Shariah Compliant Equity Investments: An Assessment of Current Screening Norms

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ABSTRACT

- The preferred Islamic investment format is equity. However equity comes along with ownership. Hence Islamic investors have to ensure that the selected company's activities and structuring are not repugnant to shariah norms.
- Due to non-availability of fully shariah-compliant investment option shariah scholars have arrived at minimum compliance criteria which, while excluding companies in gross violation, yet provide investors a reasonably wide choice.
- In this paper we have reviewed and compared the norms set by three organizations. A critical and analytical assessment of the different criteria follows. Empirical data of the Bombay Stock Exchange is used to assess the impact of the different norms.
- Based on the empirical results and analytical arguments and in the backdrop of an Islamic perspective, an independent set of norms is proposed, which better reflect the objectives of formulating shariah compliance norms.

The Issue

- An investor in the share capital of a company becomes technically a part-owner of the company and therefore responsible for its internal structuring as well.
- Due to the general prevalence of conventional banking operations it is inevitable that all businesses have to transact with banks in some way or other and, to some extent at least, rely on interest-based finance.
- Investment in equities on the stock markets is a convenient and often the main investment avenue open to ordinary Muslim investors.

- The shariah boards of various organisations have put forth various criteria to define the maximum degree of compromise which could be considered acceptable under shariah, given the current business environment.

Objective

- The norms set by Dow Jones, SEC, Malaysia and Meezan Pakistan have been considered, mutually compared and assessed critically, keeping in mind the normal relationships between various items on the balance sheet and profit and loss statements of a company.
- The published aggregate data as at end March 2005 of the companies included in the BSE-500 index of the Bombay Stock Exchange has been used to provide an empirical back-drop to the discussion and to assess the relevance and degree of stringency implied in each of three sets of parameters.

Results

- On the whole the SEC's criteria appear to be the most liberal and that of Dow Jones the most conservative.
- The use of market capitalisation in the screen ratios by Dow Jones (and also in some areas by Meezan) has been questioned as not being apt.
- In the screens for level of debt and level of interest earnings, it has been shown on theoretical grounds as well as from the statistics cited, that the defined levels of acceptability tend to be on the liberal side and need to be tightened.
- The commonly used screen for level of receivables is shown to have little relevance to the actual objective sought to be achieved by the screening.

THE BUSINESS AND STRUCTURE OF THE ENTERPRISE

- BUSINESS OF THE ENTERPRISE
- STRUCTURE OF THE ENTERPRISE
  - debt availed by the company;
  - interest and other suspect earnings of the company;
  - extent of cash and receivables with the company.

SCREENING NORMS FOR *SHARIAH* COMPLIANCE

- **DOW JONES ISLAMIC INDEX**
- **SECURITIES AND EXCHNAGE COMMISSION (SEC), MALAYSIA**
- **MEEZAN ISLAMIC FUND CRITERIA, PAKISTAN**

DOW JONES ISLAMIC INDEX SCREENING CRITERIA

- **Screens for Acceptable Business Activities**
- **Screens for Acceptable Financial Ratios**
  - **Debt to Assets**
  - **Liquid Assets to Total Assets**
  - **Receivables to Assets**

SCREENING CRITERIA OF SECURITIES AND EXCHNAGE COMMISSION (SEC), MALAYSIA

- **Core Activities**
- **Mixed Activities**
  - The public perception or image of the company must be good; and
  - The core activities of the company are *masalahah* to the *ummah* (nation) and the country, and the non-permissible element is very small and involves matters such as *umum balwa* (common plight and difficult to avoid), *uruf* (custom) and the rights of the non- Muslim community.

Benchmarks of Tolerance

- The Five-Percent Benchmark
- The Ten-Percent Benchmark
- The Twenty Five-Percent Benchmark

MEEZAN ISLAMIC FUND CRITERIA, PAKISTAN

- **Business of the Investee Company.**
- **Debt to Total Assets.**
- **Net Illiquid to Total Assets.**
- **Investment in S*hariah* Non-Compliant Activities and Income from S*hariah.* Non-Compliant Investments**.
- **Net Liquid Assets vs. Share Price**.

COMPARISON OF VARIOUS SCREENING NORMS

- **COMPARISON OF SCREENING ACCORDING TO NATURE OF BUSINESS**
  - All the three sets of norms include industries engaged in the business of (conventional) finance and insurance, liquor, non-*halal* foods, entertainment and gambling in the list of prohibited industries. The Dow Jones list also includes the industries of Hotels, Broadcasting & Media, Defense and Real Estate and Property Development among the non-compliant industries. SEC of Malaysia explicitly allows investment in companies with mixed businesses. Meezan too does allow, though indirectly, some leeway to companies with mixed activities.

SCREENING ON THE BASIS OF FINANCIAL RATIOS

- **Level of Indebtedness**
  - The aggregate borrowings (BSE 500) are US$ 109.8 billion, the total assets US$ 303.0 billion and the market capitalisation US$ 674.33 billion.
  - Thus, the cut-off level of 33% of the Dow Jones criteria is equivalent to a ratio of only 16.3% on the Meezan criteria (as against 45%) set by Meezan on its own criteria.
  - Of the total 500 companies, in the sample (excluding 4 companies for which the total assets figures were not known and 11 companies for which the TTMAMC was not available) 418 companies qualified on the Meezan criteria and only 251 on the Dow Jones.

SCREENING ON THE BASIS OF FINANCIAL RATIOS

- **Level of Receivables**
  - The aggregate values for receivables, total liquid assets and net liquid assets are US$ 103.12 billion, US$ 180.41 billion and US$ 144.42 billion respectively.
  - Comparing the parameters used by Dow Jones and Meezan, we find that on the criteria of liquid assets too, Meezan is more than twice as liberal as Dow Jones.
  - Applying the two sets of criteria to the companies in the BSE 500 set (and, as earlier excluding companies for which data is not available), only 258 companies qualify on the Dow Jones criteria, whereas 485 and 392 qualify separately on the two different measures used by Meezan and 388 if the two Meezan measures are used together.

ASSESSMENT OF VARIOUS SCREENING NORMS

- Different users having different objectives have different screening norms.
  - Portfolio managers
  - Provider of index information
  - Market regulators
  - Such screening norms

SCREENING NORMS REGARDING NATURE OF BUSINESS

- The primary screen for identifying *shariah*-compliant businesses has to be about the nature of the business. Hence the norm in this regard has to be sufficiently stringent.
- Among the non-permitted areas relating to the three organizations, the list given by Dow Jones is the most exhaustive.
- There are also some important omissions in the Dow Jones list, going by the apparent logic of their selection. These are air and sea passenger transportation. Most units in these sectors serve alcoholic drinks and non-*halal* foods to their patrons. If hotels are on the excluded list, it is difficult to understand why air and sea passengers transportation are not excluded as well. Further, these industries usually operate with exceptionally high leverage too.

SCREENING NORMS REGARDING NATURE OF BUSINESS (contd..)

- For the Dow Jones, once “a company has business activities in any of the sectors (in the prohibited list)”, it is considered inappropriate for investment. This is as it should be.
- Meezan and SEC, Malaysia, however, do not adopt this approach. For them it is the main or core business which should not figure in the excluded list.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- **Why Financial Screening?**
  - Due to the reliance of almost all companies on interest-based borrowings to part finance their business;
  - The pervasive nature of interest-based transactions in the modern economy.
  - The prohibition of exchanging debts and cash at other than par values.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- The screening on the basis of financial ratios is a corollary of the prohibition of interest.
  - **Screen for level of debt financing.**
  - **Screen for level of interest earnings.**
  - **Screen for level of receivables.**

Suitability of Market Capitalisation for Use in Screening Ratios

- The Islamic Screening Criteria should follow from the shariah objectives sought to be attained. But does market capitalization fits the bill?
- The Argument:
  - Market capitalization gives the true worth of a company. Is it true?
  - Is it possible to sell all the shares of a the company at one price?
  - Does share prices fluctuates rationally?

Suitability of Market Capitalisation for Use in Screening Ratios (Contd.)

- The IT boom and bust of a few years ago is a case in point. In a wild jacking up of share prices, new IT start-ups with no revenue stream to talk about (leave alone a profit stream) reached astronomical heights only to plummet back to the price of scrap paper.
- A practical problem of using market capitalization is that with sudden market movements, a company which was considered *shariah*-compliant one day, has to be considered *shariah* non-compliant the next day, if there is a downward price fluctuations. As a result Islamic investors would have to compulsorily exit, leading to further downward pressure on its price, thus destabilizing its price.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- **Norm for Level of Debt Financing**
  - **The purpose to know how much of the operations of the company are being financed by the *shariah* non-compliant debt component.**
  - **Meezan Uses Debt: Total Assets whereas, Dow Jones uses Debt: Market Cap. (Meezan's is more rational from the point of objective). However, Mezaan's cut-off value of 45% appears too high.**

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- Shariah scholars tend to plumb for a debt: equity ratio of 30:70 on the tenuous argument that in a certain instance the Prophet (pbuh) is reported to have said: “one-third and one –third is too much”.
- Whereas the ideal Ratio of Debt: Asset should be 0:1. Therefore, while selecting Islamic screening norms, we need to set the tolerance levels of how much debt is unavoidable.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- Considering the BSE 500 aggregate data, we find that the current assets: total assets ratio works out to about 26.8% and the Debt: Asset ratio to 16.3%.
- This implies that though investment requirement for current assets is about 27%, the actual borrowing is about 60% of that only.
- It is to be noted that the percentages quoted are based on the aggregates of a sample of companies operating in a conventional manner with no inclination of avoiding debt. For companies wishing to operate on Islamic norms, the ratios should be far more stringent.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- **Level of Interest Earnings**
  - Ideally interest earnings in the business have to be involuntary, incidental and marginal. And the same has to be compensated by donating any such earnings to charity.
- **Considering this;**
  - Meezan's approach in having an independent screen to control investment in non-compliant assets apart from the screen for non-compliant income, is therefore appears well-conceived.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- **Dow Jones screen for level of interest earnings focuses on the investment aspect rather than the income.**
  - The basis for including cash in this screen is not clear. It would be unavoidable if the screen is to assess companies on the level of liquid assets. But in that case there is no independent screen for controlling interest income, which appears a grave omission.
  - If cash was to be excluded from the ratio, one could have considered that the ratio was being used to control the interest income by controlling the investment aspect itself. However, that is not the case.
  - Further, there could be interest arising from assets which are other than securities, such as deposits with banks, deferred sales, debtors, etc. Hence the more appropriate term would have been "interest-based assets" rather than "interest based securities".

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- Coming to an empirical validation, the BSE 500 aggregate data for the period ending March 2005, shows:
  - Interest : total income ratio is 6.4 %.
  - With a screen ratio of 5 % on this ratio, almost 90 % (i.e. 444 out of 496) of the companies qualify whereas with a ratio of just 1 % still almost 75 % (365 of 496) qualify.
  - The investment: total assets ratio is 27.6 %. The investment figure includes not only interest-earning investment but also non-interest earning investments such as investments in equities of associate companies and subsidiaries (separate figures for only interest-bearing investments are not readily available). Hence assuming that the investment in interest-earning assets is likely to be a minor (25 % to 40%) part of the total investments, the ratio for interest-earning investment to total assets is not normally expected to be above about 10 %.
  - The ratio of cash : total assets is 8.5 %, which is in line with (lower than) the one we have assumed to assess the parameter in the Dow Jones screen.
  - On the basis of the Dow Jones parameters, (assuming interest-based investments as 33 % of total investments), 384 out of 489 companies qualify whereas on the Meezan screens, 444 out of 496 companies qualify on the income screen and all 496 on the asset screen.

SCREENING NORMS RELATING TO FINANCIAL RATIOS

- **Recommendation**
  - It is recommended that to assess *shariah* compliance on the level of interest income (no income should be allowed from other non-compliant activities), two screens should be used:
  - Interest income : total income (revenue) < 3%
  - Investment in interest-based assets : total assets < 10%
  - For purging of the shareholder's share of interest, it is recommended that the same should be donated to charity the pro rata amount of interest income earned per share by the company during the period of his holding of the share, irrespective of whether the company pays a dividend or not.

CONCLUSION

- The screens commonly used to assess *shariah* compliance of companies need to be modified.
- The nature of business of the companies considered acceptable has to be fully shariah–compliant.
- The use of market capitalisation in the screening ratios is inappropriate and should be replaced by other relevant balance sheet items, notably total assets.
- The value of the ratio normally set for compliance regarding level of debt financing is liberal. It should be scaled down by at least 20%. Similarly the minimum compliance level for interest income earned needs to be brought down from the normal 5% to 3%, i.e. by about 40%. An additional screen, not usually applied, should also be introduced to control the level of interest-based investments (assets) and it should be set at 10% of the total assets.