



OXFORD ISLAMIC FINANCE- DAR AL ISTITHMAR

A Universal Platform for Shari'a Compliant Equity Screening

White Paper

7/7/2009

This research white paper provides the formulae for a proprietary screening method and platform developed by Oxford Islamic Finance in conjunction with Dar Al-Istithmar. The key features of this product are its research based screening criterion and its flexible proprietary platform available for utilisation by a wide variety of end users, from fund managers, to indices providers and retail investors. Two types of options are available for product users: the multiple ratings approach and the cumulative weighted rating approach. Essentially, the multiple ratings guidance (activity, structure, tradability and social responsibility ratings) can be utilised as selection criteria by each index provider or fund manager, based on the bank's Shari'a supervisory board interpretations of acceptable levels and weightings they place on halal activity, leverage, illiquid assets and social responsibility. Alternatively, the Shari'a supervisory board can utilise the Cumulative Weighted Rating Guidance platform with the default assumptions and weightings provided by DI, adjusting the overall tolerance level to their acceptable limits.

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1. Introduction

Before investing in equities (i.e. shares of a company) an Islamic investor needs to take into consideration various aspects about the company to determine if the investment is permissible from a Shari'a point of view. These considerations can be broadly categorised into the following:

- Activities (i.e. the nature of the business being conducted including ancillary activities)
- Capital Structure (i.e. leverage ratios)
- Tradability (i.e. the level of liquid and financial assets)
- Unlawful Income (i.e. interest income)

Scholars have provided guidelines (or screening criteria) to assist investors in determining if an equity is acceptable from a Shari'a perspective. There has been a lot of thought and discussion behind these guidelines, and without trying to undermine this, here is a brief attempt at explaining their justifications.

The criteria or guidelines regarding the activities of the company are there to prevent an Islamic investor becoming a part of something which is impermissible in Shari'a, for example alcohol or gambling. The more extreme view is that any hint of a haram activity is sufficient to deem the investment unacceptable. However, some scholars have taken a more relaxed view in allowing a minimal amount of haram activity, if it is not the primary business of the company or especially if it is unavoidable in the conditions in which the company operates e.g. interest-based borrowing for working capital.

The purpose of the criteria regarding the capital structure of the company is to reduce the exposure to interest (*riba*) and interest bearing non-compliant liabilities. A company should not be over-leveraged and this is judged by either its debt-to-equity ratio or its debt-to-assets ratio.

The purpose of the tradability restrictions is to avoid assets of companies, the majority of which represent either financial assets (such as accounts receivable) or cash, since such assets cannot be traded unless the trade complies with special Islamic currency exchange rules and debt transfer rules. The liquid and debt assets (i.e. cash or receivables) are considered to be cash-equivalent. Although there is a difference of opinion amongst scholars, the majority view is that obligations on counterparties (cash or *naqd* and debt or *dayn*) cannot be traded, except at par. Since the shares of a company can be traded at varying prices depending on a number of factors, a company that is majority comprised of cash or debt assets cannot be traded according to Shari'a.

Finally, the unlawful income guidelines are meant to ensure that any impermissible income (either from interest or other impermissible activities) is reduced to a minimum, if not completely avoided.

There are various screening methods currently available. The most popular is the Dow Jones Islamic Market Index (DJIMI). Other screening methods reviewed for this paper include:

- AAOIFI
- FTSE
- Meezan
- S&P 500
- MSCI
- SEC
- Various Mutual Funds

This report is not intended to be a detailed critique of current methods. See the paper 'Shariah Compliant Equity Investments: An Assessment of Current Screening Norms' by Khatkhatay & Nisar presented at the Seventh Harvard University Forum on Islamic Finance April 23, 2006, for a comprehensive analysis. However this paper will examine current methods and propose an innovative new method.

The proposed new method will suggest a number of improvements and will consist of the following sections:

Activity

This will be a more comprehensive analysis of activities with recognition given for different types resulting in an Activity Rating.

Structure

The screening of interest income will be included in the 'Activity' section and the tradability screening is separate. Hence, this becomes a Debt Rating.

Tradability

A detailed analysis of company assets and valuations to derive a Tradability Rating

Social Responsibility

These are non-income generating activities commonly used in Socially Responsible Investment (SRI). Some of the SRI initiatives are adapted here to produce a Socially Responsible Rating.

Before we tackle these sections it is important to introduce the new concept of a Shari'a (Equity Screening) Rating.

2. Concept of a Rating

2.1 Current Screening Methods

The current screening methods result in a binary decision i.e. a company is either deemed to be acceptable from a Shari'a point of view or it is deemed unacceptable. Usually, for an investor there is no further information provided about the company other than whether it is 'in' or 'out'. Although this is simple to implement, it has a number of disadvantages as detailed below.

2.2 Disadvantages

Firstly, it does not differentiate between companies close to the boundary of acceptability from those that are far away from it. If one considers companies that are deemed acceptable, it may be useful to know whether it passed the criteria with a narrow margin (e.g. haram income of 4.9% on a limit of 5%) or with a comfortable margin (e.g. no haram income). Those that are far away from the boundary could be monitored less frequently, say every year instead of quarterly.

On the other hand if one considers the companies that are deemed unacceptable, it may also be useful to know whether it just failed the criteria. This information could be provided to the company concerned so that with a little bit of effort on their part, they could be deemed acceptable and hence be more likely to be traded.

Secondly, when reviewing the screening criteria of the various institutions, we noticed that there are certain activities that are universally agreed as being unacceptable e.g. alcohol pornography etc. However, there also certain activities that are excluded by some but not others e.g. defence industry. The current screening methods don't generally distinguish between these 'grey' areas where there is a difference of opinion. If investors knew whether the company failed on a 'grey' activity, they may choose to still invest if they disagreed with the opinion that disallows it.

Thirdly, and in a similar vein to the above, the investor does not know where the company is failing the criteria i.e. is it because of a haram activity or is it because it has a high debt-equity ratio? Once again, an investor may be less choosy if the company has halal income, but has raised the money through un-halal means in the past.

Finally, another disadvantage of the current screening methods is that it is impossible to compare between companies within an industry or between industries. This does not allow analysis of the Shari'a acceptability of companies or industries.

2.3 Proposed Method

The proposed method we are suggesting uses ratings instead of a binary decision. Each company will be assessed on various criteria and be assigned a rating for each of these criteria. The ratings will be combined to form an overall rating for the company. The rating actually represents a particular level along a scale. The scale is either numeric (say 0-100%) or some other type (e.g. Red/Amber/Green). The limit, against which the company will be assessed to determine acceptability, will be a point on the scale. There will be different ratings for each type of criteria e.g. one for activity, one for level of debt etc. These ratings will be made clearer as we discuss each type of criteria below.

2.4 Advantages

There are a number of advantages of using a ratings method over the current binary decision. Firstly, it is much more flexible and allows various features to be included which will deal with some of the limitations mentioned above. Note that using a ratings method does not involve any significant extra work as it uses information that is already being obtained as part of the screening process. All it involves is disclosing this information.

Another advantage of a ratings method is that it can provide an incentive for companies which are close to the boundary but are being excluded. With a little bit of effort on their part they could be opening themselves to a wider investor base.

A ratings method also allows us to impose penalties for lack of information. For example if a company's income from a haram activity (such as sale of alcohol) is not known, a penalty amount could be included, so that the rating would appear worse than it would be if the information was provided. This would give incentives to companies to provide this data and would also urge those applying the criteria (say fund managers) to seek this data as it would give them a bigger pool of available stocks.

2.5 Concept of Overall Ratings for 'Buy' and 'Hold' Decisions

The other concept to introduce at this stage is that of two different overall ratings depending on the purpose of the screening. Firstly if the purpose is to determine which stocks to buy, then all criteria i.e. 'Activity', 'Structure', 'Tradability' and 'Social Responsibility' will be included in the overall rating. However, if the purpose of the screening is only to assess whether a stock can be still held within a portfolio, then the only criteria to be considered are 'Activity', 'Structure' and

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'Social Responsibility'. The tradability is no longer a concern if we are looking at just holding a stock in the portfolio.

Note that this assumes that if a company which is currently in the portfolio is now considered unacceptable, then the Scholars allow the closing-out of the position irrespective of whether the stock can be traded or not. In other words the tradability criteria don't apply when an investor is trying to get out of a position.

3. Business Activities

3.1 Review of Current Methods

When considering screening criteria for haram activities within a company, there are three types of severity being applied:

- Most Strict - Companies in certain industry sectors are excluded irrespective of individual differences between companies and the nature of various activities within the company. Eg. DJIMI
- Average - Activities in companies split between primary business and secondary business with a certain level of haram secondary business being allowed. Eg. FTSE, Meezan Bank, AAOIFI.
- Least Strict - Companies analysed into different categories depending on the nature of the business with different limits applied to each category. Eg. SECM

Let's look at each type individually and in more detail.

DJIMI

The Dow Jones has prohibited investment in companies involved in these activities:

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

They admit that there is no universal consensus on the prohibition of tobacco companies and the defence industry, but choose to exclude them anyway. Dow Jones does not differentiate between primary and secondary activities. The complete list of sectors that are excluded are:

Defence	Distillers & Vintners	Food Products
Recreational Products	Tobacco	Food Retailers & Wholesalers
Broadcasting & Entertainment	Media Agencies	Gambling
Hotels	Recreational Services	Restaurants & Bars

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Banks	Full Line Insurance	Insurance Brokers
Property & Casualty Insurance	Reinsurance	Life Insurance
Real Estate Holding & Development	Consumer Finance	Speciality Finance
Investment Services	Mortgage Finance	

FTSE / AAOIFI / Meezan

These organisations recognise that modern companies are complex and usually have numerous activities some of which are unavoidable (eg. working capital financing using interest). Therefore, they allow a certain amount (usually 5% of income) of prohibited activities.

The AAOIFI are very brief in specifying which activities are forbidden.

"That the corporation does not state in its memorandum of association that one of its objectives is dealing in interest, or dealing in prohibited things like pork (swine) and other things." (AAOIFI Shari'a Standard 21: 3/4/1)

The FTSE exclude the following activities:

- Financial services based on interest
- Alcohol
- Gambling
- Night Club activities
- Pornography and Adult Entertainment
- Prostitution
- Tobacco
- Arms manufacturing
- Pork production / packaging / processing

Meezan Bank states that the basic business of the company should be halal. It excludes:

- Conventional banks
- Insurance companies
- Leasing companies
- Alcohol
- Tobacco
- Pornography

SECM

The Securities & Exchange Commission, Malaysia has split the activities into three categories each with a different limit. Activities where there is no dispute amongst scholars have a 5% limit and these are:

- Banking (riba)
- Gambling
- Production of prohibited items (e.g. alcohol, pork). This even includes printing labels for alcohol
- Insurance (gharar)
- Cinema
- Advertising
- Contraception
- Producing items that are used in religious practices leading to sins of partnership with God (*shirk*).
- Massage (different sexes)

Activities that are difficult to avoid e.g. interest income from fixed deposits are given a 10% limit. The basis for this limit arises from the benchmark set by Hanafi scholars on *ghabn fahish* (excessive profit) which was 10% for animals and 20% for assets. The limit of interest income used to be 5% but was relaxed to 10% after the 1999 economic crisis. Other activities in this category are:

- Organising events which are immoral
- Tobacco
- Penalty charges for late payment

For companies that have mixed activities the limit is set at 25%. This category is based on *maslaha*. In general it is not against Islamic principles but contains non-compliant elements. The analogy used is of a shirt which is partially made of silk. In a mix of halal and haram, the haram takes precedence e.g. in the case of the shirt, the proportion of the silk should not be greater than 50%.

The 25% level comes from a hadith of the Prophet (pbuh) which mentioned giving away a third (33%) as *sadaqat*. SECM decided that 33% was too much, so reduced it to 25%.

3.2 Universal Acceptance of Haram Activity

When considering the screening methods described above as well as others used by Mutual Funds it is clear that there are two categories of haram activity i.e. those that are universally accepted and those where there is a difference of opinion.

Activities that are 'universally accepted' as haram are those associated with:

- Alcohol
- Pornography
- Gambling
- Pork
- Tobacco
- Interest-based financial services

The activities that not everyone agrees on i.e. what we shall call 'difference of opinion' are:

- Insurance
- Weapons/Defence
- Night Clubs
- Cinema
- Contraception
- Massage Parlours

It makes sense that treatment of the latter should be different from the former in considering investing in companies.

3.3 Secondary Activities: Direct vs. Indirect

Most of the current screening methods distinguish between primary businesses of a company versus secondary businesses. They allow a certain amount of income from secondary activities which are haram. We can split the secondary activities into two types; 'Direct' and 'Indirect'.

'Direct' secondary activities are standalone activities which the company pursues purely for that activity i.e. the purpose of the activity itself is haram. These are easily quantifiable. Examples of 'Direct' secondary activities are:

- Drinks company with an alcohol division
- Conglomerate across various disciplines which has a subsidiary doing interest-based financial services
- Interest income on deposits

The other type of secondary activity is 'Indirect'. This is where a company performs an activity which on its own is not haram i.e. the purpose of the activity is permitted. However, when

performing the activity, there may be elements that result in haram items. Examples of 'Indirect' secondary activities are:

- Hotels - which may sell alcohol or have casinos
- Media - which may be dealing with pornography or 'gossip'
- Food - which may include non-halal meat
- Restaurants - which may serve alcohol or non-halal meat
- Advertising - which may be promoting haram activities
- Airlines - which may serve alcohol or non-halal meat

In these cases it may or may not be easy to quantify the non-halal element.

3.4 Concept of 'Relief'

As shown before, the haram activities are split into two categories. Those which are 'universally accepted' (e.g. alcohol) will have no relief i.e. the income counts 100% towards the aggregated haram income. For activities in the 'difference of opinion' category there will be a relief i.e. not all the income will count towards the aggregate.

Let's set the relief as 50% for all activities in this category. (Note that different relief levels can be set for different activities depending on the severity of it). This implies that only 50% of the income from activities in this category will be classified as haram, with the rest being classified as halal.

For 'Indirect' secondary activities the income will need to be analysed to determine the proportion that is halal and this will be the relief amount.

3.5 Penalty for lack of information

The advantage of having a ratings scale is that a penalty can be set for lack of information. This could act as an incentive to provide the information. The penalty could be as simple as setting a flat charge say 50% of income will be deemed *haram*. Alternatively, it could be a more complex scheme that differentiates between data that should be available and data that is more difficult to obtain.

For example, if it is a drinks company with an alcohol producing subsidiary, it should be easy to obtain the income of the subsidiary all of which will be deemed *haram*. Even in the example of the hotel, although it may be more difficult to obtain than the previous example, it should be possible to ascertain the proportion of income originating from the bar and casino. An example

where it may be difficult to obtain data would be in a ferry company that leases space on its ships to duty free shops. These shops may be selling alcohol. Now the income for the ferry company comes from the rent of the shops. To obtain the element relating to the alcohol sale would require the lessee of the space i.e. the duty free shop owner to disclose information.

These three example show different levels of difficulty in obtaining information and each could carry a different level of penalty.

3.6 Proposed Method for the Activity Rating

All the activities of the company generating income need to be listed out. Each activity will then be put into one of four categories:

- HI - Halal Income e.g. textiles
- UA - Haram income (Universally Agreed) e.g. tobacco
- DO - Haram income (Difference of opinion) e.g. arms manufacturing
- IS - Haram income (Indirect Secondary activity) e.g. hotel

The proportion of indirect secondary activities that are halal and haram, need to be analysed. Then reliefs will be applied before aggregating the halal and haram income percentages.

The best way to describe the method is using an example of a fictitious company with mixed activities as shown below:

Activity	% Inc.	Category	Halal	Haram	Relief	Notes
Textiles	60	HI	60			
Insurance	35	DO		35	17.5	50% relief
Tobacco	3	UA		3	0	
Food	2	IS		2	1.5	Say 75% halal income
			60	40	19	

Without any reliefs, i.e. as per DJIMI, the proportion of halal income to haram income would be 60:40 resulting in a rating of 60.

With reliefs the haram income is reduced to 21 (i.e. 40-19). This would lead to a ratio of 79:21 resulting in a rating of 79.

Additional information can also be disclosed for example:

- Purely halal income = 60%
- Purely haram income = 3%
- Mixed income = 37% (with reliefs of 19%)

4. Company Structure

4.1 Types of Criteria

In reviewing the company structure, the current screening methods consider three types of criteria in general. These are:

- Income from interest-based activities
- Level of debt
- Amount of liquid assets

Summary of criteria used by the popular screening methods

<u>Method</u>	<u>Criteria</u>
DJIMI	<ul style="list-style-type: none"> - cash & interest-bearing securities / market capitalisation - debt / market capitalisation - - accounts receivables / market capitalisation
AAOIFI	<ul style="list-style-type: none"> - interest bearing deposits / total assets - - interest bearing debt / total assets
FTSE	<ul style="list-style-type: none"> - cash & interest generating holdings / total assets - interest-bearing debt / total assets - - accounts receivables and liquid assets / total assets
SECM	<ul style="list-style-type: none"> - - interest income / total income (not a separate criteria)
MB	<ul style="list-style-type: none"> - interest income / total income (not a separate criteria) - interest-bearing debt / total assets - - liquid assets / total assets (also liquid assets < market capitalisation)
NCB (SA)	<ul style="list-style-type: none"> - interest income / total income - - interest-bearing debt / market capitalisation
DIB	<ul style="list-style-type: none"> - interest income (+other non-halal income) / operating income - interest-bearing debt / total assets (or market capitalisation) - - cash + trade receivables + investments + other debtors / total assets (or market capitalisation)

4.2 Proposed Method

Of the three types of criteria used by current screening methods, only the level of debt will be considered in this screen. There is a lot of overlap between the criteria for interest income and for income from other non-halal activities. Also, the proposed method for assessing activities is flexible enough to differentiate between interest income that is part of the business (e.g. banks) and which is unavoidable (e.g. working capital financing). For these reasons the interest income criteria will be included in the 'Activities' rather than 'Company Structure'.

Also, because the proposed method distinguishes between 'buying' and 'holding', it is necessary to consider the liquid assets criteria under a separate heading of 'Tradability' (see below). We will now consider the level of debt criteria.

4.3 Numerator

Should it be 'debt' or 'interest expense'?

The majority of current methods choose to use debt rather than interest expense. The argument for using interest expense instead is that not all debt is interest-bearing especially now that it is possible for companies to raise financing through sukuk or Islamic facilities. This has led screening organisations to use 'interest-bearing debt' as the numerator rather than 'total debt' (as per Dow Jones).

The problem with using interest expense is (a) it is difficult to assess (i.e. not all companies disclose it) and (b) it tends to lead to a very small ratio if the denominator is for example market capitalisation.

The Securities & Exchange Commission, Malaysia does not use a debt ratio. The argument forwarded is that it is not important where the sources of funds are originating from when considering investing in a company. Instead, what is important is how those funds are utilised. The problem with this is that the company may still be paying interest on the debt and riba is forbidden not only for those taking interest, but also for those paying interest.

In conclusion, using interest-bearing debt as the numerator appears to be the best option.

4.4 Denominator

There are three options when considering the denominator in the ratio. These are:

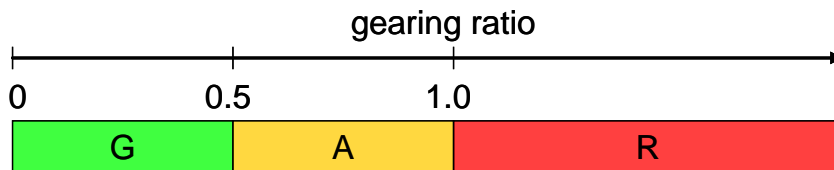
- Market capitalisation
- Total assets
- Total equity

Market capitalisation represents the market share price multiplied by the total number of shares. The use of market capitalisation in this case has a number of disadvantages. Firstly, the level of debt may not have any direct relationship to the market capitalisation of a company. Also, the market capitalisation changes from day to day for a variety of reasons even though the fundamental operations of the company haven't changed. Finally, there may be large fluctuations in the market capitalisation which may cause the company to appear as non-Shari'a compliant even though the level of debt within the company remains the same. [See the paper 'Shariah Compliant Equity Investments: An Assessment of Current Screening Norms' by Khatkhatay & Nisar presented at the Seventh Harvard University Forum on Islamic Finance April 23, 2006].

There isn't much difference in using total assets as a denominator instead of total equity. However, the ratio of debt to equity (known as the gearing ratio or leverage ratio) is a commonly used financial ratio; hence it is preferred in our proposed method.

4.5 Rating

Given the discussion above the preferred ratio is debt/equity. In this case three levels should suffice i.e. where the ratio is considered 'acceptable', 'not acceptable', and 'borderline'. The best way to represent this is using a Red/Amber/Green scale as shown below.



To keep things simple, a gearing ratio of greater than 1.0 (where the level of debt is greater than the level of equity) would be rated 'Red' i.e. unacceptable. Whereas a gearing ratio below 0.5 (where debt:equity is 1:2) would be rated 'Green' i.e. acceptable. The 'Amber' range (i.e. 0.5-

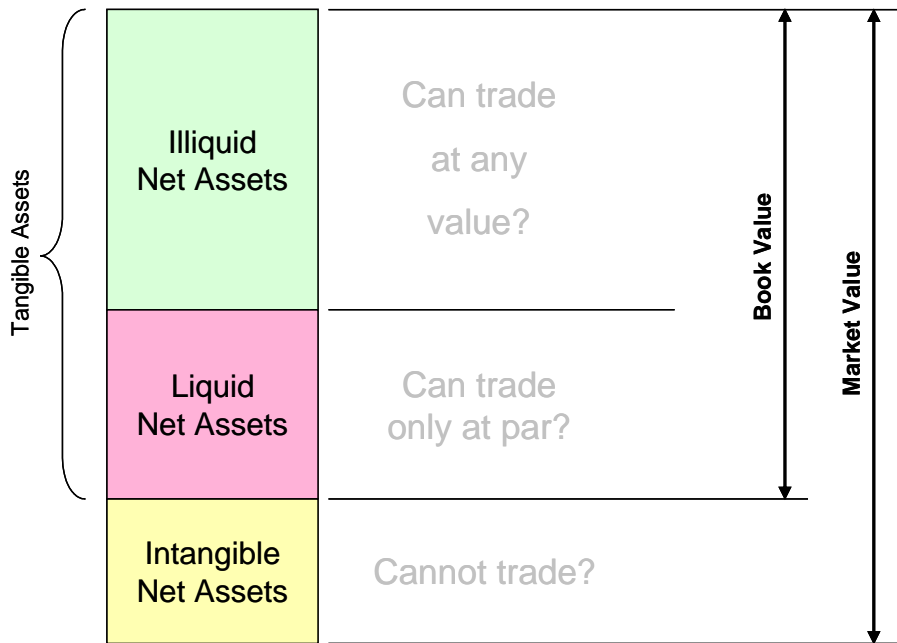
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1.0) is considered borderline. If the gearing is Amber and the other criteria are 'good', then the company would be considered acceptable to invest in. However, if an Amber rating is combined with 'poor' ratings in other criteria, then the company would be considered unacceptable.

5. Tradability

5.1 Assets and Liabilities of a Company

The balance sheet of a company contains its reported assets and liabilities. Note that for the purpose of this paper we will refer to net assets i.e. assets less liabilities. The net assets on the balance sheet are referred to as 'tangible assets' and can be broadly categorised into two types i.e. illiquid net assets and liquid net assets.



Illiquid net assets consist of:

- fixed assets
- stock or inventory
- long-term investments etc.

Liquid net assets consist of:

- cash / loans
- debtors / creditors
- receivables / payables
- short-term investments etc.

When valuing companies there is another type of assets that have to be considered which are not usually on the balance sheet. These are 'intangible assets' and consist of:

- goodwill

- intellectual property
- brand etc.

5.2 Problems with valuing companies

For any given company there may be several methods of valuing, each giving a different value. For example if you just consider the reported assets and liabilities, you would arrive at the 'book value'. Whereas if you wanted to obtain a market value you would need to include the intangible assets. The easiest way of doing this, for listed companies, is to work out the market capitalisation i.e. the total no. of shares multiplied by the market share price.

As discussed before, one of the problems with market capitalisation is that it depends on the current market share price which could be sensitive to a number of factors not directly related to how the company is doing e.g. reaction to a world event. Also, the market capitalisation is an artificial number because if someone wanted to buy the whole company rather than a few shares, the value would be different. This can be seen when companies bid for take-overs. There is also an implicit assumption that the company is a going concern, whereas if the company was to be broken up and its pieces sold off, there would be another valuation known as 'break-up value'.

If the company is not listed, another way of determining its value is to use an earnings multiple. Typically, the current earnings are used, but for start-ups a future potential earnings estimate could be used instead. As a rule of thumb the multiple used is 10, but it will be different for different industries. This could result in an approximate valuation of a company.

5.3 Problems with valuing assets (and liabilities)

There are various problems with determining the correct value of assets and liabilities. Some of these reasons are explained below.

For illiquid assets there could be a marked difference between the book value and the market value. There are different ways of accounting for assets, one of which is the lower of cost or net realisable value. This could lead to assets being stated at the price it was bought at rather than its current market value. Also, the market value may be difficult to determine, for example it may be worth more to someone who needs the assets compared with if you had to do a 'fire-sale' i.e. get rid of the assets to wind up a company. There is also the possibility that the assets are overstated and needs to be 'written down'.

For liquid assets it is usually easier to determine its value. The term 'liquid asset' implies there is a market price readily available which could be used. The one caveat is that not all of the asset is realisable. This is because not all of the receivables may be recoverable from the debtors and consequently the composite value of the liquid assets portfolio may have to be reduced.

The intangible assets are the most difficult to assess in terms of value due to the inherent subjectivity in valuing intellectual property or goodwill.

5.4 Current Views on a Tradability Criterion

The reason given for including a tradability criterion is that when an investor buys shares in a company he is buying into the assets and liabilities of that company which also includes cash and debt. Although there is a difference of opinion amongst scholars, the majority are of the opinion that cash and cash equivalents (such as debt) can only be traded at par value. Since a company's share price can change even though its assets remain the same it is assumed that the cash and cash equivalents are not being traded at par.

Here are some of the views & approaches currently used:

DJIMI

The exact reasoning is not known, but Dow Jones use a ratio of accounts receivable / market capitalisation.

Meezan Bank

Meezan have more detailed criteria. Firstly, they set the criterion on illiquid assets rather than liquid assets which overcomes the problem with intangibles. Also, they use total assets as their denominator. In addition, Meezan have a criterion of the net liquid assets per share being less than the market price per share. This is to ensure that even if the value of illiquid assets change, the value of the liquid assets can be considered to be traded at par.

SEC, Malaysia

SECM do not use a tradability criterion. This may be due to the fact that the trading of debt at non-par values is not an issue in Malaysia.

Khatkhatay/Nisar paper presented at Harvard

The authors above criticise the use of this criteria on the basis that "treating a company in the modern world whose equity is publicly traded as simply a bundle of accounting assets and liabilities, defined on its balance sheet" is too simplistic. They go on to mention some of the

difficulties identified above in the section titled 'problems in valuing companies'. They conclude that "limiting the level of receivables appears to be misconceived and invalid".

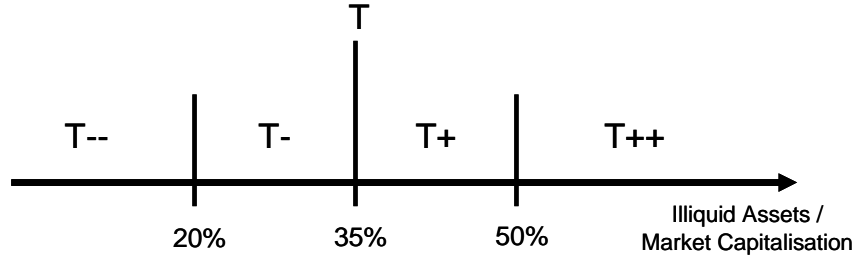
5.5 Proposed View

Although, as shown before, there are difficulties in both valuing companies and in valuing assets, it does make sense to ensure that there is an acceptable level of tradable assets (i.e. illiquid assets). If the criteria were based on liquid assets, it is arguable that these are at par and any difference between the value of liquid assets and the market value of the company relates only to the illiquid assets or intangible assets. Hence the proposed method will include a rating for tradability but focusing on illiquid assets rather than liquid assets.

As far as the denominator is concerned it makes sense to use market capitalisation as it more closely resembles the current value of the company and is also related to the market share price which an investor will buy at. If the market price is not available (i.e. company not listed) then use an earnings multiple.

5.6 Proposed Method

For this rating it makes sense to choose a five-level scale (see below).



The boundary of acceptability for illiquid assets / market capitalisation in this proposal is set at 35%. This is assigned a 'T' rating. If the illiquid assets are acceptable, but close to the boundary (35-50%) then it is assigned a 'T+' rating. If the illiquid assets are not acceptable and close to the boundary (20-35%) then it is assigned a 'T-' rating. If the illiquid assets are far away from the boundary, then a rating of either 'T++' or 'T--' is assigned depending on whether it is acceptable or not respectively.

6. Social Responsibility

Socially responsible investment (SRI) combines the social, ethical and environmental considerations of the investor with their financial objectives. In general, SRI seeks to invest in companies which make a positive contribution to the world and seeks to avoid companies which harm society or the environment.

6.1 Islamic Investment and SRI

There are lots of common aspects between Islamic investment and SRI. The screening criteria of Islamic investment of prohibited activities are similar to the ethical aspects of SRI. For example, they both seek to avoid companies dealing in gambling, alcohol, tobacco etc.

The differences are that Islamic investing focuses only on negative screening (i.e. exclusion of companies involved in prohibited activities) and does not consider non-income generating aspects such as social concerns and environmental concerns. This is despite the fact that Islam has plenty to say about how individuals should treat each other and their surroundings.

6.2 SRI Initiatives

So, are there lessons to be learnt from SRI that could be incorporated into a new method for Islamic investment screening criteria?

The answer to this question is a definite yes. There are at least three types of SRI initiatives that could enhance the Islamic equity screening. Firstly, there are the social concerns such as the use of child labour, contribution to pollution etc. which an Islamic investor should take into consideration.

Secondly, SRI uses positive screening. This is where investors actively seek to invest in companies involved in socially or environmentally progressive businesses.

Finally, SRI involves a technique called 'engagement'. This is where a fund manager (or investor) chooses to create a dialogue with companies in their portfolio and uses his/her power as a shareholder to push for change and the adoption of ethical business practices. This is in line with prescriptions from Shari'a to positively influence change in the companies in which investment is made.

6.3 Problems with SRI

The difficulty with socially responsible investing is its subjective nature. Different people will have different views as to what constitutes social responsibility. For example the classification of 'human rights' as good but 'defence/weapons' as bad is an ambiguous issue. Some would argue that blindly embracing pacifism isn't the best solution for achieving peace and point to historical examples, such as the rise of the Nazis, to support their point.

Also, it may not be easy to identify or determine whether a company is involved in activities that are considered socially irresponsible. More often than not, these activities may be suspected rather than proven. Even after identifying links to unethical activities, it is difficult to quantify the impact on the company. Another problem is that a company may sell alcohol (say) but also contribute heavily to charities. In this case how do you determine the relative impacts of these 'bad' and 'good' activities?

All these problems with the subjectivity means that we need to ensure the screening process is methodical, transparent and consistent.

6.4 Proposed Method

The proposed method takes into consideration three types of concern:

- Munkar Activities - These are socially irresponsible activities that are usually part of the negative screens in SRIs.
- Ma'roof Activities - These are activities where the company is making a positive contribution to people/environment.
- Influential Persons - This is where persons that have influence over the running of the company are linked to munkar activities.

Munkar Activities

The Munkar activities can be split into two types i.e. those concerning 'Humans' and those concerning the 'Environment'.

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	<u>Company Policy</u>
<u>Munkar Activities - Human</u>	
Links to oppressive regimes	R
Use of child labour	A
Discrimination against sex, race, nationality	A
Deals in unfair trade practices	G
<u>Munkar Activities - Environment (i.e. non-Human)</u>	
Involved in animal cruelty	A
Contributes to global climate change / pollution	G
Involved in weapons manufacture/trading	A
Develops genetically modified organisms	A
Overall	R

Each individual item above will be assessed according to a R/A/G criterion where it is defined as:

R = Company has proven or suspected links to munkar activity

A = Company is silent on the issue

G = Company has a policy to avoid the munkar activity

The overall rating depends on the extent of the company policy. The links to munkar activities will have more weight than avoidance policies. It can be set at a ratio of 1:3 i.e. one Red item is worth three Green items. There are four possible outcomes for the overall rating: G, A, R or 2R

Here are possible scenarios:

- RRAA AAGG = 2R
- RRAA AGGG = R
- RRGG GGGG = A
- RAAA AAGG = R
- RAAG GGGG = A
- RAGG GGGG = G
- AAAA AAGG = A
- AAAA AGGG = G

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Ma'roof Activities

The list of Ma'roof activities are:

<u>Ma'roof activities</u>	Actively Involved?
Programs or donations to assist underprivileged sections of society	1
Supports local communities	0
Helps economy of developing countries	0
Environmental initiatives or policies	1
Employee policies (employee welfare and anti-discrimination)	1
Lobbying against Munkar activities	0
<i>Overall</i>	1

Each item will be marked as either; 0 = company is not involved, or 1 = company is involved. The overall rating will be as follows:

- All 0 = 0
- One to three 1s = 1
- Four to six 1s = 2

The overall ma'roof rating will be used to boost the munkar rating i.e. a 1 rating on ma'roof will increase the munkar rating by one and similarly a 2 rating on ma'roof will increase the munkar rating by 2 ratings.

Influential Persons

These are people who have influence on the running of the company e.g.

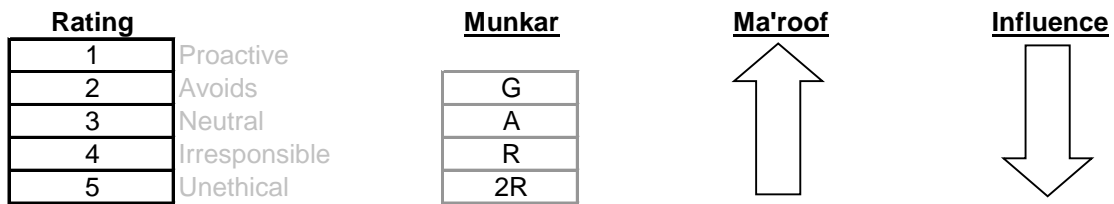
<u>Influential Persons</u>	Links to Munkar Activities
Majority shareholders	-1
Management of company	0
<i>Overall</i>	-1

Each item will be assessed as to whether the influential persons have links to munkar activities. If there are no links the person will be marked a 0, whereas if they have links it will be marked a -1. The possible outcomes are:

- No links = 0
- Some links = -1
- Strong links = -2

The overall influential rating will be used to reduce the munkar rating i.e. a -1 rating on this will decrease the munkar rating by one and similarly a -2 rating on influential persons rating will decrease the munkar rating by 2 ratings.

Overall Social Responsibility Rating



The overall Social Responsibility rating will be a scale of 1-5 with 1 being the best and 5 being the worst. The definition of each of the ratings is:

- 1 - The company is **proactive** in making a positive contribution to the world
- 2 - The company **avoids** harming society or the environment by having strong policies against such activities
- 3 - The company is silent on the issue and is considered **neutral**
- 4 - The company is socially **irresponsible** towards society and the environment
- 5 - The company is extremely socially irresponsible and is considered **unethical**

The method for obtaining an overall Social Responsibility rating is as follows:

Step 1 - Determine initial rating based on Munkar activities. Note that the maximum rating achievable at this stage is a 2 which corresponds to a G in the Munkar rating. See diagram for relationship between Munkar Rating and the SR rating.

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Step 2 - Increase the SR rating based on Ma'roof activities. The SR rating can be upgraded by up to 2 levels i.e. from 3 to 1.

Step 3 - Decrease the SR rating for links to Munkar activities by influential persons. The SR rating can be downgraded by up to 2 levels i.e. from 3 to 5.

This will give an overall Social Responsibility rating which could be combined with the other ratings as shown in the next section.

7. Purification

7.1 Current Method

The screening methods that allow a certain amount of haram income usually recommend that investors purge this income and give the proceeds to charity. This process is called purification. There are various methods being suggested, some of which include:

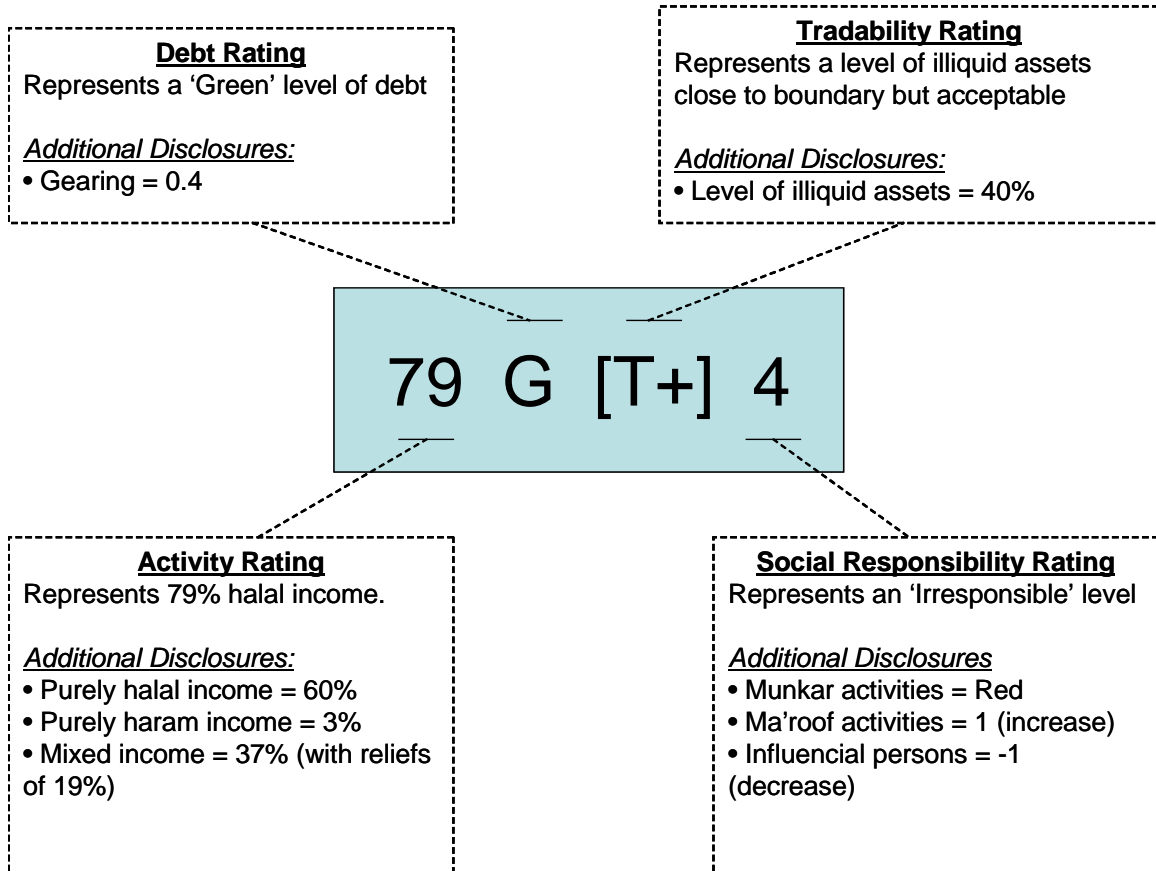
- Purification of interest only (not other haram income)
- Purification only if dividends are paid
- Purification of capital gains
- Fixed amount of purification (say 15%)

The best recommendation is to purify all of the investor's share of the haram income during the period of holding, irrespective of whether a dividend is paid or not. The calculation is done as a pro rata of the investor's shares to total shares.

7.2 Proposed Method

For the ratings mentioned above the purification could be easily set at the level of 'deemed' haram income i.e. 21%.

8. Multiple Ratings Guidance



9. Cumulative Weighted Ratings Guidance

The multiple ratings guidance can also be converted into a single cumulative weighted rating guidance that aggregates the data from the other ratings, assessing compliance out of a hundred percent. This may be useful for index providers that would like to provide concise compliance ratings to the consumers based on the index provider’s own Shari’a board’s rulings (fund managers/retail investors).

Each rating item (activity, structure, tradability and ethical concern) can be weighted based on the index provider Shari’a board preference or the index provider’s own product feature preference.

While this may inevitably include some subjectivity, the individual rating items for each of the individual items can be expressed in a numerical manner as follows:

Cumulative Weighted Rating Item Classification

	Activity	Structure	Tradability	Ethical Concerns
76-100	100	G (Green)	100 [T++]	1 100
51-75	50	A (Amber)	50 [T+]	2 50
26-50	-50	R (Red)	-50 [T-]	3 0
1-25	-100		[T--]	4 -50
				5 -100

Note: The exact classification of each rating and the weights assigned to each rating may be adjusted according to the preference of the index provider or the Shari’a Supervisory Board. For illustrative purposes, we have utilised the equal weight structure provided.

Illustrative Example (Note: Utilising previous overall ratings)

	Activity	Structure	Tradability	Ethical Concerns
	79	100	G	100
			[T+]	50
				4
				-50
Weights	2.5/10 (or 25%)	2.5/10 (or 25%)	2.5/10 (or 25%)	2.5/10 (or 25%)
Calculation	100*2.5/10	100*2.5/10	50*2.5/10	-50*2.5/10
Result	25	25	12.5	-12.5
Single Rating	50			

From each of the four individual weighted ratings, a single rating can be derived as follows:

$$25 + 25 + 12.5 + (-12.5) = 50.00$$

If the overall Shari'a compliance tolerance level set by the Shari'a board is set above 50, then this company would not be able to pass the weighted average rating and would therefore be excluded from the list of compliant stock.

10. Screening Platform Options

The two methods provided above, the multiple ratings guidance and the cumulative weighted rating guidance, are available under the screening platform designed by Dar Al-Istithmar (DI).

Essentially, the multiple ratings guidance (activity, structure, tradability and social responsibility ratings) can be utilised as selection criteria by each index provider or fund manager, based on the bank's Shari'a supervisory board interpretations of acceptable levels and weightings they place on halal activity, leverage, illiquid assets and social responsibility.

Alternatively, the Shari'a supervisory board can utilise the platform with the default assumptions and weightings provided by the Cumulative Weighted Rating Guidance platform, but adjust the overall tolerance level to their comfort zone.