Shariah Principles of Sukuk Structure in Islamic Capital Market

Norlela Kamaluddin[1] and Siti Khadijah Ab. Manan[1*], Fadzlan Sufian[2] and Shila Nu Nu Htay[2]

[1]Academy of Contemporary Islamic Studies (ACIS), Universiti Teknologi MARA, 40450 Shah Alam, Malaysia

[2] IIUM Institute of Islamic Banking and Finance (IIiBF), IIUM. 205A, Jalan Damansara, 50480 Damansara Heights, Malaysia

[*]Corresponding Author
sitik274salam.uitm.edu.my

ABSTRACT

Malaysia as the pioneer of Sukuk has captured the global Sukuk share market positively and has a successful track record in innovating and commercializing many shariah-compliant products. Nevertheless, the literatures on Sukuk are far than enough particularly its theoretical aspect. This paper explains the definition and importance of Sukuk and the comparison between Sukuk and bond. Furthermore, the shari'ah principles in structuring Sukuk, namely profit sharing principles of Mudarabah and Musharakah; sale based principles of Murabahah, Bay' Bithaman Ajil, Salam and Istisna' and hire purchase principle of Ijarah will be described. This paper indicates that a continuous innovative and creative Sukuk structures are needed in order to protect the sustainability of Islamic financial sources.

Keywords: Sukuk, profit-sharing principles, sale based principles, hire purchased principle

1. Introduction

It was reported that the past decade witnessed the Islamic financial services sector growing at a rate of more than 10 percent annually and has accumulating assets estimated to be worth USD 700 billion worldwide (Standard & Poors, 2010). This expansion is also fuelled by the impressive increase in the issuance of Sukuk. The overall Sukuk issuance volume increased to USD 179 billion at the end of Q2 2011 compared to 2010 (Malaysia International Islamic Financial Centre (MIIFC), 2011). In both periods, Malaysia leads the global Sukuk's issuance by tapping 64.4 percent and 62.7 percent of the total market issuances respectively. In fact, Sukuk has emerged as a viable financing option particularly in the millennium. Although the value of Sukuk is still below the conventional bonds' value, its importance is reflected by a 22.2 percent cumulative average growth of the Sukuk's share in 2000 to 2010 period (Securities Commission Malaysia (SC), 2011). This average growth provides a clear evidence of the increasing popularity of Sukuk among corporate issuers and signifies the huge potential of this segment of the MICM. Furthermore, Sukuk plays a vital role at micro and macro levels. At a micro level, firms can equip maturity mismatched between liabilities and assets through the issuance of Sukuk, while at a macro level, governments can issue Sukuk to tackle fiscal imbalances.

As the pioneer of Sukuk, Malaysia has captured the global Sukuk's market tremendously and has played an important role for the development of Sukuk. Malaysia has a successful track record in innovating and commercializing many shariah-compliant products. The MICM product innovation and world first achievements from 1990 to 2011 are the evidence of important role and achievement of MICM domestically and globally. Among the examples are the issuance of the Bay' Bithaman Ajil Debt Securities in 1990, Global Corporate Sukuk Ijarah in 2001 and Tradable Sukuk Istisna' in 2003, and a hybrid Sukuk Wakala of a dual tranche USD2 billion in 2011.

The primary and secondary markets of the Islamic capital market (ICM) use many shariah concepts and principles to facilitate their functions. Profit sharing principles of Mudarabah and Musharakah are used for the equity market, sale-based principles such as Murabahah, Bay' Bithaman Ajil, Salam and Istisna' are applied in the debt market, while future contracts, option and swap are relevant to the derivative market. These principles are employed to develop the Islamic capital market's instruments. Among the instruments are Asset-Backed Securities - Islamic Medium-Term Notes (ABS-IMTN), Islamic Medium-Term Notes (IMTN) and Islamic Commercial Papers (ICP).

Realizing the importance of Sukuk and its uniqueness compared to the conventional debt instruments, this paper would therefore first explore the underlying principles of Sukuk and their application in structuring Sukuk instruments. Secondly, the paper then elaborates the definition and concept of Sukuk. Then, it discusses the important role of Sukuk. The gist of the paper is explained in the section that follows. The conclusion of the paper is presented in the last section.

2. Definition of Sukuk

Sukuk is the plural of *sakk* which literally means certificates and technically refer to securities, notes, papers or certificates with features of liquidity and tradability. According to SC Malaysia, Sukuk is a document or certificate, which evidences the undivided prorate ownership of underlying assets (Securities Commission Malaysia (SC, 2004)[1]. While Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI) defines *Sukuk al-Istithmar* as certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services in the ownership of particular projects or special investment activity, however, this is true after receipt of the value of Sukuk, the closing of subscription and the employment of the funds received for the purpose for which the Sukuk were issued (Engku Rabiah Adawiyah, 2008).

Sukuk can be distinguished from the conventional bonds instruments as they represent the undivided shares in ownership of assets, usufruct, projects and services (Abdullaah, 2005; Mohd Daud & Engku Rabiah Adawiyah, 2008). Sukuk also demonstrates the partnership relationship between the issuer and the investor. On the other hand, a bond is debt obligation, which can be either secured against certain underlying assets or unsecured in the form of a promise to pay. In return, the issuer promises the investors to pay back the amount plus interest at its maturity date. This situation of indebtedness is evidenced by the issuance of "IOU" certificate. It is named securities simply because the debt created by way of securitization is negotiable and tradable. In fact, securities are debts which are tradable by its nature. Table 1 below explains the comparison between Sukuk and bonds (Asyraf Wajdi, 2011).

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[1] "Sukuk is Islamic securities i.e. *any securities issued pursuant to any Shariah principles and concepts approved by the Shariah Advisory Council (SAC) of the SC as set out in Appendix 1* (The Malaysian Securities Commission's Guidelines on the Offering of the Islamic Securities' 2004 [IS Guidelines 2004] in Para 1.05(a). *Sukuk also a document or certificate which represents the value of an asset* (IS Guidelines 2004 in Appendix 1 (BB)." [4]

Table 1: Comparison between Sukuk and Bonds

No.	Sukuk	Bonds
1.	Holder owns assets	Holder owns cash flow only
2.	Use a variety of contracts to create financial obligations between issuer and investors; e.g. sale, lease, equity partnership, joint-venture etc.	Simply use a loan contract to create indebtedness
3.	Return linked to profit elements inbuilt in the sale, lease or partnership	Return linked to interest charged out of the loan contract
4.	Instrument may be equity or debt depending on underlying contract	It is a debt instrument
5.	Tradability of the Sukuk depends on the nature of the underlying asset	No restriction on the tradability
6.	Investment in shariah-compliant activities	Proceeds are invested in any business without restrictions

In many circumstances, Sukuk is wrongly defined and translated as Islamic bonds (Abdullaah, 2005; Wahida & Rafisah, 2010). In fact, sale-based securities in most situations could not be named as Sukuk as they represent the value of debt and not a real asset owned by the holders. The right term for debt-based Islamic securities is *Sanadat al-Dayn* (Mohd Daud & Engku Rabiah Adawiyah, 2008; Mohd Daud, 2003). *Sanadat* or *Sanadat al-Dayn* is a certificate represents the promise by the issuer to pay back the debt to the investors (creditors) based on a pre-agreed date of settlement. Hence, sale-based securities are rightly named as Islamic Debt Securities. These Islamic sale-based securities involve two controversial contracts, namely Bay' al-Inah and Bay' al-Dayn. However, the jurisprudential discussion of these two contracts is not within the scope of this paper. It is sufficient to note that these two concepts are rejected by most Middle-Eastern scholars and jurists.

Islamic securitization is classified into two categories which result in two unique products serving a similar purpose yet through a different class of underlying assets. The first category is the conversion of the shariah compliant debt into a tradable paper that can be bought and sold in the secondary market. This process is known as *tawriq* and is viewed as a similar arrangement to that of the conventional securitization process (Engku Rabiah Adawiyah, 2008; Mohd Daud & Engku Rabiah Adawiyah, 2008; Mohd Daud, 2003; Abdul Aziz, Razi & Gintzburger, 2009). The difference is that the subject matter of Islamic securitization must be based on a shariah-compliant arrangement, whereas for the conventional securitization the subject matter includes interest-bearing transactions. The second category is the transformation of shariah-compliant illiquid assets into investment certificates that are tradable in the secondary market. This process is known as *taskik* and the underlying asset for *taskik* is fixed assets, investment portfolios or transferable rights (Engku Rabiah Adawiyah, 2008; Mohd Daud & Engku Rabiah Adawiyah, 2008; Mohd Daud, 2003; Abdul Aziz, Razi & Gintzburger, 2009). The product of this process is known as the Sukuk. Thus, Sukuk is another result of the shariah-compliant securitization process.

3. Importance of Sukuk

Sukuk is an essential form of financial mobility between the surplus funds units (SFUs) and the deficit funds units (DFUs). Sukuk enhances the stability of financial institution by providing them with improved portfolio, liquidity and risk management tools. It is a direct intermediation route of financing productive investment by mobilizing funds from the SFUs to the DFUs. As a result, individuals, companies, multinational organizations, and others have access to a larger pool of investible funds rather than internally generated.

As for governments, they require a significant volume of investments in infrastructure over the next decade through external sources of financing because the domestic capital markets are often insufficient to satisfy the investment needs. In Malaysia for example, huge funds are needed for infrastructure development and Sukuk is an alternative access to the funds. Until May 2011, 89 percent of the total securities issuance in the main market and ACE market is Sukuk compared to its conventional bond counterpart of 11 percent (110) (Securities Commission Malaysia (SC), 2011). Among all sectors, Sukuk has dominated 100 percent of the total securities raised for infrastructure and mining sector. Further, more than 90 percent of Malaysia securities for financing the industrial product, construction, technology, plantations and consumer product sectors are Sukuk, and 80 to 89 percent of Malaysia securities for trade and services and real estate sectors are also Sukuk.

4. Shariah Principle and Structure of Sukuk

The development of the Islamic capital market (ICM) in Malaysia has been guided by the long-term strategy outlined in the country's Capital Market Master Plan to make Malaysia as an international centre for Islamic capital market activities and followed by Capital Market Master Plan 2 (CMMP2) to widen Islamic capital market internationally (Malaysian ICM Quarterly Bulletin (MICMQB), 2011). The CMMP2 outlines the strategies to transform the competitive dynamics of Malaysia's capital market over the next 10 years. The strategies are promoting capital formation, expand intermediation efficiency and scope, deepen liquidity and risk intermediation, facilitate internationalization, and build capacity and strengthen information infrastructure (Capital Market Master Plan 2 (CMMP2), 2011). The strategies aim to expand the role of capital market in financing business ventures, creating jobs, widening the ownership of assets, and generating returns on long-term savings, foster an innovative and diverse intermediation. In addition, the role of Securities Commission and other supportive institutions such as Islamic Capital Market Department (ICMD) and the Shariah Advisory Council (SAC) have also contributed to the development.

The ICMD and SAC were established in 1996 to advise the SC on all matters relating to the development of ICM and a reference centre for all ICM issues (Securities Commission Malaysia (SC), 2009). In addition, SAC is in charge of the analysis of shariah principles in introducing new products and services for the ICM and to determine the extent to which existing conventional capital market instruments comply with the shariah. The SAC has established several benchmarks in order to determine the tolerable level of mixed contributions from permitted and non-permitted activities, based on reasoning from the source of shariah by qualified shariah scholars (Securities Commission Malaysia (SC), 2011). The securities of the company will be classified as the shariah-compliant if the contributions from non-permissible activities do not exceed the benchmark of 5-percent for activities that are clearly prohibited such as interest, gambling, liquor and pork; a 10-percent benchmark for activities that involve elements that affect most people and are difficult to avoid such as interest income from fixed deposits and a 20-percent benchmark for non-shariah compliant activities such as rental payments from premises that involved in gambling, sale of liquor, to name a few and a 25-percent benchmark for activities that may affect the shariah-approved status such as hotel and resort operations, share trading, stock broking and other activities that are non-permissible. Subsequently, the SC compiles the decisions of the SAC and published the list of shari'ah-compliant stocks twice a year. The list of shariah-compliant stocks gives investors, the necessary guidance, opportunity and confidence to select and invest in the listed securities or companies that comply with the shariah principles.

In Malaysia, the shariah principles in Sukuk are Murabahah [mark-up sale], Bay' Bithaman Ajil (BBA) [deferred payment sale], Bay' Inah [sale with immediate repurchase], Bay' Istijrar [supply sale], Bay' Salam [advance sale], Bay' Wafa [sale and repurchase], Ijarah [leasing], Ijarah Thumma Bay' [lease to purchase], Istisna' [purchase order], Mudarabah [profit sharing], Musharakah [profit and loss sharing] and Qard Hasan [benevelont loan]. Generally therefore, Sukuk are classified into three namely the equity-based Sukuk (EBS) formulated from the contract of Mudarabah and Musharakah,; the debt-based Sukuk (DBS) originated from the contract of Qard al-Hasan, Murabahah, Salam, Istisna' and Ijarah; and the hybrid Sukuk (HMS) structured from the combination between the contract of Ijarah, Murabahah and Istisna'. In addition, the supplementary shariah principles applied in Sukuk are Bay' Muzayyadah [open-biding trading], Bay' al-Dayn [debt trading], Kafalah [guarantee], Hak Tamalluk [ownership right], Hibah [gift], Hiwalah [remittance], Ibra' [rebate], Ittifaq Dhimni [pre agreed contract], Rahn [collateral], Ujrah [fee] and Wakalah [agency].

Basically, there are three players involved in Sukuk arrangement, namely the originator of Sukuk (the obligor), the Special Purpose Vehicle (the issuer of Sukuk certificate), and the investor (the buyer of the Sukuk certificate). The process of issuing Sukuk involves the following steps (Mohd Daud, 2003):

a) The origin of assets (in conventional finance, these are normally loans or other receivables, while in Islamic finance they are shariah-compliant assets such as the subject matter of Ijarah);

b) The transfer of the assets to a special purpose entity (SPE)/special purpose vehicle (SPV) which acts as the issuer by packaging them into securities (Sukuk); and

c) The issuance of the securities to investors.

The Murabahah facility involves the purchase of assets by the financiers and the immediate sale of those assets back to the issuer with a markup agreed upon by both parties. The issuer's obligation to settle the purchase price is securitized via the issuance of Murabahah Notes (Engku Rabiah Adawiyah, 2008; Mohd Daud, 2008; Muhammad Ayub, 2007;

Dar & Azami, 2010). Similarly, in Bay' Bithaman Ajil (BBA) facility, the issuer sells the assets to the financiers who immediately sell it back to the issuer with a higher price. However, the payment of the debt is usually on an installment basis with a longer period compared to Murabahah facility. In substance, it works exactly like the long-term Murabahah, except that payment can be in deferred terms. Bay' Bithaman Ajil Sukuk can be structured to simulate fixed rate Sukuk (Mohd Daud, 2008; Muhammad Ayub, 2007; Dar & Azami, 2010). The mechanism of the basic arrangement of Murabahah and Bay' Bithaman Ajil Sukuk is explained below:

Stage 1 : Resale of the asset at the selling price (creation of debt-based on Murabahah or BBA).

Stage 2 : The issuer issues Sukuk evidencing of debt (debt certificate) arising from the first sale contract to the primary subscriber. This is a process of securitization.

Stage 3 : The subscriber will trade the Sukuk in the secondary market using Bay' al-Dayn contract.

In Bay' Istisna' principle, the issuer and contractor will enter into a construction contract. This contract is an order made by the issuer to the contractor. Even though the identified assets are uncompleted, ownership already lies with the issuer. Therefore, the issuer can sell the uncompleted assets to the financiers. The financiers will then resell the assets to the issuers based on deferred payment terms. The issuer's obligation to settle the purchased price is securitized via the issuance of Istisna' notes (Engku Rabiah Adawiyah, 2008; Mohd Daud, 2008; Muhammad Ayub, 2007; Dar & Azami, 2010). The basic arrangement of Istisna' Sukuk structure is as follows:

Stage 1 : SPV issues Sukuk certificates to raise funds for the project.

Stage 2 : Sukuk issue proceeds are used to pay the contractor/builder under the istisna' contract to build and deliver the future project.

Stage 3 : Title to assets is transferred to the SPV

Stage 4 : Completed property/project is leased or sold to the end buyer. The end buyer pays monthly installments to the SPV

Stage 5 : The returns are distributed among the Sukuk holders

Ijarah is another principle being used to issue Sukuk. Unlike lease financing under conventional methods, the responsibility to maintain the underlying asset under the Ijarah facility rests on the lessor (i.e. the financiers) (Engku Rabiah Adawiyah, 2008; Mohd Daud, 2008;

Muhammad Ayub, 2007). The lessee is only responsible for lease payments as long as the asset is operational. Otherwise, the lease will be suspended until the asset is repaired. Thus, the onus is on the lessor to ensure that the asset is maintained. The costs for maintenance will be passed on to the lessee. In June 2002, Malaysia successfully launched the world's first international Islamic Sukuk issue based on the Ijarah concept, namely Malaysia Global Sukuk Incorporation. The mechanism of the basic arrangement of Ijarah Sukuk structure is as follows:

Stage 1 : Contract of cash sale (Bay' Mutlakah) - SPV purchases property from obligator (government). The asset purchased is funded by the issuance of Sukuk. The government receives cash proceeds.

Stage 2 : Contract of leasing (Ijarah) - SPV rents property to the government for specified period and collects rentals.

Stage 3 : During the tenure, SPV passed the rentals to investors periodically.

Stage 4 : At maturity, SPV sells the property to the government at an agreed price and the government pays cash to SPV. SPV simultaneously pays investors cash for Sukuk redemption.

Sukuk under the profit-sharing contracts of Mudarabah and Musharakah are also issued in Malaysia. In 2006, twenty-seven out of sixty-four Malaysia's Sukuk are based on Mudarabah, Musharakah and Ijarah principles (Engku Rabiah Adawiyah, 2008; Mohd Daud, 2008; Muhammad Ayub, 2007; Dar & Azami, 2010). They are considered as high-risk tools because returns to the financiers are uncertain as they depend on the performance of the business or project involved. Unlike conventional financing, the financier of Sukuk under these two concepts must also bear an equity risk in addition to the credit risk. The following stages explain the arrangement of Mudarabah Sukuk:

Stage 1 : Issuer issues Sukuk to the investor by entering the Mudarabah contract and the investor provides the capital to the issuer.

Stage 2 : Issuer invests the capital in a project.

Stage 3 : The profit will be shared and distributed as a pre-agreed proportion by the issuer and the investor.

Stage 4 : Any losses from the project will be totally borne by the investor.

In Musharakah Sukuk, corporate and the Special Purpose Vehicle (SPV) enter into a Musharakah arrangement for a fixed period and agreed profit sharing ratio and the appointment of the corporate as an agent to develop the land. Any losses will be apportioned based on the contributed capital. The corporate undertakes to buy Musharakah shares of the SPV on a periodic basis. The mechanism of the basic arrangement of Musharakah Sukuk is elaborated as follows:

Stage 1 : Corporate (as Musharik A) contributes land or other physical assets to the Musharakah.

Stage 2 : SPV (as Musharik B) contributes cash, that is, the issue proceeds received from the investors to the Musharakah.

Stage 3 : The corporate as an agent of the Musyarakah to develop the land (or other physical assets) with the cash injected into the Musharakah and sell/lease the developed assets on behalf of the Musharik B.

Stage 4 : In return, the agent (the corporate) will get a fixed agency fee plus a variable incentive fee payable.

Stage 5 : The profits are distributed to the Sukuk holders.

Stage 6 : The corporate irrevocably undertakes to buy at a pre-agreed price the Musharakah shares of the SPV on say semi-annual basis and at the end of the fixed period, the SPV would no longer have any shares in the Musharakah.

Generally, Sukuk inherently entails an exposure to certain market and financial risks such as interest rate risk and default risk. Its exposure to risks may be similar to that of the conventional. However, shariah rules and principles may add an extra dimension to the existing risk exposures (i.e. shariah compliance risk) and may have a material effect on the risk profile of Sukuk holders (Shamshimah, Fauziah Hanim, Abd. Halim & Noor Azizi, 2011). Recently, Islamic finance has serious problem with the default risk whereby it was officially reported that there were 15 and 31 cases of corporate Sukuk defaults in 2009 and 2012 respectively (Khnifer, 2010; Khnifer, 2012). The most concerning fact is that there were 26 registered Sukuk default in Malaysia from 1990-2011 (Rating Agency Malaysia Berhad (RAM), 2011)[2]. An example of Malaysian defaulted Sukuk is Tracoma's RM100 million BaIDS. The default was the result of credit events such as a delay in depositing the monthly amount in the PSA required for the upcoming profit payments, a failure to meet

[2] Corporate defaults rated by Rating Agency Malaysia Berhad (RAM) from 1992 to 2011 totalled 49 with a rated value of RM12.2 billion and defaulted Sukuk were eight. While corporate defaults rated by Malaysian Rating Corporation Berhad (MARC) for the 12-year period from 2000 to 2011 totaled 31 and Sukuk defaults were 18 [22].

the principal redemption of its first RM50 million series based on the original scheduled maturity and extension of its maturity scheduled principal. Although the default rate[3] and numbers of Sukuk defaults in Malaysia are relatively small and have not been widely discussed, the issue raises concern on the investors' protection, issuers' capital structure strategies and the survival of Malaysian Islamic capital market in the future (Malaysian ICM Quarterly Bulletin (MICMQB), 2009). Nevertheless, each Sukuk default represents another incremental opportunity for increased knowledge about the relevant Sukuk and its underlying structures. That increased knowledge will better equip those structuring and documenting Sukuk transactions to understand and address the risks facing those Sukuk transactions as Sukuk is new compared to the bond.

5. Conclusion

It is undeniable that Sukuk is a viable source of financing for the economic and social development. The presence of Sukuk as an alternative financial instrument in the market would allow those investors seeking shariah-compliant investment avenue to park their capital Islamically. Nevertheless, Sukuk is just like any other financial instruments which are prone to risks. Hence, innovative and creative Sukuk structures are needed in order to protect the sustainability of Islamic financial sources provided that it must follow the shariah principles. Furthermore, as the case of Sukuk defaults are increasing, it is therefore worthwhile to investigate the determinants of Sukuk default in order to guide the structuring of Sukuk issuance as well as their trading system.

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[3] RAM's average default rate is 1.4% (1992-2011) and MARC's average default rate is 2.6% (2000-2011).

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