

AN INTRODUCTION ON IJARAH LEASING DOCUMENTATION

Madzlan Hussain


ZICOLaw Partner and Head of Islamic Financial Services Practice Group

4 March 2014



An Introduction On Ijarah Leasing Documentation

Overview

- 
- What is Ijarah?
 - The definitions and core principles
 - Documentation
 - How should it be reflected in paper

Overview

Labuan Financial
Services and
Securities Act
2010 [LFSSA]

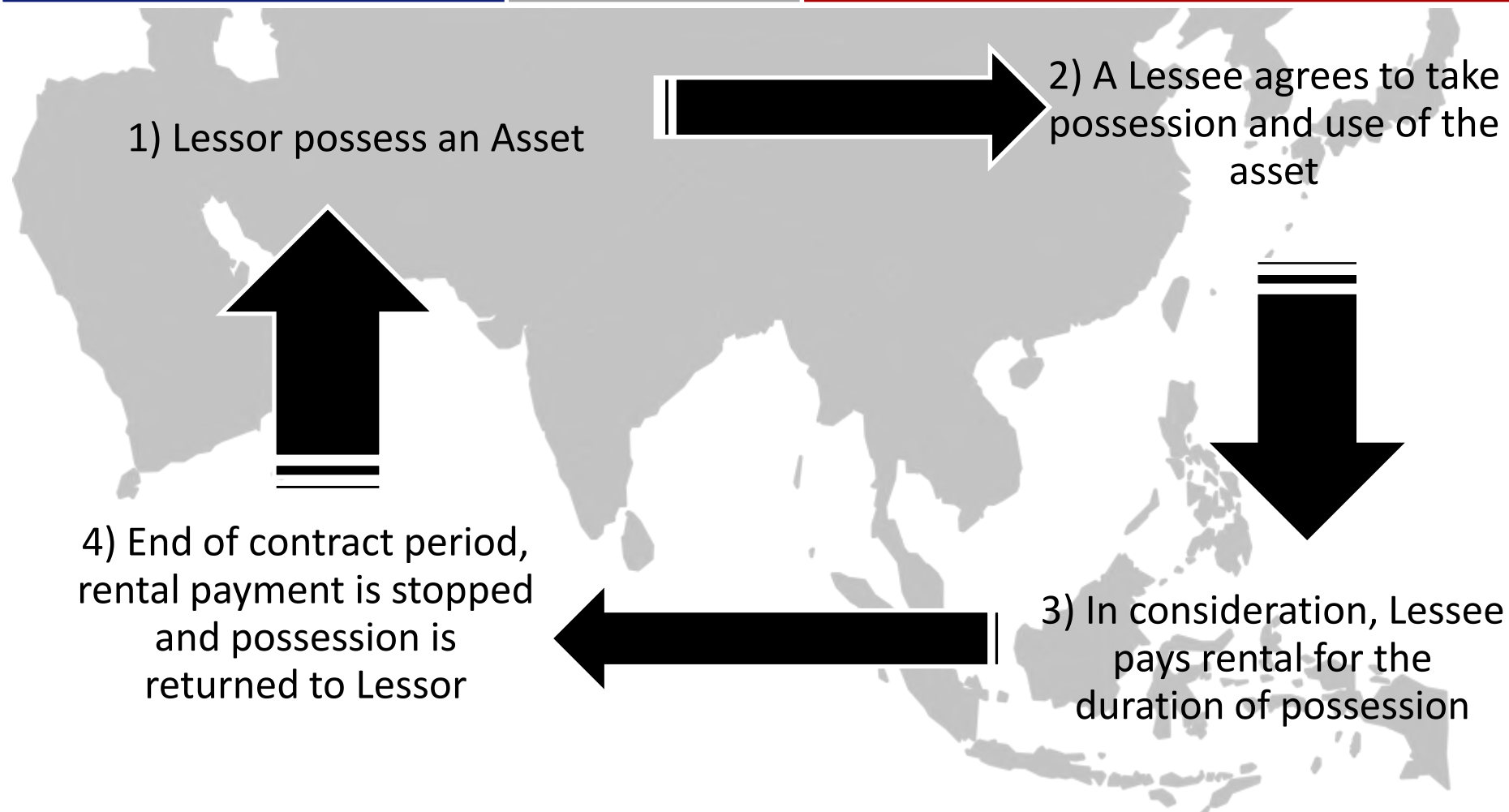
Labuan Islamic
Financial Services
and Securities Act
2010 [LIFSSA]

“Leasing
business”
and “Islamic
leasing
Business”

Overview

- Ijarah (literal. Leasing or Hiring) is a Shariah compliant arrangement where a contract is entered into to enable:
 - an asset owner to generate income (i.e. rental income) from its asset without having to depart with its rightful ownership of that asset; and
 - a customer to use/utilise/benefit from the usufruct/usefulness of an asset owned by another without having to bear the risks associated with the ownership of that asset.

Overview



Overview

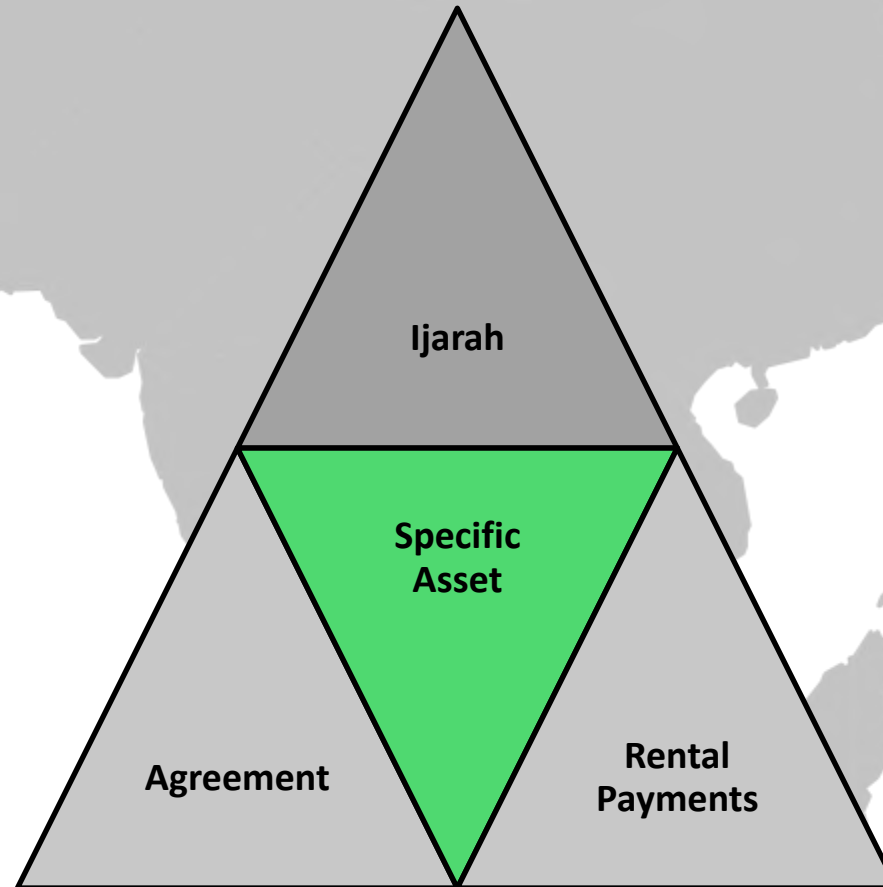
- The right to use the object is transferred to the Lessee/hirer, not its ownership. Thus, Ijarah is a sale of lawful usufruct/usefulness of the object, not of the object itself.
- Via the Shariah principle of Ijarah, it enables one to engage in *letting* or *sub-letting* assets in a Shariah compliant manner. In particular, an Ijarah contract must be free from any elements of *riba* (interest/usury), *gharar* (dubious uncertainty) and *maisir* (betting/gambling which are strictly prohibited under the Shariah).

Overview

- This expands the leasing business activity to a segment of the market that are inclined towards or committed to the adherence or Shariah rules and principles.
- Ijarah, thus can be used in various asset-based economic activities such as trade, industry, agriculture, fisheries and housing. In fact, it has been one of the most popular mode of Islamic financing by almost all Islamic Banks such as those in Malaysia, Jordan, Sudan, Qatar and even the Islamic Development Bank (IDB).

(source: Ijara Management Company, a subsidiary of The Islamic Corporation for the Development of the Private Sector (ICD))

The 3 Pillars to an Ijarah Contract



Documentation: Essence of Contract

As all contracts, including Ijarah contracts, are governed by the Contracts Act 1950, the documentation will have to comply with it to have the enforceability at law in addition to being Shariah compliant. Thus the Ijarah contract must also be:

Reciprocal of
Promises
between
contracting
parties

Given at free will
(not under fraud,
misrepresentation
or undue influence)

For a Lawful
(read: also
Shariah
compliant)
Purpose

Between parties who have proper legal capacity
to give those promises

Documentation: Lessor

Conditions for the Lessor that have to be in the Ijarah document

Rightful possession and ownership (whether legal or beneficial) **before** the Ijarah agreement is made effective

Such ownership of title comes along with the liabilities/risks associated with it such as taxation, insurance/takaful obligations, etc.

Delivery of asset to the Lessee on time for appropriate utilisation as agreed in the contract

Documentation: Lessor

The Lessor will have the right to claim compensation for any major maintenance expenses due to damage attributed to Lessee's fault or negligence

The Lessor must respect the Lessee's right to quiet possession and enjoyment in the use of the leased asset

Documentation: Lessee

Reasonable care in
usage/utilisation of the asset

Responsibility to
indemnify
Lessor for any
liability, cost or
damage caused
by Lessee's
misuse of the
asset

Conditions for the
Lessee that have to
be in the Ijarah
Document

Responsibility for
minor repairs and
preservation of
good condition,
save for normal
wear and tear

Unless stipulated
otherwise, usage as per
prescribed lawful purposes
only

For example: Shipping Ijarah



1) The Lessor must already have a ship before its commitment to deliver under the Ijarah arises

2) The Lessor is able to deliver the ship to the Lessee for use at the agreed time

3) The Lessee will use the ship with reasonable care for a fixed period

4) The Lessee will perform regular service/maintenance of the ship to ensure good condition

5) The Lessor has no right to disrupt the Lessee's lawful use of the ship in any way

6) However, if there is any serious damage to the ship during the period of the Ijarah attributed to the Lessee's fault, the Lessor has a right to claim compensation from the Lessee.

Documentation: Asset

As previously illustrated, the subject matter of an Ijarah is the lawful usufruct/usefulness. Thus, the document of Ijarah must:

Identify the object which the benefit is attached to is in existence

Identify that the object is capable of being reasonably and lawfully utilised

The benefit is legitimate under Shariah

For Example: Shipping Ijarah

The ship must exist

The purpose or the usage of the ship does not contravene the Shariah, as this will affect legality/*halalness* of the income generated



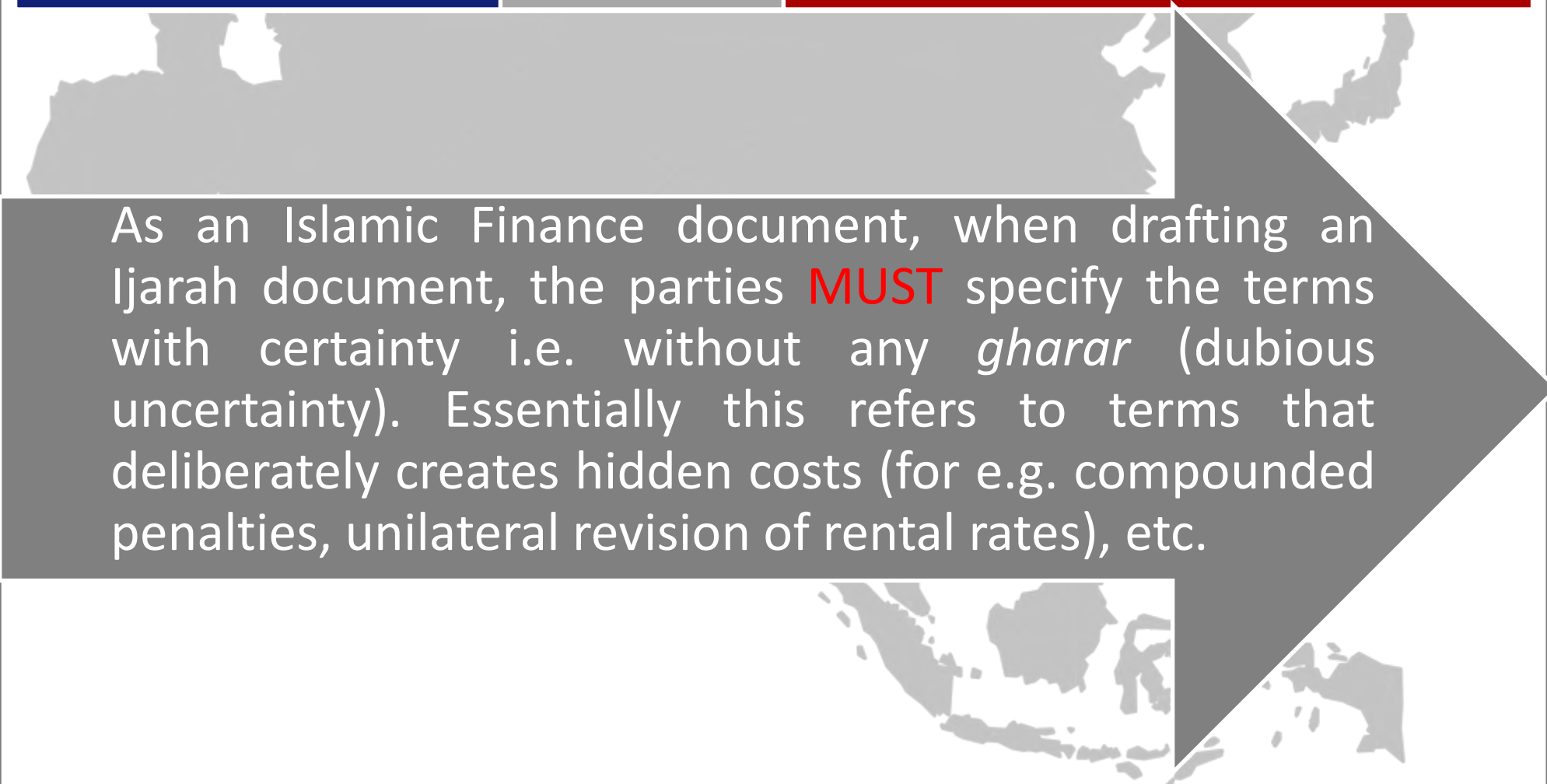
the Lessee can reasonably and lawfully use the ship

Documentation: Asset

The Documentation of the Ijarah must reflect that the leased object/asset:



Documentation: Certainty



As an Islamic Finance document, when drafting an Ijarah document, the parties **MUST** specify the terms with certainty i.e. without any *gharar* (dubious uncertainty). Essentially this refers to terms that deliberately creates hidden costs (for e.g. compounded penalties, unilateral revision of rental rates), etc.

Documentation: Certainty

The period for usage must be fixed and agreed upon



Renewal terms (if any) must be clear and agreed upon



The right to sub-lease (if any) which must not exceed the usage period or value of the current Ijarah*

* The restriction is imposed to avoid Lessee from over-leveraging on the Ijarah asset to the extent of creating artificial demand and price-hike on such asset; as such anti-competitive behaviour may deprive other genuine sub-lessees from getting a fair rental rate

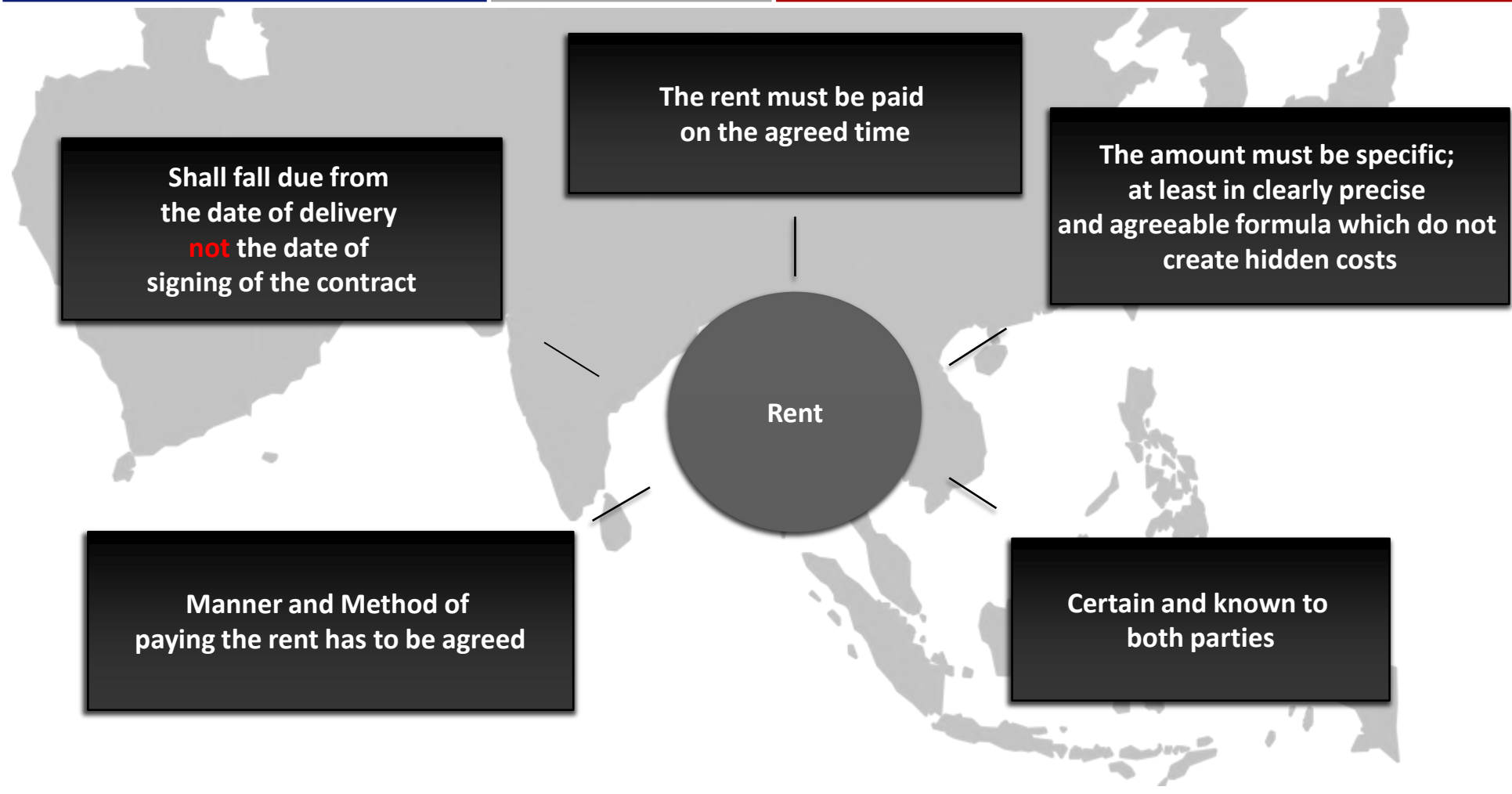
Documentation: Certainty

An important aspect of Ijarah is that it cannot involve matters of uncertainty (Gharar).

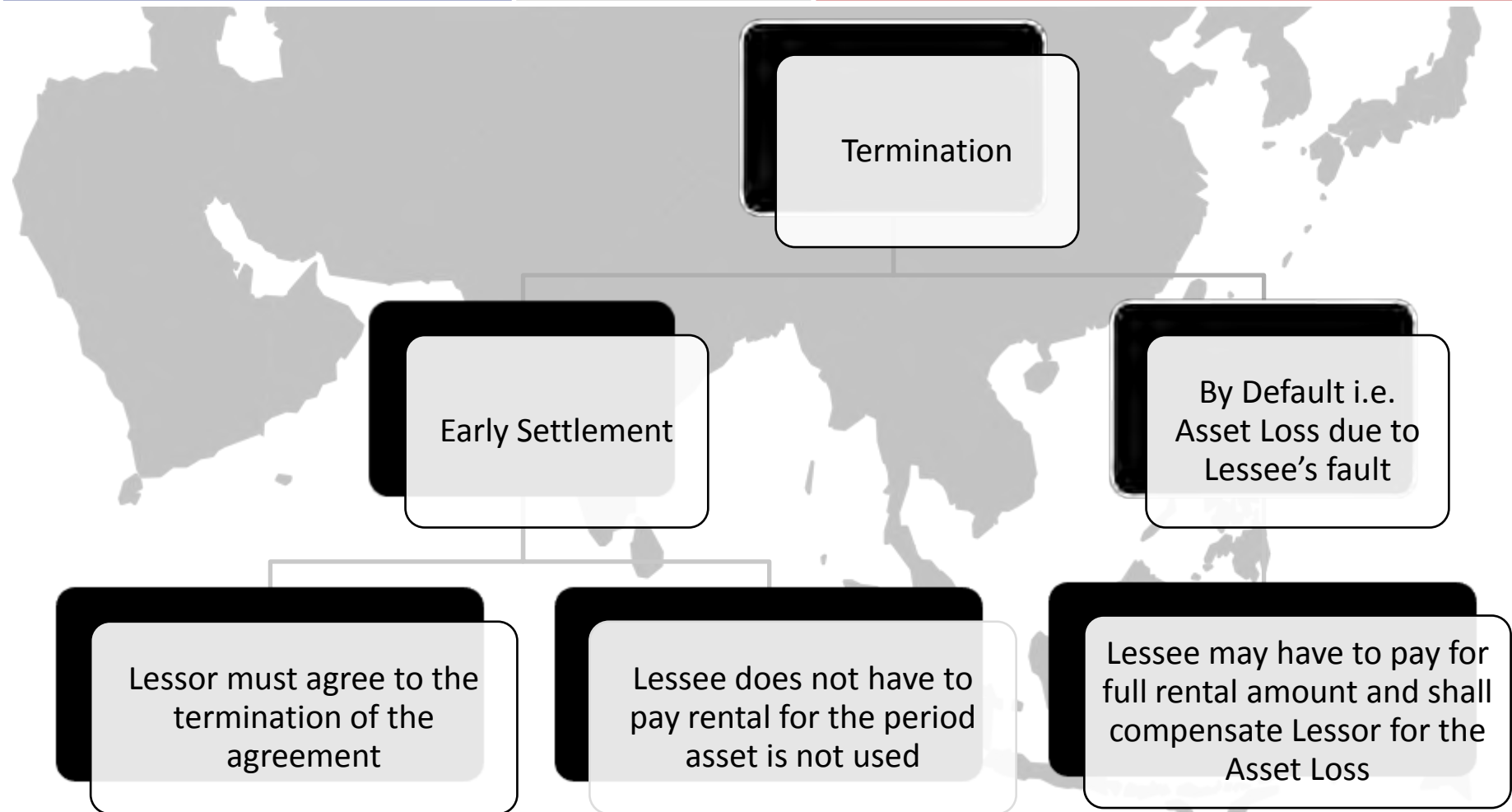
No new term can be pre-determined to take effect at the expiry of the lease (ijarah). Parties will have to enter into a new agreement to this effect

For example, at the end of the ijarah, if the party intends to continue the lease, a new agreement must be made with the price to be fixed under the new agreement.

Documentation: Rental Rates



Documentation: Termination



Documentation: Early Termination

If lease agreement was terminated prematurely at either party's request;

Lessor is entitled to rental for the period the Lessee used the property

The Lessee does not have to pay further rental and any rental paid for period asset was not used is to be returned.

The parties must mutually agree to the termination of the agreement.

Documentation: By default

* Illustration *



Not only the Lessor may keep the rent paid for lapsed usage period but also claim compensation for major repairs

The Lessee will have to pay the repairs due from the damage Lessee was faulted for but can opt to seek termination of the contract and stop rental payment

Documentation

Notwithstanding all the requirements laid out previously, Ijarah can be laid out in a document as basic as the example below:

Contents

| Clause | Page |
|---------------------------------------|------|
| 1 Definitions..... | 3 |
| 2 The Lease | 4 |
| Schedule 1 | 7 |
| BIMCO Clauses / BIMCO Documents | 7 |

The Definitions

- Will be used to reflect the meanings of the various terms that the parties use which are specific to the contract
- Such as Business day, Month, the Assets whether referred collectively or not.

The Lease Clause

- Will contain and comply with all the Ijarah principles that were laid out previously
- Such as Parties' responsibilities, the nature of the benefits, rental rate and asset, plus the lease period, etc.

Documentation

Receipt of Assets

[to confirm the Lessee has taken possession of Asset]

Promissory Note

[to be issued after signing of the Ijarah Agreement to acknowledge rental amount and promise to pay]

Evidence Documents effected pursuant to an Ijarah Contract (Optional and on Case-by-Case basis)

Undertaking to Purchase Leased Asset

[contains undertaking by Lessee to purchase the asset upon occurrence of trigger events and the Purchase Price(s)]

Undertaking for Personal Use of Ijarah Asset

Documentation

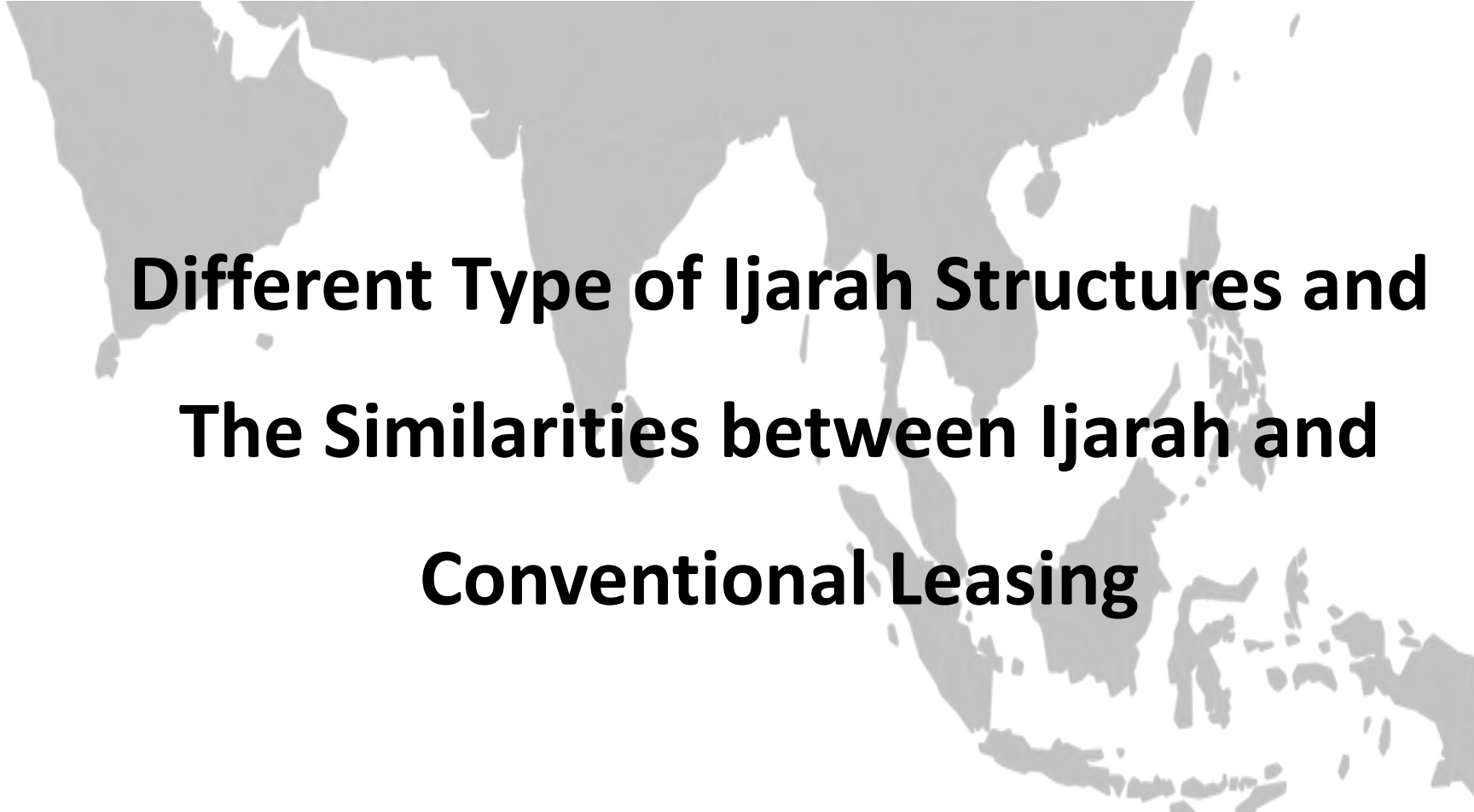
Service Agency Agreement
[where Lessee is appointed as *wakeel*
(agent) of the Lessor to carry out
required services/maintenance of the
Asset]

Assignment of Insurance or Takaful
rights attached to the Asset

**Subsidiary
instruments to an
Ijarah Contract**

Assignment of (Manufacturers')
Warranties attached to the Asset

Mortgage Document



Different Type of Ijarah Structures and The Similarities between Ijarah and Conventional Leasing

Overview

- The various forms of Ijarah
- *Ijarah Thumma al-bay* or *Ijarah Muntahiyyah Bittamlik*
- *Ijarah Mawsufah fi al-zimmah*
- Conventional Leasing
 - The Similarities of Ijarah and Conventional Leasing
 - The Differences between Ijarah and Conventional Leasing
- The value and business propositions for Islamic Leasing (vis-à-vis conventional leasing)

The Various Types



Ijarah

Ijarah Thumma
al-bay

Ijarah Mawsufah
fi al-zimmah

The Various Form (1)

- In addition to the well known simple version of Ijarah, there exist two further forms of Ijarah. The first of this is the:

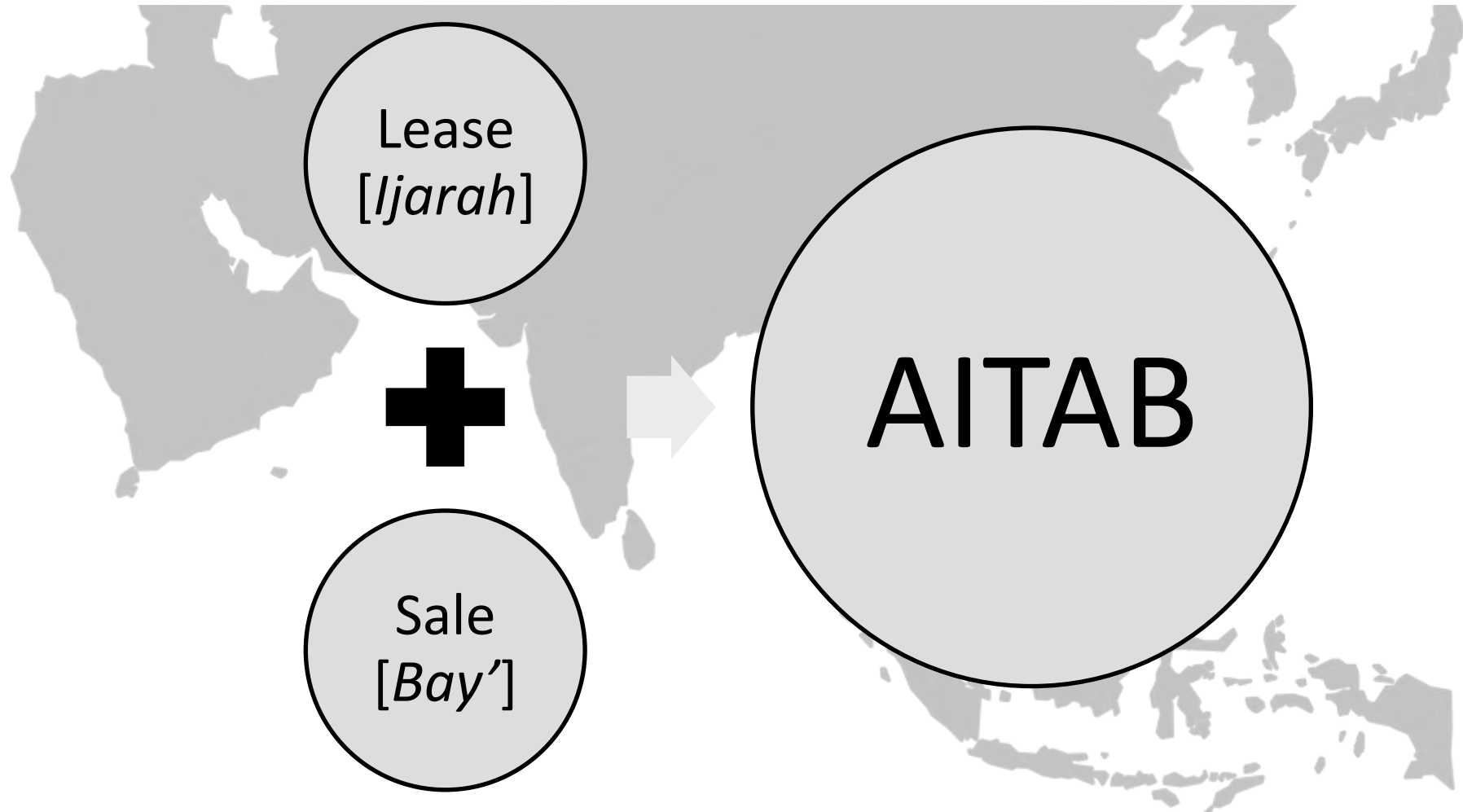
Also known as Ijarah Muntahiyyah Bittamlik

**Ijarah
Thumma
al-bay**

A form of transfer of usufruct with option to own/purchase

Option of purchase and own at the end of the lease period is executed by separate sale (*bay'*) or gift (*hibah*) contract

Ijarah Thumma al-Bay (AITAB)



Ijarah Thumma al-Bay (AITAB)

Designed to meet
current demand on
micro-financing

Most popular in
Malaysia as financing
instrument for
purchasing motor
vehicles

Very similar to
conventional hire-
purchase as governed
under the Hire Purchase
Act 1967 (“HPA”)

Transfer is affected by a
new independent
contract i.e. sale or gift

Ijarah Thumma al-Bay (AITAB)

2. Customer pays the agreed rental rate within the time period for a proportional value of the asset.

3. At the end of the agreement, purchase price of assets is paid (or transferred via gift).

Customer

Financier

1. Financier agrees to AITAB arrangement and leases the asset to the Customer.

4. Financier transfers ownership at the end of the lease agreement after agreed purchase price of the asset has been paid.

Ijarah Thumma al-Bay (AITAB)

In addition to all
the
requirements of
a regular Ijarah

An agreement to transfer ownership at
the end or during the period of rental

All rental payments and installments will
have to be paid in entirety

Transfer is affected by a new an
independent contract.

Ijarah Thumma al-Bay (AITAB)

In case the Lessor is unable to transfer the ownership of the property to the Lessee due to various circumstances

At the end of the ijarah period, despite Lessee having paid a higher rental rate to own the asset.

Lessor must review and adjust rental accordingly

All payments above normal market rental rate has to be returned to the Lessee

Before maturity date

Client is entitled to regain all payment, besides due rent, made to own the property

The Various Forms (2)

The next form of Ijarah is:

Ijarah Mawsufah Fi al-zimmah

- Also known as the forward lease

Ijarah Mawsufah fi al-zimmah

A lease on a not-yet existent/completed asset; or the asset is not ready for use

However, the asset and the benefit, will be provided in the future.

This form of Ijarah has some similarities to the *bay salam* (forward sale) and *istisna'* (manufacturing contract)

Ijarah Mawsufah fi al-zimmah

As the benefit is to be delivered in future, it is the liability of the Lessor

However the Lessee must agree to eventually see out the lease period

Thus the Lessee must pay rentals in advance until he gets to use the asset

Ijarah Mawsufah fi al-zimmah

- This type of Ijarah is primarily popular to ensure:
 - asset owner/manufacturer has access to sufficient funding to construct/manufacture/produce the asset; and
 - Customer has advanced access to such asset and able to lock-in the owner's commitment, due to scarcity/high demand for such asset
- The liquidity from the funding will facilitate the Lessor to construct/manufacture/produce the asset.
- As rental is paid in advance; the Lessor is liable to reimburse the advance payment if it fails to deliver the asset for use by Lessee within the agreed timeline.

Similarities with Conventional Leasing

Unsurprisingly, Ijarah and Conventional Leasing possesses many similarities.

Ijarah

Conventional Leasing

1. Ijarah and Conventional Leasing is usually set out in a maximum period of 7 years and have a flat fixed rate for the calculation of installments.
2. Ijarah and Conventional Lease both commonly outline similar maintenance responsibilities between the parties.
3. In Malaysia, both financing instruments are generally governed by the Contracts Act 1950 and the Hire Purchase Act 1967

Similarities with Conventional Leasing

More Similarities

Between a regular AITAB and Conventional Hire-Purchase, transfer of the asset will occur at the end of the agreement period

Both the instruments are particularly suitable for high cost assets and in respect of specialized assets

Both instruments are also open to the prospect of a sub-lease which then must not exceed the principal lease period.

The Value and Business Propositions for Islamic Leasing (vis-à-vis conventional leasing)

- Islamic Leasing expands the customer base of Islamic leasing business as it caters for and accommodates those inclined towards and committed to abiding with Shariah rules and principles.
- At the same time it is still open for customers who are merely inclined or indifferent to abiding Shariah rules, which in other words it can tap both the market of Islamic and Conventional businesses.

The Value and Business Propositions for Islamic Leasing (vis-à-vis conventional leasing)

Ijarah, being Shariah compliant, optimizes the capacity of the market to unlock the full potential of Shariah compliant assets.

Ijarah will open more doors towards the recognition and receipt of Shariah compliant income as usury/interest free income.

Ijarah portfolios can be packaged as underlying assets for Islamic securitisation - which cannot be done with other Islamic financial asset portfolios (such as *Murabahah* or *Bai Bithamin Ajil*) or with conventional instruments.



Labuan IBFC

International Business
and Financial Centre, Malaysia

Thank You

Contact Details

Madzlan Mohamad Hussain
Partner, Kuala Lumpur

Tel : Gen + 603 2087 9999
DL + 603 2087 9859
Fax : + 603 2094 4666/4888
Email : madzlan.hussain@zicolaw.com

Zaid Ibrahim & Co
a member of ZICOLaw
Level 19 Menara Milenium
Pusat Bandar Damansara
50490 Kuala Lumpur
Malaysia



Disclaimer

This presentation should not be regarded as offering a complete explanation of the matters referred to and is subject to changes in law. It is not intended to be a substitute for detailed research or the exercise of professional judgment. ZICOlaw and Labuan IBFC cannot accept any responsibility for loss occasional to any person acting or refraining from action as a result of any material in this presentation.