

# SHARIAH SCREENING NORMS

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# Outline

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## **Basics of Islam**

- Sources of Islamic Law
- Broader Goals of Quran
- Objectives of Shariah
- Major Prohibitions (Concerning Islamic Finance)

## **Screening Norms for Investments in the Stock Market**

- Dow Jones, FTSE and S&P
- SEC Malaysia
- Meezan, Pakistan
- NCB, Saudi Arabia and DIB, UAE

# Sources of Islamic Law (*Shariah*)

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- *Quran* (the Holy book of Islam)
- *Hadith* (traditions of the Prophet)
- *Ijma* (consensus of Islamic Scholars)
- *Qiyas* (analogy)
- *Ijtihad* (interpretation)
- *Urf* (custom)

# Broader Goals of *Quran*

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## ■ Equity & Justice (*Qist*)

“We sent aforetime our apostles with Clear Signs and sent down with them the Book and the Balance (of Right and Wrong), that men may stand forth in justice; ....” (Quran 57:25)

“Allah commands justice, the doing of good, and liberality to kith and kin, and He forbids all shameful deeds, and injustice and rebellion: He instructs you, that ye may receive admonition”. (Quran 16:90)

## ■ Shariah is characterized by leniency and softness rather than harshness and toughness.

“....Allah intends every facility for you; He does not want to put (you) to difficulties.....” (Quran 2:185)

“On no soul doth Allah place a burden greater than it can bear.” (Quran 2:286)

“Allah doth wish to lighten your (difficulties): For man was created Weak (in flesh).” (Quran 4:28)

# Objectives of *Shariah*

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- Al-Ghazali (d. 1111)
  - Shariah sought to promote welfare i.e *Masaalih*
    - Religion
    - Life
    - Reason
    - Progeny
    - Property

Whatever serves the protection of these is *Maslaha* i.e. welfare

# Objectives of Shariah

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- Al-Shatibi (d.1388)
  - Three levels of Realisation of *Masalah*
    - Absolute Necessities (*Daruriyaat*)
    - Needs (*Hajiyaat*)
    - Complementary (*Tahsiniyaat*)
- Ibn-e-Taymiyah (d.1328)
  - Securing Benefits (*manfa'a*)
  - Protecting from Harm (*madarraah*)

# The Religion of Islam

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*Ibadaat*  
(Worship, Prayer)

*Muamalaat*  
(Transactions, Worldly Affairs)

# *Ibadaat & Muamalaat*

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## ■ *Ibadaat*

- The “principle” is everything except what is prescribed is “prohibited”.

## ■ *Muamalaat*

- The “principle” is everything except what is prohibited is “permitted”.

# Finance in Islam

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Financial transactions fall under the category of *Muamalaat*; therefore we need to closely look at the prohibitions. Following are the major prohibitions:

- *Gharar*
- *Maysir*
- Prohibited sectors
- *Riba*

# *Gharar & Maysir*

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- **Literal meaning: to deceive, cheat, delude, lure, entice.**
  - “Gharar is that the consequences of which are hidden”. (Imam Sarakhsi)
  - “the sale of probable items the existence or characteristics of which are not certain”. (Prof. Zarqa)
- ***Maysir* is gambling, bets and wager where whatever one profits is at the cost of others.**

# *Riba*

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- Derives its prohibition directly from *Quran*; there are 12 verses in Quran dealing with *riba*. *Quranic* verse 2:275 says,

“Those who swallow *riba* cannot rise up save as he arises whom the devil has prostrated by (his) touch. That is because they say: trade is just like *riba*; whereas Allah permits trading and forbids *riba*.”

Other verses of the Quran which talk about *riba* are: (3:130; 4:160-161; & 30:39)

# Financial Screens Related to *Riba*

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- All the financial screens in use are in some way or other related to *Riba*.
  - Debt
  - Interest Income
  - Interest-based Investments
  - Receivables

# Screening Norms

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When assessing whether a specific investment proposal is compliant with *shariah* stipulations, it needs to be examined from two angles, i.e. the nature of the instrument and the nature of the contracting (counter) party.

For instance a trading transaction can be considered from two aspects:

- Whether there is any *riba*, *gharar*, *maysir* etc. involved in the structuring of the transaction, and
- The nature of the counter-party (business).

# Shariah Compliance

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## ■ **Business of the Enterprise**

- The most conservative shariah scholars do not permit investment in the company which is in *haram* business to any extent.
- Others allow investment in equities of companies which derive a minor part of their income from *haram* activities, provided such activities are not their main area of interest.
- Some scholars agree to such relaxation only if the same can be justified on grounds of *masalahah* i.e. public interest.
- While others make an exception if the *haram* activities are so pervasive in the society as to be a commonly prevalent evil, difficult to avoid.

# Issues in Shariah Compliance

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## ■ **Structure of the Enterprise**

Three important aspects to be considered:

- Debt availed by the company;
- Interest and other suspect earnings of the company;
- Extent of cash and receivables with the company.

# Issues in Shariah Compliance

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## ■ **Why Financial Screening?**

- 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.

# Dow Jones Screening Norms

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## ■ **Business Screens**

Based on revenue allocation, if any company has business activities in the shariah inconsistent group or sub-group of industries it is excluded from the Islamic index universe.

## ■ **Financial Screens**

- Total borrowings
- Cash plus Interest bearing securities
- Receivables

# SEC, Malaysia Screening Norms

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- **Core Activities**

- **Mixed Activities**

- The public perception or image of the company must be good; and
- The core activities of the company are *masalahah*, 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.

# SEC, Malaysia

## Benchmarks of Tolerance

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### ■ **Five Percent**

To assess level of mixed contributions from activities that are clearly prohibited. Such as *riba*, gambling, liquor and pork.

### ■ **Ten Percent**

To assess level of mixed contributions from activities that involve the element of '*umum balwa*' (affecting most people and difficult to avoid).

### ■ **Twenty-five Percent**

To assess level of mixed contributions from activities that are generally permissible and have an element of *maslahah* (public interest), but there are other elements that may affect the *shariah* status of these activities.

# Meezan Criteria, Pakistan

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## ■ **Business of the Investee Company**

### **Debt to Total Assets**

- The ratio should not exceed 45% of the total assets.

## ■ **Net Illiquid to Total Assets**

- The ratio should be at least 10%.

## ■ **Investment in *Shariah* Non-Compliant Activities**

- The investment of should not exceed 33% of the total assets.

## ■ **Income from *Shariah*. Non-Compliant Investments.**

- The income should not exceed 5% of the gross revenue.

## ■ **Net Liquid Assets vs. Share Price.**

- Net liquid assets should be less than the market cap.

# NCB, Saudi Arabia

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- **Business Screens**

- **Financial Screens**

- Debt should not be more 1/3<sup>rd</sup> of Market Cap.
- Interest Income should not be more than 5% of total income.
- Debt and liquid fund should not be more than 50% of the market value of the company

# DIB, UAE

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## ■ Business Screens

## ■ Financial Screens

- Interest bearing Debts must not exceed 30% of its total assets or current market cap.
- Interest-bearing lending should not exceed 30% of its total assets or the current market cap.
- Cash plus trade receivables plus investments and other debtors put together must not exceed 70% of the total assets or current market cap.
- Income from interest and other non-*shariah* compliant activities must not be higher than 5% of the operating income.

# S&P Shariah Screening Criteria

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## ■ Business Screen

## ■ Financial Screens

### ■ Leverage Compliance.

- Debt / Market Value of Equity (12 Month average) < 33 %;

### ■ Cash Compliance.

- Accounts Receivables / Market value of Equity (12 Month average) < 49 %;
- (Cash + Interest Bearing Securities) / Market value of Equity (12 Month average) < 33%;

### ■ Revenue Share from Non-Compliant Activities.

- (Non Permissible Income other than Interest Income) / Revenue < 5%

### ■ Dividend Purification Ratio.

- Dividend \* (Non Permissible Revenue / Total Revenue)

# MSCI Shariah Screening Criteria

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## ■ Business Screen

## ■ Financial Screens

### ■ Borrowings

- Total Debt / Total Assets < 33 %;

### ■ Cash Compliance.

- Sum of Cash and Interest Bearing Securities / Total Asset < 33%;
- Accounts Receivables / Total Assets < 70 %;

### ■ Revenue Share from Non-Compliant Activities.

- (Non Permissible Income other than Interest Income) / Revenue < 5%

### ■ Dividend Purification Ratio.

- Dividend \* (Total Earning – Interest Income / Total Earning)