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Islamic Financial Instruments in Iran (With Emphasis on Salam Sukuk)

In the Name of the Most High

Preface

As Islamic Capital Market expands through the world, new demands for Shariah compatible methods of financing come to the stage. This fact requires Islamic finance scholars and experts to think up and design new vibrant instruments which can meet increasing market needs. One of these innovations in order to satisfy the needs of market participants in Islamic capital markets is Salam Sukuk.

Establishing and wide spreading Islamic capital markets, Salam Sukuk has been widely accepted in the market and in the present time and many participants in the market use such an instrument in order to manage their financing needs and determining the price of the commodities in coming future.

Salam and Parallel Salam are one of the most effective tools available to Islamic financing institutions. Generally, in order for a sale to be valid under Shariah, the object which forms the subject matter of the sale should exist. The exceptions to this general position are sales affected pursuant to Salam contracts. In its simplest form, a Salam contract involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre-agreed date.

Since the Salam contract deals with the delivery of an asset which is not in existence, Shariah highlights that strict rules must be adhered to in order to ensure that the right of all parties are protected. In fact, it is necessary that the quality of the commodity is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.

Salam sale is a kind of contracts in Islam that carries specific rules for both seller and buyer. Full payments in cash at the beginning and non-tradability before maturity are some important regulations that regulatory bodies should consider in structuring Salam Sukuk. General acceptance of Salam Sukuk beside its limitations, specially the prohibition of selling Salam commodity before maturity, has encouraged Islamic finance scholars to design new mechanism based on Salam contract which is called Parallel Salam. Parallel Salam has all advantages of Salam but less of its disadvantages; It is a Salam contract where the seller enters into another separate Salam contract with a third party to acquire goods the specification of which correspond to that of the commodity specified in the first Salam contract, so that he (the seller) can fulfill his obligation under that contract. So in this arrangement, the liquidity problems of Salam Sukuk can be solved and buyers in Salam contract and sell the Salam commodity in the market before reaching the maturity.

Salam Sukuk is widely appreciated by market players and different kinds have been issued in global markets. Central Bank of Bahrain, Yemen and Gambia, as government issuers, have issued so many Salam Sukuk since 2001 up to now. In addition, so many private banks and companies have issued Salam Sukuk from different countries including Sudan, Bahrain, Qatar, Algeria, Jordan, and Kuwait and so on. So in the international market, we can see a wide variety of Salam Sukuk with different rates and maturities.

Salam and Parallel Salam can be used for wide range of commodities. According to the needs of Iranian capital market, we have designed and introduced two kinds of Parallel Salam: Crude Oil and Gold. As Iran is one of the most affluent countries in oil reserves, and has a lot of oil supplies, there is an urgent and growing need to facilitate the transactions of crude oil and finance the projects of oil exploration and deployment in the country. So the Iranian Securities and Exchange Organization (SEO) has tried to expand the financial market for crude oil transactions. According to this contract, first buyer will purchase some specified, standardized amount of crude oil from National Iranian Oil Company which will be delivered in some 4 year later. There is a possibility for the buyer to transfer this Salam crude oil to other buyers and settle up with the company. This mechanism can help the National Oil Company to pool necessary funds for its projects trough selling future oil products. In addition, it can provide a new interesting opportunity for investment.

This volume of our bulletin is devoted to introduce and specify Parallel Salam as has been experienced in Iranian capital market. This will include reviewing the concept, Fiqh aspects and Shariah Board comments, describing operational mechanism and some other related subjects. We hope it will be informative and useful for sharing ideas and experiences in Islamic capital markets. The Securities and Exchange Organization of Iran will collaboratively and willingly be prepared to exchange past experiences, solidify main themes and reinforce major ideas in this financial domain. Doubtless, genuinely collective efforts in this direction will pay off in the end.

Dr. Ali Salehabadi
President and Chairman of the Board

Shariah Board

A Review on the Islamic Aspects of Salam Sukuk Issuance and Trading

Making sure an instrument is not Shariah incompatible, Shariah Board of Iranian Securities and Exchange Organization (SEO) scrutinizes any new financial instruments from different Fiqh aspects. The Board which is consisting of some Shariah scholars as well as some finance experts approves new instruments only if they meet Shariah constraints.

The Shariah Board has discussed Parallel Salam in one session and Oil Parallel Salam in three separate sessions (Nov 9, Dec 7 and Dec 21, 2011). After a detailed discourse in the Board and reviewing different aspects of Oil Salam from Fiqh, financial and economic perspectives, the Shariah Board ratified a mechanism of Parallel Salam which is Shariah compatible. According to the board, selling a specified amount of crude oil in advance in which the characteristics of the oil as well as the time, place and state of delivery is determined, has no confliction with Shariah rules. The seller of Salam can issue some standardized certificates (Sukuk) for the buyers so that in the maturity, the Sukuk-holders can refer to Oil Company and receive their oil or its cash equivalent.

According to dominant Fiqh scholars, as exchanging Salam Sukuk in the secondary market is a kind of selling or buying Salam commodity before maturity, it is prohibited by Shariah. As any new instrument needs to be in accordance with the opinion of dominant Fiqh scholars for its acceptance and success, the Shariah board has introduced a solution by combining Parallel Salam with Hawala contract(1). In this solution, the buyer of Salam Sukuk will sell a specified amount of oil in advance through another independent Salam contract but for receiving the commodity in the maturity, refers the new buyer to the first Salam issuer, i.e. Oil Company.

In order to hedge the risk of oil price in Salam Sukuk, the board has proposed two different ways using Options(2):

1. Using put and call option in Salam contract: Through the Oil Salam contract, the buyers and the seller of oil Salam make a condition that the Salam buyer has the right to sell a specified amount of crude oil at a certain price in the maturity to the seller (put option) and Salam seller, i.e. Oil Company, has the right to buy a specified amount of crude oil at a certain price in the maturity from the buyers (call option).
2. Signing a package contract: In this way, the buyers and the seller of Salam commodity, agree to sign a package contract which includes:
   a. The Salam seller, sells a specified amount of crude oil to the buyer;
   b. Issuing Salam Sukuk, the seller permits the buyers to make new Parallel Salam and refer new buyers to the him as the first seller;
   c. The Salam seller, sells the put option to the buyers and buys a call option from them;
   d. The seller permits the buyers to have such a composite contract based on Parallel Salam with new buyers.

EndNotes

1. *Hawalah* is a contract of assignment or transfer of debt from the liability of the original debtor to the liability of another person. It is a requirement that the transfer of debt is affected immediately upon the conclusion of the contract and is not suspended for a period of time. *Hawalah* operates to release the original debtor from the debt.

2. Options, as Shariah Board approved, are a kind of promise; the seller of option against receiving a fee, promises to sell or buy a certain commodity or stock in the case that the option-buyer uses the option. In other words, the buyer of option buys the promise of other person to sell or buy something (Oct, 22 & 23, 2008).

1. Selling a specified amount of crude oil in advance in which the characteristics of the oil as well as the time, place and state of delivery is determined, has no confliction with Shariah rules.

2. Exchanging Salam Sukuk in the secondary market is a kind of selling or buying Salam commodity before maturity and is prohibited by Shariah.

3. The composition of Parallel Salam with Hawala in order to dissolve the problem of secondary market for Parallel Salam is Shariah compatible.

Some More Discussions on the Islamic Aspects

How Does Islamic Principles Structure Salam Sale?

By: Majid Pireh
Islamic Finance Expert

In its simplest form, a Salam contract involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. The purchase price of the assets is typically referred to as the Salam capital and is paid at the time of entering into the Salam contract.

It is evident from the foregoing discussion that Salam was allowed by Shariah to fulfill the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector. The price in Salam may be fixed at a lower rate than the price of those commodities delivered at spot.

Generally agreed conditions for Salam sale are that:

1. The goods sold need not be in existence at the time of contracting.
2. The delivery date and location must be specified.
3. Full advance settlement of the agreed trade price is required at the time of contracting; otherwise the contract would sanction the trading of one debt for another which is not deemed permissible in Islam.
4. The quality of the items to be delivered should be defined. Rare items, or those that are not precisely specifiable, cannot be the subject of the Salam sale contract. If the quality of the items upon delivery is found to be other than specified, the buyer has the right of refusal.
5. The quantity of the items to be delivered should be defined and fixed according to the normal method of measurement of those items and should not depend upon unforeseeable factors. The quantity of goods purchased under the Salam contract cannot for example be defined as that resulting from the cultivation of a given plot of land since such a quantity may vary according to unforeseeable factors.
6. The seller may deliver the contracted items irrespective of the buyer's circumstances on the delivery date .
7. The buyer is permitted to trade the commodity only after maturity date. So trading the commodity that is bought via a Salam contract before maturity is not permissible. (It is noteworthy that some jurisdictions permit selling Salam commodities only after real possession.)

A Review on Salam Sukuk Issuance in the Globe

In practice, Salam (or bay' al Salam) structures have proved more popular for short-run financing Sukuk than Murabaha as the latter usually involves commodity trading, the finance of which is not the aim of most Sukuk issues. Salam simply refers to a sale in which payment is made in advance by the buyer, and the delivery of the asset is deferred by the seller. The period involved is usually short, as with Murabaha, three month being typical. In practice a Salam Sukuk can be considered as a Shariah compliant substitute for a conventional treasury bill issued for three months short-term financing by governments, as the return and the period to maturity are fixed when the offer is made. Such Salam Sukuk have been issued by the Bahrain Monetary Agency at three monthly intervals since 2002 as part of the short-term financing facilities arranged on behalf of the Government of Bahrain (Bahrain Monetary Agency, 2002). The CBB also issued, on a monthly basis, three-month Al-Salam Sukuk (BHD) where the issue amount was increased from BHD 12 million to BHD 18 million, from June 29th, 2011. In addition, the Central Bank of Yemen issued some Salam Sukuk worth 50 billion Yemeni riyals ($234 million) in April 2012. This is the first Salam issue devoted to the purchase and sale of petroleum products. Subscription to the issue was restricted to Islamic commercial banks in Yemen. This Salam Sukuk were issued to help the government raise funds to purchase consumer commodities for the public. The profit margin ranged between 15% and 18%, which offered financial benefits for the government, commercial banks and the community through the provision of strategic commodities such as oil derivatives .

The Central Bank of Gambia on behalf of government, has issued many Salam Sukuk which is on similar terms and conditions (platform) as the conventional Treasury Bills and therefore, has the same maturity profiles of three, six, and twelve months. This product is designed to have similar policy objectives as the conventional Gambia Government Treasury bills of mopping up excess liquidity from the system. The volume of Gambian Salam Sukuk has increased from $215.14 million in 2010 to $345.56 million in 2011.

Despite a wide acceptance of some popular Sukuk such as Ijarah or Murabahah Sukuk, Salam Sukuk has a very little amount of global issuance. This may be in part because of its inherent and systematic risks. An inherent risk in this arrangement is that the Salam buyer, who has received the commodity in the maturity, may not be able to sell the goods in the market. Because of this risk, Islamic entities rarely enter into a Salam contract if there is no third-party guarantee. Pricing a Salam contract is also more intricate than a Murabaha contract and involves accounting for the credit risk of the buyer and expected change in value of asset over the time of the contract. If the contract spans over different countries, the bank will also have to add a discount or premium taking into consideration the forward exchange rate between the different countries.

Salam Sukuk Issuance for Financing Oil Producing Industry

Introduction

As Islamic Capital Markets develop, they become more interesting for both investors and demanders of funds. Salam Sukuk is one of attractive innovations in the ICMs especially for the producers or manufacturers who are in emergent need for cash. Salam Sukuk provides the possibility of selling future products in advance and using the pooled funds for different needs of the producers. In addition, through introducing a Shariah compatible mechanism of Parallel Salam, this kind of Sukuk can be easily traded in the secondary market. In this section, we are going to provide a general schema of Parallel Salam Sukuk especially Oil Parallel Salam Sukuk which has been introduced recently in Iranian capital market.

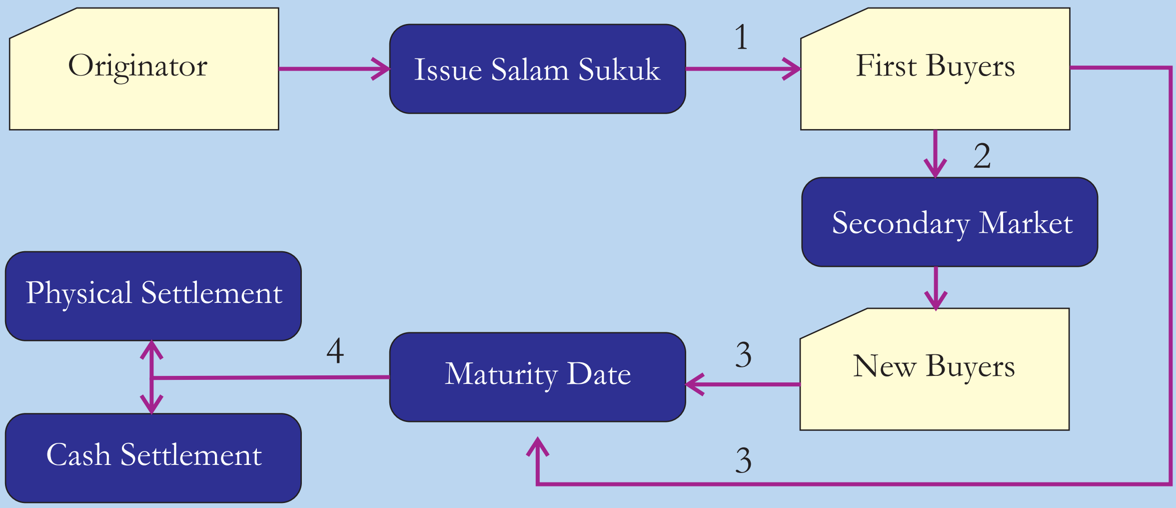
Definition and Structure

Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre-agreed date. What is given in exchange for the advance payment of the price should not in itself be in the nature of money. For the payment in advance, the contracting parties stipulate a future date for the supply of goods of specified quantity and quality. In this kind of contract, the buyers will purchase a specified amount of the commodity at a specified price which will be transferred to them at the determined maturity. In Salam contract it is necessary that the whole price of the commodity is paid at the time of agreeing on the contract.

Selling the goods purchased in a Salam contract prior to taking delivery is not generally allowed in Shariah. Instead, it is allowed for Salam Sukuk holders to make parallel Salam contracts for the same goods to be delivered even at the date and time of delivery of the original Salam. That is, in the case that a Salam Sukuk holder wants to settle him and exit the market, he can use Parallel Salam mechanism.

In Parallel Salam, there must be two different and independent contacts; one where the Sukuk holder is a buyer and the other in which it is a seller. The two contracts cannot be tied up in a manner that the rights and obligations of one contact are dependent on the rights and obligations of the parallel contract. And each contract should have its own force and its performance should not be contingent on the other. In this an arrangement, the buyer of Salam-commodity will be in the position of Salam seller in another independent contract and sells the specified amount of Salam-commodity to the second buyer. It is worth to note that the second Salam contract has no relation to the first Salam contract and they are completely independent. In addition, the prices are different and are based to the spot price of transaction date.

As an example, In Crude Oil Salam Sukuk, an oil producer country will sell a specified amount of crude oil to Sukuk-buyers through Salam contract. The crude oil or its price will be delivered or paid to the Sukuk-holders in future, say, 3 years later. The Sukuk-holders, who will receive a specified amount of crude oil in future, can enter to another parallel Salam contract with others. At first, in the second Salam, the seller of, say, crude oil, has no crude oil but in the maturity, he will divert the buyer to the initial originator, say, National Iranian Oil Company (NIOC) to receive the specified amount of crude oil. So, these two contracts are independent and only a Hawala Contract is made.



1. The Originator (i.e. Salam Issuer), sells its future commodities to the securities buyers and receives the whole price of the commodity.

2 & 3. The first buyers of Salam commodity may wait until maturity date or through Parallel Salam process, they can sell Salam Sukuk in the secondary market and settle off.

3. At the maturity, either the first buyers or new buyers who have purchased Salam Sukuk from secondary market, have two choices: physical settlement or cash settlement.

4. Based on above points, at maturity the traders may settle in cash or physically.

Profit and Loss

The profit of Oil Salam Sukuk is the difference between the cash price of crude oil (which is paid at the beginning) and the future price at the maturity. For example, if the specified price is $150 per barrel and in the maturity the spot price is $170 per barrel, the Salam buyer will gain $20 per barrel.

Risk Management

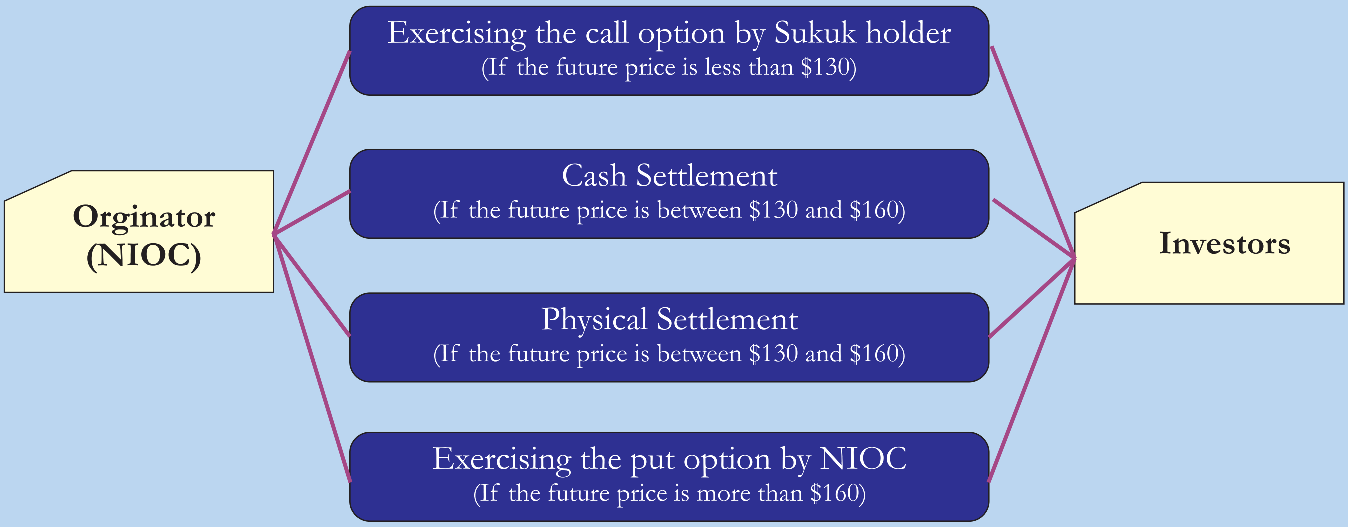
In order to manage the price risk, one can use Put or Call Options. For example, the NIOC can include a call option for the prices higher than $170 per barrel and simultaneously a put option for the prices less than $140 per barrel. So, the price of Salam commodity can fluctuate between these two limits and Sukuk-holder's gain or loss is limited by a maximum profit of $20 per barrel and maximum loss of $10 per barrel. This can make this kind of Sukuk more interesting for market participants.

Iranian Crude Oil Parallel Salam Sukuk

In order to finance oil projects, National Iranian Oil Company (NIOC) has decided to issue crude oil Salam Sukuk. According to this mechanism, NIOC will sell the crude oil to the public for the first time. Initial supply volume of crude oil is 1 million barrels and the maximum amount of supply will be 5 million barrels with a value of $500 million which be issued on both Dollar and Iranian Rial basis.

In this kind of Salam Sukuk, the supply of crude oil will be through crude oil Salam Sukuk with a minimum profit of 30% for 3 years. In the case that the average price of crude oil in Dubai and Oman Stock Exchange at the maturity becomes less than $130 per barrel, Sukuk holders can sell their crude oil to NIOC at $130. But if the average price becomes more than $130 per barrel in the maturity, the Sukuk holder can either receive crude oil or settle in cash. So the return of these Salam Sukuk during a 3-year period is 30%.

If the average price of crude oil in the maturity becomes more than $160 per barrel, the NIOC has the right to refuse physical settlement and settle the Sukuk holders in cash through buying the crude oil at a price of $160 from them.



NEWS

Designing a New Clearing and Settlement System for Issuing Oil Salam Sukuk

Jan 15, 2012

Iranian Oil Salam Sukuk will be issued aimed at financing National Iranian Oil Company (NIOC) in order to utilize and develop its oil fields. Converging Iranian oil price to global rates, some of these Sukuk will be issued in U.S. dollar. For this reason, the Central Securities Depository of Iran has designed a new settlement system for covering multi-currency transactions. This system is based on Net Clear, called Multi-Currency Net Clear, which settles and clears the securities in different currencies as rule-based. In this system, the possibility of changing all variables and rules of securities is contrived.

Among advantages of this system are (i) the possibilities of introducing unlimited number of currencies, pricing and taxation, (ii) daily settlement rates with proxy for different currencies, (iii) designing multi-currency Musharakah Sukuk and clearing any multi-currency Sukuk, (iv) Netting separately in unlimited number of levels, (v) the possibility of currency barter in all the markets and so on.

Communique Operational Instructions of Fighting Money Laundering

Feb 6, 2012

The Committee of Fighting Money Laundering in Iranian Securities and Exchange Organization has communique its operational instructions in capital market. These six instructions have been announced to the under-supervision entities. This includes:

(i) The instruction of customer identification in capital market
(ii) The instruction of suspicious transactions and operation report
(iii) The instruction of complying with the regulations of fighting money laundering in electronic services of capital market
(iv) The instruction of surveillance of suspicious persons in capital market
(v) The instruction of sending capital market related documents to the address of customers
(vi) The instruction of keeping and annihilating the documents in the capital market

Designing After-Transaction Systems of Energy Exchange

Feb 20, 2012

In an agreement, Iran Grid Management Company and Central Securities Depository of Iran agreed to provide software bases of after-transaction systems in Energy Exchange. The experts of the two companies have agreed that Central Securities Depository of Iran should design the required systems and consulting Iran Grid Management Company for designing transaction systems.

A working group consisting of both companies has started needs-assessing and determining the requirements related to the software of after-transaction in secondary market of power utilities.

Initiating the Website of Bourse Studio

March 10, 2012

Increasing demands of audiences, the website of Bourse Studio starts working at www.studiobourse.ir. The audio files of broadcasted programs in Bourse Studio are available in the website. This website is a favorable source for enthusiasts of learning about bourse. With an assistance of SEO, the radio programs of Bourse Studio are broadcasting during the week from 10 am till 10:45 in Eqtesad Radio Network.

Rating the Brokers

April 8, 2012

According to the instructions of broker ratings, the third rating of active broker companies in Tehran Stock Exchange and the second rating of active broker companies in Iran Merchandise Exchange have been started by Securities and Exchange Organization. Applying this rating program, all of active brokers should fill the required forms and provide necessary information.

Some common criteria are related to the information about offices of broker companies, paid capital, active reception office, personnel having certificate, capability of broker's system, accounting and official website, organizational certificates and the system for recording applier's conversations.

4th International Training Course of Islamic Capital Market

May 6, 2012

Aiming at sharing experiences and introducing new achievements of Iranian Capital Market, the forth international course of Islamic capital market is held in Tehran from May 6 until May 9. In this 3-day training course, the financial experts and high managers of 12 different countries have participated. Increasing cooperation with other countries specially neighbor Muslim countries, popularizing Islamic financial instruments in Islamic Capital Markets, and developing Islamic markets in financial system of Islamic countries are other goals of the conference.

In this annual course, the new achievements of Shariah Board of Iranian SEO will be introduced and discussed. Iran experience in issuing Ijarah Sukuk, operational model of Murabaha Sukuk, joint ventures, selling and buying the Certificates of Housing Right Priority, stock Waqf, credit rating of Islamic financial instruments and some discussions about selling the debt are the most important subjects of this year conference.

Rejecting Short-Selling by Shariah Board

July 14, 2012

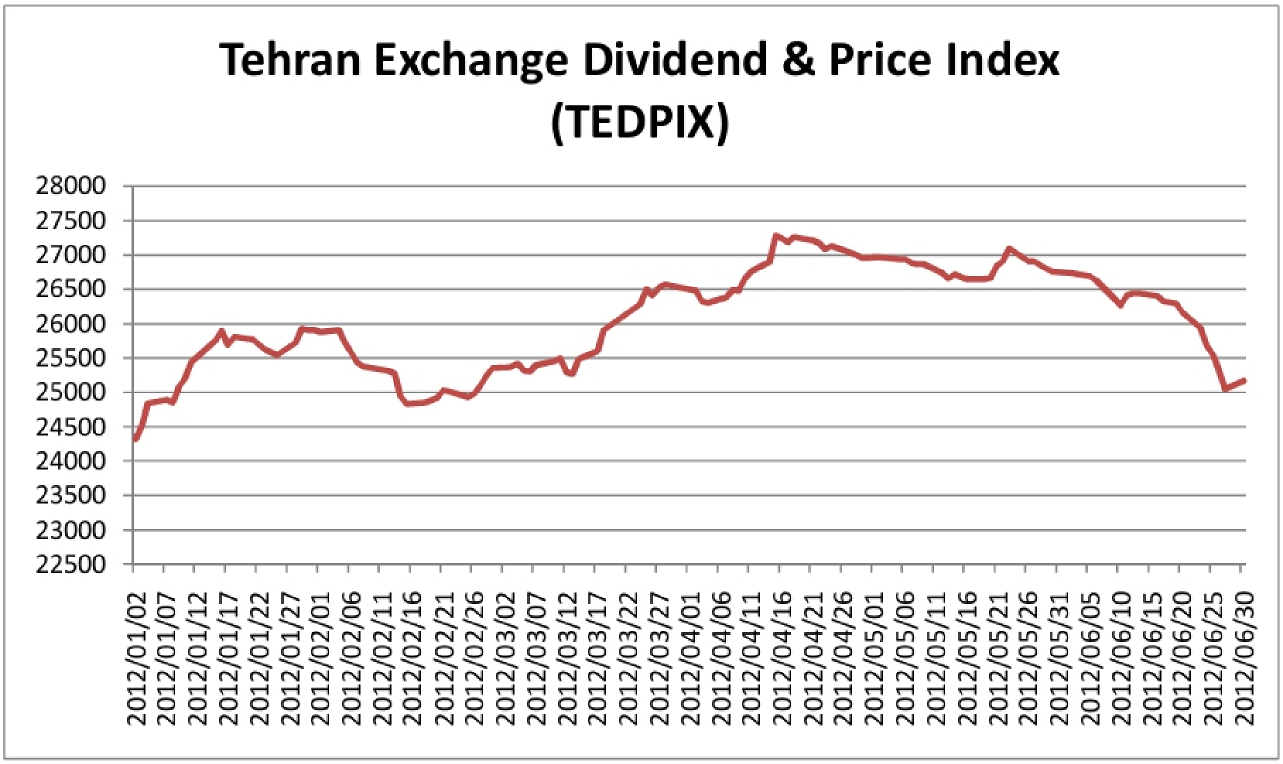
Scrutinizing short-selling of stock, the Shariah Board rejected this kind of transaction. In its recent session, the members of Shariah Board have recognized short selling as Riba-based and hence, Shariah incompatible. Short-selling is favorable in the case that the stock owner expects a price increase and so tries to keep his stock and refuse to sell it in the market. On the other side, however, another person who expects a price decline will propose a short-selling arrangement to the stock owner so that he lends his stock against interest and the borrower can sell the stock and gain or loss. At the end, when the lending period finishes and the lender wants his stock, the borrower should buy the same stock from the market and give it back. According to Shariah Board, such an arrangement is based on Riba and so it is rejected.

Introducing the Embedded Put Option

Aug 10, 2012

In order to bring more confidence to the market, the certificates of embedded put option has been introduced into Iranian Capital Market. As one of investors' concerns is gaining an expected return equal to the risk-free interest, this certificated has been designed and entered the market. Using such certificates, the stock holders can hedge themselves through having embedded option which has a specified maturity (exercise) date and determined price. embedded option can minimize systematic market risk and lead to more favorable investments in securities.

Facts and Figures



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