Role of Sukuk in Islamic capital market: experience of Iran (1994-2011)

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Abstract

Recent innovations in Islamic finance have changed the dynamics of the Islamic finance industry. Specially in the area of bonds and securities the use of Sukuk or Islamic securities have become increasingly popular in the last few years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through the offer of corporate sukuk. Sukuk has developed as one of the most significant mechanisms for raising finance in the international capital markets through Islamically acceptable structures. Therefore this study will focus on describing Sukuk's background, structures, challenges, and some cases of recent Sukuk issuance in Iran.

Keyword: Islamic finance, Islamic banking, Sukuk, Musharakah and Ijarah.

Introduction

Sukuk or Islamic bonds is the most popular component in Islamic Finance among Muslim and non-Muslim consumers alike. Sukuk refers to trust certificates or participation securities that grant investors a share of the asset including the cash flow and risks that commensurate from such ownership. Similar to financial bonds in the conventional financial industry, Sukuk are proof of ownership title and are utilised by financial institutions and corporates to raise cash. Both conventional bonds and Sukuk are structured in tandem with physical assets that generate revenue. However, unlike a bond, Sukuk can be designed from innovative applications of Islamic financial contracts. Leveraging on various Islamic principles, Sukuk can be structured in several ways to offer the issuing entity greater financial flexibility and options to meet its funding requirements.

In Islamic capital markets, interest rate swaps and other conventional forms of derivative instruments such as credit derivatives and detachable options are not available as Islamic law also prohibits these. Therefore, risk management requirements and considerations for competitiveness should force the Sukuk structures to further evolve and offer Shari'ah compliant alternatives to traditional derivatives. Without Sukuk structures with such depth, the financial markets may not fully develop in many emerging economies [1].

The market for Sukuk has grown tremendously in recent years, from less than $8 billion in 2003 to $45 billion in 2010. Sukuk provide sovereign governments and corporations with access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base. The structure of Sukuk is now well established in several corporate and sovereign/supranational issues in the international bond markets. Malaysia and the Gulf region are the main hubs for Sukuk issuance; however, Sukuk issuance is not limited to Islamic countries. There are a growing number of issuers from the United States, Europe, and Asia. Such bonds have been issued by such sovereign borrowers as the State of Qatar, the Bahrain Monetary Agency, the Government of Pakistan, the Government of Malaysia, and the State of Saxony-Germany, in addition to international agencies such as the Islamic Development Bank and companies including Nestle, several oil companies, companies in Dubai, and the Standard Chartered Bank [2]. There are certain differences between conventional bonds and Sukuk. A bond represents the issuer's pure debt, while Sukuk represent ownership stake in an underlying asset. For example, an Ijarah (lease) contract that is often used to structure sovereign Sukuk creates a lessee/lessor relationship which is different than a lender/borrower relationship. Investor protection mechanisms for Sukuk remain largely untested. Taxation could also become an issue for certain investors where the legal basis for taxation of Islamic securities is not legislated in the home country [3].

The objectives of this research are to review the evolution of Sukuk markets, describe the Sukuk structures and analyze the progress of Islamic finance in Iran's economy. The paper aims to contribute to the debate on the issuance of Sukuk as alternative investment/financing instruments.

Islamic banking in Iran

In Iran, after the revolution of 1979, the banking system was nationalized. Shortly thereafter, in 1983, the Law of Usury-Free Banking was passed, and on March 21, 1984, interest free banks started to implement Islamic banking based on the 1983 law [4].

After the Islamic Revolution, the Central Bank was mandated to establish an Islamic banking law. In 1983 the Islamic Banking law of Iran was passed by the Majlis (CBI). According to this law, Iranian banks can only engage in interest-free Islamic transactions (interest is considered as usury or riba and is forbidden by Islam and the holy book of Qur'an). These are commercial transactions that involve exchange of goods and services in return for a share of the assumed "profit".

Iran uses what are officially termed "provisional" interest rates, as rates paid to depositors or received from borrowers should reflect the profits or losses of a business. Under these rules, deposit rates, known as "dividends", are in theory related to a bank's profitability. In reality, however, these dividends have become fixed rates of return—depositors have never lost their savings because of losses made by the banks and almost never received returns larger than the provisional ex-ante profit rates. Interest charged on loans is presented as "fees" or a share of corporate profits. All such transactions are performed through Islamic contracts, such as Mozarebe, Foroush Aghsati, Joale, Salaf, and Gharzol-hassane. Details of these contracts and related practices are outlined in the Iranian Interest-Free banking law and its guidelines. This law describes and authorizes an Iranian Shiite version of Islamic commercial laws. Iran's banking system adheres to Islamic rules that prohibit earning or paying interest.

Briefly, the process of Islamization of the banking system in Iran had gone through three phases. In the first phase (1979-82), the banking system was nationalized, restructured, and reorganized. However, internal and external developments in this phase did not allow the policymakers to build an adequate plan for the Islamization of the banking system. The second phase began in 1982, and lasted until 1986. In this phase, the law of usury -free banking (i.e. no interest) was passed in 1983, which went into effect on March 21, 1984, giving a very short deadline of one year to the banks to convert their deposits in line with Islamic law and their total operations within three years from the date of the passage of the law. The third phase began in 1986 till now defines a role for the banking system that be an integral part of the Islamic government [5]. The Islamic banking system of Iran has the following features [6]: According to the law of usury – free banking in Iran liabilities incurred by the banks are basically of two kinds, as follows: gharz- al- hassanh deposits current and savings deposits. These are similar to those of conventional banks except that they cannot earn any return. Current qharz al- hassanh deposits are like demand deposits or current account in conventional banks. This account from the point of view of customers is simply a means of making transactions and payments. The other type of gharz al- hassanh is saving account. In this account, depositors are offered non-fixed prizes and bonuses in cash or kind. Other incentives for this kind of account are that the banks exempt depositors from the payment of fees or commissions, and give priority in the use of banking facilities. qharz al- hassanh deposits are the main sources of gharz-al hassaneh loans. Investment deposits, which banks are authorized to acquire are of two kinds: short term and long-term investment deposits. These deposits differ with respect to time. The minimum time limit for short term deposits is three months and long term deposits, 1, 2, 3, 4 and five years. No fixed amount, or rate of return, can be guaranteed to the depositors in advance. In practice banks pay the profit of depositors provisionally on a quarterly basis with a condition for final adjustment at the end of the financial year. Depositors can withdraw their money from long term investment deposits before the termination of agreement, if they give notice in advance. In this case, the basis for calculation of the profit will be the next lowest category of deposits, according to the time when the money has been deposited. Withdrawal from short-term deposits is possible at any time without notice.

Iranian banks are the predominant Islamic banking players, holding seven out of the top 10 ranks and 12 of the 100. In 2010, The Banker listed 13 Iranian banks in the "top 1,000 banks in the world.

Conceptual issue of sukuk

Sukuk can be structured alongside different techniques. Moreover, Sukuk present partial ownership in a debt, asset, project, investment or business while a conventional bond is a promise to repay a loan. In addition, The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued standards for 14 different Sukuk types. Moreover, the most common structure based upon is Ijarah which is based on leasing transactions. Other common structures are Musharakah, Istisna, Mudarabah, Murabahah and Salam Also, the Sukuk of Bithamin Ajil (Murabahah based) in Malaysia is very popular but not so for Arab investors. The suitable classification of the asset classes will also determine the type of certificates to be issued. Moreover, it is essential to note that these assets can be prepared for the issuance of trust certificates in a number of ways in condition to the need of the issuing entity.

Sukuk is a plural of Sakk. This means “legal documents, deed, and check”. It is an Arabic name for financial certificate but it can be seen as an Islamic equivalent of the conventional bonds. AAOIFI defined Sukuk as: “Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity”. (Page 298 of AAOIFI’s Shari’ah Standards for Financial Institutions 2004-5). Based on the definition, Sukuk can be further defined as a commercial paper that provides an investor with ownership in an underlying asset. It is asset-backed trust certificates evidencing ownership of an asset or its usufruct (earnings or fruits). It has a stable income and complies with the principle of Shari’ah. Unlike conventional bonds, Sukuk need to have an underlying tangible asset transaction either in ownership or in a master lease agreement [7].

TYPES OF SUKUK

The proper classification of the asset classes will also determine the type of certificates to be issued. It is imperative to note that these assets can be prepared for the issuance of trust certificates in a number of ways conditional to the need of the issuing entity.

- Pure Ijarah Sukuk: These certificates are issued on stand-alone assets identified on the balance sheet. The assets can be parcels of land to be leased or leased equipment such as aircrafts and ships. The rental rates of returns on these Sukuk can be both fixed and floating depending on the particular originator.
- Hybrid/Pooled Sukuk: The underlying pool of assets can comprise of Istisna’, Murabahah receivables as well as Ijarah. Indeed, having a portfolio of assets comprising of different classes allows for a greater mobilization of funds as previously inaccessible Murabahah and Istisna assets can comprise a portfolio. However, still at least 51 percent of the pool must comprise of Ijarah assets. Due to the fact the Murabahah and Istisna’ receivables are part of the pool; the return on these certificates can only be a pre-determined fixed rate of return.
- Variable Rate Redeemable Sukuk: The above mentioned two types of Sukuk would partially represent the strength of the issuer’s balance sheet. Under some conditions, implementing Sukuk by representing the full strength of an issuer’s balance sheet can prove to be beneficial. Already, several corporate entities refer to these Sukuk as Musharakah Term Finance Certificates (MTFCs). This can be considered as an alternative to Sukuk because of its seniority to the issuer’s equity, its redeeming nature and its relatively stable rate as compared to dividend payouts. MTFCs have a few advantages. First, employing Musharakah returns is preferred from

the viewpoint of jurists as such an arrangement would strengthen the paradigm of Islamic banking that considers partnership contracts as the embodiment of core ideals. Secondly, the floating rate of return on these 21 certificates would not depend on benchmarking with market references such as LIBOR but would instead be contingent on the firm's balance sheet actualities.

- Zero-coupon non-tradable Sukuk: Another possible classification of Sukuk structures can be created where the assets to be mobilized do not exist yet. Consequently, the objective of the fund mobilization would be to create more assets on the balance sheet of company through Istisna'. However, certificates of this nature would not readily be tradable because of Shari'ah restrictions. The primary asset pools to be generated would be of the nature warranted by Istisna and instalment purchase/sale contracts that would create debt obligations. The certificate on these debt arrangements can be termed as fixed rate zero coupons Sukuk.
- Embedded Sukuk: These could be Sukuk whether zero-coupon, pure-Ijara or hybrid, with the embedded option to convert into other asset forms depending on specified conditions.
- Expanded List of Sukuk: In response to the emergence of interest in issuances of Islamic asset-backed financial instruments, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) released an exposure draft of its Shari'ah standards concerning Sukuk in November 2002. According to the exposure draft: "Investment Sukuk are 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." Exposure Draft of AAOIFI Shari'ah Standard No. 18, p.4.

Benefits and Features of Sukuk [8]:

- Tradable Shariah-compliant capital market product providing medium to long term fixed or variable rates of return. Sukuk are assessed and rated by rating agencies, which investors use as a guideline to assess risk/ return parameters of a Sukuk issue.
- Regular periodic income streams during the investment period with easy and efficient settlement and a possibility of capital appreciation of the Sukuk.
- Liquid instruments, tradable in secondary markets.

Sukuk in Iran

The market for Sukuk has injected a much needed scope for liquidity management in Islamic banks. Previously, such liquidity could only be secured through continuous Murabahah transactions. In a global market where conventional finance dominates, liquidity could only be acquired by transactions limited to specific Shari'ah acceptable commodities such as industrial goods, metals and oils. The process of issuing Sukuk certificates allows Islamic financial institutions to garner a much wider asset pool that were previously either inaccessible or inefficient.

Iran`s financial system are practicing two kind of Musharakah sukuk and Ijarah sukuk , Musharakah Sukuk is widely used as a Shariah compatible financial instrument. Since in Iran all financial activities must obey Shariah principles and no one may issue any instrument that contradicts Shariah rules, the financial system uses Musharakah Sukuk widely to raise funds through people participation in economic activities.

According to a legal definition, Musharakah Sukuk is a nominal or bearer security issued with a certain nominal price for a specific period of time and rendered to the investors who intend to participate in a particular project. Applicants of Musharakah sukuk can participate in a particular project by filling the application form and depositing the required funds and receiving the securities. This would be a new instance of participation contract because this contract is not signed in a specific time and with the simultaneous presence of all participants but the process of participation is executed upon several references of participants in several days. It seems that such difference may not prevent a contract to be realized because such comprehensive participation contract with so many participants of may be more than hundreds of thousand people require such extensive time and place. Specially, where all participants, including those who receive their securities on the first day or later, are agree with offering of securities to new participants in a manner mentioned before and do invest in such project with knowledge and free will. So, beginning the offering of Musharakah sukuk by the issuer (via the agent bank) means the beginning of the participation and receiving such securities means entering the contract and the end of the offering period means the end of the contract which means that all holders of securities are participants to the participation asset and will be the owners of the asset, in proportion to their capital. Therefore, the perception of buy and sell of Musharakah sukuk may be with negligence in this step– initial offering. However, it is obvious that Musharakah sukuk themselves do not have any value, but they are documents showing the ownership proportion of the holders in a specific project. So, such securities have no value per se, but the value of which exists in the value of the asset and the profit of the asset also goes to the owner of securities.

The first Musharakah sukuk in Iran was issued in 1994. The municipality of Tehran issued the sukuk to finance Navab project. The value of issued Musharakah sukuk for that project was 28 million dollar. After the first successful experience in financing projects via issuing Musharakah sukuk, many other entities in Iran used this method to provide the capital needed for their activities. Now, many state-owned or private companies issue Musharakah sukuk as a Shariah compatible method to raise funds. Musharakah Sukuk is an instrument de-signed in Iran economy to finance the enterprises or the state sector for a specific purpose. The history of the first series of regulations concerning the issuing of Musharakah sukuk in Iran goes back to 1994 when the Central Bank of I.R.I was commissioned to make particular regulations for issuing of Musharakah sukuk called «Regulations Governing the Issuing of Musharakah Sukuk» which was ratified by the Money and Credit Council in 1994. Indeed, it was a substitute for the «Regulations on Issuing of Bonds» which were of no use in presence of Riba–Free Banking Regulations. However, all deficiencies concerning the said regulations, such as the lack of coordination with other rules and regulations, rendering of powers out of the duties of the CBI, lack of certain regulations on converting these securities to stocks, and etc., which were the results of the experience of issuing such securities resulted in amending the Regulations Governing the Issuing of Musharakah Sukuk. The Law for Issuing of Musharakah Sukuk including 13 articles was ratified by the Iran`s parliament in 1997. However, the Law and the Bylaw of issuing of Musharakah sukuk were enacted to integrate the whole efforts of private, state and cooperative sectors; specify a particular framework for the issuers' guarantees; determine the duties of respective authorities; convertible Musharakah sukuk ; and so on. According to the Law, government, state-owned companies, municipalities, non-governmental governmental public firms and institutions, welfare institutions, companies related to these authorities, private joint stock companies and cooperative manufacturing companies may issue and publicly offer Musharakah sukuk in order to provide a part of required financial resources of beneficiary development projects of the government stated in national annual budget laws and profitable manufacturing, construction and service projects, and also provide required materials for their own manufacturing units. Musharakah Sukuk may be nominal or bearer and issued with a certain par value for a specified period. Owners of these securities will be shared in earnings of the project proportioned to the par value and the period of partnership and also trading of which would be directly or via the exchange.

Table1: Some case of Musharakah sukuk in Iran

Issue	Value (USD)	Year	Duration (Year)	Provision at rate(%)
Municipality of Tehran	32000000	1995	4	20
Khorasan house building	8000000	1997	5	20
Ministry of finance	217400	1998	3	20
National Petrochemical Industry Co.	20000000	1999	2.5	20
Ministry of finance	192700000	2000	4	19
Ministry of power	30000000	2001	3	19

Central bank of Iran	344300000	2002	1	17
Ministry of road and transportation	127800000	2003	4	15
Central bank of Iran	1664800000	2004	1	17
National Petrochemical Industry Co.	150000000	2005	3	17
National Petrochemical Industry Co.	280000000	2006	3	15.5
Ministry of road and transportation	269900000	2007	4	15.5
Ministry of finance	600000000	2008	5	15.5
Municipality of mashhad	200000000	2009	4	18

Source: Bulletin of Iranian Islamic capital market.

The Law for Issuing of Musharakah Sukuk, ratified in 1997 has predicted the Central Bank of Iran (CBI) as the authority to give the required permit for issuing such Musharakah sukuk for those projects which are included in this Law except state beneficiary development projects. Following the approval of the securities market act, ratified in 2005 this responsibility has been rendered to the Securities and Exchange Organization (SEO). Using the funds of selling such securities elsewhere would be as illegal possession of public funds and assets.

Table 2: amount of Musharakah sukuk issuance and sell in Iran (Billion Rails)

Year	Total issuance	Amount of sell
1994	75	75
1995	225	225
1996	401	401
1997	2548	2548
1998	3130	3130

1999	2450	2450
2000	2380	2380
2001	6100	6099
2002	6100	5377
2003	11885	11796
2004	19700	18590
2005	19200	15775
2006	33050	23510
2007	11800	11299
2008	17700	17697
2009 to the end of march 2010	179420	156805
total	33164	295008

Source: Central bank of Iran

As can be seen from table 1, and 2, the amount and number of Musharakah sukuk is increasing in Iran's financial market. Now companies and government are exploiting an Islamic tool to finance their projects which is compatible method to Shari'ah.

Ijara shares are other kinds of Islamic bonds which are many similar characteristics to lease financing and hire-purchase arrangements. It involves a lessor (usually a financial institution) purchasing an asset, and renting it to a lessee for a specific time period at an agreed rental or receiving a share of the profits generated by the asset. There are two main types of lease under the Ijara structure. The first involves a longer term lease which usually ends with the transfer of ownership of the asset to the lessee (Ijara wa Iqtina), as in a modern finance lease. The second type of lease is for a shorter term and will usually end with the financial institution retaining ownership of the asset, in common with an operating lease. The rental income in this second type of lease will take into account wear and tear of the asset. To comply with Shariah, the leased assets must not be prohibited items (for example, machinery for the manufacturing of alcohol) and must be used in ways deemed lawful by Shariah.

The Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer instead of lending money and earning interest. In addition, Ijarah Wa Iqtina extends the concept of Ijarah to a hire and purchase agreement. Furthermore, any company intends to issue Ijarah Sukuk for 100 m, the company will sell one or some of its assets to a special purpose vehicle (SPV) for its need of money 100 m. The SPV will finance the company and buy the asset by issuing Ijarah Sukuk equal the amount of purchasing the asset (100 million). The investors will share the proportion of that asset as Sukuk holders. After the SPV buy the asset, it leases it back to the company for predetermined amount of money. The lease rental payments represent the periodical payments for the investors. At maturity, the SPV will sell the asset back to the company for the same amount plus the last payment. The investors will get their full amount of Sukuk payment and their principal of the Ijarah Sukuk [9].

Terms of financial instruments of Ijarah securities proposed by the board of securities and exchange directors were passed in 2008 in Iran. As of July 2011 and for the first time since the law was passed 3 years ago, Iranian companies such as Mahan Airlines, Saman Bank, and Amin investment company have respectively issued $30 million, $100 million and $108 million worth of this type of bonds. On 13 March 2011, Mahan Airline issued Sukuk with the value of IRR 291 billion in Farabourse (Iran's OTC market) to finance its network developmental projects for the first time in the Iranian Capital Market. Saman Bank has launched Sukuk Al-Ijarah’s 3-day initial public offering (IPO) at issue price of Rial 1,000,000 on 18 th June, 2011 through Over-the-Counter (OTC) market all over the country which opened new horizons of development for the country’s banking Industry.

Iran also will probably issue $5 billion in bonds inside and outside the country aiming to provide necessary finance to develop its oil and gas industries, the National Iranian Oil Company's managing director announced. The bonds will be offered by the end of the current calendar year (March 20, 2012). The decision is aimed to secure a portion of the total $156 billion fund which has been envisaged by the fifth five-year development plan (2010-2015) for the energy sector. The issuance of participation bonds has been forecast for National Iranian Oil Company, National Iranian Gas Company, National Iranian Oil Refining and Distribution Company, and National Iranian Petrochemical Company.

Problems and challenges

Sukuk products offer a vast scope of innovation and a large potential for the growth of Islamic finance but at the same time development of this product face some challenges in Iran which are as follow:

- Non-existence of appropriate secondary market mainly due to the lack of critical mass.
- Existence of large bureaucracy administration for companies.
- Few market makers.
- Pricing the secondary market issues - area of inefficiency and requires more transparency.
- Limited awareness and flow of information.
- Lack and limited Facilitating matters related to issuing and ranking of sukuk bonds and creation of rating agencies.

- Limitations in standardization of assets used in sukuk and also evaluation process of these assets.
- Central bank assurance restrictions to act as guarantor for banks in the issuance process.

Conclusion

The market for Sukuk has grown tremendously in recent years at about 45 percent a year. Sukuk provide sovereign governments and corporations with access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base. Financial experts estimate the current worth of Shariah-compliant assets at almost one trillion U.S. dollars globally. In 2010 Sukuk issuances hit a record of US$47.78 billion if compared to the last five years; managing to surpass 2007 peak level by around 7% and 50% if compared to 2009. If this was to convey something, it would be the increasing confidence the global markets are regaining.

Islamic Capital Markets have potential to reach several trillion dollars and in this market Iran should adopt and implement appropriate tools if wants to play the pioneer role with the biggest Islamic financial market. Now Iran's securities and exchange organization has ratified Murabahah sukuk as well to facilitate Islamic finance beside Musharakah and Ijarah sukuk but it is essential to consider for better implementation and promotion of capital markets (a) It is necessary to study all other securities and provide appropriate situation for issuance of them. (b) To create a competitive environment between monetary and financial markets, it is necessary that the current laws and regulations be revised and (c) taxation issues should be consider which is one of the main challenges for development of sukuk market.

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