

# Conceptual Model of Islamic Commercial Paper for Banks and Credit Institutions on the Basis of Murabaha Sukuk

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## Abstract

*Financial instruments are one of the fundamental dimensions of financial markets that guarantee their efficiency and effectiveness of these markets. These instruments play a main role in economy to direct money from saving sources to investment needs. These instruments provide possibility of financing companies from public and private sources and also are considered as investment instruments for cash savings in an economy that can provide a suitable return for investors. Today, various financial instruments have been developed that can meet different financial needs of corporations which can comply with investor tastes and preferences. Among these instruments, commercial paper is usually considered as a short-term financing instruments for working capital expenditures of companies. Banks and credit institutions are among the main entities which issue commercial papers for their liquidity needs. In spite of this, like other traditional financial instruments, commercial papers have been developed and structured in western markets and cannot be issued in Islamic markets due to Shariah (Islam) regulations and condition. But, Islamic contracts and regulations have the capability to develop this important financial instrument in an accepted framework of prescribed contracts in Islam jurisprudence (Fiqh). The present research with a comparative study, (Delphy method) explains the conceptual model of Islamic commercial papers for banks and credit institutions in the form of Murabaha Sukuk, in a way that these papers can be structured and issued in the Islamic markets by using opinions of the experts.*

**Key words:** Islamic finance, Commercial paper, Sukuk, Murabaha

**JEL Classification:** G21, G23, G32

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## **1. Introduction**

While Islamic finance currently is known as an essential section in finance and many researches and papers have been published by credible journals, it is still a young field of financial studies. One of the most important requirements for Islamic finance to be a comprehensive financial system is to develop financial instruments. One of these instruments is commercial papers. So, development of this instrument in compliance with all prescribed Islamic contracts of Shariah, seems to be necessary. Banks and credit institutions are among the main companies that issue commercial papers for their liquidity needs. The purpose of this study is to explain a conceptual model of Islamic commercial papers (ICP) for banks and credit institutions in compliance with Islamic regulations by using Murabaha contract, in a way that makes the use of this instrument possible in Islamic financial markets.

## **2. Literature Review**

Considering the comparative nature of this research, a review of its theoretical principles and background are performed in two sections of literature of commercial paper and literature of Islamic finance. A few comparative researches about commercial papers have already been done such as two Master Dissertations in Industrial Management Institute of Iran but they are almost general and we have not seen considerable studies about the exact subject of this research.

### **2.1. Commercial papers**

#### **2.1.1. Definition of a commercial paper and its main characteristics:**

Commercial papers are short-term, non-guaranteed debt instruments that are issued by a company for financing short-term liabilities and working capital. The maturity of commercial papers is rarely more than 270 days. These papers are not usually backed or supported by collateral and therefore, only companies with high credit rating can find buyer for their papers without offering high rates of interest.

As a fixed income, short-term bond, a commercial paper is usually issued for financing working capital and the proceeds of the issuance of these papers cannot be invested in fixed assets and long-term projects. These papers entered financial markets in the beginning of the 19<sup>th</sup> century and grew rapidly, in a

way that commercial papers are now one of the most important debt securities in leading financial markets.

Commercial papers usually do not have any coupon and are sold to investors at face value. All commercial papers can be traded in secondary market before their maturity. However, these papers are usually held until the maturity date.

### **2.1.2. Function of commercial papers**

Companies use different types of commercial papers for their financing needs in the following cases:

1. Financing short-term and seasonal financial needs;
2. Permanent need for working capital;
3. Financing long-term needs: When a company needs long-term financial resources, however, due to the current situation of capital market, cannot get these resources with the desired rate. In this case, the company temporarily refers to issuance of commercial papers and after the improvement of capital market situations, issues long-term bonds or shares;

Instead of using bank loans, companies prefer to finance themselves through issuing these papers (for short-term periods);

There are some factors that make a company issue commercial papers instead of other financing methods:

1. The company issuing commercial papers do not need to provide any collateral (although often a third person guarantees it).
2. Long-term bonds have limiting conditions; however, commercial papers don't have any for the issuer company.
3. The redemption of commercial papers (maturity date) can be set in a way which is compatible and appropriate for the special condition of the issuer.
4. Through issuing new commercial papers, the necessary funds for redemption of the previous commercial papers can be provided. Hence, these commercial papers turned into a continuous source of financing.

5. Cost of issuing commercial papers is less than the cost of short-term bank loans.
6. When banks follow rigid credit policy, issuing commercial papers would be a suitable alternative.
7. Commercial papers have some characteristics that differ in different countries with different financial and legal systems, however, these papers have the main characteristics that are common whenever they are issued and basically distinguish commercial papers from other securities.

## **2.2. Main characteristics of commercial papers**

- Short-term maturity (with the possibility of extension)
- Maturity of issued commercial papers starts from 5 days and rarely reaches a year, in a way that this shortness of maturity period can be considered as the common characteristics and the main indicator of these papers. This maturity can be extended for longer periods.
- Short-term financing
- A commercial paper is a short-term financing instrument which is issued for meeting short-term financial needs and current shortage of liquidity and working capital.
- Fixed and specific income
- Commercial papers are classified among papers with fixed income, which means that those investors who have purchased these papers with specific interest rate or with discount, will receive the fixed return that has been determined from the beginning at the maturity date and don't take the risk of participation in business of initiator.
- Secondary market
- Although commercial papers are short term and usually are kept until the maturity date by investors, it is possible to trade them in a secondary market before the maturity date.
- Being for profit
- Commercial papers are issued in a business environment and naturally for profit and are considered as an investment tool.

## 2.3. Islamic finance

Islamic finance as a financial system includes financial markets, institutions and instruments. Considering the subjects of this research, we focus on Islamic instruments and especially Islamic securities which are generally called "Sukuk".

### 2.3.1. Definition of Sukuk

Shariah standard No. 17 of Accounting and Auditing Organization for Islamic Financial Institutions, defines Sukuk as: <sup>1</sup>

Investment Sukuks are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.

The most important Sukuks which have been studied by the Shariah Committee as well as the Board of the Securities and Exchange organization of Islamic Republic of Iran and their issuance has been confirmed in the specified framework are the following:

1. Ijara sukuk
2. Salam sukuk
3. Istisna' sukuk
4. Murabaha sukuk
5. Musharaka sukuk
6. Mudaraba sukuk
7. Jua'la sukuk

### 2.3.2. Issuing process

The process of structuring and issuing Sukuk has two main forms: A) direct issue of securities and B) issuing securities based on assets (asset-securitization). The first is a process in which securities are issued and then the proceeds are invested for procurement of specific asset(s) or implementing planned project(s), income of which is distributed among securities holders. The second case, basically is a reverse process in which existing assets are

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1. Accounting and Auditing Organization for Islamic Financial Institutions, Shariah Standard No. 17: Investment Sukuk, 2004.

specified and pooled together and then securities are issued on the basis of those assets.

In the issuance of Sukuk, the following players are usually involved:

1. Initiator: A legal entity who applies for financing through issuance of Sukuk securities, in other words, this initiator is the one who starts the process.
2. Issuer [special purpose vehicle (SPV)]: A legal entity who has the responsibility of Sukuk issuance.
3. Investors (owners of securities): Legal entities or natural persons who purchase the securities.
4. Trustee: A legal entity who supervises the process of issuance and all financial transfers will be performed with the trustee permission.
5. Financing institution: Company which acts as an intermediary between issuer and investors and mainly has the responsibility of advisory and marketing and sale of Sukuk. Investment banks or finance institutions are among this entity.
6. Credit rating Company: A company with relevant license has the responsibility of credit rating of securities.

### **3. Research Methodology**

Since this study uses scientific documents and sources and uses the opinions of experts as a field study, two methods of library and field study have been applied. Considering the fact that this study has a comparative nature, the section of library study, is conducted in two sections of “commercial papers” and “Islamic finance” (especially Sukuk) literature review. In field studies also, Delphi method is used as a systematic method for making use of opinions of experts for creating innovative ideas and testing ideas, especially in the situation of lack of experimental evidences. The Delphi method allows experts to work towards a mutual agreement by conducting a circulating series of questionnaires and releasing related feedback to further the discussion with each subsequent round. The experts' responses shift as rounds are completed based on the information brought forth by other experts participating in the analysis. After selecting a group of experts based on the topic being examined, a questionnaire with the instructions to comment on each topic based on their personal opinion, experience or previous research is sent to each member of

the group. The questionnaires are returned to the facilitator who groups the comments. At the end of each comment session, all questionnaires are returned to the facilitator who decides if another round is necessary or if the results are ready for publishing. The questionnaire rounds can be repeated as many times as necessary to achieve a general sense of consensus.

In this research, field study (Delphi method) has been planned and implemented in two rounds, conceptual model of commercial paper in the framework of mortgage Murabaha Sukuk that was resulted from our comparative studies and analysis, is tested by the experts in two rounds of surveys. In fact the second round is a repetition of the first round with the result of the first questionnaires.

Since we intended to select as many experts as possible, we applied Snowball Sampling method. Snowball sample is a non-probability (non-stochastic) sampling technique in which the researcher collects data on a few members of the target population which can be located. Then those individuals are asked to provide information needed to locate other members of that population whom they know. Thus, the sample group is said to grow like a rolling snowball. As the sample builds up, enough data is gathered to be useful for research. So we formed a panel of 37 experts in the field of Islamic finance that includes all members of Shariah Committee Board of Securities & Exchange Organization of Iran (SEC), academic scholars and researchers, administrative managers and experts with relevant experience and knowledge.

The instrument used in this study is "questionnaire". Questionnaire is one of the common instruments for research and is a direct method for data collection in research. Questionnaire consists of a series of questions (phrases or items) that the respondents should provide an answer for. These answers procure the required data for the research. Through the use of a questionnaire the knowledge, interests, attitudes and opinions of a person with regards to a given topic can be evaluated and we can understand respondents' previous experiences and what the person is doing currently (Sarmad, 1998: 145).

The questionnaire being used in this study is an author-made questionnaire with three main parts: Demographics, Research model, Questionnaire items.

For analyzing the answers we allocate these values to each options of Likert's scale:

Strongly disagree = 1, Disagree = 2, No comment = 3, Agree = 4  
Strongly agree=5

Statistical methods of analysis in Delfi method is determined based on research goals, structure of rounds, types of questions and the number of respondents. In addition to the classification and summarization of questionnaire results and calculation of the indicators of frequency, frequency percentage and cumulative frequency, the main statistics used in this study are central measures (average) and measures of dispersion. In addition to descriptive statistics, proper statistical tests are used for testing hypothesis in inferential statistic section. The statistical test in this study is one-sample T test for testing whether the difference of obtained average for each variable of the proposed model with specified value as the index of weakness of the model is significant or not; this test is used for confirming or rejecting statistical hypotheses and applied for research hypothesis.

## **4. Results**

Considering the kind of this study, analysis of the research results has also been presented in two sections: Results of comparative analysis and results of field study. In the comparative studies, after studying the main characteristics of the commercial paper, Murabaha Sukuk is studied in comparison with these terms and conditions in order to reveal the compatibility of this Sukuk with specifications of commercial paper. Then, Murabaha Sukuk is studied more closely and its suitability is evaluated with general terms and type of the activities of banks and credit institutions; finally, conceptual model of Islamic commercial paper for banks and credit institutions are presented. This model, is tested by the opinions of 37 Islamic finance experts in field study.

### **4.1. Results of comparative studies and analysis**

For determining the conceptual model of Islamic commercial paper which would be tested in the field study by the experts' opinions, a comparative study between Murabaha Sukuk and commercial paper has been performed.

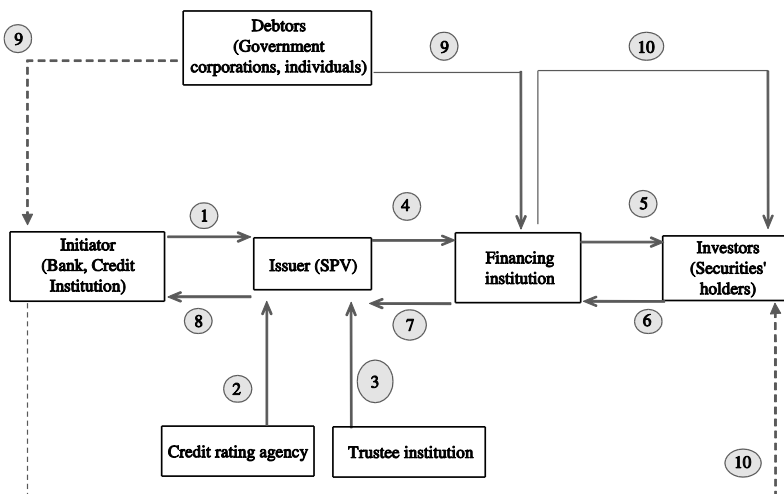
Murabaha Sukuk can be structured and issued in four forms: Financing the purchase of materials and assets, providing liquidity, providing the capital of commercial companies and mortgage securities. Murabaha Sukuk for attaining liquidity is done by sale and purchase of the same thing at different prices, which is not allowed according to the jurisprudence of Islam. Murabaha Sukuk for providing capital for commercial companies is also a kind of long-term security that has a function similar to a company's share. Murabaha Sukuk for financing can be applied by organizations and



manufacturing companies for providing all kinds of assets and materials; however, mortgage Murabaha Sukuk is appropriate for banks and credit institutions to refresh liquidity with pooling receivables resulting from Murabaha contracts of bank with customers.

Therefore, one of the most important applications of Murabaha Sukuk is for securitization of the loans of banks and credit institutions. In this method, the initiator (bank or credit intuition) who has financed some assets for government, companies and individuals by mortgage Murabaha contract (the assets have been mortgaged as a guarantee from customers to pay back their debts), can refresh its liquidity by securitizing receivables resulting from Murabaha loans in a way that the SPV with issuing Murabaha Sukuk, collects the funds of investors and then (on behalf of the investors) purchases the receivables of Murabaha loans with a discount price. Holders of securities (investors) can wait until the date of maturity and use the final profit of the securities or they can sell it in the secondary market.

Considering the fact that a significant portion of commercial papers are issued by banks and for the purpose of providing liquidity in financial markets, mortgage Murabaha Sukuk with securitizing receivables of banks and credit institutions provide fresh cash resources for these financial institutions and gives them the ability to continue and extend their activities. Therefore, commercial papers for providing liquidity for banks and credit institutions can be structured and issued in the form of mortgage Murabaha Sukuk. The conceptual model of these papers is as follows:



1. The initiator asks the issuer (SPV) to issue the Murabaha Sukuk to refresh liquidity by pooling and selling the receivables from Murabaha contracts of the bank with customers.
2. The credit rating company determines the credit rate of Murabaha Sukuk.
3. The trustee institution supervises the cash flow of issuance and use of funds until the maturity date and the settlement of securities.
4. The issued securities are delivered to the financing company.
5. The issued Murabaha Sukuk are sold to investors through a financing company. One of the requirements of this step is marketing of the securities.
6. With purchasing the securities, investors give the funds (price of securities) to the financing company in the next step.
7. The collected funds by the financing company are paid to the issuer (SPV).
8. The SPV purchases the receivables of Murabaha loans in cash and discount prices from the Initiator.
9. The paid amounts of debtors (government, corporations, and individuals) are collected by the financing company or as before, by the initiator (bank) in this step.
10. The financing company (or the initiator) passes the collected amounts in specified maturity date to investors.

#### **4.2. Results of field study and statistical test of the model**

In this section, results of inferential statistics for testing the proposed model are presented. In other words, research questions are answered on the basis of statistical analysis of data in this section. One sample t-test is used for analyzing the data averages, in a way that after studying the average of the experts' opinions for the model and for each feature of the model, we analyzed whether there is a significant difference between them and the weakness index of the model. In this study the weak answer can be considered as the opinion of "disagree" (2); because considering the cautiousness of experts specially in cases related to Shariah issues, it can be inferred that whenever the opinions of experts regarding a model or its variables is higher than "disagree" and goes

toward agree, it indicates that this model is confirmed by experts. However, considering the innovation of the proposed model and considering the fact that the success of new instruments is subjected to the consensus of experts and specialists; a strict approach has been taken and the middle level (3) and the answer of (no comment) has been determined as the index of model weakness.

On the basis of statistical analysis of gathered data in the field study that has been presented in the table below, we find that t-test results for all features of the model (Islamic commercial papers on the basis of mortgage Murabaha Sukuk) are significant.

The above test, with the obtained t-value and degree of freedom 36, is significant at the level of confidence of at least 99% (in all cases with confidence level of 0.999). Therefore, based on the result of t-test, the conceptual model of Islamic commercial paper in the form of mortgage Murabaha Sukuk has gained the confirmation of experts in all features (short term maturity, short-term financing, fixed income, tradability in secondary market, being for profit, conformity with Murabaha contract terms and Shari'a regulations). Regarding the last item of the questionnaire (overall confirmation of the model), that looks for the opinions of the experts about the capability of structuring Islamic commercial papers on the basis of mortgage Murabaha Sukuk, also with the t-value of 6.67 and degree of freedom 36, is significant at 0.001 level of significance. Finally, based on the above analysis of the opinions of the Islamic finance experts in this research, it can be asserted that in the framework of the proposed conceptual model, capability of mortgage Murabaha Sukuk for structuring Islamic commercial paper has been approved.

## 5. Conclusion

Considering the different possible kinds of Murabaha Sukuk and its characteristics and functions, mortgage Murabaha Sukuk with the proposed model of this research has the main characteristics and functions of commercial papers and is capable as a framework for structuring Islamic commercial paper for banks and credit institutions. The survey results regarding the proposed model for Islamic commercial paper also confirms this initial assumption and the inferential statistics test (t-test) also in each of the items of the questionnaire and finally for overall confirmation of the model, that is "capability of structuring commercial papers in terms of mortgage Murabaha Sukuk" is significant. These results indicates the confirmation of

the proposed model by the experts. Therefore, issuing Islamic commercial papers on the basis of Murabaha Sukuk that was structured in proposed model, is possible for banks and credit institutions. Considering the fact that in Islamic banking, a considerable portion of loans for financing purchase of assets (equipment, materials, goods, ...) is in the form of Murabaha contract, the proposed Islamic commercial paper can provide fresh liquidity for these credit institutions by securitization of loans and receivables resulting from past Murabaha contracts.

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