SYARIAH COMPLIANT SCREENING PRACTICES

Mondher bellalah
Asma Abdul Rehman
Omar Masood

March, 2013
SYARIAH COMPLIANT SCREENING PRACTICES

Mondher bellalah* ** Asma Abdul Rehman *** Omar Masood

25 Mars 2013

ABSTRACT

This study focuses on the sharia compliant screening methods that are practiced by prominent Islamic finance users in terms of qualitative and quantitative screening. This research uses the comparative analysis to recognize the similarities and differences of methods among 15 users. Analysis reveals that there is a need to set the universal standards not only for the investors but also to discourage the misunderstanding between investors and scholars. After analysis of qualitative and quantitative screening, recommendations for the both methods have been made for the shariah compliant board and users.

Keywords: Islamic finance, Shariah compliant, screening method,

JEL Classification: G21, G23
Introduction

Islamic finance and investments have grown on average of over 20% per annum for the past decade, a momentum not shared by the conventional sector. Shariaa compliant assets have a current worldwide total worth of US$800 billion and the majority of it is in Islamic equity funds (Jaffer, 2009). There exists tremendous interest in Islamic finance and investments due to the growth of wealth from the majority of oil producing Muslim countries with their specific culture and religious beliefs. With the rise in commodity prices and income in the current global economy, the appetite for Shariaa compliant investments is expected to continue to improve in the future. Financial institutions and investment houses are therefore always in search of Islamic compliant investments, which are believed to have lower risks in light of the recent development in developed financial markets, in order to attract investments.

Many new Islamic institutions and established financial institutions take the opportunity to facilitate this new market trend with unprecedented growth of Islamic investment instruments. As a result, many international bodies that influence the development of Shariah-compliant equity has been set up in recent years. This development can be traced back to the beginning of the century where the evolution of the Islamic capital market was accelerated by some Islamic bodies including: Organization of Islamic Conference (OIC) Fiqh Academy, Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI), Islamic Development Bank (IDB) and Islamic Financial Services Board (IFSB). One of the most significant index providers who drives the equity investment momentum is the Dow Jones Islamic Market (DJIM) Index established in 1999 (McMillen, 2006).

In recognition of the need for expertise, independent advice and supervision on Shariah-related matters, the AAOIFI established a standard requiring every provider of Islamic financial services to have its own Shariaa Supervisory board. Muslim countries such as Malaysia, Bahrain, and some Gulf states have made significant efforts to regulate Islamic finance separately from the conventional financial system. International developed financial markets have decided to include Islamic financial system in their existing regulatory framework. The challenge for some of these countries is to accommodate Islamic finance within a legal and regulatory infrastructure designed for existing conventional finance (Archer & Karim, 2007).

International institutions have been established to promote universal consistency in Islamic finance but their Shariaa compliant standard may not be similar according to
their respective jurisdictions. Malaysia, Indonesia, and Iran have regulations in place to ensure that any entity that is involved in the issuance of Islamic financial product complies with their own prescribed minimum standard of Shariaa compliance (Mc Millen, 2006). The Shariaa standards issued by AAOIFI are adopted by Bahrain, Sudan, Syria and some others in that region (Archer & Karim, 2007).

The process of Shariaa compliant screening differs not only due to different jurisdictions of different countries but also practiced by different set of users: portfolio managers, providers of market intelligence and regulators. These parties have different objectives for the screening of Shariaa compliant products. Some researchers claimed that too much diversity adds cost and requires a larger number of screening processes and in the long run could hamper the growth of Islamic finance (Islamic Finance Asia, 2008). There is therefore a need for Islamic scholars to standardize their screening methodologies effectively in the international market.

This paper aims to review the Shariaa compliant screening methods practiced by 15 worldwide prominent Islamic finance users: 8 apply qualitative and 11 apply quantitative methods. In addition, the paper performs a comparative analysis to detect the differences and similarities of these methods. Data are collected from their respective user website and an interview was conducted with the Assistant General Manager of Islamic Capital Market Department, Securities Commission in Malaysia.

**Review of Existing Literature**

The existence of the Shariah screening process in the financial market enables investors to invest in companies that operate permissible business activities in accordance with fair Islamic principles. Introduction of the Shariah screening process is essential to detect prohibited activities and avoid embarking onto a non-compliant investment. Nevertheless, there are few research on Shariah investment screening methods. Derigs and Marzban (2008) provided a comparative study on the Shariah compliant stocks screening practices by nine group of users. In addition, Khatkhatay and Nisar (2006) explored and compared the sets of criteria used by three organizations and derived critical assessment on each criteria. Their study proposed modification on the practices used by considering the nature of business of the companies as wholly Shariah compliant and reject companies with mixed activities.

Khatkhatay and Nisar (2006) pointed out that Shariah compatible investment is judged according to the investment structure and the nature of the contracting parties.
The Shariah law prohibits interest related investments (Riba’), monetary obligation (debt, currency, liquid assets), and future rights (uncertainty). The structure of share equity appears permissible because equities of stock do not grant fixed return and as long as the business does not involve chance events with high uncertainty similar to gambling. In addition, the existence of margin account practice, speculations, and short selling in the operational aspect of shares are also prohibited in Syariah (Iqbal and Mirakhor, 2007).

Grais and Pelligrini (2006) noted that Syariah compliance is achieved through Syariah authority which are highly respected and syariah knowledgeable individual or group of individuals to decide if an investment transaction complies with the Syariah principle. This Syariah authority which is commonly known as Syariah Supervisory Board usually consists of three or more Syariah scholars.

Nature of Business

While certain activities are accepted as Shariah compliant, Shariah scholars have started to question the allowance of share trading of companies whose core activity is lawful but that occasionally get involved in unlawful transactions. These companies are in mixed activities with some non-compliant businesses are considered as joint stock companies. Yaquby (2000) studied the differences of justifications among contemporary scholars on trading joint stock companies and suggested that arguments cited by advocates of permissibility is stronger than the conflicting view. This is mainly because the inclusion of joint stock companies plays an important role to the development of Islamic finance.

There are certain activities which are considered as non-permissible or haram according to the Syariah principles. There is consensus among all jurisdictions to prohibit investments which involve Riba’ or interest. Prohibited business activities include gambling or Maisir such as casinos. Companies which are engaged in the production, distribution, promotion and sale of non-halal goods or services are prohibited in Islam. Non-halal goods and services include alcoholic beverages, pork, immoral facilities such as prostitution, pubs, discos, etc. Companies dealing with Gharar that could lead to excessive speculations activities such as conventional insurance as explained by Derigs and Marzban (2008) is also considered non-halal. Companies that are not primarily involved in haram activities but where such activities nevertheless constitute a significant proportion of their businesses are also considered as impermissible. The exact
proportion of mixed activities allowable is not, however specified in the Quranic teachings.

**Financial Structure**

The second major screening criterion examines the financial structure of the business and benchmark against some collectively agreed level of tolerance. Derigs and Marzban (2008) explained the relevance of this type of screening in the prohibition of Riba’ and trading of money according to the Shariah. Financial structures of companies are measured to gauge the involvement of these companies in non-permissible practices. Involvement in Riba’ is measured by the company’s interest-based income as well as their interest payment for debt which is termed as interest screen and debt screen. It is also claimed that money in itself is not a permissible asset in accordance with the Islamic Syariah principles. The level of liquid assets which may include cash and cash equivalents, short term investments and accounts receivables should be kept to a minimum in Islamic finance.

The screening of cash equivalent assets, termed as the liquidity screen, helps to indicate that investments are Syariah compliant if a large proportion of return is from illiquid assets. Similarly, Khatkhatay and Nisar (2006) highlighted three aspects of business structures that need to be quantified in order to check its Syariah compliance: indebtedness of the enterprise, interest and other suspicious earnings as well as the extent of cash and receivables of the company. It is important to note that returns generated from short term near cash assets are not permissible in Islamic finance.

**Threshold Values**

Companies which have been long established are inclined towards the conventional banking system in financing their major activities, it is almost impossible for these companies to be totally free from interest and liquid assets. The threshold values as explained by Derigs and Marzban (2008) provided a limit to the level of non acceptable activities from the Shariah point of view and the relaxation of the puristic submission. The exact allowable proportion for the financial structure is however not specified in the Quranic teachings and it is instead mainly based on interpretation in the form of Ijtihad. Interpretations on the minimum acceptable ratios or threshold values from 5 to 50 percent tend to differ between different Syariah boards resulting in differing standards acceptable by various Syariah boards all over the world.
This study separates the screening methods into two groups: qualitative and quantitative. Qualitative screening method is used to screen for non-permissible business activities according to Syariah principles. Quantitative screening method involves the numerical calculation of ratios of the non-permissible activities in accordance to some maximum allowable threshold.

Comparative Analysis

This study compiles data from 15 users of the Shariah screening methods from all over the world. Table 1 provides a list of different Shariah screening users and their background. The different ways of screening assets practiced by these users are examined by the level of geographical area at two levels: micro and macro. Macro level users screen available assets worldwide while micro level users tend to screen assets from a particular country or region.

Table 1: Shariah Screen Users

<table>
<thead>
<tr>
<th>Users</th>
<th>Regulator</th>
<th>Index Provider</th>
<th>Syariah service provider</th>
<th>Fund Manager</th>
<th>Bank</th>
<th>Country of Origin</th>
<th>Stocks Screened</th>
<th>Screening Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>SC</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Malaysia</td>
<td>Malaysia</td>
<td>Micro</td>
</tr>
<tr>
<td>DJIM</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>US</td>
<td>Global</td>
<td>Macro</td>
</tr>
<tr>
<td>FTSE</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>UK</td>
<td>Global</td>
<td>Macro</td>
</tr>
<tr>
<td>MSCI</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>UK</td>
<td>Global</td>
<td>Macro</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>US</td>
<td>Global</td>
<td>Macro</td>
</tr>
<tr>
<td>Shariah Capital</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>US</td>
<td>Global</td>
<td>Macro</td>
</tr>
<tr>
<td>Al Meezan</td>
<td>✓</td>
<td>✓</td>
<td>Pakistan</td>
<td></td>
<td></td>
<td>US</td>
<td>Global</td>
<td>Micro</td>
</tr>
<tr>
<td>Azzad</td>
<td>✓</td>
<td>✓</td>
<td>US</td>
<td></td>
<td></td>
<td>Global</td>
<td>Macro</td>
<td></td>
</tr>
<tr>
<td>Amiri</td>
<td>✓</td>
<td>✓</td>
<td>UK</td>
<td></td>
<td></td>
<td>Global</td>
<td>Macro</td>
<td></td>
</tr>
<tr>
<td>Amanie</td>
<td>✓</td>
<td></td>
<td>Malaysia</td>
<td></td>
<td></td>
<td>Global</td>
<td>Macro</td>
<td></td>
</tr>
<tr>
<td>Alfa Bank</td>
<td></td>
<td></td>
<td>✓ Russia</td>
<td></td>
<td></td>
<td>Russia</td>
<td>Russia, Ukraine, Kazakhstan</td>
<td>Micro</td>
</tr>
<tr>
<td>Dubai Islamic Bank*</td>
<td></td>
<td></td>
<td>✓ Dubai</td>
<td></td>
<td></td>
<td>N/A</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Saudi Arabia National Commercial Bank*</td>
<td></td>
<td></td>
<td>✓ Saudi Arabia</td>
<td></td>
<td></td>
<td>N/A</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Unified Committee*</td>
<td></td>
<td></td>
<td>✓ UAE</td>
<td></td>
<td></td>
<td>UAE</td>
<td>UAE</td>
<td>Micro</td>
</tr>
<tr>
<td>HSBC Amanah</td>
<td></td>
<td></td>
<td>✓ China</td>
<td></td>
<td></td>
<td>Global</td>
<td>Macro</td>
<td></td>
</tr>
</tbody>
</table>

This study has compiled information on four micro and nine macro-screen users. Two of these users are not categorized due to a lack of information. Macro screen users
consist of four international Islamic index providers, one bank and four Syariah service providers. One country regulator and two banks are categorized as micro screen users due to the narrow geographical assets screened.

The four international Islamic index providers are: (a) Dow Jones Islamic Market Index (DJIM); (b) Financial Times Stock Exchange (FTSE) Global Islamic Index; (c) Morgan Stanley Capital International (MSCI) Global Islamic Index; and (d) Standard & Poor’s (S&P) Syariah Index; who prescreened universal assets prior to forming their respective Syariah compliant indices. They are private profit oriented companies with global target market and hence screen all the assets at macro level for the construction of their indices.

In addition, the four Syariah service providers include: (1) the Shariah Capital of United States that screens universal assets for global investments; (2) Al-Meezan, a joint venture of Meezan Bank and Pak Kuwait Investment Company (PKIC) in Pakistan; (3) Azzad, a joint venture between Amri Capital, a London based investment management company and Azzad Asset Management from the U.S.; and (4) Amanie Business Solutions, a Malaysian based company that screens assets based upon clients’ choices endorsed by the respective Syariah Board such as DJIM, FTSE and others. These Syariah service providers are profit oriented companies that provide Syariah compliant consulting and related services and thus screen global asset based on the clients demand.

Similar to the other profit motivated entity, some banks also provide their own screening standard and provide financial services by managing fund owned by them and their clients and globally screening selected assets which provide good return such as that practiced by HSBC Amanah. Two of these banks screen their assets at micro level: Alfa Bank of Russia which only screens assets in Russia, Ukraine and Kazakhstan; as well as the Unified Committee, a joint venture between Islamic banks in UAE, screens assets in Dubai Financial Market and Abu Dhabi Securities Exchange. The screening information from Saudi Arabia National Commercial bank (NCB) and Dubai Islamic Bank (DIB) are not available. Lastly, Securities Commission Malaysia (SC) is a micro screen user, identified as the only Syariah screen user who is also a nonprofit government market regulator with the objective to supervise the country’s capital market.
**Analysis of *Syariah* Screens**

**Qualitative Screen**

This study categorized qualitative screens into five categories according to various businesses: *Riba* and *Gharar*, non-halal products, gambling and gaming, immoral and other impermissible activities. Only eight out of all the fifteen users have made available their qualitative criteria in a list of non-permissible businesses. Table 2 provides the list of five business classifications as non-Syariah compliant. It is crucial to note that some users provide only the activities they screen while some list them exhaustively.

All eight users have a common set of industrial categories inspected except for Al-Meezan which does not specifically state gambling as one of their non-compliant criteria. For the first category of *Riba* and *Gharar* based activities; SC, FTSE, MSCI, S&P, Al-Meezan and Azzad used a general term to represent such activities while DJIM and *Shariah Capital* provided a specific and exhaustive list of particular businesses that are involved in *Riba* and *Gharar* activities.

It is complicated to categorize other unique criteria for each user as the lists of non-compliant businesses are not clearly specified in certain cases. With the second business category of non-halal products, some users are more specific in excluding all companies that deal with food and non-halal products such as DJIM, but others only specify alcohol and pork-related products only - SC, FTSE, MSCI, S&P, and others. Similarly for the category of immoral activities, SC, FTSE and Azzad made their criteria as general as possible as well as those who simply stated all media, hotels or any entertainment business as non-permissible as practiced by DJIM, MSCI, S&P, and *Shariah Capital*. For the last category of other activities deemed impermissible, not all users considered the defense industry as impermissible; this industry is only excluded by DJIM, FTSE, MSCI, *Shariah Capital* and Azzad as weapons/defense manufacturing is not Syariah compliant. Another unique industry identified as non-compliant is the trading of gold and silver as cash on deferred basis noted by S&P.

In addition, the degree of leniency of these users can be analyzed through the immediate exclusion of companies deemed impermissible according to the qualitative criteria only - DJIM and Azzad. It is also found that some users including SC, FTSE, MSCI, S&P, *Shariah Capital* and Al-Meezan first screen companies according to their business categories and then further screen these companies with mixed activities using
their quantitative screening methods. These users therefore use both the qualitative and quantitative screening methods and allow more flexibility in their screening process.
<table>
<thead>
<tr>
<th>ACTIVITIES</th>
<th>SC</th>
<th>DJIM</th>
<th>FTSE</th>
<th>MSCI</th>
<th>S&amp;P</th>
<th>SHARIAH CAPITAL</th>
<th>AL - MEEZAN</th>
<th>AZZAD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riba and Gharar</td>
<td></td>
<td>Banks Real Estate Holding and</td>
<td>Banking or any other interest</td>
<td>Conventional financial services</td>
<td>Financial services</td>
<td>Conventional banks Modarabah companies</td>
<td>Conventional financial institutions</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Development Consumer Finance</td>
<td>related activity, (excluding Islamic financial institutions)</td>
<td></td>
<td></td>
<td>Insurance Brokerage firms</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Specialty Finance Mortgage Finance</td>
<td>Brokers Life insurance</td>
<td></td>
<td></td>
<td>Securities firms</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Full line insurance Investment services Insurance brokers Property &amp; Casualty Insurance Reinsurance Life Insurance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non halal products</td>
<td></td>
<td>Brewers Distillers &amp; Vintners Food products Food retailers &amp; wholesalers. Restaurants and bars Alcohol, Pork and other non halal related products</td>
<td>Pork related products Alcohol</td>
<td>Pork related products Alcohol</td>
<td>Alcohol Pork and meat packing</td>
<td>Companies dealing in alcohol Alcohol Meat products</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gambling</td>
<td></td>
<td>Gambling Gaming Gambling / Casino Gaming</td>
<td>Gaming, casinos</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Immoral</td>
<td></td>
<td>Entertainment activities that are non-permissible according to syariah Broadcasting &amp; Entertainment. Media Agencies Hotels Recreational Products and Services Night Club Activities Pornography and adult entertainment Prostitution Music Hotels Cinema Adult entertainment</td>
<td>Pornography Advertising and Media (newspaper are allowed, sub-industries area analyzed individually) Stem-cell research</td>
<td>Hotels and motels Musical instrument Entertainment Advertising media Pornography Amusement and recreation Movies, theatres and film distribution</td>
<td></td>
<td>Pornography Other unethical entertainment various magazines and media)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other impermissible</td>
<td></td>
<td>Manufacture or sale of tobacco-based products or related products Other activities deemed permissible Tobacco Defense and Weapons Tobacco Arms manufacturing Tobacco, Defense / Weapons Tobacco Trading of gold and silver as cash on deferred basis. Tobacco Weapons Tobacco etc</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Use Qualitative Criteria only</td>
<td></td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

10
Table 3: Shariah Quantitative Screen

<table>
<thead>
<tr>
<th>DENOMINATOR</th>
<th>USERS</th>
<th>SC</th>
<th>DJIM</th>
<th>FTSE</th>
<th>MSCI</th>
<th>S&amp;P</th>
<th>SHARIAH CAPITAL</th>
<th>AL - MEEZAN</th>
<th>AZZAD</th>
<th>DUBAI ISLAMIC BANK</th>
<th>S. ARABIA NCB</th>
<th>ALFA BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Screen</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>D ratio &lt; 33%</td>
<td></td>
<td></td>
<td>&lt; 33.33 % Owner’s Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest bearing Debt (IBD)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>40 % TA or MCap</td>
<td></td>
<td></td>
<td>&lt; 30 % TA or MCap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt (D) + liquid funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>AR ratio &lt; 45%</td>
<td></td>
<td></td>
<td>&lt; 50 % MV</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables (AR) + Cash (C)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>50 % TA or MCap</td>
<td></td>
<td></td>
<td>&lt; 70 % TA or MCap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables (AR) + Cash (C) + other debtors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquid assets (LA)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>80 % TA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Screen</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&lt; 5 % Operating Y</td>
<td>&lt; 5 % Total Y</td>
<td>&lt; 5 % TR</td>
</tr>
<tr>
<td>Cash (C) + Interest bearing securities (IBS)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income (IY)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&lt; 5 % Operating Y</td>
<td>&lt; 5 % Total Y</td>
<td>&lt; 5 % TR</td>
</tr>
<tr>
<td>Non Permissible Income Screen</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non Permissible Income (NPY)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>&lt; 5 % Operating Y</td>
<td>&lt; 5 % Total Y</td>
<td>&lt; 5 % TR</td>
</tr>
</tbody>
</table>

Note: The table above outlines the quantitative screening criteria for shariah-compliant investments, focusing on debt, liquidity, interest, and non-permissible income aspects. Each criterion is expressed with specific ratios and percentages that must be met by the investment to qualify as shariah-compliant. The table compares these standards across different users, including SC, DJIM, FTSE, MSCI, S&P, and others, highlighting the varying requirements for each. The values are designed to ensure that the investments align with shariah principles, such as avoiding riba (interest), usury, and other prohibited activities.
Quantitative Screen

A comprehensive comparison of the eleven users’ quantitative screening methods is compiled in Table 3. Each user has a list of ratios for each criterion and it plays an important role in the quantitative screening method. This compilation of all ratios and criteria used provide systematic information for comparison within the Syariah context. The classification of quantitative criteria set by the users is summarized into four broad categories: Debt screen, liquidity screen, interest screen and non-permissible income screen.

Debt Screen

Debt and interest bearing debt items fall under the category of debt screen and since Islamic finance follows the principle of sharing of risks and profits, borrowings and repayments of interest and principle is not Syariah compliant. It is observed that the level of debt criterion is screened by all except SC because it does not consider debt a major issue in their quantitative screen. There seems to be a consensus among the users to apply the benchmark of one third as the parameter of tolerance level stipulated by understandings from the Quran. In addition, the divisor identified in debt screen practiced by these users includes total assets, market capitalization and owner’s equity. Syariah Capital and DIB use more than one divisor.

Figure 1: Debt Ratio of Islamic Financial Institutions

![Debt Ratio of Islamic Financial Institutions](image)

It is claimed that market capital provides the real worth of the company but since it is driven by market sentiments, the volatility of price movement affects the threshold value and create inconsistency problem where Syariah compliant status of the listed companies tend to change over time. Some users therefore argue that the use of average market capital is more.
suitable in order to smooth out any uncertainty in market price movements. This may have led to DIB and NCB’s preference to use either total assets or market capitalization to avoid the seasonality effect in the Syariah complaint status. In addition, another unique criterion set by Alfa Bank is the application of owner’s equity as the divisor to screen debt. In summary, it is generally acceptable to have some debt in Syariah compliant business.

**Liquidity Screen**

The Syariah boards classified five sets of ratios under the liquidity screen: debt plus liquid funds, accounts receivable, accounts receivable plus cash, accounts receivable & cash plus other debt, and illiquid assets. While DJIM, FTSE, MSCI, S&P and Shariah Capital quantify current asset solely to measure the level of liquidity, DIB tends to include current assets and debt in its liquidity screen. This explains the term interest bearing debt used by some users for their debt screen which imply the separation of debt and interest bearing debt. The thresholds for liquidity screen ratios diverse greatly between 33 to 80 percent and this shows different Shariah jurisdictions referral in setting the threshold level in liquidity screenings. Moreover, all users except for DJIM and MSCI tend to have higher tolerance level (45 to 80 percent) in liquidity screening compared to their debt screen which was mostly set at one third. Similar to debt screen, the various users tend to use total asset, average and total market capital as divisor in liquidity screens and those who use total market capital will have an option to use total asset as practiced by DIB. It is interesting to note that NCB is the sole user of total market capital as the divisor in liquidity screen.

![Figure 2: Liquidity Ratio of Islamic Financial Institutions](image)
Interest Screen

Under the category of interest screen, two sets of ratios are classified: interest income and cash plus interest bearing securities. Interest income is screened by five users and the general consensus is 5 percent being the maximum threshold limit. A standard benchmark of one third is used for cash plus interest bearing securities. The difference between the users is again on the divisor, while cash plus interest bearing securities use either total assets or average market capital as the divisor, interest income ratio is divided by total revenue or income. This may be due to the existence of cash and interest bearing securities in the balance sheet instead of interest income from the income statement. The nominator and denominator are matched depending on their extraction from the respective financial statements.

![Figure 3: Interest Screen of Islamic Financial Institutions](image)

Non-Permissible Income Screen

It is important to note that non-permissible activities identified from the initial qualitative screen are further quantified to check if their level is acceptable by the respective users. From the various screens published, only SC, FTSE, MSCI, S&P, Al–Meezan and DIB further screen Syariah compliant level of non-permissible income derived from these mixed businesses. DJIM, Shariah Capital, Azzad, NCB and Alfa Bank do not apply such benchmark and this implies that they are very strict in their quantitative screen. S&P further screen their non-compliant businesses by allowing non-permissible income excluding interest of not more than 5 percent. There seems to be a common consensus to use 5 percent as the maximum allowance for non-compliant businesses and income.
Securities Commission of Malaysia is the sole user that applies various benchmarks: 5 percent for clearly prohibited activities such as interest-based activities or Riba; 10 percent benchmark for the level of contributions from mixed activities with the element of `Umum balwa such as contribution of interest income from fixed deposits in conventional banks as well as for tobacco-related activities; 20 percent benchmark to account for the level of mixed rental payment from Syariah non-compliant activities, such as rental payments from premises used in gambling or sale of liquor; and lastly, 25 percent maximum allowable level of contribution from mixed activities that are generally permissible according to Syariah but have an aspect of Maslahah (public interest), such as hotel and resort operations, share trading and stock-brokering activities which may be partly involved in non-permissible businesses. Another unique criterion set by Al-Meezan is the additional benchmark of 33 percent for any investment in non-compliant businesses which is much higher than its 5 percent benchmark screen for non-permissible businesses income.

Conclusion

This paper compiled the screening methods practiced by Syariah Compliant boards around the world in terms of both qualitative and quantitative screens. Some of these users are more specific in their listing of Syariah impermissible business and activities while some are more lenient. The majority of these users practice a two-tier method of screening: qualitative and quantitative. Under quantitative screen, the range of allowable ratios among non-permissible criteria and the measurement formula differ between boards.

Some countries including Malaysia, Russia and UAE have their respective Syariah screening boards and they set different standards depending on the roles and objectives they play in the industry. The concern of a regulator is the development of the industry and this helps to explain the more relax step-by-step approach in Syariah screening as practiced in Malaysia. The concern of the market intelligence providers, namely the international index providers, is to employ principal criteria to reflect the market through the selection of high quality assets for their clients and satisfy their investment principle. Private corporations which include fund managers and Syariah service providers screen assets at macro level and are motivated by return and fees and hence apply more stringent approach to cater to the bigger Islamic market in the Middle East. Different jurisdictions practiced by the users also play an important role in the differences in standards.

Although there are possibilities that other exchanges or countries may provide their own screening method, most fund managers, banks and industry players do not have such screening facilities and thus have to rely on market intelligence providers that screen global
assets at macro level. The most prominent Syariah index providers are DJIM, FTSE, MSCI and S&P which prescreened universal stocks to form particular Syariah index constituents. Their Indices are licensed for use by institutional investors around the world for portfolio management and benchmarking purposes as well as to serve as the basis of structured products and other index-linked investment vehicles including ETFs.

Based on the findings in qualitative screening, only minor differences exist on the types of businesses considered being Shariah non-compliant where some are more specific than others. Wider dispersion are found on the threshold limit towards businesses which are considered impermissible. Consequently, there are some stringent users who immediately label companies as Syariah non-compliant according to any involvement in impermissible activities in the qualitative screen and some more flexible users still accept such companies as permissible until the next process of excessive ratios in their quantitative screen.

In summary, we can categorize DJIM and Azzad as very stringent Syariah compliant users because they reject companies who are in one way or another involved in Syariah non-compliant businesses in the first round of qualitative screen. It is also obvious from our comparison that SC is the only user who does not practice debt and liquidity screen. Alfa Bank also does not practice liquidity screen, while Al-Meezan as well as Azzad do not apply interest screen. There exists some consensus among FTSE, MSCI, S&P, and DIB to practice all four quantitative screens. Different references of Syariah jurisdictions may have also contributed towards the dispersion between the screening methods. The Middle East jurisdiction which can be represented by NCB and DIB are very much concern on the prohibition of Riba’ by stringent screen for interest received and paid. SC’s Syariah board is concern about providing a wider range of investment instruments and only concentrated on lawful and pure returns of businesses, irrespective of how capital is generated which can be seen from the absence of debt and liquidity screen.

**Recommendation**

Shariah compliant equities have gained new fervor globally but a harmonious infrastructure must exist for the Islamic financial market to inspire investor confidence and compete with greater vigor with its conventional counterpart. Key building blocks of this infrastructure are universal standards that set the status of assets to facilitate global investments.

Due to the wide divergence in screening methods practiced by users, even the best Syariah screens might seem insufficient. Standardization is seen as a need not only to make understanding of Syariah investments clear to investors but also to discourage
misunderstandings between scholars and investors. Changes of Syariah status should only be caused by changes in the companies’ core businesses instead of differences in the methods used in Syariah compliant screening. Syariah users who screen assets at macro level would have to deal with various accounting standards and standardizing them could be very costly due to the extent of monitoring and disclosure. In addition, developing investment strategies that comply with Islamic principles require support from the authorities which entails considerable amount of time and resources. The suggestion to set a universal standard applicable by all is thus relevant and logical to global ethical investing with efficient cost and time.

**Qualitative screen**

The suggestion on qualitative method is whether it should immediately exclude companies deemed impermissible or provide parameters for further screening of these companies. According to our analysis, DJIM and Azzad immediately exclude companies deemed impermissible and this is seen as a defensive measure as screening the real businesses of companies requires scrutinizing the company’s annual report and accounts. Other information needs to be extracted directly from the company’s operation and such information can only be obtained by an authorized regulator.

It is important to include qualitative screen similar to DJIM’s where an exhaustive list of industries considered as non-Syariah compliant can be used to immediately segregate companies with impermissible businesses. In order to avoid discrepancies, there should be some consideration for questionable companies provided all information needed to prove that they are permissible is available. More importantly, it is a preventive step to exclude industries which are involved in non-permissible activities. In summary, companies whose main business falls under the list of impermissible industries are not Syariah compliant.

**Quantitative screen**

From the compiled analysis, debt screen is most frequently used followed by liquidity and interest screens. The threshold limit for debt ratio is generally one third, while liquidity screen has wider acceptable range with an average of about fifty percent. As for interest screen, the allowable limit is one third for cash plus interest bearing securities and only 5 percent for interest income. The recommendation for quantitative screening method should include debt ratio of less than 33% plus either one of the following:

- Accounts receivables / total assets (less than 50%)
- Cash + Interest bearing securities/ average market capitalization (less than 33%)
- Interest income / total revenue (less than 5%)
Other ratios may not be necessary if the debt and liquidity of firms are justified to be Syariah compliant. With the standardization of Syariah screening standards by Islamic finance authorities around the globe with clear guidelines and understanding of the issue on hand, the market for Syariah compliant investments would experience more growth opportunities in the future.

References


