

## **ŞUKŪK MARKET: INNOVATIONS AND CHALLENGES**

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*Şukūk products offer a vast scope of innovation and a large potential for the growth of Islamic finance. Various structures of şukūk based on ijārah, mushārahah, muḍārbah and many hybrids such as şukūk based on the combination of ijārah with istiṣnā' or the combination ijārah with istiṣnā' and murābahah etc., has evolved. Structures with convertibility features and those allowing the possibility of substitution of the underlying assets have also come in the market. However, these innovations have generated various Sharī'ah, legal and economic issues and controversies. This paper discusses some of these important issues and challenges. Specifically, it deals with the issues of capital guarantee, contractual structures, pricing, and asset substitution in case of ijārah şukūk, mushārahah şukūk, and their various forms. It also covers the issues pertaining to rating of şukūk, harmonization of Sharī'ah rules, and problems involved in defining the governing law for şukūk issuance.*

### **1. INTRODUCTION**

The size of global Sharī'ah-Compliant assets is estimated at about \$400 billion to \$500 billion. Institutions like Standard & Poor's Ratings Services believe that the potential market for Islamic financial services is closer to \$4 trillion, meaning that Islamic finance currently has only achieved about 10% of its potential and therefore still has a long way to go. The market share of Islamic financial institutions is estimated to stand at 12 per cent in Malaysia and 17 per cent in the six GCC countries where it is growing faster than anywhere else.

One area of Islamic finance that attracted and continues to attract a lot of interest from the business community worldwide is the global *şukūk* market. The market is currently estimated at \$70 billion in value, and is expected to top the symbolic \$100 billion mark by 2010, according to recent estimates.<sup>1</sup>

Companies and governments seeking capital for the huge infrastructure projects

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<sup>1</sup> Standard and Poor's (2007, April).

from the Gulf region and across the Muslim world are expected to sell about \$30 billion of Islamic bonds during the next three years. It is also projected that in the next decade, there will be over \$1 trillion worth of investment opportunities in substantial projects in the Gulf region alone<sup>2</sup> and the *ṣukūk* market is presumed to play an important role in securing these funds. Even outside the Muslim world the issuance of *ṣukūk* is gaining momentum. After the 100 million Euro *ṣukūk* issued by Saxony Anhalt in Germany, the British Government is looking into issuing its first Sharī'ah-compliant bond in a bid to boost London's position as a centre for Islamic finance<sup>3</sup>. Japan is also considering issuing *ṣukūk*.<sup>4</sup>

However, the challenge that lies ahead is on the area of financial instruments and products innovation in the Islamic capital market in general and the *ṣukūk* market in particular. It is true that the *ṣukūk* structures are now to some extent diversified. We have, for instance, *ṣukūk* based on *ijārah*, *mushārahah*, *muḍārbah* and hybrid *ṣukūk* based on the combination of *ijārah* with *istiṣnā'* or the combination *ijārah* with *istiṣnā'* and *murābaḥah*. However, more instruments are needed and existing products need to be refined as some *ṣukūk* structures are still debated and contested.

The present paper will look at the existing structures of *ijārah ṣukūk* whether they are based on the concept of sale and lease-back mechanism or the head lease and sub-lease structure and the criticisms addressed against these structures. The paper will touch on some of the criticisms addressed against the *ijārah ṣukūk* structure such as (i) the issue of guarantee and whether it transforms the transaction into a form of *ribā al-duyun* or not, (ii) the mechanism of sale and lease back and whether it resembles *bay' al-wafā'* or *bay' al-inah* rejected by the majority of Muslim scholars, (iii) the purchase undertaking at a pre-determined price representing the original or principal amount of the *ṣukūk* and finally, (iv) the pricing mechanism of *ṣukūk* issuance which is generally tied to the London Inter Bank Offer Rate (LIBOR) and not to the actual rental of the asset underlying the *ṣukūk* issue.

A basic requirement for Sharī'ah compliance of any *ṣukūk* structure is that it shall be backed by tangible assets. However, a concern has been voiced regarding the limited number of assets eligible for *ṣukūk* under the ownership of Islamic financial institutions or corporations looking for fund raising. This shortfall of eligible assets could impede or slow down the regular issuance of *ṣukūk*. However, a recent innovation has permitted the substitution of the *ṣukūk* asset during the life of the *ṣukūk* to address these apprehensions. The paper will outline the main feature of this experience.

As a sign of innovation, a number of important Global *ṣukūk* transactions have

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<sup>2</sup> Standard and Poor's (2006, October).

<sup>3</sup> Parker, Mushtaq (2007, April).

<sup>4</sup> *Financial Times* (18 August 2006).

been issued in the past two years under the *mushārah* structure. However, this mechanism has become a point of serious controversy among Sharī‘ah boards of Islamic financial institutions. While some Sharī‘ah Boards approved the structure or allowed their respective institutions to invest in such business deals, others have prevented institutions under their respective supervision to invest in such *ṣukūk* viewing them Sharī‘ah non-compliant. The main issue of disagreement has been the permissibility for one of the *mushārah* partners to give an undertaking to purchase the shares or units of the second partner of the *mushārah*, at the maturity of the *ṣukūk*, at face value and predetermined price. A number of Sharī‘ah scholars uphold the permissibility of such an undertaking and as a result validate all *mushārah ṣukūk* issuance in the market. It should be noted that such a purchase undertaking is allowed, according to the proponents of this opinion, under *Sharikat al-milk* and not under *Sharikat al-‘Aqd*. However, is there any genuine difference between the two contracts that justify permissibility under *Sharikat al-milk* and not under *Sharikat al-‘Aqd*? The paper will look at the implications of the purchase undertaking by one of the partners at pre-agreed price.

Economic value added and Sharī‘ah compliance are at the heart of product development in *ṣukūk* market. It thus requires a process of Sharī‘ah approval. Unfortunately, it seems that the existing mechanism of Sharī‘ah scholars’ involvement in product development, harmonization and approval may not be adequate enough for a rapidly growing market that needs to expand according to international standards of best practices and at the speed of market demand. Organizations such as the OIC Fiqh Academy or the AAOIFI Sharī‘ah Board have done commendable job but they are still suffering from a number of shortcomings. For instance, the practical aspects of *ijārah ṣukūk* or even the theoretical characteristics of the *mushārah ṣukūk*, and despite their existence in the market for a number of years, have not yet been discussed by the Fiqh Academy which is in reality the highest and most influential Sharī‘ah institution addressing financial issues. Thus, there is no Sharī‘ah resolution from these institutions determining what is Sharī‘ah compliant and what is not. Such a vacuum might have grave consequences to the industry as a whole and the *ṣukūk* market in particular. Thus, any future resolution by the Academy against the existing structures might create a controversy that might erode market confidence on the *ṣukūk* market. At the same time any approval of the existing structures, despite their shortcomings, might constitute a compromise of Sharī‘ah principles. The present paper addresses the shortcomings in the Sharī‘ah scholars’ institutional decision making and their present involvement in capital market product development and suggests solutions to the problem.

A key development within the Islamic capital markets products and their acceptance into the global financial system is the increased use of credit ratings in *ṣukūk*. However, almost all conventional rating agencies are using conventional methodologies to rate Islamic financial instruments including *ṣukūk* despite the acknowledgement of these rating agencies that Islamic financial institutions and

instruments have their own characteristics. The international Islamic rating agency is supposed to play a pivotal role in addressing the issue but no major headway has been achieved yet. The paper will assess the status of *ṣukūk* rating and its impact on the development of Islamic capital markets.

A properly functioning financial market depends on the enforceability of the contracts concerned. However, looking at the governing laws of *ṣukūk* in the market it is clear that many contracts forming these transactions are governed by conventional laws such as the English law. This is despite the fact that all contracts are supposed to be based on Sharī'ah principles and should not contradict its general principles. The paper will look at the impact of this legal dilemma and its impact on the development of a stable and long-standing Islamic capital market.

## 2. CRITICISM AGAINST THE *IJĀRAH ṢUKŪK* STRUCTURE

The *ijārah ṣukūk* structure was the first *ṣukūk* structure marketed at a global level. The structure has been used by sovereign as well corporate bodies. However, it has also been criticized by some Sharī'ah scholars.

One of the most mentioned objections against *ṣukūk-ijārah* is the issue of guarantee. Generally, in *ṣukūk* issuance, a third party who is normally the originator of the *ṣukūk* will provide a guarantee for the principal capital of the *ṣukūk*.

### 2.1. Guarantee in *Ṣukūk* Issues

The issue of guarantee generally arises when the originator (sovereign or corporate) benefiting from the *ṣukūk* proceeds establishes a Special Purpose Vehicle (SPV) that issues the *ṣukūk* while the originator stands by to provide a guarantee against any shortfall.

The first collective resolution regarding Guarantee in *ṣukūk* was issued by the Islamic Fiqh Academy in its resolution 30(5/4) pertaining to *muqāraḍah ṣukūk*. The resolution states the following:

"There is no Sharī'ah objection to mention in the prospectus of the issue or in the document of *muqāraḍah ṣukūk* the promise of a third party, who is independent personally and in term of financial liability from the two parties to the contract, to volunteer an amount of money for no consideration to be allocated to make good a loss on a particular project. However, this is circumscribed with a condition that such a promise should be an obligation independent from the *muḍārabah* contract. In other words, the third party performance of his obligation should not be a condition for the enforcement of the contract and the conditions and liabilities of the parties to the contract. As such, neither the bond holders nor the manager of the *muqāraḍah* would be entitled to claim that they may fail to honour their obligations relating to their contracts because the volunteer failed to fulfil his promise and the performance

of their obligations takes into consideration the promise from the volunteer."<sup>5</sup>

The AAOIFI Sharī'ah Standards No.17. on Investment *ṣukūk* states the following:

"The prospectus must not include any statement to the effect that the issuer of the certificates accepts the liability to compensate the owner of the certificates up to the nominal value of the certificates in situations other than torts and negligence nor that he guarantees a fixed percentage of profit. It is, however, permitted to an independent third party to provide a guarantee free of charge, while taking into account item 6/7 of Sharī'ah Standard No. (5) in respect of guarantees. ..." <sup>6</sup>

This position of the AAOIFI shall also be read in close link with what has been stated in Standard No. 5 concerning the issue of guarantee in particular. The standard states the following:

"It is permissible for a third party, other than the *muḍārib* or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the *muḍārabah* financing contract or investment agency contract."<sup>7</sup>

Based on the above, the concept of third party guarantee has become one of the widely used mechanisms to protect investors in *ṣukūk*. Theoretically, the third party guarantee shall be benevolent and without any fee or consideration. Thus, if the third party guarantee is benevolent and given by a public entity such as the government for the sake of encouraging investment in the country, contemporary Muslim scholars have two opposing opinions on the issue.

The first group argues that guaranteeing the principal in *ṣukūk al-muḍārabah* or *ṣukūk mushārah* or even *ṣukūk al-ijārah* will definitely open the door of *ribā*. Moreover, it contradicts the nature of *muḍārabah* contract whereby guarantying the capital is prohibited by all schools of Islamic law. In addition, even if the third party guarantee is given by the government as it is suggested by the proponents of this opinion, it shall be declared non-permissible as the government treasury is the property of the whole community and should not be exposed to financial risk and venture of some individuals or entities. Finally, if the third party is not a government it would not be imaginable from a practical point of view for an entity to provide a benevolent guarantee to another entity without a specific consideration, be it a monetary consideration or services.<sup>8</sup>

<sup>5</sup> Islamic Fiqh Academy, Resolution no 30(5/4).

<sup>6</sup> AAOIFI Sharī'ah Standards no.17. on Investment *Ṣukūk*, clause 5/1/8/7.

<sup>7</sup> AAOIFI Sharī'ah Standards no. 5 on Guarantees, clause 7/6.

<sup>8</sup>See Al-Shibali, Yousouf Abdullah (no date), *Al-Khadamat al-istithmariyyah Fi al-Masarif Wa Ahkamuha fi al-Fiqh al-Islami*, vol.2, pp.140-147.

The second group argues that as long as the third party providing the guarantee has its own legal and financially independent personality from that of the contracting parties, he can guarantee the whole capital or a specific percentage of it. This is based on the general principles that every thing is permissible unless there is a clear text about its prohibition and there is no text prohibiting a guarantee from a third party. Indeed such a guarantee will not be permissible if it is coming from the partner of the *muḍārabah*.

From practical point of view let us take the example of guarantees in two early global *ṣukūk* structures. First, we have the Trust certificates issued by Solidarity Trust Services Limited (SPV), whereby the originator was the Islamic Development Bank (IDB). The second is the case of the *ṣukūk al-ijārah* issued by Malaysia Global (SPV) where the originator was the Government of Malaysia. Thus, it is argued whether Solidarity Trust Services Limited, a wholly owned subsidiary of the Islamic Development Bank, or Malaysia Global *ṣukūk*, an SPV 100% owned by the Ministry of Finance, Malaysia, are independent legal entities and autonomous in terms of financial liability from the guarantors, the Islamic Development Bank and the Government of Malaysia respectively. For the proponent of the permissibility of the two examples the above principle of third party guarantee would have been observed in the two transactions because legally the issuers in the two cases have their independent legal entity which is totally separated from that of the originators and therefore the two transactions are permissible.

The second group of scholars on the other hand, maintains that the transaction will be a kind of *ribā al-Duḡun* because of the following:

1. Through this guarantee the amount invested in the Trust Certificates will be redeemed in full on the date of maturity (100%) or even earlier as the principal amount invested in the certificate is guaranteed by the Islamic Development Bank or the Government of Malaysia.
2. In addition, Certificates holders are entitled to receive periodic distribution amount calculated on the basis of fixed return per annum in respect of the Trust Certificates.

Based on the above, the opponents of third party guarantee in *ṣukūk* argue that in such cases where the capital invested is guaranteed by the issuer or any interested party in the transaction and when the capital owner is entitled to receive periodic payment as proceeds of the capital, and in the form of a fixed percentage rate, the transaction would be akin to an interest based transaction. Moreover, the Islamic Development Bank or the Government of Malaysia in these particular cases are not mere third parties whose gratuitous guarantee might be permissible or not. In fact, both originators have vested interests in the issuance of these *ṣukūk*. The guaranteed fund is used to purchase the *ṣukūk* of IDB for instance, and in the absence of the guarantee the fund will not have been collected and the *ṣukūk* will

not have been marketed.

## 2.2. The Sale and Lease Back Structure

The second criticism against the *ṣukūk al-ijārah* structure is not confined to the *ṣukūk* market but goes beyond that. It touches on the Shari‘ah compliance of one of the widely used instrument by the Islamic finance industry. It is about renting an asset to the party who sold it. The issue is also at the core of the *ijārah ṣukūk* structures.

It is argued by the opponents of the structure that it is just another form of *bay‘ al-wafā* or a variation of *bay‘ al- istighlal* or a kind of *bay‘ al-inah* which are all types of contracts contested by the majority of Muslim scholars .

*Bay‘ al Wafā* is allowed by a minority of Muslim scholars, but rejected by the majority and the Islamic Fiqh Academy in Jeddah passed a resolution in 1412AH (1992) disallowing it. *Bay‘ al-Wafā* is a contract whereby the owner of an estate (house or land) sells it, with a condition that he will have it back once he returns its price to the buyer. In other words, he who needs cash sells his estate in cash, with the condition that whenever he returns the cash to the buyer, the latter returns to him his estate. Thus, it is a sale contract with an attached condition of abrogation, the seller returns the cash and the buyer returns the estate.

Thus, it is argued, even if the estate was rented out to the seller, this means renting the estate (or selling it on instalments) to who sold it in cash would give the same result as renting could be a *ijārah muntahiya bi al- tamleek* (a renting contract that ends with ownership) and therefore, the transaction of sale and leaseback is similar to *bay‘ al-wafā* contract.

The concept of sale and lease back is also similar to *bay‘ al- istighlal* according to those who reject the structure. *Bay‘ al-istighlal* or the exploitation sale is to sell an estate with a promise condition, whereby the seller leases out this estate and whenever he pays back the price, he gets back his estate and this is the end result of the concept of sale and lease back.<sup>9</sup>

The concept of sale and lease back is also considered as a form of *bay‘ al-inah*, which is prohibited by the clear *ḥadīth* of the Prophet especially when the sale and lease back is combined with a purchase undertaking at pre-agreed price from the original seller. This is because the main feature of *Bay‘ al-inah* is that the merchandise returns back to the seller and the same happens in the sale and lease back mechanism. In *al-inah* contract, there are two sales in one transaction, one with a spot specific price and the other with a deferred higher price. For example, someone sells an item for SR1000 and buys it back in cash for SR900, which means he borrowed SR.900 to be repaid SR.1000. Thus, the *ribā* in *bay‘ al-inah* is the difference between the two prices.

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<sup>9</sup> See, al-Masri, Rafic Yusus (2006/ 1427 A.H.).

Based on the similarities and end result between the above three type of contracts the sale and lease back structure is considered as stratagem to *ribā*. It shall be noted that the concept of sale and lease back has been approved by the Sharī'ah Board of the Accounting and Auditing Organization of Islamic financial Institutions.

### 2.3. Pricing of *Ṣukūk*<sup>10</sup>

The pricing of *ṣukūk* is another point of criticism against Islamic bonds. Muslim economists and Sharī'ah scholars have not come up with an alternative to the interest rate as a readily available indicator of profitability. Hence the use of LIBOR as a benchmark has become part of the practice in Islamic financial institutions. However, what shall be noted is that while it is permissible to use LIBOR as a benchmark it is not correct to rely on it for determination of returns. In *ṣukūk al-ijārah* the *ṣukūk*holders are supposed to receive their returns from the rent of the underlying asset of the *ṣukūk*. However, in practice this return is not at all reflecting the rental of the underlying asset but the prevalent interest rate. For example, if there are two real assets which are totally different from each other, then based on market realities we expect to have different rental income on them. However, it is observed that same rate of return, as reflecting the prevailing interest rate, is paid on them if they are used as underlying assets for two different *ṣukūk* issues. Such a practice is definitely unacceptable from Sharī'ah perspective. Even from practical point of view it has commercial implications. Specific *ijārah ṣukūk* using certain real estate properties as underlying assets and despite the fact that rent of properties is going up in this particular jurisdiction where the assets are located, *ṣukūk*holders will end up getting their returns coming down because the interest rate is coming down in the international market. Thus, return on *ṣukūk* is not reflecting the performance of the underlying asset but the prevalent interest rate.

The above fact is clearly reflected in the recent widening of interest rate spreads whereby the *ṣukūk* issuers are forced to be reworking their pricing scale exactly as it is in the conventional bonds.<sup>11</sup>

### 3. ADDRESSING THE SHORT SUPPLY OF ELIGIBLE UNDERLYING ASSETS FOR *ṢUKŪK*

One of the fundamental difference between a Sharī'ah compliant *ṣukūk* issuance and conventional bond structures is the requirement of a tangible asset to underlie any *ṣukūk* issuance. However, one of the challenges in accessing the *ṣukūk* market and assuring continuity in *ṣukūk* issuance is determination and segregation of the pool of assets that will produce a Sharī'ah-compliant income stream. Interest-based income securities can be backed by pure receivables (e.g. credit cards or mortgages used in conventional asset-backed financing). However, these will not qualify as

<sup>10</sup> See, Sharī'ah Standards No. 9.

<sup>11</sup> See, Augustine, Babu Das (2007, July 25).

acceptable assets under Sharīḥ. To date, a popular asset class for *ṣukūk* issuance has been real estate or other tangible assets. The rental income generated by these assets can provide cash flow returns to the *ṣukūk*holders, and the originator's obligation to repurchase these assets ensures principal repayments on scheduled maturity dates. Other eligible asset classes for *ṣukūk* include goods or commodities, and movable assets like aircrafts and motor vehicles. However, the problem is that the eligible assets are limited and a company that had issued *ṣukūk* using certain assets as underlying asset in a specific issue has to wait until maturity before being able to make use of the same underlying assets again. This issue is considered as one of the impediments that may limit the growth of the *ṣukūk* industry.<sup>12</sup>

This problem has been addressed through an innovative structure used in DAAR *ṣukūk* I & II. In this structure the underlying assets of the *ṣukūk* were certain properties that included specific land and buildings. The originator or beneficiary of the *ṣukūk* was Dar al-Arkan, a Saudi real estate development company. The issue was managed by a consortium of leading banks while the Sharīḥ and structuring adviser was Unicorn Investment Bank.

The originator of the *ṣukūk*, as property developer, may need to repossess the underlying assets of the *ṣukūk* once again before the maturity of the *ṣukūk*, say, in order to be able to sell it in the market and use their income for its next phase of property development. The originator, therefore, would like to replace the assets underlying the *ṣukūk* with some other assets. However, based on the *ṣukūk* issuance structure these properties underlying the *ṣukūk* are under the ownership of the *ṣukūk*holders until the maturity of the *ṣukūk* while the originator is just a lessee. Although the originator who is the lessee has the right to purchase these assets at the maturity of the *ṣukūk* through the purchase undertaking he signed with the issuer or the *ṣukūk*holders, he has to wait. No solution was in place for such situations.

The innovative structure in DAAR *ṣukūk* addresses this concern. In such situations the parties may agree that the property underlying the *ṣukūk* assets may in certain circumstances be substituted in whole or in part at the option of the originator on any periodic distribution date, pursuant to the terms of a property substitution undertaking.

For a better understanding of the structure, it would be useful to outline at the outset the general characteristics of an *ijārah ṣukūk* structure and how a substitution undertaking fits in.

### **3.1. General Characteristics of Modern *Ijārah Ṣukūk***

If an Islamic financial institution wants to tap the debt market in a Sharīḥ compliant manner using the *ijārah ṣukūk* structure the following steps are generally followed:

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<sup>12</sup> Clifford Chance (2006, September).

- A special purpose company needs to be established, it can be called for this general description Islamic Global *ṣukūk* (IGS).
- The IGS will issue trust certificates or *ṣukūk* to potential investors and will use the money raised to purchase a rent generating asset from the originator.
- IGS will then lease the asset back to the financial institution or originator for a period corresponding to the duration of the trust certificates or *ṣukūk*, and will keep the asset in trust for the holders of the *ṣukūk*.
- The Issuer will be responsible for major maintenance and structural repair required by the asset while the Islamic financial institution would perform all ordinary maintenance and repair required for the *ṣukūk* assets.
- The lease rental payments from the originator to the IGS will exactly match the periodic payments due to the holders of the *ṣukūk*. These rental payments are not fixed and may be calculated for instance, on six months US dollar Libor, plus a margin.
- All claims due to IGS, the special purpose company issuing the *ṣukūk*, including the rent that will fund the periodic payments on the trust certificates are direct, unconditional and irrevocable obligations of the originator under the agreement.
- The originator is also giving a binding promise to purchase from the IGS, upon the maturity of the lease, the asset leased at an agreed exercise price which will be used for the repayment of the principal to the holders of the *ṣukūk*.

Besides the above general characteristics of an *ijārah ṣukūk* structure the issuer, in the new structure is giving an undertaking to the originator pursuant to which the issuer agrees to purchase from the originator certain land and buildings (Asset B) of similar features and with an equivalent value to the property to be substituted and which represent currently the underlying asset of the *ṣukūk*. The value and benefits of the new asset will be determined pursuant to a valuation report by an independent third party. It shall be noted that this process of substitution will take place in the event that the originator wishes to substitute the land and buildings with an asset of an equivalent value. In this case, a corresponding purchase agreement will be executed. The consideration due to the originator in exchange of the asset B is deferred.

Thus, the substitution steps will be as follow:

1. The originator issues an exercise notice to the issuer expressing his intention to exercise the substitution undertaking in his favour and expressing its willingness to substitute the *ṣukūk* asset.
2. The issuer buys asset (B) from the originator in consideration for (asset A)

from the originator on a deferred basis in order to make sure that the *ṣukūk* are not left without the backing of asset at any given time even for a short period.

3. The originator agrees in the subsequent lease renewal notice, to take on lease the substituted assets.

Thus, through the above mechanism the originator will be able to substitute *ṣukūk* assets for assets of an equivalent value during the tenor of the *ṣukūk*.

#### 4. CONTROVERSY OVER MUSHĀRAKAH ṢUKŪK

As a sign of diversification in *ṣukūk* instruments and a departure from the commonly used *ṣukūk al-ijārah* structure, the *mushāraakah ṣukūk* structure was introduced at international level in 2005.

Some of the pioneering issuances involving the *mushāraakah* structure include the \$200 million 5-year *ṣukūk al mushāraakah* issued by Dubai Metals & Commodities Company (DMCC) Authority, which was the first international *ṣukūk* to be structured as a *mushāraakah* and the first rated Dubai *ṣukūk* issue (a senior unsecured A rating by Standard & Poor's). The proceeds of the *ṣukūk* are being used to build the Almas Tower, the AU Tower and the AG Tower at the DMCC Free Zone.

The second major issue is the 7-year non-amortizing \$550 million *ṣukūk Al-mushāraakah* issued by Wings FZCO on behalf of Emirates Airlines in June 2005, which was the first *ṣukūk* issued by an airline and the largest corporate *ṣukūk* issued to date. The issue's mandated lead manager was Dubai Islamic Bank, which also is the joint book runner with HSBC and Standard Chartered Bank. The proceeds of the issue, which is listed on the Luxembourg Stock Exchange, will be used to finance the new Emirates Engineering Center and headquarters building in Dubai. The issue, which is priced as 0.75 percent over LIBOR with 12-months periodic coupon payments, was well received by the market and oversubscribed to the tune of \$824 million.

The landmark *ṣukūk* based on *mushāraakah* was Dubai Ports, Customs and Free Zone Corporation (PCFC) issue. It was a landmark deal as one the world's largest single *ṣukūk* issue to date. It is also the first *ṣukūk* issue to be convertible into equity upon an IPO, and as the first *ṣukūk* to be listed on Dubai International Financial Exchange.

The landmark issue was originally planed for US\$2.8 billion. However, it was increased to US\$3.5 billion due to the overwhelming response from investors. The issue was oversubscribed raising more than US\$11.4 billion. The issue was lead-managed by Dubai Islamic Bank (DIB) and Barclays Capital. The *ṣukūk* offers a return of 7.125 per cent per annum if a Public Equity Offering happens in two years and a higher return of 10.125 per cent per annum on any amount of the *ṣukūk*

outstanding at maturity which has not been redeemed from equity offerings.<sup>13</sup> Nearly 60 per cent of the orders came from the Middle East, 30 per cent from Europe and the rest from Asia. On the other hand, 70% of the *ṣukūk* were allocated to bank, 7 per cent to high net worth investors and the remaining to asset and fund managers.<sup>14</sup>

Besides the above early *ṣukūk* structures based on *mushārah*, we have many other *ṣukūk* issuance such as the \$270 million QREIC *ṣukūk* in 2006; 200\$ Lagoon City *ṣukūk*; \$225 Sharjah Islamic Bank *ṣukūk*; \$150 Investment Dar Second *ṣukūk* and many others

These different issues of *ṣukūk al-mushārah* show the great influence of *ṣukūk al-mushārah* in the *ṣukūk* market and by consequence the great need to have a structure of such products based on clear fundamentals and acceptable to most Shari'ah scholars. This is in order to keep the confidence of the market in *ṣukūk al-mushārah* and to avoid possibilities of controversy and difference of opinions later.

Literally, *mushārah* means sharing. *mushārah* is generally a form of partnership between two parties in a lucrative project sharing the profits and loses of the joint venture. If it is a diminishing *mushārah* one of the partners undertakes to purchase the share of his partner gradually either using his profit in the partnership or from other sources. One of the classifications of *mushārah* with particular implications to our discussion on *ṣukūk al-mushārah* is to divide it into *Sharikat al-milk* (co-ownership) and *Sharikat al-'Aqd* (contractual partnership).

Several points have been mentioned as factors of differences between *Sharikat al-'Aqd* and *Sharikat-al-milk*.

1. Ownership in *Sharikat al-milk* results from a joint ownership of assets while in the other form of joint venture which is *Sharikat al-'Aqd* the partnership is based on a contractual offer and acceptance relationship.
2. Division of profit under the two concepts generally differ. Splitting of the profit in *Sharikat al-milk* follows the ratio of shares while in *Sharikat al-'Aqd* the ratio of profit may differ from that of the capital contributed.
3. *Sharikat al-'Aqd* is formed with the intention of profit generation which is not the case with *Sharikat al-milk* which can be formed on principles of non-profit or just consequential as in case of inherited property.<sup>15</sup>

The *ṣukūk* structures based on *mushārah* as stated earlier are generally based on diminishing *mushārah* (*mushārah mutanaqisah*). Diminishing *mushārah*

<sup>13</sup> Zubairi, Sohail (2006, February 15).

<sup>14</sup> Stubing, Darren (2006, April).

<sup>15</sup> Tyabji, Masood (2006/7).

is a form of partnership in which one of the partner's promises to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. This transaction starts with the formation of a partnership, after which buying and selling of the equity takes place between the two partners.

It is therefore necessary that this buying and selling contract is not stipulated in the initial partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted to make a contract as a condition for concluding the other. The capital of the partnership in *mushārah* could be in cash or in kind accurately valued.

Each partner should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into a monetary value, for example, a land or building or car or any other form of asset required for the operation of the partnership. The loss, if any, shall be borne by the parties in accordance with the participation ratio of each partner as equity stake of one partner decreases and the stake of the other partner increases.

One of the partners may arrange for the acquisition of the equity share of the other in a manner that serves the interests of both parties. This includes, for example, a promise by the first party to set aside a portion of the profit or the return that it may earn from the partnership for the acquisition of a percentage of the equity of the other party. The subject matter of the partnership may be divided into shares, in which case the second partner can purchase a particular number of these shares at certain intervals until the partner becomes the owner of the entire shares and consequently becomes the sole owner of the subject matter of the partnership.

It is permissible for either of the partners to rent or to lease the share of the other partner in a diminishing *mushārah* for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

In *ṣukūk al-mushārah* the originator or the company looking to expand its operation owns some assets (land, cars etc..) and is looking forward to develop it through the issuance of *ṣukūk* and approach the market in order to secure the needed capital by entering into *mushārah* (partnership or joint ownership) with the issuer of the *ṣukūk* and a trustee of the *ṣukūk*holders.

The general structure of the *ṣukūk al-mushārah* is as follow:

1. A Special Purpose Vehicle Company (SPV) representing the *ṣukūk*holders through the issuance of *mushārah ṣukūk* will enter into a *mushārah* agreement with the originator.
2. The SPV Company that issues the *mushārah ṣukūk* will contribute X% of the capital in cash while the originator will contribute Y% of the capital

in-kind in the form of vehicles, real estates or other kind of asset which will be valued at their actual value.

3. The proceeds of the issue (i.e. *mushārahah sukūks*) will be used by the SPV to make its contribution to the *mushārahah*.
4. Profits will be distributed, among the partners in proportion to their respective capital contributions.
5. The originator will undertake management of the *mushārahah* under a separate management agreement.
6. In case the profits exceed certain percentage agreed upon in the management agreement, the Manager is entitled to such excess amount as a bonus or incentive fees in consideration for its good management.
7. The originator will give an irrevocable undertaking to purchase the units of the SPV in the *mushārahah* pool under the declining *mushārahah* concept (or at maturity) to issuer in a way that the entire *mushārahah* units are eventually owned by the originator at a price equivalent to the original contribution of the SPV to the *mushārahah* pool.

It is the last point regarding the undertaking by the originator to buy the unit of the SPV in the *mushārahah* at face value at pre-agreed price and not at market price that has raised differences of opinion among contemporary Shari'ah scholars.

It is upheld by the opponent of the current *mushārahah sukūk* structure that a *mushārahah* is essentially a partnership under Islamic law and one of the fundamental concepts is that partner A cannot guarantee the capital of partner B. Yet, through the purchase undertaking at face value, *mushārahah sukūk* structures effectively do just that where partner B's capital is guaranteed by partner A. This will transform the transaction into an operation akin to a *ribā* based business deal.<sup>16</sup>

## 5. RATING ŞUKŪK

A key development within the Islamic capital markets is the increased use of credit ratings. Infrastructure companies and sovereign entities are looking to capitalize and harness investors' growing appetite for their assets. As noted earlier, almost all conventional rating agencies are using conventional methodologies to rate Islamic financial instruments including *sukūk* despite their acknowledgement that Islamic financial institutions and instruments have their own characteristics. However, the exclusive characteristics of Islamic instruments are not reflected in the rating and it is very probable that if these characteristics were taken into consideration the rating of Islamic instrument might have been much better. The focus of conventional rating agencies in their rating of *sukūk* is on the credit of the entity providing the guarantee or the entity providing the purchase undertaking to

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<sup>16</sup> See, Hammad, Nazih (2007); Abdul Sattar Abu Ghuddah (2007).

purchase the asset at maturity at a predetermined price. The pre-determined price would be an amount equal to the principal amount to be redeemed under the *ṣukūk* notes plus the coupon amount outstanding at the time the purchase undertaking was exercised. Interestingly, this changes the risk profile of the transaction from the asset risk of the underlying asset to the credit risk of the entity to which the assets can be put in a default. Following rating conventions, a *ṣukūk* with a purchase undertaking would not have a rating higher than the rating given to the entity to which the *ṣukūk* assets can be put, as the primary risk to the investor is not the asset risk but a credit risk of the originator. It shall be noted that the issue of guarantee and that of purchase undertaking are controversial matters from Sharī'ah perspective and therefore, fresh thinking is needed to address them. The International Islamic Rating Agency is supposed to play a much greater role in this particular issue with a direct involvement of the respected Sharī'ah scholars that it has been able to regroup as its Sharī'ah board. The role of Sharī'ah scholars is definitely important in the rating process but it is obvious that this is important in the development of the Islamic finance industry as a whole and the *ṣukūk* market in particular. However, it seems, as noted earlier, that the existing mechanism of Sharī'ah scholars' involvement in product development and harmonization and approval may not be adequate enough for a rapidly growing market that needs to expand according to international standards of best practices and at the speed of market demand. The issue will be discussed next.

## **6. SHARĪ'AH HARMONIZATION AND GOVERNANCE IN ISLAMIC FINANCE**

The emergence of modern Islamic economics as well as the expansion of Islamic finance has always been associated with the involvement of Sharī'ah scholars. They have been the main drivers behind the acceptance of the new system giving it the needed legitimacy within the Muslim masses. They played an important role in product development. This involvement is much needed nowadays ever than before as the industry has become one of the most dynamic areas in international finance. This requires closer cooperation among Sharī'ah scholars and industry players at the international level. Divergence in Sharī'ah interpretation might affect the credibility of the industry. This concern has been raised in several forums and researches. The causes for the differences of opinion, the measures already undertaken to address these concerns and the actions that need to be taken are explored below.

### **6.1. Causes for Differences of Opinion**

The primary sources of Islamic law are the Qur'ān and the *Sunnah*. However, the development of Islamic law relies on *ijtihād* or personal reasoning which depends on the intellectual capabilities of each scholar. Moreover, the primary sources address certain issues in general terms and sometimes worded in a way that is subject to different interpretations. A *mujtahid* is also under obligation to take

into consideration the effects of necessity, public interest and dire needs. All these are factors of difference of opinion.<sup>17</sup>

Moreover, Islamic Law has been sidelined during the colonial era and the laws of the colonial powers were implemented even after independence. Efforts to reintroduce Islamic law, after the advent of Islamic banking in particular, have been based on scattered initiatives that did not help much to solve the problem of differences of opinion.

The influence of major Islamic schools of Fiqh has still an impact in Muslim scholars' thinking. This may be explained by the approach taken by the Malaysian scholars in their adoption of certain Islamic financial products based on *bay' al-inah* arguing that it is approved by some early Shaf'i scholars. This could also be explained by the emergence of modern concept of *tawarruq* firstly in Saudi Arabia where the prevailing school is the Hanbali School which is also the only classical school that has explicitly approved *tawarruq*.

Although most of the resolutions of Shari'ah Boards of Islamic financial institutions are similar and harmonious to a large extent, there are occasions of differences due to limited coordination that sometimes create confusion among the practitioners and weakens the case of Islamic financial institutions in court litigations.

## 6.2. Harmonization Efforts

Towards better harmonisation and standardization of Islamic financial issues, including Shari'ah matters, several Islamic finance infrastructure organizations have been established. Each institution has its core mandate while Shari'ah issues represent a common concern to all these institutions. Thus, there is always a Shari'ah aspect in the accounting and auditing standards, in the prudential and supervisory issues and in the rating or arbitration aspects. Unfortunately, there is no effort to coordinate the Shari'ah issues separately raised in all these institutions.

The work of the Organization of Islamic Conference (OIC) Academy and the Rabitah Fiqh Academy are good examples of an attempt of Shari'ah harmonization. Researches in these institutions are done by renowned scholars representing different regions and the resolutions of these forums are not based on a specific school but on the whole heritage of Islamic law. Many of the modern Islamic finance products are directly developed or approved by the two academies.

However, the efforts by the two Academies have also their shortcomings. For example, each of the two Academies is meeting only once a year; they are not focusing on Islamic finance issues only and the involvement of Muslim economists

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<sup>17</sup> See Kamali, Mohammad (2000).

seems to be limited.<sup>18</sup> Moreover, the papers and the discussions are not accessible to English speaking practitioners as they are documented in Arabic and the two institutions are lacking adequate resources for employing full-time professional staff well versed in both the Sharīʿah and finance.

Mandated with the setting of Sharīʿah standards the AAOIFI's Sharīʿah Board addressed some of the shortcomings of the two Academies by having meetings and consultations throughout the year; focusing on Islamic financial issues; translating its standards into English and having public hearing sessions to get feedback from the industry players on every standard before its final approval.

However, there are still a number of issues that need to be addressed such as the quality and number of academic research forming the basis for the issuance of standards. Only one or two pages are attached as Sharīʿah basis of a standard instead of publishing the relevant researches. In addressing issues already covered by the OIC Islamic Fiqh Academy, the AAOIFI's Sharīʿah Board needs to be more critical as there is always room for improvement. Public hearings to get feedback from the players on a draft version of a standard shall not be limited to refining the existing ideas and styles but shall also involve fresh criticism on Sharīʿah grounds.

However, the adequate solution to these issues seems to be the establishment of an independent international Sharīʿah Board.

### **6.3. International Sharīʿah Board**

The new body shall have the objective of coordinating the work of Sharīʿah boards of Islamic financial institutions; setting up Sharīʿah standards; revising existing standards and providing adequate Sharīʿah supervision and governance in coordination with the Central Banks and Monetary Agencies.

The new institution shall not take over the role of the existing Sharīʿah Boards in individual financial institutions, as their existence is not only a vital mechanism for Sharīʿah compliance and corporate governance but also an important means for innovation and product development.

The new institution shall focus on economic and financial issues, have representation from major players and countries, accommodate influential scholars in the industry irrespective of their country of origin, and be subdivided into several subcommittees with each subcommittee focusing on the functions of a specific infrastructure institution. Members of the different subcommittees shall be involved in the discussion of fundamental Sharīʿah issues so that final approval of a standard or the endorsement of a product will not carry only the stamp of the specific committee but also the tacit approval of the international Board.

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<sup>18</sup> Going through the different financial issues discussed by the OIC Academy it is clear that in some sessions there is no economics expert involved. Perhaps it is believed that the issues are not complicated to warrant the presence of an economist.

Financial constraint that might face the new institution can be handled through membership subscription fee to the new institution by the Islamic finance industry players. It is advisable that the new institution have its own secretariat to ensure its integrity and independence.

#### **6.4. Government Support**

Governments can contribute to Sharī'ah harmonisation and governance by establishing national Sharī'ah Boards to coordinate Sharī'ah issues at national level and to expedite harmonisation at the international level. They can also undertake legal reforms in areas related to commerce and finance, support researches that promote Sharī'ah convergence and cooperate with the international Sharī'ah Board with regards to Sharī'ah issues affecting the industry at the international level and support the role of the international Islamic Arbitration Centre to minimize litigation before non-Islamic courts.

### **7. GOVERNING LAW AND SHARĪ'AH COMPLIANCE**

#### **7.1. Problem and Background**

A properly functioning financial market depends on the enforceability of the contracts concerned. Markets may thrive on economic uncertainty, but not under legal ambiguity.<sup>19</sup> One of the issues of concern in Islamic finance is the issue of dispute resolution and the submission of litigations before local or foreign jurisdictions without contravening Sharī'ah principles.

While Islamic financial institutions shall comply with Sharī'ah in all aspects of their operation including litigation and dispute resolution, local and foreign court jurisdictions are conventional in nature. Even in those countries where Sharī'ah is considered to be the fundamental source of legislation, the laws can be at variance with the Sharī'ah. In some countries, while Islamic financial practices are encouraged the prohibition of *ribā* has not been incorporated into the national commercial laws. The issue is complicated by the unpredictability of court decisions and the non-acceptance of its own decisions as a binding precedent for the later cases, the non-codification of Islamic law and the differing interpretations of Sharī'ah by Sharī'ah Boards.

The question is how to document an Islamic finance transaction in a manner that conforms to Sharī'ah principles and the governing law of a contract.

#### **7.2. Current Solutions**

Sample of contracts executed by Islamic financial institutions show that the clauses on the governing law are sometimes qualified to include expressions that restrict contract's applicability so that they do not contradict with Sharī'ah. It is common to find qualifying statements like "as long as it does not contradict

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<sup>19</sup> See, Blair, William (2005).

Sharī‘ah principles”; or “subject to the glorious Sharī‘ah rules”; or “without prejudice to the Islamic Sharī‘ah principles”. Sometimes a separate clause on Sharī‘ah compliance is included and a subsequent clause on the governing law is added but qualified by providing that this Agreement is governed by the Law of X country without prejudice to the terms and conditions herein contained, including Sharī‘ah Compliance. This qualification is sometimes limited to the avoidance of *ribā* and, therefore, clause to the effect that each Party hereby irrevocably and unconditionally waives and rejects any entitlement to recover interest from the other Party.

The resort to English law, in particular, as governing law in Islamic finance is becoming increasingly common. Islamic financial institutions resort to English law in the documentation of financial transactions perhaps due to the non-existence of well recognised local Sharī‘ah court handling Islamic financial matters, the presumed weakness of local legislations with regard to issue pertaining to cross-boarder legal aspects, and the hope for better rating from conventional rating agencies which prefer English law as governing law.

However, the question that will arise is whether this mechanism really harmonises between conventional legislation, court and Sharī‘ah principles. Some legal practitioners consider the choice of English law as the right choice that will ensure Sharī‘ah compliance and at the same time provide conformity with best legal practices. The issue is best highlighted in *Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltd & Others* case on the basis of default payment in a *murābahah* agreement. The parties’ choice of law was expressed in these wordings “Subject to the principles of Glorious Sharī‘ah, this agreement shall be governed by and construed in accordance with the laws of England.”

The High Court and Court of Appeal granted judgment to the Shamil Bank on its claims concluding that the principles of Sharī‘ah did not apply to the *murābahah* agreements, principally because that had not been the parties' intention. The Court's reasoning was that:

- The reference to the "Glorious Sharī‘ah" in the governing law clause was merely intended to reflect the Islamic religious principles according to which the Bank held itself out as doing business.
- The reference to a choice of law shall be the law of a country, not to a non-national system of law such as Sharī‘ah without identifying those aspects of Sharī‘ah which were intended to be incorporated into the contract.
- It was improbable that the parties were truly asking the Courts to get into matters of Islamic law and its application.
- The Court is of the opinion that if the relevant Sharī‘ah principles been validly incorporated in this case, the borrowers might have succeeded in

their application.<sup>20</sup>

From the above judgment it is clear that resort to conventional courts by Islamic financial institutions is not without shortcomings. While the fundamental clauses of a contract in Islamic finance are based on Sharī'ah principles the conventional court is unfamiliar with such principles and this will definitely affect its decision. Thus, in a litigation based on a *murābahah* contract the court is not considering the contract in the transaction as a relation between buyer and seller but a relation between a borrower and a creditor and this represents a clear departure from the spirit of the transaction.

### 7.3. Way Forward

A permanent solution to this problem would be a long process. It resides in the systematic harmonization of documentation of Islamic financial contracts, the minimization of the differences between Sharī'ah boards and the codification of fundamental principles of Islamic commercial law into clear set of legislation based on core Sharī'ah principles and international best legal practices. Such a process will not be effective unless some countries adopt these principles as basis for national legislation.

A transitional solution would be a process of standardisation of Islamic financial contracts by identifying the fundamental Sharī'ah principles which must be incorporated into a particular contract. The standardised contracts need to be endorsed by the Sharī'ah Board of Islamic infrastructure institutions such as AAOIFI, IIFM, IIRA and IFSB in order to give it an international dimension and acceptability in court litigation.

However, the immediate solution resides on the adoption of arbitration as an alternative method of dispute resolution in Islamic finance. Parties looking to enter into agreements incorporating Sharī'ah principles shall include provisions to the effect that disputes about Sharī'ah and its applicability shall be submitted to selected arbitrators who enjoy the confidence of the parties and possess the experience and capability in settling complicated commercial disputes. This might help to streamline the resolution of disputes and reduce the need for court proceedings which could be costly. Arbitration is also preferable due to the long process of court litigation, insufficient knowledge about the legal systems of other countries and the desire of investors to keep their investment disputes confidential.

## 8. CONCLUSION

Despite the encouraging growth and development of the *ṣukūk* market it seems that there are many controversial issues that need prompt solutions in order to sustain the development of the *ṣukūk* market. This requires a close cooperation among financial experts and Sharī'ah scholars on one hand, and more interaction

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<sup>20</sup> Lovells, "Sharī'ah Law in the English Court" [www.lovells.com](http://www.lovells.com) September 2004.

among Sharī'ah boards on the other. The focus of the Islamic capital market shall not be only on how to raise the funds and be acceptable to international financial institutions, although these are valid and well needed objectives, but to be Sharī'ah compliant first and foremost. This will also help in the growth of real economy and socio-economic development of the society.

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