

The Effects of Shariah Compliance Announcement towards Stock Price Changes in Malaysia

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Abstract—This paper seeks to investigate whether the announcement would affect the investors or funds managers' decision to buy, keep or sell stocks that are Shariah-compliant or non-Shariah compliant. The sample is based on the listed Shariah-compliant stocks (SCS) on 29 November 2013 which uses a revised methodology in screening stocks for Shariah-compliance. This has resulted a dramatic change to the number of Shariah compliant firms in Bursa Malaysia and for the first time it has caused a drastic removal of 158 previously Shariah compliant stocks from SAC's Shariah compliant list. Considering the revised screening methodology of the SC, this paper provides clear evidence that the inclusion of a stock in the Shariah-compliant list has a positive effect to the value of the stock while removal from the list negatively affects the price of the stock.

Index Terms—Shariah-compliant shares, stock price, Shariah announcement, Bursa Malaysia.

I. INTRODUCTION

The Securities Commission (SC) Malaysia has been releasing its list of Shariah compliant stocks traded on Bursa Malaysia since June 1997. The purpose of the list is to act as a reference for investors and corporations who prefer to invest in Shariah compliant shares. The Shariah screening method by the SC also acts as a guideline for corporations who wish to be listed as Shariah compliant stocks to comply with the Shariah benchmarks.

If a stock that was previously Shariah-compliant have been announced as non-Shariah-compliant, it is expected that investors or fund managers who are concerned that their wealth, investments and profits are compliant with Shariah would then sell those stocks and replace them with Shariah-compliant stocks. This would adversely affect the price of the stock, and similarly stocks that are previously non-Shariah compliant but are now recognized as Shariah compliant are expected to increase in value.

The Shariah Advisory Council (SAC) of SC has been tasked to screen listed securities for Shariah compliance and give the Shariah approval stamp for stocks that are deemed Shariah-compliant. Companies that aim to retain their current investors and increase the liquidity of their stocks would be motivated to seek the Shariah-compliance certification from the SAC [1].

The Shariah-compliant screening method used by the SAC

of the SC aids fund managers and investors in determining whether a firm's business and financial activities are compliant to Shariah. The inclusion and removal from the Shariah-compliant list acts as an indicator whether the firm is operating in accordance to Shariah or not. Therefore the list only indicates whether a particular firm complies or does not comply with Shariah based to the guidelines given by the SC and the inclusion and removal from this list should not affect how the firm is managed and its performance. However, in the recent Shariah-compliance announcement, both [2], [3] reported that stocks that were removed from the Shariah-compliant list experienced some decrease in price after the announcement was made. This indicates that investors perceive the inclusion in the Shariah-compliant list adds value to a particular stock and vice-versa.

The objective of this paper is twofold; first is to investigate the effects of Shariah announcement on the pricing behavior of previously Shariah-compliant stocks becoming non-Shariah compliant and to investigate the effects of Shariah announcement on the pricing behavior of previously non-Shariah compliant stocks becoming Shariah-compliant. This study is beneficial to publicly-listed firms, fund managers and investors to identify the extent to which the inclusion and deletion of a stock would affect the value of the stock price.

II. BACKGROUND OF STUDY

The Securities Commission follows a two-tier approach in measuring Shariah-compliance stocks, namely quantitative and qualitative approach. The quantitative approach measures the percentage contribution of non-Shariah compliant activities to total revenue or profit while the qualitative approach looks at the image of the firm.

Previously, the quantitative method looks at the contribution of non-Shariah compliant activities to group turnover and profit before tax. Four (4) benchmarks were previously set to measure contributions of different non-permissible activities; 5%, 10%, 20% and 25%. The new screening framework retains two (2) out of the previously four (4) benchmarks and adds two financial ratios into its revised screening framework. Table I depicts the comparison between previous (May 2013) and revised (November 2013) business activity benchmarks.

The new methodology that was introduced in 2013 have resulted in a significant removal of 158 non-Shariah compliant stocks, and inclusion of 18 new Shariah compliant stocks from the previous list, making only 653 stocks (72 percent) to be Shariah compliant out of the total 914 stocks listed on Bursa Malaysia. Malaysian fund managers are given a grace period of six months from November 2013 to align

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their portfolios to the new stock selection [4] and considering the substantial number of stocks that were declared as non-Shariah compliant, a substantial number of stocks will be affected by the announcement.

TABLE I: COMPARISON BETWEEN PREVIOUS (MAY 2013) AND REVISED (NOVEMBER 2013) BUSINESS ACTIVITY BENCHMARKS

Previous Activity-Based Benchmarks (May 2013)	Current Activity-Based Benchmarks (November 2013)
<p>5%</p> <ul style="list-style-type: none"> To assess the level of mixed contributions from activities that are clearly prohibited such as riba-based activities, gambling, liquor and pork; interest income from conventional accounts and instruments and tobacco-related activities. 	<p>5%</p> <ul style="list-style-type: none"> To assess the level of mixed contributions from activities that are clearly prohibited such as riba-based activities, gambling, liquor and pork; interest income from conventional accounts and instruments and tobacco-related activities.
<p>10%</p> <ul style="list-style-type: none"> To assess the level of mixed contributions from the activities that involve the element of “<i>umum balwa</i>” which is a prohibited element affecting most people and difficult to avoid. For example the contribution of interest income derived from fixed deposits in conventional banks. This benchmark is also used for tobacco-related activities. 	<p>20%</p> <ul style="list-style-type: none"> To assess the level of contributions of mixed rentals from Shariah non-compliant activities; To assess the level of mixed contributions of mixed contributions from activities that are generally permissible according to Shariah and have an element of <i>maslahah</i> (public interest), but there are other elements that may affect the Shariah status of these activities e.g. hotel and resort operations.
<p>20%</p> <ul style="list-style-type: none"> To assess the level of contribution from mixed rental payment from Shariah non-compliant activities such as the rental payment from the premise those are involved in gambling, sale of liquor etc. 	<p>Financial Ratio Benchmarks</p> <p>Compute the financial ratios:</p> <ul style="list-style-type: none"> Debt/ Total Assets; Cash and Cash Equivalent/ Total Assets <p>*Each ratio, which is intended to measure riba and riba-based elements within a company's statements of financial position, must be less than 33 percent.</p>
<p>25%</p> <ul style="list-style-type: none"> To assess the level of mixed contributions from the activities that are generally permissible according to the Shariah and have an element of <i>maslahah</i> to the public, but there are other elements that may affect the Shariah status of these activities. Among the activities that belong to this benchmark are hotel and resort operations, share trading, stockbroking and others, as these activities may also involve other activities that are deemed non-permissible according to the Shariah. 	

Source: Malaysia Islamic financial centre (MIFC), www.mifc.com.

Shariah-compliant list from the year 2000 until the most recent announcement at the end of 2013. As can be seen, the percentages of newly added stocks range between 1 percent to 9 percent of the total Shariah compliant stocks. The lowest is 0.61 percent in May 2012 and the highest, 9.08 percent is in October 2000. Meanwhile the number of removed stocks are between zero to 4 percent, the lowest being zero percent in May 2012 and the highest being 4.42 percent in April 2000. The revised screening method indicated a drastic removal of 24.2 percent of stocks from the Shariah compliant list. The main reason for the high number of removal of stocks from the Shariah compliant list is due to the companies not being able to meet the financial ratio of less than 33 percent debt to total assets and cash and cash equivalent to total assets. This ratio is first introduced in the new 2013 Shariah screening framework. Firms that were unable to reduce the amount of debt-to-total-assets and cash-to-total-assets to less than 33 percent are categorized as non-Shariah compliant.

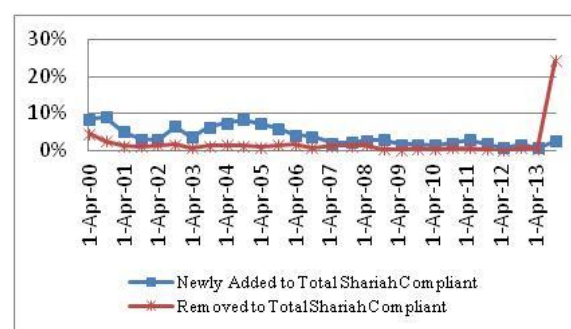


Fig 1. Percentage of newly added and removed stocks to the Shariah compliant list.

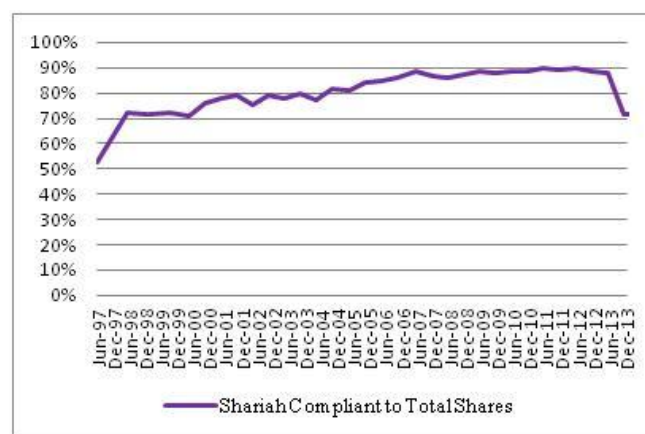


Fig. 2. Percentage of Shariah compliant stocks to total stocks on Bursa Malaysia.

Fig. 2 illustrates the percentage of Shariah compliant stocks to total stocks on Bursa Malaysia. Since first the Shariah-compliant list was introduced in 1997, the number of Shariah compliant stocks traded on Bursa Malaysia has risen from 52 percent in 1997 to the highest record of 90 percent in May 2011. Since 2003, the number of Shariah compliant stocks has always remained between 80 to 90 percent of total stocks traded in Bursa Malaysia. Due to the revision in the Shariah screening method recently, the number of Shariah compliant stocks has dropped drastically to 72 percent in November 2013. This shows that should publicly traded firms want to be included in the Shariah compliant list, certain changes need to be made in restructuring the finances

Fig. 1 exhibits the movement of stocks in and out of the

of the firm, including ensuring that its debt-to-total-assets and cash-to-total-assets remain below 33 percent. Younger firms that are expanding or in the midst of growth might find difficulties in adhering to the new benchmarks as they might need more financing to fund their expansion projects.

III. LITERATURE REVIEW

In Islam, a Muslim's way of life follows a set of Shariah guidelines and rulings. Shariah refers to the sum of Islamic teaching and system, which was revealed to Prophet Muhammad recorded in the Quran and deducted from the Sunna [5]. In the context of Islamic finance, Shariah is used as a term to refer to a financial product or service that is compliant to Islam. As long as the product or service is compliant to all the requirements of Shariah, the product is deemed permissible in Islam and acceptable for Muslims.

In Malaysia, there are two separate SACs; one is under the purview of the SC which is tasked to oversee the Shariah-compliance of Islamic financial products offered in the capital market while the other is governed under Bank Negara Malaysia (BNM). SAC of the SC is tasked to provide with the Shariah-compliant list twice a year, every May and November.

The SAC of the SC was established in May 1996 under section 18 of the Securities Commission Act 1993 (SCA). Under the SCA 1993, it has been given a mandate to ensure that the running of the Islamic capital market (ICM) complies with Shariah principles. Its role is to advise the SC on all matters related to the development of the ICM and functions as a reference centre for all ICM-related issues [6]. Members of the SAC are qualified individuals who can present Shariah opinions and have vast experience in the application of Shariah, particularly in the areas of Islamic economics and finance.

For the Malaysian stock market, the Shariah-compliant securities report is a very important document for investors and fund managers as a reference to manage their investments. Investors and fund managers that are seeking to invest in Shariah-compliant investments would have to make changes in their investment portfolio should the shares that they are investing in be declared as non-Shariah compliant. This is supported by [3] that the prices of the stocks that were declared as non-compliant by the Securities Commission on 29 November 2013 have declined after the non-compliance announcement. The decline in prices could be due to investors who are looking for Shariah compliant investments moving their funds from non-Shariah compliant stocks to Shariah-compliant stocks. However, even though there's an outflow of funds from non-Shariah compliant stocks, investors who made the switch remained in the same industry i.e. switching out of i) AirAsia (non-Shariah compliant) into AirAsia X, ii) Bumi Armada into SapuraKencana, Dialog or MMHE, iii) Media Chinese into Media Prima or Star, iv) SP Setia into UEM Sunrise or Sunway, v) Tan Chong Motor into UMW Holdings, vi) Yinson into Barakah Petroleum or vii) YTL Power into YTL Corp. This indicates that investors are substituting the non-Shariah compliant shares to those that are Shariah-compliant within the same industry [2].

The movement of stock prices due to Shariah-compliance and non-compliance listing is akin to an event that influences

the security price behavior of stocks that are affected by SAC of SC's the announcement. Event studies are study that focuses on announcement effects on stock's abnormal returns for a short-horizon around an event to provide evidence that are relevant for understanding corporate policy decisions [7]. As events occur, information related to the event will be absorbed onto the shares thus affecting the prices as returns of the share. As mentioned by [8] the information conveyed (the inclusion of a Shariah-compliant stock in the Shariah Index) would affect a firm's cash flow positively via additional investments from new investors thus enhancing the company's growth and pushing share prices upwards. Similarly, an event such as the announcement of the Shariah-compliant list would affect an investor's buying, holding or selling decision as a Shariah-compliant investor would be compelled to sell shares that are no longer listed as Shariah-compliant and substitute them with Shariah-compliant stocks. Therefore stocks that are no longer listed as Shariah-compliant would experience a decrease in share price and thus the stock returns as Shariah-compliant investors would be required to sell and invest in the other Shariah-compliant stocks that are available [9]-[11].

However, other event such as inclusion in the Shariah index (KLSI) also generates positive response to prices of shares included in the index [8]. This indicates that the investors are favorable towards the inclusion of the stocks into the index despite research proving that there is no significant difference between the returns of Islamic or conventional stock market indices [10].

IV. RESEARCH METHODOLOGY

A. Sample Selection and Data Collections

The 29 November 2013 announcement was selected because it involves the use of the new screening methodology that revises the previous benchmarks, i.e. the removal of two benchmarks; a) 10 percent benchmark which is used to assess the level of mixed contributions from the activities that involves the element of "*umum balwa*"- prohibited element affecting people and difficult to avoid b) 25 percent benchmark which is used to assess the level of mixed contributions from the activities that are generally permissible according to Shariah and addition of two new financial ratios. It would be interesting to see how the new benchmarks affect the movement of share price in Bursa Malaysia, especially stocks that are affected (i.e. previously Shariah compliant that are removed from the list and previously non-Shariah compliant but have been added to the Shariah compliant list).

The initial sample consisted of 158 non-Shariah compliant stocks which were removed from the previous list of Shariah compliant stocks that was issued in May 2013 and 18 stocks which are added to the approved list. Unavailability of share price information has reduced the sample to 144 non-Shariah compliant stocks. For Shariah compliant stocks all 18 new companies are included in the sample. Daily stock prices and the market index, namely the FTSE Bursa Malaysia EMAS Shariah Index (FBMS Index), were obtained from *Datastream International*. The data is collected in the period ranging from 150 days (more or less 6 months) before to 60

days after the announcement dates.

B. Methodology

The method that is most suitable so far in measuring the reaction of security prices to the Shariah compliant announcement made by the SAC of SC is an event study methodology. The event study is used to measure the magnitude of the abnormal share price performance at the time an event is announced, i.e. the disclosure of the Shariah-compliance list to the public, provides a measure of the (unanticipated) impact of this event on security prices. The study applies the market model to estimate the expected returns as follows:

$$E(R_{jt}) = \alpha_j + \beta_j R_{mt} \quad (1)$$

where $E(R_{jt})$ is the expected return of the company's stock j on event day t , α_j the intercept term for stock j , β_j the slope term for stock j , R_{mt} the return on the benchmark FBMS Index for each day in the event window. Following [11] the variables α and β are estimated using the historical share returns and market returns over a 100-day estimation period ending 61 days prior to the announcement date. After establishing the expected return, the abnormal or unexpected return (AR) for each share j on event day t is measure. The effect on the rate of returns on security j is as follows:

$$AR_{jt} = R_{jt} - E(R_{jt}) \quad (2)$$

where AR_{jt} is the daily abnormal returns of stock j of company for event day t , R_{jt} the actual return of the company stock j on event day t , $E(R_{jt})$ the expected return of the company stock j for event day t .

Then the average abnormal returns (AAR) for a sample of N securities for each day are calculated as:

$$AAR_t = \frac{1}{N} \sum_{j=1}^N AR_{j,t} \quad (3)$$

where N is the number of firms with abnormal returns on day t . The AR is averaged across firms to minimize the other event effects, thus providing a better measure of the effect of the announcement event. The cumulative average abnormal return (CAAR) represents the average total effect of the event across all firms. Both AAR and CAAR are calculated over an event window of $t = -60$ days to $+60$ days, thus:

$$CAAR_t = \sum_{i=-60}^n AAR_i \quad (4)$$

V. FINDINGS AND DISCUSSION

Table II contains the CAAR and the t-statistics for each of the selected event windows specifically for stocks that are no longer Shariah-compliant and newly listed as Shariah-compliant stocks. In this study, for stocks that are no longer listed as Shariah-compliant the CAAR shows to be negative for all selected event windows and only the 60-day before announcement date (-60,0) the CAAR found to be positive. This shows that, 3 months before the announcement

the investors still buy the Shariah-compliant shares, demand increased and share prices increase, leading CAAR to become positive. Therefore a negatively estimated CAAR for short-term and post-announcement event windows reflect investors to sell and invest in the other Shariah-compliant stocks that are available. It is consistent with finding found by [8] which found that stocks that are no longer listed as Shariah-compliant would experience a decrease in share price. Similarly, [9] also found that deletions as Shariah-compliant stocks experience negative impact. As mentioned by SC the investors are given six months from the effective date of the updated list (29 November 2013) to dispose of such securities. The negative returns confirm investors who invest based on Shariah principles sold their stocks. The t -statistic results found to be significant at 1 percent level except for 60-days prior to announcement.

Therefore for the 18 newly listed Shariah-compliant stocks, it is found to have positive CAAR for the post announcement period up to 13 percent average returns. This findings support results found by [9], which reported the positive impact on the stock prices when the stocks are included as Shariah-compliant stocks. [8] also found positive CAARs in the longer term. This is because the Shariah-compliant investors started to buy the Shariah-compliant stocks and the share prices started to rise, leading the CAARs to become positive. For short term and pre announcement event windows, the CAAR are found to be negative. The t -statistic results show insignificant at any level.

TABLE II: CUMULATIVE AVERAGE ABNORMAL RETURN (CAAR) AND T-STATISTICS FOR SELECTED EVENT WINDOW

	Shariah-compliant stocks to Non-shariah compliant stocks		Non-Shariah compliant stocks to Shariah-compliant stocks	
	CAAR (%)	t -statistic	CAAR (%)	t -statistic
Short term				
(-1,+1)	-2.214	-4.952***	-0.567	-0.448
(-3,+3)	-3.858	-5.373***	-0.807	-0.428
(-10,+10)	-3.848	-2.929***	-1.725	-1.111
Pre announcement				
(-15,0)	-5.100	-4.707***	0.649	0.327
(-30,0)	-3.848	-2.929***	-0.455	-0.172
(-60,0)	1.038	0.747	-6.349	-1.481
Post announcement				
(0,+15)	-3.901	-4.692***	13.128	1.686
(0,+30)	-2.218	-2.019***	11.353	1.696
(0,+60)	-2.751	-1.977***	6.728	1.599
N	144		18	

*** Denotes statistical significance at 1% level

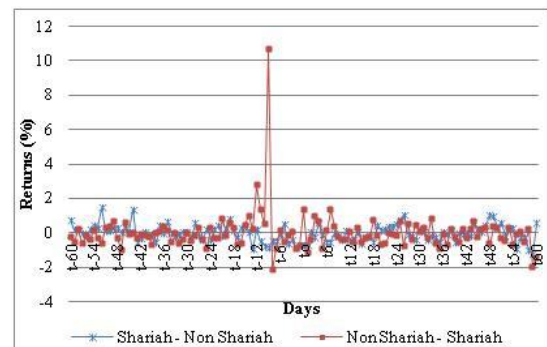


Fig. 3. Comparison of the average abnormal return (AAR) between non-Shariah compliant stocks and Shariah compliant stocks.

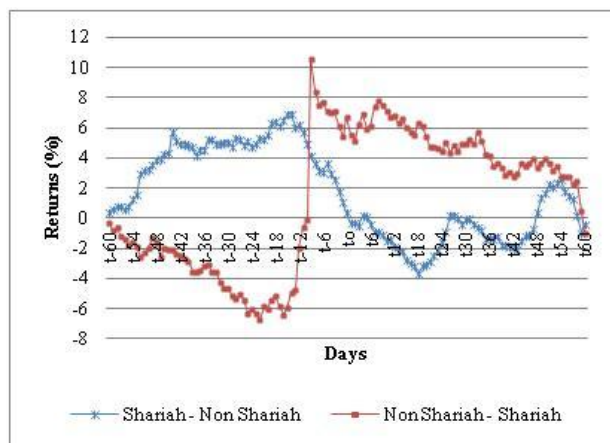


Fig. 4. Comparison of the cumulative average abnormal return (CAAR) plots between non-Shariah compliant stocks and Shariah-compliant stocks.

Fig. 3 and Fig. 4 shows the comparison of the AAR and CAAR between non-Shariah compliant stocks and Shariah compliant stocks for 121 days, (-60, +60) event window. The highest AAR for newly added Shariah-compliant stocks is 10.67 percent at day 9 prior to announcement and for non-Shariah compliant stocks is 1.47 percent at day 52 prior to announcement respectively. This shows that the information already leaked and known by the public and considered 'good news' to buy shares especially for the newly added Shariah-compliant stocks. The increase in returns prior to the announcement due to information leakage forces the returns to move up for newly added Shariah-compliant stocks and forces the returns to move down for non-Shariah compliant stocks before the announcement is made. After the announcement, the CAAR are much higher for Shariah-compliant stocks compared to the non-Shariah compliant stocks. According to [9], the highest Mean Cumulative Abnormal Returns (MCAR) was in day 60 post announcement which is 14.59 percent for newly added and for deletion stocks from Shariah list is 2.30 percent at day 60 prior to announcement. As the new criteria have changed, it actually influenced the abnormal returns for both addition and deletion of the Shariah-compliant stocks. In this study, the findings found that the highest abnormal returns were decreased from the previous study.

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