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Research Article

Sustainability Performance of Shariah-Compliant Equity Funds in India

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ABSTRACT: Sustainability is integrally linked to Islamic economic thought. Nonetheless, current Islamic banking and finance (IBF) practices do not take sustainability metrics into account when selecting the investable universe of firms, raising concerns that the IBF industry has strayed from this sustainability orientation of Islamic economic thought. The literature on this theme is scarce, particularly on the Indian market. This study examined the environmental, social, and governance (ESG) performances of all shariah-compliant funds in India. The large market capitalization fund has good performance in all three ESG categories, while funds with diverse market capitalization have only satisfactory performances in some categories. The variation could be due to their broad market capitalization orientation, as smaller firms are known to have poor ESG performance. Hence, explicit consideration of ESG performance in the shariah compliance screening methodology followed in India is required to align the IBF practices with the sustainability theme in Islamic economics. This consideration will increase the ESG performance of the funds, which will lead to their adoption by ESG investors regardless of their faith.

KEYWORDS: ESG, Sustainability, Islamic funds, Shariah-compliance, Indian Scenario.

INTRODUCTION

The origins of Islamic economic thought can be traced back to the early days of Islam in Maqasid al-Shariah (the aims of Islamic law), long before economics became a distinct field of study. Mudarabah, a type of profit-sharing, was widely used to support trade financing during the mediaeval era. Notwithstanding the rich history of Islamic economic thought, the emergence of Islamic banking and finance (IBF) as a distinct industry is more recent. The 1963 establishment of MitGhamr Savings Bank in Egypt, recognised as the world's first Islamic bank, is heralded as the birth of the modern IBF industry (Hussain, Shahmoradi and Turk, 2015). Since then, the IBF industry has grown dramatically. The global IBF industry is expected to grow by 10% in 2022–2023 (S&P Global, 2022). This growth, however, is primarily driven by asset growth in Malaysia and Gulf Cooperation Council (GCC) countries. In both 2012 and 2021, these nations accounted for more than 75% of all banking assets. In India too, the IBF industry is almost nonexistent (The Times of India, 2017). Although the first sharia-compliant fund was launched in 2009, there is hardly any interest from asset management companies (AMCs) on this theme. There are only one Shariah focused exchange traded fund (ETF) and two mutual funds in 2023.

The IBF industry has also lately begun to emphasise sustainability, which is a recent investment trend globally (Bhoyroo, 2022; Hammond, 2022). Indeed, Islamic economic thought is inextricably connected to sustainability. It stresses socio-economic justice (Aribi and Gao, 2010). It requires good sustainability practises (Sairally, 2015). Further, modern ethical standards for investing are similar to IBF industry practises in their detestation of investing in businesses that harm society, e.g., arms and tobacco (Wilson, 1997). Neverthless, the IBF industry has been criticised for its overly strong preference for negative screening for shariah compliance, which has the central theme of avoid businesses with interest-based activities. The screening procedures do not include environmental, social, or governance (ESG) performance metrics. These practises raise concerns about the deviation of the IBF industry from the Islamic economic thought of sustainability and social impact (Erragraguy and Revelli, 2015).

The existing literature indicates that Islamic banks and financial services firms are disinterested in ESG issues. These are mainly focused on profit maximisation and only look to meet shariah compliance requirements (Salma Sairally, 2013). They are less worried about the environmental issues (Mallin, Farag and Ow-Yong, 2014). They need to improve their overall and dimension-wise ESG performance (Alam, Banna and Hassan, 2022). However, there is some evidence that Shariah-compliant businesses do care about ESG issues. These firms are more inclined to follow sustainable and environmentally friendly practises (Alam, Banna and Hassan, 2022).These businesses outperform conventional businesses in terms of environmental and social performance (Qoyum et al., 2021). Nevertheless, the governance performance of shariah-compliant businesses is similar to that of conventional businesses (Hayat and Kabir Hassan, 2017; Qoyum et al., 2021). Overall, there is a dearth of studies that directly investigate the ESG performance of businesses selected according to the IBF investment selection procedure. Hence, this study investigated the ESG performance of Shariah-compliant funds with a focus on India.

The rest of the article is as follows. Materials and methods section provides data description and elaborates the methodology of the examination of the ESG performances of the Indian shariah-compliant funds. The results section presents the analyses. The final section interprets the results in the light of the extant literature and provides the implications for the investor community.

MATERIALS AND METHODS

The samples of stocks belong to three funds available in India, namely the Nippon India ETF Shariah BeES, the Tata Ethical Fund, and the Taurus Ethical Fund. The former has large stocks that only belong to the Nifty 50 index, while the latter two have large as well as small stocks. These funds have investable universe of stocks selected using shariah compliance methodologies. The first two funds use the shariah compliance methodology of Taqwaa Advisory and Shariah Investment Solutions (TASIS) (Tata Mutual Fund, 2021; NSE Indices Limited, 2022). Similar to many other methodologies, it conducts industry screening and excludes businesses that primarily earn from activities prohibited by Islam, including gambling, narcotics production and sales, conventional financial services, non-halal food production, and entertainment and related services. It also removes businesses that have the following characteristics:

1. The interest-based debt/total assets ratio is greater than 25 percent.
2. The total of interest income and returns from interest-based investments, which are presently considered at 7.5 percent, makes up less than or equal to 3 percent of total income.

3. The sum of receivables, cash, and bank balances is greater than 90 percent of total assets.

Taurus Ethical Fund follows the screening methodology of Ratings Intelligence (Taurus Mutual Fund, 2022). Like TASIS, it also removes businesses that primarily earn from activities prohibited by Islam. Further, it removes stocks that have the following characteristics:

1. The ratio of accounts receivable to the 36-month average market value of equity is greater than 48 percent.
2. The ratio of the sum of cash and interest-bearing securities to the 36-month average market value of the equity is greater than 32 percent.
3. The ratio of debt to the 36-month average market value of the equity is greater than 32 percent.

The data collection date is 4thFebruary 2023. The data regarding portfolio constituents of these funds is gathered from groww.in. The ESG performance data is gathered from Thomson Reuters' Refinitive ESG database. Their Refinitiv (2022) methodology involves comparing a firm's environmental (E) and social (S) score to those of other firms in the same industry. The governance (G) score are compared to firms belonging to the same country. The composite ESG score comprises of all three categories. A detailed methodology for estimating the scores is given in Refinitiv (2022). The score indicates not only performance on a particular metric but also the degree of openness with which pertinent ESG data is made available to the public. The score is on a scale of 0 to 100. A score of less than 25 denotes unsatisfactory relative performance. The score shows satisfactory relative performance if it is more than 25 but less than 50. If the score is greater than 50 but less than 75, it indicates a good relative performance. A score of 75 or higher is considered excellent relative performance.

The distribution and normality of ESG data for the funds are examined using boxplots. The normality of the ESG data for the funds is also assessed with the Shapiro-Wilk normality test. The t-test and Wilcoxon signed rank test are used to examine whether the ESG category performances of the funds are good. To understand the overall performance of the funds, the asset-weighted mean score of the ESG categories is also examined.

RESULTS AND DISCUSSION

The ESG panel of figure 1 presents the box plots of scores for ESG for the funds. The median of Shariabees lies almost above of the two other funds in all four panels of Figure 1, indicating its superior composite ESG performance, particularly in The S panel. Shariabees seems to have the lowest dispersion among the three funds. Nevertheless, it has an outlier in ESG, S, and G panels which is Coal India.

Table 1 presents the ESG performance of shariah-compliant funds. The normality test rejects normality assumption for four tests. So, Wilcoxon signed rank test should be considered as a non-parametric alternative. All funds show good performance the composite ESG category and the results are significant at less than 0.05 percent significance level. Only Shariabees show good performance for environmental category. The t-test results also support this finding. All funds have good social performance and the results are significant at less than 0.01 significance level. Both Shariabees and Tata ethical fund have good governance performance. The results are significant at 0.01 level in both t-test as well as Wilcoxon signed rank test. Nonetheless, Wilcoxon signed rank test could not reject the null hypothesis that the governance performance of Taurus ethical fund is below 50 and below good threshold. Since the portfolios of the funds could be heavily skewed towards some stocks, the overall ESG performances could be differ from the above results.

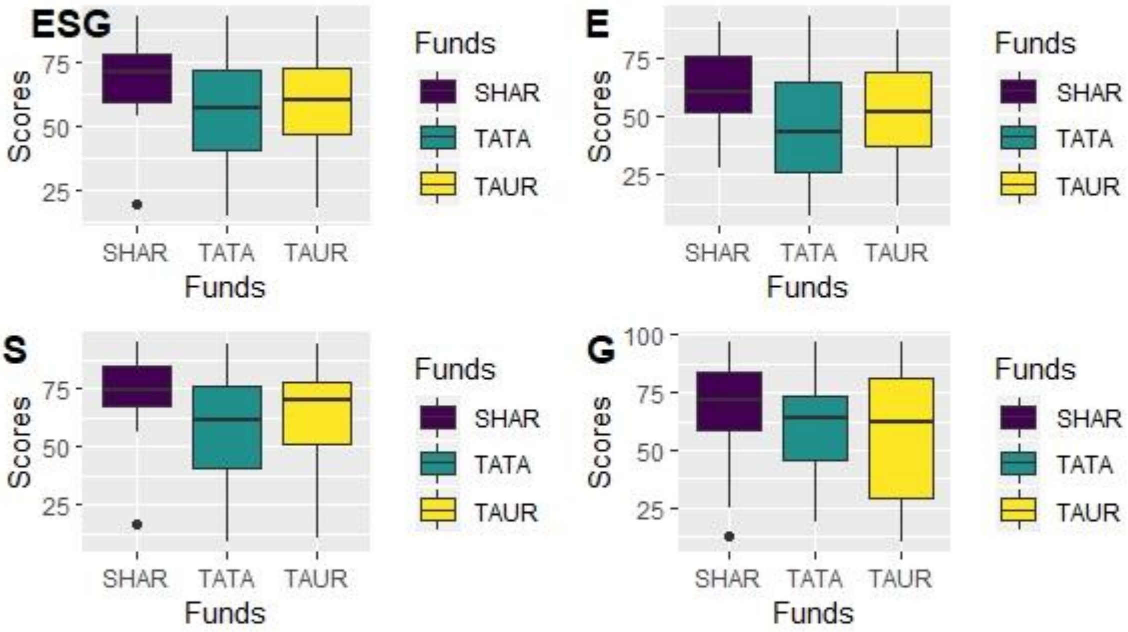

Figure 1: Box plots for ESG categories (E, S, and G means environment, social and governance performance respectively.

ESG is the composite score. SHAR, TATA, and TAUR means Nippon India ETF Shariah BeES, the Tata Ethical Fund, and the Taurus Ethical Fund.

Table 1: ESG performance of shariah-compliant funds

Category	Fund	SWNT p-value	Mean	T statistic	T test p-value	Median	WSRTsta tistic	WSRTp-value
ESG	SHAR	0.05	69.09	5.67	0.00	71.0	236.00	0.00
ESG	TATA	0.27	55.78	2.23	0.01	57.0	993.50	0.02
ESG	TAUR	0.34	58.79	2.55	0.01	60.0	419.00	0.01
E	SHAR	0.27	61.68	3.31	0.00	60.0	194.00	0.00
E	TATA	0.11	46.19	-1.20	0.88	43.5	607.50	0.88
E	TAUR	0.27	50.52	0.14	0.45	52.0	289.00	0.44
S	SHAR	0.01	73.23	6.20	0.00	74.0	238.50	0.00
S	TATA	0.08	59.17	3.19	0.00	61.5	1085.50	0.00
S	TAUR	0.10	64.61	3.92	0.00	70.0	463.50	0.00
G	SHAR	0.11	69.00	4.06	0.00	72.0	202.50	0.00
G	TATA	0.15	60.76	3.88	0.00	64.0	1136.00	0.00
G	TAUR	0.02	55.70	1.21	0.12	62.0	350.00	0.11

E, S and G means environment, social, and governance performance respectively. ESG is the composite score. SHAR, TATA, and TAUR means Nippon India ETF Shariah BeES, the Tata Ethical Fund, and the Taurus Ethical Fund. SWNT means for Shapiro-Wilk normality test. WSRT stands for Wilcoxon signed rank test.

Table II presents results for the overall portfolio of the funds by weighting scores accoding to the weightage of the stocks in their portfolios. Although the Shariabees has excellent composite ESG score whereas the two other funds have good scores in this category. Shariabees also has excellent scores in social and governance categories. Interestingly all funds have their lowest scores in environment category.

Table 2: Asset-weighted scores for funds

Category	Fund	Scores
ESG	SHAR	75.67370
ESG	TATA	63.19437
ESG	TAUR	60.86317
E	SHAR	64.40460
E	TATA	53.30979
E	TAUR	53.06385
S	SHAR	81.28540
S	TATA	67.06109
S	TAUR	66.52338
G	SHAR	76.43970
G	TATA	66.73899
G	TAUR	57.48119

E, S and G means environment, social, and governance performance respectively. ESG is the composite score. SHAR, TATA, and TAUR means Nippon India ETF Shariah BeES, the Tata Ethical Fund, and the Taurus Ethical Fund.

CONCLUSION

The statistical results broadly indicate good composite ESG performance for all three funds. The performance in the social category is good for all funds, supporting Qoyum et al., (2021) and Alam, Banna and Hassan (2022). The Shariabees is the top performer among the three in every aspect. The results for Shariabees regarding environmental and social performances strongly support Qoyum et al. (2021) and Hassan et al., (2022). The superior performance of the Shariabees is plausibly due to its concentrated portfolio of larger stocks compared to the other two funds, and supports the findings of Drempetic, Klein and Zwergel (2019) that firm size and ESG scores are positively related. Wu (2006) also find that larger firms face more public pressure to spend on social activities. Future work may examine this conclusion in detail by evaluating the ESG performance of large and small Shariah-compliant firms. Moreover, this study could be expanded by using ESG data from other providers to check the robustness of the results.

Since some results indicate performances below good category for diverse market capitalisation funds, this work supports Erragraguy and Revelli (2015) conclusion that ESG performance metrics must be explicitly considered while evaluating the shariah compliance of the firms. For instance, the ESG performance of Shariabees may improve further if Coal India is dropped from its portfolio on the grounds of poor ESG performance. The nascent IBF industry in India could greatly benefit if this positive screening approach is adopted by AMCs, which will promote interest in shariah-compliant funds among ESG investors, irrespective of their faith.

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