Journal of Islamic Banking and Finance
June 2018, Vol. 6, No. 1, pp. 16-28
ISSN 2374-2666 (Print) 2374-2658 (Online)
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Published by American Research Institute for Policy Development
DOI: 10.15640/jibf.v6n1a2
URL: https://doi.org/10.15640/jibf.v6n1a2

Evolution in the *Sukuk* (Islamic Bonds) Structure: How do Market Demands and *Shariah* (Islamic Law) Solutions Shape Them?

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Abstract

The issuing of *sukuk* (or Islamic bonds)as an instrument in Islamic finance has grown in recent years. The *sukuk* markets have advanced in the way of using tangible assets to receivables as an underlying asset. Premised on this development, *sukuk* structures have shifted from asset-backed to asset-based to asset-light and blended-assets. Given this evolution, this study will trace the development of innovation in the *sukuk* structure. Observed here are changes or trends in the *sukuk* structure, including how market participants' demands and *Shariah* issues influenced such changes in the *sukuk*. The main issues that emerge are: firstly, sufficient physical assets in response to the demands of issuers; and secondly, solutions offered by *Shariah* advisors who play a role in shaping the issued *sukuk* structure.

Keywords: *Shariah,sukuk*, innovation, underlying assets

1.0 Introduction

Innovation occurs in every market and no market can survive without it. This applies to the *sukuk*[2] market which has been exceptionally innovative since being introduced to the financial market. A basic requirement for *Shariah* compliance of any *sukuk* structure is that it shall be backed by tangible assets. Therefore, when the *sukuk* were first developed in 1990, *Shariah* (Islamic law) prescribed *s ukuk*as requiring 100% tangible assets to provide fully backed assets to investors. Therefore, this study describes the changes in the *sukuk* structure and particularly in terms of from asset-backed to asset-based and ultimately to a blended *sukuk* structure. This development is mostly associated with the problem of insufficient physical assets when issuers demand to tap funds available in the Islamic financial market. In the meantime, *Shariah* requirements and solutions offered by *Shariah* advisors also play a role in shaping the is sued *sukuk* structure. The financial community adopted and refined the concept of *sukuk* and expanded its scope to incorporate a wide range of commercial and financial activities.

The following sections will, in order, discuss *sukuk* and the requirements of underlying assets in its transactions. Further, *sukuk* structure preference since the early days of Islamic civilization up the present day will be discussed. Finally, an evolution in structuring *sukuk* with regards to underlying assets will be examined.

2.0*Sukuk*and the requirements of underlying assets in its transactions

The Islamic capital market has become a global phenomenon with *sukuk* playing a substantial part in the industry. Of all *Shariah*-compliance financing methods, the one that has received most public attention to date is *sukuk*. As reported by Standard & Poor's(2008), *sukuk* totaled less than $500 million in 2001, but it was double this in 2007 and by the end of 2016 it was close to US$319 billion(IFSB, 2017). The *sukuk* market's growth is being fueled mainly by corporates, sovereigns and financial institutions. Although corporates find that *sukuk* is an alternative form of financing for businesses or projects, banks are turning to these financial instruments to sustain growth using stable funding sources and curb maturity mismatches(Standard & Poor's, 2010).

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[2]These are Islamic investment certificates or participation certificates and also known as Islamic bonds from the Western perspective.

The Islamic debt securities market was developed to meet diverse risk-return profiles and the needs of issuers and investors who looked for a type of asset that complied with *Shariah*. Conventional bonds or *sukuk*, both are financial vehiclesattempting to mobilize the funds from surplus spending units to shortage spending units. A bond is a contractual debt obligation that pays holders a coupon of fixed or floating interest. Most conventional bonds are primarily concerned with the return on investment, not the actual object that is being financed. Hence the underlying asset for corporate bonds is money (debt). Its whole premise is to provide holders with interest in return for their capital investment. This kind of asset does not comply with *Shariah*, as they are in the form of interest-bearing loans. There is a blanket prohibition on interest under *Shariah*. Therefore, interest is fundamentally tainted with *riba*. *Shariah*-compliant transactions preclude making money with money because 'no one should be able to earn an income from money alone'. In this sense, money itself may not be a source of profit because many scholars of Islamic economics argue money has no intrinsic value within Islam (El-Gamal, 2000). The ultimate purpose of money, from their point of view, is to help fulfil basic needs, such as food, clothes and shelter(Saeed & Salah, 2012).In this approach money must be seen (and used) as a means of exchange only, not as a basic need in itself.

Given that use of money as a source of profit is forbidden by *Shariah*,the presence of underlying tangible assets in the *sukuk* transaction is required. Following *Shariah* Standard No. 17 on Investment *sukuk*, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)states that *sukuk* are 'certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity'. The Council of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC)in 1988 defined*sukuk* as "any combination of assets (or the usufruct of such assets) can be represented in the form of written financial instruments which can be sold at a market price provided that the composition of the group of assets represented by the *sukuk* consist of a majority of tangible assets". Meanwhile the Securities Commission Malaysia provides a guideline which states that an asset must be made available for *sukuk* to be issued in the case of *sukuk bay bithaman ajil*(deferred payment sale), *murabahah* (cost-plus financing), *istisna'* (contract of exchange with deferred delivery) and *ijarah* (lease)[3]. These standards clearly underpin that *sukuk* must be asset-backed and subject to compliant contract. Income from securities must be related to the purpose for which the funding is used and securities should be backed by real underlying assets, rather than being simply paper derivatives.

Since the issuance of *sukuk* is not an exchange of paper money for interest but rather an exchange of a *Shariah*-compliant asset, the asset itself must be *halal* (permissible) in nature and being utilized as part of halal activity. The *Fiqh* Academy (Jeddah) in its ruling No. 5, 1998, stated that any '*halal*' asset or collection of assets can be the underlying asset for a note or *sukuk*.Such *sukuk* can also be sold (traded) provided that the underlying asset(s) consists mainly of tangible physical assets with a minimal part of it being cash and/or interpersonal debts. *Shariah* considerations dictate that the pool of assets should not solely be composed of debts from Islamic financial contracts (e.g. *murabahah, isitisna'*) but also comprise real assets (Krichene, 2012). Clearly, all *sukuk* by definition must have an asset that is tangible, although some *fuqaha* allow for a portion of the asset to be in intangible form, all jurists require that there be an underlying asset (Bacha & Mirakhor, 2013).

While there are a number of other Islamic finance principles that must be borne in mind when structuring Islamic-compliant deals[4], Islamic scholars and practitioners view that the identification of the assets is the most essential. According to Krichene(2012) and Radzi (2012) the identification of suitable assets is a key step in the process of issuing *sukuk* for any entity that wants to mobilize their financial resources. The prominent and influential *Shariah* scholar, TaqiUsmani (1999)emphasized that one of the most important characteristics of Islamic financing is that it is an asset-backed entity. Islamic finance is justified in that it restricts finance to funding of trade or the production of real assets. In fact, of all the rules that govern the structure of Islamic finance instruments, the rule that transactions must be real asset-based is the most striking (Hoor & Kreemer, 2014).Where the funds raised are used to finance a needed tangible asset, specificity of assets is important. That is, the assets being financed should be clearly identified.

[3] See Securities Commission Malaysia (2014) Guidelines on *sukuk*, Section 7.01.

[4]Some of the key concepts in Islamic finance are set as *riba*(interest), *gharar*(uncertainty), *maisir*(gambling), *bay al-dayn* (sale of debts or monetary assets), *bay al-inah* (a sale of an asset followed by a buy-back at an increased price of that same asset). In the meantime, there are many issues that arise in relation to *sukuk* structures and transactions. Some of them are: transfer of title, nature of the assets, tax and *zakat*(a fixed portion of a Muslim's wealth which is required to be donated to charity in accordance with Islamic law), governing law, capacity and authority, tradability of *sukuk*, liability management and types of *sukuk*(O'Callagahan et al. 2012).

This is because *sukuk*, unlike bonds, cannot be used to fund the issuer's general financial needs (Bacha & Mirakhor, 2013). The role of underlying asset attached to *sukuk* will serve as a source of return to investors in the form of sales, lease or partnership or business venture. In addition, *sukuk* holders should have asset ownership in the assets as the important principle in *sukuk* securities because 'rewards are given only if profits are earned'. Thus the concept of profit-loss sharing is extremely important in Islamic finance. It is an important differentiating feature of Islamic finance and one that should be considered a source of strength since the requirement for an underlying asset precludes the possibility of excessive leverage.

To sum up, the necessity for the underlying asset is a clear requirement in all Islamic financial transactions. However, to what extent *sukuk* structures in practice truly behave according to their specific *Shariah* assets requirement has raised serious doubts among scholars. Many current *sukuk* issuances have an asset somewhere in the mix, but in mostcases, actual cash flows from the issuances are not derivedfrom that asset; they actually originate from the rest of the structure. Thus, the presence of an asset gives the *sukuk*the "form" of an Islamically permissible finance product, but not the "substance"(Howladar, 2009; Maurer, 2010, p.36).Following Al-Jarhi (2013, p.250)the gap in theory and practice in Islamic economics arises in relation to Islamic financial assets and *sukuk*. *Sukuk* are supposed to be Islamic financial assets that represent common undivided shares in *Shariah*-compliant real and financial assets. However, *sukuk* have been entrusted to the financial engineering talents of a group of *Shariah* scholars who view them not as Islamic financial instruments but are rather "Islamic bonds" or fixed income instruments that have cleverly been made up to look *Shariah*-compliant(Al-Jarhi, 2013). These doubts lead to at least two critical issues related to the underlying assets. First, should the underlying asset serve for backing the *sukuk* issuance or only just serve for the basis of *sukuk* issuance? Second, does the underlying asset have to represent tangible assets only or include intangible assets for example receivables? In response to these issues, this paper will examine *sukuk* structure preference in the *sukuk* market and trace the evolution of *sukuk* structure with regards to assets' *sukuk* requirements.

3.0 Changing trends in *sukuk* structure preference in the *sukuk* market

Sukuk or *sakk* is not a new invention of the Islamic finance industry. As a concept it originated in the early days of Islamic civilization. In the 1st century Hijri (corresponding to the 7th Century AD), the certificates for goods or *sakk al-bada'i* (groceries) were used to pay thesalaries of government officers both in cash and in kind by the the Umayyad Government(Kamali, 2002). The holders of *sukuk* were entitled to present the *sukuk* on their maturity date at the treasury and receive a fixed amount of commodities. Some holders used to sell their *sukuk* to others for cash before the maturity date (Haneef, 2009). This practice thus demonstrates that the concept of *sukuk al-bada'i* as a tradable instrument was widely accepted in the Islamic world a very long time ago.

In February 1988, the Council of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC) held its fourth session in Jeddah, Saudi Arabia, and laid the basis for the development of the *sukuk* market through the issuance of a statement of such intruments. Shortly in 1990, one of the first *sukuk* was issued in Malaysia, based on the principle of *bay bithaman ajil*, with a value of RM125 million (equivalent to $30 million). However, there were no active issuances by other players or countries following this issuance(Dusuki, 2009).The *sukuk* market only became important as a Islamic financial instrument in raising funds for long-term projectsin the year 2001. It witnessed the first few *sukuk* issued in the international market in the form of being *ijarah*-based. The *sukuk* market went international with the issuance of the very first international *ijarah* sovereign *sukuk* by the Government of Bahrain in September 2001.This was closely followed by the first quasi-sovereign global *sukuk* by Kumpulan Guthrie, a corporation based in Malaysia. It was also an *ijarahsukuk*, worth US$150 million with 5 years maturity and return of 6 months LIBOR + 1.5%.Then in 2002 the Malaysian government issued US$600 million *ijarahsukuk* that were listedon the Luxembourg Stock Exchange and rated by Standard & Poor's and Moody's(IIFM, 2009). The issue was hugely successful and was twice oversubscribed. The Malaysian *sukuk*was a significant development because it was able to successfully fuse the concept of *ijarahsukuk* with conventional bond practices such as listing, ratings, dematerialized scripts and centralized clearance. Consequently, there have been a number of successful *sukuk* issues, still based on *ijarah* contract such as the State of Qatar's initial US$700 million *ijarahsukuk* and the Kingdom of Bahrain's US$250 million *ijarahsukuk* is sued in 2004 (IIFM, 2011).

Stemming from these issuances, the *sukuk* structure was initially based on the contract of *bay bithamanajil* which basically revolves around buying and selling of financial instruments as the basis for creating a debt instrument. Subsequently, the market moved to instruments based on an *ijarah* contract which involves tangible or physical assets such as land and buildings; these are then sold and leased back.

Initially, the issuance of *sukuk* was in response to the demands of issuers and investors in Muslim countries as an alternative mode for their financing and investment needs that complies with *Shariah* requirements (Kusuma & Silva, 2014). The market's immense growth required certainty in regard to *Shariah*-related matters and standardization. Hence, in May 2003, the AAOIFI published the "Standard for investment *sukuk*".Despite 14 *Shariah*-compliant *sukuk* structures being officially recognized, only a few structures have been issued in the *sukuk* market. Specifically, these are the following: *ijarah, musharakah* (joint venture), *mudharabah* (profit-sharing between entrepreneur and investors), *murabahah* and *istithmar* (investment). These variations take up nearly 90% of the *sukuk* market share. Out of those, *ijarah* has been the most popular structure used by international *sukuk* issuers whereas *musharakah* has been the most used by domestic ones (Malim, 2010).In fact, *ijarahsukuk* have represented an important segment of the market and remained the dominant structure from 2001 until 2005 when the first *musharakah*-based *sukuk*, the DMCC Gold *sukuk*, was issued (IIFM, 2009). Since then, participatory structures such as *musharakah* and *mudharabah* exchangeable trusts picked up the pace and even outstripped *ijarah*. In 2007, more than 40% of the primary market volume was raised through *sukuk* structured on *musharakah*and *murabahah* contracts(IFSB, 2016).

However, the popularity of the *musharakah* and *mudharabahsukuk* structures has declined disproportionately when compared to other structures in 2007. The decline was driven by comments by Sheikh TaqiUsmani, that 85% of the structures of Gulf *sukuk* do not comply with *Shariah*. The comments mostly refer to *mudharabah* and *musharakah* which are also known as equity *sukuk* or partnership-based *sukuk*, but also partly on *sukuk ijarah*. Sheikh Usmani argued that most of these *sukuk* held "nearly all of the characteristics of conventional bonds" and were therefore "inimical in every way to the higher purposes and objectives" of Islamic economics (Usmani, 2007). As a direct consequence of the debate among some *Shariah* scholars regarding the *Shariah* compliance of most *musharakah* and *mudharabahsukuk* which were previously issued*sukuk*, the *sukuk* issuance declined by 83% and 68%, respectively(Hijazi, 2009, p.7).In this regard, *ijarahsukuk* returned as the most favorable structure of *sukuk* in 2008 in terms of dollar amount and number of issues.Due to the market experiencing significant growth, *sukuk* issuance and trading became an increasingly importance method of investment. However, the structure of *sukukijarah* limits the originator because they cannot issue *sukuk* if they do not have enough tangible assets.

Subsequently, to meet the demands of investors, a hybrid form of *sukuk* emerged in the market. In a hybrid *sukuk* structure, the underlying pool of assets can comprise *istisna'* contracts, *murabahah* contracts and *ijarah* contracts, which allows for a greater mobilization of funds. While such hybrids constituted only 2% of new issues in that market between 2001 and 2010, the figure rose to 15% between 2011 and January 2013(IIFM, 2013). Although more complex than the structures of other types of *sukuk* the key benefit of such a hybrid *sukuk* is that they allow a more efficient utilization of a company's assets. They can, for example, be structured in such a way as to permit the use of real estate assets within a *sukuk* structure without the need to register a legal transfer of the relevant real estate. Recently, milestones achieved by the socially responsible *sukuk* were born as a new category of investment with the issue of *sukuk* by International Finance Facility for Immunization, the World Bank linked entity and Khazanah National in the form of Ihsan *sukuk*(IIFM, 2016).

4.0 An evolution in structuring sukuk with regards to underlying assets

The changes in *sukuk* structure since 1990 reflected the preferences of Islamic financial market participants. The *sukuk* market shifted away from *baibithamanajil* to *ijarah*, towards hybrid structures to provide more flexibility with respect to the types of assets being used. This innovative change was due mostly to having insufficient physical assets in response to issuers' demands to tap funds available in the Islamic financial market. In the meantime, *Shariah* requirements and *Shariah* advisors' solutions to problems also played a critical role in developing the advised *sukuk* structure. The financial community implemented and further refined the concept of *sukuk*, expanding its scope to include many commercial and financial products, services and activities.

4.1 Early stage *sukuk* development with 100% asset-backed *sukuk*

As noted earlier, a basic requirement for *Shariah* compliance of any *sukuk* structure is that it shall be backed by tangible assets. The asset itself must fulfil the elements of subject matter of sales since the requirements of a valid contract in Islamic law consist of the offer and acceptance, the seller and buyer and the subject (asset and price). Therefore, when *sukuk* were first developed, the requirement was to have 100% tangible assets that were fully backed for the benefit of investors, in addition to the true sale requirement of the underlying assets to *sukuk* holders. This structure took the form of the first international *ijarah* sovereign *sukuk* issued by the Government of Bahrain in September 2001.

The *sukuk* was backed by US$250 million worth sovereign asset. Similar to the next *sukuk* issuance, the quasi-sovereign global *sukuk* by Kumpulan Guthrie, a corporation in Malaysia as it had the land parcels in Malaysia serving as an underlying asset.

The existence of physical assets and true sale requirement in the *sukuk* structure which is also known as asset-backed *sukuk* meets the criterion of conventional securitization. Following Dusuki and Mokhtar (2010), one of the essential features of securitization is the 'true sale' requirement. This means the sale of the originator's asset must fulfill all accounting and legal requirements to remove the asset from the originator's books. The asset is completely shifted towards a Special Purpose Vehicle for the purposes of a "true sale". The transfer of the asset is ideal which means the asset is protected from the risk of bankruptcy within the Special Purpose Vehicle. In other words the *sukuk* holders enjoy the full backing of the underlying asset because there is true sale and legal transfer of the ownership of the assets to them. As such, *sukuk* holders will have the guarantee of recourse to the assets to recover their capital in the event that the obligor becomes insolvent or faces difficulties in meeting payments. As well as this arrangement, Islamic securitization must be free from three prohibited practices, specifically *riba* (usury), *gharar* (uncertainty), and *maysir* (gambling). Thus, anything leading to these practices is not tolerated such as debt and financial assets trading (*bay al-dayn*), *haram*[5] activities, interest-bearing collateral, etc. Islamic securitization must involve the funding or production of real assets rather than financial securities, which causes irresponsible leverage as well as speculation through derivatives lending (Wilson, 2004). In this sense, asset-backed *sukuk* represent the real form of securitization because they expose *sukuk* investors to real value and risk of the underlying asset. Although the concept of asset-backing is an essential part of Islamic finance, the concept of asset-backed *sukuk* presents its own challenges that have led to the inevitable evolution in *sukuk* structure.

4.2 The emergence of asset-based *sukuk*

Initially, while *sukuk* should have tangible assets in their structures, a concern has been voiced by Islamic market participants regarding the limited number of assets eligible for *sukuk* under the ownership of Islamic financial institutions or corporations looking to raise capital (Al-Amine, 2008). Most of the sovereigns in the Middle Eastern countries were reluctant to part with public assets due to the apprehension that the disposal of such assets to foreign investors would generate public criticism. The corporates on the hand either did not have suitable assets, or the assets were not sufficient or already encumbered, or such disposal was subject to transfer taxes (Haneef, 2009). Likewise, sometimes the originator is not interested in permanently parting from his assets. Or the asset in question has strategic value to the *sukuk*-originating governments (Wouters, 2011).Hence, initially although the *ijarahsukuk* was structurally viable and legally possible, the product did not generate much interest in the Muslim world when it started(Haneef, 2009). The shortfalls in eligible assets including tax issues and legal restrictions on sale of assets to foreign investors have challenged the asset-backed *sukuk*. In an asset-backed *sukuk*, the *sukuk* holders benefit by having some form of security over the assets, enabling them to be at an advantage over other unsecured creditors(Howladar, 2006). This structure created a huge legal hindrance since it was perceived to be a direct breach of the negative pledge clause that prevents the bond issuers from issuing any future bonds that are not in *pari-passu* with the existing secured bonds, which happened to the Malaysian government in 2002 (see Box 1).

Prior to the first issuance of sovereign *sukuk* being proposed in 2002, the government of Malaysia had unsecured international bonds and some had not yet been redeemed. Therefore, in order to avoid a negative pledge, it was considered that the *sukuk* would be backed by the ownership of the underlying assets, and beneficial ownership of the assets to *sukuk* holders emerged as the solution proposed by *Shariah* scholars. A true sale element was not required and instead beneficial ownership of the assets resolved the issue of not being in *pari-passu* with the existing unsecured bonds. In the meantime, it met the *Shariah* requirements of asset ownership under *ijarah* principles. Although the *ijarah sukuk* have assets in their structures, the arrangement only facilitates the transaction and does not give investors legal rights to the assets. Consequently, *sukuk* holders cannot sell the asset to a third party in case the borrower defaults. The *sukuk* holders only have recourse to the originator/obligor (or government of Malaysia).The arrangement of *ijarah sukuk* US$600 million by the government was considered the first ever 'asset-based *sukuk*' in the market.

The characteristics of the asset-based structure demonstrated that the structure closely mirrors conventional bonds. The debt-like structure was imparted to the asset-based *sukuk* by incorporating income and capital guarantees into the *sukuk* structure(Abdullah, 2012).

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[5]Forbidden according to *Shariah*.

The income guarantee was incorporated into the *sukuk* structures by requiring issuers to pay investors a specified amount of "dividends" on specific dates. The dividends are calculated as a percentage of the total amount "invested" rather than as a percentage of total profits (similar to the way interest payments are determined as a percentage of the total amount of a given loan).

Box 1 A closer look of the first issuance of asset-based *sukuk*: US$600 million *ijarah sukuk*by the government of Malaysia

Back in 2002, Malaysia was enthusiastic to help create the international *sukuk* market. Malaysia's government was the first to issue sovereign *sukuk* for financing the public sector. This sovereign *ijarah sukuk* was backed by sovereign assets worth US$600 million in the form of government administrative buildings, hospitals and academic institutions. While the *sukuk* clearly have tangible assets, however, the asset-backed *sukuk* structure created a major legal constraints for the Federation of Malaysia. The government had previously issued international bonds and some of them were still unredeemed in 2002. All international bonds have a standard negative pledge which restrains the bond issuers from issuing in the future any bond that is not in *pari passu* with existing unsecured bonds. The standard negative pledge clause is usually worded as follows: "So long as any of the Certificates remains outstanding, the Issuer has undertaken that it will not secure any of its present or future indebtedness for borrowed money by any lien, pledge, charge or other security interest upon any of its present or future assets, properties or revenues (other than those arising by operation of law)."

Given that the Malaysian international bonds were all unsecured bonds, the proposed *sukuk* issuance was seen as a direct breach of the negative pledge clause given that the *sukuk* would be backed by the ownership of the underlying assets. The *sukuk* became effectively a secured bond and would be given priority over all unsecured bonds of the Federation of Malaysia. The Federation of Malaysia was advised not to proceed with the *sukuk* until all outstanding bonds were redeemed. The development of the *sukuk* market almost came to a standstill. This challenged called for a neat solution to avoid breaching the negative pledge. Therefore, with the help of a few prominent *Shariah* scholars, under the revised structure, the *sukuk* holders would enjoy a beneficial ownership of the assets held through the *sukuk* trustee during the life of the *sukuk*. This arrangement would meet the *Shariah* requirements of asset ownership under *ijarah* principles. However, in the event of default by the Federation of Malaysia, the *sukuk* trustee's sole recourse to the assets would be to dispose of the assets only to the government of Malaysia and seek payment. The *sukuk* trustee would not have the power to retain or sell the assets to any third party. Once the *sukuk*trustee had disposed of the assets to the Malaysian government, the *sukuk*holders would in law be treated as unsecured creditors. The revised *sukuk*structure therefore was not seen as asset-backed securities although the *sukuk*had underlying assets. The Malaysian *sukuk*became known in the market as asset-based securities.

In June 2002, Malaysia successfully launched the world's first international *sukuk* issue. A Special Purpose Vehicle (SPV) wholly owned by the government, namely Malaysia Global *Sukuk* Inc., was incorporated in Labuan and issued the US$600 million 5–years Islamic bonds. The transaction was based on the *ijarah* concept. The structure of the *sukuk* is underpinned by a portfolio of prime real estate assets owned by the Federal Land Commissioner of Malaysia, which is sold to the SPV.The SPV then leases the assets to the government for five years, a period equivalent to the tenure of the bonds. The lease payments paid by the government exactly match six monthly distributions to investors and represent a senior unsecured obligation for Malaysia. On maturity, the SPV sells the asset back to the Malaysian government at the original price (i.e. the face value of the bond issue). Proceeds from the sale of the assets will be used to repay the investors, in terms of the principle amount of trust certificates.

Source: Labuan Offshore Financial Services Authority(2002)

Meanwhile, the capital guarantee was incorporated into the *sukuk*structures by requiring originators to refund to investors their capital in full, on a specific day in the future, known as the maturity date. To comply with *Shariah* law –at least in a formal sense – the refund was accomplished by requiring originators to repurchase the underlying assets from investors on an agreed-upon date. The price at which the assets were repurchased was identical to the price at which they were first sold to the investors. This had the effect of returning to "investors" exactly the same amount they "invested" when they initially purchased the assets. Not only the *ijarah* but also partnership *sukuk* such as the *musharakah* or *mudharabah* were structured to replicate debt instruments. As far as asset-based and asset-backed structure is concerned, it should be noted at this stage that one cannot assess the risks associated with each issue by merely understanding the *sukuk* structure such as *mudharabah*, *musharakah*or *ijarah*since the actual legal structure behind the 'name' and the actual risk characteristics of the issue can vary significantly even within each structure.

Within *musharakahsukuk* for instance there can exist variations between asset-based and asset-backed *sukuk*– each one yielding a wholly different risk profile. Asset-based *sukuk* are also commonly referred to as 'Islamic bonds' and from a legal perspective in terms of taxation, are treated as bonds(Hasan, 2013). They enable Islamic investors to own certificates that offer a return similar to a coupon-bearing instrument (such as conventional bonds) and that can be traded in the secondary market.

Since 2002, the vast majority of *sukuk* in the *market* have been structured in such a way to be asset-based *sukuk*or Islamic bonds rather than asset-backed investments. Given investors' demands, the majority of issued *sukuk* have been structured so that they have similar risk profiles and pricing to that of conventional debt bonds. Though still *Shariah* compliant, they have essentially become debt obligations. In 2009, only 11 out of a total of 560 *sukuk*issues as of 5th August 2009 (or around 2% of the total) qualified to be asset-backed because they fulfilled the *Shariah* requirements of an actual sale of the underlying asset to investors (Dusuki & Mokhtar, 2010). Further, as reported by Hijazi (2010)at the end of 2009, only 4% of the US$32 billion worth of *sukuk* rated by Moody's represented secured 'asset-backed' *sukuk* and this dominance of 'unsecured *sukuk*' continued into 2010. By 2015, asset-based structures still dominated the market while asset-backed structures were very few and far between(Dey, 2015).The dominance of asset-based *sukuk* structure is due to a few reasons: firstly, asset-based *sukuk* employ a more suitable asset class thus encouraging product innovation; secondly, the personnel are more knowledgeable of asset-based *sukuk* and not asset-backed *sukuk*; and thirdly, investors understand the structure of asset-based *sukuk* better than asset-backed *sukuk* (Hasan, 2013). For this reason, asset-based *sukuk* are considered to be simpler than asset-backed *sukuk* and the price tends to be more reasonable, which confirms its popularity. However, given asset-based *sukuk* still require 100% physical assets despite the constraints, corporate as well as sovereign issuers devised alternative blended assets.

4.3 The dawn of 'blended assets' *sukuk*

Blended assets *sukuk* are also known as hybrid *sukuk* or mixed-asset *sukuk*. As the name implies, the issuing company is allowed to compose more than two or widely differing elements in the *sukuk* structure (Furqani, 2014).First, hybrid *sukuk* can combine some elements of equity and debt. It means that a hybrid *sukuk* is structured with both debt and equity-linked features in the contracts that grant the holder the right to convert the *sukuk* certificates into shares or equity ownership from the issuer (or the obligor), following the conversion of the *sukuk*. Second, while previous *sukuk* had been predominantly structured using only one *Shariah* contract, e.g. *istisna'*, *murabahah*, *mudharabah* and *ijarah*, hybrid *sukuk* allowa combination of two or more Islamic finance of these contracts into the structure. Third and finally, the hybrid *sukuk* combine *Shariah*-compatible receivables (or intangibles assets) and physical assets.

While the hybrid *sukuk* can comprise both physical assets and *Shariah*-compliant receivables, it is subjected to condition that the proportion of the physical assets has to exceed that of the receivables for *sukuk* issuance and trading. Since *murabahah* and *istisna'* contracts cannot be traded on secondary markets, the proportion of untradeable contracts in a pool of assets cannot exceed 49% of total assets(Gurulkan, 2010).This means that at least 51% of the pool in a hybrid *sukuk* must comprise tradable Islamic instruments in the market such as an *ijarahsukuk*. The modus operandi of issuing a mixed portfolio *sukuk* is an effective tool for converting non-marketable and illiquid assets to negotiable instruments and can be traded in a secondary market. It is a strategy particularly suitable for investment banks and development finance institutions. Since the first hybrid *sukuk* was issued in 2006, a large proportion of *sukuk* issuances have been in the form of convertible and exchangeable *sukuk*. Interest has grown among issuers and investors for hybrid *sukuk* due to them being equity-linked(Furqani, 2014).

4.3.1 The deviation of tangible assets in the *sukuk* structure

The emergence of blended assets *sukuk* has demonstrated that the *sukuk* market reduced the requirement of 100% physical assets in the *sukuk* structure. The dilution of required physical assets was evidenced by the *sukuk* issued by the Islamic Development Bank in 2003. In that year the Islamic Development Bank issued the first hybrid *sukuk* that was valued at US$400 million. Its underline assets comprised *ijarahsukuk* (65.8%), *murabahah* receivables (30.73%) and *istisna' sukuk* (3.4%). The *ijarah* assets had certain physical assets owned by the Islamic Development Bank and were leased out to various counterparties(GIFR, 2010).Since the *ijarah* assets could be freely transferred at any price by the Islamic Development Bank, by mixing the *murabahah* and *istisna*' receivables (*dayn*) with *ijarah* assets (*ayn*), the Islamic Development Bank was able to transfer the receivables as well. Accounting for the fact that the Islamic Development Bank had fewer physical assets and more *Shariah*-compatible receivables on its books, as other financial institutions experienced, implementing the "blended assets" *sukuk* approach was the only viable solution.

Such a structure makes it possible for the issuing company or entity to take into account the diversified demands of various investors, allowing for a wider portfolio of assets classes that, in turn, aim at a greater mobilization of funds.

The requirements for physical assets became further diluted when the Islamic Development Bank issued *sukuk* again in 2005. While the earlier *sukuk* structure comprised 65.8% of certain physical assets owned by the Islamic Development Bank, this time it was permitted to reduce the minimum physical assets to 30% in a mixed asset portfolio. Previously, some Hanafi scholars have taken a more liberal view of the *khultah* (mixture of assets)principle. They have not allocated any fixed percentage or quantity, but have left the matter to be decided on a case-by-case basis. Hence, there may be circumstances where even if the non-compatible component is more than 50%, this can still be on the whole considered *Shariah*-compatible (GIFR, 2010). Based on this view, the Islamic Development Bank was permitted to sell a mixed portfolio consisting of only 30% physical assets.

Whilst the "blended assets" *sukuk* structure has been a tremendous boost for institutions like the Islamic Development Bank and other Islamic financial institutions where the *sukuk* capital markets can be tapped, others found the prevailing *sukuk* structure to be constraining and unviable. At that time, many of these corporations were in an expansion mode fueled by the oil boom (2002 to mid-2008) that generated a large volume of revenues for the Gulf Cooperation Council countries(Saif, 2009).While the corporations were keen to tap the ever-growing and liquid Islamic finance market, they either could not meet the 30% physical assets requirement or they did not have any *Shariah*-compatible receivables. The constraint of asset requirements for the *sukuk* issuance thus led to the emergence of asset-light *sukuk*.

4.4 The temporary emergence of asset-light *sukuk* and its *Shariah* issues

To meet the growing demand of issuers who did not have the required minimum physical assets, an asset-light *sukuk*structure was conceived. The development of asset-light *sukuk* does not require any physical assets at the time of *sukuk* issuance. Its features are similar to those of the asset-based *sukuk* structure (Ismal, Muljawan, Chalid, Kashoogie, & Sastrosuwito, 2015). The *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked *pari-passu* with other unsecured creditors. These asset-light *sukuk* are based on the equity-based *sukuk*, in particular *mudharabah* and *musharakah* arrangements between the issuer and the *sukuk* holders. This kind of structure has become a market choice until equity-based *sukuk* were criticized by the Chairman of the AAOIFI, Sheikh TaqiUsmani in 2007(see Usmani, 2007).

4.4.1 *Shariah* issues and equity-based *sukuk* transactions

In analyzing Sheikh TaqiUsmani's critical comments (see Table 1), it is evident that his statements on the *sukuk* structure mainly pertained to three aspects of the *sukuk* structure. First, *sukuk* represent ownership shares in assets yet the market has witnessed a number of *sukuk* in which there is doubt regarding *sukuk* holders' ownership interest in the underlying assets. The criticism pertained to asset-based *sukuk* where there is no legal sale of the underlying assets and as such no real transfer of ownership of the assets to *sukuk* holders from the originating company. Legal documentation in asset-based *sukuk* indicates that *sukuk* holders do not have an interest in the underlying asset, which conflicts with *Shariah* principles that require *sukuk* investors to have rights over the *sukuk* assets. The other two criticisms focused mainly on the structural features of the *musharakahsukuk* and *mudharabahsukuk*. Most of the *sukuk* that have been issued are identical to conventional bonds with regard to the distribution of profits from the companies being fixed percentages of interest rates based on London Inter Bank Offer Rate (LIBOR). The criticisms also highlighted the use of *Shariah*-compliantfunding to make up for any shortfalls in actualprofit below the stipulated percentage to *sukuk* holders. Thepayment of any excess profit realized beyond the expectedprofit percentage takes the form of incentive fees/incentive fee to the manager. This includes the use of purchase undertakings to guarantee the *sukuk*holders' principal where it is expected the issuerwill buy back the underlying asset at the expiration date ofthe *sukuk*, or in the event of default at face value regardlessof their true value on that day. Such practices convert theequity-based *sukuk* into debt-based structures whereby the*sukuk* are redeemed at par value at the maturity date. Furthermore *sukuk* holders are paid a guaranteed periodic return on capital throughout the duration of the *sukuk*.

Concerns about the prevalence of these practices were also raised by other prominent *Shariah* scholars, leading to the release of an AAOIFI *Shariah* resolution on *sukuk* in 2008, which clarified the permissible structure as well as the nature of issuer-investor rights and obligations (see Table 1).

There are six core principles that underline the structuring and implementation of *sukuk* transactions, it was these principles that were often being disregarded in the larger or volume-based *sukuk*structures.

Table 1 Summary of AAOIFI's *sukuk* criticisms and its ruling in relation to *sukuk* issuance

<table>
<tr><th>Issue</th><th>Mechanism</th><th>Criticism</th><th>* Six recommendations by AAOIFI on proper sukuk structures</th></tr>
<tr><td>1. Asset ownership</td><td>▪ Ownership</td><td>Does not confer true ownership</td><td rowspan="3">1. Sukuk, in order for them to be tradable, must be owned by sukuk holders, together with all the right and obligations. The manager of a sukuk issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.

2. Sukuk must not represent receivables or debt except in the case of a trading or financial entity selling all of its assets, or a portfolio with a standing financial obligation.

3. It is not permissible for the manager of sukuk to undertake to offer loans to sukuk holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same is mentioned in the prospectus.

4. It is not permissible for the investment manager, partner, or investment agent to agree to re-purchase assets from sukuk holders at nominal value when the sukuk are extinguished at the end of their maturity. It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase, in accordance with Shariah rules of partnership and modern partnerships, and on the subject of guarantees.

5. It is permissible for the lessee in a Sukuk Al-Ijarah to agree to purchase the leased assets when the sukuk are extinguished for their nominal value, provided that the lessee is not also an investment partner, investment manager, or agent.

6. Shariah supervisory boards should not limit their role to the issuance of fatwa on the structure of sukuk, but should also oversee its implementation and compliance at every stage of the operation.</td></tr>
<tr><td>2. Regular distribution to sukukholders</td><td>▪ Management Incentive fee

▪ Liquidity facility</td><td>The prescribed incentive fee is not linked to the expected profit of an enterprise but to the cost of financing

This incentive system defeats the purpose of the Islamic concept and practice of wealth distribution
This amounts to sale linked to credit and is therefore prohibited</td></tr>
<tr><td>3. Guarantee of the return of principal</td><td>▪ Purchase undertaking</td><td>Promise to repurchase asset at face value and not market value. If the enterprise makes a loss, such losses will be borne by the manager</td></tr>
</table>

Sources: Usmani (2007) and AAOIFI's Resolution issued in February*

Some credit enhancements are prohibited in equity-based *sukuk* and in particular the use of: firstly, *Shariah*-compliant funding to smooth out periodic income distribution amounts to *sukuk* holders; and secondly, purchase undertakings to guarantee the return of the principal amount to *sukuk* holders at its par or nominal value. The AAOIFI pronouncement only allowed purchase undertakings to repurchase the assets for their net value, their market value, fair value or agreed price at the time of their actual purchase. As such, without an undertaking to buy the shares

of the *sukuk* holders at par value, it is impossible to issue an asset-light *sukuk*. Consequently, there have not been any asset-light *sukuk* offerings in the market since the AAOIFI ruling in February 2008 (Haneef, 2009). Therefore, this ruling effectively put an end to the dramatic growth of asset-light *sukuk* issuance. Nevertheless, to what extent the AAOIFI ruling resulted in a dramatic decline in new issues during 2008 is impossible to determine as in the meantime the decline was attributable to the devastating Global Financial Crisis[6]. Similarly, many of the *sukuk* issued previously would have had a three–to five–year tenure and therefore were repaid in 2008, with market conditions preventing these from being rolled over (Norman, 2009).

4.5 Back to blended-assets *sukuk*

In the past few years, the *sukuk* market witnessed increasing acceptance of asset-light structures temporarily, which reduced the proportion of fixed assets required. As many equity-based *sukuk* appeared to violate the principle of risk and profit-sharing, the AAOIFI ban played a key role in shifting the market away from asset-light *sukuk* in 2008. As such, the asset-based *sukuk* by and large in the form of *ijarah* again became attractive options to issuers. In 2009, the first domestic sovereign retail *ijarahsukuk* which was worth US$464 million by the government of Indonesia was issued. There was also *ijarahsukuk* worth US$750 million, issued Government of Bahrain and *ijarahsukuk* issued by Petrolium Nasional Berhad (Petronas), Malaysia worth US$1,500 million(IIFM, 2011). However, in recent years, there has been a change in issuer preferences relating to asset-based structures. *Ijarah* had been the most popular structure for international issuances, but a sudden transformation occurred in *sukuk* with underlying *wakalah* (investment agency) assets in 2015. The proportion of *ijarah sukuk* in the international market fell from 42% in 2014 to 14% in 2015, while *wakalah* accounted for 63% of issuances in 2015. The *wakalah* structure is also showing signs of taking over from *murabahah* as the most issued type of *sukuk* since 2015, given that the latter is required to be held to maturity in Gulf Cooperation Council markets(Thomson Reuters, 2017).

The unavailability of suitable assets for *ijarahsukuk* and the non-tradability of *murabahahsukuk* on the secondary market[7] remain challenges for *sukuk* issuers. These issues have constantly put pressure on market participants and market scholars to devise innovative structures that rely less on physical assets and be widely acceptable to investors, *Shariah* experts and stakeholders at large(Muhammad & Sairally, 2014).In this context, *wakalahsukuk* have increased their popularity as they allow issuers, particularly those who prefer holding few tangible assets, to use a smaller level of these assets, including financing assets such as *ijarah* which are asset-based themselves(Thomson Reuters, 2017). Furthermore, the issuers can access a larger variety of diverse assets such as equities and derivatives, provided they meet *Shariah* guidelines [8]. In fact, certain assets that cannot be traded on the secondary market such as *murabahah* and *istisna'* contracts can be part of the portfolio of *sukuk* assets, provided that the overall *sukuk* portfolio includes a minimum of 30% of tangible assets (or more, depending on *Shariah* approvals)(DIFC, 2009).This enables the *wakeel* (agent in the *wakalahsukuk*) to mix and match different types of assets and effectively utilize those assets which, by themselves, may not comply with the tangibility criterion. Therefore, the *wakalahsukuk* structure may be particularly useful for Islamic banks and financial institutions, which tend to have a large number of commodity *murabahah* and *istisna'* contracts on their balance sheets.

Although the *wakalah* structure is included as an asset-based structure, it functions in many cases as a hybrid structure (Thomson Reuters, 2017) as witnessed by *wakalahsukuk* issued by the Malaysian Government in 2011. The underlying asset pool for this US$2 billion dual tranche comprised 52% tangible assets consisting of lease assets which will be redeemed at maturity and 48% *murabahah* receivables arising from the sale of *Shariah*-compliant commodities which will be the initial investment.

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[6]The record growth rates achieved by the Islamic Financial Services Industry (IFSI) and the *sukuk* market in particular during the years preceding the 2008 Global Financial Crisis were unique with the market attaining its peak during 2007. In that year total global *sukuk* issuance amounted to nearly US$49 billion. Nonetheless the global *sukuk* market was not spared the effects of the crisis; it indeed witnessed with a substantial decline in *sukuk* issuance during 2008 and 2009 to US$18.6 billion and US$25.7 billion, respectively (IIFM 2011, p.6)

[7]Domestic *Shariah*rulings in Gulf Cooperation Council countries do not allow *murabahahsukuk*to be traded in the secondarymarket, in contrast to Malaysia where such tradability is permitted.

[8]The portfolio of assets may comprise a broad range of *Shariah*-compliant assets that will be selected by the *wakeel* for a period of time corresponding to the duration of the *sukuk*. The criteria for the assets that may be included in the portfolio must be set or approved by the relevant *Shariah* board that issues the fatwa. However, the range of assets may be fairly broad and could include equities (which are issued by companies complyingwith certain *Shariah* guidelines or listed on *Shariah*-approved indices), other *Shariah*-compliant assets (such as*murabaha, istisna'* or even other *sukuk* – see below). This could apply to other types of derivative products, provided they meet the demands of *Shariah* guidelines (DIFC 2009, p. 57).

The obligor is appointed as an agent (*wakeel*) to invest and manage *sukuk* proceeds on behalf of the *sukuk*holders. The transaction attracted investors from a diverse group as it was well spread out globally with 29% of the *sukuk* distributed to the Middle East, 27% in Malaysia, 22% to the rest of Asia, 14% to Europe and 8% to the US(Parker, 2011). This structure has the added advantage of allowing issuances above the value of available physical assets. Given that the *wakalahsukuk* structure demonstrates widespread acceptability, this confirms that the *sukuk* market relies again on a blended asset structure based on the principle of *khultah* (mixture of assets). The market has seen a shift away from the once-prevalent *ijarah* structure towards hybrid structures which provide more flexibility with respect to the types of assets that can be used.

5.0 Conclusion

Sukuk structures have evolved from basic to innovative structures designed to serve specific needs and demands in the marketplace. Nevertheless, not all innovation is positive as demonstrated by the failure of *sukuk* to become a *Shariah*-compliant financing instrument and alternative to conventional bonds. The challenges in structuring *sukuk*, in particular insufficient amount of physical assets to a certain extent have put Islamic market players under pressure. As a consequence the *Shariah* standards became more liberal in their interpretation of these structures. What has become a worrying practice is the 'form over substance' compliance where the assets in the *sukuk* structure are commonly used as a facade for *Shariah* compliance, or as industry jargon puts it, 'compliance in the form' only and ultimately has no bearing on the risk performance of the asset *sukuk*.

In structuring *sukuk* contracts, a dividing line needs to be drawn between financial innovations and deviations from *Shariah* principles. Therefore, for better *Shariah* compliance that also accords with market requirements, there is a demand for *Shariah* advisors to do more than just advise and approve the structure of the proposed issue. It is in fact very important for them to constantly work with rating agencies, industry professionals, accounting and auditing organizations and academics to ensure Islamic financial services do cater to customers' myriad requirements. It would therefore be important to see ideas emerging for Islamic products that break away from conventional finance and offer genuinely different ways of doing business.

Acknowledgement

The support of Fundamental Research Grant Scheme (FRGS) [Grant Number: 203.PJJAUH.6711547], Ministry of Education, Malaysia and Universiti Sains Malaysia are gratefully acknowledged.

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