

## Shari'ah Compliant Securities Screening Methodology

### **Introduction**

The Colombo Stock Exchange (CSE) has 284 companies representing 20 GICS industry groups as of 28th June 2024, with a Market Capitalization of Rs. 4,760.00Bn. Investors who are based on Islamic faith, can invest in such companies provided that it meets Shari'ah requirements. There are several Shari'ah screening standards such as AAOIFI, FTSE- Global Shari'ah, S&P 500 Shariah Index, and Dow Jones, which are globally accepted. However, considering that Sri Lanka is a relatively small market and adaptable to external factors, it is felt that a unique Shari'ah screening standard that suits the Sri Lankan capital market would be developed. This may help to standardize the process and make it uniform methodology among all the whitelisted publishers in the country.

Thus, Securities and Exchange Commission (SEC) of Sri Lanka, has accredited Six (6) scholars to oversee Shari'ah-related matters related to the Capital market in Sri Lanka. The following method is reviewed and recommended to the SEC by the six accredited scholars as the most suitable technique to execute the screening for the Sri Lankan market.

### **Proposed Methodology**

The accredited scholars by the SEC adopt that Each security (Ordinary Share) shall undergo a two-tier screening of qualitative and quantitative approach, which applies the business activity benchmarks and the financial ratio benchmarks, in determining the Shari'ah status of the listed securities. Hence, the securities will be classified as Shari'ah-compliant if their business activities and financial ratios are below these benchmarks.

#### **A. Qualitative Screening (Business Activity Benchmarks)**

Any company that is mainly involved in the following core business activities is considered impermissible and therefore would not qualify under the whitelist.

- Financial services based on *Riba* (Interest)
  - Conventional insurance
  - Manufacture or sale of non-halal products or related products
  - Gaming and gambling
  - Entertainment activities that are non-permissible according to Shari'ah
  - Manufacture or sale of tobacco-based products or related products
  - Arms and ammunition
  - Stock broking or share trading on Shari'ah non-compliant securities,
  - Other activities deemed non-permissible as determined by the accredited Shari'ah scholars of the SEC.
- a) Further, the accredited scholars of the SEC at the time of signing of whitelist for publication, shall consider the qualitative aspect which involves public perception or image of the company's activities from the perspective of Shari'ah rules and principles.
- b) If any such impermissible activity is known but does not constitute their core business, the accredited scholars of the SEC, may or may not consider such businesses to be excluded until their portion of income in the total revenue is proved.

## B. Quantitative Screening (Financial Ratio Benchmarks)

For the financial ratio benchmarks, the six accredited scholars by the SEC considers the following:

### i. **Impermissible Income**

$$\text{Impermissible Income} / \text{Total Income} < 5\%$$

Impermissible Income includes income from gambling, income from interest based transactions, income from *Gharar* (Uncertainty) based transactions i.e. derivatives, insurance claim reimbursement from a conventional insurance company, any penalty charged on late payment in credit sale, income from casinos, addictive drugs, alcohol, dividend income from above mentioned businesses or companies which have been declared Shari'ah Non-Compliant due to non-compliance to any of the mentioned criteria for Shari'ah Compliance etc.

$$\text{Elimination of Impermissible Income of} < 5\%$$

It is important for the investors to ensure the Elimination of impermissible income (Purification). It has two elements. Impermissible income in a) Dividend Distributed and b) Capital Gain. The following formula/ratio shall be adhered to compute the purification amount for Dividend Distributed.

Purification Amount = (Total Dividend Received / Number of Shares Owned \* Percentage of Impermissible Income)

### ii. **Interest Bearing Borrowings**

$$\text{Interest Bearing Borrowings} / \text{Total Assets or Market Capitalization}^{**} < 33\%$$

\*\*(whichever is higher)

Debt only includes interest-bearing debt whereas Islamic financing or sukuk is excluded from the calculation.

Interest-bearing borrowings, in this case, is classified as any interest-bearing debt including Bonds, TFCs, Commercial Paper, Conventional Bank Loans, Finance Lease, Hire Purchase, issuing preference shares etc.

### iii. **Impermissible Investment**

$$\text{Impermissible Investment or deposit} / \text{Total Asset} < 33\%$$

Impermissible Investments, include investments in conventional mutual funds, conventional money market instruments, Commercial Paper, interest bearing bank deposits, Bonds, PIBs, FIB, T-Bills, CoIs, CoDs, TFCs, DSCs, NSS, derivatives etc.

iv. **Liquidity Ratio**

**Illiquid Asset/Total Asset < 70%**

- The current assets of the company are taken into consideration and the main purpose of this ratio is to avoid trading in debt.
- Cash only includes cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments is excluded from the calculation.
- Liquid assets include Cash & cash equivalent, Short-term deposits, Other financial assets, Receivables, Trade receivables, Tax receivables/ returns etc.
- However, the accredited scholars by the SEC may look at any exceptions based on the nature of certain industries, that need to be considered specially for the service industry, as it is not practical to hold them under this category.

**Conclusion**

Further, the six accredited scholars recommend the following.

- a. Three accredited Shari'ah scholars of the SEC shall sign off the publication of whitelist securities of any publisher.
- b. In addition to publication of the whitelist securities, the publisher shall advise the investors the dividend purification ratio/amount bi-annually which shall be endorsed by the accredited Shari'ah scholars of the SEC.
- c. Investors shall consult their equity brokers for purification of impermissible income of capital gain.
- d. The proposed Shari'ah Compliant Securities Screening Methodology shall be revised every three years by the accredited scholars of the SEC to accommodate and adopt the changes in the capital market.
- e. The publication of the whitelist securities shall be carried out bi-annually by the publisher.
- f. The cumulative accounts will be adopted for screening methodology.

**References**

<b>Proposed Thresholds</b>	<b>References</b>
Impermissible Income/Total Income < 5%	AAOIFI, FTSE Russle, Dow-Jones, Meezan, and SC Malaysia
Interest Bearing Borrowings/Total Assets < 33%	FTSE-Russle, SC Malaysia
Impermissible Investment/Total Assets < 33%	FTSE-Russle, SC Malaysia
Liquid Asset/Total Asset < 70%	AAIOFI