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المقالات العربية

English Articles

A Comparative Analysis of Shariah Stock Screening Methodology for Securities Commission Malaysia and Major International Shariah Index Providers[1]

Analisis Perbandingan Metodologi Penyaringan Saham Syariah untuk Suruhanjaya Sekuriti Malaysia dan Penyedia Indeks Syariah Antarabangsa Utama

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Abstract

This article reviews and compares the Shariah stock screening methodologies adopted by the Securities Commission (SC) of Malaysia and major international Shariah index providers including Dow Jones Islamic Market World Index (DJIM), Financial Times Stock Exchange Islamic Index Series (FTSE), Standard & Poor's Shariah Index (S&P), and Morgan Stanley Capital International Islamic Index (MSCI). Qualitative methods are used to assess the Shariah stock screening methods and standards practiced by these five renowned institutions. A comparative analysis scrutinizes the variances between these methods and principles. The study reveals both similarities and differences in the Shariah stock screening methodologies developed by the five

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institutions. In general, all utilise a two-tier screening method involving qualitative and quantitative filters. Comparing the qualitative screening practices shows some institutions are more specific in listing Shariah non-compliant activities, while others take a more general approach in permitting business activities to be Shariah compliant. For quantitative screening, the allowable threshold ratios differ slightly between institutions. Overall, the language has been simplified and made more concise while preserving the key information.

Keywords: Shariah Screening Methodology, Securities Commission Malaysia, International Shariah Index Providers, DJIM, FTSE, S&P, MSCI.

Abstrak

Artikel ini mengkaji dan membandingkan metodologi penyaringan saham Syariah yang digunapakai oleh Suruhanjaya Sekuriti (SC) Malaysia dan penyedia indeks Syariah antarabangsa utama termasuk Dow Jones Islamic Market World Index (DJIM), Siri Indeks Syariah Bursa Saham Financial Times (FTSE), Indeks Syariah Standard & Poor's (S&P), dan Indeks Syariah Morgan Stanley Capital International (MSCI). Kaedah kualitatif digunakan untuk menilai kaedah dan piawaian penyaringan saham Syariah yang diamalkan oleh kelima-lima institusi terkemuka ini. Analisis perbandingan meneliti perbezaan antara kaedah dan prinsip tersebut. Kajian ini mendedahkan persamaan dan perbezaan dalam metodologi penyaringan saham Syariah yang dibangunkan oleh kelima-lima institusi tersebut. Secara umumnya, semua menggunakan kaedah penyaringan dua peringkat yang melibatkan penapis kualitatif dan kuantitatif. Perbandingan amalan penyaringan kualitatif menunjukkan sesetengah institusi lebih khusus dalam menyenaraikan aktiviti yang tidak patuh Syariah, manakala yang lain mengambil pendekatan lebih umum dalam membenarkan aktiviti perniagaan mematuhi Syariah. Untuk penyaringan kuantitatif, nisbah ambang yang dibenarkan berbeza sedikit antara institusi. Secara keseluruhan, bahasa telah dipermudahkan dan dibuat lebih padat sambil mengekalkan maklumat utama.

Kata Kunci: Metodologi penyaringan Syariah, Suruhanjaya Sekuriti Malaysia, penyedia indeks Syariah antarabangsa, DJIM, FTSE, S&P, MSCI.

Introduction

The Islamic financing industry in Malaysia registered commendable financing growth of 7.9% in 2023, outpacing the growth of conventional financing which was 3.5%. [2] This demonstrates the continued expansion of the Islamic finance sector.

The global Islamic finance industry is estimated to have reached $4.5 trillion in assets as of 2023, according to data from the LSEG. [3] The Islamic funds segment has also continued to grow, with over 600 listed Shariah-compliant funds globally as of 2023.[4] This indicates the increasing demand for Islamic investment products.

Overall, the Islamic finance industry has maintained its strong growth trajectory in recent years, with expansion across banking, investment funds, and Sukuk markets. The industry continues to gain traction globally, driven by increasing demand for Shariah-compliant financial products and services. [5]

However, as a Muslim investor, whether an individual or an institutional investor, one must always bear in mind that the investments involved should comply with Shariah principles, which prohibit elements such as *ribā* (interest), *gharar* (uncertainty), and

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[2] RAM. "Islamic banks continue to drive Malaysia's overall loan growth, profitability intact but outperformance will be limited," RAM, 20 Mar. 2024, www.ram.com.my/pressrelease/?prviewid=6583.

[3] "Islamic Market Data | LSEG," London Stock Exchange Group, accessed May 27, 2024, https://www.lseg.com/en/data-analytics/islamic-finance/islamic-market-data

[4] "Islamic Market Data | LSEG," London Stock Exchange Group, accessed May 27, 2024, https://www.lseg.com/en/data-analytics/islamic-finance/islamic-market-data

[5] Global Islamic Finance Development Center, World Bank. "[World Bank Islamic Finance]", accessed May 27, 2024, https://www.worldbank.org/en/programs/global-islamic-finance-development-center.

maysir (gambling).[6] A stock's portfolio must be reviewed because even companies whose core activities are Shariah-lawful may occasionally engage in non-Shariah compliant transactions or become associated with impermissible activities, such as gambling, producing and marketing alcoholic beverages, supplying non-halal meat like pork, or providing immoral services like prostitution.[7]

To address the needs, it is crucial to provide proper guidance for Muslim investors to avoid embarking on non-Shariah compliant investments. Today, several prominent Islamic finance entities, including index providers, Shariah service providers, regulatory bodies, association bodies, and Islamic banks, have developed a process known as Shariah screening for stocks globally. Different index providers develop their Shariah indices based on their own Shariah screening methodologies, due to traditional and geographical variances between markets and different interpretations of Shariah compliancy for each specific company by the Shariah board.

The Shariah Screening Methodology refers to "benchmarks or standards of tolerance level of non-halal elements that are allowed to be mixed within stock investment, so that it can be used to determine any specific share is Shariah compliant or not, by using screening process developed by certain scholars or Shariah advisory scholars appointed".[8]

In Malaysia, the Shariah stock screening process is undertaken by the Securities Commission Malaysia (SC).[9] Additionally, there are Shariah stock screening methodologies developed by entities such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as well as international Shariah index providers like the Dow Jones Islamic Market World Index (DJIM), Financial Times Stock Exchange Islamic Index (FTSE), Morgan Stanley Capital International (MSCI), and Standard & Poor's (S&P). These Shariah indices have served

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[6] Norlita Zainudin and Surianom Miskam, "Revised Shariah Screening Methodology for Shariah-Compliant Securities : New Standard to Meet Global Expectation," 2016.
[7] Securities Commission Malaysia, "Quarterly Bulletin of Malaysian Islamic Capital Market," 2011.
[8] Wee Ching Pok, "Analysis of Syariah Quantitative Screening Norms among Malaysia Syariah- Compliant Stocks," *Investment Management and Financial Innovations* 9, no. 2 (2012): 69–80.
[9] Securities Commission Malaysia, "About the SC," accessed December 1, 2023, https://www.sc.com.my/about/about-the-sc/.

as references for Muslim investors in identifying Shariah-compliant securities in stock markets.

However, the diversity of Shariah stock screening methodologies among index providers reflects the lack of a universal method, which may lead to confusion for investors. Catherine S.F. Ho has presented the differences in Shariah screening methodologies adopted by 34 Islamic financial users from 16 countries, revealing divergent methods in both business screen and financial screen processes. Regarding business screening, these practitioners differ in categorizing activities considered Shariah non-compliant; some use a specific approach by listing non-permissible activities, while others take a more general approach in determining Shariah non-compliant activities. Under financial screening, the range of permissible threshold ratios for Shariah non-compliant elements varies among practitioners.[10]

According to Mahfooz and Ahmad, one of the issues associated with the divergence and inconsistency of Shariah screening methods is the changing of Shariah rules, which means some modifications of standards may occur within a particular index provider. This can affect the Shariah compliancy status of a certain company. In other words, some companies deemed Shariah-compliant might become Shariah non-compliant due to changes in Shariah rules by the same board members.[11]

Yildirim and Ilhan have reviewed a few criticisms made regarding the variety of Shariah stock screening methodologies, most of which encouraged harmonization of the methodologies. The authors concluded their article by presenting a potential for standardization of the various methods.[12]

Therefore, this study intends to investigate the divergent methodologies provided by the Securities Commission Malaysia and four other prominent international Shariah index providers, namely the Dow

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[10] Catherine S F Ho, "International Comparison of Shari ' Ah Compliance Screening Standards," *International Journal of Islamic and Middle Eastern Finance and Management* 8, no. 2 (2015): 222–45, https://doi.org/10.1108/IMEFM-07-2014-0065.

[11] Saeed Mahfooz and Habib Ahmed, "Sharīʿah Investment Screening Criteria : A Critical Review," *JKAU: Islamic Econ.* 27, no. 1 (2014): 20.

[12] Ramazan Yildirim and Bilal Ilhan, "Shariah Screening Methodology - New Shariah Compliant Approach," *Journal of Islamic Economics, Banking and Finance* 14, no. 1 (2018): 168–90.

Jones Islamic Market World Index (DJIM), Financial Times Stock Exchange Islamic Index Series (FTSE), Morgan Stanley Capital International Islamic Index (MSCI), and Standard & Poor's Shariah Index (S&P).

The following sections of this article are organized as follows: Section 2 presents a brief introduction to mixed companies that led to the emergence of the Shariah screening methodology, followed by discussions from scholars pertaining to the matter. Section 3 thoroughly deliberates on an overview of the Shariah stock screening methodology. Section 4 reviews and compares the principles and rules of Shariah indices formulated by five Shariah index providers. The final section concludes the article.

Mixed Companies

Before delving into the Shariah stock screening methodology, it is important to understand the nature of mixed companies, which is considered the main reason for the origination of the Shariah screening process. Mixed companies can be defined as "a company where its core activities are permitted by Shariah, although there are some other activities that may contain a small extent of prohibited elements".[13]

There is no discrepancy among scholars regarding the prohibition of investing in a company whose core business is entirely Shariah non-compliant, and the permissibility of investing in a fully Shariah-compliant company. However, issues arise concerning the existence of a small portion that contravenes Shariah in a company whose core activity is Shariah-lawful. Scholars have disputed the permissibility of investing in such mixed companies, especially in the current practice where it is almost impossible to find a fully Shariah-compliant company nowadays, as asserted by Khatkhatay and Nisar: "in the real commercial world, a fully Shariah-compliant business is rare."[14]

The Securities Commission Malaysia has highlighted a list of activities considered Shariah non-compliant, which includes:

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[13] Securities Commission Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, Second edi (Kuala Lumpur, 2007), 150.

[14] M. H. Khatkhatay and Shariq Nisar, "Shariah Compliant Equity Investments : An Assessment of Current Screening Norms," *Islamic Economic Studies* 15, no. 1 (2007): 61.

a. Activities involving interest *(ribā),* as practiced by conventional institutions, including commercial banks, merchant banks and finance companies. *Ribā* refers to interest charged on loans or debt, which is prohibited in Islam.
b. Activities involving gambling *(maysir)* where money is wagered on an uncertain outcome, such as casinos and gaming;
c. Activities involving the production and sale of goods that are impermissible in Islam, such as alcoholic drinks, non-halal meat like pork, or providing prohibited services like prostitution, pubs, and discotheques; and
d. Activities involving uncertainty *(gharar),* where the terms and conditions of the contract are not clearly defined or known to both parties, leading to potential deceit or exploitation, such as conventional insurance trading.[15]

A mixed company may appear in several forms. For example, a company whose core activity is the production of industrial goods, but its subsidiary company carries out *ribā*-related activities. A company may also be classified as a mixed company when its core activity is permissible, such as real estate, but its subsidiary operates a hotel or resort where liquor is sold on the premises.[16]

The permissibility of investing in such companies has been discussed by scholars. Some scholars totally prohibit investment in mixed companies, considering the mandatory prohibition of *ribā* practices and other elements that contravene Shariah. Others hold the opposite opinion, based on their *ijtihad* (legal reasoning).

Prohibition of Mixed Companies

Among the scholars who agree on the prohibition of investing in mixed companies are 'Alī al-Sālūs, Shaykh 'Alī al-Shaybānī, and Ṣāliḥ al-Marzūqī.[17] The evidence supporting this opinion is as follows:

[15] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 145–49.
[16] Ibid, 152.
[17] Aḥmad bin Muḥammad Al-Khalīl, *Al-Ashum Wa Al-Sanadāt Wa Aḥkāmuhā Fi Al-Fiqh Al-Islāmī* (Riyāḍ: Dār Ibn al-Jawzī, n.d.), 141.

1. Several verses from the Quran and *ḥadīth* specify the prohibition of *ribā*; in Surah Al-Baqarah, Almighty Allah says:

﴿يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنتُم مُّؤْمِنِينَ. فَإِن لَّمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِّنَ اللَّهِ وَرَسُولِهِۦ وَإِن تُبْتُمْ فَلَكُمْ رُءُوسُ أَمْوَالِكُمْ لَا تَظْلِمُونَ وَلَا تُظْلَمُونَ. وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ ۚ وَأَن تَصَدَّقُوا خَيْرٌ لَّكُمْ ۖ إِن كُنتُمْ تَعْلَمُونَ﴾

"O you who believed, fear Allah and give up what remains (due to you) of interest, if you should be believers. And if you do not, then be informed of a war (against you) from Allah and His Messenger. But if you repent, you may have your principal, (thus) you do no wrong, nor are you wronged. And if someone is in hardship, then (let there be) postponement until (a time of) ease. But if you give (from your right as) charity, then it is better for you, if you only knew."[18]

And from a *ḥadīth*, which narrated by Jabir:

{عَنْ جَابِرٍ، قَالَ: لَعَنَ رَسُولُ اللَّهِ ﷺ آكِلَ الرِّبَا وَمُوكِلَهُ وَكَاتِبَهُ وَشَاهِدَيْهِ وَقَالَ هُمْ سَوَاءٌ}

Jabir said that Allah's Messenger (p.b.u.h) cursed the accepter of interest and its payer, and one who records it, and the two witnesses, and he said: "They are all equal."[19]

This evidence indicates the prohibition of *ribā* practices for Muslims. Hence, it is forbidden to invest in a company that is directly or indirectly involved in *ribā*-related activities, because investing in such a company is considered involving oneself in *ribā* activities, even if it is for a small portion of *ribā* .[20] It is similar to investing in a mixed company, it is *ḥarām* (prohibited) to invest

[18] *Sūrah al-Baqarah* (2:178-180).
[19] Muslim bin al-Ḥajjāj Al-Naysābūrī, *Ṣaḥīḥ Muslim* (Beirut: Dār Iḥyā' al-Turāth al-'Arabī, n.d.), vol. 3, 1219, *"bāb la'ni ākili al-ribā wa mu'kilihi," ḥadīth* no. 1598.
[20] Al-Khalīl, *Al-Ashum Wa Al-Sanadāt Wa Aḥkāmuhā Fi Al-Fiqh Al-Islāmī*, 142.

in a company that contains Shariah non-compliant elements, even though the core activity of the company complies with Shariah principles.

2. A Qur'anic verse that explains the prohibition of cooperation in sin. Almighty Allah says:

﴿وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ ۖ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ ۚ وَاتَّقُوا اللَّهَ ۖ إِنَّ اللَّهَ شَدِيدُ الْعِقَابِ﴾

"And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah; indeed, Allah is severe in penalty."[21]

This verse clarifies that Allah has forbidden His servants from cooperating in sinful and aggressive acts. Therefore, investing in a mixed company that engage in activities violating Shariah is considered aiding and abetting others in committing transgressions.[22]

3. Legal maxims, which read:

{إذا اجتمع الحلال والحرام غلب الحرام}

"When *ḥalāl* and *ḥarām* meet, the *ḥarām* prevails."[23]

And;

{درء المفاسد أولى أو مقدم على جلب المصالح}

"Preventing harm is preferred over attracting benefit."[24]

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[21] *Sūrah al-Māidah* (5:2).

[22] Al-Khalīl, *Al-Ashum Wa Al-Sanadāt Wa Aḥkāmuhā Fi Al-Fiqh Al-Islāmī*, 143.

[23] ʻAbd al-Raḥmān bin Abī Bakr Jalāl al-Dīn Al-Sayūṭī, *Al-Ashbāh Wa Al-Naẓā'ir* (Beirut: Dar al-Kutub al-'Ilmiyyah, 2001), vol. 1, 237.

[24] Aḥmad bin al-Shaykh Muḥammad Al-Zarqā, *Sharḥ Al-Qawā'id Al-Fiqhiyyah* (Damascus: Dār al-Qalam, 1989), 205.

Scholars supporting this opinion refer to the first legal maxim, which states that when lawful (*ḥalāl*) wealth is mixed with unlawful (*ḥarām*), it is prohibited to invest in both *ḥalāl* and *ḥarām*, as the entire wealth is considered *ḥarām*. This is a precautionary measure (*iḥtiyāṭ*).[25] The second legal maxim explains that when there is a conflict between good and adverse elements, the adverse must take precedence.[26] In other words, when a company combines both prohibited and permissible activities, the overall operation is deemed prohibited. Al-Zarqā (d.1936) asserted that, "When preventing harm conflicts with acquiring a benefit in a given case, preventing harm must be prioritized, as God's emphasis on prohibitions is greater than His emphasis on commands."[27]

Permissibility of Mixed Companies

Some scholars hold the view that investing in companies with mixed activities, comprising both permissible and prohibited elements, is permissible. This opinion is supported by several eminent scholars, including Muhammad al-'Uthaymin, 'Alī Qurrah Daghi, Abd al-Khāliq, and Ahmad Sālim Muhammad.[28] The following are evidence for this opinion:

1. The concept of *'Umūm al-Balwā.*

'Umūm al-balwā refers to a common plight or an unfavourable widespread situation affecting most people, which is difficult to avoid.[29] It is an unavoidable circumstance that is allowed to be practiced preventing greater harm or negative consequences.

Several legal maxims in Islamic jurisprudence support the *'umūm al-balwā* situation, such as "hardship becomes a cause for relaxation", "where a matter is narrowed, it becomes wide", and "something forbidden which occurs widely (and which is difficult to avoid), Shariah brings relief to those affected".[30] When explaining the maxim "hardship

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[25] Al-Zarkashī, *Al-Manthūr Fī Al-Qawā'id Al-Fiqhiyyah* (Kuwait: Wizārāt al-Awqāf al-Kuwaytiyyah, 1985), vol. 1, 128.
[26] Al-Zarqā, *Sharḥ Al-Qawā'id Al-Fiqhiyyah*, 205.
[27] Ibid.
[28] Al-Khalīl, *Al-Ashum Wa Al-Sanadāt Wa Aḥkāmuhā Fi Al-Fiqh Al-Islāmī*, 146.
[29] Al-Sayūṭī, *Al-Ashbāh Wa Al-Naẓā'ir*, vol. 1, 159.
[30] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 2007, 124.

becomes a cause of relaxation", al-Sayūṭī further emphasizes that considering the *'umūm al-balwā* is one of the factors to allow the *taisīr* (facilitation) principle, in order to avoid from burdening the Muslim society and bring benefits to them.[31]

Investment in mixed companies is considered as *'umūm al-balwā* situation, which is permitted in Islam. In the reality of investment world, the number of fully Shariah-compliant institutions are scarce, and the limited investment opportunities may lead to hardships for Muslims to participate in the investment industry.[32] For this reason, investment in mixed companies is allowed. However, in this case, the Sharia Advisory Council of the Securities Commission has set a benchmark for the tolerable level of impermissible elements.

2. The scholars acknowledge the reality of *Gharar yasīr* and *Ghabn yasīr.*

'Gharar' means refers to uncertainty, ambiguity or hazard in a contract or transaction, which can lead to deceit or exploitation, while *'ghabn'* refers to earning a profit significantly higher than the prevailing market price.[33] Although these elements are prohibited in Islam, they are excused when their extent is minimal and does not significantly impact the contract's integrity. In the case of mixed companies, if the levels of *'gharar'* and *'ghabn'* are below the tolerable threshold, investing in such companies is permissible.[34]

3. The principle of *Maqāṣid al-Sharīʿah* (Objectives of Islamic Law).

Islam has prescribed five essential objectives of Shariah rulings, one of which is the preservation of wealth (*ḥifẓ al-māl),* which must be regarded with utmost importance.[35] Therefore, it is crucial to empower investment and business activities, as they are considered vital factors in maintaining the economic strength of the Muslim community. Since

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[31] Al-Sayūṭī, *Al-Ashbāh Wa Al-Naẓā'ir*, vol. 1, 162.
[32] Al-Khalīl, *Al-Ashum Wa Al-Sanadāt Wa Aḥkāmuhā Fi Al-Fiqh Al-Islāmī*, 156.
[33] Nazih Ḥammād, *Muʿjam Al-Musṭalaḥāt Al-Iqtisadiyyah Fi Lughah Al-Fuqahā'* (Herndon: The International Institute of Islamic Thought, 1993), 210.
[34] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 2007, 155.
[35] Ibrāhīm bin Mūsā Al-Shāṭibī, *Al-Muwāfaqāt* (Saudi Arabia: Dār Ibn 'Affān, 1997), vol. 2, 20.

investing in mixed companies is currently unavoidable, it is permissible for Muslims to engage with such companies. Additionally, they can concentrate their wealth on permissible activities that outweigh the prohibited elements. This will benefit Muslims and provide more opportunities for them to contribute to economic growth.[36]

In summary, based on the mentioned evidence of permissibility for mixed companies, the researchers agree that investing in such companies is allowed. Furthermore, the legal maxim "when *ḥalāl* (permissible) and *ḥarām* (forbidden) meet, the *ḥarām* (forbidden) prevails" is countered by another maxim: "A *ḥarām* (forbidden) does not illegitimate a *ḥalāl* (permissible).[37]

However, a screening process is necessary to investigate the composition of mixed companies to ensure that the prohibited elements are at a minimum level to qualify as Shariah-compliant. Therefore, the next section will discuss the Shariah screening methodology for mixed companies.

Shariah Stock Screening Methodology

The Shariah screening methodology involves two types of assessments: qualitative assessment and quantitative assessment. The qualitative assessment relates to business activity screening, whereby the activities carried out by the companies are scrutinized. A Shariah-compliant company must engage in Shariah-compliant activities and must not consist of any prohibited activities such as producing liquor and liquor-related activities, tobacco and tobacco-related activities, pork and pork-related activities, non-halal food and beverages, non-Shariah-compliant entertainment, weapons and defence, as well as business activities involving conventional banking, conventional insurance, gambling, and other activities deemed non-compliant according to Shariah principles. On the other hand, the quantitative assessment is a financial ratio screening, where a company would be considered Shariah-compliant if it satisfies the established standards in terms of

[36] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 2017, 20.
[37] Al-Sayūṭī, *Al-Ashbāh Wa Al-Naẓā'ir*, vol. 1, 260.

debt ratio, liquidity ratio, interest income ratio, and other relevant financial ratios.[38]

In recent years, the need for a refined Shariah stock screening process has become increasingly crucial due to the existence of a complex modern capital market involving companies from various sectors around the globe. The Shariah screening methodology has been evolving since its inception a few decades ago. This section reviews the chronology of how the idea of this methodology was initiated and developed within the Islamic finance industry, both nationally and internationally.

The Emergence of Shariah Stock Screening

The concept of Shariah screening for stocks is derived from the prohibition of involvement in activities that violate Shariah principles. In the capital market, investors are considered owners of the companies' shares, and hence, Muslims are forbidden from owning an entity that engages in Shariah non-compliant activities. Currently, most companies are involved in the interest-based conventional financial system due to its prevalence, even though their core activities may comply with Shariah. Therefore, Shariah scholars-initiated efforts to provide a stock screening methodology to assist Muslim investors.[39]

The early effort to provide a list of Shariah-compliant stocks in Malaysia was presented by Bank Islam Malaysia Berhad in 1983. Later, in 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established, responsible for developing standards for the global Islamic finance industry. AAOIFI issued standards that were subsequently followed by other leading Islamic financial institutions worldwide to introduce indices in the capital market.[40] For examples.

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[38] International Shariah Research Academy for Islamic Finance (ISRA), *Islamic Financial System: Principle and Operation* (Kuala Lumpur: ISRA, 2012), 481–83.
[39] Securities Commission, "Quarterly Bulletin of Malaysian Islamic Capital Market," 1.
[40] Accounting and Auditing Organizations Islamic Financial Institutions (AAOIFI), Shari`ah Standards, (Manama: AAOIFI, 2017), 22.

i) In May 1996, RHB/Unit Trust Management Berhad launched its first Islamic equity index in Malaysia.[41]
ii) The Securities Commission of Malaysia published the first list of Shariah-compliant stocks in June 1997.[42]
iii) The Dow Jones Islamic Market (DJIM) Index was launched in Bahrain in February 1999.[43]
iv) FTSE launched its Islamic Global index family in November 1999.[44]
v) The Kuala Lumpur Stock Exchange's (KLSE) National Shariah Council established its Shariah Index in 1999.[45]

Shariah Stock Screening in Malaysia

Prior to the establishment of the Securities Commission, the capital market in Malaysia was regulated by six government bodies, namely: the Capital Issues Committee (CIC), Panel on Take-overs and Mergers, Foreign Investment Committee, Companies Commission of Malaysia, Ministry of International Trade, and Industry (MITI), and Bank Negara Malaysia (BNM).[46]

Since the Securities Commission's establishment in 1993, the initiative to provide a Shariah screening methodology for stocks began. In fact, this effort was initiated a few years earlier, with the issuance of a list of Shariah-compliant stocks by Bank Islam Malaysia Berhad in 1983. Later, in 1996, RHB Securities created the world's first Shariah index, signifying the beginning of the formalization of the Shariah equity market in Malaysia.[47] Meanwhile, the Shariah Advisory Council (SAC) of the Securities Commission (SC) began studying the Shariah compliance

[41] Kabir Hassan and Michael Mahlknecht, *Islamic Capital Market: Products and Strategies* (United Kingdom: Wiley Finance, 2011), 129.
[42] Securities Commission, "Quarterly Bulletin of Malaysian Islamic Capital Market," 6.
[43] Rushdi Siddiqui, "Islamic Indexes: The DJIM Framework," in *Islamic Asset Management: Forming the Future for Shariah-Compliant Investment Strategies*, ed. Sohail Jaffer (London: Euromoney Books, 2004), 49.
[44] Siddiqui, 49.
[45] Ibid.
[46] Securities Commission Malaysia, "Frequently Asked Questions on Revised Shariah Screening Methodology," accessed December 20, 2023, https://www.sc.com.my/regulation/regulatory-faqs/frequently-asked-questions-on-revised-shariah-screening-methodology.
[47] Securities Commission, "Quarterly Bulletin of Malaysian Islamic Capital Market," 6.

of securities listed on Bursa Malaysia and started developing its screening methodology in 1995. In June 1997, the Commission issued its first list of Shariah-compliant securities based on its methodology, which became the sole Malaysian standard.[48]

Since then, the Securities Commission's Shariah screening methodology has undergone several stages of development. Generally, the methodology has experienced four major phases of development as of November 29, 2013, with minor changes occurring in 2014 and 2016. The chronology of these developments is as follow table:

Table 1: Evolution of the Shariah Screening Methodology for Stocks in Malaysia

Phase	Business Activity Benchmarks	Financial Ratio Benchmarks
First Phase 1996-1997	General guidelines provided by the Shariah Advisory Council (SAC) of the Securities Commission. No specific calculation benchmark.	N/A
Second Phase 2004	5% tolerance level for conventional banking, insurance, gambling, liquor, pork, non-halal food/beverages, and other non-compliant activities. 10% allowed for interest income, tobacco, and other non-compliant activities. 25% tolerated for hotel/resort operations, share trading, stockbroking, and other non-compliant activities.	N/A

[48] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 144.

Third Phase 2007	5% tolerance level for conventional banking, insurance, gambling, liquor, pork, non-halal food/beverages, non-compliant entertainment, and other non-compliant activities. 10% allowed for interest income, tobacco, and other non-compliant activities. 20% allowed for rental from non-compliant activities and other non-compliant activities. 25% tolerated for hotel/resort operations, share trading, stockbroking, and other non-compliant activities.	N/A
Fourth Phase 2013	5% tolerance level for conventional banking, insurance, gambling, liquor, pork, non-halal food/beverages, non-compliant entertainment, interest income, tobacco, and other non-compliant activities. 20% allowed for hotel/resort operations, share trading, stockbroking, rental from non-compliant activities, and other non-compliant activities.	33% threshold for: 1) Cash over total assets (including cash in conventional accounts/instruments) 2) Debt over total assets (including interest-bearing debt)
Minor Amendments 2014	Cinema business benchmark changed from 5% to 20%.	N/A
2016	20% benchmark for hotel/resort operations no longer applicable. Other benchmarks for non-compliant activities remain.	N/A

First Phase: The Securities Commission Malaysia introduced the Shariah screening methodology on August 21, 1996, to identify the status of mixed companies. There was no specific calculation benchmark involved, but only general guidelines provided by the Shariah Advisory Council (SAC) of the Securities Commission. Subsequently, in its ninth meeting on August 27, 1997, the SAC decided on a benchmark for the image factor of a company to be used as an additional criterion.[49]

The public perception and image of a company in the context of Shariah screening methodology refer to how the general public, particularly the Muslim community, views and perceives the company's operations, products, services, and overall business conduct in relation to Islamic principles and values.

For example, an airline company's core business of providing transportation services is generally considered permissible under Islamic teachings. However, if the company is widely known and perceived by the public as serving alcoholic beverages (which is prohibited in Islam) on its flights, this negative perception and image could potentially render the company non-compliant with Shariah principles, despite its halal core business.

Thus, a positive public perception and image of a company's adherence to Islamic values and ethical practices are essential factors in determining its Shariah compliance and permissibility for Muslim investors or Islamic financial institutions.

Second Phase: In April 2004, the numbering benchmark was introduced by using the threshold value of 5%, 10% and 25%.[50]

Third Phase: Subsequently, in May 2007, the Current Shariah Screening Methodology was applied. The criteria of the current benchmark utilise the following threshold values: 5%, 10%, 20% and 25%:[51]

Fourth Phase: The latest Shariah Screening Methodology by the Securities Commission was revised in November 2013, establishing a

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[49] Securities Commission, 150.

[50] Securities Commission Malaysia, *List of Securities Approved by the Shariah Advisory Council of the Securities Commission Malaysia* (Kuala Lumpur: Securities Commission Malaysia, 2004), 18–19.

[51] Securities Commission Malaysia, *List of Securities Approved by the Shariah Advisory Council of the Securities Commission Malaysia* (Kuala Lumpur: Securities Commission Malaysia, 2007), 14–15.

two-tier process that applies business activity benchmarks and newly introduced financial ratio benchmarks.

In the revised benchmarks, the Shariah Advisory Council has permitted a maximum of 5% of a company's business activities to be mixed with the following elements:[52]

i) conventional banking;
ii) conventional insurance;
iii) gambling;
iv) liquor and liquor-related activities;
v) pork and pork-related activities;
vi) non-halal food and beverages;
vii) Shariah non-compliant entertainment;
viii) interest income from conventional accounts and instruments;
ix) tobacco and tobacco-related activities; and
x) other activities deemed non-compliant according to Shariah.

Meanwhile, a 20% benchmark is applicable to the following activities:

i) hotel and resort operations;
ii) share trading;
iii) stockbroking business;
iv) rental received from Shariah non-compliant activities; and
v) other activities deemed non-compliant according to Shariah.

For the financial ratio benchmarks, a 33% threshold has been set. There are two types of ratios to be calculated:

i) Cash over total assets. Cash placed in conventional accounts and instruments is included in the calculation, while cash saved in Islamic accounts and instruments is excluded.
ii) Debt over total assets. Interest-bearing debt is included in the calculation, while Islamic financing or sukuk is excluded.

Both ratios are intended to measure *riba* and *riba*-based elements within a company's balance sheet, which must be lower than 33%.

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[52] Securities Commission Malaysia, *List of Shariah-Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia* (Kuala Lumpur: Securities Commission Malaysia, 2013), 3–6.

For companies that are not listed as Shariah-compliant after the revision of these benchmarks, investors were given six months from the effective date of November 29, 2013, to dispose of all the securities. The disposal must be done if the respective market price of the securities exceeds or is equal to the investment cost. On the other hand, investors are allowed to keep their investment in the Shariah non-compliant securities if the market price is below the investment cost.

Additionally, there have been two minor amendments to the Shariah screening methodology issued by the Securities Commission after the latest revision in 2013. The first amendment, announced on December 31, 2014, updated the resolution on the benchmark for the cinema business from 5% to 20%. This change occurred because the cinema business is not categorized as an activity clearly prohibited by Shariah. Hence, it was deemed unsuitable to classify it under the 5% benchmark, which is reserved for activities explicitly forbidden in the Quran and Sunnah, such as *riba*-based activities, gambling, liquor, and pork consumption.[53] The second minor change was issued on April 28, 2016, in relation to the applicability of the 20% benchmark for contributions from hotel and resort operations. The SAC of the Securities Commission resolved that the 20% benchmark on hotel and resort operations is no longer applicable since the main purpose of hotel and resort operations was to provide accommodation. Despite this, other benchmarks regarding other Shariah non-compliant activities under the business activity benchmarks remain applicable for companies with hotel and resort operations.[54]

This development of the screening methodology reveals the gradual revision done by the SAC of the Securities Commission, applying the concept of *tadarruj* (gradualism). The revision of the Shariah screening methodology is conducted every few years to ensure that the method is properly developed to satisfy Shariah principles, considering the human nature of accepting changes gradually. This concept

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[53] Securities Commission Malaysia, *Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia* (Kuala Lumpur: Securities Commission Malaysia, 2019), 171.

[54] Securities Commission Malaysia, "The 184th Shariah Advisory Council Of The Securities Commission Malaysia Meeting (28 April 2016)," 2016, https://www.sc.com.my/development/islamic-capital-market/the-184th-shariah-advisory-council-of-the-securities-commission-malaysia-meeting-28-april-2016.

corresponds to Islamic practices, such as in the prohibition of *khamr* (liquor).

Comparison of Shariah Stock Screening Methodology Across Islamic Index Providers

In general, different Islamic index providers have established their own Shariah supervisory committees to formulate Shariah stock screening methodologies, leading to divergence in their jurisdictions. This section reviews the principles and rules of Shariah indices provided by five major Shariah index providers and compares these methodologies.

Shariah Stock Screening Methodology Adopted by Securities Commission Malaysia (SC)

Based on the previous discussion, the latest revised Shariah stock screening methodology of the Securities Commission Malaysia was published toward the end of 2013, undergoing a two-tier process covering business activity benchmarks and financial ratio benchmarks for the quantitative assessment. After considering the amendments in 2014 and 2016, the Commission is still using the same methodology to the present (2020). Table 1 below summarizes the methodology adopted by the SC in determining the Shariah status of the listed securities as of November 2019:

Table 2: Shariah Screening Methodology of Securities Commission[55]

Quantitative Assessment	First-tier: Business activity benchmark	5% benchmark	i) conventional banking and lending; ii) conventional insurance; iii) gambling; iv) liquor and liquor-related activities;

[55] Securities Commission Malaysia, *List of Shariah-Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia* (Kuala Lumpur: Securities Commission Malaysia, 2019), 8–10.

			v) pork and pork-related activities; vi) non-halal food and beverages; vii) Shariah non-compliant entertainment; viii) tobacco and tobacco-related activities; ix) interest income from conventional accounts and instruments; x) dividends from Shariah non-compliant investments; and xi) other activities deemed non-compliant according to Shariah.
		20% benchmark	i) share trading; ii) stockbroking business; iii) rental received from Shariah non-compliant activities; and iv) other activities deemed non-compliant according to Shariah.
	Second-tier: Financial ratio benchmark	33% benchmark	i) Cash / Total Assets; ii) Debt / Total Assets.
Qualitative Assessment	i) Image of the company; ii) *Maṣlaḥah, ‘umūm balwa, ‘uruf* etc.		

The Shariah Advisory Council of the Securities Commission will review the Shariah status of securities listed on Bursa Malaysia based on the companies' annual audited financial statements. The list of Shariah-compliant securities will be updated twice a year, in May and November. Using the two-tier quantitative approach, which applies the business benchmarks and financial ratio benchmarks, the SAC will announce the securities as Shariah-compliant if the percentage of business activities and financial ratios are within the benchmarks. Diagrams 1 and 2 below illustrate how the Shariah screening process using the SC methodology is conducted.

Diagram 1: Shariah Compliance Review Report for Company X

SHARIAH COMPLIANCE REVIEW REPORT FOR COMPANY X

1. Background:

Company Name	COMPANY X
IPO Details	(A) Public issue of 85,979,000 new ordinary shares in Company X, comprising: i) 13,000,000 shares for Malaysian public ii) 13,000,000 shares for directors, employees, and contributors iii) 59,979,000 shares by private placement (B) Private placement of 40,000,000 existing ordinary shares in Company X at RM0.46 per share for Bursa Malaysia listing.

2. Shariah Screening Analysis and Finding:

Part 1: Overview of Company X

Background	
Principal activities	Company X is involved in providing support services for satellite, fibreoptic, and mobile networks.
Audited Figures Fiscal Year-End in Ringgit Malaysia (RM)	
Revenue	RM 54,519,000
Profit Before Tax	RM 13,665,000
Interest Income	RM 1,000
Total Assets	RM 43,793,000
Total Cash	RM 11,297,000
Total Debt	RM 8,650,000

All principal activities of Company X are Shariah-compliant.

Part 2: Financial Ratio Assessment

Company X satisfies the debt ratio requirement, with a ratio below 33%.

Company X also satisfies the cash ratio benchmark, which is less than 33%.

Part 3: Interest Income Ratio Assessment

The Interest Income ratio measures the presence of interest-based elements within a company's balance sheet and must be less than 5% to be Shariah-compliant. The screening showed the following:

- Interest Income ratio based on revenue: 0% (below 5% benchmark)
- Interest Income ratio based on Profit Before Tax: 0.01% (below 5% benchmark)

Therefore, Company X passes the Interest Income ratio requirement.

Part 4: Qualitative Assessment

The public perception and image of Company X's activities are considered positive from the perspective of Islamic teachings.

3. Overall Assessment

Based on this Shariah screening, it is concluded that Company X is Shariah-compliant.

Diagram 2 on the other hand, shows that Company Y is non-compliance with Shariah:

Diagram 2: Shariah Compliance Review Report for Company Y

SHARIAH COMPLIANCE REVIEW REPORT FOR COMPANY Y

1. Background

Company Name	COMPANY Y

IPO Details	Listing scheme entails the proposed placement of 20,000,700 Placement Shares at an indicative issue price of RM0.35 each, and the proposed listing of entire 100,003,340 Shares.

2. Shariah Screening Analysis and Findings

Part 1: Overview of Company Y

Background	
Principal activities	Company Y develops software solutions for communities, including a platform connecting residents and management offices in residential areas.
Audited Figures Fiscal Year-End in Ringgit Malaysia (RM)	
Revenue	RM 139,000
Loss Before Tax	RM (543,000)
Interest Income	RM 10,000
Total Assets	RM 581,000
Total Cash	RM 200,000
Total Debt	RM 2,054,000

List of Subsidiary Companies	
Company Name	**Principal Activities**
Company Y (a)	Investment holding
Company Y (b)	Sales, marketing, and deployment of platform and related products/services in Malaysia.
Company Y (c)	Development, upgrading and maintenance of a platform and its peripheral products and services

All principal activities of Company Y are Shariah-compliant.

Part 2: Financial Ratio Assessment

Company Y failed to meet the financial ratio benchmarks, as its debt ratio and cash ratio exceeded the 33% threshold.

Part 3: Interest Income Ratio Assessment

The Interest Income ratio measures the presence of interest-based elements within a company's balance sheet and must be less than 5% to be Shariah-compliant. The screening showed the following:

Part 4: Interest Income Ratio Assessment

- Interest Income ratio based on revenue: 7.19% (exceeding 5% benchmark)
- Interest Income ratio based on Loss Before Tax: -1.84% (meeting below 5% requirement)

3. Overall Assessment

While Company Y's Interest Income ratio based on Loss Before Tax complied with the benchmark, its failure to meet the debt ratio, cash ratio, and Interest Income ratio based on revenue rendered it as Shariah non-compliant according to the screening methodology.

These examples illustrate the Securities Commission's methodology for determining Shariah compliance of companies based on their activities and financial reports. Company X meets the financial ratio and business activity benchmarks, with debt, cash ratios below 33%, and interest income ratio under 5%. It also has a positive public perception from an Islamic perspective. Conversely, Company Y fails the financial ratios, exceeding 33% for debt and cash, and the interest income ratio is above 5%, despite a positive qualitative assessment. Consequently, Company X is deemed Shariah-compliant, while Company Y is Shariah non-compliant.

Basis and Justification for Establishing the Benchmark

After discussing the methodology, it is essential to understand the basis and justification behind the establishment of the benchmarks, which form the fundamental principles of the methodology. The evidence mentioned in the previous section regarding the permissibility of investing in mixed companies is included in the basis of the methodology. This section will emphasize the rationale for establishing the benchmarks.

According to the resolutions of the Securities Commission's Shariah Advisory Council (2007), to determine the Shariah compliance of mixed companies, it is necessary to establish benchmarks to ensure that the prohibited elements are within a minimal level, which does not affect the permissible part of the company, which is more important. In formulating this methodology, the SAC took into consideration the elements of *maṣlaḥah* (public interest)*, 'urf khāṣ min asālib iqtiṣādiyyah (*widely accepted practices, especially in economic activities), *fasād al-zamān* (exigencies of the time*), and ḥuqūq ghair* muslimīn (the rights of non-Muslims).[56]

For the financial ratio benchmark, the 33% threshold is supported by a *ḥadīth* of Sa'ad bin Abī Waqāṣ who wanted to bequeath his property as charity:

أنه عاد سعد بن أبي وقاص فقال له رسول الله ﷺ: قد بلغ مني الوجع ما ترى وأنا ذو مال ولا يرثني إلا ابنة لي، أفأتصدق بثلثي مالي، فقال له رسول الله ﷺ: لا، فقال له سعد فالشطر، قال: لا، ثم قال له رسول الله ﷺ: الثلث والثلث كثير، إنك أن تذر ورثتك أغنياء خير من أن تذرهم عالة يتكففون الناس.

> "Sa'ad bin Abī Waqqās fell ill, and the Prophet (peace be upon him) visited him. Sa'ad said to the Prophet, 'O Messenger of Allah, I have much wealth, and I have only one daughter to inherit from me. Shall I give away two-thirds of my wealth as charity?' The Prophet replied, 'No.' Sa'ad then asked, 'What about half of my wealth?' The Prophet again said, 'No.' Sa'ad further inquired, and the Prophet (peace be upon him) said, 'One-third, and one-third is still a significant amount. It is better to leave your heirs wealthy than to leave them in poverty, begging from others."[57]

The hadith narrated by Sa'd bin Abi Waqqas, where the Prophet advised him not to bequeath more than one-third of his wealth as charity,

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[56] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 159–60.
[57] Muslim bin al-Ḥajjāj al-Naysābūrī, *Ṣaḥīḥ Muslim* (Beirut: Dār Iḥyā' al-Turāth al-'Arabī, n.d.), vol. 3, 1250, *"bāb al-waṣiyyah bi al-thuluth," ḥadīth* no. 1628.

and emphasised that "one-third is still a significant amount," has been used as a basis for adopting the 33% threshold in Shariah screening methodologies.[58]

While the hadith directly relates to the context of bequeathing property and giving charity, its underlying principle of considering one-third as a substantial proportion has been extended by Islamic scholars to other areas, including financial screening criteria.

In the context of mixed companies (businesses involved in both permissible and non-permissible activities), when the element of prohibited income or interest-bearing debt exceeds 33% of the company's total income or capital, it is considered to have surpassed the tolerance level of moderation outlined in the hadith.

Therefore, the Prophet's emphasis on "one-third is enough" in the hadith has been interpreted by Shariah scholars as setting an upper limit or benchmark for the mixture of prohibited elements in a company's operations and financial dealings. Exceeding this one-third threshold would be deemed excessive and non-compliant with Shariah principles, based on the guidance derived from this Prophetic tradition.

Another basis for the benchmark is the concept of *ghabn fāḥish* (excessive profit obtained through cheating or exceeding the market price). The practice of *ghabn fāḥish* in trading is prohibited in Islam, but if the profit is not excessive, it is permissible. However, if there is no element of cheating, it is allowed. The activity of *tanājush* (fake bidding) is forbidden. In such cases, the buyers have the right to cancel the contract. This indicates the prohibition of including elements of *tanājush* and *ghabn fāḥish* in a contract. Despite this, if it occurs below the maximum limit, it is excused. The Ḥanafī legal school has stated the benchmark for *ghabn fāḥish* as follows:

a) 5% for ordinary goods;
b) 10% for animals, including those used for riding; and
c) 20% for fixed assets.[59]

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[58] Securities Commission, *Resolutions of the Securities Commission Shariah Advisory Council*, 162.
[59] Ibid, 162–63.

List of Shariah-Compliant Securities by Securities Commission's Shariah Advisory Council

The Shariah Advisory Council of Securities Commission Malaysia approves and updates the list of Shariah-compliant securities listed on Bursa Malaysia twice a year. The first list is announced in May, and the second list is announced in November. The table below illustrates the number and percentage of Shariah-compliant securities listed from 2010 to 2023:

Table 3: Number of Shariah-complaint Securities Listed on the Securities Commission Malaysia (2010-2023) [60]

Year	Number of Shariah-Compliant Securities	Total Number of Securities Listed	Shariah-Compliant Securities (%)
2010	655	957	68.44
2011	839	941	89.16
2012	817	921	88.71
2013	653	911	71.68
2014	673	906	74.28
2015	667	903	73.86
2016	672	904	74.34
2017	686	905	75.80
2018	689	933	73.85
2019	696	947	73.50
2020	715	954	74.95
2021	750	967	77.56
2022	787	991	79.41
2023	811	1014	79.98

Purification of Income by Investors

The Shariah Advisory Council (SAC) of Securities Commission Malaysia has issued a resolution regarding the purification of dividends

[60] "List of Shariah-Compliant Securities - Shariah-Compliant Securities | Securities Commission Malaysia," Securities Commission Malaysia, accessed May 27, 2024, https://www.sc.com.my/development/icm/shariah-compliant-securities/list-of-shariah-compliant-securities.

received and excess capital gains from the disposal of Shariah non-compliant securities after the announcement date. The SAC requires investors to fulfill the following conditions for the purification of tainted income (capital gains and dividends received from the disposal of Shariah non-compliant securities mistakenly invested in): [61]

(i) Upon receiving the tainted income, the fund manager shall deposit it into a separate account segregated from the Islamic fund's account;
(ii) The fund manager shall distribute the tainted income to the investors as soon as practically possible, as advised by the Shariah adviser of the Islamic fund;
(iii) The fund manager shall inform or notify the investors of their obligations to purify the tainted income in accordance with Shariah principles upon distribution; and
(iv) The processes and procedures for the purification of the tainted income by the investors shall be clearly disclosed in the prospectus/offering document.

Dow Jones Islamic Market World Index (DJIM)

History of Establishment: The Dow Jones Islamic Market Index (DJIM), launched in 1999 in Bahrain, was the first index created for investors seeking Shariah-compliant investments. The DJIM has an independent Shariah Supervisory Board. The DJIM measures the Shariah-compliance of stocks in various markets worldwide, and its index family includes broad-market, blue-chip strategy, and thematic indices.[62]

Shariah Screening Methodology: Similar to the Securities Commission Malaysia, Dow Jones applies two criteria in screening stocks: business activities and financial aspects. For sector-based screening, the DJIM's Shariah Supervisory Board has established parameters for business activities deemed inconsistent with Shariah law, as listed below:

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[61] Securities Commission Malaysia, *Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia*, 139–40.
[62] Dow Jones Indices, "Dow Jones Islamic Market Indices Methodology," 2019, 3, https://us.spindices.com/documents/methodologies/methodology-dj-islamic-market-indices.pdf.

i) Alcohol;
ii) Tobacco;
iii) Pork-related products;
iv) Conventional financial services (banking, insurance, etc.)
v) Weapons and defence; and
vi) Entertainment (hotels, casinos / gambling, cinema, pornography, music, etc.)

Income from these prohibited sources cannot exceed 5% of the total revenue.

After eliminating companies with prohibited business activities, the remaining stocks will undergo an accounting-based screening process. The DJIM's Shariah board does not allow investing in companies with unacceptable levels of debt or interest income. Hence, the board regulates a maximum level of 33% for the following financial ratios:

i) Total debt divided by trailing 24-month average market capitalization.

$$\frac{\text{Total debt}}{\text{Average market capitalization (24 month)}} < 33\%$$

ii) The sum of a company’s cash and interest-bearing securities divided by trailing 24-month average market capitalization.

$$\frac{\text{Total cash} + \text{interest bearing securities}}{\text{Average market capitalization (24 month)}} < 33\%$$

iii) Account receivables divided by trailing 24-month average market capitalization.[63]

$$\frac{\text{Account receivables}}{\text{Average market capitalization}} < 33\%$$

Purification of Income: For purification purposes, DJIM provide a dividend purification ratio to the investors. The formula to calculate the dividend is as follows:

$$\text{Dividends X } \frac{\text{Non} - \text{Permissible Revenue}}{\text{Total Revenue}}$$

[63] Dow Jones Indices, 29–30.

Where the non-permissible revenue includes all forms of revenue or income that are considered non-permissible with Shariah including non-permissible activities and interest income.[64]

Financial Times Stock Exchange Islamic Index Series (FTSE)[65]

History of Establishment: The Financial Times Stock Exchange (FTSE) Islamic Index Series was launched in October 1999. The FTSE Global Equity Shariah Index Series provides Shariah indices for stocks covering global stock markets, including both developed and emerging markets.

Shariah Screening Methodology: The Shariah screening process is undertaken by Yasaar Limited, comprising Shariah scholars who represent all the major schools of Islamic thought. The initial step for the Shariah screening process is business activity screening, where the Shariah board filters out all companies involved in the following activities, which contravene Shariah law:

i) Conventional finance (conventional banking, finance and insurance, etc);
ii) Alcohol;
iii) Pork-related products and non-halal food production, packaging and processing or any other activity related to pork and non-halal food;
iv) Entertainment (casinos, gambling and pornography); and
v) Tobacco;
vi) Weapons, arms and defence manufacturing.

The next screening process is financial ratio screening, whereby the remaining companies will be evaluated based on financial criteria. The following financial ratios must be satisfied for a company to be qualified as Shariah-compliant:

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[64] Ibid, 21.
[65] FTSE Russell, "FTSE Global Equity Shariah Index Series," accessed December 1, 2023, https://research.ftserussell.com/Analytics/FactSheets/temp/0f34f98e-7cf6-4684-8227-7fa0f5c1786c.pdf.

i) Ratio of total debt over total assets must be less than 33.333%;

$$\frac{\text{Total debt}}{\text{Total assets}} < 33.333\%$$

ii) Cash and interest-bearing items are less than 33.333% of total assets;

$$\frac{\text{Total cash} + \text{interest bearing items}}{\text{Total assets}} < 33.333\%$$

iii) Accounts receivable and cash are less than 50% of total assets; and

$$\frac{\text{Account receivable} + \text{cash}}{\text{Total assets}} < 50\%$$

iv) Total interest and non-compliant activities income should not exceed 5% of total revenue.

$$\frac{\text{Total interest and income from non compliant activities}}{\text{Total revenue}} < 5\%$$

Purification of Income: FTSE has specified an appropriate purification of dividends at 5%. This ratio calculates the recommended purification amount to be paid by the investor.

Standard & Poor's (S&P) Shariah Index

History of Establishment: S&P Shariah Indices were introduced in 2006 by Standard & Poor's to meet the increasing demand for Shariah-compliant financial products.

Shariah Screening Methodology: S&P Shariah indices provide their own Shariah screening methodology and undertake the screening process for stocks globally, in collaboration with Ratings Intelligence Partners (RI), a London/Kuwait-based consulting company made up of Islamic researchers who work directly with the Shariah Supervisory Board.

The initial screening process involves filtering out companies with Shariah non-compliant activities. S&P has listed the following activities as non-compliant:

i) Advertising and media (newspapers are allowed, sub-industries are analysed individually);
ii) Alcohol;
iii) Embryonic or stem cell research and cloning;
iv) Financials;
v) Gambling;
vi) Pork;
vii) Pornography;
viii) Tobacco; and
ix) Trading of gold and silver as cash on deferred basis.

After filtering out the companies with prohibited business activities, the remaining companies are evaluated based on acceptable financial ratios, focusing on three areas: leverage compliance, cash compliance, and the share of non-compliant revenues. All these companies are examined based on the following criteria:

i) Leverage compliance:

$$\frac{\text{Debt}}{\text{Market Value of Equity (36 month average)}} < 33\%$$

ii) Cash compliance:

$$\frac{\text{Accounts receivables}}{\text{Market value of equity (36 monthaverage)}} < 49\%$$

$$\frac{\text{Cash + Interest bearing securities}}{\text{Market value of equity (36 monthaverage)}} < 33\%$$

iii) Revenue share from non-compliant activities:

$$\frac{\text{non compliant income other than interest income}}{\text{Revenue}} < 5\%$$

Purification of Income: Similar to the DJIM, S&P provides a dividend purification ratio to investors for purification purposes, where the calculation is as follows:

$$\text{Dividends X } \frac{\text{Non} - \text{Permissible Revenue}}{\text{Total Revenue}}$$

Morgan Stanley Capital International Islamic Index (MSCI)[66]

History of Establishment: Launched on July 26, 2007, the MSCI World Islamic Index is designed to measure the performance of the large and mid-cap segments of the 23 Developed Market countries (e.g., Australia, Austria, Belgium, Canada, Denmark, etc.) that are relevant for Islamic investors.

Shariah Screening Methodology: The index applies stringent screens to announce Shariah-compliant securities based on two types of criteria: business activities and financial ratios derived from total assets. The screening process begins with the business activities screen, where MSCI does not allow investments in companies that are active in, or derive more than 5% of their revenues from, the following activities:

i) Alcohol;
ii) Tobacco;
iii) Pork-related products;
iv) Conventional financial services;
v) Defence/weapons;
vi) Gambling; and
vii) Adult entertainment.

Additionally, MSCI does not allow investments in companies that derive significant income from interest or have excessive leverage. Therefore, MSCI provides three financial ratios that may not exceed 33.33%:

i) Total debt over total assets;

$$\frac{\text{Total debt}}{\text{Total assets}} < 33.33\%$$

ii) The sum of a company's cash and interest-bearing securities over total assets;

$$\frac{\text{Total cash} + \text{interest bearing securities}}{\text{Total assets}} < 33.33\%$$

iii) The sum of a company's account receivables and cash over total assets.

[66] MSCI, "MSCI World Islamic Index (USD)," accessed December 1, 2023, https://www.msci.com/documents/10199/c0b90e16-5746-4cdc-b033-1ec7da64386e.

$$\frac{\text{Account receivable} + \text{total cash}}{\text{Total assets}} < 33.33\%$$

Purification of income: If a company derives any interest income and/or is involved in prohibited activities, this proportion must be deducted from the dividends paid out to shareholders and channelled to charity. MSCI, therefore, applies a "dividend adjustment factor" to all reinvested dividends.

The “dividend adjustment factor” is defined as:

$$\frac{\text{Total earnings} - (\text{income from prohibited activities} + \text{interest income})}{\text{total earnings}}$$

Analysis and Comparison

From the previous discussion, it is observed that the five Islamic finance providers differ in many ways, such as their governance, targeted stocks screened, and screening methodologies, including both qualitative and quantitative screening. Additionally, according to Catherine et al., the Shariah index providers not only differ in their methodologies but also vary in terms of objectives, such as portfolio managers, market intelligence providers, and regulators.[67]

Table 4 below shows some similarities and differences among the four global index providers and the Securities Commission Malaysia in terms of country of origin, screening level, and governance.

The table highlights the key similarities and differences among these Islamic index providers, allowing for a comprehensive analysis and comparison of their approaches to Shariah-compliant screening and indexing.

[67] Catherine S. F. Ho et al., “Qualitative Research in Financial Markets Emerald Article : Syariah Accounting and Compliant Screening Practices,” *Qualitative Research in Financial Markets* 4, no. 2/3 (2012): 241.

Table 4: The Similarities and Differences of Four Global Index Providers and Securities Commission Malaysia (SC)

Index Providers	Country of origin	Screening level	Governance
Securities Commission Malaysia (SC)	Malaysia	Micro	Governed and regulated by Securities Commission Malaysia, applicable only to Malaysian markets.
Dow Jones Islamic Market World Index (DJIM)	USA	Macro	Governed by its Headquarters at USA, and applicable to various countries worldwide.
Financial Times Stock Exchange Islamic Index Series (FTSE)	UK	Macro	The Shariah screening process is undertaken by Yasaar Limited, applicable to both emerging and developed markets.
Standard & Poor's (S&P) Shariah Index	USA	Macro	The Shariah screening process is undertaken by its Shariah board in collaboration with Ratings Intelligence Partners (RI).
Morgan Stanley Capital International Islamic Index (MSCI)	USA	Macro	Governed and regulated by its Headquarters located at USA, applicable to 23 Developed Market countries.

Among the five parties, the Securities Commission (SC) alone is a regulatory body, while the other four are index providers. As the regulator in Malaysia, the SC's index is applicable only to Malaysian markets. The difference between these five bodies also lies in their screening level or geographical scope, i.e., macro, and micro levels. Macro-level users screen available stocks worldwide, while micro-level users screen stocks within a particular country.[68] Hence, the SC is classified as a micro-level user, and the remaining bodies screen available stocks at the macro level.

Critical Evaluation of Methodologies

In terms of methodologies, all five institutions employ a two-tier screening method: qualitative assessment and quantitative assessment. Therefore, the comparisons will be discussed from two aspects: qualitative screening and quantitative screening.

Qualitative Screening

Generally, the qualitative screening or business activity criteria formulated by the index providers and the SC are similar, except for minor differences in certain criteria. Table 5 below exhibits the list of sectors that must be excluded from Shariah-compliant stocks as set out by the four index providers and the SC.

Table 5: Sector Screening Criteria Provided by Four Global Index Providers and SC[69]

Sector	SC	DJIM	FTSE	S&P	MSCI
Alcoholic Beverages	c.b.	a.i.	c.b.	a.i.	c.b.
Broadcasting & Entertainment	c.b.	a.i.	c.b.	a.i.	c.b.
Conventional Financial Services	c.b.	a.i.	c.b.	a.i.	c.b.
Gambling	c.b.	a.i.	c.b.	a.i.	c.b.
Hotels		a.i.	c.b.	a.i.	c.b.
Insurance	c.b.	a.i.	c.b.	a.i.	c.b.
Media Agencies (except newspapers)		a.i.		a.i.	
Pork-related Products	c.b.	a.i.	c.b.	a.i.	c.b.
Restaurant & Bars	c.b.	a.i.	c.b.	a.i.	c.b.

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[68] Ho, "International Comparison of Shari`ah Compliance Screening Standards," 226.
[69] Ulrich Derigs and Shehab Marzban, "Review and Analysis of Current Shariah-Compliant Equity Screening Practices," *International Journal of Islamic and Middle Eastern Finance and Management* 1, no. 4 (2008): 289.

Tobacco	c.b.	a.i.	c.b.	a.i.	c.b.
Trading of Gold & Silver				a.i.	
Weapons & Defence		a.i.	c.b.	.	c.b.

a.i.: any involvement
c.b.: core business

The overall comparison of qualitative screening criteria shown in the table above proves that there is almost a consensus among the Shariah boards of the index providers in determining the impermissible sectors to be filtered out from Shariah-compliant listed stocks. However, there is a minor disagreement among the Shariah boards regarding the classification of weapons and defence, as well as media agencies, as Shariah non-compliant sectors. Additionally, S&P alone includes trading of gold and silver as a criterion for impermissible business activity. For the hotel industry, the SC is the only one that excludes it from the Shariah impermissible business lists, which was previously listed before a minor amendment issued in 2016.

Furthermore, we can observe that some Shariah boards are more stringent than others, whereby the DJIM and S&P Shariah supervisory boards exclude stocks with any involvement in Shariah impermissible sectors. Meanwhile, the SC, FTSE, and MSCI Shariah boards screen out only the companies whose core business is impermissible, and a company will not be filtered out if its core business is Shariah-compliant.

The qualitative screening criteria used by the providers differ in their specificity and inclusiveness. Some institutions, such as DJIM and S&P, take a more stringent approach by excluding companies with any involvement in prohibited activities, while others, like the SC, FTSE, and MSCI, allow companies with permissible core activities despite minor involvement in non-compliant sectors. This divergence raises questions about the consistency and reliability of identifying truly Shariah-compliant activities.

Quantitative Screening

The quantitative screening process is undertaken to examine the financial structure of the companies and ensure that their financial status complies with Shariah principles to qualify as Shariah-compliant stocks. Different index providers have formulated their own methods for calculating the financial thresholds. Therefore, the comparison of quantitative screening criteria by the five index providers will be summarized into four categories:

i) Debt screen;
ii) Liquidity screen;
iii) Interest screen; and
iv) Impermissible income screen.

Table 6 below deliberates the various methods of quantitative screening criteria formulated by the SC and other four major index providers:

Table 6: Quantitative Screen from Four Global Index Providers and the SC

Inst	Debt Screen	Liquidity Screen	Interest Screen	Impermissible Income Screen
SC	$\frac{D}{TA} < 33\%$	$\frac{C}{TA} < 33\%$	$\frac{IY}{TR} < 5\%$	$\frac{NPY}{TR} < 5\%$
DJIM	$\frac{D}{AvMCap} < 33\%$	$\frac{AR}{AvMCap} < 33\%$	$\frac{C + IBS}{AvMCap} < 33\%$	-
FTSE	$\frac{D}{TA} < 33.333\%$	$\frac{AR + C}{TA} < 50\%$	$\frac{C + IBS}{TA} < 33.333\%$	$\frac{NPY}{TR} < 5\%$
S&P	$\frac{D}{MVEq} < 33\%$	$\frac{AR}{MVEq} < 49\%$	$\frac{C + IBS}{MVEq} < 33\%$	$\frac{NPY}{TR} < 5\%$
MSCI	$\frac{D}{TA} < 33.33\%$	$\frac{AR + C}{TA} < 33.33\%$	$\frac{C + IBS}{TA} < 33.33\%$	$\frac{NPY}{TR} < 5\%$

D: Debt
TA: Total Assets
IY: Interest income
C: Cash

IBS: Interest-bearing securities
AR: Account receivable
NPY: Non-permissible income
TR: Total revenue
AvMCap: Average market capitalization
MVEq: Market value of equity

The use of different financial ratios and divisors (e.g., total assets, market capitalization, equity) in the quantitative screening process could lead to inconsistencies in the classification of companies as Shariah-compliant or non-compliant. Furthermore, the appropriateness and justifications for the benchmarks used (e.g., 5%, 33%) warrant further examination to ensure they are consistently applied and aligned with Shariah principles.

Debt Screening

It is observed that there is a consensus among the five practitioners in applying the concept of one-third as a benchmark for the tolerance level in the debt screening process, derived from the understanding of the *ḥadīth* mentioned earlier. Nevertheless, they differ in the divisor used for the calculation, which includes total assets, average market capitalization, and market value of equity.

It is argued that market capitalization reflects the real worth of the company, but the fluctuation of market prices affects the threshold value and may lead to inconsistency in the Shariah-compliance status of the company. However, some practitioners prefer to use market capitalization or total assets as the divisor because they agree that the use of average market capitalization is more suitable to smooth out any uncertainty in market prices, and hence they can avoid inconsistency in the Shariah-compliant status of the listed companies.[70] On the other hand, S&P employs a different method, whereby its Shariah Supervisory Board uses the market value of equity as the divisor in debt screening.

Liquidity Screening

For liquidity screening, there seems to be a disagreement between the index providers' Shariah boards in determining the threshold value. The majority sets the tolerance level at 33%, applying

[70] Ho, 241.

the concept of one-third, while FTSE and S&P determine the threshold value at 50% and 49%, respectively. This indicates different Shariah jurisdictions' referral to different Shariah boards.

Furthermore, they also differ in classifying the ratios under this screening: either cash, accounts receivable, or accounts receivable plus cash. The SC applies only liquid assets that cannot exceed 33% of total assets. Meanwhile, the other index providers are more specific, determining that accounts receivable or accounts receivable plus cash must be lower than 33% to 50% of total assets or average market capitalization.[71]

As in the case of debt screening, the index providers diverge in using the divisor for liquidity screens. The SC, MSCI, and FTSE prefer to use total assets, while the other two use average market capitalization and equity as the divisor for the liquidity screening process.

Interest Screening

Two sets of ratios are identified in the interest screens provided by the five practitioners: the first is interest income, and the second is cash plus interest-bearing securities. The SC applies the threshold limit of 5% for interest income over total assets, as interest income or *ribā* cannot exceed 5% of total assets.

The index providers other than the SC use cash plus interest-bearing securities as their ratios in interest screens, and the benchmark applied is 33% to 33.33%. Again, the divisor for interest screening by the index providers differs, either applying total assets, average market capitalization, or equity.

Impermissible Income Screening

Under the category of impermissible income screening, the non-permissible business activities classified in the initial qualitative screening are further examined in the quantitative screening to ensure that the revenue from those activities is within the tolerance level.[72] In this screening, the threshold value is fixed at 5% of the total revenue, except for the DJIM, which does not apply this benchmark in their

[71] Ibid.
[72] Ho, 242.

quantitative assessment. Additionally, S&P alone screens impermissible business activities by excluding interest income that does not exceed 5% of total revenue. In summary, there is a consensus in determining the maximum limit of 5% for impermissible income, as non-permissible business activities are categorized as activities clearly prohibited in the Quran.

Purification of Income

It is observed that there is a similarity between DJIM and S&P in providing a dividend purification ratio to investors for purification purposes, whereas MSCI provides its own dividend adjustment factor. The SC, on the other hand, has issued a resolution regarding the purification of dividends with certain conditions. FTSE alone requires an appropriate purification of dividends at 5%.

Best Practices and Areas for Improvement

While each methodology has its strengths and weaknesses, a comparative analysis could help identify potential best practices. For instance, the SC's qualitative assessment of a company's image and public perception could be a valuable addition to other methodologies. Similarly, FTSE's approach to purification of dividends at a fixed 5% rate could be considered a transparent and consistent practice.

Areas for improvement include developing more robust and universally accepted definitions of Shariah-compliant activities, aligning financial ratio benchmarks with Shariah principles, and enhancing data accuracy and transparency in the screening process.

By addressing these aspects, the Islamic finance industry could work towards a more harmonized and widely accepted Shariah stock screening methodology, fostering greater confidence and credibility among investors.

Conclusion

Findings: This article compiles and analyses the Shariah stock screening methodologies adopted by five prominent Islamic finance institutions: the Securities Commission Malaysia (SC), Dow Jones Islamic Market World Index (DJIM), Financial Times Stock Exchange Islamic Index Series (FTSE), Standard & Poor's (S&P) Shariah Index, and Morgan

Stanley Capital International Islamic Index Series (MSCI). The study reveals several key findings:

1. All five institutions practice two-tier Shariah screening methodologies involving qualitative and quantitative assessments.
2. Differences exist in the qualitative screening criteria, with some index providers being more specific in listing Shariah non-compliant activities, while others take a more general approach.
3. There is a lack of consensus among the institutions regarding certain quantitative screening ratios, such as debt screening, liquidity screening, and the divisors used for calculation.
4. While there is broad agreement on the maximum 5% limit for impermissible income screening, DJIM does not apply this benchmark.
5. The institutions vary in their methods for purification of income, with DJIM and S&P providing dividend purification ratios, MSCI offering a dividend adjustment factor, and the SC issuing specific resolutions.

Recommendations:

1. To avoid inconsistencies in determining the Shariah-compliance of stocks and to enhance the credibility and comparability of Islamic finance indices, there is a crucial need for standardization of methodologies across institutions.
2. The Islamic finance industry could benefit from collaborative efforts among Shariah scholars, regulatory bodies, and index providers to develop a unified set of guidelines or a harmonized framework for Shariah stock screening methodologies.
3. Transparency in the evaluation process is essential to facilitate better comparability and informed decision-making for investors.
4. Periodic reviews and updates to the standardized methodology should be undertaken to align with evolving Islamic finance practices and market dynamics.

5. Further research and dialogue within the Islamic finance community are encouraged to address potential challenges and promote a robust Shariah-compliant investment landscape.

6. Conduct further in-depth research to critically evaluate the effectiveness, reliability, and limitations of existing Shariah stock screening methodologies, not only in Malaysian context, but also other country and region.

7. Expand the scope of quantitative screening to include a more comprehensive set of financial metrics beyond the commonly used debt, cash, and interest income ratios.

By implementing these recommendations, the Islamic finance industry can work towards a more consistent and credible Shariah stock screening process, fostering greater investor confidence and driving the growth of the Shariah-compliant investment market.

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