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Harmonizing screening methodologies of index institutions for Shariah compliant stocks

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Abstract

The purpose of this study is to uncover an acceptable screening method used by the index institutions to reduce the gaps of Shariah-compliant status of a stock. The initial concepts are based on academic literature and followed by interview sessions of nine key experts recognized in the field of Shariah-compliant stocks as respondents. The results of this study have yielded some notable findings. Fund managers who are aware that the investors who appoint them are very much in favour of Shariah-compliant securities will certainly use methods that suit their investors' appetite. In fact, Shariah advisers have also concurred that the differences between the global index institution's screening methods are not significant and the differences found are not related to Shariah requirements. Studies on the methodology of such Shariah-compliant stocks screenings are important and have a great impact in ensuring the continued viability of Islamic financial developments so that they are not frustrated by the issue of non-uniformity of Shariah-compliant stock screening methods. In Malaysia, the stock screening method is performed by the Shariah Advisory Council of the Securities Commission of Malaysia (SACSC), while in the global market there are several index institutions such as the Dow Jones Islamic Indexes (DJII), FTSE Shariah Global Equity

Index Series (FTSE) and MSCI Islamic Index Series (MSCI), which also have their own Shariah-compliant stock screening method.

Keywords: Harmonizing Screening, Index Institutions, Syariah Compliant Stock

Armonización de las metodologías de selección de las instituciones indexadas para acciones que cumplen con la Shariah

Resumen

El propósito de este estudio es descubrir un método de detección aceptable utilizado por las instituciones de índice para reducir las brechas del estado de una población que cumple con la Shariah. Los conceptos iniciales están basados en literatura académica y seguidos por sesiones de entrevista de nueve expertos clave reconocidos en el campo de las poblaciones que cumplen con la Shariah como encuestados. Los resultados de este estudio han arrojado algunos hallazgos notables. Los gestores de fondos que son conscientes de que los inversores que los designan están muy a favor de los valores que cumplen con la Shariah, ciertamente utilizarán métodos que se adapten al apetito de sus inversores. De hecho, los asesores de la Shariah también han coincidido en que las diferencias entre los métodos de evaluación de la institución índice global no son significativas y las diferencias encontradas no están relacionadas con los requisitos de la Shariah. Los estudios sobre la metodología de tales evaluaciones de acciones que cumplen con la Shariah son importantes y tienen un gran impacto para garantizar la viabilidad continua de los desarrollos financieros islámicos para que no se vean frustrados por el problema de la falta de uniformidad de los métodos de detección de acciones que cumplen con la Shariah. En Malasia, el método de selección de acciones lo lleva a cabo el Consejo Asesor de Shariah de la Comisión de Valores de Malasia (SACSC), mientras que en el mercado global hay varias instituciones indexadas como Dow Jones Islamic Indexes

(DJII), FTSE Shariah Global Equity Index. Series (FTSE) y MSCI Islamic Index Series (MSCI), que también tienen su propio método de selección de stock que cumple con la Shariah.

Palabras clave: Cribado de armonización, Instituciones indexadas, Stock compatible con Syariah

1. INTRODUCTION

Stock screening to determine Shariah compliance is now one of the important agendas in the stream of Islamic financial development especially for fund managers (Aaoifi, 2015). Fund managers refer to investment managers appointed to meet the needs of financial industry players such as asset management companies, investors, and fund management companies (Chen et al., 1992). The players are also including institutions in the like of financial institutions and government investment bodies in expanding their investment portfolios especially in Shariah-compliant fund investment portfolios.

According to Derigs & Marzban (2008), Shariah-compliant stocks are now becoming favourite types of assets of many Middle Eastern hardcore investors especially after the Black Tragedy, September 11. This was accompanied by sentiment following Donald Trump's victory as the new 45th President of the United States (nbcnews.com, 2017). Boon Ka (2017) wrote that the scandal associated with the financial crisis of 2007/2008 has also shrunk investors' confidence in the existing conventional financial system. As such, the flow of funds from the West to the East as an alternative to

investment has encouraged the innovation of new investment product structures such as unit trusts, investment mandates, real estate investment trusts (REITs) and many other fund-centric fund investment structures (Umer, 2008). As a result, there has been a sharp increase in demand for Shariah-compliant funds especially from Western investors. For example, in England, the London Stock Exchange has successfully published 49 Shariah-compliant fund issues such as sukuk and the Exchange Traded Fund. Following the Brexit decision, Indonesia and Malaysia have led Britain in providing Shariah-compliant funds despite being marketed in the Luxembourg and Ireland markets (Abu Bakar, 2009). This is because the demand for Shariah-compliant funds has rose dramatically so that any Shariah-compliant funds issued will be attractive to investors in the Luxembourg and Ireland markets.

The outcome of the quest for these Shariah-compliant stocks and the high-level confidence of foreign investors in Shariah-compliant funds have spurred the expansion of capital market activities in Asia including Malaysia. According to FSTE (2014) the global commodity trading platform Souq Al-Sila' (BSAS) Murabahah platform saw daily Average Trade Value (ADV) increase by 24.4 per cent to RM24.3 billion from RM19.6 billion in 2017. Despite the volume of trade higher, trade revenues shrunk 5.6 per cent to RM14.9 million from RM15.8 million over the same period as more trade was executed and qualified for the volume-based incentive scheme. The platform holds great potential in view of the growing interest in Islamic stocks as it leverages on the various instruments available on

the Bursa Malaysia ACE Main Market and Markets (El-Gamal, 2006). According to the report, by the end of 2018, RM1.1 trillion or 62.1 percent of the total market capitalization, and 76.4 percent, or 689 of the 902 companies, listed in both markets were Shariah-compliant (Derigs & Marzban, 2009).

The number of Shariah-compliant trading accounts increased in 2018. In December 2018, 18,130 Shariah-compliant trading accounts opened with a 21.3 percent increase over the previous year, which saw 14,944 new accounts opened. In 2018, Bursa received banks from Iraq, Bahrain, Tanzania, Kenya, Dubai and Ajman in the UAE as a new member of the BSAS platform. In total, 32 new members were accepted in 2018, making BSAS members accounted to 173 in 2018 from 141 in 2017. In addition, the Shariah-compliant platform of Bursa Malaysia-i saw a rapid growth of transactions especially the trade from Brunei, Singapore, Indonesia, Cambodia and Myanmar. These developments indicate a growing interest in responsible and sustainable investment in Shariah-compliant markets.

Table 1 shows the fund management statistics as of March 31, 2017, quoted from the Securities Commission (SC) website. From Table 1 it can be seen that the total foreign investment in Shariah-compliant fund-class assets is 23.97 per cent (36.80B / 153.53B) compared with 19.75 per cent (144.93B / 733.88B) of investment in total class asset assets. This shows that the demand by foreign investors was very encouraging for Shariah-compliant funds.

Table 1: Statistics for Fund Management Industry as at 31 March 2017

Asset Classes (in RM billion)	Overall (including Shariah)			Shariah		
	Inside Malaysi a	Outside Malaysi a	Total	Inside Malaysi a	Outside Malaysi a	Total
Equities	278.40	85.27	363.67	40.64	22.05	62.69
Fixed income securities	119.17	28.59	147.76	22.10	11.30	33.40
Money market placemen t	161.61	0.89	162.50	48.07	-	48.07
Unit trust funds	10.72	11.72	22.44	0.95	0.40	1.35
Private equities / Unquote d stocks	4.52	8.82	13.34	0.03	0.15	0.18
Others *	14.53	9.64	24.17	4.94	2.90	7.84
Total	588.95	144.93	733.88	116.73	36.80	153.53

Sources : Securities Commission of Malaysia

* Others consist of other asset classes such as wholesale funds, REITs, ETFs, closed-end funds, derivatives, business trust, payables, receivables, accruals and uninvested cash.

Consequently, with the growth shown in Table 1, it has become an important national agenda to ensure that this unprecedented growth and demand increase should be maintained without any surfacing Shariah issues related to the Shariah-compliant stock screening status. It is appropriate that a study to be conducted in providing suggestions on resolving Shariah issues as the question of Shariah-compliant status inconsistency was always asked by the fund managers due to the different screening methods. This is because if there is a discrepancy in the Shariah-compliant status of a stock, it will create a negative impact on method of Shariah decision making and make it difficult for fund managers to select the stocks they want to buy for their investors' investment purposes.

This research is an attempt to study and find out the most appropriate methods of stock screening to be reliably used by all index institutions in determining their Shariah status of a stock. This is because any inconsistency in status of a stock, it will trigger a negative perception on the execution of the stock screening process of the Shariah adviser of an index provider. This reputational risk may further influence the interest of the fund manager to trade Shariah compliant stocks in the market. In this study, differences in Shariah interpretation among Shariah advisers of the index institutions, to determine the Shariah-compliant stock screening were found to be the

determining factor of on different results of the compliance status of a stock. Nevertheless, the study has also shown there are many other contributing factors to the differences including the manner and purpose of the Shariah-compliant stock screening method that had been conducted by respective authorities as depicted in this paper.

Objectively, the study aims to find rationalisations to issues that could strip off the efforts to motivate the growth of Shariah-compliant funds worldwide, focusing on the method used by respective index institutions including the one executed by the Shariah Advisory Council of the Securities Commission of Malaysia (SACSC). It includes analysing the quantitative calculations and qualitative methods used by index institutions, concentrating on issues related to the inconsistency of the Shariah compliance status of a stock between global index institutions and the SACSC. This is a critical factor that may have a huge impact to the Shariah compliant stock trading transactions in the international capital market.

2. METHODOLOGY

This study is a qualitative study using the basic interpretation approach of qualitative research. The main respondents of the study include three Shariah qualified individuals appointed by the index institutions in the market, two individuals from authority body, two industry individual players and two individual investors. Researchers have obtained three Shariah individuals who are responsible in

establishing and executing Shariah-compliant stock screening methods (Denzin & Lincoln,2005). The methods of interview used were via face-to-face interviews and video calls. All the answers given to the research questions and correspondences with the respondents have been recorded and kept in original and edited version. All important information from the interview process will be handled in accordance with standard qualitative methodology before data evaluation took place to conclude the result for discussion (Creswell, 2007).

3. RESULT AND DISCUSSION

Researchers have established four themes in analysing the views and findings of the study. Subsequent comparisons were made with the information and factual data obtained through the library study and from the field study. These processes are important to ensure the validity and reliability of the findings from the study (Arip et al., 2012).

There were three patterns of the reaction and three conclusions concluded from the respondents' interviews. The three reaction patterns comprises, first, the Shariah-compliant stock screening methods used by the SC, DJII, FTSE and MSCI are consistent with each other, both qualitatively and quantitatively; second, the differences in the Shariah-compliant stock screening methods used by the SC, DJII, FTSE and MSCI, are insignificant and all of these methods have been approved by their appointed Shariah advisers; and

the third is that the total standardization of the screening method is impossible but the harmonization of the screening method is more appropriate in handling the issue of differences of opinions between Shariah opinions. In achieving harmonization of the stock screening methodology, it has been suggested that the AAOIFI standard which has been commonly accepted by all the respondents, is the most appropriate standard to be referred to by all Shariah advisers of index institutions, if the aim of standardization of the Shariah-compliant stock screening method is to be attained in the long run.

The three conclusions from the interviews are, first, all the Shariah-compliant stock screening method used by SC, DJII, FTSE and MSCI, are Shariah-compliant and acceptable by most of the industry players; second, the differences in the Shariah-compliant stock screening methods have nothing to do with the Shariah issues. These methods are different from only from the asset classes required by industry players in meeting with the needs of their customers (investors); and third, the industry can continue to do business as usual, even without the standardization of Shariah-compliant stock screening methods. Having a universal stock screening method is preferable, but it is not an urgent need by the players of the industry. The harmonization of the Shariah-compliant stock screening method was suggested and most of the respondents agreed that it requires a tolerant attitude toward Shariah interpretations by Shariah advisers of the index institutions in coming up with Shariah-compliant stock status decisions.

Interestingly, there are six parallel discoveries from the interviews conducted with respondents which, may contribute to the body of knowledge. Among the matters that need further research are:

i. Exploring the qat'i and zanni factors in Shariah interpretations as suggested by Wee (2012).

ii. Using AAOIFI standard in drafting the Shariah-compliant stock screening methodology, where all respondents cited that AAOIFI standards as the only Shariah-compliant standard, although the standard is not made mandatory for some countries.

iii. Analysing the use of financial ratio denominators such as total assets, average market cap and market equity values in the Shariah-compliant stock screening method to identify and develop new product structures and new types of Shariah-compliant stocks portfolios.

iv. Having universal Shariah-compliant stock screening method as the method adopted by the SC now has been practised by AAOIFI in the case of applying debt ratio and cash ratio.

v. Exploring the possibility of having the stock screening method executed in monthly basis instead of conducting it on quarterly or half-yearly basis.

vi. Creating robo-screening method (via artificial intelligent) which can even certify the stock of a company is Shariah compliant at all time.

4. LIMITATIONS

This study begins with a methodological study adopted by the SACSC and a thorough study of each process flow applied in stock screening. The focus is only on the companies' stocks listed in Bursa Malaysia. Further, the study takes a step forward focusing on DJII, FTSE and MSCI to probe into details of the methods and benchmarks applied by their Shariah committees in the screening process of stocks of companies listed in foreign exchanges including stocks listed in Bursa Malaysia.

The information and reference materials on Shariah-compliant stock screening methods are also limited, and among the factors limiting this study are unavailability of the latest reports of methodologies, as well as updates from DJII, FTSE and MSCI are rarely published on social media or their websites. What available in the market are reports of investment strategies and some news on the profit and loss of stocks listed in international exchanges. Therefore, qualitative studies using field-based surveys with the respondents were used as a strategy to obtain up-to-date information on the latest changes and methods used by DJII, FTSE and MSCI.

5. CONCLUSION

Stock screening in determining Shariah compliance status is an important agenda in the Islamic financial development especially for

international fund managers to meet the needs of financial industry players including investment fund companies and financial institutions. It is important to meet all relevant parties' requirements in developing a Shariah-compliant investment portfolio for maximum halal returns to the investors who are hungry for Shariah compliant stocks. The results show that there are differences in the Shariah-compliant stock screening methods applied by SC, DJII, FTSE and MSCI. However, there are more similarities in the screening methods particularly in terms of the use of sectoral filters and financial ratios. The difference between Shariah-compliant screening methods between them is simply a matter of Shariah definition on some interpretation issues from one country to another as well as matters relating to the calculation of financial ratios accepted by their Shariah advisers.

In addition, it is not accurate to conclude that the inconsistency of the Shariah-compliant stock screening methodology would be detrimental to the development of Islamic stock capital markets. This is because the results of this study proved that investors and industry players are taking position to 'wait and see', as they are confidence in saying that they can survive in the current state of their Shariah-compliant stock screening methods, despite the fact that they are looking forward to have a standard Shariah-compliant stock screening method.

As for now, industry players and investors have been successful in adapting their Shariah-compliant stock options based on the requirements of the Shariah-compliant stock screening methodology. They so far can satisfy the demand and risk appetite of their customers

in terms of the choice of investment portfolios. They have shown that they have no problem adhering to any Shariah-compliant stock screening method, if their investment objectives are met by meeting their customers' needs in terms of Shariah compliance and profitability.

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