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FUNDAMENTALS, UNIVERSE CREATION AND APPRAISAL OF MAJOR *SHARI'AH*- COMPLIANT STOCKS SCREENING METHODOLOGIES

*Buerhan Saiti,
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Abstract

This study will examine and review the existing Shariah-compliant stock screening methodologies and will propose a universal standard Shari'ah screening methodology. Apart from understanding the philosophy, definition, components and functions of Islamic stocks, it is also important to understand the conditions and rules of the Islamic stock market, as well as the universe creation and stock selection, screening process, tolerable level of non-permissible elements, change of Shari'ah-compliant status, purification process, and periodic and ongoing review of Shari'ah-compliant stocks. In this paper, we demonstrate the fundamentals and processes of Shari'ah-compliant stocks and show how world major stock index providers create the universes for Shari'ah-compliant stocks. Finally, we examine the similarities and differences of Shari'ah-compliant stock screening in terms of methodologies. Despite all the differences and inconsistencies, it is recommended that the relevant authorities, or index providers, should set a universal standard with clear guidelines and understanding to be applicable to all. Eventually, this universal standard will accelerate the commercial and economic cooperation among Muslim communities around the world.

Key words: Islamic Finance, Islamic Stock, *Shari'ah*-screening Methodology

1. Introduction

The world's major religions such as Islam, Christianity, Hinduism and Judaism, followed by more than two-thirds of the world's population, have forbidden interest (Chapra, 2007¹). However, in contradiction with this prohibition, the conventional financial system is based on *riba* and has been practiced for more than two hundred years so far. However, some calls have been raised against interest. These calls have been especially prominent in Muslim countries where a determined attempt is underway to replace the interest-based system of financial system with the Islamic system.

A significant difference can be found in the nature of the stocks in Western and Islamic financial systems. The financial products exchanged on an Islamic stock must fit in the concept of partnership where business risks are shared proportionately by all partners. Due to the prohibition of interest (*riba*) the Islamic stock market can be defined as a share market with transactions undertaken exclusively in ownership contracts (Naughton & Naughton, 2000;² Hearn, 2012³).

Firstly, Islamic financial markets have several special products that are based on the doctrines of partnership contracts which between the entrepreneur and the *rabbul-mal* (contributor of capital). Secondly, there is a fundamental difference between Western and Islamic definitions in principal in terms of the common share, or equity. This is mainly because the way the Islamic contracts overcome asymmetric information between the capital issuer and provider is different from the Western one. For example, the Islamic system treats the equity contract as a form of *mudarabah*, where a contract is formed between at least two parties. In this contract, one party contributes all the capital and the other party is responsible for

¹ M. Umer Chapra, "The case against interest: is it compelling?" *Thunderbird International Business Review* 49, no.2 (2007), 161-186.

² Shahnaz Naughton and Tony Naughton. "Religion, ethics and stock trading: The case of an Islamic equities market." *Journal of Business Ethics* 23, no. 2 (2000), 145-159.

³ Bruce Hearn, Jenifer Piesse, and Roger Strange. "Islamic finance and market segmentation: Implications for the cost of capital." *International Business Review*, 21, no. 1 (2012), 102-113.

the management of the business.

Whereas, in the Western system, the risk of asymmetric information is mitigated by extensive legal contracts between contracting parties, adherence to Islamic teachings is reinforced by *Shari'ah* compliance in Islamic economies. As a result, the restriction of speculation⁴ (*gharrar*) and any type of gambling (*qimar*), including the manipulation of share prices for self-interest, practices the acts like the informational disadvantage of any party (*jahalalah*) are components of the *Shari'ah* code regulating markets. These practices must reflect common shared Islamic ethical values (Mannan, 1993⁵; Naughton & Naughton, 2000⁶; Hearn, 2011⁷).

The normative instructions make a difference on the institutional design between the Islamic and the West stock markets. For instance, Naughton & Naughton⁸ (2000) argue that the forbidding of practices such as selective information disclosure (*jahalalah*) and speculation or gambling has significant inferences both on the institutional design of the stock market in the case of the rules on disclosure, accounting and auditing, etc. Some current Western practices on disclosure of information and ownership, which causes the disadvantage of some investors while beneficial to others (*jahalalah*) are not permitted. However, disclosure in Islamic markets results in a strong-form of efficiency (Hearn, 2011⁹) where equity prices reflect all available information in both public and private domains.

Another essential difference is related to the institutional concepts of information and allocative efficiency (Naughton &

⁴ There are two groups of Islamic scholars; one group allows some degree of speculation for risk management purpose, while the other group exclusively prohibits speculation.

⁵ M.A. Mannan. *Understanding Islamic finance: A study of the securities market in an Islamic framework*. No. 26. The Islamic Research and Teaching Institute (IRTI), (1993).

⁶ Naughton & Naughton, op.cit.

⁷ Brice Hearn, Jenifer Piesse, and Roger Strange. "The role of the stock market in the provision of Islamic development finance: Evidence from Sudan." *Emerging Markets Review* 12, no. 4 (2011), 338-353.

⁸ Naughton & Naughton, op.cit.

⁹ Hearn (2011), op.cit.

Naughton, 2000¹⁰; Hearn, 2011¹¹). The incentive of Western model is to utilize the existence of arbitrage traders, who gain profit from price differences between the same stock transacted in different places. Normally, the short sale is used by financial market arbitrage traders; these traders borrow a stock to facilitate a trading strategy and derive the profit. On the other hand, the main concern of Muslim investors at the moment is whether to invest the stocks currently being traded. For example, short sale is considered as objectionable in Islam according to some Islamic scholars (Naughton & Naughton, 2000¹²; El-Din & El-Din, 2002¹³) as it is treated as gambling and speculation. Since the Islamic stocks which transacted are based on Islamic partnership contracts, both capital providers and investors have to bear an equal sharing of risk and return.

The stock markets of the Muslim World would seem to be appropriate destination for Islamic ethical investment, as they could be viewed as promoting business activities which help other Muslims (Wilson, 1997¹⁴). He considered some markets in the Muslim World as “emerging”, and these markets attract the interest of Western institutional investors. From this viewpoint, the opportunities provided by Islamic markets seem to be attractive; these channels could be alternative portfolios in their investment in addition to major Western financial markets. Put differently, the diversification opportunities of such Islamic markets can expand any portfolio choices, thus able to reduce the systematic risk in Western financial markets where stock prices are always volatile due to the financing, and gambling stocks. Therefore, the Islamic stock markets are sufficiently diverse to create portfolios which are hedged to a considerable degree.

A number of previous studies (Khatkhatay and Nisar, 2007¹⁵;

¹⁰ Naughton & Naughton, op.cit.

¹¹ Hearn (2011), op.cit.

¹² Naughton & Naughton, op.cit.

¹³ S. El-Din & T. El-Din. “Towards an Islamic model of stock market.” *Journal of King Abdulaziz University: Islamic Economics*, 3(1), (2002), 57–81.

¹⁴ Rodney Wilson, "Islamic finance and ethical investment." *International Journal of Social Economics* 24, no. 11 (1997), 1325-1342.

¹⁵ M. H. Khatkhatay and Shariq Nisar. "Shariah compliant equity investments: An assessment of current screening norms." *Islamic Economic Studies* 15, no. 1 (2007),

Mian, 2008¹⁶; Hassan and Girard, 2011¹⁷; Pok, 2012¹⁸) mainly focus on only one regulator (for example, Securities Commission of Malaysia), or one index provider (such as Dow Jones, FTSE, MSCI) of *Shari'ah*-compliant screening methodology. In this research, we are going to examine all major *Shari'ah*-compliant stock screening methodologies of major index providers, namely, Securities Commission of Malaysia, Dow Jones Islamic Index, Meezan (Pakistan), Financial Times Stock Exchange (FTSE) *Shari'ah* index, Morgan Stanley Capital International (MSCI) *Shari'ah* index and Standard & Poor's (S&P) *Shari'ah* index. End of the research, we will be able to see the similarities and differences on various *Shari'ah*-compliant stock screening methodologies so that it is a basis for the next step to set a universal standard with clear guidelines and understanding to be applicable to all. Finally, we will propose a universal standard methodology for *Shari'ah* stock screening and will justify why we need to propose such a model. It is important to understand the definition, components and function of the stock market and as well as the index construction mechanisms before examining the various *Shari'ah*-compliant stock screening methodologies.

2. Definition, Components and Functions of Stock Market

2.1 Definition of stock market

It is important to understand the definition, components and functions of the stock market before looking at the *Shari'ah*-compliant stocks. What is a stock or an equity? According to Hafer & Hein (2007, p.1¹⁹), a stock is a financial asset to its owner. In other words, stocks

47-76.

¹⁶ Kamal M.A. Mian, "Shariah screening and Islamic equity indexes." *Islamic Finance: A Practical Guide* 51, no. 4 (2008), 25-39.

¹⁷ M. Kabir Hassan and Eric Girard. "Faith-based ethical investing: the case of Dow Jones Islamic indexes." (2011).

¹⁸ 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.

¹⁹ Rik W. Hafer and Scott E. Hein. *The stock market*. (Greenwood Publishing Group, 2007).

are financial securities that represent claims of ownership. A stock is also defined as a claim against the firm that issued it. A stockholder is a partial owner of the firm: the stock represents the “prorata” of investor or proportional ownership of the business. When a company issues stock, it requires funds from those who initially buy it. Therefore, stocks can be viewed as a contractual agreement between two parties such as an investor and the firm itself. Investors are willing to give up money for the stock in order to receive some future payment that exceeds what they have given up.

According to the behavior of stock markets, some defined it as fast movements, grand life-styles, surprising fortunes and sudden heart-attacks (El-Ashkar, 1995²⁰). These events, however, do not disclose the important function of the stock market which is viewed as a financial intermediary.

2.2 Components of Stock Market

Just like other financial markets, the stock market has three basic components: i) commodities, ii) price mechanisms and iii) a market place (El-Ashkar, 1995²¹). The commodities are shares and stocks, bits of paper representing rights to the holder and obligations on the issuer. Shares are more risky but are expected to be more rewarding as well. The issuer of the stocks can be the government, public authorities or corporations. There are some other types of papers, such as preference shares and convertibles which lie between shares and stocks.

There are two types of commodities: i) brand new stocks that are newly issued, and ii) second hand stocks, which are the existing stocks moving around among existing holders. While the first one is defined as the primary market, the second one is called the secondary market. The secondary market is much larger than the primary market in terms of size and significance.

The price of commodities in the stock market is decided by the forces of demand and supply -- the same way as prices are

²⁰ Ahmad Abdel Fattah El-Ashkar. "Towards an Islamic stock exchange in a transitional stage." *Islamic Economic Studies* 3, no. 1 (1995), 79-112.

²¹ El-Ashkar, op.cit.

determined in a free market economy (El-Ashkar, 1995²²). There will be a stronger demand for shares if the company is more successful.

2.3 Functions of stock market

There are a number of functions of the stock market, but the key stock market function is economic function; it provides facility for the transfer of capital from investors to users of capital. Additionally, it allows companies looking to expand i) to raise capital from investors in the primary market and ii) to help the trade between buyers and sellers of stock in the secondary market. The benefits of the stock exchange are summarized as follows:

- i. “It provides a ready and continuous market for the purchase and sale of stocks. In other words, it facilitates a ready outlet where a large number of sellers and buyers can meet;
- ii. In terms of stock evaluation, it is useful for the assessment of stocks. Investors are able to know the true worth of their companies at any time.
- iii. It aims to remove the anxiety of investors, regarding future liquidity problems that may encourage the investors to accept a lower rate of return than they would have done in the absence of the exchange and it leads to reduced cost of capital for the firm;
- iv. It helps to provide more representative prices of securities than the case would be with separately organized markets;” (El-Ashkar, 1995)
- v. The well-defined rules and regulations provide safety, security and equity in transactions; particularly, listed companies have to conform with those rules and regulations of the stock exchange concerned and work under the supervision of stock exchange authorities.
- vi. It serves as a market place for selling government securities. Therefore, the government is able to raise public debt more easily and quickly. It also provides an effective way to issue stocks which helps corporations to raise funds.

²² El-Ashkar, op.cit.

- vii. In terms of speculation, the healthy type keeps the exchange active. In other words, the normal type speculation is not dangerous but gives more business opportunities to the exchange. On the other hand, the excessive speculation is detrimental since it is risky to investors and the growth of the corporate sector.
- viii. It indicates the health of companies and the national economy. It represents an indicator of the economic situation or conditions of a country.

Similar to stock markets in general, the *Shari'ah*-compliant stock market should have a market platform, commodities and price mechanism. However, there are some differences between the conventional stock market and Islamic market due to the quite distinct nature of *Shari'ah*-compliant securities. Since the *Shari'ah*-compliant stock market securities are based on an Islamic code of ethical values which are primarily based on honesty, fairness, clarity, mutual consent, and efficiency, the market eliminates the undesirable practices and unhealthy features that may exist in the conventional stock market.

3. Index construction and types of indexes

In order to measure the overall performance of a stock market, a stock index is needed. Basically from this barometer, we can tell that whether stock market is up or down. A basket of stocks will make an index. This basket of stocks that make up the index is usually carefully selected to be representative of the market it is measuring based on their correlations (low correlation is preferred). Broadly speaking, indexes are statistical samplings. There are three kinds of stock indexes (Bacha, 2007, p. 57-59²³) such as i) an equally weighted (price weighted) index, ii) a value weighted (capitalization weighted) index and iii) a geometrically weighted index; Even though the objective of measurement is the same, each of the above types of index differs in the way it is computed. Such a difference in computation leads to a small difference in market performance. In the

²³ Obiyathulla Ismath Bacha. *Financial Derivatives: Markets and Application in Malaysia*. (Mcgraw-Hill, 2007)

following sections, we are going to explain each type of index and their index construction mechanisms with appropriate examples.

3.1 An Equally Weighted (Price Weighted) Index

An equally weighted or price weighted index (EWI) is computed by adding the closing prices of component stocks and dividing by a divisor²⁴. In a price weighted index every stock has equal weight.

It can be computed by using the following formula:

$$EWI = \frac{\sum_i^n P_i}{Divisor}$$

Where: P_i is closing price of each stock and Divisor is statistical adjustment factor for capitalization. For example:

Stock	Return %	Equal weight %	Contribution Equal weight %
Alpha	10	25	2.5
Beta	8	25	2
Omega	4	25	1
XYZ	12	25	3
Total	-	100	8.5

From the above illustration, it is not difficult to derive that each stock has equal weight in index construction, for example, each stock has 25% of equal weights. Put differently, regardless of large or small companies, they have equal weights in index.

3.2 Capitalization Weighted Index (CWI)

Unlike an equally weighted index which has equal weights for each constituent stock, in a capitalization weighted index, each component of stock has a different weight in the calculation. The weight of each

²⁴ Statistical adjustment factor for capitalization changes; stock splits, bonus issues, rights and stock substitution.

stock will depend on its market value proportionate to the market value of the total index. Market value or market capitalization refers to the price per share multiplied by the number of shares outstanding. Thus, the capitalization weighted index gives a larger weight to big companies which have a large number of shares outstanding. In a CWI, each component stock in the index has a different weight in the calculation. Examples of CWI are S&P 500, TOPIX, FBM KLCI. Now let us look the computation mechanism for CWI.

$$CWI = \frac{\sum_i^n N_{i,t} * P_{i,t}}{O.I.V} * M$$

Where: $N_{i,t}$ – number of stocks outstanding for a company from i day on t.

$P_{i,t}$ – price of per stock of a company from i day on t.

$O.I.V$ – original index value which was the day of index computation begin.

M – Set as 100.

For example: Suppose there are five stocks in the Index and computation begins on day 1.

Stock	Number of outstanding shares	Close price on day 1	Close price on day 2
A	5000	RM 4	RM3.8
B	15,000	RM 6	RM6.2
C	20,000	RM 5	RM 5.3
D	30,000	RM10	RM9.8
E	28,000	RM12	RM12.5

$$\text{Index on day 1} = \frac{5000*4+15,000*6+20000*5+30000*10+28000*12}{5000*4+15,000*6+20000*5+30000*10+28000*12} * 100 = 100 \text{ points}$$

$$\text{Index on day 2} = \frac{5000*3.8+15,000*6.2+20000*5.3+30000*9.8+28000*12.5}{5000*4+15,000*6+20000*5+30000*10+28000*12} * 100 = \frac{862,200}{846,000} *$$

$$100 = 101.91 \text{ points}$$

From the above illustration, we can see that the index value is up by 1.91 points on day 2. If the index value is less than 100 on subsequent days, it is sign of decrease in index value. In this index construction, the large companies have larger influence on index computation.

4. Shari'ah-compliant Stocks and their screening methodologies

4.1 Condition of *Shari'ah*-compliant stocks

Akram Laldin (2008)²⁵ defined that: "Islam is a comprehensive way of life, which calls for the balance between the spiritual and the material needs of human beings. One of the significant aspects in human life is the need for a comprehensive system to oversee life and to make sure all the needs are adequately satisfied including the material needs such as the financial management."

Integrating Islamic principles with modern stock markets, a *Shari'ah*-compliant investment is the popular term for the current practice of buying and selling stocks based on Islamic principles. The basic doctrine of a *Shari'ah*-compliant investment is that Muslims should invest their assets to reflect the Islamic principles that oversee their daily lives.

To make sure Muslims consume only what is allowed, they have to ensure the income that they make and the generating wealth that they earn and accumulate must be done according to permissible ways. To help us understand this, the *Shari'ah* has outlined the basic principles that should be obeyed in our business and commercial transactions (Alhabshi, 2008²⁶).

²⁵ Mohamad Akram Laldin, "Islamic financial system: the Malaysian experience and the way forward." *Humanomics*, 24, no. 3 (2008), 217-238.

²⁶ S. O. Alhabshi, "Stock screening process". *Islamic Finance Bulletin: Towards an informed market*, issue 20 (2008)

The Holy *Qur'an* also states,

*“O ye who believe! Eat not up your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual goodwill: Nor kill (or destroy) yourselves: for verily God has been to you Most Merciful”*²⁷

We can clearly understand from the above verse that Muslims should take each other's wealth or property through lawful ways. The exchange or transactions that are mutually agreed by both parties should be transparent, proper, fair and just. At the end of the verse, it also states about killing or damaging oneself which indicates that if a person loses his property by cheating or force, you are in fact killing his livelihood although he may not die. According to such interpretations of the verse, the scholars have provided the principles of Islamic transactions as follows (Alhabshi, 2008)²⁸:

- Willing buyer;
- Willing seller;
- Well defined or specified goods, commodity or product;
- Mutually agreed price by both parties;
- Offer and acceptance;

The following can be derived from the above list of requirements (Alhabshi, 2008²⁹):

Firstly, the contracting parties in exchanges must be of age, free men, represented if blind and sane individuals. An under-aged person is not permitted to do a contract or exchange unless allowed by the guardian or parents.

Secondly, in order to avoid any ambiguity or uncertainty (*gharar*) which is not permitted, the goods, commodity or product must be well defined or specified. The goods should be owned by the vendor and can be delivered at the specified time.

Thirdly, both contracting participants such as buyer and seller

²⁷ *Al-Qur'an*, 4:28

²⁸ Alhabshi, op.cit.

²⁹ Alhabshi, op.cit.

need to agree on the price.

Last but not the least, the offer and acceptance can be verbal or in writing which implies the completion of the contract by both parties.

The Holy *Qur'an* has addressed mankind thus:

*“O ye people! Eat of what is on earth, lawful and good and not follow the footsteps of the evil one, for he is to you an avowed enemy”*³⁰.

The verse clearly says two important criteria for Muslims' food consumption: i) firstly they must be lawful and ii) secondly they must be good. From the science of the Holy *Qur'an*, the order of the words in the verse indicates that Muslims should select foods that are lawful first. Then, we should identify those that are good for us among the lawful foods. Two important implications can be drawn here: i) it indicates that what is lawful must be good. But, what is good may not be lawful, like alcohol. ii) what is good for somebody is not necessarily good for another. Therefore, one must be selective in terms of choosing among the lawful what is good for him/her.

While the first verse shows the basic principles of Islamic transactions in general, the second one provides the basis for stock screening. This implies that the basic principles of Islamic transactions can apply in the stock screening process. Actually, the third principle of Islamic transactions that relate to goods or products to be exchanged is further supported by the second verse quoted above. Put differently, the stock cannot include any prohibited elements either by action or by contents. Therefore, stock screening requires the inspection of the goods or products of the company and the way it is being produced, especially in terms of financial sources.

According to Usmani (1999)³¹, one of the most popular Islamic scholars of the modern era, Muslims can deal with equity shares under the following three conditions. Firstly, a Muslim can only invest in companies whose main businesses are compliant with

³⁰ *Al-Qur'an*, 2:168

³¹ T.M. Usmani. *An Introduction to Islamic Finance*, (Idaratul Ma'arif, Karachi, 1999).

Shari'ah, otherwise a direct entailment in that prohibited activity is obtained. This prohibition extends to all facets of such activities and is not restricted to the supplier/manufacturers, but all involved in the supply chain. Hence, Muslims are forbidden to engage in certain activities in any manner whatsoever and therefore investing in such companies constitutes a direct involvement with the forbidden activity and thus investments are restricted to *Shari'ah*-compliant businesses.

The second condition is that the main business of the company is *Shari'ah*-compliant. However, if the company has some income that is earned from interest-bearing accounts, which is included in the net income of the company, then the stocks of the company is not considered *Shari'ah*-compliant. This is because in Islam, it is clearly prohibited to pay or receive interest. To overcome this problem, a practical solution is that the proportion of interest income included in the dividend paid to the shareholder must be given away and not retained by the investor. Similarly, when selling a stock the same process must be followed. This process is referred to as dividend purification and therefore a Muslim would not be violating Islamic law, as he is not keeping the interest component of the dividend.

The third condition is that the company must own some illiquid assets (Usmani, 1999)³². Some scholars are of the view that the ratio of illiquid assets must be at least 51 percent, which is based on the juristic principle: "The majority deserves to be treated as the whole of a thing".

In addition to the above points, all forms of investments must be free from excessive uncertainty (*gharar*), which is seen as akin to gambling. In relation to *gharar*, Sanusi (1993, p. 87)³³ stated "that in legal and business terms *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction" and this would therefore certainly apply to speculative investments such as trading in futures on the stock market. Furthermore, investing in the shares of companies that entail excessive risk would also be questionable.

³² Usmani, op.cit.

³³ M.M. Sanusi. "*Gharar*". *Law of Journal*, 3(2) (1993), 87-110.

Finally, Muslims are only able to invest in ordinary shares, as preference shares are not permissible for Muslims to invest in as they offer a predetermined rate of return, which would be considered “*riba*” (usury) (Hassan and Zaher, 2001³⁴; Hussain, 2004³⁵).

4.2 Rules of *Shari'ah*-Compliant Stocks

The practical aspects of a Muslim's daily life are governed by a Divine Law - *Shari'ah*. In business, it can decide transaction style and indicate a desire to comply with *Shari'ah*-compliant investment. This kind of investment is growing fast as an alternative investment channels for all kind of investors such as Muslim and non-Muslim; this is due to “its foundation in ethical business practices, social responsibility and fiscal conservatism”³⁶. While Islamic investors may be mandated to invest only in a *Shari'ah*-compliant way, other investors do so for “the benefits they derive, including greater stability of returns, transparency and diversification”. The modern *Shari'ah* scholars have provided general rules for *Shari'ah*-compliant investors to evaluate or screen whether a particular company is *halal* (lawful) or *haram* (unlawful) for investment (Wilson, 2004³⁷; Derigs and Marzban, 2008³⁸).

Stock screening is a process of identifying whether a stock or security is *Shari'ah*-compliant or not (Alhabshi, 2008)³⁹. It comprises of various *Shari'ah* principles that produce the criteria which are used to decide whether the stock or security is *Shari'ah*-compliant or not. The key objective of stock screening is to make sure that the stock or security that one buys or invests in does

³⁴ Tarek S. Zaher and M. Kabir Hassan. "A comparative literature survey of Islamic finance and banking." *Financial Markets, Institutions & Instruments*, 10, no. 4 (2001), 155-199.

³⁵ Jamila Hussain, *Islam: Its law and society*. (Federation Press, 2004).

³⁶ CIMB Principal, “The Case for Islamic Asset Management” (31 March, 2013).

³⁷ Rodney Wilson, "Screening criteria for Islamic equity funds." *Islamic Asset Management: Forming the Future for Sharia Compliant Investment Strategies*, London: Euromoney Books (2004), 35-45.

³⁸ Ulrich Derigs and Shehab Marzban. "Review and analysis of current *Shari'ah*-compliant equity screening practices." *International Journal of Islamic and Middle Eastern Finance and Management*, 1, no.4 (2008), 285-303

³⁹ Alhabshi, op.cit.

not include any forbidden activities that make it *Shari'ah* non-compliant. It is a great sin for Muslims to be involved in something that is unlawful or prohibited.

According to a *hadith* of the Holy Prophet (peace and blessings of Allah be upon him) as reported by Jabir (may Allah be pleased with him), the Messenger of Allah said:

*“The flesh grown from unlawful provisions shall not enter Paradise, and every flesh grown from unlawful provisions deserves to be thrown in Hell fire”*⁴⁰.

From the above *hadith*, it is understood that Muslims need to be careful not to consume or feed his/her family with food that is generated from unlawful income. In fact it is not only the food we consume that must be permissible, but also all that we consume must be pure and clean.

Generally, *Shari'ah*-compliant investment strategies are based on two types of guidelines: sector guidelines and financial guidelines (Derigs and Marzban, 2008)⁴¹. *Shari'ah* clearly spells out elements or activities in which Muslims must not be involved in, such as the consumption of alcohol, pork and gambling related activities. Additionally, Muslims are disallowed to invest in assets from businesses earning mainly from impermissible activities such as alcohol producers, casinos or even partially from hotels because of their income from bars and clubs. Currently, sector guidelines are conservative prescriptions though those companies operating in non-*Shari'ah*-compliant activities are not included.

On the other hand, financial guidelines are employed to screen out how companies that are involved in financial practices which are not allowed in *Shari'ah*. Because of this, *Shari'ah* scholars determine benchmark levels for specific indicators/financial ratios through which the degree of compliance is measured. If a company issues an asset which is involved in financial practices exceeding the benchmark, the asset is considered as non-compliant and, as with the sector guidelines, has to be excluded for investment. Generally, the usage of such guidelines is a relaxation of the conservative *Shari'ah*

⁴⁰ Ahmad, *Musnad*

⁴¹ Derigs and Marzban, op.cit.

rules and a tribute paid to the complexity and the generally non-Islamic nature of the current capital markets. In order to claim *Shari'ah*-compliance, returns earned from portfolios constructed under these guidelines has to be cleansed through post-investment purification practices (Elgari, 2000)⁴², i.e. a process in which the portion of non-compliant earnings is identified and donated to charitable organizations.

The construction of *Shari'ah* approved assets must meet the following objectives (Laldin, 2008)⁴³:

- i. Facilitate investors who are looking for investment in *Shari'ah*-compliant assets listed on the exchange;
- ii. Centralization and harmonization of *Shari'ah* decisions;
- iii. Enhance disclosure and transparency;
- iv. Promote the development of Islamic capital market products and services;
- v. Encourage application of Islamic banking products;

4.3 Universe Creation and Stock Selection

So far, there is no international standard for *Shari'ah* stock screening. Different funds or fund managers utilize different standards based on their *Shari'ah* council. The stock screening process can be divided into two stages: i) First stage: Evaluation in terms of company activities, products and industry and ii) Second Stage: Computation of a set of financial ratios & compare them against specified benchmarks.

4.3.1 The screening process in terms of its activity, products and industry

All index providers have the same methodology for the first level of screening which is according to core business activities. The core business activities are considered permissible if they exclude any of those business activities which are considered as non-permissible.

⁴² Mohamed Ali Elgari, "Purification of Islamic Equity Funds: Methodology and *Shari'ah* Foundations", in *Fourth Harvard University Forum on Islamic Finance*, (2002), 77-80.

⁴³ Mohamad Akram Laldin, *Fundamentals and Practices in Islamic Finance*. Kuala Lumpur: ISRA (2008), 38.

The summary of company activities, products and industry, which are to be excluded, is shown in Table 1. We can see that almost all index providers of regulators unanimously excluded five common activities such as conventional finance and insurance, gambling and gaming, alcohol production and sale, pork and non-halal food and tobacco manufacturing and sale. Entertainment, media and broadcasting activities are excluded by major global index providers, namely Dow Jones, FTSE and MSCI *Shari'ah* indices.

For the mixed companies or business activities, the Meezan, Pakistan and Securities Commission of Malaysia have imposed additional parameters to evaluate them. It has shown in Table 2. By taking into account the good public perception or image of a company or its core activities in line with public interest which includes rights of non-Muslims, the Security Commission Malaysia issued another two additional parameters such as 5% and 20% benchmarks since November 2013.

It is important to take note that, *Shari'ah*-compliant stocks include ordinary stocks, warrants and transferable subscription rights (TSRs) as well. This implies that warrants and TSRs are considered as *Shari'ah*-compliant investment provided the underlying shares are also *Shari'ah*-compliant assets. However, loan stocks and bonds are viewed as *Shari'ah* non-compliant securities due to involvement of the *riba* unless they are issued according to *Shari'ah* principles (Alhabshi, 2008)⁴⁴.

⁴⁴ Alhabshi, op.cit.

Table 1: The summary of company activities, products and industry that to be excluded

Securities Commission Malaysia ⁴⁶	Dow Jones ⁴⁷	Meezan, Pakistan ⁴⁸	FTSE <i>Shari'ah</i> Index ⁴⁹	S&P <i>Shari'ah</i> Index ⁵⁰	MSCI Islamic Index ⁵¹
<ul style="list-style-type: none"> Conventional finance and insurance Gambling and gaming Alcohol production and sale 	<ul style="list-style-type: none"> Conventional finance and insurance Gambling and gaming Alcohol production and sale 	<ul style="list-style-type: none"> Conventional finance and insurance Gambling and gaming Alcohol production and sale 	<ul style="list-style-type: none"> Conventional finance and insurance Alcohol Pork related products and non-halal food production Tobacco 	<ul style="list-style-type: none"> Conventional finance and insurance Alcohol Pork Tobacco 	<ul style="list-style-type: none"> Conventional finance and insurance Alcohol Pork related products and non-halal food production Tobacco

⁴⁵ Securities Commission Malaysia. (2013b). Revised Shariah Screening Methodology: Dialogue Session with Public Listed Companies, Feb 2013, 1–12.

⁴⁶ Securities Commission Malaysia. (2013c). List of Shariah-compliant Securities by the *Shari'ah* Advisory Council of the Securities Commission Malaysia, (Nov. 2013), 1–40.

⁴⁷ Dow Jones, accessed from <http://us.spindices.com/documents/methodologies/methodology-dj-islamic-market-indices.pdf>

⁴⁸ Meezan, accessed from https://www.ftse.com/products/downloads/FTSE_Shariah_Indices.pdf

⁴⁹ FTSE *Shari'ah* Index, accessed from <http://us.spindices.com/documents/methodologies/methodology-sp-shariah-indices.pdf>

⁵⁰ S&P *Shari'ah* Index, accessed from https://www.msci.com/eqb/methodology/meth_docs/MSCI_April15_Islamic_Indices_Methodology.pdf

<p>Securities Commission Malaysia⁴⁵⁻⁴⁶</p> <ul style="list-style-type: none"> • Tobacco manufacturing and sale 	<p>Dow Jones⁴⁷</p> <ul style="list-style-type: none"> • Tobacco manufacturing and sale 	<p>Meezan, Pakistan⁴⁸</p> <ul style="list-style-type: none"> • Tobacco manufacturing and sale 	<p>FTSE Shari'ah Index⁴⁹</p> <ul style="list-style-type: none"> • Weapons, arms & defence 	<p>S&P Shari'ah Index⁵⁰</p> <ul style="list-style-type: none"> • Gambling, Pornography, Advertising and media except if revenue >65% from GCC • News channels • Newspapers • Sports channels 	<p>MSCI Islamic Index⁵¹</p> <ul style="list-style-type: none"> • Weapons, arms & defence
	<ul style="list-style-type: none"> • Entertainment, media and broadcasting (cinemas, music, pornography) • Hotels • Weapons and defence • Real estate holding and development 	<ul style="list-style-type: none"> • Entertainment (Casinos, Gambling, Cinema, Music, Pornography, Hotels) 	<ul style="list-style-type: none"> • Cloning • Trading of gold and silver as cash on deferred basis 	<ul style="list-style-type: none"> • Gambling, Casinos, Music, Hotels, Cinema, Cable/Satellite, Adult entertainment 	

Table 2: The additional parameters by the Meezan, Pakistan and Securities Commission of Malaysia

Meezan, Pakistan	SC, Malaysia (Effective November 2013)
2 criteria:	2 additional criteria:
i. Non-compliant business cannot exceed 33% of total assets	i. Good public perception or image ii. Core activities important in line with <i>maslahah</i> while non-permissible activity very small and difficult to avoid or involves rights of non-Muslims
ii. Income from non-compliant business cannot exceed 5% of gross revenue	<p>5% Benchmark</p> <p>“To assess the level of mixed contributions from activities that are clearly prohibited such as <i>riba</i>’ based activities, gambling, liquor and pork; interest income from conventional accounts and instruments and tobacco-related activities.”</p> <p>20 % Benchmark</p> <p>“To assess the level of contributions of mixed rentals from <i>Shari’ah</i> non-compliant activities;</p> <p>To assess the level of mixed contributions from activities that are generally permissible according to <i>Shari’ah</i> and have an element of <i>maslahah</i> (public interest), but there are other elements that may affect the <i>Shari’ah</i> status of these activities e.g. hotel and resort operations.”⁴⁵</p>

⁴⁵ Securities Commission, accessed from <https://www.sc.com.my/frequently-asked-questions-on-revised-shariah-screening-methodology/>

4.3.1 The screening process by financial ratio benchmarks

We have already evaluated the *Shari'ah*-stock screening based on business activities. In this Section, we are going to look at the evaluation process by financial ratios for all major *Shari'ah* index providers. In this process, there are three main ratios such as debt, interest earnings and cash and cash receivables. We are going to illustrate each of ratios one by one.

Table 3: Debt Screening

Index / Authority	Debt Screening Ratio
Securities Commission Malaysia	$\frac{\text{Interest Bearing Debt}}{\text{Total Assets}} \leq 33\%$
Dow Jones	$\frac{\text{Short – term debt} + \text{Long term Debt}}{\text{Trailing 24 month Average Market Capitalization}} \leq 33\%$
Meezan, Pakistan	$\frac{\text{Total interest Bearing Debt}}{\text{Total Assets}} \leq 45\%$
FTSE <i>Shari'ah</i> Index	$\frac{\text{Debt}}{\text{Total Assets}} \leq 33\%$
S&P <i>Shari'ah</i> Index	$\frac{\text{Debt}}{\text{Trailing 36 month Average Market Capitalization}} \leq 33\%$
MSCI Islamic Index	$\frac{\text{Debt}}{\text{Total Assets}} \leq 33\%$

From the debt screening which presented in Table 3, we can see that the denominators for all index providers are total asset except the Dow Jones and S&P *Shari'ah* index providers. The Dow Jones adapted the trailing 24 month average market capitalization as

denominator, whereas the trailing 36 month average market capitalization for the S&P *Shari'ah* index. And it is also obvious that all index providers limit their debt at level of 33% while Meezan Pakistan allows the level of debt is up to 45%. Put differently, Meezan allows companies to borrow up to 45%.

In terms of Interest earnings (as shown in Table 4), all index providers limit the cash and interest bearing items at 33% except the Securities Commission Malaysia. The Securities Commission Malaysia just limits the interest income of a company at maximum of 5%. Furthermore, from Table 4, we can observe that Meezan Pakistan categorizes the interest earning further 2 sub categories such as non-compliant assets (33%) and non-compliant income (5%).

Table 4: Interest Earnings Screening

Index / Authority	Interest Earnings Screening Ratio
Securities Commission Malaysia	$\frac{\text{Interest income}}{\text{Total Revenue}} \leq 5\%$
Dow Jones	$\frac{\text{Cash + interest based securities}}{\text{Trailing 24 month Average Market Capitalization}} \leq 33\%$
Meezan, Pakistan	$\frac{\text{Non – compliant assets}}{\text{Total Assets}} \leq 33\%$
	$\frac{\text{Non – compliant income}}{\text{Gross Revenue}} \leq 5\%$
FTSE <i>Shari'ah</i> Index	$\frac{\text{Cash + Interest bearing items}}{\text{Total Assets}} \leq 33\%$
S&P <i>Shari'ah</i> Index	$\frac{\text{Cash + interest based securities}}{\text{Trailing 36 month Average Market Capitalization}} \leq 33\%$
MSCI Islamic Index	$\frac{\text{Cash + Interest bearing items}}{\text{Total Assets}} \leq 33\%$

With respect to cash and cash receivables (as tabulated in Table 5), different index providers have different benchmarks. The Securities Commission Malaysia, Dow Jones Islamic Index and MSCI Islamic index limit the cash and cash receivables of a company at 33%. On the other hand, FTSE and S&P *Shari'ah* indices set this ratio is more or less same which are 50% and 49%, respectively. Again, Meezan Pakistan has different approach on this ratio. It is acceptable if the illiquid asset of a company is more than 10%.

Table 5: Cash and Cash Receivables Screening

Index / Authority	Ratio
Securities Commission Malaysia	$\frac{\text{Cash}}{\text{Total Assets}} \leq 33\%$
Dow Jones	$\frac{\text{Total Accounts Receivables}}{\text{Trailing 24 month Average Market Capitalization}} \leq 33\%$
Meezan, Pakistan	$\frac{\text{Total Illiquid Assets}}{\text{Total Assets}} \geq 10\%$
FTSE <i>Shari'ah</i> Index	$\frac{\text{Cash} + \text{Account Receivables}}{\text{Total Assets}} \leq 50\%$
S&P <i>Shari'ah</i> Index	$\frac{\text{Account Receivables}}{\text{Trailing 36 month Average Market Capitalization}} \leq 49\%$
MSCI Islamic Index	$\frac{\text{Cash} + \text{Account Receivables}}{\text{Total Assets}} \leq 33\%$

4.4 An Universal Standard Model

From the above discussion, we could see that the differences in terms of *Shari'ah* stock screening are not varying too much. It indicated that it is possible come up with an universal standard with clear guidelines and understanding to be applicable to all. One may ask why we need to propose such universal model. The justifications are follows:

1. There are many new comers in Islamic stock investment due to the less riskiness, better diversification opportunities or better stock returns in some markets. They confuse which methodology to be followed and adapted. Such universal model provides an easy reference to the new comers. Even some Islamic Finance experts (for example, Hasan, 2008⁴⁶; Laldin, 2014⁴⁷) argue that the absence of globally accepted *Shari'ah* standards is one of the factors that impedes the realisation of the full potential of Islamic finance, as well as hampering the strategic objective of positioning Islamic finance into the mainstream economy.
2. There are many Muslims in the world who live as minority in many non-Muslim countries, for example, China, India, Japan, etc. There is no regulator to regulate the Islamic stocks in those countries. Therefore, they do not know which stock to be purchased and invested. Such model will provide guidelines to those Muslims who live in non-Muslim countries. Put differently, it will serve as a guide for Islamic investment.
3. For the financial ratio screening, the chosen denominator is total assets. The reason is it is difficult to find out or calculate the 24-month or 36 months average market capitalizations. The investors can easily find out the total asset or other items from the balance sheet of a company.

⁴⁶ Zulkifli Hasan, *Shari'ah Standards*, (2008), accessed from <https://zulkiflihasan.files.wordpress.com/2008/06/w5-shariah-standards.pdf>

⁴⁷ Mohamad Akram Laldin, "Importance of Key *Shari'ah* Standards or Laws for Emerging Markets, 11th IFBS Summit (20 May, 2014), accessed from <http://www.inceif.org/wp-content/uploads/2013/11/Prof-Akram-Importance-of-Key-Shariah-Standards-or-Laws-for-Emerging-Markets.pdf>

4. For activities, products and industry screening, we proposed the most comprehensive list that which eliminates most of prohibited elements in *Shari'ah*.

The details of proposed universal model are presented in Table 6.

Table 6: The proposed universal standard *Shari'ah* screening methodology

Activities, Products and industry Screening	Financial Screening Ratio
<ul style="list-style-type: none"> • Conventional finance and insurance • Gambling and gaming • Alcohol production and sale 	<p style="text-align: center;">Debt Screening</p> $\frac{\text{Short – term debt} + \text{Long term Debt}}{\text{Total Assets}} \leq 33\%$
<ul style="list-style-type: none"> • Pork related products • Tobacco manufacturing and sale • Entertainment, media and broadcasting (cinemas, music, pornography) 	<p style="text-align: center;">Interest Earnings Screening</p> $\frac{\text{Cash} + \text{Interest bearing items}}{\text{Total Assets}} \leq 33\%$
<ul style="list-style-type: none"> • Hotels • Weapons and defense • Real estate holding and development • Cloning • Trading of gold and silver as cash on deferred basis 	<p style="text-align: center;">Cash and Cash Receivables</p> $\frac{\text{Cash} + \text{Account Receivables}}{\text{Total Assets}} \leq 33\%$

We can observe that most of the financial ratios may not exceed 33.33%. Why is the benchmark of one-third accepted? The Prophet’s condition of 1/3 (33.33%) is a very generous threshold,

which can be considered for use as the benchmark for mixed companies. This statement can be supported in the question of the legacy of Sa'ad Ibn Abi Waqas who wanted to leave his property as alms as in the following *hadith*:

*“One day, the Prophet (s.a.w) visited Sa'ad Ibn Abi Waqas who was sick. Sa'ad expressed to the prophet (s.a.w) his feelings that his illness was coming to end and that death was near. He asked for the opinion of Prophet (s.a.w) on giving his property away as alms for he had only one daughter to inherit his wealth. Therefore, he wished to give as alms 2/3 of his property. However, the Prophet (s.a.w) stated his objections. Then Sa'ad asked whether he could give away 1/2 of his property. The Prophet (s.a.w) still said no. The Prophet (s.a.w) then said: 1/3 (of Sa'ad's property to be given away as alms) is enough that also is still too much. Verily, to leave your heir wealthy is far better than to leave your heir impoverished and dependent on other people's charity.”*⁴⁸

According to the words of Prophet (s.a.w), 1/3 or 33.33% “is enough” and can be used as a guideline for the basis of formulating a benchmark. The problem is whether this benchmark is appropriate to use for mixed companies, because it relates to the bequest of property and the giving of alms. Even so, it cannot be denied that it can be used as a benchmark to set the upper limit of a mixture due to the fact that an amount exceeding this threshold will be considered as excessive (Laldin, 2008)⁴⁹.

4.5 Change of Shari'ah-Compliant Status

In order to provide a guide to investors, the SAC advises investors on the timing for the disposal of *Shari'ah* non-compliant securities.

⁴⁸ Bukhari, vol.4, bk.51, no.5

⁴⁹ Laldin (2008), op.cit., 49-50

“Shari’ah-Compliant Securities Which Are Subsequently Considered Shari’ah Non-Compliant”

This refers to those stocks which are earlier considered as Shari’ah-compliant securities but because of some reasons, such as changes in the operations of companies, are subsequently treated as Shari’ah non-compliant. Pertaining this issue, the Securities Commission of Malaysia resolved that:

“If on the date the updated list takes effect (e.g. 25 May 2011), the value of the securities held more than the original investment cost, investors who hold such Shari’ah non-compliant securities must liquidate them. Any capital gain arising from the disposal of the Shari’ah non-compliant securities made at the time of the announcement can be kept by the investors. However, any excess capital gain derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channeled to charitable bodies.

On the other hand, investors are permitted to hold their investment in the Shari’ah non-compliant securities if the market price of those securities is lower than the original investment cost. It is also permissible for investors to keep the dividends derived during the holding period until such time when the total amount of dividends received and the market value of the Shari’ah non-compliant securities held equal the original investment cost⁵⁰. At this stage, they are advised to dispose of their holding.”⁵¹

Action to be taken by the investor/fund manager is presented in Table 6.

⁵⁰ Original investment cost may include brokerage cost or other related transaction cost.

⁵¹ Securities Commission Malaysia, op. cit., 16

Table 6: Strategies of investors if the *Shari'ah*-Compliant Securities Which Are Subsequently Considered *Shari'ah* Non-Compliant

Condition	Action
On the announcement date	<p>“If Price of share > original investment cost Action: sell immediately. The investor can keep any additional capital gain.</p> <p>If Price of share < original investment cost The investors may hold the stock until price of stock equals to original investment cost; Liquidate when total dividends received (if any) together with the market price of the non-approved share equal the original investment cost.”</p>
After the announcement date (due to inadvertent mistake)	<p>“If Price of share > original investment cost Sell immediately. The investors can keep any profit (the difference between original investment cost and closing price of announcement date). Residual Profit (the difference between disposal price and closing price of announcement date) to be channelled to charitable bodies;</p> <p>If Price of share < original investment cost The Investors may hold the stock until price of share equals to original investment cost Liquidate when total dividends received (if any) together with the market price of the non-approved share equal the original investment cost.”</p>

Shari'ah Non-Compliant Securities

The SAC advises investors who invest according to *Shari'ah* principles to discharge any non-permissible securities which they currently hold, within a month of knowing the status of the securities. Any profit gained in the form of capital gain or dividend awarded during or after the disposal of the securities has to be donated to charitable organizations. The investor has a right to retain only the original investment cost (Alhabshi, 2008)⁵².

4.6 Purification or Cleansing Process

⁵² Alhabshi, op.cit.

Purification or cleansing is usually conducted when we know for certain that portion of the income or revenue of the company that is unacceptable according to *Shari'ah* principles (Alhabshi, 2008), they are:

- i. derived from unacceptable sources such as interest on conventional fixed deposits; or
- ii. funded by a part of capital that is taken from conventional loan; or
- iii. from some other sources that are *Shari'ah* non-compliant.

Such income as defined above should be separated from the total revenue or profits by donating it to charitable organizations. This process is called cleansing. If a company gains portion of its total income from interest income and/or from non-permissible activities, *Shari'ah* investment principles advocate that this portion must be subtracted from the dividend paid out to shareholders and donated to charity. Some of index providers have imposed this cleansing process while others are not. Table 7 presents the applicability of dividend/income purification on index providers.

Table 7: The applicability of Dividend/income purification on index providers

Index / Authority	Dividend/income purification norm
Dow Jones	None
Meezan	Not available
SC, Malaysia	None
FTSE	Purification of dividends at 5%, to be paid by investor
S&P	Dividends x (Non Permissible Revenue / Total Revenue)

MSCI	Proportion of prohibited income to be deducted from dividend paid
	Applies “dividend adjustment factor” to reinvested dividends
AAOIFI	<i>Shari'ah</i> Standard 21 [Clause 3/4/6/4]
	Divide total prohibited income by number of issued shares of company.
AAOIFI	Multiply this with number of shares owned by investor
AAOIFI	<i>Shari'ah</i> Standard 21 [3/4/6/1]
	Burden of purging on shareholder on last day of financial year

4.7 Periodic and Ongoing Review

The *Shari'ah*-compliant securities are reassessed intermittently on a quarterly and yearly basis. Ongoing review is also conducted particularly to monitor extraordinary events, for example, delisting, bankruptcy, merger, takeover etc. which may affect the status of the security.

The MSCI will fully review the structure of the Islamic indexes by employing the business activity screening and the financial screening on a yearly basis at the May semi-annual index review. It will also reexamine the composition of the Islamic indexes by using the financial screening to all the relevant securities on a quarterly basis at the quarterly index review. New additions to the MSCI equity indexes which resulting from a quarterly index review may be considered for inclusion to the Islamic indexes at the following quarterly index review. For instance, a security added to the MSCI equity indexes basket as an outcome of the November semi-annual index review may be considered for inclusion to the *Shari'ah*-compliant indexes at the February quarterly index review.

On a quarterly basis, MSCI's *Shari'ah* advisors will compare the list of constituent stocks forming the MSCI *Shari'ah*-compliant index series (the "Constituent Stocks") with the MSCI screening reports. Provided that the constituent stocks forming the MSCI *Shari'ah*-compliant index series can be fully reconciled with the

MSCI screening reports including the period under review, endorsing that all inclusions and removals to the MSCI *Shari'ah*-compliant index series have been made as required. MSCI's *Shari'ah* advisors will release a periodic certification covering that period of review based only on their review of the MSCI screening reports on the constituent stocks.

5. Conclusion

The different screening methodologies adopted by different jurisdictions around the globe should not be seen as revealing the weaknesses of the Muslim community or Islam itself. It is justified on the ground that Islam permits “flexibility” to suit specific circumstances faced by Muslims in their unique environment such as the different economic, political, and social systems being practiced in their respective countries. The *Shari'ah* Board of different jurisdictions have the freedom to exercise *ijtihad* as long as their rulings do not contravene the principles of *Shari'ah* as enshrined in the *Qur'an* and *Sunnah*. However, the rulings must be supported by the relevant authorities, to justify the stand taken by the *Shari'ah* Board. However, despite all the differences and inconsistencies, it is recommended that the relevant authority should set a universal standard with clear guidelines and understanding to be applicable to all. It will facilitate and provide easy reference to the new comers to the market and Muslims who live in non-Muslim countries. We are in complete agreement with Rahim (2010)⁵³ and Najib et. al. (2014)⁵⁴ that this universal standard will accelerate the commercial and economic cooperation among Muslim communities around the world. It may seem difficult given the different circumstances and backgrounds surrounding the Islamic countries now but it is not impossible to be implemented. It is hoped that the streamlining of the

⁵³ Abdul Rahim Abdul Rahman, "Islamic microfinance: an ethical alternative to poverty alleviation." *Humanomics*, 26, no.4 (2010), 284-295.

⁵⁴ Nur Hamizah Binti Najib, Iffah Raihan Bt Hamid, Seri Nadhirah Bt Nasarudin and Buerhan Saiti. "The Comparison of *Shari'ah* Screening Methodology for Stocks between Malaysia Security Commission Criteria and Dow Jones Method: A Critical Assessment." UniKL Business School Management and Entrepreneurship Conference, Malaysia, (2014).

business activity benchmarks and the inclusion of the financial ratio benchmarks will enhance the robustness of the screening methodology for listed securities and this step is expected to enhance the competitiveness of the Malaysian Islamic equity market and Islamic fund management industries in the global market. The revision is timely needed on the ground that even though there are valid reasons for Malaysia to adopt different screening methodology previously, that position had caused disagreement and confusion among the international investors on the screening standards used by the SAC of the SC. No doubt this is the right time for the SC to adopt progressively the screening standards used by other global *Shari'ah* Index providers for the benefits of the international investors. This step is seen as a serious effort taken by Malaysia to attract international investors to invest in the country, which is in line with the government's policy and initiatives to promote Malaysia as an international hub for Islamic banking and finance.

There are many similarities between Islamic investment and ethical investment or socially responsible investment (SRI), which is a recent development. Both prohibit investment in business activities that are harmful to humans. Both forms of investment require screening processes to decide whether they are ethically acceptable. The difference is that Islamic investment is deeply rooted in the teaching of the Qur'an, but SRI is a recent phenomenon based on the awareness of investors about the damage or the negative externalities from corporations to the people.

Hence, Muslims are able to invest in western equity markets rather than having to invest in Islamic institutes only. Furthermore, the implications of this are that Muslims are able to diversify their investments thereby lowering the risk of their portfolios pursuant to the principles of modern portfolio theory (Markowitz, 1952⁵⁵, 1959⁵⁶). This supports the results of Usmani (1999)⁵⁷, and extends these through the use of relevant primary sources of Islamic law,

⁵⁵ Harry Markowitz, "Portfolio selection", *The journal of finance* 7, no.1 (1952), 77-91.

⁵⁶ Harry Markowitz, *Portfolio Selection, Efficient Diversification of Investments*, (J. Wiley, 1959).

⁵⁷ Usmani, op.cit.

further enhancing the credibility of the view that investing in shares is permissible pursuant to Islamic law.

As limitation of our study, we did not discuss the issues and challenges associated by *Shari'ah*-compliant stocks such speculation, short selling, etc. It is important to carry out research on the existence of those issues in context of *Shari'ah* compliant stocks.

