UNIT-10

Ijarah – Leasing

Learning Outcomes
By the end of this unit the learner will be able to:
✓ Identify General Juristic Rules of Ijarah ✓ Discuss the conditions for the termination and amendments of Ijarah contract ✓ Describe the Modern Use of Ijarah

Unit 10

Ijarah – Leasing

Introduction

In Islamic law, Ijarah is a contract of a known and proposed usufruct of specified assets for a specified time period against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, it is the transfer of usufruct for a consideration, which is rent in the case of hiring assets or things and wages in the case of hiring people. According to the jurists, Ijarah is the sale of usufruct (and not of 'Ain or corporeal goods) of any commodity in exchange of Ujrah, wages or rent, and covers houses, shops, riding/work animals, jewellery, clothes, etc.

The permissibility of Ijarah is given in the Holy Qur'¯an, Sunnah of the holy Prophet(pbuh) and consensus (Ijma'a) of the Islamic jurists.3 Letting goods for use is a generalkind of business activity legalized by the Shari'a as it is a convenient means for peopleto acquire the right to use any asset that they do not own, as all people might not be able to own the tangible assets for use. This permissibility is subject to a number of conditions described in books of Hadith and Islamic jurisprudence.

In this unit we shall discuss in detail the rules relating to Ijarah of usufruct of goods or leasing as a form of investment and a mode of financing that normally takes the form of Ijarah Muntahia-bi-Tamleek. Ijarah of work or services will be discussed briefly where deemed necessary.

Essentials of Ijarah Contracts

As can be seen from the above given definition, the essentials of Ijarah are:

1. It is a contract.
2. Known usufruct is transferred.
3. of a particular asset.
4. for a specified time period.
5. against agreed-upon rental.

Like other contracts, parties to Ijarah have to be capable of entering into contracts. The

Less or provides the asset for benefit against rental. The lessee is considered "Ameen", entitled to use the asset against payment of the agreed-upon rental only for the purpose specified in the agreement. He is liable for loss to the asset due to his negligence, but cannot be made liable for loss caused by factors beyond his control.

For the purpose of Ijarah, the subject matter giving usufruct can be divided into two types: property or assets, like houses, vehicles, residences, etc., and labour, like the work of an engineer, doctor, tailor, carpenter, etc. While the latter involves employing the services of a person for a wage, the former relates to usufruct of any asset or property that is transferred to another person in exchange for rent. Majallah divides the subject matter of leasing into three types, where the third one is letting animals.6 in this sense, the term Ijarah is analogous to the term leasing as used in modern business terminology.

In terms of the factors of production, the asset being leased should belong to the category of land – real assets that do not alter in original/physical form due to usage – meaning that it should not be among the things that cannot be used without consuming their corpus, or a financial or monetary asset. It also implies that the less or, as owner of the asset, must bear the expenses and risks that are related to ownership.

The consideration of lease is Ujrah (rent or hire of things) or Ajr (wages in hiring ofpeople). If consideration is fixed in the contract, it is called Ajr al-Musammah (agreed rent or wage) and if it has to be determined by a judge or arbitrator, it is called Ajr al-Mithl.

Ijarah and Bai'Compared

Ijarah, in a way, is similar to the contract of sale, because in both cases something is transferred to another person for a valuable consideration. Accordingly, the benefit and the consideration in Ijarah must be known comprehensively to avoid conflict. However, the difference between Ijarah and sale is that in the latter case, ownership of the corpus of the property is transferred to the purchaser, while in the former, the corpus of the property remains in the ownership of the transferor (lessor), and only its usufruct, i.e. the right to use it, is transferred to the lessee against an agreed consideration and the ownership is not transferred. Ownership-related risksand expenses have to be borne by the lessor. If the lessee becomes owner of the corporeal property let in any way, such as by gift or inheritance, the Ijarah ceases to be in force.

Another big difference between sale and lease contracts is that the latter is always time bound, meaning that the lease has to terminate at any point in time, while sale implies. definite transfer of ownership of the sold asset just after the sale is executed, along with its risk and reward.

General Juristic Rules of Ijarah

Jurists are almost unanimous that Ijarah is valid for things which possess Manafa'ah and which can be hired or utilized but their corpus or substance ('Ayn) is not consumed. Goods like candles, cotton, food or fuel are suitable for sale, not for leasing or hiring. The great

Hanafi jurist Kasani explains that dirhams, dinars, bullion, etc. that are 'Ain, not usufruct, and all those goods taking benefit from which is not possible without consuming them cannot be given on lease. Further, the genus of the subject matter (asset leased) and the rent should not be the same, e.g. house for house, ride for ride, etc.

Therefore, lease cannot be undertaken in respect of money, edibles, fuel, ammunition, etc. because their use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charged on this invalid lease would amount to interest charged on a loan. Further, the assets/goods taking usufruct from which is almost impossible, cannot become the subject of Ijarah, e.g. land hit by salinity to the extent that it is not capable of any production cannot be leased out. Ijarah is valid for permissible usufruct only with the consent of both parties to the lease contract. The asset should belong to the lessor as owner or as lessee of the actual owner with permission for sub-leasing. An asset jointly acquired or belonging to a number of people can be leased to more than one lessee. The contract should be free from any Gharar element with respect to the nature of usufruct and its counter value and both parties should have knowledge of the nature of the contracted usufruct.

The rent or rate of hiring or renting a property can be assessed/fixed only when the property is known, whether by inspection, viewing or description. It is permissible to stipulate conditions for expediting the payment of rent or for salary and its delay or deferment, as agreed by the parties. The amount of rent or salary should be in accordance with the convention or the tradition of the locality and must be just and acceptable to both parties.

The Holy Qur'¯an has ordained in respect of suckling infants/offspring that the recompense of the suckling women should be just and reasonable. Al-Kasani has mentioned a number of conditions for the validity of an Ijarah contract with respect to the contracting parties and the asset or service hired. Important among these conditions are the following:

- The contracted usufruct has to be ascertained to avoid any dispute.
- The lease period must be specified. However, in the case of a wage/service, any of the two, i.e. the amount of work or the time period for a job should be known.
- Benefiting from the hired goods should be possible. As such, lease of a nonexistent asset for usufruct of which a description cannot be determined precisely is not allowed, because such Gharar about the description and the time may lead to disputes. In other words, the purpose of the contract must be capable of being fulfilled and performed.
- The handing over/delivery of the contracted goods for taking their benefit is essential. No rent becomes due merely because of execution of the contract, unless the subject of the lease is delivered and made available to the lessee. However, advance rent can be taken when availability is ensured for the period of the lease.
- In the case of workmen or service, the contracting person should be capable of under taking the job. Therefore, hiring a runaway animal for riding, or usurped assets is invalid.
- The usufruct of contracted goods must be lawful, meaning that the purpose of Ijarah should not be unlawful or Haram.
- The usufruct should be conventional or according to the tradition of the people.
- As indicated above, according to Hanafi jurists, rent does not become due merely with the lease contract; the emergence of usufruct is necessary for this. Shawafi'i however, areof the view that rent becomes due and payable when the lease contract is finalized, because they presume that the existence of the usufruct will be materialized by use of Mu'jar (asset being leased) by the lessee. This implies that even according to Shawafi'i, rent becomes due when the asset is in the possession of the lessee and he is in a position to use it according to his requirement.

If the asset to be leased is yet to be purchased as per the request of the prospective lessee, the lessor can demand payment of earnest money to ensure the latter's commitment to take the asset on lease when purchased by him. If the customer breaches his promise and the Ijarah contract is not executed for any reason attributable to the lessee, the lessor may reta in the amount of loss incurred by him in making and processing the lease contract, purchasing the asset, leasing it to any other or disposing of it in the market, and give back what is in excess of the actual cost and damage he has suffered.

According to the AAOIFI Standard, rental can be paid whenever it becomes due, in instalments or at any time that is mutually agreed between the parties. The lessor can demand advance rent that will be adjusted for rent becoming due when the lease takes effect. In other words, earnest money can also be taken in respect of lease at the execution of the contract of lease and this may be treated as an advance payment of rental.

Execution of an Ijarah Contract

Depending upon the nature of the asset, an Ijarah contract can be executed before or after the possession of the asset by the lessor for its instant or future enforcement/commencement. If the asset to be leased is existing, like an existing liveable house, a lease contract can be executed either for instant or future enforcement, because the usufruct of the house is clear to the parties who can stipulate the rental, keeping in mind the benefit. Future enforcement in Ijarah, as against Bai‘, is allowed also for the reason that ownership remains with the lessor, who is responsible for the risk of damage to the asset. Similarly, in Ijarah Mosufahbil Zimmah, wherein the nature or quality of the asset is specified and destruction of or damage to a particular unit of the asset does not terminate the contract, a contract can be executed either for instant or future enforcement.

However, if a particular asset is specified for Ijarah, a lease contract cannot be executed before existence or getting ownership of the asset or its usufruct (in the case of sub-lease).If the asset is destroyed in such leases, the contract will terminate. If the lessor does no town the asset, he can enter into a promise to lease from the prospective lessee. Advance rent can also be taken from the prospective lessee, but this will not be considered accrued rent and will be adjusted against the rental becoming due from time to time. Islamic banks' leases normally belong to this category. As per the requirement of the promise, the lessor can purchase the asset from the market or, in special cases, from the promisee, in which case it will be a case of "sale and lease-back" and the sale/purchase contract should precede the lease contract. The Ijarah contract should not be stipulated as a condition of the lease contract.

Determination of Rent

The determination of rental on the basis of aggregate cost incurred in the purchase, construction or installation of the asset by the lessor is not against the rules of Shari'a, ifboth parties agree to it, provided that all other conditions of valid lease prescribed by the

Shari'a are fully adhered to. Therefore, subject to mutual agreement of the parties to the lease contract, rental can be determined on the basis of aggregate cost incurred by the lessor for purchase/acquisition of the assets being leased. After the agreement is finalized, the lessor cannot increase the rent unilaterally and any agreement to affect the contrary would be void. If rental is once determined, there can be different rates for different phases based on any agreed benchmark during the lease period. Further, parties to the Ijarah contract can mutually agree during the lease period to review the lease period or rental or both.

Accordingly, in leases of long duration, it can be agreed upon that the rent shall be increased after a specified period, like a year or so. Contemporary scholars have also allowed in long-term leases tying up the rent with a variable and well-defined reference rate or benchmark or enhancing the rent periodically according to a mutually stipulated proportion (e.g. 5% every year) if the other requirements of Shari'afor a valid lease are properly fulfilled. Using any well-defined benchmark or price index for long-term lease is recommended to determine rentals for subsequent periods, as it helps in avoiding any dispute or injustice with any of the parties due to possible fluctuations in the market rate structure and binding nature of the lease contract. It can also be provided in the lease agreement that in the case of an increase in property tax or other government taxes, the rental will increase to the extent of the amount of the tax. Rent can also be tied up with the rate of inflation, i.e. if the inflation rate is 5 %, the rental will increase by 5 %.

The question arises whether any interest rate benchmark like LIBOR (London Inter-bank

Offer rate) can be agreed as the benchmark for rental. According to a minority of the scholars, with such benchmarks the transaction becomes similar to an interest-based transaction and, therefore, is not permissible. This is not the correct viewpoint, because as long as the basic requirements of Shari'a are being complied with, any benchmark can be used to price sale or lease transactions. Benchmarking the transaction's pricing to an interest-based rate does not render it Haram.

The rate of inflation, any price index, growth rate or any well-defined return rate in real sectors of an economy can be used for benchmarking. However, the Shari'a scholars do not like any interest-related benchmark for determining periodical increases in the rental due to the resemblance to interest. In principle, however, they allow it because the basic difference between valid lease and interest-based financing is that in leasing, the lessor assumes full risk in respect of the corpus of the leased assets. If the leased asset loses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent and he will have to bear the loss of destruction. In the case of interest-based lease financing, however, the lessee is made to bear all ownership-related expenses and responsibility. So far as this basic difference (of assuming the risk) between lease and interest-based financing is maintained, any transaction will not be categorized as an interest-bearing transaction.

It seems, therefore, that the use of any rate merely as a benchmark (floating rental) does not render the contract invalid, provided the amount of the rental of the first period of the Ijarah contract is specified. It is, however, desirable to use benchmarks other than interest benchmarks, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance to interest whatsoever.

In order to avoid Gharar and/or Jahala for both parties, the scholars suggest that the relation between the rent and the reference rate should be subjected to a ceiling or limit.

For example, it can be provided that rent in no case will increase or decrease by more than 5 %.

Sub-lease by the Lessee

In principle, sub-lease is permissible subject to the consent of the lessor. This can be provided in the lease agreement. All the recognized schools of Islamic jurisprudence are unanimous on the permissibility of sub-lease if the rent agreed to be taken from the sub-lease is equal toor less than the rent payable to the owner/original lessor. However, the opinions are different if the rent charged from the sub-lessee is higher than the rent payable to the owner. Shafi'is allow it and hold that the sub-lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali school as well. On the other hand, Imam Abu Hanifa isof the view that the sub-lessor cannot keep the surplus received from the sub-lessee and he will have to give that surplus to charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can demand a higher rent from his sub-lessee and can enjoy the surplus.

According to the contemporary Shari'ascholars, the viewpoint of the Shafi'i and Hanbali schools is preferable, meaning that leased assets can be sub-leased regardless of the amount of rental. However, if a lessee sub-leases the property to a number of sub-lessees or invites others to participate in his business by making them share the rentals received from his sub-lessees without transferring the part of ownership, or for making them participate in rentals he charges a specified amount from them, this is not acceptable in Shari'a, because he does not transfer the part of ownership and enters into contracts to simply share the rentals received by his sub-lessees. In this way, he simply assigns his right to receive rent against some payment. This right cannot be traded in because it amounts to selling a receivable at a discount, which amounts to Riba.

Security/Guarantee in Ijarah

As Ijarah creates a debt in the form of payable rental, the lessor can demand security and/or a guarantee from the lessee. Taking security is also permissible for the reason that the leased asset is handed over to the lessee as a trustee and he is required to protect the asset in his fiduciary capacity. He can be held liable for any damage to the asset if it is proved that damage has occurred due to any negligence on his part. In cases of such loss or defaults in payment of rental by the lessee, the lessor can recover the actual loss, excluding the cost of funds or opportunity cost in modern terminology, from the security. Any amount taken as income over and above the due rent would be Riba.

Liabilities of the Parties

There is no liability on a lessee or employee except when it is established that he has transgressed or wilfully wasted or damaged the property. In such cases he is liable to compensate the lessor for harm to the leased asset caused by misuse or negligence, or to replace the property.

All liabilities emerging from the ownership shall be borne by the lessor, but the liabilities relating to the use of the property shall be borne by the lessee. For example, in the case of lease of a house, the taxes relating to the property shall be the responsibility of the owner of the house, while the water tax, electricity bills and all expenses referable to use of the house shall be borne by the lessee. Contemporary

Shari'a experts and Islamic banks' Shari'a boards link the responsibility of the owner (lessor) to bear expenses on the asset on which the continued performance and usufruct of the asset is customarily understood with the free agreement of the parties, i.e. in the case of agreement to the contrary, expenses could be borne by the lessee. The leased property shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by factors beyond the control of the lessee shall be borne by the lessor. However, as discussed earlier, the lessee is liable to compensate the lessor forharm to the leased asset caused by any misuse or negligence on his part. A property jointly owned by two or more people can be leased out, in which case they shall be responsible for its risk and the rental shall be distributed between them according to the proportion of their respective shares in the property.

Termination/Amendment of the Contract and Implications

Ijarah is basically a binding contract, meaning that once executed, it cannot be revoked unilaterally. Unilateral and unconditional option to terminate a lease by any of the parties is contrary to the principles of justice and equity and, therefore, un-Islamic. However, both parties can amend or terminate the contract with mutual consent.

If the leased asset is damaged to the extent that it is no more able to give usufruct, the contract of Ijarah is terminated. Similarly, in the case of an impediment to achieving the normally expected objective of the contract, the lessee can terminate the contract. In this situation, the parties may adjust the rental to avoid injustice to the lessee, keeping in mind the partial damage to the asset and possibility of beneficial use. If an unidentified unit of asset is leased (Ijarah Mosufah bil Zimmah), the contract will not terminate and the lessor will be required to replace it with another asset of the agreed specifications.

If the lessee stops using the asset without the lessor's consent, accrual of the rental will continue. If the asset is sold to the lessee, the Ijarah contract is terminated due to the transfer of ownership to him. If the asset is sold to any third party, the contract does not terminate and the rights and obligations transfer to the purchaser of the asset. The lessee's consent is not necessary if the lessor wants to sell the leased asset to any third party. If the purchaser is not informed about the lease contract, he can terminate the sale contract. If he knows of it and consents to it, he takes the place of the previous owner.

The traditional jurists differed regarding the termination of lease due to death of any ofthe parties, i.e. the lessor or the lessee. But contemporary jurists have come to the conclusion that an Ijarah contract is not terminated with the death of either party. However, the heirsof the lessee can terminate if they feel that the contract has become too onerous for their resources to pay the rental.

The lessor is allowed to provide in the lease contract that he will have a right to terminate the lease if the lessee contravenes any term of the lease agreement. In that case, the

lessee would be obliged to pay the due rent and not the rent of the remaining period. In conventional leases, it is generally provided in the agreement that in the case of termination of the lease, even at the option of the lessor, the lessee would pay full or a part of the rent of the remaining period. The basic reason for inserting such conditions is that the main concept behind the agreement is to give an interest-bearing loan under the cover of lease.

This condition is obviously against the Shari'a and the principles of equity and justice. The logical consequence of the termination of lease is that the lessor should take the asset back. In this case, the lessee should be asked to pay the rent as due up to the date of termination. If the termination has been effected due to misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be asked to pay the rent of the remaining period. It can also be provided in the contract that in the case of a default in payment of rental by the lessee, the lessor could terminate the lease.

If a lessee has paid rental for any stipulated period in advance and he is obliged to return the asset because of any compelling circumstances (*force majeure*), the remainder of the advance rental must be returned to the lessee, because the lease will be considered to have been dissolved for a valid reason. The remainder, if any, will also have to be returned in the case of mutual dissolution. If, however, the asset is not returned by the lessee, enabling the bank to re-lease it, the remainder will not be returned.

Failure in Payment of Due Rent

Rental in respect of any lease contract when it becomes due takes the form of a debt payable by the lessee. It will be subject to all rules prescribed for a debt. Therefore, a charge from the lessee on the agreed rental would be Riba, prohibited by the Shari'a. Unscrupulous lessees could exploit this aspect and cause loss to the lessor by wilful default. To provide a deterrent, Shari'a scholars allow that a donation or any amount of penalty payable to charity can be provided *abinito* in the lease agreement; the amount of donation can vary according to the period of default and can be calculated on a percentage per annum basis.

Any amount charged over and above the agreed rental must not become a part of the income of the lessor and has to be given to charity. As this late payment penalty cannot become part of the income of lessor banks, it is advisable that a suitable clause be incorporated in the lease agreement to the effect that in cases of wilful default, the bank will take possession of the leased asset or enforce the collateral to recover its dues.

Fig. 1 Mechanism of Ijarah Contract:
Ijarah contract is a form of lease contract. The simplified structure of Ijarah is presented below.

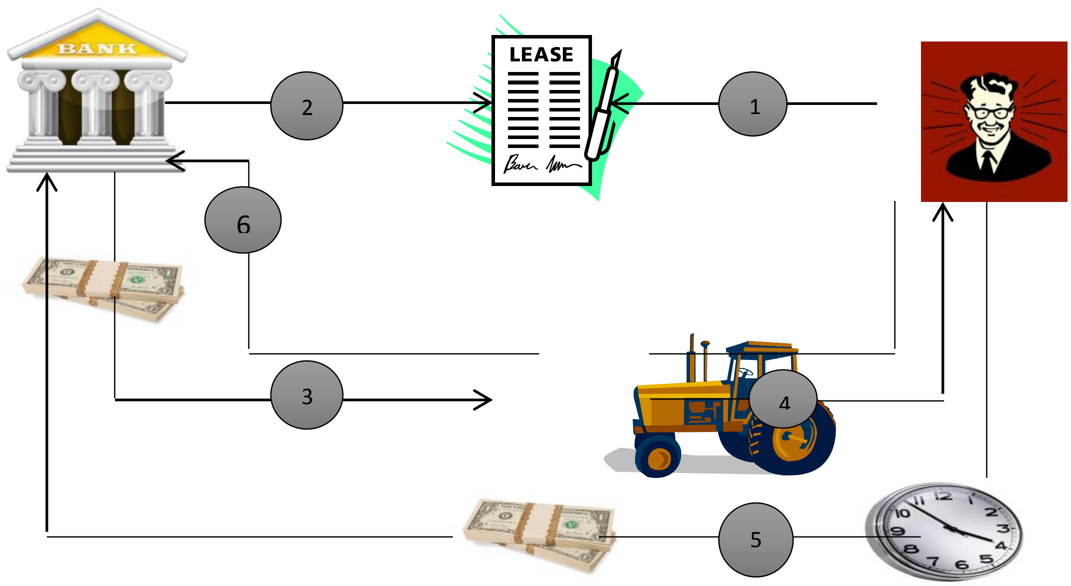

Fig: 10.1

Step 1& 2: The client approaches the Bank with the request for leasing machinery and enters into
a promise to lease agreement, between client and the Bank as Ijarah contract.
Step 3: The Bank purchases the item required for leasing and receives the title of ownership from
Vendor, and the Bank make payment to the vendor.
Step 4: The Bank leases the asset to the client after execution of lease contract.
Step 5: The client makes periodic rental payments as per the contract.
Step 6: Asset remains the property of the Islamic Bank, and reverts back to it at the end of the Ijarah contract. Islamic Bank it is used Ijarah directly for plant, machinery, automobiles, housing, consumer durables, and Ijarah is conductive to the formation of fixed assets and medium & long term investments in the economy.

Modern Use of Ijarah

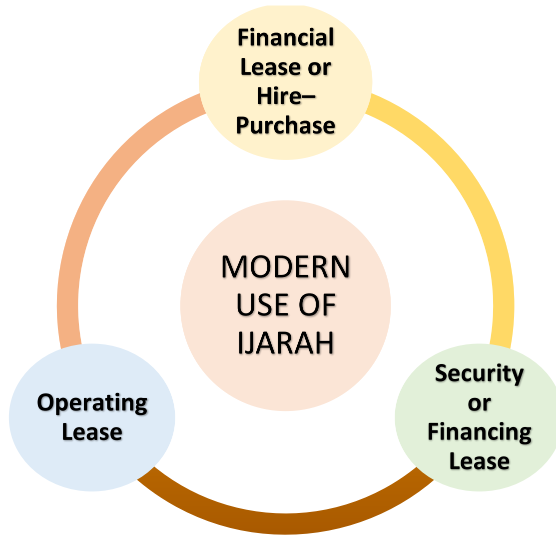

Fig: 10.2

Leasing in one form or another comprises a sizeable part of financial services in the world today. In its origin, leasing is one of the normal real sector business activities like sale and not a mode of financing. However, for certain reasons, and in particular due to some tax concessions it carries, leasing is being used in many countries for the purpose of financing, and the financial institutions lease many types of assets and equipment to their customers.

In Islamic finance also, leasing is an important instrument with a lot of potential in the business of Islamic financial institutions, not only because of these benefits but also because of the "Asset-based nature" of investments in Islamic finance. From the Islamic perspective, leasing operations by banks and financial institutions are governed by the rules prescribed in Fiqh for Ijarah transactions.

To study Ijarah as a mode of financing, we shall discuss the process of entering into modern Ijarah, purchase of the asset to be leased, treatment of Takaful and other expenses, miscellaneous rules relating to determination of rental, commencement and payment of rental, some common mistakes, commonly raised objections and their answers, termination of the contract and the possibility and modus operandi of transfer of ownership to the lessee.

Non-bank financial institutions or companies (NBFIs/NBFCs) in almost all countries of the world, and banking institutions in countries like Germany, Japan, etc. are using leasing as a business mode. The forms of leasing these institutions are using are "financial lease", also termed hire–purchase; "financing lease", also referred to as "security lease"; and "operating lease". We briefly describe modern forms of leasing below.

Financial Lease or Hire–Purchase

In modern financial leases, the lease period is long enough (usually the entire useful life of the leased asset) to enable the lessor to amortize the cost of the asset with a market return on its capital. The banks pay the price of the asset to the supplier, either directly or through the lessee. While fixing the rent, the banks calculate the total cost they have incurred for purchase of those assets and add the stipulated interest they could have claimed on such an amount during the lease period. The aggregate amount so calculated is divided by the total months of the lease period, and the monthly rent is fixed on that basis. The lease commences on the day on which the price is paid by the lessor, irrespective of whether the lessee has made payment to the supplier and taken delivery of the asset or not. This means that the lessee's liability for the rent starts even before he takes delivery of the asset. The risk of ownership is borne by the lessee, i.e. the client.

The lessor recovers the cost and interest thereon and has no further interest in the asset.

The lessee purchases the asset at a price specified in advance or at its market value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both parties. However, the lessee is normally allowed to pre purchase the asset before the lease termination. In such situations, the lessor normally charges an extra amount (say 5% of the remaining amount of the bank's funds) as a fine/liquidated damages for discontinuation of their income stream. The leased asset serves as security and, in the case of default on the part of the lessee, the lessor can take possession of the equipment without a court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in most countries. The lessor can also sell the equipment during the lease period to the effect that the rental payments accrue to the new buyer. This enables the lessor to get cash when he needs liquidity.

Normally in such contracts, compound interest is involved in the case of default or delay in payment of the instalments. As such, the end result of financial lease may turn out to be worse and more exploitative than the outright purchase of the asset by the lessee on credit instalments. For example, in a conventional lease contract of five years, the lessee is required to continue to make payments even if he no longer needs the asset, say after two years. In the case of a credit purchase on the basis of interest, he could sell the asset in the market to repay his liability. He cannot do this in financial lease and could even lose his stake in the asset, even though he has paid a part of the price of the asset in addition to the rental charges in normal operating lease.

Security or Financing Lease

A security lease in the conventional set-up is just a financing transaction and nothingmore than a disguised security agreement for the amount financed to the lessee. Itinvolves the effective transfer of all risks and rewards associated with the ownership to thelessee.

Operating Lease

In operating lease, the owner of the asset gives possession of the asset to the lessee, retaining its ownership, to have its use in return for rental. The lessor takes back the equipment/asset when the lease ends. This method is considered fully compatible with Shari'a provided some other conditions are fulfilled. Operating lease is particularly suitable for high cost assets that require large amounts of money in order to possess and have long production times, for example, aircraft, ships, etc.

Operating lease is rarely used by banks. Non-bank financial institutions sometimes use this mode of leasing in respect of specialized machinery. They maintain a number of assets to respond to the needs of different customers. The assets remain the property of the institution to re-lease them every time the lease period terminates. As such, NBFIs have to bear the risk of obsolescence, recession or diminishing demand.

Appraisal of Conventional Leases from the Shar¯ı´ah Angle

Important features of most modern leases are:

1. At expiry of the hiring contract, ownership of the leased article is transferred to the lessee, either free of any additional charge or at a nominal/token price. Particularly inhire–purchase, it is mutually agreed at the very beginning that the contract of Ijarah also includes sale of the asset and the amounts received periodically from the lessee will include both rental and the cost of the asset. In finance lease, the amount periodically paid by the lessee is the rental; however, the parties may or may not agree in the lease agreement that at the termination of the lease the lessee will get ownership of the asset.
2. The lessor starts charging rental as soon as he gives funds to the supplier of the asset. As such, he leases an asset before buying it and taking its possession and gets reward without bearing its ownership risks. As per Shari'a principles, rent has to be charged from the date when the lessee is in a position to take benefit from the leased assets, i.e. after he has taken delivery of the asset, and not from the day funds are released to the lessee or the price has been paid to the supplier.
3. The lessor shifts all the risks to the lessee, particularly when the residual value of the asset is also fixed in advance in the lease contract. According to the Shari'a principles, all expenses incurred to rectify defects which prevent the use of the equipment by the lessee are the lessor's responsibility, while the lessee is responsible for the day-to-day maintenance and running expenses. This is the major difference between conventional and Islamic leases.
4. In conventional operating leases also, all risks and expenses are the responsibility of the lessee. But in Islamic operating leases, the lessor must bear the upkeep responsibilities and bear all the risks and costs of ownership. Further, the operating lease is not for the entire useful life of the leased asset, but rather for a specified time period and ends at the end of the agreed period unless renewed by the mutual consent of both the lessor and the lessee.

Combining Two Contracts

Ijarah and sale are two different types of contract with different governing rules, particularly in view of the principle that while in sale contracts, ownership is transferred to the buyer instantly even if it is a credit sale, in Ijarah, ownership remains with the lessor. Transfer of the ownership in the leased property cannot be made by executing a sale contract that will become effective on a future date. In most commercial leases, the lessee pays, in addition to the rental, a sum which goes toward buying the leased property. If the lessee is given credit for his payments by becoming, in ever-increasing degree, the owner of the property, the proportion of his payments that goes to rent should also continually reduce and justice would require that upon making full payment along with rental, the ownership title should transfer to him. But the question is how can the lease agreement be structured to make it

Shari'a compliant and also justifiable for the lessee, who has paid the full cost of the asset and the rental?

Contemporary Shar¯ı´ah scholars recommend that a lease agreement should not contain a precondition of sale or gift after the lease period. However, the lessor may enter into a separate unilateral promise to sell the leased asset at termination of the lease. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed, whereby the promisor, say the bank, is bound to fulfil the promise, but the promise is not bound to enter into an actual purchase contract. This means that the lessee would have an option to purchase, which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise. This is to avoid a bilateral promise by the two parties, which is prohibited in Shari'a because it becomes a contract. Similarly, scholars suggest that instead of sale, the lessor signs a separate promise to gift the asset to the lessee at the end of the lease period.

This is because normally the bank, as lessor, recovers the whole cost incurred on the asset and also a return thereon as its profit margin from the lessee. As such, it seems to be the lessee's right that he gets ownership of the asset, and the best way to transfer ownership is to give him the asset as a gift.

There may be an objection that Ijarah Muntahia-bi-Tamleek also comprises two contracts in one bargain and as such it is not Shar¯ı´ah-compliant on the basis of the prohibition of two bargains in one. This perception is set aside on the following grounds:

1. Mainly the transaction is one whereby the lessor leases the asset and fixes the rental in such a way that during the lease period his cost and the rent are received. Both parties agree on this nature of the transaction.
2. It consists of an Ijarah contract, which immediately goes into effect, and a unilateral promise that may or may not become effective in a later stage or at the end of the lease period. The second part is only a unilateral promise and is not binding on the promisee; as such it is not a transaction until actually entered into by the parties.
3. This arrangement does not involve any injustice to any of the parties, Riba or any element leading to dispute among the parties. It is rather justifiable in that the lessee, who has paid the cost along with the rental, is able to get ownership title of the asset at the end of the lease period.

From this perspective, a sale executed at the end of the lease period is not in contravention

of any basic principle of the Shari'a.

Takaful/Insurance Expenses

It is a regulatory requirement in many countries of the world that the leasing entities should insure the leased assets. Islamic banks should use Takaful that has been approved by the

Shari'a scholars as an alternative to insurance and should avoid conventional insurance due to the involvement of Riba and Gharar. However, a large number of Islamic banks are using insurance due to the non availability of Takaful-based policies. Shari'a scholars have allowed this only for the transitional period.

There is criticism by many scholars of a practice whereby the Islamic banks make the lessee the actual payer of the Takaful contribution or premium by passing on the premium costs as part of the lease instalments to be paid by the lessee. This criticism is based on the understanding that the lessor has an insurable interest in the subject matter and he/it should pay the insurance premium and not the lessee. It is correct that, as owner of the asset, the bank should be the insurer and the beneficiary of the Takaful policy. Islamic banks normally include the Takaful expenses in the acquisition cost of the asset for determining the rental. Shari'a scholars allow this on the grounds that rental in leases is subject to mutual consent of the two parties and if the lessee agrees to the amount of rental, the contract is acceptable from the Shari'a angle. As regards the insurable interest, it rightly belongs to the bank as lessor. But if the transfer of ownership becomes impossible without any cause attributable to the lessee, the lessee must be protected from the loss by paying to him the difference between the rent received from him as per the lease agreement and the market rental of such assets. Some Islamic banks are not abiding by this rule; it is against the spirit of Islamic finance and the Shari'a advisors should look into the matter.

The issue of primary focus in this regard is determining the effects of loss or damage to the asset. It is usually stipulated in the agreement that the lessee will be provided with a copy of the policy and he will observe the conditions of the policy. Therefore, if the asset is destroyed and there is lack of observance of the conditions of the Takaful policy that has barred the lessor from recovery, the lessee is held liable. In the absence of any fault or negligence on the part of the lessee, the lessor bears all responsibility for damage to or loss of the leased asset. If, however, the claim paid by the Takaful company is less than the loss incurred by the Islamic bank, the remainder of the loss cannot be charged to the lessee and the bank itself should bear the loss.

Islamic Banks' Ijarah Muntahia-Bi-Tamleek

The above section implies that the Shari'a objections to modern leases relate mainly to

- **(i)** the procedure of ownership transfer to the lessee;
- **(ii)** accrual of the rentals
- **(iii)** the responsibilities of the lessor in respect of ownership-related risks and expenses.

If these aspects are taken care of by Islamic banks, they can use leasing as a mode of finance. For this purpose, they have adopted the modus operandi of Ijarah Muntahia-bi-Tamleek, according to which the transaction basically remains one of Ijarah and the ownership transfer is kept separate from the main Ijarah contract. This is closer to the conventional finance lease with the following differences:

1. In a finance lease, the rental starts accruing as soon as the payment for purchase of the asset being leased is made by the lessor; in Ijarah Muntahia-bi-Tamleek, rental starts at the time when the asset is supplied to the lessee in useable form.
2. In a finance lease, the payment of the cost price of the asset is made either to the supplier or to the lessee so that he may pay the supplier and get the asset on lease. In Islamic lease also, the price of the asset can be paid either to the supplier or to the lessee, but if it is paid to the lessee, there must be an agency agreement in addition to the lease agreement. The agency agreement will precede the lease agreement and all elements of Wakalah should be applicable to it. If the asset is destroyed before its delivery to the lessee in useable form, the loss will be that of the principal and not of the agent.
3. In Islamic lease, the risk of the asset will be that of the bank as long as the client serves as its agent for purchase of the asset, while in a finance lease, all risks are borne by the lessee.

As a hire–purchase contract includes both lease and sale at the very beginning, it is not suitable for Islamic banks. For Ijarah Muntahia-bi-Tamleek, Islamic banks normally purchase the asset in response to specific requests from customers to get the asset on a lease that ends with transfer of ownership after the lease term through a separate and a formal sale or gift contract. According to the AAOIFI Standard on Ijarah, transfer of ownership in the leased property cannot be made by a sale contract (along with the Ijarah) to be made effective on a future date.

Ownership can be transferred using one of the following means:

1. By means of a promise to sell for a token or other consideration or by accelerating the payment of the remaining amount or by paying the market value of the leased property.
2. By promise to give it as a gift (for no consideration) at the end of the lease period.
3. By promise to gift contingent on a particular event, for example, upon the payment of the remaining instalments.

The transfer of ownership in all the above forms should be independent of the Ijarah contract and not an integral part of the transaction as a whole. The promise should be unilateral and binding on the promisor and the other party must have the option not to proceed. In cases 1 and 2 above, a new contract should be drawn up because ownership will not transfer merely by virtue of the earlier promise. In respect of 3, where an Ijarah transaction has separate documentation giving the asset as gift contingent upon the condition that the remaining instalments are paid, the ownership will be transferred to the lessee if the condition is fulfilled without any other document being signed.

The ownership can also be transferred prior to the end of the lease period at a price stipulated in advance or at the market price or through the contract of Diminishing Musharakah, in which case the financier's part of ownership is gradually transferred to the lessee upon payment of rental according to an agreed schedule and the rental will decrease accordingly.

Some Islamic banks take an undertaking or a unilateral promise from the lessee that at the end of the lease or in the case of premature termination at his discretion and mutual consent, he will pay the market or a pre stipulated price. A price schedule is agreed in advance that implicitly includes the bank's possible loss in the case of termination of lease before the agreed period.

If the case is one of "sale and lease-back" – the bank purchases an asset from the client and then leases the same to him – on the basis of Ijarah Muntahia-bi-Tamleek, there should be a reasonable period between the purchase and lease contract and the transfer of ownership back to the customer, long enough that the leased property or its value might have changed. The period of one year is normally suggested for this purpose. It is necessary to avoid a contract of Bai' al 'Inah.

Procedure for Ijarah Muntahia-bi-Tamleek

Islamic banks' Ijarah Muntahia-bi-Tamleek, broadly speaking, comprises an arrangement in which leasing is the real and major contract, which is subject to all the rules of an ordinary Ijarah contract where the standard Shar¯ı´ah principles of defining the asset to be leased, its terms and essential prerequisites of contracts have to be observed. Islamic banks normally adopt the following procedure to conduct Ijarah, remaining within the limits of the Shari'a:

1. The client conveys his requirement to the bank and enters into an MoU for stipulating the overall structure of the deal. The bank takes an undertaking from the lessee along with some earnest money (Hamish Jiddiyah) to ensure that the client is serious in his dealing and will take the asset on lease when purchased by the bank. The amount of earnest money is kept as trust, but if the bank gets permission from the client for its use, it takes the form of a debt and becomes the liability of the bank. The AAOIFI Standard recommends that it should be kept as an investment trust to be invested by the bank on the basis of Mudarabah. As such, it should be kept as a PLS deposit in the name of the client. With the consent of the client, this amount can also be treated as advance payment of rental.
2. The bank can directly purchase the asset or appoint any agent for the purpose. If the asset is to be imported, the bank can appoint the customer its agent who may open an L/C and place an order with the foreign supplier on behalf of the bank. He will pay the relevant duties, taxes, transportation and other charges to the port authorities for releasing the asset. All such payments made by the importer will be reimbursed by the bank and will constitute part of the total cost of the asset. According to the AAOIFI Standard, any third party agent is preferable, but the client can also be appointed as agent. If the vendor of the asset is also indicated by the client, the bank can get a performance bond from him to the effect that the asset supplied will be acceptable to him. The bank, however, will remain liable for ownership-related risks and expenses.

Unlike sale (through Murabaha), it is not necessary in lease that the bank should first take possession of the asset and then deliver the same to the lessee. If the bank has agreed to lease the asset to a client with effect from the date of delivery and the client is appointed as agent to purchase that asset, the lease can be made operative on the date when the lessee takes delivery as agent, without any additional procedure. While in Murabaha to Purchase Orderer, simultaneous transfer by the bank and the agent is not allowed, in leasing, the lease period may begin right from the time when the client takes delivery as agent. This is because ownership of the asset remains with the lessor along with risk and reward during the leasing period.

3. Sometimes the bank and the client jointly purchase the asset and create a partnership by ownership (Shirkatulmilk) and the bank leases out its share to the client on the principle of Diminishing Musharakah. The rental to be received by the bank should be in proportion to its share in the ownership. Hence, if clients periodically purchase any parts of the bank's share, the rental should go on decreasing.
4. 4. When the asset is purchased by the bank and taken into its possession or that of the client serving as agent, the formal lease agreement is executed. Rental starts accruing from this point of time onward if all installation work is complete and the asset is in useable form.

If the lessee delays in using the asset due to any problem attributable to him, he will have to pay the rental.

5. If the client defaults in paying the rental, the bank can ask for acceleration of payment, provided it is agreed in the lease agreement. This would be the case of early termination of the lease; the bank would take the asset back or the lessee would purchase the asset as per the terms of the agreement. In the case of foreclosure of security, only the due rent can be deducted and not the rent for the remaining period.

The other subsequent contract is a contract for gift or sale, independent of the earlier lease contract. For transferring ownership title, Islamic banks use any of the three methods described above, i.e. promise/undertaking to sell (by the bank) or purchase (by the client)and executing a formal sale agreement at the time of the sale; promise to gift; or promise to a contingent gift.

The lessee pays rental that also includes the cost of the asset incurred by the lessor on acquiring the asset. Therefore, a part of the rental effectively goes towards buying the leased property, although, legally, the whole rent represents rental for use of the asset. As the parties can agree on any amount of rental with mutual consent, and the arrangement is equally beneficial for both the parties, Shar¯ı´ah scholars have accepted this as Shar¯ı´ah-compliant.

As the rental implicitly includes the cost of the asset, the AAOIFI Standard directs that if transfer of property to the lessee is not possible for any reason, like destruction or theft of the asset, or if continuity of the lease becomes impossible as per the lease contract without any cause being attributable to the lessee, the rental should be adjusted based on the prevailing market value – the difference between the prevailing rate of rental and the rental specified in the contract must be refunded to the lessee if the latter rental is higher than the former. This is to save the lessee from loss having agreed to pay a higher rental compared to the market rental of a similar asset in consideration of the lessor's promise to pass the ownership title to him upon expiry of the lease term. It also implies that if the bank has taken Takaful cover of the asset, which normally is the case, the amount received from the Takaful company, over and above the bank's cost and expenses, should be given to the client.

There might be some problems in the leasing procedure of IFIs that are working without intensive surveillance by Shar¯ı´ah supervisory boards or Shar¯ı´ah scholars, and this practice will have to be discontinued if Shar¯ı´ah compliance is the objective. The conventional hire–purchase structure cannot be dubbed Shar¯ı´ah-compliant merely by renaming it Ijarah Muntahia-bi-Tamleek or Ijarah-wal-Iqtina‘. But a large number of institutions are using the mode of Ijarah Muntahia-bi-Tamleek and are observing the Shar¯ı´ah principles under the guidance of the Shar¯ı´ah scholars. As long as the Shar¯ı´ah-compliant procedure recommended by the Shar¯ı´ah scholars is adopted in letter and spirit, IFIs should not be unnecessarily criticized.

Sale and Lease-back Arrangement

In a sale and lease-back arrangement, a customer requires finance on the basis of an asset already in his ownership. He sells the asset and then takes on rent for his use. This arrangement is legally permissible but ideally should be avoided, and Islamic banks should not adopt this as a major mode of business. However, if a client wants to get rid of Riba and does not have any other alternative, he can be accommodated by Islamic banks. It, therefore, should be used in exceptional cases and care should be taken to ensure that all parts of the arrangement conform to the related Shar¯ı´ah rules. In case of need, it can be used both for financing of a new asset (machinery, equipment, etc.) and for conversion from conventional to Islamic financing. The sale agreement must be executed before entering into the lease agreement and in order to avoid Bai‘ al ‘Inah, such a leased asset can be sold back to the client only after a reasonable period, long enough that the leased property or its value might have changed.

Destruction/Theft of the Asset

If the leased asset is totally destroyed, the Ijarah contract concluded on an identified asset is terminated. The leased asset is held by the lessee in a fiduciary capacity on behalf of the lessor; he will be held liable for any damage or destruction of the leased asset due to his misconduct or negligence. In the case of partial destruction in a manner that impairs the benefits expected from the asset, the lessee can terminate the Ijarah contract. The lessee and the lessor may also agree to amend the rental in the case of partial destruction of the leased property. The lessor is not entitled to rent for the period during which the lessee is not able to benefit from the asset, particularly if the fault occurred without any negligence on his part.

Issues Concerning Modern Use of Ijarah

With respect to the modus operandi of modern leasing business, Islamic banks face five sets of issues and problems.

1. One problem in Ijarah relates to burdens of the asset on the lessee or the lessor. For example, the Shar¯ı´ah provides that the duty of repairing the goods, other than normal maintenance, falls solely on the lessor, since the repairs benefit him as the owner. A clause in the contract purporting to shift ownership-related costs, other than the normal operating expenses, to the lessee is invalid, because it unjustly enriches the lessor.
2. Another problem arises due to Islamic banks’ lack of knowledge of the Ijarah principles. If a specified unit of asset is to be leased, the Ijarah agreement should be executed only after the asset is in the possession of the lessor (or that of the lessee in capacity of agent of the lessor). If the

agreement is signed at the time of disbursement of the money to the supplier and there is any delay in delivery of the asset to the lessee – the bank fails to deliver the asset to the lessee on the date specified in the Ijarah agreement – no rental is due for the period between the agreement date and the date of actual delivery. Therefore, Islamic banks should enter into a "promise to lease" at the beginning and the actual Ijarah contract should be executed at the time when the asset is made available by the supplier. While determining the rental, they can keep in mind the whole period for which their funds remain invested, i.e. the supply period and the lease period.

3. If any damage occurs to the asset during the supply stage, the lessee (client) serving as agent is not responsible for it until any fault on his part is proved. The rental, if received in advance, should be adjusted accordingly, unless it is agreed that the lease be extended by an equivalent period after its original expiry date.
4. Another problem relates to the fact that the usufruct is extended to the future and may therefore be risky and unstable, particularly if the usufruct is reduced materially in the future. In this respect, Islamic law has the provision of cancellation of lease if any factors or events cause the usufruct to be less than normally expected. For example, nearly all schools of Islamic jurisprudence allow the reduction or abolition of rental of land if the produce of leased farmland is damaged due to any natural calamity like drought, floods, etc. According to Imam Muhammad, if the crop of leased land is destroyed dueto any natural calamity, Ijarah will become invalid and the lessee will be entitled to a conventional wage.
5. A big problem emerges in the case of a default in payment of rental by the lessee, as the penalty taken for late payment has to be given to charity.

Another important aspect is that the general perception that Ijarah gives a fixed return to the bank is not correct. As Islamic banks have to purchase assets for leasing, they have to pay all expenses incurred in the process of their purchase, import, etc. The bank can, of course, include all these expenses in its costs and can take them into consideration when fixing the rental, but as a matter of principle, it is liable to bear all these expenses as owner of the asset. This also implies that discounts allowed by suppliers for the purchase of leased assets would be the right of the Islamic bank, as it is the owner of the leased asset during the lease period. Banks also have to pay the major expenses related to ownership, like that of Takaful and other expenses necessary for the upkeep of the asset. A claim received from a Takaful company might not be sufficient to cover the lossor expense of repair. Hence, banks might not be able to get the targeted net return with certainty.

The solution to the above problems does not lie in stratagems leading to objectionable practices and integrity problems for the movement of Islamic finance. IFIs must take care on two points. First, risk cannot be separated from ownership; as the leased asset remains in their ownership, it must remain under their responsibility (Dham¯an) and they must take that responsibility. Second, lease and sale are contracts of two different natures; they must be kept separate and independent of each other. If the above two aspects are taken care of, they can adopt any procedure for leasing the assets, mitigating the risks and transferring ownership to the lessee through any of the methods discussed in the preceding paragraphs.

Assignment of the Leased Assets and Securitization of Leases

Shar¯ı´ah experts allow the lessor to sell the asset, in whole or any part of it, to any third party along with its rights and obligations, in which case the sale will be valid and Ijarah may continue. The sale of leased assets may particularly be required in respect of high cost assets like aircraft, ships, industrial equipment, machinery, roads, bridges, etc. However, if ownership is not transferred and the lease is simply assigned to the extent of rental only, the assignment of lease for a monetary transaction is not allowed, because in that case, money(rental) would be sold for money, which must be equal for equal, i.e. one cannot charge rent more than one is paying.

The new party to whom the leased asset is sold will enjoy every right as lessor due to the former party, while he will be responsible for every liability under the lease transaction. This gives the Ijarah technique good potential for securitization and creation of a secondary market for investors on the basis of Ijarah.

If the asset is sold to a larger number of investors, the purchase of a proportion of the asset by each individual may be evidenced by certificates, which may be called "Ijarah Sukuk"or leasing certificates. The certificates will represent the holder's proportionate ownership of physical assets tied to the Ijarah contract, and the holder will assume the rights and obligations of the owner/lessor to that extent. Certificate holders are also required to maintain the asset in such a manner that the lessee is able to derive as much usufruct from it as possible. Therefore, Ijarah Sukuk are subject to risks related to real market risks arising from potential changes in asset pricing and in maintenance and insurance/Takaful costs and to the ability and desirability of the lessee to pay the rental instalments. In the case of total destruction of the asset, Sukuk holders will suffer the loss to the extent of their prorata ownership. Hence, Ijarah Sukuk may generate a quasi-fixed return since there might be default or some unexpected expenses that could not be envisaged in advance. As such, the amount of rent given in the contractual relationship represented by Ijarah Sukuk represents a maximum return subject to deduction on account of unexpected expenses.

Potential of Ijarah

Ijarah is the most important mode for financing operations of Islamic banks for meeting the needs of the retail, corporate and public sectors, and it has huge, as yet unrealized, potential. It is used directly for plant and machinery, automobiles, housing, consumer durables, etc. and indirectly for Sukuk issues by the corporate and government sectors. Ijarah is conducive to the formation of fixed assets and medium- and long-term investments in the economy.

The potential is by dint of a number of features of Ijarah as given below:

- Payment of Ijarah rental can be unrelated to the period of taking usufruct by the lessee, i.e. it can be made before the beginning of the lease period, during the period or after the period, as the parties may mutually decide. Accrual of rent, however, is based on the possibility of usage of the asset by the lessee.

- Ijarah can be contracted on an existing asset or a building and even an asset that is yet to be constructed, as long as it is fully described in the contract and is not for identified

Further Reading:

- ✓ ***Business Knowledge It in Islamic Finance By Coporation L Essvale Coporation Limited, Corporation Essvale***
- ✓ ***The Economics of Islamic Finance and Securitization, Issues 2007-2117 By Andreas Jobst***