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The Concept of Sukuk and its Applications in Contemporary Islamic Financial System

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Abstract

Sukuk is the Arabic term for financial certificates, which are also commonly referred to as Shariah-compliant bonds. Sukuk was developed as an alternative to conventional bonds, which are considered by many Muslims to be impermissible because they involve elements which are prohibited or discouraged such as usury (*riba*), uncertainty (*gharar*) and gambling (*maisir*). The paper adopts qualitative research methodology which relies on secondary data in form of textbooks, journals, newspapers, related websites etc. After discussing the concept of Sukuk that covered topics such as overview of sukuk; classifications of sukuk; types of sukuk; Shariah issues in Sukuk etc. it is found that sukuk securities are structured to be Shariah compliant by distributing profits and not interest, and generally include a tangible asset in the investment. For example, sukuk securities may be partial ownership of a property built by the investment company (and held in a special purpose vehicle) so that the sukuk holders can collect the property's profits as rent (which is permissible under Islamic law). However, there are still various Shariah issues in the different types of sukuk in the market.

Keywords: Sukuk, Islamic Bond, Islamic Finance

1. Introduction

Sukuk is the Arabic term for financial certificates, which are also commonly referred to as "Shariah-compliant" bonds. Sukuk is defined by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) as "securities of equal denomination representing individual ownership interests in a portfolio of permissible existing or future assets.

Sukuk were developed as an alternative to conventional bonds, which are considered by many Muslims to be impermissible because they pay interest (which is prohibited or discouraged as *riba* or usury) and may also finance companies involved in activities that are not permitted under Shariah (gambling, alcohol, pork, etc.).

Sukuk securities are structured to be Shariah compliant by distributing profits and not interest, and generally include a tangible asset in the investment. For example, sukuk securities may be partial ownership of a property built by the investment company (and held in a special purpose vehicle) so that the sukuk holders can collect the property's profits as rent (which is permissible under Islamic law). Because they represent ownership of real assets and (at least in theory) do not guarantee repayment of the original investment, Sukuk is similar to equity instruments, but as with a bond (and unlike equity) the regular payments end when they expire. Most Sukuk, however, are "asset-based" rather than "asset-backed" - their assets are not actually owned by the SPV, and their holders have recourse to the originator in the event of default. Different types of sukuk are based on different structures of Islamic contracts.

This paper looks into the concept of Sukuk. The first part of this paper provides an overview of Sukuk; the second part discuss Sukuk Classifications into Asset-based and Equity-based; the third part deals with Types of Sukuk and Their Basic Principles; and the last part deals with Shariah Issues in Sukuk.

2. Overview of Sukuk

Sukuk are commonly known as 'Islamic bonds.' However, this may mislead people to assume that sukuk and bonds are the same, which is not the case, as they completely differ in their nature (Dusuki & Mokhtar, 2010). In actual fact, instruments in sukuk market are being issued by using assets and various Shariah contracts. Thus, sukuk holders get their shares in revenues generated by sukuk assets and may also get shares if proceeds are realized from the sukuk assets (Mohamad Mokhtar, Rahman, Kamal, & Thomas, 2009).

The definition of sukuk comes from the singular of the word *sakk*, but it can also be defined from different perspectives, such as linguistic, Islamic jurisprudence, and Islamic finance. From a linguistic perspective, the term *sakk* is said to be of Persian origin and means two things colliding with great force. In Arabic literature, *sakk* means "to strike a seal on a document" The term *sakk* generally applies to all written documents. A narration cited by Imam Malik in *Al-Muwatta* refers to sukuk as a document that gives its holders the right to some products of the market (Sairally, B.S & et al., 2017).

From the perspective of Islamic jurisprudence, scholars use the term *sakk* to refer to a written document that confirms a transaction and specifies the rights and conditions of the parties to the contract. For example, a *waqf*, a sale, or a lease. From the perspective of Islamic finance, on the other hand, the term sukuk in its simplest form refers to 'investment certificates' that entitle the holder to have a share in the property in proportion to the underlying assets or property transactions of the sukuk, along with pro rata profits or losses related to the property, business ventures, or investment activity. Unlike conventional bonds, structuring sukuk requires Shariah-compliant underlying assets (Sairally, B.S & et al., 2017).

Literally, sukuk simply means 'certificates.' Technically, sukuk are papers or certificates that represent financial obligations due to trade and other commercial activities (Kamil, 2008). The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) defines investment sukuk (*sukuk al-istithmar*) in its Shariah Standard 17 (2) as "certificates of equal value representing undivided interests in ownership of tangible assets, beneficial interests and services, assets of specific projects or specific investment activities" (AAOIFI, 2008). The Islamic Financial Services Board (IFSB), another regulatory body for Islamic financial institutions, provides a similar definition. In its Capital Adequacy Standard (IFSB 2), Sukuk is defined as "certificates representing the holder's proportionate ownership of an undivided portion of an underlying asset, with the holder assuming all rights and obligations with respect to that asset" (IFSB, 2005).

Based on the above definition, although the term sukuk is usually translated as Islamic bond, a more accurate description of sukuk should be an investment certificate representing ownership of an asset or a company. In contrast, bonds are typically issued to evidence debt. Unlike Sukuk, bonds do not represent ownership by the

bondholders of the commercial or industrial enterprises for which the bonds were issued. Rather, they document the interest-bearing debt owed by the issuer, who is actually the owner of the enterprise, to the bondholders (Usmani, 2007).

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines sukuk as: "certificates of equal value representing undivided interests in the ownership of tangible assets, beneficial interests, and services, or (in the ownership of) the assets of specific projects or specific investment activities." (AAOIFI Shari'ah Standard (17) on investment Sukuk).

There are three requirements for a sukuk to be considered sharia compliant (Godlewski, 2013). First, the certificates must represent ownership of tangible assets, usufruct, or services from entities that generate revenue. Second, payments to the investor must come from after-tax profits, and third, the value repaid at maturity should be the current market price of the underlying asset, not the original amount invested. Sukuk comes in many different forms, as financiers are not forced to develop their own variations (Visser, 2009). Generally, however, the parties to a Sukuk issue are the company (the debtor or originator), the special purpose vehicle (SPV), and the acquirers who purchase the Sukuk. The SPV is a separate entity from the originator that is insolvency remote and issues Sukuk certificates (Pegah, 2017).

Persian Gulf Countries (GCC) and Southeast Asia (SEA) are the major players in the global sukuk market. Among the GCC countries, UAE, Saudi Arabia, Bahrain, Qatar, and Kuwait are important countries in issuing sukuk. Meanwhile, Malaysia plays an important role in the region SEA. In addition to Malaysia, Indonesia and Singapore also contribute to the global Sukuk market in this region. Today, the market is no longer limited to this region. It is also developing in other countries such as Pakistan, Japan, and other parts of Asia, as well as the US, UK, Germany, Turkey, Egypt, and Gambia, which also contribute to the market. According to a 2016 report by the International Islamic Finance Market (IIFM), a positive development in the sukuk market is the attractiveness of sukuk as an alternative source of financing from new countries in Europe, Asia, CIS, and Africa, as well as early signs of possible direct market entry from North America. It should be noted that in 2000, the total volume of Sukuk was only US\$1,172 million and there were no government Sukuk in the market. According to the IIFM report, the total volume of Sukuk has exceeded US\$68,742 million in the next 16 years ((Pegah, 2017).

3. Sukuk Classifications into Asset-based and Equity-based

The Islamic Financial Services Board (IFSB), in its Guidelines No. 2 (IFSB 2) issued in 2005, distinguishes two broad categories of Sukuk, namely asset-based Sukuk and equity-based Sukuk. The former is defined as "Sukuk where the underlying assets provide fairly predictable returns to Sukūk holders, as in the case of Salam, Istisnā, and Ijārah." Equity-based sukuk, on the other hand, are defined as those where returns are based on profit and loss sharing in the underlying asset that does not offer reasonably predictable returns (e.g., Mushārah or Mudārah for trading purposes)" (IFSB, 2005). This guidance clearly recognizes that Sukuk represent ownership of the underlying asset and that Sukuk holders assume all rights and obligations associated with the asset.

In reality, however, not all sukuk meet the criteria set forth in IFSB 2. In fact, most Sukuk structures in the market do not reflect the true ownership of the Sukuk holders in the underlying asset. Therefore, an additional standard, IFSB 7 - Capital Adequacy Requirements for Sukuk, Securitizations and Real Estate Investments, was issued in 2009. This standard addresses, among other things, the capital adequacy requirements for sukuk structures that are not backed by assets (ABS) and provides clear guidance on the criteria for derecognition of assets for a ABS (Mohamad Mokhtar, True Sale and Bankruptcy Remoteness in Sukuk, 2008).

IFSB 7 distinguishes three types of sukuk structures - one asset-backed structure (ABS) and two non ABS structures (pay-through and pass-through structures). According to IFSB 7, asset-backed sukuk (ABS) are

"structures that meet the requirements for an asset-backed structure as rated by a recognized external credit rating institution (i.e., credit rating agencies) (Dusuki & Mokhtar, 2010).

On the other hand, the IFSB distinguishes two types of asset-based Sukuk: first, Sukuk that use a purchase commitment from the originator (also called pay-through Sukuk), and second, Sukuk with a guarantee from the issuer in case the originator defaults (also called pass-through Sukuk). Based on the IFSB definition above, it became clear that asset-backed Sukuk implies that Sukuk holders have recourse to either the originator (via the purchase obligation) or the issuer (via the guarantee). In other words, Asset-Backed Sukuk involves full transfer of legal ownership of the underlying asset, while Asset-Based Sukuk involves recourse to the originator or the issuer (but not the asset) (Dusuki & Mokhtar, 2010).

Obviously, the IFSB definition of asset-backed sukuk is very much influenced by the rating agencies' definition. For example, Moody, one of the most internationally recognised rating agencies, also makes a clear distinction between asset-backed and asset-based Sukuk. According to Moody's definition, asset-backed Sukuk is those whose "investors benefit from asset-backing; they benefit from some form of security or lien over the assets and are therefore in a preferred position over other, unsecured creditors. In other words, should the issuer default or become insolvent, bondholders can recoup their risk by taking control of the assets and ultimately realising the value of those assets. In addition, the elements of securitization must be present-true sale, bankruptcy remoteness, and enforceability of the collateral" (Lotter, Philipp; Howladar, Khalid, 2007).

On the other hand, asset-based Sukuk are those in which "the originator agrees to repurchase the assets from the issuer at maturity of the Sukuk or at a predefined early termination event for an amount equal to the principal repayment. In such a repurchase obligation, the actual market value of the underlying asset (or portfolio of assets) is irrelevant to the holders of the Sukuk note, as the amount is defined to be equal to the notes. In this case, the noteholders have no special rights to the asset(s) and rely entirely on the creditworthiness of the originator, either from internal sources or from its ability to refinance, for repayment. Therefore, if the originator is unable to meet its obligation to repurchase the asset(s), the bondholders are not in a preferred position relative to other creditors, nor are they in a weaker position relative to other unsecured creditors, underscoring the importance of the purchase obligation ranking equally with all other senior unsecured obligations of the originator." (Lotter, Philipp; Howladar, Khalid, 2007).

In addition to Moody, Rating Agency Malaysia (RAM) has a similar definition of asset-backed and asset-based sukuk. According to RAM, asset-backed Sukuk are "characteristically non-recourse Sukuk in which the underlying assets are the sole source of profit and principal payments" (Mohd Noor, 2008). They also highlight the credit risk characteristic of asset-backed Sukuk, which is determined solely by the performance and credit quality of the underlying asset, i.e., the cash flow of the asset and, in certain situations, the expected value at maturity, taking into account various stresses and scenarios. In addition, RAM affirms the independence of Sukuk k investors from the originator by clearly stating that Sukuk investors "do not have access to the owner of the asset (i.e., the originator), likewise they are protected from its financial difficulties, which is ensured by the structural and legal design of the transaction" (Mohd Noor, 2008). RAM also shares a similar concern to Moody regarding the securitization element requirement that the credit risk profile of the sukuk is effectively decoupled from that of the asset originator and instead be determined solely by the performance of the underlying asset.

According to the Securities Commission Malaysia (SCM), the classification of Sukuk into Asset Based and Asset Backed is based on the technical and commercial characteristics of the Sukuk. In the first category, the underlying asset used to structure the issue remains on the originator's balance sheet after the Sukuk is issued. In this category, the originator transfers only the beneficial ownership of the asset to the Sukuk-holders but continues to retain its legal ownership. In other words, from a legal perspective, there is no true sale in an asset-based structure because the Sukuk holders have no ownership interest in the underlying asset. Consequently, the Sukuk holders cannot sell the asset to a third party. This also means that the Sukuk holders can only have recourse against the originator/debtor. On the other hand, an asset-backed Sukuk can be defined as an Islamic security issued as part of a securitization transaction (Herzi, 2016).

4. Types of Sukuk and Their Basic Principles

Sukuk are designed in accordance with Islamic law in terms of the use of funds and the method of financing. They are developed based on basic Islamic financing principles such as *mudaraba*, *musharaka*, *ijara*, etc. The Accounting and Auditing Organization for Islamic Institutions has identified fourteen permissible types of sukuk (AAOIFI, 2003-2004), of which seven are the most commonly issued worldwide:

4.1 *Mudaraba Sukuk*

The Organization for Accounting and Auditing of Islamic Institutions defines *Mudaraba Sukuk* as follows: 'Mudaraba Sukuk are investment Sukuk that represent ownership of equal shares in the equity of the Mudaraba. The Sukuk holders provide the capital for Shariah-compliant investment activities, which are carried out by the investment agency. The investment agent receives an agreed fee from the profits it earns from the business activity' (AIMS, 2010, pp.1-4). According to the Luxembourg tax authorities, *mudaraba* is defined as "a type of specialized investment in which the depositor and the beneficiary of the deposit share the profits. If the investment project fails, there is a risk of loss of equity, but if the investment is profitable, the depositor is entitled to a fee for services rendered. If the investment is not profitable, the contributor is not entitled to a fee" (Rabia & Dascotte, 2010, p.13).

4.1.1. Basic Principles of Mudaraba

- It is an investment partnership agreement for certain halal business purposes (acceptable in Shariah) where one party named *Rabbul-mal* (fund provider/owner/investor) invests, and the management and operation of the business is the sole responsibility of the other party named *Mudraib* (operator/manager).
- The *Rabbul-mal* has no right to participate in the management of the business. He or she has no executive power whatsoever.
- The Any profits from the business shall be shared between the parties according to the established ratio.
- The Losses arising from the business activity shall be borne in full by the *rabbul-mal* (investor) only. The *mudraib* (entrepreneur/manager) has lost his expected profits and his management work, skills and efforts invested in the business activity. The condition attached to this principle is that the *mudraib* (entrepreneur/manager) shall manage the business with due diligence and without any negligence. The liability of the *Rabbul-mal* (financier/owner/investor) is limited to his investment in the business unless he has authorised the *mudraib* (entrepreneur/manager/manager) to incur debts on his behalf.
- The Ownership of the business assets rests exclusively with the *rabbul-mal*. Therefore, when there is an increase in the value of the assets, they belong only to him. The *mudraib* (entrepreneur/manager) only has the right to share in the profits generated by the normal operation of the business (Al Zubi & Maghyereh, 2006, pp. 235-249).

4.1.2. Practical Aspects of Mudaraba Sukuk Structure in the Current Capital Market

This type of sukuk structure is currently used to promote public partnership in capital-intensive projects, such as airport development, seaports, dams, and power generation facilities. For this purpose, an SPV is established to issue *Mudaraba Sukuk* to raise the funds (*Mudaraba capital*) needed to develop the project. The SPV manages the development of the project on behalf of the Sukuk holders. Any revenues or fees, including proceeds from liquidation or sale, are paid to the Sukuk holders according to the agreed distribution (final capital proceeds). In 2006, Bahrain-based Shamil Bank issued \$51 million worth of *Mudaraba Sukuk* to invest the proceeds in the real estate sector in China (Shamil Bank, 2009).

4.2 *Musharaka Sukuk*

The Organization for Accounting and Auditing of Islamic Financial Institutions defines *Musharaka Sukuk* as follows: "Musharaka Sukuk are investment Sukuk that represent ownership of *Musharaka equity*. The *musharaka agreement* is a type of joint venture agreement between the issuer and (usually) the originator to carry out a

Shariah-compliant investment activity in accordance with a business plan attached to the musharaka agreement. Any profits from musharaka agreements are shared between the issuer and the originator as agreed' (Academy for International Modern Study, 2010, pp. 1-4).

According to the Luxembourg tax authorities, musharaka is defined as "investment through a participation in which the share of the profit is fixed in advance and the losses attributable to each investor are limited to the amount invested. Payments made in installments represent part of the repayment of the capital and part of the distribution of profits" (Rabia & Dascotte, 2010, p.13).

4.2.1. Basic Principles of Musharaka

- It is an investment contract to carry out a halal business (in accordance with Sharia law), in which all parties contribute capital in a certain ratio.
- The partners have the right to actively participate in the management of the business and have executive powers but are not obliged to do so. The partners can agree on one partner who can manage the business on behalf of the other.
- Profits are shared in accordance with the pre-established ratio. However, in the case of a sleeping partner, the share should not be greater than the ratio of the capital invested by this sleeping partner.
- Loss should be borne by each partner in accordance with the ratio of the invested capital and not in accordance with the predetermined profit-sharing ratio.
- The liability of partners is unlimited. However, it can be limited to partners who do not authorise others to incur debts during business operations.
- All the partners own the business assets, so any increase in the value of the assets is also shared among them according to the predetermined ratio (Al Zubi & Maghyreh, 2006, pp. 235-249).

4.2.2. Practical Aspects of Musharaka Sukuk Structure in the Current Capital Market

This type of sukuk structure is currently used by companies to develop new projects or expand existing projects. It is also used to finance other business activities on a musharaka basis. For this purpose, a special purpose vehicle (SPV) is established to provide funds (musharaka capital) to the company through the issuance of musharaka sukuk to operate the business. The company also contributes capital, usually in the form of land, and uses that capital to complete or operate a specific business or project on behalf of the SPV. The Company agrees to purchase shares of the SPV at an agreed-upon price and for a specified period of time until the SPV no longer has an interest in the business or project. All proceeds from the project or business will be distributed to the Sukuk holder in accordance with the specified share. Emirates, Dubai's national airline, issued a \$550 million Musharaka Sukuk 2005. The proceeds will be used to finance the Emirates Engineering Centre and build its headquarters in Dubai. The term of the Sukuk was seven years and it was listed on the Luxembourg Stock Exchange (Haider & Azhar, 2010).

4.3 *Ijara Sukuk*

The Accounting and Auditing Organization for Islamic Institutions defines Musharaka Sukuk as follows. these are Sukuk that represent ownership of equal shares in a rented property or usufruct of the property. These sukuk give their holders the right to own the property, receive the rent, and dispose of their sukuk in a manner that does not interfere with the tenant's right, i.e., they are negotiable. The owners of such sukuk bear all costs of maintenance and damages to the property." (AIMS, 2009, p.1-4) Ijara is a structure in which the owner transfers the right to use or benefit from a particular property or other asset/service to another person in exchange for a consideration, such as rent. It is an alternative to traditional leasing. (Usmani, 1998, p.2).

Luxembourg tax authorities define Ijarah as a "leasing contract in which the capital provider (usually the bank) buys a property on behalf of its client and then makes it available to its client in exchange for a rent over an agreed period of time" (Rabia & Dascotte, 2010, p.13). The specific terms of the contract distinguish the ijara

from the traditional lease, which should be designed with the Islamic principles of ijara in mind (Haider & Azhar, 2010).

4.3.1. Basic Principles of Ijara

- The Leasing (Ijara) should be entered into for an agreed period of time, an agreed consideration, and for an identifiable asset with clear terms. The asset to be leased should have a valuable benefit in accordance with Islamic laws, otherwise it cannot be considered Ijara.
- Ownership of the 'right to use or drive' remains with the lessor, only its 'right' is transferred. Therefore, what is consumed during use cannot be leased, e.g., fuel, food, money, etc. Otherwise, it is treated as a loan and any consideration received is considered as interest (riba), which is prohibited.
- Lessor is responsible for all liabilities associated with the leased asset, except for liabilities arising from the use of the assets. For example, the lessor is obligated to pay the property tax and insurance under takaful (Islamic type of insurance), while the normal depreciation, utility bills and taxes should be borne by the lessee only.
- The leased property should be used only for the purpose specified in the contract, otherwise the lessor's consent is required.
- All The risk associated with the leased asset remains with the lessor during the lease term. However, the lessee is responsible for the losses caused by his negligence and misuse of the leased object.
- Rental amount should be determined at the time of concluding the contract and cannot be changed without the consent of all parties to the contract.
- The lease payment is calculated from the date of actual delivery of the leased object and not from the date of the price paid or purchased by the lessor, as in the case of traditional leasing. When the lessee acquires the asset on behalf of the lessor, a principal-agent relationship arises, and after delivery, the lessor-lessee relationship arises. The difference between the two is very important in the case of ijara (lease).
- In the event of default, the lessee/owner should not seek liquidated damages. Other steps can be taken to collect the rent, including asking the lessee to vacate the property (Usmani, 1998, p.1-14).

4.3.2. Practical Aspects of Ijara Sukuk Structure in the Current Capital Market

Currently, the Ijara structure is involved in sale and leaseback transactions. It uses real estate/buildings as assets to obtain money from investors. For this purpose, a special purpose vehicle (SPV) is established to take over the building from the owner at the agreed price. Then the SPV issues Ijara Sukuk to raise funds (Ijara capital) equal to this price and make payments to the owner. Now the SPV leases the building/asset back to the owner for an agreed monthly rent or fee. This fee or rental income is paid to the investors, the ijara sukuk holders. The value of the building at the end of the rental period is also paid to the Sukuk holder and is equal to the outstanding amount, which is usually the face value of the Sukuk certificates (Standard & Poor's, 2005.pag.1). The Pakistan Water and Power Development Authority (WAPDA) issued an 8-billion-rupee Ijara Sukuk to finance the Mangala Dame project. It is secured by an irrevocable first demand guarantee from the Pakistani Ministry of Finance (Daily Times, 2005, p. 6).

4.4 Murabaha Sukuk

According to the Luxembourg tax authorities, Murabaha is a "transaction that allows the client (the investor) to purchase a property without having to take out an interest-bearing loan?" The provider of capital (e.g., a bank), the financier, buys the property and then sells it to the investor with a deferral. It is a financing model that can be used for any type of Shariah-compliant asset, but mainly for real estate (or stocks, commodities, or the like)" (Rabia & Dascotte, 2010, p.13). The Murabaha Sukuk holder or capital user purchases the specific asset/commodity from a third party and then sells it to the buyer or capital user on a cost-plus profit basis (Pollard & Samers, 2007, pp.315-316). The capital users then pay the price of the asset/good in instalments as agreed between them (Usmani, 1998, pp.1-14).

4.4.1. Basic Principles of Murabaha

- Murabaha is a sale rather than a form of financing in Islamic Sharia law and should therefore meet all the applicable conditions of a valid contract of sale.
- Finance is used only for the purchase of a specific commodity, e.g., wheat for a mill, but not for other overhead costs, e.g., utility bills, salaries, etc. It also cannot be used for assets/goods already purchased.
- The Cost of purchased goods and associated profit should be disclosed to the buyer at the time of sale.
- The seller should be the owner and possessor of the goods and bear its risk first and then sell it to the buyer. As in an agency relationship, the buyer may purchase the goods from a third party on behalf of the seller and then purchase them from the seller.
- When the price is set on either a cash or credit basis, it cannot be increased for late payment or decreased for early payment. Security of payment is achieved by accepting a promissory bill or bill of exchange (Usmani, 1998, pp. 1-14).

4.4.2. Practical aspects of Murabaha Sukuk Structure in the Current Capital Market

The murabaha structure of sukuk is used to finance a specific commodity or asset for the purpose of resale to the borrower. For example, textile factories need cotton to meet their raw material needs and can acquire it through Murabaha structures. An SPV (special purpose vehicle) is established for this purpose. The company, e.g. the textile mill, makes a commitment to the SPV to buy a specific raw material such as cotton at a pre-agreed price. Then the SPV issues murabaha sukuk to raise the funds (murabaha capital) needed to purchase that raw material from the supplier and sells it to the borrower at cost plus profit. Sukuk holders are entitled to the sale price (cost plus profit) of the commodity, usually paid in instalments over a period of time (Haider & Azhar, 2010).

4.5 Salam Sukuk

Salam Sukuk is issued to raise Salam capital. The holder of a Salam Sukuk is the buyer of the commodity from the issuer of the Sukuk, the seller, at an agreed price paid on spot in return for the commodity, the delivery of which is at an agreed date in the future (Usmani, 1998, p.1-14). Salam is a way to replace the traditional futures/forward contracts considering the Islamic laws and basic principles (Haider & Azhar, 2010).

4.5.1. Basic principles to consider while developing Salam Sukuk

- The price of the commodity/item is paid in full by the buyer to the seller at the time of delivery, but delivery is made at a specific time in the future.
- The Goods should be standardized. Quality and quantity are easily determinable, and it is readily available in the market.
- The future delivery date and place should be clearly stated in the contract. (Usmani, 1998, p.1-14).

4.5.2. Practical Aspects of Salam Sukuk Structure in the Current Capital Market

The salam structure is used to enter into a commodity futures contract with the purpose of obtaining funds against the commodity to be delivered on a specific date in the future. For this purpose, a special purpose entity is established to issue Salam Sukuk to raise funds (Salam capital) to purchase the specified commodity at a specified price and future delivery date. The company or seller receives the full selling price upfront, and usually this selling price is lower than the future spot price. The SPV takes delivery and sells the commodity at a market price that is higher than the purchase price. The difference is the profit that is distributed among the Salam Sukuk holders (Haider & Azhar, 2010).

4.6 *Istisna Sukuk*

Luxemburg Tax Authorities defined Istisna as “Consists of the financing of the production of property via an advance of payment for future delivery or a future payment for a future delivery” (Rabia & Dascotte, 2010, p.13). Istisna Sukuk certificated issued to raise capital for the production of a specific asset. Holders are the owners of that asset which is to be produced or manufactured at future date. The Sukuk holders are entitled to the sale proceeds from the certificate or the asset manufactured (Haider & Azhar, 2010).

4.6.1. Basic Principles to Consider while Developing Istisna Sukuk

- Funds are used only for the production of a specific product or asset that must be delivered at a later date.
- The selling price may or may not be paid in full in advance, as in the case of the Salam structure.
- The specifics of the intended manufactured asset should be clearly agreed between the manufacturer and the fund provider. The contract can be terminated by either party prior to the start of the manufacture of the asset or product, but not after the start of manufacture or production. (Usmani, 1998, pp. 2-14).

4.6.2. Practical Aspects of Istisna Sukuk Structure in the Current Capital Market

This sukuk structure is used to finance large and complex capital-intensive products or assets. For example, the manufacture of aircraft, ships, and the development of large infrastructure projects. It can be used under BOT (buy, operate and transfer) agreements. For this purpose, a special purpose vehicle (SPV) is established to raise the funds (Istisna capital) required to pay the sale price. These funds should be used for the production or development of the respective project or asset. Upon delivery, ownership is transferred to the special purpose entity, which can either sell it or lease it to the end user at a profit. All proceeds and profits should be distributed to the owners of the Istisna Sukuk (Haider & Azhar, 2010).

4.7 *Hybrid Sukuk*

This type of sukuk is structured to combine the principle of several sukuk structures such as ijara, mudaraba, and istisna, which consist of a pool of assets. A diversified pool of assets composed of different sukuk structures provides more attractiveness to investors in the market (Haider & Azhar, 2010).

4.7.1. Basic Principles to Consider while Developing Hybrid Sukuk

As mentioned earlier, the principles of any sukuk that is part of the hybrid sukuk should be considered when developing the type of hybrid sukuk. The principles of a particular sukuk that is part of the hybrid structure should be implemented in hybrid sukuk structures (Haider & Azhar, 2010).

4.7.2. Practical aspects of Hybrid Sukuk Structure in the Current Capital Market

This type of sukuk structure is designed to accommodate the different needs of different financial users. It includes more than one feature of the various sukuk structures available in the market. The special purpose vehicle (SPV) takes the assets and Murabaha contract from the borrower and then issues the hybrid Sukuk to raise funds (hybrid capital) for the assets taken by the buyer. All proceeds and profits are distributed to the holder of the Sukuk. The first hybrid Sukuk was issued by the Islamic Development Bank (IDB) in the amount of \$ 400 million. This structure consists of an asset pool of 65.5% Sukuk Ijara, 3% Sukuk al-Istisna, and 31.5% Murabaha (Haider & Azhar, 2010).

5. Shariah Issues in Sukuk

The critical scholars argue that the current practice of Islamic finance aims to replicate the practices of conventional finance, and in doing so, the current Islamic financial products are Shariah-compliant in form but not in substance and spirit. They criticize that the practice of sukuk simply mimics the practice of conventional bonds in the market. In addition, Sukuk practice lacks transparency in terms of documentation and the rights and obligations of the various parties in the sukuk market (Bashir, 2008). Economic value added and Shariah compliance is the focus of product development in the Sukuk market. Therefore, a process of Shariah approval is needed (Nor Fadilah Bahari, Nurul Wajhi Ahmad, Wan Shaidila Shah Shahar, Norfaizah Othman, (2016).

The following are details of some Shariah issues in Sukuk based on the Islamic commercial contracts used in the issuance of Sukuk:

5.1. *Musharakah & Mudharabah Sukuk*

5.1.1. Purchase Undertaking in Musharakah and Mudharabah Sukuk Structures

a) Introduction on Purchase Undertaking

Sukuk Musharakah and Mudharabah are typically structured with purchase commitments to ensure that 100% of the invested capital is returned to investors. They can also be referred to as repurchase promises, put or call options, which serve the same purpose. In addition, it is often associated with profit tanazul by investors. Under this concept, a party guarantees investors that the company will be profitable, and in case of losses, it acquires investors' ownership of the company in exchange for repayment at par (i.e., investors' initial capital) or a pre-agreed formula (covering investors' initial capital and expected profit for six months). In return, investors receive a "tanazul" or 'discount' on profits for the first six months of the project's life by capping their return at a conventional benchmark interest rate plus spread or other agreed-upon benchmark. If their share of profits exceeds the benchmark, the excess profit goes to the other party as an incentive fee (Lahsasna, 2012).

In November 2007, Sheikh Taqi Usmani stated that most sukuk (about 85%) in the market (which use a musharakah or mudharabah structure) do not comply with Shariah principles because the purchase commitments, which involve a promise to repay the principal, violate the principles of risk and profit sharing on which such sukuk should be based (Lahsasna, 2012).

b) Current Practice and Shariah Issues

Most musharakah and mudharabah sukuk in the Gulf region were structured and sold with a purchase obligation that mirrored the fixed-rate yield of a conventional bond. As a result of the controversy generated by Sheikh Taqi Usmani's statement, the AAOIFI Shariah Board convened a series of meetings in Bahrain on February 13 and 14, 2008, after which a statement on sukuk was drafted to provide some guidance on sukuk structures. This statement had an impact on the global issuance of Sukuk, particularly Sukuk Musharakah (Lahsasna, 2012).

Sheikh Taqi Usmani's criticism is mainly based on two critical points of the Shari'ah analysis. First, the usual redemption features are always intended to ensure that the investor recovers 100% of the principal and the associated return, and second, the redemption price and return are always fixed in advance, without regard to losses or risks that may arise in the normal course of business. Therefore, the redemption features run counter to the nature of traditional Musharakah and Mudharabah principles, making them invalid in perspective or creating a situation where the redemption feature is unenforceable in some courts. Generally, in most musharakah and mudharabah sukuk, the provider of the purchase obligation is also the investment agent (Lahsasna, 2012).

c) View of Scholars on the Shariah Issues

Jurists agree that in the context of a mudharabah structure, the mudarib is a trustee with respect to the capital that comes into his hands. The role of the mudarib is ultimately to use his best efforts to generate a profit for the

sukuk holders (i.e., rabbul mal), for which the investment representative is entitled to an agreed-upon share of the profit. It is not the Mudarib's role to guarantee the return of capital from the Sukuk in the form of a purchase commitment or otherwise. Similarly, the mudarib cannot bear any losses from the business unless there is a mistake or negligence on his part (Lahsasna, 2012).

According to the Malikis and Shafiis, the Mudarib is not responsible to guarantee the losses related to the capital, and any condition to do so invalidates the Mudharabah contract. The Hanafis and Hanbalis hold that the contract is valid but the condition is considered invalid. However, it is permissible for a third party who is not a Mudarib to voluntarily undertake to compensate for Mudharabah losses, provided that this guarantee is in no way connected with the Mudharabah contract (INCEIF, 2010).

The AAOIFI Shariah standards and the resolutions issued by the International Fiqh Academy, as well as the SAC of the SC, generally allow a third party to guarantee the capital of the mudharabah and the musharakah. However, there is no mention of the repayment price for the capital. The AAOIFI, representing the consensus of leading scholars, prefers that these repayment features be executed at a market price. In theory, buying at market price removes the certainty of a guaranteed return of principal at a profit. There is considerable debate about how to determine the market price based on three factors: Cost, Regulation, and Willingness to Execute (Lahsasna, 2012). Below are details of their opinions:

i) AAOIFI's Shariah Standards 2008 - Guarantees in a Sharika Contract (3/1/4)

All partners in a sharika contract hold the sharika's assets in trust. Therefore, no one is liable unless there is misconduct, negligence, or breach of contract. It is not permissible to agree that one partner of a sharika contract guarantees the capital of another partner. (3/1/4/1). It is permissible for one partner in a Sharika contract to agree that another party will provide a personal guarantee or pledge in the event of misconduct, negligence or breach of contract. (3/1/4/2) (Lahsasna, 2012).

ii) International Fiqh Academy's Resolution No. 30 (5/4) - Muqaradha Bonds and Investment Certificates

The Council of the International Fiqh Academy has decided that neither the prospectus nor the muqaradha documents may contain a guarantee by the fund manager of the capital or a fixed profit based on the percentage of the capital. If such a clause is implicitly or explicitly included, the guarantee condition is void and the mudarib is entitled to a profit equal to that of a similar mudharabah (Lahsasna, 2012).

iii) Resolutions by the SAC of SC

Sukuk issuers are allowed to apply a third-party guarantee for the invested capital according to the principles of Mudharabah (35th session on November 7, 2001) and Musyarakah. It was agreed that a fee (ujrah) may be paid to the guarantor on the condition that the guarantee is not on a recourse basis, which means that investors cannot claim against the issuers in the event of a business failure, since the guarantee is provided by the guarantor. Investors may also demand collateral from the issuers in the event of possible gross negligence on their part (Lahsasna, 2012).

5.2. *Ijara Sukuk*

5.2.1. Current Practice and Shariah Issues

Most recent sukuk structures are sukuk ijara, in which the party seeking financing, i.e., the originator, transfers certain of its assets to a special purpose entity. When the Sukuk matures or in the event of a default, the originator is typically required to repurchase the assets so that the SPV can redeem the outstanding certificates and repay the Sukuk holders. In this context, the rights of Sukuk holders in the event of default vary depending

on whether the Sukuk structure is asset-backed or asset-based. It has already been noted that in an asset-backed sukuk, legal ownership of the underlying assets is usually transferred from the originator to the SPV by way of a true sale, so that the sukuk holders are able to exercise certain ownership and control rights over these assets without having to resort to the originator, and therefore the credit risk performance is determined solely by the underlying asset (Lahsasna, 2012).

This has led many Sukuk issuers to resort to issuing the next type of Sukuk, the Sukuk al-ijarah. The Islamic Development Bank (IDB) issued the first hybrid Sukuk, composed of 65.8% Sukuk ijarah, 30.73% Murabahah, and 3.4% Istisna', with the latter two debt instruments allowed to represent only 34.13% of the underlying assets. Moreover, the Sukuk were guaranteed in the same manner as conventional bonds to give them international acceptance. Not surprisingly, some scholars have criticised the issuance of such Sukuk and the added guarantee, and it is also not surprising that proponents of strict legal ownership are equally critical of such issuance (Benaicha et al., 2019; Razak et al., 2019).

a) *Ownership issues in ijarah sukuk*

Ghani (2017) defines property in Islamic law as four basic elements:

1. Legal and exclusive ownership between the individual and the asset
2. Intent of exclusivity, which gives the right to either use or dispose of the owned assets
3. The ability to use or dispose of the owned asset without hindrance
4. This ability can be *ibtida'i* or *taba'i* (without reason or by contractual obligation, respectively).

The problem with the currently prevailing ijarah model for sukuk structuring is that while sukuk structures claim to confer legal ownership of the underlying asset, the actual practice involves only the transfer of beneficial ownership for purposes of issuing the sukuk and not full ownership. This is contrary to the implications of ownership of the original sale contract (Ghani, 2018) and indeed has been judged to mean that the sukuk holder has no interest in the leased asset (Dusuki and Mokhtar, 2010). However, Kamali (2007) argues that the point is that ijarah sukuk ultimately represent undivided ownership of the leased asset, which makes them equities, perhaps because ijarah assets are insolvency remote.

Another issue is the promise to repurchase, specifically the original sale and agreement to repurchase (upon repayment); such an agreement contradicts the maxim of exclusivity of sale, which states that two simultaneous contracts such as a sale and a purchase may not apply to the same property (which is binding and therefore indicates a sale) - *tawarud 'aqdayn fi ainin wahidah*. Safari et al. (2014) criticize this as being similar to traditional bond practice. Kamali (2007) also points out that this is one of the main pitfalls of sukuk according to Shariah scholars.

b) *Purchase undertaking, PLS issues and loss of contact with the real economy*

The next important issue discussed is PU, which is widely used in sukuk issuance. While Safari et al. (2014) acknowledges that sukuk securities should be based on something that has real economic value, such as stocks or real assets, to avoid dealing with *riba* (interest), the fact is that most returns on sukuk bear no relation to the performance of the underlying asset or its economic value. According to Lahsasna and Idris (2008), AAOIFI has allowed assets redeemed by the originator to be redeemed at par, which raises questions regarding compliance with the Prophet's (Muhammad, pbuh) commandment that profits (from returns in the case of Sukuk) be earned by bearing the risk of loss. It is necessary to review the Prophet's commandment in light of the objectives of the Shariah and determine whether such a commandment is itself all-encompassing or whether it was intended merely as a means to an end, i.e., to achieve an equitable distribution of profits and risks in financial transactions. In the case of Sukuk on a sale basis, market risk is mitigated in repayment. The counter arguments are that the binding promise has been allowed by some scholars, but this is based on a single opinion attributed to a Maliki jurist (Ibn Shubrumah) according to El-Gamal (2006); the other argument is the original and general permissibility of contracts in various forms by the Shariah (*al-ask fi al-mu'amala alibahah*).

5.3. *Murabaha Sukuk*

5.3.1. Current Practice and Shariah Issues

Murabahah is the workhorse of Islamic finance, and applications of murabahah vary widely between Malaysia and the GCC states. From a Malaysian perspective, the Bai al Dayn represents an Islamic promissory bill, which is a tradable instrument to confirm debt. The promissory bill is tradable, and when traded, it is considered to carry the underlying contract and can be sold at either a discount or a premium to par. Therefore, secondary market trading of Malaysian sukuk is conducted on the basis of Bai al Dayn (Lahsasna, 2012).

In contrast, the majority of opinions elsewhere hold that a tradable instrument must be linked to ownership of real assets based on an underlying contract permissible under Sharia law. Therefore, sukuk issued on a murabahah basis are tradable only prior to the sale of the goods to the ultimate purchaser or if the receivables (if there is an inventory) are less than 50%; after the sale of the goods and without an inventory greater than 50%, they are tradable only at par with recourse. Thus, the difference in the Shari'ah analysis lies in the view of what may be traded. When receivables are bundled with other tangible assets, they can be securitized and sold at a certain ratio. The ratio may differ from one Shariah body to another (Lahsasna, 2012).

5.3.2. View of Scholars on the Shariah Issues

a) Resolution of the Islamic Fiqh Academy

Two resolutions on debt were passed. The first states that it is impermissible to sell a deferred debt to a person other than the debtor in exchange for a cash payment in the same or another [currency], as this may result in *riba*. Moreover, it makes no difference whether the debt is from a loan or from a deferred payment sale (Lahsasna, 2012).

b) AAOIFI's Shariah Standards

Shariah Standard No. (17) on the issue of investment sukuk confirmed this ruling by stating that trading in Murabahah sukuk is unlawful. Shariah Standard No. (21) on the issue of financial securities (stocks and bonds) states the following regarding the regulation of trading in debt instruments mixed with other things such as tangible assets, sources of income in the form of leased or pledged property, cash, and rights:

5.4. *Istisna Sukuk*

'Istisna' sukuk also represent debt obligations, where the product being manufactured is the debt obligation to which the sukuk holders are entitled. Istisna' is far less controversial as a structure because project developers require start-up financing for the construction of buildings/equipment and therefore, as in the classical legal period, istisna' debt payment is accepted only on the basis of such need. As a result, the Shari'ah objectives of establishing ownership rather than property claims (*insha' al-milkiyyah* or *al-asl adam tashghil al-zhimam*) are not properly fulfilled; such certificates also do not embody the objective of gratuitous loan (*qardh hasan*), which should be strictly kept away from commercial ventures (Laldin and Furqani, 2013), but rather they transform loans into commercial, profit-making vehicles. Moreover, because these instruments are purely debt instruments, scholars have almost unanimously banned trading in them, so there is no secondary market for these instruments, further complicating their use (Resolution/Decision No. 178, 19th Session, April 30, 2009, UAE) (Benaicha et al., 2019; Razak et al., 2019).

Such arguments are made by critics of the practice, while its proponents argue that the original sale took place, which, as will become clear, constitutes a transfer of ownership. They also invoke the legal maxim that the structure of contracts takes precedence over their content, and in this case it is a permitted sale, which makes it permissible. Either way, as discussed, the arguments of both sides exhibit reductionist tendencies in that their

stance is based on two or three pieces of evidence that have not been tested against the Shariah texts and their complex and dynamic web of objectives (Benaicha et al., 2019; Razak et al., 2019).

5.5. Hybrid Sukuk

5.5.1. The hybrid sukuk model as an alternative to pure debt sukuk

These sukuk were introduced to improve the mobilization of funds and to enable Sharia-compliant financing. Although scholars disagree on the permissibility of such sukuk and their tradability, IIFA (Resolution/Rule No. 178, 19th Session, April 30, 2009, UAE; the actual resolution refers to general securities whose underlying assets are a mixture of cash, assets, and debt) has permitted them on the basis that the majority of the underlying assets are actually assets and not debt (Benaicha et al., 2019; Razak et al., 2019).

The dispute mainly revolves around the prophetic narrative *mudda ajwah*, in which a number of prominent jurists have allowed the exchange of a *ribawi* (usurious) commodity for another, non-*ribawi* commodity mixed or combined with a *ribawi* element (such as gold for a gold-decorated plate or a sword as an example cited by the jurists). The same logic was applied to hybrid sukuk, where assets were mixed with debts and bought and sold with money. Therefore, the concession of a number of prominent scholars such as Ibn Taymiyyah and a large number of Hanafites has been used to justify these sukuk when examining the ultimate impact of such a practice. This has opened the door for profit-oriented 'Islamic' institutions to deal in sukuk that represent only 10% of assets. This may be due to the 'paradoxical nature of majority rule,' as El-Gamal (2006) puts it, in which the asset portion of the hybrid bond is withdrawn and repurchased at the market price and then bundled with other debt instruments so that the 51:49 ratio of tangible assets to receivables is maintained. Thus, the original goal of enabling capital mobilization has simply led to a bias toward trading purely debt-based securities (Benaicha et al., 2019; Razak et al., 2019).

Opponents of such practices believe that the substance of such contracts is that they are securitized debt instruments and that trading in debt instruments is impermissible due to the presence of *riba*, as cash-say dollars-is traded in the form of securities for other cash at different values, which constitutes a usurious transaction. However, in the case of hybrid sukuk, this is less applicable because, first, the purpose is to facilitate the tradability of shares in real assets/projects, and second, a prohibition would hinder the goal of liquidity of capital, which scholars have identified as an important objective and which is confirmed in a number of Shariah texts (El-Mesawi and Ahmed, 2016).

6. Conclusion

Sukuk were developed as an alternative to conventional bonds, which are considered by many Muslims to be impermissible because they pay interest (which is forbidden or rejected as *riba* or usury) and can also finance companies involved in activities that are not permitted under Shariah.

Sukuk securities are structured to comply with Shariah by distributing profits, not interest, and generally include a tangible asset in the investment. For example, sukuk securities may represent partial ownership of a property built by the investment company (and held in a special purpose vehicle), allowing the sukuk holders to collect the profits of the property as rent (which is permissible under Islamic law). Because they represent ownership of real assets and (at least in theory) do not guarantee repayment of the original investment, Sukuk are similar to equity instruments, but like a bond (and unlike stocks), the regular payments end when they expire. However, most Sukuk are "asset-based" rather than "asset-backed" - their assets are not owned by the SPV, and their holders have recourse against the originator in the event of default.

The different types of Sukuk are based on different structures of Islamic contracts, e.g., *Murabaha*, *Ijara*, *Istisna*, *Musharaka*, *Mudharabah*, etc., depending on the project that is financed with the Sukuk. In addition, there are various Shariah issues related to the issuance of Sukuk based on these Islamic contracts as mentioned above.

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