

DEVELOPMENT OF CAPITAL MARKET UNDER ISLAMIC PRINCIPLES

by

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INTRODUCTION

The development of a capital market particularly in a capitalist, monetized economy of the modern world has been historically due to the need to facilitate the following demands:

- * those with surplus capital would have the opportunity to select the best forms of investments not only in terms of yields or returns but also in terms of a good mix of short, medium and long term investments to spread their risks;
- * those who have the opportunities and expertise to innovate and manage investment concerns but lack the funds to finance their activities to have access to surplus funds from others;
- * there are also those who need to vary their investment mix from time to time to do so with ease and rapidity at very little cost;
- * there used to be also growing needs to develop a mechanism that will ensure the generation of investment and financing activities which are operational, cost-effective and generally fair to all parties concerned;
- * there are also those who wish to put their money in very safe or less risky investments and quite prepared to receive lower returns, such as those who invest in unit trusts, etc.;
- * there are also those who are prone to price fluctuations and wish to hedge their investments through the commodity markets.

The above concerns have become the objectives of capital markets as well as the solid justifications for their establishment and development over the years. The capital markets all over the world have become part and parcel of the modern financial system which not only assists in the growth and expansion of the heavily monetized economy but often becomes a very major indicator of the business cycle movements as well as the confidence and sentiments of the business community and investors.

Of late, capital markets have also been a very important vehicle to raise the necessary amounts of public funds to effect the gigantic privatisation programmes of governments. This is a very healthy contribution of the stock markets, which would indirectly encourage the mobilisation of national savings needed for rapid economic growth.

Hence we observe the need to improve the infrastructure of the capital markets to improve efficiency and competency in handling the increasing capital turnover as well as the huge trade volumes. Indeed, efficient capital markets do attract huge amounts of foreign capital which would further influence the local bourses.

Another growing interest among the investors particularly in the last decade is the development of Islamic financing and lately the capital markets. This interest stems from the religious insurgence in a large scale the world over, in particular, that of Islamic resurgence, which demand that all business transactions should be in tandem with Islamic principles. This interest also grows from the increasing amounts of accumulated wealth in the hands of Muslims, particularly in the oil-rich countries in the seventies, and a decade later, in the hands of other Muslims who have recently been actively involved in the corporate and business sectors.

This short paper attempts to provide a critical analysis of the unIslamic elements in the current capital market and indicate the manner in which such elements could be eliminated so that the Islamic capital market can be gradually evolved as a healthy vehicle to effectively play the necessary role in economic expansion and growth. In order to achieve this objective, we need to first of all outline the principle objectives of the Islamic Shariah pertaining to business and economics. This will lead us to appreciate why Islam prohibits certain practices which actually hinder equitable economic progress. The next part of the paper will outline various modifications needed to turn the capital market into one which is in tandem with the Islamic principles and objectives. I shall try to outline here the ideal capital market along Islamic lines, followed by a discussion on the feasibility and practicality of such a market.

OBJECTIVES OF ISLAMIC SHARIAH PERTAINING TO BUSINESS AND ECONOMICS

The primary objectives of the Islamic shariah or law are succinctly described in the following definitions:

"The very objective of the Shariah is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable."

Al-Ghazali

"The basis of the Shariah is wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the Shariah."

Ibn al-Qayyim

From the above, it is clear that Islam, being a comprehensive way of life, is very concerned about the welfare of humanity which is to be achieved through the establishment of justice, application of knowledge or wisdom and the showering of mercy and benevolence, in all aspects of life. In business and economics, it means that there should be equitable distribution of income and wealth, and that all transactions should be equitably undertaken so that no one suffers from any form of injustice or loss. The following examples will hopefully illustrate some of the intricacies of certain prohibitions, such as *riba* or interest, doubtful transactions or *gharar*, unlawful food or drink, acts of cheating, deceit, etc.

Prohibition of interest or riba

That Islam prohibits *riba* is a well-known fact not only among Muslims but also among non-Muslims. However, it is well-known that there remains some disagreements among Muslims themselves who seem to opine that it is *riba* or usury that is undoubtedly prohibited and not interest, specifically the bank interest. However, it is clear that the Holy Quran is emphatic on this issue. The Holy Qur'an has vividly expressed the following:

"Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: 'Trade is like usury', but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); But those who repeat (the offence) are Companions of the Fire; they will abide therein (forever).

Allah will deprive usury of all blessing, but will give increase for deeds of charity; for He loveth not Creatures ungrateful and wicked."

[Al-Baqarah (2): 275-276]

"O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers.

If ye do it not, take notice of war from Allah and His Messenger: But if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly.

If the debtor is in a difficulty, grant him time till it is easy for him to

repay. But if ye remit it by way of charity, that is best for you if ye only knew."

[Al-Baqarah (2): 278 - 290].

The most important and relevant part of the verses above which clearly does not discriminate between usury (which is also forbidden in Judaism and Christianity) and interest is "But if ye turn back, ye shall have your capital sums". This obviously disallows completely any extra payment or charge made over and above the principle or capital sum. The other parts of the verses provide ample warning to those who continue to practise interest or usury.

The Holy Prophet's traditions, which are considered as the most important source of Islamic shariah, after the Holy Qur'an, have stated to the effect that exchange between the following six items have to be done equal for equal and hand to hand (meaning delivered instantly) if they are of the same kind. If they are of different kinds, they may be exchanged for unequal amounts but still hand to hand. The six items are: gold, silver, wheat, corn, date and salt.

Another of the Holy Prophet's traditions states that when Bilal, one of the great companions, came to him from the market with a measure of good quality dates, he asked, where Bilal got it from for he recognised that the dates were not from Madinah. When Bilal replied that he exchanged two measures of poor quality dates with one measure of good quality dates, the Prophet said that was *riba* and Bilal should have sold his poor quality dates and used the money to buy the good quality dates.

Although the Holy Qur'an did not specifically mention that it was unjust for someone to charge interest, the traditions of the Holy Prophet imply that in barter trades, it is more justified to exchange grains of different qualities in the same amounts for it is almost humanly impossible to know exactly how many grains or parts thereof of one quality grain that would justly be exchanged for some measure of another quality grain. Even if there was a grain or part thereof short or extra, it would constitute injustice.

Since Islam stands for absolute justice, interest which is the result of exchange between money (represented by gold and silver in those days) and money is definitely the root cause for injustice and hence forbidden. *Riba* or interest is forbidden chiefly because of avoiding injustice. The reason for allowing exchange of goods for money is the basis of encouraging fair trade because it is the natural forces of demand and supply that determines equilibrium or just price.

Prohibition of doubtful transaction or gharar

Gharar or doubtful transaction is the basis for gambling and hence prohibited. Gambling is a clear case of chance transaction. In the case of such chance transaction, there is no possibility of predicting the outcome. If the outcome can be predicted, there is some amount of information or knowledge available to the transactors to predict the possible outcomes of the transaction. It is here that one is supposed to take the risk based on the knowledge of the deal he is about to close. On the contrary, a doubtful or uncertain transaction, will obviously result in some unfair or unjust outcome to any of the parties involved. A traditional or classical example is one where one is not allowed to lease an orchard while the trees are just flowering. This can result in

injustice to any of the two parties, because it is the fruits that are to be transacted and not the flowers. The doubt or uncertainty here lies in the fact that no one knows exactly how many fruits will be borne by the trees.

This example again signifies the desire of the Islamic shariah to ensure justice to all parties. It is interesting to note that the Islamic way of establishing justice is to close all doors of injustices right from the start rather than to allow it to happen and mete out the action or punishment later.

Prohibition of unlawful food and drink

In general, the number of food items that are prohibited are very small indeed. It can be taken to be a test to those who hold fast to these injunctions. Just like Adam (and Eve) was forbidden to approach only one tree while they were residing in heaven, which was the limit Allah (S.W.T.) imposed on him. The Muslims are forbidden to eat only a few items, whilst there are numerous other items that could be consumed.

Secondly, the Holy Qur'an clearly enjoins us to consume lawful and good food items only. In other words, this Qur'anic injunction implies that what is lawful has also to be good and healthy for human consumption. So it is better to avoid such forbidden things rather than taking the risk of consuming harmful food.

Thirdly, this is the mercy bestowed upon us by God and it is His manner in exemplifying justice to the human race. Whilst He creates good and harmful things, he has given the true indication of what is good and what is harmful, rather than having to find out through long years of experience.

Principle of moderation

The Golden Rule is that one has to be moderate in everything that one does. In all lawful acts, including devotional acts, one should neither be excessive nor deficient. Excessive or deficient intake of food can lead to harm and hence may even be regarded as unlawful.

This principle is very relevant to the practise of overexposing oneself in the Stock Market, because it can lead to very harmful acts, including loss of lives through suicides, as often happened to those who lost heavily in the Stock Market.

Principle of ethical behaviour

Ethical behaviour is one of the most important injunctions of the Islamic shariah. Islam does not only enjoin good ethical and moral behaviour, it strongly prohibits unethical and immoral behaviours of all sorts. Most of the unethical and immoral practices will inevitably lead to injustices of various kinds. As such they are clearly prohibited.

For example, we know that insider trading, market manipulations, are not allowed in most Stock

Exchanges, but they are frequently present mainly out of utter greed.

Principle of complete ownership

Complete ownership of some item is necessary before it could be sold. It is a very important requirement in order to avoid undue cheating. One may have to resort to unethical means to obtain the goods for delivery if he has sold before possessing them. Secondly, it is most unlikely that the purchaser could ascertain the quality of the products he is buying since there is nothing he could lay his hands upon. As such short selling is obviously unIslamic and is also not allowed in most countries, except for a few.

ISLAMIC CAPITAL MARKET

The modern financial system contains at least two types of capital markets, namely, the Stock Exchange and the Commodity Exchange. The Unit Trusts are really an offshoot of the Stock Exchange, in that the stocks are converted into units of investments in various stocks. The value of the units is of course based on the total value of all the stocks invested. Together they constitute the various investment vehicles with differing degrees of risks, rates of returns and level of confidence and sentiments.

Objectives of Islamic capital market

In principle, the objectives of the Islamic capital market are again based on the Islamic shariah, which in essence should be treated as an important and necessary vehicle to transfer funds from surplus to deficit units. This is to ensure the equitable allocation of capital to sectors which would yield the best of returns to the owners of capital and hence contribute towards the overall growth and expansion of the economy.

It is also the objective of the Islamic capital market to ensure that there exists a means of attracting surplus funds for worthwhile investments in accordance with the owners' preferences in terms of the extent of risk involvement, rate of return as well as the period of investment preferred.

Without the capital market, the fund owners could not find sufficient opportunities to invest for short term. Most investments have gestation lags and of long term in character. Emergency needs may arise from time to time which cannot be easily met.

It is also unIslamic to hoard wealth. It is therefore necessary for wealth owners to invest their funds in order not to allow their funds to be unnecessarily eroded by the obligatory *zakat* (Islamic tax).

Nature of Islamic capital market

The Islamic stock market is ideally characterised by the absence of interest-based transactions, doubtful transactions and stocks of companies dealing in unlawful activities or items. It should also be free from any form of unethical or immoral transactions, such as market manipulations, insider trading, short selling, and even excessive exposure of one's financial position by contra deals that cannot be backed by sufficient funds.

I must hasten to add that contra deals are allowed because it is a transaction that complies with all the *shariah* requirements. However, it would be preferable for one to have sufficient financial backing to pick up the stocks in order to save him from any kind of misery. This preference comes from the requirements implied by the principle of moderation. In other words, from the juristic view, contra deals are allowed, but from the *sufi* viewpoint, it is preferable not to indulge in it especially when one can put oneself into unnecessary trouble.

In order to determine whether a particular stock is lawful or not, it has been agreed by the Shariah Council of Bank Islam Malaysia Berhad (whose views are generally acceptable in this country), that one should scrutinise according to the main activity of the company concerned. If the company's main activity does not involve any unlawful activity or item, it is considered lawful, even if its financing involves interest. This is so for two reasons. First, the financing needs of most companies cannot be met by the available Islamic financing means. Secondly, the financing of its activities are incidental activities and not the main activity.

The second most important criterion is the individual status of the holding or parent companies and their subsidiaries. If the holding company is considered lawful by the first criterion above, and the subsidiary is not, then both the holding and its subsidiary company are considered unlawful. On the other hand, if the subsidiary company is considered lawful whilst the holding company is not, then it is lawful to purchase stocks of the subsidiary company but not those of the holding company.

There are views that one should enter the Stock Market with the expressed intention of investing in the business of the company whose stock one purchases. This is true for those who are prepared to invest on a long term basis and collect dividends regularly. There are no qualms about its legitimacy at all. On the other hand this view precludes the possibility of buying and selling of shares for capital gains.

I am of the opinion that the buying and selling of shares as currently practised is completely legitimate because it is a form of business transaction because one is really buying or selling of a certain right (equity in this case) over a company. Hence, it should not be misconstrued as an unlawful transaction. This is so because one is not dealing with an interest-based transaction, nor a doubtful transaction. When we buy a stock, we know exactly what we buy and at what price we bargain for. Hence there is no element of doubt in the transaction.

From the above discussion, the Unit Trusts can easily be made Islamic by investing in the lawful stocks. As far as the current practice of Unit Trusts is concerned, the agreement between the Unit Trusts Company and the investor is based on profit sharing (*al-mudharabah*). Alternatively, it can be based upon an agreement whereby the investor agrees to allow his investments to be managed at an agreed management fee basis. Both models are already in practice. The former is practised by the Arab-Malaysian Islamic Unit Trusts called *Tabung al-Ittikal* while the latter is currently practised by the Asia Unit Trusts Berhad, specifically the *Tabung Amanah Bakti*, which

was formerly called the Malaysian Security Fund.

As far as the Commodity Exchange is concerned, the subject is still controversial, and very little has been done on it. However, the Islamic shariah does allow forward sales or *al-bai' salam*. Specifically, forward sales especially with respect to agricultural produce used to be allowed by the Holy Prophet provided the price, quality, quantity and period of delivery are specified at the time of transaction. Based on this principle, it is lawful to perform forward sales which is exactly what one does in the Commodity Market. However, one often does not take delivery of the commodity purchased. This raises the doubt whether subsequent transactions are allowed or not. I have no specific opinion to offer at this juncture.

FEASIBILITY OF AN ISLAMIC CAPITAL MARKET

There are a few questions to be asked as to whether the Islamic capital market is feasible or not. My answer is in the affirmative for the following reasons:

First, it is obviously feasible to only deal with the lawful stocks which will not include gaming, finance (except the Islamic Bank stocks), insurance, hotels, etc. There are still a sufficiently wide choices of stocks that are available even in today's K.L.S.E., for example.

Secondly, all stocks in the finance sector can eventually be converted to interest-free institutions which will become lawful under the shariah principle.

Thirdly, the unethical practices are mostly disallowed by even the present Stock Market.

What is necessary is the introduction of some specific rules to discourage excessive contra deals by demanding sufficient deposits or even shorten the contra period. However, we know that the facility to perform the contra deals as is practised now is a very tempting attraction to investors who are always reluctant to depart with their capital. This may be retained as a good business practice, but with additional restrictions to reduce overexposure of one's financial position.

It must be made clear that speculation per se is not unlawful in Islam. It is almost impossible to enter the Stock Market without any element of speculation. This could be dangerous and harmful if it is done excessively.

CONCLUSIONS

I would conclude that the Islamic capital market is a necessity of the present and surely of the future, when more and more Muslims and their funds become increasingly involved in the capital market. The forthcoming establishment of the BIMB Securities is a case in point. This will no doubt be another alternative vehicle for Islamic investment. *God knows best.*

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