

Shari'ah Standard No. (27)

Indices



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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

The purpose of this standard is to present basic information about Indices with special emphasis on their nature, functions, Shari'ah status of their various applications, and to what extent Islamic financial institutions (Institution/Institutions)⁽¹⁾ may apply them.

(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 definition of Indices, methods of their calculation, their main types, their various forms of applications, and the Shari'ah status of each of these forms. The Standard also sets out the Shari'ah rulings that govern Indices.

2. Definition and Main Applications of the Index

1/2 An Index is a statistically computed figure based on a selected package of financial papers or commodities dealt in organized or non-organized financial markets, or in both. Each paper/commodity is given a specific weight, according to its market value, and the total value is divided by a constant figure. Among the best-known indices at present are the Consumer Price Index, and the Dow Jones and FTSE indices in the financial markets.

2/2 An Index that is well designed to measure the market situation, indicates the general economic situation of the country, and may help in forecasting its future developments before any change takes place and, thus, facilitates investment decisions. An index may also provide a signal to investors about the future movement of the prices of financial papers, or demonstrate a certain downward or upward trend of such prices. Due to the inconsistency that might occur between one index and another, indices are used besides other analytical methods, as well as the experience and knowledge about the market situations and the predominant models of transactions.

2/3 The upward and downward movements of an index reveal the directions of the market, and hence the market is denoted as a rising or a declining market.

3. Bases of Calculation and Characteristics of Indices

3/1 Calculation of indices is a process that depends on several aspects including past and current price forecasts, market projections, time intervals, upper and lower limits of dealing prices, and display charts.

3/2 Indices differ from each other in several aspects such as the components of the index or the type of data it attempts to summarize, the weight it assigns to each component, and the method of calculation thereof. There are, however, some common characteristics among all well-known indices in the capital and commodity markets, regardless of the data that each index attempts to analyze. Most important among these characteristics are accuracy, objectivity and transparency.

Accuracy refers to proper specification of the components of the index, sources of its data input, time of obtaining the data, method of calculating the weights, and basis of rounding off the numbers.

Objectivity entails presentation of the detailed calculations of the index to leave no room for difference of opinion with regard to determination of the value of the index on a specific date or at a specific place.

Transparency entails pre-specification of the time, place, and method of announcing the readings of the index so that the process does not involve *Jahalah* (ignorance or uncertainty).

3/3 There are some general principles that govern almost all indices, such as:

3/3/1 The absolute value of the index has no implication when presented as a single figure. The value of the index, at a given point of time, becomes meaningful only when compared to the past and future values of the index. Only then, the trend and percentage of change may be observed. For instance, an increase of 9 points in the value of the index may represent 2% of its previous value.

3/3/2 The values of the index at different periods may be multiplied or divided by any constant figure (i.e., increasing or decreasing

the figures of the index by the same percentage like division of shares), without affecting the accuracy of its implications. That is to say, the implications of the index are confined to what it represents of the average upwards and downwards changes in the weights of its components from time to time.

4. Types of Indices

Indices are classified according to different considerations:

4/1 With regard to their general or specific nature, indices may be classified into the following categories:

- General Indices that measure the market situation in general.
- Sectoral Indices that measure the market situation of a certain sector or industry, such as the transport sector.

4/2 Indices that precede price movements may be classified, with regard to central and area fluctuations, into the following categories:

- Centered Oscillating Indices, which measure price changes during a specific period in the past, and indicate probable future events.
- Ranged Oscillating Indices (band) that fluctuate between two areas, like overbuying or overselling.

5. Permissible Methods of Using Indices

5/1 It is permissible in Shari'ah to use indices to discern the magnitude of change in a certain market, or to judge the performance of specialized managers by comparing the returns they achieve to the indices. Indices may be used to form up an idea about a portfolio or to estimate its systematic risks instead of monitoring the performance and risks of each financial paper independently. Moreover, Indices may also be used for forecasting the future situation of the market and discovering the pattern of changes that the market may undergo. Therefore, using indices for guidance in operations that relate to real transactions is permissible in Shari'ah.

5/2 It is permissible to use indices as a benchmark for comparison of funds and investment bonds, or for correlating the remuneration of

the manager or the bonus of the agent to the investment, or the bonus of the Mudarib to the results of the Mudarabah.

- 5/3 It is permissible to use an index like LIBOR, or a certain share/commodity price index, as a basis for determining the profit of a Murabahah pledge, provided that the contract is to be concluded on a specific profit that does not vary with further changes in the index. [see Shari'ah Standard No. (8) on Murabahah – Item 4/6]
- 5/4 It is permissible to use the index to determine the portion of the variable *Ujrah* (rent) that represents the return. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek – para 5/2/3]
- 5/5 It is permissible that work rules, regulations and the arrangements, pertaining to money-based employment contracts, stipulate a provision on wage indexation. Wage indexation here refers to periodical adjustment of wages according to changes in the price level, as determined by the concerned bodies. However, in case of accumulation of unpaid wage that takes the form of debt, Shari'ah rulings on debts should be observed.
- 5/6 It is permissible to link the deals to be undertaken by the Mudarib or the agent to a specific index, so that he can dispose of the commodity at the market price when the index reaches a certain reading, or purchase a certain amount of the commodity at a specific reading of the index.
- 5/7 It is permissible to connect the fulfillment of a binding pledge on the part of a buyer or a seller to the rate of increase or decrease of a specific index in comparison to the price of the commodity at a particular date, so that any further increase may be added to the price of the commodity.
- 5/8 It is permissible to link the amount of a donation to a charitable body, in case of delayed settlement, with a particular index, at one end.

6. Impermissible Methods of Using Indices

- 6/1 Shari'ah prohibits trading in indices or taking advantage of their changes in the financial markets, through payment or receipt of

money on the mere occurrence of certain readings of the index, and without selling or buying the real assets which the index represents or any other assets. Such dealing is prohibited even if it is practiced for the sake of hedging against potential risk.

6/2 It is prohibited in Shari'ah to conclude option contracts on indices. [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets – item 5/2]

6/3 It is also prohibited in Shari'ah to conclude contracts on the Index Contracts' Multiplier.

6/4 It is also prohibited in Shari'ah to link a contract that should not be suspended, like selling, to a specific index.

6/5 It is prohibited in Shari'ah to connect the amount of a cash debt, at the time of lending, to the price index.

7. Development of an Islamic Index

The following points should be observed while developing an Islamic Index:

7/1 Adherence to Shari'ah precepts, in addition to the technical controls relating to the components of the index, and its applications.

7/2 There should be a Shari'ah Supervisory Board for the Index, to ensure observation of the Shari'ah precepts in the components and applications of the index, and to conduct periodical review and reporting relating thereto.

8. Date of Issuance of the Standard

This Standard was issued on 12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D.

Adoption of the Standard

The Shari'ah standard on Indices was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

The Shari'ah board decided in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Makkah Al-Mukarramah, to issue a Shari'ah Standard on Indices.

On 12 Jumada I, 1424 A.H., corresponding to 12 July 2003 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft Standard on Indices.

The Committee (2) discussed the draft Standard in its meeting No. (15) held in Manama, Kingdom of Bahrain, on 8 Jumada I, 1426 A.H., corresponding to 15 June 2005 A.D., and made necessary changes thereto in the light of the discussions and comments of its members.

The Committee (2) once again discussed the draft Standard in its meeting No. (16) held in Manama, Kingdom of Bahrain, on 4–5 Sha'ban 1426 A.H., corresponding to 8-9 September 2005 A.D., and incorporated necessary changes therein in the light of the discussions and observations of the meeting.

The revised draft of the Standard was submitted to the Shari'ah Board in its meeting No. (15) held in Makkah Al-Mukarramah on 22–26 Sha'ban 1426 A.H., corresponding to 26-30 September 2005 A.D. The Shari'ah Board decided to send the draft Standard to specialized experts for review and comments before discussing it in a public hearing.

AAOIFI held a public hearing in the Kingdom of Bahrain, on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D. More than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and other interested parties attended the public hearing. Several

observations were made in the session to which members of the Shari'ah Standards Committees (1) and (2) duly responded.

The draft Standard was presented to the Drafting Committee in a meeting held in Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., and several amendments were proposed in the meeting.

The Shari'ah Board discussed in its meeting No. (16) held in Al-Madinah Al-Munawwarah, on 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D., the amendments proposed by the Drafting Committee and accepted some of them. The Shari'ah Board then approved the Standard, unanimously for some of its clauses and by majority for others, as indicated in the minutes of the Board's meetings.

Appendix (B)

The Shari'ah Basis for the Standard

- Developing indices is permissible in Shari'ah because they constitute a method of forecasting and a means of observing the state of circumstances (inferences). Resorting to inferences is a well-recognized practice in judicature and financial transactions. Ibn Al-Qayyim in his book on Judicial Methods presented a number of proofs on permissibility of using inferences.
- Permissibility of using indices to forecast the market situation is derived from acceptability of using inferences for judgment. As indicated above, Shari'ah does not object to using inferences to make current or future judgment based on past events, or to initiate practical actions in the light of probable developments.
- Selling or buying indices is prohibited because it is nothing more than payment or receipt of money for the mere existence of a certain reading or figure. Such an act constitutes a form of gambling and an illegal act of gaining money. Hence, prohibition of selling or buying indices has been well emphasized by the Resolution of the International Islamic Fiqh Academy which states that it is not permissible to sell or buy an index, because this constitutes pure gambling. It is an act of selling an imaginary object that never exists.⁽²⁾
- Prohibition of concluding option contracts that are based on indices, or on the index contracts' multiplier, rests on the same reasons for prohibition of trading in indices, in addition to prohibition of dealing in options themselves. Such transactions obviously deal with wills and intentions rather than with real commodities. Moreover, prohibition of dealing in options has been clearly stated in a resolution issued by the International Islamic Fiqh Academy.⁽³⁾

(2) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).

(3) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).

- The justification for periodical adjustment of wages subject to changes in the level of prices is to pursue application of a fair wage policy, and protect the money income of the employees against deterioration of purchasing power due to inflation. It is permissible to provide for such a condition in the contract because conditions between contracting parties are permissible in principle, unless they lead to reversing what has been permitted or prohibited by Shari'ah.

Appendix (C)

Definitions

Index Multiplier

A specific ratio added to the difference in the price of the index on expiry of the date of the transaction.

Centered Oscillating Indices

These are the indices that fluctuate around a given center or point. They measure price change in a past period, and are used for forecasting probable future events. Such indices precede market movements and measure the rate of price change during the period under study.

Ranged Oscillating Indices

These are indices that fluctuate between two specific ranges, such as the limit of overbuying and the limit of overselling.

Benchmark

It refers to any index that represents the performance of a whole industry or a particular activity. It can be used as a standard for measuring the performance of investment funds and investment units, or used as an indicator for fixing remuneration for management or bonus for the investment agent or the Mudarib.

Hedging

It is a method for mitigating investment risks (such as market risks) by using financial instruments available in the market to curb down the risks that may arise from severe price changes.

Divider

It is the total price of the two shares, divided by the average price before division.

Index Contracts' Multiplier

It is a decimal or simple number, multiplied by the nominal value of a contract that has been connected to the performance of a certain index, to calculate the value of the contract based on the performance of that index.



