MSCI Global Islamic Indices
Client Consultation

September 2008

MSCI Global Islamic Indices

- The MSCI Global Islamic Indices reflect Sharia investment principles to provide a relevant opportunity set for Islamic investors. An independent Sharia Board has granted a Fatwa on the MSCI Islamic Index Series Methodology, concluding that the methodology is in compliance with generally accepted Sharia guidelines.
- The MSCI Global Islamic Indices were launched on July 26, 2007. MSCI Barra has just completed the first annual review of the MSCI Global Islamic Indices for the May 2008 Semi Annual Index Review. As of the close of June 4, 2008 the MSCI AC World Islamic index consisted of 1094 securities.
- MSCI Barra is seeking to improve its methodologies and has been listening to its clients' comments regarding the MSCI Islamic Index Series Methodology.
- MSCI Barra welcomes any feedback from the investment community and plans to contact directly some market participants to solicit feedback. Please note that the consultation may or may not lead to changes in the MSCI Global Islamic Indices and the MSCI Islamic Index Series Methodology.

Outline of Consultation

1. Sharia Banking
2. Ratio Calculations
3. Dividend Purification
4. Business Activity Screening
5. Appendix

Sharia Banking

Sharia Banking
Current MSCI Islamic Index Series Methodology

- The current MSCI Islamic Index Series Methodology screens companies in the Financial Services sector both for their compliance to Sharia principles in their revenue from business activities, and for their reliance on debt and interest in their financial structure.
- Financial Services companies that follow Sharia principles in their business activities pass the Business Activity screening.
- Financial Services companies that do not meet the requirements for the Financial Ratio screening are excluded from the MSCI Global Islamic Indices.

Sharia Banking

Potential Enhancement to MSCI Islamic Index Series Methodology

MSCI Barra proposes the following potential enhancement to the MSCI Islamic Index Series Methodology:

Islamic financial institutions would be included in the MSCI Global Islamic Indices and would not be subject to Financial Ratio screening if the following criteria were fulfilled:

i) The Islamic financial institution is a separate legal entity and established only to deal in transactions that are Sharia compliant.

ii) The Islamic financial institution has an appointed Sharia Supervisory Board that provides oversight and sign-off on all product development, implementation and monitoring along with providing on-going guidance on all Sharia related matters and issuing pronouncements/Fatwas to that effect, where such pronouncements/Fatwas are legally binding on the Islamic financial institution.

iii) The above should be documented in the Islamic financial institution’s formation documents along with its audited financial statements.

Sharia Banking
Impact of Potential Enhancement

If the MSCI Islamic Index Series Methodology enhancements were to be implemented as described, 13 securities would have been eligible for addition to the MSCI Global Islamic Indices based on their constituents as of the close of August 22, 2008.

Ratio Calculations

Ratio Calculations
Current Calculation for Third Ratio

- Under Sharia investment principles, accounts receivable are viewed as loans to distributors. However, these loans do not always involve the explicit payment of interest. For example, accounts receivable may be interest-free, or the interest charge may have been incorporated into the price of the goods sold to distributors.
- Due to the special nature of accounts receivable, and based on consultation with its clients and the recommendations of MSCI Barra's Sharia Advisors, the third ratio's threshold has been set at <u>70%</u>.
- Other Sharia Boards can be stricter, setting the level at 49% or even 33%. On the other hand, some Sharia Boards do not recognize <u>any</u> upper limit for accounts receivable.
- MSCI Barra recognises that the Sharia Boards of its clients sometimes have stricter interpretations of the third ratio.

Ratio Calculations
Potential Enhancements to Third Ratio

- MSCI Barra is considering two alternative potential enhancements:

1. Include cash in the calculation of the third ratio

OR

2. Decrease the threshold of the third ratio to a lower level

Ratio Calculations
Option 1: Potential Enhancement

- The third ratio of the Financial Screening is defined as:

  “Accounts receivables over total assets”

- MSCI Barra would modify the ratio definition to be:

  “Accounts receivables and cash over total assets”

Ratio Calculations
Option 1: Impact

- The modified definition of the third ratio:
  - Includes securities with a low cash balance but high accounts receivable in the MSCI Global Islamic Indices.
  - Excludes securities with a high cash balance and high accounts receivable from the MSCI Global Islamic Indices.
- If the third ratio were to be changed as described, 8 securities would have been deleted from the MSCI Global Islamic Indices based on their constituents as of the close of August 22, 2008.

Ratio Calculations
Option 2: Potential Enhancement

- An alternative to the proposal would be to reduce the threshold of the third ratio to a lower level.
- The threshold could be lowered to 49% or 33%

Ratio Calculations
Option 2: Impact

- Lowering the threshold would exclude securities with accounts receivable lower than the current threshold of 70% and above the new threshold.
- If the new threshold were lowered to 49%, 11 securities would have been deleted from the MSCI Global Islamic Indices based on their constituents as of the close of August 22, 2008.
- If the new threshold were lowered to 33%, 70 securities would be deleted from the MSCI Global Islamic Indices based on their constituents as of the close of August 22, 2008.

- Which of the two options would be preferable?

Dividend Purification

Dividend Purification
Potential Enhancement to MSCI Islamic Index Series Methodology

- Currently, the "dividend adjustment factor" is defined as:-

  (total earnings – interest income) / total earnings

- MSCI Barra is considering modifying the definition of the "dividend adjustment factor" to be:-

  (total earnings – prohibited income) / total earnings

- Prohibited Income includes interest income and revenues from any prohibited activity identified in the Business Activity screening.

- How does the potential "dividend adjustment factor" match with current Sharia investment practices?

Business Activity Screening

Business Activity Screening
Threshold for Revenue from Prohibited Activities

- Currently the Business Activity screening excludes securities that are directly active in, or derive more than 5% of their revenue (cumulatively) from, the activities prohibited by Sharia law.

- The Business Activity screening could be modified to exclude securities with **any** involvement in the activities prohibited by Sharia law.

  - *Would a stricter application of the Business Activity screening be preferable?*
  - *Should any one prohibited business activity automatically exclude a company when there is any involvement, for example Pork or Alcohol?*

Business Activity Screening
Impact of Potential Business Activity Screening Enhancement

- Changes due to stricter screening on Business Activity, based on the constituents of the MSCI Global Islamic Indices as of the close of August 22, 2008.

	Number of Securities				One Way Index Turnover		
	Current	Alcohol Excluded	Pork Excluded	All Activities Excluded	Alcohol Excluded	Pork Excluded	All Excluded
World	746	694	692	553	16.4%	17.7%	26.5%
EM	344	326	325	238	13.1%	12.9%	46.8%
ACWI	**1,090**	**1,020**	**1,017**	**791**	**15.9%**	**16.9%**	**28.7%**

Data as of the close of August 22, 2008.

Appendix – Excerpts from the current MSCI Islamic Index Series Methodology

Financial Screening Ratios

Sharia investment principles do not allow investment in companies deriving significant income from interest or companies that have excessive leverage. MSCI Barra uses the following three financial ratios to screen for these companies:

1. Total debt over total assets
2. Sum of a company's cash and interest-bearing securities over total assets
3. Accounts receivables over total assets

Activities Prohibited by Sharia Investment Principles

- Alcohol: distillers, vintners and producers of alcoholic beverages, including producers of beer and malt liquors, owners and operators of bars and pubs.
- Tobacco: cigarettes and other tobacco products manufacturers and retailers.
- Pork related products: companies involved in the manufacture and retail of pork products.
- Financial Services: commercial banks involved in retail banking, corporate lending, investment banking; companies involved in mortgage and mortgage related services; providers of financial services, including insurance, capital markets and specialized finance; credit agencies; stock exchanges; specialty boutiques; consumer finance services, including personal credit, credit cards, lease financing, travel-related money services and pawn shops; financial institutions primarily engaged in investment management, related custody and securities fee-based services ; companies operating mutual funds, closed-end funds and unit investment trusts; financial institutions primarily engaged in investment banking and brokerage services, including equity and debt underwriting, mergers and acquisitions; securities lending and advisory services institutions; and insurance and reinsurance brokerage firms, including companies providing property, casualty, life disability, indemnity or supplemental health insurance.
- Defense / Weapons: manufacturers of military aerospace and defense equipment, parts or products, including defense electronics and space equipment.
- Gambling / Casino: owners and operators of casinos and gaming facilities, including companies providing lottery and betting services.
- Music: producers and distributors of music, owners and operators of radio broadcasting systems.
- Hotels: owners and operators of hotels.
- Cinema: companies engaged in the production, distribution and screening of movies and television shows, owners and operators of television broadcasting systems and providers of cable or satellite television services.
- Adult Entertainment: owners and operators of adult entertainment products and activities.

Dividend Purification

If a company derives part of its total income from interest income, Sharia investment principles state that this proportion must be deducted from the dividend paid out to shareholders and given to charity.

MSCI Barra will apply a “dividend adjustment factor” to all reinvested dividends. The “dividend adjustment factor” is defined as:

(total earnings – interest income) / total earnings

In this formula, total earnings are defined as gross income, and interest income is defined as operating and non-operating interest. MSCI Barra will review the “dividend adjustment factor” on an annual basis.

MSCI Barra 24 Hour Global Client Service

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