

DEVELOPING RATING SYSTEM FOR SHARIAH COMPATIBILITY INDICES: THE CASE OF BORSA ISTANBUL

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Abstract

Individual investors who have an ethical approach for the Islamic point of view on investing stock market commonly apply for Islamic Indices. Companies which are monitored each quarter by Shariah boards are announced and listed. These indices simplify stock market investment for those investors who are not specialized in screening annual reports to detect whether publicly traded companies have non-permissible activities both financially and operationally or not. The main problem of these indices is they are just listing the names of companies which are Shariah-compliant. However, no detailed information is given about the financial reports of companies on how much they are compatible. For instance, by just checking these indices investors cannot distinguish between a company which has no interest-bearing security on its assets at all and another company which hardly satisfies the screening criteria. The aim of this paper is to develop a special rating system for companies which are listed on Islamic Indices in Turkey. Companies are being ranked and scored according to their compatibility with the criteria. We aim to simplify the decision-making process for investors who are ethically sensitive to stock exchange market investment when they constitute their portfolio. After the analysis, investors will be able to see which company is ethically more responsible than others.

Keywords: Islamic Finance, Shariah Screening, Islamic Investment

INTRODUCTION AND LITERATURE WITH BACKGROUND INFORMATION

Shariah Indexation

Capital market is an important option for investment. Within this market, shares traded at stock exchanges take an important place besides bonds and other long-term investments. Even though buying a share of a company and becoming one of the shareholders of the same company is not inherently against Islamic jurisprudence (Shariah), it is important to decide which company is in concern since Shariah compatibility issues arise here.

By such a concern, what is called Shariah-compliant indices were started to be developed. In that regard, the very first index in the world was established by **Dow Jones** in 1999. As the main method of this screening, the followings are described: “To determine their eligibility for the indices, stocks are screened to ensure that they meet the standards set out in the published methodology. Companies must meet Shariah requirements for acceptable products, business activities, debt levels, and interest income and expenses. The screening methodology is subject to input from an independent Shariah supervisory board.”** Following the example of Dow Jones, in 2007, **S&P** launched GCC Sharia Indexes and the S&P Pan Asia Sharia Index. Today, there are different examples of Shariah indexes such as **FTSE** Global Equity Shariah Index Series, and **NIFTY** Shariah Indices.

Since then, Shariah indexation is in concern of academic studies especially in the area of Islamic finance. If we group the related studies, performance is one of the outstanding research subjects since it is wondered whether a Shariah-compliant index is performing better than a conventional one. Agussalim, Limakrisna and Ali (2017) compare conventional and Islamic stock mutual

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** Available at <https://jp.spindices.com/index-family/shariah/dow-jones-islamic-market>.

funds taken from the composite index (IHSG) and Jakarta Islamic Index for the period of 2007-2014. In the end, they also cannot find any statistical difference between the indices.

Another concern in that regard is to understand and evaluate Shariah rulings behind screening process while establishing such indexes. Alam et al. (2017) revisit Islamic principles lying behind the Islamic stock market indexation. Adam and Abu Bakar (2014) discuss Shariah screening process and suggest business screen state model to refine the process. The methodology of Shariah screening process is also included in this group of studies. Khouildi et al. (2017) compare two screening methods, which are the Shariah Advisory Council of Securities Commission (SAC-SC) and Dow Jones Islamic Index (DJIM), and their impacts.

However, as far as we know, there is no particular study which attempts to make ranking or rating among company stocks within individual indexes. This is what this study aims to do.

Shariah Indexation in Turkey

Turkey's experience with Islamic finance dates back to early 1980s when first the then special finance houses were established as correspondences of Islamic banks. However, other Islamic financial institutions besides Islamic banks needed to wait few decades more to be put into reality. In that regard, first Islamic index in Turkey which is called as participation index, since Islamic banking is also called as participation banking, was officially introduced in 2014 when Borsa Istanbul and BMD Securities –an Islamic equity fund management company- signed an agreement.

Today, there are the following participation indexes in Turkey; Participation 50, Participation 30, Participation 30 BYF (Stock Exchange Investment Fund), Participation Model Portfolio BYF, and Ziraat Katılım Index (ZPYKAT).

Currently, there are two basic screening methodologies in Turkey; the one used by participation index, the one used by Ziraat Katılım Index. According to the information shared by Participation Index^{††} and Ziraat Katılım Index^{‡‡} there are 3 basic financial ratios for the inclusion of stocks in the index which is given in Table 1.

Table 1. Comparison of Financial Screening Criteria for Shariah-compliant Indices in Turkey

	Criterion	Ziraat Participation Index	BMD Securities Participation Index
1	Interest Bearing Debt to Market Capitalization (12 months average)	< 33 %	< 30 %
2	Cash + Interest Bearing Securities to Market Capitalization (12 months average)	< 33 %	< 30 %
3	Income from Activities Specified in First Screening to Total Income (12 months Average)	< 5 %	< 5 %

^{††} Available at http://www.katilimendeksi.org/subpage/21/endeks_kurallari

^{‡‡} Available at <https://www.ziraatportfoy.com.tr/TRK/endeks-kurallari>

As it can be realized, the only difference is the relative higher ratio of acceptance for the first and second financial ratios for Ziraat Katılım Index.

In terms of literature of Islamic indexation in Turkey, one can especially notice the dominance of performance-related studies. Ata and Buğan (2015) compare Dow Jones and Morgan Stanley Islamic and conventional indices for Turkey for the period of 2008 crisis. In result, they find that there is no statistically significant difference between Islamic and conventional indices pre-and after the crisis period.

Tas et. al. (2016) apply the second-order stochastic dominance (SSD) approach to find out which company is efficient (dominates another in terms of return performance). They analyze 24 companies quoted in Borsa Istanbul and they constitute two portfolios (Ethical and Conventional) from SSD efficient selection. Their back-testing findings suggest that Conventional efficient portfolio shows better performance than Ethical efficient portfolio and the benchmark (BIST 100 index) during the testing period.

Having said that, studies about Islamic indexation in Turkey are not so ample. This is another expected contribution of this paper.

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