

Indebtedness Theory and Shariah Boards: A Theoretical Approach

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Abstract

Purpose: The current paper aims at elaborating a theoretical approach of responsibility of *shariah* board with Indebtedness theory in terms of a covenant, which establishes certain rights and obligations towards compliance of financial instruments with *shariah* rules.

Design/methodology/approach: The paper explored issues related to the theoretical approach of responsibility of *shariah* boards with Indebtedness by reviewing the responsibility of *shariah* boards towards the financial instruments and compliance with Islamic principles.

Findings: The paper identified the Indebtedness duties imposed on *shariah* boards which are under the Islamic law. *Shariah* boards are a manifest of the Covenant (Al-Mithaq) and by way of submitting its desires to His Will (i.e. the Islamic Law) corresponding to an absolute true willingness as an indebtedness of the relationship between them and Allah the Creator.

Research limitations/implications: The study was limited only to the theoretical approach of responsibility and duties of *shariah* board with Indebtedness.

Practical implications: This study contributes to the literature by deconceptualizing and developing the responsibility and duties of *shariah* boards and presenting a systematic framework that demonstrates the underlying indebtedness theory through connecting with the financial instruments and *shariah* compliant.

Originality/value: Indebtedness theory refers to a theory that deals with the human existence and the relationship with Allah, the Creator. Creations must submit to Allah and comply with *Shariah* rules as an act of obedience to Allah. However, the theory is extremely fundamental to illustrate the reasons why *shariah* board members dutifully observe Islamic rules in business conduct and financial operations.

Keywords: Indebtedness Theory, *Shariah* Boards, Financial Instruments

Introduction

Indebtedness is deemed as a formal alliance or agreement made by God with humanity in general (Rosly, 2007& Ahmed, 2012). It is a promise that mankind has with God that implies adhering and fulfilling what this bond entails. The concept of epistemology is not merely theoretical to Muslims, but influences the thought and behavior in individuals and the society at large (al-Haqq, 1986). Therefore, all practicing Muslims and scholars regard Islamic epistemology based on the Quran, Hadith and Muslim of a great importance. According Al-Attas (1979) “*The function of knowledge in Islam is to know God so that humankind may serve and worship Him*”. The essence of being a Muslim is encompassing the spiritual, moral and conceptual development is brought about by the Islamic epistemology during the period of Prophet (PBUH). In upholding the *Mithaq*, the basic meaning of this word is to incline away from falsehood toward that which is true. The relationship between God and believers is conceived in terms of a covenant, which establishes certain rights and obligations. The core of this agreement is that God binds mankind to serve God to the exclusion of any other being [1:5, 24:55, 51:56], and in return, gives the promise of material and spiritual success. In Quran chapter 13, verse 22 Allah says “And those who are patient seeking the consideration of their Lord; and they uphold the *salat* (worship), and they spend from what We have bestowed upon them secretly and openly, and they counter evil with good; these will have an excellent abode”. This *mithaq* brings about an indebtedness theory. The indebtedness theory is extremely fundamental, to illustrate the reasons why believers dutifully observe Islamic rules in business conduct and financial operations (Rosly, 2007).

And [mention] when your Lord took from the children of Adam - from their loins - their descendants and made them testify of themselves, [saying to them], "Am I not your Lord?" They said, "Yes, we have testified." [This] - Lest you should say on the day of Resurrection, "Indeed, we were of this unaware." (Surat Al-Araf: 172).

All of a believer's actions are predominantly and solely meant for Allah's sake and such obedience are shown by avoiding His prohibitions and complying to His commands. This is, as far as Islamic rules are concerned, the meaning of human existence in their relationship to their indebtedness to Allah the Creator. The indebtedness theory admits that all creations have to submit to Allah and complying with *Shariah* rules in the aspect of economy is no exception to this rule. Thus, in any daily dealings, a believer must ensure compliance to *Shariah*. Similarly, in financial instruments management, *Shariah* boards being the governing body need to demonstrate the requirement of compliance as a factor to certify the nature of financial instruments to be deemed as *Shariah* compliant (Ahmed, Amran, & Islam, 2018). Previous studies in Islamic finance (Rosly, 2007; Ahmed, 2012; Ahmed et al., 2014), have focused on the first level of the *Shariah* compliant theory and paid less attention to the second level of the theory. The first level provided the underlying link between the *Shariah* compliant variables and Islamic financial instruments only without examining their effects on legitimacy. Considered as the more modern and sophisticated framework, the second level of the indebtedness theory suggests that the interaction or fit between *shariah* board and determinants ultimately affect instruments legitimacy. Thus, the purpose of this paper to determine the theoretical approach of responsibility of *shariah* board with Indebtedness theory in terms of a covenant, which establishes certain rights and obligations towards compliance of financial instruments with *shariah* rules.

The Theory of Indebtedness

There is a set of concepts in *Shariah* screening, capital and money market instruments and a validation of contracts that are looked upon when fulfilling the demand from customers, fund managers and dedicated IFIs for *Shariah*-compliance of the available products and for due consideration to be given in the formulation of new products and financial tools (Ahmed, Islam, Zuqibeh, & Alabdullah, 2014; Ahmed, 2010). Furthermore, several *Shariah* advisors have different viewpoints regarding the legitimacy of Islamic financial tools in the Islamic finance sector (Ahmed, Amran, & Islam, 2018; Ahmed, Islam, Ariffin, Halim, & Moniruzzaman, 2013). One of the convincing opinions is the theory of indebtedness (*Al-Mithaq*). The indebtedness theory has been commonly used in Islamic finance as well as in research based on *Shariah* compliance. The theory was formulated from the work of a few authors (Rosly, 2007 & Ahmed, 2012). The central idea of the indebtedness theory is that it is based on the assumption that that human existence is explained by the debt he owes to his creator and his subsequent enslavement to His law as a means of repayment. It means that it requires humans to manifest the Covenant (*Al-Mithaq*) by way of submitting their desires to His Will (i.e. the *Shariah*) in absolute true willingness. Similar theory is also shared by Greenberg (1980), defining indebtedness as a 'state of obligation to repay another'. He believed that indebtedness is conceived as a psychological state of having motivational properties such that the greater the magnitude of indebtedness, the greater the arousal and hence the stronger the ensuing attempt to deal with or to reduce indebtedness. It is predicted on the existence of a norm of reciprocity that people should help those who have helped them and should not injure those who have helped them .

In general, Islam means *al-Din* (submission), which has many things that have to do with the meaning of indebtedness. In that regard, one of the meanings of *Din* is indebtedness, which as its root, is originally an Arabic word. It represents the indebtedness notion that gives the deeper meaning for the rationale for humans being in an economic existence in *Shariah*. This is because human beings once never existed, but now they do, as humans were created by Allah (*Al-Mu'minun* {23}:12- 14). Thus, when a human is in debt, they are supposed to repay their debt, even though Allah needs nothing from human beings, as He is definitely the Creator and Sustainer. Nevertheless, the debt that person owes must be paid, and eventually such an act is to obey Allah. As mentioned by Naquib Al-Attas, returning or paying debts according to Islamic rules refers to giving oneself up in service, to Allah. All acts have to be for Allah's sake, being the Creator, and loyalty has to be towards His prohibitions and commands, and therefore one lives by the dictates of His Law. This is, as far as Islamic rules are concerned, the meaning of human existence in their relationship to their indebtedness to Allah the Creator. Consequently, human beings' enslavement to the Law of Allah is the way humans settle their *dayn*, or debt. Through commandments and obeying Allah, the believer therefore submits their desires to Allah willingly. This is the respectful way that they can pay their dues towards Allah, the Creator .

Hence, based on the principle of Islamic compliance, business activities and operations managed by human beings are subject to the submission to the Law of Allah, and this includes the prohibition of *gharar* (ambiguities), *riba* (interest), *jahala* (fraud) and *maisir* (gambling) in all financial business operations (Ahmed, 2010). Therefore, the indebtedness theory (*al-mithaq*) is extremely fundamental, to illustrate the reasons why believers dutifully observe Islamic rules in the conduct of business and in financial operations (Rosly, 2007).

In the existing literature there are a few of pertinent studies that have determined the effect of indebtedness theory on the role of *shariah* boards in their rights and obligations; Rosly (2007) urage that the he theory of indebtedness (*Al-Mithaq*) is in play here to explain why Muslims

dutifully observe *Shariah* principles in the conduct of business and financial transactions. Ahmed, Yahy and Islam, (2013). Studies the relationship between *shubuhah* and orientation of Islamic bank in Malaysia under the theory of indebtedness. The findings was explain that the effect of indebtedness theory to financial transections in Islamic banks. Its found the full-fledged Islamic banks had lesser *shubuhah* than the subsidiary Islamic banks. A study by Ahmed (2012) utilized the of indebtedness theory to underpin the examination of relationship between the Islamic banks characteristics and *shubuhah*. The study's findings indicated there are some non-*shariah* compliant elements in Islamic banks. From tradtional persrective there is only one study by Greenberg (1980) studied the the theoretical and empirical status of the indebtedness concept, and to illuminate its utility for understanding social interaction. The study revealed there are multiple determinants of the magnitude of indebtedness which are linked to each other in complex ways which experienced by an individual at a given moment. Furthermore, the concept of isomorphism is drawn from the institutional theory is useful and is used in the *shariah* board reports. Ahmed, et al., (2014) mentioned that the indebtedness theory is useful for the disclosure practices in the pronouncement of *Shariah* in IFIs. He noted two essential reasons. It relies on and uses the indebtedness theory because the concept of consistency is derived from such theory, as well as a clear similarity among all IFIs including the generation of reports by the *shariah* boards and guidelines from the central banks.

Responsibility and Duties

In general, the members of *Shariah* Boards are a group of experts in *Shariah* who are delegated to give guarantees that instruments and products used in the Islamic financial industry are comparable to the *Shariah* aspects, which usually consist of the capital market, *Takaful* and banking (ISRA, 2013; Ahmed, & Zuqibeh, 2013). Organizations involved with the Auditing and Accounting for Islamic Financial Institutions (AAOIFI) would have noted the following definition of a Governance Standard in relation to a *Shariah* Board of an Islamic finance institution as: "*specialized jurists, particularly in Fiqh Muamalat and Islamic Finance, entrusted with the duty of directing, reviewing and supervising the activities related to Islamic finance in order to ensure that they are in compliance with Shariah rules and principles.*"

Following the *Sukuk* Guidelines issued by the Securities Commission Malaysia (2012), a *Shariah* Board has to be either a committee that meets the standards registered under the guidelines of *Shariah* advisors, or an Islamic institution or a bank approved by Bank Negara Malaysia to carry out advice from *Skim Perbankan Islam Shariah* advisors, or "The Islamic Banking Scheme." In this respect, the procedures start from the inception of the *Sukuk* until its issuance, such as the related part in directing to the intended product and then reviewing the product, and consequently the supervision of the product's execution for the purpose of effectively ensuring that it is compatible with the standards and requirements recommended by *Shariah* (Ahmed, Amran, & Islam, 2018). Thus, the responsibilities and role of the *Shariah* Boards are not only limited to stakeholders, but they cover other important religious obligations that are to be upheld (Ahmed & Zuqibeh, 2013; Ahmed, Islam & Al-Harthy, 2013). In this regard, SSBs play an important role in the issuance of *Sukuk* that should be concurrent with the product, starting from the moment of providing advice on the product. Based on this, the *Shariah* Boards' role is to ensure there is due diligence through their continued and permanent supervision, procedures and transactions. Here the important role of the *Shariah* Boards lies in two stages related to the Securities issuance: pre-*Sukuk* issuance; and post- Securities issuance (Ahmed, Amran, & Islam, 2018; Lahsasna & Lin, 2012). In relation to pre- Securities Issuance, *Shariah* committees play an important and significant

role in this stage (Ahmed, et al., 2013). The whole a process regarding Securities relies on this stage, in that any negligence or failure at this stage can lead to a bad reaction in the long term for the entire procedure of Securities. In the pre-issuance stage, there are four main tasks that ought to be taken into consideration:

- (i) There ought to be compatibility with the Securities structure and the *Shariah* rules. Any proposed diagram and transaction flow by the arrangers must be clearly understood by *Shariah* committees and moreover to identify *Shariah* issues in order to prepare and submit solutions to the interested parties (Machmudi, 2008). One of the important matters that should be tested at this stage is the compliance with all building blocks and terms in accordance with the principles of *Shariah*. For instance, it is important for there to be a capability of a building block to ensure the *Sukuk* structure's capital or return; when for example using *musharakah*, *wakalah bi al-istithmar* or *mudarabah* as essential contracts. In the same vein, dealing with purchase undertakings, liquidity facilities or sale undertakings there is a requirement for these to be constructed and arranged in such a way so that in the final analysis it leads to a guarantee and to ensure there is a return on capital (ISRA, 2013).
- (ii) Auditing procedures are to be utilized by way of checking the conditions and terms in the documents regarding the *Sukuk* issuance (AL-Maghlouth, 2009). These documents should be checked accurately by *Shariah* committees in order to ensure that there are no conditions contrary to any principle in *Shariah* (Besar, Abd Sukor, Abdul Muthalib & Gunawa, 2009). The important issues requiring checking are:
 - a) There is a facility description with a guarantee that the description and its illustration submitted is accurate and compatible with the approved aspects of the *Shariah* committees.
 - b) There is an underlying asset or assets with a guarantee that the asset(s) used in *Sukuk* issuance are compatible with the *Shariah* requirements (Tariq & Dar, 2007).
 - c) That for the utilization of proceeds, a guarantee is given that there is an obvious statement on the outcome of the *Sukuk* that it is to be used only in activities compliant with *Shariah* requirements, in addition to ensuring that the returns submitted on the list are totally compatible with *Shariah* requirements (Dusuki, 2010). This part is very important, especially if the activities of the issuer are inconsistent with the requirements of *Shariah*.
 - d) That a designated account is used to guarantee that only *Shariah* compliant accounts will be taken into consideration (Ahmed, Aiffin, Alabdullah, & Zuqebah, 2016).
 - e) The purchase price is also very important consideration, and needs to have careful observation (ISRA, 2013). This importance has been noted in several countries. For example, in Malaysia, with respect to the Securities issued, the structure of *Sukuk* based on *mu`awadah* contracts in *Guidelines on Sukuk* issued by the Securities Commission of Malaysia admitted the following points. In the instances of *Sukuk bai` bithaman ajil*, *Sukuk Murabahah*, *Sukuk Istisna* and *Sukuk Ijarah*, these are processes involving the purchase and sale of an underlying asset or assets. When investors purchase an underlying asset or assets the purchase price is to comply with the purchase price and must not exceeding 1.51 times the market value of the asset or in the scenario whereby the market value of an asset cannot be ascertained, a fair value or any other value must be applied. This admission protects all relevant parties who

- are involved in the Securities issuance from the incompatibility with the real price against the underlying asset.
- f) *ATa`widh* contract is a compensation contract: and is meant as a guarantee that the compensation rate is compatible with the decision made by a competent authority, like a *Shariah* advisory council in a central bank (BNM, 2007).
- (iii) There is to be an audit undertaken of the legal documentation to guarantee that all conditions and terms in such documents do not conflict with the principles of *Shariah*. As there are differing types of legal documentation in the issuance of Securities. There actually needs to be an accurate examination through *Shariah* committees to guarantee that there are no items incompatible with the *Shariah* guidelines (Muhamad Sori, Mohamad, & Shah, 2015).
- (iv) There is to be a guarantee given that the admission (decision) of the *Shariah* committee is understood and implemented by the issuer (Ahmed et al., 2013). However, this is a difficult task, especially since there are so many issuers that are only focused on and are familiar with traditional banking training, while there is a lack of knowledge about the issuance under the *Shariah* requirements. Thus, it is extremely important that the *Shariah* committee be alignment with the *Shariah* knowledge of the issuer of the Securities, so that the issuer might implement and fulfill the decisions accordingly (ISRA, 2013).

Finally, the *Shariah* committee ought to give more attention to the above-mentioned tasks with all documentation being checked to make sure of their compatibility with *Shariah* compliance (Yean, 2009).

Discussion on *Shariah* Boards and Indebtedness

Essentially, as discussed above, the theory admits that all creations have to submit to Allah and complying with *Shariah* rules and there is no exception to this rule. In this research, it is assumed that a SSB is a manifest of the Covenant (*Al-Mithaq*) and by way of submitting its desires to His Will (i.e. the *Shariah*) corresponds to an absolute true willingness as an indebtedness of the relationship between them and Allah the Creator. Thus, it is *assumed* that IFIs that have a SSB will follow the rules of *Shariah* to ensure there is validation of *Sukuk* contracts to fulfill the demand of *Shariah* compliance for the *Sukuk* holders as well as providing and disclosing information to the *Sukuk* holders especially concerning the legitimacy of *Sukuk* (Ahmed, Islam, & Ku Ariffin, 2015).

The *shariah* boards ought to be involved in the structure of the transactions, including providing guidance in the drafting, reviewing and approval of the documentation for compliance of *Shariah* (Ahmed, Islam, & Alabdullah, 2014; Ahmed, Islam, & Al-Harthy, 2013). This role, much like the coercive isomorphism in institutional theory, would ensure that all transaction and documentation comply with the requirements therefore enabling a desired outcome of consistency, certainty and transparency in the process of *Sukuk* management. The need to certify and market a *Sukuk* as *Shariah* compliant may be used as tool to pressure *shariah* board in following higher *Shariah* compliant levels and consequently enhance financial instruments legitimacy (Ahmed et al., 2015; Ahmed, Yahya, & Islam, 2013). The *Shariah*-compliant view asserts that controlling some characteristics and determinants, which are strategic and capable leads to a competitive advantage and superior performance of the IFIs. Following the normative isomorphism, the rest of the IFIs

and professional bodies are expected to follow the norm by being and offering a fully *Shariah* compliant *Sukuk* (Ahmed, et al., 2013).

The boards and committee size is likely to affect its ability to control and review all of the transactions of the IFIs to ensure their operations are in compliance with *Shariah* rules and principles (Rahman & Bukair, 2013). In addition, the ability of members of the SSB to monitor the institution's activities impacting on the well-being of the members of society is much higher with more members appointed to the board (Akhtaruddin, Hossain, & Yao., 2009; Chaganti, Mahajan, & Sharma, 1985). With more members, the collective knowledge and experience of the shariah board is increased, and consequently, leads to greater legitimacy of Securities (Ahmed et al., 2015).

Conclusion

The present paper explored issues related to the theoretical approach of responsibility of *shariah* board with Indebtedness by reviewing the responsibility of *shariah* boards towards the financial instruments and compliant with Islamic principles. The paper identified the Indebtedness duties imposed on *shariah* boards which are under the Islamic law. *shariah* boards are a manifest of the Covenant (Al-Mithaq) and by way of submitting its desires to His Will (i.e. the Islamic Law) corresponds to an absolute true willingness as an indebtedness of the relationship between them and Allah the Creator. Thus, it is assumed that IFIs that have a *shariah* board will follow the rules of *shariah* to ensure there is validation of operation contracts to fulfill the demand of *shariah* compliance for the stakeholders as well as providing and disclosing information to the shareholders especially concerning the compliant of financial tools with *shariah* rules.

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