JKAU: Islamic Econ., Vol. **27** No. 1, pp: 3-38 (January 2014)

DOI: 10.4197 / Islec. 27-1.1

Sharīʿah Investment Screening Criteria: A Critical Review

Saeed bin Mahfooz and Habib Ahmed

Abstract. The primary objective of the study is to provide a comprehensive description of the contemporary Sharīʿah investment screening process and its implication on the practices of managing mutual funds. This will be done by critically reviewing the application of such screening criteria, from both Sharīʿah and practical perspectives, and providing some suggestions for improvement. In practice there appears to be inconsistencies in the Sharīʿah investment screening criteria among Islamic investment institutions, as well as the changing of the Sharīʿah rules over time. That shakes confidence in the application of Sharīʿah screening criteria, which might adversely affect the Islamic mutual funds industry. The paper, therefore, attempts to identify such inconsistencies and proposes some practical solutions which may restore confidence in the investment screening process.

1. Introduction

The Islamic economic and finance system is perceived as a socio-economic and finance system that requires incorporating ethicality and morality in economic activities, such as embedded values of fairness, justice and equity (Chapra, 1985, Siddiqi, 2004 and Obaidullah, 2005). The underlying features of an Islamic economic system derive from the objectives of Sharīʿah, which Al-Ghazali identifies as: promoting human beings' welfare through the protection of their five basic interests (*maṣāliḥ*); religion, life, reason, progeny and property (Siddiqi, 2004). These five objectives are not exhaustive. For example, Ibn Taymiya argued that securing benefits for people and protecting them from harm was the general aim, under which the Sharīʿah objectives could be subsumed. Whereas Ibn Ashur stated that the objective of Sharīʿah is to reform this world and eliminate corruption (Siddiqi, 2004). According to Chapra, the implications of the objectives of Sharīʿah for economics and finance in general would be to achieve full employment, a positive economic growth rate with stability and fair distribution of real resources (Chapra, 1985).

There are two sources of knowledge in Islam, primary and secondary. Primary sources comprise of the Qur'ān and Sunnah. Secondary sources include the derived knowledge through jurisprudential research efforts (*ijtihād*) of scholars to accommodate new and contemporary issues through agreed upon methodologies such as consensus (*ijmāʿ*) and analogy (*qiyās*). Additional methodological tools to derive new rulings include *istiḥsān* (juristic preference), *maṣlaḥah mursālah* (unrestricted interest), *sadd al-dharīʿah* (blocking the means), *ʿurf* (custom), and *istisḥāb* (presumption of continuity).[1] Note that while, *ijmāʿ* and *qiyās* are agreed upon sources; there is difference of opinion on the use of others among different schools of thought.

The most distinctive feature of Islamic economic and finance system is the prohibition of *ribā*[2], *gharar*[3], *maysir*[4] and Sharīʿah-impermissible businesses[5] (Obaidullah, 2005). However, *ribā* and some sorts of *gharar* form integral parts of many products used in the existing conventional finance system, such as in financial derivatives, insurance and short selling. In addition, a conventional finance system has no objection to the operation of businesses declared unethical by Islam such as alcohol, tobacco and pornography. Thus, it is against Muslim beliefs to deal with some aspects of the existing conventional finance system since they can go against the principles of their religion.

However, contemporary Sharīʿah scholars worked on providing Islamic financial alternatives to remove the hardship of Muslims. This is to enable them to engage in the modern finance system without violating their religion. Therefore, Islamic finance has been developed with different segments. These include banking, insurance, risk management instruments and investment and capital markets including stocks, *ṣukūk* and mutual funds (all of which should operate in an Islamic manner). As the focus of this paper is the Sharīʿah screening investment process associated with mutual funds and stock market indices, the implication of

(1) Discussion on Islamic legal methodologies is found in Hallaq (2006), Kharoufa (2004) and Laldin (2006).
(2) Refers to interest-based activities in this paper.
(3) Ambiguity or deception in commercial contracts.
(4) Pure game of chance 'gambling'.
(5) See table 1.

the Islamic law on the practice of these segments is discussed and critically reviewed in subsequent sections.

The International Islamic Fiqh Academy, Jeddah issued a ruling in 1992 that approved trading common stocks of companies that do not engage in activities which would violate Sharīʿah principles.(6) This was a significant ruling for the development of the Islamic mutual funds industry, since it allowed Muslim investors to participate in equity markets (Wilson, 2004 and Hussein and Omran, 2005). Since then, the Islamic mutual fund industry has witnessed tremendous increase, with average annual growth of between 15 to 20 percent, making this particular segment one of the fastest growing areas in Islamic finance industry (Hakim and Rashidian, 2004). Sharīʿah scholars also played a crucial role in the realization of the Islamic equity mutual funds and market indices by relaxing Sharīʿah constraints on interest-based activities, in order to make it easier for Muslims to invest. Introduction of Islamic indices by globally reliable index providers such as Dow Jones and FTSE in late 1990s was also a significant turning point for the development of the Islamic investment industry. It supports Islamic mutual funds industry by promoting transparency, as well as showing the acceptance of Islamic investment industry by mainstream players (Hakim and Rashidian, 2004).

The objective of this paper is to review the Sharīʿah investment screening process critically. This is to answer the following research question: What are the critical issues relating to the Sharīʿah screening process for stocks? The remainder of the paper is organized as follows; Section 2 elaborates the implication of the Islamic law on the practice of mutual funds and market indices. Section 3 discusses critical issues with respect to Sharīʿah investment screening criteria. Finally, section 4 summarises the conclusions.

(6) International Islamic Fiqh Academy7th session, Resolution 63, 1992 item no.6. (Wilson, 2001).

2. The Implications of Islamic Law for the Practice of Mutual Funds and Market Indices

As pointed out previously, the International Islamic Fiqh Academy issued a ruling in 1992 that legalized investing in common stocks of Sharīʿah-compliant companies.(7) This is because the stockholders are shareholders and partners in the companies. Sharīʿah has no objection to such partnership contracts, since stockholders share profit and loss without getting a guaranteed fixed return (Khatkhatay and Nisar, 2006). Unlike traditional *mushārakah* and *muḍārabah* partnership contracts, investing in listed companies are less risky, since listed companies and mutual funds are monitored and regulated by stock market authorities which promotes transparency and fair transactions (Wilson, 2004 and Khatkhatay and Nisar 2006). Investing in listed companies also provides greater liquidity because stockholders can sell their stocks at any time at the going market price. Stockholders can also benefit from capital gains during a market boom (Wilson, 2004). For these reasons, the Islamic mutual funds industry has gained popularity.

In practice, there are many similarities between Islamic mutual funds and conventional mutual funds (Elfakhani et al., 2005). In fact, both types of mutual funds apply the same finance and portfolio theories in terms of asset allocation, stock selection, performance evaluation, and so on. However, unlike conventional mutual funds, Islamic mutual funds have to comply with and are governed by Islamic principles. This influences the stock selection and the operation of Islamic mutual funds. Thus, Islamic mutual funds tend to be more restrictive compared to their conventional counterparts, in terms of asset allocation, stock selection and trading strategies. In particular, unlike conventional mutual funds, Islamic mutual funds are not allowed to invest in fixed income instruments, such as government bills, government bonds, corporate bonds, etc., (Siddiqi, 2004 and Elfakhani et al., 2005).(8) Also, Islamic mutual funds are not allowed to use derivative contracts, such as futures, forwards, options and swaps, since they are not Sharīʿah-complaint owing to the excessive *gharar* associated with these contracts

(7) See footnote 6.

(8) Although *ṣukūk* are Sharīʿah-compliant (alternative instruments to fixed income bonds), the *ṣukūk* market is still in its infancy.

(Obaidullah, 2005). Islamic mutual funds are also required to undergo a purification process, whereby Sharīʿah-compliant investors must donate the Sharīʿah-impermissible portion of their income (Elgari, 2000). This section discusses Sharīʿah screening criteria for Islamic mutual funds and market indices in terms of both qualitative and quantitative screening criteria. Then, the earning purification process is discussed, followed by illustrating the role of Sharīʿah supervisory boards.

2.1 Sharīʿah Screening Criteria (Asset Allocation) for Islamic Investment

Since they will become part-owners of the companies and hence, be responsible for their activities, Muslim investors have to ensure that the business activities as well as the financial structure of the companies they invest in are Sharīʿah-compliant, (Khatkhatay and Nisar, 2006). This can be done through investing in companies that pass Sharīʿah screening criteria approved by Sharīʿah scholars. There are two categories of Sharīʿah screening criteria: qualitative sector screening and quantitative financial screening. These two must both be met in order for a company to become Sharīʿah-compliant so as to be eligible for Muslim investors money. There is a general consensus among Muslim scholars about these two Sharīʿah screening categories; as long as the business does not deal with *ribā*, *gharar* and *maysir*, and also that the business activities are permissible from a Sharīʿah perspective. Next we discuss the Sharīʿah sector screening and financial screening criteria.

Qualitative Sector Screening Criteria

According to Islamic principles companies must not produce or sell Sharīʿah- impermissible products or services, such as tobacco, alcohol, pornography, weaponry, casino games, pork-related products.[9] Furthermore, conventional banks and conventional insurance companies are not Sharīʿah-compliant since their core business is based on *ribā* and *gharar* respectively (Obaidullah, 2005). Thus, conventional finance sectors, as well as Sharīʿah unethical businesses have to be excluded from Islamic investment portfolios. Once a company passes the sector screening criteria, and its core business is Sharīʿah-permissible, it can be considered as a Sharīʿah-compliant company if it passes the financial

(9) See Table 1.

screening criteria. According to Derigs and Marzban, (2008) Sharīʿah sector screening excludes around 23% of the conventional S&P 500 investment universe.

Table (1) *Sector Screening Criteria Based on the Major Four Islamic Indices Providers.*

Sector	Dow Jones	FTSE	S&P	MSCI
Alcoholic Beverages	××	•	××	•
Broadcasting & Entertainment	××	•	××	•
Conventional Financial Services	××	•	××	•
Gambling	××	•	××	•
Hotels	××	•	××	•
Insurance	××	•	××	•
Media Agencies (except newspapers)	××		××	
Pork-related Products	××	•	××	•
Restaurants & Bars	××	•	××	•
Tobacco	××	•	××	•
Trading of Gold & Silver			××	
Weapons & Defense	××	•		•

Where ×× means some involvement and • implies core business
Source: Adopted from Derigs and Marzban, 2008.

Table 1 shows the sectors that are excluded from Islamic investment portfolios by the four major Islamic indices providers. It can be seen that there is almost a consensus among the Sharīʿah supervisory boards of the major four Islamic indices on Sharīʿah-impermissible sectors. However, there appears to be a minor disagreement between boards, regarding whether to consider the weapons and defense and media agencies sectors as Sharīʿah non-compliant or not. In addition, it can be also seen that some Sharīʿah supervisory boards are more tolerant than others. While Sharīʿah supervisory boards of the Dow Jones and the S&P exclude companies which have any involvement in impermissible activities, Sharīʿah supervisory boards of the FTSE and MSCI tolerate minor violations, as long as the core business is permissible. Clearly, such restrictions imposed by the Sharīʿah supervisory board of the Dow Jones and the S&P reduce the investment universe based on sector screening because they force Islamic portfolios to eliminate sectors such as airlines, hotels and wholesalers, since these sectors all provide alcohol (Derigs and Marzban, 2008).

It is worth mentioning that excluding industries such as broadcasting and entertainment, financial services, insurance, hotels, media agencies and restaurants from Islamic investment portfolios is due to the fact that these sectors are more likely to engage in Sharīʿah-impermissible activities. Examples of Sharīʿah-impermissible activities in these sectors, include alcohol, pornography, pork-related products, gambling, *ribā* and *gharar*. In other words, the reason for excluding these sectors is because of Sharīʿah violations, associated with their operations, rather than the core business itself. Thus, if such sectors operate in an Islamic manner, they should not be eliminated from Islamic investment portfolios. For example, hotels and restaurants in Saudi Arabia are not eliminated since they do not violate Sharīʿah principles. Similarly, Islamic banks and Islamic insurance companies are not excluded from Islamic investment portfolios.

Quantitative Financial Screening Criteria

Unlike conventional and socially responsible investment (SRI) portfolios, Islamic investment portfolios have to comply with certain financial screening criteria (Ghoul and Karam, 2007). The purpose of the financial screening criteria is to exclude companies with unacceptable levels of conventional debt, liquidity, interest-based investment and/or impure income. Ideally, according to Islamic principles, companies must not borrow on the basis of interest rate, nor invest in debt-bearing instruments, as well as not generating income through any other Sharīʿah-impermissible activities. However, such restrictions would screen out the vast majority - if not all - of the stocks that are available on the market, even those listed in Islamic countries (Wilson, 2004). This is because contemporary companies tend to have exposure to interest-based finance '*ribā*' for managing their working capital, as well as for financing the acquisition of fixed assets for expansion and diversification purposes (Khatkhatay and Nisar, 2006 and Derigs and Marzban, 2008).[10]

Some Islamic scholars, therefore, demonstrate their understanding of the difficulty by tolerating some financial ratios screening, if the basic business is Sharīʿah-permissible in nature and the exposure to *ribā* and

(10) Although dealing with Islamic banks and Sharīʿah-compliant instruments that are alternative to interest-bearing securities, such as *ṣukūk* to avoid having exposure to *ribā*, conventional companies especially in non-Muslim countries tend to deal with conventional banks.

other impermissible activities is not excessive. They argue that the judgment should be based on the majority, since the majority deserves to be treated as the whole of a thing (AAOIFI, 2004). Also, the tolerance and relaxation of the Islamic norms aims to remove the hardship, acknowledging the general need for and widespread practice of interest-based activities which does not necessarily mean the acceptance of *ribā* or other Sharīʿah-impermissible activities (AAOIFI, 2004). In other words, the reason for such s relaxation is that an individual Muslim investor has no control over the whole business practices of companies that are managed in a non-Islamic manner, it also deals with the fact that fully Sharīʿah-compliant companies are rare (Khatkhatay and Nisar, 2006 and Derigs and Marzban, 2008).

According to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI)[11], in order for a company to be suitable for Muslim investors, there are certain financial screening ratios which must be met if the nature of the business is Sharīʿah-permissible. For the determination of these percentages, the last budget or certified financial position must be used.

(1) *Interest-based debt*: The collective amount raised as a loan on interest, whether long-term or short-term debt does not exceed 30% of the market capitalization of the corporation.

(2) *Interest-based deposit:* The total amount of interest taking deposits, whether short, medium or long term, does not exceed 30% of the market capitalization of total equity.

(3) *Earning from impermissible activities*: The amount of income generated from prohibited component does not exceed 5% of the total income of the corporation, irrespective of the income being generated by undertaking a prohibited activity, by ownership of prohibited assets or in some other way.

(4) *Tangible assets and benefits:* The total market value of assets, benefits and rights should not be less than 30% of the total asset value of the corporation, including all assets, benefits, rights and cash liquidity. This is irrespective to the size of debt associated with the company (the

(11) AAOIFI Sharīʿah Standard No. (21), 3/4.

corporation's debts, current accounts with others, and bonds it holds which constitute debts), as these are secondary in such cases.(12)

Also, AAOIFI(13) indicates that it is not permissible to undertake trading in the shares of a corporation when the assets of the corporation are exclusively held as cash, or if the entire assets of the corporation are composed of debts, unless the rules for *ṣarf* and dealing with debts are observed.(14)

Table (2) *Financial Screening Criteria Based on the Major Four Islamic Indices Providers and SAC of Malaysian SEC**

	Level of Interest-based Debt	**Cash and Interest Bearing Securities**	**Liquidity**	**Impermissible Income**
Dow Jones	Total Debt/ Market Cap (Aveg.24month),less than33%	Cash and Interest Bearing Securities/ Market Cap (Aveg.24month), less than33%	Account Receivable/ Market Cap (Aveg.24mont), less than33%	Should not exceed5% of Total Revenue (Other than Interest Income)
FTSE	Total Debt/ Total Assets, less than33%	Cash and Interest Bearing Securities/ Total Assets, less than33%	Account Receivable and Cash/ Total Assets, less than50%	(Total Interest and non-Compliant Activities Income) should not exceed 5% of Total Revenue
S&P	Total Debt/ Market Cap(Aveg.36month) less than33%	Cash and Interest Bearing Securities/ Market Cap (Aveg.36month), less than33%	Account Receivable/ Market Cap (Aveg.36mont), less than49%	Should not exceed 5% of Total Revenue (Other than Interest Income)
MSCI	Total Debt/ Total Assets, does not exceed33.33%	Cash and Interest Bearing Securities/ Total Assets, does not exceed 33.33%	Account Receivables and Cash/ Total Assets, does not exceed 33.33%	Should not exceed 5%of Total Revenue
Malaysian SEC	n/a	n/a	n/a	5% - 25% of Total Revenue

Source: Official Indices Websites, 2011

* *Sharīʻah Advisory Council* (SAC) *of the Malaysian Securities and Exchange Commission (SEC).*

(12) AAOIFI Sharīʻah Standard No. (21), 3/19.

(13) AAOIFI Sharīʻah Standard No. (21), 3/17 and 3/18.

(14) The Sharīʻah rule of *ṣarf* is that liquid assets such as cash and debt must be traded at par (Siddiqi, 2004)

It can be seen from Table 2 that none of the above Islamic indices fully comply with AAOIFI standards. First, AAOIFI uses a 30% threshold for interest-based debt level, while the four Islamic indices apply either a 33% or 33.33% threshold for total debt. Secondly, the AAOIFI does not require a certain level of liquidity (account receivables and/or cash), as long as the cash deposit does not generate income from interest rate, whereas all four Islamic indices require such a liquidity ratio. Secondly, the AAOIFI does not require a certain level of liquidity (account receivables and/or cash), as long as the total market value of assets, benefits and rights exceeds 30% of the total asset value of the corporation. On the other hand, all four Islamic indices impose an explicit liquidity requirement. It should be noted that, while the levels of interest-based debts, interest-bearing securities/deposit and impure income are meant for avoidance of *ḥarām;* level of liquidity is meant for the mere validity of stocks tradability in the secondary market.

Thirdly, unlike AAOIFI standards that require the impure income portion not to exceed 5% of the total income, Islamic indices use 5% of total revenue, rather than total income. Fourth, the divisor of the ratios used by AAOIFI is market capitalization, based on the last verified position without smoothing out the ratios. On the other hand, the Sharīʿah Advisory Council (SAC) of the Malaysian Securities and Exchange Commission (SEC) does not require financial screening criteria. They are only concerned with interest-based income without considering the levels of the interest-based investment and interest-based debt. In other words, their view is that as long as the interest income does not exceed the tolerable ratio, interest-based investment and debt should be ignored. Also, the SAC of Malaysian SEC tends to be liberal in its impermissible income tolerance, which ranges from 5% up to 25% in some cases.

Obviously, there seems to be no consensus among Sharīʿah supervisory boards on the financial screening criteria, and the disagreement among scholars in such screening is much more pronounced than in the sector screening. The financial screening elements including financial ratios, threshold and divisor of the ratios are discussed next.

Financial Ratios

The main four financial ratios that are commonly used are levels of conventional debt, liquidity, interest-bearing securities/deposit and impure income, and these are discussed below.

Level of Debt

From a Sharīʿah perspective, interest-based debt is not permissible. However, Sharīʿah supervisory boards tolerate some debt, if the interest-based debt does not exceed the acceptable level of conventional debt, which is believed not to be excessive. This is due to the impracticality of such a restriction with contemporary companies, since the vast majority of companies have exposure to interest-based finance (Wilson, 2004). Thus, requiring that Sharīʿah-compliant companies do not exceed the excessive level of interest-based debt ensures that companies highly exposed to *ribā* are excluded.

Level of Liquidity

From a Sharīʿah point of view, liquid assets such as cash and debt must be traded at par (Siddiqi, 2004). Therefore, according to Sharīʿah principles, a company with the majority of its assets comprising of cash or debt cannot be traded, either above or below its book value (Khatkhatay and Nisar, 2006). Thus, requiring a liquidity screening requirement is to avoid investing in companies whose liquid assets are traded at either premium or discount. On the other hand, AAOIFI standards do not directly impose restrictions on the level of liquidity and argue that liquidity is a secondary matter in such circumstances. They, however, impose the condition that the market value of tangible assets and benefits should not be less than 30% of total assets for company's shares to be tradable. Otherwise, the rules of *ṣarf* transactions in debts should be observed.

Interest Bearing Securities/ Deposit

The purpose of this ratio is to ensure that the investment in interest-bearing securities is at an acceptable level. This is because interest-based deposit, as well as interest-based securities, such as treasury bills, government and corporate bonds, certificates of deposit (CDs) and preferred stocks, are not Sharīʿah-compliant (Elfakhani et. al., 2005). Also, minimizing the investment in interest-based securities/deposit reduces the income that is generated from *ribā* (Khatkhatay and Nisar, 2006).

Impermissible Income

According to Sharīʿah principles, income should be generated through Sharīʿah-permissible activities. However, most Sharīʿah boards tolerate a small portion of impermissible income, as long as the basic nature of the business is Sharīʿah-permissible. This is because fully Sharīʿah-compliant companies are scarce, since companies do not operate entirely in an Islamic manner and hence, judgment should be based on the majority, rather than the whole entity (AAOIFI, 2004). However, Islamic investors are required to purify the impure income portion, resulting from the impermissible activities, by giving it away to charities. The earning purification process is discussed in section 2.2.

Tolerance Threshold

As can be seen from Table 2, there is no consensus on the level of the tolerance threshold used for financial screening criteria since it varies from one Sharīʿah board to another. The commonly used thresholds are, (30-33%) level of conventional debt, (30 - 33%) interest-based investment/deposit, (33% - 50%) liquidity and (5% - 25%) of impure income. The question that naturally arises here is as to where these thresholds are deduced from. According to Obaidullah (2005) the 33% tolerance threshold was chosen by scholars since one-third is not considered as an excessive portion from a Sharīʿah perspective. This is based on a Ḥadīth of Prophet (SAAW) and a *fiqh* rule. In terms of the Ḥadīth, the Prophet (SAAW) advised one of his companions not to donate more than one-third of his wealth in a will, and commented: "one-third is too much." Furthermore, the maxim of majority is used which states that 'the majority deserves to be treated as the whole of a thing'. That implies that if securities represent composite assets, the rule of the dominating asset (having more that 50 percent) will apply to the security. It is argued that the threshold range of between 33% and 49% is deduced from this Sharīʿah maxim whereby the majority can be classified as a 'simple majority' in the case of more than 50% and a 'super majority' in the case of more than 67% (Usmani, 2005). With regards to the 5% threshold, it seems to be that this threshold is based on the *ijtihād* of contemporary scholars, rather than being explicit in the Qur'ān or Sunnah (Derigs and Marzban, 2008).

The Ratios' Divisor (Market Capitalization versus Total Assets)

As indicated in Table 2, there are two types of financial screening ratios' divisors that are used in practice, for measuring Sharīʿah financial tolerance ratios. These are market capitalization and total assets. Advocates of the total assets divisor argue that unlike market capitalization divisor, which tends to be influenced by the market price fluctuation, total assets represent the true unbiased value of the company. On the other hand, proponents the market capitalization divisor argue that a company's fair value is reflected in its market price, because it captures the current value as well as the value of the intangible assets, which are not captured by the total assets divisor. This issue is discussed in greater detail in section 3.7.

2.2 Earning's Purification

Earning's purification means that if the core business of a company is Sharīʿah-permissible but a small portion of the income comes from Sharīʿah-impermissible activities, then that impure earning portion should be given away to charities (Elgari, 2000). In fact, the earning purification process seems to be unique to Islamic investment since conventional SRI does not require such purification. According to AAOIFI standards, earning purification is obligatory for one who is the owner of the share, whether an investor or a trader, at the end of the financial period, regardless of whether the profit is distributed or not, and irrespective of the net financial result of the company (whether it made a profit or suffered a loss).[15] However, those who sell the shares before the end of the financial period are not obligated for such purification. Some scholars require that the impermissible income portion is purified from the dividends distributed only (DeLorenzo, 2000). Thus, the amount that needs to be purified, based on this view, is calculated as the ratio of impermissible income to total income multiplied by the dividend (Elfakhani et al., 2005 and Khatkhatay and Nisar, 2006). This approach is commonly used in practice, including by MSCI and S&P.

(15) AAOIFI Sharīʿah Standard No. (21), 3/4/6.

In addition, according to Elfakhani et. al., (2005) the earning purification of Islamic mutual funds can be done either by direct deduction by the fund managers before any distribution of income. Alternatively, fund managers can report the amount that needs to be purified to the investors, so that they can purify it individually. They argue that the second method makes the Islamic mutual funds more profitable and comparable to conventional mutual funds for conventional and socially responsible investors, since they will not be penalized for the purification process according to this method. However, AAIOFI indicates that the responsibility of the purification falls upon the institution, in case it is trading for itself or managing the operations.(16) Furthermore, *zakāh* which is a percentage of personal wealth that must be paid annually to charities or needy people should be purified as well (Elfakhani et al., 2005). According to DeLorenzo (2000), the matter of *zakāh* purification for Islamic mutual funds is best left to the investors themselves, since it depends on the circumstances of each investor.(17) The status of different indices in terms of earning purifications is shown in Table 3 below.

2.3 Sharīʿah Supervision

A Sharīʿah supervisory board is an independent body, assigned by the Islamic mutual fund manager or Islamic indices provider, to regulate and govern the activities of the Islamic investment portfolio in accordance with Sharīʿah principles (DeLorenzo, 2000). Furthermore, according to the AAOIFI, the Sharīʿah supervisory board has to comprise of specialized jurists in Islamic commercial jurisprudence (*fiqh al-muʿāmalāt*), and may include a member who is an expert in the field of Islamic financial institutions and with knowledge of *fiqh al- muʿāmalāt.* Since there is no universal Sharīʿah standard or Sharīʿah governing authority, each Islamic investment entity has established its own Sharīʿah supervisory board. Alternatively, a consultancy firm that has a distinguished Sharīʿah board, which specializes in Islamic jurisdiction, can be assigned to advise on Sharīʿah finance and investment matters. The first strategy is applied by the Dow Jones Islamic indices, whereas the latter is applied by FTSE and S&P Islamic indices.

(16) AAOIFI Sharīʿah Standard No. (21), 3/4/6.

(17) DeLorenzo refers to the fatwa of the Sharīʿah supervisory board of Jordanian Islamic bank.

Table (3) *Earning Purification Process Applied by the Major Four Global Islamic Indices Providers*

Indices	**Purification Status and Process**
Dow Jones	Does not apply earning purification process.
FTSE	Appropriate purification of dividends is applied. The dividend purification ratio calculates the recommended purification amount to be paid by the investor.
MSCI	A dividend adjustment factor is applied to all reinvested dividends. The dividend adjustment factor is defined as: *{Total Earnings - (Income from Prohibited Activities + Interest Income)} / Total Earnings* In this formula, total earnings are defined as gross income, and interest income is defined as operating and non-operating interest.
S&P	The dividend purification ratio is provided to investors for purification purposes. The ratio determines what portion of the dividends received must be purified. It is calculated as: *Dividends * (Non Permissible Revenue / Total Revenue)* Non-permissible revenue, in this context, includes all forms of revenue or income that are considered non-permissible from a Sharīʿah perspective and includes any income generated from interest.

Source: Official Indices Websites, 2011.

Moreover, a Sharīʿah officer might be appointed instead of a Sharīʿah board, in case the fund managers track an Islamic index since the tracked index has its own Sharīʿah board that establishes the Islamic guidelines and monitors the index (DeLorenzo, 2000). Although such a strategy is less expensive than the previous strategies due to the reduction of costs of the Sharīʿah board and fund monitor, it limits the stock menu available for the fund managers, since they have to follow the composition of the tracked index only.

The main duties of the Sharīʿah supervisory board are threefold. Firstly, they set up the Sharīʿah guidelines and a framework for fund managers in accordance with Sharīʿah principles (Elfakhani et al., 2005). Secondly, they supervise the activities of the fund managers to ensure that they are in line with the Sharīʿah guidelines setup previously (Elfakhani et al., 2005). Islamic portfolios need to be monitored on a regular basis to ensure that the stocks that have been selected in the funds' portfolio are still Sharīʿah-compliant, and the stocks that had since become non Sharīʿah-compliant are removed (DeLorenzo, 2000).

Thirdly, they make sure that earnings have been purified, by either deducting the impure earning from the dividends and giving it away to suitable charities, or by reporting it to investors to purify it on their own (DeLorenzo, 2000).

3. Critical Issues with Respect to Sharīʿah Investment Screening Criteria

This section critically reviews the Sharīʿah screening criteria and discusses the issues associated with implementing Sharīʿah screening process. The issues discussed include the credibility, inconsistency, financial ratios screening and their divisor, earning purification process, the tolerance threshold, social responsibility and Sharīʿah supervision.

3.1 Credibility

Although Sharīʿah screening criteria are commonly used and are generally accepted in practice; they have not been approved by a credible, independent and universal Sharīʿah authority, such as the International Islamic Fiqh Academy or Islamic Financial Services Board. Thus, Sharīʿah screening criteria in general and financial screening criteria in particular remain a debatable issue. For the Sharīʿah investment screening criteria issued by AAOIFI, it can be argued that members of its Sharīʿah boards are also members of Sharīʿah boards in Islamic financial institutions and hence, they are not entirely independent from the industry. Unlike International Islamic Fiqh Academy, the AAOIFI is only specialized to issue Sharīʿah principles, in order to standardize the Islamic finance industry, rather than being responsible for general religious ruling. Also, unlike the International Islamic Fiqh Academy, AAOIFI does not represent all Muslim countries.

3.2 Inconsistency

Sharīʿah parameters, as applied by Sharīʿah boards, seem to be subjective and set arbitrarily. There appears to be no uniform Sharīʿah investment code of conduct or a universal predetermined fixed set of Sharīʿah screening criteria that is agreed upon between Muslim scholars (Hakim and Rashidian, 2004 and Derigs and Marzban, 2008). This is despite the general consensus among Muslim scholars about the Sharīʿah screening criteria, in the broad sense that the business does not deal in *ribā* or *gharar,* and also the core business activities are permissible from Sharīʿah perspective. However, in practice there is disagreement among Muslim scholars, in terms of the sectors that have to be excluded, and also in terms of the financial screening with particular reference to the ratios used, ratios' divisor and tolerance threshold. For example, as indicated in Tables 1 and 2, some Sharīʿah boards require exclusion of the defense industry and media agencies from Islamic investment portfolios, while others do not. Another example, whereas some scholars tolerate only 5% impure income, others, such as the SAC of the Malaysian SEC, tolerate up to 25% of impure income in some cases. Another controversial issue is that the S&P provides an Israeli Sharīʿah-compliant index in their Sharīʿah-compliant market indices selection. This contradicts the *fatwá* of most of the Sharīʿah scholars because of the occupation of Palestinian land by Israel.

Furthermore, while some scholars require using total assets as the financial screening's divisor, others use market capitalization instead. This Sharīʿah inconsistency leads to cases where some of the fund structures or Sharīʿah-compliant instruments are considered acceptable by one board or scholar, they might be seen as unacceptable by others. In fact, Derigs and Marzban (2008) indicate that different Sharīʿah classifications by the same scholars even occur across different funds and indexes which they supervise. They also show that the same Sharīʿah scholars defined, on average, approximately one out of five companies as Sharīʿah-compliant for one product and as Sharīʿah non-compliant for the other product. This creates confusion in the Sharīʿah parameters and can shake the confidence in Islamic mutual funds and indices, as well as in the independence of the Sharīʿah boards.

Derigs and Marzban (2008) argue that there are two reasons that can explain such dissimilarities among Muslim scholars in terms of Islamic investment screening criteria. First, modern finance and investment is a new phenomenon and hence, the current practice is based on *ijtihād* of contemporary scholars who have different Sharīʿah opinions. In particular, the financial tolerance threshold used in Islamic investment screening is not stated explicitly in the Qur'ān or Sunnah. It is based on the *ijtihād* of contemporary scholars. Second, unlike in Christianity, there is no higher Islamic authority that is responsible for religious rulings to be followed by all Muslims. Therefore, each Islamic financial institution has its own Sharīʿah committee, or a Sharīʿah advisory firm, to set

Sharīʿah guidelines and approve Sharīʿah-compliant transactions.[18] However, it can be argued that although there is no higher global Islamic authority, there are credible universal Sharīʿah authorities, such as the International Islamic Fiqh Academy, which can set global Sharīʿah investment screening standards. Furthermore, the higher Islamic authority can at least be set up at the national level to enforce Sharīʿah consistency, and ensure the acceptability of the criteria and also avoid conflicts of interest arising from allowing Islamic mutual funds to assign their own Sharīʿah board. This approach has been applied in Malaysia, where there is the Sharīʿah Advisory Council of the Malaysian Securities Exchange Commission.

3.3 Changing the Rules

Changing the Sharīʿah rules is another area of criticism associated with the Sharīʿah screening process. For example, during the recent financial crisis, the Dow Jones Islamic Market index and the S&P Islamic indices increased the moving Average of the market capitalization divisor from 12 trailing months to 24 and 36 respectively to further smooth out the ratio. Another example of changing rules is the modification of the divisor from total assets to market capitalization by Dow Jones, and also the move from having a 45% threshold for the level of accounts receivable, to 33% (Khatkhatay and Nisar 2006). The issue is that different Sharīʿah rules result in a different set of Sharīʿah-compliant investment universes. In other words, some companies that are considered as Sharīʿah-compliant might become Sharīʿah non-compliant as a result of changing the Sharīʿah rules, by the same board members who allowed them earlier and vice versa. This also has the potential to damage the reputation of the Sharīʿah standards and the Sharīʿah boards.

3.4 Financial Ratios

The criticisms of financial screening ratios are discussed below:
Level of Conventional Debt and Interest Bearing Securities

The current practice of Sharīʿah screening process allows investment in companies which deal with (Sharīʿah-impermissible) interest-based debt or interest-bearing securities, as long as the exposure to such

(18) There are some exceptions where there is a higher Sharīʿah authority at the national level, such as in Malaysia.

impermissible activities does not exceed the one-third threshold believed to be not excessive. However, it is argued that the use of the *ḥadīth* that the Prophet advised one of his companions not to donate more than one third of his wealth, and commented that, "One third is too much" to tolerate interest-based activities is debatable, since it is used out of its context. This is because the situations described differ widely from the screening processes in which they are used here (Obaidullah, 2005). In particular, the context of the above Ḥadīth was for donation which is a noble act, as the companion wanted to give away all of his wealth, but the Prophet advised him not to donate more than one third to keep some of his wealth for his inheritors. This is vastly different field from the tolerance of Sharīʿah-impermissible interest-based activities. In addition, some scholars argue that the issue of *ribā* cannot be tolerated at all in Islam, regardless of the amount involved. The severity of *ribā* is evident from the Qur'ānic verse (2:279), in which God declares war on people who deal with it. There are also many *Aḥadīth* of Prophet (pbuh) which show how severe it is to get even a negligible amount of *ribā*. This might explain why the commonly used Sharīʿah screening criteria have not yet been approved by a credible independent Sharīʿah authority, such as the International Islamic Fiqh Academy.

In addition, it can be argued that tolerating conventional debt and interest-bearing securities because of the necessity (as argued by some scholars) does not seem to be valid nowadays in some Muslim countries. This is due to the wide availability of Islamic banks and Sharīʿah alternative instruments to interest-based finance, such as *ṣukūk*, in these countries. Thus, it can be argued that conventional finance should be gradually replaced by Islamic finance in Muslim countries. Lowering the threshold level of conventional interest-based finance in these countries will induce companies to adopt Islamic financing models, which will in turn lead to further growth and development of Islamic finance, as well as it being adopted, even by conventional companies. However, tolerating the level of conventional debt seems to be still needed for investment in non-Muslim countries, where all listed companies use conventional debt (Wilson, 2004). Nevertheless, it is argued that the tolerable level of conventional debt should be based on the unavoidable level of debt such as working capital, and that the currently applied tolerance level seems to be too liberal, since a concession is made about the actual level of conventional debt that is supposed to be zero (Khatkhatay and Nisar 2006).

The most liberal view is that of SAC of the Malaysian SEC, which does not place any restriction on the level of debt or level of interest-bearing securities at all. They argue that the judgment should be based on the usage of the money, rather than its source, since the debt of the company has occurred in the past (Dar Al Istithmar, 2009). In other words, as long as the current primary business of the company is permissible, its source of financing should be ignored. Another liberal view is that of Dow Jones and S&P, which do not seem to have an explicit restriction on the level of interest rate income that is also surprising. Such liberal views do not seem to be based on a strong Islamic reference and tend to increase the number of Sharīʿah-compliant stocks artificially. This is because, from a Sharīʿah point of view, Muslims are not allowed to either receive or pay interest. While the former is not avoided in the case of Dow Jones and S&P Sharīʿah screening criteria, the latter is not avoided in the Malaysian case.

Level of Liquidity

Most Sharīʿah boards require excluding highly liquid companies, in order to avoid investing in companies whose liquid assets are traded above or below their par value. This is because liquid assets such as cash and debt must be traded at par from a Sharīʿah perspective. However, as indicated above AAOIFI does not have a direct restriction on the level of liquidity as they argue that in these circumstances, such assets are deemed secondary and in such cases matters that are otherwise not normally overlooked can be disregarded. Nevertheless, AAOIFI requires that the market value of tangible assets does not fall below 30% of total assets; otherwise the rule of *ṣarf* should be applied.

It can be argued that the assumption of Sharīʿah scholars that companies whose shares are traded above their book value indicates a premium paid over their liquid assets does not seem to be valid in modern world companies (Khatkhatay and Nisar, 2006). This is because, fundamentally, investors pay a premium over book value, if the company can generate future abnormal returns that compensate for the risk taken, regardless of its liquid assets. Thus, there is no direct connection between the company's total liquid assets value and its market value. Abnormal returns might be driven by intangible assets, such as patents, copyright, management team etc., which do not appear on the balance sheet (Khatkhatay and Nisar, 2006 and Dar Al Istithmar, 2009). Another strong argument against the liquidity ratio is that market players assume ongoing concerns, that companies' assets will not be liquidated in the short term and hence, the market price does not reflect the price assigned by the market to the company's receivables, payables and cash balances (Khatkhatay and Nisar, 2006). For example, a technology or a trading company which, usually, has negligible fixed assets might be sold for a huge premium in the market, according to its breakup value. This is not because it is able to sell its receivables and cash at a premium, or liquidate its debts at a discount as the reasoning of the Sharīʿah scholars requires, but rather, it is because of its inherent or intangible strengths (Khatkhatay and Nisar, 2006).

Furthermore, it can be argued that imposing fixed ceilings on cash and liquidity holdings does not seem practical, since the level of holdings of cash and liquidity vary according to the business cycle (Wilson, 2004). For example, during a bear and uncertain market conditions, companies tend to hold more liquidity, and vice versa during a booming market. Also, applying a liquidity screening ratio might influence Islamic investment portfolios to choose illiquid companies that might suffer from insolvency (Dar Al Istithmar, 2009). The SAC of the Malaysian SEC does not require such a ratio. In fact, not requiring such a criterion seems to be justifiable, since the underlying assumption of it does not seem to be in line with the modern corporations.

3.5 Earning Purification Process

According to AAOIFI standards, in order for investors to calculate the impure income that should be purified per share, the total impure income should be divided by the total number of shares of the corporation.[19] This is regardless of whether the company declared a profit or suffered a loss

(19) AAOIFI Sharīʿah Standard No. (21), 3/4/6. However, the Standard does not indicate how the number of shares is calculated. Is it based on the number of shares outstanding as stated in the financial statement? Or is it based on the average number of shares over the period? This is because during the financial period companies may issue new shares or repurchase some of their shares.

and whether the profit is distributed or not. However, some scholars require that the impermissible income portion is purified only from the dividends distributed (DeLorenzo, 2000). In addition, some scholars require purifying interest income only (Dar Al Istithmar, 2009), whereas others such as Dow Jones and S&P do not require interest rate income purification (Khatkhatay and Nisar, 2006). Clearly, the way of purifying the impure income portion is controversial.

It can be argued that excluding the impure income portion regardless of the net financial result and the amount of dividend as proposed by AAOIFI, seems to be more rational, since Muslim investors should not utilize or benefit from that impure income portion in any way (Dar Al Istithmar, 2009). This is because dividend-based purifications affect only a minor portion of the impure income since retained earnings will not be purified (Khatkhatay and Nisar, 2006). Also, with dividend-based purification, if the subject company does not distribute the profit, or even suffered a loss, the impure income portion would not be purified. However, it can be argued that exposing investors to additional risk by requiring them to purify the prohibited income portion from their own pockets (if the subject company does not distribute the profit or suffered a loss) does not seem practical.

Furthermore, purifying capital gains also remains a controversial issue. Some scholars argue that capital gains' purification is not necessary, since the change in the stock price does not reflect the interest income, while others advocate capital gains purification (Obaidullah, 2005). Those who are in favor of capital gains purification argue that it is safe not to utilize or benefit from impure income that might be reflected in the capital gains. This is because, fundamentally, the market price capitalizes the company's total earnings including those from Sharīʿah non-permissible earning. However, critics of capital gains purification argue that earnings from interest-based activities tend to be insignificant, and, therefore, their impact on capital gains is negligible (Khatkhatay and Nisar, 2006).

Moreover, quantifying the impermissible income portion that needs to be purified, other than interest income, is a challenging task (Elgari, 2000). This is because companies are required to report their total revenue and total income without having to segregate their overall revenue and income based on their business lines or services. For example, hotels, restaurants and airline companies do not, usually, indicate the percentage of revenue or income that is generated from Sharīʿah-impermissible activities, such as alcohol and pork-related products. However, non-operating income, including interest rate income, is reported in a separate line in the income statement and hence, it can be quantified. Another difficulty associated with the earning purification process is the time at which the shares were bought and sold. For example, if someone buys the shares just before the end of the financial period, then who is responsible for the earning purification; the buyer or the seller? Based on AAOIFI standards, the buyer is responsible for earning purification in this case and such purification is not obligatory for one who sells the shares before the end of the financial period.(20) However, it can be argued that the one who bought the shares just before the earnings report should not be penalized.

It can also be argued that although the interest-earning portion can be eliminated through earning purification process, interest paid to the lenders, which is also prohibited, cannot be avoided. Another critique is that the earning purification process to some extent ensures that Muslim investors will get rid of the impure income portion. However, the purpose of prohibiting *ribā* and unethical businesses in Islam is not only to avoid unethical earning, but also for broader purposes. These include avoiding socially irresponsible investment that harms the society, besides the objective of allocating the resources properly, by using them in businesses that make positive contributions to society. This cannot be attained through the earning purification process.

3.6 Tolerance Threshold

Inconsistency also arises within the same Sharīʿah board for the tolerance threshold used across different screening ratios. For example, the level of the tolerance thresholds of debt, liquidity, interest-bearing securities and impermissible income ranges are (33.33% - 30%), (33% - 50%), (33.33% - 30%) and (5% - 25%) respectively. This leads to the question as to why the financial thresholds are not consistent across different screening ratios. As indicated earlier, the 33% and 49% tolerance thresholds deduced from the Sharīʿah maxim associated with the rule of the

(20) AAOIFI Sharīʿah Standard No. (21), 3/4/6/1.

majority, whereby the majority can be classified as simple majority (in case of more than 51%) and super majority (in case of more than 67%) (Usmani, 2005). But the question again arises regarding why sometimes the super majority applies, whereas in other cases the rule of a simple majority applies. Also, in some instances, such as impure income threshold, neither the super nor the simple majority applies. In other words, if from a Sharīʿah point of view 33% is not considered as an excessive portion for conventional debt level and interest-bearing securities level, why don't the impure income and liquidity ratios apply the same threshold? It is clear that the threshold appears to be set arbitrarily, since it is based on *ijtihād* of scholars to deal with contemporary finance issues, rather than being explicitly linked to the Qur'ān or Sunnah (Derigs and Marzban, 2008).

Furthermore, it is argued that using fixed financial thresholds regardless of the market conditions and regardless of the concerned industry needs further consideration. In other words, the financial threshold should be based on the situation that is being examined rather than generalizing that more than one-third should always be an excessive portion (Khatkhatay and Nisar, 2006). Different industries have different financial structures and hence, have different exposure to conventional debt and also, the market price fluctuates during different market conditions, affecting the ratios accordingly (Wilson, 2004 and Khatkhatay and Nisar 2006). Thus, the necessity might differ from one situation to another and hence, the tolerance threshold levels cannot remain static either.

3.7 The Divisor (Total Assets versus Market Capitalization)

As indicated earlier, market capitalization and total assets are used as divisors for the financial screening ratios. The criticisms of both the total asset and the market capitalization divisors are discussed below.

Criticisms of total assets divisor

Critics of total assets divisor argue that unlike market capitalization that reflects the true economic value of companies; total assets represent only the historical value. Thus, total assets tend to underestimate the total worth of companies since the value of some parts of the business, such as intangible assets, which are generated internally, are not accounted for in the financial statements (Derigs and Marzban, 2008).(21) Furthermore, the total assets reported in the financial statements are affected by the accounting principles/methods applied, for example, accounting for inventories, revenue recognition and depreciation (Derigs and Marzban, 2008). In other words, if two companies have similar total assets before accounting adjustments, using different accounting principles/methods might result in having different values of total assets in their financial reports. For example, in terms of accounting for fixed assets depreciation, companies can discretionarily choose the depreciation method and determine the parameters, such as the salvage value and the useful life.(22) If any of the parameters changes, the value of total assets reported in the financial statement will change accordingly. Similarly, applying different inventories methods leads to a different total assets value on the balance sheet,(23)., Another disadvantage of using the total assets divisor is that total assets are determined only through the reported financial statements which are published annually or perhaps quarterly. This is unlike the market capitalization which can be determined on a timely basis, through the market price which enables continued Sharīʿah monitoring (Derigs and Marzban, 2008).

Criticisms of market capitalization divisor

Critics of market capitalization divisor argue that using total assets divisor to measure the debt ratio seems to be more rational, since the total assets of a company are financed by the shareholders' equity and debt (Khatkhatay and Nisar, 2006). In other words, the level of debt may not have any direct relationship to market capitalization. This is because when using a market capitalization divisor, companies may become Sharīʿah-compliant or Sharīʿah non-complaint due to external market fluctuation, even though their total debts have not been changed (Dar Al-Istithmar, 2009). Furthermore, market capitalization does not necessarily represent the fair economic value of the company since market capitalization is influenced by the market price fluctuation that, in turn, might be driven by speculators

(21) However, purchased intangible assets such as patents, franchises and copyrights are accounted for in the balance sheet. Also, goodwill which is the premium paid for acquiring a business is accounted for in the balance sheet.

(22) There are different accounting approaches for fixed assets depreciation such as straight line, sum of the year's digit, accelerated and units of production.

(23) There are different accounting approaches for recognizing the costs of inventories such as FIFO, LIFO and Average cost.

or irrational investment decisions (Khatkhatay and Nisar, 2006 and Dar Al-Istithmar, 2009).

In addition, it is argued that using market capitalization as a divisor is likely to lead to more volatile financial ratios as compared to using the total assets divisor. This is because applying a market capitalization divisor makes the financial screening more vulnerable to the business cycle fluctuation since market capitalization tends to be high during a bull market, and the opposite happens during a bear market (Wilson, 2004). Therefore, applying the market capitalization divisor is more likely to increase the investment universe for Islamic portfolios during the bull market and shrink their investment universe and lead to divestment during the bear market. Thus, using a market capitalization divisor is likely to favor growth and/or speculative companies, while value companies are likely to be rejected. Hence, it might introduce growth caps bias with Islamic investment portfolios because companies with high market premium over their book value are more likely to pass the Sharīʿah screening criteria.

In addition, divestment during bear market required by the market capitalization divisor does not seem to be practical, since it might not be a good exit strategy and might lead to a further fall in the market price (Wilson, 2004). This is why those who use the market capitalization divisor need to smooth out the ratios, by taking the trailing average market capitalization. For example, in the recent financial crisis, the Dow Jones Islamic Market index and S&P Islamic indices increased the moving average of the divisor from 12 trailing months to 24 and 36 respectively. However, such a smoothing strategy might delay exclusion, but when bear markets persist, the inevitable occurs (Wilson, 2004). Moreover, total assets tend to be a more conservative divisor as compared to market capitalization, which reduces the likelihood of wrongly accepting Sharīʿah non-compliant companies. For example, the S&P Islamic index and the Dow Jones Islamic index which use a market capitalization divisor have a larger number of Sharīʿah-compliant companies in their asset universe compared to the other providers, who use total assets divisor (Derigs and Marzban, 2008).

To overcome the divisor issue some Islamic institutions, such as Al-Rajhi Bank, apply max; total asset/market cap divisor. Obviously, such a divisor always increases the Islamic investment universe. A more plausible approach is that the divisor should be chosen based on the purpose and the objective of the ratio being used, rather than applying one type of divisor for all ratios (Khatkhatay and Nisar, 2006). For example, using the market capitalization divisor for measuring liquidity seems to be more rational, since the purpose of such a ratio is to ensure that liquid assets are not traded above or below their par value, on the other hand, using the total assets divisor for measuring debt ratio seems to be more suitable (Dar Al Istithmar, 2009). Also, Dar Al Istithmar (2009) proposes using shareholders equity as a divisor for measuring debt level (debt/equity ratio), which is known as the 'leverage ratio', since it is a commonly used financial ratio that measures the level of debt.

3.8 Social Responsibility

Despite its origin with religious groups to avoid investing in sin industries, the current practice of Socially Responsible Investment (SRI) is largely dominated by mainstream institutional investors. As a result, the SRI market has witnessed a tremendous growth in the last decades, controlling €7,594 billion of global asset under management (EUROSIF, 2010). However, SRI is largely dominated by mainstream institutional investors controlling around 92% and 75% of the total SRI in Europe and US respectively (USSIF, 2010 and EUROSIF, 2010). There are several strategies that can be employed by socially responsible investors to combine their financial objectives with their concerns about social, environmental, ethical and/or corporate governance issues in their investment decisions. These include employing traditional negative screening criteria to exclude certain industries/companies for their SRI violation or employing positive screening criteria to invest in companies with a commitment to SRI practices including best in class approach. Engagement is another SRI approach that has been widely used by mainstream institutional investors especially pension funds to influence companies to adopt SRI practices through using their shareholders advocacy right. This implies that the SRI has shifted from only traditional exclusionary and inclusionary screening criteria to promote proactive shareholders approach.

Unlike SRI screening, Islamic investment screening applies only exclusion criteria. As a result, they lack positive screening criteria, whereby investments are made in companies with a commitment to socially responsible business practices to support the environment, social, community and/or corporate governance practice. For example, criteria such as human rights, employee rights, environmentally-friendly production, etc., are not considered in the contemporary Islamic investment screening process (Wilson, 2004 and Forte and Miglietta, 2007). In other words, in practice the Islamic screening process focuses on whether the output of the business is Sharīʿah-permissible or not, as well as the level of exposure to *ribā*. However, non-income generating aspects, such as social and environmental concerns, are not incorporated in the screening process (Dar Al-Istithmar, 2009). Ahmed (2009) indicates that in 2007, the Vedanta Resources (a diversified metals and mining company listed on the London Stock Exchange and a constituent of the FTSE100 index & the FTSE Sharīʿah index UK) was divested from the Norway Government Pension Fund. This is because the Council on Ethics of the fund found a serious violation of human rights and environment damage associated with its subsidiary in India. However, such an action was not taken by Sharīʿah board of the FTSE Sharīʿah index. He raises plausible questions, such as how a company involved in serious environmental and human rights violations can be Sharīʿah-compliant; is it not against the principles of Sharīʿah to disrespect human rights and cause damage to the environment?

This is surprising, since it contradicts the fundamentals of Islamic finance and investment as a socio-economic and finance system that requires incorporating ethicality and morality into all economic activities. This is down to its embedded ethical values such as fairness, justice and equity. In other words, Islamic principles promote ethicality and morality in doing business, and prohibit generating income through exploitation, deception, injustice or unethical manners that negatively affect the society or humanity.(24) Islam recognizes the rights of others, such as workers, neighbors, needy people etc., and requires and encourages charitable giving as a form of community investment. In fact, not only humans have rights in Islam, but also animals, plants and the society as a whole do. Thus, any Islamic investment screening process should emphasize both negative and positive screening criteria to invest in companies that make positive contributions to the society and avoid

(24) There are many *aḥādīth* of Prophet (pbuh) which emphasize such ethical issues.

investing in companies that cause harm (Wilson, 2004 and Dar Al-Istithmar, 2009).

It can be argued that lacking positive criteria in the screening process of Islamic investment might be due to the newness of contemporary Islamic finance and investment practice. For example, SRI started out similar to Islamic investment, only excluding sin industries, and subsequently they applied positive screening criteria. Recently, socially responsible investors have implemented the best-in-class approach and engagement approach, besides traditional exclusion and inclusion criteria. Nevertheless, there has been a turning point for Islamic investment screening criteria, when the Dow Jones Islamic Market index introduced the Islamic sustainability index in 2006. This is to incorporate sustainability and socially responsible criteria into the traditional Sharīʿah screening process. Thus, similar to SRI screening, more improvement and development with Sharīʿah screening criteria is expected.

3.9 Sharīʿah Supervision

Sharīʿah supervisory boards focus mainly on the advisory, regulation and supervision activities, but lack a crucial proactive role. DeLorenzo (2000) argues that Sharīʿah supervisory boards should ensure that the fund represents the Muslim way of life in the best and most effective manner in the annual shareholders' meetings. This can be done by influencing companies to adopt socially responsible and Sharīʿah-compliant investment practices. He also argues that Sharīʿah supervisory boards should create an added value for the investors above and beyond Sharīʿah guidelines and their supervision task, by representing investors' interest. This can be done by promoting transparency and full disclosure to investors, namely through preparing reports on a regular basis addressing the compliance of the fund with Islamic principles and informing the investors of the purification process.

In addition, the market favors and uses only a few Sharīʿah scholars, despite the rapid growth of Islamic finance and investment and despite the availability of other qualified Sharīʿah experts. As a result, a few Sharīʿah scholars dominate the market with some sitting on dozens of boards. According to Funds at Works' report (2011) it is seen that the top 6 Sharīʿah supervisory board members make up more than 30% of the entire universe of almost 1,054 board positions, and some of them form part of more than 80 Sharīʿah boards located in different countries. This obviously raises the problems of competition and conflicts of interest. In addition, while investment institutions have their own internal Sharīʿah boards, they lack external audit and corporate governance practices to ensure compliance of investment with Sharīʿah guidelines, as well as the independence of the Sharīʿah board.

4. Conclusion

The most distinctive feature of the Islamic economic and finance system is to eliminate *ribā*, *gharar, maysir* and Sharīʿah-impermissible businesses. Therefore, the Sharīʿah investment screening processes emphasize sector and financial screening criteria to ensure permissibility of the investment, from a Sharīʿah point of view. However, fully Sharīʿah-compliant companies are rare, since *ribā* and some sorts of *gharar* are embedded in the modern conventional financial system. Therefore, some scholars relax some Islamic constraints, by allowing investment in companies (even if they have interest-based activities and/or have some exposure to Sharīʿah-impermissible activities), as long as their primary business is Sharīʿah-permissible. However, the Sharīʿah-impermissible activities must not exceed the tolerable level, believed not to be excessive, and that the impure income portion should be purified by giving it away to charities. Such a purification requirement seems to be unique to Islamic investment.

In practice there appear to be inconsistencies in Sharīʿah screening criteria among Islamic investment institutions, especially in terms of the tolerance level. This is because there is no universal consensus on a predetermined fixed set of Sharīʿah screening criteria and hence, each Islamic investment institution has its own Sharīʿah board or a Sharīʿah consultant firm in order to set Sharīʿah guidelines for its operations. Despite the use of Sharīʿah screening criteria by different investment institutions, these have not been approved by a credible independent universal Sharīʿah authority, such as the International Islamic Fiqh Academy. One reason for this may be that such a screening process, especially financial screening, and the tolerance level cannot be linked directly to either the Qur'ān or Sunnah. It is rather based on *ijtihād* of some contemporary scholars. Inconsistency of Sharīʿah screening criteria raises the problem of the reliability of such rulings. Also, it raises the issue of conflicts of interest and the problems of competition and the independence of the Sharīʿah supervisory boards. This is because Islamic investment institutions that apply more stringent standards will have a more restricted investment universe.

Furthermore, another crucial issue is that Sharīʿah screening criteria tend to change over time, based on *ijtihād* of other scholars or even based on the changing opinion of the same scholars. This certainly damages confidence in the Sharīʿah screening criteria standards, which might in turn adversely affect the Islamic mutual funds industry. The AAOIFI issued Sharīʿah investment screening criteria to standardize the industry, but such criteria have not been adopted by market players, despite the fact that the AAOIFI board members are also board members of Islamic financial institutions. In order to solve the inconsistency of the Sharīʿah screening, International Islamic Fiqh Academy can come with a resolution providing a unified view detailing the criteria that can be used for screening by the industry. At the national levels, higher Islamic Sharīʿah authority should be established to set up the Sharīʿah screening standards and guidelines for the industry. This will also avoid conflicts of interest arising from allowing Islamic mutual funds/indices to assign their own, individual Sharīʿah board.

Surprisingly, non-income generating aspects such as social and environmental concerns are not incorporated in the contemporary Islamic investment screening process. Thus, unlike SRI, the Islamic investment screening process does not emphasize positive screening criteria such as human rights, community investing and environmental protection. This seems to be rather paradoxical; since it contradicts the Sharīʿah embedded ethical values of fairness, justice and equity. Therefore, positive screening criteria should not be separated from the Islamic investment screening process, as such separation is not in line with the fundamentals of Islam in general, and with the fundamentals of Islamic economic and finance system in particular, since morality and ethicality is essential in Islam. Moreover, external auditing for the implementation of Sharīʿah rules should be adopted to ensure the compliance of investment with Sharīʿah guidelines. Furthermore, it is desirable for Sharīʿah boards to adopt corporate governance practice and take proactive roles - especially in Muslim countries - to influence companies to adopt socially responsible and Sharīʿah-compliant investment practices. Again a resolution from International Islamic Fiqh Academy in this regard can help guiding the industry to introduce environmental and social aspects of in Islamic investments through positive screening.

Finally, the contemporary Sharīʿah relaxation embedded in the Islamic investment screening process was proposed last decade, when the Dow Jones and the FTSE established their Islamic indices families. However, nowadays, Islamic banking and alternative Sharīʿah instruments to interest-based finance, such as *ṣukūk,* have been developed and gained popularity and wide availability in some Muslim countries. Thus, it can be argued that the need for using interest-based finance in the modern economy might not exist in some Muslim countries. Hence, tolerance levels of conventional finance activities should be lowered in the Islamic investment screening criteria in these Muslim countries. Obviously, this will put greater pressure on companies to adopt Islamic finance models. This in turn can lead to further development and increases in the market share of the Islamic finance industry. However, such an argument is still debatable in non-Islamic countries. This is because Muslim shareholders form minority stake in most companies and hence, will not be able to influence the companies to adopt Islamic finance models. Furthermore, with no Islamic finance available in many countries, the necessity of tolerating conventional finance still exists in some regions.

Bibliography

Accounting and **Auditing Organisation for Islamic Financial Institutions** (2010) Sharīʿah Standards for Islamic Financial Institutions, Bahrain: AAOIFI.

Ahmed, Habib (2011) *Product Development in Islamic Banks*, Edinburgh Guides to Islamic Finance, Edinburgh University Press Ltd.

Ahmed, Irfan (2009) *Incorporating Socially Responsible Investing in Islamic Equity Investments*, Cass Business School, UK.

Alkassim, Faisal. A. (2009) *Mutual Funds Performance: Evidence of Stock Selection and Market Timing Ability from Islamic Mutual Funds*, Bangor, UK: Bangor Business School.

Chapra, M.U. (1985) *Towards a Just Monetary System*, Leicester: Islamic Foundation, pp. 261-2.

Dar Al-Istithmar (2009) *A Universal Platform for Sharīʿah Compliant Equity Screening*, Oxford: Islamic Finance – Dar Al Istithmar.

Derigs, Ulrich and **Shehab Marzban** (2008) Review and Analysis of Current Sharīʿah-Compliant Equity Screening Practices, *International Journal of Islamic and Middle Eastern Finance and Management,* **1**(4), 285-303.

Derigs, U. and **S. Marzban** (2009) New Strategies and a New Paradigm for Sharīʿah-Compliant Portfolio Optimization, *Journal of Banking & Finance*, **33** (6): 1166-1176.

DeLorenzo, Yusuf Talal (2000) *Sharīʿah Supervision of Islamic Mutual Funds*, 4th Annual Harvard Forum on Islamic Finance.

Elfakhani, S. and **Hassan, M.K.** (2005) Performance of Islamic Mutual Funds, *Economic Research Forum, 12th Annual Conference*, (pp. 1-33), Cairo, Egypt.

Ernest and **Young** (2010) *Islamic Funds & Investments Report 2010 Post Crisis: Waking Up to an Investor-Driven World*.

Elgari, M.A. (2000) "Purification of Islamic Equity Funds: Methodology and Sharīʿah Foundation", Proceedings of the Fourth Harvard University Forum on Islamic Finance, Harvard University, Cambridge, MA.

Europe Social Investment Forum (EUROSIF) (2010) Official Website, http://www.eurosif.org/.

Forte, G., and **Miglietta, F.** (2007) *Islamic Mutual Funds as Faith-Based Funds in a Socially Responsible Context*, Retrieved May 2011, from Social Science Research Network (SSRN): http://ssrn.com/abstract=1012813.

Funds at Works Report (2011) The Small World of Islamic Finance, Sharīʿah Scholars and Governance - A Network Analytic Perspective, http://www.islamicfinance.de/?q=node/689

Ghoul, W. and **Karam, P.** (2007) "MRI and SRI Mutual Funds: A Comparison of Christian, Islamic (Morally Responsible Investing), and Socially Responsible Investing (SRI) Mutual Funds", *Journal of Investing,* **16** (2), 96–102.

Hallaq, Wael B. (2004) *A History of Islamic Legal Theories: An Introduction to Sunni Usul al-Fiqh*, Cambridge: Cambridge University Press.

Hakim, S., and **Rashidian, M.** (2004) How Costly is Investor's Compliance to Sharīʿah?, Paper Presented at the 11th Economic

Research Forum Annual Conference in Sharjah, U.A.E. on December 14-16, Beirut, Lebanon.

Hakim. S. and **M. Rashidian** (2004) Risk and Return of Islamic Stock Market Indexes. Presented at the International Seminar of Non-bank Financial Institutions: Islamic Alternatives, Kuala Lumpur, Malaysia.

Hussein, K. and **Omran, M.** (2005) "Ethical Investment Revisited: Evidence from Dow Jones Islamic Indexes", *The Journal of Investing*, Fall, 105-124.

Kharoufa, A.E. (2004), *Philosophy of Islamic Sharīʿah and its Contribution to the Science of Contemporary Law*, Jeddah: Islamic Development Bank.

Khatkhatay, and **M.H. Nisar, S.** (2006) Sharīʿah Compliant Equity Investments: An Assessment of Current Screening Norms, Proceedings of the Seventh Harvard University Forum on Islamic Finance, Cambridge, MA: Harvard University Press.

Laldin, M.A. (2006), *Introduction to Sharīʿah and Islamic Jurisprudence,* Kuala Lumpur, CERT Publications.

Obaidullah, M. (2005) *Islamic Financial Services*, Jeddah, Saudi Arabia: Islamic Economics Research Centre, King Abdul Aziz University.

Siddiqi, M.N. (2004) *Ribā*, *Bank Interest and the Rationale of its Prohibition*, Visiting Scholars' Research Series No. 2, Jeddah, Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank.

Usmani, Mufti Taqi, *Principles of Sharīʿah Governing Islamic Investment Funds,* www.islamic-finance.net/islamic-equity/taqi2.html

US Social Investment Report (USSIF), (2010) Official Website, http://ussif.org/.

Wilson, Rodney (1997) "Islamic Finance and Ethical Investment", *International Journal of Social Economics*, **24** (11), pp: 1325-1342.

Wilson, Rodney (2001) The Economics of Mutual Funds: An Islamic Approach. University of Durham, UK.

Wilson, Rodney (2004) "Screening criteria for Islamic equity funds", in Jaffer, S. (ed.), Islamic Asset Management: Forming the Future for Sharīʿah-Compliant Investment Strategies, *Euromoney Institutional Investor* PLC, London.

المعايير الشرعية لفرز الاستثمارات: مراجعة نقدية

سعيد بن محفوظ
باحث مستقل في التمويل والاستثمار الإسلامية
binmahfouz111@yahoo.com

وحبيب أحمد
كرسي الشارقة في الشريعة الإسلامية والتمويل
جامعة درم – بريطانيا
drhahmed@gmail.com

المستخلص: الهدف الرئيسي من هذه الدراسة هو إعطاء وصف تحليلي شامل لمعايير الاستثمار الشرعية المعاصرة وتأثيرها العملي على إدارة الصناديق والمحافظ الاستثمارية، وذلك من خلال المراجعة النقدية لتطبيقات المعايير الشرعية من الناحيتين الشرعية والعملية مع إعطاء بعض المقترحات للتطوير والتحسين. من الناحية التطبيقية يظهر أن هنالك عدم تطابق في المعايير الشرعية المستخدمة من خلال المؤسسات المالية الإسلامية المختلفة، كما يظهر أن هنالك تغير في المعايير الشرعية بمرور الوقت، مما يهز ثقة المستثمرين في مصداقية تطبيقات معايير الاستثمار الشرعية والذي قد يؤثر سلباً في صناعة الصناديق الاستثمارية الإسلامية. لأجل ذلك تسعى الورقة العلمية للتعريف بالاختلافات في المعايير الشرعية المستخدمة مع اقتراح بعض الحلول العملية لاستعادة الثقة في صناديق الاستثمار الإسلامية. كما تدعو الورقة العلمية الهيئات الشرعية ليكون لها دور أكثر إيجابية وفاعلية من خلال التأثير على مدراء صناديق الاستثمار الإسلامية لتبني معايير ومبادئ المسؤولية الاجتماعية في عملية اختيار الاستثمارات لتكون متوافقة مع مقاصد ومبادئ الشريعة الإسلامية وأسوة بصناديق الاستثمار التقليدية ذات المسؤولية الاجتماعية.

Saeed Binmahfouz is a businessman and at the same time is an independent researcher. He did his Ph.D. from Durham University, UK. His research focuses on Islamic banking and finance and Socially Responsible Investment (SRI). He has published in a number of International Journals and has edited several books. He is also interested in critically reviewing and reexamining Sharīʿah issues related to Islamic finance and investments.

E-Mail: binmahfouz111@yahoo.com

Habib Ahmed is the Sharjah Chair in Islamic Law & Finance at Durham University Business School. Prior to joining Durham University in 2008, he worked at the National Commercial Bank and Islamic Development Bank Group (IRTI) in Saudi Arabia and taught at the University of Connecticut, National University of Singapore, and University of Bahrain. Professor Ahmed has authored/edited more than 70 publications that include books, monographs, articles in international refereed journals, and other academic papers. His current research interests include contemporary applications of Islamic commercial law, legal and regulatory issues in Islamic finance, inclusive finance and integration of *waqf* and financial sector.

E-Mail: drhahmed@gmail.com