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MUNIF: A Brand Name in Innovation of Shari'ah Compliant Note Issuance for Islamic Capital Market

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Abstract

This applied study was aimed at giving an insight to practitioners and academicians as well as investors and interested parties in understanding the process of a form of *shari'ah*-compliant note issuance (*shahadah al-dayn*). As such, the *shari'ah* related principles were clearly explained. Observation and scrutiny on the contents of documentation and transaction involved in handling this instrument were thoroughly carried out. Based on the archival study, a simple model of note issuance is proposed in this study. Thus, contributions in term of an innovation can offer a new knowledge to the practitioners as well as academicians and the interested parties of this capital market instrument.

Qualitative method of research and descriptive approach to research were applied in this study as they were appropriate in looking into the research issue understudied. Capitalizing on the explored and examined instrument shall then become the basis in innovating more sophisticated models for multiplicity of instruments to be made available in the capital market both for domestic and foreign markets.

Keywords: *Shahadah al-dayn*, *murabahah*, *debt* and *Shari'ah*-compliant.

1. Introduction

The *Islamic* capital market is a sub-set of the *Islamic* finance scheme aimed at effective mobilization of funds in society. [Daud Bakar, 2008].Currently, there is still a vacuum on the availability of *shari'ah*-compliant financial instruments in *Islamic* financial market. Thus, there is a necessity for very-one in this sector of economy to multiply effort in ensuring the multiplicity of such instruments in the market in the near future. The aim of this study is to offer an insight and understanding to interested parties by exploring on a version of *shari'ah*-compliant debt instrument. *Shahadah al-dayn* refers to certificate of debt evidencing the drawer's debt onto the drawee in an *Islamic* primary capital market. [Mohd Nasir M.Y. and Amirul Hafiz M.N., 2008}. The criteria for issuance of a note includes firstly, that there must not be any element of interest, be it fixed or floating. Secondly, its creation must be based on an underlying permissible transaction such as *murabahah* or cost-plus-mark-up sale [Obiathulla Ismath Bacha, 2008].

An issued certificate of debt could then be traded in the secondary market. This process is known as securitization. In enabling a debt be securitized, apart from the legal documentation, an "I owe you" (IOU), a form of promissory note must be created to evidence this debt. In this case, the issuer must draw the note onto the capital provider who shall then sell this debt to another parties or interested institutions.

In conventional environment this tradable certificates were issued for a loan with interest to raise fund. In addition to this, annual coupon rate as sweetener was often introduced for the security. The prime difference between *shari'ah*-compliant *shahadah al-dayn* and conventional bond is the absence of interest element and the existence of an underlying permissible transaction without annual coupon rate attached to the *shahadah al-dayn* and thus its characteristic is of a zero coupon bond.[Mohd Nasir M.Y. 2007]

Shari'ah-compliant note issuance in the form of *shahadah al-dayn* is just like *murabahah Islamic* accepted bill which are tradable in the *Islamic* secondary capital market based on the principle of *al-dayn* (exchange of debt). Whilst, pricing of it is at a discount to the value payable by the issuer upon maturity.[Obiathulla Ismath Bacha, 2008]

2. Archival review

The current available literature have contributed in the understanding the instruments of *Islamic* capital market. However, this particular study offered knowledge on the art of innovating a *shari'ah*-compliant note issuance, with orientation to the real practically hands-on knowledge which is important for the benefit of society (*ummah*) in carrying out the man-to man relationship activities in life in the permissible way from the *shari'ah* precept.

In order to achieve the objective of innovating or designing the instrument in this study, firstly look at the restrictions in trading of such notes to help in the understanding the characteristics of the instrument to be innovated. Generally, the secondary market trading of the notes are confined to institutional parties which include insurance companies, statutory bodies, pension funds and such other corporations as may be acceptable to the issuer. In addition to the above, there should be no physical delivery of the notes be allowed. All notes shall be deposited with the authorized depository of the facility. Usually, the authorized depository shall also act as principal dealer providing two way quotations for the notes.

Additionally, it is worthy to understand the responsibilities of issuance and paying agent (authorized depository) in the course of handling such instrument. Therefore, we began with looking into the responsibilities of the issuing agent which include; First, an issuing agent shall have to ensure the correct quantity of the executed notes. Second, an issuing agent shall also ensure such notes are numbered and dated with the issue number, serial number, the maturity date and the issuing date. Third, an issuing agent shall ensure that all notes be duly executed by the authorized signatories of the issuer and the agent. Fourth, an issuing agent shall within reasonable business days of the issue date or date of cancellation or destruction of the notes communicates with the issuer by issuing a certificate confirming the number of notes issued, the face value, serial number, the date of issue and maturity date of such notes as well as the number of notes cancelled and destroyed (if any) and their serial numbers.

Further, we also observed into the responsibilities of the paying agent which include first, a paying agent has to maintain promissory notes register containing full and complete records of all issuance, redemptions and cancellations. Second, a paying agent is to ensure the issuer is instructed within two business days of any maturity date, to place the redemption amount in a designated account at the latest on the maturity date. Third, a paying agent is to pay the face value of the notes to the owners of the notes as appeared on the promissory notes register on the maturity date. Fourth, a paying agent shall cancel and return to the issuer all notes paid and redeemed within 30 days of the date of cancellation. Fifth, a paying agent shall only allow replacing notes which are mutilated or destroyed upon receipt of the cost of replacement, evidence of destruction or mutilation and submission of safe custody receipt. Finally, a paying agent shall track out of pocket expenses (legal, cable and postages) incurred and bill it onto the issuer.

Next, we look into the responsibilities of the authorized depository agent which include; first, an authorized depository agent shall keep track of the security cover which shall be 130% of the security amounts at all times. Second, an authorized depository agent shall ensure customer to respond for additional security. Third, an authorized depository agent can act as market maker for the notes by providing a two way quotation at all times on inquiry by the public. Fourth, an authorized depository agent shall help the note holder to dispose his notes in the event he decides to sell. Fifth, an authorized depository agent shall make known the availability of notes to other potential investors. Finally, an authorized depository agent shall ensure that the total number of note holders does not exceed a specific number at any one time and be restricted to prescribed corporations such as banks and other corporations gazetted by the ministry of finance such as insurance companies, statutory bodies established under Act or any Enactments and approved pension funds. [Companies Act of Malaysia, 1965]

3. Methodology

This paper addressed the understudied issue to offer an insight and understanding as well as offering a guide in innovation of capital market instrument namely *Murabahah* Underwriting Note Issuance Facility (MUNIF) deduced from archival study based on the writer's experiences and observation in both conventional and *shari'ah*-compliant financial environments. This study emphasized on qualitative research method and descriptive research approach. Both method and approach are appropriate for designing of the focused instrument of *shari'ah*-compliant capital market. In addition, analytical and comparative approaches to research were also applied where appropriate. The data were gathered from related industry's experiences and observations of the writer. Scrutiny on relevant archived documentation with reasonable broad and in-depth manner about the pertinent subject matter has been carried out to ensure coverage on the focus of the phenomenon under-studied.

Exploratory study and interview method were also employed in this study. Discussion with randomly selected respondent from amongst the learned scholars and experienced practitioners of *shari'ah*-compliant institutions contribute in term of justifying the holistic nature of the issue being focused. In this study, it was hypothesized that innovation of MUNIF, a form of *shari'ah*-compliant note issuance to be traded in *Islamic* capital market is probable. Therefore, the justification on such assertion has to be explored in order to ensure the reliability and validity of its *shari'ah*- compliant and thus establishing the trueness of the assertion in the hypothesis of the innovated model of the instrument under-studied.

4. Discussions on modeling of MUNIF instrument

When discussing *Islamic* finance, one should always bear in mind the five principles as stated in Quran namely prohibition of interest, prohibition on uncertainty, prohibition on the forbidden economic activities, compliant to profit and loss sharing principle and conformance of asset backing principle. [Anna Maria Samsudin, August/September, 2008]. Observers view Islamic private equity, which is based on a *musharakah* (joint venture) arrangement, as among the best of Islamic financing tools and investment avenues not only because of its attractive returns potential but also that the entire concept of profit, loss and risk sharing, between owner and investor, encourages good business practices.[Anna Maria Samsudin, February/March, 2009].

In designing a model of *shari'ah*-compliant notes issuance namely MUNIF, shall include the steps and procedures involve in the innovation. The first step that a bank should look into is of the reputation of the corporate customer which normally a listed corporation. Apart from this the principal business of the corporation is looked into including the currently on-going projects for the justification of the type and amount of funds required.

Second, the bank shall obtain a mandate from this customer to arrange for the facility. This mandate is usually in the form of a resolution of meeting of the board of management or board of directors of the corporation where appropriate. The implication of insisting this mandate on the part of the bank is that, should the facility be aborted, then the bank can seek a remedy to recover its expenses from the customer.

In the next discussion, we identify the characteristics of *shahadah al-dayn*, which can suit the capital requirement of this customer. The objective of liberalising the characteristics is none other than to provide convenience in attracting both the domestic and foreign investors in investing with the corporation issuing the *shahadah al-dayn*. The liberalising the characteristics in issuance of MUNIF in foreign currencies outside the issuer's country is to facilitate the availability of such instrument in the international scene under the present *shari'ah* and legal framework and conducive tax incentive

The third step, the bank shall then negotiate the principal terms and conditions of the facility with the customer. Such terms and conditions of the facility shall then be the characteristics of this facility which usually include the tenor of this facility, the collateral of facility, the yield of this facility, the mode and related subject matter of the permissible underlying transaction to accommodate the basis for the issuance of the MUNIF. In step four, the bank shall device the following final principal terms and conditions which may basically be exhibited as a simple model in this study.

For the purpose of modeling a basic MUNIF instrument, various assumptions have to be made. Assuming (1st assumption) in this case a corporation requires RM30 million working capital funds to complete a project. Next, assuming (2nd assumption) also this customer is negotiating with one bank to save time and costs for the issuance of *shahadah al-dayn*. In furtherance of the process of issuance of shahadah al-dayn, it is further assumed (3rd assumption) that this customer requires the financing facility for a tenor of five years. This customer is also offering its shares in a listed subsidiary as collateral and at the same time the subsidiary's assets are used to facilitate a trade transaction on the basis of *al-murabahah* (4th assumption).

In order to determine the acceptable yield, both the bank and the customer will take a view of what shall be the cost of financing or market rate that will prevail in the next five years from now. One must bear in mind that, the customer would not want a yield that would be too high, if market rate is going to drop over the next five years. On the other hand, the bank would not want a yield that would be too low, if market rate is going to rise over the next five years. As such, in determining what would be the anticipated market rate over the next five years requires some knowledge, experience, skill and element of intuition that could be offered by market analysts or specialize consultants or even the banker and the customer themselves. It might be after some negotiation, the bank and customer will agree to a determinable yield. Assuming in this case the agreed yield for this facility is 8.75% p.a. (5th assumption). This is actually what would be the internal rate of return (IRR) for the bank's investment. For the purpose of understanding this MUNIF instrument, the details under the above-mentioned assumption are depicted in the following clear and précised diagram.

Finally we come to step five, which is the computation of face value of secondary notes. In this regard, all computations shall be finalized and all notes shall be issued within three months after the date of the share sale agreement. The date of notes issued shall be the date of the disbursement of the purchase price of the shares. The following computations is based on the above discussed assumptions. Now, let us begin to firstly summarize the information relating to the characteristics of the assumed MUNIF. The computation of total profit of the facility for the 5 years tenor shall then be calculated as in Appendix 1 and a sample of primary note is depicted in Appendix 2.

8. Conclusion

The above innovation is a simple model of a *shari'ah*-compliant note issuance (*shahadah al-dayn*) facility, known as MUNIF for *Islamic* capital market. Based on the above discussion relating to this innovation, the hypothesis, that innovation of *shahadah al-dayn* is probable in Islamic capital market is validated. The instrument is reliable for use by the investors in *Islamic* capital market as there is no element of usury (*riba)* involve both at the stage of its creation as well as in its trade dealings. The instrument is also created free from element of ambiguity (*gharar*) as all material facts are made clear in both its documentation as well as the instrument. Further, there is no element of gambling (*maisir*) in its trade dealings. Thus this study has empirically validated the assertion in the above hypothesis that, innovation of MUNIF, a form of *shari'ah*-compliant note issuance to be traded in *Islamic* capital market is probable.

Since its permissibility is of probable in nature, therefore it is worthy to look at the advantages of issuance of *shahadah al-dayn* so as to encourage more players both the issuer and the investors involve in it and thus benefiting the economic well being of the society (*ummah*) in achieving good living (*al-falah*). Such advantages include making available more capital market instruments and help in boosting the frontier of the Islamic capital market. The element of cost saving in term of stamp duties exemption on issuance of Islamic private debt securities is a form of incentive in attracting more issuers.

Additionally, this facility is more attractive in term of its marketability compared to a syndicated facility which is rarely being securitized. Further, the underlying transaction for the issuance of MUNIF has the ceiling limit in term of its pricing thus enabling a customer to prepare budgets and projections with certainty. It also can be issued and floated internationally thus enabling access to international Islamic funds and therefore, it can be issued in foreign currency too. MUNIF can be issued on a yield to maturity, this is known to be issuing on the basis of deep discount and thus giving full grace to the issuer. Interestingly, it can be listed on the stock exchange and thus offering opportunity of capital gains to interim investors. Finally, MUNIF is usually a guaranteed facility for reputable investors such as government linked companies.

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Appendix-1

Purchase price	RM30.0 million
Number of primary notes for RM500,000 each	$\frac{\text{RM30.0 million}}{\text{RM500,000}}$ = 60 pieces of primary notes
Tenor of facility	5 years
Maturity of secondary notes	Every six monthly basis
Number of secondary notes supporting each primary note for the tenor of five years	5 x 2 = 10
Total profit of facility for 5 years	RM30 million x 8.75% p.a. x 5 years =RM13.125 million
Portion of profit per primary note	$\frac{\text{RM13.125 million}}{60}$ =RM218,750
Portion of profit per secondary note	$\frac{\text{RM218,750}}{10}$ RM21,875

Appendix-2

HAHADAH AL-DAYN
(PROMISSORY NOTE)

PRIMARY NOTE
Issue Number:
Serial Number:
Amount:
Issue date:
Maturity date

For value received, ____ (the "issuer") promises to pay to the holders of this note on the abovementioned maturity date the sum of [Amount in specific currency] upon presentation and surrender of the safe custody receipt relating to this note to _____________________________________('the agent" which expression includes any successor appointed) pursuant to an issue and paying agency agreement (the 'agency agreement", which expression shall include the agency agreement as from time to time amended, modified or supplemented dated _______________ made between the issuer and the agent.

This note is issued with the benefit of a deed of covenants dated ________________("the deed of covenants") executed and delivered by the issuer and with the benefit of, and subject to the memorandum of deposit dated the ______________("the memorandum of deposit") made between __________________________________ as issuer, the investors as listed in sample schedule A thereof ("the investor") and the agent as trustee and for the benefit of the holders under the memorandum of deposit upon and subject to the terms and conditions of the memorandum of deposit wherein the agent shall be entitled at any time without prior notice to the issuer to sell or otherwise dispose of all the title to and interest in the shares as defined in clause 1.1 of the said memorandum of deposit if payment hereunder shall be defaulted following due presentation of this note in accordance with the terms hereunder.

All payments to be made by the issuer under this note, whether in respect of value herein stated, or any other item, shall be made free and clear of any set-off, restrictions or conditions and free and clear of, and without deduction or withholding for or account or any present or future tax, unless such deduction or withholding is required by law. In such event, the issuer shall;

1. Ensure that the deduction or withholding does not exceed the minimum amount legally required.

2. Pay to the relevant taxation or other authorities within the period for payment permitted by applicable law the full amount of the deduction or withholding.

3. On request, furnish to the holder of this note, within the period for payment permitted by applicable law, an official receipt of the relevant taxation or other authorities involved for all amounts deducted or withheld as aforesaid.

Continuation of SHAHADAH AL-DAYN PRIMARY NOTE

All payments in respect of this note will be made in Malaysian ringgit by, at the option of the paying agent, either Malaysian Ringgit cheque or draft drawn on, or transfer to a Malaysian Ringgit account maintained by the holder of this note with a bank in Kuala Lumpur.

This not is a promissory note issued pursuant to the Bills of Exchange Act, 1949 and is govern by, and shall be construed in accordance with, the laws of Malaysia.

In WITHNESS WHEREOF this issuer has caused this note to be duly executed manually on its behalf.

By:____________________________
By:______________________________
(Authorised signatory 1) (Authorised signatory 2)

Certificate of authentication (without recourse, warranty or liability)
NAMED BANK

By:_______________________
(Authorised signatory)