Islamic capital market and *Shari’ah* screening in Malaysia

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Abstract

Purpose - The Islamic Capital Market (ICM) is increasingly commanding global attention as a vehicle for adding quality options to financial products and services available in the international markets today. This recognition has encouraged the steady growth of new products as well as efforts at developing and promoting the ICM. In Malaysia, the financial market has grown in parallel with the economic growth of the country. The Islamic capital market has developed a wide range of equity products, debts securities and managed funds. The Islamic equity-related products include Shari’ah-compliant stocks listed on the Main and ACE Market Bursa Malaysia, two Shari’ah indices and equity derivatives such as warrants, transferable subscription rights (TSRs) of approved securities, index and composite future.

Key words Islamic Capital Market, Islamic equity, Shari’ah –Compliant, Malaysia

Introductions
The most notable aspect of *Shari’ah* is the scope of its application and its practical effect on the daily life of Muslims. *Shari’ah* prescribes not only the manner and frequency of worship and religious and spiritual matters but it extends to all aspect of a believer’s life. It becomes apparent, on understanding *Shari’ah* role as an all encompassing set of principles governing daily life that Muslims will seek to abide by *Shari’ah* tenets in matters of business and finance just as much as they do with their personal, social and family affairs (Rahail Ali et al., 2008).

One of the *halal* options in Islamic finance is the offering by *Shari’ah* equity finances, which helps investors to invest in *Shari’ah* compliant securities. These are the most popular type of Islamic funds. The demand for Islamic funds is set to increase significantly as Islamic and non-Islamic investors become more aware of potential rewards from investing in such funds. *Shari’ah* equity funds can either invest in companies which are *Shari’ah*-compliant or, in the case of an Exchange Traded Fund (ETF), the equity fund can invest in equities which mirror a *Shari’ah* index, for example, the Dow Jones Islamic Market Index.

The primary difference between Islamic equity funds and their conventional counterparts relates to the nature of the businesses of the underlying companies. *Shari’ah*-compliant funds can only invest in companies which do not engage in activities which are contradictory to the principles of *Shari’ah*.

**Islamic capital market – Islamic equity products**

Unlike common law, Islamic law is concerned with the moral or ethical value of commercial transactions. It is well known that in the area of diet and nourishment, Muslims follow the rules and regulations in respect of *halal* (permissible) and *haram* (prohibited). *Shari’ah* prohibits earnings income derived from the production and sale of alcoholic substances and pig products. It also prohibits usury or interest, gambling, hoarding and deceptive purchases. Financial transactions which involve the running and management of a casino or sexual and immorality activities are prohibited (Salahuddin Ahmed, 2009).

Equity market is a place where securities, shares and other exchange traded instruments are bought and sold. For an Islamic equity market, it is a vehicle to transfer funds from surplus to deficit units. It allows the owners of capital to invest according to their preference in terms of the extent of risk involvement, rate of return and period of investment. These investments and all related market activities however, must be based on principle of *Shari’ah*. *Shari’ah* compliant stock means the securities (ordinary shares / equities) of a company listed on Bursa Malaysia are classified as *Shari’ah* permissible for investment. Primary business and investment activities that generate income for the company must
conform to Shari’ah principles. In principle, Islamic equity market is characterized by the absence of interest-based transactions, doubtful transactions and unlawful stocks of companies which deal in non-Shar’ah compliance activities or items. Its market activities must be free from any form of unethical or immoral elements (Securities Commission Malaysia, 2009).

From a Shari’ah–compliant investment point of view, the key element to equity funds is the screening criteria which are used to determine the status of the companies in which investment is to be made by the funds (Imtiaz Shah, 2009). The need to screen companies before making investments in them is derived from the Shari’ah principle that Muslims should not partake in an activity that does not comply with the teachings of Islam. Various screening methodology developed and approved by the renowned Islamic scholars and are used by financial institutions around the world.

Currently, there is no international Shari’ah standard for stock screening. Different funds or fund managers utilize different standards based on the approval of respective Shari’ah council. In Malaysia, there are specific criteria used by the Shari’ah Advisory Council of the Malaysian Securities Commission. Shari’ah approved list of companies is issued by the Securities Commission and also recently by Dow Jones-RHB Islamic Malaysia Index and FTSE Global Islamic Index Series. These indexes screen the Shari’ah compliance of ordinary shares of listed companies (Engku Rabiah et al., 2008).

The main thrust of Islamic Capital Market in Malaysia is compliance with Shari’ah principles. Therefore, Shari’ah Advisory Council was established at Capital market level since 1996 under the Securities Commission Act 1993 for the screening process of the products (http://www.sc.com.my/sub.asp (accessed 24 February 2010). The main objective of the Shari’ah Advisory Council of Securities Commission is to advise Securities Commission (Resolutions of the Securities Commission Syariah Advisory Council, 2003) on Shari’ah matters and Shari’ah guidance for Islamic capital market in Malaysia (M. Fazilah et al., 2006). The Securities Commission is a statutory body set up under the Securities Commission Act 1993 (SCA), reporting directly to the Minister of Finance of Malaysia. It is the sole regulatory body for the regulation and development of the capital market in Malaysia (Ahcene Lahsasna, 2010). It is directly responsible for the regulation and supervision of the activities of the market institutions, including the stock exchanges, clearing house, and monitoring of licences under the Capital Markets Service Act 2007. SAC will be responsible in determining the status of the securities traded in Bursa Malaysia whether they can be considered as Shari’ah approved which means that the securities are considered as a halal company for investment or vice versa.
The Shari’ah Advisory Council of the Securities Commission Malaysia also has approved an updated list of securities, which have been classified as Shari’ah-compliant securities. The list is constantly updated in May and November every year. This updated list is used by the Bursa Malaysia in updating the component stocks of the Bursa Malaysia Shari’ah Index (KLSI). It is essential to help Muslims investors identify Shari’ah compliant securities and at the same time to increase their confidence when making their investments. For that purposes while classifying these securities, the SAC may receive inputs and supports from the SC. The SC gathered information on the companies from various sources, such as through inquiries made to the respective company’s management. The SC through the SAC, continues to monitor the activities of all companies listed on Bursa Malaysia to determine their status from Shari’ah perspective.

The SAC of SC carried out their study from various angels including the consideration of views from within and outside the country before publishing the initial list of securities approved according to Shari’ah principles. However, the criteria used as a basis to study the securities are constantly updated based on the research and case studies of all the listed securities on the KLSI and Bursa Malaysia. This is to ensure that Shari’ah-approved securities have gone the appropriate study process, in line with the requirements for the development and progress of the Islamic capital market in this country (Saiful Azhar, 2008).

Security Commission of Malaysia: criteria & screening methodology for Shari’ah-compliant stocks

Muslim scholars introduce the Shari’ah screening process whereby prohibited activities can be detected and avoided before one embarks into an investment or become involved in equity fund is on the basis of a hadith by Jabir ibn Abdullah who reported that the Prophet (p.b.u.h) forbade the sale of wine, swine, and idols. Thus, the existence of the Shari’ah screening process in the stock market will enable Muslim investors to invest in the companies that run the permissible activities in the business. The screening of companies before any investment is made in them is also derived from the Shari’ah principle that, Muslim should not participate in the non-permissible activities which are contradicted with the teaching of Islam.

The al-Qur’an, surah al-Mukminun verse 51 states that Muslims are commanded to participate in good things and work for righteousness (Mohd Ma’sum Billah, 2006). From the past, a majority of the Shari’ah scholars from different countries have agreed with the screening methodology and its rationale.

The Shari’ah-screening criteria provide guidelines to screen out companies conducting non–Shari’ah business activities. The criteria also exclude the companies whose financials do not meet the minimum acceptable levels. In order to protect investors the criteria
is developed with the ultimate objective of excluding companies that do not comply with Shari'ah principles.

The Shari’ah approved securities from the securities traded at Kuala Lumpur Shari’ah Index (KLSI) and main Market in Bursa Malaysia, SAC applies both quantitative (the quantitative screening methodology adopted by the SAC deals with the issues of mixed contribution (both permissible and non permissible) towards the revenue and profit of a company that has passed the qualitative test) and qualitative criteria or parameters to select the companies that are Shari’ah compliant. The criteria have been updated over the years taking into consideration the necessity needed for ICM development in Malaysia. The screening starts with the assessment of a company’s main activity or production. This will be based on the information gathered by SC on the company from the company annual reports, questionnaires and interviews conducted with the company’s management, publications like magazines, newspapers, and other KLSI’s references. For that reason, the SC has applied a standard criterion in focusing on the activities of the companies listed on Bursa Malaysia (Resolutions of the Securities Commission Syariah Advisory Council, 2003). In general, these criteria were determined after referring to the Qur’an, hadith and general Shari’ah principles and were formulated according to the activities of a particular company. As such, subject to certain conditions, companies whose activities are not contrary to the Shari’ah principles will be classified as Shari’ah –compliant securities. On the other hand, companies will be classified as Shariah non-compliant securities if they are involved in the following core activities:

(a) Financial services based on riba’ (interest)

(b) Gambling and gaming;

(c) Manufacture or sale of non-halal products or related product

The primary activity of a company is the production and sale of goods and services that are prohibited in Islam, including:

i. Processing, producing and marketing alcoholic drinks;

ii. Supplying non-halal meat like pork, etc.

iii. Providing immoral services like prostitutions, pubs, disco, etc.

(d) Conventional insurance;

The primary of conventional company is gharar (uncertainty). The basis of the prohibition on gharar is a hadith of the Prophet s.a.w.:” Verily, the Prophet s.a.w. prohibits gharar transactions’’.
(e) Entertainment activities that are non-permissible according to Shari’ah;

(f) Manufacture or sale of tobacco-based products or related products;

(g) Stockbroking or share trading in Shari’ah non-compliant securities; and

(h) Other activities deemed non-permissible according to Shari’ah;

For example, biotechnology companies involved in human/animal genetic engineering or other sectors as determined by the Shari’ah committee from time to time.

A general reason for exclusion of companies from the above mentioned industries is that Muslims are commanded to participate in good things and work for righteousness as mentioned in the Qur’an, 23: 51. The Prophet Muhammad saw (peace be upon him) has been quoted saying: “Seeking the *halal* is the duty of every Muslim” (Yusuf al-Qardawi, 2009). The products of many of the industries mentioned above have been specifically prohibited in Islamic principles.

In order to screen selected companies and their stocks for Shari’ah compliant, SC in Malaysia and well-known index providers such as DOW Jones Islamic Market Index (DJIM) Shari’ah Board and FTSE Global Islamic Index Series have established dedicated Islamic indices. The companies that fail to comply with the business activities and financial ratio screens are removed from the lists. A list of the Islamic equity indexes available in the industry are Kuala Lumpur Shari’ah Index, FTSE Global Islamic Indexes, Dow Jones Islamic Market Indexes, Global GCC Islamic Index and MSCI Islamic Index Series (Nik Norzrul Thani et al., 2008). Using research, advice from Shari’ah scholars and market information, these index providers screen stocks for Shari’ah compliance and publish information about which equities Muslims can trade in without breaching the requirement of Islamic principles (Rahil Ali et al., 2009). The following is the list of rules/compromises used DJIM:

i. Exclude companies with a debt trailing 12 month average market capitalization ration of 33% or more

ii. Exclude companies with cash plus interest-bearing securities divided by trailing 12 month average market capitalization of 33% or more

iii. Exclude companies with accounts receivable to 12 month average market capitalization ratio of 33% or more

This compromised based on a famous *hadith* where Sa’ad (r.a) asked the Prophet (s.a.w) how much of his wealth to be given in charity, and the Prophet (s.a.w) said: “one-
third, and one-third is plenty”. Based on the Prophet’s s.a.w words 1/3 or 33.33% “is enough” and can be used as guideline for the basis of formulating a benchmark.

Mixed companies

A question arises when a company’s core activity is permissible but at the same time it has other prohibited activities. For example, a big company whose activity is the production of industrial goods but has a subsidiary company whose activity involves riba’. This activity occurs within the company’s group and provides loans to the subsidiaries and the holding company for financing their activities. The form of prohibited activity in this case is more for financing the company’s purchase of machinery, equipment and others. A majority of Islamic jurists from Hanafi, Maliki, Shafi’i and Hanbali madhab had found mixed companies to be permissible.

The second important level of screening involves the quantitative screening methodology. At this level, the Shari’ah Advisory Council deals with the issues of mixed contribution (both permissible and non-permissible) in determining the revenue and profit of a company that has passed the qualitative test. In order to establish the minimum acceptable level of mixed contributions from non-permitted activities, the Shari’ah Advisory Council has established benchmarks which are based on juristic reasoning as shown below.

The SAC also takes into account the level of contribution of interest income received by the company from conventional fixed deposits or other interest bearing financial instruments. The core activities of the company must be activities which are not against the Shari’ah as outlined in the criteria above. Furthermore the haram element must be very small compared to the main activities. In addition, dividends received from investment in Shari’ah non-compliant securities are also considered in the analysis carried out by the SAC.

For companies with activities comprising both permissible and non permissible elements, the SAC considers two additional criteria:

(a) The public perception or image of the company must be good; and

(b) The core activities of the company are important and considered maslahah (‘benefit’ in general) to the Muslim ummah (nation) and the country (The existing structure of a company enables the majority shareholder of the company to control it. This means that Muslims can control a company by being the largest shareholder of the company. This is a strategic and important matter that needs to be understood by the Islamic community), and the non-permissible element is very small and involves matters such as ‘umum balwa (common plight and difficult to avoid) (There is a number of maxims of Islamic jurisprudence that excuse Muslims caught
in ‘umum balwa situations. The purpose of such an excuse is to facilitate the carrying out of daily activities. Without such an allowance, the maslahah of the public will be affected especially in an economic filed that involves the control of mal and trade as well as social stability, ‘urf (custom) and the rights of the non-Muslim community which are accepted by Islam.

It may be possible that a company is in industries which are Shari’ah compliant but the revenue from the subsidiary whose activities are not Shari’ah compliant may lead the company to be considered as non-Shari’ah compliant.

The benchmark of Shari’ah compliant securities

The SAC considered a number of benchmarks as a basis that can be considered as ihtiyat (precautionary measure), that gives caution is classifying a mixed company under the permissible category, and additional elements like maslahah, ‘umum balwa, urf khas min asalib iqtisadiyyah (something that is widely used especially in economic activity), fasaduz zaman and huquq ghair muslimin (rights of non-muslim) (Securities Commission, 2009)

To determines the tolerable level of mixed contribution from permissible and non-permissible activities towards the turnover (TO) and profit before tax (PBT) of a company, the SAC has established several benchmarks based on ijtihad (reasoning from the source of Shari’ah by qualified Shari’ah scholars). If the contributions from non-permissible activities exceed the benchmark, the securities of the company will be classified as Shari’ah non-compliant. The benchmarks are:

a. The five-percent (5%) benchmark

This benchmark is used to assess the level of mixed contributions from the activities that are clearly prohibited such as riba (interest – based companies like conventional banks), gambling, liquor, pork and non-halal food production.

b. The 10-percent (10%) benchmark

This benchmark is used to assess the level of mixed contributions from the activities that involve the element of ‘umum balwa’ which is prohibited element affecting most people and difficult to avoid for instance, interest income from fixed deposits in conventional banks and revenues generated from tobacco-related activities as a minor portion of an overall Shari’ah-compliant business.

c. The 20-percent (20%) benchmark
This benchmark is used to assess the level of contribution from mixed rental payment from *Shari’ah* non-compliant activities such as the rental payment from the premise that involved in gambling, sale of liquor etc.

d. The 25-percent (25%) benchmark

This benchmark is used to assess the level of mixed contributions from the activities that generally permissible according to the *Shari’ah* and have an element of *maslahah* to the public, but there are other elements that may effect the *Shari’ah* status of these activities e.g hotel and resort operations, share trading, stock broking, as these activities may also involve other activities that are deemed non-permissible to the *Shari’ah*.

In addition to ordinary shares of the companies, the SAC has approved the *Shari’ah*-compliant securities include warrants and transferable subscription right (TSRs). This means that warrant and TSRs are classified as *Shari’ah*-compliant securities provided the underlying shares are also *Shari’ah* compliant. On the other hand, loan stocks and bonds are *Shari’ah* non-compliant securities unless they are issued based on *Shari’ah* principles (Securities Commission Malaysia, 2009).

The above approach shows that the *Shari’ah* Advisory Council has taken different ways which are more dynamic, if compared with the Middle East screening criteria. The difference approaches, such as using benchmark for including some non-compliant businesses, not excluding the hotel and resort industry, not excluding companies with more liquid assets than illiquid assets and not accepting account receivables as a parameter, make the *Shari’ah* Advisory Council quite different from other Middle East scholars (Securities Commission, 2009).

However, Muslim scholars have raised the issue on how to determine the financial ratio. What are the justifications for each ratio such as debt should be less than 33 per cent; account receivable should be less than 33 per cent and interest income less than 5 per cent? The answers are still debatable among the scholars. Next, the issue in the screening process relates to the interest income that should be less than 5 per cent. The issue is how to justify that a company with less than 5 per cent interest income can be included and pass the screening process. In *Shari’ah*, interest is clearly prohibited, as such, the idea of income being less than 5 per cent is deemed without a strong basis.

Example of Case Study:

1. Syahdu Senja Holdings Berhad (Principal activity – Construction and civil engineering)
Tobacco business

Pre-compliance result:

<table>
<thead>
<tr>
<th>Non-permissibles</th>
<th>Calculation</th>
<th>Quantitative result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of tobacco to Group TO</td>
<td>RM900,000 / RM10.0 mil</td>
<td>9%</td>
</tr>
</tbody>
</table>
Percentage of tobacco to Group PBT | RM400,000 / RM5.0 mil | 8%

Benchmark for tobacco: 10% of Group TO or Group PBT
Pre-compliance result: Shariah-compliant (contribution from tobacco < the 10% benchmark)

*Shariah guidance on investment in Shariah non-compliant stocks*

This refers to those securities which were earlier classified as Shariah-compliant securities but due to certain reasons, such as changes in the companies’ operations, are subsequently considered Shariah non-compliant. In this regard, if on the date this updated list takes effect (30 November 2009), the value of the securities held exceeds the original investment cost; investors who hold such Shariah non-compliant securities must liquidate them. Any capital gains arising from the disposal of the Shariah non-compliant securities made at the time of the announcement can be kept by the investors. However, any excess capital gains derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channeled to charitable bodies or baitulmal.

On the other hand, investors are allowed to hold their investment in the Shariah non-compliant securities if the market price of the said securities is below the original investment cost. It is also permissible for the investors to keep the dividends received during the holding period until such time when the total amount of dividends received and the market value of the Shariah non-compliant securities held equal the original investment cost. At this stage, they are advised to dispose of their holding.

In addition, during the holding period, investors are allowed to subscribe to –

(a) Any issue of new securities by a company whose Shariah non-compliant securities are held by investors, for example right issues, bonus issues, special issues and warrants [excluding securities whose nature is Shariah non-compliant e.g. irredeemable convertible unsecured loan stock (ICULS)]; and

(b) Securities of other companies offered by the company whose Shariah non-compliant securities are held by the investors, on condition that they expedite the disposal of the Shariah non-compliant securities. For securities of other companies [as stated in (b) above], they must be Shariah-compliant securities.

(ii) Shariah non-compliant securities
The SAC advises investors who invest based on *Shari’ah* principles to dispose of any *Shari’ah* non-compliant securities which they presently hold, within a month of knowing the status of the securities. Any gain made in the form of capital gain or dividend received during or after the disposal of the securities has to be channeled to charitable bodies or *baitulmal*. The investor has a right to retain only the original investment cost (Engku Rabiah and Hassan Scott, 2008). This guidance also applies to the Islamic investment schemes such as Islamic unit trust fund and others. If the disposal of the *Shari’ah* non-compliant securities causes loss to the fund, the fund management company must bear the losses by ensuring the lost portion be restored and return to the fund.

Shari’ah-compliant securities on Bursa Malaysia (as at 23 November 2009)

<table>
<thead>
<tr>
<th>Main Market/ACE Market</th>
<th>Shari’ah-compliant securities</th>
<th>Total securities</th>
<th>Percentage of Shari’ah-Compliant securities (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Products</td>
<td>126</td>
<td>135</td>
<td>93</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>280</td>
<td>290</td>
<td>97</td>
</tr>
<tr>
<td>Mining</td>
<td>1</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Construction</td>
<td>48</td>
<td>50</td>
<td>96</td>
</tr>
<tr>
<td>Trading/Services</td>
<td>171</td>
<td>199</td>
<td>86</td>
</tr>
<tr>
<td>Properties</td>
<td>73</td>
<td>88</td>
<td>83</td>
</tr>
<tr>
<td>Plantation</td>
<td>38</td>
<td>43</td>
<td>88</td>
</tr>
<tr>
<td>Technology</td>
<td>98</td>
<td>101</td>
<td>97</td>
</tr>
<tr>
<td>Infrastructure (IPC)</td>
<td>6</td>
<td>7</td>
<td>86</td>
</tr>
<tr>
<td>Finance</td>
<td>5</td>
<td>40</td>
<td>13</td>
</tr>
<tr>
<td>Hotels</td>
<td>Nil</td>
<td>4</td>
<td>Nil</td>
</tr>
<tr>
<td>Close-end Fund</td>
<td>Nil</td>
<td>1</td>
<td>Nil</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>846</strong></td>
<td><strong>959</strong></td>
<td><strong>88</strong></td>
</tr>
</tbody>
</table>

Global Islamic index providers: criteria and screening methodology for Shari’ah-compliant stocks

The stock screening process by global Islamic index providers can be divided into two main stages:

i. Screening in terms of company activities, products and industry

ii. Computation of a set of financial ratio and compare them against specified benchmarks (note: this is not required by the Malaysian Securities Commission’s criteria)

The screening process begins with the screening of the company in terms of its activities, products and industry. Anything that is related to alcohol, tobacco, pork products,
conventional financial services, weapon and defence, entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.) is excluded.

Next, a set of measures called financial filters is used to refine the selection. The filters use a number of financial ratios and compare them against their respective benchmarks to weed out Shari’ah non-compliant stocks. The data for determining the ratios are taken from balance sheets and income statements. In the case of Dow Jones Islamic Market Indexes, they use stock market data as well. In general, these ratios can be categorized into three; liquid assets, interest income and leverage (Zamir Iqbal and Abbas Mirakhor, 2007).

The ratio benchmark ranges from:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid asset</td>
<td>30%-49%</td>
</tr>
<tr>
<td>Interest income</td>
<td>5%-15%</td>
</tr>
<tr>
<td>Leverage</td>
<td>30%-33%</td>
</tr>
</tbody>
</table>

**Cleansing of returns**

Cleansing or purification of returns is basically the act of deducting the “tainted” income (which are not acceptable from Shari’ah point of view) from the total returns of investment. The main sources of returns on investment which must be cleansed are:

i. Dividends

ii. Capital gains

There is, however, no international Shari’ah standard or consensus on the actual mechanisms of cleansing the returns. Nevertheless, the act or initiative to cleanse can be done either by the fund manager or individual investor. Generally, the returns are cleansed by causing a portion of the dividends/capital gains equivalent to the percentage of “tainted” income to be donated to charity or charitable bodies.

**Conclusion**

In conclusion, it is hoped that the discussions have managed to create a more in-depth understanding and appreciation of the Shari’ah compliant securities. By having the list, SC has able to facilitate the development of a wide range of competitive products and related services as well as to create a viable market for the effective mobilization of Islamic funds. In any case, Islamic law is very flexible, despite its finality; especially in commercial contracts where most are still not conclusively decided. The goods news is that Islamic funds are not hugely different structurally to conventional funds and for the most part the main difference is that the assets in which they invest in must be Shari’ah-compliant. In order to be successful in
this growing market, managers and administrators will need to familiarize themselves with the Shari’ah principles and legal frameworks in Malaysia.

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