Insights

SHARIAH SCREENING METHODOLOGY: ADOPTING A TWO-TIER QUANTITATIVE APPROACH

In view of the growing sophistication of Islamic capital markets in Malaysia, the Securities Commission has revised the Shariah screening methodology. The updated methodology will apply a two-tier quantitative approach, streamlined business activity benchmarks and the newly-introduced financial ratio, with the goal of increasing its robustness. It is expected that this will bolster the competitiveness of the Malaysian Islamic equity market and Islamic fund management industry and expand its international reach.

31 October 2013

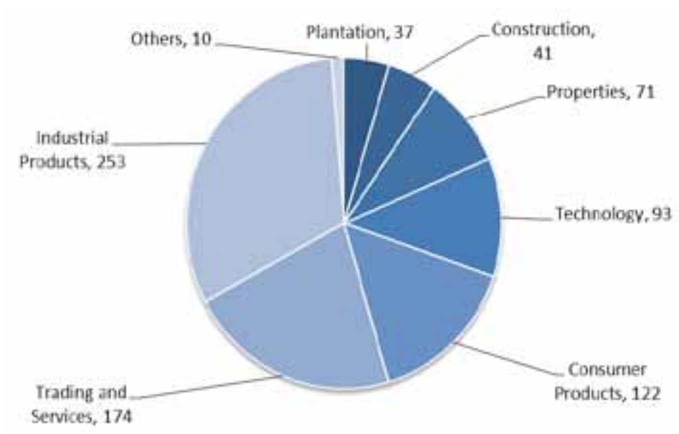
Malaysia to implement revised Shariah compliance screening methodology of listed companies

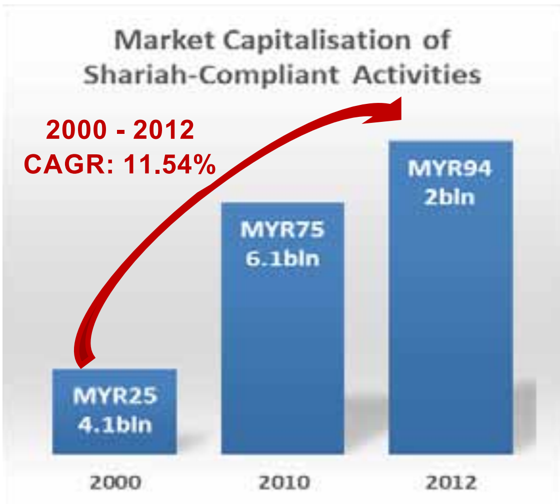
Malaysia further advances the country's Islamic capital market with the revision of Shariah screening methodology by adopting a two-tier approach, an effort to harmonise the standards to global expectation and to spur capital inflows, especially from Middle East investors.

As of May 2013, Bursa Malaysia listed 801 Shariah-compliant securities out of a total of 910 securities, constituting 88% of total securities traded. Collectively, the market capitalisation of Shariah-compliant securities valued at MYR1.017tln or 63% out of a total market capitalisation of about MYR1.6tln. The existing methodology of Shariah screening had been established in the mid 1990s keeping in view the infancy of the Islamic capital market. Since then, the Islamic capital market in Malaysia has significantly progressed, increasing from a MYR254.1bln market capitalisation of Shariah-compliant securities in 2000 to MYR1.017tln capitalisation in May 2013. The 2000-2012 period marks a CAGR of 11.54% in market capitalisation of Shariah-compliant securities.

Statistics of Shariah-compliant Securities
(as at May 2013 – Total 801 securities)

Source: Securities Commission Malaysia, KFH Research





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MALAYSIA INTERNATIONAL ISLAMIC FINANCIAL CENTRE

The Shariah compliance review in Malaysia is undertaken in two stages and the listed security must pass screening at both stages. First is the quantitative stage where the contribution from Shariah non-compliant activities were computed and compared with the group turnover and the group profit before tax. Before the revision, the benchmarks for contribution from non-permissible activities were set at 5%, 10%, 20% and 25%. The second stage is the qualitative stage where the public perception and image of the company were assessed. Hence, even if a security passed screening in the first quantitative stage, it could be deemed as Shariah non-compliant if it failed the second qualitative screening stage due to, for example, negative public perception or image of the company. The screening process is important as according to the Securities Commission Malaysia (SC), more than 60% of all companies listed on Bursa Malaysia are considered to be "mixed companies" where their business activities comprise both Shariah compliant and non-compliant transactions. The list of Shariah-compliant securities is updated and published by the SC twice a year in May and November. For pre-IPO companies, the screening of Shariah compliance status is made upon application (voluntary).

In view of the growing sophistication of Islamic capital market in Malaysia, the SC has revised the screening methodology by adopting a two-tier quantitative approach which applies the business activity benchmarks and the newly-introduced financial ratio benchmarks.

	Revised Activity-Based Benchmarks (Effective November 2013)
5%	• To assess the level of mixed contributions from activities that are clearly prohibited such as riba-based activities, gambling , liquor and pork; interest income from conventional accounts and instruments and tobacco-related activities
20%	• To assess the level of contributions of mixed rentals from Shariah non-compliant activities; • To assess the level of mixed contributions from activities that are generally permissible according to Shariah and have an element of maslahah (public interest), but there are other elements that may affect the Shariah status of these activities e.g. hotel and resort operations.

	Financial Ratio Benchmarks (Effective November 2013)
< 33%	Compute the financial ratios: • Debt/Total Assets; • Cash and Cash Equivalent/Total Assets

Source: Securities Commission Malaysia, KFH Research

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The earlier business activity benchmarks for contribution from activities involving the element of umum balwa (e.g. interest income from fixed deposits), which was set at 10%, has been tightened to 5% while contribution from activities generally considered permissible but with other elements possibly affecting its Shariah status (e.g. hotel and resort operations), which was set at 25%, has been tightened to 20%. In addition, the revised methodology will include financial ratio benchmarks which assess cash over total asset and debt over total asset screenings.Each of the financial ratios must be lower than 33% for a security to pass as Shariah-compliant.

For calculation of the debt/total assets ratio, debt will only include interest-bearing debts while Islamic financing and sukuk will be excluded from the calculation. For the cash ratio, cash will only include cash placed in conventional accounts and instruments, while cash placed in Islamic accounts and instruments will be excluded from the calculation. Malaysian fund managers will be given a grace period of six months from November 2013 to align their portfolios to the new stock selection. Possible solutions for companies that may be affected from the introduction of financial ratio benchmarks is to shift sufficient funds into Islamic deposit accounts to ensure that the 33% rule is not breached and that their interest income does not exceed 5% of total group revenue (to satisfy the revised business activity benchmark). In terms of the debt to total assets ratio, the affected companies may switch to more Islamic financing instruments such as sukuk to ensure the 33% benchmark is not breached.

The inclusion of financial ratio benchmarks has been a practice of global Shariah index providers such as by Dow Jones, MSCI, and FTSE. With this revision, the Malaysian Islamic capital market is likely to widen its international investor base and hence experience a surge in capital inflows. Both SC's and DJIM's screenings incorporate a benchmark of less

	Securities Commission Malaysia	Dow Jones Islamic Markets
Scope	Malaysian Stocks	Global Stocks
Screener	Regulator	Index Provider
Focus	Activity-based benchmarks	Industry Screen
Denominator	Total Assets	Market Capitalisation
Discretion	Qualitative Stage of Screening	N/A
Financial Ratios	Total Debt / Total Assets	Total Debt / Market Cap
	Cash / Total Assets	Cash + interest bearing securities / Market Cap
		Receivables / Market Cap

Source: Securities Commission Malaysia, Dow Jones, KFH Research than 33% for financial ratios. In comparison, some other screeners may adopt slightly different benchmarks: for example the Karachi-Meezan Index 30 (KMI-30) screening methodology incorporates a higher benchmark of less than 37% for interest bearing debt over total assets ratio. The S&P Shariah Indices methodology apply financial ratios on trailing 36-month average market value of equity while the benchmark for account receivables is set at less than 49%.

The Dow Jones Islamic Market family of Indexes includes thousands of broad-market, blue-chip, fixed-income, strategy and thematic indices and their screening criteria are regarded as the industry standard.

The new Shariah screening methodology which will be reflected in the SC's List of Shariah-compliant Securities is likely to compress the number of Shariah-compliant stocks, which currently stands at 801 as of May 2013. However, the streamlining of the business activity benchmarks and the inclusion of the financial ratio benchmarks will enhance the robustness of the screening methodology for listed securities and, in turn, is expected to bolster the competitiveness of the Malaysian Islamic equity market and Islamic fund management industries. This revision is aligned with SC's initiatives to expand the Islamic capital market's international reach, as outlined in the Capital Market Masterplan 2. This step has taken Malaysian Islamic capital market to a greater height, reflecting the proactiveness to continuosly improve the system within the growing sophistication of the industry as well as to attract wider investor base into its market.