

New hope dawns in the pearl of Asia

Sri Lanka stands a good chance of establishing itself in the global Islamic finance market due to its effective government policies, Shariah compliance framework, and a comprehensive Islamic capital market. MUATH MUBARAK delves further.

Islamic finance is a familiar buzz word in the financial markets and has been in the spotlight since the recent global financial crisis. This niche market segment is growing at a high rate, and creating history in the financial world.

On the other hand, this steady and speedy growth has led to demand for various Shariah compliant instruments by Shariah and ethically conscious investors (Muslims and non-Muslims) as per their preferences. This thrust is inspiring the birth of some innovative and creative investment products within the purview of Shariah and with the endorsement of Shariah scholars.

“ Primary markets are where company shares are issued directly to the public by the issuer ”

Islamic capital markets

The Islamic capital market is defined as a market where Shariah compliant securities are traded (buyers and sellers meet) as per Islamic rules and regulations. This market includes Shariah compliant stock/shares or Sukuk and other market instruments. The capital market is used by organizations in order to raise funds through the primary market or secondary market.

Primary markets and secondary markets

Primary markets are where company shares are issued directly to the public by the issuer, while the secondary market is where the shares are subsequently traded between the buyers and sellers in the financial market.

Primary market activity is usually in

Share screening/purification process

Stage 1 (Industry screen/core business activity screen)

(Qualitative parameters) The underlying business activity (of the holding subsidiary company) should be free from the followings:

- Conventional banking & finance
- Conventional insurance
- Alcohol & pork
- Gambling & speculation
- Pornography
- Weapons/arms production
- Hotel (casinos)

Stage 2 (Financial screening)

(Quantitative parameters) Examine the impact of non-Shariah compliant financial behaviour in the company. This filtering can be done based on the following ratios:

- Debt/total market capitalization = <33%
- Cash & Equity/total market capitalization=<33%
- Account receivable/total assets <45%
- Revenue from prohibited activities/revenues<5%

(Note: There are four globally accepted 'white listed' indices. The ratios and the screening stages may differ somewhat between different indices but overall they all adopt the same methodology, as explained above).

the form of IPOs. Investors purchase financial market instruments such as shares, bonds, trust funds, private equity, mutual funds, exchange funds and hedge funds in order to maximize their returns on investment through the permitted methods.

These financial markets have evolved over period of time and modern technologies now allow an investor to trade or take an economic decision by observing the (share) price movements. These markets have been highly regulated to protect the investors.

However, we do understand that people have been using loopholes of the underlying system in order to speculate, which is completely prohibited in Islam.

Shariah compliant investors always seek

additional objectives to conventional investors, such as additional Shariah compliant objectives and behavioral ethics. This requires a separate need for an Islamic capital market.

The Islamic capital markets first emerged in the 1990s. The additional layer of Shariah is the core of any economic decision-making for Shariah conscious investors, along with the ROI (return on investment), safety/security of the investment, etc.

Share screening methodology

This requires additional Shariah and ethical dimensions to be visible when buying or selling any shares of companies. In order to filter these companies' shares, a mechanism was

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implemented called the share screening methodology in the early 1990s. Furthermore, in 2005 Qatar and Malaysia took initiatives to introduce Islamic brokerage houses.

There several attempts and plans were drawn up, and these Islamic firms are often more committed and service-oriented compared to conventional brokerage houses. In order to attract investors, the shares require purification or 'white listing' before they can catch the interest of Shariah compliant investors to park their funds.

This purification can be done mainly through two stages: namely industry screening (qualitative parameters) and financial screening (quantitative parameters) as per the AAOIFI Shariah Standard No. 21. The preceding diagram explains the whole process of the screening methodology.

Colombo Stock Exchange

Many developed countries have more than one stock exchange, based on the size of their economy and the number of companies listed, but Sri Lanka has only one: the Colombo Stock Exchange (CSE).

This was established in 1985 and has a fully owned subsidiary, Central Depository Systems, which is responsible for all electronic records of the listed companies. The CSE market segments include a debt market, equity market, derivative market and funds market.

The CSE has been recognized as one of the most advanced stock exchanges in South Asia since the war era came to an end and the focus in Sri Lanka shifted to economic development. The estimated GDP growth rate of the country for 2011 is approximately 8%.

The end of three decades of civil war gave hope to the Sri Lankans in many ways. The two digit inflation rate narrowed down to one digit during 2010, the exchange rate appreciated, interest rates fell to one digit, yields on government bonds and treasury bills rose, and the government launched aggressive campaigns to promote tourism, infrastructure and agriculture and many more initiatives.

This led many companies to launch IPOs

early this year and according to some analysts, around 20 companies are in the pipeline for IPOs before end of 2011.

Currently more than 250 companies have already been listed in the CSE. This is a very small exchange when compared to other regions but the current economic development has given new hope to Sri Lankans.

Currently the Sri Lankan economy is poised to take off with astonishing growth, which is witnessing approved numbers increase in stock broking companies and growing numbers of local listed companies.

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Furthermore the daily turnover of the CSE is now touching nearly LKR2 trillion (US\$18 million). There are 27 stock brokerage companies operating in the CSE and most of them are now offering online trading along the lines of other developed nations.

In addition, there are a few institutions which are heavily involved in white listing Sri Lankan companies, making available Shariah compliant shares for trading.

As per the market analysts, there are more than 140 white listed companies in the CSE, in various sectors including food and beverages, chemicals, agricultural, health care, IT, manufacturing, trading, telecommunication and plantation.

The deprived Sri Lankan Shariah investors and other ethically concerned parties were also happy to see the first

fully fledged Islamic bank in the country. It took more than a decade to achieve the launch of Sri Lanka's first commercial Islamic bank, however, due to various inherent issues within the country's system.

Likewise there have been efforts to develop the Islamic capital market in Sri Lanka since this market segment has not been treated well as per the expectation of investors.

However, the established market players have now jumped into the market to grab the first mover advantage over others by introducing white listed shares.

Market players are also realizing the potential of exploring other instruments in addition to equity; and are looking at creating Shariah compliant funds and unit trusts in order to provide the Sri Lankan community with more viable Shariah compliant opportunities.

All these positive moves show us the strong appetite for Islamic finance investment opportunities in Sri Lanka. Even the players who look at Islamic finance simply as an alternative finance system are realizing that if they follow the same methodology in selecting the shares for trading, it will be beneficial for everyone.

Conclusion

Well articulated and effective government policies; an appropriate Shariah compliance framework; efficient, effective and market-based regulatory, tax and legal frameworks; accelerated institutional infrastructure set up; and comprehensive Islamic capital market product and services offerings in the market will drive this young local niche market segment.

This is the new hope dawning in the hearts of Sri Lankans, especially Shariah-conscious investors, based on the end of the civil war and the proactive initiatives of the government towards the economic development of the country.⁽²⁾

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