HANDBOOK ON INVESTMENTS IN SHARIAH TOLERANT STOCKS

PUBLISHED BY

TASIS

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INTRODUCTION

The preferred Islamic investment format is equity. However equity comes along with ownership. Hence Islamic investors have to ensure that the selected company's activities and structuring are not repugnant to *shariah* norms. Due to exigencies of modern business and particularly the pervasiveness of interest transactions, fully *shariah* compliant equities are extremely rare. So, *shariah* scholars have arrived at minimum compliance criteria which, while excluding companies in gross violation, yet provide investors a reasonably wide choice of *shariah*-compliant equities.

TASIS is approached by various institutions, companies and individuals from time to time in connection with advice regarding investments on the Indian stock exchanges. In that connection TASIS has propounded certain rules and norms, keeping in view the specific circumstances relating to India. These rules and norms as well as TASIS's rationale for the same, are explained in this document.

The rules worked out by TASIS for use by investors/fund managers to ensure that the investment of their portfolios is shariah compliant are given below. In the subsequent section we have given the rationale for the rules we have developed, in the perspective of the Indian stock market, along with an explanation (where deemed necessary) of some of the technical financial terms and concepts used in the document.

PART I: RULES PROPOSED BY TASIS

The rules for stock market investment worked out by TASIS for the Indian context are divided into five sections as follows:

A. General rules regarding permissible categories of investments
B. Acceptable procedures of dealing and entering into transactions
C. Sectors of the economy in which investment is not permissible
D. Norms for screening companies on financial parameters to arrive at those companies which are suitable for investment from a shariah perspective
E. Compliances for investors and managers of shariah compliant portfolios

A. Permissible Categories of Investment

The following rules define the permissible categories or forms of investment on the stock exchanges:

1. It is permissible to invest in, hold and derive benefit from realization of equity shares of a company, i.e. shares issued by a company which entitle their holders to a pro rata share in the distributable profits of the company as well as a pro rata share in the net assets of the company in the event of liquidation; in other words, shares which imply full ownership of the company with the attendant risk of foregoing a return on their capital as well as the entire capital too, in case of losses. At the same time they are not subject to any cap on the profit that they can earn except as may be stipulated (by government in exceptional cases) by law.
2. It is permissible to invest in, hold and derive benefit from realization of debentures, whether convertible (CDs) or non-convertible (NCDs), provided they are issued at zero percent coupon rate (interest rate) and issued, traded and redeemed at par value.
3. In case a shareholder is already holding an equity share and the company decides to issue on rights basis (i.e., to only its existing shareholders), fully convertible (FCDs) or partly convertible (PCDs) debentures/bonds, then it will be permissible for the shareholder to sell his right (entitlement) for a consideration, if such a course is possible. In the event the former course is not possible, then only can he subscribe to the FCDs or PCDs or bonds provided he sells off the security in question, immediately on being allotted the same. (In such an eventuality, for both, FCDs as well as PCDs, generally, the sale price is higher than the issue price).
4. In case a shareholder is already holding an equity share and the company decides to issue on rights basis (i.e., to only its existing shareholders), either additional equity shares (or CDs) tied with non-convertible debentures (NCDs)/bonds, then it will be permissible for the shareholder to sell his right (entitlement) for a consideration if such a course is possible. In the event the former course is not possible, then only can he subscribe to the entire package and sell off the CDs/NCDs/bonds at the earliest opportunity/immediately on being allotted the same (without earning interest) and, if available, retain only the equity shares. (In the latter scenario the price for the NCDs is generally lower than the issue price but the same is compensated by the gain on account of the allotment of the equity shares or CDs.

5. In case a shareholder is already holding an equity share and the company decides to issue on rights basis (i.e., to only its existing shareholders), FCDs with a zero coupon rate (interest rate), then the shareholder may either sell his rights (entitlement) or subscribe to the CD. In the latter event however, he must hold the CD till conversion.
6. Apart from the cases discussed above (all involving pro rata rights entitlements flowing from and arising out of ownership of equity shares), it is not permissible to invest in any loans, deposits securities or certificates whether termed as deposits, bonds, debentures of any kind, securities, stocks or shares, which offer a fixed or preferential distribution of profit relative to the invested capital and/or of the invested capital itself (in the event of liquidation) in comparison to the overall distribution of capital itself to which the equity shares as defined above, are entitled.
7. It is permissible to invest in, hold and derive benefit from realization of equity shares of a company which differ in subsidiary aspects (such as curtailment or denial of voting rights) from the equity shares as defined above, provided that they rank *pari passu* with the equity shares (as defined above) in respect of distribution of profits andreturn of capital.
8. It is permissible to invest in, hold and derive benefit from realization of securities which while not being (partaking of all aspects of) equity shares as defined above (for instance, they may be entitled to redemption at book value after a fixed period), are still entitled to a certain proportionate (but not necessarily pro rata) share of profits or capital as compared to that earned by equity shares, provided that there is no preference or seniority in distribution of profits between holders of the securities in question and the equity shareholders. Thus the rate of distribution of profits in their case could be different (differential) as compared to that of equity shares, but it does not come with seniority or a subordination (not preferential).
9. It is not permissible to enter into any transaction involving options, futures or swaps, or a derivative, whether the underlying asset is tangible and real, for instance a commodity or share or intangible, such as an index or occurrence of a projected event.

B. Acceptable Procedures of Dealing and Entering Into Transactions

The following rules define the acceptable procedures of dealing and entering into transactions on the stock exchanges:

1. It is not permissible to sell a security to which the seller does not hold legal title or over which he cannot exercise effective control.
2. It is not permissible to enter into a transaction to buy a security at a future date and fix the price for it in the current date.
3. It is not permissible to buy or sell a security in the current date at a future price (i.e., a price that will be known in future).
4. It is not permissible for a person to sell a security which was bought by him earlier but the price of which he has neither fully paid nor is it within his financial means to fully pay it without selling off the security that was bought.
5. It is not permissible to borrow or lend shares. They may only be bought and sold for a defined price and the price paid or quantum of debt involved in the transaction established unambiguously.
6. It is not permissible to defer payment of a liability by accepting to pay an additional amount in lieu therefor or to prepone payment of the same by negotiating a discount in lieu therefor.
7. If the underlying assets that a security represents or provides title to, are in the nature of cash or cash surrogates, (such as bullion), deposits, loans and receivables, it is not permissible to trade in such a security, except at its book value.
8. It is not permissible to trade (except at par) in equity shares of a new company raising initial capital, till it has substantially invested the funds raised in assets required for the activity it wishes to undertake.
9. It is not permissible to trade in equity shares of a company which is in the process of liquidation.

C. Sectors of the Economy Not Permissible For Investment

The sectors of the Indian economy in which it is not permissible to invest are as follows:

i. those sectors in which investment is impermissible ***per se***: these include conventional (interest based) banking, conventional (interest based) insurance, brokerage of conventional (interest based) financial products and provision of fund based financial services, manufacture, distribution and sale of potable alcoholic beverages and narcotics, processing, distribution and sale of pork and pork related products, gambling and tobacco; and

ii. those sectors in which investment is ***prima facie*** not permissible in the Indian context till specific reliable information is available to the effect that the activities undertaken by the industry as a whole or a specific company in that industry is in accordance with the shariah, as certified by the shariah compliance monitoring agency: such industries include all meat processing industries and units marketing such products, sugar manufacturing units, media broadcasting and entertainment industries, airlines and diversified companies; and

iii. companies whose main line of business may not lie in any of the above but which may be involved in one or more of the above activities to some extent either directly or indirectly.

It is permissible to invest in any company not coming within the purview of the impermissible industry categories elaborated above.

D. Financial Parameters for Shariah Tolerant Companies

Equity shares of companies whose nature of business is not in compliance with the shariah on the basis of the rules given in the above section, further need to meet certain minimum financial parameters, in order to qualify as acceptable for investment as shariah compliant stocks.

The rules in this respect are:

1. Their total interest-bearing debt (including from banks, financial institutions, public deposits and inter-corporate deposits) and issued preference capital should not be greater than 25% of their total assets,
2. Their interest income from all sources and 8% of interest based investments should not exceed 3% of their total income, and
3. Their receivables and cash & bank balance should not be greater than 90% of their total assets

COMPLIANCES BY MANAGERS OF SHARIAH COMPLIANT PORTFOLIOS:

There are two types of compliances which managers of shariah compliant portfolios will need to meet. They are:

i. normative compliances essential for the portfolio to be considered compliant with the shariah; and

ii. administrative compliances required to assure the shariah compliance monitoring agency that the portfolio manager is adhering to the stipulated norms for selection of the equity shares and other equity related instruments as well as the acceptable methods of dealing and entering into transactions in order that the transactions are in compliance with shariah.

The normative compliance involves determining / estimating in case of each of the scrips held under the portfolio, the quantum of impure income per share, if any, earned by the companies concerned, during holding of the scrip under the portfolio (**Please see Appendix-1 for method of calculation**). This determination / estimation has to be done at the earliest opportunity, depending on the disclosure of the relevant information by the companies concerned.

Depending on the mandate to the portfolio manager from the investor, the information regarding the quantum of impure income has to be either communicated to the investor for further action at his end (to donate it away in charity) or to be acted on so as to segregate the interest quantum from the portfolio and dispose of it in accordance with the wishes or mandate of the investor, by the portfolio manager himself.

As the estimation / determination of the impure income quantum is normally possible at the time of release of information of the income statement, the portfolio manager needs to agree with the relevant Shariah authority to a certain reasonable maximum time frame within which the action disposing of the interest quantum is implemented and / or the relevant information is communicated to the investor, as the mandate requires.

The administrative compliances are those procedures whereby the shariah compliance monitoring agency can assure itself that the investments under the portfolio are in compliance with the list of shariah compliant shares and that the transactions related to the portfolios are all carried out in a shariah compliant manner.

These compliances include specification of maximum reasonable time frames for exiting from scrips which were earlier on the compliant list but have subsequently become non-compliant, as well as for reporting compliance to the monitoring agency by the portfolio manager. Such administrative compliances also include specification of maximum intervals and minimum frequency of monitoring of the portfolios by the shariah compliance monitoring agency in a specified period.

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PART II: RATIONALE BEHIND PROPOSED RULES

We give below the rationale behind the rules worked out earlier.

A. Rules Pertaining to Permissible Categories of Investment

The rationales for the rules defining the permissible categories of investment are as follows:

i. Equity shares are permissible for investment as they are based on the principle of ***musharakah*** and do not provide any fixed advantage to any of the participants.

ii. Debentures, being essentially debt securities, usually offer a specified rate of interest and carry an assurance from the issuer to redeem at par at the end of the term for which they are issued. During their term they are traded at a price which depends on the relationship between the coupon rate they carry and the prevailing rate of interest for debt of similar characteristics (i.e., tenure, liquidity and creditworthiness). If they are issued, traded and redeemed at par value, then they satisfy all the characteristics of tradeable debt under the shariah and hence are permissible, provided they carry a zero coupon rate. (However, this is not a realistic scenario).

iii. A convertible debenture (CD) is a debenture, which comes with the promise from the issuer of either a part or the entire amount of the CD to be converted into specified number of equity shares at a specified price at a specified date in the future. Before the conversion date the CD is completely a debt security and may or may not (mostly it does) carry interest. If the CD is fully convertible, (a FCD), then on conversion the original CD stands extinguished. On the other hand, in case of a partly convertible debenture (a PCD), the unconverted portion continues as a non-convertible debenture (NCD), a pure debt instrument, till it is redeemed on the specified redemption date.

iv. Mostly, though not necessarily, CDs are offered as a rights issue, i.e., only to existing share holders in a fixed proportion to the number of equity shares held. Thus such rights CDs are in a way a benefit meant for the existing shareholders, a benefit arising out of the ownership of the equity shares. The benefit is in the pricing of the CDs, as the CDs entitle the holder to obtain equity shares at less than the prevailing market price of the shares. They also enable the company to save on tax, while helping raise funds for new projects without diluting the stake of the existing shareholders. They can be particularly beneficial for companies the shares of which command a high price on the stock market **(See Appendix-2 for more details on it).**

Generally it is possible for a shareholder to renounce his entitlement to the rights (whether shares or CDs) offered, for a price. Since such a course of action does not involve either receiving interest or buying or selling debt at other than par value and further, is required to protect his equity interest, (he could use the proceeds of the sale of his entitlement to buy additional shares from the market and maintain his proportionate holding in the company which would otherwise suffer) it is permissible.

v. Sometimes this is not possible. In such an event if a shariah compliant shareholder does not take up the CD offered in the rights issue, he will lose out because he would have otherwise obtained additional shares at a much lower price than the market price and his proportionate holding would have been maintained (not subscribing to the issue will reduce his proportionate holding). But holding the CD would involve his earning interest. To at least reduce some of his loss he can subscribe to the CD and immediately sell it (without earning any interest). However this will mean selling the CD at higher than par value. It may be noted that at this stage the CD is a debt instrument; but it is not just a plain debt security – it carries with it an entitlement to equity shares at a reduced rate after some time. Under the circumstances, the shareholder's resort to the course of action suggested is permissible.

vi. Sometimes, the CD offered is fully convertible (a FCD) and it is zero rated, i.e. it does not carry any interest during the interim period. In such a case, if the investor subscribes to it, he must hold it till conversion. This is because the holder will not earn any interest by holding it whereas in the process of selling he will be selling a debt security at higher than par value. As in this situation there is available to him an option whereby he can safeguard his financial interest without getting involved in selling a debt security at other than par value, it would be impermissible for him to sell the CD at higher value.

vii. To recap the earlier points i. to vii. above, in the event CDs are offered on rights basis to existing equity shareholders, they have the following options:

a. Ignore the offer and let it lapse. In this event the shareholder will lose whatever benefit he could derive from the offer on account of his being a shareholder. In course of time, once the CDs are converted his proportionate interest in the company too will be reduced.
b. Renounce the rights entitlement in favour of someone else for a price. The application for the CD and the investment will then be made by the person in whose favour the rights are renounced. In this case the shareholder will get part of the benefit in the form of proceeds of renouncement of his rights. With these he could buy some extra shares of the company from the market and at least partly protect his proportionate interest in the company.
c. Apply for the CDs and sell them on allotment, without earning any interest. In this case he will get a better benefit than in case b. above.
d. Apply for the CDs and hold them till conversion into equity shares. In this case his interest is fully protected.

B. Rules Regarding Acceptable Procedures of Dealing and Entering Into Transactions

The rationales for most of the rules given in the relevant section in this regard are quite obvious. So in this section, we have discussed only those rules where there could be a possibility of difference of views. The relevant issues are:

i. An equity share or an equity based security has a fluctuating price, and one which can vary widely. As the use of a share is only as either an investment instrument or in the value it can realize, borrowing a share can only be either to use it to enable squaring off an existing outstanding investment transaction or to use it by realizing its value. In either case, it is used to realize a definite store of value, defined at the point of use of the share.

   Borrowing a share thus boils down to borrowing a sum of money. However at the time of settling the debt (involving the share) the market value of the share can be very different. Thus at the time of settling the debt, there will almost always be either a discounting or compounding of the original debt, thus involving ***riba*** in the transaction.

This transaction also suffers from the defect of ***gharar*** for the borrower of the share is unaware of the liability he is incurring when borrowing the share.

ii. It is common practice in many markets for traders to take up trading positions worth several times the amount of money at their disposal. This is done by making a part payment, of say 10%, of the actual value of the transaction.

During the day, if the trader gets a favourable price he squares off the transaction and walks away with a profit. Alternatively if he despairs of the tide turning in his favour and does not want to risk further he may square off the transaction with a loss.

This is akin to gambling. The trader has put up a stake and is just taking a chance. Then, by putting up a fraction of the amount of his effective liability, he is multiplying the chances and the risks. To restrict the element of gambling in the transaction it is essential that he is not allowed at any time to transact a total liability beyond the resources at his command, irrespective of whether he has actually paid for his purchases or not. This can be done by making it impermissible for him to sell a security, the price of which he has neither paid fully nor is in a position to do so.

iii. In the case of a company which has recently made an initial issue of capital, all or a very high proportion of its assets are in the form of cash (raised from the issue). Hence trading the shares of such a company at other than book value will lead to an (inadvertent) discounting or compounding of the underlying cash (which practically accounts for the entire assets of the company).

iv. In most cases when a company is in the process of liquidation, due to large losses, the value of its assets is very small or negative and most of this is comprised of receivables, doubtful of recovery. As loans cannot be discounted, it is not permitted to trade in shares of such companies.

C. Rules Regarding Sectors of the Economy Permissible For Investment

There is general consensus about the sectors of the economy in which it is impermissible for Muslims to invest. All those sectors which involve activities prohibited by the shariah, such as manufacture and/or trading in intoxicants, interest dealings, etc., are automatically also prohibited for investment.

There are some activities in India in which investment is impermissible due to the prevailing circumstances. For example, the meat processing industry sometimes involves meat of animals which are not slaughtered in a ***halal*** manner. Similarly, the sugar industry in India, by and large, uses the molasses obtained as a by-product in the manufacture of sugar, as the raw material for the manufacture of potable alcohol. The electronic media, i.e., TV, radio and cinema, except the news channels, quite often air / exhibit content incorporating / glamourising / promoting nudity, violence, idol worship, promiscuity and such other values objectionable under Shariah.

Due to the above reasons, in the Indian situation it is considered advisable to exclude the above industries from the list of industries permitted for investment.

Complete data on companies generally classified as "diversified" is difficult to come by. Hence such companies are as a rule, initially excluded from the list of shariah compliant industries. As detailed data is obtained, on a detailed scrutiny of all the different activities in which individual companies from this grouping are involved, specific companies from this category are considered for inclusion in the shariah compliant list on a case-to-case basis.

D. Rules Regarding Financial Parameters for Shariah Compliant Companies

In respect of the rules regarding financial parameters for shariah compliant companies, we have been guided on the one hand by the ***maqasid al shariah*** and on the other by certain empirical studies carried out on the Indian stock market in the context of shariah compliant stocks. We have also kept in mind the practical aspect of availability of data for assessing the suitability of the companies.

Selection of Parameters and Ratios

In selection of the parameters we have kept the centrality of the focus on compliance with the shariah rulings against interest by the potential investee companies.

In prescribing the limiting values of various compliance (rather, tolerance) ratios for limiting interest or debt, we explicitly recognize that there is no scriptural basis for any limit other than zero. Any relaxation in this respect can only be considered on the basis and to the extent of the "need" for such relaxation. This "need" has to be assessed objectively, i.e., on environmental factors.

This approach thus leads us to the acknowledgement that the minimum compliance level has to be linked to an empirical evaluation of the level of pervasiveness of interest in the corporate environment and that minimum acceptance level below which it would be difficult for investors as well as fund managers to be provided a sufficiently large universe of compliant stocks from which they can construct a viable portfolio of shariah compliant stocks on an ongoing basis.

After analyzing the fundamentals of Indian listed stocks specifically with regard to interest and those accounting items linked to it, such as debt, interest income, preference capital and various kinds of investments over a period of nine years, we have arrived at the limiting ratios which would be sufficient and yet not unduly liberal in meeting the "need" for relaxing the absolute ban on interest, interest based debt and investments on the balance sheets of listed companies.

Needless to add, since the limits are based on empirical assessment of the environment, the limits prescribed are dynamic and could be altered if objective conditions so require. However, in laying down the criteria for arriving at the limits prescribed, due regard has also been paid to the requirement of a reasonable degree of stability in the prescribed limits.

We have selected six parameters and devised three ratios from them for assessing Indian companies for shariah compliance from the financial angle. The parameters selected are:

a. Debt,
b. Total Assets,
c. Interest Income
d. Interest based Investment,
e. Total Income and,
f. Receivables + Cash & Bank balance,

The purpose of using ratios rather than the relevant accounting items (such as debt, interest income, etc.) themselves is to take into account and neutralize the impact of size of the companies. Hence the relevant "offending" parameters are considered in relation to a pertinent parameter (a balance sheet item for a balance sheet item and a income expenditure statement item for the interest income) which will yield a ratio which is size-neutral and hence can be applied across all companies.

The ratios are:

a. Debt : Total Assets,
b. Interest Income + 8% of Interest based Investment : Total Income and
c. Receivables + Cash & Bank Balance: Total Assets.

We are aware that various institutions and Shariah scholars have formulated other ratios as well. We give our rationale for using the above parameters and related ratios in the Indian context.

Total Assets

For assessment of shariah compliance of companies, the denominators in the ratios have to be related to the capital structure and business of the company, what the companies themselves do, and not what the mass of investors think about the company. Hence the Total Assets of the company and what proportion of the Total Assets of the company is financed by Debt is what is pertinent to assessing shariah compliance for balance sheet items. As a result, for balance sheet ratios we use Total Assets in the denominator. Similarly, for assessing the Interest Income we use Total Income in the denominator.

Cash + Interest-bearing Investments v/s Interest Income

The ratio of Cash + Interest-bearing Investments to either Market Capitalization or Total Assets is another ratio used to determine shariah compliance by many organizations. Some of these do not employ any other screen to enforce a cap on interest earning, which is essential in ensuring compliance with shariah. This omission appears to imply that use of this particular ratio is for limiting interest income by constraining the investment itself which gives rise to the interest income. However in the Indian context this is likely to lead to problems, as we discuss below.

Inclusion of Cash in the parameter would tend to suggest that an alternative objective appears to be to use the ratio as a means to limit liquid assets. Interest based investments as well as cash are monetary assets and should only be traded at par. Hence there may be a desire to restrict their proportion on the company's balance sheet to ensure shariah compliance.

With regard to the latter objective mentioned, above, there are some serious objections to the use of the parameter, in the case of publicly traded companies. These are discussed below under the section dealing with "Receivables". As for using this parameter for limiting Interest Income (at source), it is unexceptionable, except that it should not include "Cash" (as that dilutes the focus). Also, in the Indian context it cannot be used just by itself (i.e., without the Interest Income parameter) as the reporting conventions do not permit an effective application of the related ratio to commercially available databases in order to screen out companies with higher levels of interest income. We discuss this below in the section dealing with Interest based Investments.

Hence we do not use a screen based on "Cash + Interest-bearing Investments" instead we use a ratio: Interest Income + 8% of interest based Investment linked to "Total Income". Here, the interest-based investments included the company's investment in preference shares, mutual funds and debt instruments. The reason for adopting this norm (Interest Income + 8% of interest based Investment: total income), was that the reporting requirements and practice in India do not allow one to clearly identify and quantify income arising out of interest due to debt based investments, but reported in the books otherwise than as interest (such as dividends or capital gains) . As a result the situation implied that impure (interest-based) income was entering the companies' books without it being reported as such. The ratio "Interest Income: Total Income" is used by some other organizations also to put a cap on the interest earned.

Interest based Investments

Use of a screen based on Interest Income allied with Interest based Investments may appear to involve some duplication. However this is not so in fact.

Unfortunately however, the reporting conventions in India (and may be in many other countries as well) do not allow one to clearly capture all income arising as or from interest as "interest income". Many money market instruments provide returns to their investors, which arise either from interest or from trading of interest bearing instruments. However, due to the nature of the instruments, the return yielded to the investor is referred as "dividend" rather than as "interest" in company accounts. Examples of such instruments are debt based mutual funds and preference shares. Companies may also trade in gilts and deep discount bonds and other such instruments and report the income as capital gains. In a few cases such interest (disguised as "dividend") can be substantial - even more than 10% of Total Income. Hence it is essential to use an additional screen based on Interest based Investments to ensure that companies with high earnings from interest reported as dividend do not pass muster.

However, we do not have information in the public domain which gives a breakdown of "Investments" in a manner which can easily allow one to segregate "Interest-bearing Investments" from the non-interest bearing investments (or for that matter, the "dividend" from interest based investments from that from legitimate equity investments). Often the detailed break-up of investments is more in the nature of destination of investment (such as, investment in group companies, investment in mutual funds, investment in public sector units, etc.) than from the point of view of type of (underlying) income generated.

From the schedule (to the Balance Sheet) relating to "Investments" for most companies one can get the break-up of the investments. From these, usually it is possible to find the investment in debt, equities, preference shares and mutual funds. Whereas the non-compliance of investment in debt and preference shares is evident and the compliance of investment in equities (including in unlisted ones_- for which data is not easily available) can be assumed till more detailed and analytical databases become available, the compliance or non-compliance of investment in mutual funds depends on the nature of the mutual funds invested in - whether debt based or equity based. The mutual funds in which most companies invest are debt-based. Hence, to obtain a definite idea as to the extent to which the investments of a company are interest based, one needs to refer to the portfolio of the mutual funds in which the company has invested, apart from taking into account the debt or debt securities in which the company itself has invested directly.

In the light of the above discussion we have adopted interest income + 8% of interest based investment to calculate the extent of interest income earned (directly or indirectly) by a company.

Receivables + Cash Balance

Most organizations have so far been using a ratio incorporating the parameter, “Receivables”. As in case of the parameter, “Cash + Interest-bearing Investments”, the use of “Receivables” in the screening ratios appears to be born out of a desire to limit monetary assets (which should only be exchanged at par), out of a bundle of assets - represented by a company share - which is freely traded. While there may be some justification for adopting such an approach to the valuation of small businesses run as proprietorships or partnerships, and in some cases, even closely held private companies, it is completely misplaced in the case of publicly traded companies listed on the stock exchanges.

To begin with, the assets and strengths of a company are not just limited to those represented by the entries on its balance sheet. Often, the intangibles that the company possesses or has access to, such as brands, distribution and logistics networks, patents, technical know-how, organizational strengths, key locations or personnel, the management team, organizational culture, software and design abilities, influence in decision-making circles, licences, etc. confer more value on the company than its tangible physical assets or its cash and receivables. Thus very rarely, if ever, do investors consider the extent or proportion of cash and receivables on a company’s balance sheet before deciding to buy a share for a certain price on the exchanges.

In fact share prices on the exchanges are driven mainly by expectations of future prospects of the company, rather than the (past) historical position reflected (and that too only partially) in its accounts statements. Hence, in the normal course, when an investor buys a share he does not even remotely consider that a part of the price he is paying is towards buying over his share of the company’s cash and receivables. Hence, there is no strong justification for limiting the proportion of Receivables (as also that of cash) on a company’s balance sheet.

At the same time, as of now most shariah authorities do require some limitation to be placed on receivables. There is however little unanimity on the level to which it needs to be restricted. In view of the near consensus among shariah scholars on using a ratio for

Receivables, we too have specified a ratio for Receivables, while adopting the most liberal norm prevalent in this regard, i.e., 90%.

Basis for Using Financial Ratios

The prohibition of interest in Islam is clear and unambiguous. There is therefore no leeway for permitting interest transactions under shariah, whether for earning interest or paying it, i.e., for availing an interest–bearing loan. In principle therefore, shariah compliance implies eschewing all interest-based transactions. On the other hand in the current situation in India, interest is rampant in all walks of life and there is a paucity of shariah compliant investment opportunities, particularly for individual investors.

In this scenario, investment in equity shares on the stock exchanges is a major investment avenue, which is per se acceptable under shariah. A difficulty arises due to the interest based debt which companies usually resort to and the interest that they may earn in the course of business. Similar situations obtain in most Muslim countries. To mitigate the difficulties faced by the investors, various shariah scholars have permitted investment in shares of companies involved in businesses that are not repugnant to shariah, provided the interest based dealings of those companies are within certain maximum specified limits.

These limits represent a temporary concession to prevailing circumstances and are meant to provide a measure of relief from the hardship faced by Muslim investors. Hence, although the companies qualifying under these norms are categorized as shariah compliant, the limits are more in the nature of tolerance limits rather than ones that define compliance; compliance would really require zero interest dealings.

Defining Maximum Limits for Financial Ratios

Different organizations use different maximum limits for the ratios used to define shariah compliance (shariah tolerance). There are those shariah scholars who do not approve of investment in equity shares at all as they are opposed to any concession (tolerance) for interest based transactions. Those who do accept the argument of mitigating hardship however are unable to convincingly adduce a direct and specific textual guidance from the ***fiqh*** as to where the line is to be drawn and how the relevant limits are to be set.

It appears that in this regard one needs to be guided by what constitutes hardship. The best solution for this is to look for an empirical definition of "hardship" for a given environment. If the results are consistent over different environments, then possibly global norms too can be formulated to define the maximum limits for the ratios.

On this premise two empirical studies were conducted on the companies listed on the Indian stock exchanges. The first study was run year-wise on the 500 companies listed on the Bombay Stock Exchange included in the bellwether index of Indian stock markets the BSE Sensex over the 5-year period 1st April 2000 to 31st March 2005.

The next, a more exhaustive study used the total population (of over 5,000 companies) of all the companies listed on the three leading Indian stock exchanges:

a. Bombay Stock Exchange (BSE)
b. National Stock Exchange (NSE)
c. Calcutta Stock Exchange (CSE)

The study was based on the year-wise data of the sample considered over the 4 -year period 2007 to 2010. After excluding companies for which the available data was not complete, an average of about 4765 companies remained. Of these, an average of about 3395 companies or 71.24% of the total, qualified as shariah compliant on the basis of nature of business. The results in respect of all the three ratios, Debt: Total Assets, Interest Income + 8% Interest based Investment: Total Income, and Receivables + Cash: Total Asset, were very interesting and broadly in line with the results of the more limited earlier study (See, Khatkhatay, M.H. and Nisar, Sharia, "Shariah Compliant Equity Investment: An Assessment of Current Screening Norms", *Islamic Economic Studies*, Islamic Research and Training Institute, IDB Volume 15, No 1, 2007).

Limit for Debt Ratio

The ratio of aggregate of Debt to aggregate of Total Assets for the companies which were shariah compliant on nature of business, varied from a low of 27.86% to a high 31.5% over the four years with a mean of 29.4%. With a maximum limit of 33% for the ratio, an average of 1,845 or 54.4% of the 3,392 companies qualified as shariah compliant. If the allowable maximum limit was reduced to 25%, still between 1,417 and 1,604 or a mean of 1,551 companies or 44.6 % of the companies qualified in different years.

Most organizations set the maximum limit for the Debt ratio at 33%. The above study shows that such a high limit is much too liberal, at least for India. As we noted earlier, the limits set for these ratios are meant to ease hardship. If in an environment like India, where there is no consciousness of operating on a shariah compliant basis, the aggregate Debt ratio is by default consistently between 27% and 32% over a period of 4 years, then there appears to be no justification for setting the ratio at 33%. Further, even with a ratio of 25%, we find that an average of 1,551 companies qualify. This number is sufficiently large to afford individual investors a reasonable choice to build a viable portfolio of shares out of just the shariah compliant ones (qualifying on the basis of a limit of 25% for the Debt ratio).

Year	**2007**	**2008**	**2009**	**2010**	**Mean for 2007 - 2010**
Aggregate Debt / Aggregate Total Assets %	27.86	28.41	29.80	31.51	29.40

Limit for Interest Income (inclusive of Income from Interest based Investments)

It is found from the financial data of all the companies which were shariah compliant on nature of business, that on average a little over 50% of Aggregate Investments were invested in equities and the remaining about 42% in mutual funds, preference shares and debt instruments. Of the latter a large proportion (about 45% on average) was invested in mutual funds. However, again more than 90% of the investments in mutual funds were in debt based mutual funds.

At the same time, it was also noted that the ratio of Aggregate Total Investments to Aggregate Total Assets for all companies compliant on business screening worked out to about 16%. Thus the ratio of Aggregate Interest based Investments to Aggregate Total Assets came to about 6.6%.

The ratio of Aggregate Total Assets to Aggregate Total Income consistently works out over various years to around 1.15, though in most individual cases it varies widely. Hence the ratio of Aggregate Interest based Investments (i.e., investment in mutual funds, preference shares and debt instruments) to Aggregate Total Assets comes to around 7.3%. We need to compare the income (gained from these Interest based Investments with the Total Income (as also with the reported Interest Income).

Generally it is not possible for an external agency such as TASIS to be able to know the exact amount of impure income earned by a company on its interest-based investments, as this information is not required to be disclosed by the company in its financial statements or annual reports. In this situation the best that can be done is to assume a rate of earnings commensurate with that which is generally obtainable from the type of interest-bearing mutual funds in which companies normally deploy their short-term excess liquidity. In this context it was decided to consider an assumed rate of return of 8% on the Interest based Investments.

The reason behind keeping the return from interest based investments at 8 % is that it is related to the Bank Rate, which is at present 6%. It is observed that the portfolios of the existing debt-based mutual funds are to a large extent deployed in government and corporate bonds, like treasury bills, and call money, G-bonds and other related money market and liquid instruments. The income generated from these instruments is related to the Bank Rate and their associated risk ratings, which are accorded them by rating agencies. Presently these investments earn a premium of around 200 basis points (2%) above the Bank Rate. Hence TASIS has considered the percentage of income generated from Interest bearing Investments as 8%.

On the basis of assuming the return from Interest based Investments as 8%, we are now in a position to assess the impact of the income from these Interest based Investments on the Total Income. The ratio of this income to the Total Income works out to 8% of 7.3%, or 0.6%. On the other hand, the ratio for Aggregate Interest Income to Aggregate Total Income for the four years varies from 0.9% to 1.5% (with a mean of 1.2%). Thus the income from Interest based Investments is a high proportion (50%) of the reported Interest Income and cannot be ignored.

So, the ratio for screening Interest Income has to include the income impact of Interest based Investments in its numerator. Hence the norm for screening Interest Income (inclusive of Income from Interest based Investments) has been defined as the ratio (of Interest Income + 8% of Interest based Investments) to Total Income not exceeding 3%.

The above norm is more objective and also more compatible with Shariah compliance than one which captures only the interest income explicitly stated in the income statement. Going further, the return of 8% on interest-based investments may vary depending on the bank rates as well as the returns generated out of the debt based mutual funds. As more data becomes available with TASIS, the 8% rate (criteria) could be revised in future. The rate of 8% will however be applicable from the financial year 2010-11.

The ratio of aggregate of Interest income + 8% of Interest based Investments to the aggregate of Total Income for the companies which were Shariah compliant on nature of business, varied from a low of 1.38% to 2.16% (with a mean of 1.79%).If the allowable maximum limit was kept at 3%, between 2,611 and 3,077 or a mean of 2,903 companies or 83.3% of the total number of companies compliant on nature of business, qualified in different years.

Year	**2007**	**2008**	**2009**	**2010**	**MEAN**
(Interest Income + 8% of Interest Based Investment) / Total Income %	1.38	1.73	1.87	2.16	1.79

Limit for Receivables and Cash Ratio

The ratio of aggregate of Receivables + Cash to aggregate of Total Assets for the companies which were Shariah compliant on nature of business, varied from a low of 23.98% to a high of 24.76% over the 4 years, with a mean of 24.38%. If the allowable maximum limit was kept at 90%, then the number of compliant companies lies between 3,087 and 3,594 or a mean of 3,406 companies or 97.9% of the companies compliant on nature of business in different years.

Year	**2007**	**2008**	**2009**	**2010**	**Mean for 2007 - 2010**
Aggregate (Receivables+ Cash) / Aggregate Total Assets %	24.76	24.70	24.07	23.98	24.38

Combination of Debt, Interest Income + 8% of Interest based Investment and Receivables + Cash Ratios

Finally, we can assess the combined effect of using all three ratios on the aspect of easing hardship and providing a reasonable choice to investors to build a viable portfolio while still allowing only a tolerable deviation from shariah principles.

Simultaneously setting the maximum limit for shariah compliance for the Debt ratio at 25%, Interest Income + 8% of interest based Investment ratio at 3% and that for Receivables + Cash ratio at 90%, we find that in different years between 1,046 and 1,191 companies qualify as shariah compliant. Almost 32.9% (varying from 32.0% to 34.0% in different years) of the total number of companies qualifying as shariah compliant on the basis of nature of business also comply on the financial ratios. These numbers are quite sufficient for investors to build viable portfolios on a shariah compliant basis.

	No of compliant companies			
Basis of compliance	**2007**	**2008**	**2009**	**2010**
Debt / Total Assets <= 25%	1,604	1,591	1,417	1,592
(Interest Income + 8% of Interest based Investments) / Total Income <= 3%	3,077	2,905	2,611	3,019
(Receivables+ Cash) / Total Assets <= 90%	3,594	3,472	3,087	3,485
Combined Ratios :				
In Nos.	1,191	1,131	1,046	1,185
As % of business compliant companies	32.38	31.96	33.41	34.00

Purging Methodology

Appendix-1

For clarity of understanding the method of determining the impure income quantum for which the investor is responsible is explained below. To avoid any confusion the most general case is considered:

Assume an investment is made in ABC Co. shares of face value 20,000 on July 1, of a particular year. Also assume total paid-up capital of ABC is 20,000,000. After holding the shares for 61 days, they are sold on August 31, of the same year. The company's accounting year is April to March and it declares its half-yearly results by October 20. The results show that it earned interest of 150,000 during the six months of April to September.

The portfolio held 20,000 / 20,000,000, i.e., 0.1% of the total capital of ABC Co.

However, the portfolio held the shares only for 61 days out of 183 days, i.e., for one-third of the half-year April to September.

Hence it has to share responsibility for one-third of the interest earned during the period, i.e., for 150,000 / 3 = 50,000.

Since the portfolio's holding is 0.1% of the total capital, it has to donate 0.1% of 50,000 or 50.

This amount has to be donated irrespective of whether the portfolio has received a dividend or not during the period of holding.

As the previous year closed in March, there is a possibility that there could have been a dividend distribution by ABC Co. during the period its share was held by the portfolio. This distribution would however be on account of the previous year and the same was already discounted (taken into account) in the price of the shares when the shares were sold by the previous holder to the portfolio. Any interest earned by ABC in the previous year was the responsibility of the previous holder.

Hence the portfolio does not need to remove any component from the dividend for the previous year but it has to give away its share of interest earned during its holding of ABC Co. shares. It is also clarified that the purging of interest income earned has to be carried out irrespective of whether the investment in a particular share resulted in a capital gain or loss.

An Illustration of Utility of Convertible Debenture

Appendix-2

XYZ Company has an existing paid-up capital of 5 million shares of Rs. 10 each. Its existing profit after tax (PAT) is 25 million, i.e., earnings per share of 5 and a dividend per share of 2 (i.e. 20%).

The face value of its share is 10, its book value 25 and its market value 100 It has a debt of 100 million on which it is paying an average interest rate of 15%. Its effective tax rate is 33%.

XYZ needs additional 100 million to set up a project which will generate additional profits.

The company can raise the additional 100 million in 3 ways:

a. *raise additional equity, or*

b. *raise additional debt, or*

c. *offer CDs as rights to the existing shareholders.*

If it offers an additional 2 million equity shares at a price of 50, it will raise 100 million and the additional offer will be absorbed too. If it increases its equity, however, the market price of its shares will fall.

In the above example, as the number of shares is increased from 5 million (i.e., 50 million / 10) to 7 million, the market price will fall from 100 to about 70, as its earnings per share will come down from 5 to about 3.5. There is also a distinct possibility that it will reduce the dividend. Even if it does not do so, the shareholders will only earn an additional 4 on every additional100 they have invested.

Alternatively, if it raises additional debt of 100 million its overall debt will double and so also probably its interest burden, till the project goes on stream and starts contributing to the profits. As a result the net profit after tax will reduce by 40% and so correspondingly will the market price of the shares.

Instead, assume it offers 1 CD of 100 for every 5 shares held, in other words, 1 million CDs for holders of the 5 million shares. Also assume that the CDs carry 6%

interest and each of them is convertible after 2 years, into 2 equity shares at a price of 50 each.

The result will be that immediately there will be no increase in the equity. The interest burden will rise by only 6 million (and in fact the average interest rate will reduce to 10.5% from 15%). As a result the net profit will reduce by about 4 million only or about 16% only. Even if the share price correspondingly drops by 16%, the existing shareholders will be happy as there will be no reduction in their proportionate stakes. Moreover, in the interim for each CD held, while foregoing a small interest income of 8 over 2 years (i.e., 2x[10-6]), due to lower than the market rate of interest (of say 10%), on conversion they stand to gain 68 (2x[84-50]) more, a net gain of 60 per CD or 12 per share of 10.