

Shari'ah Standard No. (45)

**Protection of Capital
and Investments**



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

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

Preface

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

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

Statement of the Standard

1. Scope of the Standard

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

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

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

3. Shari'ah Ruling

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

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

4. Shari'ah Compliant Means for Protecting Capital

4/1 Instruments and processes used to protect capital and investments must fulfill the following conditions:

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

4/2 Some permissible methods of protecting capital include:

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

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

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

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

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

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

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

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

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

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

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

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

6. Date of Issuance of the Standard

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

Adoption of the Standard

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

Appendix (A)

Brief History of the Preparation of the Standard

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

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

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

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

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

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

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

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

Appendix (B)

The Shari'ah Basis for the Standard

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

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

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

Shari'ah-Compliant Means for Protecting Capital

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

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

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

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

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

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

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

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

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

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

Shari'ah Non-Compliant Means for Protecting Capital

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

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

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

Appendix (C)

Definitions

Wilful Misconduct by the Manager

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

Negligence by the Manager

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

