

BISMILLAHIRRAHMANIRRAHIM

TOWARDS AN ISLAMIC CAPITAL MARKET

by

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A capital market is typically a place or station where capital is being traded between those having surplus capital and those requiring funds for their investment needs. Modern capital markets, particularly in a capitalist, monetized economy have, over a century or so, developed into a very efficient system 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 would like to have access to surplus funds from others;
- * there are also those who need to vary their investment mix from time to time and wish 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 trust, etc.; and
- * there are also those whose transactions are prone to price fluctuations and wish to hedge their investments to reduce unnecessary losses.

The above concerns have become the objectives of capital markets as well as 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 assist 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.

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 values of the units is based on the total values 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. Of course, the economy does have other forms of capital markets, namely the money market which handles inter-bank transactions, the Forex, etc., which we are not concerned here.

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 further influences 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 demands 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.

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.

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 in Islam but it would be preferable if sufficient financial backing is available to pick up the stocks when necessary. This is based on the principle of moderation which is very much encouraged. Anything excessive is bad even though the activity is good in the first place.

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).

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 company 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 is clearly no qualm about its legitimacy at all in this case. 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 for capital gains as currently practised is completely legitimate because it is a form of business transaction. In this case, 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 a price we bargain for. Hence there is no element of doubt in the transaction.

The view that purchasing of shares for capital gains is unIslamic is based on the opinion that speculation *per se* is not allowed in Islam. Speculation is not the same as involving in a game of chance which is the underlying reason for the prohibition of gambling. Moreover, in any business venture one has to indulge in speculation which is often based on some prior fundamental knowledge. This activity is completely different from gambling wherein there is no possibility of having some kind of prior knowledge. In the tossing of a fair coin for example, even if it turns heads for the first nine tosses, there is no possibility of predicting the outcome of the tenth toss. This is a clear example of a game of chance which is described as *gharar*, the underlying reason for the prohibition of gambling in Islam.

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.

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 sufficient 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.

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. However, there are some modifications that may be necessary in its daily operations so as to ensure that all transactions are interest-free, such as the interest charges on late settlements of outstanding balances, as is currently practised by the security firms. *God knows best.*

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