Fakulti
Pengurusan
dan Perniagaan

FBM INSIGHTS

UNIVERSITI TEKNOLOGI MARA CAWANGAN KEDAH

Volume 2 2020 e-ISSN 2716-599X

UiTM di hatiku

eISSN 2716-599X

SHARIAH SCREENING METHODOLOGY

Hamizah Hassan
hamiza013@uitm.edu.my
Banking Department, Universiti Teknologi MARA Cawangan Kedah

Nor Suhaira Jamil
suhairajamil@psis.edu.my
Commerce Department, Politeknik Sultan Idris Shah

INTRODUCTION

Shariah-compliant securities are among the earliest Islamic Capital Market products available in Malaysia and were initially introduced to meet the demands of domestic institutional and retail investors for Shariah-compliant investments. The Shariah Advisory Council (SAC) of the Securities Commission has developed a methodology for screening the Shariah status of securities listed on the stock exchange. The screening process for Shariah compliance, leads to the issuance of the Shariah-compliant list in May and November each year which provides certainty and clarity on the status of securities listed on the stock exchange and has encouraged greater investor participation in the Islamic equity market.

The existence of a Shariah screening process in the financial market enables investors to invest in companies that operate permissible business activities in accordance to fair Islamic principles. However, as the current business environment is dynamic and complex business process, it is implausible to eliminate all the impermissible activities from a company's core activities, hence, to find fully Shariah-compliant equities is extremely impossible. As such, the existence of Shariah screening process allows companies to operate business activities within the boundary of Shariah principles. From the Muslim investor's viewpoint, the introduction of Shariah screening process is essential to detect prohibited activities and avoid companies from embarking onto a non-Shariah compliant investment (Derigs & Marzban, 2008). Consequently, individual or fund manager in the equity investment market has to continuously monitor the market to make decision, whether to buy newly added stocks and sell those that have been removed each time the Shariah-compliant list is announced.

THE PRACTICE OF SHARIAH SCREENING

In Malaysia, SAC is a special body that deals with Shariah-compliant issues. SAC produces a Shariah-compliant list and the list is updated twice a year. The Shariah screening methodology developed by the SAC provides both quantitative and qualitative assessments to determine the Shariah status of listed stocks. The SAC has also established specific benchmarks to determine the tolerable level of mixed contributions from permissible and non-permissible activities. Furthermore, the qualitative assessment focuses on public perception and the image of the companies to the Muslim community and the country. In line with the global competitive markets and to foster the robustness of screening procedures, the SAC has revised its screening methodology effective on November 2013, by introducing the financial ratio benchmarks in addition to the existing business activity benchmarks. The summary of the financial ratio benchmarks is shown in figure 1.0 below. Meanwhile, the business activity benchmarks which have been developed since 1995 that consisted of 5%, 10%, 20% and 25% benchmarks have been reduced to only 5% and 20% benchmarks in the revised screening methodology.

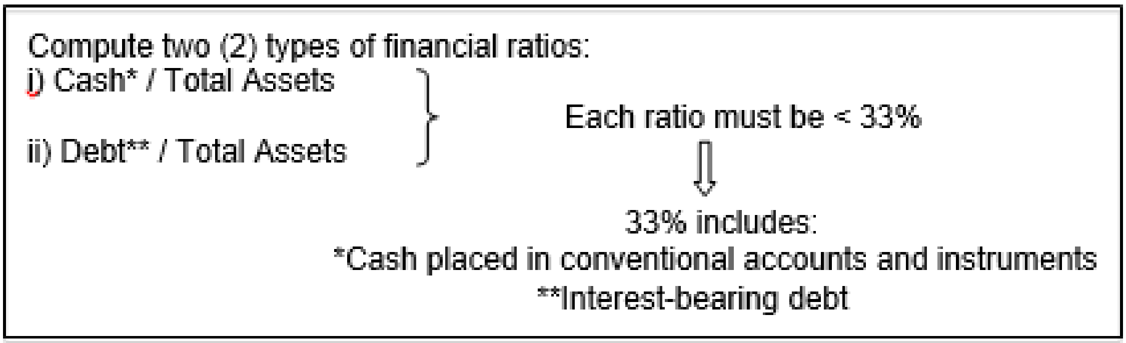

Figure 1.0. New quantitative assessment introduced in revised Shariah screening methodology Source: Jamil, Hassan and Bujang (2020)

Major Islamic indices, namely Dow-Jones Islamic World Market (DJIM), Morgan-Stanly Compliance Islamic Index (MSCI) and Standard and Poor (S&P) Shariah Index have developed their own screening methodology, which differs from each other (Wee, 2012). According to Abdul Rahman, Yahya and Mohd Nasir (2010), SAC and other indices have adopted a similar view on the core activities of a company that do not contravene the Shariah, as the general principle in determining whether the company could or could not be included in the index. However, each index uses different additional criteria in determining a permissible company. Kasi and Muhammad (2016), categorized DJIM as very stringent Shariah-compliant users because the index will reject companies that are, in one way or another involved in non-Shariah compliant businesses in the first round of qualitative screening. In addition, Wee (2012) summarized that the Malaysian Shariah-compliant stocks undergoes less rigorous screening in Malaysia’s stock exchange than elsewhere. However, this study utilized benchmarks from the previous screening methodology which excluded the financial ratio benchmarks, as part of the screening.

The process of Shariah-compliant screening differs not only due to different jurisdictions of different countries but also practiced by different objectives sets of users: portfolio managers, providers of market intelligence and regulators (Catherine, Masood, Abdul Rehman & Bellalah, 2012). As such, some prominent scholars have suggested that there is a need to standardize the screening methodology in order to obtain global Shariah-compliant stocks. By having a standard stock screening methodology, investors from all over the world can trade without the need to check the compliant status for every stock exchange. This will encourage foreign investments and thus, expanding the world economy. In this light, Derigs and Marzban (2008) have criticized that the use of different criteria set by different stock exchanges certainly has brought confusion among investors, which may lead to insecurity, distrust and the lack of confidence in investing in Shariah-compliant stocks.

CONCLUSION

The screening process is designed to identify the elements that violate the rules and guidelines of Shariah law, which is rooted from Al-Quran and the teachings of Prophet Muhammad. Shariah law prohibits elements such as usury (*riba* or interest), gambling (*maysir*) and uncertainty (*gharar*) which are present in many conventional financial activities. For a Muslim, this means getting indirectly involved in prohibited practices, which is considered as grave sin. Therefore, in developing the Islamic finance ecosystem, Shariah compliance and governance have been the utmost priority and consideration since the onset of the industry during the 1980s and 1990s. The fundamental distinction between Shariah-compliant and conventional securities is in the former’s adherence to the principles of Shariah, which is applied in the process of screening.

REFERENCES

Abdul Rahman, A., Yahya, M. A., & Mohd Nasir, M. H. (2010). Islamic norms for stock screening: A comparison between the Kuala Lumpur Stock Exchange Islamic Index and the Dow Jones Islamic Market Index. *International Journal of Islamic and Middle Eastern Finance and Management*, *3*(3), 228-240.

Catherine, S. F. H., Masood, O., Abdul Rehman, A., & Bellalah, M. (2012). Syariah accounting and compliant screening practices. *Qualitative Research in Financial Markets*, *4*(2/3), 240-254.

Derigs, U., & Marzban, S. (2008). Review and analysis of current Shariah-compliant equity screening practices. *International Journal of Islamic and Middle Eastern Finance and Management*, *1*(4), 285-303.

Jamil, N. S., Hassan, H., & Bujang, I. (2020). The effect of Shari'ah compliance announcements on stock returns in Malaysia. *International Journal of Business and Society*, *21*(1), 217-233.

Kasi, U., & Muhammad, J. (2016). Strict and uniform Shariah screening methodologies in selected Asian countries in comparison with the United States. *Asian Journal of Finance and Accounting*, *8*(1), 38-76.

Wee, C. P. (2012). Analysis of Syariah quantitative screening norms among Malaysia Syariah-compliant stocks. *Investment Management and Financial Innovation*, *9*(2), 69-80.