King Abdulaziz University

International Centre for Research in Islamic Economics

ASSESSMENT OF CORPORATE SECURITIES IN TERMS OF ISLAMIC INVESTMENT REQUIREMENTS

By:

Prof. Mohammad Mohsin

International Centre for Research In Islamic Economics
King Abdulaziz University
Jeddah – Saudi Arabia

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CENTRE'S GENERAL INTRODUCTION

The Centre's Research Series in Arabic and English are intended to elucidate ideas, clarify issues to broaden our understanding of Islamic economics. They may provoke constructive criticisms too. This is what we would welcome from our readers. This is how Islamic economics will emerge as a distinct discipline of knowledge.

In this connection, it may be mentioned that the Centre has been conducting and supporting theoretical and applied research in various fields of Islamic economics and allied areas since 1976. Under this research programme, one of our activities is to publish research papers, monographs and books on Islamic economics after due evaluation by independent reviewer(s). In order to get good quality research material, our strategy has always been to invite research proposal(s) from interested scholars around the world.

Thus on Shaban 1399/ August 1979, we sent out our first Announcement on Research Proposals suggesting a large number of suggested research topics in Islamic economics. We invited outlines of proposed papers or monographs along with a scheme of honoraria. This was done again in 1980 and in 1981. It is going to be an annual feature, Inshallah.

Every proposal we receive is studied by the Academic Committee of the Centre which comprises professional economists as well as Shariah scholars. Only such proposals which have clear Islamic dimensions and are expected to add something to the existing professional Islamic economic literature are accepted. When a manuscript is received, it is sent to referees for detailed evaluation and comments. Thus every care is taken to raise the professional standard of our research.

It is indeed gratifying to note that the Centre has been able to attract high class talents towards its research work, majority of whom are university professors.

Any scholar or institution interested in our various research programmes write to us for details. The Centre desires keenly to establish professional link with all concerned.

May Allah help us in serving His Cause.

International Centre for
Research in Islamic Economics,
King Abdulaziz University,
P.O. Box 1540, Jeddah،
Saudi Arabia.

Dr. Omar Z. Hafiz
Director.

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INTRODUCTION

Security issues, are the outcome of flow of funds in a mixed economy based upon division of labour and large scale production. The multitude of debt and ownership securities form the cluster of ‘security capitalism’, the structure of which is determined by the infusion of financial intermediatries and the level of economic development of a country. Advanced industrialised economies have thicker cluster and their financial structure is relatively complicated and complex due to multiplicity of financial agencies.

However, through the process of intermission in the finance functions, the varieties of financial securities has not only multiplied but their actual form has been changed from the primary nature in which they were originally issued by the ultimate borrower. Almost every conceivable departure from the standard pattern can be found in greater or less proportion in the modern security markets.

OBJECTIVE OF THE STUDY

The main purpose of this study is to assess the basic form and character of corporate securities from the point of view of Investment Requirements of Islam. The analysis connotes the careful study of funds flows, investment markets and corporate securities with a view to draw conclusion, the reform in an Islamic framework.

SCOPE OF THE STUDY

In this study, we shall confine our discussion on stocks and bonds (debentures) issued by modern corporations. Efforts are made to expose the form and nature of these securities in the most simple style so that those experts of Islamic Shari'ah, who are unfamiliar with complicated financial terminology, can understand the basic features. To assist them further, the author has suggested his own line of thinking on the subject.

MAIN ASSUMPTIONS

The study does not indulge into controversial issues like the *form* and *nature* of interest which is prohibited in Islam. It accepts the existing ruling of *fuqaha* which interprets interest as "predetermined positive rate of return on saving and loans". The *fuqaha* does not draw distinction between '*Usury*' and 'Interest'. According to their version, interest in any *form* at any *rate* is prohibited in Islam. Based upon this judgment we have tested various alternatives and types of corporate securities that might be nearer to the accepted version.

With minor variations corporate securities throughout the world have common standard features. Hence no particular example of any country or economy is given. However, it is assumed that Islamic institutions and/or individuals have to carry out their investment operations in a mixed economy, they will constantly come into contact with the institutions and organizations which are secular in character. Thus in a secular environment, it is not only the problem of pursuing a sound investment policy, but keeping intact the basic Islamic investment values.

LAYOUT AND ARRANGEMENT OF THE PAPER

To help this process of selection and rejection, in an Islamic framework, it is considered necessary to explain at first the main features of a secular investment environment. Accordingly, the paper is divided into three parts. Part I, explains the nature of funds flows arising in a secular environment, with particular reference to the securities issued by modern corporations. Part II, defines the fundamentals of Islamic Investment and assesses corporate securities in that context. Part III, evaluates the interaction of Islamic investment values in a secular environment.

I

STRUCTURE OF SEC1RITY CAPITALISM IN A SECULAR ENVIRONI ENT

Both in national and international perspective, Islamic investment have to interact with secular institutions and organizations which dominate the capital markets. In order to assess suitability, it is quite logical to examine their basic features. In a analysis of security capitalism in secular environment, the following three basic constitutes have to be carefully understood:

1. Nature of Funds Flow
2. Main Features of Investment Markets
3. Corporate Form of Organization and its chief characteristics.

1. NATURE OF FUNDS FLOWS

'Capital formation' involves three distinct, albeit, interdependent functions of savings, investment and financing[1]. At the early stages of economic growth the two basic functions - saving and investment - are integrated; but with the development 'process these two functions are disintegrated and financing emerges as a third function[2]. 'Transportation', of capital i.e. Flow of Funds between 'surplus' and 'Deficit Units', facilitates capital formation in every modern society. The basis of flow of funds is the use of securities which are issued by the borrowers or user of capital (also termed Ultimate Users) or drawn by the Creditors (Ultimate lenders); they may also be issued by intermediaries involved in finance functions.

It can be seen from diagram, (giver on page 7) that the 'Ultimate Users' are the consumers, business firm, and the Government Units. Primary obligations are the obligations of these Units and they include Government securities, corporate bonds, and stock, mortgage and a variety of short and intermediate - term debt. The diagram also shows that the Users of Capital - Ultimate borrower - in exchange of capital he borrows may sell primary securities through any of the three channels (1) Directly to Ultimate lenders; (2) Indirectly to them through the monetary system - commercial banks (3) Indirectly to them through non-monetary financial intermediaries - saving institutions. The mechanism of security issue is based on more or less following pattern:

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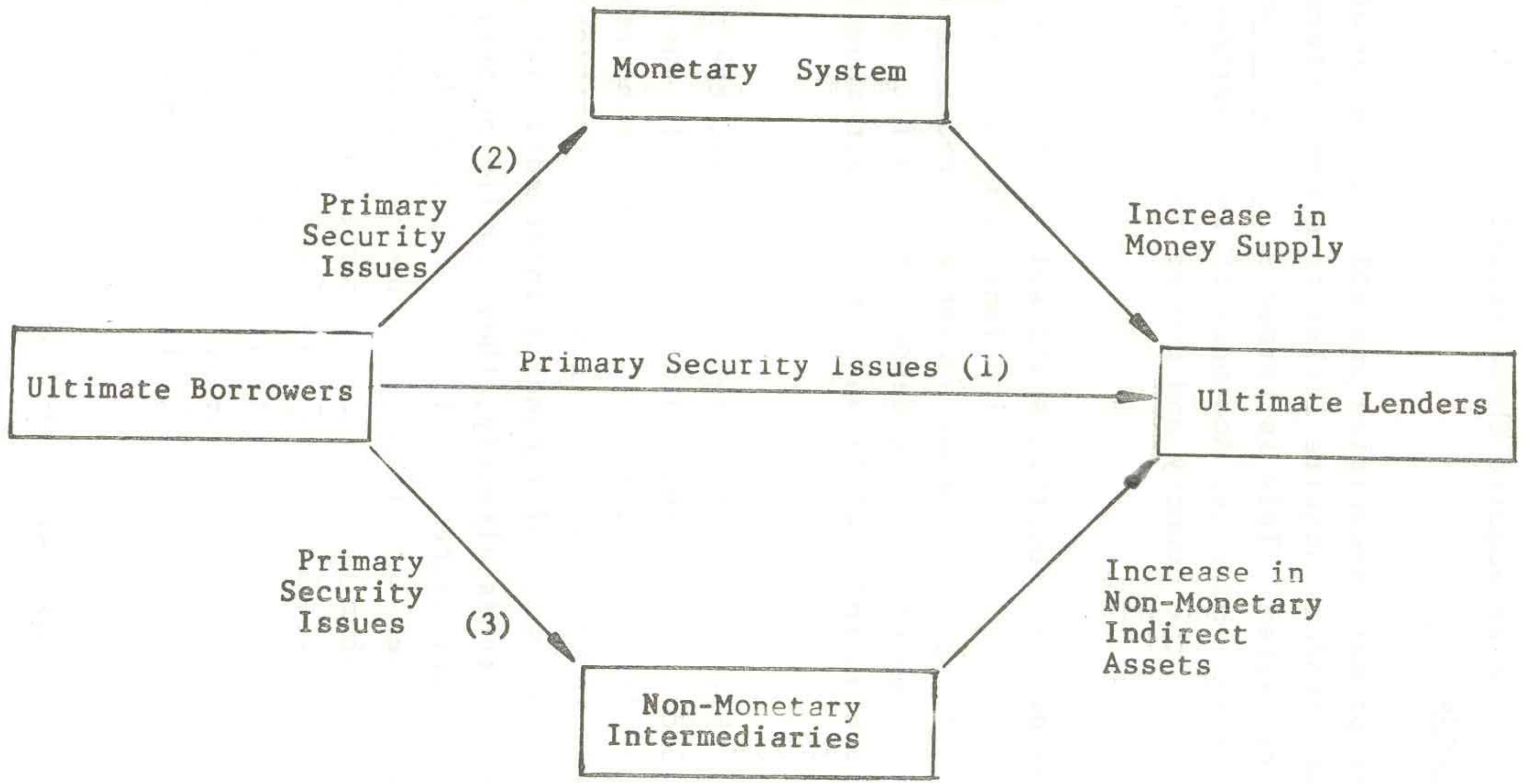
1. Mohsin, Mohammed: Investment of Life Insurance Corporation Faculty of Commerce-Aligarh (India) 1964 – pp. 4.

2. According to Arthur Lewis these two functions are again integrated in the advanced industrialised societies when the corporate earnings generate enough savings for self finance-: see Lewis, Arthur: The Theory of Economic Growth-George Allen & Unwain Ltd., London 1978 – pp. 214.

THE MARKET FOR LOANABLE FUNDS



(1) When primary securities are sold directly to ultimate lenders, the latter acquire these securities. This is called *direct finance*.

(2) When primary securities are sold to the monetary system, the ultimate lenders acquire titles from the 'intermediatries' the monetary system. This is termed a : *indirect finance through monetary system* - Monetary Accounts of the Government Treasury, Central Bank of the country and commercial banks are the main channels.

(3) When primary securities are sol to non-monetary financial intermediatries - saving institutions such as life insurance companies, savings and mutual societies. , credit societies etc. - the Ultimate lenders acquire deposit titles from these institutions. This is known as Indirect finance through non-monetary institutions.

Through this mechanism of security issues, the net supply of loanable funds, during any year is measured by the demand for primary securities by ultimate lenders, the monetary system, the non-monetary intermediatries[3] Layers of securities are formed through the operation of financial intermediatries - When ultimate lenders supply funds directly, they acquire primary securities. When the monetary system supplies loanab1e funds, it acquires primary securities and ultimate lenders accumulate money and time deposits; when non-monetary intermediatries supply loanable funds they themselves acquire primary securities and ultimate lenders receive non-monetary indirect assets - such as deposit certificates etc. The 'brokerage' process in finance functions also multiplies through Underwriting operation etc[4].

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3. Shaw, E.S: Money, Income and Monetary Policy-Richard D. Irwin , Inc. Chicago – 1970, pp. 99.

4. Rose, H.B.: The Economic Background to Investment, Cambridge University press, Cambridge, 1977, pp. 44.

2. THE INVESTMENT MARKETS

This flow of funds from individual both by direct purchase of obligations in the three field mentioned and by indirection through financial institutions, occurs in the investment market.

A bird's-eye view of the inflow and outflow of savings into the investment market covers the supply and demand factors that determine the rate of return that is the price paid to the investor for the use of his funds. Any light shed on the matter of price for capital has the same importance in the capitalist system for the investor that agricultural prices have for the farmer or wage rates for the worker.

Thus in the broadest sense, the investment market includes any form of commitment into which savings may flow. Most writers apply the term 'capital market' to the market for the *permanent* form of investment such as bonds (debentures), shares, and mortgages[5]. The security market in that sense is limited to the sub-field of stocks and bonds (debentures). The 'money market' on the other hand is thought of as the market for *short-term* lending - the field dominated by the commercial banks with their loans, typically for less than one year, to industry, commerce, agriculture and finance. Actually, the capital and money markets are so intimately inter-related that the supply-demand factors operating in either tend to spread quickly from one to the other.

The long-term capital flows would include not only the share and debenture of business, the mortgages and equities in real estate, and the debt of governments, but also bank deposit, money and even such things as jewels that have been acquired as a store of value. Conventional discussion is usually limited however, to those forms of property that produce a money income. While following the customary pattern, we shall limit our discussion to corporate securities.

5. Jordon, D.F and Dougall, H.E: Investment Prentice Hall Englewood Cliffs - N.J. 1978, pp. 9.

Market Behaviour of Corporate Securities

In the corporate field, the stock market is the meeting place for the supply and demand for ownership capital. A standard requirement for security investment is that they should be readily marketable. The 'marketability' feature, besides permitting permanent absorption of capital in business, ensures 'liquidity' to the investors. However, at the same time free marketability also create a disparity in the 'intrinsic value' and 'market price'. Both factors are the outcome of varying forces. Since they are debatable issues from the Islamic point of view, their distinction is clarified in passing.

The disparity is created by speculative operation - often instigated by brokers activities in the security market. The 'intrinsic value' of a security is related to such factors as earnings of the corporation, Dividends, Assets, capital structure and terms of issues etc. The market factors influencing the security prices are the outcome of technical and psychological manipulations created by 'bullish' and 'bearish' activities; whereas the future values of the security are effected by the management's reputation, competitive conditions and prospects of enterprise and possible and probable changes in volume, price and costs.

Intrinsic value is thus defined as 'value justified by facts'. It is important to realise that such value is by no means limited to 'value of investment' - i.e. to the investment component of total value - but may properly include a substantial component of speculative price. In the ultimate analysis therefore, it may be found that security market is not a weighing machine, on which the value of corporate issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather, correct to say that it is a market whereon countless individual register choice which are the product partly of reason and partly of speculation.

Hence in the investment market, we find two types of dealings - usually termed as 'investment' and 'speculative'. The distinction, although important from the Islamic point of view is difficult to draw. Investment is often associated with permanent holdings, while specu1ation is ascribed to temporary holdings. But this is not a scientific distinction; for assets like commodities, are bought and sold according to personal needs and circumstances.

In our analysis we shall follow Graham and Dodd definition which defines an:

> "investment operation is one which upon through analysis, promises safety of principal and a satisfactory return. Operate ones not meeting these requirements are speculative[6]."

The advantage of using this definition in Islamic Investment are many. It is in fact an extension of the ordinary concept of investment which appears to be entirely logical. The phrases, "thorough analysis" "promises safety" and "satisfactory return" are, although, chargeable with indefiniteness, yet the important point is that their meaning is clear and flexible enough to be interpreted in accordance with Islamic requirements. Islam insists upon the use of prudence, and vigilance in exercising personal discretion. Thus 'thorough analysis' simply refers to the study of the facts in the light of established standards of safety and value. The 'safety' sought in investment is not absolute or complete, the word means, rather, protection against loss under all normal or reasonable circumstances. "Satisfactory return", is a wider expression than "adequate income", since it allows for capital appreciation or profit as well as current income. "Satisfactory", is a subjective term; it covers any Late or amount of return, however low, which the investor is willing to accept, provided he acts with wisdom.

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6. Graham, Benjamin and Dodd, David, L: Security Analysis McGraw Hill Book Company Inc. New York 1971, pp. 38

It may be useful to elaborate at this stage that Islam does not prohibit trade and commerce in commodities and durable assets. Shares are simply ownership titles expressing proprietary rights in a portion of assets owned by the individual or institution. The transaction in assets simply stresses the fact that investor must always consider the *price* as well as the *quality* of the security. Strictly speaking in a market economy, there can be no such thing as an 'investment issue' in the absolute sense - i.e. implying, that it remains investment regardless of price. Assets price like those of commodities, do not remain fixed - they rise and fall according to business and market conditions. Hence both capital 'losses' and 'gains' are possible, frequent and usual. This means that the investor need not necessarily be interested in current income; he may at times legitimately base his purchase on a return which is accumulating to his credit and realized by him after a longer or shorter wait. However in distinguishing such operation from 'speculation' and 'Gambling' which is prohibited in Islam, it is not enough to identify investment with expected safety; the expectation must be based on study and standards[7].

Future expectations of profit should not be confused with 'forward dealings'. Islam lay stress upon 'spot' transactions', thus in Islamic investment, 'arbitrage' and 'hedging' might be complete ruled out. Estimating the future prospects of business or investment are somewhat different - undoubtedly they are based upon expectations, and like speculation, are very much subject to business and investment vicissitudes and are judged by its verdict. But 'future expectation' in Islamic investment, is essentially something to be *guarded against* rather than (as in speculation) to be *profited from.* If the future brings improvement, so much the better, and Islam permits its cultivation; but investment as such can not be founded in any important degree upon the expectation of improvement.

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7. The distinction between speculation and gambling – both prohibited in Islam - are important to stress at this stage. Gambling represents the creation of 'Risk' not previously existing e.g. race-track betting - whereas 'speculation' applies to the taking 0 risk that are implicit in a situation. Investment is different from these two because it underlies 'safety' which must be established after 'thorough analysis'.

Assuming that this brief review of Investment market and operations has given us a fairly clear insight of investment intricacies in a market economy with which Islamic investment have to interact, we now proceed to analysis the nature of corporate securities, in the following section.

3. CORPORATE FORM OF ORGANIZATION AND NATURE OF CORPORATE SECURITIES

The investment markets are predominated by corporate securities. While the institutions of investment could exist without capitalism upon a limited scale as in government loans of the pre-capitalist era, they owe their present magnitude and importance in industrialised countries to the technological development of capitalist society that has a great variety of durable goods in production.

The rapid industrial expansion that took place throughout the world during the nineteenth century was naturally accompanied by corresponding development in method of finance. The perfection of the corporate form of organization in advanced industrialised countries has been one of the greatest factors in encouraging the flow of funds in the modern sense, and has greatly facilitated business undertakings on a large scale. Although, by far the largest number of business organizations even in the industrialised countries, are unincorporated, the corporation is more important when large sums of capital are needed for operation.

Corporate form of business organization should be recognized as one of the institution that has an important bearing on the flow of savings into business. The three characteristics of the corporation that have been of paramount importance of the investors are: (a) the limited liability of its shareholders for business debts (b) its perpetual life, and (c) the ready divisibility of its debt and its stock into convenient units that are readily transferable.

In contrast to the owners of a corporation, whose liability as stockholder is typically limited to the original investment, the sole proprietor of or member of a business partnership is liable for all the debts of a business to the full extent of his personal wealth, as for his original investment in the business. Investors could hardly be expected to risk their savings under such conditions on a scale essential to meet the requirements of modern large scale production.

Moreover, there is a need for a form of business organization that will have as permanent an existence as the business itself. But a partnership breaks up with the death or retirement of any of its partners. So the perpetual corporation, with its ability to carry on indefinitely without regard to the life of partners of its several owners, constitutes an investment mechanism of the greatest significance.

Finally, a partnership interest can not be transferred without the consent of other partners, and in any case the investment is often of considerable size. Such bars to ready resale, handicap the acquisition of ownership funds by a partnership as compared with corporate form of organization. In contrast, the stock of corporation is ordinarily divided into shares of convenient market value and they can be transferred freely from person to person. Actual stability will of course depend upon the popularity of the issuing corporation and the previous distribution of shares to a limited or to a wide list of persons.

Nature of Corporate Securities:

Our analysis of corporate form naturally leads us to the contract of 'security' in which the investor makes his commitment. Many of us are already familiar with various details and aspects of shares and debentures. An appropriate treatment here will be a review of those aspects of the various instruments, or contracts that need particular emphasis from the Islamic point of view.

Business, as we know, acquire funds partly from owners who will buy new stock, and partly by the investment of retained earnings, and partly from borrowing from creditors. Broadly speaking, there are two classes of ownership securities ordinary shares (common stock) and Preference Shares (Preferred Stock)*. Variations in the rights which these gives exist to meet different requirements[8].

(i) **Ordinary Shares:** Ordinary shares - also termed as 'residual claimant to earnings' - are the 'real' owners of business and assume the ultimate risk associated with ownership. Their liability is restricted to the amount of their investment. In matters of income, they are entitle to 'left over earnings' after operating expenses, financial charges, and taxes have been paid. In the event of liquidation, the owners of ordinary shares get the residual, after the claims of all creditors and shareholders are paid in full. Control of the enterprise is given over to these risk takers through voting rights. This position is in distinct contrast to holders of preference shares or debentures who have only limited fixed and pre-determined rights to income and recovery of principal with no voting rights. There is no one, standard type of ordinary shares. The rights to be enjoyed by the holders are stated in the Share Certificate[9].

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*. The term 'ordinary share' and 'common stocks'; 'preference shares' and 'Preferred Stocks'; 'Debentures' and 'Bonds' are respectively English and American versions of the identical securities and in this analysis they are invariably used..

8. Mohsin, Mohammad and Masood, Khan: Cooperation Finance - Tata-McGraw-Hill Inc. New Jelhi-1980 – p. 110.

9. Mohsin, Mohammad and Masood, Khan: Cooperation Finance - Tata-McGraw-Hill Inc. New Jelhi-1980 – p. 110.

(ii) *Preference Shares*: Preference Shares implies, the holders have prior claims, before ordinary shareholders, to dividends, and possibly, in the event of liquidation, to assets. The rights do not extend to the Preference Shareholders being given privileges ahead of debenture holders or other lenders. The latter are creditors and therefore must be satisfied before there is any thought of payment of dividend.

Generally most corporation; have only one, if any, issue of preference shares; some have issued two or more series of preference shares differing principally in legal and dividend rates. Preference shares usually carry d right to a fixed rate of dividend. This might be carried forward from year to year, if a dividend is not paid in one year, than the right to it is carried forward to the next subsequent years. These are *cumulative Preference shares*. On the other hand, if failure to declare a dividend in a particular year cancels the right to that year's dividend, then the share is said to be *non-cumulative*. Sometimes the Preference shareholders are given the right to a second dividend, when the shares are called *Participating*. They may also be entitled to be paid back a part of capital upon liquidation. Some preference shares have *Callable* (Redeemable) provision in which case their capital is refunded at certain stipulated date. A few are Convertible - warrant bearing. In exchange of the privileges extended to a class of shareholders, voting right is withdrawn.

(iii) *Debentures*:

Owners of a business use their 'equity' or ownership capital (investment) as a basis for obtaining additional funds from others, which they hope to use with sufficient profit, so that it will enhance their own rate of return. When fresh funds are procured by extending partnership (offer of ordinary shares), it causes dilution of ownership and will also mean that any increase in profits from the expansion might be fully offset by a proportionate, or even more than proportionate increase in a number of shares outstanding. Earnings per share tends to decline in such a situation. Thus with this objective in mind, most of the corporations, raise additional capital, through the issue of 'debentures'.

A debenture or bond is a document by which a company acknowledges a loan. The terms of repayment, the interest payable, and the charges, if any, on the company's assets, are stipulated[10].

Debentures do not form part of the share capital, but are generally referred to as loan capital. Debenture holders are not shareholders. If the Debenture provides for a charge on the company's assets, then the Debenture holder is a creditor with special privileges. When there is no charge conferred, then the lender is an ordinary, unsecured creditor[11].

There are different classes of Debentures. The naked debenture is a bare promise to repay the loan; until the loan is repaid, it state the interest payable. Another term used is 'unsecured notes'. The issue of unsecured notes provides a convenient method for the large company to obtain finance at reasonable rates of interest[12].

Debentures may confer a floating or fixed charge on a company's assets. The floating charge does not attach to any specific asset, and therefore may allow the company to change the structure of the assets to meet changing conditions. A floating charge may crystalize when a company goes into liquidation, when a receiver is appointed, or when the conditions stated on the Debenture occurs.

The basic characteristics of creditors obligations in whatever form they are issued is the ability of the holder to enforce through legal means, of varying effectiveness, the repayment of a contractual debt. Calling for a definite sum of money at a definite date as well as, in most cases, definite amounts of income (interest) at periodic intervals throughout

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10. Mohsin, Mohammad and Masood, Khan: Cooperation Finance – op. cit. pp. 222.

11. Ibid.

12. Ibid.

the life of the contract. Some of these may be transferable and marketable, in that case there may be a chance for appreciation or loss arising from changes in market value from the time of acquisition to the time of sale. Debenture prices are effected through the medium of changes in interest rates in the market.

The debt obligations differ from the owners obligations in two important respects: (1) Loans are repayable at a stipulated date. (2) During the life time of debt, a predetermined fixed rate of interest is payable. Failure to pay either interest or principal on the dates stipulated in the contract constitutes a default. If the debtor is an individual or a business corporation, his assets may be seized by the creditors and used to satisfy their claims in full before the owners can receive anything.

In normal debt contracts, postponement is possible through mutual negotiations, but renewal especially when the business conditions are depressed, are normally at unfavourable terms. With more business risk, the lender is inclined to cover additional financial risk, as well as purchasing power risk - with relatively high rate of interest. Interest rate is related directly to business risk.

II

THE FUNDAMENTAL REQUJREMENT5 OF ISLAMIC INVESTMENT

After examining the nature of security capitalism in a secular environment, it is necessary to examine its acceptability in Islam. The pertinent questions in Islam is the 'return attribute' and 'nature of debt contracts'. It may be pointed out at the very outs it that Islam does not prohibit debt transactions. Use of credit instruments - the essential basis for any form of security capitalism is rather necessary in Islam, as Al-Quran clearly directs:

> 'ye who believe: when ye
> contract a debt for a fixed
> term, record it in writing.
> Let a scribe record it in
> writing between you in (terms of)
> equity. No scribe should
> refuse to write as Allah
> hath taught him, so let him
> write, and let him who
> incurreth the debt dictate,
> and let him observe his duty
> to Allah his Lord, and diminish
> naught thereof.' 282:2

Because contracts are written by human beings, who vary in skill and in their knowledge of the law and financial customs, and because they are sometime framed with reference to unusual situation, their forms and variety will differ. Al-Quran requires that the debt contracts should be without rate of interest, and for a specified *fixed period* and must be drawn in *terms of equity*.

In the typical credit arrangement with which we are familiar in the Capitalist System, the lender receives a bond or a mortgage or other promise to pay a fixed principal sum of money at future date, and in the meantime a stipulated, fixed rate of interest. But the nature and form of financial transactions in Islam are conditioned according to the following Aiyah of Al-Quran:

> Allah permitteth trading and
> forbiddeth usury' 275:2

The Aiyah determines the scope and pattern of investment activities and also sets an outline for the flow of funds in an Islamic economy. Let us therefore examine the conditions of 'Equity' and 'Debt' Contracts which may be acceptable to Islam.

EQUITY INVESTMENT IN ISLAM

Guided by the above Aiyah, the *fuquaha* has allowed 'equity investment' - the 'profit' "from which may be positive or negative, and which is not pre-determined." Equity holdings may be in *real estate* or in *business*.

In real property like houses, business buildings, or farms, the equity is the stake that the owner - occupant or landlord has in the property, while the mortgagee, if any occupies the position of the creditor. In forbidding interest, Islam has not illegalised all those transactions from where fixed income may accrue without labour. Islam allows that income which accrues from the rent of the property or from the rent of agriculture land.

In the field of business, the equity ownership may take the form of individual proprietorship a partnership, a business trust, a corporation, or some of the other organisational devices employed. In any of these forms, no matter into how many parts it is divided, the equity is the ownership with all the risks and opportunities which this implies[13].

Equity holdings in business by individuals can be direct or indirect through the financial institutions. In recent years Islamic banks, have beer collaborating with business concerns in various forms of partnership allowed in Islam. The first of these forms is the *musharaka* - a system similar to that of Joint venture, whereby the bank enters into partnership for a limited period for a particular project. Both the bank and the client contribute to the capital, with the client maintaining the right to buy back gradually the bank's shares. Profits emanating from such venture are normally shared by the bank and the client in some agreed upon ratios. Another form of partnership is the *mudaraba*, a formula by which there is a marriage of capital with expertise: as a sleeping partner the bank provides the capital, and the client is entrusted with the technical know-how and the actual management of the project. Again profits or losses are split according to some agreed upon ratios and not on the basis of capital contribution. The third system is the *murabaha* - similar to that of consignment business where the bank purchases a commodity for the client at a known price and resells it to the client or to any third party at c profit.

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13. Sculley, C.A: The Purchase of Common Stocks as Trust Investments - Macmillan & Co. New York, 1976, pp. 105.

RETURN ON CORPORATE SECURITIES AS MAY BE ACCEPTABLE TO ISLAM

Return on investment in ownership securities as explained earlier are based on 'current earnings' and also through changes in market value of shares. We shall examine its two component separately.

(i) Income attributes of Corporate Ownership Securities:

Ordinary shares, as we have seen, have no fixed claim, but have a right to whatever residual of property or income is left over after claims of creditors and preference shares are met. This is true whether the owner holds an equity in a piece of real estate on which there is a mortgage debt, or shares in a corporation whose assets are subject to the claims of creditors. Because property values and income are typically fluctuating for most real estate and business corporations, the residual claims of the real estate owner and ordinary shareholder will fluctuate in value, as will the income, although the variation may sometimes be great sometimes small[14].

This nature of income accruing to the ordinary shareholders may be closer to *fuquaha*; apparently preference shares in their present form do not conform to this general picture of ownership even though they are legally an ownership instruments. Preference Shares resemble a credit instrument on two most important points: (1) its claim to income is a fixed amount, or rate rather than a ariable residual such as the ordinary shareholder receives. (2) in case of dissolution of the corporation, preference shares are usually repaid a stipulated sum for their principal claim, before anything is paid to holders of ordinary shares. Because of these two features, Preference shares are identified in financial circles with bond form as 'Quasi Credit Instruments'.

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14. Sauvain, Harry: Investment Management, Prentice - Hall Englewood Cliffs, 1979, p. 145.

However, the genesis of 'Prior or 'Prefential' right must be carefully understood and disassociated from its other feature - the predetermined fixed rate. The predetermined fixed rate of preference share may be objectionable to *fuquaha*; but it should not be confused with various type of priorities arranged for the distribution of profit. The profit distribution is purely an internal matter which is agreed upon between the parties at the time of issue of such shares. Management of the corporation and those who supply capital agree on the terms of issue that the latter would like to associate itself purely as a *sleeping partner* without in anyway associating with the intricate problems of management.

Besides, the question of 'priority' is attached only with the distribution of profit. *If*, there is a profit, preference shares get their *share ahead* of the Ordinary shares. Various other concessions given to the preference shares must be seen in exchange of voting rights. *The cumulative* feature is added because in deciding the allocation of profits, preference shareholders are not consented. What part of profit should be 'retained' and what part should be 'distributed' is exclusively the right of Board of Directors which receives concurrence from the ordinary shareholders in the annual general meeting, where the preference shareholders are not invited. The cumulative feature is a protection of the preference shareholders' right of dividend.

It may be that the preference shareholders, who are kept away from the process of decision making inside the corporation are dissatisfied, they have two options open. They may seek retirement if the 'Redemption' feature is attached; or become active partner, if the 'conversion' provision is included. The 'priority' rights and other conditions are stated at the time of issuance of shares to which the seekers of preferences subscribe with clear understanding.

The provision of 'withdrawal' is similar to *musharaka* agreements on which basis Islamic banks are associating themselves in project financing. In *musharaka*,the Islamic banks enter into partnership for particular project. Both the banks and the clients contribute, to the capital, with client maintaining the right to buy back gradually the bank's holdings. Redemption feature must be identified with this type of 'temporary partnership.'

The position of shares with 'priorities' and 'preferences' can thus be compared with the 'sleeping partner' in *musharaka* or *mudaraba*, where profit arising from such arrangements may be given to the preference shareholders according to a *negotiated ratio* and not as a percentage of capital at predetermined fixed rate. After eliminating the fixed rate, preference shares will loose their 'hybrid nature' and will lean more heavily towards the 'ownership' side. The negotiated 'ratio' implies an *appropriation* of profit, unlike interest it will not be a *charge* on the profit. The directors can defer the dividends, if, in their opinion, the needs of the business require it. This will be different from credit instruments, interest upon which must be paid from whatever cash resources are available and regardless of whether current earnings are sufficient if the corporation solvency is to be maintained. Again, the preference share owner's claim to both income and principal will remain subordinate to all claims of creditors, but it will outrank the claim of the ordinary, or common stockholders. Moreover, preference share without the option of 'redemption', will have no maturity but will run to perpetuity. The corporation may agree to set aside, a sum for the regular 'repurchase' of redeemable preference shares. To facilitate such requirements, the provision will be included in a preference stock agreement that will state the terms, conditions, and price (whether face value or market value). Corporation may call in its preference shares and pay it off. Failure to keep up sinking fund payments does not constitute a default, however as it, might in the case of debt.

It should be stressed again, that legal instruments known as 'securities' must exist in a profusion of types varying with the nature of relationship between the user of capital and its supplier. Business may require capital for only a brief period of employment or it may want to offer a permanent stake. The diversity in business need may also coincide with diverse circumstances of supplier of capital. Some of them seek permanent partnership and are willing and capable pf assuming 'risk'; other desire to part from liquidity only for a short period. Thus the issue of bewildering array of varieties of shares to cater every sort of taste, ultimately helps the business in attracting funds according to its own needs. In Islamic economy, or in institutions based on Islamic principles, offers must be made in varying form, which should differ in time, duration and rights. Some contracts may be permanent; others may be temporary; some may carry voting rights and others may be without voting rights.

A word of caution is considered necessary here. In selecting corporate securities in the mixed capital market we should be aware of business sources of income and their uses. A perusal of 'income statement' of most of the corporation will show a credit entry for 'interest received' and also 'interest paid' on the debit side. The receipt and payment of interest pollutes the dividend income received by the shareholders. This may not be acceptable to Islam. Since Islamic investors are willing to supply funds free of interest, the corporations who are interested in mobilising funds from a wider sector of the economy, could be restrained from entering into transactions involving interest.

(ii) Capital 'Gain' - the other part of income:

The other part of 'return' on ordinary shares may be received in the form of 'surplus accumulation' or appreciation in market value Share as we have defined, represent the title of ownership on the property and other assets of a corporation. These are negotiable instruments; they could be bought and sold in the market. Like other property values, the value of shares also fluctuate in the market. Sometimes the market price of share is at *par* with the *book value* or *face value* of the securities. Sometimes the market value is above par, sometimes the market value may be below par. Capital 'gain' or 'loss' is incurred at the time of sale of shares or property in the open market. When the property is sold at a price above par it results in 'capital appreciation' and when sold at a price below par, it results into a loss of capital[15].

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15. cf : 10-12

Gains or losses on sale may be incidental or deliberate. Incidental gains or losses arise from the forceful liquidation of stock out of the cash needs of the investors. Capital gains are also cultivated with the planned sale of securities or 'switch over' to other securities[16]. Such capital gains can be compared with the direct sale of 'real estate' and property; and other durable assets. Again we must be careful in drawing a distinction in what is termed as 'legitimate' gain realised from sale of assets from 'illegitimate' gain realised from speculation, gambling and forward dealings. The last three activities are outrightly condemned and prohibited in Islam. But capital gain which is realised through normal sales is a part of the income ascribed to the ordinary shareholders who is the real owner of the enterprise. His return, theoretically as well as practically, includes a larger element of economic profit or risk premium[17], than the other class of ownership securities. The stakes of ordinary shareholders are not only in 'dividend' rates but as the real owner, he is interested in 'total earnings', for the reason that all earnings of the corporation - whether reinvested in the business or paid out as dividend, actually belongs to him. When they are re-invested in the business instead of being paid out as dividends, the value of the equity behind the stock should be increased by the amount of such retained earnings. Ultimately the ordinary shareholders should get, if the re-invested earnings are employed successfully, a return in the form of a larger current dividend rate, of appreciation in the value of his holdings or of both. But such appreciation in the security market from where the 'gain' is realised, are more often than not the result of general external conditions affecting a whole group of securities, rather than the result of factors peculiar to the particular business[18].

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16. Turvey, Ralph, Interest Rates and Asset Prices, George AlIen & Unwin Ltd. London, 1977, pp. 54.

17. Schumpeter, Josepth, A: The Theory of Economic Development, Oxford University Press, New York, 1961, pp. 210.

18. Graham, Benjamin & Dodd, David, L: Security Analysis, op.cit., p. 12 .

Realization of such capital gain can be 'speculative' when manipulated by the brokers. Generally speculators seeking to reap short-run profits often ignore the situation of the individual companies. Share prices also rise with the profitability of business and also by its dividend policy. Investors may be more interested in dividends than in the total earnings of the corporation. This interest may stem from the need for immediate cash income or from skeptism of the potential benefits to be had from reinvested earnings[19].

The question of 'capital gain' as explained earlier is often confused with 'gambling' and 'speculation'. Gambling is discernable from an economic activity. It is a risk assumption for gain in which the participant create the risk-taking, as a wager or in a game of chance. Speculative activity is related to manipulation and 'forward' dealings, which is also prohibited in Islam[20]. Investor seeks its return primarily from the earnings of business rather than through 'buying' and 'selling' operations in a fluctuating market. The difference between speculation and investment is also based on motives. Speculation is primarily for the purpose of 'appreciation' in principal; Islamic investment is basically for 'income'. The consideration for income means a permanent stake in business for holding its stock[21]. This feature is akin to real partnership which is admissible in Islam.

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19. Dice, C.A & Eiteman, W.J.: The Stock Market, McGraw Hill Book Co., New York, 1977, pp. 207.

20. Austray, Jacques: A Non-Muslim Scholar Approach to Islam's Key Problems - Economic Development. The Islamic Review and Arab Affairs. Vol. 56, No. 2-3 February-March 1968, pp 31.

21. Graham, Benjamin & Dodd, David, L: op.cit. pp. 34.

REQUIREMENTS FOR DEBT TRANSACTIONS

Like investments in equities, debt transactions in Islam are based upon certain conditions. Some of these requirements are straight and clear. We have proceeded in this study by accepting the popular *fuquaha* interpretation which prohibits interest in any form and rate.

The other aspects, especially he provision for "Equity", in debt transactions needs further discussion and clarification. In this respect, the most important issue is the postponement of delt recovery, where the lender has been asked to 'postpone debt' under conditions when the debtor is in 'strain' circumstances The problem of 'Equity' sought in debtor and creditor relations in Al-Quran can also be discussed along with this issue.

We know that in a secular environment, the debt postponement principal and interest can be adjusted according to the terms stated in the contract. Further changes are accommodated as per the understanding and good relations of the parties concerned with mutual consent. However in case of default legal actions are open to the creditors.

Various measures where the debtor violates the terms and conditions of contract of loans are also open in Islam, but creditors are advised to be cautious and patient in exercising their rights. In an Islamic framework, the enterprises that are sponsored with free of interest loans are expected to fill a definite economic need in a manner capable of yielding a real economic surplus, it is also expected that the management of the enterprise to whom interest free loans are entrusted should be both honest and efficient. However, despite integrity in performing production function enterprise sometimes incur losses. Withdrawal of cash in tense situation or forceful liquidation of some of the assets in adverse economic situation, might damage the very cause for which interest free loan was extended. Thus in order to relieve the business from any outside pressure, Al-Quran directions are very relevant:

> ‘if the debtor is in s rained circumstances then (let there be) postponement to the time of ease; and that ye remit the debt as alms giving would be better for you ye did but know’ 280:30

Obviously, in postponing the debt the creditor would like to know the circumstances of business and uses of cash. Such postponement must be only for productive purpose. It will not be desirable, and in fact against the spirit of Al-Quran, to allow cash hoarding for *speculative motive*. Islam forbids *speculation* and *forward dealings*; which means that the payment of loans can be postponed only when the consumer or the producer are in ‘strain circumstances’ to meet the genuine consumption or production needs. These requirements of Al-Quran will engage funds till production cycle is completed. The funds are not expected to be used for ‘stock-trading’ or ‘inventory piling’.

But we must also consider the creditors’ interest what postponement or the prolonged commitment of funds can mean to him. If the ‘time of ease’ is stretched till the business returns to prosperity and during the period of ‘postponement’ the price of goods and services increase (or currency is debased), the creditor is likely to suffer in terms of purchasing power of money. This obvious and in recent years extremely well known phenomenon - that the real value of fixed money obligations may change before maturity, is unavoidable in any contract extending over a period of time, for prices of goods and services are continuous in a state of flux[22].

It has long been recognised that whenever any commitment promising a fixed money return in the future is entered into the parties to it face the possibility that the purchasing power of money will change. That is to say money transferred in future may be less valuable in terms of the actual goods and services it will purchase than the same nominal sum of money now buys. In other words, should prices of goods and services fall, the sum of money to be transferred will increase in real value. The burden of payment of the sum will be greater than is now contemplated and its value to the recipient will be correspondingly augmented. Should prices of goods and service rise, the reverse will occur, the burden on the payer decreasing and the recipient losing through his reduced purchasing power.

CONCEPT OF 'EQUITY' IN DEBT CONTRACTS IN ISLAM

These changes in the value of money (in terms of purchasing power) have special significance in Islam. Interest free loans must be based and 'written' on 'Equity' as contemplated in Islam; but real 'equity' may be difficult to attain, because since World War I, it became quite clear that long-term trend is towards inflation, punctuated by equally troublesome periods of deflation. To achieve the ideal of 'equity', lending of money must accommodate itself, as far as it can to both possibilities .

It is necessary at this stage to clarify, the real sense of Equity as it is desired in Aiyah 282:2 quoted elsewhere in this paper. The interpretation may not be easy to relate to modern conditions, because in long-term debt contracts, the form of Equity will vary with different types of price movement. We should try to grasp that what actual 'Equity' impales in debtor-creditor relations so as to meet the requirement of Al-Quran. Should it mean nominal 'Equity' in terms of money, or should it mean 'equity' in terms of purchasing power. In other words does 'equity' mean only payment of principal, or does it mean that investor should be able to recover at all times all or substantially all his purchase price. Or does it mean; that the purchasing power of money should not deteriorate below a 'fair value'; or does it include some aspects of preservation of purchasing power under any of the foregoing definitions? Answer to these problems are paramount in understanding the concept of 'Equity' in its true perspective. Perhaps it may be relevant to infer with the help of the following Aiyah:

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22. Shaw, E.S: Money, Income and Monetary Policy - Richard D. Irwin Inc. Chicago – 1977, pp. 89.

> "Believers have fear of Allah and waive what is still due to you from usury; if your faith be true; or war shall be declared against you by Allah and His Apostle. If you repent, you may retain your principal, suffering no loss and causing loss to none."

The conditions imposed of 'suffering no loss and causing loss to none' in matter 'of settlement of principal amount may be relevant to changing value of money. Specially under inflationary economic conditions, when the value of money declines, the lender of money gets back 'cheaper money' in relation to the 'dearer money', he has loaned sometimes ago; and vice-versa happens when the value increase in deflation. Thus certain amount of erosion in principal sum is obvious in long-term debt contract on account of changes in commodity prices or due to debasement of currency or due to both.

Not only this, repayment of debt in terms of a 'debased' currency (cheaper credit) tentamounts to fraud, which is outrightly rejected in Islam. Al-Quran lay unequivocal stress on honesty and justice in Aiyah - 152:6

> " … and give full measures with justice .."

Aiyah 85:7 is also relevant to quote:

> "so give full measure and weight without defrauding people in their belonging and do not corrupt the world after its reform This is better for you if you are believer."

Fraud and debasement in a debt contract may not be committed deliberately by the debtor or creditors; they are inflicted on them by the administrative, political and economic policies of the Government over which they have no control. Thus it is a reality of our mixed society that equity between debtor-creditor relations can not be attained when the purchasing power of money continue to change.

True, variations in price level changes may not develop abruptly and the degree of change which is likely to occur may not be great. The 'cost of living' of the average individual, the most satisfactory general measure of his purchasing power, tends to fluctuate more slowly still owing to the importance of many relatively inflexible expenses. Moderate changes in living costs may actually be barely discernable to the individual particularly if accomplished gradually. Unfortunately, shifts in prices (and conversely in value of money) are not always moderate. Occassiona1 1y, they are large or even vio1en1. Major changes in the level of commodity prices have in numerous instance, both recent and remote, greatly altered the parity in the purchasing power of money and threatens to jeopardise the 'Equity' between debtors and creditors - and of course also between other strata of society[23]. 'Equity' in debt contracts in Islam is not established at the cost of creditor (supp1ier of capital).

From the various concessions given to 'borrower', it is often misunderstood that - savings are discouraged in Islam. Specially imposition of 'Zakah' which is payable from savings sometimes creates that impression. This is a wrong generalisation. A small rate of Zakah is unlikely to change the individual's desire or ability to save. Besides in Islam both 'miser' and 'extravagant' are condemned. Savings are the direct outcome of adopting that middle course in spending, which is suggested by our Prophet (be peace upon him). The savings of a Muslim, just like the savings of any other human sect are based upon certain motives[24]. These motives for savings and the natural urge of mankind to save and control of 'Treasure' is recognized in AI-Quran:

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23. Prince, J.H: Investment Analysis, Prentice Hall, New York, 1976, pp. 320.

24 Cassel, Gustav: The Nature and Necessity of Interest, Kelly and Millman Inc. New York, 1957, pp. 24.

> If Of ye of Is ye, had control of the Treasures the Mercy of my Lord, Behold, would keep them Back, for fear spending Them: for man Is (ever) niggardy." 100:17

Generally selection of assets (forms of savings) is based on motives - that may help in quick relaisation of those objectives[25]. AI-Quran mentions some of the forms of savings:

> ". . . (air in the eyes of men)
> Is the love of things they covet:
> Women and sons:
> Heaped-up hoards of gold and silver; houses
> Branded (for blood and excellence)
> And (Wealth of) cattle
> And well-tillted land
> Such are the possessions
> of this Worlds' life؛
> But in the neatness to God
> Is the best of the goals
> (To return to) Verse 14; Sura 3

Beside, serving individual ends, savings also have social significance. Almost as important as the volume of savings of a nation, is the form savings take. Small sums held in family 'stocking' or 'cookiejars' are of little significance to the capital market. They merely withdraw purchasing power from the present for later consumption and thus contribute

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25. Kuznets, Simon: Share of Upper Income Groups in Income and Savings, National Bureau of Economic Research, New York, 1950, pp. 37.

nothing to expansion of production[26]. Islam encourages the flow of capital (transportation of capital) by eliminating interest; by insisting on the use of credit instruments; by 'postponing' the debt, if the user is in 'strained' circumstances; by ensuring that the lender gets back his 'principal suffering no loss' and protecting the borrower at the same time as the return of principal should 'cause loss to none'. Equity must be sought within this framework

This interpretation of 'Equity' may be meaningful. Money, in Islam is seen purely as means of exchange with no intrinsic value of its own. Unless money is translated into production process, it is considered immoral to pay a premium for it - it is on this ground that 'Ribah' or 'interest' is forbidden in Islam - and it is on the same basis that we suggested that 'Equity' may be identified in terms of purchasing power and not in terms of 'Units of Money'. Thus it will be fair enough to say that without interest debt contracts must specify that loans signed on a date shall be paid in terms of its purchasing power of that date If during the period loan is sanctioned and repaid, the value of money in terms of goods and services, has declined, the debtor shall compensate the lender by paying the difference. If the purchasing power of money in terms of goods and services has increased during the currency of the loan, the debtor shall pay lesser units of money. If the price level remained stable, no difference will arise in Units of money.

Such an explicit written provision of Equity in terms of purchasing power shall be in the interest of the debtor, creditor and also in the larger social advantage of the country. If the individual saver is not protected from the possible 'loss' of his purchasing power, there is a greatly reduced incentive for potential saver to assume investment risks when ultimate enjoyment of postponed satisfaction appears doubtful. Under such conditions, total savings will be smaller and the tendency to hoard or hold capital in idle form greater, even though

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26. Powelson, J.P: National Income and Flow of Funds Analysis, Mc Graw Hill Book Co., New York, 1960, pp, 268.

natural impulse to save among the lower income groups and unavoidable savings by the wealthy may continue. But the general expectation about future trends in commodity prices is of dominant consideration in time of inflation - and this may induce the 'motivated' and 'automatic' savings to shift in idle forms or precious metals and jewels. Such passive forms of savings, even though not objectionable to Islam, can damage the economic activity[27].

Similar danger is open in case of interest bearing obligations, but their losses are partly compensated by interest rate and they have also a wide area open by taking 'hedge' through a well diversified portfolio. For interest free loans we have to balance the accounts of Creditor and Debtor on the basis of parity in purchasing power. In other words loans to be settled at constant prices of goods and services and not on current purchasing price of money

THE PROBLEM OF INDEXING: MEASURF ENT OF THE CHANGES IN PRICE LEVEL

In applying this interpretation of 'Equity', we have to device a criteria and a method to measure changes in price level so as to settle the differences. What is required is a sort of Ready Reckoner that could help the Debtor and Creditor in settling their accounts. Such an indexing is difficult to prepare because of he complex varieties of inflation and indirect relation between money and prices.

When monetary and banking system were primitive, and transactions were effected main through transfer of metallic coins the effect of currency debasement on the level of prices was direct. Actual reductions in the contents of precious metal in the Unit of

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27. Powelson, J.E.: op. cit. pp. 29.

measurement tended to produce an approximately corresponding rise in commodity prices[28]. In the more complex modern world, however, the effects are often indirect and obscure. When circulation is make up entirely of inconvertible paper money, the theoretical metal content of a nation's monetary Unit may have little effect on the internal price level, other than through stimulation of production of metal and through international trade and capital movement[29].

Owing to general acceptance of the gold standard, with paper money convertab1e into gold and with fixed weight of gold in each currency unit, and because of the importance of international trade and currency devaluation for a long time brought compensating rises in commodity prices despite the general use of paper money. At present however, with inconvertable paper money, the general rule with international transactions restricted and regulated by governments, and with governmental agencies with large resources devoted to controlling foreign exchange fluctuations so as to lessen the impact of such change on internal price level, there is a large element of unreality in the metalic coins still nominally acting as standard of value. It is not surprising that much doubt exists about the degree of relationship to be expected between alterations in currency units in terms of monetary metals and movements in the price level.

Hence shrinkage in the'va1ue of money necessarily affects the creditor through a rise in commodity prices, the causes at work behind fluctuations in the price level are extremely varied and complex. No attempt at a comprehensive analysis of them is feasible here, nor, as a matter of fact, it is necessary at this stage. Our task at present is not to explain why

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28. Bauer, P.T.: Economic Analysis and Policy in Underdeveloped Countries, Cambridge University Press, 1977, pp. 32.

29. Grundy, Molton: Money at Work, Sweet & Maxwell Ltd., London, 1978, pp. 101.

such movements happen or to conjecture how they may be foretold, but rather to suggest that since the question of linking the principal amount with the changes in price level will be subject to variation with different types of price, movement, a comprehensive study has to be made with a view to adjudicate the 'real differences'.

A distinction is also required to segregate the after effects of price level changes arising due to *inflation of commodity values* and *devaluation of the currency*[30]. This distinction is essentially between price advances brought on through a wave of unusual prosperity or otherwise inflationary demand and supply conditions and those developing as a result of financial strain. Though the consequences in terms of commodity prices are similar, the question is whether emphasis is on increasing value of commodities or on its reverse side, a depreciation in the value of money. Such distinction may at first appear artificial, but is of practical importance as it stem from background which may have different ethical roots[31].

References to these and other similar difficulties suggest that one is unlikely to find any simple and dependable formula for establishing 'equity' between debtor and creditor relation in a mixed economy, where the institutions and organizations, are governed with policies which are not based upon Islamic principles. Thus for most of the lending without rate of interest, proper treatment of 'equity' will probably continue to present a confusing problem, despite the great amount of investigation and discussion which was centered around it in recent years.

Apart from this the most important source of confusion in establishing 'equity' is to be found in the concept of any 'additional amount' that may a company with the principal

30. (Not available)

31. Harris, S.E.: The National Debt and New Economics, McGraw Hill Book Co. Inc., New York, 1977, pp. 175.

sum for purpose of compensating the loss of purchasing power that might occur. The plus or minus amount which will vary with the price level changes, can not be attributed to ‘interest’ or even to ‘Quasi interest’. In free of interest loan contract which will be strictly drawn in accordance with Islamic requirements, interest will be forbidden but the settlement of debt will take place on ‘constant prices’. Based upon the change in the level of prices, it is the principal amount in question that will vary. If there is no debasement of currency and no changes in the prices of commodities, during the period of indebtedness of the parties concerned, there will be no changes in the number of units paid. It is only when the price level will change that the question of paying difference will arise.

This adjustment of account as per agreement of the parties, is very much different from the nature of interest which in economics is defined as reward for waiting’ or for ‘risk taking’. Parting from liquidity is confronted with numerous risks for which the lender according to capitalist theory is entitled to a ‘reward’. In prohibiting the acceptability of this ‘reward’, Islam does not deny the existence of ‘risk’, it suggests ‘risk sharing’ as a basic conditions for the entitlement of any ‘reward’. This obviously means that equity in debt contracts can not be established by accepting arbitrary standards. Islamic organizations and financial institutions have to ponder over these questions to work out a satisfactory basis of indexing.

III

INTERACTION OF ISLAMIC INVESTMENT VALUES IN A SECULAR ENVIRONMENT

The basic characteristics of Islamic investment emanating from the preceding sections is special nature of debt contracts and profit sharing. How the peculiar nature of Islamic investment can have viability in a secular environment are examined in this part of the study.

THE INTERACTING FEATURES EXAMINED:

The three important conditions of Islamic investment which in one form or other conflicts with the secular environment are: nature of debt contracts acceptable to Islam; fixed rights of profit sharing attached with preference shares; and the concept of 'rate of return' at present employed in business.

Credit instruments, such as debentures have been outrightly rejected because they bear a fixed-rate of interest. There is no harm in discarding debentures from the economic point of view, either; as debt securities represents only a small part of invested capital of a country[32]. But borrowing are necessary to meet the short-term and medium requirements of

32. Kuznets, Simon: Capital in the American Economy: Its Formation and Financing in American Economy, Princeton University Press, Princeton, 1 61, pp. 290.

business. Profit-sharing can not be a substitute; to short-term debt. To what extent Islamic brand of interest free loans with special requirements attached to it in terms of 'Equity' can be acceptable will depend upon business need or funds.

Also the privileges and priorities attached with preference shares are open for negotiations. Actual terms will depend upon respective bargaining powers of the parties concerned. We shall re-examine the question of 'privileges' with the question of 'rate of return' as may be acceptable to Islam.

In the modern corporation of the general measure for rate of return is to compare the earnings with the capital invested. This figure is usually found by defining earnings as the net income after *all* taxes, that is available for the payment of interest on long-term debt and for dividend to shareholders. The invested capital is defined as the sum of the long-term debt, usually debentures, plus the preference shares and ordinary shares equity. Earnings are thus expressed as percentage to capital contributed by ordinary shares and preference shares. This formula is applied to measure the efficiency of capital[33].

For the sake of clarity, the difference in the terminology of business practice, or accounting, and of economic theory must be kept in mind. The economic concept is related to the nature of premium for risk of capital loss[34]. In business practice, 'interest' is the contractual rate paid to creditors, debentureholders and mortgagees, and dividends are paid

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33. Williams, J.B: The Theory of Investment Value, North-Holland Publishing Co. Amsterdam, 1968, pp. 138.

34. In economic theory, the term 'interest' refers to that imaginary fraction of the return to the supplier of capital whether his legal position in that of a creditor or owner, for the use of capital if such use entails no risk. Any surplus over this imaginary amount represents economic profits, which are in the nature of premium for risk of capital loss. Presumably this premium demanded by the investor will be but a small part of the promised return in the case of fully secured debenture; somewhat more for preference shares; and relatively larger for ordinary shares

to shareholders, both ordinary and preference, out of the residual earnings, which are called the *net profits.* This figure of 'net profit' is arrived at after paying interest charges on loans and debentures. In this manner 'interest' appears as a charge; and dividends to preference shares and ordinary shares as an 'appropriation of profit'.

Accounting approach thus presents a realistic situation and we shall therefore refer this more frequently with reference to the allocation of profit. In case of interest free loans there is no contractual interest payable. Hence we directly enter into the question of distribution of earnings as well as amended form of corporate securities which may be suitable to Islamic investment requirements.

ALLOCATION OF CORPORATE EARNINGS:

Following the accounting approach, *Earning per share* are computed by dividing the total earnings (Retained plus Distributed) with the number of shares. The same earnings can also be expressed in terms of capital employed when they are known as *Dividend Rate.* Current earning per share are computed by dividing the distributed part of earnings with number of shares outstanding at that time; expressed in terms of capital employed it is current rate of dividend.

Where different classes of share are issued, allocation is made on the basis of priorities fixed for each class. The profit in that case will be allocated on the basis of a *pre-determined ratio*. The former is accepted form of distribution of profit in *musharaka* and *mudaraba* now being used by Islamic banks. Applying the same principle of allocation, earnings for each class of shareholders will be calculated by dividing earnings to a particular category with the number of shares outstanding in that class, in terms of capital employed from each class of shareholders say, Dividend Rate of Preference Shares Class A, Class B etc. etc.

Earnings per share will vary with the amount of profit earned in a year; and also with the number of shares outstanding at that time; just like the dividend rate which varies with the amount of capital employed through the issue of a particular class of securities. Earnings per share and Dividend Rate must be distinguished from 'yield' which is computed on the basis of market value of shares. Since the investor buys shares in the market, and not directly from the issuing corporation, the market value may be different from the face value. From the point of view of the investor the total amount invested will be the actual price at which he bought the shares and not the face value of shares. Thus his investment outlay can be more or less than the aggregate of the face value of securities. He is more interested on a 'return' on his outlay. But the corporation declares a dividend on the basis of the face value of shares; and this causes a discrepancy. Suppose that for every share of US$ 100, a corporation allocates $ 5 of Earnings; but, suppose the investor has bought that share for $ 200; the investor's yield in that case is only 2.5 per cent. Thus the market yield can be different from the dividend rate of Earning per share declared by the corporation[35].

Apart from the factors determining the Earning per share, market yield is affected by the forces of demand and supply for loanable funds at that time. The internal factors effecting Earning per share or Dividend Rate are (1) Total Earnings of Corporation (2) Amount allocated for distribution to each class (3) Changes in the number of shares outstanding at any time; or in the amount of capital employed .

Other things being equal, the Dividend rates vary with the profitability of the company. If there is no change in the allocation ratio, and the number of shares or the capital employed remains the same, the increased earnings will be fully reflected in the Dividend rates. However, the management may choose to follow a 'Stable Dividend Policy', irrespective of the profitability of the company.

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35. Mohsin, Mohammad & Massood, Khan: Corporation Finance, op. cit. pp. 310.

The concept of Stable Dividend Policy is different from a fixed predetermined rate of interest guaranteed on debenture or bond. All earnings, as we know - Retained and Distributed - belong to shareholders and are affected by fluctuations on profit. But in following a Stable Dividend Rate Policy, the influence of changes in earnings is transmitted only on Retained Profit. Surplus or 'abnormal' earnings in any year are absorbed in Retained Earnings; similarly in 'lean years', the corporation may retain less, or even, withdraw, from past savings, in order to support a stable rate of dividend. Such stabilization policy is managed by creating a 'Dividend Equalization Fund'. In this fund a contribution is regularly made out of the profits earned every year[36].

Thus the concept of 'pre-determined ratio' and 'Stable Dividend Rate' or 'Stability in earning per share', in the distribution of profit is purely an administrative arrangement which is very much different from the fixed rate of interest. Pre-determined Ratio is essentially a 'ranking device' which is used in the allocation of profit when more than one class of ownership securities are issued. Stable Dividend Policy or Stable Earnings per share has its roots in 'profit'. There is no 'contractual' obligation; on the part of management. Pre-determined ratio and stable dividend rate policies are the part and parcel of judicious financial management policies. It shows management farsightedness as such in accordance with Islamic principles of using pr prudence and sagacity in the management of affairs[37].

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36. Mohsin, Mohammad & Massood, Khan: Corporation Finance op. cit. pp 350.

37. Austroy, Jacques: op.cit. pp. 33.

THE QUESTION OF AMENDED FORMS OF PREFERENCE SHARES:

We have seen that investors buy preference shares to enjoy a. fixed rate of profit without fully assuming the business hazards. This suits the management as preference shares are not allowed voting. Besides distinctive features attached to shares also suits the corporations, because in the first place, there is the desire of management to cater to every sort of investment taste and thus to tap all possible sources of supply of funds. Coupled with this is the fact that the managers of enterprise desire to obtain from investors as much money as possible with a minimum of concession to them in the form of (a) liens against the income and assets of the company, and (b) grants of the right to vote, which might possibly enable them to secure control of the management. Islamic investment may allow these tendencies to perpetuate with corporate management. They may accept preference shares with different types of privileges attached in exchange of voting rights but without any fixed rate of return.

This form of ‘preference’ attach with a class of securities will be quite different from the traditional types of preference shares now in vogue. The return on preference shares at present in use is partly interest, and partly profit, since all stocks, both preference and ordinary, represent ownership in the corporation; yet the average investor probably regards dividends received on preference shares just as much a return on capital as he does the interest that he received on debentures.

From the viewpoint of Islam, the objectionable element is not ‘preference’ in the allocation of profit or any other privilege attach with the security, but the pre-determined fixed rate. Preference share acquire priority in the distribution of profit mainly because they surrendered voting rights and are not participating in management. Generally, with a view to compensate the loss of voting power, some more advantages are also added. For example temporary partnership may be offered through ‘Redemption’ feature. The term and tenure of such temporary partnership securities can be tailored to match the requirements of individual investors for liquidity and the business needs for funds. Such term securities offering ownership rights temporarily will also appeal to financial institutions - who are anxious to find matching asset to suit the duration of liabilities they assume under contract from their diverse clients[38].

Similarly, cumulative or participating feature, could be added to suit the requirements of 'sobre' investors. The 'participating' feature may give a preference share an income position and market price action similar to that of ordinary shares[39]. In, fact the return of participating preference shares may be received in any of the following form: dividends, subscription right or conversion rights; surplus accumulation or appreciation in market value. Theoretically, therefore, as well as practically, the return on participating preference shares, and ordinary shares, appears as participation in profits, in that it is a residual, not a fixed claim.

Both 'regular income' from the corporate earnings, and 'capital gain' realized from the sale of share in the market may be acceptable to Islamic investment, provided the former is free from any adultration of interest and the latter is free from any element of forward or speculative trading. It, therefore becomes necessary to find ways and means of preventing corporate management from indulging in transactions involving interest; and at the same time exerting pressure on market so as to eradicate any possible element of 'speculative tendencies'.

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38. Mohsin, Mohammed: Investment of Life Insurance Corporation Fund, op.cit. pp. 299.

39. Where the non-cumulative feature substracts something from the convential preferential arrangement, the participating feature adds something to the usual arrangement. Non-participating preference share will receive profits only on priority basis and not on fixed rate as found in present issues. The participating preference shares will have right to share in the retained earnings. The extra participation, in retained earnings may be limited or unlimited. In any case it will be mentioned in the securities. Participation in profit does not automatically confer voting right.

However in a mixed capital market the required legal and technical changes affecting security structure and character can not be brought in by scattered small savings of individuals. It will need institutions and organizations, to acquire musicale to which Walter Bagehot commented in 1873:

> "A million in the hands of a single banker is a great power; he can at once lend it where he will; and borrowers can come to him ... But the same sum scattered in tens and fifties through a whole nation is no power, at all; no one knows where to find it or whom to ask for it"[40].

This is evident from the experience of advanced countries where the saving institutions - banks, savings and loans association, insurance companies, investment companies, investment banking houses and mutual funds etc - have gained enormous strength by mobilising scattered savings of individuals on account of which their investment requirements and policies have been exerting influence on the capital structure of the companies. Similar trends are now found in developing countries[41].

The proposition is very simple. If for example, Islamic banks succeed in mobilizing a sizeable savings of *momins*, scattered throughout the country, they can bring necessary pressure on corporate management to issue securities suited to their investment requirements. The terms of subscription offered by Islamic banks can be of special significance to user of capital especially when these institutions are willing to offer free of

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40. Bagehot,Walter: Lombard Street, Scriber Armstrong, New York, 1873. pp. 5-6.

41. Mohsin, Mohammad: Investment of Life Insurance Corporation Fund, op. cit., pp. 206.

interest loans to the business facing cash flow problems - a process which will lead to elimination of short-term borrowing with interest and hence to improving the profitability of operation.

Thus the emerging Islamic banks and Dar Al Maal Al-Islami in different countries can play an important role in bringing suitable changes in the mixed capital market. Their growth could exert decisive influence on corporate management requiring financial assistance to issue securities acceptable to Islam. The safest investment for the individuals seeking interest free avenues in a mixed capital market is to buy 'secondary securities' to be issued by the Islamic Banks. These institutions in turn will be introducing varieties to suit the diverse taste, needs and circumstances of 'ultimate lenders'. Buying stocks and shares through Islamic banks can be useful option for the '*momins*' with limited knowledge and means who are looking for long-term investment as well as of shorter duration.

IV

CONCLUSION

In the contemporary world of Islam both a moral as well as practical need exist to facilitate flow of funds in the economy without imposing managerial responsibilities on all types of suppliers of capital. There is also a social as well as individual aspect of the problem. Resources committed to enterprise which can not profitably fill some economic need are wasted, and society as a whole loses. A similar situation may be said to exist where loanable funds remain ideal in the hands of those who have no ability to use them in some sort of productive activity. The same result follows: loss to the individual saver; and an economic waste of society's resources.

Thus to encourage the flow of capital both in individual interest and social interest, Islamic funds should take advantage from the investment offers emerging from the secular institutions. One of the most important institutions that ensures stability is the modern corporation which is perpetual in life, and offers limited liability. Opportunities are also extended for specialisation among owners and creditors in respect of risks and participation of profits. The transferability of shares and the market mechanism provide mobility of capital that enables an individual to withdraw his capital from employment easily and quickly and to shift it headily from one form of liquid assets to another. At the same time the bulk of values in corporate business remain intact within the economy.

Islamic financial institutions should open these lucrative investment opportunities by mobilising savings and exerting their pressure on corporate management in introducing necessary changes in securities form. However there will be a continuous need for exploring the new possibilities of investment in the corporate sector. Researches need to be oriented in working out proper ways and means to establish 'equity' among debtor and creditor in debt transactions. Once requirement of 'Equity' is carefully interpreted and presented in the true spirit of AI-Quran, possible avenues of investment can be found in the corporate and other sectors of the economy even in a secular environment.