The Challenges and Prospects of *Sukuk*
The Challenges and Prospects of *Sukuk*:

*A Content Analysis-Based Study*

By

Essia Ries Ahmed, Md. Aminul Islam, Ku Halim Ku Ariffin and Azlan Amran

Cambridge Scholars Publishing
<table>
<thead>
<tr>
<th>TABLE OF CONTENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface ................................................................. x</td>
</tr>
<tr>
<td>Acknowledgements ................................................... xiii</td>
</tr>
<tr>
<td>About the Authors ................................................... xiv</td>
</tr>
<tr>
<td>Chapter 1 ................................................................. 1</td>
</tr>
<tr>
<td>Introduction</td>
</tr>
<tr>
<td>Introduction</td>
</tr>
<tr>
<td>Sukuk Legitimacy</td>
</tr>
<tr>
<td>The Sukuk Market in Malaysia</td>
</tr>
<tr>
<td>Chapter 2 ................................................................. 10</td>
</tr>
<tr>
<td>The History and Development of Sukuk</td>
</tr>
<tr>
<td>Introduction</td>
</tr>
<tr>
<td>The Definition of Sukuk</td>
</tr>
<tr>
<td>The Difference between Sukuk and Debt Bonds</td>
</tr>
<tr>
<td>The Basic Foundations of Sukuk in Islamic Law</td>
</tr>
<tr>
<td>Shariah Sources</td>
</tr>
<tr>
<td>Ijtihad Method for Sukuk</td>
</tr>
<tr>
<td>History and Roots of Sukuk</td>
</tr>
<tr>
<td>Origins of Sukuk</td>
</tr>
<tr>
<td>Sukuk in the Present Times</td>
</tr>
<tr>
<td>Basic Principles of an Islamic Financial System</td>
</tr>
<tr>
<td>The Concept of Debt and Equity in Islam</td>
</tr>
<tr>
<td>Chapter 3 ................................................................. 24</td>
</tr>
<tr>
<td>The Structure and Types of Sukuk</td>
</tr>
<tr>
<td>Ijarah Sukuk</td>
</tr>
<tr>
<td>Features of an Ijarah Sukuk</td>
</tr>
<tr>
<td>Steps involved in the Structuring</td>
</tr>
<tr>
<td>Musharakah Sukuk</td>
</tr>
<tr>
<td>Mudharabah Sukuk</td>
</tr>
<tr>
<td>Salient Features of the Mudharabah Sukuk</td>
</tr>
<tr>
<td>Murabahah Sukuk</td>
</tr>
</tbody>
</table>
Steps involved in the *Sukuk Murabahah* Transaction Structure
*Salam Sukuk*
Steps Involved in the *Sukuk Salam* Transaction
*Sukuk Istisna*
Steps Involved in the Structure of the *Sukuk Istisna* Transaction
*Hybrid Sukuk*
Steps Involved in the of the *Sukuk Hybrid* Transaction Structure

Chapter 4 .................................................................................................. 42

**Literature Review**
- The Legitimacy of *Sukuk*
- Disclosure of *Shariah Compliance*
- Determinants
- *Sukuk Pricing*
- Mechanism of Pricing
- Pricing from the Islamic Perspective
- Type of Structure (Asset-Backed and Asset-Based)
- Studies Related to the Structure of *Sukuk*
- *Shariah Auditing*
- *Shariah Auditing by the Shariah Supervisory Board*
- Risks of *Sukuk*
- *Shariah Risks*
- *Shariah Risks on Sukuk*
- *Shariah Documentation*
- The Role of *Shariah Supervisory Board*
- *Shariah Supervisory Board Procedures in Sukuk Issuance*
- *Shariah Supervisory Board as Moderator*
- Summary

Chapter 5 .................................................................................................. 89

**Research Background**
- The Research Problem
- Research Questions
- The Scope of the Study
- Definition and Illustration of the Key Terms
- The Legitimacy of *Sukuk*
- Pricing Bench-marking
- Type of Structure
- *Asset-Based Sukuk*
- *Asset-Backed Sukuk*
- *Shariah Risk*
Shariah Auditing
Shariah Documentation
Shariah Supervisory Board
Special Purpose Vehicle

Chapter 6 .................................................................................................. 97
Research Methodology
Theoretical Framework
Underpinning Theories
The Theory of Indebtedness
The Institutional Theory
Hypotheses Development
The Relationship between Pricing and Sukuk Legitimacy
The Relationship between Sukuk Legitimacy and Type of Structure
The Relationship between Shariah Auditing and Sukuk Legitimacy
The Relationship between Shariah Risks and Sukuk Legitimacy
The Relationship between Shariah Documentation and Sukuk Legitimacy
The Effect of the SSB as a Moderator in the Relationship between Determinants and Sukuk Legitimacy

Research Methodology
Research Design
Population and Sampling for a Quantitative Study
Sampling in the Qualitative Study
Research Instruments
Instruments for the Quantitative Study
Instrument for the Qualitative Study
Data Collection Methods
Data Collection for the Quantitative Study
Data Collection for the Qualitative Study
Semi-Structured Interview
E-Mail Intertwining
Interview Design
Interview Process
E-Mail Interviewing
Interview Design
Interview Process
Measurement of the Variables
Descriptive Statistics
Table of Contents

Structural Equation Modeling (SEM)
- The Structural Model
- Bootstrapping Model
- Moderating Effect
- Hypothesis Testing
- Qualitative Data Analysis

Chapter 7 ................................................................................................ 145
Research Findings (based on Quantitative Data)
- Introduction
- Population versus Sample
- Descriptive Statistics
- Descriptive Statistics (Frequency) SSB
- Descriptive Statistics on Sukuk Legitimacy
- Assessment of Measurement Model
- Assessment of Structural Model
- Hypotheses Testing
- The Moderating Effect
- SSBM as a Moderator between Determinants and Legitimacy
- SSBC as a Moderator between Determinants and Legitimacy

Chapter 8 ................................................................................................ 167
Research Findings (based on Qualitative Data)
- Introduction
- Qualitative Findings Based on Interviews
- Measurement and Extent of Legitimacy of Sukuk
- The Relationship between Determinants and Sukuk Legitimacy
- Pricing Benchmark
- Type of Structure
- Shariah Auditing
- Shariah Risk
- Shariah Documentation
- The Moderating Effect of the Shariah Supervisory Board on the Relationship between Determinants and Sukuk Legitimacy

Chapter 9 ................................................................................................ 178
Discussion
- Discussions
- Evaluation on the Legitimacy of Sukuk
- The Impact of Determinants on Sukuk Legitimacy
- The Moderating effects of Shariah Supervisory Boards on the
The Challenges and Prospects of Sukuk: A Content Analysis-Based Study

Relationship between Determinants and Sukuk Legitimacy
The Moderating Effects of Shariah Supervisory Board Members (SSBM) on the Relationship between Determinants and Sukuk Legitimacy
The Moderating Effects of Shariah Supervisory Board Committees (SSBC) on the Relationship between Determinants and Sukuk Legitimacy

Chapter 10 .............................................................................................. 192
Conclusion
Theoretical and Methodological Implications
Practical Perspective
Limitations of the Study
Recommendations for Future Research
Conclusions

References .............................................................................................. 199
Over the past decades, Sukuk (Islamic bonds) have emerged as one of the most important tools for Islamic investment and financing. They have become the most successful financial product in the Islamic financing industry. The International Islamic Financial Market (IIFM) believes the global Sukuk market will be able to sustain its expansionary phase into 2015, with total issuance likely to top US$150 billion, despite the uncertainty in the global economy. Total Sukuk issues crossed the US$130 billion mark in 2014. The world Sukuk issuance crossed the landmark US$100 billion mark in 2012, when a total of US$137.45 billion was raised in the corporate year. However, the controversy over Sukuk became heated when Taqi Usmani critically commented on unscrupulous Sukuk issuance. Taqi Usmani is reported to have said that 85% of the Sukuk issued worldwide are un-Islamic. The pricing of Sukuk is one of the main contributory factors to this controversy. Currently, conventional finance benchmarks, such as KLIBOR, LIBOR etc., are used to determine the cost of funds, and the return to financial investments, which creates controversy. The LIBOR benchmark has been employed as a reference guide for long-term investment pricing among Islamic financial institutions. It is generally accepted and recognized in the Islamic banking industry, without making any serious or innovative moves to become free from a usury-based benchmark. The arguments made are based on complete replication of the conventional (usury-based) financial indicators, and the unjustified view of some scholars is that it is a complete surrender to the long-lasting control of western practice to the financial markets, since modern Islamic finance is still in its infancy.

The rise in the Muslim population around the globe begs for Shariah (Islamic law)-compliant financial instruments, as the conventional products in the market go against the religious orientation of Muslim clients. Sukuk (Islamic bonds) are among the most promising and popular Islamic financing instruments which are promoted as being Shariah-compliant. However, Sukuk’s compliance to Shariah became questionable when a breach of Shariah principles in Sukuk’s issuance was reported. Thus, this study is aimed at examining the factors that affect Sukuk’s legitimacy and the moderating role of the Shariah Supervisory Board (SSB) in relation to Sukuk legitimacy determinants (pricing, type of structure, Shariah risk,
Shariah auditing, and Shariah documentation). Based on indebtedness and institutional theories, a conceptual model is developed and tested using the data from 82 Sukuk products listed in the Bursa Malaysia’s exempt regime. This study adopted a mixed research method to build a framework based on qualitative findings, verified by literature, and tested quantitatively. The study began by first analysing data obtained from interviews (primary source) and Shariah reports (secondary source) between the years 2005 to 2015. Using descriptive statistics, the existence, and the extent of existence, of legitimacy in Islamic Sukuk in Islamic financial institutions in Malaysia was ascertained. The research found that the pricing, rating, Shariah compliance risks, Shariah auditing, and Shariah documentation, significantly influence Sukuk legitimacy. An analysis of the quantitative data was then made using the Partial Least Squares (PLS). The research found that pricing, type of structure, and Shariah auditing, have a significant effect on Sukuk legitimacy. In contrast, Shariah risk has a negative effect on Sukuk legitimacy, while Shariah documentation has no significant effect on Sukuk legitimacy. As for the moderating role of the SSB, the study proves that the combination of the determinants and SSB leads to greater monitoring, and therefore resulting in higher disclosure levels, which is in compliance with Shariah tenets and rules. The results from the interviews confirmed and validated the results obtained from the quantitative analysis done in the current study. These findings could be used as subjects of references in determining the existence of legitimacy in Shariah pronouncements. This study contributes to the literature by presenting a systematic framework that demonstrates the underlying indebtedness theory, and introduces a disclosure index as a measurement to represent Sukuk legitimacy. In addition, the moderating role of SSB as a governance mechanism that can influence Sukuk compliance to Shariah is strengthened positively. These findings also contribute to the practitioners by promoting the importance of disclosing elements of Shariah compliance among the Sukuk legitimacy determinants, as well as affirming the pivotal role that SSB plays in enhancing the legitimacy of Sukuk.

Although the Islamic finance industry has been developing rapidly in many respects, and the growing demand for Islamic Sukuk is noticeable, both domestically and internationally, there are a number of challenges that the Islamic Sukuk products are facing. Some scholars have argued for the need to reconsider the existing method of structuring and marketing Islamic Sukuk, which impedes the desired goals. The target audience for Sukuk is mostly a conventional bonds audience; while the return of Sukuk is more like the return of conventional bonds, in terms of their relation to (LIBOR), in terms of risks, or in terms of subscriptions and marketing through brokers.
This contributes towards limiting the liquidity of Sukuk due to the restricted quantity of Sukuk that are offered for trade in the secondary market. In general, we can focus on the following three most important contemporary challenges that the Islamic Sukuk has been facing: the challenges of the Sukuk market; the challenges of developments of Sukuk; and challenges based on the mechanisms of Sukuk. There are some controversial issues and challenges that need prompt solutions in order to sustain the development of the Sukuk market. This requires close cooperation among Shariah scholars and financial experts on one hand, and more interaction among Shariah Committees on the other. In order for the Sukuk market to be acceptable to the international financial institutions, the Sukuk products must overcome their limitations against the conventional market. However, Sukuk compliance with Islamic Sharia remains the first and foremost criterion. A well-defined, and well-developed Sukuk system can help in the growth of a real economy and socio-economic development. Towards the end of this book, we have attempted to propose an alternative Islamic Pricing Benchmark Model (IPBM) that will help to determine Sukuk cost of capital. This proposed benchmark will assist in pricing Sukuk that is usury-free and Shariah compliant.

This book is written on our content-analysis-based research of Malaysian Sukuk. It is primarily meant for researchers, academics, practitioners, and policy makers, who are interested in understanding and finding solutions in order to sustain the development of the Sukuk market. This book will be highly useful for lecturers teaching Sukuk, researchers, PhD scholars, and practitioners concerned about the challenges and prospects of Sukuk. This book is organized into 10 chapters. Chapter One describes a general understanding of Sukuk for readers. Chapter Two describes the history and development of Sukuk. Chapter Three presents types of Sukuk and their modes of operation. Chapter Four reviews relevant literatures and explains theoretical foundations in conducting research on Sukuk. Chapter Five presents our research backgrounds, while Chapter Six describes research methodology, and Chapters Seven and Eight present our research findings and their implications. The challenges and prospects of Sukuk and our recommendations are presented in Chapter Nine.
Alhamdulillah, to our creator and sustainer, we surrender and offer our praises for all the blessings. Many people have helped along the path that brought us to the writing of this book. We would like to begin with joint ‘thank you’s’. We both offer our heartfelt appreciation to Yang Berbahagia Brig. Jen. Datuk Professor Dr. Kamarudin Hussin, the Vice Chancellor of UniMAP for motivating us to embark on this CSR book project. We also want to thank Associate Professor Dr. Hazry Desa, the Dean of the School of Business Innovation and Technopreneurship, UniMAP, for his words of encouragement. We would also like to extend our appreciation to UniMAP’s Publication unit, especially its Director, Professor Dr. Asiah bt. Sarji and its Publication Officer, Zuhlizzlan Bin Othman for giving us all the support and assistance in the process of publishing this book. Our appreciation also goes to Jay Lee Sze Fern for her excellent editing job on this book. We also want to thank Associate Professor Dr. Idris Md. Noor from the School of Business Innovation and Technopreneurship, UNIMAP for his valuable feedback and reflections. Many thanks to Ajinder Kaur, Timbalan Pendaftar (Academic Affairs and International Department, USM), Dr. Tarsame Singh, (a Teacher Trainer at the Institut Pendidikan Guru Kampus Tuanku Bainun) and Dr. Jasbir Singh from Singapore for their words of encouragement and support. Last but not least, we would like to thank Sentral College Penang, and its CEO Dr. Chiang Geok Liang, for her support and encouragement in working on this book project. To our parents, our spouses, and our children, we remain ever so grateful for their love, and to whom we dedicate this accomplishment.
ABOUT THE AUTHORS

Dr. ESSIA RIES AHMED, PhD

Essia Ries Ahmed is currently working as an Asst. Professor of Accountancy at University of Nizwa. He is instructor (trainer) in a training program prepared by the International Center for Training and Development (ICTD) in Kuala Lumpur.

He is an Auditor and a member of the Iraq Institute of Accountants. Dr Essia Ries received his Bachelor’s degree majoring in commercial science from the Baghdad College of Economic Science University, and his Master’s degree in Accounting from Universiti Sains Malaysia (USM). He received his PhD from University Malaysia Perlis (UniMap). Dr Essia’s primary research interests concern financial reporting, and accounting and Islamic finance. He has published articles in the Journal of Accounting and Business and the Journal of Islamic Accounting and Business Research, as well as contributing to proceedings and presenting papers at both national and international conferences. Dr Essia Ries Ahmed is a reviewer and a member of the editorial boards of several journals.
ASSOC. PROF. MD. AMINUL ISLAM, PhD

Md. Aminul Islam is currently working as a Professor in the School of Business Innovation and Technopreneurship at Universiti Malaysia Perlis. He received his Bachelor’s degree from the International Islamic University Malaysia, and his MBA and Doctor of Philosophy degrees from Universiti Sains Malaysia. He also completed an advanced diploma in teaching in higher education from Nottingham Trent University, in the UK.

An award-winning academic and researcher, Professor Islam received the Raffles Education Founder’s Award for being the most deserving academic staff member of Olympia College Malaysia in 2006, the Excellent Academic Support Award 2009, the Best Lecturer Award in 2010, and the Best Supervisor Award in 2018 and 2019, for producing the greatest number of PhD graduates, as well as the Research Excellence Award in 2020 from Universiti Malaysia Perlis. He also won the Best PhD Thesis Award for the most outstanding PhD dissertation at Universiti Sains Malaysia in 2011.

He is a member of the Asian Academy of Management, the Malaysian Institute of Management, and an associate member of the Malaysian Finance Association. He is a visiting Professor of Northern University Bangladesh, Daffodil International University, East Delta University, Thammasat University Thailand, and an Academic Advisor of Sentral College Penang. He has authored and co-authored three books, two book chapters, and about 200 research papers. His writings have so far attracted about 400,000 readers through the Research-gate, and about 3500 citations in Google Scholar. His recent research has spanned issues related to Entrepreneurship, IPO under-pricing, Earning Management, Block chain, Blue Economy, Islamic banking, and Sukuk.
ASSOC. PROF. KU HALIM KU ARIFFIN

Ku Halim Ku Ariffin is an Associate Professor in the School of Business Innovation and Technopreneurship at Universiti Malaysia Perlis, Malaysia. He received his Bachelor’s degree and MPA from the University of Science Malaysia. Ku Halim Ku Ariffin served as Dean, Deputy Dean and University Registrar. He has been involved in university management development and consulting for many entrepreneurship training schemes. Ku Halim Ku Ariffin has authored or co-authored eight books, including Islamic Entrepreneurship (University Malaysia Perlis, 2010), Islamic Entrepreneurship Value (University Malaysia Perlis, 2011), Business and Innovation (University Malaysia Perlis, 2012), Successful Entrepreneurship (University Malaysia Perlis, 2010), Perspective and Alternative on Islamic Entrepreneurship (University Malaysia Perlis, 2012), Development Transformation (University Malaysia Perlis, 2011), Islamic and Asia Civilization (Pearson, 2012), and Ethnic Relation (Oxford, 2006). He has also authored or co-authored dozens of scholarly articles, papers, and chapters. His undergraduate and graduate teaching is primarily focused on management, leadership, strategic management, human resource management, business innovation, engineering entrepreneurship, and marketing.
The Challenges and Prospects of Sukuk: A Content Analysis-Based Study

PROFESSOR DR AZLAN AMRAN

Professor Dr Azlan Amran is the Dean of the Graduate School of Business, Universiti Sains Malaysia (USM). Prior to joining USM, he worked as an accountant for several years. He has published a significant number of articles in the area of Corporate Sustainability Reporting and Corporate Social Responsibility in both local and international journals. He has been involved in several training and consultancy projects in Accounting-related issues and Corporate Social Reporting. He is also a member of the editorial board for several international journals. At the national level, he has been involved as a Technical Committee member for ISO 26000.
Muslim populations are expected to increase rapidly, growing from about 1.6 billion in 2010 to nearly 2.8 billion in 2050 (Lipka & Hackett 2015). This rise in the Muslim population is the key motivating driver for the growth in the Islamic finance industry whose reach has also begun to extend beyond the Muslim majority emerging markets (Mitchell, Rafi, Severe, & Kappen 2014). The main factor for the acceptance of Islamic finance globally is the compliance of the Islamic banking services with the religious orientations of their clients, illustrated by the Islamic law, the *Shariah* (Metawa & Al-Mossawi 1998, Naser, Jamal, Al-Khatib 1999, Bley Kuehn 2004, Alnasser & Muhammed 2012). The *Shariah* involves a series of prohibitions as well as guidance regarding the practices to be undertaken in a Muslim’s day-to-day life. The prohibitions, in relation to the financial aspect, include paying or receiving interest (*riba*) speculating or gambling (*gharar* or *maysir*) and being involved in prohibited (*haram*) industries, such as those related to alcohol, pork, pornography, weapons, or conventional banking (Gheeraert 2014). It is crucial, therefore, that the Islamic finance product meets the basic requirement of being in compliance with the *Shariah* (Dawood 2008) in order to be deemed acceptable by Muslims.

*Shariah* stems from the nexus of Islamic rules derived from two foundational sources. The primary source is the *Qu’ran*, God’s (Allah’s) revelation to the Messenger Prophet Muhammad (peace be upon him [PBUH]). The other is the habitual practices of Prophet Muhammad’s (PBUH) actions and precepts, collectively called the *Sunnah*. While the primary source of *Shariah* is the *Qu’ran*, for cases that are not addressed explicitly in either the *Qu’ran* or the *Hadith*, especially concerning the recent (modern) Islamic issues, other sources are used, such as *Ijma* (general agreement), *Qiyas* (analogical deduction), and *Ijtihad* (interpretation of one or a few scholars) (Aksoy 2005). The availability of these sources exhibits the flexibility of Muslims in finding solutions to their problems everywhere, and under any circumstances. Hence, when conventional banks are established under the...
principles of capitalism, and transect business by charging interest, which is unacceptable (forbidden) by Shariah, Muslims resorted to finding alternatives under Islamic principles (Hanif 2010), by applying the various aforementioned Islamic jurisprudence. One such Islamic innovation under the capital market is Shariah-compliant financial instruments known as Sukuk (Islamic bonds or Islamic Investment Certificates) (Tahmoures 2013). Sukuk are asset-based securities, while conventional bonds are debt-based securities. Unlike conventional bonds, the holders of these certificates are the true owners of the underlying asset, and therefore, can share in the actual success, or otherwise, of the venture.

The Islamic capital market (ICM) consists of the debt market and the equity market. Sukuk are the most active Islamic debt market financial instruments to date. Sukuk (the plural of Sakk meaning a deed or check) can be defined as trust documents or investment certificates representing a contract of transference of rights and revenues or obligations earned in alignment with the Islamic Shariah law (Abdullah 2011). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has defined Sukuk as “certificates of equal value representing undivided shares (in the ownership of) tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activities” (AAOIFI 2008). Sukuk are asset-backed, stable income and tradable trust certificates. The primary condition for the issuance of Sukuk is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institution, or any entity that wants to mobilize its financial resources (Tariq & Dar 2007).

Malaysia is the pioneer in Sukuk issuance, capturing the global Sukuk market, and has played an important role in the development of Sukuk (Kamaluddin, Manan, Khadijah, Sufian, & Htay 2012). According to Malaysian Rating Cooperation Berhad (MARC 2010), the appeal of Sukuk as a funding source has grown tremendously with an increasingly large investor base, which is attributed to their appeal as a Shariah-compliant alternative to conventional fixed-income instruments (Haron 2012). It is anticipated that Shariah-compliant financial institutions’ assets, worldwide, will expand in the next few years, from the current $2 trillion to approximately $3 trillion, despite the moderate level of growth of the Islamic finance industry forecasted in 2016 (Standard & Poor's Ratings Services). The Islamic financial institutions’ (IFI) market share is expected to be 12 percent in Malaysia, in comparison to 17 percent in the six Gulf Cooperation Council (GCC) countries of Kuwait, Saudi Arabia, Qatar, the
United Arab Emirates, and Oman, where the market share is growing at a faster rate than elsewhere in the world.

Figure 1.1 allows several observations to be made. The global Sukuk market in 2010 reached US$52.97 million, which was an increase of 50 percent in comparison to 2009, when the total global market only reached US$37.09 million, according to Islamic Finance Information Services (IFIS) sources. However, in 2014, the Sukuk issuance declined to $120.85 million from $138.17 million in 2013. Despite that, as forecasted, Malaysia continued to dominate the Sukuk issuance market in 2015, and remains as the global Sukuk market leader. Figure 1.2 below provides the geographic distribution of Sukuk issuance by country in 2014, with Malaysia easily outstripping the other countries.

In 2011, Malaysia’s primary Sukuk market was seen to be one of the most active markets, with an 86.1 percent increase over a two-year period, growing from an issuance of $32.7 billion in 2010, to an issuance of $60.9 billion in 2011. Furthermore, Malaysia continues to retain its position as the number one country in the world for Sukuk issuance, maintaining a 71.6 percent market share. Malaysia’s government has supported this level of growth through a significant level of Sukuk issuance, in addition to a robust corporate sector which is flourishing as a consequence of Malaysia’s healthy economic growth, coupled with an active Islamic capital market (KFH 2014). By the end of 2013, Malaysia’s secondary Sukuk market claimed a record increase of 9.6 percent year-on-year, with $173.4 billion. The Bank Negara Malaysia, being the central bank of Malaysia, is recognized as the leader in Sukuk issuance, and its operations are being leveraged by other central banks globally. In 2014, the Central Banks’ total issuance of Sukuk reached $50.2 billion globally, which represented 43.1 percent of all securities issuance. Of this sum, Malaysia accounted for 92.1 percent at the 2014 year-end, followed by Qatar’s Central Bank, at 3.7 percent.
Chapter 1

Figure 1: Total Global Sukuk Issuance 2006 – 2015
Source: International Islamic Financial Market (IIFM) Sukuk Database
Introduction

Figure 2: Geographic Distribution of Sukuk in 2014
Source: Standard & Poor’s
A number of strategic initiatives are in place for Malaysia to emerge as the ICM international hub. The intent is to introduce more services and products, for funds to be mobilized in an effective way, and a comprehensive tax, accounting, and regulatory framework founded on Shariah principles to be established. Sukuk, in comparison to conventional bonds, are different in terms of their very structure, their classifications of ‘asset-based’ and ‘asset-backed’, and the risk/return mechanisms (Usmani 2002, Kantakji & O’haj, 2010). Sukuk issuance involves global investors, issuers and intermediaries, and their transactions require certain standards to be met in relation to governance, transparency, and compliance (Laldin 2013). Accordingly, there are efforts in Malaysia to ensure that Sukuk issuance is benchmarked with international standards and complies with Shariah best practices (Ginena 2014). The standardization and coordination of the Shariah ruling is essential to minimize any divergence amongst Shariah scholars regarding Shariah interpretations (SC 2003, 2007).

**Sukuk Legitimacy**

Sukuk have several legitimacy (lawfulness or authenticity) determinants that are of interest to investors, financial institutions, and regulators, such as pricing, rating, Shariah auditing, Shariah risk, and Shariah documentation (Lahsasna, Ibrahim, & Othman 2014, Grassa 2015b). Although there are other factors that may influence the legitimacy of Sukuk, these determinants are general in nature and are found in Sukuk reports that are available for review by IFIs, investors and regulators (Haron & Ibrahim 2012, Hasan & Sabirzyanov 2015). However, the Chairman of AAOIFI, Taqi Usmani, in 2007, criticized the fact that most of the Sukuk products in the market were not fully compliant with Shariah, and thus required an urgent review (Usmani 2008). In reaction to that, the Muslim Council of Britain (2008), in co-operation with the Utrujj Foundation and the Islamic Finance Council, released the Islamic Finance Transparency Standard, a consultative document with a threefold purpose: to improve the level of consumers’ understanding of retail products that are Islamic; to reduce consumers’ skepticism about non-compliance of Shariah products; and to enhance the protection of consumers (Ginena 2014). A document entitled Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services was released by the IFSB in December 2009. Bank Negara Malaysia (BNM) followed shortly thereafter in 2010, by issuing its own document on the subject, called the Shariah Governance Framework.
Acknowledging the requirements for stringent measures to validate *Sukuk* legitimacy, numerous guidelines and rulings were put in place. In July 2011 the Malaysian Securities Commission amended its Islamic Securities Guidelines to provide a comprehensive direction on the subject, covering topics such as the applicable *Shariah* rulings, the approval process, disclosure requirements, and ratings for *Sukuk* issuance. In addition, Malaysia has also listed *Sukuk* on Bursa Malaysia under an exempt regime for *Sukuk* that are issued, offered, or subscribed, in accordance with section 229(1) and section 230(1) of the Capital Markets and Services Act 2007 (CMSA). The exempt regime is specifically meant for issuers who intend to list their *Sukuk* or debt securities on Bursa Securities for listing status and for profiling purposes only, but not to be quoted or traded. This listing enables investors to participate in bonds trading in a transparent manner (Securities Commission Malaysia 2009). Furthermore, the Securities Commission (SC), under the Private Debt Securities (PDS) Guidelines (paragraph 32), requires the Islamic Private Debt Securities’ (IPDS) issuers to appoint an independent *Shariah* advisor, approved by the SC, to advise on all aspects of the IPDS, including documentation, investment, and structuring (SC 2003). These advisors-cum-*Shariah* scholars play a crucial role in maintaining and ensuring public confidence in the ICM by guaranteeing that the *Sukuk* issued by the market participants are fully compliant with *Shariah* principles, both from the accounting perspective with regards to the *Sukuk* issuance process, as well as in a complete and transparent disclosure on its determinants’ legitimacy limitations.

**The *Sukuk* Market in Malaysia**

Recently, more efforts have been directed towards the development of the *Sukuk* market, which has now increased to such a state that it encompasses in excess of fifty percent of the bond market in Malaysia (Abdel-Khaleq & Richardson 2006). This situation has been made possible through the participation of international corporations and multilateral agencies that have raised substantial amounts of funds and invested in the *Sukuk* issuances outside Malaysia (Jobst, Kunzel & Mills 2008). In lieu of this foreign participation, proportionally continuous innovation has been witnessed, and an increasing number of issuances in foreign currency have occurred. Zeti Akhtar (2010) vowed that Malaysia will offer international participation in the Islamic financial system, opening up an international gateway, leading to the strengthening of the link between the two important dynamic growth regions of Asia and the Middle East.
Malaysia’s Sukuk market was initialized by Shell MDS Sdn. Bhd. with a modest issue in the order of RM125 million in 1990. Since that time, continuous and encouraging development has been seen. The recent issue of RM15.4 billion ($4.7 billion) by Binariang GSM Sdn. Bhd. is the largest Sukuk issuance, demonstrating a positive ongoing development. Incidentally, with an average annual growth of 22 percent issued for the period 2001 to 2007, the Sukuk market in Malaysia is among the fastest-growing funds in the world for the corresponding period. Since the inception of the first sovereign global Sukuk in the world in 2002, more successes followed with the introduction of innovative Sukuk structures, such as the convertible Sukuk musharakah issued by Khazanah Nasional Berhad, the Malaysian government’s investment holding institution. This pioneering measure brought together the features of the first full convertibility that is usually only used for conventional equity-linked transactions (BNM 2007)

Meanwhile, in an attempt to further improve Sukuk funds, Malaysia extended its cooperation with other regulatory authorities to guarantee financial stability in the Islamic financial system. This cooperation involved Malaysia actively collaborating with the Islamic Financial Services Board (IFSB), the Islamic Financial Stability Forum (IFSF), the Islamic Development Bank (IDB), and the International Islamic Liquidity Management Corporation (IILMC). In addition, secondary trading in the Malaysian Sukuk market has increased the depth and liquidity of the market with the participation of more companies, including foreign-owned companies which continue to use this market for funding purposes (Bin Ibrahim & Wong 2006). Naturally, a large number of corporate issuances serve to finance long-term funding needs. In practice, this has helped to create an energetic secondary market due to the diversity and size of Sukuk transactions, which possess an increasing value proposition that is appealing to investors out to vary their asset portfolios (Tariq 2004).

Apart from this, the Malaysian Sukuk market has also developed sufficiently to handle the varied risk-return profiles and requirements of both issuers and investors, innovatively and in a sophisticated way (Wedderburn-Day 2010). In order to encourage the participation of both local and foreign investors in the market, the propagation of new types of instruments with extended maturity profiles have been put into operation by the Sukuk issuers (Zin, Sakat, Ahmad, Bhari, Ishak & Jamain 2011). In 2005, the Malaysian government threw in more support by liberalizing the market to allow for the issuance of debt securities by foreign corporations and multilateral agencies in Ringgit-denominated papers (Hamid 2000). Subsequently, the issuance of debt securities was extended to foreign currency-denominated...
issuances in 2007. As a result, many foreign corporations, multinational corporations, and multilateral agencies, began to raise funds and invest in issuances and originations out of Malaysia (Zin, Hashim, Khalid, Opir, and Sulaiman 2011). This indirectly strengthened the Malaysian market, and simultaneously forged stronger bonds with other international financial markets. On the whole, this illustrated the government’s efforts to transform the Malaysian economy into a more diversified and private sector-driven economy, through the development of the Sukuk market in Malaysia (Zaid 2011a).

This diversification reflected the government’s effort to transform a market dependent on its debt securities into long-term financing requirements for the private sector. This move has certainly boosted the market capitalization of the private sector in Malaysia. The debt securities and Sukuk market helped to meet the financing requirements from one-third, ten years ago, to almost three-fifths currently. More significant and liquid debt securities as well as Sukuk markets have directly helped to stabilize the financial system. Therefore, Malaysia has the world's largest Sukuk market with the total of Sukuk issues standing at 58.1 percent, or US$308 billion of the total global outstanding amount at the end of 2015. Last year, the total global Sukuk outstanding was a little over $300 billion with Malaysia accounting for more than half of the total at $173 billion. Saudi Arabia came in second, making up 16.7 percent of the total global Sukuk outstanding.

Interestingly, Malaysia possesses the most developed Sukuk market in terms of total Sukuk issuance, and also the introduction of innovative Sukuk structures which are competitive enough to attract more investors (Ab Majid, Shahimi & Bangaan 2010). Furthermore, Malaysia aims to promote the Malaysian debt security market and increase the capital market investment options offered. As a result, debt securities and Sukuk have been listed on Bursa Malaysia under the exempt regime, by both listed and non-listed issuers, for Sukuk that are issued, offered, or subscribed, in accordance with section 229(1) and section 230(1) of the Capital Markets and Services Act 2007 (CMSA). This regime enables institutions and investors to enhance the transparency of Sukuk issued, as well as offering profiling opportunities for the instrument issuers. It allows any currency denominations by either listed or non-listed local or international entities, but is subjected to the rules of Bursa Malaysia Listing Requirements which are comparable with other Exchanges which provide similar listing facilities. In short, the Sukuk market has developed into the most successful Islamic financial product in the financial industry, and among the global finance sectors, it is one of the fastest-growing sectors (Zin et al. 2011).
CHAPTER 2

THE HISTORY AND DEVELOPMENT OF SUKUK

The current chapter reviews and describes the history and development of Sukuk. It begins with an explanation about the definition of Sukuk, their history, and the basic foundations of Sukuk in Shariah (Islamic law), and outlines the sources from Shariah, as well as the concepts of Ijithad. It also gives an explanation of the basic principles of the Islamic financial system, and the concept of debt and equity in Islam. Finally, the chapter continues with an outline of the development of the Sukuk market and the Sukuk structure.

The Definition of Sukuk

There have been many definitions for Sukuk derived from previous studies, and from recognized organizations, globally, and locally within a Malaysian context. According to Al-Jumuah (2000), Sukuk are property certifications. Sukuk are also sometimes referred as Islamic bonds or Sukuk sanadat (negotiable papers) and ownership (Al-Bastawaisi 2006). In comparing Sukuk to bonds, Sukuk have more generalized meaning than bonds (Engku Ali 2005). Furthermore, Sukuk refer to securities characterized as compliant with Islamic Shariah rules and with the principles of investment which prohibit and prevent dealings with interest charges (LMC 2008). In addition, as mentioned by Al-Buolayan, (2006) and LMC (2008), Sukuk are represented by their stability; being asset-backed, they are compatible with Shariah rules, and can be considered as trust certificates. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI, 2012) defines Sukuk as “Certificates of equal representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity”. There are several kinds of Sukuk. Nevertheless the common ones, as mentioned by AAOFI, are: Musharakah Sukuk; the Ijarah Sukuk; Murabahah Sukuk; Mudarabah Sukuk; Istisna Sukuk; Salam Sukuk; and the Hybrids.
The Islamic Financial Services Board (IFSB) defines Sukuk thus, “Sukuk (plural of sakk), frequently referred to as ‘Islamic bonds’, are certificates, with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture. These assets may be in a specific project or investment activity in accordance with Shariah rules and principles” (IFSB 2009b).

On the other hand, the Malaysian Debt Securities and Sukuk Market (2009) provides another definition to explain Sukuk as follows: “Certificates of equal value that represent an undivided interest (proportional to the investor’s interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services or investments in particular projects or special investment activities”. Also, the Securities Commission (SC) Malaysia (2012) has defined Sukuk as “[…] any securities issued pursuant to any Shariah principles and concepts approved by the Shariah Advisory Council (SAC) of the SC, as set out in Appendix 1 […] (and subsequently) Appendix 1 (B): A document or certificate which represents the value of an asset” (SC 2004 and SC 2009).

Al-Buolayan (2006) stated that the Sukuk Security Model is derived from traditional securitization procedures that are based on a special purpose vehicle (SPV) which lies in gaining assets and issuing financial compensation on these assets. Such assets represent appropriate aspects with beneficial ownership to the Sukuk investors.

The Sukuk issuance process lies in the following steps (LMC 2008):

1. A feasibility study must be prepared in detail;
2. A general framework is to be prepared in addition to setting up an organizational structure;
3. The work should be in line with the structure and principles of Shariah;
4. Issuance must be conducted by a leading manager;
5. Arrangement of agreed Islamic legal documentation;
6. Arrangement of special purpose vehicles (SPV) to represent Sukuk holders;
7. Circulation of the Sukuk into the financial markets.

**Difference between Sukuk and Debt Bonds**

A Sukuk certificate duplicates some of the functions of the tradable bonds and conventional securities to inject liquidity into the reserves of government
and corporations, to mobilize market resources and to provide a steady source of income for investors or Sukuk holders (LMC 2008). However, there are a number of distinctions between bond debts and Sukuk. Amongst these, the most significant is that in the creation of Sukuk, they are founded on an array of contracts to underpin the financial commitment between the investors and issuers. A lease (Ijarah) and others such as Musharakah (partnership) are such examples, whereas debt bonds are issued on the basis of loan contracts to secure the debt (AL-Bashir 2008).

Furthermore, the profit from Sukuk for the investors is derived from the margin of the intrinsic revenue in the lease or partnership contracts, whilst the return for holders of conventional debt bonds is derived from the interest, which is the additional sum of monies charged on the principal loan amount. For Sukuk, there is also a requirement to be backed by tangible asset, but such is not the case for conventional debt bonds where the investors can be sold simple receivables (Afshar 2013).

The pricing mechanism between Sukuk and conventional bonds varies as well. Sukuk pricing is based on the market, and, therefore, is dependent upon market supply and demand. Hence, the asset’s underlying value may depreciate or appreciate, but in the case of conventional debt bonds, returns are solely dependent upon the issuer’s creditworthiness (Al-Maghlouth 2009). Another difference is that Sukuk are security-based and the holders of Sukuk have ultimate ownership against the assets. However, in relation to a conventional debt bond, the investors’ interest is not the owner of the underlying asset (AL-Bashir 2008).

The structure of Sukuk provides a mechanism which is self-controlled and operates as a safety valve, so that in the event of the issue being oversubscribed, the issuer of the Sukuk is already conscious of its limitation, and has retained a certain amount, so that the total subscription is not able to surpass the leased asset’s value. Conversely, in the event of over-subscription of a debt bond, the action from the issuer to preserve the maximum possible amount may not prove to be responsible, and may, indeed, put the investor’s interest at risk. Should a problem occur in relation to the asset-backed Sukuk, the investors will still be able to reclaim a significant part of their investment as they own an undivided share in the Sukuk ownership (AL-Bashir, 2008). Finally, in evaluating the issuance of Sukuk, the investment involves the production of tangible assets or the funding of trade, so that there is direct linkage of the Sukuk to real sector activities. In other words they are linked to the economy, and therefore, do