



TOWARDS HARMONIZATION OF SHARI'AH SCREENING FRAMEWORK

By:

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for Master of Science in Islamic Banking and Finance

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ABSTRACT

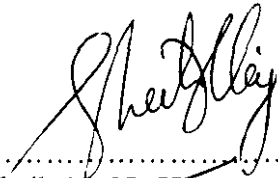
Shari'ah screening is a methodology to screen out stocks and build *Shari'ah* compliant indexes. However, currently *Shari'ah* index providers are employing different kind of screening criteria which seems to be hampering the headway of the industry and, subsequently, hindering the globalization of Islamic equity market. Therefore, this research aspires to investigate the differences and similarities in the *Shari'ah* screening norms of the five leading *Shari'ah* indices namely Dow Jones Islamic Market Indexes, Financial Times Stock Exchange *Shari'ah* Global Equity Index Series, Securities Commission Malaysia, Standard and Poor *Shari'ah* Indices and Morgan Stanly Capital International Global Islamic Indices and aims to propose framework to harmonize those differed criteria. Qualitative methodology is employed to carry out this research. The interview is also conducted using Delphi technique with the panel of scholars and practitioners after identifying the disparity in the *Shari'ah* screening norms from the literature available. The findings suggest that there is an urgent need to harmonize *Shari'ah* screening norms in order to facilitate cross-border investments. The study finds that the decision to include weapon and media industry should be left with the respective *Shari'ah* body due to their subjectivity. The companies involved in human engineering should not be incorporated in *Shari'ah*-compliant investments. *Maslaha* aspect of a company may be taken into account during screening. The benchmark for cash compliance should be 33% and market capitalization and total asset should be employed for computing *Shari'ah* index. It also urges to conduct *Shari'ah* screening operation annually. Furthermore, the study proposes the precise framework to attain harmonization. In addition, it is anticipated that the undertaken research should pave the way towards harmonization of *Shari'ah* screening. Finally, based on the findings, the researcher recommends carrying out future research on the methodology of purification.

ملخص البحث

الفحص الشرعي للأسواق المالية هو طريقة لفرز الأسهم المالية الشرعية وإنشاء الصناديق المالية الإسلامية. لكن، حالياً مزودو الصناديق المالية الإسلامية يقومون بتوظيف أساليب شتى في التدقيق الشرعي ويبدو أنها تعيق التقدم في السوق المالي الإسلامي و بالتالي تبطئ عولمته. بناءً على ذلك، هذا البحث يطمح إلى التحقيق بين المعايير المشتركة والمختلفة للتدقيق الشرعي عند المزودين الخمسة الأساسيين للصناديق المالية الشرعية واللذين هم: مؤشرات داو جونز للأسواق المالية الإسلامية، فاينانشال تايمز للأوراق المالية الشرعية، هيئة الأوراق المالية ماليزيا، مؤشرات الشرعية لستاندرد أند بورز، مؤشرات مورغان ستانلي كاييتال الدولي الإسلامي العالمي. ويهدف الباحث إلى اقتراح هيكل لإنسجام تلك المعايير المختلفة. ويتم إعداد هذا البحث باستخدام المنهج الوصفي. ولقد أجريت المقابلة مع مجموعة من الخبراء والممارسين الشرعيين بمنهج دولفي بعد تمييز الخلاف في معايير التدقيق الشرعي من المواد المطبوعة المتوفرة. النتائج تقترح بأن هنالك حاجة ملحة لجعل معايير التدقيق الشرعي متجانسة لتيسير الاستثمار عبر العالم. الدراسة أثبتت بأن القرار بإدراج قطاع الأسلحة و الإعلام ينبغي ان يترك للقسم الشرعي المعني به لسبب موضوعيته. الشركات المعنية بإستنساخ البشر لا يجوز إدراجها في الصناديق المالية الشرعية. جانب "المصلحة" ينبغي اخذه بعين الاعتبار في حالة الفحص. الحد للسيولة المالية هو 33%، وقيمة الشركة السوقية وممتلكاتها الكلية يجب توظيفهما عند حساب الصندوق المالي الشرعي. ويفضل انجاز الفحص الشرعي سنوياً. وكذلك، تطرح الدراسة إطاراً دقيقاً للحصول على الانسجام في المعايير الشرعية. بالإضافة، يتوقع من هذا البحث ان يمهد الطريق لتقييس معايير الفحص الشرعي. أخيراً، بناءً على نتائج البحث، يوصي الباحث بإعداد بحث بموضوع التطهير المالي بالمستقبل.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.



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Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance (IIiBF) and is accepted as a fulfillment of the requirement for the degree of Master of Science in Islamic Banking and Finance.



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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for my other degrees at IIUM or other institutions.

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Date 11/04/2013

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INTRODUCING TAKAFUL IN INDIA: PROSPECTS AND CHALLENGES

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In the name of Allah, the inspirer of truth, all praise is to Allah, Most Merciful and Compassionate, and all blessings and peace to our Master Muhammad, his family, companions, and those who follow them.

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LIST OF ABBREVIATIONS

AAOIFI	Auditing and Accounting Organization for Islamic Financial Institutions
DJIMI	Dow Jones Islamic Market Indexes
FTSE	Financial Times Stock Exchange Shariah Global Equity Index Series
IIFA	International Islamic Fiqh Academy
IFSB	Islamic Financial Services Board
MSCI	Morgan Stanly Capital International Global Islamic Indices
SCM	Securities Commission Malaysia
S&P's	Standard and Poor Shariah Indices

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic capital market has very crucial role to play in the process of developing and widening the scope of overall Islamic financial industry. The vehicle of Islamic finance will not be able to run without the prevalence of the vibrant and resilient capital market in the system. The very absolute abolishment of *riba* by Islamic doctrine in all forms of financing and business dealings has confined Islamic banks, *Takaful* and other sectors largely to the investments activities. In addition to that, capital market is the top avenue to invest and borrow money. Consequently all Islamic financial institutions have to venture their deposits, savings and surpluses in the stock market ultimately (Rushdi, 2006).

However, the key function of capital market is to channelize funds from surplus unit income to deficit unit income to allocate the resources efficiently and to carry out the business projects. Similarly, savers invest in equity like stocks or debt-base instruments like bonds; securities are generally fixed-income generating financial instruments with specific time frame. Whilst the subscribers of stocks are not assured of pre-determined profit neither are they periodic as security (Mishkin and Eakins, 2009). Thus, based on their fundamental and apparent characteristics it can be deduced that investments in shares is less problematic from the *Shari'ah* perspective in relation to bonds and securities wherein profit is fixed and pre-determined. Additionally investing in stock is relatively more akin to the *Shari'ah* principles if certain conditions are observed (Rodeny Wilson, 2006). So the research and development in this particular phenomenon is very much

needed with respect to structuring innovative products and furnishing with sound *Shari'ah* framework.

Although stocks in appearance are rather compatible with Islamic rulings of transaction, additional examination is required to confirm the degree of compliance with *Shari'ah* since stock comes along with ownership. The subscription to shares in a company is considered, under *Shari'ah*, a proportionate ownership of the company business and assets (Shariq Nisar, 2007). Muslim investors therefore cannot own a company that is involved in any non-*Shari'ah* compliant activity. The non-*Shari'ah* compliant activities range from having a line of business that is considered impermissible such as investments in the arms industry to the dealing with interest while managing the financial affairs of a company like taking interest based loan. Due to the prevalence of interest-based conventional banking system, most of the companies in today's world end up dealing with interest even though it is not part of their major business activities. These companies would not qualify for *Shari'ah* compliant investments. Such a component had kept the majority of Muslim investors away from the stock markets for a long time (Kamal MA Mian, 2008).

In 1987, a panel of leading *Shari'ah* scholars agreed and arrived at certain criteria in order to enable Muslim investors to own, hold and trade the shares of the listed companies in view of the current market scenario and acknowledging the significant role played by the listed companies in an economic system. Justice Muhammad Taqi Usmani from Pakistan, Saleh Tug from Turkey and Sheikh Muhammad Al-Tayyeb Al Najjar from Egypt were the prominent scholars in that team (Kamal MA Mian, 2008). The idea behind the approach adopted by these scholars is that it is almost not viable to carry out financial activities purely in harmony with the principles of *Shari'ah*, though the companies whose core business does not contradict the *Shari'ah* tenets. This simply connotes that Muslim

investors will not be able to take part in an essential section of the world financial system. Therefore, it is imperative to investigate vigilantly the non-*Shari'ah* compliant components in a firm and look for techniques and ways to either prevent them or handle them in a way that would be consistent with the tenets of *Shari'ah*. The scholars had developed the *Shari'ah* screening criteria of the stocks and ruled that Muslim investors may trade stocks of the companies which satisfy certain conditions and criteria. Thus, *Shari'ah* scholars of the present time have put forth various criteria to define the maximum degree of compromise which could be considered acceptable under *Shari'ah*, given the current business trends (Muhammad Imran Uthmani, 2002).

However, the *fatwa* given by the *Shari'ah* scholars was actually an eye-opener to other Islamic financial institutions in offering Islamic equity funds. Islamic funds were later offered in a large scale but there was no Islamic index to help rank fund performance. As a result, some institutions used the existing conventional indexes as the benchmark for their investments funds. Other institutions used their own internal Islamic equity benchmark. This scenario did not earn investors' confidence in Islamic funds, thus the creation of an Islamic index became a necessary (Security commission Malaysia, 2009).

Islamic index is structured by including stock of companies that are approved by the index provider's *Shari'ah* supervisory board. The index shall be maintained based on stringent screening and review process. Some Islamic indexes have few levels of screening which will be followed by monitoring the approved companies. Throughout the monitoring and review process, which may be done quarterly or semiannually, if the index provider finds out any of the company breaches the *Shari'ah* parameters, they shall be detected immediately from the *Shari'ah* index (Securities commission Malaysia, 2009).

Currently there are several index providers throughout the world that continue to create, maintain and disseminate *Shari'ah* indexes. However, The first Islamic index was

structured by Dow Jones market index in February 1999. Later, the Financial Times Stock Exchange launched the Islamic global index family in November 1999 and almost at the same time, the Kuala Lumpur Stock Exchange was also followed (Security Commission Malaysia, 2008).

Nevertheless, the mechanism used by the Islamic index providers in order to test the level of compliance with the teachings of *Shari'ah* is termed *Shari'ah* screening; *Shari'ah* screening is the process of identifying *Shari'ah*-compliant investments. *Shari'ah* explicitly defines activities in which Muslims are not allowed to engage, such as *riba* and the consumption of alcohol and pork. Accordingly, Muslim cannot invest in assets of businesses driving income mainly from such activities (Syed Othman Alhabshi, 2008).

To quantify these *Shari'ah* requirements, *Shari'ah* scholars define *Shari'ah* mandates containing a set of sector, financial screens as well as procedural requirements to ensure that investments adhere to the *Shari'ah*. It should be made clear here that screening criteria might vary from one *Shari'ah* board to the other and thus might result in a different compliant stock universe to invest in.

Sectoral screening or filtering is general prescription through which all companies operating or involved in specific types of non-*Shari'ah*-compliant business activities are excluded, exceeding a specific threshold are considered non-compliant and excluded from investments group of assets (Shariq Nisar, 2007). Financial screens, on the other hand, are used to analyze how deeply an individual company is involved in financial practices that are not *Shari'ah*-compliant. For that purpose *Shari'ah* scholars define threshold level for specific financial ratios through which the degree of compliance is measured (Ulrich Derigs, Shehab Marzban, 2008).

1.2 PROBLEM STATEMENT

Since *Shari'ah* screening is relatively new phenomenon to Islamic finance, number of hurdles are being faced by Islamic equity market. It would be no exaggeration to contend that one of the crucial problems is the inconsistency or lack of standardization in *Shari'ah* screening norms and practices. The inconsistency is surfaced at both, previously discussed, levels; sectoral and financial screenings. To illustrate the inconsistency in sectoral screening norms, Financial Times Stock Exchange *Shari'ah* Global Equity Index Series (FTSE) and Standard and Poor *Shari'ah* index (S&P's) instance can be sighted whereby *Shari'ah* index of FTSE includes media and broadcasting sector in its *Shari'ah* compliant portfolio (FTSE International Limited, 2011) and *Shari'ah* board of S&P Islamic index does not allow this sector to be part of *Shari'ah* investment universal (S&P Indices, 2011).

Similarly, Inconsistency is found in financial screening mechanism, for example, the Dow Jones Islamic Market index uses three additional financial characteristics, i.e. level of debt, level of liquidity, and a level of interest income as compulsory criteria during the screening process for prospective companies and the threshold for level of liquidity is 33% (Dow Jones Indexes, 2011). While the ceiling limit for cash compliance is 70% in the case of MSCI Shariah index (MSCI Barra Equity Research, 2007) and it is 50% according to FTSE *Shari'ah* board (FTSE International Limited, 2011).

Beside these differing stances, other sort of inconsistency appears to be in the computing methods which are being employed currently by various Islamic fund managers and index providers globally (Ulrich Derigs, 2008). For instance, use of market capitalization versus total assets as ratio divisor; index providers employ either a market capitalization or total assets based approach to carry out the financial ratios screening of stocks for eligibility. They assess the suitability of companies based on the percentage of either market capitalization of company's stock; or total assets, debt, cash and accounts

receivable, Financial Times Stock Exchange (FTSE) uses a total assets approach to calculate financial ratios while Dow Jones Index adopts a market capitalization method (Islamic finance Asia, 2010; Dow Jones Indexes, 2011).

Thus, using different *Shari'ah* parameters and various calculation methodologies in *Shari'ah*-screening process and not having proper standard causes inconsistency and disparity that leads to insecurity and distrust of Islamic investors into *Shari'ah*-compliant investments and thereby hinders the further development of the Islamic equity area and the attraction of large investments (Ulrich Derigs, 2008). The researcher believes that the existing lack of standardization type may expose the industry to the potential *Shari'ah* risk due to the fact that under such circumstances the index providers may be tempted to use their leverage to influence a *Shari'ah* board, resulting what is commonly referred “*Fatwa* shopping”. It is also seen as hindrance to facilitate cross-border investments activities effectively and efficiently.

It is abundantly made clear here from the aforementioned instances and arguments that this kind of lack of stability and not standardized *Shari'ah* practices lower confidence in the industry and limit its mobility, applicability and growth (Jamal Abbas Zaidi, 2011). It would be hazardous as well to the industry in long term (Ijlal Alvi, 2008). Therefore, the issue of inconsistency in *Shari'ah* screening norms shall be examined and addressed thoroughly in order to bring about the uniformity.

1.3 RESEARCH OBJECTIVES

Therefore, this paper is intended primarily to enhance and standardize the *Shari'ah* screening methods by proposing international, uniform *Shari'ah* screening technique which will ensure the industry against *Shari'ah* risk, smooth and accelerated growth of

Islamic investments market as well. It is also expected to examine the *Shari'ah* basis of this practice critically and identify the underlying causes, contributing to differing exercises carried out by various Islamic index providers. Furthermore, this research is expected to make analyses of the different leading Islamic index providers such as Dow Jones Islamic index market, Global Islamic Index of Financial Times Stock Exchange and Bursa Malaysia's *Shari'ah* index and their techniques. The objectives of the research can be summarized as follows:

The prime objective of the study is to propose harmonized *Shari'ah* screening framework in order to enhance the practice and foster the growth of Islamic equity market. The secondary objectives are as follows:

- a. To investigate the differences and similarities in the practice among the more dominant players of the market globally such as Dow Jones Islamic index and S&P *Shari'ah* index.
- b. To find out the extent to which harmonization or standardization of *Shari'ah* screening criteria is attainable.

1.4 RESEARCH QUESTIONS

1. How the prevailed inconsistencies in *Shari'ah* screening criteria can be minimized and harmonized?
2. To what degree the differences and similarities in the practice are prevailed among the more dominant players of the market globally like Dow Jones Islamic index and S&P's *Shari'ah* index?
3. To what extent the harmonization or standardization of *Shari'ah* screening criteria is attainable?

1.5 SIGNIFICANCE AND THE CONTRIBUTION OF THE RESEARCH

The research is motivated to propose harmonized and internationalized *Shari'ah* screening framework to facilitate cross-border *Shari'ah* investments universe and to preserve the Islamic finance industry against *Shari'ah*-risk. It is also hoped that it will enhance the efficiency in the system and boost the credibility among investors and other stakeholders that will eventually lead to the rapid growth of Islamic equity market.

Furthermore, it is anticipated to contribute to the limited number of literature created to make comparison of the various leading Islamic indexes as well as would provide the exploratory analysis of basis of *Shari'ah* screening framework from the sources of *Shari'ah* and Islamic legacy. In addition to that, the result of this research is expected to help policy makers, regulators, *Shari'ah* advisors, investors and other stakeholders understand the functions of *Shari'ah* screening thoroughly.

Shari'ah scholars will be able to better appreciate the *Shari'ah* screening operation, from structuring the *Shari'ah* portfolio to the profit declaration and purification mechanism. This research also exposes them to the different kind of screening methodologies prevailing at the global level. This research can also be instrumental for them to discharge the advisory and supervisory duties in an Islamic financial institution.

Beside, this research is anticipated to help investors make informed decision in *Shari'ah* compliant investments portfolio according to their preferences and religious sentiments. Exploratory analysis of *Shari'ah* screening norms shall serve them to identify the level of *Shari'ah*-orientation of a particular index over other index providers in terms of adherence to the *Shari'ah* objectives.

Moreover, this study shall assist index providers and regulators to establish, design and implement the rules and regulations of the market in a particular region or country. On the other hand, it will facilitate them to maintain and ensure the market discipline in terms

of *Shari'ah* compliant investments and activities among the investors, borrowers, and the fund managers.

Likewise, the undertaken research will enable general public and all stakeholders to better understand the criteria of Islamic form of investments and their adoption to the ethical oriented investments vis-à-vis conventional investments.

1.6 SCOPE OF THE RESEARCH

The undertaken study basically deals with *Shari'ah* screening criteria. It explains the methodology used to construct, disseminate and maintain *Shari'ah* indices. It describes the *Shari'ah* screening processes of stocks extensively. In addition, it reveals the *Shari'ah* ground for coming up with benchmarks and other *Shari'ah* parameters and it unfolds the numerous issues, the industry is experiencing recently. Furthermore, it identifies the inconsistency and disparity found in the *Shari'ah* screening criteria and makes critical analysis of them. Next, the researcher conducted interviews using Delphi technique with panel of scholars and practitioners to propose the framework in order to harmonize *Shari'ah* screening criteria. The study also gives insight on the point of bringing harmonization to the *Shari'ah* screening criteria and proposes the framework based on the findings attained.

1.7 LIMITATIONS OF THE RESEARCH

Due to the time and other constrains only five influential and leading indexes are included in the study to be examined and compared. However, it is believed that the rigorous selection of the indices compensates and ascertains the soundness of the research findings

since the indices incorporated in the study are from the various parts of the world and they are dominant and highly influential such as Dow Jones, and Financial Times Stock Exchange. In addition, the study embraces both kinds of indices which employ market capitalization and total assets into the research sample. Thus, the findings of the research shall not be affected and will serve the purpose of harmonization.

Furthermore, the researcher did not cover all the *Shari'ah* scholars and experts of Islamic finance in conducting interviews. Only eight prominent panels of scholars and practitioners were interviewed due to time and other limitations. Nevertheless, it will not affect the accuracy of the findings as the respondents were selected rigorously and with due diligence. It was also attempted to have respondents from different schools of thought and various parts of the world to ensure the extensiveness of the findings. Therefore, the findings were not expected to affect the accuracy and applicability.

1.8 RESEARCH METHODOLOGY

Qualitative research method was used and the data was gathered through secondary data and primary data as well. To gain the primary data, prominent *Shari'ah* scholars was interviewed for the purpose of achieving core objective of this research i.e. to propose uniform *Shari'ah* screening framework. Delphi technique was employed for interviewing as it is deemed to be more compatible with the research objectives. Interview's questions were structured semi standardized and interview with scholars was done using e-interview method due to time and place constraints. The researcher selected the group of most leading *Shari'ah* indices throughout the world as research samples in order to identify the differences and similarities in the existing *Shari'ah* screening norms.

1.9 CONCLUSION AND ORGANIZATION OF THE RESEARCH

The mechanism which is employed to examine the level of compliance with *Shari'ah* is termed *Shari'ah* screening, whereby it has to ensure that the particular company shall not be involved in any non-*Shari'ah* compliant activity like carrying out interest-based transactions, producing and supplying alcoholic drinks and so on. This screening is executed at two levels; firstly, to identify the core sector of the company. Secondly, to assess the level of liquid, debt and to screen the ratio of profit generated out of Haram activities, this is termed as financial screening.

However, the issue which is hampering the progress of Islamic equity market is the lack of standardized *Shari'ah* screening practice. For example, use of market capitalization versus total assets as ratio divisor; index providers employ either a market capitalization based or total assets based approach to carry out the financial ratios screening of stocks for eligibility. So, using different *Shari'ah* parameters and various calculation methodologies in *Shari'ah*-screening process and not having proper standard causes inconsistency and disparity that leads to insecurity and distrust of Islamic investors into *Shari'ah*-compliant investments and thereby hinders the further development of the Islamic equity area and the attraction of large investments.

Therefore, the objective of this research is (a) to investigate the differences and similarities in the practice among the more dominant players of the market globally (b) to find out the extent to which harmonization of *Shari'ah* screening criteria is attainable and needed and (c) to propose framework to harmonize screening criteria.

This research basically consists of five chapters; the first chapter contains the introduction of the topic with brief discussion over the background of the study and it also includes problem statements, research objectives, research questions and the research methodology employed for this research. Previous literature is reviewed in the second

chapter and it formulates the foundation of *Shari'ah* screening criteria and *Shari'ah* indices with quantifying the research gap to be filled by this study. Third chapter explains what research methodology will be used to carry out this research and the rationale behind that. Chapter four presents the finding of the study extensively gathered through first and second round interview. In addition, the findings obtained are interpreted and analyzed at the end of the chapter. The Final chapter concludes the research and highlights the further research area.