

Operational models for Ijarah, Istisna, and Murabaha sukuk from Islamic point of view¹

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Abstract

The absence of bonds in the capital market and the capability of Islamic contracts in designing of new financial instruments have come to different Islamic financial instruments as sukuk be proposed by the Islamic financial experts. However, although they all lack of those required jurisprudential and economic criteria, few of them have a high operational and economic feasibility in compliance with Islamic jurisprudential rules.

Three of such instruments which have been designed on the basis of Ijarah, Istisna, and Murabaha contracts, are presented in this article. Those who are active in different economic and productive sectors, including government and state companies, private companies, municipalities and all commercial and leasing companies would be able to issue such securities and collect funds of natural and legal entities and enter the investment in forms of Ijarah, Istisna' and Murabaha. The profit made by these contracts would be distributed among the owners of securities after deducting the wakalah fee. Ijarah, Istisna and Murabaha sukuk are some kinds of fixed-income financial instruments in proportion to the rate of return in the real part of the economy. These instruments will cause higher production statistics and increasing job opportunities by redirecting liquidity to the productive sectors of economy; and on the other hand, will be a bases for the development of Iran financial markets.

Keywords: Ijarah, Istisna, Murabaha, Ijarah sukuk, Istisna sukuk, Murabaha sukuk, wakalah, primary market, secondary market, financial policy, monetary policy.

¹ Jurisprudential views of this article are on the basis of SEO Shariah Board Resolutions.

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Introduction

Following the realization of Riba – free Banking thought in a few Islamic countries, Muslim intellectuals decided to design particular Islamic financial instruments and started a series of studies on shariah – compatible contracts and the capability of which to help replace some financial instruments such as bonds with Islamic ones. Muslim intellectuals succeeded in designing financial instruments in compliance with Islamic principles and compatible with true requirements of Islamic societies. These instruments, some of which with more than ten years of scientific experience and some just in form of ideas include three main groups as follows:

- Non – profit financial instruments, designed in accordance with such charitable intentions as qard ul – hasana and endowment;
- Financial instruments with expected rate of returns, designed on the basis of such participation contracts as Mudarabah, Muzara'ah, and Musaqat;
- Financial instruments with specified rate of returns, designed on the basis of contracts such as Murabaha, debt buying, Ijarah, and Istisna.

In this article, three types of these instruments which have been designed on the basis of Ijarah, Istisna' and Murabaha contracts are presented in compliance with Imamia fiqh and economic conditions in Iran. Since the legal and jurisprudential issues of these contracts are studied in designing such securities as Ijarah, Istisna and Murabaha, we will have a quick look at the legal and jurisprudential nature of these contracts.

Islamic securities experience

Islamic securities or sukuk are such certificates with a unique par value which after subscription implies the payment of par value to the issuer by the buyer and the holder of which is the owner of one or a pool of assets and their benefits.

The total of US Dollars 5 billion of sukuk has been issued by the governments of Bahrain, Malaysia, Pakistan, Qatar and Saxony – Anhalt state of Germany, between 2002-2005. These securities have been rated by credit-rating firms in accordance with the risk rating in the issuers' country. However, Bahrain government did not take the required measures for rating its first local issue. Malaysia was the first issuer of global sukuk with an international rating called global Ijarah sukuk.

Ijarah, Istisna and Murabaha Contracts

Definitions

Ijarah is a contract in which lessee is the owner of the benefits of a specified asset in a specified period of time for the fund paid to the lessor and is divided into regular Ijarah and Ijarah Al-muntahiyah Bi-ttamlik.

In regular Ijarah, the specified asset shall be returned to the lessor after the specified period but in Ijarah Al-muntahiyah Bi-ttamlik the lessor, according to a condition stated in the contract, shall change the ownership of the asset for the benefit of the lessee.

The word Istisna means to order for producing a commodity. In this contract, one of the two parties undertakes to produce and deliver a specific commodity or project for a certain amount of money and in a specified period of time. Istisna contracts include, order to produce a commodity or complete a project, order to produce a number of conventional commodities, order to produce a certain commodity, order to establish certain projects, and order to produce for making a transaction.

Murabaha is a sale contract in which the seller informs the cost price, including purchase price plus transportation costs, maintenance and other costs to the customer then sells the subject of contract by adding a sum of money or a percent of total costs as profit.

Islamic securities (sukuk) structure:

1. Originator: A legal entity for which securities are issued.
2. Issuer (SPV): A legal entity established on behalf of the owners of securities for transferring and issuing of securities.
3. Investors: Natural or legal entities who buy such securities and become partner owners of the underlying asset.
4. Custodian: A legal entity with the responsibility of supervising the whole operation on behalf of the investors and to protect the rights of whom, in compliance with the rules and regulations.
5. Investment bank: A company working as an intermediary between issuer and investors.
6. Agent: A bank or a financial and credit firm which has the function at collecting funds from the investors and paying the principal and profit of the securities on certain maturities on behalf of the issuer, in accordance with the agency contract.
7. Guarantor: A legal entity who undertakes and guarantees the repayment of the principal and the profit on maturity dates.
8. Auditor: Trusted auditor of the Securities and Exchange Organization working under supervision of the custodian.
9. Rating agency: An agency authorized by the SEO to rate securities.
10. Market maker: An authorized broker/dealer or investment bank which is engaged in trading of securities with the intent to increase liquidity, regulate supply and demand of the securities, and limiting their price fluctuations.
11. Regulator: securities and Exchange Organization. Public issuing of any kind of securities shall be approved by the SEO.

Ijarah, Istisna and Murabaha sukuk

Definitions

The owner of Ijarah sukuk is the owner of a part of a certain asset which is transferred on the basis of a regular or on Ijarah Al-muntahi Bi-ttamlik contract. It has a specified return called rental and can be transferred to others.

The owner of Istisna sukuk is the owner of a part of the underlying financial asset of an Istisna contract. It has a specified return and can be traded in the secondary market.

The owner of Murabaha sukuk is the owner of a part of an underlying financial asset of a Murabaha contract. It is fixed-income and can be traded in the secondary market.

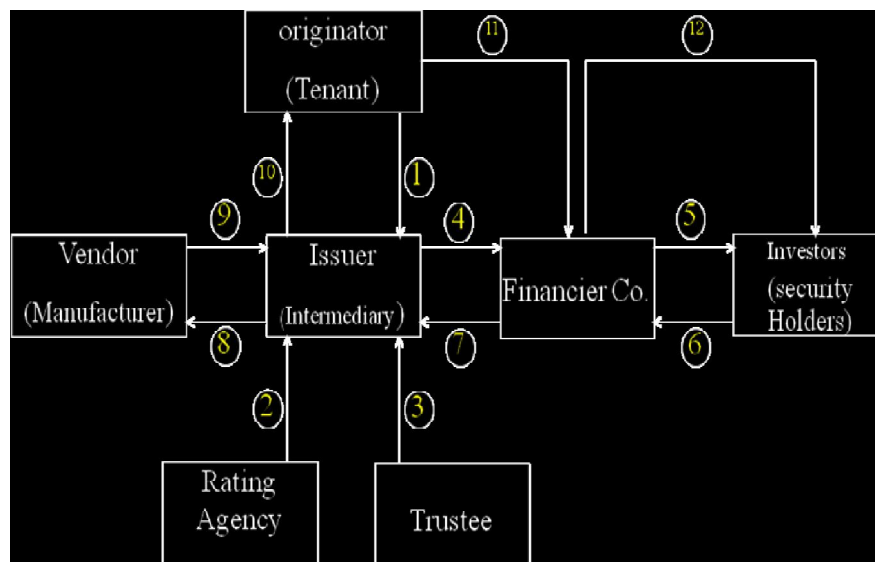
Types of Ijarah, Istisna, and murabaha sukuk

Ijarah sukuk:

1- Ijarah sukuk for finance

Issuer collects the investors' funds and buys the originator's required asset from the producer (seller) in cash and on behalf of the investors, then leases the asset to the originator in form of a regular Ijarah or an Ijarah Al-muntahi Bi-ttamlik. Originator undertakes to pay the rentals to the owners of securities via an investment bank on certain maturity dates. Issuer, at the end of the regular Ijarah, gets back the underlying asset and sells it in the used assets market on behalf of the investors, than changes its ownership to the lessee. The owners of securities can either wait until maturity and receive the rentals or sell their securities in the secondary market.

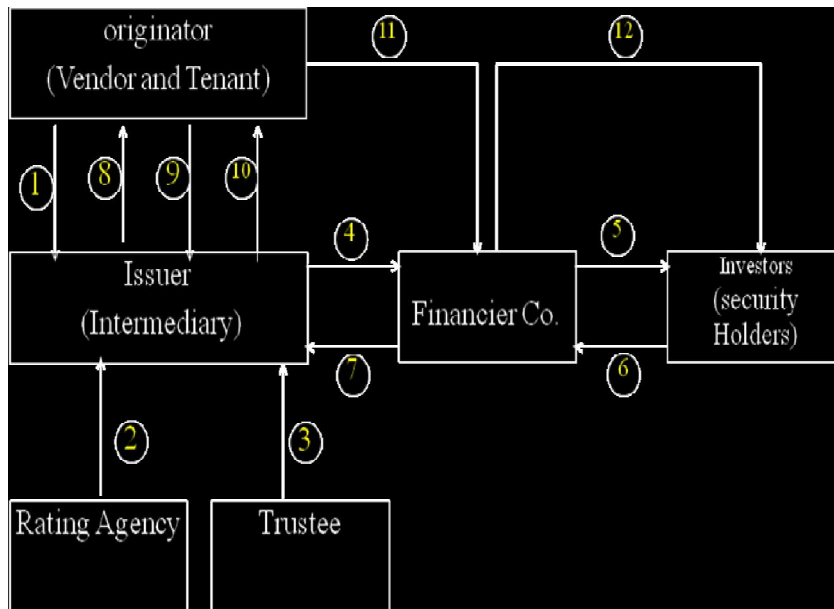
The operational model of the Ijarah sukuk for finance is as follows:



The primary market for this kind of Ijarah sukuk is a combination of wakalah contract, cash selling, regular Ijarah, or Ijarah Al-muntahi Bi-ttamlik. Issuer collects the funds, buys the originator's required commodity in cash, and then leases it to the originator in form of a regular Ijarah contract or an Ijarah Al-muntahi Bi-ttamlik contract. The secondary market for these securities is the selling a portion of joint ownership of the leased asset however, has far as Islamic jurisprudential point of view is concerned, wakalah, cash selling, regular Ijarah, Ijarah Al-muntahi Bi-ttamlik, and selling a portion of joint ownership of the leased asset contract are permissible.

2- Ijarah sukuk for collecting liquidity

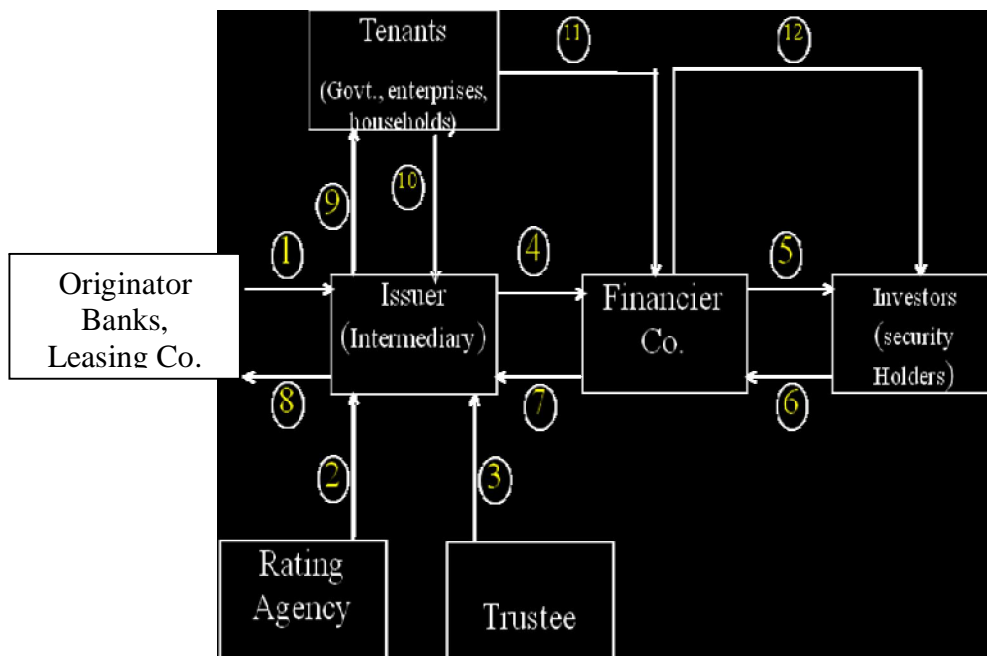
Here, issuer collects the investors' funds; buys one of the originator's physical assets in cash, then transfers its ownership to the originator itself in form of a regular Ijarah or an Ijarah Al-muntahi Bi-ttamlik contract. Then originator undertakes to pay rentals to the owners of securities via an investment bank on certain maturity dates. The issuer, at the end of the regular Ijarah contract, gets back the underlying asset from the originator and sells it in the used assets market on behalf of the investors, and in Ijarah Al-muntahi Bi-ttamlik, changes the ownership to the originator. The owners of securities can either wait until maturity date or sell their own securities in the secondary market before maturity. The operational model of the Ijarah sukuk for collecting liquidity is as follows:



As far as the Islamic jurisprudential point of view is concerned, these securities, like the previous model, have got no problem in the primary and secondary market but it should be emphasized that buying and leasing should be done in a real manner. Originator should really identify the specified asset and when changing the ownership, the said asset should really sell to the issuer. So, bay' and Ijarah contracts, should be applied as two independent contracts, and in the buying contract, the ownership should be really transferred to the investors and leased to the originator via a real contract. Here, the Bay' ul inah doubt is not accepted. Bay' ul inah is a trick to bypass Riba and is not permissible in Islamic jurisprudence. However, There exists such doubt in Murabaha sukuk and is quite acceptable but in Ijarah sukuk you sell your own asset and lease it for a five years period. Here, in these five years, the ownership of the asset is transferred to the buyer. So, it would be a real contract and quite different from Bay' ul inah.

3- Mortgage Ijarah sukuk

Here, issuer collects the investors' funds by issuing Ijarah sukuk, then buys those assets which the originator (bank or leasing company) has transferred to the government, firms or families, in form of Ijarah Al muntahi Bi-ttamlik, on behalf of the investors. Originator undertakes to collect all rentals of the assets from the lessees on specified maturity dates and pay them to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their own securities in the secondary market. Operational model of the mortgage Ijarah sukuk is as follows:



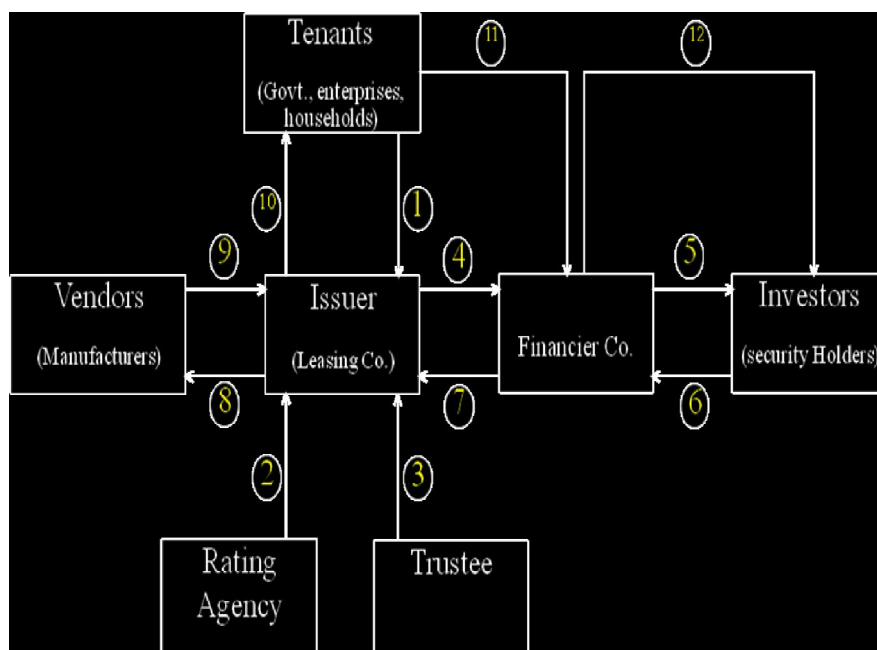
As far as the Islamic jurisprudential point of view is concerned, these securities have got no particular problem in either primary or secondary markets.

4- Leasing companies Ijarah Sukuk

In this model, issuer (leasing company) collects the investors' funds by issuing Ijarah sukuk, then buys the government, firms, or families' required assets in cash from the producers (sellers) and leases them to the government, firms or families after adding all particular costs and also the benefits of the owners of securities.

Issuer (leasing company) collects all rentals on maturity dates from the lessees (government, firms and families) and pays them to the owners of securities via an investment bank. The owners of securities can either wait until maturity date or sells their own securities in the secondary market.

The operational model of leasing companies Ijarah sukuk is as follows:



As far as the jurisprudential point of view is concerned, these securities have got no particular problem in either primary or secondary markets.

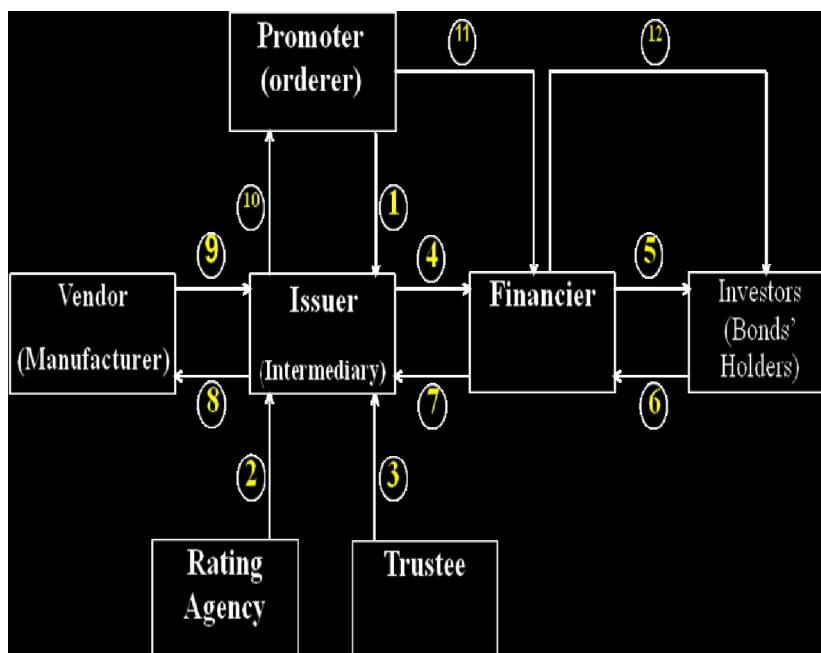
Istisna sukuk

Ministries, municipalities, state and private companies can use Istisna' sukuk for the finance of their development projects and this could be executed in two forms:

1- Parallel Istisna

Originator establishes an intermediary (SPV) and transfers the functions of finance and executing the project via an Istisna contract then pays the price of the contract by Istisna sukuk with certain maturity dates. Issuer of securities also, according to a different Istisna contract orders those particular projects to the contractor and undertakes to pay for the price of the contract in due course. SPV also sells the Istisna sukuk to the investors via an investment bank and pays its debt to the contractor. For example, ministry of Road and Transportation establishes an SPV and seeks to execute a particular project via an Istisna contract. SPV undertakes to execute the project against a sum of one thousand billion IRRs (US Dollars 1 billion) and it is paid in form at Istisna sukuk with certain maturity dates. SPV gives the project to a certain contractor on the basis of a different Istisna contract and this contractor undertakes to deliver the project against a sum of seven hundred billion IRRs (US Dollars 700 million) in due course, e.g., 3 years. After beginning the execution of the project, the SPV sells the Istisna sukuk via a particular bank or an investment bank to the public, and then pays its debts to the contractor out of the collected funds.

The operational model of the parallel Istisna sukuk is as follows:

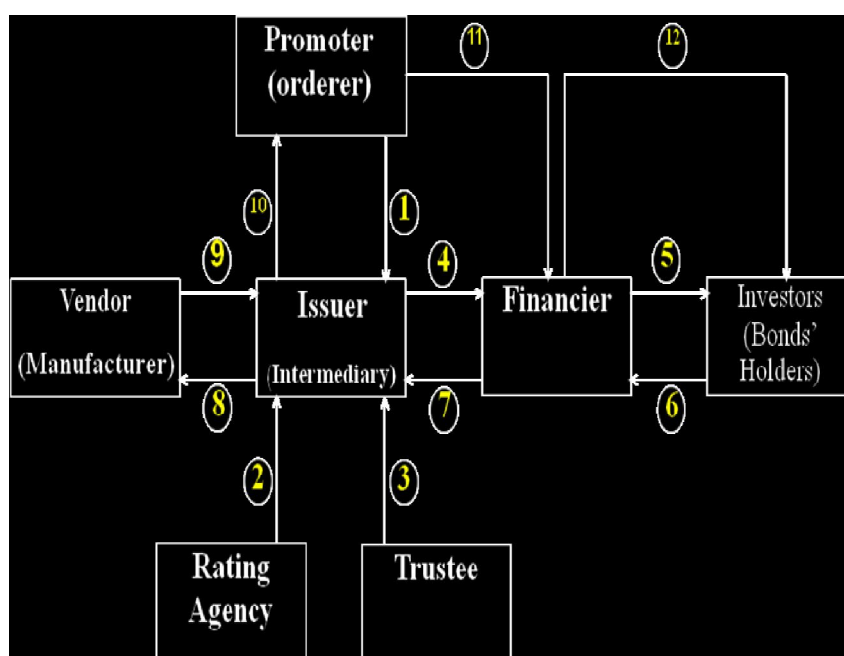


The secondary market for the parallel Istisna sukuk is on the basis of debt buy and sells and requires a jurisprudential study. The majority of shi'it jurists and a group of shaafe'i jurists believe that the process of commercial papers discount by a third person is a kind of Bay' dayn and is permissible if the document is a real one. However, it is possible to buy and sell these securities in the secondary market because Istisna sukuk is a kind of commercial paper which is issued on the basis of Istisna contract and against an economic operation, so it is real.

2- Istisna and Ijarah Al-muntahi Bi-ttamlik

In this model, originator establishes an intermediary firm (SPV) and undertakes to receive a particular commodity or project supplied by this firm in form of Ijarah Al-muntahi Bi-ttamlik. The SPV also orders the commodity or project to a contractor to be manufactured according to an Istisna contract and undertakes to pay the price in due course, then offers the Istisna sukuk to the public via an investment bank and collects the funds and pays for its debts to the contractor. The SPV receives the commodity or project from the contractor and gives it to the originator in form of Ijarah Al-muntahi Bi-ttamlik on behalf of the owners of securities.

The operational model of Istisna sukuk and Ijarah Al-muntahi Bi-ttamlik is as follows:



The secondary market for Istisna sukuk and Ijarah sukuk will be on the basis of trading a title deed of a physical asset and there is no legal and jurisprudential problem.

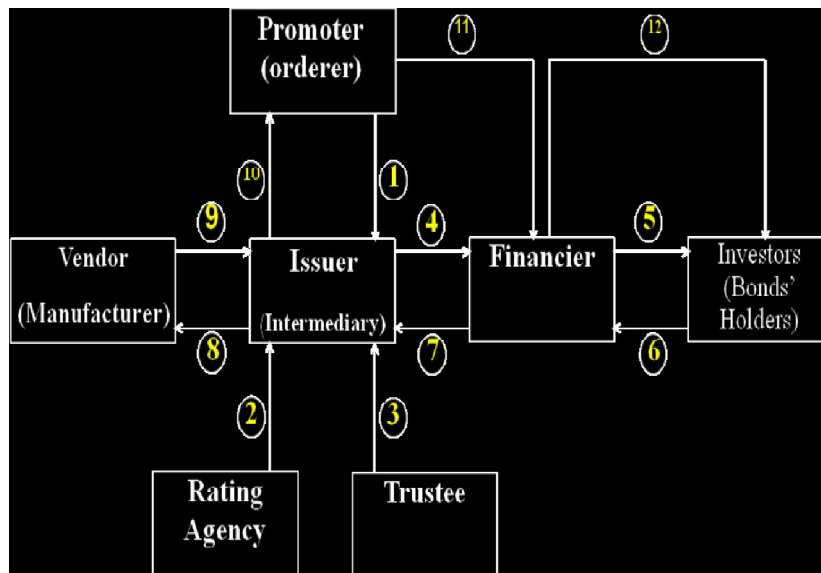
Murabaha sukuk

1-Murabaha sukuk for finance

In this model, issuer collects the investors funds, buys the originators' required commodity from a producer (seller) in cash on behalf of the investors, then sells it to the originator in a higher price and in form of a Murabaha Bay' with deferred payment. Originator undertakes to

pay the price to the issuer on certain maturity dates. Then issuer gives the originators' payments to the owners of securities via an investment bank. The owners of securities can either wait until the maturity date or sell their securities in the secondary market.

The operational model of Murabaha sukuk for finance is as follows:

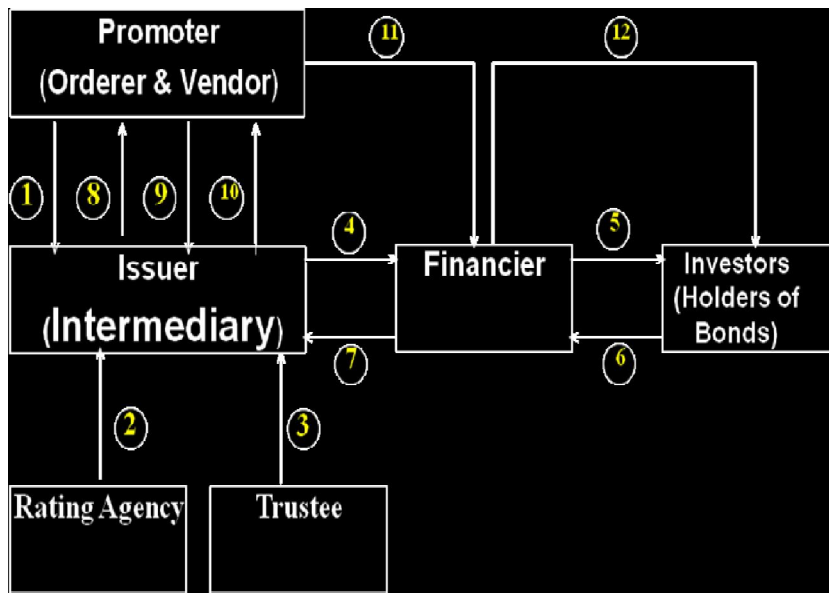


The primary and secondary markets for these securities are a combination of Wakalah, cash selling, Murabaha Bay' with deferred payment, and Bay' Dayn (discount) contracts in such a manner in which the issuer collects the funds, buys the originators' required commodity on cash and on behalf of the investors, then sells it to the originator in form of Murabaha with deferred payment. As far as the jurisprudential point of view is concerned, there shall be no problem with Wakalah, cash selling and Murabaha Bay' with deferred payment contracts but there is a dispute on selling securities in the secondary market (discount). Majority of shi'it jurisprudent believe that this is permissible but majority of Sunni jurisprudents do not accept it and believe that it is batil.

2-Murabiha sukuk for liquidity

In this kind of Murabaha sukuk, issuer collects the investors funds, buys one of the originators' physical asset in cash on behalf of the investors, then sells it to the originator on a higher price in form of Murabaha Bay' with deferred price. Originator undertakes to pay the price on certain maturity dates, and then issuer gives the funds received from the originator to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their securities in the secondary market before maturity.

The operational model of Murabaha sukuk for cash supply is as follows:

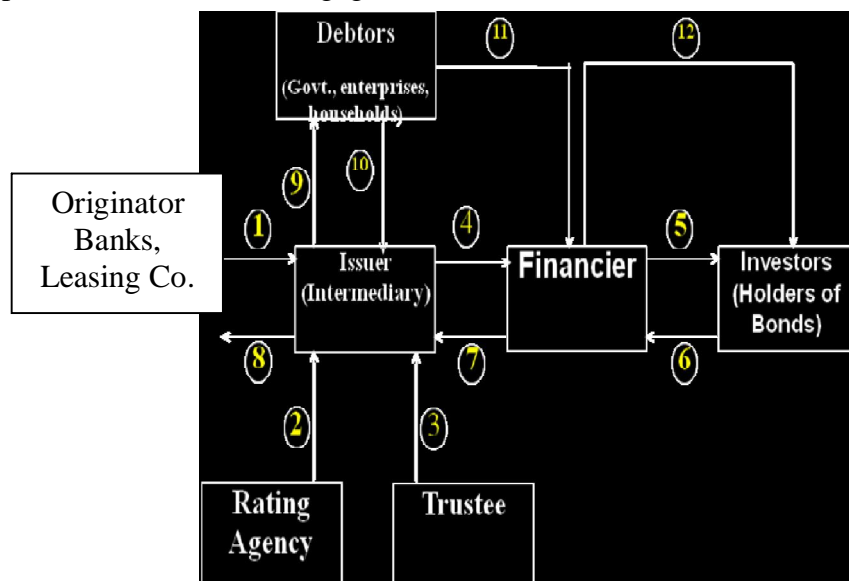


The primary and secondary markets for these securities are a combination of Wakalah, cash selling, Murabaha Bay' with deferred payment, and Bay' Dayn (discount) contracts, in such a manner in which the issuer collects the funds, buys one of the originators' required commodity in cash and on behalf of the investors, then sells it to the originator in form of Murabaha with deferred payment. Here, in addition to discount issue, buy and sell in cash and with deferred payment in the primary market which is called Bay'al inah, shall be of jurisprudential problem and majority of shi'it and Sunni jurisprudents believe that it is batil and not permissible.

3-Mortgage Murabaha sukuk

In Mortgage Murabaha sukuk, issuer (SPV) issues Murabaha sukuk, collects investors' funds and buys, on behalf of the investors, the originators' (bank or leasing company) mortgage facilities of the Murabaha Bay' (installment selling) to the government, firms and families in cash and in a price lower than nominal price, then the originator undertakes to collect the facilities from the debtors (government, firms and families) and give them to the issuer. Issuer also pays the funds received from the originator to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their securities in the secondary market before maturity.

The operational model of mortgage Murabaha sukuk is as follows:

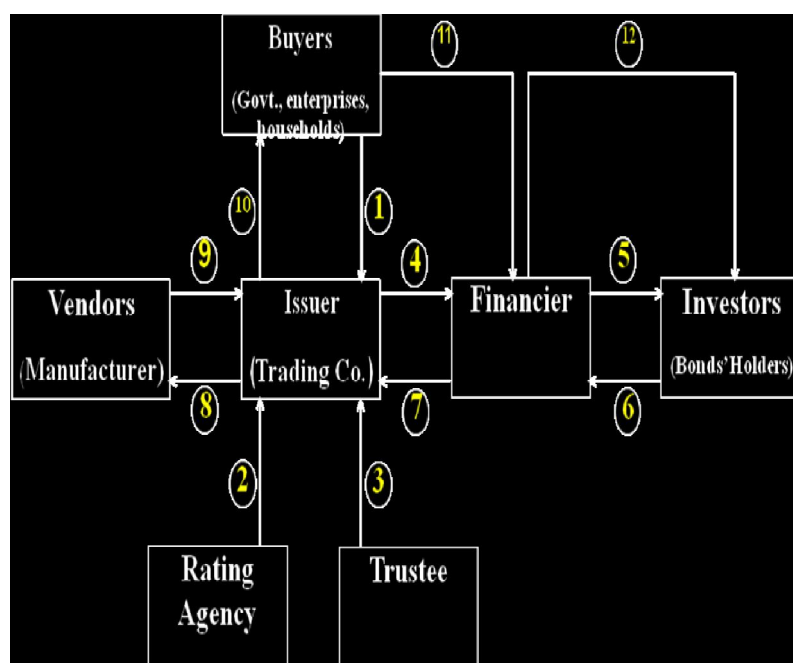


The primary and secondary markets of these securities are combinations, of Wakalah and buy and sell of debt (discount) contracts in which issuer collects funds and buys the originators' debts of mortgage facilities in cash on behalf of the investors (owners of securities). Investors can either wait until maturity date or sell these securities in the secondary market (discount). In jurisprudential point of view, buy and sell of debt (discount) is disputable and majority of shi'it jurisprudents believe that it is permissible but majority of Sunni jurisprudents believe that it is batil.

4-Companies Murabaha sukuk

Here, the issuer of Murabaha sukuk (company) collects the investors' funds, frequently buys the required commodity of the government, firms, and families in cash from the producers (sellers) on behalf of the investors and sells it to the government, firms, and families in form of a Murabaha Bay'. The issuer (company) receives the price of the commodity from the debtors (government, firms, and families) on maturity dates and pays to the owners of securities via an investment bank. The owners of securities can either wait until maturity date or sell their securities in the secondary market.

The operational model of this kind of Murabaha sukuk is as follows:



The owners of securities give their funds to the company to be engaged in Murabaha trades in form of partnership on behalf of the investors. Company buys the required commodities of the government, firms, and families in cash and sells it in form of Murabaha with deferred payment, then collects the receivables of the owners of securities in certain maturity dates and at the end of the fiscal year, distributes the profit among the owners of securities after deduction Wakalah fee. The owners of securities can sell their own portion of the company's assets whenever they decide to do that. Trades of this kind are combinations of Wakalah, Wakalah purchase, Wakalah selling, and asset selling in the secondary market which are permissible.

Economic domain of Ijarah, Istisna and Murabaha

- 1- Families finance for buying consuming goods and durable assets.
- 2- Firms finance for buying production tools, material, and leasing fixed capitals and production tools.
- 3- Government and state enterprises finance for buying required commodities and leasing durable goods.
- 4- Cash supply required by government and firms.
- 5- Securitization of mortgage facilities of the banks and leasing companies.
- 6- Supply of capital for commercial and leasing companies.

Possibility of secondary market for Ijarah, Istisna, and Murabaha sukuk

All kinds of Ijarah, Istisna, and Murabaha sukuk are from amongst the beneficiary fixed income financial instruments, so they can cover the goals and preferences of a major group of the owners of excess funds willing to make a risk-free investment. Thus, if there is no jurisprudential problem, they could be of a great capacity to be bought and sold in the secondary market.

Microeconomic study of Ijarah, Istisna, and Murabaha sukuk

- 1- All kinds of Ijarah, Istisna and Murabaha sukuk are amongst the financial instruments.
- 2- All these securities are fixed – income.
- 3- All these securities are in a high level of liquidity, in the secondary market.
- 4- The more the various the securities, the more efficient they are.

Macro economic study of Ijarah, Istisna, and Murabaha sukuk

- 1- These securities would have a great impact on macroeconomic variables, including consuming costs, government costs and investment, and the particular impact on real economic growth could be examined.
- 2- When there is a competition, the rate of return of these securities, would be close to the real rate of return and this would help the fair distribution of incomes, but when there is no competition, the rate of return of these securities would be more than the added value.
- 3- Such securities would be applied as the instruments of financial policy against budget deficit of the government, state institutions, ministries and municipalities and would have an inflation impact of less than borrowing from the central Bank.
- 4- If there exists a well-developed market with a good variation of Ijarah, Istisna, and Murabaha sukuk, the Central Bank could make a great impact on the volume of liquidity by trading such securities in the secondary market; thus, these securities could be introduced as an instrument for monetary policy, and especially in Muslim countries in which bonds are not permissible and the Central Banks can not apply their monetary policy of open market operation by trading of bonds. This would be possible by trading such securities. So, in recession conditions in which the Central Bank would have an expansionary monetary policy, it would enter the secondary market of Istisna sukuk and buy the people's and commercial bank's securities on a higher price and expand the volume of liquidity amongst the society and increase the credit impact of the banks, but when it is to apply a contractionary policy, it lowers the price and sells the securities in order to collect the liquidity.

- 5- Murabaha sukuk could be designed for very short-term maturities of three, six and months in special cases, and be used instead of state treasury bonds, with short-term maturities.

Summary and suggestions

We believe that it is possible to design various financial instruments in line with Muslim clients' objectives and preferences using the Islamic contracts. By issuing the Ijarah, Istisna and Murabaha sukuk, there would be provided secure instruments for risk-averse and conventional investors, and on the other hand, such appropriate instruments are provided to be used by the government, municipalities and state enterprises for project financing. However, they could be supplements for other Islamic securities and would help capital market be well developed. They could provide designers of financial markets with good opportunities for designing beneficiary fixed income instruments and could also be good substitutes for bonds. Thus, regulating authorities, including the government, Central Bank, Islamic Consultative Assembly, and Securities and Exchange Organization are requested to pave the roads to institutionalize the Islamic financial instruments, including Ijarah, Istisna and Murabaha sukuk.

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