methodology

of

DSEX SHARIAH INDEX (DSES)

Designed by S&P Dow Jones Indices

DHAKA STOCK EXCHANGE LTD.

www.dsebd.org

Introduction

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The DSEX Shariah Index (DSES) serves as a Shariah-compliant broad market benchmark measuring the performance of the Bangladesh equity market. The Index is constructed as a subset of the DSE Broad Index (DSEX) and includes all stocks included in the parent index that pass rules-based screens for Shariah compliance. An Index Committee is set up to govern the maintenance of the index.

Highlights

The DSEX Shariah Index (DSES) provides broad market coverage of Shariah-compliant equities listed on the DSE. It is designed to be a broad market benchmark. All locally listed stocks that meet size and liquidity criteria are eligible for inclusion. Constituents are weighted by float-adjusted market capitalization.

Partnership

S&P Dow Jones Indices served as a consultant to the Dhaka Stock Exchange in designing the methodologies for the DSEX Shariah Index (DSES), the DSE Broad Index (DSEX) and the DSE 30 Index (DS30). S&P Dow Jones Indices also provides the list of securities passing Shariah-compliance screens to the DSE at each monthly rebalancing, but is not otherwise involved in the governance or ongoing maintenance of the Indices.

Shariah Screening

The DSEX Shariah Index (DSES) utilizes the Shariah screening methodology and processes employed by the S&P Shariah Family of Indices. S&P Dow Jones Indices 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 Shariah Supervisory Board. It is continually working with regional banks to create Shariah-compliant equity products and expand investment offerings.

RI works with a Shariah Supervisory Board, which is a board of Islamic scholars serving to interpret business issues and recommend actions related to business decisions for the indices. The members are:

- Dr. Muhammad Ali Elgari – PhD in Economics from the University of California, U.S.A.
- Dr. Abdul Sattar Abu Ghuddah – PhD in Islamic Law from Al Azhar University, Cairo, Egypt.
- Dr. Nazih Hammad – PhD in Islamic Law from the University of Cairo, Egypt.
- Dr. Mohammad Amin Ali-Qattan – PhD in Islamic Banking, University of Birmingham, United Kingdom.
- Dr. Mohd Daud Bakar -- PhD from the University of St. Andrews, United Kingdom.

Eligibility Criteria

Sector-Based Screens

Business activities related to the following are excluded:

1. Advertising and Media, with the following exceptions:
   - Media and advertising companies generating revenues in excess of 65% of total income from the GCC countries
   - News Channels
   - Newspapers
   - Sports Channels
2. Alcohol
3. Cloning.
4. Financials, except:
   - Islamic Banks
   - Islamic Financial Institutions
   - Islamic Insurance Companies

     Defined as a company having:
     - Shariah Committee to supervise all activities
     - All products are Islamic
     - All investments of the company are Islamic
     - Passes accounting based screens
5. Gambling
6. Pork
7. Pornography
8. Tobacco
9. Trading of gold and silver as cash on deferred basis

During the selection process, each company's latest financial statement is reviewed to ensure that the company is not involved in any non-Shariah compliant activities, regardless of whether the latest statement is a quarterly, semi-annual or annual statement. If the latest statement is available in all three of these frequencies an annual statement will likely be used, as these are more likely to be audited. Those that are found to be non-compliant are screened out. The above industries are not considered Islamic and would not be appropriate for investment for observant Muslims.

Accounting-Based Screens

After removing companies with non-compliant business activities, the rest of the companies are examined for compliance in financial ratios, as certain ratios may violate compliance measurements. Three areas of focus are leverage, cash, and the share of revenues derived from non-compliant activities. All of these are subject to evaluation on an ongoing basis.

Such accounting based screens are not applicable to companies which are run on a fully Shariah compliant basis and such companies shall be considered Compliant. Such companies may be characterized by (the list below is indicative, non exhaustive and reviewed on a case to case basis):

- Having a Shariah Supervisory Board
- All transactions (business and financial) are in accordance with Shariah principles
- Incorporated and managed in a fully Shariah compliant manner.

Leverage Compliance

This compliance is measured as:

Debt / Market Value of Equity (36 month average) < 33 %

Cash Compliance

There are compliances with reference to cash holdings. These are:

Accounts Receivables / Market value of Equity (36 month average) < 49 %;

(Cash + Interest Bearing Securities) / Market value of Equity (36 month average) <33%

Revenue Share from Non-Compliant Activities

In certain cases, revenues from non-compliant activities can be tolerated, if they comply with the following threshold:

(Non-Permissible Income other than Interest Income) / Revenue < 5%

Dividend Purification Ratio

This ratio is provided to investors for purification purposes, it is calculated as:

Dividends * (Non Permissible Revenue / Total Revenue)

Index Eligibility

The stocks, first, must be constituents of the DSE Broad Index (DSEX). They are then screened for Shariah compliance. Only those stocks that are compliant remain in the DSEX Shariah Index (DSES).

For details on the eligibility requirements for the DSE Broad Index (DSEX) please refer to the DSE Bangladesh Indices Methodology.

Timing of Changes

The DSEX Shariah Index (DSES) will see additions and deletions on an ongoing basis due to corporate activity linked to changes in the parent index. Updates due to changes in compliance are applied once a month on the third Thursday of the month.

Additions are made to the DSEX Shariah Index (DSES) once a month, typically the third Thursday of the month after the addition to the parent index, if found compliant by the Shariah board.

Deletions will be done at the same time as the underlying index.

Additions

Once an announcement is made of an impending addition to the DSE Broad Index (DSEX), RI will screen it for compliance. If the stock is found to be compliant, after approval by the Shariah board, it will be added to the respective Shariah index. RI will also regularly monitor the existing non-compliant stocks of the underlying index. If any of these stocks become compliant because of changes in financial ratios or a change in business activity due to mergers or restructuring, it will be added to the Shariah index with notice to clients.

Deletions

All deletions from the parent index will be deleted from the Shariah compliant index on the same day. RI will also conduct an ongoing review of existing Shariah index constituents for continued inclusion in the index.

Additions and deletions to the index which will occur due to ongoing reviews and changes in compliance are done on the third Thursday of each month with advance notice to clients.

Frequently Asked Questions

1. What are the S&P Shariah Indices?

Our Shariah indices provide investors with a comprehensive set of Shariah-compliant investment solutions. Representative of each market, with high correlations to their underlying indices, each index offers a comparable investable portfolio while adopting explicit, transparent selection criteria as defined by Islamic law.

2. Is screening sector- or stock-based?

Stocks that are considered for inclusion in the S&P Shariah Indices are screened using a sector-based screening regime supplemented by a stock-based screening scheme. As a result, although certain sectors (e.g., hotels) are often classified as non-compliant, each stock is individually screened and the non-permissible revenues are determined using various methods that include consulting company statements, third-party sites (e.g., Bloomberg and Google Finance), and contacting the companies themselves. This method has the benefit of being more accurate than a simple sector-based screening, particularly in the case of conglomerates, where a single sector-based classification is unlikely to be representative of all the activities of the conglomerate.

3. Are advertising and media companies considered Shariah-compliant?

The S&P Shariah Indices Methodology states that companies in the advertising and media sector are generally not Shariah-compliant with the exception of:

- Newspapers
- News channels
- Sports channels
- Media and advertising companies generating revenues in excess of 65% of total income from GCC countries (also see question 15).

4. Are embryonic and stem cell research and production companies considered Shariah-compliant?

Companies engaged in genetic cloning activities are generally excluded from inclusion in any S&P Shariah Index with the following exception: embryonic/adult stem cell research is permissible only if it is used for therapeutic/healing purposes and not for duplication of tissues or organs of humans and animals.

5. Are all financial companies considered Shariah-non-compliant according to the S&P Shariah Indices Methodology?

All companies in the financial sector such as conventional banks and insurance companies are considered Shariah-non-compliant with the exception of Islamic banks, Islamic financial institutions and Islamic insurance companies. Such financial companies are defined as:

- Having a Shariah Committee to supervise all activities
- Having only Islamic products
- Investing in only Islamic products or companies
- Passing accounting-based screens.

6. Why are defense stocks included?

The Ratings Intelligence/S&P Shariah Control Committee1 takes the view that weapons can be used for both permissible (e.g., self-defense) and non-permissible (e.g., unprovoked aggression) purposes. The weapons themselves are neutral. Hence, the manufacturing of weapons is considered permissible.

7. How are companies with a large percentage of income generated through interest judged to be compliant?

The S&P Shariah Indices Methodology does not use interest income (as a percentage of total income) as a screening filter. The S&P Shariah Indices Methodology filters out non-permissible income excluding interest income as a percentage of the total revenues. Non-permissible income includes such things as alcohol sales, sales of products containing pork, etc.

The reason for this is to allow for investment in the shares of companies who are in the research and

development phase (e.g., mining or energy companies). These companies often do not generate a sizable revenue (during the R&D phase) from operations, but have a market capitalization well in excess of the cash on their balance sheet2 based on the expectation of high future revenue and profits.3 However, they usually have a high dividend purification ratio (requiring purification at a high level) because any interest they may have received during the R&D phase appears exaggerated due to the small or non-existing revenue from operations.

Such stocks, if they pass all other Shariah screens, and if the cash balances plus any interest-bearing marketable securities (these are the sources of interest income) are within the Shariah limits with respect to the average market capitalization, are allowed for investment.

8. How are investments in mutual funds by companies treated? Is the income derived from these investments considered compliant?

Investments in mutual funds are generally considered to be non-compliant unless the funds in question are Shariah-compliant Islamic funds. There are, however, occasions where regional or circumstantial assumptions may be employed (e.g., having observed that around 50% of the investible universe in India comprises Shariah-compliant stocks, 50% of the income from a mutual fund based in India may be considered compliant).

9. How does the S&P Shariah Indices Methodology define debt? How is it calculated?

Debt, as defined by the S&P Shariah Indices Methodology, is the sum of all short- and long-term interest-bearing borrowings and liabilities. It is calculated by summing all such items reported in constituent companies' statements.

10. How is the average market capitalization of stocks calculated?

The average market capitalization of X over n months is calculated by multiplying the moving average daily closing price of X over n months (must be adjusted for corporate actions) (Pavg) with the total number of shares outstanding for X.

For stocks that have multiple share classes, this is estimated as Pavg/Plast * M, where M is the current market capitalization and Plast is the last closing price of X (for Pavg and Plast, the figures for the main share class are used).

For companies that do not have a sufficiently long price history (e.g., recent IPOs), the figure Pavg is calculated as the moving average daily closing price of X over n days where n is the number of days X has been trading or the number of days that a daily closing price for X has been available.

11. How is the dividend purification ratio calculated? What goes into the component of dividends to be purified?

The dividend purification ratio is calculated as:

DP ratio = Non-Permissible Revenue/Total Revenue

Non-permissible revenue, in this context, includes all forms of revenue or income that are considered non-permissible from a Shariah perspective (e.g., alcohol sales, gambling revenue, etc.) and includes any income generated from interest.

The DP ratio determines what portion of the dividends received must be purified (i.e., given to charity). As an example, a DP ratio of 0.10 (i.e., 10%) implies that 10% of the dividends need to be given to charity, while a DP ratio of 1.0 (i.e., 100%) requires all of the dividends received to be purified.

12. How are consolidated statements used? Are any unconsolidated balance sheets used?

In certain regions (e.g., Japan and India), companies often publish separate consolidated and unconsolidated balance sheets and income statements. However, Ratings Intelligence (S&P's Shariah screening partner) has observed that these companies usually are large conglomerates having a large number of subsidiaries, often with a less than 100% holding in each subsidiary. In such cases, using a consolidated company statement often results in the Shariah ratios being distorted (e.g., debt/equity ratios of 200% or above). Because of this, Ratings Intelligence and S&P Dow Jones Indices have sought and obtained Shariah Committee authorization to use unconsolidated balance sheets by default and calculate pro-rata figures by taking into account the parent company's holding in each subsidiary.

13. Do the S&P Shariah Indices use only audited results or are unaudited results used as well?

In determining Shariah compliance for inclusion in the S&P Shariah Indices, we use the latest financial statement regardless of whether the latest statement is a quarterly, semi-annual, or annual statement. Annual statements are typically audited while quarterly and semi-annual statements are often unaudited.

14. Are any interim or quarterly results used?

We use the latest statement regardless of whether the latest statement is a quarterly, semi-annual, or annual one. If the latest statement is available in all of these three formats, the annual statement will be preferred, since it is more likely to be audited and often more complete.

15. Are there any differences in treatment by market?

The properties of the S&P Shariah Indices Methodology are market-independent in that stocks in all markets are treated with the same rules.4

16. Why are the norms of standardized organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) not used?

The S&P Shariah Indices' screening methodology reflects the latest thinking of the Shariah Control Committee. This may differ from the norms of organizations like AAOIFI for two reasons. Firstly, different Shariah committees can come to different conclusions. Secondly, these "consensus" organizations tend to be less dynamic in their thinking. We do expect screening norms to converge on the S&P Shariah Indices' criteria over time.

17. When does the monthly Shariah review process occur?

- During the week of the first and second Fridays of the month, the Shariah screening of the underlying index members occurs. Values may be fixed (subject to Shariah Control Committee approval) at any point during this time, but this usually happens on the Tuesday of the week of the second Friday of the month, with the

moving average market capitalizations corresponding to the three years immediately preceding the Tuesday of the week of the second Friday of the month.

- During the week of the second and third Fridays of the month, Shariah committee authorization is obtained.

S&P Dow Jones Indices announces changes to the S&P Shariah Indices on the third Friday of the month.

Changes to the Shariah indices take effect at the start of business on the Monday immediately following the third Friday of the month.

18. In the debt/36-month average market cap, which clauses are considered debt?

Our definition of debt includes the following (this list is non-exhaustive):

- Long-term interest-bearing debt as disclosed by the company's management
- Short-term interest-bearing debt as disclosed by the company's management
- Current portion of long-term interest-bearing debt as disclosed by the management
- Interest-bearing short-term liabilities such as overdrafts, bridge loans, etc.

We exclude:

- Short-term non-interest-bearing operational payables/liabilities such as gratuity payable, creditors for goods and services, provisions, etc.
- Long-/short-term Islamic debt
- Long-/short-term non-interest-bearing debt

19. Accounts receivable/36-month average market cap: what is included in accounts receivable?

Our definition of accounts receivables includes the business/operational/trade and non-trade receivables.

20. Do cash and interest-bearing securities include short-term investments, cash equivalents, deposits and bonds?

Our definition of cash and interest-bearing securities includes the following (this list is non-exhaustive):

- Cash in hand
- Cash at bank
- Term deposits (three months)
- Short-term investments held for sale/trading
- Government bonds (if classified as short-term investments)
- Investments in mutual funds, other equity funds held for sale/trading

We exclude:

- Islamic investments

21. Are companies that are fully Shariah-compliant subject to accounting-based screens?

Companies that are fully Shariah compliant are not subject to accounting-based screens, subject to Shariah Board approval. Such companies are classified as Shariah-compliant irrespective of their leverage ratios. While the subsequent list is non-exhaustive and companies are reviewed on a case-by-case basis, companies are typically characterized by the following:

- Presence of a Shariah Supervisory Board
- All transactions (business and financial) are in accordance with Shariah principles.
- Incorporated and managed in a fully Shariah-compliant manner

Notes

1. The Ratings intelligence/S&P Shariah Control Committee is made up of prominent scholars who are very experienced in the application of Shariah to financial products and services. Ratings Intelligence is a consulting firm focused on Islamic Finance.
2. Shariah law promotes the development of businesses and fair trade.
3. If a company only has cash on its balance sheet, with no prospect of future revenues, the equity market will likely see through this, ensuring that its market capitalization will generally be less than the value of its cash holdings. As a result, the stock will fail the cash compliance screens and so be non-compliant.
4. During the meeting held on March 31, 2010 in Dubai, the Shariah Committee recommended that media and advertising companies generating revenues in excess of 65% of total income from the GCC (Gulf Cooperation Council) countries may be allowed for investment while most other advertising and media companies are not allowed (except for newspapers, news channels and sports channels, also see question 3). However, this rule applies to companies originating from any market (i.e., it is not limited to the GCC region). The rule itself is related to the fact that globally-used media (versus that media used only in the GCC region) typically includes images and/or advertising/media language that is inappropriate from a Shariah perspective.