essentially own a part of the company that is equivalent to the number of stocks owned from
the total number of the company’s shares. By increasing the number of shares held by
investors in the company, they assist in the positive growth of that company, and, in return,
they are rewarded through dividends, warrants, appreciation of the value of shares and
other benefits.

The companies which offer their shares in a stock exchange can be divided into three
main categories as per their business and operations:
companies with business and operations which are impermissible from the Sharī‘ah perspective;

(2) companies with permissible business and operations; and

(3) companies with mixed business and operations or companies involved in both permissible and impermissible business and operations.

A Muslim investor cannot participate or invest in companies with completely Sharī‘ah non-compliant business and operations. The Qurʾān says:

وَلَا أَلْهَهَا الَّذِينَ أَمَلُوا لَا تَأْكُلْنَ آمَالَهُمْ بِالبَعْثَةِ

Oh you who believe, do not wrongfully consume each other’s wealth, but trade by mutual consent (Qurʾān, 4: 29, Trans. Abdel Haleem, 2004).

Al-Šābūnī (1997) explains that wrongful consumption here includes every manner of acquiring wealth that is not permitted by Sharī‘ah, for instance, theft, dishonesty, usurpation, usury (riba‘), gambling (qimār) and similar things. They are all forms of wrongful consumption of wealth.

As for companies that are involved in completely Sharī‘ah-compliant business and operations, it is allowed for the Muslim investor to participate in them, according to the Islamic Fiqh Academy of Organization of Islamic Cooperation (IFA-OIC, 2000, Resolution No. 63/1/7) and Islamic Fiqh Council of Muslim World League (IFC-MWL, 2006, Session No. 14, Resolution No. 4). It is, however, generally observed that it is difficult to find such companies. Most companies are involved in activities that are either completely Sharī‘ah non-compliant or a mix of compliant and non-compliant (Hashim and Habib 2017).

The main issue, therefore, concerns investing in companies that are involved in mixed activities. On the one hand, participation in such companies is tantamount to involvement in impermissible business and, on the other hand, prohibiting participation in such companies would inflict harm on the public and cause hardship. That is why many Sharī‘ah authorities and committees, standard-setting bodies and individual scholars support the view that participation in such companies should be allowed based on the principle of removal of hardship and harm from Muslim investors, provided that the impermissible business and operations of such companies are restricted to a certain tolerable limit (SAC-SC, 2006; AAOIFI, 2015).

The requirement for stock screening from Sharī‘ah perspective

From the above discussion, it can be construed that most of the companies which are available for Muslim investors are companies with mixed activities. Even the case of companies established in Muslim countries is not much different (Hashim and Habib 2017). There are many reasons for this situation, such as:

- The global financial framework itself is not Sharī‘ah-compliant. Companies usually fulfil their financial requirements through conventional financial institutions and instruments. For example, the non-existence of Islamic banks in many countries to support cross-border transactions is a big issue. Similarly, Islamic capital markets to facilitate trade are underdeveloped in many jurisdictions, and there is little or no Islamic insurance (takaful) to cover associated trading risks. There is a particular lack of institutions specialised in absorbing large risk. These gaps leave companies with no choice but to obtain such services from conventional sources.
In many cases, companies are established or managed by non-Muslims who, although required to fulfil legal and regulatory requirements of specific jurisdictions, are not required to follow Sharīʿah rules. Such companies may get involved in impermissible business activities along with permissible ones, for example, borrowing on interest, earning interest on deposits, etc.

- The Sharīʿah respects the rights of non-Muslims. Even though some practices are prohibited for Muslims, the same may not be imposed on non-Muslims. This is particular to cases where the prohibition is solely based on religion such as eating pork and drinking liquor. Therefore, to a certain extent, some allowance needs to be made for such practices for non-Muslims.

Given this situation and the reasons behind it, Sharīʿah scholars, regulatory authorities and other Islamic finance players recognised the need to have criteria or methodologies for Sharīʿah screening of shares. Those criteria were to facilitate Muslim investors in identifying the shares which at least fulfil the conditions set in the criteria. Those conditions mainly focus on the core business of the company with exceptions that include certain Sharīʿah non-compliant activities. Hence, they can offer a list of shares of companies which do not have impermissible business and operations as their core activity, and their impermissible secondary activities are restricted or limited to tolerable benchmarks specified within each criterion.

The logic behind having a Sharīʿah stock-screening tool is to limit or control the Sharīʿah non-compliant activities of a company and, subsequently, restrict the participation of Muslim investors in such activities. This is to limit cooperation in sinful acts, a fundamental requirement imposed by the following verse of the Qurʾān:

\[\text{وَلَا تَعَوَّلُوا عَلَى الْأَنْثَى} \text{ وَالْخَيْرَاتُ}\]

Do not help one another towards sin and hostility (Qurʾān, 5: 2, Trans. Abdel Haleem, 2004).

**What should be screened?**

The first criterion of all the Sharīʿah screening methodologies is to exclude companies whose main business activity is impermissible. If the main business activity is Sharīʿah-compliant, whereas some secondary activities are not, examination turns to whether or not those secondary activities are within the tolerable benchmarks. One of the ways to examine those secondary activities is by the percentage of income generated from such activities. This component of the criteria is important because it not only facilitates the measurement of the level of compliance of a company but also indicates how much of the profit needs to be cleansed. The cleansing aspect is also vital for Muslim investors who take a stance that any income generated from a company’s Sharīʿah non-compliant activities is impure and thus must be cleansed.

To measure a company’s involvement in impermissible secondary activities, its financial operations need to be scrutinised. For this reason, Muslim investors are required to understand the composition of a company’s business conduct from two aspects:

1. the company’s general business activities; and
2. its financial operations.

The first aspect is covered under the “Sector and Activity Based Screening”, whereas the second aspect is dealt with under the “Quantitative or Financial Screening”. 


The quantitative or financial screening involves mainly two approaches:

(1) Ensuring that a company’s main assets are not predominantly cash or cash-related is the first approach. If a company’s main assets are cash based, trading of its shares is tantamount to trading of cash for cash at a discount or premium. This will trigger the issue of ribā (interest) because, in trading currencies or cash, the Sharīʿah rules of currency exchange (bayʿ al-ṣarf) should be observed. Similarly, a company’s main assets should not be in the form of debts (receivables); otherwise, the Sharīʿah rules of debt trading (bayʿ al-dayn) must be observed to avoid any element of ribā.

(2) Next approach is ensuring that a company is not involved directly or indirectly in ribā-related activities that exceed the tolerable benchmark specified within the criterion. The ribā-related activities of a company can be in two forms:

- investment and/or placement of cash in conventional or interest-based instruments; and
- acquiring funds from the capital market or banking sector through interest-based facilities.

It should be observed that the first approach considers all types of cash and debt regardless of whether they are Sharīʿah-compliant or not. If the cash or debt reaches or exceeds a certain threshold, the company will be regarded as a cash-based or debt-based company. Therefore, trading its shares at a discount or premium will trigger the issue of ribā. On the contrary, the second approach focuses on the involvement of the companies in ribā-related activities such as paying ribā in conventional loans or receiving ribā from investment activities. This approach, therefore, only takes into account the cash placed or invested in Sharīʿah non-compliant instruments. Similarly, only the conventional debt raised through Sharīʿah non-compliant instruments is taken into consideration in the calculation against a certain base.

It is worth noting that some criteria cater for both approaches, whereas some cater for the second approach only. For example, AAOIFI (2015) has a benchmark of maximum 70 per cent of the total value of all the assets of a company for cash and debt, whether they are Sharīʿah-compliant, Sharīʿah non-compliant or a mixture of both. It means that cash and debt of a company in any form should not exceed 70 per cent of the total assets. As for the second approach, AAOIFI (2015) suggests that cash placed in interest-based instruments should not exceed 30 per cent of the market capitalisation of the total equity of a company. And the interest-bearing debt of a company should not exceed 30 per cent of the market capitalisation of the company. In this way, AAOIFI (2015) covers both approaches in its Sharīʿah standards. In contrast, the Shariah Advisory Council of Securities Commission Malaysia (SAC-SC, 2017) only applies the second approach by having a benchmark of maximum 33 per cent of total assets for cash placed in conventional instruments, excluding deposits in Islamic accounts. The interest-bearing debt of a company also has a benchmark of maximum 33 per cent of total assets, excluding Islamic financing facility. With these filters, SAC-SC (2017) opts to observe the second approach only.

Another point to be noted from the above discussion is that some criteria use total assets of a company as a measuring tool for their filters. For instance, SAC-SC (2017) has adopted total assets to compare interest-earning cash and interest-bearing debt against them. On the contrary, AAOIFI (2015) has suggested market capitalisation of a company to be used for comparison of cash and debt against it. Market capitalisation is the total dollar market value of all outstanding shares of a company. It is calculated by multiplying a company’s shares
outstanding by the current market price of one share. Investors use this figure to determine a company’s size, as opposed to sales or total assets figures.

**ISRA-Bloomberg screening methodology**

Similar to other screening criteria, the ISRA-Bloomberg screening methodology also has sector- and activity-based screening. After screening out the companies having impermissible main business activities, it focuses on companies with mixed activities. The sector- and activity-based filter ensures that impermissible secondary activities of companies are within a tolerable benchmark. This is captured by the income generated from such activities. Based on the market norm and established custom, the criterion suggests that the income from such activities should not exceed 5 per cent of the total income of a company, which is termed as revenue. The formula for calculating the ratio is (Table I).

The threshold of 5 per cent is important to indicate that Sharīʿah non-compliant activities of a company are minor, and, therefore, the overall investors’ participation in the company should not be regarded as assisting in the growth of the impermissible activities of the company. This is in line with the majority of existing Sharīʿah stock screening criteria. For example, AAOIFI (2015) Sharīʿah Standard No. 21 states:

That the amount of income generated from prohibited component does not exceed 5 per cent of the total income of the corporation irrespective of the income being generated by undertaking a prohibited activity, by ownership of a prohibited asset or in some other way (AAOIFI, 2015, p. 563).

It is also important to highlight here that the basis of this 5 per cent threshold is inferred from the corporate view that below 5 per cent shareholding is still a minor position taken in the company because a shareholding of more than 5 per cent will enable a wider spectrum of rights and more active participation of the shareholder. Therefore, the 5 per cent threshold is considered an insignificant participation in the company’s activities and as such the company that has business activities that do not reach this threshold may still be considered Sharīʿah-compliant.

However, the unique element in the ISRA-Bloomberg methodology is that the platform highlights the degree of Sharīʿah non-compliant activities of companies. It does not merely list them as Sharīʿah-compliant companies. Company ABC, for instance, may be listed as a Sharīʿah-compliant company with 4.7 per cent of its income coming from Sharīʿah non-compliant activities. This extra feature will bring mainly two benefits to investors:

- Better decisions can be made on whether to buy, hold or sell shares of Sharīʿah-compliant companies which are near the 5 per cent threshold.
- The amount of dividend cleansing can easily be done based on the disclosed percentage of income derived from Sharīʿah non-compliant activities.

Operationally, activities of companies are categorised in different colours to identify their Sharīʿah-compliant status. The different colours shown are the result of a sophisticated consideration process. The companies which are completely Sharīʿah non-compliant are highlighted in red; the companies which are completely Sharīʿah-compliant are shown in white; and the companies which have mixed activities are shown in blue. The companies in

<table>
<thead>
<tr>
<th>Table I. Criterion for Sharīʿah non-compliant income</th>
<th>Formula</th>
</tr>
</thead>
</table>
| Sharīʿah non-compliant income tolerance test | \[
\frac{\text{Income from prohibited activities}}{\text{Total revenue}} \leq 5\%
\] |

IJIF 9,1

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red and the companies which have exceeded the tolerable benchmark in blue are excluded from the Sharīʿah-compliant universe. In addition, the system can compute how much income (the exact amount) is from impermissible activities based on the revenue segment, which may be coded either red or blue. This system helps investors in precisely knowing which type of sectors and activities the companies are operating and involved in.

The blue-coding basically indicates the following:

- It is not known if the company’s activities in a sector are Sharīʿah compliant or not, for example, the category of “Food and Beverages”. In this regard, company’s activities in the sector are regarded as Sharīʿah non-compliant unless declared otherwise by the company. The declaration must fulfil certain criteria including its transparency in Bloomberg’s portal. For instance, a company may declare through a supplementary document that it is only involved in halāl food and beverages. Based on this declaration, the “blue status” may be changed to “white”.

- The sector and activity may involve mixed activities. Part of those activities may be regarded as Sharīʿah non-compliant. “Hotel” is an example where its activities include accommodation (Sharīʿah-compliant) and non-halāl food and beverages and liquor bar (Sharīʿah non-compliant). In this regard, the sector and activity will be regarded as Sharīʿah non-compliant except if declared otherwise by the company. Similar to the previous case, in this case as well, the company has to follow the same procedure to be included in the Sharīʿah-compliant list.

After the sector screening, the companies are subject to financial screening. There are two financial ratios that need to be met. These are cash-based ratio and debt-based ratio. If a company does not meet the tolerable benchmark of these two ratios, shares of the company will not qualify as Sharīʿah-compliant. The ratios and their benchmarks are stated below (Table II).

It should be noted from the above table that the ISRA-Bloomberg screening methodology has adopted the second approach in quantitative or financial screening mentioned previously, which is aligned with the approach of SAC-SC (2006). This is based on the argument that shares actually represent the “business” of the companies regardless of whether assets of the companies are in the form of cash, receivable (debt) or physical assets. Therefore, the issue of debt trading does not arise. It is worth noting here that under this methodology, the shares of Islamic banks can be listed as Sharīʿah-compliant stocks and hence can be traded, even though most of their assets are in the form of receivables created by financing activities.

In principle, the methodology uses market capitalisation to compare the benchmarks against whenever the value of the 24-month market average goes above the value of the assets. It is argued that the calculation should be based on market capitalisation because, under this scenario, it represents the true market value of a company, i.e. the real value of a company that the investor is willing to pay for. This is also in line with AAOIFI (2015). This principle is applicable to certain companies that operate without owning many physical assets, for example, Uber and Airbnb, which generate revenue from assets that mostly belong to others.

The 24-month market average is used because it reflects a more stable and reliable figure of the value of the company, particularly, during periods of financial instability or crisis.

The methodology will also use the assets of the companies to compare the benchmark against them under exceptional cases such as for newly listed companies.
### Table II.
Criteria for cash and debt based ratios

<table>
<thead>
<tr>
<th>Benchmark</th>
<th>Formula</th>
</tr>
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| **Cash-based** | \[
\frac{\text{Cash}^1 + \text{Interest bearing securities}^2}{24\text{ months average market capitalization}} \leq 33\%
\] (or Total Assets or under exceptional condition) |
| **Debt-based** | \[
\frac{\text{Debt}^3}{24\text{ months average market capitalization}} \leq 33\%
\] (or Total Assets under exceptional condition) |

1: Cash only includes cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments is excluded from the calculation. In the case of no information provided by the companies to distinguish whether the cash placed in Islamic accounts and instruments or otherwise, the system will assume that all the cash is placed in conventional accounts and instruments. Hence, the companies are required to provide evidence (i.e. supplementary documents) to show that the cash is placed in Islamic accounts and instruments if they want deduction to be made.

2: Interest-bearing securities include both short-term and long-term instruments.

3: Debt only includes interest-bearing debt, whereas Islamic financing or *sukūk* are excluded from the calculation. Debt may consist of interest-bearing both short-term and long-term borrowings and finance lease liabilities. The amounts are available from the liability side of the statement of financial position.

**Short-Term Debt:**
- Short-term debt includes bank overdrafts, short-term debts and borrowings, repurchase agreements (repos) and reverse repos, the short-term portion of long-term borrowings, current obligations under capital (finance) leases, current portion of hire-purchase debt, trust receipts, bills payable, bills of exchange, bankers' acceptances, interest-bearing loans and short-term mandatory redeemable preferred stock. It also involves short-term debt netted with unamortised premium or discount on debt, and may include fair value adjustments of embedded derivatives. The category of “banks and financials” includes call money, bills discounted, federal funds purchased and what is because of other banks or financial institutions.

**Long-Term Debt:**
- Long-term debt includes:
  - All interest-bearing financial obligations that are not due within a year
  - Convertible, redeemable, retractable debentures, bonds, loans, mortgage debts, sinking funds and long-term bank overdrafts
  - Long-term portion of long-term debt, pension obligations
  - Subordinated capital notes
  - Long-term hire purchase and finance lease obligations
  - Long-term bills of exchange and bankers’ acceptances
  - Mandatory redeemable preferred and trust preferred securities
  - Other debt which is interest bearing

**Calculation of Interest-Bearing Debt:**
- Borrowings X
- Finance lease liabilities X
- Bank Overdraft X
- Other interest-bearing debt X
- Total interest-bearing debt X*

* Debt based on Islamic financing or *sukūk* to be deducted from the total if these amounts are included in the calculation. Similarly, in case no information is provided by a company to distinguish whether the debt is based on Islamic financing or *sukūk* the system assumes that all the debts are interest-bearing debts. Hence, companies are required to provide evidence (i.e. supplementary documents) to show their debts are based on Islamic financing or *sukūk* if they want the deduction to be made.
where the market capitalisation is unknown or under bad economy situation where the market is considered as "too much under value". These exceptional situations shall be determined in a clear manner to avoid manipulation by any party. The justification to revert to the assets under the said situation is because of the fact that it represents the tangible value of the companies.

It can be observed from the above explanation that ISRA-Bloomberg Methodology is unique in the sense that it relies on both 24-month market average and total assets under certain conditions to compare the benchmark against.

**Cleansing methodology for stocks**

If a company passes the above proposed criteria, its shares will be considered Sharīʿah compliant for investment purposes. Despite that, because such companies are involved in some impermissible secondary activities, part of the income generated from them is impermissible for Muslim investors to retain. The Qurʾān states:

> Andaเยื้อม فَلَم رَأَى الْأَمِينُ أَنَّ فَلَمْ لا تُطَلَّقَنَّ وَلا تُطَلَّقَنَّ

You shall have your capital if you repent, and without suffering loss or causing others to suffer loss (Qurʾān, 2: 279, Trans. Abdel Haleem, 2004).

This verse discusses the effects of the prohibition of *riba* in loans. It indicates clearly that the lender is entitled only to the loan principal and not to the interest portion. The principal is the permissible portion here, and the interest is the prohibited portion. In other words, a Muslim should not recognise any income that originated from interest or other impermissible activities. The Prophet (ﷺ) mentions:

> There is no flesh nourished by the unlawful except that the fire is more appropriate for it (Al-Tirmidhi, 1975, Vol. 2, p. 512, *hadith* no. 614).

This *hadith* has established a very important principle that the source of wealth or income should be permissible. The consumption of wealth or income that originated from impermissible sources may lead a person to the fire in the hereafter.

Therefore, it is important for Muslim investors to avoid the income generated from the impermissible activities of the company whose shares they hold. In other words, such income requires special treatment, known as cleansing or purification, which will be discussed in the following section.

Cleansing of stocks can be defined as:

> The process of identifying, separating and channelling the impermissible income of the stocks to charity (Hashim and Habib 2017, p. 66).

The cleansing methodology basically focuses on what needs to be cleansed from the income of the stocks and how it is cleansed. There are a number of scenarios in the context of stock trading that require cleansing of income. The first scenario involves cleansing the Sharīʿah non-compliant portion of income from Sharīʿah-compliant shares while an investor continues to hold the shares. The second scenario involves cleansing capital gains realised from selling Sharīʿah-compliant shares. The third scenario involves the cleansing of any income generated during the process of disposing of shares that have been excluded from the Sharīʿah-compliant list after the latest periodic review. The fourth scenario involves the cleansing of any Sharīʿah non-compliant income from shares excluded from the Sharīʿah-compliant list that an investor continues to hold. Each scenario has its specific Sharīʿah rulings, which are discussed below.
Cleansing Sharī‘ah non-compliant income while holding Sharī‘ah-compliant shares

As discussed earlier, there is a maximum threshold of 5 per cent of total revenue for income generated from any Sharī‘ah non-compliant activities of a company. In other words, a company may remain in the Sharī‘ah-compliant list if its income from Sharī‘ah non-compliant activities remains at 5 per cent or below. The question is whether or not that small portion of Sharī‘ah non-compliant income must be cleansed.

It is worth noting that while holding shares of a company, investors may earn cash income from the dividends distributed by the company. They may also earn non-cash income such as bonus shares. They might also be awarded with warrants or options to subscribe to preference shares. These warrants or options may be sold to other investors. Hence, the benefits realised from shares of a company can be divided into two main categories:

1. Cash income from dividends; and
2. Non-cash benefits such as bonus shares, warrants, options or others.

Cleansing of cash income from dividends. The approach of ISRA-Bloomberg for cleansing cash income is that the cleansing is made in proportion to the percentage of Sharī‘ah non-compliant activities of the company. For example, according to the audited financial report of Company A, 3 per cent of the income is generated from Sharī‘ah non-compliant activities. Therefore, 3 per cent of the dividend distributed by the company should go to charity as a result of the cleansing process.

Though the above methodology looks simple, it is not easy for investors to know the exact percentage of income generated from Sharī‘ah non-compliant activities except by performing a deep analysis and calculation based on the financial audited report of a company. It is observed that almost all index providers or institutions conducting Sharī‘ah screening of stocks only provide information on whether or not a company is in the list of Sharī‘ah-compliant stocks. It is difficult for investors to find out the exact percentage of impermissible income. On the contrary, the ISRA-Bloomberg platform provides the exact percentage of income generated from Sharī‘ah non-compliant activities so that investors can accordingly cleanse the cash income with enhanced reliability and ease.

Cleansing of non-cash benefits. As stated earlier, these benefits can be in the form of bonus shares, warrants, options or others. The approach of ISRA-Bloomberg in this regard is that there is no cleansing required for such benefits, simply because there is no direct cash inflow to the investors. Though on paper it is recorded that the investors will have more shares, the cash income from those additional shares will only flow in through the next cycle of dividend distribution.

No cleansing is needed for warrants and options for the same reason: no income is received by the investors in these cases. Instead, the investors’ money flows out when they exercise warrants and options. The cash income flows in through the next cycle of dividend distribution; hence, the cleansing exercise will then be performed at that particular point of time. Nevertheless, if the investors choose to sell their rights in the form of warrants and options, then cleansing of the income received from them is required. This is because of the fact that the investors, in this case, have converted the “dividend” in the form of warrants and options into cash income. Therefore, the same rule of cash dividends is applied here.

Cleansing of capital gains received from selling Sharī‘ah-compliant shares

The treatment of capital gains from the cleansing perspective remains under debate. Some scholars such as Sheikh Taqi Usmani suggest that it is a safe approach to cleanse capital gains from selling shares. It is based on the understanding that the market price might
reflect an element of interest or impermissible income (Usmani, 2002). On the contrary, ISRA-Bloomberg opines that there is no need to cleanse capital gains. It is argued that the change in the stock price does not directly reflect interest or other income generated from Sharīʿah non-compliant activities of a company. In reality, the changes in stock price in the market comprise a complex phenomenon that is attributed to multifarious factors, including supply and demand. Therefore, capital gain is not direct income from Sharīʿah non-compliant activities. Moreover, the stock price in the market basically reflects the price that the buyer is willing to pay to acquire those shares. It would be far from reality to think that the investors consider interest or impermissible income during trading shares as the principal factor or objective of the transaction, especially when it is in a negligible amount (less than 5 per cent of the total revenue in this case). This opinion is based on the Islamic legal maxim stating:

ِيَغْفِرُ اللَّهُ مَا بَعْدَ ذَلِكَ مَا يَغْفُرُ مِنْهُ مَنْ

Something can be forgiven as the subsidiary which cannot be forgiven as the principal (Al-Zuhayli, 2006, vol. 1, p. 447).

The above maxim proposes that when a factor or element is subsidiary to a principal factor or element, it might be overlooked in issuing the Sharīʿah ruling for the whole case, whereas that element cannot be overlooked otherwise. Putting it in the context of cleansing capital gains, it can be said that the interest or impermissible income is definitely a subsidiary factor. Therefore, it seems more appropriate to exclude capital gains from the income cleansing process.

**Cleansing of income generated during the process of disposing the shares that have been excluded from the Sharīʿah-compliant list**

In principle, investors are not supposed to hold any share that has been excluded from the Sharīʿah-compliant list. In other words, investors should dispose of it by selling it in the market. The reason for this requirement is to stop investors from helping or contributing in impermissible activities, as per the previously mentioned Qurʾānic verse:

َوَلَا تَعَارَوْنَ عَلَى الْإِمَامِ وَالْأَذْوَانِ

Do not help one another towards sin and hostility (Qurʾān, 5: 2, Trans. Abdel Haleem, 2004).

Holding shares of companies that are deeply involved (beyond the threshold) in Sharīʿah non-compliant activities could be considered as “helping” those companies in their prohibited activities. Therefore, those shares should be disposed of.

In disposing of such shares, the main issue to be clarified is the price of such shares that can be considered as the baseline (principal), which investors would be allowed to keep as their capital. In other words, the following should be decided: how much of the capital gains from selling such shares can be retained by the investors and how much should be cleansed. This is in line with the verse of the Qurʾān (2: 279) cited above where investors are eligible to receive their capital without suffering loss or causing others to suffer loss.

In the methodology of ISRA-Bloomberg, the baseline or principal is the acquisition price or the price of shares on the pronouncement date, whichever is higher. It is logical to see the acquisition price as the principal amount because this is the actual price paid by the investors when they acquired such shares.

For example, an investor has acquired a particular Sharīʿah-compliant share on 1 November 2000 at US$1.00 per share. On 1 November 2016, the price of the said share has increased to US$15.00 per share. On the same date, the share was declared Sharīʿah non-
compliant. On 2 November 2016, the investor sold the share at US$15.50 per share. Under this scenario, the principal is the share price on the day of pronouncement (US$15.00). The investor is entitled to retain the price on the pronouncement date because such increase in value occurred while the share was regarded as Sharīʿah-compliant. Any price increment thereafter (in this example, it is 50 cents) should be channelled to charity and should not be recognised as income.

In another scenario, let us assume that price on the pronouncement date (1 November 2016) fell below the acquisition price at US$0.95 per share. Under this scenario, the principal should be US$1.00 per share which is the acquisition price. However, it should be noticed that, in this case, if the investor decides to sell the share on the same date, he would not be able to receive back his principal (US$1.00 per share), as the price is US$0.95 per share. Therefore, the investor can hold the share and wait until either the price of the share goes back to US$1.00 or the company pays dividends which can compensate for the loss incurred by the investor because of cleansing. In other words, the investor can receive back his principal through capital gains and dividends both.

**Cleansing of income generated during the process of holding shares that have been excluded from the Sharīʿah-compliant list**

It is understood that once a share is declared as Sharīʿah non-compliant, investors need, on the one hand, to dispose of that share as soon as possible and, on the other hand, to get back their principal amount. However, it is possible that an investor, particularly an institutional investor, sometimes holds a very large number of shares. To dispose of such a number at a price that enables recovery of the principal amount requires a very long period. It is possible that during this period, the share is included again in the Sharīʿah-compliant list. It is likely to happen in the case of companies whose activities or financial ratios marginally exceed the threshold.

In the methodology of ISRA-Bloomberg, it is allowed for the investors to hold such shares, and they do not need to dispose of them. However, the issue here is how to decide whether or not a difference of ratio is marginally above the threshold. For instance, if a company’s debt ratio exceeds 33 per cent of its 24-month average market capitalisation, how can it be decided whether or not the difference is marginal? According to the methodology of ISRA-Bloomberg, a difference of 5 per cent can be tolerated. Nevertheless, it is important to be clear that the original benchmarks of the ratios remain as they are and continue to apply in general and that this extra 5 per cent is tolerated only for this particular scenario. In this scenario, investors do not need to immediately dispose of the shares which have been excluded from the Sharīʿah-compliant list because of a marginal difference of only 5 per cent. Moreover, there are three main requirements which need to be fulfilled in this scenario:

- Any impermissible income received in the form of dividends should be channelled to charity. This is to ensure that only cleansed income is realised by Muslim investors.
- Investors need to continuously monitor the trend of the ratios specified in the criterion by taking into account interim financial reports of the company. Most publicly listed companies issue their interim financial reports on a quarterly basis or any other intervals. While holding shares under this scenario, investors must be more sensitive towards the movements in the trends or ratios of the company. Through interim financial reports, investors can get an indication of whether or not the company is likely to make its way back to the Sharīʿah-
compliant list. Investors may continue to hold the shares if the company is moving towards greater Sharīʿah compliance. On the contrary, investors should dispose of the shares if the company is heading in the wrong direction.

- If investors decide to sell the shares of such a company, any capital gains above the acquisition price or the price on the pronouncement date, whichever is higher, should be channelled to charity. In this case, the same principle of disposing of Sharīʿah non-compliant shares is applicable. This condition is applied to avoid any exploitation by investors through “arbitrage”, whereby investors may benefit from the price movement during the holding period.

Limitations in the screening and cleansing processes and some recommendations

It is generally observed that many index providers and organisations performing Sharīʿah screening of stocks carry out stock screening and cleansing with due diligence. Similarly, the ISRA-Bloomberg methodology is also used with the best efforts to ascertain that the screening and cleansing processes are as accurate and thorough as possible. The accuracy and thoroughness of these processes are crucial in maintaining reliability of the output and market confidence. However, there are many limitations and major hurdles in performing these processes with precision. Some of them are highlighted in this section, along with some suggestions on how to minimise their negative effects.

The main source of information in determining the Sharīʿah non-compliant revenue of a company is its audited financial statements. These statements are not “current”; rather, they reflect the activities of a company that occurred during the previous financial year or period. This poses a great challenge in determining the amount of income to be cleansed. Therefore, the amount may not be an accurate reflection of the company’s actual position during the period of dividend calculation, particularly when the dividend is distributed in the middle of the financial year. More accurate data could be supplied by companies if they wanted to do so. However, because this is not a requirement of any accounting standard or relevant regulatory body, the best available data are limited to the audited financial statements of a company. Some companies might provide a few interim statements in between the annual financial audited statements. However, these interim statements are not officially audited and, therefore, are not as reliable as the audited financial statements.

Another obstacle in screening and cleansing exercises is the format of financial audited statements. The statements are prepared in different forms according to regulations and requirements of different jurisdictions. Most jurisdictions have adopted International Financial Reporting Standards as the format for their financial reports. While some other countries use other standards. The point here is that these standards have not been designed to cater for matters related to the Sharīʿah. There is no requirement, for example, to differentiate between income from the sale of permissible and impermissible products or between placing capital in Sharīʿah-compliant or Sharīʿah non-compliant instruments. Therefore, the screening and cleansing methodology is only based on whatever information is available to the index providers or organisations carrying out screening or cleansing exercises.

Another main hurdle facing the screening and cleansing process is that, in most cases, screening and cleansing exercises are done by private organisations or index providers. There are few regulators that perform these exercises. In Malaysia, for example, the Sharīʿah screening of listed stocks is undertaken by the Shariah Advisory Council of the Securities Commission Malaysia (SAC-SCM). The SCM complies with the decision of the
SAC and publishes the list of Sharīʿah-compliant stocks twice a year. However, in other countries, screening of stocks is generally performed by private organisations rather than by the regulatory authorities. For instance, both Dow Jones and FTSE have introduced global Islamic indices which track the performance of securities approved by their Sharīʿah boards. Some others such as IdealRatings issue the list of Sharīʿah-compliant stocks based on the criteria outlined by AAOIFI.

The main issue with private organisations performing screening of stocks is that they solely rely on the financial audited statements of companies. It is difficult for them to obtain more information. Regulators on the other hand, because of their authoritative position, can ask the companies to furnish more information for the purpose of screening their stocks. To elaborate further, let us assume that a company states in its financial audited statement that its income from the sale of food products is ten million. If a regulator is screening the company, it can ask the company to provide a detailed breakdown of impermissible and permissible food items if there is any. The company has to supply the required information. In contrast, private organisations cannot ask the company to provide the required information. Therefore, screening done by regulators is sometimes more accurate because of extra information that they can acquire from the companies.

However, it is also important to highlight here that a regulator’s authority is limited to its own jurisdiction only. The authority of the SCM, for example, is limited only to the companies listed on Bursa Malaysia (Malaysian Stock Exchange). It does not have authority to ask a company listed on the Singapore Stock Exchange to provide such information. That is why it can be observed that, in general, regulators only screen companies which are listed on the stock exchange of their own jurisdictions. On the contrary, private organisations screen companies based on their own database without such restriction.

**Conclusion**

This paper explains the Sharīʿah screening and cleansing criteria for shares with particular focus on the ISRA-Bloomberg’s methodology in both aspects. The ISRA-Bloomberg methodology is based on the best efforts from ISRA and Bloomberg by combining Sharīʿah expertise, market data and analytics. It is not only unique in the sense that its methodology relies on stronger Sharīʿah justification and rationale but also exceptional in terms of coverage of stocks as Bloomberg is one of the world’s most renowned databases because of its comprehensiveness. Leveraging on such synergy between ISRA and Bloomberg, the methodology may add a new dimension to the Sharīʿah screening of stocks and cleansing exercise.

In terms of specific features, the ISRA-Bloomberg platform boasts a novel colour-coding approach which would provide knowledge of the status of a particular share that is easy for the users/investors to interpret. Moreover, it also provides the exact ratios of the Sharīʿah compliance criteria to facilitate the investors closely observing changes in the trend of ratios. That would enable investors to decide whether or not a company is likely to remain within the tolerable benchmarks of the Sharīʿah-compliance criteria. Finally, the formulas used for the financial ratios in the Sharīʿah-compliance criteria are taken based on the best practice approach, which may or may not concur with most of the current leading Sharīʿah stock screening providers.

Subsequently, this paper discusses cleansing of the income or profit from the Sharīʿah perspective and how it should be applied in the context of stocks. Understanding the cleansing process of the income or profit generated from stocks is pivotal for managing and maintaining a Sharīʿah-compliant stock portfolio.
It is believed that the methodology of Sharī‘ah screening and cleansing of stocks will be well received in the global market and will enhance the Sharī‘ah screening of shares and income cleansing exercises worldwide.

References


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Causes and solutions for the stagnation of Islamic banking in Turkey

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Kuveyt Türk Participation Bank Research & Development Center, Kocaeli, Turkey

Abstract

Purpose – This paper aims to evaluate the root causes of stagnation of the Islamic banking sector in Turkey in three steps and proposes solutions and policy recommendations.

Design/methodology/approach – First, global Islamic banking practices in terms of governance and instruments are summarised and compared with the Turkish experience. Second, the financial and efficiency ratios of Turkish Islamic banks (IBs) and conventional banks (CBs) are compared and analysed for the period 2005 to 2015. Finally, the long-term growth strategy of Turkish IBs is evaluated.

Findings – This paper asserts that Islamic banking in Turkey diverges from Islamic banking practices of prominent countries by not having a Sharīʿah governance framework at either a national or bank level. Turkey is thus immediately in need of a sound Sharīʿah governance framework. Increasing the variety of instruments and improving the perception of Islamic banking in the society are other critical points. Furthermore, regulatory and research institutions specifically focusing on Islamic banking are insufficient. A large number of financial and efficiency ratios reveal that the efficiency and profitability of IBs fall behind that of CBs. IBs should improve their business models, operational efficiencies and information technology infrastructure as these issues are undervalued in their growth strategy.

Originality/value – This study sheds light on the Turkish Islamic banking sector, which is a rarely studied topic. It is the first study that provides institutional differences of banking practices and evaluates the efficiency status and growth strategy of IBs in Turkey.

Keywords Islamic banking, Profitability, Sharīʿah governance, Turkish participation banking

Paper type Research paper

Introduction

The Ernst & Young World Islamic Banking Competitiveness Report (EY, 2016, p. 10) reveals that international participation banking assets reached US$882bn and have spread widely from the Gulf to the Far East. There are more than 900 Islamic financial institutions (IFIs) according to Thomson Reuters Islamic Finance Development Report 2014 (ICD Thomson Reuters, 2014, p.34).
While Islamic banking, which is called “participation banking” in Turkey, started there in 1985, at roughly the same time as other Muslim countries, it has failed to reach the market share levels of other successful countries. Islamic banking in Turkey was initially established under the name “Special Finance Houses” (SFHs) without making any reference to Islamic requirements because of the secular political culture of the country. Islamic banking stayed at a crawling stage for a long time because the secular sensitiveness hampered the improvements required to catch up with the global practices of Islamic banking (Asutay, 2013). In 2002, the Justice and Development Party, which has a strong bond with the Islamic heritage, won the majority in Parliament, whereupon conditions for Islamic banking started to improve. In 2005, a new banking law brought a legal framework which is deemed more sound, entitling the SFHs to be recognised as participation banks (PBs)[1]. Recently, two state banks established Islamic banking subsidiaries with very ambitious targets.

Even though both the political and economic situations have substantially improved[2] over the past 15 years, the market share of Islamic banks (IBs) has stagnated at around 5 per cent, which is quite small compared to countries such as Malaysia (21 per cent), Qatar (26 per cent) and Kuwait (45 per cent). Thus, Islamic banking in Turkey still remains as a “big potential”.

The purpose of this study is to critically review the global Islamic banking practices and identify how Islamic banking in Turkey resembles or differs from Islamic banking in other prominent countries. This study also examines a large number of key ratios reflecting business models and efficiency of conventional banks (CBs) and IBs in Turkey between 2005 and 2015 to provide a more comprehensive picture of the problems and to recommend workable solutions.

The rest of the paper is organised as follows:

- the next section summarises the global practices of Islamic banking;
- this is followed by an explanation of the progress of the Turkish Islamic banking experience along with a comparison of financial and efficiency ratios of PBs; and
- the final section then concludes the paper.

**Islamic banking practices**

The progress of the Islamic banking industry has followed different paths in different countries/regions, based on their diverse political, cultural, religious environments and financial structures. Full-fledged IBs were first launched in Saudi Arabia (1974), the United Arab Emirates (UAE) (1975), Kuwait (1977), Bahrain (1978) and Malaysia (1983). While Islamic banking has been spreading over the world, Iran (1979), Pakistan (1980) and Sudan (1984) tried to convert their banking systems into Islamic. However, Sudan and Pakistan left off and turned back to a dual banking system later (Imam and Kpodar 2010). Even though Iran banned interest-related transactions, it is said that it is said that interest has not been fully removed from the monetary and banking system (Hassani, 2010). The UK’s interaction with Islamic banking started with wholesale banking. UK banks provided deposit accounts with *murābahah* markup to IBs in the Gulf region based on London Metal Exchange rates. Afterwards, the first IB of the UK was established in 1982 (Ainley et al., 2009).

The annual growth of international participation banking assets is 15-20 per cent, and, between 2010 and 2014, assets increased from US$490 to 882bn (EY, 2016, p. 10). In terms of market share, Figure 1 reports the changes in domestic markets. It is noted that even with a very small base level, changes in market share in Turkey are far from satisfactory compared with other countries.
Governance and regulations

Banking is a highly regulated sector. A sound regulatory framework is the foremost requirement for the success of the industry. Moreover, governments should provide the necessary confidence by protecting banks and depositors against liquidity shortfalls and bankruptcies. Modern Islamic banking is not independent from the aforementioned issues. Malaysia is a very good example of how government support and planning is fructuous. The Malaysian government initially established a council to study how to set up Islamic banking in 1981, and the first Malaysian IB was launched in 1983. Afterwards, the Islamic money market (1983) and the first *takāful* company (1985) were established. In 1990, Malaysia issued its first *ṣūkūk* and has presently become one of the leaders in the global *ṣūkūk* and Islamic finance markets[3]. The UK failed to support Islamic banking and stumbled at its first attempt because of tax and regulative disadvantages faced by IBs (Wilson, 2010). In 2000, a working group was established by the Bank of England to study how to make Islamic banking sustainable (Hasan, 2009). This resulted in new and efficient regulations, and Islamic banking started to flourish (Khan and Bhatti, 2008).

From a regulatory point of view, almost every country has its own way of governing the Islamic banking sector. Debate is ongoing whether this heterogeneity is the main reason for the lack of standardisation in Islamic finance instruments. For example, Malaysia has a detailed regulatory framework for Islamic banking. The Shariah Advisory Council was set up under the aegis of the central bank in 1997, and it has been the highest authority for Islamic banking matters since 2009 (Hasan, 2009). IBs also must have their own Sharīʿah boards. Indonesia has no separate Islamic banking law (Zaher and Hassan 2001). The central bank is responsible for prudential issues related to IBs just as it is for CBs; however, religious issues are handled by the National Sharīʿah Board of the Ulama Council of Indonesia (Lindsey, 2012). Legal disputes regarding Islamic banking are handled by the Sharīʿah court (Majid and Ghazal, 2012). IBs have separate Sharīʿah boards, and CBs are allowed to have Islamic windows.

Although the Gulf Cooperation Council (GCC) countries have very common economic, political and cultural attributes, they have considerably different practices for Islamic banking. Saudi Arabia does not specifically regulate IBs. There is no National Sharīʿah Board, and IBs are not obliged to have Sharīʿah boards. It does not even mention the term interest and neither regulates nor prohibits it (Hasan, 2009). Even with this peculiar framework, IBs have been able to reach 51 per cent market share, and banks do have Sharīʿah boards even though it is not necessary. Table I provides the basic statistics related to Islamic banking for a number of countries.

![Figure 1. Changes in market share of Islamic banking](https://example.com/figure1.png)

**Source:** EY (2016, p. 13)
<table>
<thead>
<tr>
<th>Country</th>
<th>Population (millions)</th>
<th>Muslim population (%)</th>
<th>GNI per capita 2013 (USD)</th>
<th>Islamic banking market share (%) (2014)</th>
<th>Islamic banking global market share (%) (2014)</th>
<th>National Shariah Board</th>
<th>Islamic bank level Shariah board</th>
<th>AAOIFI accounting standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>1.3</td>
<td>81.20</td>
<td>21,050</td>
<td>29.30</td>
<td>1.60</td>
<td>Exists</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Indonesia</td>
<td>257.56</td>
<td>88.1</td>
<td>3,511</td>
<td>3.7</td>
<td>2.5</td>
<td>Exists</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Kuwait</td>
<td>3.89</td>
<td>86.40</td>
<td>52,000</td>
<td>45.20</td>
<td>10.10</td>
<td>None</td>
<td>Required</td>
<td>Not required</td>
</tr>
<tr>
<td>Malaysia</td>
<td>30.33</td>
<td>61.4</td>
<td>10,551</td>
<td>21.3</td>
<td>15.5</td>
<td>Exists</td>
<td>Required</td>
<td>Not required</td>
</tr>
<tr>
<td>Oman</td>
<td>4.49</td>
<td>87.70</td>
<td>16,870</td>
<td>7.5a</td>
<td>N/A</td>
<td>None</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Qatar</td>
<td>2.23</td>
<td>77.50</td>
<td>89,950</td>
<td>25.80</td>
<td>8.10</td>
<td>None</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>31.54</td>
<td>97.10</td>
<td>25,140</td>
<td>51.20</td>
<td>33</td>
<td>None</td>
<td>Optional</td>
<td>Not required</td>
</tr>
<tr>
<td>Turkey</td>
<td>78.66</td>
<td>98.60</td>
<td>10,260</td>
<td>5.50</td>
<td>5.10</td>
<td>None</td>
<td>Optional</td>
<td>Not required</td>
</tr>
<tr>
<td>United Arab Emirates (UAE)</td>
<td>9.15</td>
<td>76.00</td>
<td>43,860</td>
<td>21.60</td>
<td>15.40</td>
<td>Exists</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>United Kingdom (UK)</td>
<td>65.10</td>
<td>4.6</td>
<td>42,350</td>
<td>&lt;1</td>
<td>&lt;1</td>
<td>None</td>
<td>Optional</td>
<td>Not required</td>
</tr>
</tbody>
</table>

Notes: aOman Islamic Bank market share is 2015 data; bFatwa Board in the Ministry of Awqaf handles Shariah-related disputes
Source: Data derived from EY Islamic Bank Competitiveness Report 2016, World Bank and Sesric databases
Bahrain is distinctive with its regulation-oriented approach and hosts crucial Islamic finance institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency and the Liquidity Management Center. Bahrain has a National Sharīʿah Board which is at the advisory level (Shanmugam and Zahari, 2009). The UAE, a federal union of seven emirates, has two different Sharīʿah governance frameworks as IBs in Dubai have to comply with the Dubai Financial Services Authority (FSA) (Hasan, 2009). The Sharīʿah governance in the UAE can be considered as more restrictive. The National Sharīʿah Board decisions are binding. Further, IBs have to get approval from the National Sharīʿah Board before assigning scholars to bank-level Sharīʿah boards. IBs in both Bahrain and the UAE have to comply with the AAOIFI accounting standards. Kuwait can be considered as less restrictive as the AAOIFI framework is not a must and Sharīʿah boards of banks are appointed by the bank management. Bahrain, the UAE, Kuwait and Qatar all consider Islamic law as the main legislative source but make exceptions for commercial transactions and allow interest-based transactions.

Oman resisted implementing Islamic banking for political reasons (Hasan, 2009). In May 2011, Islamic banking products were allowed along with conventional ones (Magd and McCoy, 2014) to attract capital from other GCC countries. Its market share reached 7 per cent in three years.

As a non-Muslim country, the UK does not have a national Sharīʿah board. There is also no requirement for IBs to set up their own Sharīʿah boards, and Islamic windows are allowed. The FSA allows banks to have Sharīʿah boards as long as their role is not executive. The FSA also expects IBs not to adopt a Sharīʿah governance framework tied to a jurisdiction outside of the UK (Hasan, 2009).

The overall picture of Islamic banking practices indicates a strong relationship between the development of Islamic banking and government support as well as regulations related to Islamic banking. Almost all prominent countries have the necessary regulatory frameworks and the solid intention to enlarge their Islamic banking sectors. The only exception seems to be Saudi Arabia, which is silent on the term “interest” and on Islamic banking. However, this negligence is not meant to discourage Islamic banking; instead, its implicit purpose is to allow the existence of conventional banking. Meanwhile, there are very different practices regarding Sharīʿah governance. National Sharīʿah boards, if they exist, mostly perform in an advisory capacity as their decisions are not binding for the IFIs, and the overall banking systems work with conventional banking principles.

**Instruments**

Instruments have a crucial role in Islamic banking as its raison d’être comes from the prohibition of interest in Islamic law. IBs are obliged to use Sharīʿah-compliant instruments for both the asset and liability sides, as well as for liquidity and risk management. Put simply, a commercial activity can be financed in two ways, via borrowing or establishing a partnership. Establishing a profit-and-loss sharing (PLS) contract is the ideal case for Islamic banking (Khan, 2010). *Muḍārarah* and *mushārakah* are PLS-based contracts in which IBs set up a partnership with an entrepreneur. However, in practice, trade-based or debt-based instruments heavily dominate the PLS instruments, which often leads to the criticism that IBs actually resemble CBs (Khan, 2010; Azmat et al., 2015; El-Hawary et al., 2007). Widely used trade-based instruments are *murābāhah* (cost plus sales), *salam* (forward sales), *ijārah* (leasing) and *istiṣnā‘* (project financing).
Figure 2 reports the instrument breakdown of some of the prominent countries. *Murābaḥah* is the most widely used instrument worldwide. Saudi Arabia and Iran are distinct with more than 90 per cent utilisation of *murābaḥah*.

Other than available banking instruments, new products have been developed with the help of financial engineering to support liquidity and risk management in Islamic finance. This process gave birth to *ṣukūk* and Islamic equity funds (Mannan, 2008). According to the Islamic Financial Services Industry Stability Report (IFSB, 2015, p. 17), *ṣukūk* represent the fastest growing market in the Islamic banking and finance industry. Practically, *ṣukūk* are referred to as Islamic bonds or Islamic investment certificates. The key distinction is that *ṣukūk* must be asset-based and should represent a cash stream tied to the underlying asset instead of a debt.

Islamic indices and Islamic funds are also available in Islamic capital markets. Malaysia was the first country that published a list of Shari‘ah-compliant equities in 1983. The first Islamic equity index was also introduced in Malaysia in 1996. Afterwards, in 1999 the Dow Jones Islamic Market, the Kuala Lumpur Sharī‘ah Index and the FTSE Global Islamic Index Series were launched (Mannan, 2008). The first Islamic fund was established in the USA in 1986. Saudi Arabia is the leader of the fund market; however, Malaysia is growing fast with related tax incentives (Shanmugam and Zahari, 2009). According to IFSB (2015 p. 22), the annual growth of Islamic funds was 6.6 per cent between 2009 and 2013. As of the third quarter of 2014, the Islamic funds sector reached US$75.8bn. Table II provides a breakdown of the key components of the Islamic finance industry by region.

*Takāful* is the Shari‘ah-compliant substitute for insurance. The major distinction of *takāful* models is that customers are considered as partners, and they receive a share of the profit at the end (Billah, 2007). *Takāful* is important for Islamic banking for risk management purposes. Malaysia and Saudi Arabia are the leaders of the *takāful* market.

**Figure 2.** Use of Islamic banking instruments in 2013

The annual growth in the takāful market was 17 per cent between 2005 and 2008 (Ernst and Young, 2010, p. 31) and 16 per cent between 2008 and 2013 (IFSB, 2015, p. 44).

Turkey heavily relies on murābaḥah on the Islamic banking side. For capital markets, Turkey entered the sukūk market quite late. The first regulation titled “rent certificates” was released in 2010 and Kuveyt Türk PB then issued the first sukūk in Turkey. In 2011, some tax exemptions (stamp tax, notary duties and others) were introduced, and income tax was reduced to 10 per cent. In 2012, the Turkish Treasury entered the sukūk market and the Lease Certificate Market was opened at Borsa İstanbul to stimulate the market. The Turkish central bank also started to accept sukūk as collateral. In 2013, more comprehensive regulations were issued allowing five schemes (murābaḥah; ijarah; ijarah and wakalah; muḍāraḥah and mushāraka k; and istiṣḥāna‘) corresponding to most of the schemes in the world (Deloitte, 2016, p. 18). Alternative schemes are also allowed to be proposed to the Capital Markets Board of Turkey. According to the Deloitte Islamic Finance Insights Series Report (Deloitte, 2016, p. 18), between 2013 and 2015, sukūk worth US$10bn and TRY 10bn (roughly US$4.43bn) were issued in Turkey. Currently, sukūk issuances in Turkey reached 3 per cent of the global market and seem to be competing well with most of the GCC countries even though the Turkish sukūk market is not as mature as the GCC sukūk markets. Figure 3 depicts the percentage of sukūk issuances in key jurisdictions.

The first participation index in Turkey was initiated in 2008 and has been calculated and disseminated by Borsa İstanbul since 2011. The index consists of 30 companies that are in line with Islamic banking principles. The Participation 50 index was established in 2015.

### Table II.

<table>
<thead>
<tr>
<th>Region</th>
<th>Banking assets</th>
<th>Sukūk outstanding</th>
<th>Islamic funds assets</th>
<th>Takāful contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>203.8</td>
<td>188.4</td>
<td>23.2</td>
<td>3.9</td>
</tr>
<tr>
<td>GCC</td>
<td>564.2</td>
<td>95.5</td>
<td>33.5</td>
<td>9.0</td>
</tr>
<tr>
<td>MENA (exc. GCC)</td>
<td>633.7</td>
<td>0.1</td>
<td>0.3</td>
<td>7.7</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>20.1</td>
<td>1.3</td>
<td>1.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Others</td>
<td>54.4</td>
<td>9.4</td>
<td>17</td>
<td>0.3</td>
</tr>
<tr>
<td>Total</td>
<td>1,476.2</td>
<td>294.7</td>
<td>75.8</td>
<td>21.5</td>
</tr>
</tbody>
</table>

**Source:** IFSB (2015, p. 7)

[Figure 3. Sukūk issuances by domicile and share (October 2014)]
Turkey has lagged behind in Islamic equities and funds. Even though Turkey has reached a significant share in the global sukūk market, its share in Islamic funds is still negligible. The takāful market is also at its infancy stage and is thus not satisfactory either. Nonetheless, IBs recently started to establish takāful subsidiaries. The first takāful company – Neova Sigorta – was established in 2009, and, in 2014, its market share reached 1.67 per cent (Aslan, 2015). However, takāful is not well known in Turkey and customer awareness is extremely low.

Islamic banking in Turkey

Islamic banking began under the name of SFHs in 1985. However, for a long time, IBs had to operate within a minimal legal and regulatory framework and even without mentioning interest-free banking principles. The lack of necessary framework was mainly because of the dominant secular sentiments that prevailed within the state, businesses and media. Any sign of religious symbols could easily ignite irritation and anger at the Islamic banking system. Between 1985 and 1991, six interest-free finance companies, namely, Al Baraka, Kuveyt Türk, Faisal Finans, Anadolu Finans, İhlas Finans and Asya Finans, were established. In 2001, Turkey experienced a devastating economic crisis, during which İhlas Finans – the key player – went into bankruptcy because of a liquidity problem. On the conventional banking side, over 20 banks also failed during the crisis (Hardy, 2012). Because deposits of IBs were not covered by a deposit insurance scheme, the bankruptcy of İhlas Finans caused a chain reaction such that many customers of the remaining IBs rushed to withdraw their monies (Tunç, 2010). The market share of Islamic banking was thus reduced by 50 per cent, and the necessity of the deposit insurance scheme became undeniable. Thus, in 2001 the Union of SFHs was established and at the same time a deposit insurance scheme was launched among IBs.

In 2002, the Justice and Development Party gained a majority in the November election, which eased pressures on Islamic institutions. At the same time, the economic situation as well as Islamic banking started to normalize and then to improve. A new banking law issued in 2005 altered the name of SFHs to “Participation Banks” and finally provided an acceptable legal framework for Islamic banking. Further, the Union of SFHs changed its name to Participation Banks Association of Turkey (PBAT, 2016).

Between 2014 and 2015, the Islamic banking sector faced another internal hardship. It was no secret that Bank Asya, the leader of the market, had a direct relation with the Gulenist movement[4], and a significant amount of deposits was withdrawn by the public because of hostile actions of Gulenists against the Turkish government in late 2013. Afterwards, Bank Asya rejected to share information about its privileged shareholders and its control was transferred to the Saving Deposit Insurance Fund in 2015. This issue significantly disturbed the Islamic banking sector and considerably reduced its total market share.

One significant development in Turkey was the recent entry of two state banks to the Islamic banking sector. Two state banks – Ziraat Bankası and Vakıflar Bankası – established Islamic banking subsidiaries in 2015 and 2016, respectively.

Figure 4 shows the market share of Islamic banking assets as a percentage of the total banking sector in Turkey. For the first 15 years (1985 to 2000), the share of Islamic banking rose to around 2 per cent. During the 2001 economic crisis, in which İhlas Finans went bankrupt, Islamic banking lost almost half of its market share. Since then, the share of Islamic banking has been steadily but slowly increasing to 5.5 per cent until 2013. While the disenchantment of Bank Asya caused a negative effect on the increasing trend, the entrance of two large state banks into the sector is expected to put the trend on the right track. It is
noted that in 2015 PBAT issued a strategy document that covers 2015-2025 to achieve 15 per cent domestic market share until 2025.

The institution/education side of Islamic banking is quite underdeveloped in Turkey. Graduate/undergraduate programmes targeting participation banking or Islamic economics are at the initiation level. Currently, there are three graduate (master) level programmes offered by Sakarya University, Istanbul Sabahattin Zaim University and Istanbul University. Istanbul University (PhD level) and Karatay University (undergraduate level) each have a department of Islamic economics and finance. The International Islamic Economics and Finance Research Centre was established under Istanbul Sabahattin Zaim University in 2012, and the World Bank Global Islamic Finance Development Centre has been operating at Borsa Istanbul. The current academic performance of Turkish scholars on Islamic economics is quite poor. According to Thomson Reuters Islamic Finance Development Indicator (IFDI), Turkish scholars published only 10 research papers between 2011 and 2013 and 33 papers between 2013 and 2015. The numbers for Malaysia are 421 and 833 respectively (ICD Thomson Reuters, 2014, p. 21; 2016, p. 31).

Studies regarding Turkish Islamic banking are very rare. Savas et al. (2013) investigate the demand side of Islamic banking by surveying a large sample of conservative businessmen. The results are very interesting and have significant repercussions. They report that 54 per cent of businessmen choose banks to work with based on the cost of financing regardless of the bank type. Only one-third of the businessmen consider IBs to be Sharīʿah-compliant, which is another sign of the poor perceptions of Islamic banking. Another 34 per cent of them declare that they have no idea whether IBs are Sharīʿah-compliant or not.

Ongen and Şendeniz-Yüncü (2011) show that IBs mainly deal with young, multiple-bank, industry-focused and transparent firms. Aysan et al. (2016) demonstrate that IBs are relatively more involved in SME financing. Hassan et al. (2016) utilise stress tests to determine how capital adequacy ratios of IBs and CBs react to credit, market and operation risks and find that IBs in Turkey are more sensitive to stress compared to CBs.

**Governance and regulations**

Between 1985 and 1999, IBs – called SFHs at that time – were excluded from the banking law and were governed based on cabinet notices without any solid legal
background. IBs were included within the scope of banking law only in 1999. This change brought a more acceptable legal framework (Battal, 2000). In 2001, as mentioned previously, the union of IBs was established to start deposit insurance. Additionally, invoicing obligations during deferred sales were abolished[5], and further adjustments were carried out to make guarantee letters of IBs acceptable by state institutions (Halaçoğlu, 2014).

2005 represented a key milestone for the Islamic banking industry in Turkey. The regulation introduced in 2005 further strengthened the legal framework for IBs. The area of activities of IBs was defined as being wider than that of CBs. IBs were allowed to do leasing and PLS investments over and above banking activities. IBs were permitted to do some real estate and commodity-related transactions that CBs could not carry out (Halaçoğlu, 2014). Deposit assurance funds of IBs were merged with the funds of CBs under the name of savings deposits insurance fund. It is noted that two decades after the establishment of Islamic banking, the sector has finally attained a sound legal framework that enables it to compete with the conventional banking system.

However, Sharīʿah governance issues and sustaining the compliance of banking instruments to Islamic principles are still grey areas. There is no nationwide Sharīʿah board in Turkey. IBs have their own internal “advisory boards”, and there is no standard procedure on how to set up a board, what are its responsibilities or how it is expected to function.

Islamic banks in numbers
IBs have been operating under an improved legal framework since 2005. Therefore, this paper evaluates the Islamic banking industry vis-à-vis the conventional banking sector between 2005 and 2015[6] by using some key performance indicators (KPIs). The related data were derived from the Banking Regulation and Supervision Agency (BRSA, 2016) database.

The study considers the market share of IBs in terms of financial values (total banking assets, total financing/credit allocation, total deposits/all deposits, current accounts, PLS/interest bearing accounts and off-balance sheet items) and in terms of number of branches/personnel/ATMs in Figures 5 and 6, respectively. Figure 5 shows that there are no considerable improvements in any of the KPIs of IBs in terms of their market shares. For example, the market share of off-balance sheet items reached 16 per cent in 2008 but then returned to its 2005 level in 2015.

Figure 6 indicates that the stable growth of the number of branches, ATMs and personnel clearly imply their intentions to expand more. Although the exit of Bank Asya

Figure 5.
IBs Market shares in assets, financing and deposits

Source: Banking Regulation and Supervision Agency Database
reduced IBs’ market share in 2015, it seems that expansion of current IBs and entry of newcomers can make up this loss quickly.

Figure 7 reports several critical financial ratios for IBs and CBs such as return on asset, return on equity, net interest/profit margin and non-performing loans. The first salient point is the substantial decrease in the profitability of IBs. Although CBs’ profitability significantly fluctuates over the period, their average level in 2015 is similar with the 2005 average with a decreasing trend since 2010. It seems that IBs were more profitable than CBs until 2009. It is noted that NPL of IBs has an increasing trend since 2012, which further raises concerns over IBs’ profitability.

Figure 8 shows a comparison of IBs with CBs in terms of a number of efficiency ratios. The asset and deposit per personnel/branch figures indicate the improvements in efficiencies of both IBs and CBs. However, CBs have usually been more efficient, and the gap continues to increase. Personnel per branch figures are pretty close to each other. Thus, the efficiency gap should not be a result of excess employment. Overhead costs per asset have been decreasing for both bank types. Considering commission and banking service income ratio, IBs have a decreasing trend, which may explain the decrease in the profitability of IBs. While IBs may have to charge less in commissions to compete with CBs, it seems that they cannot increase their deposits and financing amount in parallel. In short, IBs collect fewer deposits, do less fund utilisation and gain less commission income per personnel and per branch.

Table III presents several KPIs for the business patterns of both IBs and CBs. As expected, IBs at least initially have higher overall financing ratios. However, CBs have raised their funding ratio from 37 to 62 per cent during the period considered and lately outperformed IBs. Regarding funding specifically to SMEs[7], IBs utilise almost 40-45 per cent of their funding activity on SMEs, whereas the number is around 25 per cent for CBs. This is a very critical distinction and an indication of IBs’ contribution to the real economy through supplying loans to small-scale businesses that are supposed to be riskier. However, it is noted that NPL resulting from SME funding activities is on the rise.

An interesting finding from Table III is the higher ratio of current accounts to total deposits for IBs. Given that current accounts are deposits for which customers receive no profit or interest, it is important to understand why customers of IBs tend to keep their monies in current accounts and give up profits. There are at least two possible explanations. Either customers do not prefer PLS accounts because of the risk of losses or they hesitate to obtain a surplus from a PLS account and consider the gains as quasi-interest or within the “grey area”. Anyhow, in both cases, although IBs may take advantage of these higher ratios, it is crucial to understand the underlying problem causing the higher ratios. This ratio may
implicitly indicate serious doubts about Islamic banking in general, given that IBs always distribute comparable profits with CBs.

Overall, these numbers imply that because Islamic banking was not able to reach a certain size to take advantage of economies of scale, IBs try to grow further by opening new branches. IBs generate less profit and operate with higher NPL. However, ignoring the situation that IBs cannot utilise their resources as efficiently as CBs might prevent IBs from finding the real problems and their solutions. Identifying the reasons behind these problems is crucial. These issues may not be directly related to the absence of nationwide Shari‘ah governance or regulatory constraints. A decade after the major legal provisions in 2005, Islamic banking has a very small market share considering Turkey’s potential. It is noted that utilisation of information technology (IT) is especially crucial to raise the efficiency of IBs, considering that banking is increasingly being shifted to the online system.

The lack of instrument variety could be another explanation for the very small market share and lower efficiencies. As discussed above, IBs heavily rely on *murābāhah* instruments (more than 90 per cent), and the current business model for IBs may have reached its limits. Given that there exist serious concerns on the legitimacy of Islamic banking, it is clear that the *murābāhah* scheme is not well understood and

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**Figure 7.**

Key financial ratios

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**Source:** Data derived from Banking Regulation and Supervision Agency Database
Figure 8. Efficiency KPIs between 2005 and 2015

Source: Data derived from Banking Regulation and Supervision Agency Database
accepted in Turkey. Higher ratios of current accounts can also be considered as evidence for this issue.

Way forward
The problems or concerns inhibiting an expansion of the Turkish Islamic banking sector can be summarised as follows:

- Lack of Shari’ah governance causes misperceptions. Except for Saudi Arabia, all Muslim countries have Shari’ah governance frameworks at the bank level and some even have nationwide boards. It is hard to standardize practices among IBs without the jurisdiction of a higher board.

- There is a lack of regulatory institutions focusing specifically on Islamic banking constraints and legal improvements.

- Lack of instrument variety pushes IBs to operate almost solely on murābahah transactions. Only Saudi Arabia has achieved high Islamic banking penetration by using murābahah schemes dominantly. All other prominent countries have introduced various instrument schemes.

- The perception of Islamic banking is very weak within the society. A significant portion of the society thinks that IBs are not necessarily interest-free and makes choices based on cost-benefit considerations. IBs have to express their moral merits more and be cost-efficient at the same time.

- The operational efficiency of IBs is lower compared with CBs. Worse, the gap is not closing.

- The lack of academic research and educational institutions to study the aforementioned problems further aggravates them.

PBAT issued a strategy document in March 2015 regarding how to expand the market. PBAT selected five strategic domains, notably:

- industrial coordination;

  instrument variety;

  Table III. Several ratios regarding business patterns

<table>
<thead>
<tr>
<th>Year</th>
<th>Total financing/Total assets (%)</th>
<th>Current account/Total deposits (%)</th>
<th>SME funding ratio (%)</th>
<th>SME NPL (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CB</td>
<td>IB</td>
<td>CB</td>
<td>IB</td>
<td>CB</td>
</tr>
<tr>
<td>2005</td>
<td>37.48 65.09 20.18 23.44</td>
<td>27.17</td>
<td>41.79</td>
<td>3.66</td>
</tr>
<tr>
<td>2006</td>
<td>43.02 67.79 17.59 21.82</td>
<td>27.06</td>
<td>31.50</td>
<td>3.75</td>
</tr>
<tr>
<td>2008</td>
<td>49.44 68.46 13.52 17.98</td>
<td>21.01</td>
<td>29.64</td>
<td>8.44</td>
</tr>
<tr>
<td>2009</td>
<td>45.94 70.30 15.40 18.88</td>
<td>23.29</td>
<td>40.15</td>
<td>3.14</td>
</tr>
<tr>
<td>2010</td>
<td>51.38 71.12 15.73 19.31</td>
<td>24.22</td>
<td>47.21</td>
<td>3.26</td>
</tr>
<tr>
<td>2011</td>
<td>55.48 68.64 16.95 25.39</td>
<td>25.31</td>
<td>46.42</td>
<td>3.17</td>
</tr>
<tr>
<td>2012</td>
<td>57.41 68.24 17.65 21.94</td>
<td>25.31</td>
<td>46.42</td>
<td>3.17</td>
</tr>
<tr>
<td>2013</td>
<td>60.00 64.56 18.33 24.54</td>
<td>26.66</td>
<td>45.45</td>
<td>3.22</td>
</tr>
<tr>
<td>2014</td>
<td>61.97 61.41 18.48 24.50</td>
<td>26.21</td>
<td>41.92</td>
<td>3.87</td>
</tr>
</tbody>
</table>

Source: Data derived from Banking Regulation and Supervision Agency Database
• Sharīʿah advisory boards;
• education/HR/certification; and
• perception and strategic targets.

Actions in the strategy report cover almost all critical fields of Islamic banking. After 30 years of existence, Islamic banking finally has a solid roadmap. There are 84 actions defined in total; 40 per cent of these are PBAT’s responsibility, whereas 60 per cent are the government’s responsibility. The actions mostly address the problems highlighted in this paper such as establishing a nationwide advisory board, setting up a Sharīʿah governance framework for IBs, increasing instrument variety, improving education and perception of Islamic banking. Although PBAT commits to restructure itself to be more proactive and effective, its role will apparently remain advisory and not binding.

Several regulatory and advisory entities are suggested to be established under various government institutions such as the Banking Regulation and Supervision Agency and Capital Markets Board. However, an Advisory Board[8] is proposed to be formed under PBAT. It is understandable not to set up this board under a finance-related government institution because of the secular sensitiveness. Yet, letting IBs select board members independently may further damage the perception and trust of Islamic banking within the society. It is noted that involvement of the Presidency of Religious Affairs can certainly be beneficial. Given the fact that there is no formal Sharīʿah governance framework in Turkey, the need for a framework is extremely high. However, the strategy document does not mention the IFSB or AAOIFI Sharīʿah governance standards. Instead, it claims that different practices are going to be examined and the framework is going to be decided. There is also no clue on the structure of the bank-level framework.

There are 45 actions in the instruments section; 29 of them target raising the efficiency of current instruments. Šukūk have the highest number of tasks (17). Actions for šukūk are quite specific, and, if implemented, they could reduce the operational effort and time for preparation to issue šukūk. There are no strong commitments for PLS instruments. Instead, proposals target improvement of the trade-based instruments. Establishing working groups for regulations and new instruments under PBAT is a right step with potential benefits.

PBAT is the main entity that is responsible for strategic actions regarding human resources and education purposes, and the required actions in the strategy document are reasonable. Regarding the perception side, the report indicates that a survey will be undertaken (actually it should have been implemented already) to gauge the attitude of the society. Currently, there are very few studies on the subject, and they are of narrow scope. Interestingly, the list of actions in the strategy document gives the impression that the main reason for the poor perception of IBs in the public derives from the lack of knowledge within the society. Required actions are listed such as increasing transparency, standardisation and utilisation of campaigns to inform and persuade the public. However, the possibility that people may not be convinced with the current business model is omitted. There should be further actions strengthening perception via improving the business model as well.

The biggest disappointment in the document is that there is almost nothing about improving the efficiency of IBs. It is important to note that IBs can take several actions to raise the efficiency of the sector. While CBs mostly benefit from economies of scale, IBs can also benefit from them in certain areas by acting as partners – that is quite in line with the nature of Islamic banking. For example, IBs can allow customers of other
IBs to use their ATMs free of charge and increase penetration ratios to benefit from economies of scale. A shared credit card and point of sale system can allow IBs to reduce their costs and increase their efficiency and penetration levels in the market. These efforts do not require any new regulations or government support. Indeed, this can improve the overall perception of Islamic banking as well. Considering the efficiency and financial ratios shown above, the performance of IBs is not satisfactory, and solid actions and strategies are required. Moreover, there is no mention of alternative distribution channels and IT. The banking sector in 2025 will be much more in web/mobile applications rather than buildings, and IBs should pay more attention to the related technology to obtain a 15 per cent market share.

Conclusion
This study mainly evaluates the global Islamic banking practices and compares them with those of Turkey. The Turkish Islamic banking sector is also compared with the conventional banking sector by using large numbers of efficiency and profitability measures. Successful practices of Islamic banking in the world mostly started with an introduction of the institutional framework. Establishment of IBs was followed by launching takāful, šukūk and Islamic funds. Afterwards, different institutions were set up to study various aspects of Islamic banking and finance. Turkey was not able to follow a similar pattern because of the lack of adequate political support. Turkey was able to set up a reasonable legal framework for IBs comparatively late, in 2005, and introduced takāful (2009), šukūk (2010) and a participation index (2011) quite late as compared to other prominent countries. Problems preventing Turkish IBs from expanding can be summarised in five dimensions:

1. **Sharīʿah governance**: No framework exists, and practices of IBs may widely differ.
2. **Instrument variety**: IBs rely almost totally on murābahah.
3. **Perception of Islamic banking**: The public seems to be not convinced of the Sharīʿah compliance of Islamic banking.
4. **Inefficiency of IBs**: The figures show that IBs are less efficient and the gap is widening.
5. **Lack of academic studies and research institutions**: There are not sufficient intellectual efforts to tackle the aforementioned problems.

PBAT issued a strategy document in 2015 that touches all the dimensions above except for efficiency. There are 84 actions regarding coordination, instrument variety, advisory boards, education/HR/certification. There are a number of proposed tasks meant to improve especially šukūk and to raise intellectual efforts on Islamic banking. Topics on efficiency improvements, technological developments, and coordination among IBs are largely omitted. It is noted that internal efficiency and utilisation of advanced technology must not be underestimated. Furthermore, the report does not sufficiently focus on the domains of PLS instruments and perception-related issues. It is extremely crucial for IBs in Turkey to understand the sensitivity and the expectations of the public correctly and to take necessary steps. Given the very strong political support from the current top policymakers for interest-free banking, complaining of past attitudes can no longer be used to justify the tiny market share of IBs. A reasonable Sharīʿah governance structure and enhanced instrument variety can indeed boost the growth of the sector.
Notes

1. The term “participation banking” exclusively refers to Islamic banking in Turkey.

2. Turkey is the largest economy in the Organisation of Islamic Cooperation (OIC), ranked tenth in GDP per capita, and ranked seventh in terms of population [Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC) 2015]. Between 2000-2015 inflation was reduced from 55 to 7.7 per cent, and 216 per cent GDP per capita growth was achieved (The World Bank, 2015a, 2015b).

3. As of 2011, Malaysia issued 65 per cent of total global sukuk (IFSB, 2015, p. 19). Even presently, Malaysia holds 70 per cent of the Islamic banking assets in Asia. Malaysia also hosts very important institutions for Islamic banking such as the Islamic Financial Services Board (IFSB) and the International Centre for Education in Islamic Finance (INCEIF).

4. The Gulenist movement revolted against the Parliament through its bureaucrats settled in the government in the late 2013. After its failure, the attempt repeated as a bloody military coup on 15 July 2016, which also failed.

5. Similar to the initial experiences in the UK, Turkish SFHs had to buy and sell the assets subject to financing and thus face value-added tax (VAT) and related operations. This obligation was also removed 18 years after the interest-free financing model started.

6. The timing (2005-2015) is also limited by data availability. It is very hard to obtain data for the earlier periods.

7. See, Aysan et al. (2016) for the detailed empirical evidence on the subject.

8. The term Sharī'ah is still a taboo in Turkey so the term “Advisory Board” is in use.

References


Further reading


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Purging of impure income: a comparative study of the existing purging methodologies

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Abstract

Purpose – The purpose of this paper is to study the concept of purging and present a comparative study of the existing purging methodologies prevailing in the market with a view to evolving a more effective method of capturing the entire impure income to be purged.

Design/methodology/approach – To illustrate the present discussion, a case study of purging based on numerical examples has been included. The argument has also been supported with empirical data related to the universe of Sharīʿah-compliant stocks listed on Indian stock exchanges.

Findings – During the study, it was found that the existing purging methodologies of calculating impure income to be purged have conceptual and practical shortcomings.

Research implications/limitations – The scope of the current research is limited to calculation of impure income which accrues on account of Sharīʿah non-compliant investments directly or indirectly. It does not try to quantify the benefit which may be imputed in the form of capital gains made in trading of the investee company shares due to higher market value of the shares as a result of the impure income earned by the investee company. The paper has focused on identifying and calculating the impure income on account of interest. Impure income earned from specific Sharīʿah non-compliant products or services has not been considered directly. The reason for this is that companies dealing in such products or services are generally excluded at the business screening stage itself. In the case of those companies which derive a relatively small proportion of their total income from such activities and pass the business screening stage, the quantum of the impure income is not generally reported separately in company accounts.

Practical implications/limitation – The result of adopting the proposed methodology will lead to complete purging of impure income (to the extent that is possible under present Company Law and stock exchange reporting regulations). Implementation of the proposed method requires a proper understanding of the working of listed companies and either a sound mathematical background or access to a software application to calculate the impure income to be purged.
Originality/value – The current paper is original and based on the authors’ personal understanding and experience of providing Shari’ah consultancy services related to Shari’ah-compliant investments.

Keywords India, AAOIFI, Dow Jones, Indian capital market, Purging, Impure income, Shari’ah-compliant investment, TASIS

Paper type Research paper

Introduction
In the present business environment, it is very difficult to find fully Shari’ah-compliant companies for investment on the stock exchange. Due to this unavoidable market scenario, Shari’ah scholars have set a limitation on the percentage of impure income to be accrued in a company’s account, below which the company (stock) is declared Shari’ah-compliant (AAOIFI, 2015). This relaxation implies that a Shari’ah-compliant company, despite its objective of making only pure income out of its business, may end up earning a proportion of impure income. Thus, the investor seeking a fully Shari’ah-compliant investment needs to purge this impure income accrued in the accounts of the company in which the investment is made (AAOIFI, 2015).

The process of removing impure income from the total income realised from an investment is known as purging (or purification). It is one of the important requirements to make an investment fully Shari’ah-compliant. Purging can be done either to remove only interest income or to remove all types of impure income arising out of Shari’ah non-compliant investments or business sources (AAOIFI, 2015).

It is to be noted that the investor who invests in the shares of a company through the stock market or by subscribing to a mutual fund would automatically become (morally) responsible for the economic activities (and financial transactions) of the company to the extent of his exposure (investment in the capital) to the activities of the company. Hence, the investor needs to purge his share of the impure income that has accrued to the company’s account to the extent of his investment in the shares of the company.

Purging is a concept which has emerged and evolved in the Islamic finance industry over the past two to two-and-a-half decades. Therefore, the methods of purging or calculation of impure income to be purged have not yet received sufficient scrutiny.

The objective of the current paper is to discuss the basic concepts of purging, present a comparative study of the existing purging methodologies prevailing in the market, highlight the issues pertaining to the existing purging methodologies and propose issues for experts and researchers to research further.

To illustrate the present discussion, a case study of purging based on a numerical example has been included in the last section of the paper. The argument has also been supported with empirical data related to the universe of Shari’ah-compliant stocks listed on Indian stock exchanges. The reason for this is twofold:

(1) Primarily, it is to illustrate to capital market participants such as lay investors, brokers, institutions and portfolio managers, the correct method of purging and the factors to be taken into account in the process of actual application.

(2) Secondly, to debunk the claim often made that the right method of purging requires detailed calculations and access to company data that present daunting practical difficulties.

The usual dividend purification method of purging commonly adopted is definitely simple and easy to apply. Unfortunately, it does not meet the objective (as discussed in the
following paragraphs) for which purging needs to be done. It thus ends up only as a cosmetic treatment to assuage one’s conscience while reducing the demand on one’s wallet. In the present time, computing ability and access to the internet via mobiles, tablets, computers and specialised data providers are readily available, which means the arguments of inaccessibility of data and difficulty of calculation are no longer valid. This is especially relevant when viewed in the context of needing to prevent one’s income from being tainted by *ribā* (interest), which has been denounced in the strongest terms in the Qurʾān (2: 275-279) and authentic *ḥadīths* (see, Al-Bukhari, Volume 3, Book 34, *ḥadīth* no. 382).

**Impure income**

After a brief introduction to the concept of purging, it is worthwhile to understand what constitutes “impure income”, as the latter is the base on which the whole purging process relies. In broad terms, impure income consists of interest income recognised (stated) as such in the company’s accounts, income realised from Sharīʿah non-compliant financial investments and income accrued on account of Sharīʿah non-compliant business sources (products and subsidiaries) (AAOIFI, 2015). These components of impure income are briefly described next.

**Interest income**

Generally, interest income is revenue accrued on account of bank and other deposits, loans advanced and certificates of deposit held and directly reported (stated) as “interest income” in financial statements of the company. This income needs to be removed to make an investment in listed companies Sharīʿah-compliant.

**Impure income from Sharīʿah non-compliant investments**

The reporting conventions in India (and perhaps in many other countries) do not allow companies to recognise the returns (income) arising from certain interest-based investments as “interest” under the “interest income” category. For example, many money market instruments such as debt-based mutual funds and preference shares provide returns to their investors which arise either from interest or from trading of interest-based instruments. However, due to the nature of the instruments, the return yielded to the investor is referred to as “dividend” rather than as “interest” in company accounts (Income Tax Act, 1961, Chapter 1, Sec.2, 22a&b; Interes Tax Act, 1974, 7 to 7b). In addition, companies may also trade in gilts, deep discount bonds, debentures, units of debt and liquid mutual funds and even preference shares, and report the income as “capital gains”. A similar practice arises in the case of insurance claims from conventional insurance, which are generally clubbed with other income and not reported separately as receipts of insurance in the financial reports of companies. As a result, we end up with a situation of receipts or income on account of Sharīʿah non-compliant investments entering the companies’ books without being reported (stated) as “interest income”.

Hence, such impure income components are likely to be overlooked during the process of calculation of impure income to be purged. Therefore, to purge such impure income disguised as dividend or capital gain or receipts, it is essential to first identify those interest-based investments of the firm from which such “disguised” interest or interest-derived income arises and then estimate[1] the quantum of such disguised interest income as a proportion of such interest-based investments (Khatkhatay and Nisar, 2007).

**Impure income from Sharīʿah non-compliant business sources**

In a few cases where the primary business of the company is Sharīʿah-compliant, some impure income accrues on account of a few minor business sources which are Sharīʿah
non-compliant (such as from non-compliant products of the parent company or of a subsidiary). In such cases, the impure income accrued on account of Sharīʿah non-compliant sources can be identified from product and investment schedules of the company and its subsidiaries and can be purged in proportion to the contribution of income from such offending products to the total income.

However, this can practically be done only in those cases where the information related to such products and services is available in the public domain. Not all companies disclose detailed information about income derived from their various products in their financial reports or filings with the regulators.

As per the Sharīʿah, all the three categories of impure income, i.e. general interest, income from interest-based investments and income from Sharīʿah non-compliant business sources, should be considered for calculating the amount to be purged. However, the extent of reporting detail may differ as well as the heads of account under which income from different sources is consolidated for reporting. This may create minor differences in the extent to which the total impure income can be correctly captured and purged. To allow for this lack of precision, the parameter (ratio) used to estimate the disguised interest income on the basis of interest-based investments can be set at a relatively liberal level.

Various purging methodologies

After a brief discussion on the concept of “impure income”, this section discusses the prominent purging methodologies prevailing in the market[2].

There are two prominent purging methodologies practised globally. One is the dividend-based purging method, and the second is the purging method suggested by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). In view of some shortcomings in these existing methodologies, a third method, which is a modified version of the AAOIFI purging method, has evolved and been applied by Taqwaa Advisory and Shariah Investment Solutions Private Limited (TASIS) – a premier Sharīʿah advisory services provider from India. The details of these three purging methodologies are provided next.

Dividend-based purging method

Under this method, generally followed by the S&P, MCSI and FTSE Sharīʿah Indexes, the purging of impure income is primarily linked to dividends. The purging amount is calculated by multiplying the dividend received on the shares of the company held by the investor (whether individuals, institutions or funds) by the ratio of impure income to the total income of the company (S&P Dow Jones Indices, 2017).

The formula for the amount to be purged can be expressed as:

\[
\frac{\text{Dividend Paid per Share} \times \text{Number of Shares Held}}{\text{Total Income}} \times \left(\frac{\text{Interest Income}}{\text{Total Income}}\right)
\]

Under this method, only the stated interest income can be purged, as this method takes into account only the stated interest income and fails to take into account the “disguised” interest income discussed above.

Moreover, under this method, the investor is liable to purge the impure income only if the company pays a dividend. In the event a company does not pay dividend in a particular year, the interest income of that year is not purged. Hence, there is no rationale for linking the purging to receipt of a dividend.
Furthermore, the recipient of the dividend may not even be the holder of the shares during the period when the interest was earned. It is common knowledge that dividends for any specific period are generally declared by companies not during that period itself but after the concerned period has closed and the accounts for that period are prepared. Hence, dividends are generally paid out three to six months after closing of the accounting year of the company. At such point in time, it is very likely that the person holding the shares may be someone who had not held the shares for even a single day of the period when the violation (of earning interest) occurred.

The AAOIFI purging method based on share-holding

The second method is that of AAOIFI. Under this method, purging is primarily based on interest earned per share by the company rather than (as in the previous method) on the dividend received per share by the investor. According to this method, the purging amount is calculated by dividing the total prohibited income by the total number of outstanding shares of the company and then multiplying the resulting figure by the number of shares owned by the investor (AAOIFI, 2015).

The formula for the amount to be purged can be expressed as:

\[
\text{Interest Income} \div \text{Total Outstanding Shares} \times (\text{No. of Shares Held at Year-end})
\]

Purging under this method is obligatory upon the investor only if the investor holds the shares of the firm at the end of the accounting period. It is not applicable to those who may have held them during the financial period but exited before the year-end (AAOIFI, 2015).

Again, under this method, only the stated interest income can be purged, as this method takes into account only the stated interest income and fails to take into account the “disguised” interest income discussed above.

Moreover, there appears to be a tenuous justification for laying the responsibility of purging the interest for the entire year only and fully on the person who is found to be holding the shares at the time of closing of the financial year. In fact, doing so constitutes an injustice to the person holding the shares at the time of closing of the financial period of the company unless he has indeed held the shares for the entire financial period.

The interest income is generally earned throughout the year. It should thus be the proportionate responsibility of all those who held the shares during the year, to the extent of the duration for which they held the shares for the respective periods. It should not be the exclusive liability of the one who is found holding the shares at year’s end.

As per available information, the FTSE Russell Indexes have adopted the AAOIFI purging methodology for their Islamic Indexes (FTSE Russell, 2016). Russell too considers only the stated interest income and not the “disguised” interest income.

The Modified AAOIFI method

In addition to the above mentioned two methods, TASIS has developed and applied another method which could be considered a modification of the AAOIFI method to make it more just and comprehensive.

This method requires the purging of impure income earned per share of a company held by an investor pro-rated over the period for which the shares were held in his portfolio by that investor.

Hence, according to this method, purging of impure income is imperative for the investor who had ownership of the shares when the impure income was earned by the company. He needs to donate the pro-rata amount of interest income earned per share by the company for
the relevant holding period, irrespective of whether the company or the investor made profits, and whether the company declared dividends or not.

The formula for the amount to be purged can be expressed as:

\[
\frac{\text{Total Impure Income}}{\text{Total Outstanding Shares}} \times \frac{\text{No. of Shares Held}}{\text{No. of Days or Months the shares were held}} \times \frac{\text{No. of Days or Months}}{\text{Total No. of Days or Months in the entire Accounting Period}}
\]

where:

\[
\text{Total Impure Income} = \text{Interest Income} + k\% \text{ of Interest-based Investments}
\]

where, “k” is the applicable ratio for estimating the “disguised” impure income from the interest-based investments.

In case the investor needs to purge a portfolio of various shares he held, the above method needs to be applied for all stocks in his portfolio, taking into account the relevant holding periods for the various stocks.

**Case study of purging with numerical examples: the case for an individual investor**

For clarity of understanding the method of determining the quantum of impure income for which the investor is responsible, a numerical example is explained below taking into consideration the three different methods of purging income and considering different scenarios. To avoid any confusion, the most general cases are considered.

Tables I and II below provide further details on the financial position of company PQR Co. Ltd. and the investment by the investor in the company, respectively.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Unit</th>
<th>31.03.2012</th>
<th>31.03.2013</th>
<th>31.03.2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding shares</td>
<td>Million</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Interest-based investments</td>
<td>US$ million</td>
<td>10,000</td>
<td>12,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Total income</td>
<td>US$ million</td>
<td>500,000</td>
<td>550,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Interest income (stated)</td>
<td>US$ million</td>
<td>2,000</td>
<td>1,800</td>
<td>2,500</td>
</tr>
<tr>
<td>Income from interest-based investments(^a)</td>
<td>US$ million</td>
<td>800</td>
<td>960</td>
<td>1,200</td>
</tr>
<tr>
<td>Dividend@10%</td>
<td>US$ million</td>
<td>3,600</td>
<td>Nil</td>
<td>Nil</td>
</tr>
</tbody>
</table>

The financial year for PQR Co. is April to March

**Note:** “Impure income (disguised income) is assumed at 8% of interest-based investments as per TASIS Shari‘ah norms.

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction details</th>
<th>No. of shares (million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 April 2011</td>
<td>Purchases/Opening balance</td>
<td>10</td>
</tr>
<tr>
<td>30 June 2012</td>
<td>Sale</td>
<td>4</td>
</tr>
<tr>
<td>1 April 2013</td>
<td>Purchases</td>
<td>2.5</td>
</tr>
<tr>
<td>30 June 2014</td>
<td>Closing balance</td>
<td>8.5</td>
</tr>
</tbody>
</table>

**Table I.** Financial details of PQR Co. Ltd. for the period of three years, i.e. 2011-2012, 2012-2013 and 2013-2014

**Table II.** Details of investment by investor in PQR Co. Ltd.
The purging amounts applicable to the investor using the three different methods discussed above are as follows.

**Purging calculation under the dividend method**

Under the dividend method, the purging calculations for the three years are as described below. The purging amount can be calculated using the appropriate formula given above:

\[
(\text{Dividend paid per Share}) \times (\text{No. of Shares Held}) \times (\text{Interest Income/Total Income})
\]

Purging amount for the period 2011-2012 = \([3,600/100] \times 10 \times [2,000/500,000]\) = US$1.44m.

As the company did not pay any dividend during 2012-2013 and 2013-2014, the purging amount for those periods is nil. Table III summarises the purging amount for the three years as per the dividend method.

**Purging calculation under the AAOIFI method**

Under the AAOIFI method, the purging calculations for the three years are as described below. The purging amount can be calculated using the formula given below:

\[
(\text{Interest Income/Total Outstanding Shares}) \times (\text{No. of Shares Held at Year-end})
\]

Purging amount for the period 2011-2012 = \((2,000/100) \times (10)\) = US$200m.

Purging amount for the period 2012-2013 = \((1,800/100) \times (6)\) = US$108m (as the shareholding at the year-end was 10 – 4 = 6).

Purging amount for the period 2013-2014 = \((2,500/100) \times (8.5)\) = US$212.5m (as the shareholding at the year-end 2013-2014 was 6 + 2.5 = 8.5).

Table IV summarises the purging amount for the three years as per the AAOIFI method.

**Purging calculation under the Modified AAOIFI method**

Under the Modified AAOIFI method, the investor needs to purge the impure income for the period he held the shares, irrespective of whether he still held the shares at the end of the financial year or not and whether a dividend was paid or not. The formula for the purging amount is:

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Purging amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011-2012</td>
<td>1.44</td>
</tr>
<tr>
<td>2012-2013</td>
<td>0</td>
</tr>
<tr>
<td>2013-2014</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1.44</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Purging amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011-2012</td>
<td>200</td>
</tr>
<tr>
<td>2012-2013</td>
<td>108</td>
</tr>
<tr>
<td>2013-2014</td>
<td>212.5</td>
</tr>
<tr>
<td>Total</td>
<td>520.5</td>
</tr>
</tbody>
</table>
\[
\text{Total Impure Income} = \text{Total Outstanding Shares} \times \left( \frac{\text{No. of Shares Held}}{\text{No. of Days or Months the Shares Were Held}} \right) \times \left( \frac{\text{Total No. of Days or Months in the Entire Accounting Period}}{k} \right)
\]

where, \( k = 8 \) per cent (assumed)

\[
\text{Total Impure Income} = \text{Interest Income} + 8\% \text{ of Interest-based Investments}
\]

Purging amount for the period 2011-2012 = \((2,000 + 800)/100 \times (10 \times 365)/365 = US$280\text{m} \) (as 10 million shares were held for 365 days).

Purging amount for the period 2012-2013:

- For 4 million shares held for 91 days = \((1,800 + 960)/100 \times (4 \times 91)/365 = US$27.52\text{m} \) (as 4 million shares were held for 91 days).
- For 6 million shares held for 365 days = \((1,800 + 960)/100 \times (6 \times 365)/365 = US$165.6\text{m} \) (as 6 million shares were held for 273 days).

Purging amount for the period 2012-2013 = 27.52 + 165.6 = US$193.1\text{m}.

Purging amount for the period 2013-2014 = \((2,500 + 1,200)/100 \times (8.5 \times 365)/365 = US$314.5\text{m} \) (as 8.5 million shares were held for 365 days) (Table V).

In the above case study, the investor owns at different points over the three years, between 6 million and 10 million shares of the company’s total outstanding 100 million shares, i.e. between 6 to 10 per cent of the company’s total shares.

From the purging amounts calculated according to the three methods (summarised in Table VI above), the following conclusions can be drawn.

**Dividend method.** Under this method, in the first year (2011-2012), the investor is required to purge an amount of US$1.44\text{m}, i.e. about 0.5 per cent of the actual interest amount (US$280\text{m} as per the Modified AAOIFI method) that the investor is liable to purge. In the second and third years (2012-2013 and 2013-2014), as the company did not pay a dividend, purging is not applicable. Therefore, though in those two years, the company earned US$1,800\text{m} and US$2,500\text{m} as interest, the investor is not required to purge any amount. Hence, effectively he retains the impure income of US$193.1\text{m} and US$314.5\text{m} (as per the Modified AAOIFI method), which he is actually liable to purge.

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Purging amount (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011-2012</td>
<td>280.0</td>
</tr>
<tr>
<td>2012-2013</td>
<td>193.1</td>
</tr>
<tr>
<td>2013-2014</td>
<td>314.5</td>
</tr>
<tr>
<td>Total</td>
<td>787.6</td>
</tr>
</tbody>
</table>

**Table V.** Purging amount for the three years as per the Modified AAOIFI method

<table>
<thead>
<tr>
<th>Financial year</th>
<th>Dividend method</th>
<th>AAOIFI method</th>
<th>Modified AAOIFI method</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011-2012</td>
<td>1.44</td>
<td>200.0</td>
<td>280.0</td>
</tr>
<tr>
<td>2012-2013</td>
<td>0</td>
<td>108.0</td>
<td>193.1</td>
</tr>
<tr>
<td>2013-2014</td>
<td>0</td>
<td>212.5</td>
<td>314.5</td>
</tr>
<tr>
<td>Total</td>
<td>1.44</td>
<td>520.5</td>
<td>787.6</td>
</tr>
</tbody>
</table>

**Table VI.** Purging amount for three years as per the different methods
This anomaly is due to the fact that purging in this method is linked to the dividend payment and also because it does not consider the disguised impure income derived on account of interest-based investments. Hence, a large amount of impure income is retained in the company and with the investor.

**AAOIFI method.** Under the AAOIFI method, in the first year (2011-2012), the investor is required to purge an interest amount of US$200m, i.e. around 71 per cent of the actual interest amount (US$280m as per the Modified AAOIFI method) that the investor is liable to purge on account of the 10 million shares, irrespective of whether the company declares a dividend or not. However, in the second year (2012-2013) and the third year (2013-2014), the shareholding pattern of the investor at the end of the financial years is reduced to 6 million and 8.5 million shares, respectively; therefore, the investor is liable to purge the corresponding proportionate amounts, which are US$108m, i.e. around 56 per cent of the actual amount to be purged (US$193.1m as per the Modified AAOIFI method for 2012-2013) and US$212.5m, i.e. around 67.5 per cent of the actual amount to be purged (US$314.5m as per the Modified AAOIFI method for 2013-2014).

In the second year, though the investor held 4 million shares until 30 June 2012, according to the AAOIFI method, he did not incur any liability to purge the corresponding interest amount in relation to these 4 million shares because they were not held till the end of the financial period. Obviously, this liability amounting to about US$18m was transferred onto some other investor who was holding those shares at the end of that financial year, i.e. as on 31 March 2013.

In addition, the variation in the amount to be purged is due to the fact that under the AAOIFI method, the disguised impure income is not considered while calculating the total impure income. Hence, the latter impure income continues to remain in the business. Thus, the AAOIFI method has the potential to misallocate the purging liability among investors, depending on whether the one holding the shares at year’s end has also held them throughout the year.

**Modified AAOIFI method.** Unlike the above two methods, under the Modified AAOIFI method, the disguised impure income derived from the interest-based investment is also included as part of total impure income along with the interest income. Due to this effect, in the first year (2011-2012), the investor is required to purge the entire impure income amount of US$280m received by the company on the 10 million shares of the investor. The additional US$80m is on account of the estimate of the disguised interest income provided under the Modified AAOIFI method but not considered under the AAOIFI method.

In the second year (2012-2013), the 4 million shares are held with the investor up to 30 June 2012 (91 days) and 6 million shares are held for the entire year (365 days). Therefore, he is liable to purge the total impure income, which is US$193.1m (US$27.5m on account of 4 million shares held for 91 days and US$165.6m on account of 6 million shares held for the full year). In the third year (2013-2014), the investor needs to purge impure income of US $314.5m, including US$102.0m on account of disguised interest income during the year.

**Comparison.** With the given example, in terms of total purging liability for three years, the investor is responsible for only US$1.44m under the dividend method, which is far less than the US$520.5m under the AAOIFI method and US$787.5m under the Modified AAOIFI method. If the Modified AAOIFI method of purging is considered the more correct and equitable one, then the investor is paying around 66 per cent under the AAOIFI method and just a pittance (less than 1 per cent) under the dividend method of what he actually is liable to pay (as per the Modified AAOIFI method).

It is to be noted that a part of the additional purging liability of the investor in the second year in the above illustration on the basis of the Modified AAOIFI method is due to the
specifics of the illustration. In case the details such as the period of holding of the shares were to be different, the purging liability in the illustration could even have been greater in the case of the AAOIFI method than the Modified AAOIFI method. Say, for instance, if in any year, the investor were to have bought shares towards the end of the year, under the AAOIFI method, he would have had to shoulder the liability for purging on account of those shares for the entire year. On the other hand, under the Modified AAOIFI method, his liability would have been limited to the purging on account of only the few days for which he had held the shares by the time the year ended.

Empirical study of applying dividend-based purging to Indian Sharīʿah-compliant stocks

An objective approach to assessing the impact of the different methods of purging on the extent of purging required would be to apply each of them separately to the latest updated (as on 31 January 2017) universe of Sharīʿah-compliant stocks, as determined on the basis of the screening criteria followed by TASIS, the leading Indian Sharīʿah investment advisor.

According to the latest Sharīʿah list referred above, there were 1,077 Sharīʿah-compliant companies listed on the main Indian stock exchanges. Of these, only 337 companies had declared a dividend, and of these, 13 companies had not reported any interest income. Thus, only 324 companies which had declared a dividend were liable for purging. On the other hand, the number of companies which had reported interest income was 848. An additional 11 companies had reported interest-based investments, though they had no interest income. Thus, compared to the companies required to purge under the Modified AAOIFI method, only about 38.2 per cent of the companies were liable for purging under the dividend method.

The total interest income for the entire universe of Sharīʿah-compliant companies was Indian Rupee (INR) 151.83 trillion; the purging amount on the basis of the dividend method was only INR 3,088.7 million, or an insignificant 2 per cent of the purging amount on the basis of the Modified AAOIFI method. The above figures clearly indicate the ineffectiveness of the dividend method in eliminating interest income earned by the Sharīʿah-compliant companies from their earnings for Sharīʿah-conscious investors.

Case study of purging with numerical examples: purging of mutual fund

In the case of a financial instrument such as a unit of a Sharīʿah-compliant mutual fund or pension fund, the overall interest purification ratio for the portfolio of the fund needs to be calculated on the basis of the portfolio of stocks held under the respective instruments and communicated by the mutual fund to individual holders or subscribers of the fund/scheme as a ratio (i.e. the purging amount per unit of the security held per day). Calculation of the purging amount for a financial instrument like units of a mutual fund/venture fund/insurance fund is more tedious compared to that for a specific share or a portfolio of shares held by an individual investor.

For clarity of understanding, the method of determining the impure income quantum for a mutual fund for which the investor is responsible, according to the Modified AAOIFI method evolved and applied by TASIS, is explained in the following paragraphs (TASIS, 2017). To avoid any confusion, the most general cases are considered.

Prior to moving on to the purging calculation directly, it is worthwhile to know the various details related to the fund and the investors that are required for the purging calculation:
• **Purging date**: This is the date on which the purging for the fund and investor is being done. In our present example, this period is September 2016.

• **Purging period**: This is the financial period for which the purging for the fund and for the investor is being done. In our present example, this period is April 2014 to March 2015.

• **Fund profile**: Fund profile includes date of inception of the fund, the scrips/stocks included, details of transactions and holdings (during the year), fund investment value (average for the year), number of outstanding units (average for the year) and net asset value (average for the year). This information can be collected from the periodic reports regarding the portfolio of the fund.

• **Financial details of investee companies**: Financial details of scrips include total impure income and outstanding shares of the respective companies for the financial period 2014-2015 (applicable for this example).

• **Investor’s investment details**: Investor’s investment details include details of his transactions in units of the fund. This information can be collected from the report of holdings of units issued to investors by fund managers.

It is to be noted that, in case of funds, purging is done for the fund first. This involves determining the purging amount applicable due to investment by the fund in different scrips held by the fund in its portfolio. For this, one has to obtain from the accounts of each company, the total impure income earned by the company and the number of its total outstanding shares. From these figures, the interest earned by the company (in terms of rupees per share per day) is calculated. Applying this ratio to the number of share-days of investment by the fund in the scrip, the amount to be purged by the fund on account of its investment in the company can be calculated.

Then based on the total purging amount calculated on account of all the scrips in the portfolio of the fund and the average number of units outstanding during the year, the purging ratio for the fund (in terms of purging amount per unit per day) is calculated. This is the purging ratio for the fund. From the investment history (transaction details) of the investor with regard to the particular fund, one can calculate the total unit-days of his investment in the fund. Applying the purging ratio of the fund to the unit-days of investment in the fund, one can arrive at the purging amount for the particular investor on account of his investment in that fund.

Let us assume that the Sharī’ah-compliant fund is launched on April 01, 2014. The fund comprises five shares (A to E). The average number of units of the fund outstanding during the period 2014-2015 is 100,000 and the average value of the fund is US$10m. The average net asset value of the fund is US$100. The impure income for A, B, C, D and E is US$100,000, 90,000, 150,000, 70,000 and 80,000, respectively. The shares outstanding for each of the scrips are 100,000. Tables VII and VIII provide details of the Sharī’ah-compliant fund and the financial details of each stock included in the Sharī’ah-compliant fund for the financial period 2014-2015.

The process of calculating the purging amount for a fund is as follows:

• **Share-days for all the scrips/stocks in the fund**: For this purpose, the monthly shareholding pattern of the fund for all the shares during the year needs to be collected. The details of transactions in the portfolios of mutual funds are disclosed in the public domain. The exact holdings of the fund cannot be known. Mutual funds do, however, publish the details of their share portfolios on a monthly basis. From the opening and closing stock of each scrip in the portfolio for every
month, one can calculate the average holding of each scrip in the portfolio during each month of the year. Multiplying the average holding of shares of each scrip by the number of days in that month and cumulating the same over the year gives the total share-days of investment in that scrip by the fund. Please refer to Table IX in which the total number of share-days for scrip “A” is calculated and shown as 8,205,000. The total number of share-days for each scrip will be calculated in the same way. As per Table X below, the share-days for scrips B, C, D and E are 7,217,500, 9,525,000, 6,997,500 and 7,312,500, respectively.

- **Purging ratio**: The purging (impure income) ratio for each of the scrips is calculated separately by dividing the total impure income for that scrip by the number of its shares outstanding, and the resulting figure is again divided by 365. Please refer to Tables VIII and XI.

- **Purging amount for the fund**: For this purpose, first the total purging amount for each scrip is calculated by multiplying the total share-days for the scrip with its respective purging ratio. Purging amount of all the scrips is added together.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Unit</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of inception</td>
<td>Date</td>
<td>01.04.2014</td>
</tr>
<tr>
<td>Number of scrips in the fund</td>
<td>Number</td>
<td>05</td>
</tr>
<tr>
<td>Average number of outstanding units</td>
<td>Number</td>
<td>100,000</td>
</tr>
<tr>
<td>Average value of fund</td>
<td>US$</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Average NAV</td>
<td>US$</td>
<td>100</td>
</tr>
</tbody>
</table>

**Table VII.**
Details of XYZ Sharīʿah-compliant fund

<table>
<thead>
<tr>
<th>Scrips/Stocks in fund</th>
<th>Impure income (US$)</th>
<th>Outstanding shares</th>
<th>Impure income/share</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>100,000</td>
<td>100,000</td>
<td>1.0</td>
</tr>
<tr>
<td>B</td>
<td>90,000</td>
<td>100,000</td>
<td>0.9</td>
</tr>
<tr>
<td>C</td>
<td>150,000</td>
<td>100,000</td>
<td>1.5</td>
</tr>
<tr>
<td>D</td>
<td>70,000</td>
<td>100,000</td>
<td>0.7</td>
</tr>
<tr>
<td>E</td>
<td>80,000</td>
<td>100,000</td>
<td>0.8</td>
</tr>
</tbody>
</table>

**Table VIII.**
Financial details of stocks included in XYZ Sharīʿah-compliant fund for the period 2014-2015

<table>
<thead>
<tr>
<th>Months</th>
<th>Opening</th>
<th>Closing</th>
<th>Holding during the month</th>
<th>Average holding period days</th>
<th>Share-days for the month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr-14</td>
<td>0</td>
<td>25,000</td>
<td>12,500</td>
<td>30</td>
<td>375,000</td>
</tr>
<tr>
<td>May-14</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
<td>31</td>
<td>775,000</td>
</tr>
<tr>
<td>Jun-14</td>
<td>25,000</td>
<td>10,000</td>
<td>17,500</td>
<td>30</td>
<td>525,000</td>
</tr>
<tr>
<td>Jul-14</td>
<td>10,000</td>
<td>15,000</td>
<td>12,500</td>
<td>31</td>
<td>387,500</td>
</tr>
<tr>
<td>Aug-14</td>
<td>15,000</td>
<td>35,000</td>
<td>25,000</td>
<td>31</td>
<td>775,000</td>
</tr>
<tr>
<td>Sep-14</td>
<td>35,000</td>
<td>20,000</td>
<td>27,500</td>
<td>30</td>
<td>825,000</td>
</tr>
<tr>
<td>Oct-14</td>
<td>20,000</td>
<td>15,000</td>
<td>17,500</td>
<td>31</td>
<td>542,500</td>
</tr>
<tr>
<td>Nov-14</td>
<td>15,000</td>
<td>20,000</td>
<td>17,500</td>
<td>30</td>
<td>525,000</td>
</tr>
<tr>
<td>Dec-14</td>
<td>20,000</td>
<td>35,000</td>
<td>27,500</td>
<td>31</td>
<td>852,500</td>
</tr>
<tr>
<td>Jan-15</td>
<td>35,000</td>
<td>35,000</td>
<td>35,000</td>
<td>31</td>
<td>1,085,000</td>
</tr>
<tr>
<td>Feb-15</td>
<td>35,000</td>
<td>25,000</td>
<td>30,000</td>
<td>28</td>
<td>840,000</td>
</tr>
<tr>
<td>Mar-15</td>
<td>25,000</td>
<td>20,000</td>
<td>22,500</td>
<td>31</td>
<td>697,500</td>
</tr>
</tbody>
</table>

**Table IX.**
Share-holding pattern of a scrip in XYZ Sharīʿah-compliant fund

Total share-days: 8,205,000
to ascertain the total purging amount for the fund. As mentioned in Table XI below, the purging amount for scrips A, B, C, D and E is assumed as US$22,479, 17,797, 39,144, 13,420 and 16,027, respectively. The total purging amount for the fund thus comes to US$108,867.

- **Purging amount per unit**: For this purpose, the total purging amount of the fund is divided by the average number of its units, which is calculated in US$ in the current example. Please refer to Table XII below.

- **Purging amount per unit per day**: For this purpose, the purging amount per unit is divided by 365. For the current example, the purging amount per unit per day is US$0.0030. Please refer to Table XII below.

**Purging for an investor investing in the mutual fund**

After deriving the purging amount for the fund, let us move on to determine the purging amount for an investor (Table XIII).

The process of calculating the purging amount for an investor is as follows:

- **Unit-days for the investor**: For this purpose, the unit transaction details are collected from the investor. The number of units purchased or sold is multiplied by the period for which they were held (no. of days) to get the unit-days. Unit-days for the total period are added to get the total unit-days. As presented in Table XIV below, the number of units purchased/sold on 1 April, 1 July, 1 October and 1 January.

### Table X.

<table>
<thead>
<tr>
<th>Share-days for all the scrips included in XYZ Sharīʿah-compliant fund</th>
<th>Total share-days</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>8,205,000</td>
</tr>
<tr>
<td>B</td>
<td>7,217,500</td>
</tr>
<tr>
<td>C</td>
<td>9,525,000</td>
</tr>
<tr>
<td>D</td>
<td>6,997,500</td>
</tr>
<tr>
<td>E</td>
<td>7,312,500</td>
</tr>
</tbody>
</table>

### Table XI.

<table>
<thead>
<tr>
<th>Scrips/Stocks</th>
<th>Total share-days</th>
<th>Purging ratio (US$)</th>
<th>Purging amount (Total share-days × purging ratio)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>8,205,000</td>
<td>0.0027</td>
<td>22,479</td>
</tr>
<tr>
<td>B</td>
<td>7,217,500</td>
<td>0.0025</td>
<td>17,797</td>
</tr>
<tr>
<td>C</td>
<td>9,525,000</td>
<td>0.0041</td>
<td>39,144</td>
</tr>
<tr>
<td>D</td>
<td>6,997,500</td>
<td>0.0019</td>
<td>13,420</td>
</tr>
<tr>
<td>E</td>
<td>7,312,500</td>
<td>0.0022</td>
<td>16,027</td>
</tr>
<tr>
<td>Total interest income to be purged for the fund</td>
<td></td>
<td></td>
<td>108,867</td>
</tr>
</tbody>
</table>

### Table XII.

<table>
<thead>
<tr>
<th>Calculation of purging amount for the fund</th>
<th>Purging calculation</th>
<th>Purging amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purging amount per unit per year</td>
<td>108,867/100,000 = 1.09</td>
<td>1.09 (US$/Unit)</td>
</tr>
<tr>
<td>Purging amount per unit per day</td>
<td>1.09/365 = 0.0030</td>
<td>0.0030 (US$ Unit/Day)</td>
</tr>
</tbody>
</table>
1 October, 1 January and 31 March is, respectively, 100, 90, −75, 80 and 90. It means 100 units were held for 365 days, 90 units were held for 274 days, 75 units were not held for 182 days, 80 units were held for 90 days and 90 units were held for 0 days. Accordingly, the unit-days invested by the investor were 36,500, 24,660, −13,650, 7,200 and 0, i.e. a total of 54,710 unit-days.

- **Purging amount for the investor:** For this purpose, the total unit-days for the investor are multiplied by the purging amount per unit per day. As per Table XIII below, total unit-days for the investor are 54,710 and the purging amount per unit per day is 0.0030. Hence, the purging amount for the investor comes to US$163.1.

\[
Purging\ Amount\ for\ Investor = (Total\ Unit\ Days\ of\ Investor \times \text{Purging Amount per Unit per Day})
\]

\[
= 54,710 \times 0.0030 = 163.1
\]

**Major purging-related issues**

Apart from the conceptual issues discussed above relating to purging, there are certain practical issues pertaining to the abovementioned methodologies, some of which have also been highlighted in the literature (Hashim and Habib, 2016), which we shall address in the current section of the paper. However, the purging methodology discussed in the following paragraph takes into account the impacts of both the conceptual as well as the practical issues involved in purging.

Incidentally, there is also discussion in the literature on the issue of capital gains. The view of the authors of this paper is that as far as Sharī‘ah-compliant portfolios are concerned, it is a non-issue and can be ignored. We turn in the next section to the real issues identified below.

In the process of advising on the purging amount for investors and funds over the past decade, we have identified a few major technical issues which complicate the process of determining purging amounts for portfolios and need to be addressed. They deserve the
attention of Sharī'ah scholars and, more so, that of practitioners who are involved in the actual process of determining purging amounts. The issues are as follows:

- bonus;
- rights/warrants;
- splits; and
- change in financial year.

It is evident that determination of the amount of interest to be purged – whether for an individual portfolio or a mutual fund investment – requires calculating, separately for each scrip in the portfolio, the ratio of interest to be purged in terms of rupees of interest earned during the year per share per day. This implies the need to determine the divisor, i.e. the number of outstanding shares. The problem arises when the quantity of issued shares of a company changes during the course of the year. As a result, from a financial perspective, the weight or importance of a share which existed prior to the change (increase in issued shares) undergoes a transformation in terms of its entitlement to proportional ownership of the company.

The number of issued shares increases as a result of bonuses. In the process of calculation of interest income per share, all the figures used are those relating to the year-end.

The transactions which took place prior to the bonus date must be brought on par with the transactions that occurred after the bonus date. To do so, the figures for the number of shares transacted between the start of the financial year and the bonus date must be suitably amended. This process can be termed as normalisation.

While accommodating the change and giving the right effect to it in the computing process, one needs to be aware of the nature of the change. We consider below each type of change that can potentially occur.

**Bonus**

In case of a bonus, the company issues additional shares to all the existing shareholders in a specified ratio by capitalising some of its reserves. As a result, there is an increase in the number of issued shares. Let us say a company issues \( A \) number of new shares for every \( B \) number of existing shares held. As a result, subsequent to the bonus, the number of issued shares of the company will be \( A + B \). As the existing shares were fewer in number earlier and subsequent to the issue are part of a larger total number, their proportionate weight or importance has reduced subsequent to the issue. Let us illustrate this point with an example pertinent to our current discussion.

Assume that PQR Co. Ltd., whose year begins on 1st April, had 100 issued shares. On 1st July, it issues an additional 50 bonus shares, i.e. in the ratio 1:2 (1 additional for every 2 held). The company is earning US$30 as impure income every month. Hence, every shareholder of the company was responsible for US$0.3 of impure income every month before the issue of bonus. After the bonus issue, there are now 150 issued shares, which share the responsibility for the impure income earning of US$30 per month from 1st July onwards. So, from 1st July onwards, all 150 shares are each responsible for US$0.2 of impure income per month. Obviously, the purging required for the same number of days of holding on account of a share held during the prior period will not be the same as that for a share held for the same number of days in the latter period.

As the portfolio may be actively buying and selling the shares of PQR Co. Ltd., one may not be able to keep track separately of the number of issued shares of the company each time shares of the company are bought or sold by the investor at different times. Instead, the possible way is to normalise the number of shares bought or sold earlier, so that
computation for both types of shares can be carried out in an undifferentiated manner on the basis of the number of issued shares at the end of the year.

Normalisation of shares can be done by increasing the number of shares bought or sold prior to the bonus date in the ratio \((A + B)/B\), (no. post-bonus/no. pre-bonus). This effect is given in all transactions from the start of the financial year in which the bonus is declared and extending up to the bonus date. By doing this, the extra effort of keeping track of the two types of shares separately is avoided. This is illustrated below by calculating the purging liability for a few transactions in the shares done pre- as well as post-bonus.

Let us assume that the transactions took place as depicted in Table XV.

The company is earning US\$30 impure income per month. Hence, during the financial year 1 April to 31 March, it has earned US\$360.

Tables XVI and XVII illustrate the calculation of the purging amount based on the direct method and normalisation method:

(1) direct method;
(2) normalisation method;
(3) Total interest earned = 30 \times 12 = 360;
(4) Total issued shares at year-end = 150;
(5) Purging amount per share = 360/150 = 2.4; and
(6) Purging amount per share per month = 2.4/12 = 0.2.

Rights and warrants
Rights/warrants are issued by a company when it wants to offer an opportunity to some, or all, of its existing shareholders to increase their holdings for a consideration (which is

<table>
<thead>
<tr>
<th>Date</th>
<th>No. of shares purchased</th>
<th>No. of shares sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 April</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>1 May</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>1 June</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>1 August</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>1 December</td>
<td></td>
<td>2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Month</th>
<th>Purging calculation ([\text{monthly impure income} \times \text{no. of shares} \times \text{holding period}])</th>
<th>Purging amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>April</td>
<td>(\text{For 2 Shares held for 3 Months (a)}: 0.3 \times 2 \text{ shares} \times \text{interest of 3 months} = 1.8)</td>
<td>7.2</td>
</tr>
<tr>
<td></td>
<td>(\text{For 3 Shares held for 9 Months (b)}: 0.2 \times 3 \text{ shares} \times 9 \text{ months} = 5.4)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total ((a + b) = 1.8 + 5.4 = 7.2)</td>
<td></td>
</tr>
<tr>
<td>May</td>
<td>(\text{For 2 Shares held for 2 Months (a)}: 0.3 \times 2 \text{ shares} \times \text{interest of 2 months} = 1.2)</td>
<td>6.6</td>
</tr>
<tr>
<td></td>
<td>(\text{For 3 Shares held for 9 Months (a)}: 0.2 \times 3 \text{ shares} \times 9 \text{ months} = 5.4)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total ((a + b) = 1.2 + 5.4 = 6.6)</td>
<td></td>
</tr>
<tr>
<td>June</td>
<td>(\text{For 2 Shares Not held for 1 Month (a)}: 0.3 \times 2 \text{ shares} \times \text{interest of 1 month} = -0.6)</td>
<td>-6.0</td>
</tr>
<tr>
<td></td>
<td>(\text{For 3 Shares Not held for 9 Months (a)}: 0.2 \times -3 \text{ shares} \times 9 \text{ months} = -5.4)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total ((a + b) = -0.6 + -5.4 = -6.0)</td>
<td></td>
</tr>
<tr>
<td>August</td>
<td>(\text{For 4 Shares held for 8 Months (a)}: 0.2 \times 4 \text{ shares} \times 8 \text{ months} = 6.4)</td>
<td>6.4</td>
</tr>
<tr>
<td>December</td>
<td>(\text{For 2 Shares not held for 4 Months (a)}: 0.2 \times -2 \text{ shares} \times 4 \text{ months} = -1.6)</td>
<td>-1.6</td>
</tr>
<tr>
<td></td>
<td>Total purging amount</td>
<td>12.6</td>
</tr>
</tbody>
</table>
generally at a discounted price compared to the ruling market price of the share). While we are not concerned in purging calculations with the pricing aspect, as such offers are generally taken up and lead to an increase in the issued number of shares, they have an implication for calculation of the purging amount.

Though financially the implications of bonus and rights for shareholders are different, as far as purging calculations are concerned, the treatment in the calculations is the same as with a bonus, i.e. normalise all transactions relating to the scrip from the start of the related financial year till the date of the rights issue using the rights ratio in a similar manner as described above in the case of the bonus issue.

Split
Split refers to the situation where a share/s of a certain face value is/are split into shares of a different face value. The result is again an increase in the number of issued shares, though in this case there is no increase in the value of the share capital. Again, normalisation needs to be done here by considering the relative figures. Generally, splits are expressed in terms of the face values pre- and post-split. In this case, the ratio used is the face value pre-split/face value post-split.

Change in financial year
Generally, a change in financial year of a company leads to the company closing its books either earlier or later than a full calendar year. Though not a frequent occurrence, it does happen at times. In this case, calculation of the purging ratio (purging amount per share per day) requires the purging amount to be divided by the number of days in the truncated or extended period rather than by 365, as is normally done.

Conclusions
After a detailed discussion and comparative analysis of the three existing purging methodologies, the following conclusions can be drawn:

- Under the dividend method, purging is restricted to the case where the company distributes a dividend. If the company does not declare a dividend, or even if it declares a dividend, but the investor had already sold his shares earlier, he is not required to purge any amount though the interest was earned when he held the shares. Hence, complete purging of impure income is not possible by using this method – in fact, only a very minor part of the interest gets purged.
- Under the AAOIFI method, purging liability becomes the responsibility of the investor only if he continues to hold the shares till the end of the accounting period; otherwise, the entire liability of purging must be borne by someone else.

<table>
<thead>
<tr>
<th>Months</th>
<th>Normalisation of shares</th>
<th>Share months</th>
<th>Purging amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>April</td>
<td>$2 \times (2 + 1)/2 = 3$</td>
<td>$3 \times 12 = 36$</td>
<td>$36 \times 0.2 = 7.2$</td>
</tr>
<tr>
<td>May</td>
<td>$2 \times (2 + 1)/2 = 3$</td>
<td>$3 \times 11 = 33$</td>
<td>$33 \times 0.2 = 6.6$</td>
</tr>
<tr>
<td>June</td>
<td>$-2 \times (2 + 1)/2 = -3$</td>
<td>$-3 \times 10 = -30$</td>
<td>$30 \times 0.2 = -6.0$</td>
</tr>
<tr>
<td>August</td>
<td>$4$</td>
<td>$4 \times 8 = 32$</td>
<td>$32 \times 0.2 = 6.4$</td>
</tr>
<tr>
<td>December</td>
<td>$-2$</td>
<td>$-2 \times 4 = -8$</td>
<td>$8 \times 0.2 = -1.6$</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$63$</td>
<td>$12.6$</td>
</tr>
</tbody>
</table>

Table XVII. Purging calculation based on the normalisation method
who was holding the shares at the end of the accounting period and may have
perhaps held them only for a fraction of the entire period over which the interest
was received. Hence, mostly complete purging of impure income by the person
who is actually responsible for it is not possible by using this method either.

- On the other hand, the Modified AAOIFI method applies irrespective of whether
  the company declares a dividend or not and whether he was holding the shares
when the company closed its accounting period or otherwise. The criterion is only
how much interest was earned by the company on account of his shares and during
the period he held the shares. That is the exact amount he is required to purge.

Taking an overall view of the existing methods of purging, it is clear that there is a
commitment, in principle, to purge the impure income under all the methods. Though
there are certain shortcomings in the calculation methodologies adopted under the dividend and
AAOIFI methods, it is hoped (particularly in the case of the dividend method – as the
effective quantum of purging under this method is negligible) that these shortcomings are
not due to any wilful flouting of Sharī‘ah requirements. Instead, they stem from an
inadequate comprehension of the practical application of Sharī‘ah guidelines and
complexities of financial calculations.

The AAOIFI modified method of purification is logical and equitable. In fact, under this
method, the shortcomings of the other two methods are successfully addressed, making the
full purging of the impure income possible.

To our understanding, the Modified AAOIFI method is deemed a more correct, just and
comprehensive method of purging. It is hoped that researchers and practitioners may
consider this method for further study and experimental implementation.

Notes
1. AAOIFI Sharī‘ah Standard No. 21, 3/4/4 (2015) recognises the need for an institution to exercise
additional effort and caution to identify such impure income, as it may not be directly reported in
the accounting statements of companies. Considering this provision, TASIS has decided to
recognise 8% of investment in preference shares and mutual funds as “impure income on account
of Sharī‘ah-non-compliant investments” and includes the same in total impure income.

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icometaxindia.gov.in/pages/acts/income-tax-act.aspx
icometaxindia.in/Pages/govacinterest-tax-act.aspx


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Towards the establishment of cash waqf microfinance fund for refugees

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Abstract
Purpose – This paper aims to propose cash waqf (endowment) to develop a conceptual model that can be utilised to extend microfinance for refugees.

Design/methodology/approach – Qualitative method is used in this research. An extensive review of the literature has been conducted. Latest literature on refugees, microfinance has been critically examined beside the current cash waqf models.

Findings – Empirical studies have shown that many refugees are equipped with marketable skills and talents that can be utilised to improve their socio-economic situations. The proposed model – cash waqf refugee microfinance fund (CWRMF) – is structured to extend microfinance to potential refugee microentrepreneurs. To address the lack of collateral, which is a requirement to gain any microfinance, CWRMF has been incorporated with a takaful unit (cooperation) by which refugees may guarantee each other. Additionally, the model has also been structured to address the challenge of sustainability of the institution that would provide microfinance. Hence, a reserve fund has also been integrated into the model.

Practical implications – CWRMF represents a potential model to be implemented by humanitarian non-governmental organisations (NGOs) and aid agencies to support livelihood of refugees in particular for Muslim refugees. Positive outcome is expected from the implementation of this model. This is because of the various advantages of microfinance programs not only on refugees but also on concerned NGOs, host populations and donor parties. Additionally, this paper is a set of primarily thoughts aims to open the door wider for more researchers to explore the potential of cash waqf as one of the instruments to finance refugee microenterprises and business activities.

Originality/value – Recently cash waqf has been into several models for socio-economic development and poverty alleviation. This paper is proposing cash waqf as a source for a microfinance fund that can contribute in the improvement of socio-economic situations of millions of refugees around the world.

Keywords Refuge, Cash waqf, Microfinance

Paper type Research paper

Introduction
The current phenomenal increase in the number of displaced populations and refugees has not been witnessed since the Second World War (UNHCR, 2015). According to the UNHCR report (UNHCR, 2016), a new record of 65.3 million displaced, including 21.3 million refugees, was set at the end of 2015. The length of time that refugees are spending in exile before they manage to return home has also increased to an average of 26 years (UNHCR,
With the scale of the refugee crisis, the current system of providing for the basic needs of refugees (e.g. food, drink, shelter and, at times, education and health care) is exhausting the resources of the United Nations (UN) agencies and humanitarian non-governmental organisations (NGOs) and is deemed unsustainable in the long term. Even the solutions proposed by the United Nations High Commissioner for Refugees (UNHCR) in the form of repatriation, integration and resettlement have proven ineffective, insufficient and beyond the reach of the majority of refugees. What makes the situation even worse is the fact that over 85 per cent of refugees are hosted by poor developing countries which already have their own development and poverty challenges (UNHCR, 2016). There is thus increasing pressure on stakeholders to find sustainable solutions to the problems faced by refugees.

The economic engagement of refugees in income-generating activities, projects funded by microcredit and microfinance – what is commonly known as livelihood programmes – has been long recognised as an effective means for improving refugees’ livelihood and socio-economic situations. This brief paper discusses how the charitable institution of waqf (endowment) can be used to develop a sustainable model to promote the economic engagement of refugees. It delves into the establishment of microfinance and start-up funds to promote entrepreneurship among refugees in refugee camps and urban areas. This model is particularly relevant to Muslim NGOs and might appeal to Muslim donors as it uses one of the well-known charitable institutions in Islam that has played a significant role throughout the history of Islamic civilisation in providing for the social, educational and economic welfare of Muslim communities.

**Cash waqf**

The concept of cash waqf can be traced back to as early as the second Hijri century (eighth century CE). Although the fatwa (legal ruling) of Imām Zufar (d. 158 H) is considered the most common reference on the permissibility of donating measurable or weighable properties including money as waqf (Cizakca, 2011), another account reveals that the issue of cash waqf was discussed among scholars even earlier. Imām al-Bukhāri reported that Imām Ibn Shihāb al-Zuhri (d. 124 H) was asked about the permissibility of a waqf in the form of 1,000 dinars held in perpetuity for trade with the profits being assigned to the poor and underprivileged (al-Bukhāri, 2002). Another account relating to cash waqf is found in the famous Mālikī book ‘al-Mudawwanah al-Kubrāh’ which documented the fatwa of Imām Mālik (d. 179 H) that asserted the obligation of zakāh on 100 dinars offered as waqf to be given as loans to people (Imām Malik, 1994).

The popularity of cash waqf has recently grown rapidly in Muslim societies. Many wealthy Muslims have been giving cash in the form of waqf to specific institutions; the funds are used for providing social services to the vulnerable groups of society (Cizakca, 1995).

Because of its distinct advantages in fund mobilisation and its liquid and flexible nature, cash waqf has recently been integrated into several models that have been developed for improving socio-economic development and poverty alleviation. The following are some examples of the use of cash waqf:

- for small- and medium-sized enterprises (Asmy, 2015; Lahsasna, 2010; Tohirin, 2010);
- for education (Aziz et al., 2013);
- for microfinance (Alpay and Haneef, 2015; Nadwi and Kroessin, 2013; Masyita, 2012; Ahmed, 2007; Zarka, 2007);
• for economic development (Ibrahim et al., 2013);
• for use by financial institutions (Haji Mohammad, 2011; Abdel Mohsin, 2007);
• for use by non-profit financial intermediaries (El-Gari, 2004);
• for poverty alleviation (Hassan and Ashraf, 2010);
• for microenterprises (Kahf, 2004; Ahmed, 2002); and
• for health care services (Ahmed, 2013).

Proposed model
A cash *waqf* refugee microfinance fund (CWRMF) is proposed to provide Islamic microfinance and microcredit facilities to refugee entrepreneurs who have the potential to run their own businesses and to support themselves. This model utilises the concept of cash *waqf* to raise funding required to provide these facilities.

As illustrated in Figure 1, two types of cash *waqf* are used, namely, temporary as well as perpetual cash *waqf*. The temporary cash *waqf* aims at targeting participants who would like to contribute funds to the model on a temporary basis. The funds are directed towards financing microfinance programmes for refugee micro-entrepreneurs. It is worth mentioning that it might be challenging for the management to keep finding temporary cash *waqf* donors to replace the old donors. However, this challenge can be overcome with proper marketing and promotion techniques. The second type is the perpetual cash *waqf*, comprising non-refundable donations. This type of cash *waqf* will be invested in relatively low-risk Shari‘ah-compliant investments, such as company shares or government *sukūk*. The profits generated from the perpetual cash *waqf* investment will be channelled to the

**Notes:** *OIC (Organisation of Islamic Cooperation); UNHCR (The United Nations High Commissioner for Refugees); IFRC (The International Federation of Red Cross and Red Crescent Societies); IDB (Islamic Development Bank)*

**Source:** Author

**Figure 1.** Cash *waqf* refugee microfinance fund (CWRMF) (conceptual model)
reserve fund which will be used to cover the operational expenses of the model. The process of fundraising can also include the issuance of *waqf* certificates (ṣukūk) to participants or donors who can benefit from tax exemption as a form of incentive to encourage them to invest in the cash *waqf* fund.

As in the above self-explanatory model, the fund could be founded and monitored by well-established organisations such as the OIC, UNHCR, IFRC or IDB. Contributors and participants could also include governments, institutions, companies and banks. In this model, it is proposed that large contributions are dedicated to form the principal fund – the CWRMF – whereas individual contributions can be directed to the reserve fund.

**Reserve fund**

The reserve fund has been incorporated in the model to ensure its sustainability. In addition to the profits generated by the perpetual cash *waqf* investment which are channelled to it, it will also include funds/charities collected from individual donors. These donations are expected to be accepted throughout the year and will be in small amounts. The reserve fund is expected to contribute to the operational expenses of the model in case the profits of the investment could not cover all the costs and expenses. Such expenses may include staff salaries, utility bills, office rents and others. The reserve fund would, in addition, keep the potential surplus amounts if there is any remaining from the investment revenues after settling the operational expenses.

**Takāful unit**

This unit would be integrated into the model to provide guarantees for refugee microenterprises. Each and every new participating refugee should join this unit before applying for any financial assistance. This unit is considered essential in the absence of any financial collateral and with the considerable ineffectiveness of social collateral in the refugee camp setting. Accordingly, new refugee entrepreneurs are required to obtain signed recommendations from older members of the *takāful* unit or the operating organisation. Additional functions of the *takāful* unit could include providing compensation for any default in the payment of refugees/participants for any reason of underperforming business or unexpected illness or death.

**Conclusion**

The refugee phenomenon has been widely perceived as a temporary problem; however, the statistics of the UNHCR confirm that nearly two-thirds of refugees are usually stuck in protracted situations, helpless and hopeless (UNHCR, 2016). Accordingly, temporary solutions have become ineffective and insufficient. This research note attempts to combine the advantages of microfinance and cash *waqf* to provide microfinancing facilities to refugees. The model uses two types of cash *waqf*, namely temporary and perpetual to be as accessible as possible to all potential participants. The model incorporates some risk management measures, in particular, the reserve fund to cover the operational expenses and the *takāful* unit to address the issue of adverse selection and default risks. It is important to note that although the model is proposed for refugees, it can also be utilised to cater for microfinance programmes for all displaced and war-affected populations. Nonetheless, it is admitted that the model needs further refinement and that a number of issues need to be discussed such as the details of the modes of financing for refugees and the issuance of *waqf* certificates (ṣukūk).
References


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Proposal for a new Sharīʿah risk rating approach for Islamic banks

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Abstract

Purpose – Customers of Islamic banking industry continue to be skeptical on Sharīʿah compliance of Islamic banks despite receiving fatwa from the competent authorities. The purpose of this paper is to quantify the Sharīʿah risk taken by Islamic banks, so that customers are better informed on the level of Sharīʿah compliance that will help in removing the persistent level of skepticism toward Sharīʿah compliance.

Design/methodology/approach – This research has used the scorecard based modeling approach to build the Sharīʿah risk rating model, which consists of 14 factors that capture Sharīʿah risk and are grouped in 5 major areas revolving around regulatory support, quality of Sharīʿah supervision, business structure, product mix and treatment of capital adequacy ratio. The score calculated by applying the model is grouped into 4 tiers reflecting the level Sharīʿah compliance at bank as non-compliant, weak compliance, satisfactory compliance and high level of Sharīʿah compliance. Three case studies were conducted by applying the model to Islamic banks from Malaysia, Pakistan and Saudi Arabia.

Findings – The final Sharīʿah risk scores calculated by the model clearly differentiate the 3 banks on basis of their Sharīʿah risk. The underlying scores also highlighted the areas where banks need to improve to reduce their Sharīʿah risk.

Originality/value – This model can be applied by customers of Islamic banks who are interested in understanding Sharīʿah-related aspects of Islamic banking industry. This model can be applied on standalone basis or as an extension to the conventional counter party risk rating models. This model can benefit management of Islamic banks toward allocation of capital against Sharīʿah risk under Basel III, and regulators can apply the model to measure industry wide risk of Sharīʿah non-compliance.

Keywords Basel III, Sharīʿah non-compliance risk, Rating models, Islamic banking industry, Sharīʿah supervision

Paper type Research paper

Introduction

Islamic banking customers tend to pose a highly relevant question pertaining to the Islamic banking business: Are banks labeled as “Islamic banks” really Islamic? Dar’s (2013) question “Is Islamic banking as exploitative as conventional banking?” reflects the fact that...
there is still skepticism among customers about the practice of Islamic banking and that it extends to the issue of Sharīʿah compliance of Islamic banks. Islamic banks address this concern by sharing the fatwas (Islamic legal rulings) of their respective Sharīʿah boards or other competent authorities on the Sharīʿah compliance of their business activities. Islamic banks tend to place high emphasis on the eminent personalities who constitute the members of their Sharīʿah boards to assure the public of their Sharīʿah compliance. In practice, bank customers do not rely solely on the fatwa or credentials of the Sharīʿah board members validating the banks’ financial products in their decision to patronize Islamic banks. Nonetheless, the aspect of Sharīʿah risk—that is, the risk of Sharīʿah non-compliance—is an important factor to which customers pay special attention in their decision to endorse Islamic financial products. Moreover, it is argued that the level of Sharīʿah compliance of a bank cannot be qualified in absolute terms as “yes” or “no”; rather, there should be a rating system which scores an institution’s Sharīʿah compliance across a range; for example, high, satisfactory, weak and non-compliant. This is deemed commercially attractive, as banks with higher levels of Sharīʿah compliance should be able to fetch higher ratings and enjoy a better market positioning in Islamic financial markets.

The issue of determining the level of Sharīʿah compliance, more specifically, measuring the Sharīʿah risk of Islamic banks, motivates this research. So far research in the area of quantifying Sharīʿah risk and allocating an adequate level of capital charge to mitigate this risk remains limited. A standardized Sharīʿah risk rating model is not available for Islamic banks to compare their levels of Sharīʿah compliance.

**Research objective**

The objective of this paper is to develop a Sharīʿah risk rating model to measure the Sharīʿah risk of Islamic banks. It aims at answering the question relating to Sharīʿah compliance of Islamic banks in a more satisfying manner to convince a larger set of customers that are still skeptical about the Islamic banking industry. The scope of this paper is limited to reviewing the existing risk rating models with respect to their relevance to measuring Sharīʿah risk, coming up with a more relevant Sharīʿah risk rating model, testing the model on Islamic banks for its accuracy, and finally providing a risk score that represents the Sharīʿah and financial risk of an Islamic bank. It is noted that the model does not calculate financial risk, which is already available from the ratings of conventional rating agencies. The overall score derived from the model can be used by customers to evaluate the level of Sharīʿah compliance of Islamic banks and by the banks to determine the adequate amount of capital that should be allocated to mitigate this risk.

**Review of existing rating models**

Existing market practices to evaluate banking sector risk and Sharīʿah compliance revolve around three areas, notably:

- conventional risk rating models;
- ratings by the Islamic International Rating Agency (IIRA); and
- guiding principles on Sharīʿah governance issued by the Islamic Financial Services Board (IFSB).

The existing rating models from three conventional rating agencies, namely Standard & Poor’s (S&P), Fitch and Moody’s, as well as from IIRA, highlight the gap in measuring the Sharīʿah risk of Islamic banks, especially from the perspective of a standardized yardstick that can be applied on basis of publicly available information about an Islamic bank. A bank
rated AAA can be financially very strong and can have very low credit risk, but it can be Sharīʿah non-compliant as well. Similarly, a fully Sharīʿah-compliant bank can have a rating of C or D by Fitch or Moody’s. As a result, these rating agencies are not effectively incorporating Sharīʿah risk rating into their risk rating systems. This calls upon the need to accommodate new risk rating factors which are important for Islamic banks to arrive at their overall credit score, including their Sharīʿah score.

Proposed methodology
The proposed rating model has two parts:
- Sharīʿah risk score; and
- overall counterparty financial risk score.

As highlighted above, the model calculates the Sharīʿah risk score only; the financial score, on the other hand, is taken from the rating of conventional rating agencies. The combined rating of Sharīʿah risk and financial risk is reported in a two-part format. The first part communicates the financial rating as calculated by the rating agencies, and it ranges from AAA to D or equivalent for all three conventional rating agencies. The second part of the rating reflects the Sharīʿah compliance score and, it is reported in four categories whereby the SSS category reflects the highest level of Sharīʿah compliance and SN corresponds to the lowest level, i.e. Sharīʿah non-compliant. As an example, the model output rating of AAA: SN means that bank is financially very strong, but its business is not Sharīʿah-compliant.

Proposed Sharīʿah risk rating factors
This model proposes to include five areas when measuring Sharīʿah risk. These are further sub-divided into 14 risk rating factors which are not quantified by conventional risk rating agencies from a Sharīʿah-compliance perspective. These factors provide detailed insight regarding the Sharīʿah risk of an Islamic bank and hence can provide valuable feedback to customers. A summary of these 14 factors is provided in Table I.

These 14 factors are considered relevant to measure the Sharīʿah risk of an Islamic bank based on the following rationale.

Regulatory support. Islamic contracts used by Islamic banks must be recognized by the laws and regulations of a country. For instance, it is important to know whether a murābaḥah transaction documents will be given due consideration in the courts of law. Many countries provide little support for the execution of Islamic contracts. Therefore, Islamic banks that get support from the laws and regulations of a country are in a better position to conduct Islamic banking business. In case of dispute, customers have confidence that the laws and regulations of the country will uphold Islamic transactional documents.

Quality of Sharīʿah supervision. A bank with a single Sharīʿah advisor reporting to the CEO is likely to compromise on Sharīʿah standards as compared with a bank having a full-fledged Sharīʿah board which independently reports to the Board of Directors (BOD). Therefore, this framework effectively captures the independence of the Sharīʿah supervisory function at a bank. Sharīʿah opinion is the most weighted factor to measure Sharīʿah risk. If a bank has adverse Sharīʿah opinion in its annual report, the negative weight will simply turn the Sharīʿah compliance score of a bank into an overall negative score.

Business structure. Legal incorporation: A separately incorporated and publicly limited Islamic bank gets more weight than a branch of a conventional bank having a mixed pool of funds. This is because the former will be able to manage and implement Islamic banking laws in a better way when it comes to the requirement for segregation of funds.
| 
| --- |
| **Regulatory support** |  |
| 1 Legal support | Separate Islamic banking law in the country | Single law covering Islamic and conventional banks | Weak legal support for Islamic contracts | No legal support for Islamic contracts |
| Score | 10 | 6 | 3 | 1 |
| 2 Central Bank Support | Independent supervisory board conducting Shari'ah audit | Shari'ah board with advisory function without audit | No Shari'ah board at central bank |
| Score | 10 | 8 | 3 |
| **Quality of Shari'ah supervision** |  |
| 3 Independence of Shari'ah supervisory function | Shari'ah advisory board reporting to BOD | Single Shari'ah advisor reporting to the BOD | Shari'ah advisory committee reporting to the Chief Executive Officer (CEO) | No Shari'ah committee/advisor |
| Score | 10 | 6 | 3 | 0 |
| 4 Opinion of the Shari'ah supervisory committee/advisor | Full compliance with Shari'ah (unqualified) | Qualified (some exceptions) | Disclaimer (no opinion) | Adverse (Shari'ah non-compliant) |
| Score | 10 | 6 | 3 | 0 |
| **Business structure** |  |
| 5 Legal identity of Islamic banking business | Separate legal entity | Separately incorporated legal subsidiary of a conventional bank | Division with separate pool of funds of a conventional bank | Branch operation of a conventional bank with mixed pools of funds |
| Score | 10 | 8 | 7 | 3 |
| 6 Number of Years in Shari'ah-compliant Business | 10+ years | 3-5 years | 1-3 years | Less than 1 year |
| Score | 10 | 8 | 7 | 3 |
| 7 Compliance with AAOIFI and IFSB standards | Regulatory full compliance | No regulatory requirement but individual compliance | Partial individual compliance | No compliance |
| Score | 10 | 7 | 8 | 0 |
| 8 Profit equalization reserve (PER) | Yes | 5 | 3 |
| Score | 10 | 8 | 7 | 3 |

(continued)
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<tr>
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<td>2% above the applicable Basel CAR (Basel II/ III)</td>
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<td>11</td>
<td>More than 50% of total assets</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>10 to 25% of total assets</td>
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<td>–10</td>
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<tr>
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<td>Less than 10% of total assets</td>
<td>5</td>
<td>1</td>
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<td>No mushārakah/ muḍarrabah based assets</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
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<td>More than 50% of total assets</td>
<td>2% above the applicable Basel CAR (Basel II/ III)</td>
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<td>Equal to Basel CAR</td>
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<td>under mushārakah/ muḍarrabah partnership</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Murābāh-based deposit</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Current/saving deposit) contracts under qard</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Table I.
Years in Islamic business: Fitch & Moody’s capture the total number of years in business but do not capture the total number of years in Sharīʿah-compliant business. Therefore, this scorecard gives additional marks to the tenure that a bank has been involved in Sharīʿah-compliant business.

AAOIFI & IFSB standards: Implementation of these standards at a bank adds to the Sharīʿah compliance score. However, the scope of measurement is limited to the disclosure (auditor’s certification) that the bank is following IFSB and AAOIFI standards while a check on practical compliance is outside the domain of the end user (customer).

PER: PER actually belongs to investment account holders and adds stability to their returns by mitigating displaced commercial risk. From the Sharīʿah perspective, it adds to the Sharīʿah compliance score because a bank has to develop different deposit and asset pools and adopt a Sharīʿah-compliant profit-sharing ratio mechanism to apply PER. Therefore, chances of Sharīʿah compliance are higher for a bank having a PER arrangement than a bank that is operating without PER.

Charity fund: The proper use of charity fund reflects the level of Sharīʿah compliance of an Islamic bank. Islamic banks having documented charity policies and an independent committee that spends the charity fund get a higher score. This factor is particularly important, as some banks continue to rollover their bad loans without transferring the overdue income charge to the charity account. Furthermore, some banks have started to use the charity fund as a promotional fund by using the money for advertising purposes.

Width and depth of deposit products. Equity-based products: Banks that use products based on participation and profit/loss sharing get a higher score as compared to a bank which simply relies on murābaḥah-based products. This factor particularly helps in diversifying the risk of Sharīʿah non-compliance from one product to multiple products.

Width of asset products: A bank which has more products is much likely to diversify its Sharīʿah risk while banks that continue to rely on a single product (such as murābaḥah) are assigned a lower score under this model.

Debt-based products: A bank which is mainly relying on debt-based products is likely to rollover the credit deals and hence is exposed to higher levels of Sharīʿah risk.

Structure of deposit: Many Islamic banking businesses operating as windows of conventional banks do not maintain separate deposit pools and hence are not fully Sharīʿah-compliant as compared with those Islamic banks that maintain separate deposit pools and hence qualify for higher Sharīʿah compliance scores.

Capital adequacy standards. External rating agencies calculate the Capital Adequacy Ratio (CAR) as per the applicable Basel definition and therefore penalize Islamic banks, especially when they have solicited deposits on the basis of profit/loss sharing and can pass the loss to depositors rather than charging it under equity. This scoring model calculates CAR as per the IFSB standards and adjusts the CAR premium/discount into the scoring according to the result.

Allocation of weights and scores
Scores and weights have been allocated based on the authors’ own judgement. This judgmental approach has its precedence in conventional risk rating model-building practices. Top rating agencies had started building their models by allocating judgmental risks and weights and have refined factors over a period through statistical back testing. Historical data are not available at this point in time on Sharīʿah non-compliance risk to back test these models on a statistical basis. These initial weights are subject to further calibration as large-volume data sets are tested by applying this model, and adjustments are made to improve the model’s accuracy.
Sources of information: model input
All the sources of information required as an input for this model are publicly available. This gives the model flexibility and makes it very easy for any individual/customer of the Islamic banking industry to use the model and get the Sharīʿah compliance score.

Interpretation of the Sharīʿah risk rating model score: model output
A bank can earn a maximum risk-weighted score of 150 and a minimum score of 138 under this Sharīʿah risk rating model. The interpretation of Sharīʿah risk rating scores is given in Table II.

A bank having a risk-weighted score of above 80 per cent is considered highly Sharīʿah-compliant and hence gets SSS rating. S+ rating is quite wide, including banks meeting most of the Sharīʿah-compliance standards. S-rating is awarded to those banks which are barely meeting Sharīʿah standards and require significant improvements in implementing the Sharīʿah guidelines into their day-to-day business dealings. An SN rating stands for a Sharīʿah non-compliant bank. The Sharīʿah rating score can be sub-divided into further categories to reflect various degrees of Sharīʿah compliance, but this would obviously add complexity for banking customers. Banks may, however, add additional tiers for more refined monitoring of their Sharīʿah risk.

Testing of the Sharīʿah risk rating model
The newly developed Sharīʿah risk rating model was applied to three banks to evaluate their degree of Sharīʿah compliance. These ratings were conducted on an unsolicited basis. The summary of results is provided in Table III.

<table>
<thead>
<tr>
<th>Category</th>
<th>Maximum weighted score</th>
<th>Minimum weighted score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory support</td>
<td>30</td>
<td>6</td>
</tr>
<tr>
<td>Sharīʿah supervision</td>
<td>20</td>
<td>−150</td>
</tr>
<tr>
<td>Business structure</td>
<td>50</td>
<td>7</td>
</tr>
<tr>
<td>Product width and depth</td>
<td>40</td>
<td>9</td>
</tr>
<tr>
<td>CAR (IFSB)</td>
<td>10</td>
<td>−10</td>
</tr>
<tr>
<td>Model output score</td>
<td>150</td>
<td>−138</td>
</tr>
<tr>
<td>% degree of Sharīʿah compliance</td>
<td>(Achieved score × risk weight)/maximum achievable score</td>
<td></td>
</tr>
<tr>
<td>Achieved degree of compliance</td>
<td></td>
<td>Rating table</td>
</tr>
<tr>
<td>80% and above</td>
<td>SSS</td>
<td>High Sharīʿah compliance</td>
</tr>
<tr>
<td>50 to 80%</td>
<td>S+</td>
<td>Satisfactory Sharīʿah compliance</td>
</tr>
<tr>
<td>0 to 50%</td>
<td>S−</td>
<td>Weak Sharīʿah compliance</td>
</tr>
<tr>
<td>Negative score</td>
<td>SN</td>
<td>Sharīʿah non-compliant</td>
</tr>
</tbody>
</table>

Table II. Interpretation of Sharīʿah risk rating scores

<table>
<thead>
<tr>
<th>Bank</th>
<th>Achieved degree of Sharīʿah compliance</th>
<th>Awarded rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Alfalah Ltd, Islamic Banking Division, Pakistan</td>
<td>95/150 (63%)</td>
<td>S+ (Satisfactory Sharīʿah compliance)</td>
</tr>
<tr>
<td>Bank Aljazira, Saudi Arabia</td>
<td>66.5/150 (44%)</td>
<td>S− (Weak Sharīʿah compliance)</td>
</tr>
<tr>
<td>Bank Islam Malaysia Berhad, Malaysia</td>
<td>122/150 (81%)</td>
<td>SSS (High Sharīʿah compliance)</td>
</tr>
</tbody>
</table>

Table III. Applying the Sharīʿah risk rating model on three banks
Conclusion

The Sharī‘ah risk rating model proposed in this paper includes 14 Sharī‘ah risk rating factors to determine the degree of Sharī‘ah compliance of an Islamic bank. The model has clearly differentiated the banks on basis of Sharī‘ah non-compliance risk. The weights assigned in the model were based on personal judgments, and these were correct to the extent that the end score calculated for each bank has clearly highlighted their strengths and weaknesses. This model can be used by individuals and the public to check the Sharī‘ah compliance score of any bank. This rating will introduce a healthy competition among Islamic banks to comply with Sharī‘ah laws and regulations. Further research is required to apply the model to more Islamic financial institutions.

References


Further reading


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Abstract

Purpose – This paper aims to explore the challenges facing the development of a *takāful* retirement annuity plan in Malaysia. It also aims at exploring a new platform to re-launch the same product after being withdrawn from the Malaysian annuity market a few years ago.

Design/methodology/approach – The research adopts a qualitative approach to address the possible challenges hindering the development of a *takāful* retirement annuity plan in Malaysia. The research will not discuss the Sharī‘ah issues deemed settled in previous researches but will only focus on technical challenges related to the instruments of investment and prudential measures.

Findings – The research found that various challenges face the development of a *takāful* annuity plan in Malaysia. Some of those challenges are the downsizing of the *sukūk* market, the shortage of long-term *sukūk*, longevity risk and risk-based capitalization. The research found that there is a need for a diversified portfolio of securities instead of solely using *sukūk* as an investment instrument in this product.

Originality/value – Re-launching the *takāful* annuity plan in Malaysia requires the identification of actual challenges facing the development of such a product. The product purported to be re-launched would benefit a large segment of retirees who do not have enough savings during the retirement age. The introduction of such a product will also expand the *takāful* market in annuities, which remains untapped.

Keywords *Takāful*, Retirement annuity plan, Longevity risk, *Sukūk*

Paper type Research paper

Introduction

Annuities have long been perceived as back-up financial plans during retirement age and a means to reduce longevity risk when an individual outlives his/her assets. The annuitant seeks to secure steady payouts during retirement age by trading liquid lump sums in return for a series of payments until he/she passes away. The product can also include riders such as death benefits or a combination between fixed and variable annuities to protect against the shortfall of investing the annuity fund. The product, which is sold by life insurance and investment companies, passes through two phases: an accumulation phase followed by an annuitization phase. During the accumulation phase, the contributions of the annuitants are accumulated, and the annuity fund is invested in long-term bonds with variant exposure to market risk. During the annuitization phase, the stream of payments during retirement is

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The different types of annuities – such as fixed, variant, guaranteed and joint – have helped the market to cater for the needs of annuitants and their heirs before and after retirement age (Alhabshi et al., 2012).

Takaful markets such as Malaysia’s have sought to develop a Sharī‘ah-compliant annuity product serving the same objective sought by a conventional annuity, i.e. guaranteeing a stream of payments during retirement age with available riders to secure death benefits. In 1999, Malaysia launched the first Sharī‘ah-compliant annuity plan dubbed Employment Provident Fund (EPF) takaful Annuity Scheme (SATK) (Yusof et al., 2011). Although the product was widely received by the industry and employees, it was withdrawn in 2002 due to pricing and risk-based capital (RBC) requirements, among other reasons (Ismail, 2017). Some institutions such as Amanah Raya offered a Sharī‘ah-compliant Public Mutual Private Retirement Scheme (PRS) that invested the contributions in both sukūk and stocks as a strategy to diversify returns in view of the volatility of the stock market. HSBC Amanah offered a non-guaranteed annuity up to the age of 75 years (Ismail, 2017). By and large, this product was offered under the PRS, which insurance companies, takaful operators, banks and unit trusts are permitted to offer.

The International Sharī‘ah Research Academy for Islamic Finance in collaboration with Prudential BSN takaful came up with the conceptual framework and structure for a Sharī‘ah-compliant model of a retirement annuity plan (Ali et al., 2014). The paper discussed the potential Sharī‘ah issues arising in the proposed model and highlighted some challenges of introducing the takaful annuity plan in Malaysia.

The current paper explores the possibility of relaunching the annuity retirement plan in Malaysia. It particularly seeks to address the key operational challenges in view of previous practices and input from industry players as well as research findings on annuities in Malaysia.

**Proposed Sharī‘ah-compliant model for retirement annuity plan**

Ali et al. (2014) proposed wakālah (agency) and hibah mu‘allaqah (conditional gift) as the underlying concepts for offering a Sharī‘ah-compliant retirement annuity plan. The wakālah concept is used to manage and invest the annuity fund until the retirement age (i.e. during the accumulation period). This will be followed by hibah mu‘allaqah whereby the contributions and the profits arising from the investment of the annuity fund will be donated to the tabarru‘ (donation) fund to start the annuitization stage. The tabarru‘ fund is used to make the stream of payments during retirement (i.e. retirement payout) and to pay the death benefits (i.e. death payout). Figure 1 depicts the mechanics of the proposed product.

After establishing the Sharī‘ah compliance of the model, Ali et al. (2014) identified sukūk as a potential investment instrument during the accumulation period. Citing longevity risk and lack of investment instruments as potential challenges, the paper recommends issuance of more long-term or perpetual government sukūk.

**Research objectives**

The current research aims to achieve the following objectives:

- to unveil the potential market of takaful retirement plan in Malaysia;
- to identify the main challenges facing the development and the launching of takaful annuity plan in Malaysia;
- to explore the possible synergy between the takaful industry and the sukūk market in Malaysia;
Methodology
The research is qualitative in nature and uses three methodological instruments:
- literature review: review the main literature on annuities to identify the main challenges of takāful retirement plans;
- content analysis: analysis of the literature from Shari‘ah, legal and operational perspectives; and
- semi-structured interviews: identify the main challenges facing the development of a viable takāful annuity retirement plan in Malaysia and the way forward.

Challenges of introducing takāful annuity plan in Malaysia
From the practices of takāful annuity in Malaysia as well as some research outputs conducted on the feasibility of the proposed product, there is a need to assess the cited challenges of the proposed product and zoom in on the real challenges hindering the development of takāful annuities in Malaysia. The present research focuses on operational
challenges in view of previous practices and input from industry players as well as research findings on annuities in Malaysia. Preliminary challenges found are the following:

- Insufficient sukūk instruments that can be used in the accumulation stage of the annuity product. This is based on statistics that showed that the number of long-term sukūk (20 to 30 years' maturity) and perpetual sukūk are dwindling, which makes it difficult to develop an annuity product that guarantees a stream of payments from retirement till death of the annuitant.

- Downsizing of the sukūk market as a result of sukūk under-rating and possible default events.

- The majority of sukūk are redeemed long before maturity, a factor that would affect the expected returns on sukūk, jeopardizing the long-term payouts during retirement.

- The challenge of longevity risk as people are living longer due to improved living conditions and health care programmes. This would mean that the regular payouts of the annuities would have to undergo a harmonization of assets and liabilities to avoid paying more annuities for longer lives (asset-liability mismatch).

- The deficit of the annuity fund and the operational aspect of qard (loan) injection and its repayment. As depicted in Figure 1, in the event of deficit, the takāfīl operator provides qard to the tabarru’ fund. This may be seen as a capital guarantee on its part, as it is merely a wakil (trustee) not a guarantor during the accumulation period. If the qard is injected into the tabarru’ fund, then it would be difficult to justify the occurrence of the deficit if the payout is based on an “upon claim basis”.

- RBC requirement makes takāfīl annuity products less affordable as the uncertainty featuring the longevity risk would require more allocation of capital with prices soaring beyond the affordability of annuitants.

- EPF is unlikely to accept any withdrawals by employees to contribute to the annuity scheme. Annuitants would have to find other sources to buy the product, which is practically very challenging in view of the scarcity of sources and strict regulations on pension schemes.

- The applicability of the Islamic Financial Services Act 2013 on the proposed takāfīl annuity plan has yet to be put to the test. The definition of a defined risk in a typical takāfīl arrangement versus a known event in an annuity may pose a Sharī’ah and legal issue as far as this product is concerned. Governance issues may arise as well.

Conclusion
The present study capitalizes on previous practices of takāfīl retirement plans and research conducted on takāfīl annuities in Malaysia. The research aims to identify the main challenges facing the development of such a product and the possibility of relaunching it by takāfīl operators in Malaysia. The preliminary findings of the research have unveiled a number of challenges that will be put to the test via content analysis and semi-structured interviews. Preliminary conclusions suggest that the takāfīl annuity product should have diversified investment portfolios both in terms of maturity and asset quality. Capitalization of annuities should be better regulated to reduce cost and price. Besides, outsourcing the contributions from funds such as EPF is not recommended in view of a sukūk market marred by uncertainty and scarcity of long-term sukūk instruments.
References

Further reading

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Utilisation of zakāh and waqf fund in micro-takāful models in Malaysia: an exploratory study

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Salami Saheed Adekunle
International Centre for Education in Islamic Finance, Kuala Lumpur, Malaysia

Abstract

Purpose – This paper aims to investigate the utilisation of both zakāh and waqf fund as external resources to ensure micro-takāful services are delivered to underserved communities in an effective and sustainable manner. It also addresses Sharī‘ah issues related to the zakāh- and waqf-based model.

Design/methodology/approach – The study is a qualitative-based research. It uses both focus group and content analysis approach to gather primary data and identify and interpret relevant secondary data and Sharī‘ah concepts in developing the zakāh- and waqf-based micro-takāful model.

Findings – It is discovered throughout the investigation of attributes of beneficiaries of zakāh and waqf institutions as well as micro-takāful scheme that all share commonalities in terms of social securities and socio-economic support to low-income households in societies. The study also finds that the disintegration of zakāh and waqf which form part of the Islamic ecosystem from the micro-takāful model makes it less effective and sustainable.

Originality/value – This study appears as a primitive attempt to discuss and develop a zakāh and waqf-based micro-takāful model with reference to Malaysian jurisdiction.

Keywords Waqf, zakāh, micro-takāful, financial inclusion

Paper type Research paper

Introduction

Micro-takāful is an Islamic form of micro-insurance designed to provide protection to low-income and underserved communities against risk and misfortune. As opposed to regular takāful products which target participants with financial capabilities, micro-takāful is dedicated to low-income groups that are partly or wholly excluded from formal takāful products due to their financial constraints. Zakāh and waqf are Islamic instruments prescribed for socio-economic development to help and support eligible zakāh recipients and waqf beneficiaries. This paper investigates the nature of micro-takāful as a tool of financial inclusion. It examines how zakāh and waqf can be harnessed in micro-takāful to provide social security and uplift the economic conditions of underserved communities.
The Sharī'ah issues related to the use of zakāh and waqf as part of the micro-takāful model are also examined.

Research objectives
This study aims to realise the following objectives:

- to examine the role of zakāh and waqf in socio-economic development and in what ways both can be streamlined to suit micro-takāful models; and
- to identify possible Sharī'ah issues related to the operations and contractual obligations in utilising zakāh and waqf in micro-takāful models.

Research methodology
This research is qualitative in nature. It uses the content analysis approach in identifying and interpreting relevant Sharī'ah concepts to be used in developing the zakāh- and waqf-based micro-takāful model. The research uses evidence gathered mainly from secondary sources of data. These include the Qurʾān and Sunnah (Prophet’s teachings) as well as the resolutions of internationally recognised Sharī'ah bodies such as the International Fiqh Academy of the Organisation of Islamic Cooperation (IFA-OIC), the Islamic Fiqh Academy of the World Muslim League (IFA-WML) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Other sources of reference include books, journal articles and conference proceedings on the related topic of discussion.

In developing the theoretical framework and the zakāh- and waqf-based micro-takāful model, a focus group discussion (FGD) was held to seek first-hand expert opinions on micro-takāful models in Malaysia and the possibility of incorporating zakāh and waqf as part of the model. The focus group involved representatives from different stakeholders including the Malaysia Takaful Association (MTA), takāful operators (TOs) and zakāh institutions such as Pusat Pungutan Zakat (PPZ), Lembaga Zakat Selangor (LZS) and Bahagian Zakat (BZ) under Majlis Agama Islam Negeri Johor.

Sharī'ah issues related to the zakāh- and waqf-based micro-takāful model

Sharī'ah issues in the use of zakāh funds
The Sharī'ah issues in the use of zakāh funds are divided into two, namely, issues related to zakāh allocation and issues related to the operation of zakāh-based micro-takāful.

Sharī'ah issues in zakāh allocation in micro-takāful
The utilisation of zakāh in micro-takāful stems from discussions of contemporary scholars on the permissibility of utilising zakāh for investment or using it to establish microfinance funds or guarantee funds (al-Shubaily, 2012). Thus, the allocation of zakāh – whether for investment, Islamic microfinance funds or guarantee funds – has been categorised into three groups based on the source of the zakāh:

1. zakāh allocation by zakāh payers;
2. zakāh allocation by a zakāh authority; and
3. zakāh allocation by zakāh recipients.

Classical scholars have two different views on zakāh allocation by zakāh payers. The first view, held by Mālikī, Shāfi’ī and Ḥanbalī scholars as well as the majority of Ḥanafīs, disallows it, as zakāh funds are meant to be used immediately (Ibn Qudāmah, 1983: 2/541;
regarding zakāh allocation by a zakāh authority, it does not pose serious Shari’ah issues as in the case of allocation of zakāh funds by zakāh payers because the zakāh obligation is actually being discharged without delay by zakāh payers to the zakāh authority. However, the main concern here lies in whether the allocation helps to cater for the urgent needs of zakāh recipients. If this is not the case, it would defeat the purpose of zakāh altogether. In that regard, the baseline of the arguments and discussions of contemporary scholars is to adopt the view of classical scholars that utilisation of zakāh funds should have immediate effect.

Scholars have two views about zakāh allocation by a zakāh authority. The IFA-MWL in its Resolution No. 6 in its 15th session, the Fatwa Council of Saudi Arabia, al-Zuhaylī, Alwānī, and Taqi Usmani viewed that it is not allowed (al-Fawzan, 2012; al-Shubaylī, 2012). The second view is based on the decision of the IFA-OIC in its Resolution No. 15 (3/3), the Zakat House in Kuwait in its third symposium on contemporary issues on zakāh and the Shari’ah Committee of Kuwait Finance House, which allowed zakāh allocation by the management (Zakat House, 2016; al-Fawzan, 2012). The preferred view is the second view that allows zakāh allocation by the management. The reason is that the concerns raised by the opposite view can be easily addressed. First is the zakāh disbursement delay: there should be no cause for delay once zakāh payers have paid their zakāh dues, and the zakāh management is a legal proxy for the zakāh recipients. Second is the denial of the right of zakāh recipients: it is established that zakāh allocation is for the welfare and benefit of the recipients; therefore, the zakāh management is responsible to ensure that the interest of the zakāh recipients is taken care of.

With regard to zakāh allocation by zakāh recipients, classical and contemporary scholars unanimously agree about the permissibility of allocation of zakāh by its recipients for investment or other lawful purposes. This view is substantiated by some narrations, especially from Shafi’ī classical books:

Shafi’ī and Ahmad in a report allowed giving the poor and destitute zakāh funds for investment. As such, a person who makes handicrafts would be given zakāh funds to purchase a machine to make income that is sufficient to maintain a decent standard of living (al-Nawawī n.d.: 6/193-194).

Sharīʿah issues related to the operation of the zakāh-based micro-takāfūl model

Sharīʿah issues arise in the distribution of zakāh funds. This triggers the following questions: Is it compulsory to disburse zakāh funds to all zakāh recipients in the micro-takāfūl plan, or is it allowed to prioritise in accordance with the level of need and urgency? Does the latter alternative violate the concept of tashrīkh (inclusiveness) implied in the relevant Qur’anic texts? There is an incidental question to address before addressing these questions: Is it necessary to have all the categories of zakāh recipients in one place at the same time? The response to this question came from Imām al-Ghazālī when he categorised the zakāh recipients into three major categories. The first category refers to al-muʾallafah (those inclined towards Islam) and al-ʿāmilīn (zakāh collectors). The second category
involves *al-ghuzāh* (those fighting for Allah’s cause) and *al-mukātabūn* (slaves). The third category includes the remaining *zakāh* recipients (*al-Ghazālī* n.d.).

In response to the first question, it is not compulsory to cover all available *zakāh* recipients during *zakāh* disbursement for the following reasons:

- First, Ibn Abbās reported that the Prophet (peace and blessing be upon him) said:

  "Allah has prescribed *zakāh* on their wealth, to be taken from the rich and given to the poor" (al-Asqalānī, 2001: 3/307, *ḥadīth* no. 1363).

- Second, the majority of classical scholars favoured giving *zakāh* recipients what is sufficient for their daily needs. The Mālikīs, Shāfīʿīs, Ḥanbalis and some other scholars did not specify a particular amount due to variation in needs and values over time. Therefore, the Mālikī school leaves it to the *ijtiḥād* (reasoning) of the *zakāh* management. In the same vein, the Shāfīʿī view that recipients should be given what satisfies their needs, even if the portion reaches the minimum threshold of *zakātatable* items. Meanwhile, the discussion of what suffices for *zakāh* recipients prompted the Shāfīʿīs to revisit the minimum threshold of eligible items of *zakāh* (*Al-Nawawī*, 2002, pp. 318-320; Ibn Rushd, 1995: 2/654; Ibn Qadāmah, 1983: 2/707).

Another question relates to whether the contribution made by the *zakāh* management is considered the right of *zakāh* recipients from the *zakāh* fund. As highlighted earlier, scholars who favour *zakāh* allocation for investment or microfinance funds unanimously agreed to give such allocated or invested portion for the benefit of *zakāh* recipients. Therefore, in the case of micro- *takāfūl*, the contribution is donated and owned collectively by the micro- *takāfūl* participants, who are also among the *zakāh* recipients. For example, the entitlement from a family micro- *takāfūl* account solely belongs to the participants. As such, in the event of the death of any of the participants, the fund under this account is subject to conditional *hibah* (gift). This is based on the resolutions of the Shariah Advisory Council of Bank Negara Malaysia in its 165th meeting, which state that after the death of the participant, money coming from the *tabarru* fund or savings and investment funds would be given to the nominee on the basis of conditional *hibah*. The Sharīʿah committee of the micro- *takāfūl* operator may decide that the savings and investment funds be subject to the rules of Islamic law of inheritance (*al-mūṯārīḥ*).

**Sharīʿah issues related to the use of *waqf* funds for micro- *takāfūl***

Acceptance of *waqf* donations by beneficiaries requires further discussion on how to relate it to micro- *takāfūl*. The consent of prospective *waqf* beneficiaries, if the *waqf* donor specifies the beneficiaries in a *waqf*, is crucial to conclude the *waqf* contract. The same goes for a situation where *waqf* is made as a source for a micro- *takāfūl* plan. Before proceeding with the micro- *takāfūl* policy agreement between the *waqf* management and the micro- *takāfūl* operator, the *waqf* management may first need to have the consent and acceptance of the *waqf* beneficiary. Similarly, in the underwriting policy, micro- *takāfūl* participants are required to stipulate a nominee. The question is whether the failure of the nominee to give consent would affect the policy? The reply to this question may be attempted from two perspectives. First, the views of classical scholars in respect to acceptance and possession of
specified beneficiaries in a *waqf* contract may be considered. The majority of scholars allow conclusion of a *waqf* contract without the acceptance of the beneficiaries; the same goes for the nominee in a micro-takāfūl. Therefore, the *waqf*-based micro-takāfūl plan can be concluded without the acceptance of the nominee. Second, the issue of *waqf* does not come into the picture. Although the contribution comes from a *waqf*, it is no longer a *waqf*. This is because micro-takāfūl participants are the *waqf* beneficiaries. Their entitlement to claim from micro-takāfūl risk funds represents their portion in *waqf* funds, which they are fully authorised to give to those whom they want, e.g. their nominees or heirs as agreed in the micro-takāfūl policy and endorsed by the relevant Sharī‘ah scholars. Also, the payment of micro-takāfūl benefits follows the policy agreed between the micro-takāfūl participants and the micro-takāfūl operator, which has been duly approved by the relevant Sharī‘ah committee, and it is not subject to *waqf* rules.

**Conclusion and recommendations**

This study has examined micro-takāfūl and discussed some pertinent Sharī‘ah issues and views of both past and present scholars in respect of utilisation of *zakāh* and *waqf* in the micro-takāfūl model. *Zakāh* is a legal instrument and *waqf* is a voluntary instrument to serve the poor and the needy for attaining social welfare. The effective integration of both concepts in micro-takāfūl to support financial inclusion will certainly have positive impacts on the lives of underprivileged members of the society.

The paper makes the following recommendations:

- The use of *zakāh* and *waqf* funds to complement participants’ contribution in micro-takāfūl plans.
- The use of *zakāh* and *waqf* funds to finance the contribution of the whole micro-takāfūl plan.
- The use of *zakāh* and *waqf* to establish mutual assistance funds for micro-takāfūl schemes.
- The fund may have an independent legal personality registered under the relevant authorities under the management of people with technical expertise to deliver micro-takāfūl services to poor and low-income households.
- There is a need for *zakāh* and *waqf* authorities to issue fatwas and work closely with takāfūl operators to come up with micro-takāfūl products to serve the needs of the society.

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Fiqhī views on bayʿ wa salaf and qard-based Islamic banking deposit accounts in Malaysia

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Abstract

Purpose – Islamic banks are obliged to carry out transactions that only comply with Islamic commercial laws. Malaysia has been championing the Shari‘ah-based banking system, and so, continuous improvement on the compliance level of the institutions offering Islamic financial services is key to its global recognition in this industry. One of the issues that can affect deposit products is existence of a sale contract and loan facility in one transaction. Famous prophetic tradition prohibits this. Hence, this paper aims to examine the linkage between bayʿ wa salaf (combination between a sale contract and loan in one transaction) and deposits accounts in Malaysia.

Design/methodology/approach – The subject matter of this paper is one that is researchable within library-based research. It is on this premise the research used the non-empirical qualitative research methodology. It used inductive method of analysis of both Islamic and policy documents on Islamic banking in Malaysia. Literature from Islamic jurisprudence, websites of some of the Islamic banks in Malaysia and relevant resolutions from the Shariah Advisory Council of Central Bank of Malaysia were consulted.

Findings – Based on the methodology mentioned above, the researchers arrived at the following findings: that, although there is no juristic disagreement about the prohibition of bayʿ wa salaf, disagreement, however, occurs in results of some contracts. The most notable area of agreement on the existence of bayʿ wa salaf is when there is express stipulation of sale or rendering of service and express or implied stipulation of loan alongside of the sale or service rendering. In an organized reversed tawarruq, the use of these deposits by the banks is regarded as loan from the depositors to the banks, who will soon put the money into sale that will generate profit to be divided between the banks and their depositors. However, this study finds that this is not bayʿ wa salaf prohibited by the prophetic tradition.

Originality/value – The originality of this topic is proven by the new banking regulation regime of Malaysia, which compels Islamic banks to guarantee all deposits under them. As Islamic banks carry out their banking activities through trading, there is need to conduct a research such as this. This is to examine whether Islamic banks’ unilateral use of depositors’ funds in non-investment accounts which is translated, constructively, as loan from the depositors to Islamic banks amounts to bayʿ wa salaf before the future tawarruq. Here there is loan and sale, which is the tawarruq. Hence, the need to do this research.

Keywords Fiqh, Bayʿ wa salaf, Tawarruq, Deposit accounts

Paper type Research paper

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Introduction

Contemporary Islamic financial institutions (IFIs) are obliged to comply with Islamic commercial laws as well as the regulations of the central bank of their respective jurisdictions. The Malaysian central bank, Bank Negara Malaysia (BNM), issued a policy document titled *Qard* in 2016. Section 22.2 mandates all IFIs in Malaysia to revise all products based on *wadīʿah yad ʿamanah* (savings with guarantee) to *qarḍ* (loan) by 31 July 2018. This will affect deposit accounts. The bank, as borrower, is entitled to use the deposited funds and must return them upon demand to the customer/lender. Because the deposited funds are a loan to the bank, there can be no contractual benefit to the lender. This regulatory requirement poses a challenge to Islamic banks in competing for funds with conventional banks that offer interest on deposits. An instrument was therefore required by IFIs that would enable them to retain their customers and maintain their market position.

One of the alternative incentive tools considered by IFIs has been to channel Islamic deposits into *tawarruq* (tripartite sale) transactions. However, this practice raised some *Sharīʿah* concerns among *Sharīʿah* intellectuals since the Prophet (peace be upon him), in an authentic *hadīth*, prohibited combining a sale contract and a loan (*bayʿ wa salaf*) in one transaction. The *tawarruq*-based deposit account works as follows: the bank conducts a reverse *tawarruq* transaction where it purchases a commodity on a spot basis on behalf of the customer with money deposited by the customer; then, acting as the customer’s agent, it sells the commodity to itself on a *muraḥrah* (cost plus mark-up) basis with deferred payment; then it sells the commodity to a third party on a spot basis and credits the customer’s account when the transaction is completed. The issue of *bayʿ wa salaf* may arise in this transaction, particularly when the bank accepts the money and holds it (say for two working days) on the basis of *qarḍ* and then carries out the *tawarruq* transaction. Here, *bayʿ wa salaf* has apparently occurred because the customer first gives a loan to the bank (in the form of a bank deposit) and then sells a commodity to the bank through reverse *tawarruq* (Hong Leong Islamic Bank Berhad, 2017). The question is whether this combination of loan arising from the deposit product, sale arising from the *tawarruq* transaction and *wakālah* (agency) carried out by the bank on behalf of the customer really amount to the prohibited *bayʿ wa salaf*? That is the subject of research in this paper.

Jurists like al-Māwarī (1999) in discussing the prohibition of *bayʿ wa salaf* pointed out that lending/borrowing as a single contract is not prohibited in the *Sharīʿah*, nor is sale/purchase as a single contract; even having the two contracts together is permissible as long as there is no stipulation linking them. What the *hadīth* on *bayʿ wa salaf* actually prohibits is the stipulation of a loan in a sale contract. Against that backdrop, this paper aims to conduct a theoretical study on the prohibition of *bayʿ wa salaf* and its link to the *qarḍ* policy relating to Malaysian Islamic banking deposit products.

*Jurists’ interpretations of the *hadīth* on *bayʿ wa salaf**

The majority of jurists agreed that if anyone stipulated receiving a loan from, or giving a loan to, his counterpart in a sale contract, the sale contract is void and rejected. One exception is the view of Imam Malik, who in a popular opinion of his *madhhab* (school of jurisprudence), validated the contract subject to renouncing taking delivery of the loan (Ibn ʿAbd al-Barr, 1287AH). Nevertheless, the detailed rulings derived from this *hadīth* and its effect on a sale contract may vary from one *madhhab* to the other. Thus, Imam al-Shafiʿī said that the prohibited *bayʿ wa salaf* occurs when the contracting parties form a contract and insert a condition to make a sale and loan binding on them, resulting in ignorance of the price. Explaining further, Imam al-Shafiʿī (1990) said that this is because the commodity has been sold against a price, and the benefit of the loan represents a portion of the price as well,
A sale contract with stipulation to give or take a loan (al-Nawawi, 1991).

In the above example, ignorance of the price is established as the Ṣaḥābi madhhab’s ‘illah (ratio legis) for the prohibition of ṣaw‘ al wa ‘alaf. It is expressly mentioned by al-Mawardi (1999) in his al-Hāfiz. He also states that, in the Ṣaḥābi madhhab, ṣaw‘ al wa ‘alaf can only occur if the combination of sale and loan contracts is in one contract with the conclusion of one depending on the other. Based on that, a contract in which a loan occurs, but it was not a condition for the performance of a sale contract between the same parties, such a contract cannot be interpreted as the prohibited ṣaw‘ al wa ‘alaf.

Meanwhile, the Ḥanafī School of jurisprudence interpreted ṣaw‘ al wa ‘alaf as interpreted by the Ṣaḥābi School but with some additional terms:

They interpreted the prohibition of ṣaw‘ al wa ‘alaf when the sale is on condition that [one of the contracting parties gets] the benefit of a loan or gift or charity or the like [from the other] (al-Zayla‘ī, 1313AH).

Therefore, the ‘illah identified by the Ḥanafī School for prohibiting ṣaw‘ al wa ‘alaf is added benefit for either of the parties. There is no effective difference between this ‘illah and that inferred by the Ṣaḥābi School because ignorance of price still exists in such a loan. The difference is that the Ṣaḥābi School originally interpreted stipulation of the loan to come from the seller. It could, however, also come from the buyer. Thus, by extension, the Ḥanafī School sees the action as the original case for either of the two contracting parties, depending on which one has the stronger bargaining position. In either case, the same ‘illah of ḥahālah will ensue, and the contract will be void (al-Māzirî, 2008). It is worth noting that despite the Ṣaḥābi School’s focus on the ‘illah for the prohibition of ṣaw‘ al wa ‘alaf being ignorance of price, they also agree on other ‘illahs that were expressly mentioned by the Ḥanafī School. These are:

- It amounts to a sale contract with an added stipulation (ṣaw‘ shart).
- It contravenes the Prophet’s prohibition of every loan that attracts benefits.

Irrespective of these other ‘illahs, it can be argued that the contract would be already void due to the deficiency of an essential element for the validity of a contract, which is knowledge of the subject matter of a contract, which is the price in this case.

Regarding the ‘illah in the Ḥanbalī School, Imām Aḥmad said:

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\text{bay‘ wa salaf refers to a contract in which a man grants a loan to another man and subsequently sells a commodity to him at an increased price. [Such a sale] is invalid because every loan that extracts added benefit [for the lender] is usury (Ishaq Ibn Mansur, 2002/1425AH).}
\]

It appears from this interpretation that the ‘illah for prohibition of ṣaw‘ al wa ‘alaf according to the Ḥanbalī School is čhabn and khid ah (price manipulation and deception). This means that the Ḥanbalī School also concurs with the Ṣaḥābi and Ḥanafīs on the ‘illah for the
prohibition of bayʿ wa salaf as price manipulation is caused by jahālah. The result is that something has been taken in excess at the expense of the other party at his ignorance.

On the legal implication of the contract of bayʿ wa salaf, most scholars including the Shāfiʿīs, Mālikīs and Ḥanafīs consider it void as the contract lacks the essential element of knowledge of the subject matter, either the commodity or the price. The Ḥanafīs have a rather surprising position on this issue. They consider the sigah (contractual format) to be the only essential element of a contract and categorise other elements as conditions of a contract. Based on that, they normally declare a contract as voidable and not void if it involves ignorance regarding the subject matter. It is thus surprising that in the case of bayʿ wa salaf, the Ḥanafīs declared it void ab initio in agreement with the Shāfiʿīs and Ḥanafīs, as against the Mālikī School, which validated it if taking delivery of the loan is discontinued.

Application of the jurisprudential rulings on organised tawarruq-based Islamic banking deposit products

Without undermining any opposite view on organised tawarruq, the findings of this study will be applied on bayʿ wa salaf based on the view of Sharīʿah scholars who approved organised tawarruq with conditions. The concept is not approved by the OIC Fiqh Academy (International Islamic Fiqh Academy, 2009), whereas the Sharīʿah Advisory Council (SAC) of BNM approves it on the condition that the parties or their agents take delivery (Bank Negara Malaysia, 2016a2016b). It is also approved by some individual contemporary jurists on the condition that the commodity does not go back to the bank (Ḥammād, 2013).

Having stated the underlying principles that will guide this discussion, it should be mentioned that under Islamic commercial law, the obligation of a debtor to his creditor is limited to repayment of the loan amount, and the creditor has no other right over his debtor except that. However, it is permissible for a debtor, if he so wills, to repay the debt with a premium as a token of appreciation of the facility granted to him by the creditor (Ibn ʿAbd al-Barr, 2000/1421AH). As Islamic banks are also competitors in the banking industry, market practice compels them to give incentives to their customers that deposit with them. Otherwise, they risk the loss of depositor funds. It is from this perspective that Islamic banks in Malaysia have made efforts to conduct business with depositors’ funds so that they can give such incentives to them. Part of this effort has been the initiation of tawarruq-based deposit products. The question remains whether the issue of bayʿ wa salaf arises in this product when the banks treat Islamic deposits as qard irrespective of the deposits being current or savings accounts.

To answer this question, let us take a brief look at the two underlying principles in wadī ah yad ḍamānah-based deposit accounts and qard-based deposit accounts. Under wadī ah, the custodian has an obligation to protect and safeguard the item placed under his custody as ḍamānah (guarantee) until he returns it to the rightful owner. The custodian is not liable for any damage or loss of the wadī ah unless he commits misconduct or negligence. If the custodian uses the wadī ah to conduct business without the permission of the owner, while there is no disagreement among the scholars about his liability, they disagreed with regard to his entitlement of profit. The best view is that the custodian deserves the profit whilst he is liable for the capital (Ibn ʿArafah, n.d.; al-Sarakhsī, 1993). On the other hand, if he carried out business with the funds deposited with the permission of the owner, he becomes a muḍārīb, and all the rules of muḍārabah apply (al-Bājī, 1332AH).

As mentioned above, the two major Sharīʿah rulings on the effect of bayʿ wa salaf are that both the loan and the sale contract are void ab initio, while the other ruling says that the sale
contract remains valid, subject to discontinuance of the loan. Based on the second opinion that has been preferred by the researchers, connection of an organised *tawarruq* with Islamic banks’ *wāḍī‘ah* or *qard*-based deposit accounts will not immediately trigger the Shari‘ah issues of *ribā* (interest), *gharar* (uncertainty) or *jahālah* (ignorance). This decision is based on the following grounds:

- As mentioned earlier, *bay‘ wa salaf* only occurs if the sale and loan contracts are related to each other in one transaction, whereby execution of one is anchored on the execution of the other. This is not the case in *qard*-based deposit accounts, as there was never such an agreement between the Islamic banks and their customers. The loan comes first in the form of a mere deposit at the option of the depositor, then the debtor (Islamic bank) uses the loan to do business in which he is at liberty to give part of the profit to the depositor or not to give any profit because the only liability he owes to his depositor is refund of his deposit. The researchers argue that it is not appropriate to invoke the following *qa‘idah* (jurisprudential legal maxim) in this case:

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\text{ﺍﻟﻤﻌﺮوף ﻋﺮﻓاً ﻋﻠﻰ شروط ﺷﺮاً}
\]

The legal maxim means that, what is known as a common practice is similar to a prior condition (Ibn Nujaym, 1999). This is because under the *qard*-based deposit products, the bank does not give profit to customers on a regular basis. Also, the bank is not under any obligation to pay any profit to its depositors. This position is even clearer with the *wāḍī‘ah*-based account as stated above.

- Regarding a deposit account being operated based on *qard*, there is juristic disagreement on the commencement of ownership of *qard* by the debtor. One of the opinions says that the debtor’s ownership of a loan commences immediately upon taking delivery of the loan. Another opinion states that his ownership does not start until he has started using the loan (al-‘Imrānī, 2000/1421AH). In line with the Shari‘ah concept of *taysir* (facility), the researchers choose the second opinion because it clears the bank from being obliged by the rules of loans when they channel depositors’ funds into *tawarruq*. Therefore, the accumulated deposits made by customers before the bank uses the funds to conduct *tawarruq* transactions do not fall under the loan contract until the bank actually channels the funds into its commercial operations; hence, there will not be any Shari‘ah issues arising. One may argue that the withdrawal being made by other customers is a form of the bank’s commencement to operations. This argument is countered by the nature of money as a fungible asset, which is only replaced by its type and not by itself. Thus, the withdrawal is from the other monies of the bank and not really from the deposits that may soon be channelled into *tawarruq*.

- Even for the *wāḍī‘ah*-based deposit products, it should be noted that there is not one jurist from all the classical jurists that has raised the issue of *bay‘ wa salaf* in their discussion of the custodian’s use of the fund kept under his custody, with or without the permission of the owner.

**Findings and conclusion**

This paper investigated the Shari‘ah rulings on the combination of a sale and loan in one transaction and linked such rulings to the Malaysian *qard*-based accounts and the Shari‘ah
stance on IFIs using such deposits to carry out tawarruq transactions. The paper adopted the opinion of those who permitted organised tawarruq.

The major findings of the research are as follows:

- The prohibited ḍawī ṣalaf is a sale or an exchange contract in which one of the contracting parties stipulated (or acted in a manner equal to stipulation) that he will give a loan to, or receive a loan from, his counterparty alongside the sale contract, or a stipulation to sell or buy was included in a loan contract, thereby resulting in receiving the price and the benefit of the loan against the commodity or service delivered, or resulting in the seller selling a commodity and providing a loan facility to the buyer.

- There is no juristic disagreement about the prohibition of ḍawī ṣalaf, as expressly ruled by the Prophet (peace be upon him). There is, however, disagreement among jurists on the status of such contracts that combine a sale and a loan in one transaction. Most jurists invalidated the contract ab initio without allowing for remedy, whilst the Maliki School validated the contract if the prospective beneficiary does not receive the loan.

- There is unanimous agreement that whoever sealed a sale contract with a stipulation of receiving or giving a loan, the sale is invalid, except the ṭūkisah (dispensation) provided by the Maliki School, which validated the contract formation if the loan was not received.

- There is no ḍawī ṣalaf that causes a contract to be void if the loan agreement arises after the sale contract was concluded. This is on condition that the execution of one contract is not dependent on execution of the other and on condition that the market attitude of each towards the other in the sale contract is not influenced. The example provided by Imam Ahmad was that the loan is accompanied by a higher-than-market price for the sold item.

- In applying the preceding fiqhī findings, the researchers hold that there is no violation of Shari‘ah if qard-based Islamic deposits are used by IFIs to carry out tawarruq.

- In light of the above, the researchers did not find any Shari‘ah issue capable of causing riba, gharar or jahalal in the deposit practices of IFIs, neither in the case of wadi‘ah nor in the case of qard-based deposit accounts. However, it is important to note that to avoid any ambiguity and confusion, the bank must not make a binding promise to the customers of qard-based deposit accounts. Any profit given by the bank must be at its sole discretion and not on prior agreement between the bank and the depositors. The researchers opine that Islamic banks’ depositors should be made to understand that they should not expect any profit from the IFIs because it is an act of worship to keep their money in non-interest deposit accounts, and if they would like to earn profits they should opt for Islamic investment accounts.

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