Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp.77-80

Purification of Islamic Equity Funds

Methodology and Sharīᶜa *Foundation*

Mohamed Ali Elgari*

ABSTRACT

One of the fundamental *sharīᶜa* aspects in Islamic funds is purification, which simply means cleansing the investor's returns from income whose source is questionable from a *sharīᶜa* point of view. To some *sharīᶜa* scholars, the entire permissibility of an Islamic fund hinges on purification. This paper will expound on the *sharīᶜa* foundation of the concept of purification and on the basis for applying it as part of an equity investment program. It will illustrate the main formulae used by fund managers for this purpose and will also reflect on the differences of opinion among *sharīᶜa* scholars on who should implement such purification.

I. INTRODUCTION

The basic model of a publicly traded limited-liability company is a contemporary one dating back to no more than 100 years in Muslim countries. This form of company presents a momentous departure from the simple form of partnership. Such a model has never been rejected by contemporary *sharīᶜa* scholars who see in it a modern form of the *Anan* company, well known in Islamic jurisprudence.[i]

Except for a minor dissension, the majority of today's *sharīᶜa* scholars accept company shares as exemplifying an undivided ownership over the assets of the company as well as the basic transferability of ownership through purchase and sale of company shares (negotiability). Up to the 1980s, the prototype of a public company on which all the jurisprudence was applied to, was one free from every prohibited activity or questionable source of income, including borrowing and lending on the basis of interest. However, the business environment and the state of economic affairs in the contemporary world made such model unreachable and non-existent, even within Muslim countries, due to the problem of *ribā*. It may not be impossible for a company to refrain from prohibited activities such as production of *®arām* goods. However, it is not possible for a modern corporation to survive without any access to capital and money markets as well as basic banking services. Even companies that maintain large liquid assets can hardly do without a regular overdraft account with the local bank. In most cases this is not the only facility such companies need and cannot arrange on an Islamic basis. Such transactions were based on interest that purported to borrow on the basis of *ribā*. Unfortunately Islamic banks were yet to develop a substitute for regular overdraft accounts. This effectively meant that public companies, regardless of how dedicated their management was to the *sharīᶜa*, were unable to fully refrain from interest-based transactions.

Many Muslims started shunning equities all together as this appeared to them to be the best thing to do from a religious point of view.

In 1991, the OIC *Fiqh* Academy made a monumental and decisive ruling on "what is a company share" and what exactly is the objective of the sale contract when such share is sold.[ii] Scholars were now able to revisit the issue related to investing in companies that were not *so pure*. Such issue is now articulated in a manner that affords a *sharīᶜa* discourse.

In the last few years, *sharīᶜa* scholars succeeded in developing an equity investment program that was implemented by professional investment managers, of which, purification was a pivotal element. Islamic equity funds were born.[iii] Today, the market for such funds is sizable. According to the author's estimation, it may have already passed the $20 billion mark worldwide, affording two market indexes (and a third on the way).

While the study of the *sharīᶜa* basis for Islamic equity funds is important, it is the subject of a different paper. This paper takes such aspects as a given and concentrates on the issue of purification.

II. THE MEANING OF PURIFICATION

Purification simply means deducting from one's investment those earnings the source of which is not acceptable from a *sharīᶜa* point of view. In the case of equity investment, this refers primarily to interest earnings

* Associate Professor, King Abdulaziz University, Jeddah, Saudi Arabia.

and incidental income from other non-permissible sources of income to the investee company such as a sale of alcoholic beverages or pork. Estimating the earnings from sale of pork and alcoholic beverages is not easy and interestingly quite arduous. For example, a company is a going concern. It is a living entity with far-reaching enterprises and widely stretched activities. From an accounting and financial point of view, it is also very complex. It is a far cry from the single partnership of the *Anan* form of company. Therefore, estimating income is a formidable task, requiring an excellent knowledge of accounting and corporate finance as well as an exceptional ability to handle *sharīᶜa* issues. This is a combination that is not always within reach.

III. THE *SHARĪᶜA* BASIS FOR PURIFICATION

From an increasing number of *sharīᶜa* scholars and the Muslim public at large, Islamic equity investment programs gain more and more acceptance everyday. Although, the opinion is still held by some that the *sharīᶜa* basis for such programs are speculative to say the least. Nevertheless, no part of these programs is on a more solid ground from a *sharīᶜa* point of view, than that of purification. This is because the issue of purification is not new. It finds a clear *sharīᶜa* foundation exemplified within the classical annals of *fiqh* and statements of major learned scholars of the early centuries. Their understanding of the texts (Qur'an and Sunna) epitomized the principles for such procedures

However, articulating these *sharīᶜa* principles into a formal procedure for purification in portfolio investments is quite a formidable task and one with a number of unsettled issues, as will be described below.

IV. THE ISSUES

A. What is to be purified?

1. Dividends

There are those who think that non-permissible earnings of a company (such as interest) will transpire into an investor's returns only if such investor collects a direct receipt from the company in the form of a dividend. Hence, what is to be purified is only that part. As according to this viewpoint, return derived from capital gain, as most of the returns accruing to equity investors, need no purification. Capital gain is a market element, the argument goes. The main consequence of this approach is that no cleansing will need to be applied if the dividend is distributed, even if the company did earn interest income.

2. Capital Gains

Others differentiate between investing in a single company and being a subscriber to an investment fund. While it makes sense to only purify dividend incomes in the first case, in the second, the fund itself should be treated as a company, where the investment units are akin to company shares. In this case, the investment returns one derives from such fund (which is primarily capital gain) must all be purified as they are not dissimilar to company shares and dividends. No capital gain is realized from the sale of such fund units, and hence any income is similar to a dividend. A third view holds that the increase in share prices in the market (capital gain) is a complex phenomenon. Such an increase can be attributed to multifarious factors from which cash and debt securities (the source of interest earnings) cannot be excluded. Hence, even capital gain ought to be purified.

3. Assets or Liabilities

According to current thinking, only the company assets need to be purified. An Islamic equity investment program is based on, among other considerations, the *sharīᶜa* maxim, "*Li-al-kathīr ®ukm al-kull*," or, "The rule is based on the majority, not the minority." Since the bulk of sources of funds for the company comes from permissible sources (two-thirds), the minority source is ignored and hence should have no consequences to purification. However, there are those who believe that the above mentioned maxim permits us to invest only in the company and that composition of the liability side should be considered for purification. In this case, we need to assign a portion of the income of the company to the debt source of funds and dispose of it.

B. Net or Gross

A Company deposits some money in a time deposit, or holds government bonds and earns interest on them. This interest will be part of that company's income for the year. But, it remains to be determined whether such interest earnings should be net income or just revenue. In other words, when we transpose the interest earnings of a company to the return on investment received by a participant in an equity fund, we need to relate such interest earnings to either net income or the revenue of the Investee Company. It appears that income is not a very reliable element, whereas, revenue is less influenced by such factors. By counting interest as revenue we indirectly allow charging operational expenses to such source of income, like any other source. This is not the case when we relate interest to net income.

C. Purification vs. Screening

It is important to distinguish the method of handling interest and all incidental non-permissible earnings in the screening phase of the Islamic investment program to that of the purification phase. There is no basis in the *sharīᶜa* for saying that 5% is acceptable while 6% is not. In other words, screens that permit investing in a company if its interest earnings are 5% or less of its income are clearly founded on expedience, not conformity to the *sharīᶜa*. Due to this point many *sharīᶜa* boards are now moving to a stricter criterion. It is different at the purification stage, as all interest earnings must be dispensed with.

D. Deduct or Inform?

Investors in most equity investment funds are advised on a quarterly basis the percentage of their investment that they need to dispose of in order to purify their return. It is the duty of every subscriber to purify on his or her own. In other funds, such burden is entrusted to the fund manager. He is not only required to calculate but also to dispose off the tainted amounts. The first method is clearly more practicable. Since no deduction from the net asset value of the portfolio is taken, the fund appears more profitable. Furthermore, this attracts strict Muslim investors (who would be keen to dispose off this amount every quarter), and those who are non-practicing or non-Muslims to invest in the fund.

Some *sharīᶜa* scholars, on the other hand, think that an equity fund will not be truly Islamic unless all returns to investors are "pure." In this case, the manager must deduct such amount and dispose of it to charity.

In the author's personal view, money itself is neither pure nor tainted. Such things can only take place in the "*dhimma*."[iv] If one earns impermissible income, he will be cleared if he disposes of the same from other sources. In the final analysis, those who subscribe to the fund with the intention of earning pure and clean return will purify.

V. METHODS OF PURIFICATION

We have deducted in the practice of Islamic equity fund management several methods of purification, which will be presented below. Each method is based upon assumptions the purposes of which are to embody *sharīᶜa* requirements into a formula that lends itself readily for implementation by fund managers. All the methods presented here are already in practice, and are used by one or more fund managers. However, these are probably not the only methods, albeit the most common.

In each methodology, a formula is set-up to find factor P through which interest income can be estimated.

A. First Method

Let us assume that we have a portfolio of company shares. On January 1 (t_1) we have investee companies (c) each earning interest equal to ί.

Hence, we have interest income equal to:

$$ί_{c1} + \ldots + ί_{cn} = a$$

Let us assume that the net operating income for any company in the portfolio is y.

Hence, the total net operating income for the portfolio is equal to:

$$y_{c1} + \text{——} + y_{cn} = b$$

Let us assume that the net asset value of the fund on Jan 1 is equal to $NAV_{t1.}$

Then calculate Z, which equals $NAV_{t2} - NAV_{t1.}$

The purification factor P will then equal ZH = P.

$$\text{Then} \quad H = \frac{a}{b}$$

Hence for every dollar invested, the investor must multiply by P and donate this amount to charity.

If for example, P = .007 and the investors Z = \$2000 then he must dispose of the amount of \$14.00

B. Second Method

Let us assume that we have n companies in the portfolio: C_1, C_2 …C_n

Then calculate dividend yield (d) where d equals = $\dfrac{\text{dividend}}{\text{market value}}$ = d

Therefore, the annual portfolio dividend yield will be = $d_{c1} + d_{c2} + \ldots + d_{cn}$
Calculate interest income ratio for each company (í) which equals = $\dfrac{\text{interest income}}{\text{net operating income}}$

for the portfolio it will be = $í_{c1} + í_{c2} + \ldots + í_{cn}$
Hence, purification factor is = (d) (í) = P
This means that for every dollar invested, the amount of \$P must be donated annually to charity.

C. Third Method

Let us assume that reported interest income for each company in the portfolio is X. We will then have X_1 to X_n where 1 and n denotes investee companies.

Let us assume that T is equal to each company's tax rate and that there is a tax rate for each investee company.

A equals the percentage of the total company shares owned by the fund.

M equals the number of months the share is held in the portfolio. Then we have interest income in the portfolio ip equals S X (1 – T) (X) (a) (M).

$$\sum x\ (I - T)\ (X)\ (A)\ (M)$$

VI. Conclusion

The concept of purification is the *sharīʿa* scholars' answer to the problems faced by public companies prior to the 1990s. At that time, a company had to be free from the outset of every prohibited activity or questionable source of income, including borrowing and lending on the basis of interest. Today, purification of equity investments is simply made by cleansing the investors' returns from income whose source is questionable from a *sharīʿa* point of view. To some *sharīʿa* scholars, the entire permissibility of an Islamic fund hinges on purification. Islamic equity funds were born from this purification process, creating a sizeable market. Yet the process of purification itself is difficult and has led to a variety of approaches and opinions.

Disagreements proliferate as to what actually must be purified. Some argue that the dividend is what needs to be purified, others point to capital gains, while a third group believes that the company's assets and liabilities need to be purified. Moreover, disagreements exist over whether interest earnings should be considered as part of net income or revenue.

This paper expounds on the *sharīʿa* foundation of the concept of purification and its application, particularly as part of an equity investment program. Three common methods of Islamic equity fund purification were discussed, each method with its followers and critics.

---

[i] Of course, some argue that such acceptance was not the product of rigorous scholarship but was mostly based on *istis®āb al-®āl*.

[ii] *Fiqh* Academy session of the Year 1412 H.

[iii] There are now over 55 public Islamic equity funds worldwide and two Islamic market indexes.

[iv] If one becomes obliged from payment of *zakāt*, for instance, it suffices if he pays the due amount from funds other than the one on which *zakāt* is due.