

Ijarah

Applying Islamic Finance Principles in the Mauritian Leasing Industry



Ashraf Esmael
21 May 2009

Agenda

- Corporate Intro – Mauritius Leasing
- Mauritius Leasing Industry at a Glance
- Relevance of Ijarah in the Islamic Finance Industry
- Ijarah : Mauritius Leasing Rationale
- Salient Features of Ijarah
- Economic Benefits of Islamic Leasing
- Development Process / Governance Structure
- Implementation Challenges / Issues
- Future Development / Roadmap / Opportunities



Vehicles



Machinery



Equipment



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Company Profile

- Incorporated in 1987 as a joint venture between the Government and private sector
- Pioneer leasing company in Mauritius, 22 Years of Leasing Presence
- Controlled by BAI since 1997 and listed on the stock exchange of Mauritius (SEM) since February 2004
- First to issue debenture stock in SEM (1990) and first leasing company to be licensed by Bank of Mauritius in 1995 as NBDTI.
- Provides finance and operating leases to companies and individuals – mostly involved in equipment and vehicle leasing
- Has a well-diversified and balanced portfolio in 18 different sector classifications; mainly in manufacturing, construction, traders, personal and infrastructure



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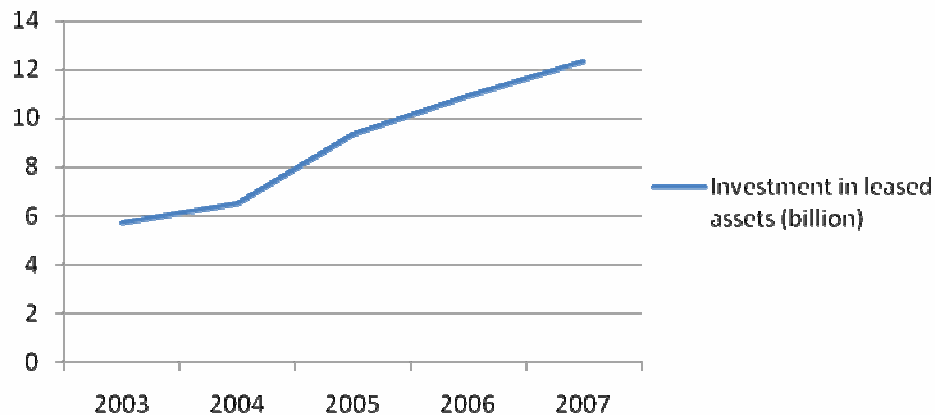


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Mauritian Leasing Industry

- 11 leasing companies operating in Mauritius, all of them licensed both by the Financial Services Commission and by the Bank of Mauritius.
- The portfolio of leased assets stood at MUR 12.5 billion at the end of 2008, up 15% compared to 2006 but limited growth in 2008.
- The leasing business is characterised mainly by finance leases (90%) to corporate and retail customers.
- Operating leases (10%) remain fairly underdeveloped,
- Vehicles represent around 60% while other equipment account for the remaining 40%

Investment in leased assets (billion)



	2003	2004	2005	2006	2007
Investment in leased assets (billion)	5.7	6.5	9.3	10.9	12.3

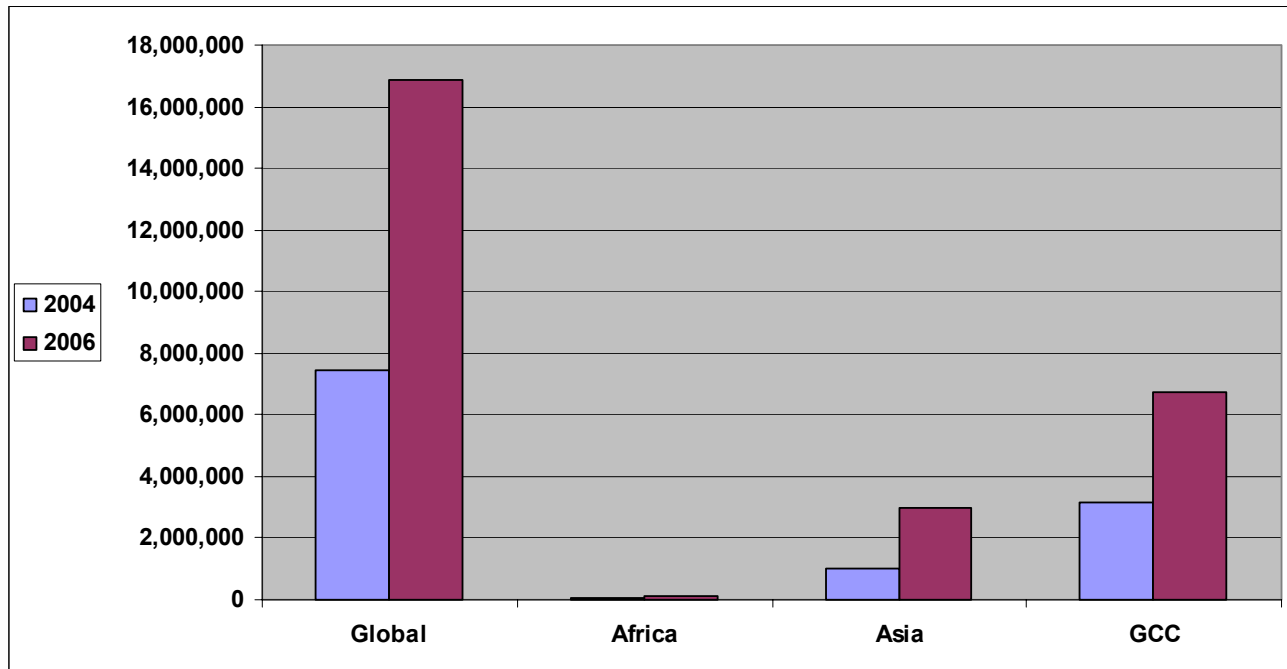
Mauritian Leasing Industry

	2004	2005	2006	2007
GDP (million)	152,425	162,171	181,968	206,934
Total national expenditure on plant & machinery (million)	14,961	16,242	23,343	24,267
Annual leasing volume (million)	3,200	4,600	5,400	6,100
Market Penetration (%)	21.4	28.3	23.1	25.1
White Clarke/GDP (%)	2.10	2.84	2.96	2.95

- Penetration ratios shows that Mauritius has a fairly matured market, comparable to those of Australia, Canada and the US.
- Fairly fast pace of evolution in the last twenty years in Mauritius.
- From finance leases for productive equipment to businesses and extending to motor vehicles to businesses and individuals,
- Finance, Operating and Full service leasing solutions.
- Operating leases remaining underdeveloped
- With the recent regulations in place, indications of amalgamations, takeovers and cessations on the horizon.
- Lessors now exploring cross-border leasing, especially on the back of solid “Double Tax Avoidance” treaties with some 34 jurisdictions, but at the same time explore Islamic and immovable property leasing.

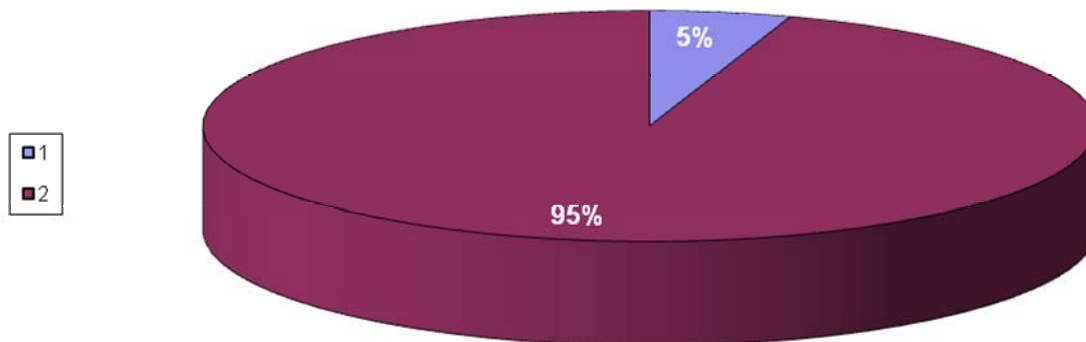
Significance of Ijarah (Leasing) in Islamic Finance

Leasing Finance Amount in 000, USD



Leasing Constitutes 5% of Total Islamic Finance at Global Level

% of leasing in total financing



Growing Importance of Ijarah in the Islamic Finance Industry

Dar Al Arkan

US\$ 1,000,000,000

Ijara Sukuk for the development of real estate projects



Joint Lead Manager



July 2007

Etihad Airways

US\$ 400,000,000

Ijara Financing Facility for the purchase of Airbus airplanes



Dar Al Arkan

US\$ 600,000,000

Ijara Sukuk for the development of real estate projects



Mandated Lead Arranger



March 2007

Qatar Liquefied Gas Company Limited (II)

US\$ 530,000,000

Ijara Financing Facility for the construction of liquefied gas trains and related facilities



Sharjah Electricity & Water Authority (SEWA)

US\$ 350,000,000

Ijara Wa Iqtina Financing Facility to enhance water and power capacity and distribution



Mandated Lead Arranger



October 2006

Vehicles

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Equipment

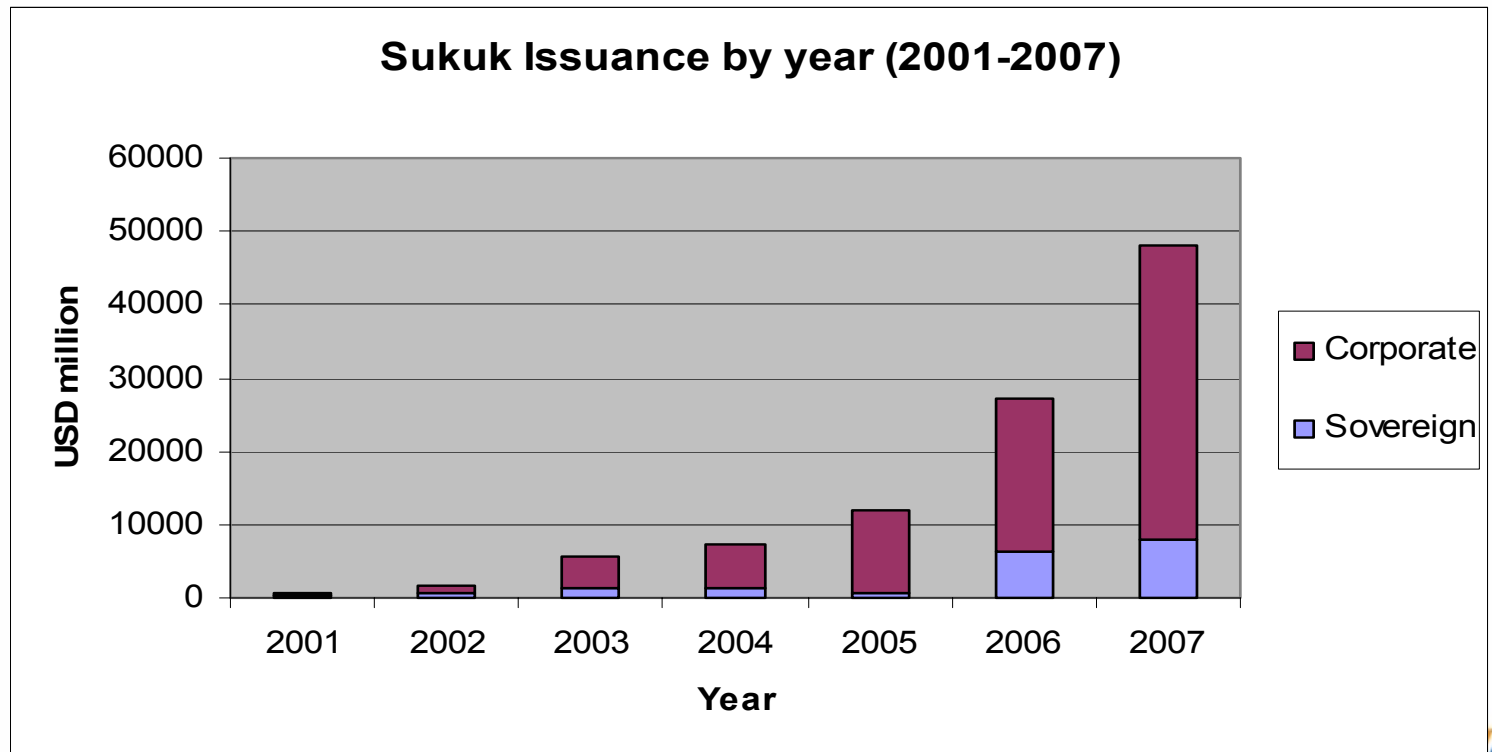
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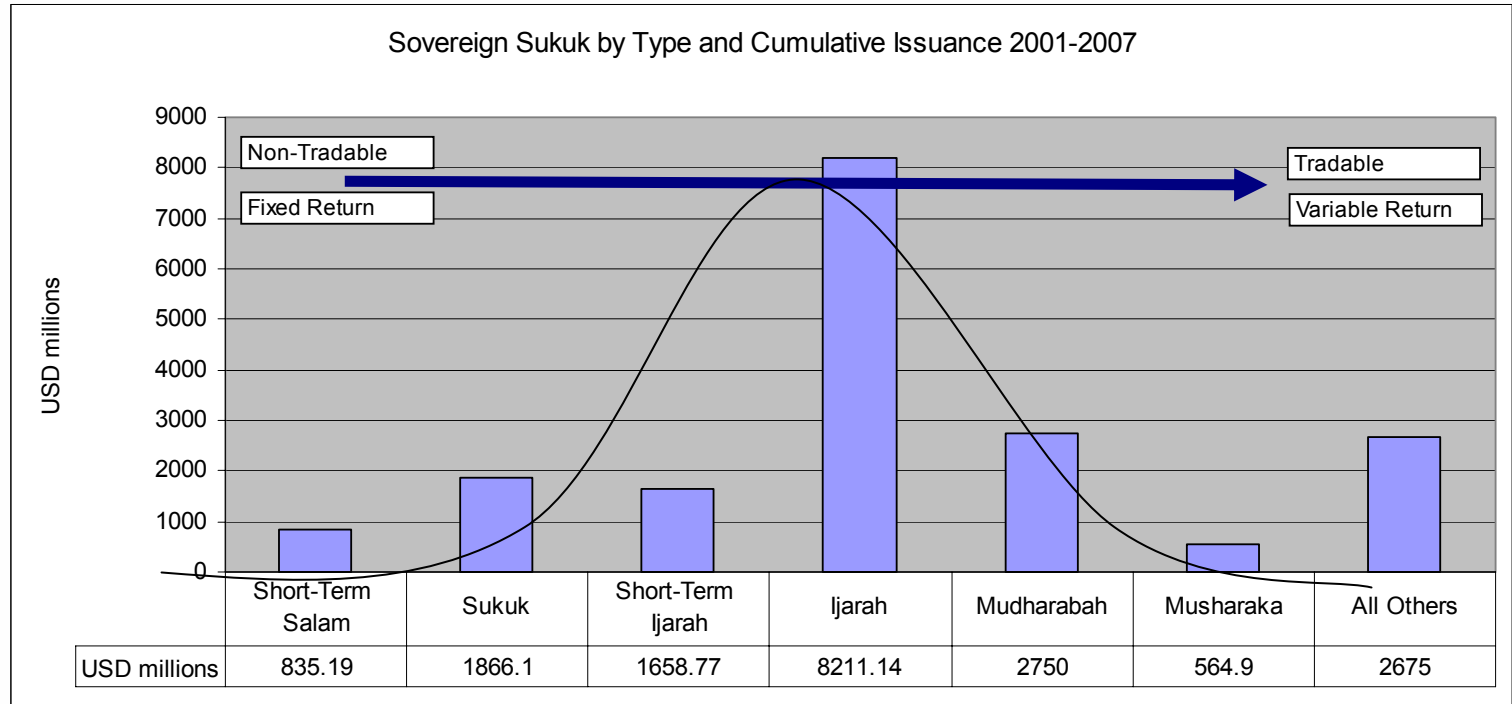
بنك المؤسسة العربية
Bank (S.C.)

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Sukuk Issuance by Year



Sovereign Sukuk: by Type and Cumulative Issuance (2001-2007)



Growing use of ijarah in Sukuk issuance

BUSINESS

ARAB TIMES, WEDNESDAY, MARCH 18, 2009

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By Mohieddine Kronfol

THE pronouncement of AACIFI, which prohibited, amongst other items, the mudarab (investment manager), sharik (partner) or waki (agent) to undertake the repurchase of assets from sukuk holders for its nominal value at maturity, has provided a catalyst for change in sukuk structures for most of 2008 and going forward.

The caveat to the ruling of AACIFI —

the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions — is that a purchase undertaking can be embedded in the structure provided it is by a third party and at arm's length.

This will allow new issues to be issued with minimal changes to the existing ijarah sukuk structure, albeit with the potential transfer of the underlying assets market value to the sukuk holder.

The announcements, we believe, are

positive in that they will effectively distinguish sukuk from conventional bond markets and improve the Islamic industry's general perception of authenticity.

The announcements are also likely to make ijarah sukuk closely associated with securities having fixed-income characteristics while musharaka and mudaraba sukuk become associated with equity-linked features.

Investors in all new structures, however, should now enjoy better protection as

sukuk become asset-backed rather than asset-based.

We estimate that of the \$29.33 billion sukuk issued in 2008 approximately 20 percent were ijarah, compared to 10 percent in 2007. Five percent of 2009 issues have been ijarah.

Despite the AACIFI pronouncement, sukuk issuance in the Middle East and North Africa has fared better than conventional bonds, with corporate sukuk issuance in 2008 down 55.1 percent

year-on-year versus conventional bond issuance falling 70.8 percent, thereby increasing new issue market share to above 60 percent.

It is clear from our point of view that the most significant risk affecting sukuk and Islamic finance in general is the health of the global economy and its financial markets, particularly the clearly dysfunctional credit markets.

It is difficult to forecast or predict trends in the short term with so much

uncertainty surrounding the health and stability of the world's financial infrastructure, of which Islamic institutions remain a part of, even if they are growing at faster rates, and with seemingly stronger fundamentals.

The question in 2009 will less be whether ijarah structures gain popularity or market share over musharaka and mudaraba sukuk but whether the primary markets reopen to issuers, be it Islamic or conventional. (RTSR)

Ruling backs fixed-income nature of ijarah sukuk

Islamic schemes' leasing format provides stability

Ijarah sukuk to remain popular with risk-averse investors

Ikhla Daredia is head of capital markets and institutional banking at Bahrain-based Islamic investment bank Unicorn.

— Editor

By Ikhla Daredia

IT is our belief that 2009 will be characterised primarily by the increasing popularity of ijarah as a mode of financing in the sukuk market.

At Unicorn we have already been focusing on ijarah, primarily because of its actual and perceived stability among alternatives

in the Islamic bond market.

The sukuk market was already showing indications of contraction in the period between 2007 and 2008 mainly due to global economic conditions. According to the Islamic Finance Information Service, in 2007 total Sukuk issuance stood at approximately \$46 billion but this contracted to \$15 billion in 2008. Expectations in the market this year mark the total sukuk issuance to be less than \$10 billion.

This is not a huge surprise considering the massive turbulence every sector and market experienced last year, but what is

surprising is the percentage of this total which was based on the ijarah mode of financing.

Ijarah's leasing format provides stability as it involves a contract whereby the bank buys and then leases a durable item to a customer for a specific rental amount and a specific period.

The duration of the lease, as well as the basis for rental, are set and agreed in advance.

Critically, the purchase undertaking at the end of the transaction is fixed at market price, thereby drastically reducing the risk to the investor.

The ijarah structure is highly appealing to investors as it is based on goods that have a terminal value and is not based on consumables, therefore deeming the value of the asset to be safe and more secure than other options.

In depressed markets ijarah's popularity should be no surprise, as investors are less willing to accept the risk profiles of mudaraba or musharaka products.

Under mudaraba, the capital-providing bank will carry potential monetary losses, while under musharaka parties will share potential losses according to the capital contribution ratio.

At Unicorn we believe ijarah products will therefore continue to grow and we expect to see an even higher percentage of sukuk issuance based on it.

It could also be the case that the rise of ijarah sukuk is due to the debate surrounding the compliance of other forms of sukuk with sharia, or Islamic law.

Governing directives on mudaraba and musharaka sukuk suggest that there could be technicalities involved in these structures implying that they are more akin to equity-like issuances and therefore there cannot be a par value assurance that the face value is paid back at

maturity.

In Unicorn's experience, we have found that the tendency of investors is to veer towards stability and longevity, and this is proving to be a welcome development for issuers given the climate in which we find ourselves.

Although 2008 saw a contraction in the sukuk market, it is important to recognise the growing importance of ijarah based products, as this highlights the market's lower risk profile.

Other riskier products will return to the market, but at the moment risk is something investors want to reduce.

Issuers prefer to replicate rather than innovate '08 success

Markets shy from riskier sukuks

Structure always been popular form

Mohamed Azahari Kamil is chief executive officer of Malaysian Islamic lender Asian Finance Bank, which is owned by Qatar Islamic Bank. RUS

Islamic investors snap up sukuk ijarah as risks grow

Rationale for BAI/Mauritius Leasing to launch Islamic Products / Islamic Leasing

- Mauritius Banking and Financial Services typically using traditional and conventional financing methods.
- Difficulty of access to capital specially for those in need of ethical and fair methods of financing.
- Slow pace in the development and introduction of islamic financial products and services in the Mauritian Market since the announcement.
- Window of Opportunity given growing importance of Islamic Finance and absence of market players to serve a particular market segment / need.
- Expressed willingness of BAI Leadership to respond to this need of the market and as a part of its CSR.
- Provide access to alternative financing methods – offer a choice.



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Ijarah

- It is defined by jurists as: "Possessing of a usufruct for a consideration" hence the concept of use of an asset (other than a consumable!) against payment of rentals instead of borrowing money to buy an asset and then using it (use versus ownership).
- The principle is as follows: The Company (Lessor) buys an asset and rents its out to its client (lessee). The Lessee pays a monthly rental over the duration of the lease to the Company. There is no interest (riba) involved but only a rental, just like a car hire, only in this case it will be for a longer, defined period.
- The company applies a profit on the cost of the asset. The cost + the profit is paid to the company in the form of rentals over the duration of the lease.
- Ijarah and Ijarah Muntahia Bittamleek are by nature purely leasing transactions in which the subject matter is the usufruct of the asset and not the amount of money as in case of typical lending transactions. In other words it is not a "financing" transaction and instead, it is a substitute to financing transactions.



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Ijarah (ctd)

- The leased asset remains in the ownership of the Company (Lessor) over the duration of the lease and only its right of usage is transferred to the lessee.
- The Company gives the lessee the first call for buying the asset at the end of the lease period (*under Ijarah Muntahia Bittamleek*). Only a nominal (token) amount is paid to buy the asset and this is done under a separate sale contract.
- Until the assets to be leased are delivered to the lessee, no lease rental become due and payable. (i.e. Ijarah cannot be recorded until the subjected asset is delivered to the lessee.)
- The Lessor bears the risk and reward associated with the ownership of the asset hence insurance cover for e.g. has to be ensured by the Lessor.
- Different treatments for Late Payments in case of default. “Overdue interest” cannot be charged and recognised as income. Lessor has to ensure prompt recovery action in case no arrangement can be reached.
- If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent.



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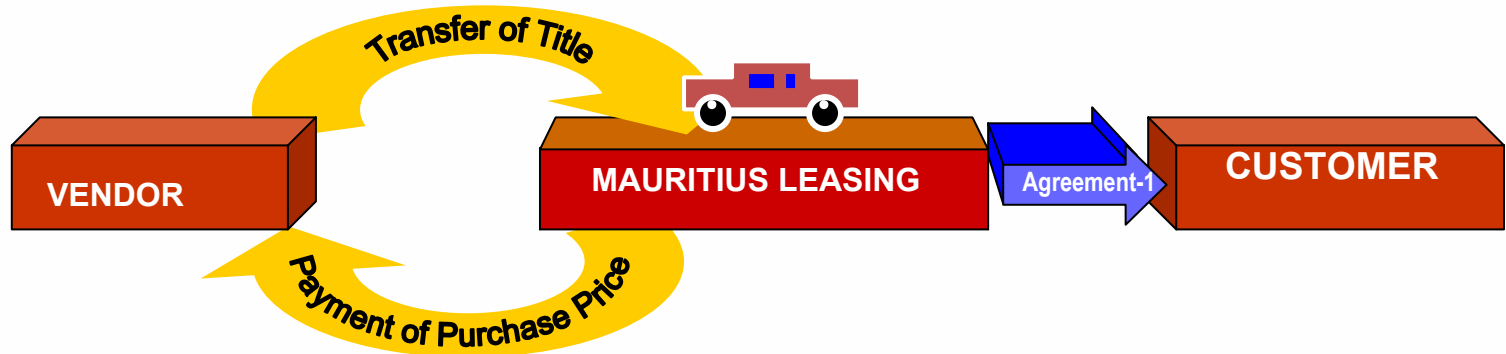


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Process of Ijarah



- The customer approaches the Company (Mauritius Leasing, “Lessor”) with the request for Ijarah Leasing and enters into a promise for a lease agreement (Offer Letter and Acceptance by client).
- The Company purchases the item required for leasing and receives title of ownership from the vendor.
- The Company makes payment to the vendor.

Process of Ijarah



- The Company leases the asset to the customer after execution of lease agreement which takes place after possession of the asset has taken place.
- The customer makes periodic fixed rental payments as per the contract after delivery has taken place.
- At the end of the tenure customer can purchase the asset from the Company under a separate Sale agreement at a token price.

Economic Benefits of Islamic Leasing

1. Islamic leasing necessarily involves real, tangible assets. This ensures and strengthens the linkage between the financial sector of the economy and the real sector contributing to economic stability.

There is no proliferation of financial assets without any counterpart in the real sector of the economy.

2. Islamic leasing creates a great potential for securitization. *Sukuk* based on *Ijarah* can potentially be traded in the market,

3. Islamic leasing is especially suitable for some public sector projects (e.g. infrastructure). As a matter of fact most of the leasing based *sukuk* issued recently belong to this category.

4. Lease finance is easier to practice as it involves less documentation and takes less time to conclude a deal. Unlike lending, it does not generally need collateral (Lessor owns the asset!). The physical presence of a tangible asset, the subject of the lease, whose ownership remains with the lessor, makes these formalities unnecessary.

5. Lease finance has some attractive features as the payment obligation of the lessee, the rent, is a fixed amount.



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Implementation Challenges

- Lack of Past Experience on the market / Trailblazer
- Regulatory framework still new / infancy stage
- Setting up and Functioning of SAB / - On going Compliance monitoring
- Training of Sales, Operations, Accounting and Compliance Staff
- Working “within the Box”
- Educating the Market / Players
- Managing Customer Expectations / Sensitivities
- Stakeholder Groups
- Adoption of Standards / Harmonisation



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IFRS vs AAOIFI: *Irreconciliable Differences?*

Two types of leases:

- Operating Lease

- Financial Lease

Parallels in Islamic leasing

- Operating Ijarah

- Ijarah Muntahi Bittamleek (Lease ending in transfer of ownership)

 - Transfer as gift

 - Transfer at a (token) price

 - Transfer at a price before expiry of lease

 - Gradual transfer, pro rata to price installments built into rent payments.



IFRS vs AAOIFI:

Irreconcilable Differences?

- the AAOIFI standard (FAS 8) suggests the accounting treatment for both Ijarah and Ijarah Muntahia Bittamleek be similar to an operating lease transactions with certain exceptions.
- On the other hand, conventional financial institutions, as well as, Islamic FIs currently operating in some jurisdictions (e.g. Pakistan) are accounting for Ijarah Muntahia Bittamleek as a financing transaction, just like finance lease – in accordance with IAS-17.
- IAS-17 v/s FAS 8



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Future Development Roadmap

*Structuring using Ijarah
and potential opportunities*



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Structuring using Ijarah

Leasing for Life

The apparently simple and straightforward Ijarah contract could be adopted to achieve many ends:

- An Ijarah could be the retail structure of a Sukuk – Al – Ijara, that permits the originator to raise funds.
- Sukuk holders can potentially trade in the Sukuk certificates to enable the liquidity management.
- Ijarah also a means for unlocking and realizing the capital value of an asset to fulfill the working capital needs of an organization.
- An organization that already owns an asset may sell it to the financier for immediate funds and continue to use it under an Ijarah agreement on payment of periodical rentals.



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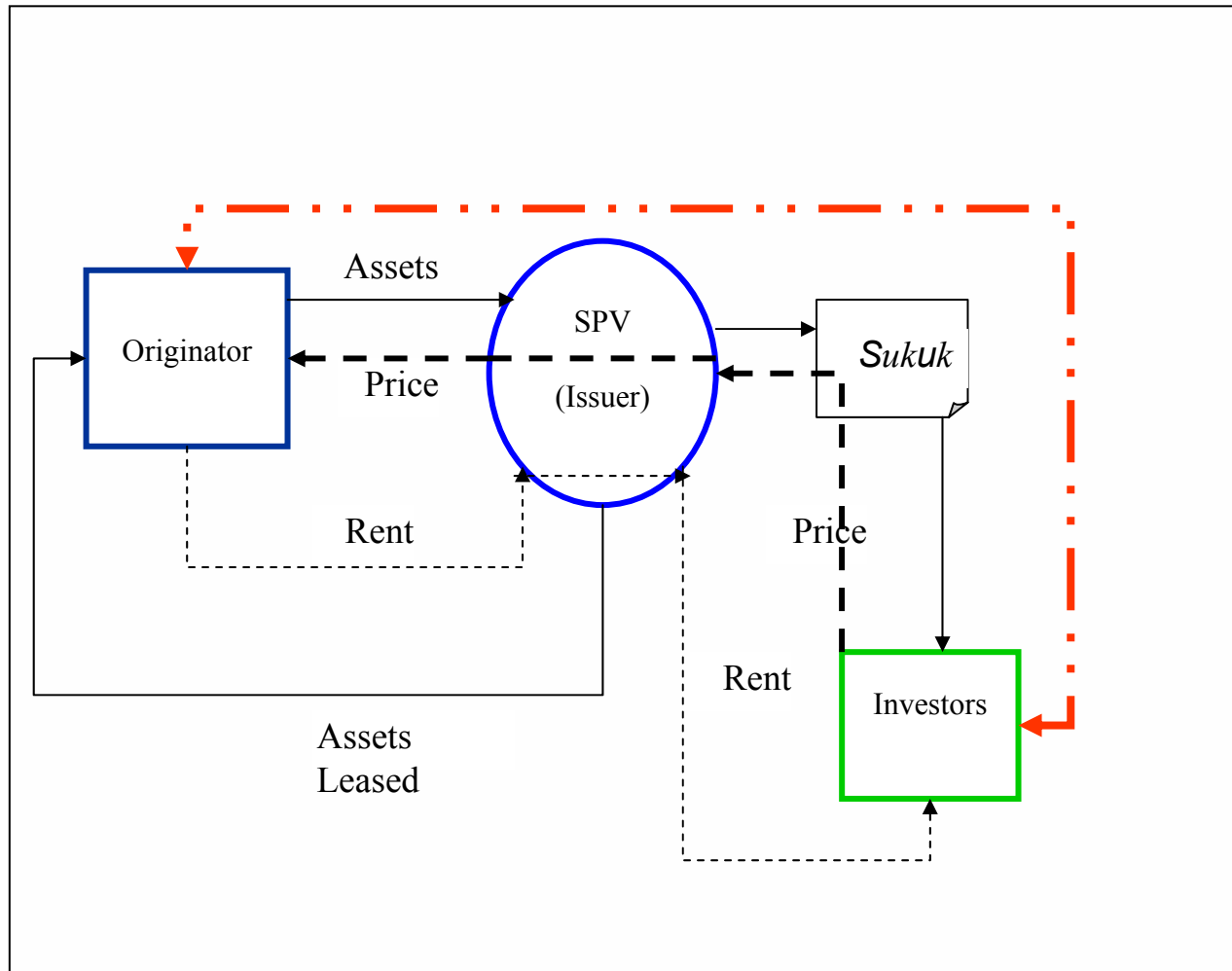


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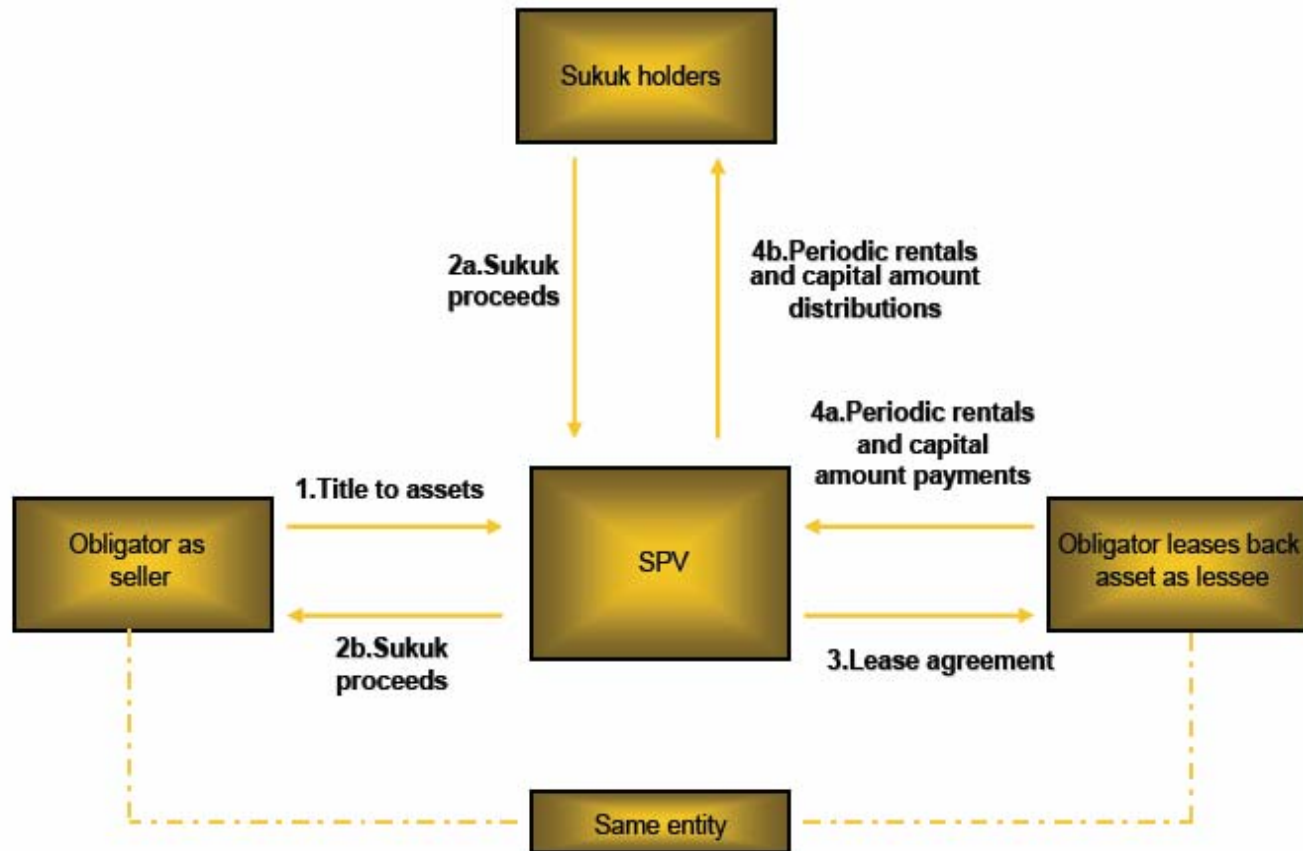


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Structure of a generic *Ijarah-Sukuk*



Sukuk al-Ijara transaction structure





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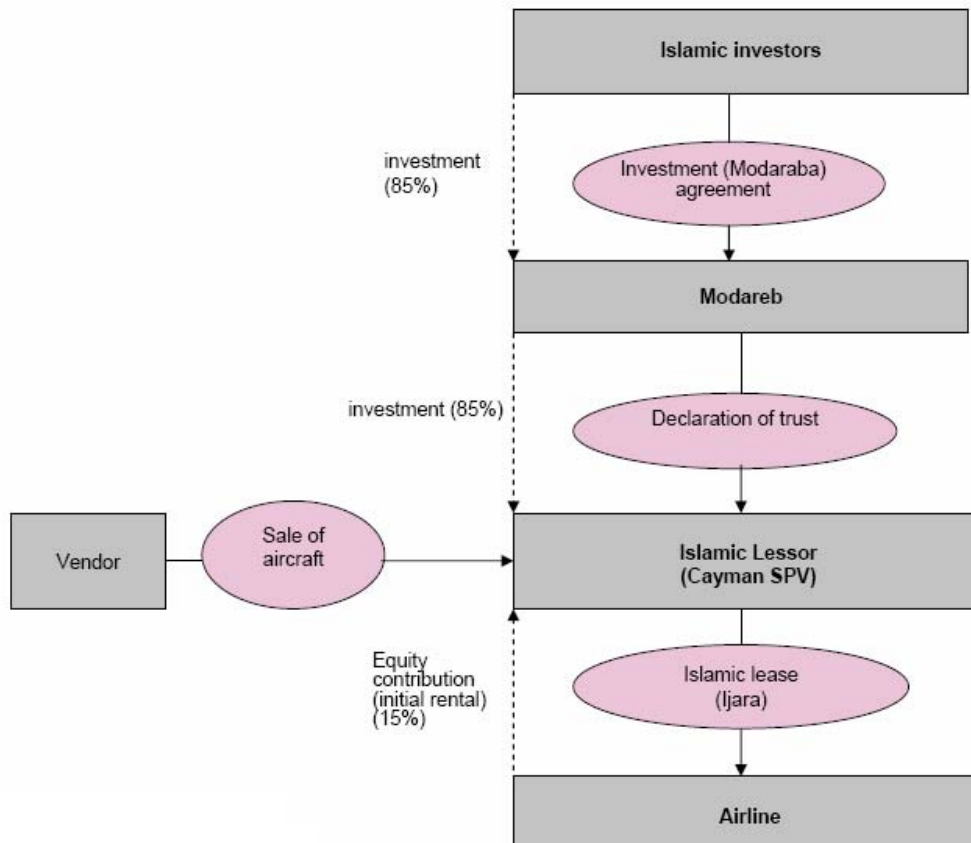


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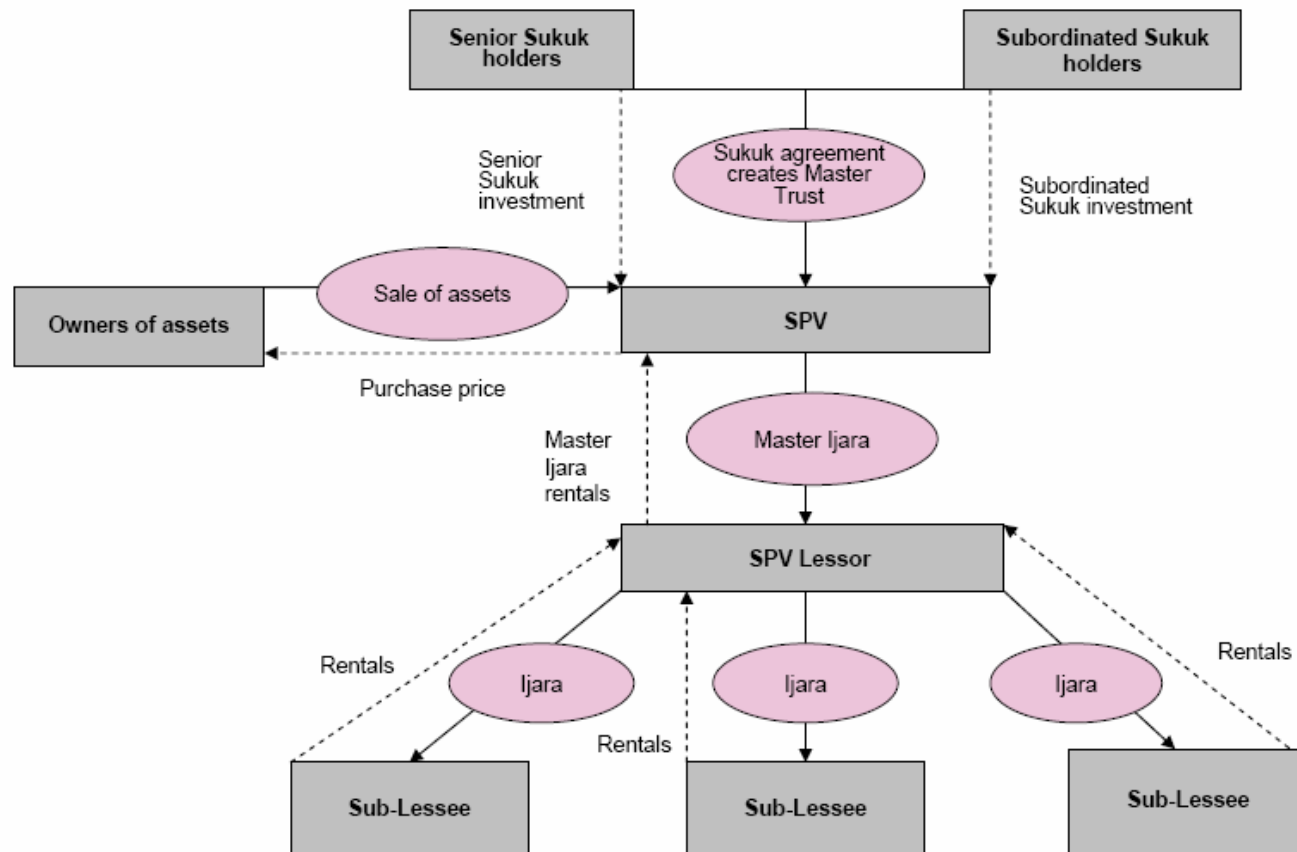
Steps involved in the structure

1. The obligator sells certain assets to the SPV at an agreed pre-determined purchase price.
2. a. The SPV raises financing by issuing Sukuk certificates in an amount equal to the purchase price.
b. This is passed on to the obligator (as seller).
3. A lease agreement is signed between SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee.
4. a. SPV receives periodic rentals from the obligator;
b. These are distributed among the investors i.e. the Sukuk holders.
5. At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the Ijara Sukuk.

Islamic leasing structure



Islamic securitisation structure



Conclusions

Ijarah of central importance in the Islamic Finance Industry

Important for domestic and the global market

Better Penetration of Ijarah would in turn create opportunities for other Islamic Financial Products to be introduced

Importance of having clearly defined regulatory framework and standards governing the industry

Dialogue and full collaboration between the key stakeholders in the industry and the economy

Knowledge Transfer and Training key to capacity building



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Thank you



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