Islamic BANKING & FINANCE

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BRAZIL SPREADS ITS WINGS
Opportunities in booming economy

COMPLIANT EQUATIONS
Ethics by algebra

SCREENING SHARES
Comparing methods

Share screening **methodology**

Filtering is a vital part of the investment process into Islamic capital markets. **Muath Mubarak** provides an overview of the white-listing process

ISLAMIC CAPITAL markets are a growing sector. They allow investors to transfer excess funds from surplus units to deficit units and to those in need of money. Islamic capital market instruments are an ideal investment vehicle for Shariah-conscious and ethical investors.

Investors usually rely on fund managers to select shares based on Islamic principles. This predetermined screening criteria is known as share screening or purification methodology.

Criteria

Two types of screening are considered in filtering or white listing the shares in Islamic fund management. The first is referred as an "industry screen" and the other is a "financial screen". It is implemented based on AAOIFI Shariah Standard 21 (see diagrams opposite).

These two screening methodologies are carried out by Islamic indices companies to ensure shares are sufficiently white listed for Islamic financial clientele to trade.

The index is a basket of filtered shares according to Islamic principles. Shares have been carefully screened based on the two tests.

In the early days, Islamic fund or share performance was benchmarked against conventional indexes, based on a weight for the unacceptable shares. With the introduction of Islamic indices, this practice was no longer required.

There are a number of professional firms that carry out these two screening tests with their own Shariah supervisory board to ensure Shariah compliance. Islamic indexes do not follow standardised criteria to identify white-listed shares. Companies that index shares include Dow Jones Islamic Market Index (DJIMI), FTSE, MSCI, Standard & Poors and Russel Jadwa.

Dow Jones Islamic Market Index

The Dow Jones Islamic Market Indexes include nearly 70 Islamic indexes that cover a variety of Shariah-compliant equities and fixed income securities across the globe.

Three tests are given to white list a share.

❶ Industry screening—the primary business must be halal and exclude activities involving alcohol, pork-related products, conventional financial services, entertainment, tobacco and weapons and defense.

❷ Financial ratios or constraints. The following should be less than 33%:

- Total debt divided by trailing 12-month average market capitalisation
- The sum of a company's cash and interest-bearing securities divided by trailing 12-month average market capitalisation
- Accounts receivables divided by trailing 12-month average market capitalisation

Stage 1 - Industry / core business activity screen

The underlying business activity of the holding or subsidiary company should be free from:

Conventional banking & finance
Conventional insurance
Alcohol & pork
Gambling and speculation
Pornography
Weapons / arms production
Hotels / casinos

Stage 2 - Financial screen

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 capitalisation = <30%
Cash & equity / total market capitalisation = <30%
Accounts receivable / total assets = <45%
Revenue from prohibited activities / revenue = <5%

❸ Continuous monitoring of the above variables. If a company share is slipping from the above norm, it will be removed from the white list.

The FTSE Global Islamic Index Series

The FTSE Global Islamic Index includes five regional indices—Global, America, Europe, Pacific Basin and South Africa. The following list of business activities is excluded.

- Banking or any other interest-related activity
- Alcohol
- Tobacco
- Gaming
- Arms manufacturing
- Life insurance
- Pork production, packaging and processing or any other pork-related activity
- Sectors or companies significantly affected by the above
- Companies whose gross interest-bearing debt to total assets exceeds the percentage permitted under Shariah law from time to time (33% as per the Golden Rules of FTSE—October 2011)

MSCI Global Islamic Indices (GCC)

MSCI Islamic Index Series methodology is screened against a

ALONG with white-listing shares, Shariah screening methodology is used in Islamic funds, Islamic indices, private equities, takaful companies and Islamic investment companies

series of business activities and financial ratios, and a dividend adjustment factor is applied to adjust for any non-Shariah-compliant income. The three screens are:

❶ Business activity screening

❷ Financial ratio screening

❸ Dividend purification. This is a feature unique to MSCI,and involves total earnings minus income from prohibited activities and interest income / total earnings.

MSCI, operates with four modules—MSCI, Islamic Core Plus DM Module, the MSCI, Islamic Core Plus EM Module, the MSCI, Islamic Small Cap Plus EM Module and the MSCI, Islamic Core Plus AP Module.

Shariah screening methodology is used widely by most global indices firms. It is not just used for white-listing shares and trading. It has been used in Islamic funds, Islamic indices, private equities, takaful companies, Islamic investment companies, Shariah screening software companies, stockbroking companies, Shariah-compliant funds, among others.

Issues

Business level or industry screening is clear about prohibitions. Although there is a set of prohibited businesses, certain cases can be permitted on close evaluation.

Businesses involving advertising, film making, theatres, aerospace and satellite are generally prohibited. But if they follow Shariah principles, they become *halal*.

So certain businesses require a closer look and careful understanding before we declare them as a black list or white list of shares. The list of prohibited businesses should not be taken as a comprehensive list from Shariah scholars or boards—instead, the business should be analysed properly.

The list may also contain a business which is *halal* but, at the bottom level (subsidiary), may be dealing with non-Shariah compliant business or facilitating for it. To mitigate this, we must have a full understanding of the group's business—including holding company and its subsidiaries—and not to judge merely based on holding company.

When we perform the filtering process for companies, we must consider the company's announcements, which may influence business dealings in the future.

Companies use different financial ratios. All three financial ratios must meet the following requirements for a Shariah-compliant endorsement.

Interest bearing debt/total assets <30%

This ratio screens out companies that excessively use interest bearing debt—such as bank loans, overdrafts, preference shares, notes, debentures, finance lease—to finance their business activities and limit the interest-bearing financing. This can include derivatives with no indirect involvement of interest based financing.

Total interest income generating assets / total assets <30%

The purpose of this ratio is to limit interest-generating assets and filtering companies that have excessively invested in interest-generating business activities such as bank deposits, bank advances, customer advances and commercial papers.

Cash + accounts receivables + pre-payments total assets <45%

This is a test ratio for the liquidity or tradability of company assets. It ensures that companies do not have a significant portion of "real and tangible" assets on their balance sheet—such as fixed assets, stocks or investments in equities.

Financial ratios are crucial for businesses, especially for financial institutions or banks. In the case of a financial ratio test, the latest financial statements available must be used.

The influence of the company may also have an impact on ratios where filtering companies may request to do the testing on either management account or favourable audited financial accounts.

The accuracy of an audited financial statement relies on the audited firm, and filtering companies may only use it for the purpose of calculation of ratios. There is always the possibility of false information being provided, which may influence the economic decision of the investors.

Another important issue is that, while AAOIFI has issued standards for financial ratios, individual firms may also have a Shariah supervisory board to determine the maximum tolerate point by a ratio.

This point varies according to different firms. So a share may be Shariah compliant by one firm's criteria but not under another. It can leave investors confused.

Despite the global expansion of Islamic capital markets, inherited issues—such as harmonisation of global Shariah standards, regulatory issues, investor protection, a tool for the performance measurement of the instruments, disclosure requirements, monitoring and supervisory—have room for improvement.

But screening methodologies in Islamic finance is forging a path for other sectors to follow, such as the Islamic money and bond markets. ■

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