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Istisna Sukuk: Structuring and Application

Dr. Md. Golzare Nabi,* Md. Mokhlesur Rahman**

Abstract: Following insufficient supply of funds raised from traditional sources, Muslim countries have started using Istisna and other sukuk as viable alternative option for financing infrastructure projects as well as conducting monetary policy. The present study aims to examine the key features of Istisna sukuk, its structures and application and suggest for steps toward building a vibrant Istisna sukuk market in Bangladesh.

JEL Classification: E5, F3, G2, P4

Keywords: Istisna Sukuk, Infrastructure financing, Monetary Policy

1. Introduction

Sukuk has emerged as a viable financing tool in Muslim majority countries of South East Asia, Middle East, South Asia, Africa and non-Muslim countries like Singapore, Hong Kong, UK and Germany. Islamic capital market products, sukuk in particular continues to grow and its assets are estimated at USD 930.3 billion in 2021 accounting for 30.5% of global Islamic financial industry's assets (IFSB, 2022). Malaysia occupies the top position among sukuk outstanding (42%) followed by KSA (25%), Indonesia (15%), Turkey (3%), UAE (7%), Pakistan (2%), Qatar (2%), Kuwait, Bahrain and Oman (1%). Outstanding sukuk of major sectors include sovereign (54%), corporate (20%), quasi-sovereign (17%), and financial sectors (8.6%) (IFSB, 2022).

Recently Bangladesh Government authority has issued rules/guidelines for issuance and management of Islamic Shariah compliant investment instrument sukuk in public and private sector. These rules/guidelines include Bangladesh Government Investment Sukuk Guideline, 2020 and Bangladesh Securities and Exchange Commission (Investment Sukuk) Rules, 2019. Following issuance of necessary rules/guidelines on sukuk, first sovereign sukuk and maiden corporate sukuk were issued in Bangladesh in 2020 and 2021 respectively.

Bangladesh Bank on behalf of the Government has issued maiden sovereign investment Sukuk on 28 December, 2020 to raise BDT 80.00 billion for the implementation of the safe water supply project across the country. The overall

* Director (Research), Bangladesh Bank Training Academy (BBTA), **Joint Director, Research Department, Bangladesh Bank, Bangladesh. Views expressed in the paper are authors own which do not reflect the views of the institutions they work.

cost of the project was estimated at BDT 88.51 billion of which BDT 8.51 billion has been provided by the Government. The Ministry of Finance and Bangladesh Bank are playing the role of originator and the special purpose vehicle (SPV) respectively for the Sukuk. In first phase, the Government collected BDT 40.00 billion for the projects through the auction held on 28 December, 2020 at 4.69 percent profit rate. The second auction was held in 9 June, 2021 to raise the remaining amount of the fund worth BDT 40.00 billion at 4.69 percent profit rate. For implementation of the “Need Based Infrastructure Development of Government Primary Schools Project (1st Phase)” the third auction of Sukuk was held in 29 December, 2021 to raise BDT 50.00 billion at 4.65 percent profit rate. The forth auction of Sukuk was held in 20 April, 2022 to raise BDT 50.00 billion for “Important Rural Infrastructure Development Project on Priority Basis (IRIDP-3)” at 4.75 percent profit rate.

The total amount of Sovereign Sukuk issued stood at BDT 180.00 billion till end of September 2023. Profits of the Sukuk are paid to the investors on a half-yearly basis. An investor needs to invest a minimum of BDT 10,000 in this security and there is no upper limit. Banks, corporate institutions and individuals are permitted to invest in the Sukuk which is matured in five years.

For the first time in Bangladesh, Bangladesh Export Import Company Limited (Beximco) issued corporate sukuk worth BDT 3,000 in the name of Beximco Green-Sukuk Al Istisna’a in order to purchase the Solar and Textile Machineries. The second firm, Banga Building Materials Limited, a sister concern of the Pran-RFL Group has successfully secured Tk. 300 crore through the issuance of Sukuk.

Istisna Sukuk, one of the sukuk is used as financing infrastructure project and monetary policy tool. The primary objective of the current paper lies in examining the key features of Istisna sukuk, its structures and application and suggest for steps toward building a vibrant Istisna sukuk market in Bangladesh. Broad objectives include (i) explaining concept of Istisna sukuk, and its features, and application, (ii) Structuring Istisna sukuk (iii) investigating potentials of Istisna sukuk and exploring challenges and (iv) providing recommendations for building a vibrant Istisna sukuk market in Bangladesh. For achieving the objectives, the paper applies descriptive qualitative research method based on reviews of literatures and different reports.

The remaining portion of the paper has been organized as follows: Following introduction, the second section deals with review of literatures; the third section focuses on concept of Sukuk. The fourth section focuses on Sukuk al Istisna, its features, application and structure. The Beximco Green Sukuk al Istisna is analyzed in the fifth section. The sixth section examines potentials and

challenges for Istisna Sukuk and finally, the seventh section concludes with policy options and directions for future research.

2. Literature Review

Istisna Sukuk does not incur public debt or require payments of interest. This type of sukuk can be effective as a monetary policy instrument and an alternative source of government/private project financing or budget deficit financing.

Manzoor, D et al. (2017) demonstrated that Istisna Sukuk has the potential to be used for infrastructure project financing and can be combined with other contracts, including Ijarah and Musharakah. In developing countries, the lack of proper response to financing needs in the economic infrastructure will result in major challenges and difficulties in economic development. Thus, designing an optimal solution to finance these types of projects is a fundamental need. States in developing countries have so far preferred to raise funds based on debt, ignoring the fact that this kind of financing and choice of method will cause many problems for the economy. Financial crises and economic stability, creating leverage in the economy, a budget deficit, inflation, and the distribution of risk among economic agents are the issues that affect the structures and models of financing. Islamic financial innovations based on Islamic contracts can meet many of these needs. This study examined that by adapting the financial flows of state-owned projects to the real economy, especially in the field of infrastructure, macroeconomic imbalances can be avoided. This is most relevant in the "Istisna-Musharakah-Stock" model.

Mohammad M. Alfadhli et al. (2019) aims to propose an alternative source of electricity that is both renewable and ecofriendly. Solar power is proposed in this paper as an alternative source of energy. The paper examines the feasibility of a finance scheme that can both ease the financial obligations on the government and boost the banking system in the country. A product of Islamic finance that can meet such a need for financing is Parallel Istisna Sukuk Finance. Using SWOT and PESTEL analysis, the feasibility of Parallel Istisna sukuk funding was investigated in this study. The aim of this research is to propose an alternative source of electricity that is both renewable and ecofriendly. Solar power is proposed in this paper as an alternative source of energy.

Nasucha, M. N., et al. (2019) examined the viability of Istisna for project financing with an emphasis on its economic aspects and the risks associated with the Istisna contract. They also aimed to investigate the challenges Islamic banks face in adopting Istisna as a mode of project financing. This study first provided an overview of Shariah-compliant project financing and discussed the characteristics of Istisna and barriers to Istisna implementation for construction

and infrastructure project development. Economic and general legal considerations are key factors that influence the development of Istisna as project financing. This study also sought to explore ways to increase the use of Istisna.

Selimet al., (2019) attempted to explore how building a most modern Airport can be financed by pursuing Istisna-Sukuk based expansionary monetary policy. Central Bank (CB) can buy and sell such Sukuk in open market as tools of monetary policy. Sukuk are interest-free modes of financing. They are issued against assets, such as, the Airport, and their holders are the true owners of the Airport who derive their income from this asset instead of coupon or interest rates. Istisna-Sukuk based expansionary monetary policy does not incur public debt nor require payments of interest. They showed in this study that Istisna-Sukuk financing will have expansionary monetary policy effects and, as such, it will increase output and employment and consequently will reduce unemployment rate. In addition, the government will no longer have to pay interest on its public debt, which would free up more money for public spending. Economic growth and prosperity will therefore keep growing. In the long run, it will assist in stopping the transfer of domestic resources as interest payments to foreign creditors. An expansionary monetary policy based on Istisna-Sukuk does not incurring public debt or require payments of interest.

Selim M., (2020) aimed to explore Istisna'a as a monetary policy tool and examine its effectiveness in achieving full employment, income, and price stability. Istisna'a-based monetary policy's effectiveness and impact were examined using an aggregate output and aggregate expenditure model embedded with Islamic economic principles, including the zakat function. The study found that an Istisna-based monetary policy immediately creates well-paid jobs, positively contributes and expands the size of the manufacturing sector, increases capital per person employed, increases labor productivity, and thus increases output and employment and promotes industrialization. The study showed that if the manufacturing sector grows, value-added exports will go up and high-value imports will go down, which will increase the positive trade balance and reduce trade deficits in the long run. An increase in labor productivity will improve the standard of living, and eventually, the economy will yield sustainable high growth rates, full employment, and prosperity.

Lawal, N. M., & Sani Yahuza, B. (2022) explored potentials of Istisna-Ijarah Sukuk in Kano State of Nigeria. To alleviate the power shortage, the state started construction of an Independent Power Plant (IPP). The state government decided to finance the construction of the N14.2 billion Kano IPP with its internally generated revenues (IGR). Alternatively, this study proposed that

Istisna-Ijarah Sukuk may be used as an alternate financial source for the State's project. Using the interview method, cross-sectional data were collected from the state and its 44 Local Governments Authority (LGAs), the Regulators (Securities and Exchange Commission (SEC)), the Private Sector (Mergers Association), the Kano Electricity Distribution Company (KEDCO), and investors. 20 respondents were purposively selected from the total 60 sample size. Thematic analysis with coding was employed to analyze the data. Other relevant online sources were used as secondary data. The study found that Istisna'-Ijarah Sukuk is suitable for financing the state's IPP and other relevant infrastructure. Thus, it suggests that the state should draw a good lesson from the successful Osun State Sukuk and use Istisna'-Ijarah Sukuk instead of IGR or public borrowing. In addition, the paper recommends for Policy and regulatory framework and stresses on awareness for private sectors and investors for its huge potential.

3. Concept of Sukuk

Sukuk is the plural of Arabic word sakk. Sukuk meaning “legal instrument”, “deed” or “check” in Arabic language mainly refers to the Islamic Shariah-compliant equivalent of interest bearing conventional bond. Sukuk can be defined as the real asset backed security which embodies the claim on the revenues generated from the underlying asset as well as the ownership of the asset. Since the charging of interest is strictly forbidden by Islamic Shariah, Sukuk are constructed by avoiding the accrual of interest and making fully compliant with Islamic principles.

3.1 Definition of Sukuk

Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines Sukuk as: “Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity”. According to Malaysia based Islamic Financial Services Board (IFSB), “Sukuk (plural of sakk), frequently referred to as “Islamic bonds”, are certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a muarabah)”.

3.2 Sukuk vs. Conventional Bonds

Though both conventional bond and sukuk are financial assets used in financing projects and both have similarities, there are some basic differences between the two (Nabi, M. G et.al., 2016):

- Conventional bond is a debt instrument which has a contractual debt obligation for a specified period of time with a fixed or floating interest rate whereas sukuk is an equity instrument having no interest or any debt obligation.
- Traditional bond holders are entitled to cash flows derived from the issuer's contractual commitment according to pre-agreed dates, interest, and principal repayment. Such bond holders bear no loss if issuer incurs loss. Sukuk holders have a right to the ownership of the underlying asset and are entitled to receive profits generated from the underlying real or tangible asset (partnership, lease, or sale) as well as they bear any loss if incurred.
- Face value of a conventional bond is based on the credit worthiness of the issuer whereas the face value of sukuk is based on the market value of underlying asset.
- Bond holders are generally not affected by the cost incurred of the financed project but sukuk holders are affected by the cost incurred of the underlying asset. The higher the cost of the underlying asset the lower the profit for the investor from the investment.
- If sukuk represent debt obligation anyhow, it will not be tradable in the secondary market and will have to hold until the maturity. Asset back sukuk is traded in secondary market. But conventional bond is tradable in the secondary market despite a debt obligation.
- Conventional bonds can be used to finance any asset, business or project that complies with law of the country. On the other hand, sukuk finances only those assets, business or projects which are complied with Islamic Shariah.
- Market and financial risks may have adverse impact on the competitiveness of an asset's pricing in case of both conventional bonds and sukuk. But the special unique features of sukuk inherently entail a higher exposure compared to conventional bonds as sukuk have to consider an additional risk namely Shariah compliance risk. Shariah compliance risk refers to the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with Shariah.

3. 3 Major Players Involved in Sukuk Issuance and Structure

Originator: It refers to the beneficiary of issuance of sukuk. Initially it is more viable for the Government to originate Sukuk. Corporate originators may come later when the market for Sukuk are matured and floatation cost of Sukuk are reduced. Sukuk is attractive to those who possess substantial tangible asset on their balance sheets and are interested to expand funding through securitization of those assets.

Special purpose vehicle (SPV): SPV is created to manage issuance of sukuk. Either separate entity or Islamic banks and investment banks can work as SPV.

Investors of Sukuk: The investors of Sukuk are central banks, Islamic banks, private commercial banks and non-bank financial institutions. Initially the investors of Sukuk certificate are confined in institutional players until large number of individual investors participate in the Sukuk market. Sukuk can be traded in the secondary market only at the face value of the sukuk or at the market value of the underlying asset depending on the type and structure of sukuk.

Shariah Board- This board comprising Shariah experts, Islamic economist and finance advisors look after Shariah compliance issues in sukuk structuring.

There are also other players such as issue manager, trustee, obligor, rating agency, accountant, auditor, etc.

4. Sukuk al Istisna: Features, Application and Structure

The term ‘Istisna’ is rooted in the Arabic word "Sana'a" meaning request and order for manufacturing something. It is commonly used to refer to a situation in which someone requests a contractor or supplier to build something. In Law and jurisprudence, it refers to a contract by which one of the parties commits itself to manufacture and deliver a certain produce for the other party within a certain period of time and in exchange for a certain amount of money.

Issoufou, Chaibou (2018) mentions that Istisna contracts have three distinguishing features: First, they usually do not include the product in question (subject of Istisna') and it will be built and delivered by the manufacturer in the future. Secondly, the supply of raw materials and tools falls upon the manufacturer. Thirdly, at the time of signing the contract, the entire financing is not made, but only part of it is paid as an advance payment and the rest will be paid gradually until the goods are delivered. Sometimes, some part of the financing is paid only after the delivery of the goods.

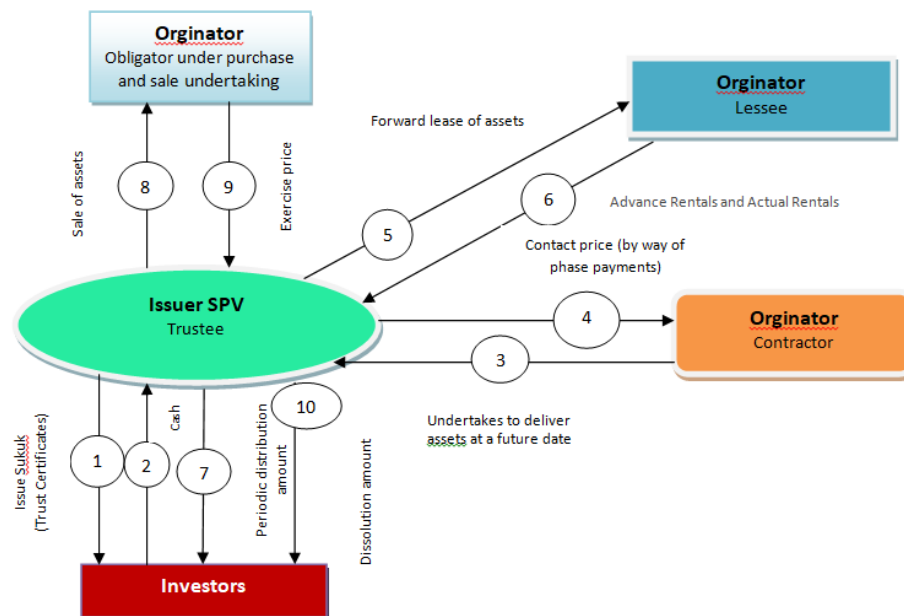
Sukuk al-Istisna is designed on Istisna contract which is a non-tradable Sharia-compliant financial instrument. This kind of sukuk is derived from the istisna'a lease finance arrangement. Financial demands for the production of particular commodities can be met through Istisna Sukuk's medium- and long-term financing options.

4.1 Application of Sukuk al Istisna

- i. Sukuk al Istisna is used to mobilize fund for implementing short or medium or long-term project (construction/manufacturing financing).

- ii. This type of sukuk is applied for the advance funding of real estate development, major industrial projects or large items of equipment such as turbines, power plants, ships or aircraft (construction/manufacturing financing).
- iii. The Islamic financial institution funds the manufacturer or the contractor during the construction of the asset, acquires title to that asset and upon completion either immediately passes title to the developer on agreed deferred payment terms or, possibly, leases the asset to the developer under an Ijarah sukuk.
- iv. It can be used to finance working capital for viable investment projects.
- v. It allows the financing of infrastructure projects such as roads and highways.
- vi. Issuing parallel Sukuk al Istisna on an asset that will be manufactured in the future wherein the proceeds derived from the subscription are used to finance the project.
- vii. It can be used as monetary policy tool.

4.2 Structuring Istisna Sukuk



In a Istisna sukuk transaction, the entity (originator) that needs asset financing makes a deal with a special purpose vehicle (SPV). The originator agrees to build or make an asset that will be given to the SPV at a later date, and the SPV agrees to pay the cost of building or making the asset in installments as certain

milestones are met. With the funds from a sukuk issuance, the SPV pays for these assets. The sukuk holders, who each own a proportionate stake in the assets based on the value of their investments, are held in trust for by the SPV, which holds the assets. Once the asset is built, the SPV makes a deal with the originator to lease the asset back to the originator. The SPV pays the sukuk holders with the rental payments. It can be used to pay for working capital for investment projects that are likely to be successful. It can also be used to finance for infrastructure projects like roads and sewers.

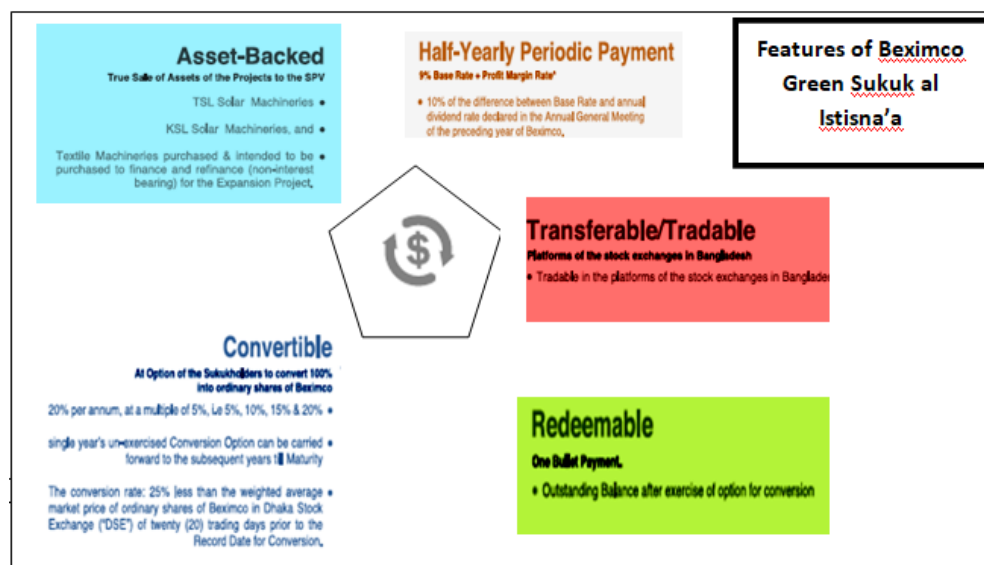
Steps in Structure

- I. Sukuk are issued by the SPV. They stand for a claim to payment of the periodic distribution amount and the dissolution amount made against Issuer SPV.
- II. Investors purchase sukuk and transfer the funds to the Issuer SPV. Issuer SPV appoints itself as Trustee on behalf of the investors by declaring a trust over the proceeds.
- III. Originator makes an Istisna deal with Trustee, whereby Originator agrees to make or build certain assets and promises to deliver them at a future date, and Trustee agrees to order those assets to be delivered at a future date.
- IV. As payment for the Assets, Trustee gives Originator a sum of money equal to the Principal Amount.
- V. In accordance with a forward leasing agreement, Trustee agrees to lease the Assets to Originator for a duration that corresponds to the sukuk's maturity.
- VI. At regular intervals, Originator pays Trustee Advance Rental before to the delivery of the Assets and Actual Rental following the delivery of the Assets in amounts equal to the Periodic Distribution Amount due under the sukuk at that time.
- VII. Each Periodic Distribution Amount is paid by Issuer SPV to the Investors using either the Advance Rental or Actual Rental that it has acquired from the Originator, depending on the situation.
- VIII. At the applicable Exercise Price, which is equal to the Principal Amount plus any accumulated but unpaid Periodic Distribution Amounts owed to the Investors, Trustee will sell the Assets and Originator will buy those.
- IX. Originator pays the Exercise Price.
- X. The Exercise Price that Issuer SPV received from the Originator is used to pay the Dissolution Amount to the Investors.

5. Beximco Green Sukuk al Istisna: The Maiden Corporate Sukuk in Bangladesh

Bangladesh Export Import Company Limited (Beximco), one of the top conglomerates in Bangladesh, recently launched the country's first-ever private sector Sukuk (Green-Sukuk Al Istisna). The size of the sukuk was BDT 30 billion issued on August 31, 2021 which was also the largest in the subcontinent.

Beximco Green-Sukuk Trust issued Beximco Green Sukuk al Istisna'a as a secured convertible or redeemable asset-backed Shariah-compliant security (Guided by AAOIFI Shariah Standards), and the proceeds received from the subscription utilized for solar projects and financing textile machineries. The tenure of the green Sukuk is five years or 60 months from the issuance date. The face value of each Sukuk is BDT 100, and the minimum subscription is BDT 5,000 or 50 green Sukuk. The rate of return of the Sukuk is 9 percent in addition to the margin. The margin is 10 per cent of the difference between the base rate (9 per cent) and the annual dividend rate declared by BEXIMCO Limited. The profit of Beximco's Sukuk is paid on a semi-annual basis.



The first project Teesta Solar Limited's (TSL) power plant, with a capacity of 200 MW, is located at Sundarganj, Gaibandha. The project utilized a part of Sukuk Fund and successfully started commercial operations on January 8, 2023. The second project, the textile project utilized a part of fund received from the sukuk and has successfully commissioned the textile machinery. The third project, Korotoa Solar Limited (KSL), with a capacity of 30 MW, is located at Tetulia, Panchagarh. The project utilized the full fund received from the Sukuk.

6. Potentials and Challenges for Istisna Sukuk

There are great potentials of Istisna sukuk in OIC and non-Muslim majority countries. Key factors which show bright prospects of sukuk market:

- Rising trend of GDP and trade in OIC countries
- Success of Islamic banking in both Muslim and non-Muslim majority countries
- Rising Muslim population
- Huge gaps in physical and social infrastructures
- Use as Monetary Policy

However, a series of economic, legal and regulatory challenges stand in the way of promoting Istisna sukuk.

- (i) **Shortcomings in legal framework:** Most Muslim majority countries lack in required legal framework for sukuk that works as a major constraint for its promotion. An unambiguous legal and regulatory framework is required for issuance of sukuk and its management and accounting procedures.
- (ii) **Lack of skilled human resources:** Paucity of skilled human resources work as limiting factors in issuing sukuk. There is lack in adequate specialized personnel having thorough expertise on sukuk. Most countries have low number of Shariah expert who can provide necessary advice in issuing sukuk from viewpoints of Shariah.
- (iii) **Absence of fiscal incentives:** In a fact, tax incentives work as catalyst for increasing interest about sukuk issue in Malaysia. Currently, there is lack of tax incentives for sukuk in most countries. The inclusion of tax incentives in existing fiscal policies may induce public and corporate sectors to issue sukuk, and attract both institutional and individual investors for investing in sukuk.
- (iv) **Awareness programs:** Awareness is very crucial to introduce and promote any financial product in any economy. There are knowledge gaps among policy makers, entrepreneurs and general investors regarding cost-benefits of sukuk in many countries. Since most of the concerned people are aware of conventional bonds and sukuk is a new instrument, mobilization of support for its introduction is also a major challenge in new jurisdiction.

6. Conclusions and Policy Options

Following insufficient supply of funds from traditional sources, Muslim countries can adopt Istisna and other sukuk as viable option for raising fund domestically and globally to implement infrastructure projects as wells conduct

monetary policy. The success of Islamic banking, rising Muslim population, growing GDP and demand for Shariah financial services have already created field for vibrant sukuk market. But the emergence of a strong sukuk market would depend on how quickly Muslim majority and minority countries can create necessary legal and regulatory framework, develop skilled manpower and provide fiscal incentives to bring all parties altogether to encourage promotion of sukuk market.

Based on examining challenges of Istisna and other sukuk market, following recommendations may be made for promoting sukuk market.

Sukuk can be viable option for financing large scale infrastructure investments in OIC countries if proper policy options are undertaken to address the challenges. In order to reap the potentials of sukuk, countries need to undertake the following steps for its promotion.

- i. **Developing Legal and Regulatory Framework:** In issuing sukuk, there needs to bring about changes in legal and regulatory framework which can pave the way for the issuance of sukuk.
- ii. **Standardization of Sukuk:** Since there are legal uncertainties and conflicts arising from Sukuk transactions as well as Shariah divergences, Sukuk need to be standardized and streamlined in terms of legal documentation and Shariah standards.
- iii. **Islamic Shariah Governance:** The Shariah governance framework provides a proper structure based on Islamic Shariah principle for issuance of sukuk and its overall management. Such framework helps strengthen the investors' confidence. It is also imperative to develop Islamic Shariah governance framework for issuance of sukuk, its management and accounting procedures.
- iv. **Fiscal Incentives:** There should have favorable tax framework that is conducive to issuance of sukuk. As sukuk are asset-back in nature, double taxation should be avoided to attract the investors and establish sukuk market.
- v. **Human Resource Development:** Undertaking effective programs to develop human resources for handling sukuk market is a must. These programs should include intensive training programs on Islamic capital markets, introduction of diploma and master's program in Islamic finance at college/university level.
- vi. **Firm Commitment of Policy Makers and Entrepreneurs:** There should have firm commitment of the policy makers to introduce sukuk in any economy. As sukuk can be a viable tool in raising funds for physical and social

infrastructure projects, policy makers should give top priority to float sukuk in respective jurisdiction. Similarly, corporate sector should come forward to pave the way for sukuk market development.

- viii. **Exploring International Experiences on Sukuk:** Countries which have no or low experience in issuing and managing sukuk, they can explore the experiences of Malaysia, Bahrain, UAE and other countries in issuing and managing sukuk. If needed, they can also seek technical assistance on issuance of sukuk from IDB, AAOIFI, and IFSB. So, exploring international experience can provide necessary guidelines and insights for successful issuance of sukuk.

The directions for future research include identification of areas for Istisna Sukuk based financing and examination of case studies on application of Istisna sukuk of other countries applicable in Bangladesh.

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