Shariah Compliance Requirements for a Mutual Fund

By S M Wasiullah for Maeeshat

In India, the availability of fully *Shariah* compliant investment avenues is in general very limited. In such an environment the stock market presents one option which is essentially in sync with the core *Shariah* philosophy of linking profit from investments with risk. In addition, it is also an option which incorporates good liquidity, involves small ticket size and is subject to quite close monitoring and regulation.

Apart from investment in *Shariah* compliant stocks listed on BSE and NSE, *Shariah* conscious investors in India have the option of investing in *Shariah* compliant mutual funds.

As far as *Shariah* compliant mutual funds are concerned, TATA Ethical Fund is a fund monitored and certified by TASIS. Presumably, there are two other such funds: a) Taurus Ethical Fund – which claims to be *Shariah* compliant though it is not certified as such and is not transparent regarding purging of interest, b) Reliance Shariah Bees (ETF), which goes under a *Shariah* moniker and claims its portfolio comprises only of shares included in Nifty 50 Shariah Index (which is advised by TASIS), but has an explicit disclaimer in its literature mentioning that it is not a *Shariah* compliant fund – probably because certain requisites for claiming *Shariah* compliance are missing in its case.

We have been receiving queries related to *Shariah* compliance of funds. Generally, there are two types of funds. The first category is that of fully *Shariah* compliant funds and the second is of funds that are benchmarked or linked to *Shariah*Indexes. In the present article, we would like to highlight the difference between these two types of funds so that investors can differentiate between them while taking their decisions.

The basic conditions for a mutual fund to be *Shariah* compliant are:

1. the structure of the fund should be *Shariah* compliant,
2. trading procedures and the manner of investment should be *Shariah* compliant,
3. the avenues in which the monies from the fund are invested should be *Shariah*
4. the liquidity management should be *Shariah*
5. interest which is accrued on the investments (as a result of the tolerance allowed due to the interest ratio being higher than zero), is purged out and donated to charity.
6. the fund should be regularly monitored and certified by a *Shariah*

Shariah guidance and assistance for a *Shariah* compliant fund is required to ensure its formulation, which includes setting the ground rules for operations impacting *Shariah* compliance and review, and if necessary, for modifying the related documents pertaining to the Fund. The documents which usually need to be considered at this stage for review and design of the fund are: Document filed/to be filed with the regulator (SEBI); the document to be executed with the clients/investors (Offer

Document); marketing material discussing the investment strategy to the extent of the *Shariah* compliance aspect; and any relevant internal documents discussing the *Shariah* compliance aspect of the Fund, as considered necessary by the management. As these documents form the foundation or structure of the fund, any violation due to the terminologies, content, terms and conditions and mechanism can make the Fund *Shariah* non-compliant. Hence, the fund manager should take care of these issues at the initial phase of launching a *Shariah* compliant fund by seeking a *Shariah* opinion from a *Shariah* Board/Scholars/*Shariah* advisory firms (such as TASIS).

Once the *Shariah* compliant fund is structured, the fund manager should adopt an investment strategy which is transparently based on profit and loss sharing. Usually, it is advised that the fund manager should invest the monies in securities that share risk of loss – *like equities*. Capital protection strategies/manner of investments that generally offer a (fixed) return without exposing the monies to risk of loss are *Shariah* non-compliant. In addition, trading procedures and investment strategies such as short-selling, day-trading, intra-fund investments, lending of shares, futures and options which involve 'excessive uncertainty' – '*Gharar*' in terms of *Shariah*, are also not allowed. Hence, adoption of such strategies and procedures may violate *Shariah* stipulations and the fund may become non-compliant.

Shariah compliant equities are equities of those companies which comply with the business and financial parameters laid down by *Shariah* scholars. As per *Shariah* it is not allowed to invest in a business or economic activity which is directly prohibited in the Holy *Quran* and the *Sunnah* such as pork, alcohol, gambling, etc. In addition, to this 'Business compliance' parameter, *Shariah* Scholars have also specified Financial compliance parameters (ceiling limits for interest ratio, debt ratio and receivables ratio) to screen the company. The stocks to be *Shariah* compliant should qualify on both criteria. One way of complying with this aspect is to select the stocks for investment from the universe of *Shariah* compliant stocks provided by a *Shariah* Board/advisory firm. Another way could be to select the stocks for the fund from the stocks which comprise the universe for a particular *Shariah* index. In India TATA Ethical Fund uses the total universe of *Shariah* compliant stocks provided by TASIS to select scrips for its investment portfolio on an ongoing basis. Reliance *Shariah* Bees uses the universe of Nifty 50 Shariah (which is a sub-set of the TASIS *Shariah* List) to construct its investment portfolio. The Taurus Ethical Fund presumably uses the universe of one of the S&P BSE 500 Shariah index for building their investment. When the selection of stocks is restricted to the universe which defines a *Shariah*index, the share portfolio of the fund by default complies with *Shariah* norms regarding selection of stocks. It should be noted however that benchmarking of a fund/portfolio to a particular index does not necessarily imply that the stocks in that fund/portfolio adhere to the theme or strategy which defines that index. It only means that the performance of the particular fund is being assessed against that of the specified index.

As far as the management of liquidity of a fund is concerned, the manner of deployment of any uninvested or liquid funds should be *Shariah* compliant. It is advisable that the uninvested funds should be kept in current account at banks or should be parked in the avenues that offer zero interest or in other *Shariah*compliant avenues. At present the only option for funds to deploy their liquid funds is either in current accounts of banks or in schemes which deploy 100% of their funds in gold and current accounts of banks. Tata Ethical Fund, (presumably) Reliance Shariah Bees and Taurus Ethical Fund deploy their liquid funds only in current accounts of banks.

In the present business environment, it is very difficult to find fully *Shariah*compliant companies for investment on the stock exchanges. Due to this unavoidable market scenario, *Shariah* scholars have set a maximum tolerance percentage limit for the impure (interest) income earned by a company (as a percentage of its total income. Interest income above this limit renders the stock of the company liable to be declared *Shariah* compliant. This relaxation implies that a *Shariah* compliant company despite its objective to make only pure income out of its business may end up earning a proportion of impure income. Thus, the investor seeking a fully *Shariah* compliant investment needs to purge this impure income accrued in the accounts of the company in which the investment is made.

Purging involves determining/estimating the quantum of interest income which should be removed or purged by the end investors and is an integral part of being *Shariah* compliant at all times. Adoption of the correct amount to be purged is also essential. Most funds, not only in India but also globally, are deficient in this respect.

In case of a financial instrument such as a unit of a *Shariah* compliant mutual fund, the overall interest purification ratio for the portfolio of the fund needs to be calculated on the basis of the portfolio of stocks held under the respective instruments and communicated by the mutual fund to individual holders or subscribers of the fund/scheme as a ratio (i.e., the purging amount per unit of the security held per day). *Shariah* compliant funds abroad generally indicate in their offer documents that their interest income will be purged by the fund (by donating it to charity). In India, as not all investors may be agreeable to lose the part of earnings represented by the purging amount, the ratio should be communicated to the investors so that they may at their own discretion purge out the impure income accrued on account of their investment in the fund.

Regular *Shariah* Compliance Monitoring and Supervision followed by a *Shariah*Audit serves the function of providing continuing assurance to investors that the Fund/Scheme continues to operate in the manner as initially certified and deemed compliant according to *Shariah.* It adds to the creditability of the fund with investors. There are three ways this aspect can be addressed. One is that the fund should be regulated by the government – as happens in case of funds in Malaysia. Second, each fund should have its own *Shariah* Board –as happens in case of some funds and Islamic Banks in West Asia –

which reviews the operations of the fund and certifies it. Third is that the fund should seek a third party *Shariah*monitoring and audit services – such as TASIS provides to TATA Ethical Fund. Each of these modes has its own merits and disadvantages but all of them help in ensuring *Shariah* compliance of the fund both at the time of its formulation and over its tenure.

As can be understood from the discussion above, a *Shariah* compliant fund has to comply with various *Shariah* compliance requirements including the documents, manner of investments, and exclusion of investments in prohibited businesses, purging and regular *Shariah* audit, monitoring and certification. By either selecting their stocks from the universe of a *Shariah* index, or even worse, just benchmarking the investments of the fund to a *Shariah* Index – as most of the funds in India are doing -the funds may be complying with the investment compliance aspects, but the other major aspects are being ignored leading to *Shariah* compliance risks faced by investors of such funds; the investors may not be aware of this aspect. Hence, it is advisable to invest in funds which comply with *Shariah* in all the aspects discussed above to qualify as *Shariah* Compliant Funds fully.

*[**Mr. S M Wasiullah** is a Manager at **Taqwaa Advisory and Shariah Investment Solutions** (TASIS) Private Limited, which is India's premier Shariah Finance advisory institution. He can be reached at: wasi@tasis.in]*

This article is available at ***http://www.maeeshat.in/2018/09/shariah-compliance-requirements-for-a-mutual-fund/***