screening criteria & methodology for for Islamic equity Investment

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Abstract:
Islamic investing has much in common with modern forms of investing known as 'ethical investing', 'socially responsible investing', 'faith investing'and 'green investing'. Each of these investment funds has much of value to contribute and each has something in common with the teaching of Islam. From Shari'ah –compliant investment point of view, the key element to equity funds is the screening criteria which had been used to determine the status of the companies in which investment is to be made by the funds .Presently there are various screening methodology being developed and approved by the renowned Islamic scholars that are being used by financial institutions around the world.
The focus of this paper is on how to screen equity investments in stock markets throughout the world to identify companies that are potentially acceptable to Islamic investors in terms of their degree of compliance with the *shariah* law.

Introduction:

There are close parallels between the Islamic fund management industry and the principles of ethical fund management, notably with respect to the criteria for stock selection for inclusion in a portfolio, or screening as it is more commonly called. Although both Islamic and ethical funds can include bonds and even assets such as real estate, most of the investment has been in traded equities. (Rodney Wilson,2004)
However currently, there is no international *Shari'ah* standard for stock screening. Fund managers utilize different standards based on the approval of their respective *Shari'ah* council.

Equity Funds

Equity funds or equity-based mutual funds are the financial institutions which mobilize investments from the public against the units of their fund and invest all these funds in listed equity shares. Thereafter, they calculate the NAV (Net Asset Value) of the fund units on a daily basis and may allow investors to exit or enter the fund at or around NAV. The fund may declare dividends periodically and even liquidate itself at a certain stage and pay off the investors on the basis of the final break-up value of the units. The expenses of this fund and the remuneration of the fund Manger are defrayed from the earnings of the fund. A mutual fund unit thus closely resembles an equity share in that it too does not guarantee any fixed returns to the investors or an assurance of return of any part of the initial investment.
In addition, it gives the investors the benefit of a diversified investment portfolio and the services of expert investment advice, in spite of a modest investment outlay. The downside for him from an Islamic point of view is that his investment goes into shares of a large number of companies engaged in different businesses and with varying types of financials, over the selection of which he has no control, except to the

extent the offer document of the fund defines the investment policy of the fund.
Thus, though the investor can normally ensure (by selection of the right fund) that his money is invested only or overwhelming in equities, he cannot be certain that all the companies in which his money goes are in permitted businesses or have financial structures which are Shariah compliant (M. H. KHATKHATAYand SHARIQ NISAR 2007)

The advantages of fund management for Islamic equity investments:

Muslims like any other investors can of course purchase equities directly and build up their own investment portfolios rather than investing indirectly through fund management groups and incurring management charges. The search costs are however higher for Muslim direct equity investors if they want to satisfy themselves that the companies they are investing in are acceptable from the point of view of the *shariah* law. Screening requires a considerable amount of information which can only be ascertained by scrutinising the company's annual reports and accounts, perhaps over a period of several years to discern trends, and discover the extent to which the company has kept to its stated intentions. Skills are also needed to know what figures to use to calculate ratios which are important from an Islamic perspective, notably leverage, the ratio of debt to equity.(Rodney Wilson,2004)
Those with large amounts to invest can of course engage their own personal independent financial consultants, accountants, and even *shariah* advisors, but the problems of interpreting and co-ordinating potentially conflicting advice are far from easy. Islamic banks are not geared up to providing such an integrated portfolio management service for their more wealthy clients, the favoured alternative being to suggest that the client opens a specified investment account in which the depositor shares in profits of the businesses using his funds rather than the banks profits, as is usually the case with investment accounts. Specified investment accounts approximate closely to a one way multiple *mudarabah* with the bank charging a management fee as intermediary and the client having a direct (one way) relationship with the companies (hence multiple *mudarabah*) being financed.[1] This is not a substitute for an equity portfolio however, as the specified investment is for a fixed time period, and returns are based on profit sharing, not capital gains.

[1] The Jordan Islamic Bank pioneered specified investment accounts from the early 1980s.

If there were specialist firms of stockbrokers providing dedicated Islamic portfolio management services on behalf of Muslim investors this would be an acceptable alternative to the use of fund management services, but such services have yet to emerge although Islamic investment groups such as Al Rajhi and Al Baraka offer partial services of this type. They are not however stock broking companies or equity specialists.

For most Muslim investors the most sensible route into equity markets is through fund management groups that offer Islamic services. There are four basic advantages for the Muslim investor from using such services:

1. A broader portfolio diversification which can reduce risk for a given return or increase return for a given risk
2. The ability to participate in new risks, including unquoted companies whose shares are not available on the open market.
3. Professional portfolio management by fund managers who are usually better informed and qualified to make investment decisions than individual investors
4. Smaller transactions costs as the fund manager can buy and sell stock in large amounts.

Islamic instruments:

There is a broad range of Islamic assets and instruments. While the major categories of Islamic assets and financial instruments are conceptually simple, they may become complicated in practice when issuers of such instruments combine aspects of two or more types of instruments.

This impacts how the securities are set up in the fund administrator's accounting system and how the instruments should be accounted for.

Islamic instruments should be set up as distinct assets. As the profit accruals are different from other asset types, new accrual classifications also have to be created. The general ledger reports should be adapted to reflect the profits and losses from Islamic instruments such as sukuk, murabaha and wakala. All mentions in relation to "interest" should be removed and replaced by "profit" or "loss". The accounting treatment of Islamic products should be disclosed in the fund's prospectus.

The trade capture process may or may not be fully automated, depending on the instrument type. Generally, when an instrument such as sukuk are custodised, then the transaction is handled in a straight-through process in the same manner as a conventional bond.

Principles and practices of Islamic equity investment:

Before examining the specific criteria used in screening, it is important to be aware of the key principles guiding Islamic equity investment.
The fundamental characteristic of *The Islamic Capital Market* (ICM) is the *Shari'ah* compliant which is commonly branded as *halal*. One of the *halal* options in Islamic finance is the offering by *Shari'ah* equity finances, which helps investors to invest in *Shari'ah* compliant securities.
Islamic law is concerned with the moral or ethical value of commercial transactions. Basically the Muslims are governed by the rules and regulations in respect of *halal* (permissible) and *haram* (prohibited). For example *Shari'ah* prohibits earnings income derived from commercial transaction with elements of interest, production and sale of alcoholic substances, gambling, hoarding and deceptive purchases. However the Muslims are encouraged to participate in commercial transaction in respect of those which *Shari'ah* rules as *halal. (*Salahuddin Ahmed, 2009).
So companies will be classified as *Shariah* non-compliant securities if they are involved in the following core activities:

(a) Financial services based on *riba'* (interest)

(b) Gambling and gaming;

(c) Manufacture or sale of non-*halal* products or related product

(d) Conventional insurance; because the primary factor of conventional insurance is *gharar* (uncertainty) which is prohibited in Islam.

(e) Entertainment activities that are non-permissible according to *Shari'ah*;

(f) Manufacture or sale of tobacco-based products or related products;

(g) Stock broking or share trading in *Shari'ah* non-compliant securities; and

(h) Other activities deemed non-permissible according to Shari'ah.

Clearly there are potential conflicts of interest and moral hazard problems involved in Islamic equity investment that highlight the need for transparency and proper monitoring and regulation of the industry.

There will always be risk and uncertainty with equity investment, but managers of Islamic funds have a moral as well as a legal obligation to ensure that the investor has clear information about how the investments are being deployed. (Rodney Wilson,2004)

Islamic equity fund managers have less autonomy than conventional fund managers, as they are usually accountable to a *shariah* committee or *shariah* advisor who rules on the screening criteria for stock selection and how this is to be interpreted under changing market conditions and company circumstances. In practice not all funds have their own *shariah* committee, but rather rely on the screening criteria adopted by the international institutions such as the Dow Jones Islamic Indexes, and approved by the Dow Jones *shariah* board, although this should not be seen as a substitute for local *shariah* monitoring.

To facilitate the investment decision for Islamic fund managers, many index providers have launched Shariah compliant versions of their indexes (e.g. Nasdaq, MSCI, Dow Jones, FTSE, S&P…). This has been achieved by implementing a technology, which automatically removes from the conventional index all companies that fail to comply with business activity and financial screenings. It is worth noting that the screening criteria can be different depending on the index. Therefore, depending on the Shariah compliance sensitivity of their investors, Islamic funds might decide to invest in one Islamic index instead of another.

Sharia* Screening Criteria for Islamic Investment*:

As mentioned earlier, different Islamic banks, investment companies and equity funds have their own norms for assessing Shariah compliance of companies in which they consider investing. Most such organizations do not publicize the norms they use for selection or screening of the companies *(M. H. Khatkhatay* and *Shariq Nisar*.) Organizations such as Islamic Development Bank, the Association of Islamic Banks, AAOIFI and the *Fiqh* Academy of the OIC also have not laid down any definite criteria in this regard.
On the other hand, information is available on the screening criteria used by Dow Jones for inclusion and tracking of equities (listed at various stock exchanges) in its Islamic equity indices. Similarly, the screening criteria used by the Securities and Exchange Commission, Malaysia are also available as is the criteria used by Meezan, Pakistan. (Ali, Salman

Syed 2005) Unfortunately, the rationale for adopting a particular norm by each of them is not known**.**

There are two categories of *Sharia* screening criteria, qualitative sector screening and quantitative financial screening.
These two *Sharia* screening criteria must be met in order for a company to be eligible for Muslim investors. There is a general consensus among Muslim scholars about these two *Sharia* screening categories in the broad sense that the business does not deal with *riba* and *gharar* and also the business activities are permissible from a *Sharia* perspective**.**

Qualitative *Sector Screening Criteria:*

According to Islamic principles, companies must not produce or sell *Sharia* impermissible products or services such as tobacco, alcohol, pornography, weaponproductions, casino, pork related products etc.40 Furthermore, conventional banks and conventional insurance companies are not *Sharia* compliant since their core business based on *riba* and *gharar* respectively (Obaidullah, 2005). Thus, conventional finance sectors as well as *Sharia* unethical businesses have to be excluded from Islamic investment portfolios. Once a company passes the sector screening criteria and its core business is *Sharia* permissible, it can be considered as a *Sharia* compliant company if it passes the financial screening criteria. According to Derigs and Marzban, (2008) *Sharia* sector screening excludes around 23% of the conventional S&P 500 investment universe for their *Sharia* violation.

Quantitative Financial Screening Criteria:

Unlike conventional and socially responsible investment (SRI) portfolios, Islamic investment portfolios have to comply with certain financial screening criteria (Ghoul and Karam, 2007). The purpose of the financial screening criteria is to exclude companies with unacceptable levels of conventional debt, liquidity, interest-based investment and/or impure income. Ideally, according to Islamic principles, companies must not borrow with an interest rate, nor invest in conventional debt-bearing instruments, as well as not generating income through any other *Sharia* impermissible activities. However, such restrictions would screen out the vast majority -if not all- of the stocks that are available on the market, even those listed in Islamic countries (Wilson, 2004). This is because contemporary companies tend to have exposure to interest-based finance '*riba*' for managing their working capital, as well as for

financing the acquisition of fixed assets for expansion and diversification purposes (Khatkhatay and Nisar, 2006 and Derigs and Marzban, 2008).
Some Islamic scholars, therefore, demonstrate their understanding by tolerating some financial ratios screening, if the nature of the business is *Sharia* permissible and the exposure to *riba* and other impermissible activities is not excessive. They argue that the judgment should be based on the majority, since the majority deserves to be treated as the whole of a thing (AAOIFI, 2004). Also, the tolerance and relaxation of the Islamic norms aims to remove the hardship, acknowledging the general need for and widespread practice of interest-based activities, and that does not necessarily mean the acceptance of *riba* or other *Sharia* impermissible activities (AAOIFI, 2004).
In other words, the reason for such relaxation is that an individual Muslim investor has no control over the whole business practices of companies that are managed in a non-Islamic manner, it also deals with the fact that fully *Sharia* compliant companies are rare (Khatkhatay and Nisar, 2006 and Derigs and Marzban, 2008).
According to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI), in order for a company to be eligible for Muslim investors there are certain financial screening ratios must be met if the nature of the business is *Sharia* permissible. For the determination of these percentages recourse is to be had to the last budget or verified financial position. These are as follow;
1) Interest based debt: Collective amount raised as loan on interest whether long term or short term debt does not exceed 30% of the market capitalization of the corporation.
2) Interest based deposit: The total amount of interest taking deposits whether short, medium or long term shall not exceed 30% of the market capitalization of total equity.
3) Earning from impermissible activities: The amount of income generated from prohibited component does not exceed 5% of the total income of the corporation irrespective of the income being generated by undertaking a prohibited activity, byownership of a prohibited assets or in some other way.
4) Tangible assets and benefits: The total market value of assets, benefits and rightsshould not be less than 30% of the total asset value of the corporation, including all assets, benefits, rights and cash liquidity. This is irrespective to the size of debtassociated with the company (the corporation's debts, current accounts with others,and bonds it holds which constitute debts), as these are secondary in such cases.

Also, AAOIFI indicates that it is not permissible to undertake trading in the shares of a corporation when the assets of the corporation are cash exclusively or if the entire
assets of the corporation are composed of debts, unless the rules for *sarf* and dealing with debts are observed.

Widening the remit for *shariah* screening:

Developing sound and acceptable screens is crucial for both Islamic and ethical finance. It reduces the workload of the *shariah* board, as once the criteria are agreed, fund managers can simply apply the rules and exclude *haram* stock. Many institutions offer a wide range of Islamic equity funds as clients have different time horizons and risk preferences, and it would be impossible for *shariah* board members to advise on every single stock purchase by fund managers. The availability of standardised screens can therefore facilitate the development of the industry. For example the National Commercial Bank of Saudi Arabia could introduce new products such as the Islamic Equity Builder Certificates without increasing the workload on their *shariah* advisors, as fund managers simply apply the screening software supplied by the Dow Jones Islamic Indexes.

Satisfying the *shariah* advisors regarding screening is a necessary but not a sufficient condition for the success of Islamic equity funds. Having a *shariah* committee composed of eminent and respected scholars is a source of comfort for most clients, and is a major factor in ensuring a sound reputation for the fund. However knowledgeable clients in the future may want direct assurance of *shariah* compliance rather than indirect assurance through the *shariah* committee as intermediaries. As with ethical funds clients may wish to make their own judgements in the light of full information on the screens, and an explanation of why they are relevant to *shariah* compliance. This will not necessarily reduce the role of the *shariah* advisors, but rather they may become more communicators and educators as well informed clients ask ever more questions about the rationale for investing according to conscience and not simply on the basis of financial returns. (Rodney Wilson,2004)

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