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# Sharia Screening Process: A Comparison of Pakistan and Malaysia

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**Abstract**

This paper aims to examine the Sharia screening methodologies used by Securities Commission of Malaysia and KSE Meezan Index (KMI-30 of Pakistan). The two set of screens used by both Islamic indices are business screens and financial screens. The existence of certain similarities and differences in screening methodology is evident. The findings also implicate that there is a dire need for standardisation of said process which will be beneficial in many ways and will surely aid in the development of ICM worldwide.

**Keywords:** Sharia screening, ICM, Securities Commission of Malaysia, KMI-30 of Pakistan

## Introduction

Despite the rapid globalisation of Islamic finance industry and Islamic Capital Market, there is still lack of standardisation regarding practices adopted by different countries for the promotion of ICM products. The adoption criterion is duly influenced by the Task Technology Fit characteristic of any innovation and measure Abbas et al. (2018). This matter is open for discussion, whether standardisation can be achieved or not given the fact that each country has its own set of circumstances which form the basis of practices adopted. So uniformity of practices is a strenuous function (Abbas S. K., Hassan, Asif, & Zainab, 2018). Furthermore, the remodeling of risk management procedures has become integral part of the current financial market Abbas et al. (2018).

Sharia scholars and advisors have taken an initiative to concentrate on this impediment by introducing a process of filtration for the purpose of distinguishing between Sharia compliant and non-compliant stocks and equities. This process is termed as Sharia screening process. This process to a certain level indicates flexibility in Islamic laws. It sets a proportion to which companies can be involved in such (impermissible) activities. The process also specifies the criterion to purify the income generated from impermissible (Haram) activities. Certain ambiguities surround the screening process making it a difficult task to do. “Screening for Sharia-compliant is a tedious process” (Popotte, 2011; Sefiani, 2009; Derigs & Marzban, 2008; Siddiqi, 2006; Asia, 2008) “and far from easy” (Sengupta, 2012). The said process helps Muslim investors in recognizing Sharia-compliant stocks and equities. It is also a source of attracting investment from international investors.

Many countries have their criterion for the screening of stocks and equities for compliance. Different indices like Dow Jones Islamic Market Index (DJIM), the Wellington Islamic Index, Financial Times Islamic Index Series (FTSE), Standard & Poor Sharia Index (S&P), Kuala Lumpur Stock Exchange Sharia Index (KLSESI), Morgan and Stanley Capital International Islamic Index (MSCI) and Meezan Pakistan have established their own screening parameters to monitor the compliance status of businesses and stocks. “These indexes screen the Sharia compliance of ordinary shares of listed companies” (Pok, 2012; Sengupta, 2012; Obaidullah, 2009; Abdul Rahman, Azlan Yahya, & Herry Mohd Nasir, 2010). The differences in setting parameters of individual indices are due to varying conditions of individual countries.

Many studies have been undertaken to evaluate the impact of screening process on individual indices. Comparison of performance of various indices and their screening processes have also been made. An exclusive comparison of Malaysia and Pakistan has not been made yet. This study ventures to compare the screening processes used in Malaysia and Pakistan.

## Background

Investments and businesses are filtered to assess and confirm their degree of compliance with Sharia. Nor can Muslims take part in any activity comprising of strands of gaming, uncertainty, gambling, interest, entertainment forbidden in Islam, trading in or consumption of products categorised as haram such as alcohol and pork neither can they invest in any business earning profit from said activities (Hassan, Abbas, & Zainab, 2018). Islam and Sharia have laid down the distinct and clear path to be followed by Muslims. Certain tenants in real estate and equities are intolerable. Sharia mandate has been specified by Sharia scholars and advisors to quantify requirements of Sharia. Sector and financial screens are used to distinguish between Sharia compliant and non-compliant companies. Sector screens exclude companies involved or operating in any activity deemed impermissible by Sharia. Financial screens are applied to individual companies to ascertain their degree of involvement in conventional finance practices. When applying financial screens, the main point of focus is riba, which is prohibited by Sharia but a certain level of flexibility or tolerability is acceptable as fully interest-free companies are the exception (Obaidullah, 2009); (Bin Mahfouz & Ahmed, 2014).

Malaysia was the first Muslim country to launch the screening process in an effort to stimulate the growth of ICM. The Sharia Advisory Council (SAC) of Securities Commission (SC) engineered the Sharia screening process to facilitate investors in discerning securities as Sharia-compliant or otherwise. The said process aims to confirm that elements like gharar, riba and maysir are not present in securities. Taking into account the genesis of Malaysian ICM in the mid-1990s the earlier screening process consisting quantitative analysis based on four activities and qualitative analysis was introduced. Securities were classified as Sharia-compliant or non-compliant by SAC on the basis of this methodology. To match with global standards and expectations, a two-tier quantitative approach has been introduced as a result of the revision of the said methodology in 2012. The new approach comprises of benchmarks for business as well as financial activities, while the prevalent qualitative analysis is also applicable (Pok, 2012).

In Pakistan KSE-Meezan Index (KMI 30 Index) was introduced in September 2008. The index serves as a benchmark for determining Sharia-compliant equities for investment. The index complies with the recommendation of the Sharia board. All the listed companies regularly screened for compliance with principles specified by Sharia. Asset classes approved by Sharia advisors are considered for investment. The Sharia Advisory Board (SAB) of Securities Exchange Commission of Pakistan (SECP) is responsible for determining the compliance status of companies listed on Pakistan Stock Exchange. KMI 30 Index uses six key tests to qualify stocks as Sharia-compliant or Sharia non-compliant. These tests are designed to ensure that listed companies do not indulge in impermissible business and financial activities (Usmani, 1999), (Ali, 2008).

The screening criteria adopted by both countries are different from one another due to varying circumstances as mentioned above.

**Literature review**

Various religious minds have various notions to define compliance and non-compliance. It is utterly difficult to find a company which is in stringent abidance with laws of Sharia when it comes to equity (Usmani, 1999). The importance of capital markets in development of businesses and economic growth of a country cannot be ignored (Abbas S. K., Hassan, Hashmi, & Waqar, 2018). Investment in conventional shares is strictly prohibited by Islamic laws. Islamic finance industry is not deemed complete in the absence of capital market of its own. The ICM is guided by the laws of Sharia. Religious minds have argued on many subjects relating to different modes of investing that are permissible for Muslims and vice versa (Soke Fun Ho, Masood, Abdul Rehman, & Bellalah, 2012).

The increase in desire for financial products that comply with Islamic or Sharia laws has necessitated the need for embracing the process of filtration. The labyrinthine nature of capital markets existing today and their instruments for investment have made the process of filtration a high-priority. In Muslim countries all over the world the desire for financial products that are Sharia-compliant is intense, and its effect can also be seen on non-Muslim investors as they too invest in products that are Sharia-compliant (Pok, 2012). Stocks and businesses are filtered or screened for compliance with Sharia to eradicate any connivance with profane components. For this purpose, time, thorough research, analytical judgment and a well-elaborated process is required (Popotte, 2011).

Rules have been set by Sharia scholars and international standard setting bodies like IFA and AAOIFI to distinguish between Sharia compliant and non-compliant investment products. The screening methodologies adopted by different groups are not uniform (Abdul Rahman, Azlan Yahya, & Herry Mohd Nasir, 2010); (Derigs & Marzban, 2008). This makes maintaining the quality of screening process more and more difficult. A different school of thoughts, i.e. Hanbali, Malik, Hanafi and Al-Shafai have different opinions when deeming permissibility and non-permissibility of financial products. The intricacy of remodelling ancient and vocal Sharia etymology into quantifiable and bona fide guidelines to be used in modern systems of evaluation and portfolio management can also be the reason for the difference in opinions (Derigs & Marzban, 2008). The non-existence of a supreme institution with the power to govern Sharia to oversee and ensure that the screening processes

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currently in use are in accordance with the recommendations given by AAOIFI (Bin Mahfouz & Ahmed, 2014).

The screening of stocks could be either positive or negative (Obaidullah, 2009). Investing in businesses interested in providing the society with essentials symbolise positive screening whereas, businesses which adopt accumulation of immoral and sinful practices symbolise negative screening (Sefiani, 2009), Abbas et al. (Abbas S. K., Hassan, Asif, Junaid, & Zainab, 2018). Lack of accord among different scholars is a prominent threat to the role of Sharia advisors and scholars is of utmost importance in guiding compliance status of products for investment. This will help in gaining trust and enhancing the confidence of investors (Asia, 2008).

**Purpose of the study**

The two predominantly used filters are qualitative screens, i.e. business or sector screens and quantitative, i.e. financial screens. This paper aims to compare the filters adopted by Malaysia and Pakistan to determine their similarities and differences. Some directions relating to uniformity of screening process will also be given to help scholars, AAOIFI, IFA and different Islamic indices to refine the current screening practices to attain common ground that can be acceptable and applicable worldwide.

**The scope of the study**

The study only considers the screening methodologies used by two Islamic indices, i.e. SC of Malaysia and KMI-30 of Pakistan as its focal point. Screening criteria used by other Islamic indices around the globe is not taken into account.

**Research question**

“What is the Sharia screening process”?

“What are the similarities and differences between the screening methodologies embraced by the two indices”?

**Research objective**

To examine the Sharia screening process.

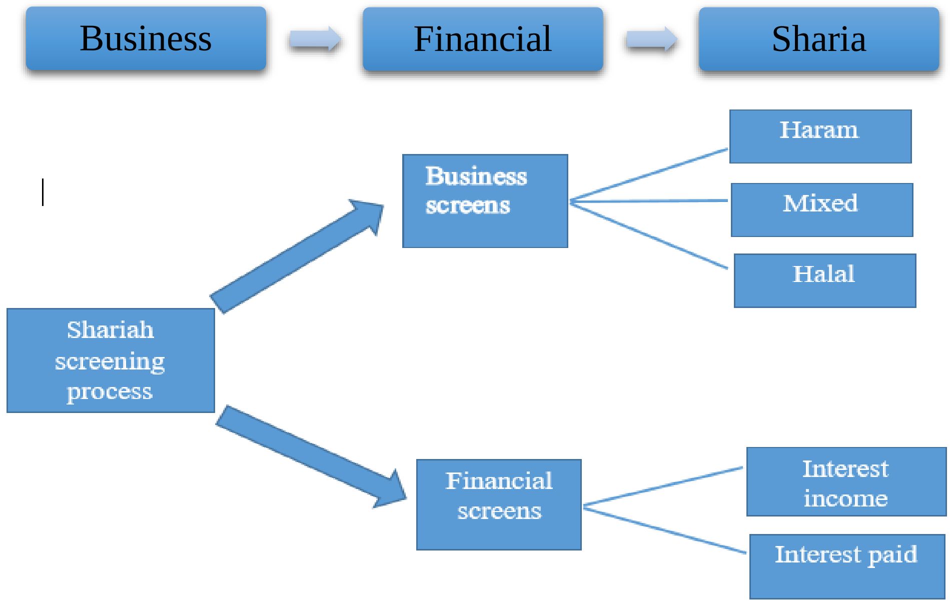
To examine the similarities and differences between the screening methodologies embraced by the two indices.

**The screening process**

Filters applied to businesses and their stocks to govern their status of compliances with norms of Sharia. These norms derived from the Holy Quran, Sunnah and Hadith. Crystal clear instructions concerning what is permissible, i.e. Halal and what is not permissible, i.e. Haram can be obtained from these sources. The said process is engineered by using guidelines from these sources. Investment in stocks deemed permissible only if the businesses and their stocks pass through the set filters as Halal (Ali, 2008), (Sengupta, 2012).

These filters are applied to businesses on two fronts:

- Business or sector screens
- Financial screens




(Conceptual Framework)

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The business screens (also known as sector screens) filter the business on the basis of basic activities undergone by that particular business. It means that the core business of the organisation should abide by the laws of Sharia. Financial screens are applied to organisations to ascertain the profit earned by them. It means that the profit should be earned through activities permitted by Sharia and should not include any strand of impurity except the acceptable ratio given by the Sharia screening process (Ali, 2008). Any amount more than the set ratio is deemed impermissible. This ratio is set due to Umum al-balwa which means common plight, i.e. it cannot be avoided. The businesses and their stocks after passing through these screens are said to be Sharia-compliant (Sengupta, 2012). This process was introduced to develop the ICM and also encourage investors to take part in ICM by ensuring that their investments are in accordance with laws of Islam.

**Screening methodology used by securities commission of Malaysia**

The securities commission (SC) of Malaysia uses the specifications set by Sharia Advisory Council (SAC) to screen listed stocks for compliance with Sharia. In 1996, the Securities Commission (SC) established the Sharia Advisory Council (SAC). The screening process given by SAC is categorised into two general sets. The first set examines the basic or core business activities of any company under consideration and the second examines all the financial aspects of the company by checking the amounts of interest-bearing debts and interest income earned by that particular company (Securities Commission Malaysia, 2013).

If the core business of the company based on any activity prohibited by Sharia, then its stock is considered unqualified without the need to screen the stock of that company any further. Examples of prohibited activities are:

- Manufacturing or selling pork or meat not slaughtered as specified by Sharia
- Manufacturing or selling alcohol and related products
- Commercial banks
- Conventional insurance
- Pornography
- Gambling and other related games
- Impermissible entertainment like casinos, discos, etc.
- Tobacco and related products
- Production and distribution of weapons

The companies practising any of the above activity as its core business can be eliminated easily. Screening a company involved in mixed activities for compliance is challenging (Bin Mahfouz & Ahmed, 2014). Investing in stocks of such companies is forbidden by Islamic jurisprudence (Fiqh). However, given the extant facts, there is a general agreement among religious minds that such companies should be taken into consideration. In light of this agreement additional sets have been developed by SAC for such companies which can be exemplified as follows:

- The organisation should not undertake any of the activity mentioned above as its core business.
- In comparison to the core business, the proportion of mentioned Haram factors should be very trivial.
- The general profundity of the organisation should be good in public view.
- Beneficence (Maslahah) and importance of core activities, in general, are crucial.
- In addition to the proportion of Haram factors being trivial, it should take into account the content of common plight (Umum al-balwa) and custom (urf).
- The consideration should also be given to the privileges of non-Muslims as Islam has given acceptance to such privileges.

The criteria mentioned above are subjective, so to make them applicable, the SAC has rendered the instructions to fabricate a two-step process of filtration, i.e. the screening process.

Step 1: Qualitative filter or screen

Step 2: Quantitative filter or screen

**Qualitative filter or screen**

The use of qualitative filter innately depends on practices adopted by the individual company. If the company solely is involved in permissible activities whether core or minor it is adjudged as Sharia compliant and investment in stocks of such company is very much Halal (permissible according to Sharia) (Obaidullah, 2009). The public profoundness of the company should be good. However, these filters are more applicable, when the core business of the company has predominance as Maslahah, i.e. general benefit to the public but may also comprise trivial factor of haram. Involvement of privileges of non-Muslims or customs can be another reason to derive such activity. 10% to 25% is the minimum level set by SAC to scan individual companies.

Any company that passes this limit at present may exceed it in future. It is due to rapidly and constantly changing nature of the companies. For this reason, the SAC reviews the companies on a regular basis and publishes apprised list of Sharia-compliant companies after six months.

**Quantitative filter or screen**

The percentage participation of activities deemed impermissible in income and profit before tax of a company is compared using quantitative screens. The amounts from the most recent profit & loss account or income statement of the company are taken into consideration. The percentage is computed as follows:

- Ascertain the total income and profit before tax of a company.
- Recognize and compute the income and profit before tax earned from impermissible activities.
- The percentage is computed as follows:
    1. (*earnings from impermissible activities ÷ total earnings of the company*) × 100
    2. (*profit before tax from impermissible activities ÷ total profit before tax from all activities*) × 100
- The percentage of earnings and profit before tax is contrasted with the two minimum levels set by SAC.

**Screening criteria before revision**

a) **The 5% criterion:** the participation from strictly forbidden activities such as pork, gambling, interest, alcohol, etc. should not be more than 5%.

b) **The 10% criterion:** the participation from activities involving components of Umum al-balwa such as manufacturing and selling tobacco and related products, interest earned from fixed deposits, etc. must not be more than 10%.

c) **The 20% criterion:** the level of participation from mixed rental activities such as rental payment received from premises that are being utilised for gambling, the sale of alcohol, etc. should not be more than 20%.

d) **The 25% criterion:** this criterion is for mixed activities involving a factor of Maslahah (general benefit) for the public. However, the additional impermissible activities attached to these activities may affect the Sharia-compliant status. Share broking, hotels, resorts, share trading, etc. are examples of such activities. The participation from these activities must not be more than 25%.

**Revised screening criteria**

The qualitative screening criteria are the same. Changes were only being made in the quantitative screening criteria. The revised quantitative filters were announced by SAC on June 18th, 2012. These new benchmarks are now being used by Securities Commission (SC) of Malaysia to filter organisations to determine their status of compliance with Sharia (Securities Commission Malaysia, 2013). Revised criteria adopt a two-step quantitative approach. The first step includes benchmarks for activities of the business and newly introduced second step includes benchmarks for financial ratios.

a) **The 5% criterion: the** stock of any organisation earning income and profit before tax from impermissible activities more than the set benchmark of 5% will be excluded from the Sharia-compliant list of stocks.

Here the fact that should be kept in mind is; the 5% benchmark is acceptable only where income earned from haram activities can be recognised and computed. For example, any company earning interest of more than 5% on its deposits in the bank will be ruled out. Similarly, any manufacturer or seller earning more than 5% of its income from manufacture or sale of products like pork, alcohol, tobacco, etc. will also be ruled out as Sharia non-compliant. Furthermore, this criterion is also applicable to a business earning profits from conventional insurance, gambling, entertainment not considered Halal and other non-Sharia compliant activities. In given examples the participation of impermissible (Haram) activities in earning of a company can be readily recognised and computed.

b) **The 20% criterion:** the stock of any organisation earning income and profit before tax more than 20% from impermissible activities will be excluded from the list of Sharia-compliant stocks. This criterion is applicable on activities like share trading, stock broking, operations of hotels and resorts, rental payment from properties used for activities, not in compliance with Sharia and other activities impermissible in accordance with principles of Sharia.

c) **Cash over total assets:** only cash deposits in conventional accounts and investment in conventional instruments are considered for computation of this ratio. Deposits in accounts that are Islamic are not included in the computation.

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d) **Debt over total assets:** only debts bearing interest are considered in the computation of this ratio. The instrument of finance that is Islamic such as Sukuk is not included in the computation.

To be Sharia compliant, both the ratios must not exceed the threshold of 33%. Securities issued by only those companies will be qualified as Sharia-compliant which meet both the qualitative and quantitative essentials mentioned above (Securities Commission Malaysia, 2013). The financial screening criteria can be summarised as follows:

| Screening for | Screens applied | Acceptable threshold |
|---|---|---|
| Income from impermissible activities | benchmarks | Not more than 5% |
| Income from activities having element if Maslahah and Umum al-balwa | benchmarks | Not more than 20% |
| Cash to Total assets | Financial ratio | Not more than 33% |
| Debt to Total assets | Financial ratio | Not more than 33% |

**Screening methodology used by KMI-30 of Pakistan**

The screening tests or gauges used by KMI-30 can be classified into two distinct classes. The first class includes filters on the basis of the main business of the company or business screens. The second class includes filters based on financial ratio also known as financial screens. A company is required to pass all the essentials to be deemed Sharia compliant (Siddiqi, 2006).

**Business screens**

a) **The business of the investee company**
The main line of business of the company should be Halal in all aspects given by Sharia. Therefore, investment in any company involved in following activities is not permissible:

- Pork and related products
- Tobacco and related products
- Alcohol and related products
- Conventional banking and investment
- Conventional insurance
- Entertainment deemed impermissible in Islam
- manufacturing of weapons

**Financial screens**

b) **Debt to total assets**
The ratio of debt to total must not be more than 37%. All interest-bearing debt such as preference shares, interest-bearing loans and bonds etc. are comprised.

c) **Non-compliant investment to total assets**
The ratio of non-compliant investment to total assets must not be more than the set threshold of 33%. This ratio will comprise investment in bonds that are non-compliant for computation.

d) **Non-compliant income to total revenue**
The ratio of non-compliant income to total assets must not be more than 5%. The total amount of revenue is inclusive of gross revenue and any other revenue earned by the company. Income earned from any of the impermissible activity mentioned above is classified as non-compliant income. The income from such activities is cleansed using a charity that is given away on a pre-determined proportion of dividend issued by the company.

e) **Illiquid assets to total assets**
The ratio of illiquid assets to the total asset must be at the minimum of 25%. Trade of assets permissible by Sharia at a price other than par included in illiquid assets.

**f) Market price per share of net liquid asset per share**

The market price per share must be more than the net liquid asset per share. The ratio can be computed as follows:

(Total assets – Total liabilities – Illiquid assets) ÷ Number of shares.

As of December 2016, 131 companies have been listed on the KMI-30 index as Sharia compliant.

Financial screening criteria are summarised below:

| Screening for | Screens applied | Acceptable threshold |
|---|---|---|
| Debt to Total assets | Financial ratio | Not more than 37% |
| Non-compliant investment in Total assets | Financial ratio | Not more than 33% |
| Non-compliant income to Total revenue | Financial ratio | Not more than 5% |
| Illiquid assets to Total assets | Financial ratio | Must be at the minimum of 25% |
| Market price per share of net liquid asset per share | Financial ratio | Market price per share should be more than net liquid asset per share |

**Comparison of screening criteria used by both indices**

**Qualitative or business screens**

The filters used to discriminate core activities of the company as Halal or Haram are similar in all aspects. Both the indices do not allow any company to indulge in activities like production and distribution of pork, alcohol, tobacco and weapons as its main line of business. Moreover, indulgence in conventional banking, insurance, entertainment and other activities deemed non-Halal is also forbidden.

**Quantitative or financial screens**

Differences can be seen in financial screens embraced by both the indices.

| Benchmarks | SC of Malaysia | KMI-30 of Pakistan |
|---|---|---|
| **Impermissible income and investment** | Earnings from strictly impermissible activities should not be more than 5% criterion. Earnings from activities having a factor of Maslahah should not be more than 20%. | The ratio of non-compliant income to total revenue must not exceed 5%. The ratio of non-compliant investment to total assets must not exceed 33% |
| **Cash to total assets** | The ratio must not be more than 33% | Nil |
| **Debt to total assets** | The ratio must not be more than 33% | The ratio must not exceed 37% |
| **Illiquid assets to total assets** | Nil | The ratio of illiquid assets to total assets must be at a minimum of 25%. |
| **Market price per share of net liquid assets per share:** | Nil | Market price/share must be more than net liquid assets/ share |

The comparison of quantitative screens reveals that procedure of computation for income from strictly impermissible activities differs but the set threshold of 5% is the limit specified by both indices. SC of Malaysia uses a threshold of 20% for income from activities having a factor of Maslahah for public whereas, the threshold set by KMI-30 for investment in non-compliant securities as a proportion of total assets is 33%. Cash to total assets ratio is used by SC. No such ratio is used by KMI-30. Debt to total assets ratio is set at 33% by SC whereas KMI-30 has set this ratio at 37%. The ratio of illiquid assets to total assets and market price per share to net liquid assets per share is embraced by KMI-30. No such ratio is embraced by SC.

**Findings**

SC uses two-step quantitative process. The first step uses benchmarks for assessment and second step uses financial ratios. The financial screens used by KMI-30 comprise 5 set of ratios. The threshold for income from non-Halal activities is same. The threshold for income received from activities having a factor of Maslahah is 20% as per SC criteria. Investment in non-permissible activities as a proportion of total assets set by KMI-30 at 33% and not more. Cash to debt ratio is embraced by SC only. KMI-30 is more liberal when considering debt to total assets ratio as it has set the threshold at 37% which is higher than that of SC, i.e. 33%. Two additional ratios used by KMI-30 are illiquid assets to total assets and market price per share of net liquid assets per share.

The deduction derived from a comparison of filtration process adopted by both the indices is that although qualitative screens are identical but quantitative screens used by KMI-30 are more elaborative than SC. Moreover, the financial screening criteria are entirely based on ratios. As for SC, it uses two different sets. First, benchmarks on income and earnings before tax and second set use financial ratios. Such benchmarks are not a part of KMI-30's screening criteria. Some ratios are identical, and others are not present in the procedure of one index or the other. The most interesting part is the comparison of debt to total assets ratio. KMI-30 is more liberal here as it has set the threshold at 37% which is higher than that pertained by SC, i.e. 33%.

| | **Securities Commission Malaysia** | **KMI-30 Pakistan** |
|---|---|---|
| **Scope** | Malaysian stock | Pakistani stock |
| **Screener** | Regulator | Regulator |
| **Focus** | Activity-based benchmarks | Activity-based screens |
| **Denominator** | Total assets | • Total assets<br>• Total revenue<br>• Net liquid assets per share |
| **Homogeneity** | Qualitative screening stage | Qualitative screening stage |
| **Financial ratios** | • Debt / Total assets<br>• Cash / Total assets | • Debt / Total assets<br>• Non-compliant investment / Total assets<br>• Non-compliant income / Total revenue<br>• Illiquid assets / Total assets<br>• Market price per share / net liquid assets per share |

**Conclusion**

The difference in criteria suggests that there is lack of agreement among scholars and advisory boards or councils of individual countries and it also indicates inconsistencies in screening practices. Lack of a regulatory body to ensure uniformity of practices may be the reason behind a vast variety of screening practices being used today. As stated in Islamic Finance Asia 2008 vast variety of screening methodologies practised by individual countries and business add the burden of increased cost and too many screening processes which could hinder the growth if Islamic finance in the long run (Ali, 2008). To overcome this issue institutes like AAOIFI and IFA need to step in. They need to take the initiative to develop a governing body to oversee screening practices all over the world. Moreover, they need to make an effort to achieve the yet not accomplished task of standardisation of screening practices.

The said task is no doubt difficult for many reasons, but it is not impossible to achieve. This can be done by collaboration with Sharia scholars and advisors from a different school of thoughts and countries with the aim to devise a screening process in the light of consensus of everyone. A standard screening process will not only reduce the cost for everyone involved but also facilitate the growth of ICM and also help in boosting the confidence of investors worldwide. Individual countries can join hands to initiate an open forum for Sharia scholars worldwide for eliminating the inconsistencies in the current practices and to clarify any ambiguity that may arise along the way.

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