

ISLAMIC BONDS (SUKUK): OPPORTUNITIES AND CHALLENGES[†]

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ABSTRACT

Jurists have made several attempts to search for alternatives to internationally known financing systems or to establish benefits from Islamic Law financing principles in current international financial systems. Though significant, these efforts have not culminated in an integrated perception of all relevant aspects of the discussion, including appropriate legal frameworks, relation of the philosophy of market liberalisation to the proposals made, economic and financial consequences, investor protection, legal heritage of conventional systems, market confidence, implementation of mechanisms for the transition from the current system to proposed systems without prejudice towards market stability and investor rights, and so on.

The global financial crisis has shown that a stand-alone financing system capable of attracting all potential investors is not in place. Therefore,

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the researcher proposes a new financing system, which combines merits of the capital system (the Anglo-American market-based financial system) and Islamic financing systems, while at the same time avoiding the flaws of each. The new system can be introduced based on Islamic jurisprudence of financial transactions as well as established principles of the capital system. This combination of systems will positively impact the broader international financial system by materialising the interests of various stakeholders in financial operations and achieving national financial stability in states that adopt it.

INTRODUCTION

The last two decades have witnessed rapid and successive developments in the field of banking and financial services, particularly in the Asian region and the Arab World. Financial experts have increasingly begun to hear of and deal with Islamic Financial Establishments and the investment products they offer. These products conform to Islamic Shari'a and some of the new terms being used in this space in the media include: 'Murabaha' (English transition: Profit), 'Mudarabah' (English transition: Partnership) and the 'sukuk' (bonds)^{1 2}. The latter term, sukuk - the so-called 'Islamic bond' - is among the terms that attract the most attention and provoke wide-spread argument and controversy inside institutions in many of the countries headed by religious institutions and the Islamic Fiqh and Fatwa Councils. Among these councils, law and economic experts have different points of view and interpretations that lead to a variety of perspectives on Sukuk³.

¹ Hassan, "Comparison Between Bonds (Sukuk) and Conventional Bonds": Value at Risk Approach', Social Science Research Network, September 4, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215194.

² Ibid., I. Glossary of Arabic terms: Shari'a: Islamic law. Sukuk: Islamic bonds. Riba: Interest. Mudarabah: Partnership. Musharakah: Trustee finance or sleeping partnership. Salam: Forward sale. Ijarah: leasing. Gharar: Hazard or Chance. Qimar: Gambling. Kafalah: Guarantee. Wikalah: Agency.

³ Mohammed Al-Qattan, "Bonds (Sukuk) and Their Important Roles," Investors Electronic Magazine, viewed September 16, 2013, <http://mosgcc.com/mos/magazine/article.php?storyid=298>.

Thorsten Beck, Asli Demirgüç-Kunt, and Ouarda Merrouche, "Islamic vs. conventional banking: Business Model, Efficiency and Stability," *Journal of Banking & Finance*, no. 2 (2013): 433-448.

M. Umer Chapra, "Is It Necessary to Have Islamic Economics?," *The Journal of Socio-Economics* 29, no. 1 (2000): 21-37.

Beng Soon Chong, and Ming0Hua Lui, "Islamic Banking: Interest-Free or Interest-Based?," *Pacific-Basin Finance Journal* 17, no. 1 (2009), 125-144.

Bruce Hearn, Jennifer Piesse, and Roger Strange, 'The Role of the Stock Market in the Provision of Islamic Development Finance: Evidence from Sudan', *Emerging Markets Review* 12, no. 4 (2011): 338-353.

The issue of the adoption and accreditation of the Islamic bond as an economic mechanism is marred by misinformation and misunderstanding⁴. This has led to many organizational and legislative challenges that may limit the attractiveness of sukuk for many investors and businessmen⁵. The feasibility, and the ability of sukuk to support and perhaps even save the economic situation of companies, countries or even regional federations in the event of financial crisis⁶ remains.

In addition, although the utilization of Islamic bonds (sukuk) started in Jordan, Sudan and Turkey decades ago, they did not reach any high levels of success by any measurement. Success was not gained until the Gulf Cooperation Council (GCC) Countries and Malaysia utilized their collective financial strengths and allowed for the approval of Islamic bonds by the State institutions. The question thus arises: why was the experience in the countries of origin so poor and yet Islamic bonds seem to be flourishing elsewhere? Further questions raised include: is the subsequent success of Islamic bonds (sukuk) at all connected with the investment stability and prosperity in the country wherein they have been introduced? Are there any connections between the prosperity of the Islamic bonds (sukuk) in the GCC countries and the intellectual and cultural trends of the systems of this region? The

Hussein Elasrag, "Global Financial Crisis and Islamic Finance," Social Science Research Network, April 17 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1591563.

Juan A. Solé, "Introducing Islamic banks into conventional banking systems," IMF Working Papers (2007): 1-26.

Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking," International Journal of Business and Social Sciences 2, no. 2 (2010): 166-175.

F. Moneim, "The Islamic Sukuk Al-Fajr for Administrative and Economic Consultancy," (Proceeds of The Second Islamic Banking Conference, Dubai, United Arab Emirates, 2005).

Charles A. Rarick, "Islamic Finance: An Alternative in the Global Financial Market?" Social Science Research Network, January 25, 2009, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=1332793.

Omar Salah, "Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk," Berkeley Journal of International Law Publicist 4, (2010): 19-32.

Salman Ahmed Shaikh, "Proposal for a New Economic Framework Based on Islamic Principles," Islamic Economics Project, 2010, <http://www.microfinancegateway.org/sites/default/files/mfg-en-paper-proposal-for-a-new-economic-framework-based-on-islamic-principles-2010.pdf>.

Shaikh Shaikh, and Shan Saeed, "Bonds (Sukuk) Bond: The Global Islamic Financial Instrument," 2010, https://mpira.uni-muenchen.de/26700/1/MPRA_paper_26700.pdf.

⁴ Al-Qattan, "Bonds (Sukuk) and Their Important Roles."

⁵ Al-Rahman Al-Jubair, and Ahmed bin Abdul, "Types of Islamic Sukuk", Al-Riyadh Newspaper, accessed August 22, 2013, <http://www.alriyadh.com/320551>.

⁶ A. Al-Sattar Al-Heeti, "Contemporary Financial Crisis, Reasons and Treatment, Islamic Economic Reading," (Conference volumes, Fourth International Scientific Conference of Dubai Police Academy: Legal, Economic, and Security Aspects of the Contemporary Financial Crisis, Dubai, United Arab Emirates, March 15-17, 2009), 334-337.

broader question is whether Islamic finance would be a complementary or marginal economic feature for the current economic system, and whether or not the system actually contains new solutions for any economic crisis in the future, or is simply no more than an attempt of religious reference parties to market the Islamic finance system. This question will to be clarified later in this article, through the answers to the following questions: Is Islamic finance primarily an economic feature? Or is it rather a legal framework stemming from socio-cultural traditions? Perhaps the answer is both.

a. Research problem and research goals

One of the most important features of an economic mechanism is its flexibility and ability to be adapted to unforeseen circumstances. How then is it possible to deal with the fluctuations in the international economic climate with a “sacred” mechanism subject to the consideration of the legal authorities, religious edicts and a sole perspective for secular and worldly matters in terms of material transactions like sales and leasing? Another difficult point is that of Shari’a supervision, as a Shari’a Supervisory Board is appointed by the issuance authority to decide on all aspects of the legitimacy of the bond (sukuk) issuance process. The question here arises in relation to the Islamic Shari’a jurists and clerics. Do they supervise the issuance process with sufficient commercial and economic knowledge? What are the mechanisms used to take decisions related to changes in the economic market under the determinants of halal and haram (i.e. what is permitted and not permitted in Islam, as well as the Islamic Shari’a controls)? How is it possible to mix or confuse the science of economics and religious jurisprudence and the basis upon which the jurists and clerics will be appointed?⁷ Is there not a need, therefore, for persons who have full knowledge of the Islamic Shari’a requirements to also have some knowledge and understanding of modern economic thought and theory? One may argue that knowledge of the Koran – and the Bible too for that matter – implies to a degree an understanding of the commercial rationale of certain provisions. The prohibition of interest rates being at the heart of this normative framework in all three monotheist religions (Islam, Christianity, Jewish).

Furthermore, what is the nature of the projects that will be financed by means of Islamic bonds (sukuk)? The types of future investments possible are

⁷ M. Al-Akaz, “Islamic Sukuk, Economic Machinery or Political Decor?” Nawaat, accessed December 15, 2014, <http://nawaat.org/portail/2014/02/20>.

still quite obscure and vague. Existing institutions and projects might be funded as might completely new enterprises that have no relationship to old assets. In addition, what are the negative impacts and repercussions on the local economy when major subscriptions or IPO's are made in the bonds (sukuk),⁸ attracting funds outside of the banking system and the resulting transfer of wealth from the banks to bonds (sukuk)? All these legitimate questions represent real challenges in proving the efficiency and ability of Islamic bonds (sukuk) to compete with, attract, and advance the economies of individuals and countries.

The ultimate aim of this research is to examine the possibility that Islamic bonds (sukuk) can be a substitute for conventional bonds, and to state the most important problems and challenges facing the growth of the Islamic bond sector. The conclusion will outline the strengths and weaknesses of the current Islamic bond system and propose possible solutions to some of the most pressing problems. This study will rely on the inference methodology through the elicitation of the Shari'a controls governing the Islamic bonds (sukuk) such as the Fatwas issued from the Islamic Fiqh and Fatwa councils. Based on the failure of the financial system as a whole to be stable and less risk-prone, this study will draw inferences on how the Islamic bond system should work, and I will argue why the bond market needs to be reformed and a new model proposed as a substitute to the bond market.

b. Research methodology

To achieve the main goal of this research and answer its key questions, the research will be implemented using the following methodology:

- Undertaking a desk review of all relevant documents, materials, articles, and instructions. During the desk review, the focus will be on benchmarking regional and international practices about bonds.
- Finalizing the research paper that outlines the major issues to be addressed as shown below in the research plan, based on content analysis of all data gathered, and discussions raised regarding bonds.

⁸ Ibid.

c. **Research plan**

The organization of this research paper is based around two major components. The first attempts to address the nature of Islamic financial bonds, highlighting relevant functions and operations, and analyses these bonds by providing answers to the significant questions already mentioned.

The second core component discusses the environment within which Islamic bonds (sukuk) can operate. It will clarify the appropriate structure for Islamic bonds (sukuk) and the Shari'a standards and controls organizing their issuance and circulation. The risks and challenges faced during this process will also be examined. Furthermore, questions as to whether Islamic bonds provide an alternative to conventional bonds and whether an Islamic stock market can generate returns to financial assets that are capable of attracting savings and providing profitable financing opportunities in various economic activities will be answered.

I. **WHAT ARE ISLAMIC BONDS (SUKUK)?**

The term 'Islamic bonds' ('sukuk') has spread during the last decade, mainly due to the success of the Malaysian experience in introducing and prospering from this instrument. The Islamic bonds (sukuk) industry has also developed and seen an increase in interest in the aftermath of the Global Financial Crisis in 2008. There is an expectation amongst global markets and financiers that there will be a growth in the Islamic bonds (sukuk) sector worldwide in 2014 and 2015 of not less than 12% annually. According to a report issued by the Kuwait Finance House during the first quarter of 2014, the total volume of the bonds (sukuk) issuance in 2013 amounted to 118.7 billion dollars with a decline of 8% compared to 2012 when the issuances registered a record level. A Thompson Reuters report also predicts the Islamic bond market will boom with issuances to continue rising rapidly in 2014 to reach 130 billion dollars and by 2018 to reach 237 billion dollars. At the beginning of 2014 a new wave of broadening the base of the Islamic financial system began. Several Islamic banks announced their decision (including several international central banks) to issue more bonds (sukuk) during the current year with expectations of reaching 20 billion dollars by the end of this year. This push has been driven by the "Basel 3" rules that prompted and pushed the largest banks in the world to start implementing the rules of fully

new capital five years prior to the final date in 2019.⁹ The bonds (sukuk) are distributed to countries in almost all continents of the world, but they are concentrated in the Gulf region, Malaysia, Turkey and Britain¹⁰. So what are Islamic bonds (sukuk) and how did they originate? Why are they important? What are their characteristics and various types? Finally, what is the difference between them and the more traditional bond instruments?

a. The concept

The issuance process of the Islamic bonds (sukuk) is called “securitization”. It also had the name “Tawaruq” when this development first started.¹¹ “Bonds” (“sukuk”) is the plural of the singular “bond” (“suk”) which means “certificate” or “document.” Many definitions were given to the term. One example is the name given in the content of the resolution of the International Islamic Fiqh Academy. It defined the bonds (sukuk) process as “issuing financial documents and certificates of equal values representing shares in the ownership of the assets (properties or utilities or rights or a mixture of objects, utilities and debts) really existing or that will be established

⁹ Ibid.

¹⁰ K. Hwalidar, “Issuance Criteria in NASDAQ Matches the International,” accessed February 2nd 2014, [http://www.albayan.ae/economy/islami/news/2014-01-17-\(1.2042088](http://www.albayan.ae/economy/islami/news/2014-01-17-(1.2042088).

¹¹ It is worth mentioning that the final statement of Al-Baraka Symposium (22) for the Islamic economy, held in Bahrain 2002, recommended using the name (securitization) instead of the term (Tawreeq). The scholars agreed to call the (Tawreeq) operation as (securitization) operation for two reasons:

The word securitization is derived from the word Bonds (sukuk) and it represent the Islamic alternative for the word (bonds) which means dealing with a financial instrument based on the debts and religiously forbidden interest, (Ribba).

The word (Tawreeq) in the conventional intellect is based on the (debts) component and through transferring these debts into negotiable security in the financial market which is forbidden by the religion in exchange.

See: S. Nasser, and R. Bin Zaid, “Islamic Bonds (Sukuk) as an Instrument for Financing Economic Development and Extent of Its Benefit in Algeria,” (proceeds of the Conference of Innovation and Financial Engineering Products Between Conventional Financial Industry and Islamic Financial Industry, Farahat Abbas University, Algeria, May 5-6, 2014. Accessed November 14, 2015): 3. <http://www.drnacer.net/fichier/34.pdf>.

Fateh Al-rahman Daleh, “Bonds (Sukuk) Role in Financing Developmental Projects” (paper presented to the Islamic Money Exchange Symposium, Arab Banks Union, Beirut, Lebanon, 2008. Accessed September 5, 2013). <http://www.kantakji.com/media/6916/628.pdf>.

Ahmed Bekhait, “Religion as One of the Reasons of the International Financial Crisis, (Reading in the Islamic Transactions Jurisprudence)” (paper presented in the Fourth International Scientific Conference of Dubai Police Academy: Legal, Economic and Security Aspects of the Current Financial Crisis, Dubai, United Arab Emirates, March 15-17, 2009): 258.

from the proceed of the subscription or IPO and will be issued according to a legal contract and adopting its provisions".¹² The Accounting and Auditing Authority for the Islamic financial institutions has defined the bonds (sukuk) in the Criteria No. 17 Article 2 of 2007 as "documents of equal values upon issuance, representing common shares in the ownership of properties or utilities or services, or in the assets of certain project or private investment activity, after collecting the value of the Bonds (sukuk), and closing the subscription or the IPO and starting using them for the purpose they are issued".¹³

As can be seen in the two aforementioned definitions, they agree on the key matters that truly reflect the essence of the Islamic bond (sukuk). They define Islamic bonds as financial documents of equal value and as representing common shares in the ownership of properties, benefits, services and financial rights prepared thereto, or a mixture of some or all of them. The definition of the Islamic Fiqh Council states that it is conditional for issuing the bonds (sukuk) to be according to a clearly defined legal contract like selling, leasing and the alike and accordingly it will adopt its provisions. On the other hand, the definition of the Accounting and Auditing Authority states of the necessity to provide and make available important financial and legal matters that without them the issued bonds (sukuk) will not be considered, which is the collection of the bonds (sukuk) value and closing the subscription or IPO and starting using them for the purpose they have been issued for. We clarify these matters as follows¹⁴:

1- Collection of the bond (suk) value: The bonds (sukuk) process means that the bond should be an instrument for collecting the funds necessary for a certain activity. This activity cannot be achieved until after collecting the value of the bonds (sukuk). And without the use of a bond, the collection of funds is just a paper-free contract.

2- Closing the subscription or IPO: The non-closing of the subscription or IPO would result in not achieving the intended and desired goal from issuance of the bonds (sukuk), as the specific value of the project or activity is

¹²International Islamic Fiqh Academy, "Resolution no. (178) (4/19)" (19th session of the International Islamic Fiqh, Sharjah Emirate, United Arab Emirates, April 26-30, 2009, accessed November 14, 2015, <http://19sh.ciifa.org/qarat-twsyat/>).

¹³ Accounting and Auditing Organization for Islamic Financial Institutions, accessed November 2015, <http://iefpedia.com/arab/wp-content/uploads/2012/01/AAOIFI.pdf>: 238.

¹⁴H. Al-Shareef, "Islamic Bonds (Sukuk) Securities" (Presentation and evaluation at Symposium on Islamic Sukuk, King Abd Al-Aziz University, Jeddah, Saudi Arabia, 2010).

distributed equally on the number of the bonds (sukuk) and it is necessary to collect the required amount by selling all the bonds (sukuk). If the subscription or IPO does not occur, then the desired goal for which the bonds were invested in will not be achieved, and the situation may affect the value of the bonds (sukuk). This could lead to the cancellation of the subscription or the IPO if they are unable to be sold.

3- Starting to use the bonds (sukuk) for the purpose for which they have been issued: Bond (sukuk) proceeds are transferred to a real investment, qualifying them for trading. This is considered one of their important characteristics, as the owner of the bonds (sukuk) is the owner of the share that these bonds (sukuk) represent in the financial properties, or the share in the capital of the project established by the value of these bonds (sukuk), and the bond (suk) represents a non-divided percentage in the ownership of an asset (building, ship, aircraft) and the associated right to regular income generated from this asset. These regular incomes will be structured in the form of tradable securities in stock exchange markets.¹⁵

Islamic bonds (sukuk) are one of the legal borrowing instruments issued according to the provisions of Islamic Shari'a against assets. Often they are issued against real estate assets or assets in securities with proceeds; therefore, it is wrong to call the bond (suk) a bond, because the bond represents a specific amount of money paid for a certain maturity, and this amount consists of the asset paid at the beginning to purchase the bond and the interest that is calculated on the maturity (the latter of which is forbidden in Islam). Therefore technically the bond and similar treasury bills are usury financial instruments that cannot be dealt with according to the provisions of Islamic Shari'a. Given that this is the case, using the expression "Islamic bonds" to describe the bonds (sukuk) has a clear contradiction in the meaning, because how can the financial instrument be usury and Islamic at the same time?¹⁶ This matter necessitates agreement on a clear name having clear and well-known or familiar linguistic and idiomatic meaning without any contradiction or ambiguity.

Since the essence of the idea of the Islamic bonds (sukuk) is to participate with the bonds (sukuk) holders in urban, industrial, agricultural or

¹⁵ Al-Qattan, "Bonds (Sukuk) and Their Important Roles."

¹⁶ M. Al-Jarhi, and A. Al-Azem Aboo Zaid, "Sujuk are Jurisprudential and Economic Cases" (Proceedings of the 19th session of the International Islamic Jurisprudential Academy, Islam Conference Organization, Sharhah Emirate, United Arab Emirates, April 26-30, 2009): 5.

service-projects where the capitals are divided equally as to the value and privileges and will be offered to the public for selling and collective financing for these projects, the bonds (sukuk) holders will have the right to dispose of the bonds by selling, and they are subject to profit and loss.¹⁷ As previously mentioned, the bonds (sukuk) can be defined in a more comprehensive and consistent manner as being: documents of equal values upon issuance that can be traded and are indivisible, representing common shares in the ownership of properties or utilities or services or in the assets of a certain project or a private investment activity, subject to profit and loss and...issued according to a legal contract and taking their provisions after collecting their value and closing the subscription or IPO and starting to use them for the purpose they are issued for.

b. Emergence

The reason for the appearance and emergence of Islamic bonds (sukuk) stems from Islamic society's need for funding sources derived from Islamic Shari'a as a substitute for the bonds coupled with fixed interest,¹⁸ on the basis of allowing the bonds (sukuk) holders to share in the profit and loss of the projects as per the agreement mentioned in the prospectus of the bonds. The Islamic Shari'a jurists and muftis deemed that Islamic bonds (sukuk) would serve as a gateway out of the economic crisis. They considered them to be the Islamic alternative for the bonds in the capitalist system, especially if they became an international financial product, after the share in Islamic countries became much less than the share in western countries which reached to 80% of the issuance of Islamic bonds (sukuk)¹⁹.

The Islamic bonds (sukuk) were issued individually for the first time in Jordan via the Jordanian Islamic Bank in 1978. Then a new type of the Islamic bonds (sukuk), called "Participation Bonds", were issued in Turkey in 1984 and were allocated for funding to build the second Bosphorus Bridge (Mohammad Al-Fateh Bridge). They were then issued in Sudan in 1999 via

¹⁷ Ibid.

¹⁸ M. AlSeehani, "Islamic Bonds (Sukuk) Structure" (Proceeds of a panel discussion on Islamic bonds (sukuk) organized by the Research Unit in Al-Shari'a College in Riyadh, Saudi Arabian Kingdom), accessed August 15, 2013, http://uqu.edu.sa/files2/tiny_mce/plugins/filemanager/files/4290561/40/cc348.pdf

¹⁹ H. Thabit, "Islamic Bonds (Sukuk) Between Positive and Negative Aspects," Egynews.net, accessed March 23, 2014, <http://www.egynews.net/wps/portal/profiles?params=208835>.

the Sudanese Central Bank.²⁰ The Islamic Fiqh Council emanating from the Organization of the Islamic Conference (OIC) held in Jeddah in 1988 issued in its 4th Session resolution No. 30(3/4) containing the Shari'a controls for what the council proposed to call Muqarada bonds (Islamic Financial Banks and Institutions General Council 2010).

However, the real start of the Islamic bonds (sukuk) mechanism was in Malaysia,²¹ after public ownership of the state in most of the projects was abandoned; that is, the bonds (sukuk) began where privatization began, as the bonds (sukuk) fit mainly with the economies of the private sector, such as those emerging from the privatization processes conducted in Malaysia during the period from 1983 and 1999. The most important of the privatized sectors were the industrial sector, electricity and water sector, agricultural sector, and services and mining sectors. Malaysia was a "pioneer" in the field of Islamic bonds (sukuk), and as the first issue of the bonds (sukuk) in Malaysia was in 1990 by Shell MDS (Malaysia)²² and then in 1995 for building a power station for the amount of 350 million dollars, Malaysia was able to dominate this market by owning over 69% of the total issues in 2013. Malaysia was followed by the Kingdom of Saudi Arabia with 12% of total issues, then the United Arab Emirates (UAE) with 6%, then Indonesia with 5%, and Turkey with 3%.²³

Knowing that London strongly participates in the market of Islamic assets, more than 20 of the banks providing the Islamic financing services for the bonds (sukuk), are based in the UK. Of them, 6 banks conform with the provisions of Islamic Shari'a completely, a number that is larger than the number of banks issuing Islamic bonds (sukuk) in any other western country. The volume of bonds issued by end of 2014 is expected to reach up to one million pounds sterling.²⁴

²⁰ I. Al-Zain Al-Mahi, "Islamic Bonds (Sukuk) and Its Role in Financial Market Development and Deepening" (Proceeds of the 4th Investment and Financial Market Conference, Syria, viewed October 2, 2013), <http://rcweb.luedd.net/rc9/A921.pdf>.

²¹ Abdullah Jalil, "Islamic Bonds Issues: The Malaysian Experience," Social Science Research Network, 2005, <http://ssrn.com/abstract=1785098>.

²² S. Jawahra, and A. Disooqi, "Critical Evaluation of Legitimate Issues Concerning the Ownership of the Bonds (Sukuk) Based on Assets" (Presentation and evaluation from the Symposium Islamic Sukuk, King Abd Al-Aziz University, Jeddah, Saudi Arabia, May 24-25, 2010).

²³ A. Al-manee, "Islamic Bonds (Sukuk) Exceeding and Correcting" (Presentation and evaluation from the Symposium Islamic Sukuk, King Abd Al-Aziz University, Jeddah, Saudi Arabia, May 24-25, 2010): 2-3.

²⁴ "London is the Capital of Islamic Sukuk," <http://www.noonpost.net/content/814>.

"Britain Preparing to Issue Islamic Bonds," accessed June 26, 2014, <http://elaph.com/Web/News/2014/6/913485.html>. It is observed that Britain authorized HSBS Bank in January 2014 to arrange the Bonds (sukuk) Issuing Deal and it added now four more banks to that bank.

II. THE ORGANIZATIONAL AND LEGISLATIVE ENVIRONMENT OF THE ISLAMIC BONDS (SUKUK)

Due to the fact that some of the process's provisions are founded in the purposes and principles of Islamic Shari'a, the procedural organization of the Islamic bonds (sukuk) issuance process is considered one of the most important matters needing clarification. From reading Islamic Shari'a rules we conclude that these rules provide a large capability for producing a variety of competitive financial tools like bonds (sukuk) that can be dealt with on the basis of sound and honest Shari'a practices away from usury, ambiguity, gambling, damage, injustice and monopolized markets. Furthermore, the disclosure of the profit or proceeds distribution rules to the bonds' (sukuk) holders is considered as the terms of healthy dealing with bonds (sukuk).²⁵ Hence, we will discuss the organizational environment of the Islamic bonds (sukuk) through discussing the parties to the bonds (sukuk) process, bonds (sukuk) structuring, issuance, trading and their specific controls.

a. Bonds (sukuk) process (securitization) parties

In the bonds (sukuk) securitization process, like with any contract, there is a party that gives rise to the rights and the consequent obligations of the principal contracting parties thereof. In addition, the bonds (sukuk) securitization process has other parties whose functions are to serve and organize the process properly.²⁶

These banks are: Barwea bank in Qatar, SIMB Bank in Malaysia, Abu Dhabi National Bank and Standard Chartered Bank.

²⁵ A. Al-Mansoor, "Utilizing Islamic Bonds (Sukuk) on Official Level and the Need for New Legislation" (Proceedings of the Conference Islamic Banks Between Reality and Expectations, Islamic Affairs and Charity Department, Dubai, United Arab Emirates, May 31-June 03, 2009): 29.

A. Al-Saleh, "The Islamic Economic System as an Alternative for the Capitals System" (Proceeds of Part Two of the conference volumes for the Fourth International Scientific Conference of Dubai Police Academy: Legal, Economic and Security Aspects of the Contemporary Financial Crisis, Dubai, United Arab Emirates, March 15-17, 2009): 428 - 433.

Al-Sattar Al-Heeti, "Contemporary Financial Crisis, Reasons and Treatment, Islamic Economic Reading", 334-337.

A. Al-Wafa, "Validity Extent of the Islamic Economic System as an Alternative for the Capitals System in Leading International Economy" (Proceeds of Part Two of the conference volumes for the Fourth International Scientific Conference of Dubai Police Academy: Legal, Economic and Security Aspects of the Contemporary Financial Crisis, Dubai, United Arab Emirates, March 15-17, 2009): 295-303.

²⁶ Z. Al-Dammag, *Islamic Bonds (Sukuk) and Their Role in Economic Development* (Amman, Jordan: Culture Publishing and Distribution House, 2012), 84-86.

The main parties participating directly in the bonds (sukuk) process are as follows:

Originator: It is called the issuing entity or the authority owner of the assets intended to be securitized, and can include individuals, groups, or countries. This authority will make an inventory of assets and assemble all the varieties of its financial assets generating cash returns into a pool or one investment account known as a bonds (sukuk) portfolio (portfolio asset).

Issuance Agent: This party undertakes the management of the owned assets for the bonds (sukuk) holders and on their behalf. Furthermore, often it is a company of special purpose known as a Special Purpose Vehicle (SPV) undertaking the issuance process. The assets' subject matter (bonds [sukuk]) will be bought from the owner company to undertake the issuance process of the bonds (sukuk) (the structures bonds (sukuk)), as it carries out all the necessary procedures for the bonds (sukuk) process against charges or specific commissions in the prospectus. This owner company may have a pool of several functions assigned thereto as an issuance manager or investment trustee, and it is to be legally and financially independent from the authority from which it originated to ensure transparency and protect the rights of the investors of the bonds (sukuk) holders. Currently there are numerous well-known and reliable issuance authorities in many countries.

Bonds (sukuk) holders: The investors buying bonds (sukuk) offered for subscription or the IPO in assets put into bonds (sukuk) in return for recovering the original value of the bonds (sukuk) and the proceeds resulting from the activity of the assets put into bonds (sukuk) at the maturity time. The sukuk holders may be financial institutes, local or international banks, or individuals or governments.

A. Dawaba, *Islamic Bonds (Sukuk) Between Theory and Application* (Cairo: Dar Al-Salam, 2009), 65-66.

F. Muhsin, "Towards an Islamic Applicable Sample for the Tawreeq of Assets" (Ph.D thesis, Arab Academy for Financial and Banking Science, Jordan, 2006), 35.

S. Nasser, and R. Bin Zaid, "Islamic Bonds (Sukuk) as an Instrument for Financing Economic Development and Extent of Its Benefit in Algeria" (Proceeds of the Conference of Innovation and Financial Engineering Products Between Conventional Financial Industry and Islamic Financial iIndustry, Farahat Abbas University, Algeria, May 5-6, 2014) accessed November 14 2015, <http://www.dnacer.net/fichier/34.pdf>, 3-5.

Bonds (sukuk) portfolio (portfolio asset): It is an investment bowl, including various assets put into bonds (sukuk) in favor of the originator, with the aim of obtaining liquidity or cash for either the financing establishment of a new investment project or expanding and developing the base of an existing project in accordance with the Islamic financing formulas. The proceeds from such bonds (sukuk) portfolios (portfolio asset) will be collected and deposited in a special account used for the settlement of the dues of the bonds (sukuk) holders on their maturity dates.

Bonds (sukuk) securitization process auxiliary parties are those who agreed to carry out special services for the bonds (sukuk) processes. The most important parties are as follows:

Investment Trustee: The mediator financial institute undertaking the protection of the interests of the bonds (sukuk) holders in addition to the supervising and monitoring of the issuance manager to ensure their compliance with the organization's conditions on the investment process mentioned in the prospectus. Furthermore, it will maintain the documents and guarantees on the basis of an agency contract, with fixed charges specifying the prospectus with clear and express instructions.

Underwriters: It is the authority undertaking to subscribe the rest of the bonds (sukuk) that are not subscribed. Underriters can undertake to pay the rights of the bonds (sukuk) holders after collection, provided that such obligation is made free of charges by the applicant, and is announced in the prospectus.

Shari'a Supervisory Body: It is the authority studying the issuance structure from Shari'a in terms of legitimacy, and the authority that decides whether or not the bonds (sukuk) process is sound in terms of legitimacy and integrity. In addition, the Supervisory Body will set the Shari'a standards that control the bonds (sukuk) process (securitization) and the contracts organizing the relations between their parties. In some cases it will be obliged to have the authority to monitor the issuance authority and the issuance manager using Shari'a controls. Usually the Shari'a Supervisory Body consists of clerics and jurists in the Islamic religion in addition to the Research and Shari'a Fatwa centers in that country.

Credit Rating Agency: These represent specialized agencies, like the Malaysian Credit Rating Agency based in Malaysia, which assess the extent of the credit

and financial worthiness of the offered securities with guarantees and the fixing of a fair price, along with the proportion of the risks involved in the issued securities. Also, in the case of the Islamic bonds (sukuk), they will assess the efficiency of the client in the al-Musharakha activity and his integrity and honesty to protect the bonds (sukuk) holders. It is worth mentioning here of the necessity to develop a working system for the credit rating authorities that take care of the bonds (sukuk), and to have an umbrella for all the countries dealing with bonds (sukuk) in its financial system, especially in the emerging Asian and Arab countries, and then followed by other countries.

b. Structure of the bonds (sukuk) process

The Islamic bonds (sukuk) structure has benefitted from the bonds (sukuk) process in western countries. This process contains the following a number of steps which are detailed below.²⁷

1- Identifying the relevant parties involved in the bonds (sukuk) process as well as the tasks, duties and rights of each party in the bonds (sukuk) process. The parties include the originating company, which can be an Islamic bank or any Islamic finance house or a charitable organization (Expectation for the Expansion of Issuing Islamic Bonds (sukuk) in the World 2014); a (SPV/Special Purpose Vehicle) company which will execute and manage the bonds (sukuk) process; the targeted investors; the issuing manager; the underwriter; and the investment trustee and other parties assisting in the process.

2- Assessing of the establishment or issuance expenses and designing of the main contracts for the bonds (sukuk) process. These include the prospectus or subscription, which contains the contracting conditions and data on the participants concerned, as well as the assets sale contract, the subject matter of

²⁷ Al-Dammag, "Islamic Bonds (Sukuk) and Their Role in Economic Development."

M. Al-Shayani, "Islamic Bonds (Sukuk) Structuring" (Proceeds of a panel discussion entitled Islamic Sukuk at the Research Unit in Shari'a College, Al-Riyadh, Saudi Arabia, 2008), accessed January 2 2014, <http://www.syrianfinance.gov.sy/assets/files/20033.doc>

M. Jaser, "Bonds (Sukuk) Issuing Experiences in Various States," *Banking Financial Studies Magazine*, 2013.

Nasser and Bin Zaid, "Islamic Bonds (Sukuk) as an Instrument for Financing Economic Development," 3-5.

the bonds (sukuk), the assets management contract and assets value guarantee contract, and so on.

3- Undertaking to cover the full issuance and managing it in accordance with the conditions stipulated in the prospectus and according to the specified schedule.

4- Appointing the assets to be put in bonds (sukuk) by conducting an inventory and collecting information on the variety of assets in an investment bowl (portfolio asset); selling the the assets to the bonds (sukuk) company (SPV/Special Purpose Vehicle) and the selling process itself if correct and final; and transferring all the rights and obligations of the originator to the bonds (sukuk) company (SVP).²⁸

5- Re-rating of the assets by the SVP, dividing them into suitable parts or units that also meet the needs and desires of the investors. Then SVP will transfer the assets to bonds (sukuk) and sell the bonds to the investors, after which they will manage the bonds (sukuk) portfolio on behalf of the investors throughout the issuance period by collecting the proceeds and the periodical incomes resulting from the assets put into bonds (sukuk) and distributing it to the investors (bonds (sukuk) holders). It will also provide all the services the portfolio requires, and then it will amortize the bonds (sukuk) by paying the bonds (sukuk) value agreed on the dates specified in the prospectus.

The following is an applied example on the structuring process of one of the most prevalent Islamic bonds (sukuk), i.e. leasing bonds.²⁹ A company intends to buy a building valued at 400 million dollars, and would like to finance its purchase through the issuing of Islamic bonds (sukuk). We will call this company the financing company. After researching and studying its purchase options, the company found suitable terms of specifications associated with the purchase, and negotiated with the owner of the building on the final price and to collect the building price. The financing company has established a company (SPV) for the purpose of issuing bonds (sukuk) (SPV); its role is to issue leasing bonds (sukuk) certificates for the investors and collect its value to use for payment for the building, and then transfer the building's ownership thereto (to the SVP). Then the SVP company will lease the building to the financing company for a limited period and collect the

²⁸ Hassan, "Comparison Between Bonds (Sukuk) and Conventional Bonds."

²⁹ Al-Seehani, "Islamic Bonds (Sukuk) Structure."

periodical rent thereof, transferring it to the bonds (sukuk) holders. Afterwards the financing company will fulfill its promise by re-buying the building from the SVP company after the expiry of the lease contract for a certain price agreed on upon purchase, or as per the price of the building in the market. After that the bonds (sukuk) will be amortized through the payment of the building value by the SVP Company to the bonds (sukuk) holders.

It is worth mentioning that the building owner in the leasing bonds (sukuk) structuring process may be the financing company itself or an authority associated therewith. The leasing bonds (sukuk) are tradable because they represent the ownership of a real asset (building). In addition, the leasing bonds (sukuk) are of relatively low risk because their proceeds (the amount of the rent)³⁰ are known in advance.

c. The Shari'a controls for issuing the Islamic bonds (sukuk)

To organize the issuance of bonds (sukuk) in compliance with Islamic Shari'a and expand the scope of activity that can be financed by Islamic bonds (sukuk), it is vital to set the necessary controls for both issuance and subscription processes, both for the protection the rights of the holders of such bonds (sukuk) and stabilization of the financial markets.³¹ The most important Shari'a controls governing the Islamic bonds (sukuk) issuance are:³²

1- The type of assets intended to be put into bonds (sukuk) – properties, utilities and services – are to be of the legally permitted assets valid for bonds (sukuk) without any Shari'a risks like usury and ambiguity. For example, debts based on usury loans may not be put into sukuk because they are consequences of usury and the consequences of something to acquire its provisions. Revenues or debts are also prohibited from being put into bonds (sukuk) for the purpose of trading unless a commercial or financial authority sold all the assets or portfolios it owned that had an existing financial

³⁰ Ibid.

³¹ Government of Egypt, Bill Organizing Islamic Bonds (Sukuk) Issuance, <http://www.diconline.org/NewsDetails.aspx?id=38585&language=en> (accessed September 20 2013).

³² Al-Dammag, "Islamic Bonds (Sukuk) and Their Role in Economic Development."

Abd Al-Sattar Aboo Guda, "Legitimate Criteria for Bonds (Sukuk) Issuing and Trading" (Bonds (sukuk) course, Egyptain Saudi Finance Bank, Alexandria, Egypt, July 2008).

Hwaldar, "Issuance criteria in NASDAQ matches the international," 5 - 6.

position, and the debts related to the properties and utilities were entered unintentionally in the assets.³³

2- Bonds (sukuk) are issued on the basis of a legal contract. Their parties are the bonds (sukuk) issuers and the subscribers, and they are governed by Islamic investment contracts like al-Musharakah, al-Salam, al-Istisna'a, leasing and the like. These contracts are in compliance with the provisions and principles of Islamic Shari'a, and controlled by the Musharakah rules regarding the profit and losses, i.e. applying the principle of sharing the profits and losses.

3- The prospectus is an invitation extended by the issuer to the subscribers. Subscription means bonds (sukuk) positively, whereas acceptance means the approval of the issuing authority. The prospectus contains many matters, of which the most important are the contracting conditions and sufficient data about the parties, their rights and obligations. It also contains the text on the compliance with Islamic Shari'a and principles and how to comply in order to be assigned a Shari'a Supervisory Body, which has to issue the Fatwa for permitting the bonds (sukuk) structures and following up and auditing the contract and the relevant documents. The board will also compose the text regarding the participation of the owner of each bond (sukuk) in any profits, and stipulate that the owner shall bear the losses in proportion to the bonds (sukuk) represented by him in the case of losses. It will also determine the method of distribution of the proceeds (profit) between the participants holding the bonds (sukuk) and the bonds (sukuk) issuing company. Determining the method of distribution cannot be postponed to after the expiry of the project or the financing process from the bonds (sukuk)³⁴.

4- The issuing company of the personal legal independent bonds (sukuk) for the persons participating in the bonds (sukuk) is responsible of the management of the sukuk.

³³ Legitimate Standard no. (21) Regarding Securities," in Legitimate Standards of the Islamic Financial Institution (Bahrain: Authority Islamic Financial Institution Accountancy & Auditing, 2009), 299-300, <http://iefpedia.com/arab/wp-content/uploads/2012/01/AAOIFI.pdf>.

³⁴ "Legitimate Standard no. (21) Regarding Securities," 299-300.

5- The bonds (sukuk) issuing company shall manage them in return for a common percentage of the proceeds. Sometimes the participants in the bonds (sukuk) agree with the issuing company (in charge of the management) agree to allow the latter to deal with the management against an agency contract with known charges, regardless of achieving any profit.

6- If any losses occur, or if there is an infringement or omission from the bonds (sukuk) issuing company in charge of the management, the losses/infringements/omissions will be borne by the participants and not by the managing company.

7- The ownership of the periodically distributed profits (progress) under the account may not be established until there is capital safety (in accordance with the principle of profit protection of capital, or the accounting concept of 'no profits until after capital safety').

8- The bonds (sukuk) issuing company may undertake to re-purchase the bonds (sukuk) from their holders as per their market value or in the price offered thereby. This is done by mutual consent between the two parties.

d. The Shari'a controls for trading the Islamic bonds (sukuk)

Trading of the bonds (sukuk) means transferring ownership from one person to another, which is one of the legally permitted dispositions, as the bonds (sukuk) are documents representing properties, utilities and services. Dealing and dispositions relating to the bonds (sukuk) must take into account Shari'a and Fiqh provisions in the disposition of types of ownership represented by the bonds (sukuk), so the disposition of the bonds (sukuk) is the disposition of the offers. It is well-known that the Shari'a provisions do not put any restrictions on the dispositions of the offers unless their properties are prohibited (like alcohol) or if the contracting includes injustice or deception, but the provisions of Islamic Shari'a put some restrictions on dispositions related to debts and cash (liquidity). The most important Shari'a controls for trading the bonds (sukuk) are the following:

1- The tradable bonds (sukuk) represent the ownership of bonds (sukuk) holders with all their rights and obligations in real assets that can be owned and sold legally and legitimately, whether they are properties, utilities, or services. The bonds (sukuk) manager must establish the transfer of the ownership of the assets in its records and not keep them in its own assets.

Bonds (sukuk) may be traded and recovered if they represent a common share in the ownership of the assets (properties, utilities, or services) after closing the subscription or the IPO and starting the activity.

2- The bonds (sukuk) may be traded in any recognizable way, provided it is not inconsistent with the provisions of Islam. Examples of methods inconsistent with the provisions are Islam are recording in the registers or handling if the bonds for their holders or via electronic means.

3- Al-Musharakah sukuk, al-Mudarabah bonds (sukuk) and investment agency bonds (sukuk) may be traded after closing the subscription or the IPO and allocating the bonds (sukuk) and starting the activity in the properties and benefits.

4- Al-Murabaha bonds (sukuk) may not be traded after selling the commodity to its buyer because at that point the bonds (sukuk) represent a cash debt on the buyer, and therefore the bonds (sukuk) may not be traded unless as per the debt provisions. However, after buying the commodity and before selling it to the buyer, they can be traded because the bonds (sukuk) represent assets.

5- The Resolution of the Islamic Fiqh Council No. 178(4/19) held in its 19th Session in April 2009 titled "The Islamic bonds (sukuk) (Tawriq) and their contemporary Applications" states that in the bonds' (sukuk) ability to be traded and their compliance with the controls stated in the resolution of the International Islamic Fiqh Council No. 30(3/4) must be taken into account as follows:³⁵

- If the components of the bonds (sukuk) are still cash and not yet converted to assets, then the trading of the bonds (sukuk) acquires the provision of selling cash against cash and the provision of the exchange will be applied thereon.
- If the assets are overturned to become debts, as is the case in al-Murabaha sale, then the provisions of the debt will be applied on the trading of the bonds (sukuk), in restriction, unless likewise as a Hawalah.

³⁵ "The Islamic bonds (sukuk) (Tawriq) and their contemporary Applications," Resolution no. 178(4/19) of the Islamic Fiqh Council, 19th session, accessed November 14, 2013, <http://www.islamfeqh.com/News/NewsItem.aspx?NewsItemID=1361>.

- If the bonds (sukuk) funds are converted to assets as a mixture of cash, debts, properties and benefits, they may be traded according to the agreed price, provided that the majorities in this case are properties and benefits. However, if most are cash or debts, then the Shari'a provisions must be taken into account in trading.
- All cases must duly register the trading in the records of the issuer.
- The permission to trade may not be taken as an excuse or used as a trick to put the debts into bonds (sukuk) and trade them as if turning the fund activity to trading in debts arising from the commodity, and keep some of the commodity in the fund to mislead during trading.

Therefore, the bonds (sukuk) may be traded after being issued by their first price if this is stated in the issuing terms and conditions. This happens in cases where the bonds (sukuk) are not traded on the stock exchange market (Bursa). If, however, the bonds (sukuk) enjoy the feature of being traded in the stock market, they may then be sold at the price determined by the market based on the assessment of the assets represented by the sukuk, or any other of the bonds' (sukuk) pricing indicators. The bonds (sukuk) may also be purchased by the issuer or by individuals or other establishments according to the rules in the prospectus.³⁶

III. THE RISKS ASSOCIATED WITH ISLAMIC BONDS (SUKUK)

The risks associated with Islamic bonds arise from the regular and irregular fluctuations occurring in the values and proceeds of the assets. In other words, it is the possibility of loss that affects the market in general and all tradable securities of all classes. In other cases, economic, political or social factors may affect special classes of securities in special ways while not broadly affecting the market.³⁷ It is necessary to measure the risks to know the degree (high or low) in order to be ready to bear it, because there is no set cost of the risks from a scientific point of view if one is not able to measure and rate the risks in a way that can identify the degree before selecting the investment. This is done by comparing the risks contained in the different investment

³⁶ Al-Mansoor, "Utilizing Islamic Bonds (Sukuk) on Official Level and the Need for New Legislation," 29.

³⁷ Al-Dammag, *Islamic Bonds (Sukuk) and Their Role in Economic Development*.

H. Maroof, *Investment and Financial Markets* (Amman, Jordan: Safa Publishing & Distribution House, 2003).

decisions for the activities and then comparing these risks with the expected proceeds from the investment.

Bonds (sukuk) are distinct from traditional bonds due to some risks that each issuer and investor must take into account. Islamic bonds (sukuk) should not be treated simply as debt instruments that do not differ from traditional bonds and whose underlying assets and contractual structures are akin to a bridge for transferring funds from investors to the bonds (sukuk) issuers. This perception leads to the inability to properly assess the bonds (sukuk) and, as a result, these risks will not be covered by the appropriate means.

The risks that the bonds (sukuk) encounter vary according to the structure of the bond (“sak” – the singular for “sukuk” [bonds]); so the risks of “Bonds (sukuk) al-Murabaha” differ from those of “Bonds (sukuk) al-Musharaka”; just as the risks of “Bonds (sukuk) al-Istisna” differ from those of “Bonds (sukuk)al-Ijara”. Furthermore, the bonds (sukuk) formed by a combination of many contracts differ from those of “Bonds (sukuk) al-Basita” formed from one contract. These risks also vary depending on the underlying assets of these sukuk, and whether they were fixed or movable assets, utilities or services.

a. Violation of the Islamic Shari’a provisions

A number of scholars and entities supporting Islamic Banking like General Council for Islamic & Financial Institutions (CIBAFI), Accounting and Auditing Organization for Islamic Financial Institutions (AAQIFI) in Bahrain, and Islamic Financial Services Board (IFSB) in Malaysia believe that some forms of bonds (sukuk) introduced by financial institutions are inconsistent with Shari’a. Since the bonds (sukuk) are financial tools based on Islamic Shari’a provisions, violations of these Islamic Shari’a provisions at any time over the lifetime of the bond (sak) would lead to damages that vary according to the type of violation and the degree of its seriousness. Violations range from voiding the bond (sak) in its entirety to the cancellation of certain conditions. For example, when the underlying components of the bond (sak) are “Deyoun Murabahat” (debts to be paid back through fixed return notes) and “Usul Mouajara” (leased-assets based on variable return notes) the percentage of the debt could not exceed 33% of (the assets) underlying the bond (sak) throughout the lifetime of the bond (sak) in order to permit its circulation. If the debts were higher than this percentage, then the bond (sak) could not be circulated and thus would become a weak liquidity (tool).

Otherwise the ownership of the assets of “Bonds (sukuk) Al-Ijara” becomes artificial.

Such artificiality may nullify the ownership contract; what is built on falsehood is false, and therefore the bond (sak) will be null and void. For example, many Islamic institutions transfer the ownership of some of their customers’ assets to a mortgage status, which is not for an actual sale. If these institutions bond these assets to a form of “Bonds (sukuk) al-Ijara,” “Musharaka,” or other kinds of available bonds (sukuk), these bonds (sukuk) will become null and void because the institution had sold something that they do not own to the bonds (sukuk) holders, which is prohibited in Islamic shari’a. There are many ways of violating Islamic law and those cannot be limited in this article. Each of the bonds (sukuk) structures has Islamic religious controls whose violations are considered among the risks of the bond, and for which the possibility of their occurrence, the ways to reduce them, and the methods to address them must be studied.³⁸

b. Operational risks

These risks arise due to human or technical errors or accidents. These risks are listed under General Risks if they are due to external factors like natural disasters, such as damage caused by disasters or accidents causing the destruction of the plants in the agriculture bonds (sukuk) investments or destruction of the leased asset in the Ijarah bonds (sukuk) investments, etc. These risks are listed under Special Risks if caused by internal factors like insufficient supplies, means of technology, or trained human resources; corruptions; or administrative incompetence (i.e. administrative efficiency).

Since the structures of tradable Islamic bonds (sukuk) must be based on assets and the return on these bonds (sukuk) originates from these assets, the operational risks of these assets must be carefully studied. For example, it is known that the return in the “Bonds (sukuk) al-Ijara” is the revenue of the bond (sak); so if the utilities regarding the leasing tenants as underlined in the “the bond (sak) al-Ijara” were late to materialize, the lessee must not pay for the lease and therefore the bond (sak) would have no revenue. Hence, property-based “Bonds (sukuk) al-Ijara” are less prone to the risks of revenue loss due to the delay in getting their utilities compared to those bonds (sukuk)

³⁸ Adil Amer, “Islamic Sukuk, between sovereignty, Shari’a and the law,” *Donia Al-Watan*, March 24, 2013, <http://pulpit.alwatanvoice.com/articles/2013/03/24/289206.html>.

that are based on vehicles, factories, aircrafts or ships. Furthermore, the potential risks arising from ownership of these assets will be carried out by the bonds (sukuk) holders. Potential risks include environmental damages caused by factories or ships and other risks that are separately related to each asset.

c. Credit risks and receivables acceptable by Shari'a

There exists a risk of the probability that the client will be unable to fulfill its contractual obligations entirely and on their due dates. The source of such risks may be due to ill client choice: either the choice against fulfilling the obligations of the work assigned thereto for the al-Musharakha, al-Mudrabha, Muzaraa, Musaqat, Mugharasa and Istisna'a sukuk; or if the client does not like to receive the purchased commodity and a failure to fulfill its promise in Murabaha bonds (sukuk) investments. Further risks arise if the client does not wish to receive the manufactured commodity in the Istisna'a bonds (sukuk) investments; if the Istisna'a contract is permissive but not binding; if there is a delay or unsettlement of whatever obligations due thereto for al-Murabaha bonds (sukuk) investments and Ijara bonds (sukuk); or non-compliance to supply the agreed on commodity as per the description and on the specified time for the Salam bonds (sukuk) investments.

The risks of inefficiency of the client, bad reputation, and not wishing or being unable to settle all fall mainly on the bonds (sukuk) issuer granting the credit to the client, and will negatively affect proceeds. Therefore these risks are listed under Special Risks.³⁹

The risks of delay in settlement - "Slow Pay Risk": These risks occur if, for example, the bonds (sukuk) holders expect that the proceeds distributed thereon will be delayed for many months, due to the desire of the debtor to delay fulfillment. This will lead to disappointment, which will not only affect the ability of the asset to fulfill predictions, but also confidence in the entire bonds (sukuk) deal.⁴⁰

The risks of failure to pay - "No Pay Risk": These risks occur if the debtor fails to fulfill requirements due to financial failure or bankruptcy, which highlights the importance of the role of the International Credit Rating Companies in preventing these risks through the credit rating degree given during the Taskik process. This will help the investors to predict such risks before making the decision to invest in the bonds (sukuk). In addition, it

³⁹ Hwaldar. "Issuance Criteria in NASDAQ Matches the International."

⁴⁰ AlDammag, *Islamic Bonds (Sukuk) and Their Role in Economic Development*.

will allow sufficient guarantees against these bonds (sukuk) to strengthen the confidence of the investors therein.⁴¹

d. Economic risks

Market and economic risks are listed under General Risks as they are related to the up and down trends occurring to the market, whether they are real assets markets or financial markets which consist of the money markets and the capital market (which consists of the issuing and trading markets).

The risks of the bonds' (sukuk) assets are associated with the nature of the Islamic bonds (sukuk) as they represent a common share in the ownership of non-cash assets, perhaps properties or commodity for buying and selling. Therefore, they are prone to damages or impairment in value due to the market risks (change of prices) and even if provision of maintenance is taken into account, it will prolong their lifetime but will not prevent them from exposure to damages and destruction. The bonds (sukuk) that represent trading by buying and selling commodity or real estate may result in debts, and they are prone to delays in settlement and perhaps loss. The risks of the bonds' (sukuk) assets are considered the greatest risks, because loss of the assets also leads to loss of the proceeds.⁴²

The risks of the exchange rate arise from the fluctuations in the currency exchange rates in the deferred transactions. In the event that a commodity is bought in a foreign currency and the rate of that currency declines, it may result in losses in the amount of the foreign currency devaluation against other currencies. The risks of the exchange rate appear upon issuing the bonds (sukuk) in a certain currency, and investing its proceeds in other currencies, or if the bonds (sukuk) issuing facility maintains open locations towards some foreign currencies or payment obligations. This is especially the case in the Murabaha processes and international trading.

The risks of the interest arise due to variations in the level of interest rates in the market in general, and they affect all investments regardless of the nature and circumstances of the investment itself. The Islamic bonds (sukuk), may be affected by the interest rate if it is taken as a reference price in financing with Murabaha. Furthermore, the interest rate, being a mechanism on which the money and banking system is established in most Islamic countries, will therefore no doubt affect the Islamic bonds (sukuk), especially if there is no role for the religious faith in guiding the investors, and some of

⁴¹ Ibid.

⁴² Abd AL-Sattar Aboo Guda. "Legitimate Criteria for Bonds (Sukuk) Issuing and Trading."

them misinterpret the Fatwas as a pretext which permits an interest rate contrary to the consensus of scholars.

The risks of inflation arise due to the decline in the purchasing power of money through rising prices, which means the invested funds are exposed to decline in their real value. Islamic bonds (sukuk) are of variable yielding, and components stem from cash, debts, properties and utilities, hence the impact of inflation is inversely associated with an increase in the amount of the bonds' (sukuk) components coming from cash and debts.

Another risk is failure of the bonds (sukuk) issuers to fulfill their obligations. In this case we will confront a disaster not less in size than the one the real estates bonds caused in the USA.

e. Legal risks

Since many of the regulations and laws in many countries are (man-made) emplacement regulations, which cause many of their clauses to violate the provisions of Islamic Shari'a, a conflict between these regulations and the provisions of Islamic Shari'a might occur, and the application of Islamic Shari'a provisions will be ignored in litigations.

The importance of taking into account the difference between bonds (sukuk) and traditional debt bonds is clear. This difference would result in risks that must be studied and measured utilising an accurate scientific method, followed by efforts to cover these risks by appropriate means that are compatible with Islamic Shari'a.

f. Risks for non-existence of secondary market

This allows for the trading of the bonds (sukuk) between a limited group of financial institutions and some companies and individuals. There is a series of reasons leading to the non-existence of secondary markets for these bonds (sukuk), such as: the limited number of bonds (sukuk) offered; the desire of the bonds (sukuk) holders to keep them as yield guaranteed return; and lack of an alternative thereto in the market.

IV. CHALLENGES

Islamic bonds (sukuk) face many challenges and problems. The most important of them are as analyzed below.

a. Limited Islamic products viable for listing in the stock market

Many of the products that can be offered to investors such as derivatives and deferred contracts are considered as “deception” and they are in non-compliance with Islamic Shari’a. A small percentage of the issuances are listed in the local stock exchange markets. For this reason the issuing company from, for example, the UAE may choose to list its bonds (sukuk) in stock exchange markets like London because this is easier and faster with respect to organizational and legislative rules, despite the legislation and standards of bonds (sukuk) issued in NASDAQ Exchange market in Dubai being equal to the legislations in the international stock exchange markets. Such actions allowed the NASDAQ to become the third largest stock exchange market for the Islamic bonds (sukuk) trading in the world (after Malaysia and the London stock exchange markets) within only two years. Bonds (sukuk) amounted to 6.7 billion dollars by the end of the third quarter of the last year in NASDAQ.⁴³

b. Lack of legislative and regulatory environment appropriate for the issuance and trading of sukuk

It is considered as the most prominent challenge that the legislation and standards of the Islamic bonds (sukuk) issuance in their stock exchange markets are equal to the legislation of the International stock exchange markets like New York and London. Therefore it is required that the regulatory and legislative authorities in Islamic countries provide an appropriate legislative and regulatory environment for issuance of the bonds (sukuk). For example, issuance of the regulations for offering and trading Islamic bonds (sukuk) and the regulatory authority supervising the capital market in each country shall establish one Shari’a authority. This authority will have the entire reference for the issuances of the bonds (sukuk) intended to be offered or or listed on the stock exchange market, in order to narrow the Fiqh differences, stabilise the market, and increase the confidence therein (Mehra 2010).

The growth registered by the bonds (sukuk) sector makes it especially sensitive to fluctuations in the global economy. As such, despite registering great rates in 2013, this sector is struggling to record the exceptional levels

⁴³ C. Heweught, “Issuance Criteria in NASDAQ Matches the International,” 2014, [http://www.albayan.ae/economy/islami/news/2014-01-17-\(1.204208.8](http://www.albayan.ae/economy/islami/news/2014-01-17-(1.204208.8)

achieved in 2012 due to the difficult circumstances surrounding the market. This has led the international level of the bonds (sukuk) issuance to amount to 77.4 billion dollars as of 22 September (contrary to the reports that deemed that it had reached to 61 billion dollars), a decline of 25%, even though this figure is close to the total issuances registered in 2011.⁴⁴

c. Tax neutrality

Tax neutrality constitutes a challenge to the countries issuing Islamic bonds (sukuk) to take the necessary steps to provide tax neutrality between the Islamic and conventional transactions, and to incorporate tax incentives to strengthen the attraction of the bonds (sukuk) to the investors and issuer and mediators of securities. It has been mentioned in a report published by the Malaysian Business Times that Malaysia exerts great efforts and offers customs exemptions to maintain its position as an International Center for Islamic financing containing the largest international market for Islamic bonds (sukuk), and activates the Islamic banking depending on a variety of contracts like agency, sponsorship, Murabaha, al-Salam and Ijarah.⁴⁵

d. Relying on the short-term financing

Islamic banks have historically suffered from an excessive reliance on the short-term financing market, especially in the form of al-Murabaha. Due to its guaranteed profit and lower level of risk, in addition to not freezing the money and its speedy turnover, al-Murabaha has been incompatible with the development role given to these banks. The real development has been mainly relying upon the establishment of the productive projects and permanently operating the manpower.

Overcoming this obstacle will be achieved only through short-term and long-term financing, which is usually embodied in al-Mudarabat and al-Musharakat; however, after various warnings to Islamic banks, the rationale of reliance on al-Murabaha has been undermined and thus declined. It currently

⁴⁴ "Standard & Poor's Financial Services Company Report," Alyaum.com, accessed March 11, 2013, <http://www.alyaum.com/News/art/101172.html>. A report issued by Standard & Poor's Financial Services Company for credit rating expected that the volume of the Islamic Bonds (sukuk) will reach more than 100 milliard dollars (100 billion dollars) by the end of the year.

⁴⁵ "Malaysia is the largest Islamic Bonds (Sukuk) Market," Eamaar.org, June 11 2012, accessed December 4 2013, <http://www.eamaar.org/?mod=article&ID=2897>.

ranges between 35 – 40% of the total bank financing after being very close to 80 – 90% at the beginning of the work of these banks. Perhaps the spread of the issuance and trading of the Islamic bonds (sukuk) in the stock exchange markets in the future may help the Islamic banks to solve the problem of relying on short-term financing for the possibility of liquefaction of the long-term investments represented in the bonds (sukuk), despite the problem of the necessity for these bonds (sukuk) to be in compliance with the Shari'a controls.⁴⁶

e. The small size of Islamic banks

This constitutes an obstacle in front of the development of banking in compliance with Shari'a, especially given that the largest bank in the world, "Deutsche Bank," has total assets of 2.8 trillion US dollars, whereas the volume of all the Islamic financing in the world currently amounts to 1.6 trillion US dollars. This means that the total volume of such financing represents only about half of the assets of the largest bank in the world. The big size of the Islamic banks represent only rare and limited models, like Al-Barakah Banking Group and the Islamic Development Bank, which is international and government of special nature. In addition to the development of the size of the banks, there is a need for human resources with experience of the mechanisms of Islamic financing and keeping the bonds (sukuk) in compliance with Islamic Shari'a.⁴⁷

f. The problem of the conflicts of the Fatwa and different standards

Conflicts have occurred on many occasions in the Fatwas between the authorities and organizations supporting the Islamic banking work, including the standard issued by the Accounting and Auditing for Islamic Financial Institutions (AAOIFI) for organizing and regulating the Tawaruq process. Later the International Islamic Fiqh Council (which is the largest and most famous Fiqh council) issued a Fatwa prohibiting the Tawaruq, especially the organized and the reverse ones.⁴⁸ It is necessary to solve the problem of such conflicts and different standards through unifying the Sahria Fatwa and

⁴⁶ S. Naser, "Volume of the Islamic Finance of Various Branches Internationally Is Nearly US \$6.1 Trillion," *Al-Jazirah Online*, accessed June 19, 2014, <http://www.al-jazirah.com/2014/20140614/ec13.htm>.

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*

setting standards and mechanisms for issuing the bonds (sukuk) in a unified way across most of the countries issuing the Islamic bonds,⁴⁹ and also by creating independent organizing authorities to ensure the safety of the bonds (sukuk) from the financial and Sahria side.

g. The costs of putting into bonds (sukuk) and providing the administrative and human resources capabilities

There are certain considerations that should be taken into account for the bonds (sukuk) process, as the costs of the bonds (sukuk) process may be high. This is because the cost includes not only the cost of the financing itself, but also the cost of the time for management and organization, and the necessary documentation thereof. It also includes the provision of administrative and human capabilities that may constitute a large financial burden, especially in the absence of the legal legislations regulating the Islamic bonds (sukuk) structure process, the lack of which constitute a challenge or real obstacle to Islamic banks entering into the area of bonds (sukuk) as issuer.⁵⁰

h. Some of the researchers considering bonds (sukuk) as a means for attracting the funds of the citizens in the banks and recruiting their savings

Instead of bearing the name "Investment Certificate", bonds (sukuk) bears the name "Islamic bonds (sukuk)", and these bonds (sukuk) are reproductions of the funds employing companies with the aim of collecting the savings of citizens or selling the State's assets.⁵¹

i. The bonds (sukuk) are connected with the interest rates index in the market

Among the challenges facing the bonds (sukuk) is their connection with the interest rates index in the International markets, known as "LIBOR". In addition, a strong criticism extended to the Islamic bonds

⁴⁹S. Al-Naser, "Several Challenges Face the Growth of the Islamic Sukuk," Aleqt.com, 2011, accessed June 5, 2014, http://www.aleqt.com/2011/05/08/article_535750.html.

⁵⁰ Al-Dammag, Islamic Bonds (Sukuk) and Their Role in Economic Development.

⁵¹ F. Jwaidah, "Bonds (Sukuk) and the Ten Sins," Egynews, 2013, accessed May 28, 2014, <http://www.egynews.net/wps/portal/articles?params=207926>.

(sukuk) that has worried many of the Islamic Shari'a Supervisory Bodies is that the proceeds are usually correlative with the interest rates in the international markets, and such correlation between the prices based on the usury, which is prohibited according to the Shari'a laws.⁵²

CONCLUSION

After reviewing the studies and reports related to the research subject matter, in addition to the author's own knowledge and experience in the reality of the Islamic bonds (sukuk) market and conventional bonds systems, this study concludes that it is difficult to say there is an independent system of financing able to accommodate all the potential investors who might seek to engage with the Islamic bonds framework. Therefore, it is suggested that a new financing system combining the pros of each of the capitalism systems and the Islamic financing system be created in order to eliminate all the potential flaws and defects of each. The features of the new system will be based on the contemporary Islamic Fiqh for the financial transactions, and the established, tested, and stable principles of capitalism, and will provide viable options for a unique combination. As long as the Islamic Shari'a basis for rules is not abandoned, the interests of the different parties associated with Islamic bonds (sukuk) can be accommodated. A harmonious financial system can achieve national financial stability in the countries that may adopt such a proposed system, which may finally positively influence the international financial system. Hopefully the end result will be the avoidance of another economic calamity and the other setbacks that the world has witnessed during the last two decades.

These proposals are based on the findings of this study, the most important of which are as follows:

- 1- There are significant differences between Islamic bonds (sukuk) and conventional bonds, especially the avoidance of interest (Riba) on the bonds and relying on the principle of participation in profit and loss as per the base (profit and loss sharing). In some ways they are similar, however, in that the industry of Islamic bonds (sukuk) operates in the same environment and conditions in which conventional bonds operate. They are both also exposed to similar risks in terms of volatility of interest rates and exchange rates.

⁵² A. Salman, "Continued Challenges Facing the Islamic Bonds (Sukuk) Issuances," *Al-Wasat Bahraini Daily*, August 10, 2009, <http://www.alwasatnews.com/2530/news/read/207980/1.html>.

Islamic bond markets should therefore learn from the experiences of conventional bond markets in terms of dealing with similar dilemmas.

2- There is a clear lack of any legislative framework capable of regulating the issuance of Islamic bonds (sukuk), listing them and trading in them in some Islamic countries. This has resulted in a lack of uniformity in the transactions related to this instrument. Different jurisdictions have conflicting visions of how Islamic bonds should work. Some of these differences stem from alternative viewpoints as to the applicable jurisprudence and confusion between religion and politics in matters that should be left to experts in the fields of economics investment and management.

3- There is still an insufficient contribution of Islamic bonds (sukuk) to achieving the desired growth and economic development goals of a given jurisdiction. Their nature and objectives are not compatible with the investment seen from other instruments and investment classes, such as foreign currencies, gold and silver. The negative impact on the economic growth of Islamic bonds is a result of the instrument not adding anything to the real economy but rather only increasing the level of debt.

4- Islamic bonds (sukuk) lack supporting regulatory infrastructure and institutions such as trading and settlement systems, evaluation and control institutions, accounting and auditing standards, as well as a clear legal frame to regulate the litigation procedures in disputes relating to dealing with such bonds (sukuk). Such regulatory infrastructure and institutions should be established in order to facilitate the growth of the Islamic bonds sector.

5- Islamic bonds (sukuk) face many credit, marketing and operational risks that will influence their adoption as an alternative to bonds unless such risks are avoided and taken into consideration when issuing the bonds (sukuk), in order to contribute to introducing an Islamic financial product with low risk. This factor relates to the adequate disclosure of financial product advice at the point of issuance.

6- Due to the short period of dealing in Islamic bonds (sukuk), the customs established by global markets, such as elements and structures, have not been applied and should not be overlooked to enable the bonds (sukuk) to find a place in these markets and with their clientele. This custom is duly ensured by the unity of conduct and behavior, common knowledge, and ensuring non-violation thereof.

7- Islamic bonds (sukuk) do not protect their holder from the risk of loss or failure of the investment. When an investor gains profit from returns that investor also bears the burden of loss, and even bankruptcy. Thus, bonds (sukuk) do not differ in any aspect from investment funds with high risks devised by western banks. Islamic bonds are also similar in character to the ownership of shares in any of the stock exchange markets. Growing regulation of Islamic bonds should therefore look at these experiences in this context to gain a perspective on best practice regulation.

8- Trading rules and regulations would have many benefits. If a complete framework of legal legislation to deal in Islamic bonds (sukuk) was created the Islamic securities market would be able to generate financial assets able to attract savings and provide profitable funding opportunities in various economic activities. This would require the legal regulation of the Islamic bonds (sukuk) trading market in all its aspects, such as the rules regarding trading and the specialized agencies of assessment.

9- There is still some confusion and lack of information about Islamic bonds (sukuk). This results in many potential investors turning away from Islamic bonds (sukuk) as an investment instrument to move their portfolios to competing instruments – mainly conventional bonds. Greater information and information availability will address this problem.

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