# DISPUTES AND RESEMBLANCE: COMPARATIVE ANALYSIS OF SHARIAH ADVISORY COMMITTEE METHODOLOGY AND INTERNATIONAL INDICES

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## ABSTRACT

*In line with Malaysian Capital Market Masterplan 2 to expand the Islamic capital, Malaysian Shariah Advisory Council (SAC) has revised the Shariah screening process for listed companies in late 2013. The screening methodology was revised by adopting a two-tier approach to the quantitative assessment which applies business activity benchmarks and newly-introduced financial ratio benchmarks while maintaining the qualitative assessment at the same time. This revision is parallel with the international screening providers (such as Dow-Jones Islamic World Market, Morgan-Stanly Compliance Islamic Index, London Stock Exchange (FTSE) Shariah Index, and Standard and Poor Shariah Index) methodology to identify Shariah-compliant investment for Muslims investors. Despite the similarity between the latest SAC 2013 Shariah screening methodology and the International Indices, various discussions on these screening methodology implications and detail filters are still being debated. The questions on which indices best follow the Shariah rules and are too liberal have yet to be discovered. Thus, there could be a need to provide clearer understanding with a more uniform Shariah investment screening methodology to convince investors with international portfolios. Any disputes or resemblance among these international indices and SAC are highlighted in this paper.*

**Keywords**: *Shariah-compliant, screening indices, mixed activities, securities*

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## INTRODUCTION

The modern day interdependence and linkages of business transactions, has provided a more complicated task for shariah scholars and regulatory bodies to assist investors in identifying Shariah-compliant securities. Hence, it is almost impossible to find a company that fully complies with principles of the Shariah (Adil, Ho, Isa, Yaakub & Khalid, 2013). However globally, screening providers has developed a methodology which implies a degree of tolerance that would allow Muslim investors to invest in companies with mixed activities, provided the Shariah non-compliant contribution to profit does not exceed a certain acceptable percentage.

Due to the different measures used by each of the international indices, this study will highlight similarity as well as difference in screening indices used for the Shariah Compliant Firms (SCF) between Malaysian revised shariah screening methodology (SAC of SC 2013) in comparison to the International Indices, Dow-Jones Islamic World Market (DJIM), Morgan-Stanly Compliance Islamic Index (MSCI), FTSE Shariah Index (FTSE), and Standard and Poor Shariah Index (S&P).

## LITERATURE REVIEW

Islamic finance is becoming the fastest growing segment of the global financial system by experiencing an impressive double-digit growth in current history. Persuasively, this has promoted a rapidly rising affluent and well-educated middle class Muslims from the Islamic world and Western countries, matching finance with faith and fueling demand for Islamic investments (Rahman, 2015). According to the Securities Commission Malaysia (2015), Muslims population, which represents nearly 20% of the world's population, has instill an increasing demand for Shariah-Compliant investment products as it provides stability and lower risk which attracted more listed companies to claim for Shariah-Compliant status through the screening process.

Under Shariah principles, Shariah-compliant securities have always been associated with not only halal or lawful practices, but also related to good image in the physical context, such as in quality, safety, environmental friendly, and process efficiency of the company who issues the stock (Mcgowan & Muhammad, 2010). Nowadays Muslim investors are sensitive to Islamic investment guidelines, therefore examining and updating whether the company undertakes its activities according to Shariah principles or not is essential for helping Muslim investors to identify Shariah-compliant companies for making their investment decisions (Mohd Sanusi, Ismail, Hudayati & Harjito, 2015). Therefore, it is necessary to have a proper Shariah screening process in the financial market which enables investors to invest in companies that operate permissible business activities in Islam. This Shariah screening process will detect prohibited activities and guide investors for a halal investment.

In Malaysia, there are two separate SACs; one is under the purview of the SC, which is tasked to oversee the Shariah-compliance of Islamic financial products offered in the capital market, while the other is governed under Bank Negara Malaysia (BNM). The roles of the SAC of SC are to screen or review the companies or stocks in order to ensure fulfillment of shariah requirements for listing shares on the shariah-compliant board. Shariah screening methodology was formulated by SAC of SC to assist investors in identifying Shariah-compliant securities. This is to ensure that their investments are in accordance with Shariah principles, which prohibit the elements of riba, maysir and gharar (Yazi, Morni & Imm, 2015). SAC of the SC is tasked to provide with the Shariah-compliant list twice a year, i.e. every May and November.

Malaysia was the first Muslim country with a conventional stock market to have come up with a formal evaluation for Shariah compliant stocks and a Shariah stock index. Between 1996 and 1997, SAC of SC developed the screening criteria and in June 1997, the SC introduced the official list of Shariah-compliant stocks or securities listed in Bursa Malaysia (Najib, Hamid, Nasarudin & Saiti, 2014). Following this in 1999, Dow Jones, the U.S.-based publisher of Wall street Journal and financial information provider, designed the Dow-Jones Islamic World Market (DJIM), a global index of Shariah-compliant stocks (Sadeghi, 2014; Najib, Hamid, Nasarudin & Saiti, 2014). The DJIM index constituents are screened from around the globe and are mostly located in non-Muslim countries. In addition to Dow Jones, other conventional index providers such as FTSE and S&P have also launched their Islamic indexes in recent years. However, in contrast to Dow Jones, they do not have their own independent Shariah Supervisory Board (SSB) to screen the shares.

Similar to SAC, SSB selects Shariah-compliant companies according to qualitative and quantitative procedures (Saidi, 2007; Sadeghi, 2014). The qualitative criteria are used to assure that companies are not involved in activities such as financial services based on riba (usury), gharar (conventional insurance), maisir (gambling), or the production or trade of non-halal (prohibited) goods such as alcohol and pork. While quantitative parameters are mainly used to determine the level of contribution from halal and non-halal elements towards revenue and profit of a company, El-Gamal (2006) emphasised that these screening indices can be best described as *"avoiding explicit and major violations of legal prohibition"*. There are similarities between these indices to that of social indices in terms of screening, with the supervisory boards providing advice on eligibility of companies. The only main difference between them is that it focuses on religious matter for Islamic indices and compliance is guaranteed by the Shariah boards.

The process of Syariah compliant screening not only differs by its jurisdictions but also by its different objectives of parties, such as portfolio managers, providers of market intelligence and regulators (Ho, Masood, Abdul Rehman & Bellalah, 2012). Some researchers claimed that too much diversity adds cost and requires a larger number of screening processes and in the long run could hamper Islamic finance growth (Derigs & Marzban, 2008). There is therefore a need for Islamic scholars to standardiae their screening methodologies effectively in international market.

## SAC of SC Revised (2013) and International Indices

Before the revision, Malaysia's SAC allows the inclusion of non-halal business as long as the contribution to earnings and profit before tax is no larger than 5 percent and also does not evaluate a firm's balance sheet. As such, the Malaysian criteria was described as more liberal than other international indices (Khatkhatay & Nisar, 2006; Pok, 2012; Adil, Ho, Yaakub, Khalid, 2013). Hence in 2013, SAC of SC has revised the screening methodology by adopting a two-tier quantitative approach, which applies the business activity benchmarks and newly introduced financial ratio benchmarks.

The new methodology has resulted in a significant removal of 158 non-Shariah compliant stocks, and the inclusion of 18 new Shariah compliant stocks from the previous list, making only 653 stocks (72 percent) to be Shariah compliant out of a total of 914 stocks listed on Bursa Malaysia. Malaysian fund managers are given a six month grace period from November 2013 to align their portfolios to the new stock selection and considering a substantial number of stocks that were declared as non-Shariah compliant, a substantial number of stocks will be affected by the announcement (Yazi, Morni & Imm, 2015).

**Table 1: Comparison of the Previous and Revised (2013) Screening Methodology of Malaysian SAC**

| | Previous | Revised | Activity |
|---|---|---|---|
| Business Activity Benchmark | 5% | 5% | Conventional banking; Conventional insurance; Gambling; Liquor and liquor-related activities; Pork and pork-related activities; Non-halal food and beverages; Shariah non- compliant entertainment; and other activities deemed non- compliant according to Shariah. |
| | 10% | | Interest income from conventional accounts and instruments; Tobacco and tobacco-related activities; and other activities deemed non-compliant according to Shariah. |
| | 20% | 20% | Rental received from Shariah non-compliant activities; and other activities deemed non-compliant according to Shariah |
| | 25% | | Hotel and resort operations; Share trading; Stock-broking business; and other activities deemed non-compliant according to Shariah. |
| Financial Ratio Benchmark | None | 33% | Non-compliant cash deposit over total assets Non-compliant debt over total assets |

Table 1 highlights that in terms of business activity benchmark, revised SAC stick to 5% leniency for both business activities related to conventional banking, insurance, non-halal food and beverages as well as interest income earned from conventional accounts and tobacco related activities. Comparing this to the previous SAC methodology the same 5% is allowed for business activities related to conventional banking, insurance, non-halal food and beverages while a more lenien 10% allowable was given to interest income earned from conventional accounts and tobacco related activities. Such leniency has drifted SAC methodology away from other international indices. Revised SAC methodology had identified that rental received from Shariah non-compliant activities as well as income earned from hotel and resort operations, share trading, stock-broking business, and other non-compliant Shariah business activities are allowed only for 20%. The previous SAC methodology was 5% more lenien in terms of income earned from hotel and resort operations, share trading, stock-broking business, and other non-compliant Shariah business activities. Too lenience on business activities has made SAC Shariah compliance methodolology differ from other international indices, thus a harmony Shariah compliance index is seemingly absurd.

The Comparison between Malaysia SAC of SC Revised (2013) Screening Methodology and Other International Indices.

**Table 2: Comparison of Screening Index between Five Indices**

| | DJIM | MSCI | FTSE | S&P | SAC Revised (2013) |
|---|---|---|---|---|---|
| Business Activity | Any involvement (exclude companies which have any involvement in impermissible activities) | Core business (tolerate minor violations, as long as the core business is permissible) | Core business (tolerate minor violations, as long as the core business is permissible) | Any involvement (exclude companies which have any involvement in impermissible activities) | Core business (tolerate minor violations, as long as the core business is permissible) |
| Liquidity Ratio | < 33% of:<br>Acc Rec/24Mth MA Market Cap<br>Cash + Int Bearing Sec / 24 Mth MA Market Cap. | < 33.33% of:<br>Total Cash + Account Receivable / Total Assets<br>Cash + Interest Bearing Sec. / Total Assets | <50% of:<br>Acc. Receivable + Cash / Total Asset<br><33% of:<br>Cash + Interest Bearing Sec. / Total Assets | <49% of:<br>Acc. Receivable / 36 Month MA Market Capital<br><33% of:<br>Cash + Interest Bearing Sec. / 36 Month MA Market Capital | < 33% of:<br>Cash and Cash Equivalent / Total Assets |
| Debt Ratio | < 33% of:<br>Total debt divided by trailing 24-month average market capitalization | < 33.33% of:<br>Total Debt / Total Assets | <33% of:<br>Total Debt / Total Assets | <33% of:<br>Total Debt / 36 Month MA Market Capital | < 33% of:<br>Total Debt / Total Assets |

S&P and DJIM use market average market capitalisation as a divisor for their financial ratios, while FTSE, MSCI and SAC Revised use total assets as a denominator. The fluctuation of stock market trends are suspected for the use of market average figure. The same pattern shown for qualitative test on business activities where S&P and DJIM both would strictly exclude companies which have any involvement in impermissible activities while FTSE, MSCI and SAC Revised have some degree of tolerancy with minor violations, as long as the core business is permissible. Its clear that S&P and DJIM are stricker as compared to FTSE, MSCI and SAC Revised.

SAC Revised had showed some extent of disputes and resemblance among other international indices. The closer the gap between SAC Revised with other indices reflected positive indicators as the harmonisation of Shariah compliance business is almost globally uniform. This study should be read with awareness that it is not about to portray which Shariah compliance practice index is the best, however it is just to highlight the difference and similarities among mentioned indices.

The implication in having non-uniform Syariah compliance index would much affect the result of compliance stocks if it is be tested with different screening indices, thus making a mess and noisy in portfolio diversifications in maintaining the compliance status for muslim investors. Furthermore, in order to mitigate the market risk, stock diversification is preferable among investors (Zakaria & Daud, 2013). Thus, stocks are distributed worldwide and different indices would be used to determine whether these stocks comply with shariah, depend upon the country of stock issuance.

## CONCLUSION

The efficiency in stock screening would precisely determine the future success the Islamic wealth management segment. Thus, there is a need to strike a balance in its role to regulate and develop the Islamic capital market. A strict screening standard would have the effect of reducing the universe of Islamic securities and this may curtail development and growth of the Islamic capital market.

On the other hand, too liberal screening processes may jeopardize the local market from the eyes of international Islamic investors. The move to use financial ratios in addition to the simplification of the current non-permissible income screen may be considered as the right combination to move forward. Shariah screening would result in only a subset of the entire market being available to Muslim investors, and this would put them at a disadvantage from an efficient portfolio if the dispute among indices is too huge as portfolio diversification matters in explaining the efficient entire portfolio, as explained in the seminal work of Fama and Miller (1972). It is hoped that a more uniform Shariah compliance screening index would emerged in future with a more universal method, thus reducing the Shariah compliance diversification stocks dilemma.

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