Doing Good or Simply Avoiding Sins: A study of the NIFTY50 Shariah Index Constituents

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Abstract: Negative screening to remove sinful enterprises is the current IBF approach, rather than positive screening to include firms who are proactive in addressing environmental and social concerns. This approach may make it more difficult to achieve the fundamental goals of Islamic rules, which are to promote social welfare. To gauge the effects of this approach, this study investigates the Environmental, Social and Governance (ESG) performance of the firms listed in the Nifty50 Shariah Index, the benchmark index for Indian shariah-compliant financial products. These have a good overall ESG performance. The governance performance, on the other hand, lags behind the environmental and social performance. Given the overall ESG performance of the index, the available exchange-traded fund (ETF) based on this index is another promising ESG investment choice.

Keywords: Islamic, ESG, NSE, Shariah-compliant.

1. INTRODUCTION

As an alternative financial system, the main objective of Islamic finance and Banking (IBF) is to accomplish *maqasid al-shariah,* which promotes socioeconomic justice, poverty reduction, income equality, and economic productivity. *Maqasid al-shariah* is very much aligned with the UN's sustainable development goals. It is expected that investors supporting this objective must only invest in companies whose operations further sustainable development rather than only profits. Nevertheless, the present IBF industry is focused on negative screening and avoiding indebted and sin stocks, which may hinder investors in accomplishing this objective.

Shariah-compliant companies are screened on Islamic principles. Based on Islamic principles, there are many shariah compliance methodologies. However, their essence is the same. First, for a company to be shariah-compliant it must not primarily belong to non-halal (impermissible) industries. Some examples of non-Halal industries are conventional finance and entertainment. Secondly, the company must not be deeply indebted or substantially benefit from debt income. Good environmental, social, and governance practices are indispensable parts of *maqasid al-shariah* (Sairally, 2015). Currently, the shariah compliance methodologies do not explicitly consider these practices for shariah compliance. Yet it is envisaged that these methodologies would shortlist companies that support *maqasid al-shariah* and in turn support sustainable development.

Investors desirous of investing in shariah-compliant financial products do not have many options. Presently there are one exchange-traded fund (ETF) and two mutual funds that cater to these investors. The concerned ETF, Nippon India ETF Shariah BeES (SHARIAHBEES), tracks the Nifty50 Shariah Index. This ETF uses a passive investing strategy which has become quite popular globally. Nonetheless, despite being quite old, the asset under management (AUM) for the ETF has not grown like conventional ETFs. It is plausible that the fund house may close the ETF if it remains unpopular which may lead to low financial inclusion of these investors.

Investors are increasingly using investment as a tool for supporting the environment (Richardson 2008). Stock prices of companies, focusing on products that somehow are related to sustainable development, have skyrocketed in recent years. Some prominent examples are stocks belonging to solar energy and electric mobility. These environment-friendly stocks belong to the broad environmental, social, and governance (ESG) category. The term ESG was coined in 2005 (IFC n.d.). ESG investors want to *"do well while doing good".* Nevertheless, there is a scarcity of products focusing on values in the Indian financial industry. There is a need to offer financial products that support the cherished values of the investors (Nair and Ladha 2014). If the Nifty50 Shariah Indexed stocks are good ESG performers, ESG investors may readily adopt the SHARIAHBEES ETF which may lead to its popularity and continued operation. Shariah-compliant portfolios have distinct industry exposure than ESG portfolios (Miglietta and Forte 2011) and could act as a diversifier for ESG investors (Charfeddine, Najah, and Teulon 2016). The ETF offers significant exposure to the information technology (IT) and consumer sectors, both of which have experienced a secular growth in recent decades, and may emerge as a viable option for ESG investors seeking such exposure. Thus, the objective of this work is to assess the ESG performance of Nifty50 Shariah Index constituents.

The remainder of the article is structured as follows. The next section develops hypotheses based on the above-mentioned objective. Section 3 describes the data and the

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methodology for the assessment. Section 4 presents and discusses the results and section 5 provides the conclusion.

2. BRIEF LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Socio-economic justice is an essential element of Islam (Aribi & Gao 2010). In spirit, the shariah-compliant investment approach is not very different from the ESG investment approach. Wilson (1997) found that both approaches stress ethical and moral considerations in the selection of companies. For example, both approaches detest investing in tobacco and armaments businesses. Modern versions of these approaches have developed parallelly (Charfeddine et al. 2016). Nevertheless, these do not always concur because Islamic principles and modern ethical values differ at times.

Islamic principles treat interest as a social evil whereas interest-based operations are acceptable according to modern ethical business practices. For instance, a conventional bank may be funding some poverty alleviation programme but it will be still considered non-compliant because it belongs to the conventional financial industry. Again, a highly indebted company that is spending on social initiatives will be non-compliant. Though stocks with good ESG attributes may not be shariah-compliant, it is expected that shariah-compliant stocks shall have good ESG attributes due to their alignment with *maqasid al-shariah*. Critics such as Erragraguy & Revelli (2015), however, point out that shariah compliance screening procedures do not contain ESG performance metrics, raising concerns about whether the Islamic banking industry's operations and ethical origins are incompatible.

Few studies have examined this concern as the research has been mostly focused on assessing the comparative performance of shariah-compliant investments against conventional or ESG investments. Studies concerning ESG attributes of Islamic banks generally find that they are mostly disinterested in ESG issues. Hassan & Harahap (2010) observe that Islamic banks are unconcerned about corporate social responsibility (CSR) issues. Sairally (2013) assessed the corporate social responsibility practices of Islamic financial services globally using a questionnaire survey and content analysis and found that they are focused on profit maximization while seeking to meet the shariah compliance requirements rather than excelling in these requirements. Mallin et al. (2004) find that Islamic banks are less likely to manage earnings. However, they are also less concerned about environmental issues. Alam et al. (2022) suggest Islamic banks should attend to the rising concern about ESG friendliness of banking activities similar to conventional banks in enhancing their general and dimension-wise ESG performance.

A few studies have that have examined the ESG concerns of shariah-compliant firms find that they have appropriate ESG attributes. Hayat & Hassan (2017) found that the governance of shariah-compliant firms is not significantly different from conventional firms. They suggest including ESG parameters in the shariah compliance screening methodology. Recently, Qoyum et al. (2021) also examined the ESG performance of Islamic firms in the context of Malaysian and Indonesian stock markets. Their findings support Hayat & Hassan (2017) regarding governance performance issues. Nevertheless, they found that Islamic firms have better environmental and social performance than conventional firms. Hassan et al. (2022) find that sharia-compliant companies are more likely to follow sustainable and responsible business strategies, which are notably focused on environmental issues. They show that shariah-compliant firms are highly responsive to CSR initiatives in significant natural catastrophes and social events.

In India too, this concern remains unaddressed. Indian studies on Islamic finance are mainly concerned with the return and risk performance of shariah-compliant stocks and indexes. In the vein of Qoyum et al. (2021), this work addresses this crucial concern. This work analyses the ESG performance of the Nifty50 Shariah Index, which is the Indian shariah stocks' benchmark and is free from the discretion of investment managers. The portfolio of this Index consists of the largest stocks in the Indian capital market. According to Wu (2006), large stocks are likely to see more pressure to invest in CSR activities. So, it is expected that the concerned sample of stocks will have good CSR related performance. Moreover, one prominent characteristic of the sample is low debt. Low debt companies are expected to be well governed as the shareholders do not need to discipline the managers regarding resource wastage (Arping and Sautner 2010; Jiraporn et al. 2012). Hence, similar to Hayat & Hassan (2017), this work postulates that shariah-compliant firms will be well-governed. Based on the literature, the following are the hypotheses.

H1: Shariah-compliant stocks have good composite ESG performance H2: Shariah-compliant stocks have good environmental performance H3: Shariah-compliant stocks have good social performance

H4: Shariah-compliant stocks have good governance performance

3. DATA AND METHODOLOGY

The data is collected on 22nd February 2022. The sample consists of the shariah-compliant stocks that are part of the Nifty50 Shariah Index and gathered from NSE Indices Limited. The shariah compliance is based on the screening methodology of *Taqwaa Advisory and Shariah Investment Solutions* (TASIS). It has industry screening and financial screening. The industry screening removes stocks that primarily belong to conventional financial services, gambling and narcotics. Further, non-halal food, entertainment, and other services are also removed. The financial screening removes stocks that Interest-based debt/total assets greater than 25 per cent, interest-based income greater than 3 per cent of total income, or a sum of receivables, cash, and bank balance greater than 90 per cent of total assets.

The index weighs the shariah-compliant stocks according to market capitalization. At the time of rebalancing, it also requires that a single stock shall not account for more than 33 per cent of the total weight, and the weights of the top three stocks shall not account for more than 62 per cent of the total weight. The rebalancing is done monthly.

Thomson Reuters' Refinitive ESG database is used to collect data for environmental, social, and governance (ESG) categories and their components' scores. The essence of their methodology is relative performance. That is, the scores for envi-

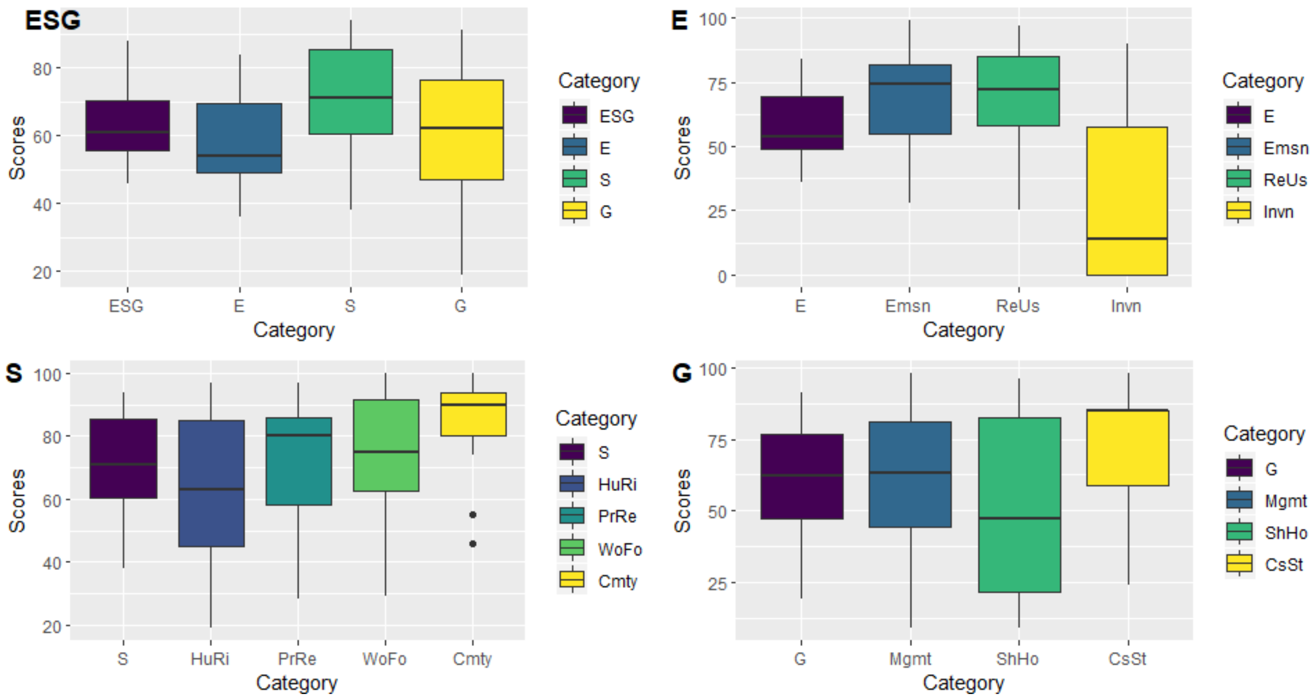

Fig. (1). Boxplots for categories.

ESG, E, Emsn, ReUs, Invn, S, HuRi, PrRe, WoFo, Cmty, G, Mgmt, ShHo, and CsSt are scores for ESG, environment, emissions, resource use, innovation, society, human rights, product responsibility, workforce, community, governance, management, shareholders, CSR strategy.

ronmental and social categories for a stock are relative to its industry peers. Further, the scores for governance are relative to a stock's country peers. Detailed methodology to estimate the scores is available on their website.

ESG categories and their component scores are assessed using boxplots. Before per- forming hypothesis testing, the normality of the sample is tested using the Shapiro Wilk normality test. The defined hypotheses are tested using a t-test for statistical significance and Cohen's D for effect size. According to the Refinitive ESG score calculation methodology performance is considered good if the score is above 50. The weighted mean for the index is estimated for the overall performance of the Index.

4. RESULTS AND DISCUSSION

The ESG panel of Fig. (**1**) presents the box plots of scores for ESG and its components. All categories depict low dispersion except governance. ESG and E category scores are right-skewed whereas S and G are left-skewed. The selected stocks sample has the highest and lowest medians for the social and environmental categories. Nevertheless, all categories have median scores above 50.

E panel of Fig. (**1**) presents components of the environment category. The sample performs well on the emissions and resource use components as their medians are way above 50 and their boxplots depict low dispersion. However, scores for innovation are be- low 25 and show remarkable dispersion, indicating a low inclination to invest in and develop green technologies. However, individual stocks' component scores hardly influence the ESG or its categories' scores because their weights vary according to their importance to industries. S panel of Fig. (**1**) show all components have medians above 60. Interestingly, the concerned stocks have performed appreciably well on the community component which has a median of 90 and small dispersion. This boxplot highlights the selected stocks' commitment to citizenship, public health, and business ethics. Overall, these stocks have done considerably good in the social category and its components.

G panel of Fig. (**1**) presents scores for governance and its components. Management and shareholders components are 63 and 47 respectively. Nevertheless, the CSR strategy has a median score of 85 and small dispersion which reflects that the concerned stocks actively undertake environmental protection and social development initiatives. This observation supports Hassan et al. (2022). Importantly, this finding could be due to the pressure to invest in CSR activities these stocks are one of the largest and most profitable stocks available on the Indian stock market.

Table **1** presents the results of the hypothesis tests. Since the sample is small and the boxplots show skewness, and category scores are checked for normality assumption for the t-test. Shapiro Wilk normality tests show normality for all the category scores (p- value>0.10). Hence, a t-test can be used to test the hypotheses. The population mean score for the ESG category is 64.47 with a lower limit of 59.48 at a 0.95 confidence level and is strongly statistically significant ($p<0.01$). The effect size is also large as the Cohen's D is 1.15. Thus, the results substantially support H1. The shariah-compliant large stocks have good ESG performance and are in line with the findings of Qoyum et al. (2021).

The population mean for the environmental category is 57.79 with a lower limit of 52.27 at 0.95 confidence and statistically significant ($p<0.05$). The Cohen's D is 0.56 indicating a medium effect size. So, there is moderate support for H2, re-

Table 1. T-test and Related Tests.

Category	Estimate	t statistic	p-value	LCL	UCL	CohenD	SW p-value
ESG	64.47	5.03	0	59.48	Inf	1.15	0.28
E	57.79	2.45	0.01	52.27	Inf	0.56	0.3
S	72.32	6	0	65.86	Inf	1.38	0.39
G	59.42	1.86	0.04	50.66	Inf	0.43	0.39

This table reports the one-tailed t-test with the alternative hypothesis that the mean value is greater than 50, Co- hen's D, Shapiro Wilk normality test results. LCI, UCI, CohenD, and SW p-value represents lower confidence interval, upper confidence interval, Cohen's D, and p-value for the Shapiro Wilk normality test. Inf means infinity.

flecting that the shariah-compliant firms are indulging in environmental initiatives. This result is in line with Hassan et al. (2022). The population mean for the social category is 72.32 with a lower limit of 65.86 at 0.95 confidence and statistically significant ($p<0.01$). The Cohen's D is 1.38 indicating a strong effect size. The result strongly supports H3 and shows the exceptional social commitment to shariah-compliant stocks. This result strongly concurs with Qoyum et al. (2021). Plausible drivers of the social category scores are product responsibility, workforce, and community components as they have median scores above 75 in the S panel of Fig. (**1**). Generally speaking, the findings reflect that these stocks value all stakeholders.

The population mean for the governance category is 59.42 with a lower limit of 50.66 at a 0.95 confidence interval and statistically significant ($p<0.05$). However, Cohen's D is 0.43 suggesting a small effect size. Hence, the result for governance performance for the shariah-compliant stocks weakly supports H4. Generally speaking, the finding is similar to Hayat and Hassan (2017) and Qoyum et al. (2021).

Table **2** contains scores for the Nifty50 Shariah Index. The scores are the product sum of market capitalization and scores of the constituent stocks. So, larger stocks play a bigger role in the estimation of the scores for the Index. The ESG score is close to 75. Environmental and governance scores are well above 50. Moreover, the social score is 80 reflecting the excellent performance of the index on social parameters. The index performs well on many components, especially on the community components. However, it performs poorly on environmental innovation. Further, the Shareholders weighted score is below 50 reflecting that minority shareholders do not have much say in the constituent stocks.

Table 2. Category scores for Nifty50 Shariah Index.

Category	Scores
ESG	73.60
E	63.80
Emsn	80.13
ReUs	75.96
Invn	42.91
S	81.29
HuRi	73.90
PrRe	78.30
WoFo	85.12
Cmty	91.27
G	70.86
Mgmt	76.54
ShHo	48.86
CsSt	76.92

This table presents the category scores weighted using weights of the constituents of Nippon India ETF Shariah BeES. ESG, E, Emsn, ReUs, Invn, S, HuRi, PrRe, WoFo, Cmty, G, Mgmt, ShHo, and CsSt are scores for ESG, en- vironment, emissions, re- source use, innovation, so- ciety, human rights, prod- uct responsibility, work- force, community, gover- nance, management, share- holders, CSR strategy.

5. CONCLUSION

Investors who support shariah's goals are supposed to invest solely in companies whose activities support sustainable development. The current IBF industry focuses on negative screening by avoiding indebted and sin stocks. This approach may make it difficult for shariah investors to invest in good ESG performers. Few studies have been conducted to assess the ESG performance of shariah-compliant firms. Furthermore, this issue is unaddressed in India. ESG investors may readily embrace the shariah-compliant funds if the shariah-compliant firms are strong ESG performers. This embracement may alleviate the apprehension that these funds may become defunct due to low investor interest.

In this article, the environmental, social, and governance performance of shariah-compliant stocks belonging to Nifty50 are assessed. Though there is wide variability of scores for the categories and their respective components, they have a great emphasis on citizenship and corporate social initiatives. Overall, they have a good ESG performance which is in line with Qoyum et al. (2021) and Hassan et al. (2022). The findings show that shariah compliant stocks have a strong social commitment and are aligned with *maqasid al-shariah.* Nifty50 Shariah Index is appropriate for both Muslim investors and ESG investors.

Though the results are strong, it applies to large stocks only. Moreover, the sample size is small. Future studies may expand the sample to Nifty500 Index constituent stocks. It should be noted that different ESG data services follow different methodologies and there is no consensus on whose methodology is best. Hence, validation of these results with

ESG data from different data service providers may give them more robustness.

CONFLICT OF INTEREST STATEMENT

The author declares that he has no conflict of interest.

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