

Musharakah-Sukuk in Islamic Republic of Iran

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Abstract:

After Islamic revolution in Iran, investing in bonds by private sector was recognized as incompatible in accordance with Islamic jurisprudence. Therefore Musharakah certificate substituted bond. Musharakah Sukuk is bearer or registered securities which issued based on certain par value for the certain period of time and sold to the investors which want to participate on execution of projects. Issuer, subject-matter of participation, on-account profit, agent and Trustee are the components of the sukuk in the Law concerned. Development of Musharakah sukuk in two phases, from it's commence in 1994 to now, was explained in the article with the characteristic of some projects. In spite of remarkable successes of Musharakah sukuk in Iran, it faces some challenges.

Key words: Musharakah, Iran, Sukuk, participation-on account profit.

Introduction:

After Islamic Revolution of Iran, buying bonds by private sector was recognized as incompatible in accordance with Islamic Jurisprudence. Because capital from issuing bonds should inject for the development plans of Government and profit-based construction plans with desirable level of return, one alternative of conventional bond could be a specific type of sukuk which is similar to the certificate of deposit with respect to disbursement of profit. In this regard like CDs in banking system in Iran, based on IRR or ROR of the projects, specific portion of profit could be paid to the sukuk holders in advance and at the end of period of Musharakah Sukuk, materialized profit could be payable to the investors. It means that at the beginning of issuance and based on the ROR of the project, percentage of profit paid to holders of Musharakah Sukuk and at the maturity based on final calculation of profit, materialized profit could be determined. This module became as basis for first issuance of Musharakah Sukuk in Iran and rules and regulations governing such an issuance. Issuing Musharakah Sukuk and its payable profit has been exempted from tax.

Musharakah Sukuk based on its definition, are bearer or registered securities which based on law or central bank permit shall be issued based on Par value and certain period of time and in order to afford financial resources required for construction, completion and development of producing, building and service projects including financial resources required for procurement of raw material of producing units by government, state-owned companies, municipalities and public non-governmental institutions, non-profit institutions and affiliate companies of all these entities, public and private joint stock companies and producing cooperatives. These Musharakah Sukuk are sold through public offering to the investors which want to participate to the aforementioned plans.

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One of differences between Musharakah Sukuk and ordinary share is related to the lifetime of the project. By issuing Musharakah Sukuk companies which their life period limited to the period of project execution will be formed while joint stock companies formed based on unlimited lifetime. According to the current rules and regulations, for each investment plan, the volume of issuing Musharakah Sukuk should not exceed 50% of total amount of investment in IRRs terms and the ceiling of 70% of NAV of issuing company. Therefore board of directors of issuer undertakes executive management of participation project. Issuer can guarantee principal and on-account profit of Musharakah Sukuk at the maturity date. It means that buyers of these Sukuk share only expected profit of project and potential losses are related to the issuer. However in joint stock companies, shareholders share both profit and loss of company.

Although based on commercial act of Iran, share could be issued in form of registered or bearer but in Iran shares are mostly issued in registered form. However all Musharakah Sukuk are issued during recent years in bearer form.

The main difference between Musharakah Sukuk and conventional bond refers to the fixed and predetermined interest rate which conventional bonds have. However Musharakah Sukuk are formed as participation contracts (Musharakah Contract) and materialized profit (interest) will be determined after final calculation of project profit and will be disbursed after deduction of on-account profit (interest).

Objective of Issuing Musharakah Sukuk

According to Article 1 of Musharakah Sukuk Act, Objectives and targets of Musharakah Sukuk are:

- For public participation in execution of profit-based construction projects of Government included in Annual Budget Acts and producing, building and service profitable projects, government, state-owned companies, municipalities and public non-governmental institutions, non-profit institutions and affiliate companies of all these entities and also public and private joint stock companies and producing cooperatives are authorized to afford some amount of financial resources required for execution of aforementioned projects including financial resources required for procurement of raw material of producing units through issuing Musharakah Sukuk based on public offering and according to the regulations of this Act."²

Therefore, the main objective of issuing Musharakah Sukuk is financing of projects of Government, state-owned companies, private companies and cooperatives. Another objective which is considered for issuing Musharakah Sukuk is as an instrument for implementing monetary policy by central bank of Iran and will be elaborated more during this paper.

Definition of Musharakah Sukuk

According to Article 2 of Musharakah Sukuk:

"Musharakah Sukuk is bearer or registered securities which according to this Act issued based on certain Par value for the certain period of time and sold to the investors which want to participate on execution of projects which mentioned in Article 1 of this Act. Holders of Musharakah Sukuk share profit generated from execution of specific project based on Par value and participation period. Buying and selling of Musharakah Sukuk authorized directly or via stock exchange." (Ibid, Page 282)

² See Monetary and Banking Rules and Regulations, Page 281.

Therefore Musharakah Mukluks are deeds imply ownership of its holder toward a portion of one physical property which belongs to government, cooperatives or private companies and till maturity of Sukuk, any change in price of property is pertaining to the holder of Sukuk.

Components of Musharakah Sukuk

According to the Act, major components of Musharakah Sukuk are:

1. Issuer:

According to the Act and its executive bylaw, ministries, state-owned companies, municipalities, public institutions, non-profit institutions, public or private joint stock companies and cooperatives are authorized to issue Musharakah Sukuk based on Act and permission of Central Bank of Islamic Republic of Iran.

2. Subject-matter of Participation

The meaning of Subjects refers to the projects planned to be financed via issuing Musharakah Sukuk and during certain period of time will be sold or utilized and it is expected that the value of project will be exceeded materialized costs and expenses. Article 3 and 4 of the Act, describe responsible and the manner through which projects will be ratified and approved according to the subject-matter of participation.

"Issuing Musharakah Sukuk by Government is authorized only for affording financial resources required for executing profitable construction projects of government, subject of Article 1, and to some extent which predicted and planned in Annual Budget Acts. (Ibid)"

According to Article 4, Central Bank of Islamic Republic of Iran examines projects of state-owned companies, municipalities and non-governmental companies and institutions and if the project is economically, technically and financially feasible, it will issue its permission for issuing Musharakah Sukuk after it receives enough guarantees from Applicant Company and/or institution. (Ibid, Page 282)

3. Capital, Profit and Loss

Financial resources originated from selling Musharakah Sukuk considered as cash capital and according to Article 10, any Seize of money gathered via selling Musharakah Sukuk for cases rather than execution of relevant project is considered as seize of public funds and properties. (Ibid, Page 284)

Articles 3 to 5 of this Act and bylaw describe the manner through which principal and accrued profit will be disbursed. It is stated in Article 3 that in relation to the profit-oriented projects of Government:

"The disbursement guarantee of principal and on-account profit and materialized profit of Musharakah Sukuk will be provided by Ministry of Economic Affairs & Finance based on budget resources which provided for in the annual budgets with regard to these sukuk by Managing and Planning Organization"(Ibid, Page 282).

Article 5 of the Act describes disbursement of principal and profit of non-governmental projects as follows:

"State-owned companies, municipalities and non-governmental institutions and companies which are the subject-matter of Article 1, are obliged to guarantee and assure the disbursement of principal and accrued profit of Musharakah Sukuk at due date if they issue such sukuk"(Ibid, Page 283).

In accordance with Note of Article 5, issuer is authorized to disburse on-account profit to the holders of Musharakah sukuk monthly, quarterly or yearly and deduct it from the certain and materialized profit at maturity(Ibid).

4. Agent (Broker)

Agent is a bank which on behalf of issuer proceed to issue Musharakah sukuk and undertake disbursement of on-account profit, certain and materialized profit and reimbursement of principal amount of these sukuk at maturity and in accordance with Article 5, if issuer fails to meet its obligations at maturity, agent bank can directly take an action through predetermined guarantees. (Ibid)

5. Trustee (Custodian)

Trustee is personal or legal entity which is selected by central bank and preserves interests of Musharakah Sukuk holders with respect to the utilization of principal, manner through which accounts are managed, financial statements and executive performance of projects. In accordance to Article 13 of the Act " Ministry of Economic Affairs & Finance and Central Bank of Islamic Republic of Iran are obliged to send document or report which consists of principal amount (capital) and types of Musharakah Sukuk issued during each year in addition to their assessment with respect to economic impacts of issuing relevant Musharakah Sukuk for information of Planning and Budget Commission, Economic Affairs and Finance Commission, Cooperative Commission and Supreme Audit Court Commission of Parliament of the Islamic Republic of Iran." (Ibid, Page 284)

Therefore in addition to personal or legal entity on behalf of Central Bank as trustee for each of specific projects, legal personality of Ministry of Economic Affairs & Finance and Central Bank are taken into account as trustee for all projects.

6. Characteristics of Musharakah Sukuk

According to the foregoing, Musharakah sukuk are a new financial instrument which introduced to the capital market for the first time. Although such instrument has some similarities to other instruments like bond, common and preferred stocks but the Act of Issuing Musharakah Sukuk and records of recent years have created some sole features for this type of financial instrument. Some of these features are as following:

1- Ownership without voting right

Accordance to the Act, holders of Musharakah Sukuk are partners of the relevant projects with respect to the Par value of Sukuk and will be mutually owners of project and its properties and assets. If project needs more amount of capital generated from selling Musharakah Sukuk and raised through issuer, issuer will be also partner of project like owners of Musharakah Sukuk. The Act is silent about management right, voting right and supervision right of Musharakah Sukuk holders but practical procedure of recent years implies non intervention of Sukuk holders in terms of execution of project. In this regard, Musharakah Sukuk are similar to bond which their holders don't have any intervention to the management of economic activities of bond issuer.

2- Temporary Participation

Although the Act of Issuing Musharakah Sukuk does not have certain particular time which indicates maturity for participation in the project but practical procedure of

issued Musharakah Sukuk during previous years shows maturity between 6 months up to 5 years. It means that issuer of Musharakah Sukuk based on particular planning buys the owner's share of Musharakah Sukuk with respect to the project at maturity based on actual market price or agreed price and terminates the participation. Maturity of Musharakah Sukuk usually determined according to the period required for construction and start up of the project. In this regard Musharakah Sukuk is similar to bonds which have certain maturity.

3- Return of Musharakah Sukuk

Because of nature of Musharakah Sukuk and ownership of their holders toward participation project, any profit derived from execution of project and any price increase of project properties and in the other words any value-added of project belongs to holders of Musharakah Sukuk. For example in projects like hospital, university, dam or highway which started up within 5 years with certain costs and expenses, return of Musharakah Sukuk will be the difference between present value of project and materialized costs or expenses and such amount belongs to Sukuk holders. In accordance with the Note of Article 5 of the Act, issuers of Musharakah Sukuk can disburse a profit in advance in a timely manner and at maturity deduct on-account profit from final and materialized profit of project. (Ibid, Page 283) Records of issuing Musharakah Sukuk during previous ten years show that all issuers have disturbed profit in advance to owners of Musharakah Sukuk on quarterly or semi annually base. (Mirmotahari, Page 151) Musharakah Sukuk are similar to participation type of preferred stocks from the perspective of return because preferred stocks pay fixed rate of profit to their holders and at the end if the actual profit is more than on-account profit, stockholders will become partner. The only difference between Musharakah Sukuk and this type of preferred stock relates to the certainty of on-account profit. It means that on-account profit of Musharakah Sukuk isn't certain and final profit might be lower than on-account profit. Although in practice, for 35 projects which are financed by issuing Musharakah Sukuk during previous years, on-account profit rate and final pricing of project have been in a manner that on-account profit have been considered as base and certain profit from the viewpoint of Musharakah Sukuk buyers.

4- Guarantee of principal and accrued profit

Although because of nature of partnership contract, profit and loss derived from partnership relate to all partners but according to the viewpoint of some Islamic jurisprudent, some of partners can accept probable loss and assure principal of other partners. On the other hand as mentioned previously under the discussion about components of Musharakah Sukuk, Act of Issuing Musharakah Sukuk describes how to reimburse principal and disburse on-account and materialized profit through Article 3 to 5, making Ministry of Economic Affairs and Finance as guarantor in case of governmental projects and issuers for the other cases³. For interpretation of above-mentioned articles, two possibilities can be delivered:

From phrase of "guarantee of reimburse of materialized profit", the first interpretation can be explained as follows: guarantee doesn't mean assurance of money and determined rates but it means guarantee of principal operation, reimbursement of principal and disbursement of on-account and materialized profit if any. In other words, Ministry of Economic Affairs and Finance assures in favour of Musharakah Sukuk owners that if project

³ See Monetary and Banking Rules and Regulations, Pages 282 and 283

done successfully and profit derived, surely principal and its accrued profit will be disbursed. But there isn't any guarantee about the amount of profit rate. This interpretation doesn't have any discrepancies regarding nature of partnership contract⁴ and in fact it's pursuant to the nature of partnership contract.

Based on the second interpretation, guarantee means assurance of money and declared rates as principal, on-account and materialized profit. Although records of past years also imply this interpretation but it is contrast to the nature of partnership contract (profit and loss sharing) and makes Musharakah Sukuk very similar to bonds. .(Ibid, Page 50)

5- Buying and selling Musharakah Sukuk through secondary markets and convertibility to or substitution by stock

Under Article 2 of the Act of Issuing Musharakah Sukuk, trading of these Sukuk is authorized directly or through stock exchange⁵ and in accordance with Article 6, public joint stock companies can issue Musharakah Sukuk which can be converted to or substituted by stocks based on provisions of this Act.(Ibid, Page 283) Tradability, convertibility and substitution features of Musharakah Sukuk double importance of these Sukuk and provide a chance for Central Bank to enter and exit to the secondary market of Musharakah Sukuk and use them as an instrument for monetary policy. We will discuss it more through the other parts of this paper.

Evolution and recent development of Musharakah Sukuk of Iran

Development of Musharakah Sukuk in Islamic Republic of Iran has been done during two phases:

First Phase: from 1994 up September 1997

Second Phase: from September 1997 up to now

Legal framework and executive module of Issuing Musharakah Sukuk settled out based on rules and regulations governing issuance of Musharakah Sukuk (25 June 1994) its bylaw(5 September 1994) which ratified by Money and Credit Council (Central Bank).

In this period, for 6 projects totally 948.1 billion Rials of Musharakah Sukuk issued:

First: Navvab Project; the first experience of issuing Musharakah Sukuk goes back to the October 1994 in which Musharakah Sukuk of Navvab project issued by municipality of Tehran. This project includes construction of expressway with length of 5.5 Kilometers which connect north of Tehran to its south and construction of 6596 apartment buildings, 4479 commercial and administrative buildings next to the expressway. Total amount of Musharakah Sukuk issued for execution of Navvab project was 250 billion IRRs which issued through four tranches. The maturity of these Sukuk was October 1998. Principals of these sukuk repaid by Bank Melli Iran as a guarantor. Because this was the first experience at that time and there were not any rules and regulations with this respect, Central Bank made "Regulations Governing Issuing Musharakah Sukuk" at 25 June 1994 ratified by Money and Credit Council and this rules became as a legal base for issuance of Musharakah Sukuk of Navvab project.

⁴ See Hadavi Tehrani, Mehdi, Jurisprudent Principals of Musharakah Sukuk, Essay on 10th Islamic Banking Conference, Page 49

⁵See Monetary and Banking Rules and Regulations, Page 282.

On-account profit of this Sukuk was 20% which disbursed semiannually. Holders of these Sukuk had preemptive rights to select their arbitrary building including apartment buildings, commercial and administrative buildings in proportion to their Sukuk which they had. Maturity was 2.5 to 4 years in proportion and trustee was Auditing Organization. Materialized and final profit of Navvab project was totally 2% more than on-account profit (0.5% annually) which paid to Sukuk holders at maturity.

Second: project of healthy city and development of Abdul-Azim's Holy shrine

Healthy city project includes 6 projects which proposed by municipality of Tehran as below:

- Construction of Shahre-ray Ring Road
- Completion of torrent place of Kebritsazi
- Substitution of Varamin road
- Construction of eastern boulevard of Abdul-Azim's Holy shrine
- Construction of southern boulevard of Abdul-Azim's Holy shrine
- Construction of a park named Sizdah-Aban

In this regard, Central Bank issued permit of issuance of Musharakah Sukuk at October 1995 which amount 70 billion IRRs with 20% annually of on-account profit and maturity of 2.5 years. In this project agent bank was Meli Bank of Iran. Based on approval of the President at that time, municipality of Tehran paid 20 billion IRRs of money gathered by selling Musharakah Sukuk for development project of Abdul-Azim's holy shrine to the management of holly shrine. Because of this transfer, Council of Ministers approved that 10% of on-account profit of this Sukuk which equivalents to 17.5 billion IRRs shall be paid by Government. Regarding prepared plan for feasibility study, actual expense and cost of healthy city project and development project of Abdul-Azim's holy shrine has been predicted equivalent to 231 billion IRRs out of which a sum of 70 billion IRRs gathered by selling Musharakah Sukuk and the rest derived from cash capital of municipality of Tehran, holy shrine of Abdul-Azim and government aid. Trustee of project was Auditing Organization.

Third: 10 hospital projects which not fully constructed and completed by Ministry of Housing and Urban Development (Note 68, Annual Budget Act of 1374 (1995-1996) and Note 39 of Annual Budget Act of 1375 (1996-1997))

According to Note 68 of Annual Budget Act of 1374 and also its bylaw which also ratified by Council of Ministers, Ministry of Housing and Urban Development became authorized to attract people participation by issuing Musharakah Sukuk in order to complete building of 10 hospitals which were under construction. For this purpose, Bearer Musharakah Sukuk was issued by Ministry of Housing and Urban Development with maximum amount of 30 billion IRRs. The maturity was 5 years and on-account profit was annually 20% which disbursed semiannually. These hospitals were:

- Birjand Hospital
- Gha-en Hospital
- Kordkoy Hospital
- Ahar Hospital
- Boieen Zahra Hospital
- Kazeroon Hospital
- Nour abad Hospital
- Eghleed Hospital

- Sa'adat Shahr Hospital
- Ardakan Hospital

These Sukuk were the first one which could be tradable in Tehran Stock Exchange after listing. In accordance with Note 68 of Annual Budget Act of 1374, Government guaranteed reimbursement of principal and disbursement of accrued profit of these Sukuk and Management & Planning Organization on behalf of Government obliged to predict required financial resources in annual budget of Ministry of Housing and Urban Development. Also it was stipulated that Ministry of Housing and Urban Development on behalf of Government buys assets and properties of project based on actual and materialized costs and expenses associated with considering materialized profit of participation. These Sukuk were not noteworthy from viewpoint of people because of their non tradability before maturity and in overall during issuance period, approximately 16.4 billion IRRs of these Sukuk have been sold. Consequently approximate amount of 2 billion IRRs on behalf of Ministry of Housing and Urban Development sold to project contractors in consideration of delivered progress reports and the rest delivered to Bank Maskan of Iran. They Sukuk have been matured at 24 January of 2001 and Mellat Bank as agent bank paid principal and profit of last coupon to their holders.

Fourth: Project of Khorasan (Thamen) House Builders

The company of Khorasan House Builders was established based on Directive of Government and in accordance to Commercial Act. Its stockholders were as follows: National Organization of Land & House (Ministry of Housing and Urban Development) (40%), Razavi Holy Shrine (35%), Municipality of Mashhad (10%) and environment Construction (affiliate of Ministry of Housing and Urban Development) (15%).

This company has undertaken reconstruction and rehabilitation of 262 hectares of timeworn zones of city of Mashhad adjoining to Holy Shrine of Imam Reza (peace be upon him). Saderat Bank of Iran as agent bank issued Musharakah Sukuk during three phases. Maturity was 5 years and on-account profit determined 20% annually which was paid semiannually and also Auditing Organization selected as trustee of Central Bank in the project.

In addition to having redemption privilege in proportion to the amount of Musharakah Sukuk which their holders had, they also had preemptive rights to buy prepared lands and constructed buildings based on preferential prices.

Fifth: National Automobile Production Project

Iran Khodro Company requested to issue Musharakah Sukuk in order to execute projects aiming at increasing capacity of car building companies to produce modern automobile at the beginning of 1997. This project comprised 16 projects including reformation, reconstruction and rehabilitation of cutting and press factory, body construction, final assembly of founding, research & development, body of Peugeot 405, cylinder founding of Peugeot 405 and diesel engine and etc. After preliminary study by Melli Bank of Iran as agent and broker, Central Bank agreed that Iran Khodro Company issues Musharakah Sukuk of National Automobile Production Project through 3 tranches up to maximum of 585.8 billion IRRs⁶.

During first stage, Musharakah Sukuk of aforementioned project issued equivalent to 325.6 billion IRRs at 21 December 1996. Maturity of Sukuk was 4 years and on-account profit rate determined 24% annually which disbursed semiannually. Each unit of Musharakah Sukuk embedded one coupon to buy automobile. In addition to receive principal, on-account and

⁶ Only the amount of 513/1 billion IRRs Musharakah Sukuk issued

materialized profit, holders of Sukuk can refer to the company at maturity and in consideration of delivery of coupon of 50 million IRRs of Musharakah Sukuk, they enabled to receive one automobile with 20% discount rate in terms of market price. Second and third stage of Musharakah Sukuk of abovementioned project were issued and publicly offered at 7 October 1997 in lump-sum of 187.525 billion IRRs. Maturity of these Sukuk was 3.5 years and on-account profit rate was equivalent to 20% annually which disbursed semiannually. Therefore total amount of capital which derived from these stages was 513.1 billion IRRs. Auditing Organization was trustee of this project.

Sixth: construction project of apartment buildings in towns of Hashtgerd and Andishe and Urban Development by National Organization of Land & House (affiliate of Ministry of Housing & Urban Development) (Note 85 of Iran's Second Economic, Social and Cultural Development Plan (1989-1993))

According to Paragraph A of Note 85 of Iran's Second Economic, Social and Cultural Development Plan, Ministry of Housing and Urban Development (National Organization of Land & House) authorized to raise capital in housing sector through Maskan Bank and issuing (selling) Musharakah Sukuk aiming at execution of housing projects in towns of Hashtgerd and Andishe. Ministry of Economic Affairs & Finance on behalf of Government assured redemption of these Sukuk and its accrued profit.

Money and Credit Council determined the characteristics of Sukuk as follows: maturity of 3 years, 20% annual on-account rate of profit, semiannual payment of on-account profit and 3 tranches totally equivalent to 110 billion IRRs.

The first tranche of Sukuk issued for construction of 800 apartment buildings in phase 2 of New City of Parand, infrastructure preparation and construction of apartment building in phase 2 of New City of Andishe, preparation and construction of 1000 apartment buildings in phase 3 of New City of Hashtgerd. Broker of these issuing was Maskan Bank. If Musharakah Sukuk holders wanted, they could have preemptive right to buy land or apartment building of abovementioned project in consideration of 20 million IRRs of Musharakah Sukuk and benefited from 7% annual discount rate with respect to total amount of Musharakah Sukuk.

New Construction Towns Company was as executor and Auditing Organization was as trustee. Principal amount and profit of last coupon of these Sukuk which matured at 9 May 2000 disbursed through Maskan Bank to their holders.(Rahimi,2002)

Legal framework and executive procedure of first phase of issuing Musharakah Sukuk and its bylaw (approved by Money & Credit Council) are as follows:

1. Musharakah Sukuk issued by project executor which was the owner of project for the purpose of financing required for profitable producing and service projects based on the framework of partnership contract and Central Bank permission.
2. Each of Musharakah Sukuk implied share of its holder considering partnership (participation). Relation between attorney and constituent corresponded between issuer of Sukuk and their buyer.
3. Broker was a bank or institution which proceeded on behalf of issuer to offer Sukuk, disburse on-account profit in due time and reimburse principal at maturity.
4. Trustee was a legal or personal entity which examined using capital in due manner, accounts and project progress on behalf of Central Bank.
5. Materialized profit of project shall be approved by trustee and the margin between materialized profit and on-account profit shall be disbursed to Sukuk holders.
6. Musharakah Sukuk could be assigned to others.

7. On-account profit paid to the Sukuk holders in due dates in consideration of embedded coupon of Sukuk. (Money & Credit Council, Rules and Regulations Governing Musharakah Sukuk approved at 25 June 1994 and its bylaw approved at 5 September 1994).

Eventually the Act of Issuing Musharakah Sukuk ratified by Parliament of Islamic Republic of Iran at September 1997 and its bylaw approved by Council of Ministers at August 1998.

Legal framework and executive module of issuing Musharakah Sukuk was based on the Act of Issuing Musharakah Sukuk (ratified by Parliament of Islamic Republic of Iran at 21 September 1997) and its bylaw (approved by Council of Ministers at 9 August).

Second feature of second phase of issuing Musharakah Sukuk was related to different types of Sukuk as:

- Governmental Musharakah Sukuk (Budgetary and Non-budgetary)
- Sukuk issued by Central Bank for monetary policies
- Sukuk issued by Corporations

Headlines of Issuing Musharakah Sukuk Act are as follows:

- 1- Authorized institutions to issue Musharakah Sukuk are Government, state-owned companies, municipalities, public and non-governmental institutions, non-profit institutions, public joint stock companies, private joint stock companies producing cooperatives (Article 1).
- 2- Holders of Musharakah Sukuk are partners with respect to profit generated from execution of the project based on par value and time period of partnership (Article 2).
- 3- Musharakah Sukuk can be issued by Government if and only if such issuance required for financing of profit-oriented construction projects (Article 3)
- 4- Maximum amount of Musharakah Sukuk which can be issued yearly shall be determined by Money & Credit Council in accordance with Fiscal and Monetary policies of Iran (Note 2 of Article 4)
- 5- Joint stock companies can issue Musharakah Sukuk which can be converted to or substituted by stock (Article 6)

Operational procedure of issuing Musharakah sukuk is sequent:

First: request of applicant from Central Bank attached with a technical, economic and financial feasibility study of project which indicates its profitability and introduce agent bank.

Second: Central Bank permits issuance and determines the date, conditions and stages of Sukuk offering based on stock market conditions.

Third: After Central Bank permit, issuer shall announce the subject-matter publicly through media.

Fourth: Trustee (Auditing Organization) is selected by Central Bank and appraises continuously performance of project issuer with respect to capital employed, accounts, financial statements and executive performance of issuer and discloses its opinion in order to preserve interests of Sukuk holders.

Fifth: Issuer of Sukuk holders shall deliver required collaterals to the agent bank in order to guarantee principal and its accrued profit of Sukuk.

Sixth: Agent bank offers Musharakah Sukuk for selling and disburses on-account profit after tax in due dates and reimburses principal at maturity. If materialized profit is lower than on-account profit, issuer would compensate difference from its own financial resource.

Seventh: Musharakah Sukuk can be redeemed by agent banks before maturity (bylaw of Musharakah Sukuk Issuing Act approved by Council of Ministers).

Musharakah Sukuk Status Report

Table (1): Musharakah Sukuk issued between 1994 and 2006

Year	Number of Project financed through Musharakah Sukuk	On-account Profit Rate (annually) (Tax Exempt)
1994	1	20
1995	3	20
1996	3	20
1997	5	20
1998	6	20
1999	5	19
2000	4	19
2001	11	17
2002	11	17
2003	11	17
2004	15	17
2005	17	15.5-19
2006	18	15.5
Total	109	---

Source: Central Bank of Islamic Republic of Iran, Economic report and Balance of Payments between 1994 and 2006

Table (2): Status Summary of Musharakah Sukuk issued at year 2006

Type of Musharakah Sukuk	Subject-matter of project	Maturity (year)	On-account profit rate (annually)
Issued by Government for:	Construction budget	5	15.5
	1. Investment through the Budget 2. Investment by state-owned companies	6	15.5
Issued by Central Bank	Monetary Policy	1	15.5
Issued by corporations	Petrochemical plants	4	15.5

Source: Central Bank of Islamic Republic of Iran, Economic report and Balance of Payments (2006) pages: 256-257

Musharakah Sukuk has been issued in bearer form till now. Based on first and third type, Musharakah Sukuk are issued for financing capital assets and working capital of producing factory but based on the second one, Musharakah Sukuk issued for controlling monetary base and decreasing liquidity volume. Musharakah Sukuk of Central Bank issued as tools of monetary policy as well as controlling inflation in the manner through which it can speculate on international gold and silver market and Musharakah Sukuk holders share the profit of assets portfolio of central Bank. While Sukuk of Central Bank usually has maturity of one year, (short-term Sukuk) the other types of sukuk have maturity of 3 to 5 years.

Governmental Musharakah Sukuk (budgetary type) are issued in order to facilitate purchase plans of capital goods and repaying principal and their accrued profit are mentioned in Annual Budget Acts.

Governmental Musharakah Sukuk (Non-budgetary type) is issued in order to complete purchase plans of capital goods of state-owned companies and principal amount repaid through their internal cashes.

Corporation Musharakah Sukuk is issued in accordance with Article 4 of the Act of Issuing Musharakah Sukuk (approved at 1997).

Secondary Market of Musharakah Sukuk

All Musharakah Sukuk issued by governmental organizations can be redeemed before maturity based on par value and daily profit. Although this possibility increases Sukuk liquidity for the benefit of Sukuk holders but it also decreases issuer reliance in terms of capital employed. Solution is the trading of Musharakah Sukuk via stock exchange which makes Sukuk as marketable instruments. Because only registered instruments can be traded in stock exchange, Musharakah Sukuk shall also be registered in stock exchange by means of subscription method. Subscription of Musharakah Sukuk can be done like stock subscription by virtue of agent bank and or brokers and through trading system of stock exchange in a manner of order registration. This option cancels redemption guarantee of Musharakah Sukuk by bank and any trading of these Sukuk shall be done through stock exchange. Trading of Musharakah Sukuk in stock exchange decreases their liquidity and this necessitates market makers operations for them. (Securities and Exchange Organization, Surveillance Deputy of exchanges and issuers," assessment of structuring secondary market of Musharakah Sukuk", January 2008, pages: 2-7)

Challenges of Musharakah Sukuk in Iran

Main challenges are as follows:

1- Because of redemption option before maturity based on par value and daily profit, these Sukuk have not been designed in marketable manner and does not change with respect to economic recession and growth.

2- Agent banks guarantees redemption of Sukuk at a specified time. This causes increase in agency costs of bank, decrease in accessible financial resources of issuers, increase in possibility of using from financial resource of bank, residue of Sukuk in bank assets portfolio and consequently increases in issuer costs. In addition banks commitment to redeem Sukuk before maturity and/or at maturity restricts management of banks financial resources. Liquidity preference of Musharakah Sukuk doesn't have any costs and expenses for their owners.

3- In case of issuing Musharakah Sukuk by Central Bank, financing costs increase from 15.5% to 17.2%. Considering 5% to 25% of principal amount which shall be retained by agent bank aiming at market making, the rate of 17.2% exceed approximately to 18% up to 22.4%.

4- In accordance with Article 2 of the Act of Issuing Musharakah Sukuk, Sukuk holders share profit derived from project based on par value and partnership period. While a specific project might be profitable at the time of preparation of technical, economical and financial feasibility study but in practice, its expected profitability might be decreased even lower than disbursed on-account profit because of some uncontrollable and predictable variables or even it might be faced with loss. In such cases, issuer shall consider disbursed on-account profit as certain profit and repay principal and the difference between on-account profit and materialized one (certain profit) from its own financial resourced because of its commitment at the time of issuance. If issuer wants to share probable loss with Sukuk holders, it won't be possible to distinguish all their holders because such Sukuk are bearer and they might be traded for many times. That is why only the last holder shall undertake loss of project execution at maturity. But this doesn't make sense because Sukuk owners do not supervise issuer activities and in order to prevent any uncertainties for Sukuk buyers, repayment of principal at maturity is guaranteed by issuer. On the other hand, issuer of Musharakah Sukuk frequently considers on-account profit as a profit which surely shall be paid and repay merely principal amount at maturity. But value of project assets usually increases and according to partnership contract, holders of Musharakah Sukuk shall be entitled to capital gain of project assets.

5- According to the Act of Issuing Musharakah Sukuk, it is authorized to buy and sell such Sukuk but in practice, small volume and amount of these Sukuk are traded among institutional traders in stock exchange in manner of block trading. Trading of Musharakah Sukuk in stock exchange is faced with two problems:

First: although Musharakah Sukuk are bearer instruments and there isn't any limitations among traders with respect to buying and selling but trading of these Sukuk has transaction costs and brokerage fees.

Second: because Musharakah Sukuk can be liquidated by agent bank based on par price and receiving daily profit before maturity, one who wants to buy Musharakah Sukuk isn't happy with prices which higher than par price and one who wants to sell Musharakah Sukuk aren't happy with prices which lower than market price in stock exchange. Therefore the possibility of having market is vanished in this regard and regardless of trading authorization of Musharakah Sukuk in stock exchange, buying and selling of these Sukuk practically done by branches of agent bank. In fact secondary market of Musharakah Sukuk is the agent bank and in this market buyer (agent bank) plays passively with respect to buyer action.

6- In the process of issuing Musharakah Sukuk, project and its profitability are considered but economic and financial status of issuing company is not well enough assessed. While in other countries, credit rating of financial instruments calculated based on country risk and issuing company risk and independent agencies undertake rating of financial instruments. Although the distinction between governmental and corporate securities assessment in other countries and Musharakah Sukuk assessment in Iran can be arisen from the different nature of bond and Musharakah Sukuk, it is necessary to have some institutions which undertake rating responsibility of corporations and securities in Iran. Such institutions enable buyers of Musharakah Sukuk to assess risk and return of their Sukuk.

7- Direct sale and creating Central bank debts towards local public are considered to be done only by issuing local currency.

8- No possibility of selling Musharakah Sukuk directly to the banks and affecting their ability to provide facilities (loans).

9- By paying 15.5% as profit rate to Sukuk holders, efficiency of Sukuk to gather purchase power of Iranian society vanished about 15.5%. Effectiveness of Musharakah Sukuk will be remained only if their profits are collected from economy through taxes.

10- According to Unpleasant Monetarist Arithmetic, Musharakah Sukuk of central bank in their current structure transfers only liquidity from one year to the next year and doesn't have sustainable effect to control monetary volume.

11- Because in other countries the government uses widely bonds, central bank can control liquidity by selling and buying of treasury bonds so-called open market operation. But in Iran because of limited volume of governmental Musharakah Sukuk, in practice, Central Bank has to issue directly Musharakah Sukuk in order to neutralize monetary base expansion.

12- In minority group of monetary policy-making regimes, central bank issues debt instruments by its own. World successful experience proofs that long-run debt instruments should be issued by treasury and traded by central bank for open market operation.

13- From the beginning of Iran's Fourth Economic, Social and Cultural Development Plan and based on reformation of Paragraph (H) of Article 10, the authority of Central Bank to issue Musharakah Sukuk has been repealed and it became subject to the ratification of Parliament of Islamic Republic of Iran. This causes delay of Central Bank when it decides to implement its monetary policy. Therefore Musharakah Sukuk encounters with problems which cause failure to achieve planned objectives of the policy maker. Consequently, it necessitates doing some renovations with respect to definitions and conditions of issuing Musharakah Sukuk in order to eliminate their shortcomings and restrictions⁷.

Conclusion

1- Musharakah Sukuk could be divided into two types: governmental and non-governmental. At the moment, because Musharakah Sukuk are new financial instruments in Iran, non-awareness of people and also their non-established culture in Iran, all Musharakah Sukuk have been guaranteed by banks. This guarantee means that agent bank assures repaying of principal and profit at maturity date and at due of profit amounts. But based on economic and financial theories it seems that governmental Musharakah Sukuk should be offered at lower rates of profit and risk averse investors buy this type of securities because they are guaranteed and assured by Government. On the other hand, it is necessary not to provide abovementioned guarantees for non-governmental Musharakah Sukuk and issuer should undertake assurances. Therefore non-governmental Sukuk have a higher rate of profit versus governmental ones and risk-taking investors will select this type of Sukuk. In spite of what discussed above, in practice, there have not been any distinctions between Musharakah Sukuk issued by governmental sector and non-governmental sector with respect to their profit rate yet.

2- It is important to assess economic power of Musharakah Sukuk issuer. In the process of issuing Musharakah Sukuk in Iran, project assessment and its profitability are examined but another important issue which is rarely considered financial, economical and social status of Sukuk issuer. For example, a specific project might be profitable but issuing company is comparatively at a lower rank with respect to its efficiency. Usually in other countries, ranking of debt securities like Musharakah Sukuk are calculated according to the country and issuing company risk and independent agencies undertake their ranking. It is necessary to

⁷ See Pathology of Governmental, Corporate and Central Bank Musharakah Sukuk, Central Bank of Islamic Republic of Iran, Department of Analysis and Economic Policies, 2007, Pages 5 to 10

establish such agencies to undertake this function in order to prevent issuing Musharakah Sukuk by deficient companies (Rahimi' 2002-2003).

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