



**FACTORS INFLUENCING ISSUERS' SUKŪK
STRUCTURE
PREFERENCE: THE CASE STUDY OF KSA BANKS**

BY

HANADI ABU BAKER N HUSSAIN

**A research paper submitted in fulfilment of the requirement
for the degree of Master of Science (Islamic Banking and
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International Islamic University Malaysia**

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ABSTRACT

The Purpose of this research paper is to examine the impact of Sukuk on the performance of the Kingdom of Saudi Arabia (KSA) Sukuk issuing listed banks and the factors that influence the issuers Sukuk structures using the pooled OLS regression and the random effect panel data models. Despite of the high R-squared and the overall significance of both of the pooled OLS regression models (1A and 2A) as well as the random effects model (1B), however, we report only the findings of the random effect model (2B) due to its consistency with theory. Hence, the results of the study suggest that bank size and amounts of issued Sukuk affect the KSA listed banks performance positively at 5% level of significance whereas the leverage ratio affects them negatively at 1% level of significance. Nevertheless, the dummy Sukuk though not significant, the negative magnitude clearly indicates the profit maximization aspect. Therefore, we may conclude that even though Sukuk impacts the KSA Sukuk issuing banks performance positively, the factors that influence the issuers Sukuk structures is profit maximization rather than Shariah compliance. Finally, the findings of this research paper may provide some policy insights to practitioners, policymakers and some Shariah scholars in the KSA.

خلاصة البحث

سعى هذا البحث إلى تحديد مدى توافر التقنيات الرقمية في المدارس الابتدائية العامة وحجم كمؤشر لأداء البنوك المدرجة (ROA) البنوك والامثال للشرعة الإسلامية على العائد من الأصول والمصدرة للصكوك في المملكة العربية السعودية، وتهدف أيضا الى التحقق من العوامل المؤثرة في هياكل الصكوك. ولتحقيق هذه الأهداف تم الحصول على البيانات المرتبطة بهذا البحث من وانتهت في فترة معينة والتي بدأت من عام 2008 (Bloomberg Thomson Reuters) خلال في عام 2016 باستخدام التحليل الاقتصادي القياسي للوحة البيانات باستخدام نظام ستاتا إصدار 14 للبرمجيات الإحصائية. وعلى وجه التحديد تم استخدام نماذج الانحدار المجموع لنظام اولس ونماذج قاعدة بيانات التأثير العشوائي (OLS) وتشير نتائج هذه الدراسة الى ان حجم البنوك وكمية الصكوك المصدرة يؤثران بشكل إيجابي في أداء البنوك المدرجة في المملكة العربية السعودية بنسبة 5% من الأهمية، في حين يؤثر المستوى المالي بشكل سلبي بنسبة 1% من الأهمية. ومع ذلك فإن معامل الصكوك ليس له قيمة إحصائية، فإن الحجم السلبي يشير بكل وضوح الى تفضيل تعظيم الربح في أداء البنوك المدرجة والمصدرة للصكوك في المملكة العربية السعودية والتي أعطت الأفضلية لتعظيم الأرباح على الامثال للشرعة الإسلامية. واخيرا وبناء على هذه النتائج املستنبطة من هذه الورقة البحثية فان التوصيات تقدم لكل من ممارسي وصانعي السياسات في المملكة العربية السعودية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science (Islamic Banking and Finance).

.....
Engku Rabiah Adawiah Engku
Ali
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance).

.....
Syed Musa Alhabshi
Dean, IIUM Institute of Islamic
Banking and Finance

DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Generally, any economy has two main sectors - which are the real and the financial sector. While the real sector provides the goods and services in the economy, the financial sector on the other hand offers the financial services i.e. financing, that real sector needs to grow through the financial system that comprises, banking and the capital markets (Mirakhor, 2013). Although, both the banking system and the capital markets play similar role of intermediation of the surplus units who have excess funds for investment, with the deficit units who need the funds for various purposes. For example, to initiate new investment projects or to finance existing businesses.

However, though their roles may seem similar, they are quite different. The banks act as a financial intermediary while the capital market offers a more direct connection between the surplus units (investors) and the deficit units (investees) in the capital markets. It is evident that surplus units with smaller amounts of funds from depositors who are risk averse and want to invest for the short-term, they usually use the banking system as an intermediary. This is due to the ability of banks to invest the depositors' funds and generate some decent profits while ensuring the safety of the funds. Nevertheless, for investors with larger surplus who have some experience in capital markets and are willing to take some calculated risks, they would use the capital markets where debt and equity are created and traded.

In the case of Islamic capital market, *sukūk* is an important instrument that is mainly issued by the deficit units to raise large amounts of funds to finance their investment and/or development projects. Interestingly, many financial institutions including

banks, nowadays, are extensively issuing *sukūk* either as underwriters or issuers especially after the recent global financial crisis of 2008-2009. It is worth mentioning that *sukūk* has many benefits for both issuer and investors. The issuer could get lower cost of funds due to higher rating via credit enhancement, access to capital markets and its liquid tradable instruments, diversification of sources of funds, improvement of financial ratios, potential risk reduction, anonymity of financing, capital tax relief and potential of structuring it as off-balance sheet finance. Meanwhile, investors may benefit from high quality investment, better risk-reward relationship, diversification, liquidity and reduction of event risks (Ismail A. G., 2013).

It is worth mentioning that the Kingdom of Saudi Arabia (KSA) is considered as one of the biggest markets in the Muslim world when it comes to the issuances of *sukūk*. Furthermore, as it was reported recently by the International Monetary Fund (IMF), the sharp decline in the oil revenues since 2014 had severely turned the KSA from surplus country of 10% of GDP in 2014 to a deficit nation by 16% of GDP in 2015. In order to avoid the worse consequences of the fiscal deficit, the KSA government has issued a US\$9 billion *sukūk* in April 2017 besides raising some conventional bonds (Fund, 2017).

In the KSA, banks represent the core of the Saudi financial system with assets worth of US\$1.2 trillion constituting 186% of the GDP as at the end of 2016. Out of the total 24 commercial banks in the KSA, 12 are foreign and the remaining are domestic. Four of the domestic banks are majority owned by government agencies and pension funds. The domestic banks represent 97% of the total banking assets in the country (Fund, 2017). Some of these 24 banks, both conventional and Islamic, have engaged in the issuance of *sukūk*. As of 2016, the total number of banks that have been involved in the issuance of *sukūk* are 10 banks of which only two are Islamic: The Bank of

AlJazira and Bank AlBilad. The Al Jazira Bank has issued two hybrid *sukūk* both with a maturity of ten years, while the Al-Bilad bank has issued a ten-year maturity of another type of *sukūk*. All in all, the issuing banks have concentrated on the four forms of *sukūk*: *Muḍārabah* (4), Hybrid (8), *Istithmār* (2), *Murābahah* (3) and other *sukūk* (1) . Nonetheless, the exact reason influencing the banks' choice to issue *sukūk* and their preference of certain *sukūk* structure(s) is still subject to a lot of debate in the literature. It may be reasonably be assumed that conventional banks' choice to be involved in *sukūk* issuance could just be commercial for-profit maximization. However, what are the factors that have really influenced both Islamic banks (IBs) and conventional banks to prefer certain forms of *sukūk* structures over the rest? To the best of our knowledge, the exact factors are not clearly known clearly so far, i.e., whether these factors are Sharī'ah compliance concerns, mere profit maximization or other factors as well. Therefore, the objective of this study is to examine the factors that influence the issuers' choice of *sukūk* structure given the case study of KSA banking system.

1.2 STATEMENT OF THE PROBLEM

Though the Islamic finance industry is composed of four sectors, the dominant ones are the banking system and the *sukūk* sector as of 2016 with a share of 72-79% and 15-17% of total Islamic finance assets respectively (Sidlo, 2017). Meanwhile, both of the sectors found to have positive impacts on the financial stability and economic growth. This very evident from the expansion of Islamic banks and the massive growth of *sukūk* despite the recent moderate decline. Nonetheless, the KSA, which is the fourth in terms of the global Islamic banking share in total assets, is also an active *sukūk* issuer. However, besides other financial and non-financial institutions, 10

including 2 Islamic banks of the 24 banks have issued different types of *sukūk* structures. One of the main reasons that both the corporate and the sovereign institution has stated to issue *sukūk* is because of the issue of risk diversification, if these institutions have opted for conventional financing through the issuance of bonds, they will incur huge losses when there is any interest rate rise, which is quite the same case for the KSA. Nonetheless, the reason we also focus the banking industry, firstly, there is no any empirical studies that have been conducted, to the best of knowledge, that have examined the impact of *sukūk* on the banking performance. Furthermore, there is no research been carried out that determine the motivation of the banking institutions in the KSA; whether it is Sharī‘ah compliance or profit maximization. However, the main reason for conducting such research is that most of the *sukūk* that have been issued by the banks are debt based *sukūk*, and this highly undermines the Sharī‘ah principles despite the Sharī‘ah approvals. Therefore, this study is the first attempt to examine the impact of *sukūk* on the KSA listed banking performance and the motivation behind the issuing banks under the options of Sharī‘ah compliance and profit maximization. Finally, the findings of this research paper will add new findings to the growing literature body of Islamic finance.

1.3 PURPOSE OF THE STUDY

The aim of this research paper is to examine the factors that influence the issuers’ *sukūk* structure preference for both Islamic and conventional banks in the KSA. This study is an honest attempt to understand the reasons behind the use of particular *sukūk* structures and their impacts on the banks performance using an empirical analysis. Hence, this research paper will determine which factor influences the KSA banking system *sukūk* structures: Sharī‘ah compliance or profit maximization.

1.4 RESEARCH OBJECTIVES

Given the above discussion of the most issued *sukūk* structures in KSA and those that are issued by the banking system, we attempt to address the objectives of this study as follows:

- 1- To identify the factors that influence the issuer's *sukūk* structure from the perspective of Sharī'ah compliance and profit maximization.

It is well known that all financial institutions especially the banking industry main objective is profit maximization irrespective of the means of attaining this objective. However, the Islamic banking system must be abided with Sharī'ah and therefore can only maximize their profits if and only if they have meet with the Sharī'ah compliance requirement. Hence, the first objective of this study is to identify the factors that influence the issuing banks *sukūk* structures in the KSA. This objective is key because most of the issuing banks are conventional and the most used *sukūk* structures are the Hybrid and *Murābahah*.

- 2- To examine the impact of *sukūk* on the KSA banking system performance.

As an indirect intermediary between the surplus and the deficit units, the banking industry has to generate sufficient profits to give back returns to the surplus units who have invested their money through the different instruments and contracts as well as to pay for their operational costs and shareholders. Meanwhile, for banks to attract a great number of customers and investor, they must maintain a consistent high financial performance besides sound reputational and ethical values. Hence, the banking industry engages in any activity either through financing and/or investing to keep its financial performance records higher than their competitors. Therefore, the

second objective of this study examine the impact of *sukūk* on the KSA listed banking performance as a new financial instrument.

3- To investigate the reasons behind the use of the specific *sukūk* structures.

The two mostly emphasized on *sukūk* structures of profit and loss sharing also known as risk sharing are the *Muḍārabah* and *Mushārahah*. However, it is evident that out of the 63 issued *sukūk* structures in the KSA, the number of *Sukūk Muḍārabah* and *Mushārahah* are 7 and 2 respectively. Meanwhile, out of the seven *Sukūk Muḍārabah*, the banking industry in KSA has only issued four and none of the only two *Sukūk Mushārahah*. Nonetheless, some of the prominent researchers and scholars in Islamic finance have argued that with exception of the *Muḍārabah* and *Sukūk Mushārahah* structures which are profit and loss sharing i.e. risk sharing, the remaining *sukūk* structures are either risk shifting or risk transferring financial instruments due to their debt like characteristics. Therefore, the final objective of this study is to propose for the KSA banking system the *sukūk* structure of the profit and loss sharing mode for reasons that will illustrate later.

1.5 RESEARCH QUESTIONS

In this project paper, we seek to provide answers to two main broad research questions:

1. Taking into consideration the structure of the issued *sukūk* by the 12 listed banks including the 4 Islamic banks; Do *sukūk* issuance increase the KSA banking performance?
2. Analyzing from the perspective of Shari‘ah compliance or profit maximization; what are the factors that influence the issuing banks in the KSA?

Hence, the analysis of the data will provide empirical results which will offer an answer to these main research questions.

1.6 SCOPE AND LIMITATION

This study is conducted to find out the impact of *sukūk* on the KSA banking institutions as well as the factors that influence the issuers' *sukūk* structures from the perspective of Shari'ah compliance and profit maximization. However, since *sukūk*-issuing banking institutions are only 10 of the 12 listed banks of the total of 24 banks in the KSA, therefore, the analysis of the study will be limited to the 10 banks including the two Islamic banks. We also excluded other financial institutions from the analysis and intended to focus on the banking system for two reasons: First, eight of the issuing banks are conventional with Islamic windows, and second the structure of the issued *sukūk*, which are debt like forms rather than profit-loss sharing structures. Finally, the outcome of this study could be a good indicator and starting point for further studies but not conclusive as it does not represent neither the total financial system nor the banking industry.

1.7 RESEARCH PAPER ORGANIZATION

This research paper comprises of four chapters. Chapter one is the introduction of the study in which we discuss about the background of the study, aim of the study, most issued *sukūk* structures in KSA such as the Hybrid and *Istithmār* besides some illustrations about factors influencing *sukūk* Structures, and we finally conclude with the objectives of the study. However, in chapter two, we present the research review concerning the global and KSA structures, the impact of *sukūk* on the KSA banking performance and economic growth, and finally we end up the chapter with some brief

discussions of the motivation behind the issuance of certain *sukūk* structures and some of the Sharī'ah issues pertaining to *sukūk* structures. Nevertheless, in chapter three, we discuss the proposed model: Panel Data Analysis, collected data and their sources and the employed methods. Finally, in chapter four, we sum up the research paper with broad discussions and conclusions concerning the proposed outcome of the data analysis and highlight on some future research topics.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The earliest Shari‘ah resolution on *sukūk* was made in the fourth session of the Council of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC) which took place in February 1988 in Jeddah, Saudi Arabia. However, the first contemporary *sukūk* was issued in Malaysia by Shell in 1990, and since then *sukūk* have gained both momentum and popularity in the financial market. In May 2003, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) published the Standard for the investment *sukūk* and has defined *sukūk* as certificates of equal value representing undivided ownership shares in tangible assets, usufruct and services. Nonetheless, on the global capital markets, *sukūk* is now considered as one of the best alternatives as well as the preferred financial structure by governments and private institutions for raising finance (Zulhibri, 2015).

Generally, *sukūk* can be classified under two main types known as asset-based and asset-backed *sukūk*. The first category normally involves tangible assets and grants beneficial ownership to *sukūk* holders while at the same time preventing them from full recourse to the underlying assets. The latter category, however, allows the true sale of asset or business venture which represents a securitisation transaction. *sukūk* has some similarities with conventional bonds in terms of fixed returns, maturity and principal repayment in addition to their tradability in the secondary market. Meanwhile, it differs from the conventional bonds in the case of asset ownership, investment returns and risks beside the issuance and pricing procedures (Naifar & Hammoudeh, 2016). Therefore, this chapter discusses the literature review of *sukūk*,

its structure, some Sharī‘ah issues as well as its impacts on the banking system performance, taking the KSA as the case study.

2.2 GLOBAL AND KSA SUKUK STRUCTURES

Since January 2001 to December 2015, the total global *sukūk* issuances for all tenors and all currencies has reached US\$767,099 million. However, the distribution for the global *sukūk* issuance by issuer status was US\$437,031 million (58%) for sovereign, and US\$255,077 million (37%) for corporates, while the Quasi-sovereign was equivalent to US\$74,992 million (5%) only. The growth of *sukūk* showed a decline during the financial crisis of 2008, after which, it has grown sharply till 2013, before declining once again as we can see from figure 2.1 below.

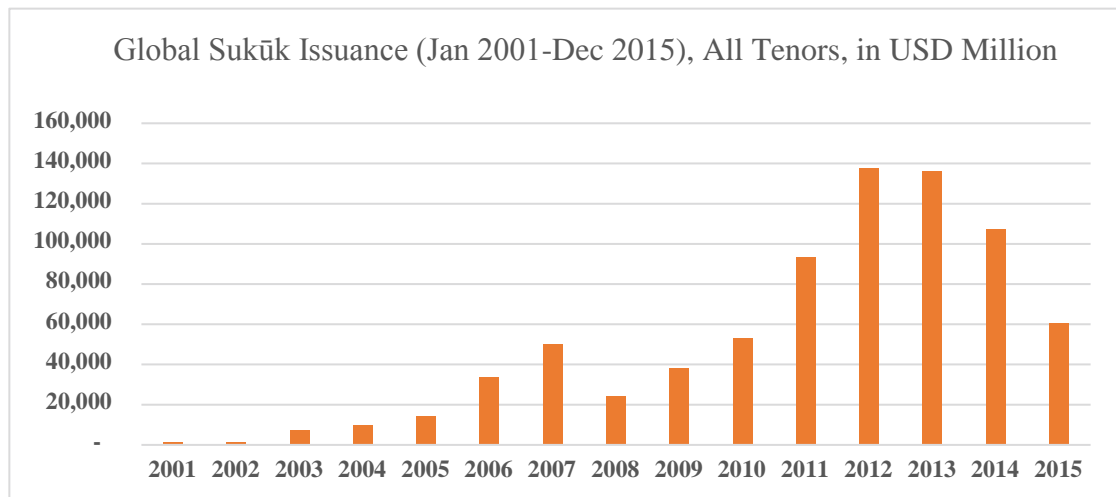


Figure 2.1 Global *Sukūk* Issuance, All Tenors Jan 2001-Dec 2015 in USD Million

Note: Figure 2.1 above is adopted from the IIFM 2016 *Sukūk* Report.

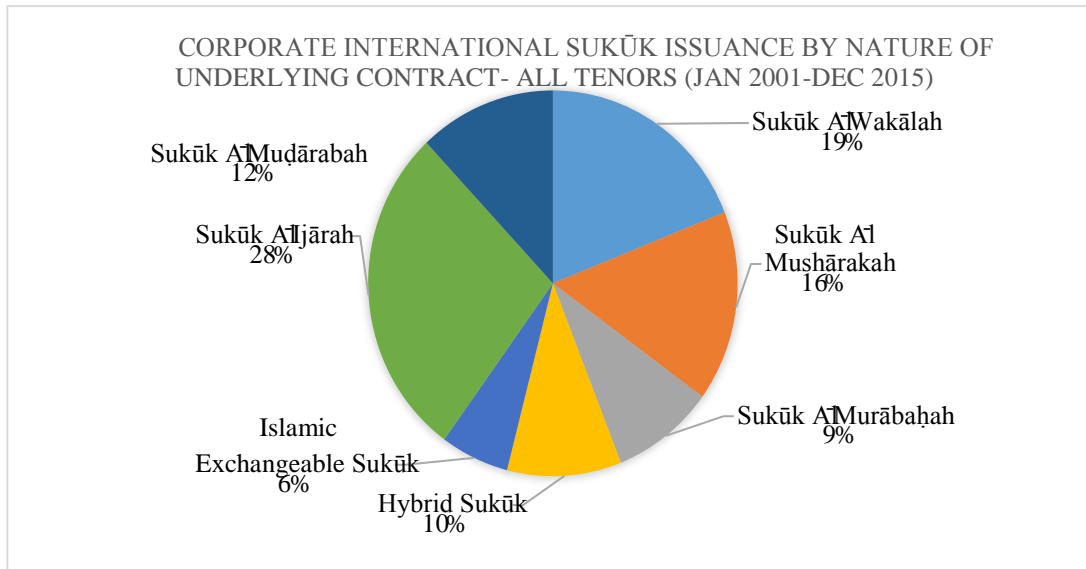


Figure 2.2 Corporate International *Sukūk* Issuance By Nature of Underlying Contract

Note: Figure 2.2 above is also adopted from the IIFM 2016 *Sukūk* Report.

Meanwhile, the *sukūk* structures used in those issuances were as follows:

For the corporate *sukūk*, there were ten structures, which were *Wakālah*, *Salam*, *Mushārahah*, *Murābahah*, *Ijārah*, *Bai Bithaman Ājil*, Hybrid, Islamic Exchangeable *Sukūk*, *Istisnā* and *Muḍārahah*. Similar structures have also been used by the sovereign issuers except for the Islamic exchangeable *sukūk*. for the Quasi-Sovereign *sukūk*, there were only seven *sukūk* structures which were the same as the sovereign issuances except that quasi-sovereign issuances have not used *Salam* or *Istisnā sukūk* structures¹. However, from figure 2.2 above, we can observe that, the three top structures for corporate International *sukūk* were *Ijārah*, *Wakālah*, and *Mushārahah* comprising of 28%, 19% and 16% respectively. This is followed by the other four structures: *Muḍārahah*, Hybrid, *Murābahah* and the Islamic exchangeable *sukūk* consisting of 12%, 10%, 9% and 6% respectively.

1 - International Islamic Financial Market 2016, 5th Edition *Sukūk* Report

However, in the case of the KSA *sukūk* structures, as we can see in figure 2.3 below, the most common *sukūk* structures issued since 05/06/2006 to 17/04/2017 were those of the Hybrid, *Istithmār* and *Murābahah* totaling to 18, 13 and 12 *sukūks* respectively. Meanwhile, others like *Muḍārabah*, *Wakālah bil Istithmār* and other *sukūk*, were 7, 5, and 24% respectively. There were only 2 issuances each for *Mushārah* and *Ijārah Sukūk*.

Nonetheless, in term of issued volume, as can be seen in Figure 2.4, *Murābahah* and *Istithmār Sukūk* registered the highest volumes comprising of 58% which were more than half of the overall *sukūk* volumes. It is evident that, even though the number of the hybrid *sukūk* were the biggest, their volumes were smaller by almost half that of *Murābahah*. Meanwhile, the issued volumes of the *Mushārah* and *Muḍārabah* structure quite big given the number of *sukūk* which were issued. Finally, the issued volume of the *Wakālah bil Istithmār* and other *sukūk* were very low compared to the number of the issued *sukūk*, which are 5% and 4% respectively.

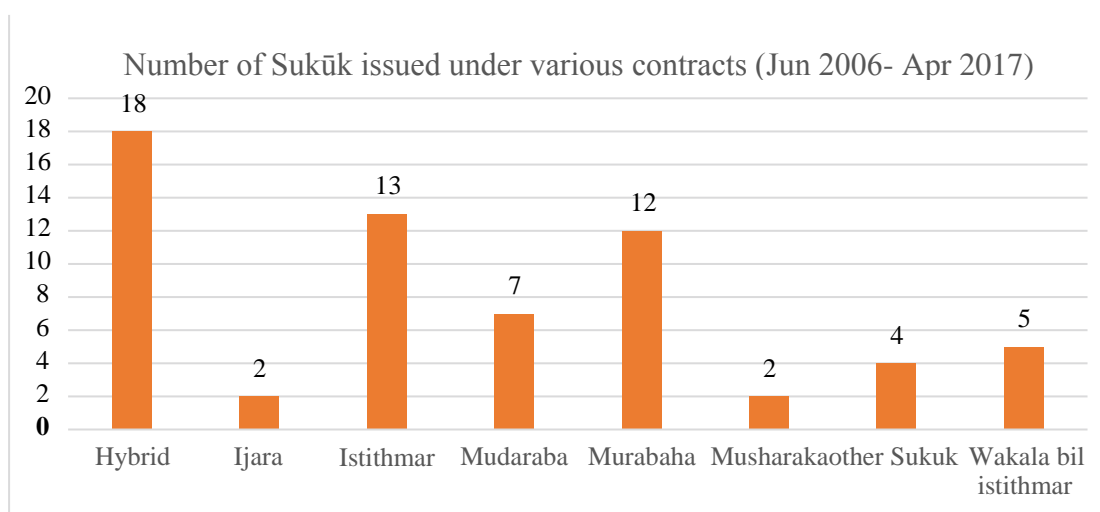


Figure 2.3 Number of *sukūk* issued under various contracts (5 Jun 2006–17 Apr 2017)

Note: The data used for Figure 2.3 sourced from Thomson Reuters DataStream Eikon.

Interestingly, in a recent study by Godlewski, C.J., Turk-Ariss, R. and Weill, L (2016), it has been found that both the choice of *sukūk* structures and choice of Sharī‘ah scholars do have impact on the market valuation of the issuing company. For instance, the study has shown that both *Ijārah* structures and the advising Sharī‘ah scholars’ reputation have positive impacts on the issuing firm’s stock price (Christophe j. Godlewski, 2016). However, the study by (Yusuf Ayturk, 2017) indicates that the quality of Sharī‘ah scholars as a variable is an insignificant coefficient due to the high concentration rate among Sharī‘ah scholars in the international corporate *sukūk* where a few scholars advise almost all *sukūk* issuances. This is due to the limited number of reputable Sharī‘ah Scholars, resulting in most of the international corporate *sukūk* being approved by just a handful of the same group of Sharī‘ah scholars.

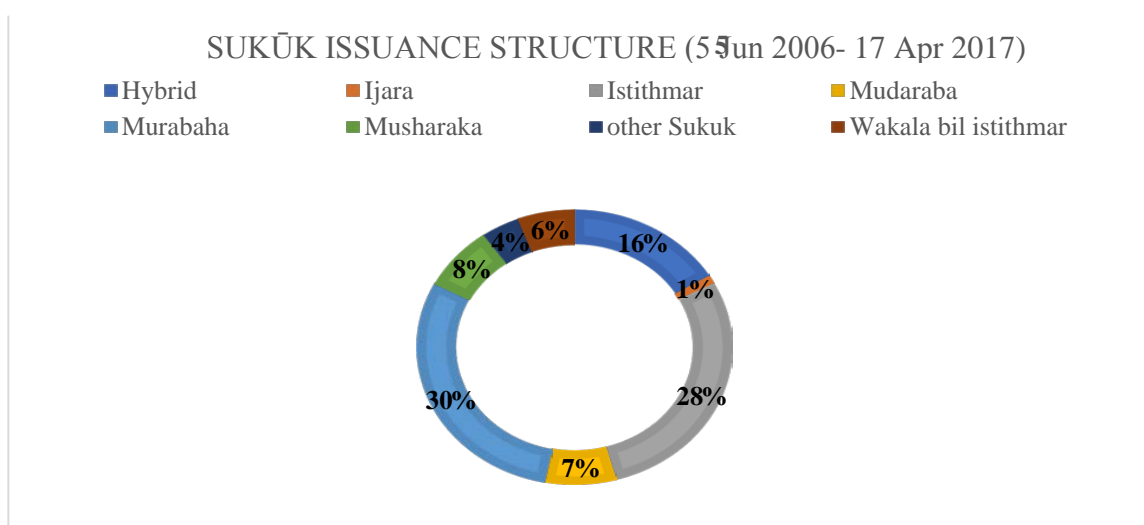


Figure 2.4 Sukūk Issuance Structure (5 Jun 2006–17 Apr 2017).