



Sharia Stock Screening: A Fund Manager's Conundrum

Executive Summary

A *Sharia*-compliant Islamic equity fund is an integral part of the Islamic wealth management bouquet. Unlike a conventional equity mutual fund, managers must focus on investing ethically in businesses which comply with the Islamic law, or *Sharia*. For example, *Sharia* prohibits *Riba* (interest), *Maysir* (gambling) and *Gharar* (uncertainty).

A fund manager has to abide by a set of business and financial parameters before selecting and including a particular stock in an Islamic fund portfolio. There are various Islamic screening methods followed by stock indices and banks, namely Dow Jones Islamic Market Index (DJIMI), FTSE Global Islamic Index Series, S&P 500, MSCI (Morgan Stanley Capital International) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). *Sharia* stock screening is based on the business activity performed by the companies; their financial ratios are generally perceived as an easy and direct function because they rely on data feeds from the various data providers (e.g., Bloomberg). But in real life, it is far from simple; there are various issues that plague the *Sharia* screening of a stock and its subsequent selection/omission from a fund portfolio.

A fund manager could follow the current prevalent system of picking stocks from the *Sharia*-compliant indices from various index providers (e.g., DJIMI). He could also use an in-house developed proprietary tool that performs the

screening. Lastly he has the option of numerous third-party screening providers (e.g., IdealRatings) and off-loading the entire screening process.

This white paper identifies key issues surrounding *Sharia* stock screening and how these issues could be resolved by adopting a more prudent screening framework.

Sharia Screening: A Snapshot

Sharia stipulates that any fund manager managing an Islamic fund needs to get the approval from a *Sharia* supervisory board set up by a financial institution, which would be comprised of at least three *Sharia* scholars who are champions of Islamic banking. They are responsible for laying down guidelines (*Fatwas*) for the fund manager and monitoring his investment practices.

A fund manager selects a set of *Sharia*-compliant stocks by screening and selecting from an overall universe of stocks that meet his fund's investment objectives. The resultant set is reviewed by the *Sharia* scholars and on compliance they sign off on the investment. The screening conducted by the fund management is two-fold: business activity/industry screening and financial screening. Business activities that are considered to be non-compliant with *Sharia* include alcohol, tobacco, gambling, cinema, adult entertainment, advertising and media, conventional financial services and defense. The various financial ratios used for the *Sharia* screening of securities primarily consider interest, cash and receivables with the company and debt availed by the company.¹



Challenges to Islamic Stock Screening

Automated vs. In-depth Researched Screening

Most fund managers use the Global Industry Classification Benchmark (GICS) or the Industry Classification Benchmark (ICB) to filter stocks on the basis of their lines of business (LOBs). GICS is an industry classification taxonomy developed by MSCI and the S&P. It comprises 10 sectors, 24 industry groups, 68 industries and 154 sub-industries into which all major public companies are categorized. ICB is a taxonomy, developed by Dow Jones and FTSE, which is used to segregate markets into sectors within the macroeconomic. It uses a system of 10 industries, divided into 20 super-sectors further segregated into 41 sectors, which then contain 114 subsectors.

The issue with both GICS and ICB is that their categorizations for a company classification is one dimensional and based only on the core business activity in which an individual enterprise is engaged. It does not take into account the other non-core businesses that the company might have. Let us consider the example of Louis Vuitton (LVMH), the renowned French fashion house. Louis Vuitton, per the ICB, is classified as a “clothing and accessories” company. Businesses belonging to this subsector are described as “manufacturers and distributors of clothing, jewelry, watches or textiles.” Hence, a fund manager on the basis of the ICB classification would consider LVMH as *Sharia* compliant. However, a close examination of LVMH’s financial statement for fiscal 2010 (see Figure 1), reveals that revenues from wines and spirits (*Sharia* prohibited) represents more than 16% of the company’s total revenue, and hence much above the *Sharia* allowed benchmark of 5%.

As a result, if a fund manager uses an automated screening he could treat LVMH as a compliant company whereas in reality it is non-compliant. The fund manager could largely solve this problem if he employs the Standard Industry Classification (SIC) system, where any company is typically assigned multiple SIC codes based

LVMH at a Glance

Revenue by Business Group			
(Euro millions)	2010	2009	2008
Wine & Spirits	3,261	2,740	3,126
Fashion & Leather Goods	7,581	6,302	6,010
Perfumes & Cosmetics	3,076	2,741	2,868
Watches & Jewelry	985	764	879
Selective Retailing	5,378	4,533	4,376
Other Activities & Eliminations	39	(27)	(66)
Total	20,320	17,053	17,193

Source: www.lvmh.com

Figure 1

on the different industries or businesses in which it operates. But since very few organizations actually use SIC classifications and report revenue generated through the SIC classification system, the problem largely persists. Sometimes a business description keyword filter is also built into the screening system. For instance, the keyword “roulette” might signify that the selected company is involved in gambling or the casino business.

Automated screening may result in classifying compliant companies as non-compliant and vice versa. For instance, if a fund manager exercises an automated screening on a global asset universe, the tool would classify about 8.38% (4.36% + 4.02%) of companies wrongly as compliant or non-compliant (see Figure 2), which means that if a fund manager invests in 50 equities for his fund’s portfolio, six may actually end up being non-compliant.²

Automated vs. Researched Screening

Global Asset Universe	Researched Screening		
	Fail	Pass	
Automated Screening	Fail	66.64%	
	Pass	4.02%	
		Pass	4.36%
		Fail	24.98%

Source: www.islamicfinancenews.com

Figure 2

Another major issue with automated screening and relying on the list of *Sharia*-compliant stocks as provided by indices such as DJ and FTSE is that these global indices have assessed too few companies in their portfolio. Hence, when a fund manager uses these lists to pick up stock for investing, he realistically misses out on a number of potentially winning stocks, as they are not listed in a DJIMI, FTSE or any other *Sharia*-compliant stock index.

Inconsistently Published Financial Statements

Many organizations report erroneous and/or incomplete financial disclosures on a quarterly and annual basis. There are a large number of companies that do not report interest income as a part of their quarterly/annual financial statements. In this scenario, the data which a fund manager uses can be erroneous and results in an improper selection of a *Sharia*-compliant stock. Many companies in their financial reports do not differentiate between cash and cash equivalents (e.g., money market instruments, Treasury bills that can be readily converted into liquid cash). It has also been noticed that many companies use old financial data to calculate the various financial ratios, resulting in misleading information. In other cases, data providers may miss out on important corporate announcements such as stock splits, bonus declarations, dividend payouts, etc. declared by companies.

Gray/Ambiguous Aspects in Business Activity Categorization

There are certain industries or LOBs which are generally regarded as *Sharia* non-compliant. But on closer inspection, there exist certain gray areas. As a result, various eminent *Sharia* boards cannot be unanimous in the treatment of such companies. Let us take the example of the defense industry. Generally this industry is deemed to be *Sharia* non-compliant by most practitioners. But since per *Sharia*, defense is necessary to guarantee the safety of the citizens and the functioning of the state, many *Sharia* scholars, instead of rejecting all defense and weapon manufacturing organizations as non-compliant, have instituted certain clauses and segregated the industry based on the nature of the weapons produced, mechanisms used, the target audience, etc.

All weapons sold to legal military institutions (e.g., United States Marine Corps) could be deemed as compliant, whereas the ones which are specifically sold to non-military establishments (e.g., sold in the retail market or to institutions not affiliated

with a legal government or state defense body) would be treated as *Sharia* non-compliant. Again, all intelligent weapons that require high-precision targeting mechanisms to launch – thereby minimizing unintended casualties (e.g., civilians) – could be deemed compliant. On the other hand, weapons that can be used without such targeting functionality are deemed as non-compliant. Finally, all weapons manufactured for mass destruction (e.g., chemical/nuclear weapons) are treated as non-compliant even if they are manufactured for the consumption of the legal defense body or other similar organizations.³

Mistakes in Computing Interest Bearing Financing Ratio

Debt capital becomes a key element when computing the ratios for the financial screening of a company's stock. However, many practitioners do not consider the fact that nowadays there are many companies in the Islamic world that issue debt capital not through conventional ways but through issuance of *Sukuk*, which is similar to a bond in conventional terms that complies with *Sharia*. Since *Sharia* does not permit the issuance of a bond which pays out interest to the beneficiary holder, the issuer of the *Sukuk* sells an investor group a certificate, which then rents it back to the issuer for a predetermined fee.

When a practitioner performs the financial screening, he frequently includes debt capital raised through *Sukuk* as well, though it should be omitted from the conventional debt amount. Let's assume a company has a debt capital of \$50 million on its books, of which \$15 million is raised through *Sukuk* while the rest is conventional debt. The total assets of the company are \$125 million. If the practitioner erroneously does not segregate between non-interest and interest-bearing debt, the interest bearing ratio to total assets is calculated as 40% (i.e., 50/125). Since this ratio needs to be 33% or less to be compliant, in this case the company is treated as non-compliant. But if the actual interest-bearing ratio is computed, by deducting *Sukuk*, this ratio becomes 28% (i.e., 35/125), thereby making it a *Sharia*-compliant stock. A few prominent indices, like DJIMI, compute this ratio by applying "total debt" instead of "total interest bearing debt" and hence fund managers who use data from DJIMI fail to get the correct picture.

The Securities Commission Malaysia does not employ the interest-bearing ratio for the purpose of stock screening. According to this body, it is

irrelevant to take into account where the funds are originating from; it believes the sole determining criteria should be the end use of such funds. This contradicts *Sharia* principles which forbid *Riba*.

Lack of Uniformity in Rules, Fatwas Across Geography

The screening techniques as followed by various players across the globe vary widely. The reasons can be attributed to culture, government regulations and different Islamic schools of thought. Hence, the rules applicable in places like Malaysia might not be applicable in Europe or Gulf Cooperation Council (GCC) countries. The *Sharia*-compliant investments are considered taking into consideration the localized requirements. Professor Ulrich Derigs and Dr. Shehab Marzban, both of the University of Cologne, Germany, are two prominent exponents of *Sharia* compliance who conducted a study to learn how different *Sharia* compliance strategies applied to the same asset universe could deliver differences among the sets of assets classified as compliant. They chose the asset universe of S&P and the following were the key findings:

- Differences between S&P and DJIMI were negligible (1.3%). This was attributed to the fact that both these indices use average market capitalization as the denominator in calculating the financial screening ratios.
- Differences between S&P/DJIMI and MSCI/FTSE/HSBC Amanah were quite high (21-26%). The reason for this was that the latter set uses total assets as the denominator.
- Though identical in the use of the same denominator in the financial ratio calculation, there is a difference of 6% to 8% between MSCI/FTSE

and HSBC Amanah. This was attributed to Amanah's use of more conservative financial ratios.⁴

Issues with "Purification" of Non-compliant Earnings

In the case of prohibited company earnings which is less than 5% of the total revenues, *Sharia* stipulates that such earnings need to be cleansed or purified. Once the fund manager is certain of the amount of total income that is to be considered as *Haram*, he can proceed with the purification process. He can either resort to the dividend method of computing purification or the *Haram* income method.⁵ After computing the purification value, he directly deducts the proportional amount of non-*Sharia* income of the total earnings (the direct method), and subsequently passes on the net earnings to the investors.

Alternatively, he can inform the investors about the proportion of the earnings that the investor needs to subtract from the total income (the indirect method), sometimes subject to *Zakah* (a form of religious charity as per *Sharia* law). In order to cleanse the *Riba*-contaminated earnings, it is quite difficult to compute the interest part of the earnings for an equity investment fund as "interest earned" may not be a separate heading in the income account or may be disguised by offsetting interest against certain types of expenditure. It is practically impossible to obtain all the detailed information required to determine the amount of *Haram* earnings that may arise within an investment pool that could include 100 different stocks and in most cases the effort spent in performing the analysis will totally outweigh the benefit in having the precise figures.

Assets and Variation Among Classification Compliance Strategies

	Compliant Asset Universe Size	S&P	DJ	MSCI	FTSE	HSBC Amanah
S&P	271		1.30%	24.40%	24.90%	21.60%
DJ	266			25.70%	26.20%	22.90%
MSCI	247				1.60%	8%
FTSE	241					6.50%
HSBC Amanah	232					

Source: *Islamic Banking & Finance*

Figure 3

Some confusion also arises in determining whether purification is necessary, particularly in the case of capital gains arising from the sale proceeds of a fund. One school of thought says that there ideally would be an interest component in the capital gains as the asset value of the company in context would reflect some interest; the other school of thought ignores this interest component, arguing that it is too miniscule to consider. Though the latter is easier, the former option is more ideal especially in a scenario when a dividend is declared for a particular fund. If the fund manager does not calculate and subsequently deduct the purification amount on the appreciation, and the unit holder redeems his units when he has not received any dividend, he would receive a higher price as the price of the unit would ideally result from the appreciation in the share price held by the fund. Conversely, when the units are redeemed post-dividend payout and the amount of purification has been deducted by the fund manager before the dividend is distributed, reducing the net asset value (NAV) per unit, he will get a lower price compared with the former case.

Smaller Asset Universe and Limited Sector Exposure

All of the Islamic indices have a limited universe of stocks. There are many companies that are not included in these indices. A leading third-party Islamic stock screening provider recently stated that it has used its proprietary screening tools to screen out almost 4,500 companies that are presently trading on various U.S. exchanges (e.g., NYSE) as *Sharia* compliant, whereas the current Islamic market indices have a much smaller *Sharia*-compliant company universe of around 2000. Hence, fund managers find it difficult to select a particular stock, however appropriate it might be for his portfolio construction, if the same does not feature in the index the fund manager is following. Also there are certain sectors which form an integral part of any traditional fund, but are absent because of *Sharia* regulations. A perfect example in this is the traditional banking and financial services sector; almost all the companies (barring some strictly Islamic financial institutions) are deemed *Sharia* non-compliant.

Lack of Consistent Monitoring on Stock's Compliance Status Change

Many stocks that form a part of the fund manager's *Sharia*-compliant fund portfolio in a particular year might become non-compliant the next year. There can be various reasons

leading to such status change (e.g., discontinuation of a *Sharia* business; an airline stops selling alcohol/cigarettes to its passengers; or an auto company closes down its financing arm), such as a rise or decline in market capitalization due to certain internal/external factors or merger and acquisition activity, which as a result renders the stock non-compliant. For instance, an LOB (such as alcohol) is shut down or new initiatives are launched. It's the prerogative of the asset management company's internal compliance department to keep a close eye on these activities so that they could inform the fund manager, so that he could make necessary adjustments in his portfolio and plan for any future adjustments as and when required to align to *Sharia* needs as well as fund objectives. The internal *Sharia* scholar board also needs to be apprised so that the scholars could study the new changes, analyze the same and pass a new Fatwa if required. Apart from that, the compliance monitoring system is vital for historical performance analysis, which newly launched funds calculate to observe how compliant holdings would have performed.

Lack of Eminent *Sharia* Scholars

Currently there are too few *Sharia* scholars available compared with the number of Islamic financial institutions. As a result, many *Sharia* scholars occupy board positions on at least 20 to 25 institutions. There are scholars who regularly sit on the board of 70 to 80 institutions, which could easily be burdensome and impact their quality of judgment and subsequent *Fatwas*. Proponents of *Sharia* finance see this as a problem and growth inhibitor.

Funds@Work, a financial services strategy consulting firm, has compiled *Sharia*-advisory statistics over the past two years. It states that there are 1,141 board positions in 28 countries, of which the top 10 scholars hold 450 positions (~40%). Apart from that, as the boards of two different financial institutions might be comprised of almost identical scholars, there is always a fear of conflict of interest as both institutions might be in the same industry and geography, offering an identical product bouquet and catering to the same target audience.

Degree a Company is Deemed Compliant/Non-compliant

Current screening methods do not normally reveal to the fund manager by what margin a particular stock is deemed as *Sharia* compliant or non-compliant. There might be companies whose portion of *Haram* income just surpassed

the acceptable threshold of 5%. If that stock is a potential stock for the fund manager's portfolio, there could be some communication between the fund management and the company in question, so that in the future the proportion of *Haram* income can be slightly reduced in order to classify the same as *Sharia* compliant. On the other hand, there may be companies whose proportion of *Haram* income is just below the 5% limit. Those companies could be kept under tighter supervision as they are at the borderline of becoming non-compliant, and, if not monitored carefully, might soon become so.

Solutions to Make *Sharia* Screening More Effective

Use of Third-party *Sharia* Stock Screening Providers

Fund managers are now gradually moving towards third-party Islamic equity screening providers for screening purposes. The reason behind it is threefold.

- First, the results are much more accurate and detailed as compared to straight vanilla automated screening.
- Second, from the fund performance perspective, the *Sharia*-compliant asset universe as furnished by third-party screening providers is much larger than the normal universe published by the FTSE, DJIMI and S&P. Hence,

the fund manager misses out on many opportunities for choosing an appropriate stock for his fund, simply because it is not included in the *Sharia*-compliant list of DJIMI, though it appears in the compliant list of a third-party provider. These providers have their own *Sharia* board chaired by eminent *Sharia* scholars, and their screening techniques and proprietary software are endorsed by Fatwa issued by the board.

- Last but not least, the fund manager faces a lot of issues in the course of his purification process in the absence of a standardized structure, and ultimately ends up in purifying more/less than the optimal purification amount and wasting a lot of time as a result. Third-party providers have a structured, well defined and logical purification model in place, which mitigates this problem. Figure 4 depicts a prototype model of *Sharia* stock screening that is somewhat similar to the screening procedure followed by many third-party providers. In this model, an in-depth analysis is undertaken at the business logic screener layer, which is currently quite non-uniform and ambiguous and is a prime area of concern in the *Sharia* stock-screening process. A two-layer screening approach is adopted in which both the automated and the manual mode of screening is used at different stages.

Third-party Islamic Equity Screening Provider: Business Logic Process Flow

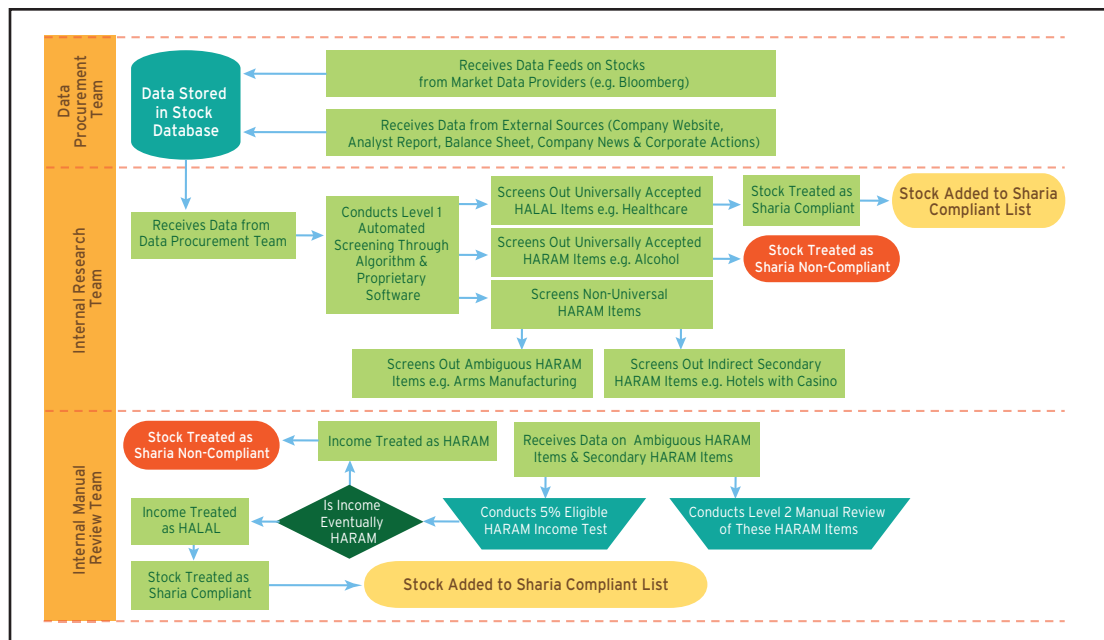


Figure 4

Here's how it works:

- At the outset, the data procurement team collects stock data from global market data providers (e.g., Bloomberg, Thomson Reuters, IDC, Six Telekurs, etc.) and other secondary sources (e.g., company balance sheets, analyst reports, corporate actions, etc.), and stores the same in the internal equity database.
- The internal research team picks up a stock and the level 1 automated screening through complex algorithms and its proprietary software. If the stock belongs to a company like Diageo, which is an alcoholic beverages company (i.e., its primary activity being alcohol), it would be straightaway categorized as a company engaged in a universally accepted *Haram* business (i.e., alcohol) and rejected. If the stock belongs to a company like Nike, which is a footwear and clothing company, and is not engaged in any *Haram* or ambiguous secondary businesses, it would qualify as universal *Sharia*-compliant stock. The rest of the selections can either be companies whose activity is ambiguous like an arms manufacturer such as Alliant Techsystems, which is a large aerospace and defense company, or companies whose secondary business activity is *Haram* (its primary business being *Halal*) like Marriott, a hotel chain which, while its primary business is compliant, sells alcohol/pork items and operates nightclubs.
- These ambiguous set of stocks are then manually reviewed (level 2) by the in-house review team, who analyze whether these stocks are to be deemed as non-compliant or not. For example, if the revenue generated by Marriott from all non-compliant activities like alcohol/pork sales, etc. exceeds the stipulated relaxation limit of 5%, it would be deemed as non-compliant. The ambiguous stocks on the other hand need to be screened more subjectively and it is qualitative in nature as in the case of defense companies, where the nature of weapons produced, the technology and their buyer category are carefully analyzed.

It has been frequently argued by some Islamic banking pundits, that the fund manager should concentrate in maximizing the alpha on his portfolio rather than involving himself in the nuances of stock screening. This should be entrusted to a third party in exchange for a pre-determined fee. Currently, there are quite a few professional third-party screening providers in the global market.

There are a host of parameters that a fund manager should consider before selecting a particular third-party screening provider:

- **Quality of screening output:** The fund manager needs to minutely analyze the quality of screening that is performed by third-party providers. It needs to be seen that the resultant *Sharia*-compliant set of companies are signed off by reputed scholars who form the screening provider's advisory *Sharia* board.
- **Type of product suite:** A fund manager could select a product suite based on his needs. There are screening providers who provide customized packages on stocks belonging to various regions. For example, Amanie offers 15 different packages, of which the "Global Package" covers all regions and is the most expensive one, while there are packages focusing on particular areas as well. There are other providers that offer different packages based on different requirements. For example, Amiri S3 offers four different packages (Platinum, Gold, Silver and Bronze).
- **Cost:** The fund manager needs to do a detailed cost-benefit analysis especially in the long term (typically a three- to five-year view) before purchasing any particular product. If it's too expensive and economies of scale cannot be obtained, then the fund manager needs to opt out of it. The fund manager also needs to see whether there is any hidden cost involved in the deal.
- **Ease of integration and customization:** The fund manager needs to see whether the program has a comprehensive set of APIs (application programming interfaces), supports different integration technologies and can be plugged into another product if required. Apart from that, he needs to see whether the software/product can lend itself to customization and configuration.
- **Product version upgrades:** The fund manager needs to see how the third party upgrades its products, and whether he has to pay for each new version of the product or the company has adopted an evergreen policy where the asset management company does not have to pay for each upgrade. He also needs to check whether it is possible to skip versions (e.g., the company is currently using version 2.0 and wishes to use the latest version 4.0, without upgrading to version 3.0 first).
- **Implementation support and training:** The fund manager should consider implementation

needs while choosing a provider with sound implementation knowledge. Some providers may charge the asset management company a separate fee for implementation, but most will include the implementation cost in the overall training costs. Regarding training needs, fund house resources need to be trained to work on third-party software/product suites and the advisory firm should provide for that.

- Industry recognition and depth of existing clientele:** Various awards and recognition that a particular product suite has received should be viewed as another valid indicator of the quality and acceptability of that particular product. The existing list of clients and the various client segments should also assist the asset management company in making a choice. For example, IdealRatings (per its Website) caters to asset managers, index providers and brokers/dealers, and does business with numerous prominent clients.
- After-sales support:** After-sales support is a key criterion that needs to be considered while selecting a third-party screening advisory. This helps in building a long-term relationship with the vendor. The fund manager needs to see whether that provider has a toll-free helpline, Web or e-mail support.

Figure 5 compares the key attributes of four prominent third-party *Sharia* finance advisory companies – IdealRatings, Amiri Capital (Amiri S3), Amanie Advisors and *Sharia* Capital Inc. – using information gathered purely from their respective Websites.

The fund manager’s responsibilities once he has outsourced the screening and purification task to a third-party screening partner should remain more or less identical. Though he would no longer be involved with these tasks, it is the fund manager who remains responsible for his fund’s performance, compliance, etc. All the leading advisories have their own *Sharia* board chaired by eminent scholars, so it’s unlikely that their screened list of *Sharia*-compliant stocks would be questioned by Islamic institutions and regulators.

These advisories also have proprietary tools to calculate non-compliant income purification. Hence the fund manager has to make a call as to whether he should outsource the purification part to these providers or keep it to himself. If he does outsource, it is unlikely that he would opt for a shadow purification computing in which he would conduct an in-house computation of purification (parallel to the third-party purification), as it would involve much additional effort and time. Though theoretically possible, it is also unlikely that the fund manager would opt for a shadow screening of stocks when he has outsourced the screening piece, though the asset management company might retain its own screening mechanism – maybe not for current use but for future needs.

A fund manager who has not used the service of third-party screeners usually picks stocks of companies that are present in the *Sharia*-compliant list published by index providers such as DJIMI. But even after outsourcing, he may still continue to use this list. It is at his discretion whether he would solely use the list provided by

Third-party Islamic Equity Screening Providers and Their Key Attributes

Ideal Ratings	Amiri S ³	Amanie Advisors	Shariah Capital, Inc.
Covers 42,000+ stocks and 100+ nations. Data securely delivered to end-consumer has an iPhone app for instant screening. Periodic (even daily) and ad hoc audit reports for <i>Sharia</i> board. Data updated on daily basis enabling fund manager to take prompt investment calls. Back testing tools for suitability of conventional funds being <i>Sharia</i> compliant.	Only system to issue Fatwa in its own right. 40,000 companies covered, strong coverage in GCC. 29 tests to validate screening. Customized financial ratios for clients. Direct access to key static screening results on Bloomberg terminals. No software installation required. Different packages as client needs. Has a Blackberry app for instant screening.	Can deliver <i>Sharia</i> approved data set for 5 methodologies (4 indices and AAOFI). Covers 33,000 stocks in 70 nations. Data request template can extract data from multiple sources. Uses “Business Description Keyword Filter” for business screening. Offers various geography-based packages. Subscription can add up to 20 stocks to portfolio.	Screening tests approved by all five scholars within the DJMI <i>Sharia</i> Board. Over 4,500 companies covered. Claims to have one of the largest <i>Sharia</i> -compliant stock universes. Thomson Reuters as per contract collects publicly reported corporate financial information from 242 countries prior to stock screening.

Source: Respective Websites
Figure 5

third-party screeners or resort to the index list as well. Whatever he does, there is usually an annual compliance audit executed by an external agency, which checks whether the *Sharia*-compliant stocks forming a part of the fund's portfolio abide to all the stipulated *Sharia* principles.

Inclusion of Fresh Scholars in *Sharia* Board

The industry needs to induct more *Sharia* scholars to various *Sharia* boards. Specific schools need to be set up to nurture the young talent with requisite knowledge. The Centre for Islamic Finance at the Bahrain Institute of Banking and Finance (BIBF) is preparing to launch a program for young scholars along these lines.⁶ Another critical need is that a ceiling should be created to limit the number of memberships that a particular *Sharia* scholar may simultaneously hold. With the aging of scholars, financial institutions need to hire fresh talent. Otherwise, nearly all institutions might suddenly experience a serious paucity of quality scholars.

Uniformity in Financial Ratio Screening Techniques and Treatment of *Sukuk* Across Geographies

As noted earlier, different indices and other financial institutions calculate the financial ratios in different ways. S&P and DJIMI use average market capitalization as a divisor for their financial ratios; others, such as FTSE and MSCI, use total assets as a denominator. Apart from that, the treatment of debt raised through *Sukuk* should also be treated similarly across the board, as many institutions do not exclude debt availed through *Sukuk* from interest-bearing conventional debt. Uniformity is needed so the financial ratios for a particular company cannot be interpreted in various ways, which might mislead the fund manager.

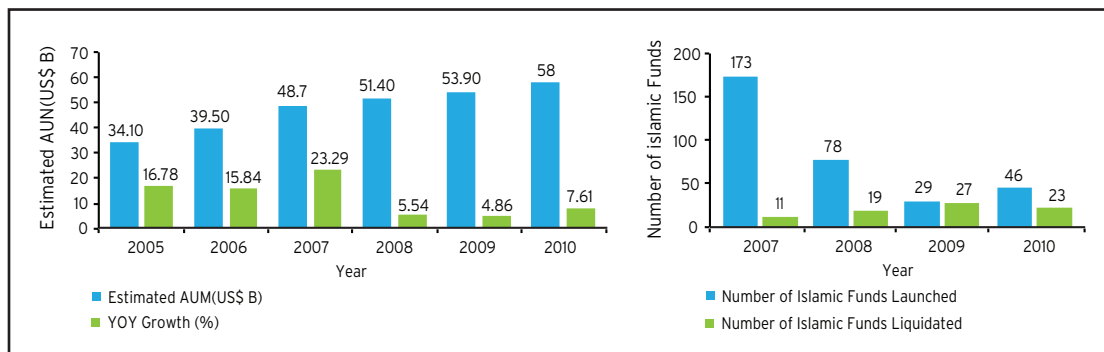
Conclusion

The Asian Development Bank estimates that Islamic assets, currently estimated at U.S. \$1 trillion, will increase 10% to 15% per year over the next two to three years. The Islamic funds industry grew to U.S. \$58 billion in 2010, a 7.6% increase. The addressable universe for Islamic fund managers is more than U.S. \$500 billion, which will add more than U.S. \$70 billion to the GCC pool by 2013. Plenty of Islamic funds have been launched over the last four to five years, though the number of funds liquidated is also quite alarming. There needs to be a standardized legal, accounting, regulatory and *Sharia* supervisory framework, which would provide an essential foundation for future growth, as well as a level playing field for *Sharia*-compliant funds in the global marketplace.

Though *Sharia*-compliant funds are issued primarily by the Islamic banks, global private banking players like Bank of America Merrill Lynch, Morgan Stanley, UBS, etc. are about to hop on the bandwagon with their own set of products. In such a scenario, especially when there is a dearth of quality *Sharia*-compliant fund products (vis-à-vis traditional fund products), a proper *Sharia* screening mechanism assumes a role of utmost importance. The efficiency in stock screening would precisely determine the future success of an asset management company in the largely untapped Islamic wealth management segment. The asset management company could build an in-house screening system or alternatively outsource it to a third party, apart from the prevalent practice of following the *Sharia*-compliant list provided by an index provider.

The concept of third-party screening is relatively new and some fund managers are still circum-

Growth of the Islamic Fund Management Industry



Source: *The Islamic Funds & Investment Report 2011* (E&Y, Eurecathedge and Zawya)

Figure 6

spect about the credibility of the process these companies follow as well as the resultant cost-benefit. But in the future, with the growth of the Islamic fund industry and increased global competition, these advisories might well be the preferred way of screening. It would be convenient

for the fund manager, while adhering to *Sharia* principles, to be more competitive by gaining greater bandwidth and flexibility in terms of stock selection from a much larger stock universe – thereby improving investor returns.

Footnotes

- ¹ Interest bearing financing ratio (i.e., total interest bearing debt/total assets \leq 33%) Interest generating assets ratio (i.e., total interest generating assets/total assets \leq 33%) Tradability ratio (i.e., cash plus accounts receivables and pre-payments / total assets \leq 70%).
- ² www.islamicfinancenews.com January, 2011.
- ³ www.opalesque.com November, 2010.
- ⁴ Prof. Ulrich Derigs & Shehab Marzban, 'Inequalities of screening', *Islamic Banking & Finance* Volume 6, Issue 2, p. 12.
- ⁵ Dividend approach of purification: (prohibited or Sharia non compliant income / total income)
* dividend received *Haram* income purification: (total prohibited income including interest) / no of shares issued * no of shares held.
- ⁶ Asa Fitch, 'Islamic Finance Industry needs for experts', www.thenational.ae, April 11, 2011.

References

Islamic Banking & Finance | Islamic Finance News | EurecAhedge | Euromoney plc | Islamic Research & Training Institute (IRTI) | The Islamic Funds & Investment Report 2011 | Failaka Advisors | Journal of Banking & Finance | E&Y | Bank Sarasin | Institute of Islamic Banking & Insurance | Islamic Financial Services Board | QFinance | Zawya | Funds @ Work AG

About the Author

Biswadeep Sengupta is a Senior Consultant within Cognizant Business Consulting's Banking and Financial Services business unit. He has for the last five years functioned as a lead business analyst and consultant for various bank implementation projects across various geographies. Biswadeep's areas of expertise include asset and wealth management, retail banking and consumer lending. He holds an MBA in finance and strategy and can be reached at Biswadeep.Sengupta@cognizant.com.

About Cognizant

Cognizant (NASDAQ: CTSH) is a leading provider of information technology, consulting, and business process outsourcing services, dedicated to helping the world's leading companies build stronger businesses. Headquartered in Teaneck, New Jersey (U.S.), Cognizant combines a passion for client satisfaction, technology innovation, deep industry and business process expertise, and a global, collaborative workforce that embodies the future of work. With over 50 delivery centers worldwide and approximately 130,000 employees as of September 30, 2011, Cognizant is a member of the NASDAQ-100, the S&P 500, the Forbes Global 2000, and the Fortune 500 and is ranked among the top performing and fastest growing companies in the world. Visit us online at www.cognizant.com or follow us on Twitter: Cognizant.



World Headquarters

500 Frank W. Burr Blvd.
Teaneck, NJ 07666 USA
Phone: +1 201 801 0233
Fax: +1 201 801 0243
Toll Free: +1 888 937 3277
Email: inquiry@cognizant.com

European Headquarters

1 Kingdom Street
Paddington Central
London W2 6BD
Phone: +44 (0) 20 7297 7600
Fax: +44 (0) 20 7121 0102
Email: infouk@cognizant.com

India Operations Headquarters

#5/535, Old Mahabalipuram Road
Okkiyam Pettai, Thoraipakkam
Chennai, 600 096 India
Phone: +91 (0) 44 4209 6000
Fax: +91 (0) 44 4209 6060
Email: inquiryindia@cognizant.com