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UNDERSTANDING SHARIAH SCREENING METHODOLOGY

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BURSA MALAYSIA

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Article

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ISLAMIC EQUITIES, SHARIAH COMPLIANCE, SHARIAH SCREENING

Malaysia has cemented its position as the global centre of the Islamic Capital Market (ICM) by developing various capacities and capabilities in every segment of the market. The holistic approach adopted by the Securities Commission of Malaysia to institutionalise a comprehensive legal, regulatory and Shariah framework, as well as a tax structure, has contributed to the strong growth of the Islamic Capital Market. It is no surprise, therefore, that Malaysia houses an ever-growing number of leading Islamic fund management and stockbroking companies that offer first-class Shariah-compliant funds and services to both local and international investors.

The sustained interest in Malaysia of the Islamic Capital Market's major players has resulted in ICM growth outpacing the growth of its conventional counterpart.This is further evidenced by the continuous double-digit growth in the market capitalisation of Shariah-compliant equities and the net asset value of Shariah-compliant unit trust funds.

A key driver of this growth appears to be the high level of confidence that market players and investors have in the Islamic Capital Market's Shariah governance measures. The revised and comprehensive Shariah stock screening methodology provides a higher level of certainty and assurance about the Shariah-compliant nature of the companies listed on the stock exchange.

Stock Screening vs Shariah Stock Screening

Stock screening is a process of identifying and selecting, from the stock exchange universe, those companies that meet certain criteria. The focus of the screening procedure might be: financial performance in the case of index building; or ESG (Environmental, Social and Governance) performance if the screening is related to the company's level of responsibility towards social and environmental needs;or the quality of fiduciary stewardship on behalf of the company's stakeholders.

Unlike in the conventional market, transactions in the Islamic Capital Market are carried out only in ways that do not conflict with Shariah law. This necessitates the creation of a specialised stock screening process to identify and list Shariah-investable companies. This process is known as Shariah stock screening.

The Beginnings

In Malaysia's Islamic Capital Market, the Shariah stock screening methodology was established as early as in the mid-1990s. Back then, the Shariah governance framework in Malaysia's financial market was rather unique as it had adopted a centralised approach. This contrasted with the market approach practiced by the international markets to determine Shariah matters.

In a centralised approach, the market regulator or authority sets the standard of Shariah requirements to be adopted through fatwas or scholars' opinions issued by its own Shariah Advisory Council. In a market approach, the market players or financial institutions issue their own fatwas through their own Shariah boards while the financial authority observes and monitors the developments.

The Shariah stock screening process called for the filtering of data and examining the information contained in the listed company's latest published annual report. Should the information in the annual report be deemed insufficient, a physical due diligence exercise was to be performed, although this requirement was to be decided on a case-by-case basis.

Elaborating on this minimal frame of reference, the Shariah Advisory Council of the Securities Commission of Malaysia introduced, in 1995, a comprehensive Shariah stock screening methodology comprising four activity-based screening benchmarks, which required both quantitative and qualitative assessments. In June 1997, the first list of screened Shariah-investable stocks was announced and published. Eventually, the time and frequency of this listing would change to two times a year – in May and November.

The Revisions

This initiative demonstrated the effort to harmonise the Shariah stock screening standards with global expectations and to spur capital inflows, especially from investors in the Middle East. The revised version has been received positively by international investors and market players who have been adopting the practice of global Shariah index providers such as the Dow Jones Islamic Market Index.

Structure & Process

One of the best ways to understand the concept and application of the Shariah stock screening methodology is by breaking it down into two components – its structure and its process.

The structure of the Shariah stock screening methodology in use now includes the test of a company's core business activity and its financial ratios, and the assessment of public perception and image of the company. The test portion is usually referred to as the quantitative test and the assessment portion is referred to as the qualitative test. For a company to be Shariah-investable, it must pass both tests.

In its process component, the Shariah stock screening methodology uses several tiers of filtering processes to produce the list of Shariah-investable stocks. The filtering process begins with the quantitative components and is followed by the qualitative.

The quantitative filtering process follows the prescribed benchmarks in both the core business activity and the financial ratios of the companies. The qualitative filtering process usually relies on the views of the Shariah Advisory Council of the Securities Commission.

In practice, three types of business activities are subjected to filtering in the Shariah screening process: Shariah-permissible business activities, Shariah non-permissible business activities, and mixed activities.

- Shariah-permissible business activities include the provision of lawful needs, goods and services, like food, garments, furniture, education, and healthcare.

- Shariah non-permissible business activities include conventional banking and conventional insurance, gambling, liquor and liquor-related activities, pork and pork-related activities, non-halal food and beverages, Shariah non-compliant entertainment, tobacco and tobacco-related activities, and other activities that are deemed Shariah non-compliant.

- Mixed business activities are a combination of both permissible and non-permissible activities.

While Shariah-permissible stocks and Shariah non-permissible stocks are quite easy to filter, the challenge lies in the mixed category.

For companies with mixed business activities, the guidelines for Shariah stock screening stipulate the application of -

- the 5% benchmark if the activities involve conventional banking, conventional insurance, gambling, liquor and liquor-related activities, pork and pork-related activities, non-halal food and beverages, Shariah non-compliant entertainment, interest income from conventional accounts and instruments, and tobacco and tobacco-related activities, or

- the 20% benchmark if the activities involve hotel and resort operations, share trading, stockbroking, rental received from Shariah non-compliant activities, and other activities that are deemed Shariah non-compliant.

The 5% and 20% benchmarks are referred to as the thresholds of tolerance.

In practice, for any company holding a subsidiary with a mixed business activity that includes, for example, the banking business, the percentage of the revenue from the activity in the group's revenue or the percentage of the profit before tax of the activity in the group's profit before tax must be less than 5%. If it is 5% or more, it fails the filtering process.

The same method of calculation, but using 20% as the benchmark, is used in the filtering process for companies with mixed business activities involving hotel and resort operations, share trading, stockbroking, and rental received from Shariah non-compliant activities.

The second-tier of the filtering process involves the screening of the company's financial ratios. The need for screening financial ratios lies in the Shariah trading rules, which apply differently to different classes of commodities, debts, assets, etc. For example, cash and accounts receivables, which are considered financial assets, may not be traded at a premium or a discount.

This means that the category of assets into which a stock or equity falls must be determined. Shariah scholars in Islamic finance have unanimously agreed that equity or stock is a general type of asset that can be traded at a premium or a discount. This also means that the price of a stock can be traded at market value or negotiated at a willing buyer and willing seller price.

Keeping in mind that a company's stock value cannot be accurately reflected from the company's cash and cash equivalent instruments or interest-bearing debt, the Shariah Advisory Council of the Securities Commission of Malaysia has set a tolerance threshold, or benchmark, of 33% of the company's cash and cash equivalent instruments as well as the interest-bearing debt over its total assets. Anything at 33% or above would render the stock Shariah non-compliant

Summary

Malaysia's Shariah Stock Screening Methodology

1. Quantitative Screening of Business Activity

5% Tolerance Threshold

a. To assess the level of mixed contributions from clearly prohibited activities, such as interest-based activities, gambling, liquor and pork, interest income from conventional accounts and instruments, and tobacco-related activities.

b. Where the company is involved in any of the above business activities, the stock screening process calculates the percentage of the revenue of the activity over the group revenue or the profit before tax of the activity over the group profit before tax (whichever is higher).

c. Calculation:

- Step 1. Determine the total income and profit before tax from the company's financial statements.

- Step 2. Determine the income and profit before tax from the non-permissible activities.

- Step 3. Calculate the percentage as follows:

  i. [Income from non-permissible activity / Total income] x 100

  ii. [Profit before tax from non-permissible activity / Profit before tax from all activity] x 100

- Step 4: Determine which is higher and check whether it is less than 5%

The result of the above calculation must be less than 5% to pass the Shariah stock screening process.

20% Tolerance Threshold

a) To assess the level of mixed contributions from activities generally permissible according to Shariah and also have an element of maslahah (public interest) but might involve other elements that affect the Shariah status of these activities e.g. hotel and resort operations.

b) Where the company is involved in any of the above business activities, the stock screening process calculates the percentage of the revenue of the activity over the group revenue or the profit before tax of the activity over the group profit before tax (whichever is higher).

c) Calculation:

- Step 1: Determine the total income and profit before tax from the company's financial statements.
- Step 2: Determine the income and profit before tax from the non-permissible activities.
- Step 3: Calculate the percentage as follows:
    - 1. [Income from non-permissible activity / Total income] x 100
    - 2. [Profit before tax from non-permissible activity / Profit before tax from all activity] x 100
- Step 4: Determine whichever is higher and check whether it is less than 20%

The result of the above calculation must be less than 20% to pass the Shariah stock screening process.

2. Quantitative Screening of Financial Ratio

33% Tolerance Threshold

a) To assess the level of a company's cash and cash equivalent instruments as well as the interest-bearing debt over its total assets.

b) Calculation for the cash and cash equivalent over total assets:

- Step 1: Determine the total cash and cash equivalent from the balance sheet.
- Step 2: Determine the total assets from the balance sheet.
- Step 3: Calculate the percentage as follows:

  [Cash + Cash equivalent / Total asset] x 100

- Step 4: Check whether it is less than 33%

  The result of the above calculation must be less than 33% to pass the Shariah stock screening process.

c) Calculation for the interest-bearing debt over total assets:

- Step 1: Determine the total interest-bearing debt, debt instruments and Shariah-compliant financing (if any) from the balance sheet.
- Step 2: Determine the total assets from the balance sheet.
- Step 3: Calculate the percentage as follows:

  [Interest bearing debt + debt instruments — Shariah-compliant financing / Total assets] x 100

- Step 4: Check whether it is less than 33%

The result of the above calculation must be less than 33% to pass the Shariah stock screening process.

3. Qualitative Screening of Public Perception and Image of the Company

To assess the policies or activities of the company that might breach Shariah rules and tarnish the image of Islam.

This process is conducted on a case-by-case basis by the Shariah Advisory Council of the Securities Commission of Malaysia on two criteria, as follows:

a) The public perception or image of the company must be good, and

b) The core activities of the company are important and considered maslahah (in public interest) for the Muslim ummah (community) and the country, and the non-permissible element is minor and involves matters such as `umum balwa (common plight and difficult to avoid), `uruf (custom) and the rights of the non-Muslim community accepted by Islam.