

Shariah Screening for Compliance: A Survey

Noor Latiffah Adam^{1*}, Nordin Abu Bakar²

^{1,2}Faculty of Computer and Mathematical Sciences, Universiti Teknologi
MARA, 40450 Shah Alam, Malaysia

*Corresponding Author
latiffah@tmsk.uitm.edu.my

ABSTRACT

The rising awareness of Islamic values has taken shariah compliance notably into another phase of expansion in Islamic finance. One of the critical aspects in shariah compliance is screening process. Past research only outlined the screening process in general thus, screening for shariah compliance is lacking of details in the literature. This study would therefore examine the matter. The study adopts qualitative approach using expert interviews to highlight the technicalities in the screening process. The interviews outcome explains the process involved and is confirmed with the outline found from the literature. The characteristics of negative screening from the literature are also surveyed. The outcomes of the study will serve as groundwork for knowledge management as well as data analytics in Islamic finance. Once the processes and characteristics are understandable, the key points can be structured hence; it can be modeled and expanded to other area.

Keywords: compliance, expert interviews, knowledge management, Shariah screening

1. Introduction

Shariah compliant investing has gained its own audience in recent years. The growth in Muslim population together with increasing level of awareness towards Islamic value is probably one of the reasons.

Latest figure of Muslim population is 2.18 billion as in 2014 (www.muslimpopulation.com) with growth rate of 1.84%. The demand for Islamic indices, which adhere to the Islamic law, has increased the interest for Islamic investment solution, which led to screening for shariah compliance. Shariah screening (Adam & Bakar, 2014; Derigs & Marzban, 2008; Khatkhatay & Nisar, 2007; Zainudin, Miskam, & Sulaiman, n.d.) was introduced in Islamic capital market to examine the existence of any prohibited elements in stocks and securities which are unacceptable under shariah law. Such stocks will be eliminated from the list of Shariah compliant stocks that Muslims can invest in. Since business is expanding and many new things come up, the compliance status of companies need to be reviewed from time to time to ensure that their activities comply with the shariah. In this context, Securities Commission of Malaysia (SCM) issues an updated listing twice a year. The screening process is carried out to check the presence of prohibited elements such as *riba* (usury), *maysir* (gambling), *gharar* (excessive uncertainties), *haram* (such as alcohol and pork related) and others in the companies' core business.

This study aimed to uncover the screening and testing process for shariah compliant companies. In specific, the study would like to investigate how the SCM carried out the screening process and what criteria are they using in the screening. Interviews were conducted with the experts of Securities Commission of Malaysia.

2. Literature Review

The issue of shariah screening started to gain interest way back in 2011. Then, sources of literatures on the topic were mainly in the forms of newsletters and short articles. Five years later, there was a notable increase in the articles written on the topic. Many were gaining more interest in searching and researching, investing into the matter thoroughly out of curiosity. It is in fact an indication that Islamic finance has gained more attention from many parties.

Islamic finance is a financial system that operates according to Islamic law. It consists of Islamic capital market, Islamic banking

and Islamic insurance (takaful). These components held the same responsibility of examining their products for shariah compliant. This study will only discuss the shariah screening for stock and securities. Before delving into the issue of screening, the relationship between Islamic finance and shariah compliant is discussed.

2.1 Shariah Compliant in Islamic Finance

Shariah law is rooted from the Quran and the Hadith. Compliance is a state of being in accordance with established guidelines or specifications. Therefore, shariah compliant is the state of being in accordance to shariah law. As of today, we cannot find any stock that is fully shariah compliant as businesses in the country are owned by Muslims and non-Muslims (Khatkhatay & Nisar, 2007). Therefore, certain bench markings are introduced to accommodate the non-halal portions of the sources and activities. In addition, shariah compliant is not only about compliant stocks (Osmadi & Zainuddin, 2016; Rahman, 2015), but it also cover other elements such as financial reporting (Che Azmi & Hanifa, 2015) and auditing (Kasim, Mohamad Ibrahim, & Sulaiman, 2009).

A critical review on Shariah investment screening criteria can be found in Abdul Rahman, Yahya, & Mohd Nasir (2010); Donia & Marzban (2009) and Mahfooz & Ahmed (2014). Screening can be defined as examining or testing something to find out if they are suitable for a particular standard or criteria. Shariah screening is conducted to eliminate stocks which are unacceptable for investments i.e. which involved in prohibited elements. Examples of shariah screening framework are given by IdealRatings (idealratings.com) and Amiri Capital (amiricapital.com).

2.2 The Process

Screening process involves two main activities: qualitative screening and quantitative screening. Qualitative screening looks at the core business of the companies. They should adhere to Islamic principles not to involve with producing or selling impermissible product or services

such as tobacco, casino games and pork-related product (Mahfooz & Ahmed, 2014). Qualitative screening can be carried out using positive screening or negative screening (Obaidullah, 2005; Sefiani, 2009). Positive screening looks for companies that engage with activities to provide basic necessities to the society. On the other hand, negative screening will screen the company's involvement with prohibited element. Quantitative screening criteria is in place to exclude companies with excessive involvement with unpermitted income from e.g. interest-based investment and conventional debt (Mahfooz & Ahmed, 2014). Most of the literature outlined the characteristic but not the overall process. The characteristic can be categorized into five broad categories (Ho, 2015): *riba* and *gharar*, non-halal products, gambling, immoral and other impermissibles.

Ngadimon (2009) displayed the overall process flow of the screening as depicted Fig. 1. The screening processes are carried out in four different phases. First phase is carried out to gather information. The next step is to go through shariah compliance review. Then, the outcome will be compared with the shariah financial benchmark. Finally, the result will be presented to SAC for approval.

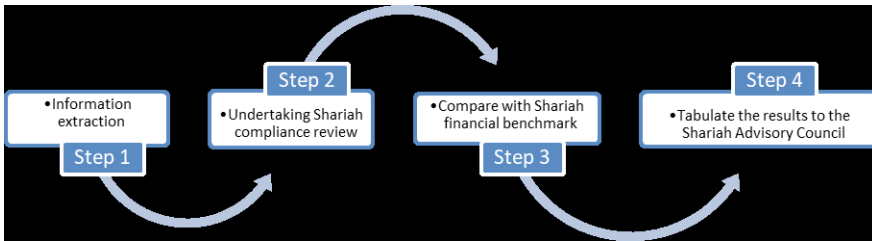


Fig. 1. Shariah-compliant screening process

Steps 1 to 3 are conducted by a team of experts. Whatever findings that they have will be presented to the Shariah Advisory Council for certification.

3. Methodology

The first part of the study is to go through the literature to obtain both the characteristics and the screening process. Comprehension on the screening process will help us to design a suitable set of questions for

the expert interviews. It also helps to post supporting questions during the interview session.

Qualitative approach is employed to achieve the objective of the study where expert interview with the person in charge with the screening process is conducted. An expert in the matter is the person who is responsible for the development, implementation or control of solutions or policies, such person who has authorization to information about decision processes (Meuser & Nagel, 2009). They have high degree of skill and knowledge in the industry due to long time experience and status, power to act and decision-making opportunities based on these skills and knowledge (Belting, 2008).

Expert interview is a quick way to obtain specific information (Belting, 2008). It offer researchers an effective means of quickly obtaining results and, indeed, of quickly obtaining good results (Bogner, Littig, & Menz, 2009). It also has high insight in aggregated and/or specific knowledge. In this study, expert interview is conducted because such processes and information are difficult to be explored by other methods (Audenhove, 2007; Bogner et al., 2009). Even if they may be available in literature, the resources are insufficient, such as only discussing on general guideline, do not expose the actual implementation which may subject to private and confidential (Bogner et al., 2009). This study will discuss the processes with the confidentiality in mind.

The flow of the interview process is given in Fig. 2. The potential respondent(s) was first identified. Appointment is made upon confirmation of their availability to be the respondents. The interview took place at the respondents' workplace and it took about one hour per interview to complete. The next process is to transcribe the data that has been obtained before analysis could be made. The finding is presented in the following section.

A semi-structured interview was carried out with the personnel at Securities Commission with the aim to investigate the specific task used to do screening for Shariah compliance. Additional questions were added to the session wherever necessary.



Fig. 2. The interview processes

4. Results and Discussions

Screening is indeed a tedious process (Popotte, 2010; Sefiani, 2009) and of course getting the correct information is crucial. The following subsections discuss the findings from the literature survey and the expert interview.

4.1 The Characteristics of Negative Screening

The characteristics of negative screening are summarized in Fig. 3. Generally, the characteristics are divided into five broad categories namely gambling, non-halal product, *riba* and *gharar*, immoral and others (Abdul Rahman et al., 2010; Derigs & Marzban, 2008; Ho, 2015; Sengupta, 2012). Literally, *riba* means an increase or addition. In Islamic banking, *riba* refers to interest charged on loan and the penalty for any late payments. *Gharar* on the other hand is uncertainty which may happen when details concerning the conditions of contract are unknown in financial products. Gambling or *maysir* can be defined as games of chance, while immoral activities mostly concerns with entertainment.

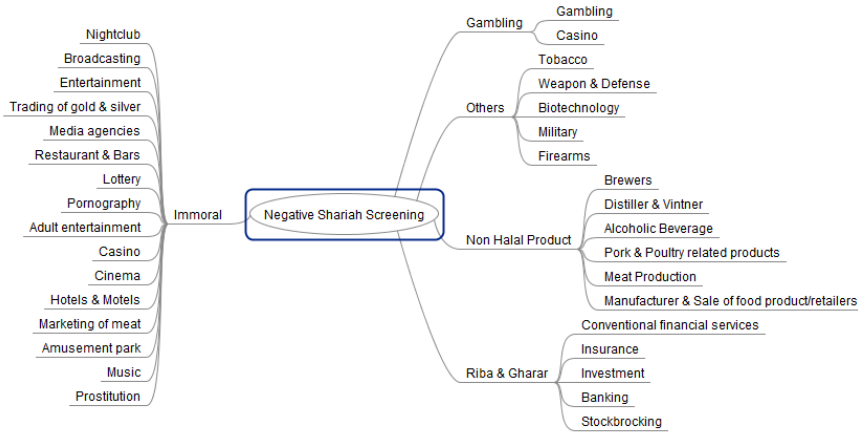


Figure 3: Negative Shariah Screening Characteristics

The negative screening characteristics as displayed in figure 3 might give informative keywords for the review team to make screening. However, no visible attempt was found so far on how to structure the knowledge of shariah compliance to be used in apps, thus give a solid background for data analytics. Much of the data and information available online are duplicates and redundant, which need to be transformed into meaningful data. By having structured data in place, it may help the data scientist to further understand the Shariah compliant characteristics since they do not have background knowledge in e.g. the Islamic finance domain.

4.2 The Screening Activities

Screening for compliance is an on-going process as companies' activities are not static. They may experience product improvement, new partnership, new market and many other activities that may increase their profit. Therefore, their activities need to be monitored periodically to ensure their compliant status. Furthermore, each company has different entry into the compliant screening system. Therefore, each has different dateline in submitting report for analytical purpose. The busiest time at the office is before the announcement of the new updated list that takes place every May and November each year.

The outcomes of interview on screening process are summarized in Table 1. The response from the interview indicated that the review team follows the required steps in screening each company under review. The main sources of information come from company's prospectus and annual report. If there is additional information required, they may request such information directly from the company itself. This is the advantage of serving as the authorities, which cannot be done by ordinary Shariah consultant. The approval is subject to the guidelines by SAC of Securities Commission. They have released a new benchmark in 2013 which first take effect on November 2013 Shariah compliant list. The revised screening methodology introduce financial ratios: cash over total assets and debt total assets (Securities Commission Malaysia, 2013). Both ratios must be lower than 33%. The rationale of having the ratios is intended to measure riba and riba-based elements.

Table 1. Summary of main questions and answers

NO.	QUESTIONS	RESPONSE
1.	When is the screening process carried out?	Twice a year to produce the new list of Shariah compliant companies
2.	How the screening process is carried out?	It follows the steps as in Fig. 1 subject to guideline from the government body
3.	What are the sources of data?	Company prospectus, annual report and special request to the company
4.	Who perform the screening process?	A team under Securities Commission
5.	Who will approve the screening output?	Board of Shariah committee known as Shariah Advisory Council.

Table 2. Refined screening process from expert

STEP	PROCESS	ACTIVITIES CARRIED OUT
1.	Information extraction	Prospectus, annual report, special request information
2.	Undertaking Shariah compliance review	The core business is manually screened towards prohibited element
3.	Compare with Shariah financial benchmark	Involvement with prohibited element income is checked
4.	Tabulate the results to the SAC for final decision	The tabulated information is presented to the SAC. They will approve the compliant status

Table 2 displays the refined screening process according to the steps. As stated in Table 2, information was extracted from prospectus, annual reports and special request to the respective company. One big challenge awaits Securities Commission is information overflow as huge amount of data are available on the web. They can no more rely solely on the supplied data by the company but to open their data repository e.g. social media to dig on. Certain information available in social media may sometimes become a good reference in supports of data analysis.

5. Conclusion

Shariah compliant investment is one of the popular alternatives in investment world. It opens its door for Muslims to gain wealth without violating the Islamic rule. This study was carried out to gain understanding on how the screening process is conducted. The characteristics that may lead to non-compliant status are also examined. Any involvement in activities such as producing non-halal products, involvement in conventional banking and entertainment; may put the company at risk of non – compliant status. The study managed to gain a clearer picture on how the screening process is being carried out. Although plenty of research articles had discussed the issue of screening, further extension of the work is needed to analyse the data from the scientific point of view. Hence, further study is necessary to look for the possibility of modelling the process into modern technological apps.

6. Acknowledgements

We thank Zainol Ali and Mohamad Zahril Jumari from Securities Commission for their cooperation. The data presented, the statements made, and the views expressed are solely the responsibility of the authors.

7. References

- Abdul Rahman, A., Yahya, M. A., & Mohd Nasir, M. H. (2010). Islamic norms for stock screening: A comparison between the Kuala Lumpur Stock Exchange Islamic Index and the Dow Jones Islamic Market Index. *International Journal of Islamic and Middle Eastern Finance and Management*, 3(3), 228–240. <https://doi.org/10.1108/17538391011072426>
- Adam, N. L., & Bakar, N. A. (2014). Shariah Screening Process in Malaysia. *Procedia - Social and Behavioral Sciences*, 121(September 2012), 113–123. <https://doi.org/10.1016/j.sbspro.2014.01.1113>
- Audenhove, L. Van. (2007). Expert Interviews and Interview Techniques for Policy Analysis. *Technology*. Retrieved from [http://www.ies.be/files/060313 Interviews_VanAudenhove.pdf](http://www.ies.be/files/060313%20Interviews_VanAudenhove.pdf)
- Belting, J. (2008). Empirical Methods : Expert Interviews.
- Bogner, A., Littig, B., & Menz, W. (2009). Introduction: Expert Interviews – An Introduction to a New Methodological Debate. In A. Bogner, B. Littig, & W. Menz (Eds.), *Interviewing Experts*. Palgrave Macmillan. Retrieved from <http://www.palgraveconnect.com/pc/doifinder/view/10.1057/9780230244276>
- Che Azmi, A., & Hanifa, M. H. (2015). The Sharia-compliance of financial reporting practices: a case study on waqf. *Journal of Islamic Accounting and Business Research*, 6(1), 55–72. <https://doi.org/10.1108/JIABR-10-2012-0069>
- Derigs, U., & Marzban, S. (2008). Review and analysis of current Shariah-compliant equity screening practices. *International Journal of Islamic and Middle Eastern Finance and Management*, 1(4), 285–303. <https://doi.org/10.1108/17538390810919600>

- Donia, M., & Marzban, S. (2009). Shariah-Compliant Equity Investments Frameworks , Trends and Crisis. Retrieved from http://www.eiff.info/uploads/Marzban_HIFF2010_Paper.pdf
- Ho, C. S. F. (2015). International Comparison of Shari'ah Compliance Screening Standards. *International Journal of Islamic and Middle Eastern Finance and Management*, 8(2), 222–245. <https://doi.org/10.1108/17538391111144515>
- Kasim, N., Mohamad Ibrahim, S. H., & Sulaiman, M. (2009). Shariah Auditing in Islamic financial institutions: Exploring the gap between the “desired” and the “actual.” *Global Economy and Finance Journal*, 2(2), 127–137. Retrieved from [http://www.wbiconpro.com/6\[1\].-Nawal_latest.pdf](http://www.wbiconpro.com/6[1].-Nawal_latest.pdf)
- Khatkhatay, M., & Nisar, S. (2007). Shariah compliant equity investments: an assessment of current screening norms. *Islamic Economic Studies*. Retrieved from [http://www.shariqnisar.com/images/My_writings/Islamic Economic Studies Vol 15-1 \(2007\).pdf](http://www.shariqnisar.com/images/My_writings/Islamic Economic Studies Vol 15-1 (2007).pdf)
- Mahfooz, S. bin, & Ahmed, H. (2014). Shari'ah Investment Screening Criteria: A Critical Review. *Journal of King Abdulaziz University, Islamic Economics*, 27(1), 3–39. <https://doi.org/10.4197/Islec.27-1.1>
- Meuser, M., & Nagel, U. (2009). The Expert Interview and Changes in Knowledge Production. In A. Bogner, B. Littig, & W. Menz (Eds.), *Interviewing Experts* (pp. 17–42). Palgrave Macmillan. Retrieved from <http://us.macmillan.com/interviewingexperts/AlexanderBogner>
- Ngadimon, M. N. (2009). Shariah Screening Process in Islamic Capital Market. In *IFSB Seminar on Islamic Capital Market*. Retrieved from <http://www.iefpedia.com/english/wp-content/uploads/2010/02/Shariah-Screening-Process-in-Islamic-Capital-Market-Dr-Md-Nurdin-Ngadimon.pdf>
- Obaidullah, M. (2005). *Rating of Islamic financial institutions: some methodological suggestions*. June.

- Osmadi, A., & Zainuddin, N. M. (2016). The Development of Shariah-Compliant Listed Companies Index. *Jurnal Teknologi*, 5, 135–138.
- Popotte, M. (2010). Industry Snapshot Opening the Black Box of Shariah Stock Screening. Retrieved from http://www.opalesque.com/OIFIArticle/96/the_Black_Box_of_Shariah_Stock850.html
- Rahman, S. (2015). Ethical Investment in Stock Screening and Zakat on Stocks. *Journal of Islamic Finance*, 4(1), 39–62.
- Securities Commission Malaysia. (2013). Revised Shariah Screening Methodology -Dialogue Session with Public Listed Companies 20-21. Retrieved from http://www.bursamalaysia.com/misc/system/assets/4641/islamic_markets_dialogue_session_20-210213b.pdf
- Sefiani, Z. (2009). New Generation of Shariah Stock Screening. *Focus*, (July), 20–21. Retrieved from <http://www.kantakji.com/fiqh/Files/Fatawa/es1.pdf>
- Sengupta, B. (2012). Sharia Stock Screening : A Fund Manager's Conundrum, (January), 1–10. Retrieved from <http://www.cognizant.com/InsightsWhitepapers/Sharia-Stock-Screening-A-Fund-Managers-Conundrum.pdf>
- Zainudin, N., Miskam, S., & Sulaiman, M. (n.d.). Revised Shariah Screening Methodology For Shariah-Compliant Securities: New Standard to Meet Global Expectation, 76–86.