PESA Center for Political, Economic and Social Research PUBLICATIONS

INTERNATIONAL JOURNAL OF ECONOMIC STUDIES

ULUSLARARASI EKONOMİK ARAŞTIRMALAR DERGİSİ

April 2023, Vol:9, Issue:1 Nisan 2023, Cilt:9, Sayı:1
e-ISSN: 2149-8377 p-ISSN: 2528-9942
journal homepage: https://dergipark.org.tr/tr/pub/ead

Islamic Stock Indices: An Overview

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ARTICLE INFO

Article History:
Received 18 January 2023
Received in revised form 15 February 2023
Accepted 17 March 2023

Keywords:
Sharia screening, Islamic stock index, Islamic finance

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ABSTRACT

This article contributes to the ongoing debate and mixed findings in the literature regarding the potential diversification benefits of Islamic stock indices by investigating the reasons behind this contradictive evidence, as it raises important questions regarding the establishment and development of Islamic stock indices. The lack of a comprehensive overview of the genesis of Islamic stock indices, the different Sharia screening processes and the issues related to these screening processes represent one of the main reasons behind the low diversification opportunity. The authors investigate the current Sharia screening criteria for Islamic indices and critically analyse their performance. They provide a historical overview of Islamic indices, followed by an explanation of the basics of Sharia screening and its main issues. The authors conclude that effective diversification necessitates significant changes to Islamic financial instruments, especially considering the ongoing convergence of the Islamic and conventional markets. These changes include the standardization of screening criteria, a comprehensive statement outlining the methodologies utilized, and the alignment of ethical screening with existing normative frameworks.

INTRODUCTION

The potential diversification benefits of Islamic stock indices have been a subject of considerable debate within the financial literature. While a number of studies suggest that Islamic equity provides a viable alternative solution for hedging against economic externalities, given its greater stability and resilience during crises, less disturbance during bad market states, and superior performance compared to conventional equities, there remains a significant body of scholarship that challenges the decoupling hypothesis and argues that Islamic and conventional equities follow similar dynamic patterns. Such claims are supported by previous research examining the performance of Islamic and conventional equities in various contexts (Ashraf, 2016; Camgöz et al., 2019; Sherif, 2016; Essayem et al., 2022). Nonetheless, other studies have found evidence of the diversification benefits of Islamic stock indices, as well as their effectiveness as a hedging tool against market risk and other economic shocks (Alexakis et al., 2017; Alkhazali and Zoubi, 2014; Arouri et al., 2013; González et al., 2019; Hassan et al., 2017; Safiullah and Shamsuddin, 2019; Yousaf et al., 2022). Given the ongoing debate and the mixed findings in the literature, further research is needed to more fully understand the mixed empirical evidence. It is important to understand the reasons behind this contradictive evidence since they raise important questions regarding the establishment and development of Islamic stock indices. The literature on Islamic finance lacks a comprehensive overlook regarding the genesis of Islamic stock indices, the different Sharia screening processes and the issues related to these screening process which represent one of the main reasons behind the low diversification opportunity. In this article we investigate the current sharia screening criteria for Islamic indices and critically analyse the performance of Islamic indices. In this paper, we present a historical overview of Islamic indices, followed by an explanation of the basics of Sharia screening along with its main issues. Finally, we scrutinize the current state of Islamic indices, and we conclude that effective diversification necessitates significant changes to Islamic financial instruments, especially considering the ongoing convergence of the Islamic and conventional markets. These changes include the standardization of screening criteria, a comprehensive statement outlining the methodologies utilized, and the alignment of ethical screening with existing normative frameworks.

1.A Historical Background of Islamic indices

Political and economic dynamics, most notably the rise of pan-Islamism and the energy crises of the 1970s and early 1980s, are strongly related to the development of Islamic finance (Warde, 2000). Individuals in the middle east, specifically in the gulf region, began to accumulate large amounts of capital by the 1980s, and a channel had to be created to absorb the gulf's oil surplus. Only then did the idea of investing in products adhering to Islamic principles gain traction as investors started looking for alternative financial instruments in which to invest their funds (Shanmugam & Zahari, 2009). As a result, the core of the quickly growing Islamic finance industry has been the oil-rich Gulf region.

Recent years have seen a rise in the development of Islamic capital markets, their institutionalization, and most importantly, the mainstreaming of Islamic finance. To do so, indices and ratings were two fundamental components that were required to validate and distinguish the new alternative niche in the world of global finance. While the latter represents the creditworthiness of financial entities and assets (such as sukuk), the former gauges the performance of equities. Together, they establish credibility and visibility, ensuring the investability of the aforementioned financial products. This is crucial for Islamic capital markets and instruments more than their conventional peers because, primarily, they are nascent and have had little time to be tried out and develop a reputation, and secondarily, their dubious reputation is a result of unfounded facts about terrorist financing and money laundering. (Rethel, 2011;Warde, 2000).

As our research scope limits us to one side of the capital market, we will only discuss the equity issues. To begin with, a large number of Muslim scholars accept stocks or equities as a valid

type of investment. This does not imply that all the financial instruments offered on the stock markets and trading procedures adhere to Shariah law. As a result, many stock trading-related activities are not. For instance, speculative trading, short selling and margin trading are not acceptable (Naughton & Naughton, 2000). Furthermore, the equity should represent companies operating in activities permissible under Shari'a principles, and the majority of its revenues must be generated from activities other than the trading in alcohol, arms, tobacco, pork, pornography, and in some cases the whole entertainment industry, gambling, or profits associated with charging interest on loans (Shanmugam & Zahari, 2009).

In fact, due to these constraints, the first stages of Islamic equity development were challenging, investment conditions and strategies were not clear. Investors seeking faith-based investment needed a benchmark that they can use as a reference to build their portfolio and set their investment plans. To overcome this problem the first international benchmarks for Islamic stock were introduced by Dow Jones and FTSE in 1999 and 2000, respectively. Since then, MSCI and S&P have done the same. S&P started offering the S&P 500 Sharia Index in 2006, while MSCI launched three indexes in 2007. In 2007, S&P introduced a set of narrower indexes as a follow-up to the debut of their three broad indices. Six Sharia-compliant country indices are included in the S&P/International Financial Corporation Investable GCC Indices, each of which represents the Gulf Cooperation Council nations of Saudi Arabia, the UAE, Kuwait, Qatar, Bahrain, and Oman. By the end of 2008, 70 indices at the industry, national, regional and market capitalization levels had been added to the Dow Jones Islamic Market Index series (Shanmugam & Zahari, 2009).

Islamic equity investing has evolved through time from an uncommon form of investing to a more mainstream and "legitimate" area of the financial industry. For instance, in the GCC, despite the recent pandemic, political tensions, and unstable oil revenues, Islamic equity investments have been attracting investors in the region, and more financial institutions and stock markets are enabling such investments to suit investor demand. Currently, sharia compliant companies represent 85% of KSA's stock market, 41% of UAE's market, 56% of Qatar's, 49% of Kuwait's, 26% of Bahrain's and 19% of Oman's stock market .

However, there has not been much effort put into developing distinct Islamic stock markets, since equity finance is largely Sharia-compliant (Rethel, 2011). Ever since creation of the Islamic capital market, the emphasis has been on a passive method to ensure permissibility, and as a result, sharia screening has been gaining ground.

2.The Islamization of Stock Market: Understanding the Sharia Screening Process

The Islamic capital markets, as we previously stated, are divided into an equity side and a finance (debt) side. Prior to 1999, there was no systematic mechanism in place to evaluate which companies were acceptable for investment and which were not. The process of selecting the companies commenced in 1998, After the Dow Jones Islamic Market Indexes' shariah board issued a fatwa outlining the guidelines and standards for screening stocks for shariah compliance and inclusion in Dow Jones indices. In so doing, it also institutionalized certain concepts, such as permissible deviations from regid application of key Shariah principles and methods of purifying impurities.

Specific ratios must be met so that investing in permissible equities is approved under the balance-sheet ratio standards outlined in the DJIMI fatwa. The ratios cover the relationship between market capitalization and debt, cash and marketable securities, and accounts receivable. Ratios cannot pass 33. Purifying is acquired by donating interest income to charity. The guidelines set forth in the Dow Jones fatwa have been crucial for Islamic finance to thrive in global markets. Thus, the Dow Jones fatwa may be the most significant fatwa ever given since the emergence of Islamic finance and is a key factor in the development of this sector (McMillen, 2013).

All leading index providers, such FTSE, S&P, and MSCI, currently create and offer Islamic equities indices predicated on various Sharia screening standards at the global, regional, and

national level. Also, institutions such as Malaysia SAC and Bahrain based AAOIFI creates and impose their own Sharia screening standards. The figure1 below shows that, depending on how the Sharia board's decision-making is construed, each of these index providers implements a somewhat different screening criterion for the incorporation of stocks in Islamic indices.

Figure 1: Sharia screening criteria

	Index Providers				Gouvernance Institutions		
	DJ	*MSCI*	*FTSE*	*S&P*	*SAC Malaysia*		*AAOIFI*
Business screening	Alcohol (brewers, distillers & vintners, packagers, transporters, sellers and resellers), Tobacco and electronic cigarettes, Recreational cannabis products, Pork-related products (food products, food retailers & wholesalers, hotels, restaurants & bars), Conventional financial services, Weapons and defense, Entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.). **Financial institutions that are transitioning to being fully Islamic are also considered compliant if they satisfy the following criteria:** 1/ The Company must have a decision from its board of directors to convert to being fully Islamic. 2/ The Company has an independent Shariah supervision mechanism throughout the transition period. 3/ The Shariah supervisor after reviewing and approving the conversion road map has given an approval	alcohol, tobacco, pork-related products, conventional financial services, defense/weapons, gambling, or adult entertainment	Conventional finance, Alcohol, Pork related products and non-halal food production, packaging and processing or any other activity related to pork and non-halal food, Entertainment (casinos, gambling and pornography), Tobacco, weapons, arms and defence manufacturing.	Advertisers of pork, alcohol, gambling, tobacco, and all other non-Islamic activities, Advertising means and modes which contravene the tenets of Islam. Media & Entertainment except, News Channels, Newspapers Sports Channels, Children's Channels, Educational Channels. Alcohol, Financial Services, except: Islamic Banks , Islamic Financial Institutions, Islamic Insurance Companies, Gambling , Pork related activities, Pornography, Tobacco and electronic cigarettes/vaping products. Recreational cannabis, including products derived from cannabis used recreationally, rading of gold and silver as cash on deferred basis	Conventional banking and lending; conventional insurance; ambling; liquor and liquor-related activities; pork and pork-related activities; non-halal food and beverages; Shariah non-compliant entertainment; tobacco and tobacco-related activities; interest income from conventional accounts and instruments (including interest income awarded arising from a court judgement or arbitrator); dividends from Shariah non-compliant investments; and other activities deemed non-compliant according to Shariah principles as determined by the SAC.	Share trading; stockbroking business; rental received from Shariah non-compliant activities; and other activities deemed non-compliant according to Shariah principles as determined by the SAC.	Conventional financial institutions, Conventional insurance companies, Alcoholic beverages, Gambling, Pork and Non-Halal food, Non-Halal food, Tobacco-related Products, Any activities deemed unlawful

Note: See S&P Dow Jones Indices. (2023). Methodology: S&P Dow Jones Islamic Market Indices.

In addition, there is a growing list of third-party Sharia services companies, mutual funds, and banks providing stock screening methodologies and criteria beside the Sharia boards of indices providers. Furthermore, national, and regional governance bodies have been involved in the institutionalization of the sharia screening such as the Malaysian securities commission sharia advisory council (SAC) and the Bahrain-based AAOIFI.

In general, the commonly used screening criteria for inclusion of any security in an Islamic index depends on both qualitative and quantitative screens. Qualitative screens eliminate Stock of all such businesses involved in activities that are categorically forbidden in Islam. These include businesses whose primary activity entails engaging with Riba, Maysir, and Gharar-related financial transactions, as well as any enterprise operating in prohibited commercial activity. Quantitative filters are employed to additionally check firms whose principal activities are Sharia-compliant but who also earn a significant portion of their revenue from prohibited activities as borrowing or lending money at interest or having a large percentage of liquid assets. Hence, The Sharia stock-screening criteria used by most screening entities include both qualitative and quantitative requirements. However, on an institutional level, Malaysia's SAC unlike AAOFI, has also adopted positive Sharia screening criteria along with the negative screening. In order for a company to pass the positive Sharia screening, it must have a solid reputation and engage in core activities that are significant to the local and worldwide Muslim communities. The company's guidelines should be in line with Muslim Maslahah. It is acceptable to invest in businesses that cater to non-Muslim communities, such

as those run by Malaysia's Chinese community, as long as their commercial practices are in line with those that Muslims have traditionally accepted (Shanmugam & Zahari, 2009).

However, some Muslim scholars argue that Islamic indices based on quantitative criteria are not permissible for investment. They contend that since the screening parameters permit debt ratios to approximately reach 33 percent, approving the indices is equivalent to claiming that a meal is halal even though it only contains a small amount of pork (Shanmugam & Zahari, 2009). Others contend that these screens, which are highly divisive within the Muslim community, are based on arbitrary ratios that are not comprehensively explained by the sharia boards (Ashraf, 2013, 2016).

Aside from this dubious selection practice, Islamic indices hardly control for the profitability of Islamic equities, let alone their ethical convenience. Islamic indices therefore mimic traditional financial performativity, Islamic stock market indices therefore mimic traditional financial performance, neither questioning the index building process nor the poor grasp of performance as being limited to financial factors. However, the introduction of Islamic indexes marked a significant turning point in the growth of Islamic financial markets. This may be in part due to the fact that at present Islamic international governance entities place a high priority on acceptability advocacy and market integration. In order to establish itself as a mainstream financial activity, Islamic finance is consequently being rebuilt as a part of the global financial infrastructure (Rethel, 2010, 2011).

In short, rather than providing an ethical substitute, the current legal framework for Islamic finance simply replicates the current governance mechanisms. Its preoccupation with maintaining the status quo and continuous integration with the international financial system conflicts with its purported ethical ideals and its seeking legitimacy comes at the expense of greater purpose. Furthermore, this evolution is being driven from within rather than from the outside; it has not been imposed by any entity and is the choice of Islamic finance proponents. As AAOIFI promotes; it is not detrimental to begin where others have ended if what others have established is helpful and does not contradict Islamic Sharia. Therefore, given the current course of action, Islamic finance will only contribute to replicate, validate, and therefore further reinforce existing financial mechanisms rather than bringing about an alternative financial system (Rethel, 2011; Rudnyckyj, 2018).

3.Scrutinizing the Current State of Islamic Indices

The comparison between the Islamic indices and their conventional counterparts reveals a lack of differentiation between the two. The trend of convergence is driven by the desire of Islamic indices to attain international recognition and conform to international standards, with a view to increase efficiency. However, this approach results in a neglect of meaningful constructive work, and instead, adopts an Islamized version of global standards. The application and formulation of these standards lack clarity and do not have a direct relationship with Islamic juristic norms. For instance, the AAOIFI standards on Islamic investment remain vague and are not well understood by scholars and academics, who are unable to fully grasp the rationale behind the AAOIFI's three well-known financial ratios. Furthermore, the Sharia stock screening norms do not explicitly consider environmental issues, social welfare, and good governance practices (ESG), unlike the SRI indices. This has prompted many stakeholders of Islamic finance to call for the enhancement of Sharia stock screening criteria to include these elements. It can be argued that current Islamic indices are simply modified versions of conventional financial instruments. In reality, industry leaders often interpret and follow, or deviate from, Islamic legal opinions depending on the impact they have on "the market," which is typically their foremost concern (Maurer, 2010).

However, this deviation from the ontological sources of Islam, and their understanding frameworks such as Maqasid and the basis of permissibility rooted in Islamic knowledge, is of concern. It is then imperative to address the ongoing discourse regarding the distinction between sharia-compliant and sharia-based finance. Sharia-compliant finance adopts a formalistic approach, in which the compatibility of existing financial instruments with a standard interpretation of Islam is evaluated to determine compliance. This perspective views

Islamic and secular knowledge as distinct systems. In contrast, sharia-based finance regards Islam as the source of independent truths and endeavors to synthesize new financial instruments from the key principles and historical practices of Islam, rather than adapting conventional financial instruments for compliance purposes. Although the sharia-based approach is more independent and ambitious, it necessitates a more substantial investment in thought and effort (Rudnyckyj, 2014, 2018).

CONCLUSION

The issue of the lack of genuine diversification provided by Islamic finance is multi-dimensional, extending beyond the integration of Islamic financial markets into the global economy, as mentioned previously. A number of studies have indicated that Islamic financial assets mimic their conventional counterparts, with the main difference being their compliance with Sharia. There are several underlying reasons for this observation. Firstly, the criteria and limits for sharia screening differ across regions and indices. Secondly, the screening criteria remain opaque to the public, with limited understanding of the rationale behind the financial ratio limits. Lastly, sharia compliance is based on negative screening, necessitating the alignment of ethical screening with existing normative and operational screening to create an effective and meaningful diversification tool (Tanin et al., 2021). Given the ongoing convergence of the two markets, significant changes to Islamic financial instruments are required for effective diversification to be achieved such as the standardisation of the screening criteria, a comprehensive statement regarding their methodologies and the necessity the alignment of ethical screening with existing normative.

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