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# Is Being *Sharia* compliant worth it?

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ABSTRACT

We investigate the effect of *Sharia* compliance on stock valuations. To this end, we examine the price effects of additions to and deletions from the Dow Jones Islamic Market Index (DJIMI). Using the event study methodology, we measure abnormal returns for companies from Muslim countries and the US over the period of 2000–2017. We find that additions to the Islamic index lead to a positive stock market reaction in Muslim countries but a negative reaction in the US. Conversely, deletions from the Islamic index generate a negative stock market reaction in Muslim countries but a positive one in the US. The differing valuation effects can be explained by different perceptions of investors. In Muslim countries, investors have a positive perception of the *Sharia* compliance because of religious beliefs, while in the US they negatively react because of a negative perception of Islam and of the restrictions associated with *Sharia* compliance.

## 1. Introduction

There has been a large expansion of Islamic finance in the last two decades. Islamic financial assets have increased from $150 billion in the mid-90s to $1880 billion at the end of 2015 (Islamic Financial Services, 2016). This growth has been driven by the development of Islamic banks but also by the issuance of *sukuk* and the development of Islamic investment funds.[1] According to the same report, the Islamic funds industry has grown from $28.2 billion assets under management in 2004 to $71.3 billion in 2015.[2]

Islamic funds contain equities of companies that are compliant with *Sharia* (Islamic law). *Sharia* includes a set of principles that prohibits interest, excessive uncertainty, gambling, the financing of certain economic activities, and promotes risk sharing, profit sharing and asset-backed financial transactions. Islamic fund providers therefore use Islamic indices, such as the Dow Jones Islamic Market Index (DJIMI). To become eligible for inclusion in an Islamic index, a company must undergo several screening filters (Rahim and Masih, 2016). On the one hand, a firm's primary business must be compliant with *Sharia*. On the other hand, the firm must meet financial criteria. The DJIMI sets upper limits for the following ratios: total debt to market capitalization, sum of cash and interest-bearing funds to market capitalization and accounts receivables to market capitalization.

Our objective in this paper is to study the price effects of additions to and deletions from Islamic indices. Reconstitutions of Islamic indices provide a unique opportunity to investigate the effect of *Sharia* compliance on stock valuations. By examining how stock market investors respond to these reconstitutions, we can determine how worthwhile it is for investors to be *Sharia* compliant. The hypothesis of an increase in the price of added firms to Islamic indices has its roots in two arguments.

First, being added to an Islamic index provides access to a new class of investors and should therefore increase the demand for the stocks of firms that are newly included in the Islamic index. The literature on conventional indices has provided evidence regarding the price pressure hypothesis, which states that inclusion in a conventional index leads to an increase in demand from tracker funds for firms newly included in the index (Harris and Gurel, 1986; Woolridge and Ghosh, 1986). In accordance with this hypothesis, membership in an Islamic index should enhance the demand for stocks of the newly included firm.

Second, the financial filters associated with the Islamic index may be considered positively by stock market investors. On the one hand, this addition is a signal of low indebtedness, which is perceived as an indicator of lower bankruptcy risk. In addition, less debt helps mitigate the agency costs that originate from conflicts between debtholders and

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[1] See Gheeraert and Weill (2015) and Imam and Kpodar (2016) for evidence on the economic impact of Islamic banking.
[2] The number of Islamic funds has grown from 285 in 2004 to 1220 in 2015, with Malaysia and Saudi Arabia as the leading markets.

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shareholders (Jensen and Meckling, 1976). On the other hand, a low level of cash can be perceived as an indicator of good corporate governance since managers may be optimally deploying the cash (Dittmar and Mahrt-Smith, 2007; Harford et al., 2008), and can also indicate a low level of risk, which decreases the need to retain cash reserves (Han and Qiu, 2007).

However, the positive stock market reaction following additions to an Islamic index can differ between regions based on the perception of investors of *Sharia* compliance. In Muslim countries, investors may place more value on companies that are added to Islamic indices. Such companies comply with specific Islamic prescriptions for financial ethics and can thus encourage purchase behavior that is based on the beliefs of the investors. There is evidence that culture influences stock market decisions (Grinblatt and Keloharju, 2001; Kumar et al., 2011). Religious attitudes and values impact the behavior of investors. Religious events such as Ramadan can influence stock prices in Muslim countries (Turk-Ariss et al., 2011; Bialkowski et al., 2012; Bialkowski et al., 2013), suggesting a relation between the Muslim religion and investor behavior.[3] Conversely, investors with a negative perception of Islam can react negatively to an Islamic index addition. Therefore, this event would lead to a negative stock market reaction.

A financial crisis may influence the stock market reaction following additions to and deletions from an Islamic index by increasing the favorability of inclusion in such an index. The signal of low indebtedness associated with being *Sharia*-compliant can be more beneficial during episodes of generalized financial distress. Furthermore, Islamic indices had better financial performance than conventional indices during the financial crisis (Walkshäul and Lobe, 2012; Ho et al., 2014). Moreover, the screening rules used by *Sharia* boards had excluded stocks such as Enron, WorldCom, Tyco and Global Crossing; these were included in the conventional Dow Jones index before they experienced scandals. In addition, the literature has shown that Islamic banks had better resilience than conventional banks during the financial crisis (Hasan and Dridi, 2010; Farooq and Zaheer, 2015). Therefore, the positive perception of being added to an Islamic index may have been amplified during the financial crisis.

To isolate the impact of following Islamic principles on stock market valuation, we based our identification strategy on an event study methodology to investigate the effects of additions to an Islamic index. We measure the abnormal stock returns of listed companies during the 2000–2017 period for two subsamples based on the reconstitution of the DJIMI. This Islamic index, which is considered the most important, was launched in 1999.

The first subsample contains US firms, while the second includes listed companies from nine countries with a large Muslim population (Egypt, India, Indonesia, Jordan, Kuwait, Malaysia, Morocco, Qatar, and Turkey). The results are compared for these subsamples because the psychological motives of these two populations can differ greatly. On the one hand, in accordance with evidence that the Muslim religion can influence the behavior of investors, investors in Muslim countries may prefer *Sharia* compliant stocks. On the other hand, per the polls showing a negative opinion of Islam by a large proportion of the US population, US investors may have a more negative perception of being added to an Islamic index.[4] In accordance with the conclusion of Morse and Shive (2011) and Benos and Jochec (2013) that patriotism affects investor decisions, such a view can therefore govern financial decisions. In addition, US investors can also have a negative view of the restrictions associated with *Sharia* compliance: they can consider that they represent additional constraints which lead to a trade-off between profitability and *Sharia* compliance.

Thus, the analysis of the stock market reaction following the reconstitution of the Islamic index provides information on the value of following Islamic principles. By considering two different regions, we can determine whether this reaction differs by region, while the comparison of the periods before and during the financial crisis informs whether the reaction differs by time.

Our paper therefore broadly contributes to the literature on Islamic finance recently surveyed by Narayan and Phan (2017). By providing insights on the stock market valuation of being Islamic, this paper provides crucial information to assess the value of a firm's *Sharia* compliance. This paper also extends the literature on Islamic indices. Many papers have compared the financial performance of Islamic indices with conventional indices (e.g., Girard and Hassan, 2008; Ashraf, 2014), while others have investigated the exposure of Islamic indices to risks (e.g., Shamsuddin, 2014).[5] To our knowledge, we have conducted the first study that examines the stock market reaction to the additions to and deletions from an Islamic index. We therefore also contribute to the literature on the reconstitutions of indices, which has previously investigated conventional indices (Chen et al., 2004) and sustainability indices (Cheung, 2011; Becchetti et al., 2012; Kappou and Oikonomou, 2016).

This study has important implications for companies and investors. It provides insights to companies regarding the short-term implications of being added to or deleted from an Islamic index. It therefore enables the determination of whether the efforts of managers to meet Islamic filters contribute to creating or destroying value in the short-run. It brings relevant information for investors and portfolio managers to know the price effects which accompany Islamic index reconstitutions.

The remainder of the article is structured as follows. Section 2 provides an overview of Islamic indices. Section 3 describes data and methodology. Section 4 displays the results. Section 5 presents the study's conclusions.

## 2. Overview of islamic indices

The creation of Islamic indices has allowed both the provision of a list of *Sharia*-compliant investable equities and usage as a benchmark for Islamic funds managers. Indeed, having a list of Islamic fund investable equities is key for Muslim investors and Islamic fund managers since they construct their portfolios by selecting stocks from these Islamic indices. In addition, because speculation and investment in conventional bonds and monetary assets are prohibited, the management of Islamic funds is essentially passive; portfolio managers tend to track the financial performance of *Sharia*-compliant indices.

Many *Sharia*-compliant indices have been established by major index providers: the DJIMI, the Financial Times Stock Exchange (FTSE) Shariah Indexes, the Standard and Poor's (S&P) Shariah Indices and the Morgan Stanley Capital International (MSCI) Islamic index series. The first Islamic index was launched in 1999 by Dow Jones, followed by the FTSE in 2000, the S&P in 2006 and the MSCI in 2007.

*Sharia* compliance of each stock composing the Islamic index is certified by a *Sharia* board. The members of this board are scholars who have theological, financial and legal skills, and are internationally recognized because of their rarity. The number of board members can vary from one index provider to another.[6] The *Sharia* board oversees the construction of Islamic screening rules. To be considered *Sharia*-compliant, the firm must pass both qualitative and quantitative screenings. The qualitative or sectorial screen consists of excluding companies whose primary activity is considered prohibited (*haram*) by Islamic scholars. These firms include those whose core business involves conventional alcohol, tobacco, entertainment (e.g., casinos/gambling and pornography), weapons, pork, or conventional financial services, such as

[3] In the context of predominantly Christian countries, the literature shows also that religious events like Easter week affect investor's decisions (Pantzalis and Ucar, 2014).

[4] According to the Pew Research Center, in 2007, 45% of Americans believe that Islam encourages violence more than other religions. According to Brookings, in 2015, 61% of Americans have a generally unfavorable opinion of Islam.

[5] For instance, the *Sharia* board of the DJIMI includes four *Sharia* scholars.