EUROPEAN COMPANIES: EVALUATION FOR SHARIA COMPLIANCE "OPPORTUNITIES AND CHALLENGES"

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Abstract— **The continuous growth of Islamic finance investments and the innovation in its various financial instruments make it an attractive financial system especially for the Western countries. Islamic finance is currently introduced in some European countries however the rest of the continent is studying the idea of having dual financial system (i.e. Islamic system and conventional system). Attracting Islamic investors to Europe requires the compatibility of the investments with Sharia. The aim of this paper is to evaluate European companies for being Sharia compliant. Qualitative and empirical approaches are used in the research methodology to test the European companies' eligibility using a Sharia compliant methodology screening. The results should be a key element in understanding the nature of those companies and figuring out if it will be a win -win situation; in one hand those companies can be financed through Islamic financial instruments and on the other hand examine the profitability of those companies.**

Keywords- Sharia compliant, Islamic finance, European companies, Sharia compliant screening, and Sharia indices

I. INTRODUCTION AND LITERATURE REVIEW

Islamic finance is as old as Islam and its roots go back to almost 1500 years ago, and its practices have been really used throughout those years across the Muslim world. However, it has moved recently from a mere old theoretical concept to a practical reality. A natural consequence of this progress is the opening up of new means for its growth and development worldwide. Islamic Financial products, while they are derived from Islamic ethical laws, are not limited to Muslims population only but they are available to everybody (Warde, 2000; Usmani and Taqi, 2002; El-Gamal, 2006; and Ayub, 2009) [25, 24, 8, & 2]. From a Western prospective; it is a technical financial system that is operating on an ethical basis that is very similar to the social responsibility investments that promotes for an ethical finance; and this makes of it an attractive system for the Western countries.

The recent global financial and economic crisis has brought to evidence many issues concerning the stability of the conventional financial system. This has prompted an extensive global re-evaluation by the international community on the adequacy of the existing international economic and financial system. There was a need to establish financial transactions that add value to the real economy and that avoid speculative investments. This could be represented in Islamic finance, which is based on the ethical Sharia principles (Askari, Iqbal, & Mirakhor, 2010) [1]. These principles have socioeconomic goals like sustainability and poverty alleviation where it encourages Muslims to maximize their wealth as long as they do not create a situation that is creating a social distortion or violating the norms of Islamic justice (Dusuki, 2006) [7]. Sharia provides guidelines for aspects of Muslim life, not only religion but also politics, economics, finance, and social life (Silva, 2006) [22].

There are two sources of knowledge in Islam; primary and secondary (Siddiqi, 2004) [21]. Primary sources comprise the Quran and Sunna - revealed/divine knowledge from Allah to his Prophet Mohammad. Secondary sources are the derived knowledge through Ijtihad "exertion" of scholars to accommodate new and contemporary issues, through agreed upon methodologies, such as Ijma "consensus" and Qiyas "analogy.

The most important principles of Islamic finance that are derived from Sharia include a prohibition for Riba "usury/interest", prohibition of Gharar "uncertainty/speculation", prohibition of Maysir "Gambling" and prohibition on investment in a Non- Halal activity that is equivalent to Haram "unethical" businesses products or services (such as alcohol, tobacco, pork, adult entertainment, and weapons). Sharia compliant products must be backed by or based on an identifiable and tangible underlying asset; it is also important that the investor and investee adhere to the concept of profit and loss sharing which is in other terms sharing the risk of all financial transactions. Last but not least is the obligation of Zakat "Charity/ Purification" for poor and needy (Biancone, & Radwan, 2015) [4].

Islamic finance industry in Europe has an increasing trend in terms of growth rate and this can be related not only to that Europe is searching for attracting Arab investments for liquidity but also for the growing Muslim population in Europe. Islamic funds domiciled in Europe accounted for 16.3% of the global aggregate Sharia Compliant assets under management in September 2014 up from 11.8% at the end of 2012. [11]

European companies no matter their size are seeking the high solvency of the Islamic investors. It is a diversifying source of funding for large companies through Sukuk, but also for financing Small and Medium Enterprises (SMEs) through different Equity or Debt financing mechanisms. Equity-based mechanisms are based on the profit and loss sharing. Musharaka "Joint Venture or Partnership of Equity Participation" and Mudaraba "Partnership" are famous examples for this type of financing mechanism. While Debt-Based mechanisms are based on mark up cost plus concept that can be applied easily in purchase and sales operations. Murabaha "cost plus mark up", Ijara "leasing", Salam and Istisna are the most well known used contracts in the debt-based mechanism.

The Islamic financial markets have developed rapidly as new investment instruments over the last two decades. Over the past decade, the global capital market scene has witnessed the introduction of Islamic indices, which are designed to filter out the stocks in conventional indices in accordance with the Islamic principles. Some of these indices are: Financial Times Islamic Index Series (FTSE), Dow Jones Islamic Market Index (DJIM), Standard & Poor Shari'ah Index (S&P) and Morgan Stanley Capital International Islamic Index (MSCI) (Ho, Rahman, Yusuf, and Zamzamin, 2014) [9]. In their analysis for the performance of the global Islamic indices they found that Islamic indices outperformed their conventional counterparts during crisis periods.

Accessing Islamic funds and financing instruments needs a full compatibility with the Sharia principles, since Sharia compliance of the underlying equities is a pre-requisite for being eligible for investments by Islamic financial institutions. The European companies are facing a real challenge especially in their current debt structure that represents the highest factor for their exclusion from being a Sharia complaint due to the high loans and interests.

There is a very little literature that focuses the Islamic indices and funds and in specific for the Western companies eligibility for accessing Sharia compliant financing mechanisms. We propose to fill the gap by providing analysis for the different Islamic indices and evaluation of the European companies for being a Sharia compliant through studying and applying the Sharia compliant screening methodology. This is to understand the impact of the screening for eligibility on origin, size, and profitability of the companies and what would be the opportunities and challenges in their compliance. And answering the question of those companies can be financed through Islamic financial instruments or not as well as examining the profitability of those companies.

The paper is organized as follows; section II is an explanation for the Sharia compliance screening methodology, section III clarifies the differences among the different Islamic indices, section IV discusses the debatable issues in the Sharia screening methodology, while section V is the empirical study for evaluating the Sharia compliance of the European companies, and finally section VI concludes.

II. Sharia Compliance Screening Methodology

Within the Sharia concept; the ownership of some shares in a company is considered a partial share in the company itself. So in order to get a Muslim investor in a company; this company should be a Sharia compliant. There are technical steps applied for classifying a company as a Sharia complaint as well as there are several worldwide current indices for the screening process that provide confidence to Muslim investors that the profit is permissible according to Islamic Sharia ethical principles.

For conducting the screening process the criteria are divided into qualitative criteria and quantitative criteria. By controlling the qualitative and quantitative criteria the companies would be screened for their typology of business activities and investments on one hand and for their resources "assets", profit and financial structures on the other hand.

This screening process is supervised and controlled by the Sharia supervisory board that should be totally independent committee composed of specialized Islamic jurist and Islamic finance expertise who are assigned by the Islamic indices provider and its role is to verify, control and assure that the business is done according to Sharia principles. Such expertise raises the attractiveness of Sharia compliant financial intermediaries to investors considering Islamic investments (Sole, 2007). [23]

Qualitative Screening

Qualitative screening represents the classification of the business of each company. Companies must have their activities within the permitted activities "Halal" and avoid all non permitted activities which are referred as to Haram activities. Activities should of course include also all of the production and sales process of their products. Disallowed activities are; alcohol, pork related products, pornography, tobacco, gambling, conventional financial services, weapons and defence, biological human and animal genetic engineering, and media and advertising companies with exception to news channels, newspapers, and sports. The companies that are excluded after this screening do not qualify for quantitative screening.

Quantitative Screening

After companies had passed through the qualitative screening they should pass to the second phase of screening which is quantitative screening. In this screening phase the financial rations of the companies should be tested for not exceeding specific thresholds that are different among the different global indices. Not only the percentage thresholds are different but also the calculation formulas in some instants are different. However the levels that are subject for testing are the same which are: the leverage level (debt level), interest level, and the liquidity levels. It is worth mentioning that in some indices there is the dividend purification and in some others revenues purification which is a measurement for the portion of revenue that is generated from non compliant operations in which minimum level of tolerance is accepted as long as the business sector is Sharia compliant.

III. Differences among Sharia Compliance Indices

There are some differences among the major worldwide indices for Sharia compliant. Regarding the qualitative criteria there are not too many differences as what is permissible and what is not but only in few points. For example, in the S&P 500 Shariah Index it is not excluded the company that has activities in weapons /defence but it is excluded the company that has business activities in the hedging of gold and silver or that has activities in cloning. On the contrary according to Dow Jones Islamic Market indices; it is not excluded the hedging in gold and silver and considered excluded any activity related to weapon and defence and hotels. Some others are more flexible as in the case of Morgan Stanley Capital International (MSCI) Islamic Index Series, FTSE Sharia Global Equity Index and the Shariah Advisory Council of Malaysia (SAC) that are accepting some impermissible activities as long as the core business is permissible. On the contrary to the S&P and Dow Jones that exclude companies that have any involvement with impermissible activities.

Moving forward to the quantitative criteria we can figure out that there is a lot of differences among the worldwide indices whether in the calculation method (where one is using the market capitalization and another is using total assets) or in the threshold limits (e.g. one is setting 49% threshold for the liquidity ratio and another is setting it to 33%). Mentioning again the same five major indices; the following table explains the difference among them in the three used financial ratios:

TABLE I. Quantitative criteria

	S&P	**Dow Jones**	**FTSE**	**MSCI**	**SEC**
Level of Debt	Total Debt / Market Capitalizatio n(avg 36 months) < 33 %	Total Debt / Market Capitalizatio n(avg 24 months) <33 %	Total Debt / Total Assets < 33 %	Total Debt / Total Assets < 33.33 %	Total Debt / Total Assets < 33 %
Interest Ratio	Cash & Interest bearing Securities / Market Capitalizatio n (avg 36 months) < 33 %	Cash & Interest bearing Securities / Market Capitalizatio n (avg 24 months) < 33 %	Cash & Interest bearing Securities/ Total Assets < 33 %	Cash & Interest bearing Securities / Total Assets < 33.33 %	-
Liquidity Ratio	Accounts Receivables / Market Capitalizatio n(avg 36 months) < 49 %	Accounts Receivables / Market Capitalizatio n(avg 24 months) < 33 %	Accounts Receivable s & Cash / Total Assets < 50 %	Accounts Receivable s & Cash / Total Assets < 33.33 %	Cash / Total Assets < 33 %
Non Permissible Income (NPI)	NPI (excluding interest) / Total Revenues < 5 %	-	NPI (including interest) / Total Revenues < 5 %	NPI / Total Revenues < 5 %	Two classes of NPI / Total Revenues Class 1 < 5% Class 2 < 20%

IV. Debatable Issues in Sharia Screening Methodology

The global different indices disagree among themselves and there is no unique unified index that can be a reference point for both companies and investors to rely on. Standardization of Islamic finance regulations has been of increasing interest in the industry. Sharia is open to interpretation and Islamic scholars are not in complete agreement regarding what constitutes Sharia compliant. Islamic finance laws and regulatory practices vary across countries. The lack of concurrent viewpoints makes it difficult to standardize Islamic financing (Shameen, 2005) [19].

Who set the rules and thresholds?

There is an absence of a unique universal framework among all Sharia indices (Derigs & Marzban, 2008) [6]. Every index provider has a Sharia supervisory board that set the framework in which the index would work on. The dilemma is that; we have a different set of indices with two same main criteria qualitative and quantitative but with different basis, formulas, and thresholds under those two main criteria. Not only Sharia supervisory board is not unified in one framework but also some of them are already members in some financial institutions which strongly hits the credibility of the set of rules they put to regulate each index.

Another point is that some of the indices rules are rigid and some are flexible, some excluding totally any involvement of non Halal transaction and some accept and permit if it is not the core business (Khatkhatay & Nisar, 2007) [12]. Some set a rigid threshold for financial ratios of 33% and some set more loose and flexible one up to 50% (Mahfooz and Ahmed, 2014) [13].

A third issue is the frequent changes of the set of rules as some indices every now and then change their set of rules and their thresholds applied for the financial ratios as well as the formula of calculation like the modification of the threshold for one item which is the liquidity ratio to be up to 33% instead of previously was up to 45%. This problem also strongly hits the stability of the position and classifications of the companies, i.e., one company could be classified as Sharia compliant and then after changing the ratios and formula could be excluded and considered a non Sharia compliant one.

Another debate is the non permissible income ratio that is related to the total revenue in some indices with a tolerance level of maximum 5% to be purified. In this issue scholars also did not agree about it as they claim it should be taken out from dividends not from revenues and others say if distributed (Mohamed Donia and Shehab Marzaban, 2010) [14]. Some indices ignore it totally because in order to specify the amount that need to be purified is difficult enough as it is easy to sort out the generated income from interest bearing investments but it is infeasible to know the information regarding all non Sharia compliant transactions that could occur occasionally if the main primary business is Sharia compliant simply because companies report revenue , rate of return, and dividends but without specifying any details about any non permissible transaction.

Challenges from a Western Prospective

In Western countries since the existence of the Islamic banks and Sharia compliant investments are still not widely spread, and companies in their financing instruments and debts rely upon conventional banks and institutions. Due to this fact they seek a level of tolerance for the interest bearing debts and for the interest bearing securities. On the other hand, many scholars debate and argue about this fact as they debate that the tolerance level which is 33% is too much and that Riba cannot be tolerated by any mean. As a result this represents a challenge as many Western countries are still studying how to introduce the Islamic finance along with the conventional one.

This is not an easy process as most of them need a harmonization of the local laws and regulations of each country with the regulations of Sharia. Another challenge is that Sharia requires an asset based investments and tangible assets so this means that is not very much appreciated the high liquidity, and this has raised some claims saying if we exclude companies of high liquidity level or in case of imposing low level of tolerance then this could lead to insolvent pool of companies.

V. Evaluation for Sharia Compliance of European Companies “Empirical Study”

This paper aims for evaluating the European companies; for their compliance to Sharia, and therefore the possibility of opening up to Islamic investments opportunities. Another objective is to figure out what are the European countries that have more Sharia compliant companies and also analyzing the findings to understand the available information as regards the size, sector, and profitability of those companies.

Research Tool and Assumptions

This empirical research is conducted based on several assumptions to be tailored and applied on to follow the Sharia compliant screening methodology for all European Union Companies. The assumptions that had been used are covering both the qualitative and quantitative criteria for Sharia compliant screening. The used search database bank for reaching information regarding all European Union (EU) companies is Amadeus. The pool that is to be examined is the EU companies in specific the unlisted ones since indices are referring to the listed companies and this paper tries to understand the chances that those unlisted companies have to be financed with an Islamic finance investments.

Assumptions:

a) Unlisted companies only; to evaluate the companies that are not previously evaluated or traded in a stock exchange. Moreover, those companies mostly are SMEs and have weak access to financing means.
b) Excluding all Haram (non Halal) business industry and activities that are considered not permitted according to Sharia to fulfill the qualitative screening. The criteria of exclusion were done taking into consideration the most rigid parameters among all the above mentioned indices.
c) As it was mentioned before that we are testing assumption for the unlisted companies so there is no available market capitalization (like what is used in S&P or Dow Jones). As a result the formula was set to measure relatively to the Total Assets (like FTSE, MSCI, and SEC) but instead we choose the most rigid threshold which is 33%. The used formulas are as follows:

    - Liquidity Ratio:
      Total Accounts Receivables / Total Assets “threshold: < 33%”

    - Interest Ratio:
      Cash & Interest Bearing Securities / Total Assets “threshold: < 33%”

- Debt level Ratio:
  Total Debts / Total Assets "threshold: < 33%"

d) No non permissible income was considered like the Dow Jones index. This choice was done also based on the difficulty to sort out details referring to impermissible transactions.
e) EU countries only (Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and United Kingdom).
f) Ultimate Owner: It was imposed to select companies that are owned by ultimate user and by imposing this we assured that companies are not a controlled by another company.

Research Findings

The whole sum of the European companies that were the starting pool was 3,100,308 companies. Then the number was reduced by limiting it to the unlisted companies to be 2,901,048 companies. This number was the initial pool for applying qualitative criteria that then was reduced after exclusion of Haram businesses activities to be 2,634,716.

The set of assumptions fulfilling the qualitative criteria showed that there is no real challenge in that aspect as excluding 266,332 companies which represents 9% is very acceptable percent. However, moving to the quantitative criteria reflects the real problem. This can be clearly seen especially when the debt ratio was applied as the number of compliant succeeded to pass this threshold were 472,632 only. This figure represents only 16% out of the original pool and 18% out of the qualified companies from qualitative Sharia screening. That result reflects the most significant challenge for the European companies is their debt structure and that is naturally done through conventional financial instruments.

The same was revealed after applying the interest and liquidity ratios as the number of companies passed these thresholds were reduced again to be 372,492 companies. This last reduction has decreased the qualified percent of companies to be only 13%.

Moving to the last two assumptions where limiting it to the EU countries which has not decreased the number a lot, but then the ultimate owner imposition has heavily decreased then to reach a final total of 9,286 companies.

As it is clear from the previous sequence; 9286 companies had resulted to be Sharia compliant out of a pool of almost 3 million companies.

An analysis for the full data for the research findings to figure out the details by country regarding their percent out of the total number of Sharia compliant companies that were found in each of the EU countries can be demonstrated in the following pie:

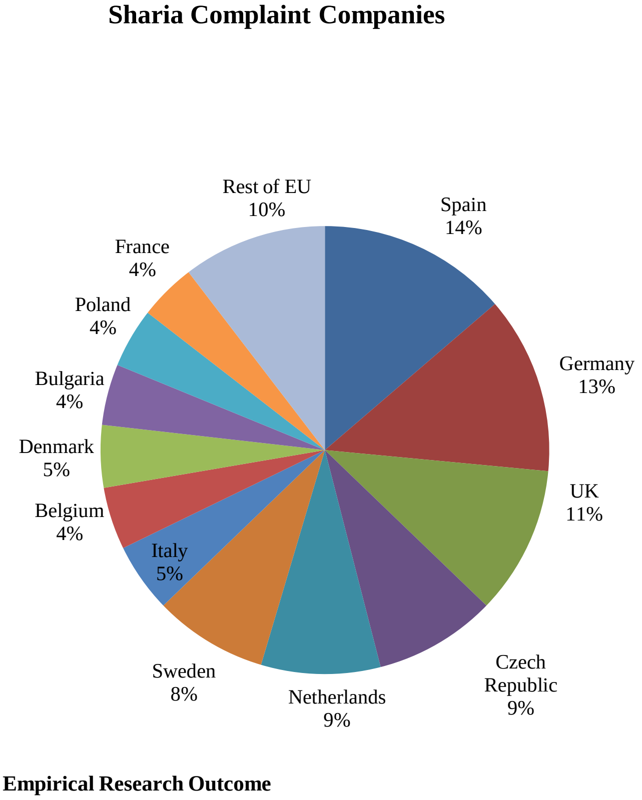

Figure 1. Sharia complint companies by country

As we can see that it was specified the first highest 12 countries then for the rest of the EU countries that represents 16 countries were summed collectively since they represent a small share.

According to the known classification of SMEs regarding the number of employees that is classified as follows: Micro: 1 – 9 employees, Small: 10 – 49 employees, Medium: 50 – 249 employees, and finally Large: > 250 employees.

Analyzing the three countries that had a share higher than 10% which are Spain (14%), Germany(13%), and UK (11%), we found that in Spain 77% of the companies are micro size companies (i.e. employees' number is between 0 and 9), with good results in terms of profitability where 67% have a positive ROE. While in Germany; the size of the companies is so different from those of Spain and is divided as follows; 18% are large companies (i.e. employees' number higher than 250), 32% medium size companies (employees' number is between 50 and 249), 26% small companies (i.e. employees' number is between 10 and 49), and finally 24% micro sized companies. Almost half of the German companies operate in the services sector and second half is divided between retail and wholesale trading, and manufacturing sector. Regarding the United

Kingdom companies that are mostly operating in the services with small and medium sized companies; however the significant thing that was seen in their high profitability values.

The four countries that had a share between 5% to 10% out of the total final Sharia complaint companies were as follows; Czech Republic (9%), Netherlands (9%), Sweden (8%), and Italy (5%). In Czech Republic around 74% of the companies are small and medium size while on the contrary is the Netherlands where the majority is micro sized. In Sweden what is really different from all previous countries is that half of the companies are large companies and the other half is small and micro sized companies and very few medium sized companies. Their profitability is relatively high in comparison to others and with a majority operating in services sector. On the contrary is Italy where the majority is micro sized companies (84%), small sized (12%), the rest were medium sized and no large sized companies almost but with more than 80% of positive profitability. Looking for the rest of the countries whose share was below 5% of the total companies; the most observable was Bulgaria that most of its companies are large and medium sized.

After analyzing the outcomes in both the qualitative and quantitative screening, we have found that the challenge that could face the European companies on the level of qualitative for example for the food and beverage sector could be reduced by providing full details about the nature of activities that could be evident to investors or to the screening measures by acquiring Halal label or certificates from authorized recognized entities for their line productions. Acquiring the Halal would implicitly mean that their production operations and business activities are qualified as a qualitative screening. On the other hand, the challenge that they face on the quantitative level is all correlated to two points; first is that the European companies' debt level is too high and this could be solved through working on the debt structure through decreasing the debts and consequently increasing the equities through the tools of the Islamic Equity-based mechanism Musharka and Mudaraba, and second is the used financial institutions for financing and investing which are the conventional banks and this could be solved through dealing with Islamic financial institutions instead using Debt-based mechanism of Murabha, Ijara, or Istsnaa.

Looking with a future scope after the qualification of the companies and their success to pass the Sharia compliant screening and find the suitable financing mechanism we have to think about the corporate governance problem. Since the resulted companies are mostly small companies and in Europe it is probably family businesses which have many corporate governance measures problems. According to a recent survey about family businesses in Europe (2014) [15]; the problems could be seen in the composition of the board of directors' members where 50% of the board seats are given to family members with really few independent seats and in the board efficiency where 39% of those boards do not have an "Audit and Risk" committee while 43% of them have "Nominating/Remuneration" committee. Another problem could be seen that many of them have no CEO succession plan (Russell Reynolds Associates, (2014), "Survey of Corporate Governance Practices in European Family Businesses" Russell Reynolds Associates). In the case of financing those companies there must be corporate governance model applied for controlling and assuring investors' rights and this needs a board of directors for managing those companies and an independent supervisory board for monitoring and controlling.

Limitation of the Research

This empirical research was limited to the registered companies in the used database, also with the some limited transparent information provided by the companies. Another limitation was faced in the qualitative screening since there were some companies not explicitly specifying in details their activities and just were stating food sector so it was set to exclude them since we had not enough information to choose if they are Halal activities or not. One last limitation was the difficulty of comparison between countries since they are unlisted companies so many of them use their local accounting standards and not a unified accounting standards like the IFRS.

VI. Conclusion

The potential growth of the Islamic finance in Europe is really high for several reasons; the emerging need for an alternative finance that is more stable and does not depend on speculation, the several serious initiatives that were taken by EU countries toward accommodating and promoting Islamic finance (e.g. UK, Germany, Ireland and Luxembourg), the growing Muslim population in Europe, the huge interest in Europe to attract investors from Islamic markets consequently boost the economy and increase liquidity, and finally the geographic location of Europe and the strong trade agreements with the major Islamic markets. No doubt those factors will enhance the opportunity for the Islamic finance to grow however this should be supported by creating the suitable environment for promoting that finance. This empirical research has reflected an evaluation for the European companies for their compatibility with the principles of Sharia and consequently compatibility with Islamic finance. The research findings had revealed a good opportunity for a basic moving step toward Islamic finance and this was seen in the qualitative criteria with a challenge related to certifying activities and production with Halal labeling is needed sectors like food and beverage, cosmetics, medicine, and tourism sectors. The other real challenge is in the quantitative criteria since the financing model in Europe depends heavily on debt and that was the main reason behind eliminating almost 80% of the companies. This challenge could be resolved if those companies changed their debt structure or their financing financial institutions using Islamic equity-based or debt-based mechanisms. Another challenge is that for avoiding the debt s and interests from conventional banks this requires the existence of the Islamic banks to support and finance those companies. One of the major opportunities in that most of the economies depend heavily on the SMEs for their important role in capital accumulation and creation of employment opportunities but on the other hand those companies suffer from the inability to access finance and limitation of international exposure; the Islamic finance represent a real opportunity for then in resolving those problems. However, this needs a well defined corporate governance model to be applied in those companies where the paper pointed out that this could represent a future problem since those companies really lacks it. However, taking all threats and challenges into consideration and working on them is feasible and benefiting from the Islamic finance investments is a possible target.

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