AMANAH
ADVISORS
Global Islamic Finance
& Fintech Services

SHARIAH REVIEW OF COMMUNITY SHARES

August 2020

ISLAMIC FINANCE INTRODUCTION

Islamic Finance is premised on ‘Shariah Compliance’. Shariah linguistically refers to “the clear, well-trodden path to water”. Technically, it refers to a body of knowledge based on the values of Islam revealed by God. Hence, one of the classical Islamic scholars called Ibn Taymiyyah said:

“Shariah was revealed to establish and perfect that which is beneficial and to prevent and eliminate that which is harmful.”

The Shariah has guidance for the economy and transactions too. These principles are there to ensure parties are treated fairly and that there is no injustice in the transactions nor any unethical practice.

OVERVIEW OF THIS DOCUMENT

1. Shariah Screening of Enterprises ____ p4
2. Review of Various Elements ____ p6
3. Areas of Concern ____ p9
4. The Potential Islamic Structure of Community Shares ____ p13

1. SHARIAH SCREENING OF ENTERPRISES

In principle, any enterprise or investment for which community shares will be offered must satisfy the following two Shariah screenings:

1. Business activity screen

a. Companies in the Financial services industry that are involved in interest-based lending and/or distribution of interest-based products. This includes financial intermediaries such as conventional banks, conventional insurance, interest-based lending (excluding windows operating in compliance with Shariah principles).

b. Manufacturing or distribution of alcohol and tobacco;

c. Companies operating in betting and gambling operations like casinos or manufactures and providers of slot/gambling machines;

d. The production, packaging, processing, or any other activity related to pork and non-halal food and beverages;

e. Bio-technological companies involved in human genetic manipulation, alteration, mutation and cloning; excluding those that are involved in medical research.

f. Shariah non-compliant entertainment, that deals with the operation of cinema theaters, composing, production and distribution or sale of music or pornography, the operation of Shariah non-compliant TV or radio stations; and

g. Any other activities not permissible under Shariah, as determined by the Shariah Advisor.

If any investment has a permissible core-business activity, an equity investment shall also be subject to additional balance sheet analysis in the event that these investments are not part of an approved Sharia index/fund/product.

2. Financial screen

Investments shall not be made in companies with the following financial ratios:

a. Total conventional debt (interest bearing) divided by the average market capitalization that is equal to or greater than 30%;

b. the sum of cash plus interest-bearing securities/deposit divided by the average market capitalization that is equal to or greater than 30%; and

c. Non-permissible income equal to or greater than 5% of revenue.

d. For private equity investments, the above ratios will be based upon the total asset of the company as of the last audited financial statements whereas for public listed company the market value will be considered.

2. REVIEW OF THE VARIOUS ELEMENTS IN COMMUNITY SHARES

Withdrawable share capital

Societies can issue a form of shares known as withdrawable share capital, which is unique to society law. Withdrawable share capital can be withdrawn from the society, subject to the society's rules and any conditions set out in a share offer document. Most societies have rules that give the board discretionary powers to refuse or suspend withdrawals if it is financially prudent to do so. This means withdrawable share capital is fully at risk.

From a Shariah compliance perspective, every society's rules and conditions must be reviewed before it can be certified for Shariah compliance. As long as the rules give the board discretion and that is mutually agreed by the members, the refusal or suspension of withdrawals is Shariah compliant.

It is possible to create a model template of rules and conditions which are Shariah compliant for societies wanting to operate within a Shariah compliant framework.

Voting rights

Voting rights in a society are normally attached to membership rather than share capital, with most societies adopting the co-operative principle of one-member-one-vote.

From a Shariah compliance perspective, votes can be based on the co-operative principle of one-member-one-vote.

Transferable Shares

Transferable shares are shares that can be traded between buyers and sellers at a mutually agreed price. Any type of society is free to issue transferable shares, as long as provision has been made for this in its rules. Transferable shares cannot be withdrawn from a society, unless the rules state otherwise. As such, transferable share capital is part of the permanent capital of the society, freeing it from any responsibility to make provision for liquidity. Instead, it is the responsibility of the shareholder to find a buyer if they want to realise the value of their shares.

The rule of transferable shares is compliant and not a Shariah concern. The sale of such shares must be done in a Shariah compliant way. That is the duty of the shareholder.

Cannot sell for capital gain

The purpose of a society is wholly different to that of a company. Company law grants full rights over the enterprise to shareholders, underlining its central purpose, which is to make profits and generate wealth for the owners. Societies are different. Community benefit societies are obliged by law to conduct business for the benefit of the community, and all profits must be used for this purpose. Co-operative societies are allowed to distribute some of their profits to members, but they must not conduct their business "with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person."

Community shares are defined by the Community Shares Unit as non-transferable, withdrawableshares in an independent society with a voluntary or statutory asset lock that is owned and democratically controlled by the community it serves. Shareholders have the right to withdraw their share capital, subject to the terms and conditions stated in the society's rules and share offer document. But they cannot sell or transfer their shares or liquidate the business in order to achieve a capital gain.

This principle in and of itself does not violate Shariah principles as it is merely indicating to the social nature of the investment. Making a capital gain is still possible in theory but it is not the objective or primary goal in community shares. Community shares promote a different sort of business model, where it is in the interests of all stakeholders to work together to create wealth and to use their democratic rights to determine how that wealth is distributed. It is in the mutual interests of all stakeholders to become members and investors.

Surplus

The term profit is rarely used by co-operatives because it does not sit easily with co-operative values and principles. Instead, the term surplus is used by the International Co-operative Alliance's (ICA) Statement on the Co-operative Identity, Values and Principles, which states how surpluses should be used: "Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."

This suggests that co-operative societies should only distribute current surpluses, or at least have a policy limiting the distribution of historical reserves.

Surpluses can be distributed to members in proportion to their transactions with the co-operative. This is usually referred to as a dividend or rebate. Only a co-operative society is allowed to distribute surpluses this way, a community benefit society cannot distribute profits in the form of a dividend on member transactions. Such surplus treatment is acceptable and does not pose a Shariah risk.

Purchasing shares by instalments

Some societies, especially those with a high minimum shareholding requirement, may invite applications from people to purchase shares by instalments. There are several matters to be addressed when establishing such arrangements. If the society is making a time-bound offer and any purchase by instalments is likely to extend beyond the closing date of the offer, then it will be necessary to decide how such purchases count towards the fundraising targets, and how the society will meet its cashflow needs.

As long as the sale terms are Shariah compliant, the purchasing of shares in instalments is not a Shariah risk.

3. AREAS OF CONCERN

Pioneer shares

Because pioneer investors are asked to take far higher risks than subsequent investors, consideration should be given to establishing a separate class of "pioneer shares" with different terms and conditions, such as a higher rate of financial return, or a preferential right to withdrawal ahead of other classes of share. Introducing more than one class of share can have an impact on the attractiveness of future share issues. This matter is dealt with in greater detail in Section 2.2.6.

From a Shariah compliance perspective, preferential rights are not compliant. Any such share class in an investment will make the investment not Shariah compliant.

Interest

The payment of interest on share capital held in a society is regarded as a discretionary operating expense, and not as a distribution of profit. A society should exercise caution in how it determines share interest rates, setting it at the lowest rate sufficient to attract the capital it requires, and making it clear to members that this rate will only be paid if it is affordable to the society.

Interest on share capital should never be treated as a profit distribution. Instead, share interest should be treated as a discretionary operating expense, payable only if the society can afford to do so, having taken into account the other liabilities of the society, and the need for reinvestment in the society. The FCA makes it clear that a society should not pay an interest rate above the declared maximum rate, even if the society has made above expected profits, or has paid below the maximum rate in previous years.

The term interest brings a Shariah compliance risk in the contracts even though it does not operate as a regular interest payment. From the information provided and the documentation, it seems that the interest classification is based on accounting convention and regulatory treatment of community shares. Community shares are not a profit-seeking initiative for capital gain, as such, gain is not classified as profit, but as interest. Interest is a discretionary operating expense which is only payable if the society can afford to do so.

Therefore, although the term interest attracts more risk, this interest is not the same form of interest payable on loans, rather it is akin to a profit. However, this needs further scrutiny to ensure that the structure and method of calculating this is truly akin to profit.

Institutional investments

Community shares can provide the foundations for building a robust capital structure in a society. Some societies may be able to raise all the capital they require from individual members and by reinvesting their surpluses. But, more often than not, community shares act as a lever to access institutional investment. This investment might be in the form of grants, loans or equity. The institutions might be public funding bodies, social investment specialists, banks, ethical investment funds, charities, and corporations, including other societies.

Societies should be cautious of accepting loans for more than 50% of their total capital requirements. For loans of between 25% and 50% of their total capital requirements, caution should also be exercised if the cost of the loan is significantly above the maximum interest rate payable on community shares, and or where the lender requires full capital repayment in less than five years. In such circumstances a society's members and prospective members should be fully informed about how the loans might affect their financial interests

For Shariah compliance, a company must seek Shariah compliant financing. To raise capital through interest-based financing is not Shariah compliant and is not permitted.

Arrangement with creditors

An arrangement with creditors, also called a scheme of arrangement, is a legally binding arrangement made by a society with its members and creditors to address its insolvency.

The terms of all such arrangements must be reviewed to ensure that it is Shariah compliant.

Investments in other legal entities

Section 27 of the Act allows societies to invest funds in other registered societies, building societies, companies or securities issued by a "relevant authority", meaning certain types of local government body. It makes no provision for investment in partnerships, including limited liability partnerships.

The Act also requires societies to state in their rules whether, and if so, by what authority and in what manner, any part of their funds may be invested. It is permissible for a society to invest some of its general reserves in other legal entities, but it should only do so to further the objects of the society, and in a way that meets the needs of the society to maintain liquidity and solvency.

This would include normal treasury practices of keeping cash in deposit accounts and other types of liquid investment.

Investments made into other societies or companies need to undergo Shariah screening. Only those investments which pass the screening can be permitted.

Loan stock

There are other ways of raising loan capital from the public, including the offer of loan stock or debenture stock: the former is fully at risk, while the latter is usually secured against a specific asset held by the enterprise. Selling any form of debt product to the public is a regulated activity, subject to the Financial Services and Markets Act 2000 and its associated Regulatory Orders, unless there are exemptions. Co-operative and community benefit societies are usually exempt.

Any loan stock or debenture stock must be interest-free. If loans or debentures pay interest, it will not be Shariah compliant.

Loans and deposits

A society must have rules stating whether it will allow members or others to hold deposits or make loans to the society and, if so, under what terms and conditions. The rules must also state the maximum amount that can be borrowed.

These rules must be reviewed for Shariah compliance.

Sweat Equity

Many new societies are highly reliant on their founder members and volunteers doing unpaid work to help get the enterprise up and running. This is sometimes referred to as sweat equity. If a society decides to issue sweat equity it should do so by paying the person for services rendered, following UK income tax law, and for that person to voluntarily purchase withdrawable share capital on the same terms and conditions as other members. New societies should carefully consider the operating losses this practice will generate, and its potential impact on solvency.

Any sweat equity must be reviewed for Shariah compliance.

Borrowing

All societies are required to state in their rules the terms and conditions on which they may borrow capital from members and others, including

commercial sources. These terms may include details of the security offered to lenders and the maximum amount that can be borrowed. Society legislation makes an important distinction between loans and deposits: loans are used for the business purposes of the society, whereas deposits can be used for other purposes.

For Shariah compliance, any rule which permits borrowing on interest will be a non-compliance risk and must be removed.

Asset lock

An asset lock is a constitutional device that prevents the distribution of residual assets to members. The purpose of an asset lock is to ensure that the public benefit or community benefit of any retained surplus or residual value cannot be appropriated for private benefit of members. Asset locks are a defining feature of community shares, because they remove the scope for members to make speculative capital gains resulting from the dissolution, disposal or conversion of the society into a company. Societies can adopt a voluntary asset lock, but only community benefit societies have the option of adopting a statutory asset lock.

From a Shariah compliance perspective, every shareholder has right to the residual assets. They have invested their funds and therefore have more right to the residual assets. Investors should have an option for forgo the distribution of residual assets for the benefit of the community.

4. THE POTENTIAL ISLAMIC STRUCTURE OF COMMUNITY SHARES

If all the terms in a community shares offer are Shariah compliant, the community shares will then result in a Shariah compliant equity ownership of the underlying business. If the business also has equity, then the joint ownership in equity among shareholders as well as the business falls under the structure known as Musharakah in Islamic Finance. A Musharakah is an investment partnership or joint venture compliant with Islamic principles. In a Musharakah, investors contribute assets (cash or property) to a joint venture and share the returns of the joint venture in agreed percentages. Losses, however, are shared in accordance with the parties' initial investment. All Musharakah parties have the right to exercise control over the joint venture but it can be modelled with one party being the active party.

APPENDIX 1: Community Shares Overview

Community shares are a type of share capital, unique to co-operative and community benefit societies, that are ideally suited to the needs of community businesses. Community shares in societies are wholly different to share capital in companies, represented by two entirely separate and distinct bodies of corporate legislation; society law and company law.

It is "permanent capital" because the company is under no obligation to refund share capital. This provides reassurance to other creditors, such as lenders, suppliers, customers and employees, who know that what is owed to them must be paid in full before the shareholders are paid anything. As long as the share capital in an enterprise exceeds its accumulated losses then other creditors have their liabilities covered by the share capital in the business. It is the shareholder who will suffer the losses in these circumstances.

The value of shares is whatever another person is willing to pay for them, regardless of the price paid to the company for those shares. This valuation might be based on the net asset value of the business, its current or future profitability, or the worth to the buyer of owning and controlling that company.

Company law favours majority shareholders, and generally does not encourage minority shareholders and distributed ownership unless it is a large public company with shares sold through a stock exchange. In short, company law is designed for businesses in pursuit of profit and capital growth. These goals There are two main bodies of corporate law in the UK; company law and society law. Both give the corporate form its own legal identity and limit the liability of shareholders are incompatible with the aims of a community business with primarily public, social or community objectives. But community businesses still need risk capital to get established and to succeed.

Societies can issue a form of shares known as withdrawable share capital, which is unique to society law. Withdrawable share capital can be withdrawn from the society, subject to the society's rules and any conditions set out in a share offer document. Most societies have rules that give the board discretionary powers to refuse or suspend withdrawals if it is financially prudent to do so. This means withdrawable share capital is fully at risk. Members could lose some, or all, of the money they invest. But they also have the scope to withdraw some, or all, of their capital when they need it, subject to consent. Unlike with transferable shares, members don't have to find a willing buyer, or negotiate a price for their shares.

Withdrawable share capital places a responsibility on a society to manage its capital prudently. It needs to establish reserves to provide for withdrawals, or to attract new share capital from new or existing members to replace capital that is being

withdrawn. Most new societies suspend withdrawals for an initial period, typically three or more years, so that they can build up reserves to finance withdrawals.

Voting rights in a society are normally attached to membership rather than share capital, with most societies adopting the co-operative principle of one-member-one-vote. Investment in share capital can be encouraged by offering a financial return on shares expressed as an interest rate, but the interest rate offered must be the minimum necessary to attract and retain the capital. Profits cannot be distributed in the form of a dividend on share capital.

Most societies choose to have an asset lock, similar to those found in charities and Community Interest Companies, which prevents any residual assets being distributed to members or subscribers in the event of the enterprise being wound-up. This means that members cannot benefit from the sale of the society or its assets.

Society law restricts a member's withdrawable shareholding in a society to £100,000, although this limit does not apply to societies investing in other societies, or to transferable share capital issued by a society. The purpose of this limit is to prevent a society being financially dependent upon members who can afford to invest larger amounts. It is good practice for smaller societies to limit shareholdings even further, to no more than 10% of the total share capital in the society.

Society law is suited to distributed ownership by hundreds, or even thousands, of members. Each member contributes a relatively modest amount of share capital and there is an established mechanism for withdrawing this share capital without the need for a stock market or the sale of the enterprise. Members have a democratic say, but their financial interests are restricted to a modest interest rate on capital and without the scope for capital gain. The purpose of a society is wholly different to that of a company.

Community shares are defined by the Community Shares Unit as non-transferable, withdrawable shares in an independent society with a voluntary or statutory asset lock that is owned and democratically controlled by the community it serves. But they cannot sell or transfer their shares or liquidate the business in order to achieve a capital gain. In solving the liquidity problem for shareholders, societies create a liquidity problem for themselves. A society must plan how it will generate enough cash to allow share capital to be withdrawn. The most effective way of doing this is by attracting new members and new shareholders, to replace members and shareholders that are leaving the society.

Community shares promote a different sort of business model, where it is in the interests of all stakeholders to work together to create wealth and to use their democratic rights to determine how that wealth is distributed. It is in the mutual interests of all stakeholders to become members and investors. Community identity

can transcend geography and focus instead on shared interests, values, concerns, or beliefs. Examples include a shared interest in renewable energy, local food production, affordable housing, support for a football club, or community services provided by a faith group. But, more often than not, community shares act as a lever to access institutional investment. This investment might be in the form of grants, loans or equity. The institutions might be public funding bodies, social investment specialists, banks, ethical investment funds, charities, and corporations, including other societies.

Societies should be cautious of accepting loans for more than 50% of their total capital requirements. For loans of between 25% and 50% of their total capital requirements, caution should also be exercised if the cost of the loan is significantly above the maximum interest rate payable on community shares, and or where the lender requires full capital repayment in less than five years. In such circumstances a society's members and prospective members should be fully informed about how the loans might affect their financial interests.

AMANAH
ADVISORS
Global Islamic Finance
& Fintech Services

0044 7399 828 377
info@amanahadvisors.com

amanahadvisors.com