Are *sukuk* debt or equity? A classification of *sukuk* by regulatory bodies and credit rating agencies

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**ABSTRACT**

*Sukuk* (Islamic bonds) are the *Shariah* (Islamic law) instrument that serves as an alternative to conventional bonds that are used in the modern capital market. In theory, *sukuk* represent a form of equity as they represent certificates conferring ownership to holders of an asset or pool of assets or claim to its cash flows. In practice, they have become known as Islamic bonds with their investors holding debt. Following the question of whether *sukuk* are debt or equity, this paper aims to classify *sukuk* from the perspective of regulatory bodies and credit rating agencies. Furthermore, to what extent the innovations in this Islamic instrument make it differ substantially from conventional bonds in practice will be examined.

1. Introduction

The term *sukuk* is often cited in Islamic literature as 'Islamic bonds' or 'Shariah-compliant bonds'. Directly translated, it means a pure-bond debt obligation; this is classified as the approved form in *Shariah* (Islamic law). Although it appears to be a common practice for the literature to differentiate between *sukuk* and conventional bonds for various reasons, the literature does suggest that both are very different in many aspects (Alawi & Al-Quati, 2014; Ariff & Safari, 2012; Zolfaghari, 2017). In the meantime, some scholars have attempted to differentiate *sukuk* from equity, generally finding that *sukuk* are similar to stocks in the sense that they represent ownership and no guarantee of a fixed return (Godlewski, Turk, & Weill, 2013; Hossain, Uddin, & Kabir, 2018). Consequently, some scholars argue that the term “Islamic bond” does not entirely cover the substance of *sukuk* (Rethel & Hardie, 2017; Saeed & Salah, 2012). This scenario focuses on the debate about whether *sukuk* are debt or equity as it currently remains unanswered.

The status of *sukuk* was threatened by the global financial crisis in 2008, as this was the first time any issuers of *sukuk* “defaulted” in the bond’s history. For years, the market generally accepted that an

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investment in sukuk is more “secure” than an investment in conventional bonds, given that the initial condition for the issuance of sukuk is the existence of assets that back the sukuk (Mashni, 2011). On the other hand, some have argued that there is no such thing as default in Islamic finance due to profit sharing and the risk avoidance nature of related transactions (RAM, 2010). In conventional finance, a default on a pure debt obligation is straightforward. The issuer’s failure to make scheduled interest and principal (re) payments, differs from sukuk since the latter has interest prohibitions. Standard & Poor’s (2006), a leading international credit rating agency pointed out that the profit-sharing nature of some Islamic financial institutions funding instruments makes it difficult to ascertain at what point they enter default. The ambiguous nature of the instrument is now emerging in these cases of default with regards to the designation of sukuk holders, specifically in terms of whether they are either equity holders or debtors (Essam, 2013). Some sukuk behave like corporate bonds in terms of capital preservation and periodic distribution frequency, for example, ijarah (lease) or Murabaha (cost-plus financing), yet certificate holders are still owners of the underlying asset that is leased to the beneficiary. While some may be structured as an equity-based model, the sukuk default still happened in the case of The Investment Dar Company (TID) and Gulf Holding Company (Villamar Šukûk) (Bahrain) musharakah sukuk (Ali, 2016; Radzi & Shaharuddin, 2018). The issue of investors as equity holders or debtors became apparent given that musharakah is premised on profit-sharing among partners.

While theoretically, sukuk are not interest-bearing instruments while conventional bonds are, much debate has arisen on the nature of this instrument in practice. Renowned Shariah scholars back these concerns. According to the President of the AAOIFI Shariah Council, Mohammad Taqi Usmani, current practices of issuing sukuk replicate the structure of conventional bonds in terms of the lack of ownership, right to a fixed return, and the guarantee of repayment of the principal, thus in fact making most sukuk un-Islamic (Usmani, 2007). Some innovations which try to achieve the same economic outcome as conventional instruments resulted in sukuk structures being commonly criticised as deviations from Islamic law. The issue here is the tension between legalistic forms and ignoring the substance of Islamic law (Abdullah, 2018). Given that some contentious issues remain concerning the status of sukuk as debated in the literature and following default, the demand for a proper classification of sukuk from regulatory bodies and credit rating agencies is to be reviewed. Furthermore, to what extent the innovations in this Islamic instrument make it differ substantially from conventional bonds in practice will be examined.

2. Mechanics of a typical sukuk transaction

The concept of sukuk would be more tangible by understanding in advance the typical sukuk transaction. Generally, sukuk (plural of word sukk) is akin to the current concept of securitisation (Iqbal & Tsubota, 2006). It is a process in which ownership of the underlying assets is transferred to a large number of investors through certificates representing the proportionate value of the relevant assets. Sukuk can be structured in many ways, and most involve numerous parties in the issuance process. However, in its simplest form, at least three parties are fundamentally involved. They are as follows: the originator of the sukuk (the obligor); the Special Purpose Vehicle (SPV) who is the issuer of the sukuk certificates; and the investors who buy these certificates (Tariq & Dar, 2007). Essentially, the structure of sukuk has to be reviewed and approved by Shariah advisers so that compliance with Shariah is ensured before it can be issued.

The necessary arrangement of the sukuk structure is that an originator begins underlying assets and funded on that originator’s balance sheet. These assets may be both tangible or intangible, existing or described with deferred delivery, usufruct or services. Further, the originator will establish an SPV—a stand-alone entity that is bankruptcy remote from the originator and then sells the assets to the SPV
through a purchase agreement. In this context, there must be an appropriate method of transferring the proposed sukuk assets to the SPV. Generally, the outright sale of the assets and a long lease will be exercised for tangible assets, while assignment, novation, or trust may take place in the case of contractual interests. For the sukuk structure to comply with Shariah principles, some degree of ownership of assets must be transferred to the investor. Transfer of registered title is not necessary, rather a collection of ownership rights that would allow the investors to perform duties related to ownership (if desired) or rights granting access (subject to notice) over the asset would be sufficient to satisfy Shariah. The idea behind placing assets in the SPV is to ensure that, when issuing sukuk, the process results in a Shariah-compliant transaction in which parties share in the risks and rewards of a specific asset or asset pool (in the SPV).

In financing such assets, the SPV will issue sukuk certificates to the investors or sukuk holders. This issuance requires the exchange of a Shariah-compliant underlying asset for financial consideration through the application of various Shariah principles such as ijarah, salam (advance purchase), istisna (contract of exchange with deferred delivery), Murabaha, musharakah (joint venture), mudharabah (profit-sharing between entrepreneur and investors), etc. The SPV will then use the sukuk proceeds to pay the originator, enabling them to finance the said assets. When such an investment is made, SPV receives a return from the obligor and further makes periodic distribution amounts to the investors throughout the sukuk’s tenure. The return provided to sukuk holders takes the form of a profit from a sale, rental or a combination of both depending on the Shariah contracts used. At maturity, or on a dissolution event, the SPV sells the assets back to the obligor at a predetermined value, and the proceeds of this sale will be transferred to the sukuk holders.

The structuring process may also involve the provision of additional protection for investors against late payment, pre-payments, potential write-offs and other similar risks. There are various types of credit enhancements such as profit retention, third-party guarantee, creation of spread/reserve accounts, cash collateral including tranche subordination of conventional securitisation. These credit enhancements can be incorporated into sukuk structures in order for a proposed sukuk structure to have better credit profiles (than conventional bonds) and satisfy the current need for Shariah-compatible, tradable instruments. Islamic law does not rule out the use of credit enhancement per se as long as it is optional to the investors. Most importantly, the use of credit enhancements in a transaction should not change the character of the structure, but merely “augment” the credit of the debt within.

Sukuk can be structured in many ways, and therefore there is no one-size-fits-all sukuk structure. Although some structures are used more frequently than others, from the Shariah perspective, there is no preference for the use of one Shariah contract over another. Different structures serve varying commercial purposes and their suitability to a range of circumstances.

3. Debt or equity: a review of the classification of sukuk by regulatory bodies and credit rating agencies

The necessary arrangement of sukuk has demonstrated that sukuk primarily can be structured using various Shariah contracts, depending on the economic purpose of the issuer. In this regard, AAOIFI, in its Shariah Standard No. 17 tends to classify investment sukuk structure based on the underlying Shariah contracts. There are 14 permissible sukuk structures, i.e. ijarah (ownership in leased assets, ownership of usufructs of existing assets, ownership of usufructs of described future assets, ownership of services of a specific party and ownership of described future services), salam, istisna, Murabaha, musharakah, mudharabah, wakalah, muzara‘ah (sharecropping), musaqah (irrigation), and mughararah (agriculture). However, most of the commonly adapted structures are murabahah, ijarah, musharakah and wakalah
(contract of agency). This 14 different sukuk are further classified following their traceability in the secondary market, in particular, tradable and non-tradable sukuk. Whether or not sukuk issuance can be traded depends on the type of assets underlying the sukuk (see further AAOIFI Shariah Standard (17) on Investment Sukuk and AAOIFI Shariah Standard (21) on Financial Papers).

The sukuk should represent a direct link with physical assets, as opposed to denoting debts. Typical examples for tradable sukuk are ijarah, musharakah and mudarabah; these represent tangible assets or proportionate ownership of a business or investment portfolio. Meanwhile, non-tradable sukuk represent receivables of cash or goods with typical examples including sukuk salam and murabahah. However, there is a difference of opinion amongst Shariah scholars; some of them accept assets as underlying sukuk structures, representing at least 33% of the face value of the sukuk, while others require between 51% and 70% to be considered physical assets. The classification of sukuk can further be understood from AAOIFI’s Financial Accounting Standard No. 25, which makes a distinction between debt-type sukuk and equity-type sukuk. Debit-type instruments are defined as “investments that have terms that provide fixed or determinable payments of profit and capital.” Equity-type instruments, on the other hand, are defined as “investments that do not exhibit features of debt-type instruments and include instruments that evidence a residual interest in the assets of an entity after deducting all its liabilities.”

From the perspective of Malaysia’s Securities Commission, the sukuk can be classified based on the specific contract of exchange of Shariah-compliant asset and its technical and commercial paper (SC, 2009). The various Shariah contracts have been grouped into four main categories based on the mode of financing: sale-based, leased-based, partnership-based and agency-based. For sale-based and leased-based, both structures are using exchange contracts and represent debt obligations of the issuers from a sale or lease transaction. The returns to sukuk holders are predetermined, and the structure closely mirrors conventional bonds. On the other hand, Islamic partnership contracts depart from a typical debt-based arrangement to a profit-and-loss-sharing agreement that seeks to provide a pay-off to the sukuk investors. These equity-based principles, i.e. mudarabah and musharakah sukuk, are Shariah-compliant modes of pooling capital. These contracts are based on the performance of the underlying business in which sukuk investors have an undivided proportionate interest in the partnership venture. Furthermore, agency-based transaction sukuk consists of wakalah sukuk – the new sukuk format uses non-physical assets instead of the traditional resort to physical assets.

In terms of its technical and commercial paper, Securities Commission Malaysia has classified sukuk into asset-based and asset-backed types. In asset-based sukuk, the originator only passes on the beneficial ownership of the asset to sukuk holders, while retaining legal ownership. From a legal perspective, there is no actual sale in the asset-based structure since sukuk holders do not hold proprietary rights in the underlying asset. As a consequence, the sukuk holders cannot sell the asset to a third party, in case of default by the borrower. It means the sukuk holders only have recourse to the originator/obligor.

On the other hand, asset-backed sukuk can be defined as Islamic security issued according to a securitisation transaction. This is usually evidenced by an independent legal opinion stating that the rights to the underlying assets have been perfected through a ‘true sale’ transfer to the issuing SPV and after that, the originator has limited or no access to such assets as part of its assets pool. If the borrower defaults, sukuk holders can exercise certain rights of ownership and control over such assets. This kind of classification becomes prevalent in the literature as the issue of ownership and sale status of the underlying assets in the sukuk has come to the fore following several high profile sukuk defaults in 2008.

Further, since sukuk have real assets at their core, a detailed analysis of the commercial terms and legal structure shows that sukuk can be categorised into three basic types. The categorisation made by the Islamic Financial Services Board (IFSB) attempted to define, through the use of current financial terminology, the acceptable parameters in which assets could be transferred and owned. The first category
is asset-backed *sukuk* which are "structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies)." In this structure, the *sukuk* holders will bear any losses due to the impairment of assets. In other words, the *sukuk*-holders have recourse to the asset and not the originator.

Meanwhile, the other two are asset-based *sukuk* that utilise a purchase undertaking from the originator (also termed pay-through *sukuk*) and *sukuk* with a guarantee from the issuer in case the originator defaults (also termed pass-through *sukuk*). Asset-based *sukuk* imply that *sukuk* holders have recourse to either the originator (via the purchase undertaking) or the issuer (via the guarantee). In other words, asset-backed *sukuk* involve the full transfer of legal ownership of the underlying asset while asset-based *sukuk* involve recourse to the originator or the issuer (but not the asset) (IFSB, 2009).

In ascertaining the creditworthiness of *sukuk*, international credit rating agencies, in particular Standard and Poor’s, Moody’s and Fitch and domestic credit ratings agencies, namely Rating Agency Malaysia (RAM) and Malaysia Rating Corporation Berhad (MARC) have organised *sukuk* into several categories under which *sukuk* may be issued (see Table 1). These different *sukuk* categories determine the best approach to evaluating the credit risk of *sukuk*, which dictates to a large extent the applicable rating methodology. Even though the method of classification of *sukuk* does vary between RAM, MARC and international credit rating agencies, by and large, they are inclined to classify *sukuk* as either asset-based or asset-backed, and additionally for project-backed *sukuk* by RAM. Except for Standard & Poor’s, they classify *sukuk* into three categories according to their credit enhancement features. This agency takes the view that rating an Islamic debt instrument varies, depending on the degree of performance of risk of the asset backing the transaction, collateral type and transaction structure.

In general, the primary critical drivers of a rating methodology for asset-based *sukuk* are the creditworthiness of issuers or entity providing the guarantee and level of seniority of the originator’s guarantee, whether it ranks *pari passu* with all other similar obligations of the guarantor. In rating, this guaranteed *sukuk*, credit rating agencies will evaluate the creditworthiness of the guarantor because the guarantor will provide a Shari'ah-compliant shortfalls amount in the case of the issuing vehicle (usually SPV) which cannot make a payment. For the *sukuk* that resembles the asset-backed securities (ABS) in a securitisation, credit rating agencies place a more significant concern on the ability of underlying assets to generate sufficient cash to meet promptly - the SPV’s obligations. To be exact, the rating would depend mainly on the nature of the underlying assets as the pool of underlying assets is the sole basis for the coupon and principal payment. For project-backed *sukuk*, these investors rely on the performance of the underlying projects in which the *sukuk* investors have full and proportionate ownership. As such, two elements that are relevant in the rating methodology of project-backed transactions are: (i) the quality of cash flows and (ii) quality of the project’s assets. In sum, even though *sukuk* must have assets in their structure, overall the performance of *sukuk* is still driven by cash flows regardless of whether they are sourced from an asset or underlying asset, project or corporate obligor.
Table 1 Classification of *sukuk* and analytical framework for rating approach of *sukuk* by credit rating agencies

<table>
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<th>Credit rating agencies</th>
<th><em>Sukuk</em> category</th>
<th>Rating approaches</th>
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| Standard and Poor’s    | Credit enhancement features of *sukuk* | • *Sukuk* with full credit-enhancement mechanisms  
• *Sukuk* with no credit-enhancement mechanisms  
• *Sukuk* with partial credit-enhancement mechanisms |
| Moody’s                | Nature and characteristics of *sukuk* | • Unsecured asset-based *sukuk*  
• Secured asset-backed *sukuk* (Islamic securitisation) |
| Fitch                  | Structure of the underlying *sukuk* transactions | • Originator-backed *sukuk* (also called asset-based *sukuk*)  
• Asset-backed *sukuk* (securitisations) |
| Rating Agency Malaysia | Depending on the nature of the asset that backs the *sukuk* and considering *sukuk* may originate from one or a combination of approved Islamic contracts. | • Asset-based *sukuk* transactions  
• Asset-backed *sukuk* transactions  
• Project-backed *sukuk* transactions |
| Malaysia Rating Corporation Berhad | Depending on the basic structure of *sukuk*, since the *sukuk* can exhibit characteristics of debt or equity or asset-backed securities if the securitisation elements are present. | • Asset-based *sukuk* transactions  
• Asset-backed *sukuk* transactions |

Source: Radzi (2012)

The regulatory bodies and agencies seem to have provided a complete classification of *sukuk* by covering all types of *sukuk* available in the Islamic capital market so far. It may not be possible to find one overarching regulatory definition for all types of *sukuk*. Premised on this classification, some overlaps in different categories of *sukuk* exist. Debt-based *sukuk* are a reflection of sale-based *sukuk* or debt-type *sukuk*, for the underlying *Shariah* contacts such as *Murabaha*, *salam* and *istisna’*. This *sukuk* represent debt obligations of the issuer. However, the debt originated from a sale or lease transaction, unlike the debt in a bond which derives from a loan contract. Some structures denote equity relationships similar to shares and do not represent debt obligations. This equity-type instrument, partnership-based and agency-based *sukuk* are represented by *musharakah* and *mudharabah*. Irrespective of the *Shariah* underlying contracts being sale-based, lease-based or partnership, they can be structured as asset-based or asset-backed.
In terms of risk/return profile, as credit rating agencies are concerned, asset-backed sukuk are arguably closer to an equity position because sukuk holders own the underlying asset and have no recourse to the originator in the event of a payment shortfall. Asset-based sukuk are closer to debt because sukuk holders have recourse to the originator if there is a shortfall in payments. Therefore, it is worth noting that one cannot assess the risks associated with each issue by merely understanding the sukuk underlying contracts such as mudharabah, musharakah or ijarah since the actual legal structure is behind the ‘name’. Furthermore, the actual risk characteristics of the issue can vary significantly even within each structure. Within musharakah sukuk, for instance, there can be variations between asset-based and asset-backed, each one yielding a wholly different risk profile. Thus, it is essential to note that sukuk are not always debt instruments, but sometimes equity depending on how they are structured. Meanwhile, different types of assets underlie the sukuk structure, making both the ‘nature and type of asset’ classification a common factor of other classifications.

4. Equity trapped in a debt-based market.

While there are many different sukuk structures available in the financial markets, however, most of the sukuk issuances to date have been wholly asset-based rather than asset-backed. At the end of 2009, only 4% of the US$32 billion worth of sukuk rated by Moody's represented secured 'asset-backed' sukuk, and this trend of 'unsecured sukuk' dominance continued in 2010 (Hijazi, 2010). Flash-forward to 2015, the industry has not progressed very much from the asset-based structures still dominating the market, and asset-backed structures are very few and far between (Dey, 2015). The debt-like structure was built into the asset-based sukuk by incorporating income and capital guarantees in the sukuk contracts. Such guarantees are critical features of conventional bonds (Abdullah, 2012). The incorporation of income and capital guarantees ensured that a single failure to make a periodic payment on time or to redeem the principal amount on the due date would constitute default.

Sukuk are structured in such a way that their holders run a credit risk and receive a share of the profit with no interest payment fixed in advance (Chermi & Jerbi, 2015). Since investors prefer to play safely in terms of structures to invest in, it is not surprising that ijarah sukuk remains the preferred structure in the sukuk market (Farook & Ansari, 2017). The ijarah instrument is one that bears the closest resemblance to a current lease contract and offers the flexibility of both fixed and floating-rate pay-offs. The cash flows of the lease, including rental payments and principal repayments, are passed through to investors in the form of coupon and principal payments. In this respect, it can be used in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile. Additionally, the use of a purchase undertaking is widely accepted in the context of ijarah sukuk without Shariah objections. These characteristics make ijarah relatively straightforward to use in the underlying structure for a sukuk issuance.

Instead of the ijarah the participatory sukuk such as the musharakah or mudarabah were structured to replicate debt instruments (Abdullah, 2012). Equity-grown sukuk have been re-engineered to swim in the vast pool formed by the common bond (debt) markets which have the following characteristics (Wouters, 2011):

- Personal claims on the borrower (pure credit risk – independent of the success of the project or performance and survival of the asset), where possible are secured by additional collateral and ranking preferential over equity
- Steady and fixed income generation: pre-agreed returns (based on interest rates) not dependent on any real underlying profit or loss
- Mid-term maturity

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Musharakah and mudharabah sukuk are supposed to be designed as profit-risk sharing securities, the profits by definition depending on the efficiency that assets generate (Abdullah, 2011). This means that periodic payments depend on the performance of the underlying assets or projects since those projects’ revenues are the sole source of the periodic payments made to the sukuk holders. On this issue, sukuk holders do not receive a fixed return, and there is even a risk that the sukuk holders will not receive the expected return in case the underlying projects do not succeed. In terms of risks, it must be shared among the originator and investors, with the likelihood of fluctuations in dividend/profit payment and capital redemption (Saeed & Salah, 2012). Premised on this structure, the idea of this sukuk exhibits the interest of the two parties being in harmony during the upside as well as the downside of the business in a partnership contract.

However, idealising Shariah prescriptions of equity-based sukuk structure may not be attractive to conventional mind-set risk-averse investors. In particular, the characteristics of mudharabah and musharakah do not meet the risk appetite of investors who mainly expect capital preservation and fixed income instruments as commonly featured in conventional bond instruments (Ghani, 2009). In the market, investors, on their part, do not want to become owners of assets and assume the risks of ownership. They only want their profits to be guaranteed and to earn them rewards without taking a risk (Abdullah, 2012). Pressure on the "investors’ ‘appetite’ towards fixed return" resulted in the vast majority (90%) of sukuk in the market being structured to mimic conventional unsecured bonds (Hassoune, 2010). These contexts demonstrate that the investing public wants an "Islamic" structure, yet in the meantime, the features of debt are also evident. Therefore, following the paradox in structuring equity-based sukuk, some practitioners contend that the real issue for the default of Islamically structured Dubai bonds is mostly based on Shariah advisers appearing to be increasingly driven by rising demands of commerce for them. This is forcing them to show more flexibility when they rule on the validity of large financial transactions (Saleem, 2010). Islamic financial innovation, the way it has been practised, can be defined as the process of utilising Islamic legal contracts in new ways to develop financial products that comply with Shariah and have the ability to replicate the economic effects of conventional financial products (Dar, 2013).

Because of some common characteristics with bonds and market preference, sukuk are classified as fixed income and sold in debt capital markets. It is very much like fitting a square peg into a round hole. It is a continuous attempt to sell an equity-based instrument in debt markets and to be able to complete the in-consistent sale, sukuk issuers and arrangers had to innovate features or mechanisms that shift the structure of sukuk so that they function as conventional bonds. Sukuk are strictly ownership certificates but in practice are investors who hold debt. Thus, unsurprisingly, sukuk are very popular as Islamic bonds – debt instruments that are forced to be Shariah-compliant while mimicking many features of the common bond.

5. Conclusion

Sukuk is a different category of financial instruments because in their structure they use many traditional techniques of Islamic finance, which in turn refer to different assets, such as tangible assets, usufructs, debts, money, services, economic rights or a mixture of some or all of these kinds. Sukuk can resemble conventional bonds in some aspects, but they are technically neither debt nor equity. It is complex to understand the exact nature of sukuk and to differentiate them from bonds. Unlike bonds, sukuk are not technically debt instruments – although they are treated as such for regulatory purposes in some jurisdictions. Correspondingly, sukuk do not generate returns in the form of interest payments, although the rent or profit received by a sukuk investor will typically be equivalent to the interest a bond investor would receive if the relevant issuer had issued bonds rather than sukuk.
However, all these instruments are not the substitutes of interest in the strict sense, and it will be wrong to presume that they may be used precisely in the same fashion as interest is used. The primary difference between those instruments consists of the fact that sukuk may not involve riba. They also vary in terms of the transaction structure, the nature of investment and the manner of collecting benefits. They have their own set of principles, philosophy and conditions which without it is not allowed in Shariah to use them as modes of financing. Therefore, an ignorance or poor understanding of their basic concept and relevant details may lead to confusing Islamic financing with the conventional system based on interest.

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