

GOVERNMENT OF PAKISTAN
SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

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Islamabad, the 9th April, 2018

NOTIFICATION

S.R.O. 436 (I)/2018. The draft Shariah Standards of Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) namely; Shariah Standard No. 21 – Financial Papers (Shares & Bonds), Shariah Standard No. 27- Indices, Shariah Standard No. 30 – Monetization (Tawarruq), Shariah Standard No. 44 - Obtaining and Deploying Liquidity, Shariah Standard No. 45 – Protection of Capital and Investments, Shariah Standard No. 46 - Al-Wakalah Bi Al-Istithmar (Investment Agency), and Shariah Standard No. 53- Arboun (Earnest Money), proposed to be adopted by Securities and Exchange Commission of Pakistan (the Commission) in exercise of the powers conferred by sub-section (1) of section 225 of the Companies Act, 2017 (XIX of 2017) are hereby published for information of all persons likely to be affected thereby and notice is hereby given that objections and suggestions, if any, received within fourteen days from the date of placement on the Commission's website, shall be taken into consideration.


(Bilal Rasul)
Secretary to the Commission

Shari'ah Standard No. (21)

**Financial Paper
(Shares and Bonds)**

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to elaborate the rules for the shares of corporations just as it seeks to explain the rules for interest-bearing bonds.

Statement of the Standard

1. Scope of the Standard

This Standard covers shares with respect to their issuance and flotation including investment, trading, renting, loaning, pledging and Salam in them, along with the rule for concluding futures, options and swapping contracts on the basis of shares.

The Standard also covers issuance of and trading in interest-bearing bonds. The Standard does not cover investment Sukuk for which there is a separate specific standard.

2. Rules for Issuance of Shares

2/1 The issuance of shares is permissible if the objectives for which the corporation was established are permissible according to the Shari'ah, thus, the objectives of its formation should not be transactions that are prohibited, like the manufacturing of liquor, trading in swine or transactions in Riba. If the objectives of the corporation are impermissible, the formation of the corporation is permissible too, and consequentially so is the issuance of shares that constitute such a corporation.

2/2 It is permissible to add a determined percentage to the value of the share at the time of subscription to cover the expenses of issuance as long as this percentage is fixed and determined to be a reasonable amount. [see item 4/1/2/2 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/3 It is permissible to issue new shares for increasing the capital of a corporation if such shares are issued at a price that is equivalent to the value of the old shares, which is worked out through expert valuation of the assets of the corporation or on the basis of the market-value whether this is at a premium or at a discount with respect to the price of the issue. [see item 4/1/2/3 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

- 2/4 It is permissible to underwrite the issue when this is done without compensation in lieu of underwriting. This is an agreement, at the time of the formation of the corporation, with someone who undertakes to purchase the entire issue of shares, or a part thereof. It is an undertaking from the person bound to subscribe at the nominal value to all that remains and has not been subscribed to by another. It is permissible to acquire compensation for work, like the preparation of feasibility studies or the marketing of shares, irrespective of the work being undertaken by the underwriter or someone if such compensation is not in lieu of a guarantee. [see item 4/1/2/4 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]
- 2/5 It is permissible to split the value of the share into instalments at the time of subscription so that one instalment is paid and the remaining instalments are deferred. The subscriber will be considered a participant to the extent of what he has paid up and will be bound to pay his additional capital in the company, and this on the condition that the instalments apply to all the shares and that the liability of corporation remains restricted to the value of the shares subscribed to. [see item 4/1/2/5 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]
- 2/6 It is not permissible to issue preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits. It is permitted to grant certain shares features related to procedural or administration matters, in addition to the rights attached to ordinary shares, like voting rights. [see item 4/1/2/14 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]
- 2/7 It is not permissible to issue *Tamattu'* shares. These are shares that grant the participant compensation in lieu of his shares, whose value is redeemed during the existence of the company, and he is granted *Tamattu'* shares that grant him rights that are available for shares based on capital, except the right to profits and the distribution of assets at the time of winding up, insofar as the *Tamattu'* shares

are entitled to profit lesser than that given to the owner of shares based on capital, just as the owner of *Tamattu'* shares does not have a share in the assets of the company at the time of winding up until the owners of shares based on capital have been granted the value of their shares. [see item 4/1/2/15 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

- 2/8 The share certificate – or what stands in its place – is a document that is deemed evidence of ownership of the shareholder for his undivided share in the assets of the company. It is permitted that this document be in the name of the owner, to his order, or for the bearer.

3. Rules for Dealing in Shares

- 3/1 A share represents an undivided share in the capital of a corporation, just as it represents an undivided share in its assets and the rights associated with it upon conversion of the capital into tangible things, benefits, debts and so on. The subject-matter of the contract at the time of trading of shares is this undivided share.⁽¹⁾
- 3/2 It is permissible to buy and sell shares of corporations, on a spot or deferred basis in which delay is permissible, if the activity of the corporation is permissible irrespective of its being an investment (that is, the share is acquired with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in prices).
- 3/3 Participation or trading in shares for purposes of conversion
- Participation or trading is permitted for purposes of conversion for one who has the ability to effect conversion by adopting a resolution for

(1) See the Shari'ah basis for the standard, item (18), for the permissibility of trading in shares of corporations whose assets represent tangible things and profits along with debts and cash that are in excess of the tangible assets and profits with the stipulation that such tangible and cash assets should not be less than one-third. The reason is that the debts and cash can be properly considered as secondary to them. (This explanatory note is intended to complete the text of the Standard for implementing subsequent amending procedures, God willing).

conversion in accordance with the Shari'ah at the first general meeting or by striving for conversion in line with item 3/4/6. [see Shari'ah Standard No. (6) on Conversion of a Conventional Bank into an Islamic Bank]

- 3/4 Participation or trading (for investment and trading) in the shares of corporations whose primary activity is permissible, but they make deposits or borrow on the basis of interest

The fundamental rule is that of prohibition of acquiring shares of and transactions (investment and trading) in the shares of corporations that sometimes undertake transactions in Riba and other prohibited things even when their primary activity is permissible, but from this rule subscription and transactions (investment or trading) are exempted with the following conditions:

- 3/4/1 That the corporation does not state in its memorandum of association that one of its objectives is to deal in interest, or in prohibited goods or materials like pork (swine) and the like.
- 3/4/2 That the collective amount raised as loan on interest – whether long-term or short-term debt – does not exceed 30% of the market capitalization of the corporation, knowingly that raising loans on interest is prohibited whatsoever the amount is.
- 3/4/3 That the total amount of interest-taking deposits, whether short-, medium- or long-term, shall not exceed 30% of the market capitalization of total equity, knowingly that interest-taking deposits are prohibited whatsoever the collective amount is.
- 3/4/4 That the amount of income generated from prohibited component does not exceed 5% 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. If a source of income is not properly disclosed then more effort is to be exerted for identification thereof giving due care and caution in this respect.

- 3/4/5 For the determination of these percentages, recourse is to be had to the last budget or verified financial position.
- 3/4/6 It is obligatory to eliminate prohibited income specific to the share that is mixed up with the earnings of the corporations, and this in accordance with the following:
- 3/4/6/1 The elimination of prohibited income is obligatory on one who is the owner of the share, whether an investor or a trader, at the end of the financial period, even if the payment is due at the time of issuance of the final financial statements whether quarterly, annual or for other period. Accordingly, elimination is not obligatory for one who sells the shares before the end of the financial period.
- 3/4/6/2 The subject-matter of elimination is the prohibited income specific to the share whether or not the profits have been distributed and whether or not the corporation has declared a profit or suffered a loss.
- 3/4/6/3 Elimination is not obligatory for the intermediary, agent or manager out of part of their commission or wages, because this is their right in lieu of the work they have undertaken.
- 3/4/6/4 The figure, whose elimination is obligatory on the person dealing in shares, is arrived at by dividing the total prohibited income of the corporation whose shares are traded by the number of shares of the corporation, thus, the figure specific to each share is obtained. Thereafter the result is multiplied by the number of shares owned by the dealer – individual, institution, fund or another – and the result is what is to be eliminated as an obligation.
- 3/4/6/5 It is not permissible to utilise the prohibited component in any way whatsoever nor is any legal fiction to be

created to do so even if this is through the payment of taxes.

3/4/6/6 The responsibility for elimination of the prohibited component of the income, for the benefit of all, falls upon the institution in case it is trading for itself or in case it is managing the operations. In the case of intermediation, however, it is bound to inform the person dealing in them of the mechanism for the elimination of the prohibited component so that he can undertake it himself. The institution may offer these services, with or without a charge, for those dealers who desire them.

3/4/7 The institution will apply the above rules whether it does so directly or through another and whether it is trading for itself or for another by way of intermediation or management of wealth, like funds, or is doing so as the agent of another.

3/4/8 It is necessary to observe these rules throughout the period of participation or trading. If the rules cannot be applied, it is obligatory to give up such investment.

3/5 It is not permissible to purchase shares by raising interest-bearing loans through a broker or another (margin sales), just as it is not permitted to mortgage the shares for such a loan. [see item 4/1/2/6 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

3/6 It is not permissible to sell shares that the seller does not own (short sale), and the promise of a broker to lend these at the time of delivery is of no consequence. [see item 4/1/2/7 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

3/7 It is permissible to the buyer of a share to undertake transactions in it by way of sale to another and the like after the completion of the formalities of the sale and the transfer of liability to him even though the final settlement in his favour has not been made.

- 3/8 To secure lawful interests, it is permissible to specialised official agencies to organize trading in some shares so that it cannot be undertaken except through specialised brokers or those licensed to undertake the activity. [see item 4/1/2/8 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]
- 3/9 It is not permissible to lend shares of corporations.**
- 3/10 It is permissible to mortgage shares that are lawful according to the Shari'ah, and in this respect there is no difference whether the assets of the corporation are cash, tangible assets or debts or they are a combination of cash, tangible assets and debts and irrespective of one type being predominant in them. This is to be done in conformity with the conditions for selling shares at the time of liquidation.
- 3/11 The contract of Salam is not permissible in shares.**
- 3/12 It is not permissible to conclude futures contracts for shares. [see item 5/1 of Shari'ah Standard No. (20) on the Sale of Commodities in Organized Markets]
- 3/13 It is not permissible to conclude contracts of options for shares. [see item 5/2 of Shari'ah Standard No. (20) on the Sale of Commodities in Organized Markets]
- 3/14 It is not permitted to conclude swap contracts with respect to shares and their returns.
- 3/15 It is not permissible to rent shares, whether this is for pledging them or for the purpose of selling the rented shares, and returning shares similar to them, as is done in the stock-markets, or for acquiring their profits or for showing a stronger financial position of the hirer or for another reason.
- 3/16 It is permitted to lend shares by way of I'arah for the purpose of pledging them or for the purpose of granting their profit to the borrower as is done in stock markets. The borrower does not have the right to sell the shares except for the execution of the terms of the mortgage.

- 3/17 It is not permissible to undertake trading in the shares of a corporation, when the assets of the corporation are cash exclusively, whether this is during the period of subscription or after that, prior to the commencement of the business of the company or at the time of liquidation, except at their nominal value and with the condition of delivery of possession.
- 3/18 It is not permissible to undertake trading in the shares of a corporation if the entire assets of the corporation are composed of debts, unless the rules for dealing in debts are observed.
- 3/19 If the assets of a corporation are composed of tangible assets, benefits, cash and debts, the rule for trading in the shares of such a corporation will differ according to the primary asset, which conforms to the objective of the corporation and its usual activity. If its purpose and activity pertain to trading in tangible assets, benefits and rights, trading in its shares is permissible without taking into account the rules of *Sarf* or transactions in debts, with the condition that the total market value of assets, benefits and rights should not be less than 30% of the total assets value of the corporation including all assets, benefits, rights and cash liquidity (the corporation's debts, current accounts with others, and bonds it holds which constitute debts) irrespective of their size as in such a case these are secondary. If, however, the objective of the corporation and its usual activity is dealing in gold, silver or currencies (*Sirafah*), it is obligatory to undertake trading in its shares in the light of the rules of *Sarf*.
- 3/20 It is stipulated for the implementation of what is laid down in paragraph 3/18 that it shall not be adopted as a means for bargains in debts and trading in them by merging parts of tangible assets and benefits with the debts as a legal device for transaction in debts.

4. Rules for Issuance of Bonds

The issuance of all kinds of bonds is prohibited when these bonds include stipulations for the return of the amount of loan and excess in any form, whether such excess is paid at the time of the satisfaction of the principal amount of loan, is paid in monthly or yearly instalments or in another

manner and whether this excess represents a percentage of the value of the bond, as in the case with most types of bonds, or a part of it, as is the case with zero-coupon bonds. Likewise, prize bonds are also prohibited. This applies irrespective of the bonds being private, public or governmental.

5. The Rule for Trading in Bonds

Trading in bonds, both sale and purchase, is prohibited and so is their pledging and endorsement and so on.

6. Shari'ah Substitute for Bonds

The Shari'ah substitute for bonds are investment Sukuk. [see Shari'ah Standard No. (17) on Investment Sukuk]

7. Date of Issuance of the Standard

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 20 May 2004 A.D.

Adoption of the Standard

The Shari'ah standard on Financial Paper (Shares and Bonds) was adopted by the Shari'ah Board in its meeting No. (12) held at Al-Madinah Al-Munawwarah from 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

The Shari'ah Board in its meeting No. (7) held at Makkah Al-Mukarramah from 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D., decided to issue the Shari'ah standard on financial paper (Shares and Bonds).

On 25 Rajab 1423 A.H., corresponding to 2 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant for the preparation of an exposure draft on the Shari'ah Standard on Financial Paper (Shares and Bonds).

In meeting No. (6) of the Shari'ah Standards Committee (2) held from 14-15 Muharram 1424 A.H., corresponding to 17-18 March 2003 A.D., in the Kingdom of Bahrain, the Committee discussed the Shari'ah standard and required the consultant to incorporate necessary amendments in the light of the discussion and observations of the members.

In meeting No. (7) of the Shari'ah Standards Committee (1) held from 14-15 Safar 1424 A.H., corresponding to 16-17 April 2003 A.D., in the Kingdom of Bahrain, the Committee discussed the exposure draft of the Shari'ah Standard on Financial Paper (Shares and Bonds) and made necessary amendments, just as the Committee discussed the exposure draft of the Standard in its meeting held from 25-26 Rabi' II, 1424 A.H., corresponding to 25-26 June 2003 A.D., and made necessary amendments in the light of the discussion and observations of the members.

In its meeting No. (9) held from 23-24 Jumada I, 1424 A.H., corresponding to 23-24 July 2003 A.D., at Amman, the Hashimite Kingdom of Jordan, the Committee discussed the exposure draft of the Standard and made necessary amendments in the light of the discussion and observations of the members.

The revised exposure draft of the Shari'ah standard was presented to the Shari'ah Board in its meeting No. (11) held in Makkah Al-Mukarramah from 2-8 Ramadan 1424 A.H., corresponding to 27 October - 2 November 2003 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard, and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for the discussion of the standard in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qadah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was attended by more than 50 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qadah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.H., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held at Al-Madinah Al-Munawwarah during the period 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

Appendix (B)

The Shari'ah Basis for the Standard

Issuance of Shares

- The basis for the permissibility of the issuance of shares, when the objectives for which the corporation has been established are permissible, is the basis for the permissibility of the corporation (Sharikat al-Musahamah), which is the generality of the evidences conveying the obligation of abiding by contracts and conditions, the generality of the evidences conveying the permissibility of partnership, and the generality of the evidences conveying the permissibility of 'Inan, Mudarabah, Musaqat and Muzara'ah. 'Inan is the basis for the permissibility of participation by two or more persons with their wealth and labour, just as Mudarabah, Musaqat and Muzara'ah are the basis for the permissibility of participation with wealth from one side and labour from the other side whether the subject-matter of the contract is cash, as in the case of Mudarabah, or is tangible assets that are developed with work on these assets, as in the case of Musaqat and Muzara'ah. The evidences for all these forms are well known.
- The basis for the permissibility of underwriting the issue without compensation is that it is an undertaking that does not have a counter-value, which is the taking of compensation for it. In this regard a resolution of the International Islamic Fiqh Academy has been issued.⁽²⁾
- The basis for the impermissibility of the issuance of preference shares, that is, in other than the prescribed manner, is that this leads to the severance of participation in profit and the imposition of injustice on the other shareholders.⁽³⁾
- The basis for the impermissibility of issuing *Tamattu'* shares is that the owners of these shares claim their rights to profit and their redemption is

(2) International Islamic Fiqh Academy Resolution No. 63 (1/7) on Financial Markets.

(3) International Islamic Fiqh Academy Resolution No. 63 (1/7) on Financial Markets.

only in form as they continue to be owners of these share and are entitled to rights at the time of liquidation.

- The basis for the permissibility of share being in a person's name, at his order, or for bearer is that the Lawgiver wishes to establish rights through writing and other forms, but He has not determined a particular form for this. If -in the case of corporations- this takes place through the issuance of shares on which names of the shareholders are written then this is valid. Likewise, if this is undertaken by recording the names of the shareholders in special registers, or indexes, or in any other way, or even if the names are not recorded at all -neither on the certificates nor elsewhere- then this is permissible.

Trading in Shares

- The basis for the permissibility of the sale and purchase of shares of corporations, when the activity of the corporation is permissible, is that the shares are owned by the shareholder, and he has the right to undertake transactions in them as he desires whether this is by way of sale, gift or another way, especially when each one of the shareholders has been granted permission to undertake such transactions through their participation in the memorandum of the corporation and by subscribing to it.
- The basis for the permissibility of participation by one who has the ability to convert or makes an effort to convert insofar as that is a means to alter the rejected and belongs to the category of *al-Amr Bil-Ma'ruf Wa al-Nahy 'An al-Munkar* (enjoining good and forbidding evil), which is an act approved by acknowledged evidences. In this regard a jurstic opinion (Fatwa) has been issued by the Third Seminar on Financial Markets.⁽⁴⁾
- The basis for exempting trading in the shares of these corporations, whose primary activity is permissible, however, they deposit amounts and borrow on the basis of interest, is the application of the rule of removal of hardship and acknowledging of general need, widespread practice, the acknowledged principles of surplus, shortage and predominance,⁽⁵⁾ as well

(4) Held in the Kingdom of Bahrain during Jumada I, 1412 A.H., corresponding to November 1991 A.D.

(5) *"Al-Furuq"* by Al-Qarafi [4: 104]; *"Al-Muwafaqat"* [1: 37]; *"Ahkam Al-Qur'ani"* by Ibn Al-Arabi [4: 1804]; and *"Qawa'id Al-Ahkam Fi Masalih Al-Anam"* [1: 18, 41-45].

as the permissibility of dealing with one the major part of whose wealth is permissible,⁽⁶⁾ along with reliance upon the issue of separation of bargains according to some Jurists.⁽⁷⁾ This is upheld by most fatwa issuing organisations as well as the Shari'ah Supervisory Boards of Islamic banks.⁽⁸⁾

- The basis of the impermissibility of buying shares by raising interest-bearing loans from the broker or someone else, is the indulgence in interest and securing this through mortgage, and these are activities prohibited by the Texts along with a curse for those who charge Riba, pay it, write it down and witness it.
- The basis for the impermissibility of the sale of shares that the seller does not own is that this leads to the sale of something that is not within the liability of the seller nor in his ownership, and this is prohibited according to the Shari'ah.
- The basis for the permissibility of undertaking transactions in shares even though the final registration formalities have not been completed is the transfer of the liability for loss (*Daman*) to the buyer. This is attained through constructive possession that is granted through the transacting in what he has purchased.
- The basis for the impermissibility of lending the shares of corporations is that the share at the time of repayment-in consideration of what it represents-does not represent the same thing that it did at the time of lending due to the constant change in the assets of the corporation.
- The basis for the permissibility of mortgaging the shares of corporations is the established principle that a thing can be mortgaged if its sale is permissible. As the sale of shares is permitted, mortgaging them is also permitted. The reason is that the purpose of a mortgage is the securing of a loan and recovering it through the sale price of the asset mortgaged in case recovery is not possible from the debtor. This is what is achieved through the mortgaging of shares and is, therefore, permitted.

(6) *"Bada'i' Al-Sana'i"* [4: 104]; *"Al-Ashbah Wa Al-Naza'ir"* by Ibn Nujaym (pp. 112-114); *"Al-Bayan Wa Al-Tahsil"* [18: 194-95]; and *"Al-Manthur Fi Al-Qawa'id"* [2: 335].

(7) *"Fath al-Qadir"* [6: 89-90]; *"Iqd Al-Jawahir Al-Thaminah"* [3: 439]; *"Al-Sharh Al-Kabir Ma'u Al-Dusuqi"* [3: 15]; *"Al-Rawdah"* [3: 420-25]; and *"Majmu' Al-Fatawa"* [29: 48].

(8) Among these is Al Rajhi Organization in its resolution No. 48, 23/8/1422 A.H.

- The basis for the impermissibility of Salam in shares is that the subject-matter of Salam is a debt and not an ascertained thing, while in shares of corporations nothing works except ascertainment. This is done by mentioning the name of the corporation whose shares are desired through Salam thereby rendering the shares an ascertained thing and not a liability for a debt. Shares cannot, therefore, essentially be the subject-matter of the contract of Salam. Further, Salam in shares implies the sale of ascertained things that are not owned and this is not permitted. In addition to this, the constant availability of specified shares in the market and the ability of the buyer to deliver them at the end of the period is something that cannot be guaranteed.
- The impermissibility of concluding futures contracts for shares is that these contracts imply the stipulation of delay in the delivery of an ascertained sold commodity, that is, shares, and this is prohibited and not permitted. Likewise, the delay in the price and the priced commodity, for this is the sale of a debt for a debt, which is prohibited by agreement. Further, the seller - mostly - does not own the shares for which the futures contract has been concluded and is, therefore, selling something that is owned by another. This is something over which there is no disagreement among the scholars as to its impermissibility. It is also included primarily in the meaning of the Shari'ah Texts established By Prophet Muhammad (peace be upon him) that convey the prohibition of the sale of something that one does not possess. Again, most of the futures contracts are completed through a cash settlement between the parties, and this is brazen gambling if this is stipulated within the contract. If it is not stipulated in the contract, it is still one type of gambling. Thereafter, the purpose of contracts is the delivery of possession, while in futures contracts delivery of possession is not the primary purpose of the contracting parties. These contracts, thus, create an obligation for, and engage the liability of, each party for a debt that is of no benefit, except by way of Mukhatarah and for waiting for a loss that will inevitably be incurred by one party.
- The basis for the impermissibility of concluding options contracts for shares is the right of option- which is the subject-matter of options

contracts transacted in financial markets- is not included in rights that can be sold. The reason is that this right is not established at all for the seller as it is created through the contract and after its creation it is not related to wealth rather it is related to an abstract thing, that is, sale and purchase. If established rights cannot be sold when these do not relate to wealth, like the right of pre-emption, the right to custody of children, the right of Qisas, then, rights-like the right of option- cannot be permitted in the first instance. Added to this is the fact that dealing in options contracts is based on Gharar, and Gharar is prohibited, just like dealing in options contracts is based upon gambling and games of chance, equally for the buyer and the seller of a right to an option, and this occurs in cases that terminate in a cash settlement between the two parties. The contract for an option falls under the sale by a person of something that he does not own when he writes an option to buy, for he does not own the shares or commodities that he undertakes to sell; and the sale of what one does not own is prohibited according to the Shari'ah.

- The basis for the impermissibility of concluding swap contracts for the dividends of shares is that these contracts include Riba in both its forms if the contracts involve the same currency, or *Riba al-Nasi'h* alone if it involves two different currencies; the sale of a debt for a debt as it is a contract in which both counter-values are deferred; Gharar due to the uncertainty about the amount of the cash at the time of the contract; gambling, as the purpose of these contracts is the acquisition of the difference between the two average returns on the shares and it is not the delivery of possession, which is the purpose of contracts, thus, one of the parties gains and the other inevitably loses, and this is truly gambling. Each one of these prohibitions alone is sufficient to prohibit this type of contracts, then what about all of them collectively?
- The basis for the permissibility of trading in shares or corporations, which include cash assets and debts, without regard for the rules of Sarf and dealing in debts, even when such debts are more than one-half, is that in such circumstances such assets are deemed secondary, and in secondary things matters that are not normally overlooked otherwise are overlooked. If, however, the tangible assets and benefits are less than a third, it is not

permitted to deal in the shares, except by observing the rules of *Sarf* or transactions in debts, because in such a case the assets and benefits are meagre and here debts and cash cannot be deemed secondary to them, and they are the primary objective of the contract, thus, those conditions are to be stipulated for them that would be applied to them if they were desired separately.

- The basis for the permissibility of trading in shares of corporations whose assets include debts and cash, when the objective and activity of the corporation is dealing in things and benefits, without regard for the percentage of debts and cash, is as follows:

1. The Hadith of Ibn Umar (may Allah be pleased with him) stating: "... *When a person buys a slave, who has wealth, then the wealth is for the seller, unless the buyer stipulates this too.*"⁽⁹⁾ The Hadith is explicit on the permissibility of the sale without regard for the genus of the price. The general meaning of the Arabic term "*Mal*" in the Hadith includes all his wealth whether this is cash, debts or goods and whether this is less or more. It indicates that debts or cash, less or more, in comparison with the price of the slave are not taken into account in the *Hukm*, because they are in this case secondary and are not the primary purpose of the contract.

Imam Malik relates this Hadith in *Al-Muwatta'* and then says: "The matter is settled unanimously in our view that if the buyer stipulates the wealth of the slave then it belongs to him, whether this is cash or debt or goods, known or unknown. This applies even if the wealth owned by the slave is more than that with which he is purchased, and irrespective of whether the price is cash debts or goods."⁽¹⁰⁾

2. The Hadith of Ibn Umar (may Allah be pleased with him) stating: "*When a person buys a palm-grove after pollination, then the fruit is*

(9) Agreed upon by both Al-Bukhari and Muslim. The text of this Hadith belongs to Al-Bukhari: "*Sahih Al-Bukhari*", "*Kitab Al-Musaqat*", chapter: When the person has a right of way or right to water in an orchard or palm-grove (No. 2250); and "*Sahih Muslim*", "*Kitab Al-Buyu*", chapter: When a person sells palm-grove with fruit (No. 1543).

(10) See "*Al-Muwatta'*".

for the seller, unless the buyer stipulates this too."⁽¹¹⁾ The Hadith conveys the permissibility of an absolute stipulation on the part of the buyer for the fruit whether or not the fruit has begun to ripen despite the prohibition of the sale of fruit before it has begun to ripen, as is found in the Hadith of Jabir (may Allah be pleased with him) saying: "The Messenger of Allah (peace be upon him) forbade the sale of fruit before it has begun to ripen."⁽¹²⁾ As the fruit was secondary to the primary subject-matter, which was the palm-grove, it was overlooked when it would not be if it was the only subject-matter of the contract.

3. Among the established principles of Fiqh according to the scholars is that the secondary is subservient. One who examines the various issues flowing from this principle, and the cases structured upon the principle, will find that these principles as a group convey the meaning that the secondary thing will take the rule of the primary and will not be assigned a separate rule; it will come to be owned along with the ownership of the primary, and something that will not be overlooked separately will be overlooked when the thing is secondary.

Among the cases derived from the rules are the following:

- a) The subservience of what has not begun to ripen to what has begun to ripen even when what is ripening is very little. It is stated in "*Kashshaf Al-Qina*" as follows: "The ripening of some of the fruit of a tree in a garden is its ripening, that is, of the tree as well as the ripening of all that falls in this category in a single garden. ... It becomes valid with what has begun to ripen as it is subsidiary to it."⁽¹³⁾
- b) The sale of a house, whose roof is painted with gold, for gold, or is painted with silver for silver; the sale of a sword ornamented with gold for gold; the sale of milk for milk; or a thing made of wool for wool and so on.

(11) Agreed upon by both Al-Bukhari and Muslim. The text of this Hadith belongs to Al-Bukhari: "*Sahih Al-Bukhari*", "*Kitab Al-Musaqat*", chapter: When the person has a right of way or right to water in an orchard or palm-grove (No. 2250); and "*Sahih Muslim*", "*Kitab Al-Buyu*", chapter: When a person sells palm-grove with fruit (No. 1543).

(12) Agreed upon by both Al-Bukhari and Muslim.

(13) "*Kashshaf Al-Qina*" [3: 287]; see also "*Al-Mughni*" [6: 156].

Issuance of Bonds

- The basis for the impermissibility of issuing interest-bearing bonds is that they represent, in their customary nature, a loan and the meaning of a loan is applied to them in their nature according to the Shari'ah. As each loan that yields a benefit is Riba, and the issuance of bonds is based upon loans with interest, their issuance is prohibited according to the Shari'ah.

Dealing in (Negotiation of) Bonds

- The basis for the impermissibility of dealing in bonds is what has been settled with respect to their issuance due to their being based on Riba. The reason is that the word negotiation includes the meaning of continuity and the transfer of the bond from one hand to another bearing interest benefits. This means that the buyer of a bond continues to be a creditor of the issuing corporation and demands Riba for his debt. This is impermissible according to the Shari'ah, and all dealing leading to this is impermissible.

Appendix (C)

Definitions

Share

It is the share of a shareholder in the assets of the corporation and is represented by a certificate that can be negotiated. The term share is also applied to the certificate that represents such share.

Preference Shares

These are shares whose bearer is accorded priority over the holder of the ordinary share in the distribution of dividends and in claiming his share in the assets of the corporation at the time of liquidation.

Tamattu' Shares

These are shares whose holder is granted compensation for his shares that are offered for redemption during the existence of the corporation, and in exchange for this he is granted Tamattu' shares that grant him the rights that belong to the holder of shares based upon capital, except in dividends and the distribution of assets at the time of its winding up, insofar as the owner of the Tamattu' shares is given a share in the profits less than that given to the shares based upon capital, just as the owner of the Tamattu' shares does not get a share in the assets of the corporation at the time of winding up until the owners of shares based on capital are granted the value of their shares.

Futures Contract

It is a contract for a specified thing, or one described as deferred liability, for a deferred price.

Option Contract

It is a contract for compensation for an abstract right granting the owner the right to sell a specified thing, or to buy it for a specified price, during

a determined period, or at a fixed date, either directly or through an organisation that guarantees the rights of the two parties.

Swap Contract

It is an agreement between two parties to exchange at a subsequent date the average return on a specified share, or a group of share for the average return on a share or for another financial asset.

Bond

It is a financial paper issued by trading establishments and governments in order to raise long-term loans (wealth) in lieu of interest that is paid to the bearer of the bond after periods. They are sometimes issued at a discount with respect to their face value.



Shari'ah Standard No. (27)

Indices

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The purpose of this standard is to present basic information about Indices with special emphasis on their nature, functions, Shari'ah status of their various applications, and to what extent Islamic financial institutions (Institution/Institutions)⁽¹⁾ may apply them.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers definition of Indices, methods of their calculation, their main types, their various forms of applications, and the Shari'ah status of each of these forms. The Standard also sets out the Shari'ah rulings that govern Indices.

2. Definition and Main Applications of the Index

1/2 An Index is a statistically computed figure based on a selected package of financial papers or commodities dealt in organized or non-organized financial markets, or in both. Each paper/commodity is given a specific weight, according to its market value, and the total value is divided by a constant figure. Among the best-known indices at present are the Consumer Price Index, and the Dow Jones and FTSE indices in the financial markets.

2/2 An Index that is well designed to measure the market situation, indicates the general economic situation of the country, and may help in forecasting its future developments before any change takes place and, thus, facilitates investment decisions. An index may also provide a signal to investors about the future movement of the prices of financial papers, or demonstrate a certain downward or upward trend of such prices. Due to the inconsistency that might occur between one index and another, indices are used besides other analytical methods, as well as the experience and knowledge about the market situations and the predominant models of transactions.

2/3 The upward and downward movements of an index reveal the directions of the market, and hence the market is denoted as a rising or a declining market.

3. Bases of Calculation and Characteristics of Indices

- 3/1 Calculation of indices is a process that depends on several aspects including past and current price forecasts, market projections, time intervals, upper and lower limits of dealing prices, and display charts.
- 3/2 Indices differ from each other in several aspects such as the components of the index or the type of data it attempts to summarize, the weight it assigns to each component, and the method of calculation thereof. There are, however, some common characteristics among all well-known indices in the capital and commodity markets, regardless of the data that each index attempts to analyze. Most important among these characteristics are accuracy, objectivity and transparency.

Accuracy refers to proper specification of the components of the index, sources of its data input, time of obtaining the data, method of calculating the weights, and basis of rounding off the numbers.

Objectivity entails presentation of the detailed calculations of the index to leave no room for difference of opinion with regard to determination of the value of the index on a specific date or at a specific place.

Transparency entails pre-specification of the time, place, and method of announcing the readings of the index so that the process does not involve *Jahalah* (ignorance or uncertainty).

- 3/3 There are some general principles that govern almost all indices, such as:

3/3/1 The absolute value of the index has no implication when presented as a single figure. The value of the index, at a given point of time, becomes meaningful only when compared to the past and future values of the index. Only then, the trend and percentage of change may be observed. For instance, an increase of 9 points in the value of the index may represent 2% of its previous value.

3/3/2 The values of the index at different periods may be multiplied or divided by any constant figure (i.e., increasing or decreasing

the figures of the index by the same percentage like division of shares), without affecting the accuracy of its implications. That is to say, the implications of the index are confined to what it represents of the average upwards and downwards changes in the weights of its components from time to time.

4. Types of Indices

Indices are classified according to different considerations:

4/1 With regard to their general or specific nature, indices may be classified into the following categories:

- General Indices that measure the market situation in general.
- Sectoral Indices that measure the market situation of a certain sector or industry, such as the transport sector.

4/2 Indices that precede price movements may be classified, with regard to central and area fluctuations, into the following categories:

- Centered Oscillating Indices, which measure price changes during a specific period in the past, and indicate probable future events.
- Ranged Oscillating Indices (band) that fluctuate between two areas, like overbuying or overselling.

5. Permissible Methods of Using Indices

5/1 It is permissible in Shari'ah to use indices to discern the magnitude of change in a certain market, or to judge the performance of specialized managers by comparing the returns they achieve to the indices. Indices may be used to form up an idea about a portfolio or to estimate its systematic risks instead of monitoring the performance and risks of each financial paper independently. Moreover, Indices may also be used for forecasting the future situation of the market and discovering the pattern of changes that the market may undergo. Therefore, using indices for guidance in operations that relate to real transactions is permissible in Shari'ah.

5/2 It is permissible to use indices as a benchmark for comparison of funds and investment bonds, or for correlating the remuneration of

the manager or the bonus of the agent to the investment, or the bonus of the Mudarib to the results of the Mudarabah.

- 5/3 It is permissible to use an index like LIBOR, or a certain share/commodity price index, as a basis for determining the profit of a Murabahah pledge, provided that the contract is to be concluded on a specific profit that does not vary with further changes in the index. [see Shari'ah Standard No. (8) on Murabahah – Item 4/6]
- 5/4 It is permissible to use the index to determine the portion of the variable *Ujrah* (rent) that represents the return. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek – para 5/2/3]
- 5/5 It is permissible that work rules, regulations and the arrangements, pertaining to money-based employment contracts, stipulate a provision on wage indexation. Wage indexation here refers to periodical adjustment of wages according to changes in the price level, as determined by the concerned bodies. However, in case of accumulation of unpaid wage that takes the form of debt, Shari'ah rulings on debts should be observed.
- 5/6 It is permissible to link the deals to be undertaken by the Mudarib or the agent to a specific index, so that he can dispose of the commodity at the market price when the index reaches a certain reading, or purchase a certain amount of the commodity at a specific reading of the index.
- 5/7 It is permissible to connect the fulfillment of a binding pledge on the part of a buyer or a seller to the rate of increase or decrease of a specific index in comparison to the price of the commodity at a particular date, so that any further increase may be added to the price of the commodity.
- 5/8 It is permissible to link the amount of a donation to a charitable body, in case of delayed settlement, with a particular index, at one end.

6. Impermissible Methods of Using Indices

- 6/1 Shari'ah prohibits trading in indices or taking advantage of their changes in the financial markets, through payment or receipt of

money on the mere occurrence of certain readings of the index, and without selling or buying the real assets which the index represents or any other assets. Such dealing is prohibited even if it is practiced for the sake of hedging against potential risk.

- 6/2 It is prohibited in Shari'ah to conclude option contracts on indices. [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets – item 5/2]
- 6/3 It is also prohibited in Shari'ah to conclude contracts on the Index Contracts' Multiplier.
- 6/4 It is also prohibited in Shari'ah to link a contract that should not be suspended, like selling, to a specific index.
- 6/5 It is prohibited in Shari'ah to connect the amount of a cash debt, at the time of lending, to the price index.

7. Development of an Islamic Index

The following points should be observed while developing an Islamic Index:

- 7/1 Adherence to Shari'ah precepts, in addition to the technical controls relating to the components of the index, and its applications.
- 7/2 There should be a Shari'ah Supervisory Board for the Index, to ensure observation of the Shari'ah precepts in the components and applications of the index, and to conduct periodical review and reporting relating thereto.

8. Date of Issuance of the Standard

This Standard was issued on 12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D.

Adoption of the Standard

The Shari'ah standard on Indices was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

The Shari'ah board decided in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Makkah Al-Mukarramah, to issue a Shari'ah Standard on Indices.

On 12 Jumada I, 1424 A.H., corresponding to 12 July 2003 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft Standard on Indices.

The Committee (2) discussed the draft Standard in its meeting No. (15) held in Manama, Kingdom of Bahrain, on 8 Jumada I, 1426 A.H., corresponding to 15 June 2005 A.D., and made necessary changes thereto in the light of the discussions and comments of its members.

The Committee (2) once again discussed the draft Standard in its meeting No. (16) held in Manama, Kingdom of Bahrain, on 4-5 Sha'ban 1426 A.H., corresponding to 8-9 September 2005 A.D., and incorporated necessary changes therein in the light of the discussions and observations of the meeting.

The revised draft of the Standard was submitted to the Shari'ah Board in its meeting No. (15) held in Makkah Al-Mukarramah on 22-26 Sha'ban 1426 A.H., corresponding to 26-30 September 2005 A.D. The Shari'ah Board decided to send the draft Standard to specialized experts for review and comments before discussing it in a public hearing.

AAOIFI held a public hearing in the Kingdom of Bahrain, on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D. More than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and other interested parties attended the public hearing. Several

observations were made in the session to which members of the Shari'ah Standards Committees (1) and (2) duly responded.

The draft Standard was presented to the Drafting Committee in a meeting held in Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., and several amendments were proposed in the meeting.

The Shari'ah Board discussed in its meeting No. (16) held in Al-Madinah Al-Munawwarah, on 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D., the amendments proposed by the Drafting Committee and accepted some of them. The Shari'ah Board then approved the Standard, unanimously for some of its clauses and by majority for others, as indicated in the minutes of the Board's meetings.

Appendix (B)

The Shari'ah Basis for the Standard

- Developing indices is permissible in Shari'ah because they constitute a method of forecasting and a means of observing the state of circumstances (inferences). Resorting to inferences is a well-recognized practice in judicature and financial transactions. Ibn Al-Qayyim in his book on Judicial Methods presented a number of proofs on permissibility of using inferences.
- Permissibility of using indices to forecast the market situation is derived from acceptability of using inferences for judgment. As indicated above, Shari'ah does not object to using inferences to make current or future judgment based on past events, or to initiate practical actions in the light of probable developments.
- Selling or buying indices is prohibited because it is nothing more than payment or receipt of money for the mere existence of a certain reading or figure. Such an act constitutes a form of gambling and an illegal act of gaining money. Hence, prohibition of selling or buying indices has been well emphasized by the Resolution of the International Islamic Fiqh Academy which states that it is not permissible to sell or buy an index, because this constitutes pure gambling. It is an act of selling an imaginary object that never exists.⁽²⁾
- Prohibition of concluding option contracts that are based on indices, or on the index contracts' multiplier, rests on the same reasons for prohibition of trading in indices, in addition to prohibition of dealing in options themselves. Such transactions obviously deal with wills and intentions rather than with real commodities. Moreover, prohibition of dealing in options has been clearly stated in a resolution issued by the International Islamic Fiqh Academy.⁽³⁾

(2) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).

(3) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).

- The justification for periodical adjustment of wages subject to changes in the level of prices is to pursue application of a fair wage policy, and protect the money income of the employees against deterioration of purchasing power due to inflation. It is permissible to provide for such a condition in the contract because conditions between contracting parties are permissible in principle, unless they lead to reversing what has been permitted or prohibited by Shari'ah.

Appendix (C)

Definitions

Index Multiplier

A specific ratio added to the difference in the price of the index on expiry of the date of the transaction.

Centered Oscillating Indices

These are the indices that fluctuate around a given center or point. They measure price change in a past period, and are used for forecasting probable future events. Such indices precede market movements and measure the rate of price change during the period under study.

Ranged Oscillating Indices

These are indices that fluctuate between two specific ranges, such as the limit of overbuying and the limit of overselling.

Benchmark

It refers to any index that represents the performance of a whole industry or a particular activity. It can be used as a standard for measuring the performance of investment funds and investment units, or used as an indicator for fixing remuneration for management or bonus for the investment agent or the Mudarib.

Hedging

It is a method for mitigating investment risks (such as market risks) by using financial instruments available in the market to curb down the risks that may arise from severe price changes.

Divider

It is the total price of the two shares, divided by the average price before division.

Index Contracts' Multiplier

It is a decimal or simple number, multiplied by the nominal value of a contract that has been connected to the performance of a certain index, to calculate the value of the contract based on the performance of that index.



Shari'ah Standard No. (30)

Monetization (Tawarruq)

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The purpose of this standard is to indicate the essence of Monetization and explain the Shari'ah conditions for its validity, as well as the controls pertaining to its application in Islamic financial Institutions (Institution/Institutions).⁽¹⁾

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers the different applications of monetization, whether the beneficiary is the customer or the institution.

2. Definition of Monetization and Its Distinction from *Bay' Al-'Inah*

Monetization refers to the process of purchasing a commodity for a deferred price determined through Musawamah (Bargaining) or Murabahah (Mark-up Sale), and selling it to a third party for a spot price so as to obtain cash.

Whereas *'Inah* refers to the process of purchasing the commodity for a deferred price, and selling it for a lower spot price to the same party from whom the commodity was purchased.

3. Mutawarriq (Monetization Beneficiary)

3/1 The Monetization beneficiary may be a customer who purchases the commodity from the Institution and sells it to a third party to obtain liquidity. It may also be the Institution itself when it purchases the commodity from the customer or another Institution and sells it to a third party to obtain liquidity. The controls for both cases are shown in items (4) and (5) below.

3/2 The institution should not perform Monetization for the benefit of conventional banks when it discovers that such banks are going to use the liquidity for interest-based lending instead of Shari'ah-compliant operations.

4. Controls on Monetization Transactions

4/1 The requirements of the contract for purchasing the commodity on deferred payment bases should be fulfilled, for both Musawamah and Murabahah transactions, with due consideration to Shari'ah Standard

No. (8) on Murabahah. There shall also be a real commodity that the seller owns before selling it. If the process is to involve a binding promise, it shall be from only one party. As regards the commodity sold, it shall not be gold or silver or any type of currency.

- 4/2 The commodity sold shall be well identified so as to become distinct from the other assets of the seller. This may be done by separating the commodity from the other assets of the seller, or recording the numbers of its identifying documents such as storing certificates. [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets, item 4/2/2]
- 4/3 If the commodity is not made available at the time of signing the contract, the client shall be given a full description or a sample that indicates the quantity of the commodity and the place of its storage, so that his act of purchasing the commodity becomes real rather than fictitious. In this sense, using local commodities for Monetization is more preferable.
- 4/4 The commodity shall be actually or constructively received by the buyer, and there remains no further condition or procedure for receiving it.
- 4/5 The commodity (object of Monetization) must be sold to a party other than the one from whom it was purchased on deferred payment basis (third party), so as to avoid 'Inah which is strictly prohibited. Moreover, the commodity shall not return back to the seller by virtue of prior agreement or collusion between the two parties, or according to tradition.
- 4/6 The contract for purchasing the commodity on deferred payment basis, and the contract for selling it for a spot price shall not be linked together in such a way that the client loses his right to receive the commodity. Such linking of the two contracts is prohibited whether it is made through stipulation in the documents, acceptance as a normal tradition, or incorporation in the procedures.

- 4/7 The client shall not delegate the Institution or its agent to sell, on his behalf, a commodity that he purchased from the same Institution and, similarly, the Institution shall not accept such delegation. If, however, the regulations do not permit the client to sell the commodity except through the same Institution, he may delegate the Institution to do so after he, actually or constructively, receives the commodity.
- 4/8 The Institution should not arrange proxy of a third party to sell, on behalf of the client, the commodity that the client purchased from the Institution.
- 4/9 The client shall not sell the commodity except by himself or through an agent other than the Institution, and shall duly observe the other stipulations.
- 4/10 The Institution shall provide the client with the information that he or his appointed agent may need for selling the commodity.

5. Controls on Monetization When the Institution Is the Beneficiary

- 5/1 Monetization is not a mode of investment or financing. It has been permitted when there is a need for it, subject to specific terms and conditions. Therefore, the Institutions shall not use Monetization as a means of mobilizing liquidity for their operations, and exert no effort for fund mobilization through other modes such as Mudarabah, investment agency, Sukuk, investments funds, and the like. The Institution shall resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients.
- 5/2 The institutions shall avoid proxy in selling the Monetization commodity, even if proxy is to be arranged with a third party. In other words, Institutions shall use their own bodies for selling the monetization commodity, though using brokers for this purpose is permissible.

6. Date of Issuance of the Standard

This Standard was issued 1 Dhul-Qa'dah 1427 A.H., corresponding to 13 November 2006 A.D.

Adoption of the Standard

The Shari'ah standard on Monetization was adopted by the Shari'ah Board in its meeting No. (17) held in Makkah Al Mukarramah on 26 Shawwal - 1 Dhal-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (7) held on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D., in Makkah Al Mukarramah, to issue a Shari'ah Standard on Monetization, as practiced by banks.

On 17 Sha'ban 1423 A.H., corresponding to 3 October 2005 A.D., the Shari'ah Standards Committee (2) decided to commission a Shari'ah consultant to prepare an exposure draft on Monetization.

On 6 Rabi' I, 1426 A.H., corresponding to 15 April 2005 A.D., the Shari'ah Standards Committee (2) decided to commission another Shari'ah consultant to redraft the Monetization Standard in the typical format of the other Shari'ah Standards.

The Committee (2) discussed the exposure draft in its meeting No. (15) held in Manama, Kingdom of Bahrain on 8 Jumada I, 1426 A.H., corresponding to 15 June 2005 A.D., and introduced necessary changes in the light of the comments and observations of the members.

A joint committee comprising members from Shari'ah Standards Committees (1) and (2) discussed the exposure draft in a meeting held in the Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., and introduced further changes in the light of the comments and observations of its members.

In its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7-12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D., the Shari'ah Board discussed the amendments suggested by the joint meeting of the two Shari'ah Committees and accepted what it deemed appropriate.

AAOIFI then held a public hearing in the Kingdom of Bahrain on 6 Rajab 1427 A.H., corresponding to 31 July 2006 A.D. The public hearing was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, university teachers and other interested parties. Several observations were made in the public hearing to which the members of the Shari'ah Standards Committees (1) and (2) duly responded.

In its meeting No. (17) held in Makkah Al-Mukarramah on 26 Shawwal - 1 Dhul-Qadah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the changes proposed by the participants in the public hearing, accepted some of them, and adopted the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

Appendix (B)

The Shari'ah Basis for the Standard

- Differentiation between Monetization and 'Inah with regard to permissibility and prohibition stems from the fact that, contrary to the former, the latter is a trick for practicing Riba (usury). 'Inah takes place between two parties who are in fact a borrower and a lender. The lender sells the commodity to the borrower for a deferred price and buys it back from him for a less price payable on spot. The majority of the Fuqaha subscribe to prohibition of 'Inah and permissibility of monetization, except Ibn Taymiyyah and Ibn Al-Qayyim who consider monetization as prohibited or worthy of aversion.
- Permissibility of constructive receipt of the commodity has already been catered for in the Shari'ah Standard No. (18) on Possession (Qabd) and the Shari'ah Standard No. (1) on Trading in Currencies.
- Permissibility of monetization transactions that observe the Shari'ah controls indicated in this Standard can be traced in the texts of the Qur'an and the Sunnah that permit sale transactions. It has also been confirmed by two resolutions issued by the Islamic Fiqh Academy of the Muslim World League,⁽²⁾ and the Standing Committee of the Supreme Board of Shari'ah Scholars of the Kingdom of Saudi Arabia (Fatwa No. 19297), as well as the Fatwas of several Shari'ah Supervisory Boards. Therefore, monetization is an exit for avoiding Riba rather than a trick for performing it, as it is usual-

(2) Resolution of the 15th Session which imposes no condition other than that Monetization should not be performed like 'Inah. Also, the Resolution of the 17th Session which comprises other conditions (well-observed in this standard) most important of which is non-commitment of the bank to become the agent of the client in selling the commodity which "makes Monetization similar to 'Inah" - using the same words of the Resolution - and non-violation of the condition relating to receipt of the commodity: (the Resolution here did not impose actual receipt only, similar to what it did in its 11th Session where it considered legal receipt to be sufficient in currency exchange, which requires more controls than sale transactions).

ly practiced by those who do not want to be involved in interest-based borrowing. It has been reported by Abdullah Ibn Al-Mubarak⁽³⁾ that 'A'ishah (may Allah be pleased with her) practiced it.

- Prohibition of joining together the contract for purchasing the commodity and the contract for selling it is justified by the fact that joining them together would impose a commitment on the client to sell the commodity right away. Hence, such immediate transfer of the ownership of the commodity may not enable the client to receive it. This is again the same reason for prohibition of agency-related commitments.
- Permissibly of resorting to agency of the Institution when the client, by virtue of law, cannot sell the commodity directly, is meant to safeguard the deal from being nullified by the law.
- The ruling that the Institution shall provide detailed information about the commodity to the client aims at preventing fictitious transactions and helping the client to obtain liquidity. Such requirement holds true whether the commodity in question is a commodity, a car, shares of a company, international goods, or local goods. The latter are more suitable for monetization due to the easiness of ensuring their existence, and the chance available to the client to actually hold them if he so desires.
- The ruling that the Institution shall provide the client with a full description or a sample of the commodity is to ensure that the latter's act of purchasing the commodity is actual rather than fictitious.
- Monetization (where the client or the Institution is beneficiary) shall be subjected to strict controls and restrictions so that institutions fulfill the main objectives underlying their presence and the interest of customers to make dealings with them.
- Principally, institutions have to show strict commitment towards using modes of investment and financing such as the various forms of Musharakah (Partnership) and exchange of goods, usufructs and services that conform to the very nature and basic activities of Islamic banking. Hence, imposition

(3) Al-Azhari Al-Shafi'i, "Al-Zahir" (P. 216); and "Al-Fa'iq Fi Ghrib Al-Hadith" [2: 108]. For permissibility of Monetization see also Al-Mardawi, "Al-Insaf" [4: 250]; "Kashshaf Al-Qina" [2: 447] and [3: 185]; "Al-Mughni" [4: 127]; Al-Sarakhsi, "Al-Mabsut", [11: 211]; and Al-Nawawi, "Al-Rawdah" [3: 416].

of controls and restrictions on monetization would curb any tendency for expanding monetization to the extent that jeopardizes the extensive use of the original modes of investment and financing. Therefore, Institutions shall not use monetization except in the limited scope defined in this Standard. They shall also restrict the use of monetization to the cases of clients whose transactions cannot be disposed of through other modes of financing and investment such as Musharakah, Mudarabah, Ijarah, Istisna'a and the like. Monetization may also be used as a means for helping the clients to dispose of their previous interest-based debts, after ensuring that they have developed genuine intention not to deal in usurious transactions any more.



Shari'ah Standard No. (44)

Obtaining and Deploying Liquidity

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to define liquidity and the methods of obtaining, deploying and utilising it within Institutions.⁽¹⁾

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers what is meant by liquidity and the permissible means of obtaining and deploying it.

2. Definition of Liquidity and Liquidity Management

2/1 Liquidity refers to cash or that which can be easily converted to cash.

2/2 Liquidity management means achieving a balance between obtaining liquidity as swiftly and cheaply as possible and investing and deploying it effectively.

Liquidity is achieved in various ways depending on where it is being utilised. For example, in institutions it is the ability to cover withdrawals; in the money market it is the ability to swiftly convert securities into cash; and with Sukuk and investment funds, it is the ability to redeem or sell them in the secondary market.

3. Need to Utilise Liquidity in Institutions

Institutions need liquidity to meet numerous requirements, such as:

3/1 To distribute profits, which may rely on the liquidation of assets, see Shari'ah Standard No. (40) on Distribution of Profit in Mudarabah-Based Investment Accounts.

3/2 To discharge liabilities by selling inventory assets and converting them to cash to pay what is owed to creditors, to face contingent liabilities, or liquidate investment vehicles or the institution itself, and similarly to expand its activities, or to achieve capital adequacy or to improve its credit rating, see Shari'ah Standard No. (43) on Insolvency.

4. Obtaining and Deploying Liquidity

4/1 Obtaining and deploying liquidity through interest-bearing loans is prohibited by the Shari'ah, whether transacted directly or through

overdrafts or interest-bearing or commission-based facilities. Any liquidity support made available by supervisory or regulatory bodies (such as central banks) must be provided only through Shari'ah-compliant modes, such as Mudarabah and investment agency.

4/2 Permissible modes of obtaining liquidity include:

4/2/1 Selling commodities on a Salam (deferred delivery) basis, receiving payment up-front, and then purchasing the relevant commodities for delivery on the maturity date. It is permitted to secure a promise to sell (from a third party commodity broker) to mitigate the risk of fluctuation between the sale price and purchase price. [see Shari'ah Standard No. (10) on Salam and Parallel Salam]

4/2/2 Istisna'a concluding an Istisna'a-based sale contract stipulating advance payment -although advance payment is not obligatory- and concluding a parallel Istisna'a-based purchase contract stipulating deferred or installment payment. [see Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a]

4/2/3 The institution selling some of its assets for immediate cash and then, if required, leasing the asset back on rent payable in arrears, taking into consideration what has been stated in Shari'ah Standard No. (9), item 5/8, on Ijarah and Ijarah Muntahiah Bittamleek.

4/2/4 Financing working capital to expand the institution's activities

This involves the institution inviting investors to participate in financing its working capital on a Mudarabah or Musharakah basis for a specified period of time determined by its liquidity requirements and with the ability to liquidate the Mudarabah or Musharakah at the end of such period. The investors enter into the Mudarabah or Musharakah by contributing their capital while the institution contributes its current assets, after valuation, as its share of the capital of the Musharakah or Mudarabah. The institution's fixed assets do not form part of

the Musharakah; rather, fixed assets are either lent or leased to the venture and rental payments are accounted as expenses of the Mudarabah or Musharakah.

4/2/5 Issuing investment Sukuk to expand the institution's activities

This involves issuing the types of investment Sukuk explained in Shari'ah Standard No. (17) on Investment Sukuk in order to obtain funds from Sukuk investors and undertake projects required of the institution. The institution may securitise some of its assets by selling them to Sukuk subscribers, managing the assets on their behalf and promising to purchase them at the market price or at a price to be agreed. If the institution is only the lessee and not the manager of the Sukuk assets, it may promise to purchase them at face value.

4/2/6 Tawarruq

This should be done in accordance with Shari'ah Standard No. (30) on Tawarruq.

4/2/7 Interest-free loan

An application of interest-free loans is outlined in Shari'ah Standard No. (26) on Islamic Insurance in item 10/8 regarding loans given by the Takaful operator to the Takaful fund.

5. Liquidity Should Only Be Deployed Using Shari'ah-Compliant Modes, which include:

- 5/1 Purchasing commodities in cash and selling them for deferred payment through Musawamah or Murabahah contracts.
- 5/2 Leases, lease contracts that end in ownership and forward leases, whether for tangible assets or services.
- 5/3 Purchasing commodities on a Salam basis (immediate payment for deferred delivery), then selling them after taking physical or constructive delivery, whether personally or by appointing the seller, in a separate contract, to sell the commodities to his customers.

- 5/4 Istisna'a and parallel Istisna'a, which involve the institution commissioning the manufacture of products or projects on an Istisna'a basis with immediate payment for deferred delivery upon completion and then selling the same manufactured products to a third party through a second Istisna'a contract for deferred price and delivery, without linking the two contracts, or procuring the sale by appointing the manufacturer as an agent, through a separate contract, to sell the manufactured product or project to his customers.
- 5/5 Musharakah and Mudarabah which involve the institution as the capital provider.
- 5/6 Investment agency, which involves the institution appointing another institution or those with whom it deals to act as its agents.
- 5/7 Subscription to purchase Shari'ah-compliant stocks, investment Sukuk or shares in investment funds.
- 5/8 International commodity trading in the financial markets in accordance with Shari'ah.
- 5/9 Currency trading in accordance with Shari'ah.

6. Date of the Issuance of the Standard

This Standard was issued on 14 Jumada II, 1431 A.H., corresponding to 28 May 2010 A.D.

Adoption of the Standard

The Shari'ah Board adopted the Standard of Obtaining and Deploying Liquidity in its meeting No. (27) held in the Kingdom of Bahrain during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

On 24 Dhul-Qadah 1428 A.H., corresponding to 3 December 2007 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Obtaining and Deploying Liquidity.

In its 25th meeting held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qadah 1430 A.H., corresponding to 21-23 October 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Obtaining and Deploying Liquidity and made the necessary amendments.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (26) held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (27) held in the Kingdom of Bahrain, during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in the United Arab Emirates, on 7 Sha'ban 1436 A.H., corresponding to 25 May 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

- The basis for the definition of liquidity as referring to cash and whatever is easily converted into cash is that the traditional terminology for liquidity is Tandid (literally, to convert to cash), actually or by estimation. Actual Tandid means converting commodities into cash by selling them. Tandid by estimation means evaluating commodities in order to arrive at the expected monetary value that can be realized from them.
- The basis that profit distribution depends on the availability of liquidity is that there cannot be any profit except after the protection of the capital, and this protection is realized by liquidating the assets.
- The basis for the prohibition of procuring liquidity through interest-based loans is the prohibition of any type of Riba (usury). The supervisory bodies are the entities most responsible for overseeing that the institutions' liquidity is compliant with Shari'ah. This is because it is these bodies that have licensed the institutions to operate by Shari'ah-compliant procedures and prohibited them from that which violates the Shari'ah.
- The basis for the Shari'ah-compliant methods of obtaining liquidity is provided in the Shari'ah standard for each method.
- The basis for the Shari'ah-compliant methods of deploying liquidity is provided in the Shari'ah standard for each method.

Appendix (C)

Definitions

Diversification of Liquidity

The deployment of liquidity in various instruments; for example, purchasing short-term, medium-term and long-term Sukuk to protect investments from sharp fluctuations in the returns.

Liquidity Preference

It means to hold on to cash instead of deploying it. That is for the purpose of financing current purchases, or investing it in securities whose prices are expected to decline, or paying for contingent expenses.

Liquidity Balance

It means reconciling the need to obtain liquidity and the need to deploy it.

Liquidity Surplus

The availability of liquidity exceeding the institution's needs.

Liquidity Deficit

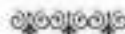
The need for liquidity in order to meet financial requirements.

Good Liquidity

It is based on two principles: The best price and the shortest period for obtaining it.

Liquidity Risk

It is the risk of having to sell commodities or securities at a loss in order to procure liquidity.



Shari'ah Standard No. (45)

**Protection of Capital
and Investments**

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims at explaining the most important ways of protecting capital and investments in Islamic financial Institutions.⁽¹⁾ It also aims to explain what is permissible according to the Shari'ah and what is not permissible as well as the Shari'ah basis for it.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers the instruments and methods used to protect capital and investments from loss, decrease and destruction.

2. Definition of Capital and Investment Protection and the Difference Between Protection and Guarantee

Protection of capital and investments means using available methods to prevent loss, decrease or destruction. It is wider than a guarantee of invested capital, as a guarantee is an undertaking by a particular party to bear any loss, decrease or destruction of the capital. On the other hand, protection refers to the safeguarding of capital.

3. Shari'ah Ruling

- 3/1 Protecting capital by permissible means is desirable in Shari'ah as it serves the objectives of Shari'ah with regard to wealth.
- 3/2 It is compulsory for an investment manager, whether he is a Mudarib, an investment agent or a managing partner, in his fiduciary capacity, to exercise due diligence to protect the funds from loss, decrease or destruction. If he fails to do so using usual means of protection, he is liable (for loss), taking into consideration items 4/1 and 7/1.
- 3/3 It is permissible to use Shari'ah-compliant instruments and processes to protect investment from risks that it may be exposed to whether they are risks relating to a loss of capital, depreciation in value, inflation, or the fluctuation of exchange rates, etc.
- 3/4 The investment manager acts in a fiduciary capacity with regard to the funds. He is not liable for loss of capital except in case of his wilful misconduct, negligence or breach of contractual terms and conditions.

- 3/5 The efforts exerted by the investment manager to grow the capital must be suitable for the nature of the relevant investment. It is also incumbent on him to take professional measures that normally provide suitable protection for the funds. Otherwise, he will be deemed negligent.
- 3/6 It is not permissible to stipulate in an investment agreement that the investment manager is unconditionally liable for any loss of capital in cases other than willful misconduct, negligence and breach of contractual terms and conditions.
- 3/7 If a loss occurs caused by the Mudarib's wilful misconduct, negligence or breach of contract, the capital provider may hold the Mudarib liable for the loss of capital but not the loss of profit. However, if it is determined through actual or constructive liquidation that the investment accrued profit which was added to the capital and then suffered a loss due to the Mudarib's wilful misconduct, negligence or breach of contract, the Mudarib is liable to indemnify for loss of that profit as it has become a part of the capital. If destruction of the whole or a part of the capital is caused by the Mudarib's wilful misconduct, negligence or breach of contract, the Mudarib is liable for the value of the capital.

4. Shari'ah Compliant Means for Protecting Capital

- 4/1 Instruments and processes used to protect capital and investments must fulfill the following conditions:**
 - 4/1/1 The investment partners should bear the risks and losses according to their respective shares in the capital.
 - 4/1/2 The objective should not be to hold the investment manager liable in cases other than willful misconduct, negligence or breach of contract.
 - 4/1/3 The means adopted for capital protection must not be a non-Shari'ah compliant contract and should not be a pretext to achieve an objective violating Shari'ah.

4/2 Some permissible methods of protecting capital include:

- 4/2/1 Takaful (Islamic insurance) for the investment to protect the capital or cover the risks of willful misconduct, negligence, breach of contract, procrastination, death or bankruptcy. Takaful coverage may be obtained either by the investors themselves or through the investment manager on their behalf.
- 4/2/2 Obtaining Takaful cover for the leased assets underlying the Sukuk or other instruments against the risk of destruction and for major maintenance.
- 4/2/3 An undertaking provided by Takaful institutions to guarantee exports and investments.
- 4/2/4 A voluntary undertaking by a third party acting in the public interest, such as the state, or relevant public interest authorities, such as a guardian, executor or father, to indemnify against a loss of capital without any right of recourse to the investment manager, such as a government pledge in respect of an investment project. In order for this undertaking to be valid, the third party should be administratively independent of the investment manager and there should be no direct or indirect ownership relationship of more than a half between the investment manager and the third party.
- 4/2/5 An undertaking by a third party to indemnify against a loss of capital resulting from the investment manager's wilful misconduct or negligence without receiving consideration for providing such a guarantee. However, the guarantor has the right of recourse to the investment manager.
- 4/2/6 Creating reserves to protect the capital through deductions from the investors' share of profits but not from the investment manager's share of profits due to him in his capacity as the Mudarib.
- 4/2/7 Diversifying the investment assets to achieve an appropriate return and minimize risks. This may include:

a) Combining real assets, such as real estate and commodities with financial assets (such as stocks and *Sukuk*) or combining assets denominated in two different currencies.

b) Dividing the capital into two parts by deploying the capital in Murabahah and Musharakah contracts, respectively.

The first part is used in Murabahah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the profit of Murabahah protect the initial capital and the second part is invested in Musharakah contracts.

c) Dividing the capital into two parts by deploying the capital in Ijarah and Musharakah contracts respectively.

The first part is used in Ijarah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the rental amount protect the initial capital and the second part is invested in Musharakah contracts.

d) Dividing the capital into two parts and deploying them in Murabahah and 'Arboun contracts respectively.

The first part is used in Murabahah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the profit of Murabahah protect the initial capital. The second part is used in 'Arboun contracts to purchase assets. If the value of the assets rises, the purchase contracts are completed and the assets are sold for a profit. If the value of the assets declines, the purchase contracts are not completed and the loss is limited to the amount of the 'Arboun, while the capital is protected by the Murabahah contracts. It is compulsory in this method to observe the Shari'ah rules relating to 'Arboun. This includes the requirement to reserve the assets sold under the 'Arboun contract from the time of contract conclusion until the settlement date and the impermissibility of trading in 'Arboun contracts. [see Shari'ah Standard No. (53) on 'Arboun]

- 4/2/8 Taking security and guarantees in Murabahah, Salam or Istisna'a contracts to ensure that debts are paid.
- 4/2/9 A sale with an option to terminate due to non-payment (*Khiyar al-Naqd*).
- 4/2/10 It is permissible to use other permissible instruments and processes with the consent of the investor to protect the capital from risks, whether those risks are related to the destruction of the original investment capital, depreciation in value, inflation or the fluctuation of exchange rates, etc.
- 4/2/11 If the investor has required the investment manager to adopt certain Shari'ah-compliant ways to protect the capital, the manager is obligated to do so. If he does not do so, he is liable for any resulting loss of capital, in accordance with item 4/4.

5. Shari'ah Non-Compliant Means for Protecting Capital

It is not permissible to protect the capital by Shari'ah-non-compliant means or means that result in violations of the Shari'ah, such as:

- 5/1 Stipulating that the investment manager is liable for loss of capital.
- 5/2 An undertaking by a third party to indemnify for loss of capital in the cases other than wilful misconduct or negligence of the investment manager with a right (of the third party) to have recourse to the investment manager.
- 5/3 A commitment by or obligating the investment manager to purchase the investment assets at their nominal price or at a price that was initially agreed upon.
- 5/4 An undertaking by a third party to guarantee the capital for a fee. This is a form of conventional insurance.
- 5/5 Protecting the capital by use of conventional hedging contracts such as futures, options and swaps.

6. Date of Issuance of the Standard

This Standard was issued on 24 Dhul-Qadah 1431 A.H., corresponding to 30 November 2010 A.D.

Adoption of the Standard

The Shari'ah Board adopted this Standard in its meeting No. (28) held in the Kingdom of Bahrain during the period of 22-24 Dhul-Qa'dah 1431 A.H., corresponding to 27-29 May 2011 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

On 24 Dhul-Qa'dah 1428 A.H., corresponding to 20 December 2007 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Protection of Capital and Investments.

In its meeting held in Kuwait, on 20 Shawwal 1430 A.H., corresponding to 9 February 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Protection of Capital and Investments and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (24) held in the Kingdom of Saudi Arabia, during the period of 25-27 Jumada II, 1430 A.H., corresponding to 18-20 June 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (26) held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (28) held in the Kingdom of Bahrain during the period of 22-24 Dhul-Qa'dah 1431 A.H., corresponding to 28-30 November 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated

the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in Al-Madinah Al-Minawwarah, on 30 Sha'ban 1436 A.H., corresponding to 17 June 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

- The basis for capital protection being a desirable objective is the Divine Command to adopt ways and means to protect wealth like having witnesses and documentation of the financial contracts and securing debt with mortgages and the like. Protection of wealth is one of the essential objectives that the Shari'ah has taken care of.
- The basis for the obligation of the manager to take due diligence to protect the investment is that his role regarding the investment is that of a fiduciary. This means that he should manage the investment in a way that serves the interest of the capital provider in his capacity of his fiduciary representative. He should thus use prudent means consistent with accepted standard practice to increase the funds.
- The basis for using permissible means to protect the investment is that all (financial) contracts are permissible by default unless proved otherwise. Furthermore, these instruments achieve the intent of the Shari'ah to safeguard wealth.
- The basis for the investment manager not being liable for the loss of the capital, except in cases of his wilful misconduct and negligence is the consensus of Muslim jurists.⁽²⁾ That is because he takes the capital with the owner's permission and deals with it in the interest of the capital provider. He is thus the capital provider's representative in terms of possessing and managing the capital. This means that the loss or destruction of the capital in his possession is just like its loss or destruction while in the possession of its owner because he took it with his permission. Moreover, no person, including the manager is liable to anything without a specific command by Shari'ah.

(2) *"Al-Bahr Al-Rai'iq"* [6: 313]; *"Al-Bahjah Sharh Al-Tuhfah"* [2: 217]; *"Mayyarah 'Ala Al-'Asimiyyah"* [2: 131]; and *"Al-Mughni"* [7: 76].

- The basis for the impermissibility to stipulate an absolute guarantee to be provided by the manager, is that this condition strips partnership (Mudarabah and Musharakah) and agency contracts of their essential content, and turns them into a guaranteed loan contract. Moreover, these contracts are based upon trusteeship, and this condition violates their nature and implications; hence, it is void. Ibn Qudamah said, "The third type (i.e., of invalid conditions) is to stipulate what is not in the interest of the contract nor consistent with its nature and implications; e.g., stipulating that the partner is liable for the capital or for a share of the loss."⁽³⁾ There is no disagreement among the jurists that this condition is void.⁽⁴⁾
- The basis for the opportunity cost not being compensated in the events of wilful misconduct or negligence is that it is non-existent wealth which has not been realised yet. However, realized profit after actual or constructive liquidation is treated like capital.

Shari'ah-Compliant Means for Protecting Capital

- The basis for stipulating equality among the partners in bearing loss is that partnership is based on equality between the partners. Stipulating that some partners should bear the loss more than others should violates the nature and implications of a partnership contract. Bearing the portion of loss that is supposed to be borne by another partner causes the latter partner to gain profit from that for which he has assumed no liability. The jurists agree that loss sharing in the partnership contract should be proportional to capital (contribution).⁽⁵⁾
- The basis for the permissibility to protect the capital with Takaful against any type of investment risks is that Takaful is an undertaking to make donations between the participants. It is not a contract to exchange counter-values (Mu'awadah). Its purpose is to achieve cooperation and solidarity among the participants. Hence, the Shari'ah prohibitions that apply to (conventional) commercial insurance do not apply to it.
- The basis for the permissibility of a third party's undertaking to bear the loss without the right of recourse to the manager is that, according to the

(3) *"Al-Mughni"* [5: 41].

(4) *"Al-Mabsut"* [15: 84]; *"Al-Bahjah Sharh Al-Tuhfah"* [2: 217]; *"Al-Hawi Al-Kabir"* [9: 113]; and *"Al-Mughni"* [7: 179].

(5) *"Bada'i' Al-Sana'i"* [7: 517]; *"Hashiyat Al-Dusuqi"* [3: 353]; *"Tuhfat Al-Muhtaj"* [5: 292]; and *"A-Furu"* [4: 403].

Shari'ah, this is an undertaking to make a voluntary donation. Therefore, it is permissible by the Shari'ah provided that the third party is independent from the manager so that his undertaking does not result in the manager becoming the guarantor.

- The basis for permissibility of deducting reserve amounts (from the profits) is that it is done with the consent of the relevant parties and is in the investors' interest as it strengthens the investment's financial situation. No deduction should be made from the manager's share because the liability for loss is borne by the capital providers, not by the manager.
- The basis for the permissibility of diversifying investment assets is that diversification achieves the interest of the investors. It does not fall under the prohibition of combining contracts in one contract because each contract is conducted independently of the other, whereby the manager divides the capital into parts and each part is invested independently in one type of contract or investment asset that differs from what the other portion of the capital is invested in. This is for the purpose of mitigating risks and diversifying returns. The parameters for each of these contracts may be sought by referring to the relevant Shari'ah Standard.
- The basis for the permissibility of obtaining securities and guarantees for deferred payment contracts is the Quranic Verse: *{“And if you are on a journey and cannot find a scribe, then (you may resort to holding something as) mortgage, taken into possession”}*,⁽⁶⁾ and *{“...who produces it is (the reward of) a camel load; I guarantee it”}*.⁽⁷⁾
- The basis for the liability of the manager to bear the loss if he violates the Shari'ah-compliant conditions stipulated by the capital provider is the Quranic Verse: *{“O you who believe! Fulfil (your) obligations”}*.⁽⁸⁾
- Fulfilling contractual obligations requires the fulfilment of the conditions stipulated in them. The Prophet (peace be upon him) said, “Muslims are

(6) [Al-Baqarah (The Cow): 283].

(7) [Yusuf (The Prophet Joseph): 72].

(8) [Al-Ma'idah (The Table): 1].

bound by their conditions (stipulated in contracts and undertakings)".⁽⁹⁾ Breaching these conditions amounts to negligence from the manager. Hence, it is compulsory upon him to bear any loss arising from this breach.

Shari'ah Non-Compliant Means for Protecting Capital

- The basis for the prohibition of a third party's undertaking to bear the loss with the right of recourse to the manager is that this condition results in making the manager liable for the loss, which is prohibited by the Shari'ah.
- The basis for prohibiting the manager from undertaking to buy the investment assets at their face value or at a value initially agreed upon is that this condition results in the manager undertaking to bear the partial or complete loss of the assets' value, which is a forbidden condition as aforementioned.
- The basis for the prohibition of a third party's guarantee for a fee received in exchange for the guarantee is that it firstly entails excessive ambiguity because the extent of the loss is unknown at the inception of the contract, and because giving a guarantee in exchange for a fee, is prohibited by the Shari'ah.
- See Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets for the basis of the prohibition of trading in options, futures and swaps.⁽¹⁰⁾

(9) Related by Al-Tirmidhi from the Hadith of Amr Ibn 'Awf, may Allah be pleased with him, in *"Kitab Al-Ahkam"*, Chapter on *"Ma Dhukira 'An Rasuli Allah, peace be upon him, Fi Al-Sulh"*, No. (1272); it is related also by Abu Dawud from the Hadith of Abu Hurayrah, may Allah be pleased with him, in *"Kitab Al-Aqdiyah"*, Chapter on *"Bab Fi Al-Sulh"*, No. (3120); also it is related by Al-Darqutni from the Hadith of 'A'ishah, may Allah be pleased with her, with the addition of "...that which is consistent with the truth", [2: 3]. It is an authentic Hadith when all its chains of transmission are taken into consideration; *"Tahqiq Al-Ta'liq"* [3: 280]; and *"Fath Al-Bari"* [4: 451].

(10) See Resolution No. (63) 1/7 of the International Islamic Fiqh Academy regarding Financial Markets.

Appendix (C)

Definitions

Wilful Misconduct by the Manager

Wilful misconduct by the manager that renders him liable is to do what he is not allowed to according to the dictates of the Shari'ah, or the contract, or customary practice.

Negligence by the Manager

Negligence by the manager that renders him liable is to fail to do what it is required of him by the Shari'ah, or the contract, or customary practice.



Shari'ah Standard No. (46)

**Al-Wakalah Bi Al-Istithmar
(Investment Agency)**

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to explain the rules of Investment Agency applicable to Islamic financial institutions,⁽¹⁾ the conditions for its validity, its types, its implications and its contemporary applications.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers Investment Agency in various fields, or parts thereof, and the powers and responsibilities of the principal and the investment agent. It does not cover Agency in general or the acts of Uncommissioned Agent (Fodooli) as they are covered by Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli).

2. Definition of Investment Agency and Its Permissibility

2/1 Investment Agency means appointing another person to invest and grow one's wealth, with or without a fee.

2/2 Investment Agency is permissible subject to the relevant Shari'ah rules.

3. Investment Agency: Integral Parts (Arkan) and Its Key Types

3/1 The integral parts (Arkan) of a valid investment agency are offer and acceptance, the subject matter of the contract, and the two contracting parties (the principal and the agent). [see Shari'ah Standard No. (23) for the conditions that are required for a valid agency and the rules relating to the acts of the uncommissioned agent (Fodooli)]

3/2 It is permissible to make the appointment of an agent contingent agency upon the fulfillment of certain conditions or to cause to take effect on a specified future date. It is also permissible to stipulate conditions/restrictions that are compliant with Shari'ah. For further details, see Shari'ah Standard No. (23).

3/3 It is permissible for the investment agency to be restricted to a particular kind of investment, or a specific place or be subject to other restrictions. It is also permissible that it be unrestricted, in which case it would still be restricted by customary practice and that the agent acts in the principal's best interests.

- 3/4 It is not permissible for any one of the parties to unilaterally amend the restrictions in the agency contract. [see Shari'ah Standard No. (23) for the types of agency]

4. Characteristics of Investment Agency

- 4/1 Investment agency contracts, whether remunerated or unremunerated, are binding on institutions because they are invariably fixed term contracts in which both parties agree not to terminate within a specified period.
- 4/2 Where the parties agreed to terminate for a specified period, it is permissible for the contract to stipulate the right of one of the parties to terminate the contract unilaterally in specific circumstances.
- 4/3 When the term of an agency expires, the agent is required not to enter into new investment activities, but may not liquidate ongoing existing investments.

5. Agency Fee

- 5/1 If the agency is remunerated, the agent's fee should either be a fixed amount or a percentage of the amount invested. It is also permissible to link the fee to an established index/benchmark that is known to both parties and is referred to before every investment period after the fee of the first period has been determined. It should, however, be capped and floored (by assigning it maximum and minimum limits).
- 5/2 If the fee was not specified in the contract and the agent customarily charges a fee as is normal practice in institutions then the agent will be entitled to a fee which is prevalent in the relevant markets. This also applies when the agent does not complete the task required after starting and realizing returns that are beneficial to the principal.
- 5/3 The principal is required to pay the investment agent's fees in accordance with stipulated time and manner.
- 5/4 It is permissible to stipulate that the agent, in addition to his fee, is entitled to all or part of any amount over and above the expected profit as a performance incentive.

6. Amount, Term and Profit of the Investment

- 6/1 The amount and term of the investment should be determined, irrespective of whether the amount is paid as a lump sum or in installments.
- 6/2 The principal is responsible for any expenses related to the investment such as transportation, storage, taxes, maintenance and insurance. It is not permissible to require the agent to pay them from the agent's own funds, or to defer any reimbursement due to the agent where he has paid them on behalf of the principal or to make such reimbursement subject to the yield of the investment. And the investment agent is liable, as a legal entity, for any expenses related to its employees or equipment.
- 6/3 The agent may start investment activity before receiving the funds (from the principal), and with the principal's permission, by:
 - 6/3/1 Incurring a debt on behalf of the principal by purchasing on credit;
 - 6/3/2 Advancing a loan to the principal by purchasing something on his behalf.
- 6/4 Any loan advanced by the agent is construed as an interest free loan which may not bring any benefit to the agent as creditor. The agent is entitled to its fee and performance incentive, without consideration to the loan advanced.
- 6/5 The profit in its entirety is the right of the principal unless it is stipulated that the agent shall be entitled to all or part of any excess above the expected profit as a performance incentive in addition to its fixed fee.
- 6/6 It is permissible for the agent, with the principal's consent, to set aside a portion of the profit to create a profit equalisation reserve for the benefit of the principal.
- 6/7 Upon liquidation, the balance of the profit equalisation reserve is returned to the principal without affecting the agent's entitlement to the fixed fee or performance incentive for the period in which the reserve was set aside.

7. Liability of an Investment Agent

- 7/1 The agent acts in a fiduciary capacity in relation to the investment and therefore is not liable for any loss in cases other than willful misconduct, negligence, or breach of contract unless the breach happens to be advantageous to the principal such as selling an asset for a price higher than the price required by the principal. In situations where the agent is held liable for loss of capital, such liability is limited to the capital amount and the agent is not liable for loss of expected profit whether the capital was invested immediately or delayed or not invested at all.
- 7/2 If the investment results in profit or capital gain in case of a breach that is advantageous to the principal, then such profit or capital increase belongs to the principal without affecting the agent's right to its performance incentive.

8. Rights and Obligations of the Contracts Executed by the Agent

The results of the contract (like transfer of ownership and entitlement to the fee) belong to the principal. However, the rights and obligations (like pursuit of payment or delivery including litigation) belong to the agent.

9. Appointment of a Sub-Agent

- 9/1 The investment agent is not permitted to appoint a sub-agent for the prescribed investment activities except for activities outside its area of expertise, or what is normally outside the capacity of the agent or its employees or where the principal grants the agent permission to subcontract.
- 9/2 The sub-agent appointed by the agent with the consent of the principal cannot be dismissed by the agent but can only be dismissed by the principal. However, if the principal authorizes the agent to appoint any sub-agent at his will, the agent is entitled to dismiss the sub-agent.

10. Restrictions Stipulated in Investment Agency

- 10/1 The investment agent must adhere to a restriction requiring it to consult the principal before any investment and if any breach by the agent results in loss, the agent shall bear it.

10/2 If the Investment Agency is restricted to activities that yield a minimum specified profit margin and the agent does not find such an investment, then it should seek the principal's consent before investment. If it invests in lower-yielding transactions, it is liable to compensate the principal for the difference between the profit earned and the average profit prevalent in the market (if it is less than the stipulated amount/percentage). It is not liable for the minimum profit margin specified for the investment by the principal. [see Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli), item 6/3/2]

11. Rules of Investment Agency

If the agent co-mingles his own funds with the principal's funds or with the funds that he manages, he may not then purchase, for his own account any assets from the assets owned by the co-mingled funds without giving notice on each occasion. This is to establish the transfer of ownership and liability for the asset from the co-mingled funds to the agent's account. This requirement is impracticable in relation to investment accounts (and therefore this requirement may be waived). [see items 7/1/2 and 7/1/3]

See also Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli).

12. Contemporary Applications of Investment Agency

12/1 Co-mingling the funds of an unrestricted agency with Mudarabah funds or with the agent's funds.

12/1/1 It is permissible to co-mingle funds on the basis of Investment Agency with funds from Mudarabah investment accounts. Such funds are treated as if they were extra funds provided by a capital provider in a Mudarabah investment or shareholder funds when they are co-mingled with funds in Mudarabah investment accounts. Allocation of profits is calculated by the standard prorated method (usually daily weighted

average method) for funds invested in Mudarabah which takes into account each investor's amount and the tenor of the investment. All the profits of the invested funds in Murabahah belong to the principals and the agent is entitled to his fee and any performance incentive stipulated. The agent is not entitled to any profits generated from the Mudarabah accounts he invested.

12/2 Investment agency for the financing of working capital⁽²⁾

Investment agency can be used as a substitute for an overdraft. The amount provided to the client is regarded as the institution's undivided share in the working capital of the client. It is permissible for the client to use the withdrawn amount to settle the client's liabilities relating to his activities or his employees' salaries. The client is entitled to a fee for his service and profit from his portion of the working capital and losses occurring after the agency, if any, are borne by both parties on a pro-rata basis. If the client has any interest-bearing deposits or loans, the institution should stipulate that the client is solely responsible for them.

When the client does not require financing anymore, then the relationship may be terminated on the basis of Takharuj which means that either the joint account is distributed between them pro-rata or one party will purchase the share of the other at a price agreed upon at that time.

12/3 Appointing conventional banks by the institutions as their investment agents and vice versa

12/3/1 It is permissible for institutions to appoint a conventional bank as an investment agent, provided that the relevant contracts are compliant with Shari'ah approved by the institution's Shari'ah Supervisory Board, and that the conventional banks have among their activities Shari'ah-compliant modes of financing and investment with proper Shari'ah supervision

(2) As an alternative to an overdraft, its application requires precise accounting treatment.

and Shari'ah audit without violating the requirements of the regulatory authorities.

12/3/2 It is permissible for the institution to accept funds based on Wakalah from conventional banks and invest them in its activities which have been approved by its Shari'ah Supervisory Board, provided that the contract is free from conditions and restrictions that are prohibited by the Shari'ah.

12/4 Expiry of the investment agency term before collecting amounts receivable

If the agency expires and the receivables are yet to be collected, and the agency is not mutually renewed, the investment agent is required to collect the receivables and take necessary actions against the debtors or other counter-parties delaying their payments.

The agent is not entitled to any fee for such collection unless agreed otherwise. It is not permissible for the agent to use such funds received for his personal use or to re-invest them. The agent is not required to pay to the principal such receivables from his own personal funds, or to seek financing like Tawarruq for this purpose.

12/5 In the event of early termination of the agency either by mutual agreement, or by one party unilaterally exercising its right to terminate or by early settlement of the amounts due (from the obligors), it is permissible (if mutually agreed upon) to reduce the performance incentive stipulated for the agent, if any, in proportion to the tenor of the investment.

13. Date of Issuance of the Standard

This Standard was issued on 26 Jumada II, 1432 A.H., corresponding to 29 May 2011 A.D.

Adoption of the Standard

The Shari'ah Board adopted this Standard in its 30th meeting held in the Kingdom of Bahrain during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

On 23 Muharram 1430 A.H., corresponding to 20 January 2009 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Investment Agency.

In its meeting held in Kuwait, on 6 Rabi' I, 1431 A.H., corresponding to 20 February 2010 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Investment Agency and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its 28th meeting held in the Kingdom of Bahrain, during the period of 12-14 Dhul-Qadah 1431 A.H., corresponding to 20-22 October 2010 A.D. The amendments that were deemed appropriate were included.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its 29th meeting held in Makkah Al-Mukarramah, during the period of 28-30 Rabi' I, 1432 A.H., corresponding to 3-5 March 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 25 Jumada II, 1432 A.H., corresponding to 28 May 2011 A.D. All the comments made in the public hearing were listened to, and a representative of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (30) held in the Kingdom of Bahrain, during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it deemed appropriate, and adopted the Standard.

Shari'ah Standard No (46): Al-Wakalah Bi Al-Istithmar (Investment Agency)

In its meeting held in Al-Madinah Al-Munawwarah, on 30 Sha'ban 1436 A.H., corresponding to 17 June 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

- The basis for the differentiating between investment agency and agency in general is that the former is in order to increase wealth, and it is similar to Mudarabah and Musharakah in this respect. However, the difference between investment agency and Mudarabah and Musharakah is that Investment Agency is a form of Ijarah (hiring), while Mudarabah and Musharakah are forms of partnership. As for the general agency, it is an authorization to perform specific tasks such as payment etc. Even if the authorization is to engage in a sale/purchase, such as the authorization of the client in a Murabahah contract, its main purpose is to acquire ownership for the institution rather than investment on its behalf.
- The basis for the permissibility of investment agency is the Hadith stating: *"Engage in trade with the wealth of orphans so that it will not be consumed by Zakah"⁽³⁾* as well as numerous Verses of the Qur'an on seeking sustenance, striving and earning.
- The basis for the binding nature of the investment agency is that it is entered into for a specific period; i.e., there is an agreement between the counterparties that neither of them can unilaterally dissolve the contract except in certain circumstances specified in the contract.
- The basis for allocating for the investment agent any profit amount in excess of the expected profit is that it is a type of conditional gift and is an incentive.
- If the agency contract stipulates a certain percentage of profit and the agent invests in lower-yielding transactions, the agent is liable to compensate the principal for the difference between the profit earned and the average

(3) Related by Al-Tabrani in *"Al-Awsat"* and graded authentic (*sahih*) by Al-'Iraqi. Ibn Hajar graded it as good (*hasan*). *"Fayd Al-Qadir"* [1: 108]. It is found in *"Al-Muwatta'"* as a statement of Umar (may Allah be pleased with him).

profit prevalent in the market (if it is less than the stipulated amount/percentage), because he is in breach of the conditions of the Agency. However, the agent is not liable for the specified percentage stipulated in the contract if it is higher than the prevalent market rate, because it will be tantamount to acquiring another's wealth by illegitimate means.⁽⁴⁾

- The basis for the permissibility of employing the agency's funds in the Mudarabah portfolio is that the authorization granted by the investment agency includes such employment when the agency is unrestricted.
- The basis for the principle that the agent, in a situation where the agency's funds are employed in a Mudarabah portfolio, is entitled to the agency commission and not to Mudarabah profit is that his contract with the institution is that of agency and not of Mudarabah. Even if the agent has employed the funds in a Mudarabah portfolio, the profit entitled to the institution is generated from the Mudarabah portfolio and not on the basis of agency.



(4) See *"Al-Mughni"*, vol. 5, (P 135).

Shari'ah Standard No. (53)

'Arboun (Earnest Money)

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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to explain the Shari'ah rules relating to the payment of 'Arboun (Earnest Money) in sale contracts and its application in the activities of Institutions.⁽¹⁾

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers the definition of 'Arboun (Earnest Money), the rules applicable to it and its applications in the activities of institutions in commutative financial transactions that do not require spot delivery of countervalues. It does not cover payments made prior to contract such as refundable security deposits, commissions or advance payments made subsequent to contracts that are not subject to options.

2. Definition of 'Arboun (Earnest Money)

- 2/1 Earnest money is paid by the buyer to the seller⁽²⁾ at the time of contract on the basis that the buyer has the option to revoke the contract during an agreed period of time. If he confirms the contract, the earnest money is credited towards the price. If he does not confirm the contract or fails to pay the remaining price during the stipulated time, the seller is entitled to forfeit 'Arboun (Earnest Money).
- 2/2 An agreement to execute a contract in the future (an agreement to sell) is a promise and not a contract. If money is paid with the promise, it is not considered to be earnest money ('Arboun).
- 2/3 'Arboun (Earnest Money) can be paid in cash, in kind and with a usufruct.

3. Permissibility of Earnest Money

- 3/1 It is permissible to pay 'Arboun (Earnest Money) in commutative contracts that do not require spot payment of one or both counter-values whether the sale item is identified or is sold by description

(2) What applies to the buyer also applies to the lessee and the purchaser in an Istisnā'a contract, and what applies to the seller also applies to the lessor and the seller in an Istisnā'a contract, etc.

for future delivery (*Ijarah Mawsufah Fi al-Dhimmah*), such as sales, Istisna'a contracts, leases of identified assets and of assets leased by description for a future date.

3/2 Payment of 'Arboun (Earnest Money) is not permissible in Salam and currency exchange contracts.

4. Option Period Arising from 'Arboun (Earnest Money) Payment

The option period arising from the payment of 'Arboun (Earnest Money) must be specified either by express stipulation of the parties, or by custom if there is an existing custom that specifies the option period.

5. Lapsing of the Option Arising from 'Arboun (Earnest Money) Payment

5/1 The buyer loses his right to revoke the contract if he informs the seller that he has confirmed the contract or disposes the sold item in a manner that indicates confirmation. The contract may stipulate conduct that indicates lapsing of the option and confirmation of the contract in order to avoid dispute. [see Shari'ah Standard No. (52) on Options to Reconsider]

5/2 If the option period expires without the buyer paying the remaining price to the seller and without the seller having agreed an extension, the contract is considered revoked and the buyer is not entitled to recover the 'Arboun (Earnest Money).

6. Ownership and Liability for the Sold Item During the Option Period

Prior to delivery, the seller is liable for any loss to the sale item. If it is destroyed or damaged before delivery to the buyer or delivery is not possible, the contract is void and the earnest money must be returned to the buyer. After delivery, the buyer is liable for the sale item. If it is destroyed or damaged after delivery to the buyer, the buyer's option is canceled and he is required to pay the balance (unpaid part of the price) to the seller.

7. Delivery of the Sale Item During the Option Period

The buyer may take delivery of the sale item during the option period, which does not on its own indicate confirmation of the contract unless the buyer's conduct indicates that he has accepted the sale item.

8. Increase in the Sold Item During the Option Period

- 8/1 Increase that is physically connected to the original is considered part of the original.
- 8/2 In principle, any growth in (increase to, and/or yield of) the sale item that is physically separate from it, which occurs during the option period whether prior to delivery or after delivery is considered part of the sale item. It is permissible for the party who is liable for the sale item to stipulate that any increase that is physically separate should belong to him, even if ultimate ownership of the sale item is not vested in him.

9. Disposal of the Sale Item Under 'Arboun (Earnest Money) Arrangement

- 9/1 If the sold item is identified, the seller is not entitled to dispose of it. If the seller does dispose of it by sale or lease or otherwise, his actions are subject to the rules relating to uncommissioned (Fodooli) disposals. If the buyer ratifies the seller's actions, he loses his option and is liable for the remainder of the price to the first seller. The first seller's disposal becomes binding and the first buyer is entitled to receive the sale price. If the first buyer does not ratify the seller's actions, the second disposal is void. [see Shari'ah Standard No. (23) on Agency and Acts of Uncommissioned Agent (Fodooli)]
- 9/2 If the sale is related to an identified item, the seller cannot deliver a different item even with same specifications, except with the consent of the buyer, in which case what the buyer has paid remains 'Arboun (Earnest Money).
- 9/3 If the buyer stipulates that he will offer the sale item to his clients during the option period and the seller accepts this, the buyer's right to revoke the contract remains valid during the option period, even after offering the item to his clients. The conclusion of a sale to one of his clients is deemed to be confirmation of the contract.
- 9/4 It is not permissible to negotiate/trade options arising from payments of 'Arboun (Earnest Money). [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets]

10. Stipulating Refund of Earnest Money in the Contract

It is permissible for the buyer to stipulate a condition in the contract providing for a refund of earnest money in specific situations, such as the buyer's failure to obtain licenses from the relevant authorities.

11. Date of Issuance of the Standard

The Shari'ah Board issued this standard on 15 Muharram 1435 A.H., corresponding to 8 November 2014 A.D.

Adoption of the Standard

The Shari'ah Board adopted the standard on 'Arboun (Earnest Money) in its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

On 19 Rabi' I, 1433 A.H., corresponding to 12 March 2012 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on 'Arboun (Earnest Money).

In its meeting No. (35) held in Al-Madinah Al-Munawwarah on 22-23 Shawwal 1434 A.H., corresponding to 29-30 September 2013 A.D., the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable.

In its meeting No. (37) held in the Kingdom of Bahrain on 19-21 Jumada I, 1435 A.H., corresponding to 20-22 March 2013 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

In its meeting No. (38) held in the Kingdom of Bahrain on 28 Sha'ban – 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Saudi Arabia (Riyadh) on 28 Dhul-Hajjah 1435 A.H., corresponding to 22 October 2014 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah Standards Committee responded to a number of observations raised by the participants.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the changes proposed at the public hearing and introduced the changes it deemed suitable to the exposure draft of the standard, and adopted the standard.

Appendix (B)

The Shari'ah Basis for the Standard

- The basis for permissibility of 'Arboun (Earnest Money) is a narration that Nafi' Ibn Abdul-Harith purchased a building in Mecca to be used as a prison from Safwan Ibn Umayyah, provided that if Umar (may Allah be pleased with him) approves the sale, then the sale is considered to be effected by him (Umar) and on his behalf (Umar's), and if not, then Safwan shall be paid 400 dinars.

Also, there is a narration that Ibn Sirin said: "A man said to a lessor of ride camels: prepare your camels, so that if I did not leave with you on so and so day, you get 100 dirhams. Then he did not leave with him". And Shurayh said: "He who voluntarily makes it incumbent upon himself to do something (with a condition and without coercion), then he shall have to honor the condition". Hence, 'Arboun is similar, where a buyer pays part of the price and says: "If I did not confirm the sale, the 'Arboun is yours to keep". Payment of the 'Arboun either at time of contract or later at the time of relinquishing it is valid.

- The basis for impermissibility of 'Arboun in *Sarf* and *Salam* contracts is that 'Arboun is embedded with a cooling-off option (*Khiyar al-Shart*), which according to the majority of Fuqaha (of the Four Schools of Fiqh) is impermissible in *Sarf* contracts (currency exchange transactions). This rule was deduced from the Hadith: "Gold for gold, silver for silver... like for like, equal for equal, and hand to hand. If these types differ, then sell them as you find proper, provided it is hand to hand".

Ibn Umar (may Allah be pleased with both of them) is reported to have said: "O, Messenger of Allah, hold on that I may ask you a question: I sell camels in Baqi', so that I sell for dinars and receive dirhams, and I sell for dirhams and receive dinars. I take so and so of this and pay so and so of that? Then the Prophet (peace be upon him) said: "No harm that you apply

the market rate unless you (you and the counterparty) leave the transaction session without settlement of dues". Therefore, this was an evidence on the requirement to take possession of both countervalues (Qabd) at the contracting session (Majlis al-'Aqd).

'Arboun is also impermissible in Salam contract, because in Salam, payment of the price (capital of Salam) shall be settled at the contracting session. The Prophet (peace be upon him) said: *"Whoever pays money in advance for dates (to be delivered later) should pay it for a known specified weight and measure (of the dates)...."*. This implies that unless the price is paid in full before the two parties leave the contracting session, the transaction is not deemed to be Salaf (or Salam).

- The basis for determination of a specific term for 'Arboun is to avoid Gharar that may result from an unknown term (Jahalah that involves 'Arboun term).
- The basis for the seller being liable for the object of sale before delivery and for the buyer being liable for it after delivery is the Shari'ah maxim: "Ownership (title) shall be established upon the conclusion of the contract, while liability is contingent upon delivery (Qabd)".
- The basis for attributing growth connected to the original is that it represents an integral part of it.
- The basis for attributing growth and yields, separate from the object of sale, to the object of sale is the saying of the Prophet (peace be upon him): *"Al-Kharaj Bi al-Daman"* (i.e., entitlement to revenue is based on bearing liability for the revenue-generating asset).

