

**In the Name of Allah
the Beneficent the Merciful**

Islamic Financial Instruments

Sukuk



**Capital Market Central Asset
Management Co.**

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Iran Capital Market Central AMC Profile:

- The company was established under article 2 SPVs activities instruction approved by high council of stock exchange in August 2010
- The main goals of this company are establishment and management of SPVs, under paragraph «د» Matter of Law «the development of new financial instrument & institution in order to facilitate the implementation of forty-four constitution».

□ Services:

In fact, Central Asset Management Company acts as a trustee that constantly reviews and comments on the consumption of funds, maintenance of accounts, financial statements, and performance of the issuer according to the signed contract in order to maintain the interests of the owners of securities and gain assurance about the accuracy of issuer's activities. Among other responsibilities of this corporation is to do all administrative, financial, managerial, legal and lawful responsibilities of an SPV, maintain the accounts and financial books of the institution and rejecting them after the end of the contract.

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SPV is a financial entity established to finance large projects through Islamic contracts which aims to reduce the risk and increase the clarity

Legislation of «development of new financial instruments & institutions» law in August 2010

Article 1:
Possibility of
using Islamic
contracts in
securities
issuances

Article 11:
SPV tax
exemption
on financing
proceeds

Article 12:
Tax exemption
on proceeds from
selling the asset
to the SPV

□ Introduction

Companies have always needed to be financed for establishment, mobilization and development of their activities. In a financial system various instruments are provided to fulfill this need. Such financial instruments are mainly divided into four types:

1. Equity instruments
2. Debt instruments
3. Derivative instruments
4. Hybrid instruments

Since such instruments are formed in western countries based on their principles and legal systems, in some cases, they do not comply with Islamic laws and principles. For instance, bonds are the best debt instruments in a common financial

system, while in Islam they are “Hiram” (prohibited) because they are considered “Riba”. As far as Islamic governments and companies follow Islamic laws and principles, they need financial instruments which are in compliance with Shariah.

□ Historical background of Islamic instruments

The financial market is divided into money and capital markets; as a result, the financial instruments applied in these markets are divided into two groups of money market instruments and capital market instruments.

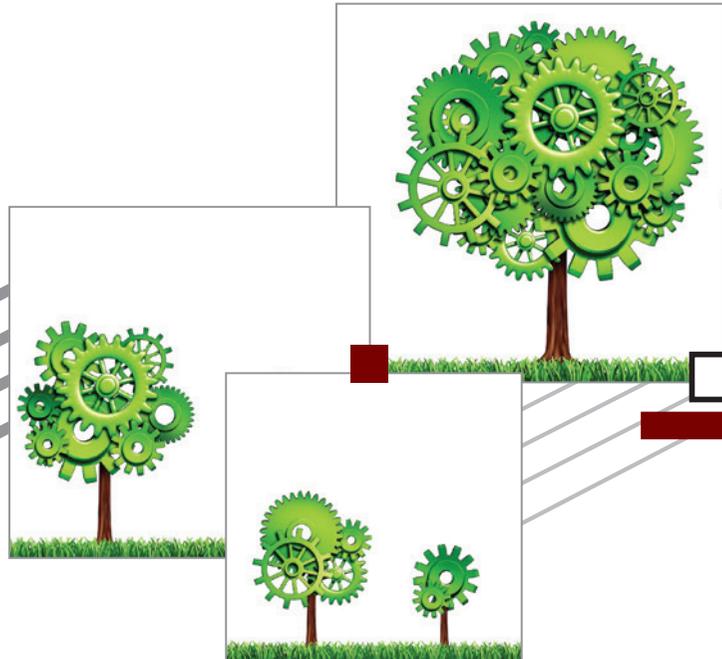
The first idea of Islamic financial instruments was raised in the mid 1970s, when the first Islamic banks in countries such as, Egypt, Saudi Arabia and Sudan made their debut and afterwards Islamic banking was established in Pakistan and Iran, too, which mainly focused on Riba-free banking.

In line with the development of transactions structures by the Islamic banks, the idea of Islamic financial instruments was also improved in the capital market.

The idea of issuing Ijarah certificates as the first Islamic financial instrument was brought up by Dr. Monzar kahf in 1997. Kahf considers the international sukuk issuances of Malaysia and Bahrain in 1999, as the debut of Islamic financial instruments.

□ Sukuk Definition

The term of “sukuk” for Islamic financial instruments was first suggested by jurisprudence committee of Islamic Development Bank in 2002. “Sukuk” is an Arabic word and plural of “sakk”, which means “cheque” in Persian or script of property ownership. Juridical standard No. 17 of accounting & auditing organization of Islamic financial Institution, have defined Sukuk as: «The certificate with equal nominal value after underwriting operation, confirms the payment of forenamed nominal sum in certificate by purchaser to publisher and their holder will become owner of one or more assets, the profit of assets or beneficiary of a project or a specific investments activity».



□ Differences between sukuk and the conventional bonds (Riba securities with fixed interest)

	<i>Conventional Bonds</i>	<i>Sukuk</i>
Asset ownership	Bonds don't give the investor a share of ownership in the asset, project, business, or joint venture they support. They're a debt obligation from the issuer to the bond holder.	Sukuk give the investor partial ownership in the asset on which the sukuk are based.
Investment criteria	Generally, bonds can be used to finance any asset, project, business, or joint venture that complies with local legislation.	The asset on which sukuk are based must be sharia-compliant.
Issue unit	Each bond represents a share of debt.	Each sukuk represents a share of the underlying asset.

	<i>Conventional Bonds</i>	<i>Sukuk</i>
Issue price	The face value of a bond price is based on the issuer's credit worthiness (including its rating).	The face value of sukuk is based on the market value of the underlying asset.
Investment rewards and risks	Bond holders receive regularly scheduled (and often fixed rate) interest payments for the life of the bond, and their principal is guaranteed to be returned at the bond's maturity date.	Sukuk holders receive a share of profits from the underlying asset (and accept a share of any loss incurred).
Effects of costs	Bond holders generally aren't affected by costs related to the asset, project, business, or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.	Sukuk holders are affected by costs related to the underlying asset. Higher costs may translate to lower investor profits and vice versa.

□ Benefits of sukuk

There are several benefits in sukuk. According to some authorities, sukuk is considered as a bridge between money market and capital market. Major advantages of sukuk are as the followings:

- 1- It increases the originator's liquidity
- 2- Sukuk can be used by corporates to achieve an optimum balance between debt and equity on their balance sheet.
- 3- Although a part of originator's assets is isolated, he can still use it.
- 4- Since sukuk are issued based on assets, they reduces the risks and funding costs.
- 5- It affects the capital market development by changing the assets to securities (securitization)
- 6- Sukuk are tradable in secondary markets.

□ Sukuk background in Iran

Islamic Republic of Iran provided regulations for issuing Musharakah sukuk in 1994 and Tehran Municipality (originator) issued the first Musharakah sukuk in order to finance Navab Highway project. Since Islamic finance researchers were not aware of this innovation, they believe that the idea of Islamic financial instruments was first generated in 1997, i.e., 3 years after applying it in Iran. However, Malaysia and Arabic countries play a key role in developing such instruments and designing various kinds of sukuk.

□ Sukuk issuances in Iran August, 2010 – May, 2014

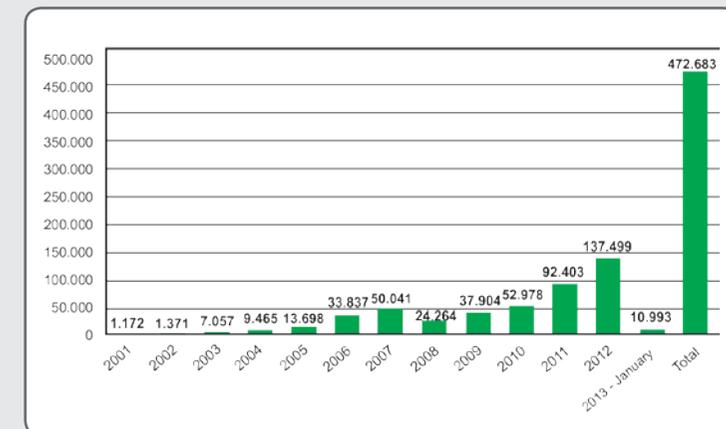
Originator	Structure	Volume (million Rials)	Return Rate	Tenor (Years)	Rental Payment Periods
Industrial Group of Boutan Co.	Murabaha	301,306	20%	2	Every 3 Months
Pars Petroleum Co.	Ijarah	1,040,000	20%	4	Every 3 Months
Rayan Saipa Leasing Co.	Ijarah	227,865	20%	4	Every 3 Months
Mapna Group Co.	Ijarah	2,000,000	20%	4	Every 3 Months
Sina leasing Co.	Ijarah	100,000	20%	4	Every 3 Months
Maskan Investment Group Co.	Ijarah	238,000	20%	4	Every 3 Months
Joupar Co.	Ijarah	415,250	20%	4	Every 3 Months
Saman Bank	Ijarah	1,000,000	20%	4	Every 3 Months
Omid Investment Co.	Ijarah	1,087,000	20%	4	Every 3 Months
Mahan Co.	Ijarah	914,250	20%	4	Every 3 Months
Mahan Co.	Ijarah	291,500	20%	4	Every 3 Months
Chadormalu Co.	Ijarah	1,500,000	20%	4	Every 3 Months
Mapna Group Co.	Ijarah	1,970,000	20%	4	Every 3 Months
Sepehr Saderat Co.	Ijarah	400,000	20%	2.5	Every 3 Months
Glucosan Co.	Murabaha	200,000	20%	4	Every 3 Months
Rightel Co.	Ijarah	3,000,000	20%	4	Monthly
Dana Petro Rig Co.	Ijarah	775,000	20%	4	Every 3 Months
Ghaed Bassir Petrochemical Co.	Ijarah	500,000	20%	4	Every 3 Months

The First Ijarah sukuk was issued in Iranian Capital Market on January 2011 for financing Mahan Airline Company with the value of 291,500 million Rials. From April to December 2011, financing through Ijarah sukuk in capital market was reached to 3,673,750 million Rials.

It is noteworthy that global sukuk issuances from 2001 to 2013 worth about 472.7 billion dollars.

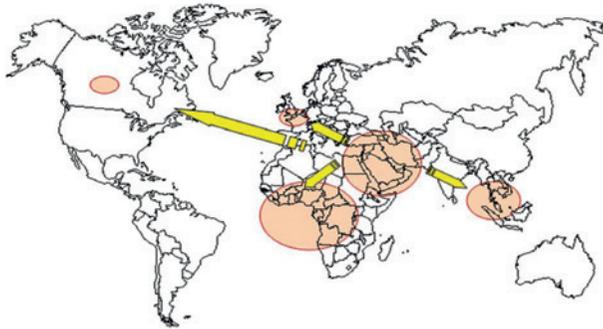


■ Total Global Sukuk Issuance – US\$ Millions

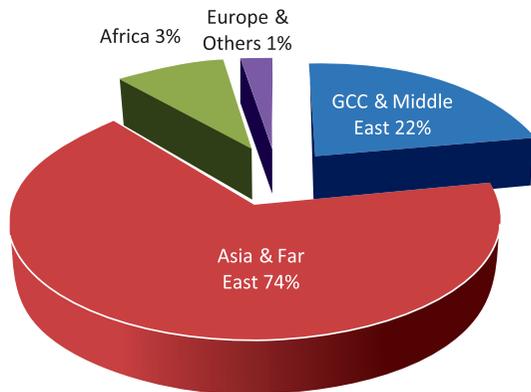


Local and international issuances, respectively, take 394.36 and 78.33 billion dollars of all issued sukuk.

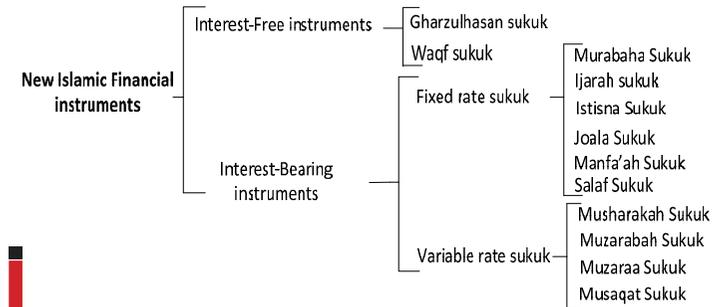
Global Sukuk Markets Outlook



Total Global Sukuk Issuance by Regional Breakdown 2001 - 2013

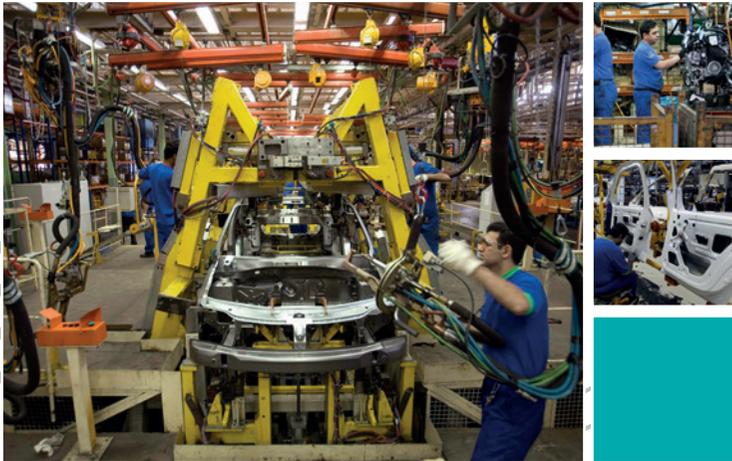


Different types of Islamic financial instruments (sukuk)



Interest-free instruments

- Gharzulhasan sukuk:** They are securities that are issued on basis of interest-free loan contracts. According to Gharzulhasan contract, issuer of securities seeks loans from Sukuk holders and will become indebted to them. At maturity date, he must pay the nominal value of Sukuk to Sukuk holders. Governments and charitable institutions can use Gharzulhasan securities for implementing public utility projects or for establishing relationships between philanthropists who intend to grant part of their property to people in need of Gharzulhasan and applicants of Gharzulhasan. There are many people who can start economic activity if a capital is granted to them in form of Gharzulhasan and then gradually pay their loan installments.
- Waqf Sukuk:** These securities are issued at a face value for a certain period of time (the time for carrying out a project). Sukuk holders are Waqifs (endowers) who intend to participate in charitable projects.



Fixed rate interest-bearing financial instruments (tradable in secondary market)

- **Ijarah sukuk:**

A security, the holder of which owns in common, parts of an asset that has been transferred on the basis of Ijarah contract. The ijara contract is essentially a rental or lease contract; it establishes the right to use an asset for a fee. The basic idea of ijara sukuk is that the sukuk holders (investors) are the owners of the asset and are entitled to receive a return when that asset is leased. In this scenario, the SPV receives the sukuk proceeds from the investors; in return, each investor gets a portion of ownership in the asset to be leased. The SPV buys the title of the asset from the same company that is going to lease the asset. In turn, the company pays a rental fee to the SPV. The ijara contract process begins when a company that needs an asset but can't afford to purchase it outright contracts with an SPV, which agrees to purchase the asset and rent it to the company for a fixed period of time.

- **Murabaha Sukuk:**

These are certificates that represent equal value issued for the purpose of financing the purchase of Murabahah commodity

and therefore, the certificate holders become the owners of the purchased commodity.

- **Istisna Sukuk:**

These are certificates that represent equal value issued with the aim of mobilizing required funds to be used for the production of certain goods which to be owned by the certificate holders when its produced on Istisna basis.

- **Joalah Sukuk:**

Certificates that represent joint ownership of a service proceeds based on the joalah contract.

- **Salaf Sukuk:**

It is a sort of Bay'. Originators who intend to distribute or manufacture a certain product can apply this type of Sukuk in order to finance their projects. In fact, in these securities, investors buy the product in advance.

- **Manfa'ah Sukuk:**

Financial certificates that represent ownership of the holder on certain usufruct of a durable asset or service for specific time in future. The holders of these certificates obtain such rights in exchange for an agreed amount of money they pay to the issuer.



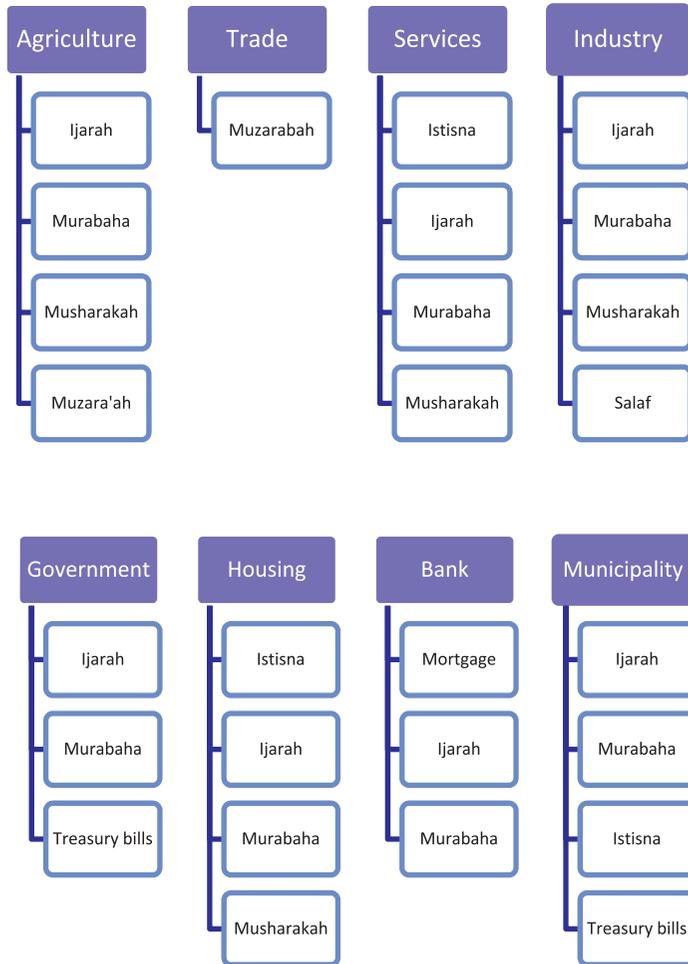
Variable rate interest-bearing financial instruments

- **Musharaka Sukuk:** These are certificates that represent equal value issued with the aim of using the mobilized funds for establishing a new project or developing an existing one or financing business activity on the basis of any of partnership contracts. Thus, the certificate holders become the owners of the project or the assets of the activity as per their respective shares.
- **Muzarabah Sukuk:** These are certificates that represent projects or activities that are managed on the basis of Muzarabah contract by appointing Muzarib who could be one of the partners or any other person for the management of the operation. In this transaction, the issuer of these certificates is the Muzarib, the subscribers are the capital owners and mobilized funds are the Muzarabah capital. Thus, the certificate holders own the assets of Muzarabah and share the profit as per the agreement. They also being the capital providers, bear the losses, if any.
- **Muzara'ah:** These are certificates of equal value issued for the objective of using the mobilized funds in financing a project

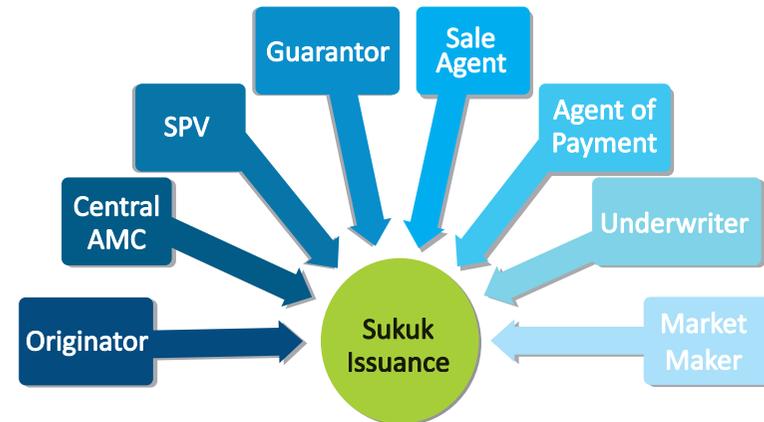
on the basis of a Muzara'ah contract. Thus, the certificate holders become entitled to a share in the crop as per the terms of the agreement. In this transaction the issuer of these certificates is the owner of the land, the subscribers are the cultivators who invest on the basis of Muzara'ah contract and the mobilized funds are the cultivation cost. Thus, the certificate holders are entitled to a share of the produce of the land as per the agreement.

- **Musaqat sukuk:** These securities are designed based on Musaqaq contract. The issuer of Musaqaq Sukuk transfers the Sukuk and collects the money paid by the applicants of these Sukuk and then will purchase cultivation fields using this money. It then gives the fields to horticulturists on behalf of the owners of Sukuk and based on the Musaqaq contract so that they work on the lands. The harvest will be distributed later. In these Sukuk, the owners play the role of landowners, the issuer has the role of an attorney, and the horticulturist has the role of agent in the Musaqaq contract. Musaqaq Sukuk are the deeds of Sukuk-owners' joint ownership of certain cultivation fields.

□ **Applying Islamic financial instruments in different sectors of economy**



Sukuk issuance entities



1- Originator:

It is an institution that could issue securities in order to finance itself. Originator cannot issue securities on its own and needs to embark on this issuance through an SPV. Based on the type of securities, the Islamic originator plays different roles. In lease securities, the originator plays the role of a tenant, in Muzaraba the originator acts as a partner or an agent, in Murabaha the originator plays the role of a mortgage purchaser and in other securities it plays the particular legal role associated to the securities.

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2- Central Asset Management Company:

This Company embarks on establishing SPVs (Limited Corporation) in order to use them with regard to the process of issuance of securities. In fact, Central AMC acts as a trustee that constantly reviews and comments on the consumption of funds, maintenance of accounts, financial statements, and performance of the issuer according to the signed contract in order to maintain the interests of the owners of securities and gain assurance about the accuracy of issuer's activities. Among other responsibilities of this corporation is to do all administrative, financial, managerial, legal and lawful responsibilities of an SPV, maintain the accounts and financial books of the institution and rejecting them after the end of the contract.

3- Intermediary Institution (SPV):

SPV is a limited corporation that is established by Central Asset Management Company; and as the only institution that is allowed to issue securities, acts as the agent of issuing different kinds of Islamic securities or Sukuk. Each SPV cannot issue securities for financing more than one project at the same time. In most cases, such companies have no staffs except the manager and in some cases; they are staffed by two people at most.

4- Guarantor:

The Guarantor acts as someone who guarantees the capital and the profit of Securities owners. Credit rating will determine the existence or nonexistence of the Guarantor. If the corporation has credit rate, the existence of Guarantor is not required. Credit rating reveals that whether the Originator has sufficient financial power and enough capital to meet its obligations or not; and guarantees its financial qualification to pay profit and the Securities itself.

5- Sale Agent:

The sale agent is a legal person who acts on offering Sukuk for sale on behalf of the issuer. In fact, the sale agent is the intermediary between the issuer of securities, i.e. the SPV, and the purchasers, i.e. investors. The sale agent is chosen among the banks, credit or financial institutions that are under the supervision of the Central Bank, finance corporations, Tehran Stock Exchange broker firms, or Iran's OTC.

6- Agent of Payment:

Central Securities Depository Corporation is the agent of payment for the Islamic securities. This institution signs a contract under the title of "sale agency contract" with the SPV. The agent of payment is entrusted with any payment related to securities to investors or owners of the securities at certain maturity dates.

7- Underwriter:

The commitment of underwriting is the commitment of a third party for purchasing the securities that are not sold by the underwriting deadline. The Underwriter is introduced by an originator and if the capital is determined to be sufficient, the underwriter will be selected with the approval of the organization.

8- Market Maker:

Market Maker is a broker/dealer who commits to deal in certain securities in a way to increase liquidity and regulate supply and demand for such securities with the aim to limit price fluctuations.

Applied Islamic financial instruments in Iran capital market

Ijarah Sukuk

One of the most significant types of Sukuk, is Ijarah Sukuk, which in fact refers to the securities in which the owner, jointly, owns some part of the assets the profits of which has been transferred to the consumer or the originator according to the Ijarah contract. In Ijarah Sukuk the right of using the profits of the assets or a series of assets is transferred from the owner to another party in exchange for the payment of the rent.

The tenor of Ijarah contract is definite and the rent could be paid at the beginning or end of the period or at monthly, quarterly, or annual maturity dates. Since Ijarah Sukuk are securities that are indicative of joint ownership, they could be traded at secondary markets and with a price that is determined by market agents.

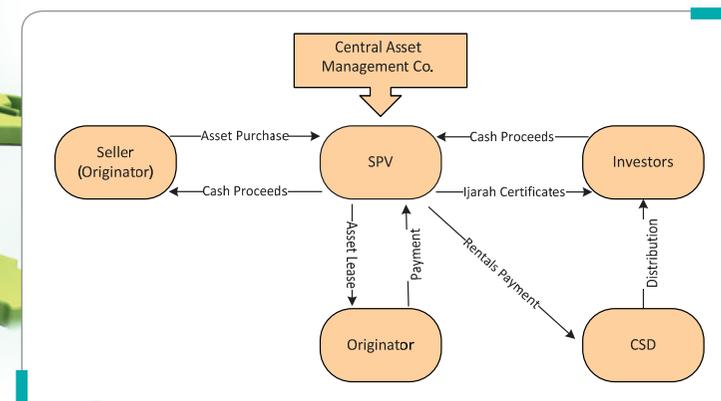
Types of Ijarah Sukuk

1. Financing Ijarah Sukuk: In this type, the Issuer of Ijarah Sukuk collects the funds of investors, and acting on their behalf, buys in cash the asset needed by the originator from the manufacturer (seller), and rents it to the originator. The originator undertakes to pay the holders of securities the rental fee for the asset on due dates.

2. Liquidity Ijarah Sukuk: In this type, the Issuer of Ijarah Sukuk collects the funds of investors, and acting on their behalf, purchases one of the originator's physical assets in cash and assigns it to the originator on the basis of Ijarah contract. The originator undertakes to pay the rental fee for the assets to the holders of the securities on due dates.

3. Leasing Co. Ijarah Sukuk: In this type, the issuer (leasing co.), by issuing Ijarah Sukuk, collects the funds of investors and as their agent, buys in cash the assets needed by the govt., enterprises and households from the manufacturers (sellers) on a continuous basis and leases the same to the govt., enterprises and households by taking into account the finished cost and adding the profit for the security holders.

Operational model of Ijarah sukuk



1. The originator who intends to finance itself in order to buy pieces of land, airplanes, facilities or equipments has an SPV established by Central AMC (trustee).
2. The SPV acquires needed permissions and issues securities. After collecting the funds, it buys the needed asset on behalf of the investors and lease it to the originator (originator and asset seller could be a same person).
3. The originator receives the asset from the SPV and pays the rentals at specified periods to the SPV.
4. The SPV pays the rentals to the investors through Central Securities Depository Company.

□ Murabaha Sukuk

Murabaha sukuk are securities the holders of which are the common owners of receivables which are raised from Murabaha Contract. These securities shall have fixed rate of return. There are three types of Murabaha sukuk.

Types of Murabaha Sukuk

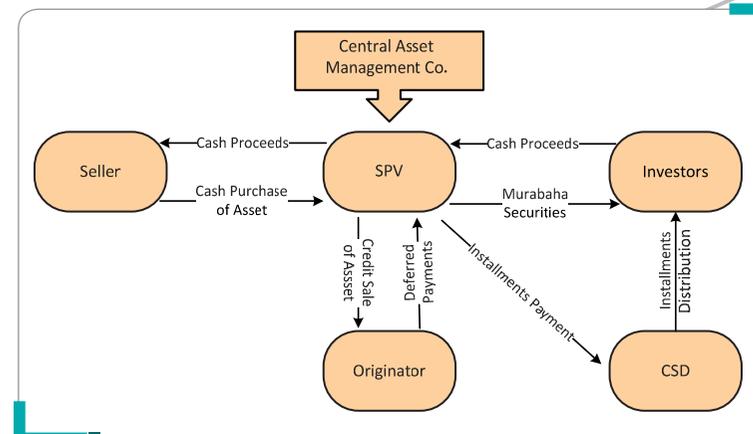
1. Financing Murabaha Sukuk: The issuer (SPV) issues the Murabaha Securities, collects the funds of the investors, then as their agent, buys the goods needed by the originator from the manufacturer (seller) in cash and sells them to the originator at a higher price which is paid in installments. The originator undertakes to make the deferred payments of the goods to the issuer on due dates. The issuer hands over the proceeds through the Investment Bank to the Sukuk holders. Trading these securities in the secondary market is not OK for all jurisprudents. Most shi'a scholars permit receivables trading with some preconditions.

2. Mortgage Murabaha Sukuk: The major function of this type of sukuk is to securitize the facilities of banks or leasing companies. The issuer (intermediary) issues the Securities,

collects the funds of the investors then as the agent, buys originator's mortgage facilities arising from the Murabaha Contract of Sale (credit sale) in cash and at a price lower than the face value. The Originator undertakes to collect on the due dates the debtors' debts from mortgage facilities and deliver them to the issuer. The issuer will give to the holders of the Securities the funds received from the Originator through the Investment Bank.

3. Trading Co. Murabaha sukuk: The issuer (trading co.) issues the Murabaha Securities, collects the funds of the investors, then acting on their behalf buys in cash on a continuous basis the goods needed by the government, enterprises and households from the manufacturers (vendors) and sells the same at a higher price on credit terms to the government, enterprises and households. The issuer (trading co.) collects the credit price of the goods from the debtors (government, enterprises and households) on due dates and pays the Sukuk holders. Issuing and trading these securities are OK.

Operational model of Murabaha sukuk



1. The originator (who needs an asset but can't pay for it right now) signs an agreement with the SPV (established by Central AMC) to purchase the asset on a deferred-payment schedule.
2. The SPV acquires needed permissions and issues the Murabaha Securities, collects the funds of the investors, then as their agent, buys the goods needed by the originator from the manufacturer (seller) in cash and sells them to the originator at a higher price which is paid in installments.
3. The originator receives the goods and undertakes to make the deferred payments on due dates.
4. The SPV hands over the installments (proceeds) to the investors through Central Securities Depository Company.



the relevant contractor (constructor) and undertakes to pay money to constructor in accordance with specified time schedules. Special Purpose Vehicle (SPV) shall sell Istisna securities to public through Investment Bank and settles its debt with contractor. This type of Istisna Sukuk is based on receivables trading and is NOT permitted by all jurisprudents.

2. Istisna and hire-purchase: Under this method, Originator shall by establishing Special Purpose Vehicle (SPV), undertake that should Special Purpose Vehicle (SPV) arrange for any special product or project, it shall receive it from Special Purpose Vehicle (SPV) on hire-purchase basis. Special Purpose Vehicle (SPV) shall order manufacture of intended product or construction of project to contractor on the basis of Istisna contract and undertakes against it to pay money according to specified time schedule. Special Purpose Vehicle (SPV) shall assign Istisna securities to public through Investment Bank and shall collect its monies as agent shall pay its debts to contractor. Special Purpose Vehicle (SPV) shall take delivery of product or project from contractor and then, as Sukuk holders' agent, give it to Originator on hire-purchase basis. This type of Istisna Sukuk is based on Istisna and Ijarah Contracts and is OK.

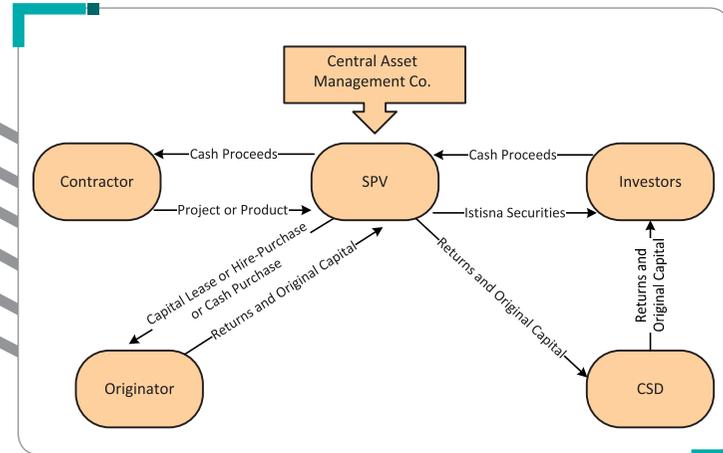
Operational model of Istisna sukuk

26 Istisna Sukuk

Istisna is a contract between a buyer and a manufacturer in which the manufacturer agrees to complete a construction project by a future date. In this type of Sukuk, securities holders are common owners of property that is acquired on the basis of Istisna contract. Istisna could be of two types.

Types of Istisna Sukuk

1. Parallel Istisna: Under this method, the originator shall by establishing Special Purpose Vehicle (SPV), assign financing and completing the project to it through Istisna contract and instead of paying money, issues Istisna Sukuk. Special Purpose Vehicle (SPV) (issuer) shall according to second Istisna contract, order construction of intended project to



1. The originator (e.g. a ministry, municipality, public or private company) has the SPV established by Central AMC, then undertakes to receive the manufactured products or carried out projects from the SPV in one of the following ways:

I. Capital Lease, when the originator intends to sell and lease back the manufactured asset.

II. Hire-Purchase, when the originator intends to purchase the manufactured asset in installments.

III. Cash Purchase, when the originator intends to purchase the manufactured asset in cash.

2. The SPV,

I. Orders the contractor to manufacture the product or carry out the project.

II. Undertakes to pay for the project or product on the schedule.

III. After acquiring needed permissions, issues Istisna Sukuk, collects the funds, and as the investors' agent pays the costs of the project to the contractor.

3. The SPV receives the product or the project from the contractor and on behalf of the sukuk holders, delivers it to the originator (in 3 ways mentioned above).

4. The originator hands over the returns and the original capital to the investors through Central Securities Depository Company.

Conclusion

Raising funds through sukuk has become an integral part of Islamic finance and a pivotal pillar of overall Islamic finance's continuous growth. Since 2001, the world has seen steady growth of the global sukuk market attracting great interest from the wider international community. Considering successful attempts of applying sukuk, now, it has become a significant player in Iran capital market, though; it was formerly strange even to some market players. Since sukuk complies with Shariah, provides low or no risk and contains definite returns, it is attracting a broad range of investors in comparison with other financial instruments and banking systems.

The growth of the Islamic financial market worldwide has been very impressive and remarkable, in a sense that, some western countries have started to take advantage of sukuk in their financial systems.

We hope to witness the continuous growth of money and capital markets in our precious land.

