

# Islamic Financial Instruments

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# Definition of Islamic Financial Instruments



Islamic Financial Instruments are kinds of financial instruments which are based & designed in compliance with Shariah Rules & Regulations.



# Different Types of Islamic Financial Instruments



Main types of Islamic Financial Instruments are:

Sukuk

Islamic mortgage-Backed Securities (MBS)

Islamic Futures Contracts

(The information about Sukuk & Islamic MBS is adopted from S.A.Mousavian)



# Sukuk



The term “Sukuk” was first proposed for Islamic financial instruments in the Islamic financial jurisprudence session of Islamic Development Bank in the year of 2002. Sukuk means certificates with identical nominal value that after completion of subscription operations evidence payment of a nominal amount mentioned in it by the purchaser to the issuer; and its holder will be the owner of a set of assets or profits arising from assets, or beneficiary of a project or a special investment activity (Source: AAOIFI)



# Main Types of Sukuk

Main Types of Sukuk are as follows:

“Ijarah Sukuk

“Istisna Sukuk

“Musharakah Sukuk

“Gharzulhasan Sukuk

“Murabaha Sukuk



# Ijarah Sukuk

Ijarah security is a security, the holder of which owns in common, parts of an asset that has been transferred on the basis of Ijarah contract.

This security has a fixed yield and can be transferred to other parties in the secondary market.



# Various Types of Ijarah Sukuk

Ijarah Sukuk have various types

- “ Financing Ijarah Sukuk
- “ Liquidity Ijarah Sukuk
- “ Leasing Co. Ijarah Sukuk



## Various Types of Ijarah Sukuk (Cont)



### 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 (vendor), and rents it to the originator.

The originator undertakes to pay the holders of securities the rental fee for the asset on due dates.





## Various Types of Ijarah Sukuk (Cont)

### 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.



## Various Types of Ijarah Sukuk (Cont)

### **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 (vendors) 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.



# Istisna Sukuk



Istisna Sukuk are securities whose holders are common owners of property that is acquired on the basis of Istisna contract.



# Various Types of Istisna Sukuk

Istisna Sukuk may be designed in 2 types as follows:

- “ Parallel Istisna
- “ Istisna and hire-purchase



## Various Types of Istisna Sukuk (Cont)

### **Parallel Istisna**

Under this method, the originator shall by establishing Special Purpose Vehicle (SPV), assigns financing and completing the project to it through Istisna contract and instead of paying money, issues Istisna Sukuk.



## Various Types of Istisna Sukuk (Cont)

### Parallel Istisna

Special Purpose Vehicle (SPV) (issuer) shall according to second Istisna contract, order construction of intended project to 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.



## Various Types of Istisna Sukuk (Cont)



### 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.



## Various Types of Istisna Sukuk (Cont)

### Istisna and hire-purchase

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 Sukukholders' agent, give it to Originator on hire-purchase basis.

This type of Istisna Sukuk is based on Istisna and Ijarah Contracts and is OK.





# Musharakah Sukuk

Musharakah Sukuk are securities in which its holders are owners of a specified property in common. Sukukholders will gain (lose) from any increase (decrease) in the underlying asset prices. (S.A.Mousavian,2006)

Musharakah Sukuk have a specified maturity date, and are negotiable in the secondary market.



# Musharakah Sukuk (Cont)



Public corporations, municipalities and non – public institutions and corporations, in case of issuing participation papers, are obliged to ensure and guarantee repayment of the principal and the accrued profit of these papers in the specified maturities. In case of non – fulfillment of these obligations in due maturities, the agent is obliged to take action by itself from the guarantee.

Payment of provisional profit is allowed as stipulated in papers.



# Gharzulhasan Sukuk



Gharzulhasan securities are securities that are issued on basis of interest-free loan contracts.

According to Gharzulhasan contract, issuer of securities seek loans from Sukukholders and will become indebted to them. At maturity date, he must pay the nominal value of Sukuk to Sukukholders.



# Benefits Of Gharzulhasan securities



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.



# Murabaha Sukuk

Murabaha Securities 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.



# Various Types of Murabaha Sukuk



There are 3 kinds of Murabaha Securities

9 Financing Murabaha Securities

9 Mortgage Murabaha Securities

“ Trading Co. Murabaha Securities



## Various Types of Murabaha Sukuk (Cont)



### Financing Murabaha Securities

The issuer (intermediary) issues the Murabaha Securities, collects the funds of the investors, then as their agent, buys the goods needed by the Originator from the manufacturer (vendor) in cash and sells them to the Originator as a Credit Murabaha Contract of Sale at a higher price.

The Originator undertakes to pay to the issuer the credit price of the goods on due dates. The issuer hands over the proceeds through the Investment Bank to the Sukukholders.

Trading these securities in the secondary market is not OK for all jurisprudents. Most shi'a scholars permit receivables trading with some preconditions.



## Various Types of Murabaha Sukuk (Cont)



### Mortgage Murabaha Securities

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 price than the nominal price.

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.





## Various Types of Murabaha Sukuk (Cont)

### Trading Co. Murabaha Securities

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 Sukukholders.

Issuing and trading these securities are OK.



# Islamic Mortgage-Backed Securities (MBS)



Islamic Mortgage-Backed Securities (MBS) may be issued using with the following facilities :

“Murabaha facilities (Installment sales)

“Hire-purchase facilities



# Various Types of Islamic MBS

## **Murabaha facilities (Installment sales)**

Under this method, a bank sells certain assets in form of Murabaha Mortgage-Backed Securities (installment sale).

An intermediary institution, collects investors' money by issuing Murabaha Mortgage-Backed Securities. Thereafter, acting as their agent, purchases the debts arising from Murabaha facilities at discounted price from the bank.

The bank undertakes to recover nominal amount of debts from debtors on maturity dates and assign it to security holders.

These securities are approved only by those jurisprudents who permit debt trading.



# Various Types of Islamic MBS (Cont)



## Hire-purchase facilities

Under this method, a bank sells certain assets in form of hire-purchase contract.

An intermediary institution collects investors' money by issuing hire-purchase securities. Thereafter, acting as their agent, purchases the subject of hire-purchase facilities at discount price.

The bank undertakes to recover nominal amount of facilities from debtors on maturity dates and assign it to holders of securities.

Issuing & trading these securities are OK.



# Islamic Futures Contracts



## Futures Contract:

A legally binding agreement to buy or sell a commodity or financial instrument at a later date. Futures contracts are standardized according to the quality, quantity and delivery time and location for each commodity (Source : NFA (National Futures Association)) .



# Definiton of Islamic Futures Contract



Islamic Futures Contracts are a special designed type of futures contract which are based and complied with the Shariah rules.

There are many jurisprudential matters for Islamic Futures Contracts. What is the structure of this contract ?



# Structure of Islamic Futures Contracts

Islamic Futures Contracts are based on the following  
Islamic Contracts (Uqud) :

- Mutual Commitment
- Cash Sale

And : Articles Added To The Contract

**Islamic Futures Contracts are :**

A mutual commitment to buy (sell) a specified amount of real goods at a future date in cash. Islamic Futures Contracts are based on the intention for delivering real goods.



# Margin In Islamic Futures Contracts

The Traders according to the article added to the contract (Al-Shart), put an amount as margin to the broker as the agent (Wakil). Also, would allow him to give some percentage of margin to the other party based on the futures contract price fluctuations. At the maturity date or while cash settlement, both parties would settle and the exact gain (loss) would get determined.





# Some Figures for Islamic Futures in Iran

Duration	10 Months	
The Listed Contract	4 Contracts	Gold Bullion Gold Coin Copper Cathode Copper Wire
Trading Value	9,548,500 US Dollar (since beginning until 22/04/2009)	



Thank You