Garden of Knowledge and Virtue

ISLAMIC EQUITY AND STOCK MARKET

Presented By:
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• Islamic Stock Market
• Shariah principles in Finance
• Basics of Islamic Equity
  • Stock screening based on negative list and financial benchmarks
  • Purification of non-halal income
• Conclusion
Islamic Stock Market

• A market that provides a platform for players to buy or sell Shariah-compliant securities and whose operations conform to Shariah principles
Shariah Principles in Finance

• Freedom of contracts—provided the prohibited elements are avoided

• Some aspects of the contractual relationship determined by Shari’ah/Fiqh to avoid
  • Injustice
  • Conflicts/Misunderstandings
  • Exploitation, fraud

• The prohibitions in transactions include:
  • *Riba*
  • *Gharar*
  • *Maysir (gambling)*
  • *Prohibited commodities*
Riba

- **Riba** (literal meaning ‘increase’) is prohibited
  “...they say: trading is only like riba, whereas God has permitted trading and forbidden riba...” (Quran 2:275)
- Various interpretations of *riba*
- Implications of *riba*:
  - Interest is forbidden
  - Selling debt (at a discount) is not allowed
Gharar

- *Gharar*—Excessive risk, hazard, or ambiguity
- *Gharar* can exist in the object or terms of the contract such as delivery time, price, mode of payment or doubts over the ability to deliver

**Implications of gharar:**
- Existence of the object (& ability to deliver)
- Two sales in one
- The future sale
Maysir (gambling)

• A game of chance between two contracting parties, each of whom undertakes the risk of loss and the loss of one means gain for the other

• Stock market can be used for speculative activities
Transactions involving prohibited commodities

• Not allowed to trade prohibited commodities such as pork, liquor, etc
• Exchange to provide a Shariah compliant list
Prohibition of fraud and deception

- Concealing of defects and adulteration of merchandise
- Contracts specifications are clearly spelt out
Basics of Islamic Equity

• Currently there are no international Shari'ah standard to determine whether a particular stock is Shariah compliant
• Different jurisdictions/funds or fund managers utilize different standards based on their respective Shari'ah councils
• In Malaysia we have the list issued by Syariah Advisory Council of Securities Commission, Dow Jones-RHB Islamic Malaysia Index and FTSE Bursa Malaysia namely FBM Hijrah Shariah Index and FBM EMAS Shariah Index
• At the global level we have the AAOIFI standard, Dow Jones Islamic Market Indexes, FTSE Global Islamic Index Series and S&P Islamic Index Series and MSCI Islamic Index Series, etc
Screening Methodology for Shari'ah-Compliant Stocks

• Rules to ensure that the company ordinary shares are Shari'ah compliant

• The stock screening process is divided into two stages:
  • Negative List Screening - Evaluation in terms of company activities, products and industry
  • Financial ratios benchmarks - Computation of a set of financial ratios & compare them against specified benchmarks

• The screening process begins by screening the company in terms of its activity, products and industry
  • alcohol, tobacco, pork-related products, conventional financial services, weapon and defense, entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.) are excluded
Screening Methodology for Shari'ah-Compliant Stocks

- Next, a set of measures called financial filters is also used to refine the selection.
- The filters use a number of financial ratios and compare them against their respective benchmarks to weed out non-Shari’ah compliant stocks.
- The data for ratios are obtained from Balance Sheet and Income Statement. Dow Jones and S&P Indexes use stock market data as well.
- In general these ratios can be grouped into 3; liquid assets, interest income and leverage.
- The ratio benchmark ranges from:
  - Liquid asset: 17% to 70%
  - Interest income and/or Income from Shariah Non-compliant activities: 5% to 15%
  - Leverage: 30% to 33%
Screening Methodology for Shari'ah-Compliant Stocks:

Securities Commission of Malaysia

- Securities Commission of Malaysia applied additional criteria to companies which are involved in multiple business, i.e., companies whose business activities comprise both Shari'ah permissible and non-permissible elements. The analysis is done at the holding company, subsidiary company and associate company levels. The additional criteria include:
  - Core activities of the company are activities not against the Shari'ah principles as mentioned earlier
  - Haram element is small compared to core activities, i.e., compared against benchmark
  - Public image/perception of company is good
  - Core activities of the company are important and of public interest (maslahah) to the Muslim ummah and the country
  - Proportion of haram element is small and in matters such as umum balwa (common plight), ‘uruf (customs) and the rights of the non-Muslim community which are accepted by Islam
• It may be possible that a company’s main business is Shari’ah compliant but the revenue from the subsidiary whose activities are not Shari’ah compliant may lead to that company being considered as non-Shari’ah compliant.
Screening Process of SAC, Securities Commission, Malaysia

Stage 1
Activity, Industry & Product
- Financial services based on riba (interest)
- Gambling/gaming
- Manufacture and/or sale of non-halal products
- Manufacture or sale of tobacco-based products or related products
- Conventional insurance (gharar)
- Entertainment
- Stockbroking or share trading in Shari’ah non-compliant securities
- Other activities deemed non-permissible

Stage 2
Quantitative Analysis
- TO and PBT of non-approved activities
- SOP of non-approved securities
- Interest Income
- Dividend received from investment in non-approved securities
- All of the above must be below certain threshold

Stage 3
Qualitative Analysis
- Image – public perception or image of the company, importance of the companies to ummah, uruf (custom), umum balwa (common plight), rights of non-muslims etc.

Permissible

• List is updated every end of May and end of Nov. Previously it was end of April and October
SC - Financial benchmarks

• **The 5-percent benchmark**
  • to assess the level of mixed contributions from the activities that are clearly prohibited such as riba (interest-based companies like conventional banks), gambling, liquor and pork

• **The 10-percent benchmark**
  • to assess the level of mixed contributions from the activities that involve the element of ‘umum balwa’ which is prohibited element affecting most people and difficult to avoid e.g interest income from fixed deposits in conventional banks and tobacco-related activities
• **The 20-percent benchmark**
  - This benchmark is used to assess the level of contribution of mixed rental payments from Shariah non-compliant activities, such as rental payments from premises used in gambling, sale of liquor, etc.

• **The 25-percent benchmark**
  - To assess the level of mixed contributions from the activities that are generally permissible according to Shari’ah and have an element of maslahah to the public, but there are other elements that may affect the Shari’ah compliance status of these activities for e.g hotel and resort operations, share trading, stockbroking, as these activities may also involve other activities that are deemed non-permissible to the Shari’ah.
# Financial Filters of SAC, SC Malaysia

<table>
<thead>
<tr>
<th>II</th>
<th>PROHIBITED INCOME</th>
<th>≤ 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Interest Income/Group Turnover</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Non Permissible Income other than Interest Income/Revenue</td>
<td>≤ 5%</td>
</tr>
<tr>
<td>8</td>
<td>Income from Tobacco/Revenue</td>
<td>≤ 10%</td>
</tr>
<tr>
<td>11</td>
<td>PBT of Subs or Asso Co (non-halal activity)/PBT of Group</td>
<td>≤ 5%</td>
</tr>
<tr>
<td>12</td>
<td>PBT of Subs or Asso Co (mixed rental income)/PBT of Group</td>
<td>≤ 20%</td>
</tr>
<tr>
<td>13</td>
<td>PBTax of Subs or Asso Co (hotel &amp; resort)/PBT of Group</td>
<td>≤ 25%</td>
</tr>
<tr>
<td>14</td>
<td>Turnover of Subs or Asso Co (non-halal activity)/Turnover of Group</td>
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<td>Turnover of Subs or Asso Co (hotel &amp; resort)/Turnover of Group</td>
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</tr>
</tbody>
</table>
Screening Process of Dow Jones Islamic Index (2003)

**Stage 1**
- Activity, Industry and Product
  - Non-Permissible Activities:
    - Pork Production
    - Non-Halal Food Products
    - Alcohol Beverages
    - Gaming
    - Interest based Financial Institution
    - Entertainment
    - Arms, Defense
    - Tobacco
    - Activities Contrary to Islam

**Stage 2**
- Financial Ratio Filters
  - Total Debt to Trailing 12-Month Moving Average Market Capitalization ≤ 33%
  - Account Receivables to Trailing 12-Month Moving Average Market Capitalization ≤ 33%
  - Cash + Interest Bearing Securities to Trailing 12-Month Moving Average Market Capitalization ≤ 33%

* List is updated every quarter
Screening Process of FTSE Global Islamic Index Series (In collaboration with Yasaar, 2006 onwards)

<table>
<thead>
<tr>
<th>Company</th>
<th>Stage 1</th>
<th>Stage 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity, Industry and Product</td>
<td></td>
<td>Financial Ratio Filters</td>
</tr>
<tr>
<td>Non-Permissible Activities:</td>
<td>- Pork Production</td>
<td>• 5 ratios are computed</td>
</tr>
<tr>
<td>• Pork Production</td>
<td>• Non-Halal Food Products</td>
<td></td>
</tr>
<tr>
<td>• Alcohol Beverages</td>
<td>• Gaming</td>
<td></td>
</tr>
<tr>
<td>• Interest based Financial Institution</td>
<td>• Entertainment</td>
<td></td>
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<tr>
<td>• Arms, Defense</td>
<td>• Tobacco</td>
<td></td>
</tr>
<tr>
<td>• Activities Contrary to Islam</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* List is updated every quarter

* Drop

* Yes

Permissible

Cleanse tainted dividend

Yes

Drop

5%

No
## FTSE FINANCIAL FILTERS

<table>
<thead>
<tr>
<th></th>
<th>LIQUIDITY</th>
<th>FTSE GI**</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Acc Rec + Cash/Total Asset</td>
<td>&lt; 50%</td>
</tr>
<tr>
<td>6</td>
<td>Cash + Int Bearing Sec/Total Assets</td>
<td>&lt; 33%</td>
</tr>
</tbody>
</table>

### PROHIBITED INCOME

<p>| | | |</p>
<table>
<thead>
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</tbody>
</table>

### DEBT

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Total Debt/Total Asset</td>
<td>&lt; 33%</td>
</tr>
</tbody>
</table>
Screening Process of S&P Shariah Indices

Stage 1
Activity, Industry and Product
Excludes:
- Pork Production
- Non-Halal Food Products
- Alcohol Beverages
- Gaming
- Interest based Financial Institution
- Entertainment
- Arms, Defense
- Tobacco
- Gold & silver trading as cash on deferred basis
- Activities Contrary to Islam

Stage 2
Financial Ratio Filters
- 4 ratios

Drop

Permissible
Cleanse tainted dividend

* List is updated every quarter
# S&P FINANCIAL FILTERS

<table>
<thead>
<tr>
<th></th>
<th>LIQUIDITY</th>
<th>S&amp;P SI</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Acc Rec/12 Mth MA Market Cap</td>
<td>&lt; 49%</td>
</tr>
<tr>
<td>5</td>
<td>Cash + Int Bearing Sec/12 Mth MA Market Cap.</td>
<td>&lt; 33%</td>
</tr>
<tr>
<td></td>
<td><strong>PROHIBITED INCOME</strong></td>
<td></td>
</tr>
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<td><strong>DEBT</strong></td>
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</tr>
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<td>1</td>
<td>Total Debt/12 Mth MA Market Cap</td>
<td>&lt; 33%</td>
</tr>
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MSCI Shariah Index

• Established in May 2007
• Stage 1: Core Business – Negative Screen:
  • Alcohol
  • Tobacco
  • Pork-related products
  • Financial services
  • Defense/weapons
  • Gambling
  • Music
  • Hotels
  • Cinema
  • Adult Entertainment
• Stage 2: Financial Filters

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debt/Total Assets</td>
<td>&lt; 33.33%</td>
</tr>
<tr>
<td>Cash + Interest-bearing securities / Total Assets</td>
<td>&lt; 33.33%</td>
</tr>
<tr>
<td>Account Receivables / Total Assets</td>
<td>&lt; 70%</td>
</tr>
</tbody>
</table>

• Stage 3: Dividend Purification

• Argues that part of company’s total income is derived from interest income. Hence a portion of dividend paid out to shareholders must be deducted and given out to charity
• Dividend adjustment factor is used to determine “clean dividends”
• Calculated as follows:
  • \((\text{Total Earnings} - \text{Interest Income}) / \text{Total Earnings}\)
• Note that Total earnings are defined as gross income, and interest income as operating and non-operating interest
Jakarta Shariah Index

• Stage 1: Core Business Selection-Negative Screen
  • Gambling
  • Conventional financial institutions
  • Production, distribution, provision and trading of products and services that are prohibited by Shariah

• Stage 2: Financial Filters
  • Interest-bearing debt/Total Equity : <45%:55% or 81.82%
  • Interest Income & Income from Non-Shariah compliant business activities/Total Revenue: ≤ 10%
AAOIFI Criteria for Shariah Compliant Shares

• Requirement for main business of company not to engage in prohibited business according to Shariah

• Financial filters and their respective benchmarks are as follows:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Interest -based Debt/Total Asset</td>
<td>30%</td>
</tr>
<tr>
<td>Income from prohibited activity/Total Income</td>
<td>5%</td>
</tr>
</tbody>
</table>
Purification of Non-halal Income

- Investor/Unit trust fund receives income from invested companies in the form of dividend and capital gain. Not all income are considered “clean”. Some are derived from non halal sources such as interest income.
- Purification of income requires identifying the prohibited income received from invested companies and deducting it from the total income prior to distribution.
- The income net of purification is then distributed to the investors.
Purification of Non-Halal Income

• The prohibited income cannot be distributed to investors but instead donated to charities
• It is also possible for the fund manager to allow discretion to investors in deciding the recipient charitable organization
• No consensus among Shari’ah scholars in implementing purification
• No standard available from AAOFFI but provides a method to compute the prohibited income
• FTSE GII recommends 5% of the dividend received is taken out and given to charities
• S&P SI provides the following formula to estimate tainted dividend
  • Div*(Non-permissible Revenue/Revenue)
Conclusion

• No commonly agreed standard on what constitutes a Shariah compliant securities
  • A stock can be pronounced as Shariah compliant by one body but not Shariah compliant in another body
• Do we need to purify “tainted” income?
THANK YOU & WASSALAM