

Lease Securities: a Tool for Financing Stock Companies



Law

KEYWORDS : lease securities, corporate bonds, sukuk, stock company.

Dr. Sam Mohammadi

Associate professor in private law, university of Mazandaran

Mehdi Rahmani

PhD student in private law, university of Mazandaran

ABSTRACT

The aim of this paper is to review the lease securities as a new and efficient instrument to finance the stock companies. In this regard, first we explain the nature and structure of these lease securities and study their characteristics.

Afterwards bonds and corporate bonds are evaluated and compared with lease securities while their defects and flaws are examined. At the end, the issuing of lease securities as an efficient tool and proper alternative to conventional bonds and corporate bonds is emphasized.

1. Introduction

Nowadays, financial companies and institutions use a variety of financial instruments to finance themselves. One of the most common financial instruments for financing is bonds in which company borrows its needed capital directly from the people and pays interest at certain times and gives back the debt at maturity. After Islamic revolution and the adoption of usury-free banking law in 1985, according to the prohibition of interest in Islamic economics, purchasing and selling of the bonds based on a determined interest rate was stopped. Therefore the oldest and most well known and yet most important instrument of financing was abandoned.

Prohibition of implementing usury instruments for financing led companies to seek alternative instruments. Corporate bonds are the first proposed alternative to bonds in Iran which have been used in various forms for several years. Although these corporate bonds perform some of the tasks of bonds, they have many drawbacks and deficiencies. As a result, it seems that they cannot be a complete replacement for bonds and we should seek to introduce and use a new financial instrument which can be a suitable alternative to bonds and besides being legal will not have the problems of corporate bonds.

In recent years, Islamic financial instruments know as Sukuk have grown considerably. The use of the word "sukuk" for referring to Islamic financial instruments was offered for the first time in 2002 during a juridical meeting of the Islamic Development Bank. After that the Accounting and Auditing Organization for Islamic Financial Institution introduced 14 deferent types of Sukuk¹. One of the most important types of Sukuk presented is Ijarah Sukuk which is accepted and tradable in the Stock Exchange of our country. In addition to providing the necessary conditions for financing the manufacturing and serving institutions, these lease securities are capable of being purchased and sold in secondary markets (Stock Exchanges) and can be used as an efficient financial instrument in Islamic countries.

The main purpose of this article is to review the lease securities as a new and efficient instrument to finance the stock companies. In this regard, first we explain the nature and structure of these lease securities and study their characteristics. Then bonds and corporate bonds are evaluated and compared with lease securities while their defects and flaws are examined. At the end, the issuing of lease securities as an efficient tool and proper alternative to conventional bonds and corporate bonds is emphasized.

2. The concept and structure of lease securities

The term "Sukuk" is drawn from Arabic word "Sakk" which means check, debit note, promissory note and bill of debt and normally is defined as "Islamic financial securities". In general,

sukuk are asset-based securities with fixed or variable income in conformity with the Shariah principles.

1. AL-IJARAH SUKUK, IJARAH MOWSUFA BITHIMA SUKUK, MANFAA IJARAH SUKUK, MANFAA IJARAH MOWSUFA BITHIMA SUKUK, MILKIYAT AL-KHADAMAT SUKUK, AL-SALAM SUKUK, AL-ISTISNA'A SUKUK, AL-MURABAHA SUKUK, AL-MUSHARAKA SUKUK, AL-MUDARABA SUKUK, AL-WAKALA SUKUK, AL-MUZRA'A SUKUK, AL-MUSAQA SUKUK, AL-MUQARASA SUKUK

In the definition provided by the Accounting and Auditing Organization for Islamic Financial Institution, it is mentioned that: "Sukuk are securities with equal nominal values which after closing subscription represents the payment of the nominal amount stated in them by the buyer to the publisher and its holders become the owners of an assets or a series of them, benefits resulting from assets or a special investment activity. Accordingly, fourteen types of investment Sukuk are presented which in this paper we will focus on Ijarah Sukuk.

3. The concept of Ijarah Sukuk

Lease securities are securities in which the owner, jointly, owns some part of the assets the profits of which has been transferred to the customer according to the contract. In Ijarah Sukuk the right of using the profits of an asset or a series of assets is transferred from the owner to another party (originator) in exchange for the payment of the rent. The tenure of Ijarah contract is definite and the rent could be paid at the beginning or end of the period or at monthly, quarterly, or annual maturity dates. Since Ijarah Sukuk are the securities that are indicative of joint ownership, they could be traded at secondary markets and with a price that is determined by market agents.

Under the instruction for issuance of lease securities, lease securities are tradable securities with a name in which every rent sheet represents the jointly ownership of its holder in asset based upon the issue of lease securities. An asset based upon the issue of lease securities can be any movable or immovable property with characteristics determined by the exchange (paragraph (d), article 1, instruction for lease securities). This contract like other ones is subjected to article 190 of the Civil Code and the intention of the parties and their consent, competence of parties to the transaction, specific topic and legitimacy to transact are among the general conditions for its validness. Special conditions include a specified time on name for these securities.

2.2. The foundation of lease securities issuance

According to the instructions for issuance of lease securities, at least the following financial institutions are required for issuing these securities:

2.2.1. Originator

Paragraph C, Article 1 of the instruction provides: "originator is

a legal entity which intermediary institution issues lease securities in the form of Islamic contracts to finance it". So the lease securities are issued for originator's access to asset and financial resources; originator has to be a legal entity.

In Article 2 of the above instruction, originator is divided into two groups of governmental and non-governmental.

- A non-governmental legal entity which:

1. Is registered in Iran and the center of its operations is in Iran,
2. Its legal forms are joint-stock, cooperative and investment fund or he is among non-governmental public institutions except municipalities,
3. Total cash flow resulting from its operations is positive during last two fiscal years. If the cash flow resulted from originator's operations is positive according to midterm financial statements audited in the current year, it can be considered in the calculation of total cash flow.
4. Its maximum ratio of debt to assets is 90 percent,
5. The opinion of company's inspector and auditor about financial statements during last two fiscal years is not negative.

- A governmental or public legal entity includes:

1. Ministries
2. Legal entities subjected to the Iranian Public Calculations Acts, Article 4 that is a public corporation created legally as a company or by the law or a competent national court is confiscated and known as a public company and more than 50% of its capital belongs to the government.

Therefore, lease securities can be issued by both public and private sectors. The issuance can be conducted by the financial services institutions or directly by the financing companies.

2.2.2. Intermediary Institution or Special Purpose Vehicle (SPV)

SPV is a legal entity which constitutes the holder of lease securities and also issuing of these securities in order to transfer assets to the attorney. The tasks of Intermediary institution are predicted in two instructions governing institution's activity i.e. the instruction for issuance of lease securities and the instruction for activity of intermediary institution. Based on Instruction for Issuance of Lease Securities, Article 3, issuing of these securities is only authorized through SPV and according to Article 13 of the said instruction, after issuing lease securities, an attorney-client relationship establishes between issuers and purchasers of these securities. Issuer on behalf of the purchasers are obliged to use funds resulted from selling of lease securities in order to purchase the asset which is the subject of issuance and rent it to the originator. The acquisition of lease securities implies accepting of the issuer's attorney and the attorney of issuer can't be dismissed and is enforceable and valid until maturity date and final settlement of lease securities. It means that signing lease securities is required in order to necessitate the attorney contract.

Intermediary institution is created in form of a company with limited responsibilities by Central Asset Management Company (private joint stock) according to regulations and activity of the company and its management is done according to business law and its statute. Using of intermediary institute reduces the risks and increases information transparency, since in most cases these companies are established only to issue one type of securities and are liquidated after the end of maturity date.

2.2.3. Trustee (Central Asset Management Company)

The new Act on development of Financial Instruments paved the way for establishing a company called Central Asset Manage-

ment Company. The main purpose of this company is to establish intermediary companies and do their tasks. Creating such a structure solves the challenges on the way of establishing intermediate institutions. Central Asset Management Company is obliged to establish a intermediary institute for financing and thus some of the operational risks in issuing of Islamic securities is are covered,

2.2.4. Guarantor

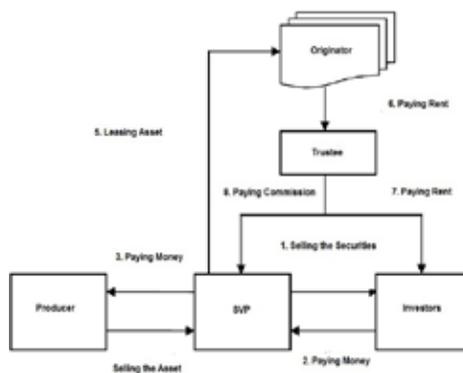
According to Paragraph V, Article 1 of the instruction for issuance of lease securities, a guarantor is a legal entity, who guaranties rental payments and according to circumstances, the purchase price of the asset leased by the originator to intermediary institute. According to this instruction, guarantor in addition to having a legal entity should be recommended by the originator and appointed only by banks, financial and credit institutions under supervision of the central bank of Islamic Republic o Iran, insurances and financing companies, investment companies or public institutions accredited by the organization. Only if lease securities have credit rating and the originator attempted to get the credit rating before getting the authority for issuance and also providing the activity of authorized credit rating agency, the originator is not obliged to introduce a guarantor.

3. Types of lease securities

Generally three types of lease securities can be issued:

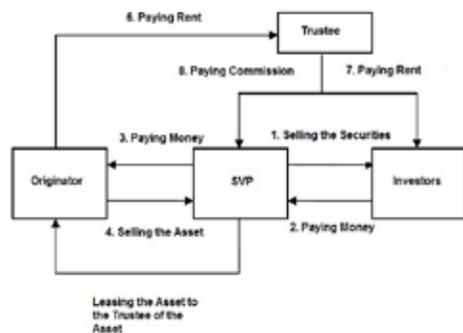
3.1. Asset-backed lease securities

Asset-backed lease securities are securities in which SVP on behalf of investors purchases the assets required for the originator form the seller and rent it to the originator. Since in this situation the lease securities are issued by SVP In order to obtain a specific asset for the originator, the securities issued during this process are called asset-backed lease securities.



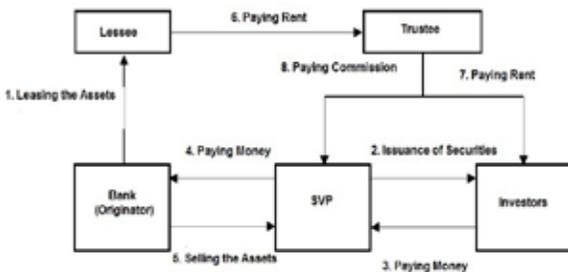
2.3. Liquidity-backed lease securities

In Liquidity-backed lease securities, SVP on behalf of investors purchases the originator's asset or a set of assets by issuing securities and collecting funds and rent it again to the originator. This type of securities is based on sale and lease back and for this reason are called Liquidity-backed lease securities.



3.3 Mortgage-back lease securities

This type of lease securities is most commonly used by banks, leasing and credit institutions. In these securities, originator (bank) sells facilities in form of a lease contract to a third party (SVP) which has paid on the condition of acquisition. On this basis, SVP first issues the lease securities and then purchases those assets which bank has given to various people during the time in form of a lease contract and on the condition of acquisition. By selling these assets, the relationship between the originator and SVP stops and SVP on behalf of investors becomes owner of the assets which bank has already transferred to the receivers of facilities in form of a lease and on the condition of acquisition.



So the issuance of lease securities is a combination of sales contact, lease and attorney. That is to say, originator (legal entity who needs stable funds or asset) first goes to SVP which is a company with independent legal entity. Intermediary institute attempts to issue the lease securities and collect funds. Then originator or another legal entity during the sales contact transfers the ownership of a part of its rentable asset to asset issuer. In the next step, intermediary institute on behalf of investors rents the target asset to the originator and pays the rent to holders of these securities in proportion to the securities.

4. Characteristics of lease securities

Many of the characteristics of lease securities are similar to other securities such as conventional bonds and corporate bonds. Therefore using the principle of unity criteria, the characteristics of these securities can be evaluated.

4.1. Securities are valuable

According to the instruction for issuance of lease securities, Article 1, lease securities are transferable securities that are issued according to this instruction. According to Paragraph 24, Article 1 of Securities Markets Act of 2005, securities are considered as any paper or document which guaranties the transferable financial rights and its benefits for the owner.

One of the effects of securities being valuable is the transferability of them. In addition to Paragraph 2, Article 1 of Establishment of Stock Exchange Act, in Paragraph 2 of instruction for issuance of lease securities the transferability of these securities is specified. Therefore, securities do not have value only for the parties but they are valuable by themselves and can be transferred to third parties. In Paragraph 24 of Business Law Reform Bill it is mentioned that stock certificate is a tradable document which represents the number of shares its owner has in the stock company.

4.2. Securities have name

In the Articles 43 to 50, nominal and bearer are mentioned and the Paragraph 2, Article 1 of Corporate Bonds Issuance Act refers to nominal and bearer corporate bonds.

Bearer security is transferred on the condition of delivery (Article 24) but in the case of nominal security, in addition to agreement between the parties, registration should be done in stock register of the company. The problem and restriction in the case

of nominal security is the limitation in its transfer because of existing formalities, i.e. the requirement of registration in the stock register. Although nominal securities are more in accordance with the principles of commercial law which means the principles of speed and wealth flow. On the other hand, if bearer document or security is taken away from its holder (by stealing, losing and so on), those who acquire these securities illegally can misuse them.

According to Instruction for Issuance of Lease Securities, Paragraph A, Article 1, lease securities are nominal securities. In this instruction, there is no mention of the signs for these securities being nominal. Therefore it seems that in this context, these securities must be considered as subjected to the regulations of business law.

4.3. Securities have period

Period is the time during which the securities are valid. Also it is the deadlines in which some payments stipulated in the contract should be executed. It has been mentioned about lease securities having a period Articles 52 and 57 and also about corporate bonds in Article 2 of Corporate Bonds Issuance Act.

In the instruction for Issuance of Lease Securities, time period has been mentioned for three cases:

- A. Period of contract: according to Article 16 of this instruction, the maturity of lease securities cannot exceed the remaining period of the asset's economic life. In Paragraph T, Article 1 of instruction for issuance of lease securities it has been mentioned about the economic life: it is the time expected for an asset to be economically usable by one or more users or is the number of productions or similar units expected to be acquired in the process of using an asset by one or more users.
- B. Period of company: according to Instruction for Issuance of Lease Securities, Paragraph 2, section A, Article 1, total cash flow resulting from the originator's operations must be positive during last two fiscal years. Also the audited financial statements of originator in last two years are one of the mentioned objects in the declaration of registering lease securities (Paragraph 2, Article 20 of Instruction for Issuance of Lease Securities). It shows that at least two years must be passed since the company was founded.
- C. Payment Deadlines: payment deadlines for revenues related to lease securities should be mentioned in prospectus with originator's request (Article 18 of Instruction for Issuance of Lease Securities). According to Article 19 of this instruction, payments related to lease securities are permitted in two ways:

1. Paying the whole rent on payment deadlines until the final maturity.
2. Paying a portion of the rent on payment deadlines until the final maturity and liquidate the remaining revenues of lease securities in the final maturity date.

4.4. Securities are guaranteed

The guaranty of bonds is mentioned in Articles 114 and 115 and the guaranty of corporate bonds is mentioned in Article 3.

According to Article 5 of Instruction for Issuance of Lease Securities, originator is obliged to introduce a guarantor. Also in Note 1 of this Article it is mentioned that guarantor is independent of the originator and this independency should be confirmed by the auditor of the originator.

The auditor of originator must be selected from auditing institutions trusted by the securities and exchange organization of Iran at the time of presenting the financing project by issuing lease securities and the last financial year. So the auditor of originator

is trusted by securities and exchange organization of Iran and since he has been selected from auditing institutions trusted by the organization, he act as representative of the organization in auditing affairs.

The first section of Paragraph V, Article 1 of Instruction for Issuance of Lease Securities defines guarantor as a legal entity. As a result, originator can be selected from the guarantying legal entities. Although according to Article 5 of this instruction, guarantor must be selected only from these entities:

1. Banks
2. Financial and credit institutions under supervision of the central bank of Islamic Republic of Iran
3. Insurances
4. Financing companies
5. Investment companies
6. Public institutions accredited by the organization

5. Comparing lease securities with conventional bonds and corporate bonds

In this topic, problems of bonds in the usury-free banking law and the effects of eliminating interest in this law are reviewed. Then alternative to conventional bonds in usury-free banking which is corporate bonds are evaluated and its drawbacks and deficiencies are presented and requirement for defining and using a new instrument in order to finance stock companies are suggested.

5.1. Drawbacks and deficiencies of bonds

Bonds are documents by which its issuer of bonds becomes debtor of the buyer. These securities have interest sheet and their interest is paid on periods determined by the bank that is represented to issue securities and the original debt is refunded at a specific maturity date. Given that a definite interest is in nature of bonds, after the approval and adoption of usury-free banking law which seeks to eliminate usury form Finance and Banking system of Iran and comply with Shariah, using bonds was completely banned.

In addition to fixed interest rate which is the biggest problem of conventional bonds, there are other differences between bonds and Sukuk.

1. Lease securities show the joint ownership of a specific asset by the holder of securities while in conventional bonds, ownership of the holders is not significant and these securities only show the obligation of the debt or usurious loan.
2. The asset which is the subject of lease securities should be authorized and valid based on Shariah; while this is not a requirement for bonds and sometimes assets are considered as backing which do not comply with Shariah.
3. The exchange of bonds in a secondary market includes only purchase and sale of debt, but the exchange of lease securities in secondary market is the transacting the ownership of an asset.
4. Credibility of bonds depends on the credibility of its issuer or publisher and is evaluated by it while the credibility of lease securities only depends on the value of asset which backs the securities.
5. The contract used in bonds is debt contract while the contract used in lease securities is lease contract. Therefore all the differences of these two contracts include the differences between these two financial instruments.
6. In conventional bonds the interest is fixed and guaranteed while in lease securities both interest and loss are possible.

5.2. Drawbacks and deficiencies of corporate bonds

Legal nature of corporate bonds is based on the analyzable civil partnership contract. Depositor instead of loaning and receiv-

ing its interest provides all or a part of the asset needed for financial institution and participates in its interest and loss and at the end of every financial period, the resulting interest is divided between the holder of corporate bonds and economical agent (employer) according to shares agreed in the contract. This system can appear as simple form of two or more partners in a small economic institute and can be proposed in an extended level as joint-stock company. According to the definition of corporate bonds and replacing advance interest with fixed interest, it seems that corporate bonds unlike conventional bonds are in accordance with Shariah.

Corporate bonds are issued based on investing in specific economic projects with positive efficiency rate and their interests are divided between investors and securities issuers. Therefore these securities should finance a particular project and cannot be used in other places. Also in every case, issuer should guaranty a minimum of the interest resulting from the target project.

It is mentioned in the definition of corporation bonds that these securities can be issued by private and public section, but during this time, the approval of these securities by the private section was almost zero. This disapproval by private section can be resulted from various factors such as lack of an active secondary market, the cost of these securities and companies being required to guaranty the payment of original money and its interest in exchange for issuing corporate bonds before the maturity date. Also corporate bonds are redemptive anytime while bonds are redemptive only at the time of maturity and can only be traded at the secondary market before that. This is one of the reasons why companies do not approve of corporate bonds since non-governmental companies like the government are not capable to redeem corporate bonds at any time. On the other hand it is mentions in the definition of securities that these securities should finance a particular project and cannot be used in other places. So if – for example – a company needs liquidity, cannot use corporate bonds.

Another drawback of these securities is that are quasi-usury. Can we truly say that the interest of these securities is not definite and is advanced? When the paid interest of these securities is exactly equal with what is announced and is never more or less than that, can be more likely quasi-usury and this leads to disapproval of many people in the society.

As stated above, it seems that corporate bonds are not a suitable alternative to conventional bonds and in addition to evaluating and correcting their flaws, we should seek to introduce and use a new financial instrument which can be a good replacement for conventional bonds and aside from complying with Shariah do not have the problems or corporate bonds.

5.3. The benefits and risks of lease securities

The most important purpose of various types of lease securities is to finance the originator and increase the liquidity. Using this financial instrument, stock company can provide its needed asset or convert its asset to cash. In this situation, assets with less liquidity are removed from the balance sheet and cash replaces it. In addition, company is still able to use those assets. Finally, by providing an active secondary market, lease securities can facilitate the development of financial markets and by using strategies for strengthening the credibility and obtaining a high credit rating, reduce the cost of financing.

Beside the stated benefits for lease securities, they also have some risks. Tariq has presented a classification of risks related to lease securities which includes: the risk of losing assets or decreasing of their value, the risk of interest rate, the risk of inflation and the risk of credibility. In addition to these cases, the risk of failure to collect sufficient cash in order to purchase asset, the

risk of SVP misusing the money received, the risk of not selling goods to SVP, the risk of net renting goods by the consumer, the risk of total or partial loss of asset, the risk of leased asset's costs and the risk of not paying the rent on time can be suggested. Although most of the risks related to securities are manageable by using an appropriate mechanism. For example, the risk of reducing the asset's credibility at maturity date can be eliminated by granting the right of selling to the securities holders since in this way they can sell the lease securities to the intermediary company or originator with the price stated in the paper of selling right by using their selling right.

Conclusion

One of the most important financing instruments are bonds which after the prohibition of interest in Islamic economics, issuing, purchasing and selling of them which are based on a determined interest rate was stopped. Therefore we have to seek a replacement for it. Initial suggested alternative to conventional bonds in Iran is corporate bonds which their drawbacks and deficits was briefly outlined. It was stated that Sukuk securities and specially lease securities can be used as a supplement or replacement for corporate bonds in order to finance stock companies. By using this financial instrument, stock company can prove its needed asset or convert it to cash. In this situation, assets with less liquidity are removed from the balance sheet and cash replaces it. In addition, company is still able to use those assets. Finally, by providing an active secondary market, lease securities can facilitate the development of financial markets and by using strategies for strengthening the credibility and obtaining a high credit rating, reduce the cost of financing.