



WORLD BANK GROUP

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Developing Shari'ah Compliant Stock Index

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Roadmap

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I. What is an Islamic Index?

What is an Islamic Index?

- An Islamic index, combines the performance-related statistics of a conventional index with Islamic screening methodologies.
- It is very much like any other index, with a major difference being that the constituent stocks of such indices have to be Shari'ah compliant.
- The securities included in an Islamic index need to go through a rigorous Shari'ah screening and review process

What is an Islamic Index?

Shari'ah Indices	Details	Weighting	Shari'ah Review	Inception
Dow Jones Islamic Market Index (DJIM) World Index	DJIM was the first Islamic equity benchmarked index introduced in February 1999. It is one of the Dow Jones Global Index Series and the aim of the DJIM is to track stocks traded globally and pass the rules-based screens for compliance with Islamic investment guidelines. The DJIM World Index was first calculated on 24 May 1999. The selection universe for the DJIM World Index includes the components from 57 country-level benchmark indices, each of which covers 95% of the float-adjusted market capitalization of the underlying market.	Free float market capitalization	Quarterly	1999
MSCI Singapore IMI Islamic	The MSCI Global Islamic Indices are derived from MSCI's country indices. The MSCI Singapore Investable Market Index (IMI) Islamic measures the performance of large, mid and small cap segments of the Singapore market relevant to Islamic investors. There are 31 constituents.	Free float market capitalization	Quarterly	2007
FTSE Bursa Malaysia EMAS Shari'ah Index	The index comprises the constituents of the FTSE Bursa Malaysia EMAS Index that are Shari'ah-compliant according to SC Malaysia's Shari'ah Advisory Council (SAC) screening methodology. The FTSE Bursa Malaysia EMAS Shari'ah Index incorporates the large and mid cap stocks of the FTSE Bursa Malaysia Top 100 Index and the FTSE Bursa Malaysia Small Cap Index. It also replaced the Kuala Lumpur Syariah Index (KLSI) in 2007.	Free float market capitalization	Semi-annually	2007
S&P 500 Shari'ah	S&P 500 Shari'ah is the part of the S&P Global Investable Shari'ah index series which is designed to offer investors a set of Shari'ah-compliant investment solutions. S&P 500 is widely regarded as the best single gauge of the US equities market and includes 500 companies in leading industries in the US economy.	Free float market capitalization	Monthly	2006
Edbiz NASDAQ-100 Shari'ah	The Edbiz NASDAQ-100 Shari'ah Index is designed to track the performance of securities of the NASDAQ-100 Index that meet the Shari'ah requirements as prescribed by AAOIFI and adopted by NASDAQ OMX.	Market capitalization	Quarterly	2010

Source: ISRA (2015)

II. Shari'ah Screening Process

Shari'ah Screening Process

Qualitative and Quantitative Screening Methods

- **Business Screen:** Does the company partake in activities deemed by Shari'ah to be impermissible?
- **Financial Screen:** Does the financial management of the company involve undertaking financial obligations that are not entirely in conformity with Shari'ah?

Shari'ah Screening Process

Business Screen

A company is regarded as Shari'ah non-compliant if its primary activities are in the following lines of business:

- Sale and manufacturing of alcohol
- Gambling, gaming, casino operations
- Conventional interest-based finance including insurance
- Pornography
- Sale and production of pork-related products and non-halal meat
- Other non-permissible activities (including Shari'ah non-compliant entertainment)

The list of Shari'ah non-compliant activities varies across screening methodologies based on the jurisdiction's preferences.

Shari'ah Screening Process

Financial Screening

Regulatory bodies, index providers, funds and Islamic banks can have different criteria for the same ratio, or different ratios altogether.

The ratios intend to measure two main aspects of the financial management of companies:

- Indebtedness and interest income
- Cash and receivables

III. Shari'ah Screening Methodologies

Shari'ah Screening Methodologies

Some examples:

1- Dow Jones Islamic Screening Methodology

2- Securities Commission Malaysia Screening Methodology

3- AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) Screening Methodology

Shari'ah Screening Methodologies

Dow Jones Islamic Market Index

Business Screening

Income from the following impure sources cannot exceed 5% of revenue:

- Alcohol, Pork-related products, Conventional financial services, Entertainment (hotels, casinos/gambling, cinema, pornography, music), Tobacco, Weapons and defence

Financial Screening

- Total debt divided by trailing average market capitalization should be less than 33%. (Total debt includes: Short-term debt plus current portion of long-term debt plus long-term-debt.)
- Cash and interest-bearing securities divided by average market capitalization should be less than 33%.
- Accounts receivables divided by trailing average market capitalization should be less than 33%. (Receivables include current receivables plus long-term receivables)
- **Note:** Average market capitalization could be based on 12, 24 or 36 months trailing average market capitalization, depending on the volatility of the market. The more volatile the market is, the longer duration is used for calculating the average. This ensures stability of the indices.

Shari'ah Screening Methodologies

Securities Commission Malaysia

- The screening methodologies first introduced by SC Malaysia in 1995 have been revised in line with current developments in the Islamic banking and finance industry.
- SC Malaysia has now adopted a two-tier approach to the financial assessment which applies to business activity benchmarks and the recently introduced financial ratios, while keeping a check on the quality.

Shari'ah Screening Methodologies

Securities Commission Malaysia

Business Screening

- There are two thresholds for the business activity, 5% and 20%.
 - Companies will be included if they generate less than 5% revenue or profit before tax from the following sectors:
 - Conventional banking including insurance, Gambling, Liquor and liquor-related activities, pork and pork-related activities, non-halal food and beverages, Shari'ah non-compliant entertainment, Interest income from conventional accounts and instruments, Tobacco and tobacco-related activities, Other activities deemed Shari'ah non-compliant
 - In addition, there is a 20% benchmark which is applicable to companies that generate part of their revenue or profit before tax from the following activities:
 - Hotel and resort operations, Share trading and stock-broking business, Rental received from Shari'ah non-compliant activities, Other activities that are deemed Shari'ah non-compliant
- Contributions of the Shari'ah non-compliant activities to the overall revenue or profit before tax of the company will be calculated and compared against the relevant business activity benchmarks.

Shari'ah Screening Methodologies

Securities Commission Malaysia

Financial Screening :

The financial ratios include:

- **Cash divided by total assets should be less than 33%.** Cash includes only that placed with conventional accounts and instruments, whereas cash placed with Islamic banks will not form part of it.
- **Total debt divided by total assets should be less than 33%.** Debt will include interest-bearing debt whereas Islamic debt/financing or sukuk will not be part of the calculation.

The aim of both ratios here is to capture and measure interest-based elements within a company's balance sheet, which should be less than 33%.

Shari'ah Screening Methodologies

AAOIFI

Business Screening conditions

- The company does not state in its memorandum of association that its objective is to deal in interest, or in prohibited goods or materials like pork and others.
- The total amount of income generated from such prohibited activities should not exceed 5% of the total income of the corporation.

Financial Screening conditions

- Total long- and short-term debt divided by market capitalization is less than 30%.
- Total interest-bearing securities divided by market capitalization is less than 30%
- Interest income divided by total income or total revenue is less than 5%.
- Cash and receivables divided by total assets is less than 70%.

Shari'ah Screening Methodologies

Comparison of Screening Benchmarks

	AAOIFI	SC Malaysia	DJIM	MSCI Islamic	FTSE	Russell Jadwa
Business Screening	5%	5% and 20%	5%	5%	5%	5%
Financial Screening						
Interest-Bearing Debt / Market Capitalization	30%					
Interest-Bearing Securities / Market Capitalization	30%					
Cash and Receivables / Total Assets	70%					
Total Debt / Total Asset		33%		33.33%	33%	
Cash and Interest-Bearing Securities / Total Asset				33.33%	33.33%	
Accounts Receivable and Cash / Total Asset				33.33%	50%	
Total Cash / Total Assets		33%				
Debt / 24-Month Average Market Capitalization			33%			
Cash and Interest-Bearing Securities / 24-month Average Market Capitalization			33%			
Accounts Receivable and Cash / 24 Month Average Market Capitalization			33%			
Interest-Bearing Debt / 12-month Average Market Capitalization						33%
Total Cash, Deposits and Receivables / 12-month Average Market Capitalization						70%
Total Cash, Deposits and Interest-Bearing Securities /12-month Average Market Capitalization						33%

Source: ISRA (2015)

IV. Shari'ah Supervisory Board

Role of Shari'ah Supervisory Board

- Even though there is a general consensus on the broad outlines of the two Shari'ah screens (business and financial), differences of opinion remain on specifics.
- Standard-setting bodies such as AAOIFI and regulatory bodies such as Securities Commission Malaysia have issued guidelines and guidance on the business and financial screens.
- While NASDAQ OMX Islamic Indices follow the screening methodology of AAOIFI, other major index providers like Dow Jones Islamic Index and MSCI have their own set of guidelines and follow the methodologies approved by their respective Shari'ah board.

Role of Shari'ah Supervisory Board

Examples for Presence of Shari'ah Boards

Screening Benchmark	Presence of Shariah Board
Securities Commission Malaysia	The Shariah Advisory Council (SAC) set up at the Securities Commission Malaysia (SC) approves the list of securities which have been classified as Shariah-compliant securities. The SAC has 11 members.
Dow Jones Islamic Market Index	The Dow Jones Islamic Market™ Index Shari'ah Supervisory Board was established to advise the company on the methodology for screening securities for inclusion in the Dow Jones Islamic Market™ Indices and matters relating to the Shari'ah compliance of the index components. The board consists of four eminent Shari'ah scholars from around the world. The geographic diversity of the scholars helps to ensure that diverse interpretations of Shari'ah law are represented. The board has 4 members.
S&P Shariah Indices	S&P has contracted with Ratings Intelligence Partners (RI) to provide the Shariah screens and filter the stocks based on these screens. Ratings Intelligence Partners is a London/Kuwait-based consulting company specializing in solutions for the global Islamic investment market. Its team consists of qualified Islamic researchers who work directly with a Shari'ah Supervisory Board, which is a board of Islamic scholars serving to interpret business issues and recommend actions related to business decisions for the indices.

V. Implementation Considerations

Implementation Considerations

- Determination of Objectives
- Target Investors – Domestic or international
- Index versus ETFs
- Governance on the operations of Index
 - Transparency
 - Disclosure
 - Maintenance, i.e. re-balancing
- Shariah Governance
 - Domestic versus international

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