

## **A SHARIAH OVERVIEW OF CREDIT STRENGTHENING FOR EQUITY-BASED SUKUK IN THE ISLAMIC CAPITAL MARKET IN MALAYSIA**

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### **ABSTRACT**

*The purpose of this paper to overview the potential of sukuk and shariah principles applied by industry players in the capital market in the process of strengthening credit mechanisms and practices based on previous studies. This study uses a qualitative approach in which fiqh books, journal articles and Islamic finance books and websites are the reference sources for data acquisition. Once collected, the information is selected, screened and classified into specific topics related to this study, which is to explore Islamic fiqh and finance experts' view on the issue of credit consolidation in sukuk. Thus, this section divides the research methods into data collection and analysis. This study reviews the extent to which new sukuk-related studies have been able to grow, innovate and be able to resolve old issues that still haunt product structuring such as granting operator profit rights to sukuk investors. However, the survey also recognizes old findings that are still relevant such as the concept of tanazul which is the granting of profit rights to the management of sukuk if the profit rate exceeds expectations.*

**Keywords:** *Shariah Overview; Credit Strengthening; Equity-Based Sukuk, Islamic Capital Market*

## **TINJAUAN SYARIAH TENTANG PENGUKUHAN KREDIT UNTUK SUKUK BERASASKAN EKUITI DALAM PASARAN MODAL ISLAM DI MALAYSIA**

### **ABSTRAK**

*Tujuan kertas kerja ini adalah untuk meninjau potensi sukuk dan prinsip syariah yang diterapkan oleh pemain industri dalam pasaran modal dalam proses pengukuhan mekanisme dan amalan kredit berdasarkan kajian lepas. Kajian ini menggunakan pendekatan kualitatif di mana buku fiqh, artikel jurnal dan buku dan laman web kewangan Islam menjadi sumber rujukan untuk pemerolehan data. Setelah dikumpul, maklumat tersebut dipilih, disaring dan diklasifikasikan kepada topik khusus berkaitan kajian ini, iaitu meneroka pandangan pakar fiqh dan kewangan Islam mengenai isu penyatuan kredit dalam sukuk. Oleh itu, bahagian ini membahagikan kaedah penyelidikan kepada pengumpulan dan analisis data. Kajian ini meninjau sejauh mana kajian berkaitan sukuk baharu mampu berkembang, berinovasi dan mampu menyelesaikan isu lama yang masih menghantui penstrukturan produk seperti pemberian hak keuntungan pengendali kepada pelabur sukuk. Bagaimanapun, tinjauan itu turut mengiktiraf penemuan lama yang masih relevan seperti konsep tanazul iaitu pemberian hak keuntungan kepada pengurusan sukuk sekiranya kadar keuntungan melebihi jangkaan.*

**Kata kunci:** *Tinjauan Syariah; Pengukuhan Kredit; Sukuk Berasaskan Ekuiti, Pasaran Modal Islam*

### **INTRODUCTION**

In general, sukuk can be understood as a document or certificate that proves the ownership rights of the investor (holder of the certificate) over the underlying asset (underlying asset). A sukuk can also be said to be a certificate that proves the ownership of a project or investment. Meanwhile, Islamic capital market refers to a market in which all trading activities are conducted in accordance with shariah principles. All forms of transactions must be free from any elements and activities that are not allowed by Islam such as riba (usury), maysir (gambling) and gharar (uncertainty). In Malaysia, the Islamic capital market operates in tandem with the conventional capital market by offering various types of financial products based on Islamic philosophy. To ensure that this market continues to grow and be globally competitive, this market needs to have effective and efficient market characteristics. An efficient Islamic capital market is a market that not only meets shariah standards and norms but is able to offer competitive financial products, cheaper financing costs, more effective risk management as well as legal support and programs that can stimulate capital injections and flows enter the market. To achieve these goals, studies have been conducted to design new financial products or improve existing financial instruments. Among the products are sukuk which are structured using various shariah principles such as mudarabah, musharakah, ijarah and so on.

The emergence of sukuk has had a positive impact on the economic system, especially on Islamic banking and financial institutions in managing funds and overcoming the problem of liquidity of money. Previously, Islamic banking and financial institutions did not have much choice in making investments and channeling funds. In a global market that adopts a conventional financial system, the opportunities to control liquidity for Islamic financial institutions are quite limited due to the very limited transactions allowed by shariah in the conventional system. With the issuance of sukuk, it provides ample opportunities for Islamic banking and financial institutions to obtain funds or financing, make investments and address liquidity problems more efficiently and effectively. Despite being exposed to various market risks as other financial instruments, the issuance of sukuk is seen as the right choice as it is able to attract investors from various categories including non-Muslims as well as provide space for Muslim investors to engage in investments that allowed by shariah.

## **BACKGROUND OF PROBLEM**

There are several obstacles in the asset-backed sukuk structuring process such as the transfer of ownership of the underlying asset from the obligor to the sukuk holder, and tax issues have given rise to asset-based sukuk which only transfers beneficial ownership to the sukuk holder. This makes the sukuk holder an ‘unsecured creditor’. In addition, the difficulty of corporate entities in finding suitable assets to be used as underlying assets has given rise to ‘blended-asset’ sukuk and ‘asset-light’ sukuk. The underlying assets for ‘blended-asset’ sukuk consist of a combination of tangible assets and intangible assets, while for ‘asset-light’ sukuk, it does not require the underlying assets in the initial structuring process. With the advent of these two styles of structuring, it provides an opportunity for corporate entities to obtain financing or funds in a shariah-compliant manner, but no less, some parties have rejected it. The current market and financial situation not only demands sukuk to be more innovative and competitive, but also takes into account the credit rating. The philosophy, maqasid and rules in muamalat, which are the core of the sukuk structuring process, have made this instrument different in terms of its ‘habits’. Although sukuk and conventional bonds have the same purpose in the context of the capital market to raise funds and are both subject to certain standards, due to being in the same ‘field’, shariah matters such as bans on riba, gharar and maysir as well as profit-sharing, needs to be taken into account in its structuring process. This indirectly has a negative impact on credit ratings, especially sukuk, where they are structured using the principle of profit and loss sharing. Apart from that, some shariah issues need to be looked more carefully so that the structuring process does not affect the shariah-compliance status of these financial products. Among the techniques currently used are the application of the principle of tanazul, the principle of dhaman (guarantee) given by the originator, repurchase of sukuk at face value as well as other techniques aimed at protecting the interests of investors without the interests of entrepreneurs, have invited various reactions among sharia experts around the world. If these techniques are not carefully structured, the use of this mechanism will be seen to mimic that of conventional bonds.

## **OBJECTIVE OF THE STUDY**

This study aims to overview the potential of sukuk and shariah principles applied by industry players in the capital market in the process of strengthening credit mechanisms and practices based on previous studies.

## **RESEARCH METHODOLOGY**

This study uses a qualitative approach in which fiqh books, journal articles and Islamic finance books and websites are the reference sources for data acquisition. Once collected, the information is selected, screened and classified into specific topics related to this study, which is to explore Islamic fiqh and finance experts’ view on the issue of credit consolidation in sukuk. Thus, this section divides the research methods into data collection and analysis.

## **DATA COLLECTION**

This study refers to the classic books such as the books of usul fiqh, fiqh and hadith that are authoritative to understand the subject of study. Data is obtained from information related to Islamic bonds or sukuk in terms of concepts and definitions, laws and regulations, form and type of issue, structuring process, management, risk, implementation, achievements and progress that has been achieved since it was first issued with a focus on the sukuk market in Malaysia. The data is also obtained in the form of journal articles, dissertation or thesis, books related to the subject of study, seminar proceedings as well as reports issued by the institutions or parties involved. The author also refers to the internet to obtain information such as online journals, reports of statutory bodies or corporate companies as well as unpublished related information. The data were obtained from within and outside the country through the sources mentioned

above. Information related to the study subject was also obtained from university, public libraries, published materials such as magazines, bulletins, conference and meeting reports as well as unpublished materials from the Securities Commission, Bank Negara Malaysia, Cagamas, Khazanah and other bodies and corporate companies involved in the issuance of these instruments. In addition, data and information from working papers, conferences and reports from the Islamic Development Bank (IDB), journals published abroad such as the King Abdul Aziz University Journal, journals published on the internet such as the International Journal of Islamic Financial Services and others.

## DATA ANALYSIS

A total of 14 sukuk-related references in the Islamic capital market were overviewed and further reviewed according to several themes that have been classified. This classification process uses the method of content analysis in which the contents presented by previous researchers have been identified as the focus area of discussion. The identification of the topic or focus of their discussion is important to see what issues are raised and subsequently this study can look at the priorities of the discussion by previous studies. The priority of the focus discussion is very important because that is where the problem statement begins which will lead to a more in-depth research question. The classification of themes and details of discussions by past researchers can be seen in the table below.

Table 1: The Classification of Past Literature Theme

<i>Theme</i>	<i>Sub-theme</i>	<i>Authors</i>
<i>Implementation of Sukuk</i>	-Application, innovation and performance of sukuk - Islamic debt securities and its implementation in the capital market in general	-Suleiman Abdi Dualeh (1998) -Shariq Nisar (2007), -Fathelrahman A.M. Saleh (t.t) and Rodney Wilson (2006) -Asmak Abd Rahman (2000)
<i>The potential of sukuk and its challenges</i>	-The potential of sukuk and its challenges in the current financial markets - The structuring, risk, evolution and competition or competitive nature of sukuk -The use of sukuk as a medium of financial fund generation	-Muhammad al-Bashir -Muhammad al-Amin (t.t), -Muhammad Ayub (t.t) and Michael Saleh Gassner (t.t). -Ali Arsalan Tariq (2004)
<i>Discussion on Sukuk Structure and Principle</i>	-Practice of bay 'al-'inah and bay al-dayn -Sukuk al-ijarah - Determining the value of sukuk -The issue of tanazul in sukuk	-Saiful Azhar Rosly (2005) -Saiful Azhar Rosly and Mahmood M. Sanusi (1999) -Mohd Hashim Kamali (2007) Rafe Haneef (2012) Mohd Bahroddin Badri et alia (2014) Aznan Hasan (t.t) Sheikh Taqi Uthmani Azman Mohd Noor, Muhamad Nasir Haron (2015)

## LITERATURE REVIEWS

Several studies and writings have been conducted to see whether shariah -based securities instruments can be created and can be applied in the contemporary economic and financial system. Suleiman Abdi Dualeh (1998) has discussed about Islamic securities from the aspect of its practicality in the Islamic financial and banking system while Shariq Nisar (2007), Fathelrahman A.M. Saleh (t.t) and Rodney Wilson (2006) discuss the application, innovation and performance of Islamic bonds or sukuk in brief, starting with the issuance process. They are optimistic that Islamic securities will be able to keep pace with other fund-raising instruments and be able to compete with conventional securities if research for continuous improvement is conducted.

In addition, there are also studies that address the potential of sukuk and its challenges in the current financial markets. The writing was conducted by Muhammad al-Bashir Muhammad al-Amin (t.t), Muhammad Ayub (t.t) and Michael Saleh Gassner (t.t). Meanwhile, the study conducted by Asmak Abd Rahman (2000) is more focused on the role of Islamic debt securities and its implementation in the capital market in general. This study also discusses the capability of Islamic debt securities as an alternative financial instrument to conventional debt securities.

Ali Arsalan Tariq (2004) analyzes issues related to the structuring, risk, evolution and competition or competitive nature of sukuk in an effort to replace conventional bonds as the main instrument in the money and capital markets. This study focuses on the risk management of Islamic securities due to changes in the current financial markets. The study published by the Islamic Research & Training Institute (IRTI) of the Islamic Development Bank was found to be more general but its content was quite comprehensive. The study entitled Islamic Capital Market Product: Developments and Challenges (2005) examines the state of the Islamic capital market in the world as well as the ability of Islamic financial instruments to withstand risk. Another study entitled Financing Public Expenditure: An Islamic Perspective (2004) focuses more on how the use of sukuk as a medium of financial fund generation, can play a role in improving the living standards of society and the economy of a country.

In addition, there are other studies that are more specific in discussing the issues that occur in the securitization industry, especially in Malaysia. However, specific discussions on the pattern of structuring and issuance of Islamic bonds in Malaysia, which are largely based on the bay 'al-'inah and bay' al-dayn mechanisms, have led to a variety of views and criticisms. This diversity of views has been put forward by analysts as well as shariah and economic experts, both from within and outside the country. Saiful Azhar Rosly (2005) explained that this difference of opinion arises due to the practice of different sects between Malaysia and the Middle East countries. For Malaysia to allow the practice of bay 'al-'inah and bay al-dayn contracts in the Islamic securities market is because they rely on the approach in the Syafi'i school. However, Muhammad Ayub (t.t) disagreed with the action that allowed Islamic bonds based on al-murabahah and Bay Bitaman Ajil to be traded in the secondary market. He disagreed bay 'al-'inah and bay al-dayn contracts to be applied because it did not take into account the opinion of the entire Syafi'i school. Muhammad Ayub further explained that the fuqaha of the Syafi'i school only allowed the case when the debt was traded above par price.

Saiful Azhar Rosly (2005) in his other writings suggested that the views of Islamic financial experts from the Middle East should be taken into account and considered if we want to improve the quality of Islamic financial instruments in the Islamic capital market in Malaysia, not only economically but also from shariah law. Next, Saiful Azhar Rosly and Mahmood M. Sanusi (1999) argue that bond securitization based on al-muqarada contracts is seen as a good alternative to address the issue. In addition, the contract can also attract a lot of capital from investors in the Middle East and can prevent the securitization process from falling into the use of controversial contracts. The same thing was also raised by Mohd Hashim Kamali (2007) on the securitization practiced in Malaysia. He opined that sukuk al-ijarah has the potential to be a more efficient and flexible financial instrument compared to al-murabahah and BBA besides being able to avoid using controversial contracts such as bay 'al-'inah and bay' al-dayn. The issue of buying and selling sukuk in the second market was also analyzed by Rafe Haneef (2012) who suggested that the *mud ajwa* case discussed by past jurists can be used as a backup in determining

the minimum rate for determining the value of sukuk traded. The issue of tanazul in sukuk has also received attention from many scholars. Some researchers, among them Mohd Bahroddin Badri et al (2014) allow tanazul in the initial process of issuing sukuk musharakah and mudarabah. Although the profit has not been made because the project has not started and paid off, but the existence of rights and obligations already exist when the contract is signed. The same thing was also expressed by Aznan Hasan (t.t) who saw the upfront of tanazul as not contrary to shariah rules. However, he is of the view that it is safer if the tanazul is done after the signing of the master contract in the sukuk structuring. Sheikh Taqi Uthmani (t.t) on the other hand criticized the mechanisms that implicitly lead to capital guarantees to investors. He criticized mechanisms such as upfront tanazul and the concept of wa'ad, which is the concept of promising to repurchase sukuk at a nominal price. He also criticized the concept of qard, which is a loan given from an issuer to an investor when the profit rate does not meet expectations and this is seen as contrary to the aspirations or purpose of a profit and loss sharing contract.

## **DISCUSSION**

### **Theme 1: Implementation of Sukuk**

Initially, sukuk has been used traditionally by the Muslim community since the middle ages as a certificate or proof representing any rights and obligations in trade and other commercial activities. However, it should be noted here that the current sukuk structure is different from the sukuk structure used in earlier times. (Azman MN & Muhamad NH, 2015) Sukuk also differs from the conventional concept of securitization which refers to a process of ownership of assets especially debt unpaid is transferred to a large number of investors through certificates representing the value of the relevant assets. (Global Islamic Finance Magazine, March 2011). Thus, the law prohibiting transactions with sukuk as mentioned in the hadith above does not apply to modern sukuk transactions where investors have ownership of an underlying asset sukuk. (Adam, Nathif J. & Thomas, Abdulkader, 2004)

Technically, sukuk also refers to any security, note, document or certificate, which has liquid and tradable characteristics. (Suruhan Sekuriti Malaysia, 2009) The Securities Commission Malaysia defines sukuk as follows:

*“Islamic securities (sukuk) refer to certificates of equal value and as proof of ownership and investment of undivided assets using shariah principles and concepts approved by the Shariah Advisory Council (SAC)”.*

According to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) (Bahrain: AAOIFI, 2010) sukuk are defined as follows:

*“Certificates that have the same value, represent divisions which is not divided in the ownership of tangible assets, benefits, and services or equity from a given project or equity from a particular investment activity”*

Based on the above definition, the difference in the two definitions, it is on the underlying asset. The definition given by AAOIFI emphasizes that investment sukuk does not represent a debt payable by the issuer and the sukuk cannot be issued to collect debts. (Nathif J. Adam dan Abdulkader Thomas) Whereas, sukuk as defined by the Securities Commission represents a claim of ownership on a group of assets, or a right to receive from a debtor or participant. It is evidence of the value of an asset that may involve debt and non-debt. In other words, sukuk can represent debt arising from the price of goods sold deferred, goods to be received by order (salutation contract), undivided joint ownership of tangible assets under a lease contract, shares in enjoying the benefits derived from rental contracts, rights in projects under the concept of mudarabah or musyarakah partnership, as well as a portfolio of assets that incorporate debt receivables arising from deferred sales contracts. (Azman MN & Muhamad NH, 2015)

## **Theme 2: The Potential of Sukuk and Its Challenges**

Malaysia leads as the world's largest Sukuk market by 2020, with most issuances related to the principles of Sustainable and Responsible Investment (SRI). Malaysia accounts for more than 45 percent of the total global sukuk market or about US258 billion. From financing renewable energy infrastructure such as solar and hydro, to supporting social purposes, such as microfinance and education, Malaysian Sukuk issuers appear to be interested in such ventures, reflecting increased strong commitment towards a sustainable future through Islamic financing products. (Tengku Zafrul, during his special address on “Strengthening Islamic Finance Towards Shared Prosperity” at 16th Kuala Lumpur Islamic Finance Forum 2021 (KLIFF 2021), 9 March 2021) Data from the stock market and the fund management industry also proves that Islamic finance shows strong resilience and continues to attract investors during this uncertain period. This has led to more demand for Shariah -based investments with total Islamic assets under management growing from 22 per cent of total assets in 2017 to 24 per cent by the end of 2020 worth RM217 billion. (<https://www.hmetro.com.my/bisnes/2021/03/682310/malaysia-dahului-pasaran-sukuk-terbesar-dunia>)

## **Theme 3: Discussion on Sukuk Structure and Principle**

Azman Mohd Noor, Muhamad Nasir Haron (2015) concluded that in sukuk musyarakah, the practice of tanazul of profit affecting profit sharing based on the agreed profit sharing ratio is permissible, if profit has been earned, as long as there is no denial against profit sharing or loss indemnity. Nevertheless, there is disagreement over the situation of a partner promising to tanazul his rights over profits that do not yet exist. The majority of jurists forbid such acts, and there are some who allow them. Azman Mohd Noor, Muhamad Nasir Haron (2015) argues that this practice can be allowed on the basis of incentives from the partner of the sukuk holder to the partner of the sukuk issuer who manages the project under sukuk issuance. This takes into account that there is no violation of the concept of musyarakah itself whereby all partners will enjoy profits, while the expected profit indicator is only used as a benchmark to the profit -sharing tanazul given to partners on an incentive basis. The waiver of the right of claim (tanazul) on profits in excess of the indicative expected profit in the name of giving incentives (tanazul) also applies to sukuk mudarabah and wakalah. However, the author is of the opinion that it is strictly forbidden for sukuk issuers who act as mudaribs for mudarabah sukuk, partners for musyarakah sukuk or representatives for wakalah bil istithmar sukuk to promise to guarantee a certain amount of profit, bear any certain losses or guarantee to cover differences in rate of return.

## **CONCLUSION**

Sukuk investment instruments in the Islamic capital market have great potential, especially in further expanding financing for investments based on Islamic principles. However, some challenges need to be overcome by Islamic financial scholars, especially issues related to shariah so that its implementation coincides with the requirements of Islamic principle. At the same time, the flexibility of Islamic ruling needs to be maintained, in order to keep the instrument relevant and attractive in the eyes of investors.

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