

# **Shariah Screening Process in Islamic Capital Market**

**By**

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**Securities Commission of Malaysia**

# Agenda



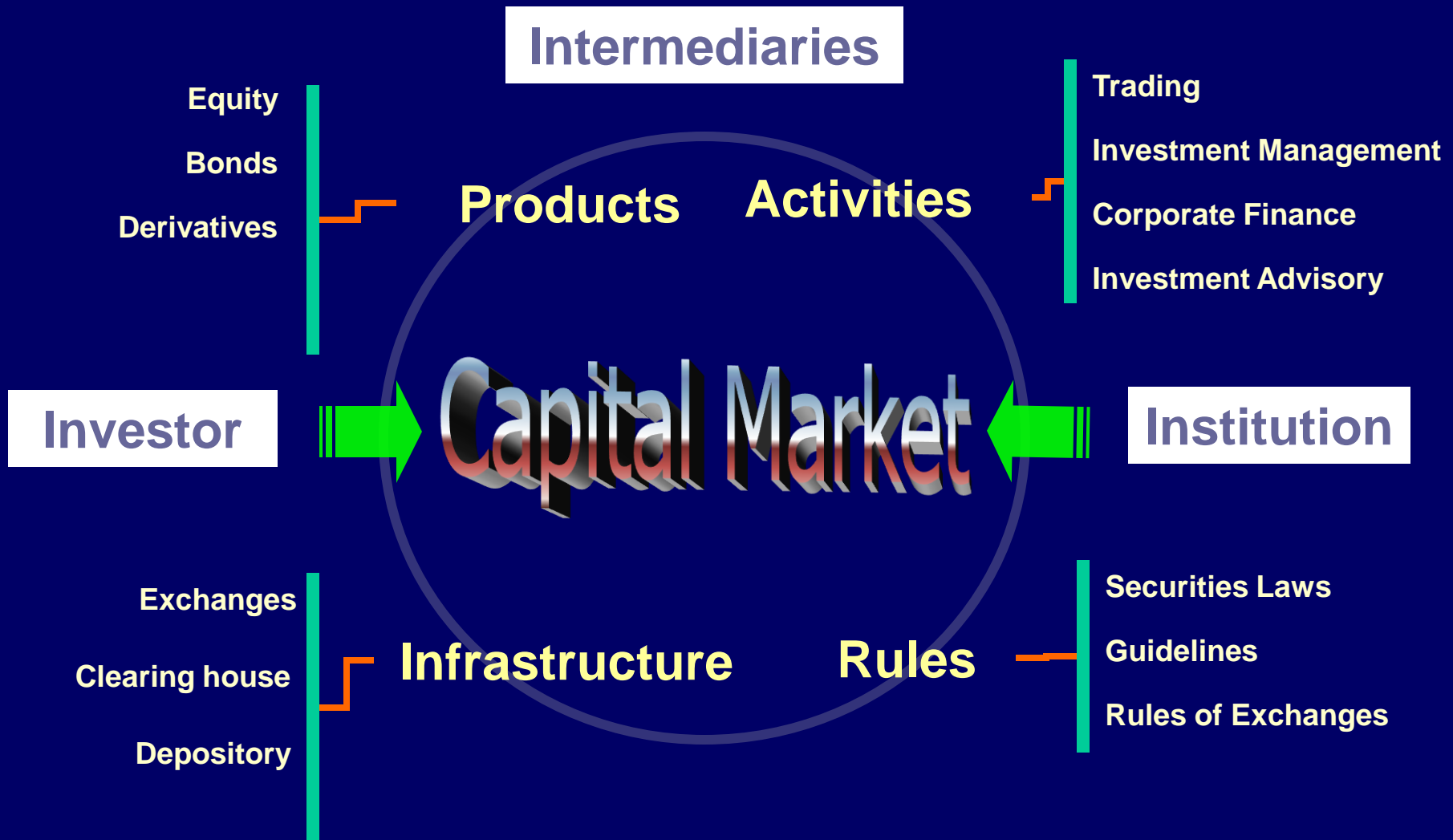
## **Shariah-Compliant Securities**

**Approach and Methodology**

**Case Study and Shariah Guidelines**

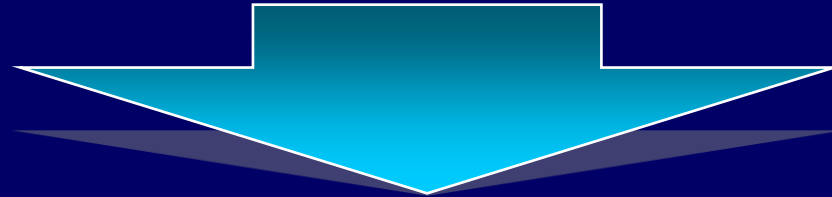
**Development & Initiative for Screening**

# Why capital market



# Shariah-compliant Securities

## Shariah-compliant Securities



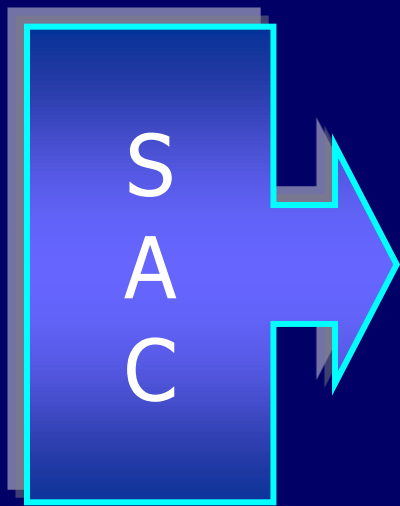
**Implementation of understanding of  
shares and mixed companies conduct  
by Muslims and non-Muslims**

# Availability of Shariah-compliant securities sets the foundation for Islamic equity investment

## Shariah-compliant Securities

- Securities (ordinary shares / equities) of a company listed on Bursa Malaysia which is classified as Shariah permissible for investment
- Primary business and investment activities that generate income for the company must conform with Shariah principles
- In Malaysia, the body that gives Shariah approval is the Shariah Advisory Council (SAC) of the Securities Commission (SC)

# The Shariah Advisory Council (SAC) reviews and endorses Shariah-compliant securities



- Established in 1996 under the Securities Commission Act (SCA)
- Represented by ten members
- Advises on Shariah compliance with regard to new products and structures
- Screens listed securities for Shariah compliance

# Shariah-compliant securities broaden investment opportunities

- Participation by Muslim investors was minimal in 1970s
- Insufficient guidance on securities that can be traded (Shariah)
- Listed companies involve in various business activities (halal & haram)
- The scenario had limited the participation of Muslims in economic activities
- Lost of opportunity (in the early 1990s) in terms of capital gain while there was a significant increase in the number of companies listed on the stock exchange

# Islamic equity investment in the early years

Year	Milestones
Mid-1960s	Lembaga Tabung Haji (Pilgrims Fund) explored the possibility to invest its funds in Shariah-approved investment
Prior to 1997	Bank Islam Malaysia initiated the review to determine Shariah status of listed stocks [but for internal use only]
1996-1997	the Shariah Advisory Council (SAC) of SC developed Shariah screening criteria to facilitate compliance review process
June 1997	SC introduced the official list of Shariah-compliant stocks/securities listed on Bursa Malaysia



# Shariah compliance review is performed at national level

- SC has a regulatory power to obtain relevant information and other business information from listed companies which are not publicly available
- Enables SC to issue appropriate guidelines on Shariah compliance e.g guidelines on disposal of non-compliant stocks
- Facilitates efforts to promote centralisation and harmonisation of Shariah decisions on the status of listed stocks
- Enhances market confidence as the stocks are endorsed by the Shariah body at national level



## **Shariah-Compliant Securities**

### **Approach and Methodology**

## **Case Study and Shariah Guidelines**

## **Development & Initiative for Screening**

## Importance of Stock Market

- Perform important roles in national economies
- Encourage investment by providing platform for buyers and sellers to trade securities
- Enables corporations to obtain funds to expand their businesses
- Protect investors by upholding rules and regulations that ensure buyers will be treated fairly

# Approach and methodology

- Wealth and ownership of company and asset
- Technology and strategic-big corporation business world wide
- Support growth of the country and mobilize capital efficiently
- Disclosure and efficiency to protect the industry and investor

## Modern Business and Corporation not far from Musharakah



Musharakah

A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind. Any profit derived from the venture is distributed based on a pre-agreed profit sharing ratio and a loss is shared on the basis of capital distribution

# Economic/business activities of ICM

The economic/business activities must be Shariah compliant

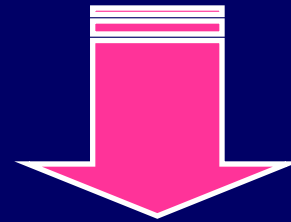
Activities do  
not involve in;

- Riba- excess or surplus over and above the loan capital
- Gharar*- ambiguity/element of deception
- Maisir*- Gambling
- Liquor
- Other activities that are not allowed under Islamic principles.

# SC's SAC Shariah methodology and criteria

Based on  
Shariah criteria  
sourced from  
the Quran, the  
Sunnah, Qiyas,  
Ijma' and other  
Shariah  
principles

Determine income contribution from Shariah prohibited activities of listed companies using Shariah methodology and criteria set out by the SAC



Classify a stock as Shariah-compliant if income contribution from the prohibited activities is within Shariah tolerable level

# The Shariah compliance process



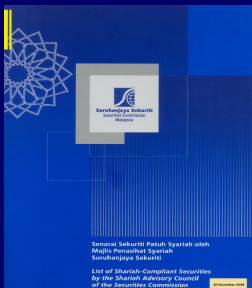
Extraction of relevant financial information from audited financial report and other material information



Undertaking Shariah compliance review process to identify contribution from non-permissible activities



Compare with Shariah financial benchmark



- Compile the result and issue list of Shariah-compliant securities
- Announcement in May and November every year



Tabulate the result to SAC for final consideration / decision based on quantitative method (financial benchmark) and/or qualitative consideration



# Shariah compliance review criteria

Classified as Shariah-compliant if the company is not significantly involved in the following activities:



1. Financial services based on riba (interest)
2. Gambling
3. Manufacturing or sale of non-halal products
4. Conventional insurance
5. Entertainment
6. Manufacture or sale of tobacco-based products or related products
7. Stockbroking or share trading in non-compliant securities
8. Other activities deemed non-permissible

1. Interest income from conventional fixed deposits / interest bearing instruments
2. Dividend income from investment in non-approved securities

# Mixed Companies: *Shirkah al-'inan*

- **Profit and losses:** will be shared according to the partner's contribution to the capital
  - **if the capital contribution** is equal, profit & losses will be shared equally
  - **Hanafis, Hanbalis & Zaidis:** distribution of profit to be disproportionate to the capital contribution; entitlement to profit due to either contribution to capital or to work load and management of the partnership
- **In a nutshell:** profits are shared according to the parties' condition, nevertheless losses are shared according to shares in the capital
- Equal religion of the partner is not a condition
  - This type of partnership is the most common form
  - Tolerant with the modern type of partnership/ company/corporation

# Mixed companies benchmark



**Suruhanjaya Sekuriti**  
Securities Commission  
Malaysia

**Muslims and non-Muslims are allowed to form a company together and Islam recognises ownership of non-Muslims and their property**

# Mixed Companies Benchmark

Classical scholars discussed on to what extent non-Shariah compliant activities are allowed

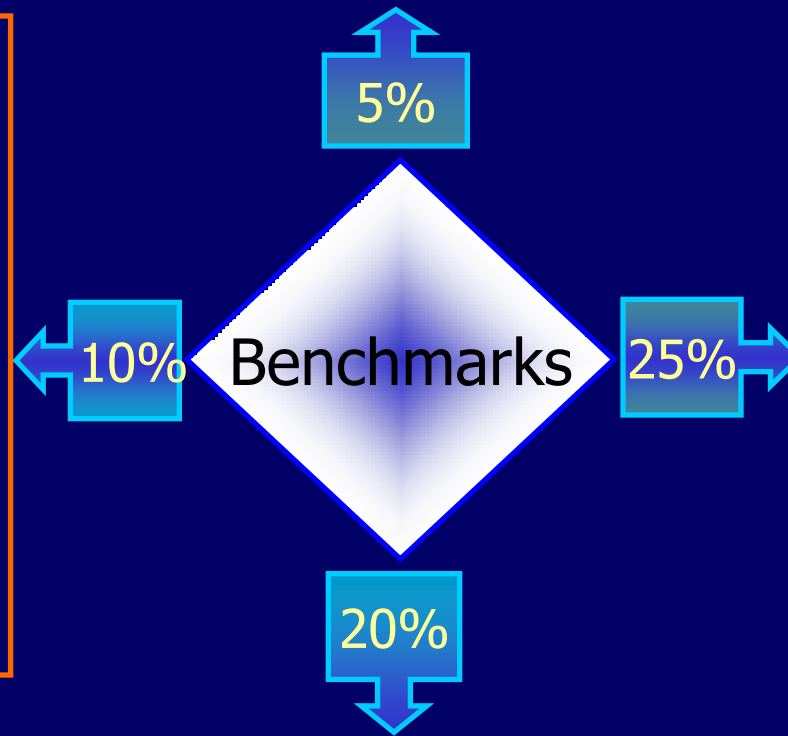
It must be minimum and at tolerable level

Benchmark

# Specific benchmarks are established

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

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



To assess the level of mixed contributions from the activities that are generally permissible according to Shariah and have an element of *maslahah* to the public, but there are other elements that may affect the Shariah status of these activities e.g hotel and resort operations, share trading and stockbroking

To assess the level of contribution of mixed rentals from Shariah non-compliant activities, such as rental income from premises used for supermarket which sales liquor, etc.



**Shariah-Compliant Securities**

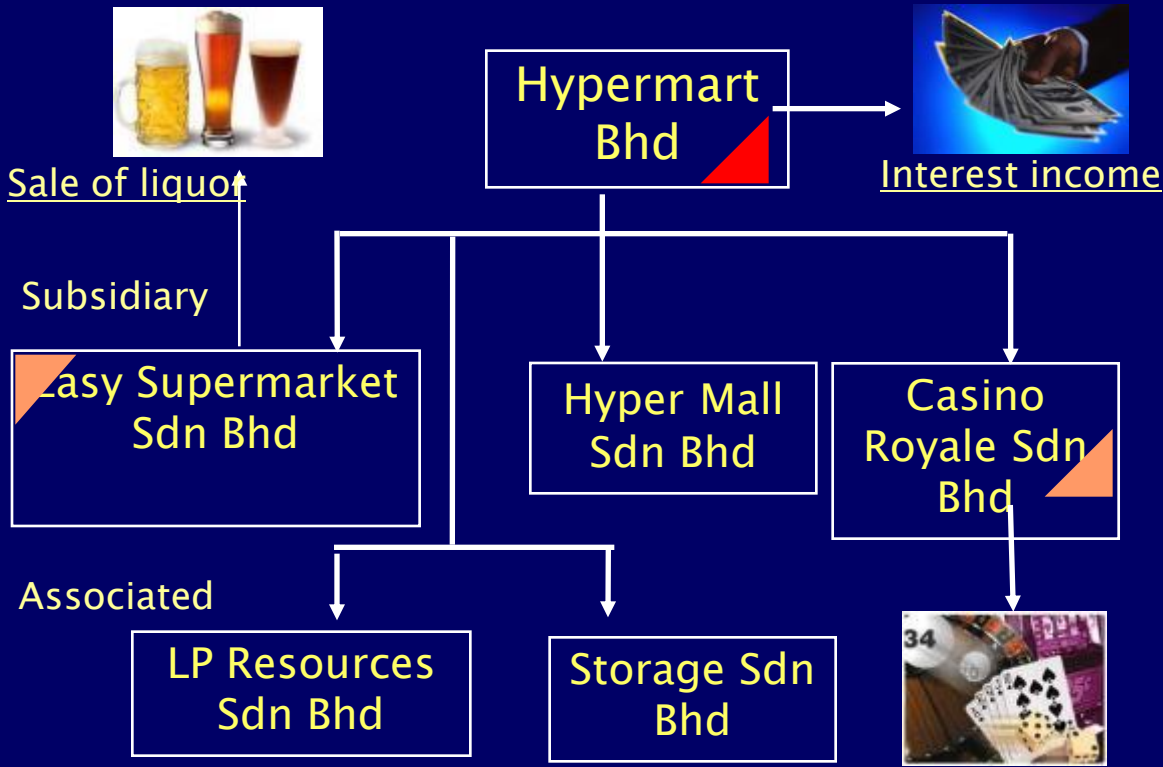
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# Case study: Hypermart Bhd\*

**Principal activity – service of hypermarket and other related activities**



**Related information**

**Group info:**  
 Group TO: RM 10 mln  
 Group PBT: RM 5 mln  
 Group Int. Income: RM 0.8 mln

**Non-permissible activities info:**  
 TO liquor: RM 0.35 mln  
 PBT liquor: RM 0.12 mln  
 TO gaming: RM 0.19 mln  
 PBT gaming: RM 0.1 mln

**\*Not listed anywhere**

- Bhd is Public Limited Company
- Sdn Bhd is Private Limited Company

# Pre-compliance result

Non-permissible	Calculation	Quantitative result
Interest income to Group TO	RM0.8 mln/ RM10 mln	8%
Percentage of liquor to Group TO	RM0.35 mln/ RM10 mln	3.50%
Percentage of liquor to Group PBT	RM0.12 mln / RM5 mln	2.40%
Percentage of gaming to Group TO	RM0.19 mln / RM10 mln	1.90%
Percentage of gaming to Group PBT	RM0.1 mln / RM5.0 mln	2%

Benchmark for interest income: 10% of Group TO

Benchmark for liquor and gaming: 5% of Group TO or Group PBT

Contribution from interest income and non-compliant activities:

Interest income: 8%

Group TO: 5.4% (TO liquor + TO gaming)

Group PBT: 4.4% (PBT liquor + PBT gaming)

Pre-compliance result: **Non-compliant stock**



# Shariah guidance on investment in non-compliant stocks

## Case 1: Investment in Shariah-compliant stocks, which subsequently reclassified as Shariah non-compliant stocks

### Price of Shariah Non-compliant Stocks

#### On the announcement day

##### Price > original investment cost

- liquidate immediately
- Any capital gain from disposal can be kept by investors

##### Price < Original Investment Cost

- Hold until the price of stocks equal to original investment cost
- Dividends received can be used to expedite the disposal

#### After the announcement day

##### Price > Original Investment Cost

- Liquidate immediately
- Profit (difference btw original investment cost and closing price of announcement date) – can be kept
- Profit (difference between disposal price and closing price of announcement date) – channeled to charitable bodies

##### Price < Original Investment Cost

- Hold until the price of stocks equal to original investment cost
- Dividends received can be used to expedite the disposal

# Example

Investment Cost (2 January)	Announcement date (30 May)	Disposal price (3 June)
RM5.50	RM6.00	RM7.50

Profit kept by  
investor (RM0.50)

Profit to be  
channeled to  
charitable bodies  
(RM1.50)

Investment cost = RM5.50/share

Closing price on the announcement date = RM6.00/share

Disposal Price = RM7.50/share

If investor disposes securities on 3 June, the capital gain is RM2 per share. He is only eligible to keep the profit of RM0.50 per share (While RM1.50 should be channeled to charitable bodies)



# Example

Investment Cost (2 January)	Announcement date (30 May)
RM5.00	RM4.00



Price < investment cost

**Hold until the price of the stocks equal to the investment cost**

**Used dividends received to expedite the disposal**



# Shariah guidance on investment in non-compliant stocks

## Case 2 : Investment in (existing) non-compliant stocks

- Investors to dispose their non-compliant stocks within a month of knowing the status of the stocks.
- Any gain made in the form of capital gain or dividend received during or after the disposal of the stocks to be channelled to charitable bodies.
- Investors are entitled to keep their original investment cost



# Sample List of Shariah-compliant securities booklet



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# Development & initiative for screening

- SC and Bursa Malaysia facilitate the development of new Shariah Indices
- Bursa Malaysia in collaboration with FTSE Group:



Two new Shariah indices introduced

- Jan 2007  
FBM Emas Shariah Index
- May 2007  
FBM Hijrah Shariah Index  
(tradeable)

# FBM EMAS Shariah Index Design



- ✓ Constituents was subjected to the international indexing features, such as free float and liquidity, Shariah screening by FTSE and SAC
- ✓ Reduced number of constituents compared to the existing Shariah Index.
- ✓ Index constituent review dates are the same as FBM Index Series i.e. in June and December



# FBM Hijrah Shariah Index Design (Tradeable)

Investable Universe → Filter → Filter → Investable Index

FBM EMAS  
Index

Yasaar

Shariah Advisory  
Council List

FBM Hijrah  
Shariah Index

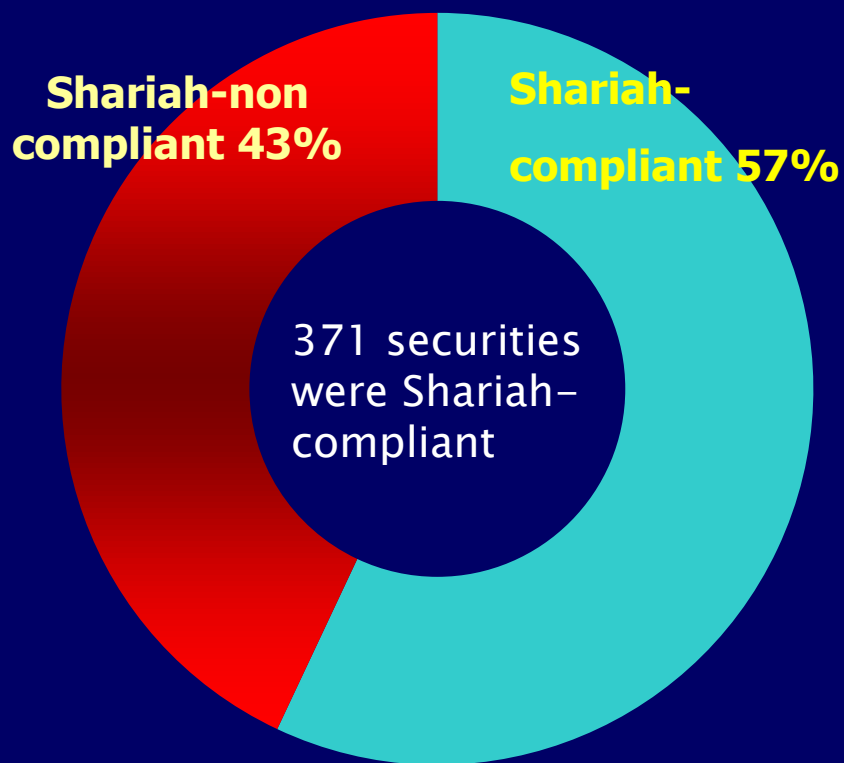
- ✓ FBM Hijrah Shariah Index is a tradable index with the total number of constituents fixed at 30
- ✓ Constituents are subject to FTSE's screening for free float and liquidity
- ✓ Constituents must pass Yasaar and SAC screening for Shariah compliance
- ✓ Index constituent review dates are the same as FBM Index Series i.e. in June and December

# The list of Shariah-complaint stocks received positive response from the private sector

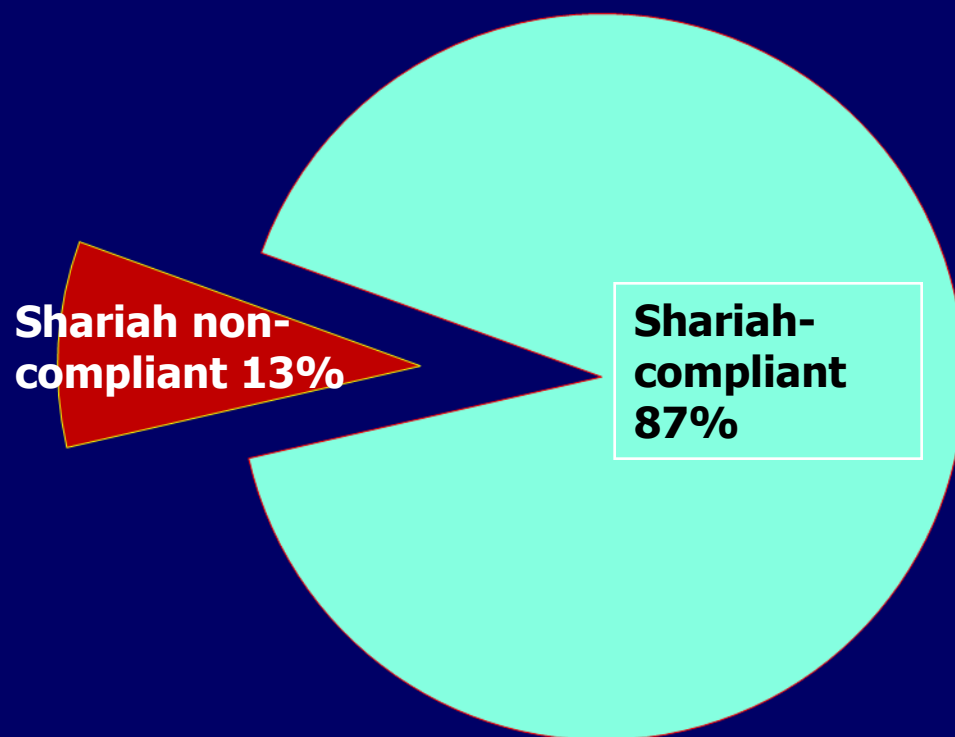
Year	Milestones
Pre-1997	Bank Islam M'sia Bhd issued list of Shariah-compliant securities for internal reference
Pre-1996-1997	SAC of SC developed basic criteria for Shariah compliance review process
Jun 1997	1st official list of Shariah-compliant securities was introduced by SC
1999	Bursa M'sia launched Kuala Lumpur Shariah index
2004	SC disclosed Shariah financial benchmarks applied in compliant review process
2007	Bursa Malaysia and FTSE launched two Shariah indices

# As a result Islamic capital market has seen tremendous growth over the last decade

First List issued by SAC in June  
1997

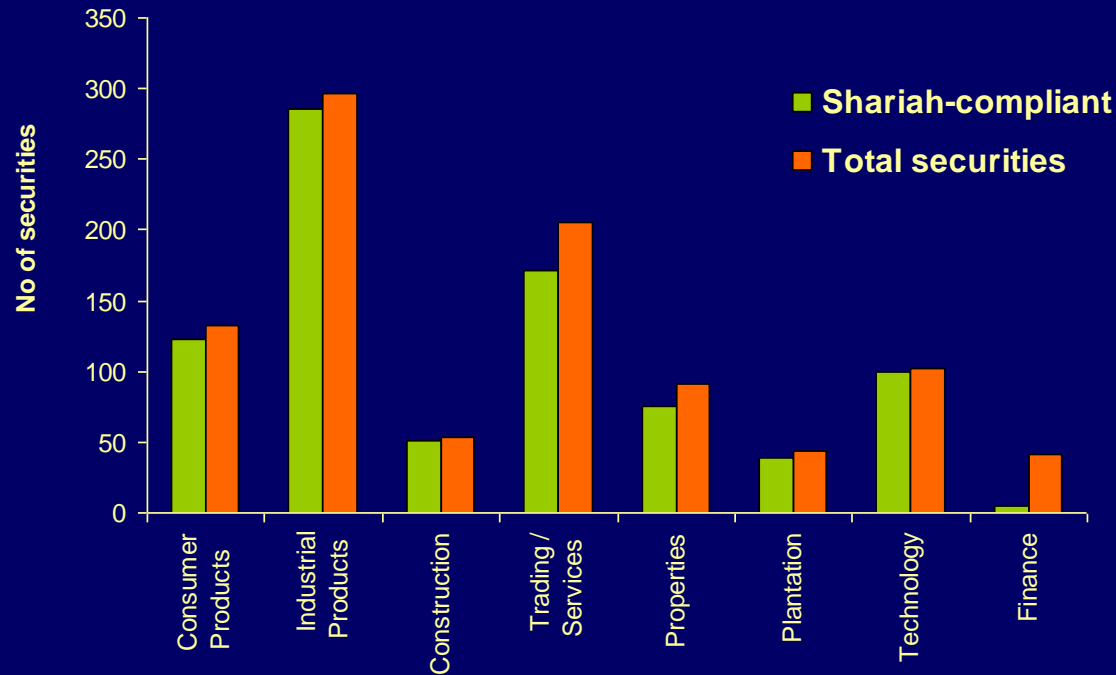


As at Nov 2008



# Market Capitalization

As at November 2008



Market cap\* : RM 426.4 bln or 64.2% of total market cap

\* As at 31 Dec 2008

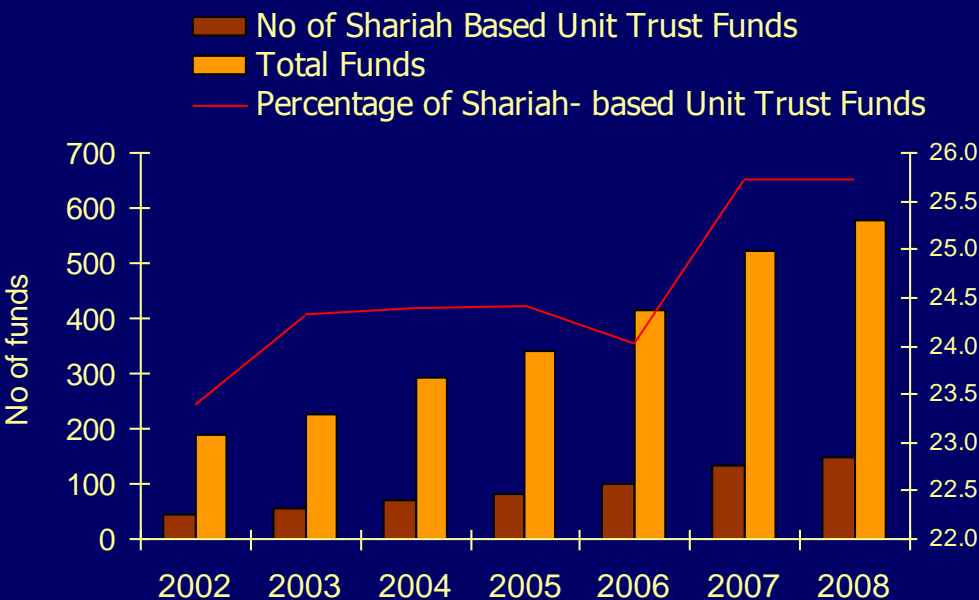
# List of Shariah-compliant stocks as a catalyst of other ICM product & services developments

- Tabung Haji
- Islamic religious bodies
- Bursa M'sia
- Islamic UTs
- Stockbrokers
- Other institutional investors
- Islamic banks
- Retails investors

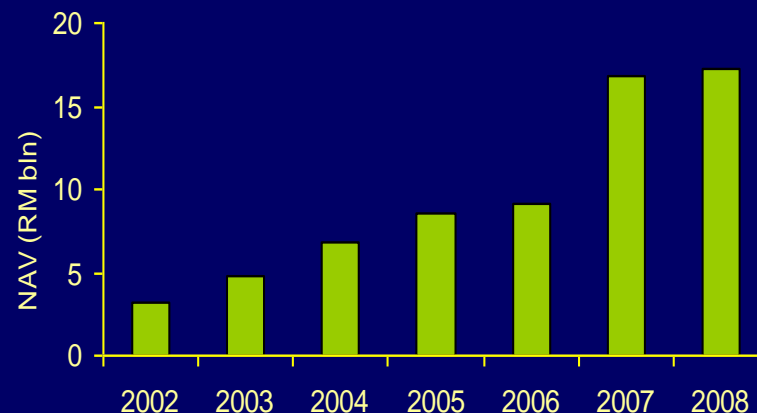
- The list is a main source of reference to Islamic-based corporations & investors who only invest in Shariah-compliant instruments
- The list forms a basis for Shariah index constructed by Bursa M'sia and FTSE which lead to the introduction of Islamic ETF, Islamic structured products, etc.
- Promotes growth of Islamic unit trust funds
- Spill over effect – listed companies re-invest their surplus funds into Islamic banking accounts to earn profit instead of interest (*riba*) [10% benchmark of interest income]
- Non-Muslim investors who are concerned with ethical investment

# The list has given a significant impact to the tremendous growth of Shariah-based unit trust funds

## Number of Shariah based Unit Trust Funds



## Net Asset Value of Shariah based Unit Trust Funds

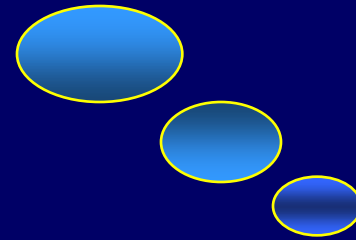


Number of Shariah-based unit trust funds–  
 1993 : 2 funds  
 Dec 2008 : 149 funds

Net Asset Value of Shariah-based unit trust funds–  
 1993 : RM 0.97 billion  
 Dec 2008 : RM 17.19 billion



**QUESTION?**



# Thank you

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