SHARIAH-COMPLIANT STOCKS: HARMONIZING INDEX INSTITUTION SCREENING METHODOLOGIES

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

Keywords: Harmonizing Screening; Index Institutions; Syariah Compliant Stock

INTRODUCTION

Stock screening for Shariah compliance is becoming one of the most important priorities in the Islamic financial development stream, particularly for fund managers (Aznan Hasan, personal communication, 2017). Investment managers selected to suit the demands of financial sector actors such as asset management businesses, investors, and fund management companies are referred to as fund managers. Institutions such as financial institutions and government investment agencies are extending their investment portfolios, particularly in Shariah-compliant fund investment portfolios, among the players. According to Patrick L Mason and Andrew Matella (2014), Shariah-compliant stocks have become a preferred asset class for many Middle Eastern hardcore investors, particularly in the aftermath of the September 11 Black Tragedy. This was accompanied by sentiment following Donald Trump's election as the United States 45th President (nbcnews.com, 2017).

According to Adam Ng (2017), the controversy surrounding the financial crisis of 2007/2008 eroded investors' faith in the established conventional banking system. As a result of this flow of funds from the West to the East as a substitute for investment, new investment product structures such as unit trusts, investment mandates, real estate investment trusts (REITs), and a variety of other fund-centric fund investment structures have been developed. As a result, demand for Shariah-compliant funds has increased significantly, particularly among Western investors. For instance, in the United Kingdom, the London Stock Exchange has successfully issued 49 Shariah-compliant fund issues, including sukuk and exchange-traded funds (FSTIB, 2013). Following the Brexit vote, Indonesia and Malaysia have taken the lead in selling Shariah-compliant funds in the
United Kingdom, even though they are promoted in the Luxembourg and Ireland markets (Financial
Observe, 2016). This is because demand for Shariah-compliant funds has increased significantly,
making any Shariah-compliant funds produced attractive to investors in Luxembourg and Ireland.

The pursuit of these Shariah-compliant stocks, combined with foreign investors’ high level of
confidence in Shariah-compliant funds, has fueled the rise of capital market activity in Asia,
particularly Malaysia. According to the Bursa Malaysia Report (2018), the daily Average Trade Value
(ADV) on the global commodity trading platform Souq Al-Sila’ (BSAS) Murabahah increased by 24.4
percent to RM24.3 billion in 2018 from RM19.6 billion in 2017. Despite the increased amount of
trade, revenue from trade fell 5.6% to RM14.9 million from RM15.8 million over the same time, as
more trade was performed and qualified for the volume-based incentive system. The platform has
enormous potential, given the increased interest in Islamic stocks, as it leverages the diverse
instruments offered on Bursa Malaysia’s ACE Main Market and Markets. According to the research, by
the end of 2018, Shariah-compliant firms accounted for RM1.1 trillion, or 62.1 percent of total
market capitalization, and 76.4 percent, or 689 of the 902 companies listed in both exchanges.

In 2018, the number of Shariah-compliant trading accounts grew. In December 2018, 18,130
Shariah-compliant trading accounts were opened, an increase of 21.3 percent over the previous
year, when 14,944 new accounts were opened. Bursa welcomed banks from Iraq, Bahrain,
Tanzania, Kenya, Dubai, and Ajman in the United Arab Emirates to the BSAS platform in 2018. In
total, 32 new members were approved in 2018, bringing the total number of BSAS members to 173,
up from 141 in 2017. (www.malaysiastock.biz, 2018). Additionally, Bursa Malaysia-Shariah-
compliant i’s platform saw a surge in transactions, particularly from Brunei, Singapore, Indonesia,
Cambodia, and Myanmar. These trends show a growing interest in Shariah-compliant markets for
responsible and sustainable investment.

According to the Securities Commission’s (SC) website, Table 1 summarises fund management
statistics as of March 31, 2017. As shown in Table 1, total foreign investment in Shariah-compliant
fund-class assets is 23.97 percent (36.80 billion / 153.53 billion), compared to 19.75 percent
(144.93 billion / 733.88 billion) of overall class asset investment. This demonstrates the strong
demand for Shariah-compliant funds from foreign investors.

<table>
<thead>
<tr>
<th>Asset Classes (in RM billion)</th>
<th>Overall (including Shariah)</th>
<th>Shariah</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>Inside Malaysia</td>
<td>Outside Malaysia</td>
</tr>
<tr>
<td></td>
<td>278.40</td>
<td>85.27</td>
</tr>
<tr>
<td>Fixed income securities</td>
<td>119.17</td>
<td>28.59</td>
</tr>
<tr>
<td>Money market placement</td>
<td>161.61</td>
<td>0.89</td>
</tr>
<tr>
<td>Unit trust funds</td>
<td>10.72</td>
<td>11.72</td>
</tr>
<tr>
<td>Private equities / Unquoted</td>
<td>4.52</td>
<td>8.82</td>
</tr>
<tr>
<td>Others *</td>
<td>14.53</td>
<td>9.64</td>
</tr>
<tr>
<td>Total</td>
<td>588.95</td>
<td>144.93</td>
</tr>
</tbody>
</table>

Sources: Securities Commission of Malaysia

* Others consist of other asset classes such as wholesale funds, REITs, ETFs, closed-end funds, derivatives, business trusts, payables, receivables, accruals, and uninvested cash.
As a result of the growth depicted in Table 1, it has become a critical national priority to ensure that this extraordinary growth and demand increase is sustained without any surfacing Shariah-related difficulties about the Shariah-compliant stock screening status. It is appropriate for a study to be done to make recommendations for resolving Shariah concerns, as fund managers have constantly raised the issue of Shariah-compliant status inconsistency due to the various screening procedures. This is because if there is a mismatch in a stock's Shariah compliance status, it will have a detrimental effect on the Shariah decision-making process and make it more difficult for fund managers to select stocks for their investors' investing reasons.

This research aims to investigate and determine the most appropriate methods of stock screening that can be applied reliably by all index institutions in evaluating a stock's Shariah status. This is because any inconsistency in the status of a stock will have a detrimental impact on the Shariah adviser of an index provider's stock screening process. This reputational risk may also weigh on the fund manager's decision to trade Shariah-compliant stocks in the market. In this study, it was discovered that discrepancies in Shariah interpretation among Shariah advisers of index institutions used to assess Shariah-compliant stock screening were the determining element of the stock's compliance status. Nonetheless, the analysis found that other additional elements contribute to the variations, including the way and goal of the Sharia-compliant stock screening process used by the respective authorities, as described in this paper.

The study's objective is to identify rationales for issues that could undermine efforts to grow Shariah-compliant funds globally, with a particular emphasis on the methodology used by respective index institutions, including the one used by the Securities Commission of Malaysia's Shariah Advisory Council (SACSC). It entails an examination of the quantitative computations and qualitative methodologies employed by index organizations, with a particular emphasis on issues concerning the inconsistency of a stock's Shariah compliance status between global index institutions and the SACSC. This is a significant issue that could have a profound effect on Shariah-compliant stock trading in the international capital market.

RESEARCH METHODOLOGY

This is a qualitative study that uses the qualitative research method of fundamental interpretation. Three Shariah-qualified individuals nominated by index institutions in the market, two individuals from an authorized body, two industry individual participants, and two private investors are the study's primary responders. Three Shariah-compliant individuals have been identified to be responsible for developing and implementing Shariah-compliant stock screening processes. Face-to-face interviews and video conversations were employed as interview strategies. All responses to study questions and communication with respondents were recorded and retained in their entirety, both in their original and edited forms. All pertinent material gathered throughout the interview process will be processed by established qualitative methods before data analysis to conclude the discussion.

RESULT AND DISCUSSION

In analyzing the study's viewpoints and findings, researchers came up with four themes. Following that, comparisons were done using the information and factual data gathered from the library and field studies. These procedures are necessary to assure the study's findings' validity and reliability. There were three patterns of reaction and three conclusions concluded from the respondents' interviews. The three reaction patterns comprise, first, the Shariah-compliant stock screening methods used by the SC, DJII, FTSE, and MSCI are consistent with each other, both qualitatively and quantitatively; second, the differences in the Shariah-compliant stock screening methods used by the SC, DJII, FTSE, and MSCI, are insignificant and all of these methods have been approved by their appointed Shariah advisers; and the third is that the total standardization of the screening method is impossible but the harmonization of the screening method is more appropriate
in handling the issue of differences of opinions between Shariah opinions. In achieving harmonization of the stock screening methodology, it has been suggested that the AAOIFI standard which has been commonly accepted by all the respondents, is the most appropriate standard to be referred to by all Shariah advisers of index institutions, if the aim of standardization of the Shariah-compliant stock screening method is to be attained in the long run.

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

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

i. Exploring the qat‘i and zanni factors in Shariah interpretations as suggested by AkramLaldin (2019).
ii. Using AAOIFI standard in drafting the Shariah-compliant stock screening methodology, where all respondents cited AAOIFI standards as the only Shariah-compliant standard, although the standard is not made mandatory for some countries.
iii. Analysing the use of financial ratio denominators such as total assets, average market cap, and market equity values in the Shariah-compliant stock screening method to identify and develop new product structures and new types of Shariah-compliant stock portfolios.
iv. Having a universal Shariah-compliant stock screening method as the method adopted by the SC now has been practiced by AAOIFI in the case of applying debt ratio and cash ratio.
v. Exploring the possibility of having the stock screening method executed every month instead of conducting it on a quarterly or half-yearly basis.
vi. Creating a robot-screening method (via artificial intelligence) which can even certify the stock of a company is Shariah-compliant at all times

LIMITATIONS
This study begins with an examination of the SACSC's methodology and a detailed examination of each process flow used in stock screening. The emphasis is solely on the stocks of companies listed on Bursa Malaysia. Additionally, the study takes a step forward by examining the DJII, FTSE, and MSCI indexes in depth to ascertain the techniques and benchmarks used by their Shariah committees in screening equities of firms listed on overseas markets, including those listed on Bursa Malaysia.

There is also a scarcity of information and reference materials on Shariah-compliant stock screening methods, and one of the factors limiting this study is the absence of recent methodology reports, as well as updates from DJII, FTSE, and MSCI, which are rarely published on social media or their websites. What the market has are reports on investment methods and some news on the profit and loss of equities listed on international exchanges. As a result, qualitative investigations utilizing field-based questionnaires with respondents were employed to gather up-to-date information on the DJII, FTSE, and MSCI's latest modifications and methodologies.
CONCLUSION

Stock screening to determine Shariah compliance status is a critical agenda item in the growth of Islamic finance, particularly for foreign fund managers, to meet the needs of financial sector participants such as investment fund companies and financial institutions. It is critical to meet the standards of all relevant parties when building a Shariah-compliant investment portfolio to maximize halal returns for investors hungry for Shariah-compliant stocks. The findings indicate that the Shariah-compliant stock screening methodologies used by SC, DJII, FTSE, and MSCI differ. However, there are additional parallels in the screening processes, most notably the employment of sectoral filters and financial ratios. The distinction between Shariah-compliant screening procedures is merely a matter of Shariah interpretation differences between countries, as well as differences in the calculation of financial ratios accepted by their Shariah consultants.

Additionally, it is not correct to assert that the inconsistency of the Shariah-compliant stock screening process is averse to the development of Islamic stock capital markets. This is because the study's findings demonstrated that investors and industry participants are taking a 'wait and see' stance, confident in their ability to survive in the current state of their Shariah-compliant stock screening methods, despite their desire for a standard Shariah-compliant stock screening method. As of now, industry participants and investors have successfully adapted their Shariah-compliant stock options to the Shariah-compliant stock screening methodology's requirements. They have thus far been able to meet their customers' demands and risk tolerance in terms of investment portfolio selection. They have demonstrated that they have no difficulty adhering to any Shariah-compliant stock screening process as long as their investment objectives are accomplished while also meeting the Shariah compliance and profitability requirements of their consumers.

REFERENCES