IJARA-BASED FINANCING

Definition of Ijara (Leasing)

✧ The term Ijara (Leasing) in Arabic literally means to give something on rent.

✧ Ijara contract is an agreement wherein a lessor (mu’ajjir) leases physical asset or property to a lessee (musta’jir) who receives the benefits associated with ownership of the asset against payment of predetermined rentals (ujrah). Ijara is for a known time period called ijara period.

✧ The contract of ijara financing can be utilized as a mode of financing to provide the customers with short to medium-term financing to lease such items which may include: real estates, buildings, equipments, machineries, computers, motor vehicles, and other acceptable (not be haraam or forbidden assets).

✧ Ijara is comparable (but not identical) to conventional leasing contract.

Similarities and Differences between Ijara and Murabaha Financing

1. Ijara, like murabaha is a debt-based financing. In both cases, the bank is not a natural owner of the asset (sold under murabaha or given in lease under ijara.) It acquires ownership upon receiving a request from its customer.

2. Similar to murabaha, the ijara rentals are also paid in installments over time to cover the cost of the asset or value of investment for the bank plus a fair return on investment.

3. In ijara, ownership of property is not transferred throughout the ijara period while the customer receives the benefits of using the asset. Risks associated with ownership of the asset remain with the bank and the asset is supposed to revert to the bank at the end of the ijara period.
In *murabaha* on the other hand, the benefits and risks of ownership of the asset are transferred to the customer along with ownership.

4. Both products involve cash outflows for customer or cash inflows for the bank over a definite future time period. The cash flows are structured in a way that cover the cost of the asset and provide for a fair return on the asset to the bank.

5. However, these cash flows are predetermined in case of *murabaha* and no subsequent increase or decrease is allowed. In case of *ijara*, however, the rentals could be flexible and be made to reflect the changing economic and business conditions as we shall see later.

**Reasons for Ijara rather than Murabaha**

◇ There are many reasons why a customer will choose *ijara* (leasing) rather than *murabaha* (borrowing) from the bank to purchase the needed asset.

For example:

1. It is easier to lease than borrow for short-term needs.
2. To avoid different types of risk
3. Ijara mostly do not require credit evaluation.
4. Gives more freedom of changing equipment as technology advances
5. Easier to get finance through leasing for companies with credit standing; these kinds of companies may not be able to borrow from banks or the public and if they do, have to pay high rate of interest.
6. In many cases, leases can be advantageous from taxing point of view. Since equipment leased remains the ownership of the lessor and hence the lessor pay the taxes.
7. In many countries, leasing is an off-balance-sheet financing. The asset itself is kept on the lessor's balance sheet, and the lessee
reports only the required rental expense for use of the asset. Companies will often use off-balance-sheet financing to keep their debt to equity (D/E) and leverage ratios low, especially if the inclusion of a large expenditure would break negative debt covenants.

SALIENT FEATURES OF THE IJARA CONTRACT

1. Asset to be leased must have a valuable use that is compliant with *Shariʿa*.
2. Asset to be leased must not be consumable. That is, it can be returned to the lessor in its original form at the end of the lease period. Normal wear and tear accepted.
3. Ownership of the asset remains with the lessor and only the usufruct is transferred to the lessee. Usufruct means the right of using another’s property for profit, without spoiling its substance.
4. Liabilities and risks incidental to ownership will reside with the lessor.
5. Period of the *ijara* arrangement must be clearly specified.
6. Purpose and mode of usage should be agreed upfront.
7. The leased asset is a trust in the hands of the lessee. Lessee liable for damage to leased asset only to the extent of the lessee’s negligence.
8. Lessee does not guarantee the safeguarding of the leased asset nor indemnifies the lessor of damages.
9. Rental payment must commence after the delivery of the leased asset either actually or constructively (e.g. give keys to house).
10. Upon loss or non-existence of usufruct, the *ijara* contract is terminated.
TYPES OF IJARA ARRANGEMENTS

✧ In conventional leasing, there are two types of leases
  ○ Operating lease – where the lessor owns the asset and bears maintenance costs as well as ownership risks
  ○ Financial lease – where the lessor only “technically” owns the asset, maintenance costs and ownership risks are borne by the lessee

✧ In Islamic finance, there are many types of Ijara financing arrangements:

I. Simple Ijara (Operating Lease)

✧ Simple *ijara* that is not tied with a purchase agreement is more commonly known as operating lease. Such transactions are suitable for expensive assets such as ships, aircraft, and heavy-duty industrial and agricultural equipment. This type of lease is also called a service lease, or a true lease. It is a short-term arrangement.

✧ The full cost of the equipment or property is not amortized during the primary lease period.

✧ The lessee may cancel the lease any time he wishes to do so, with a prior notice according to the contract.

✧ In an *Ijara*, the title of the equipment or property always remains with the lessor irrespective of how much the lessee has paid out as lease installments. Consequently, the risks and responsibilities of ownership are always borne by the lessor.

✧ In this type *ijara*, ownership of the asset remains with the lessor (bank), the asset reverts to the bank at the end of the lease period. The bank may then lease it out to another customer if the asset is in good shape.

✧ This type of *ijara* can be presented in one of the following three structures
  1. The simplest form of *ijara* involves the bank as the owner of an
asset and leasing it out to its customer against predetermined rentals for an agreed period of time. The identity of the bank is same as that of the vendor of the asset. From an Islamic point of view, this is the most ideal type of *ijara* as it conforms entirely to features of the classical *ijara*. However, this is also the least common and the least popular structure. An Islamic bank usually does not deal in a variety of physical assets.

2. In real life, usually there is an involvement of a vendor in the process. In this structure, there are two distinct phases in the arrangement. In phase one, the bank purchases the asset needed by its customer from the vendor. In phase two, the bank as owner of the asset leases out the same to its customer against predetermined rentals for an agreed period of time.

3. Another possible scenario is when the bank would not like to deal directly with the vendor in connection with the first purchase/sale of the item. The bank here appoints the customer as its agent. In this case, there are two separate sets of relationships between the bank and its customer. In the first instance, the customer is an agent of the bank in respect of purchase of the asset on behalf of the bank. The second stage begins from the date when the customer takes delivery from the supplier. At this stage, the relation of lessor and lessee comes into existence. These two capacities of the parties should not be mixed up or confused with each other.

◊ The simple three-party financing process with the customer as an agent is presented below. The other two structures are the same with necessary modifications.

1. There is an agreement of mutual promise between Bank and Customer whereby the Bank promises to lease and the Customer promises to take on lease the asset against
predetermined rentals for a definite time period;
2. Bank appoints Customer as its Agent;
3. Customer identifies the vendor, selects the asset on behalf of the bank and advises its particulars, including the vendor's name and its purchase price to the bank in writing;
4. Vendor makes physical delivery of asset to Agent (Customer) of Bank; trained staff from bank oversee the process of customer taking physical possession of asset;
5. Bank makes arrangement for payment of purchase price to Vendor;
6. The agency contract comes to an end; Bank leases the asset on the basis of the agreement of mutual promise, transfers possession and right of specified use to Customer;
7. Customer pays known rentals over future (known) time period(s).
8. Asset reverts back to Bank.

II. Ijara-thumma-al-Bay' (Lease-sale) or (Financial Lease)

✧ Businesses often require financing to purchase machinery, equipment, other fixed assets and land and buildings
✧ To address this need, Islamic financial institutions have resorted to a type of *ijara* contract which is loosely comparable to the conventional financial lease
✧ In *ijara*-thumma-al-Bay' (lease-sale), or as some call it "*Ijara-wa-Iktina'a*" or “*Ijara muntahiea bitamleek*”, the lessee is offered the option of ultimately purchasing the asset or property at the end of *ijara* period at a predetermined price.
✧ The basic idea is for the bank to finance the purchase of an asset via a leasing arrangement and at the end of lease period, ownership of the asset is transferred to the customer
In this type of *ijara*, the full cost of the asset or property is amortized during the lease period; that is why it is called by some as "full payment lease"

This type of leasing cannot be canceled except if the lessor is compensated for any losses.

*Ijara-thumma-al-Bay'* cannot be constructed to imply that it is a combination of two different contracts.; that is, it is not a leasing (*ijara*) contract with a condition to sell. Rather, it involves two different contracts to be executed at two different stages. First contract is a leasing contract (*ijara*) with a unilateral promise (*wa’ad*) to sell the asset to the customer at a predetermined price. Once the lease expires and lessee has made all payments, the lessor is obliged to fulfill his promise to sell by executing the contract of sale (*bay’*).

Such a promise is made as an additional agreement to the main *ijara* agreement. From the standpoint of the customer, such promise may be seen as an option to purchase the asset at the end of the lease period. Since an option is a right without obligation, by implication, the unilateral promise must be binding on the bank.

Note that the sale contract is independent of the *ijara* contract.

In an *ijara*-thumma-al-Bay', the bank remains the owner till the very end bearing all the risks and responsibilities, and the customer is responsible for only the rentals as long as he uses the equipment or property. He becomes the owner only if, and when, he exercises his option to purchase at the end of the period.

The financing process of *ijara*-thumma-al-Bay' is the same as the process mentioned above except point 8 where now the bank transfers the ownership of asset to customer at the end of *Ijara* period.
III. Ijara with Musharaka or Mudharaba

- Another method of ijara ending with transfer of ownership to the customer is provided by a combination of ijara with partnership (based on musharaka or mudharaba).
- This structure is quite common in housing finance, where the bank and its customer enter into a partnership specifically formed to finance the acquisition of the property that the customer is interested in.
- The bank and the customer contribute to the equity of the partnership in a certain ratio. Nevertheless, the bank acts as the agent-manager of the partnership.
- The partnership then purchases the property and leases it to the customer against known periodic rentals.
- The proportion of rental accruing to customer is used to redeem part of the bank’s stake in the property. This results in a decrease in the bank’s stake over time.
- Eventually, the bank’s stake in the property reduces to zero and the customer becomes the full owner of the property.
- The mechanism that uses diminishing musharaka or mudharaba in combination with ijara is a recent innovation in Islamic banking and finance.

IV. Sale-and lease back

- While in murabaha the identity of the vendor has to be different from that of the customer. This constraint is not relevant in the context of ijara.
- In a sale-and-lease-back arrangement the customer may sell an asset that it owns, to the bank for a price and then take it back on lease.
- The result is an immediate cash inflow for the customer (in the form of sale price of the asset). The customer continues to use the asset in lieu of periodic ijara rentals paid to the bank, which now owns the asset.
- The process of a sale-and lease-back is presented as follows
1. Customer sells an asset it owns to Bank on cash basis;
   (Possession of the asset remains with the Customer while
   ownership papers are transferred to the Bank)
2. Customer enters into an *ijara* contract with Bank for the same
   asset;
3. Customer pays known rentals over future (known) time
   period(s).
4. Bank transfers ownership of asset to customer at the end of
   *ijara* period either through gift or sale.

IMPLEMENTATION ISSUES IN IJARA FINANCING

Risk and Return

✧ As discussed earlier in the context of *murabaha*, it is very important for
the bank to bear a certain amount of risk in order that its profits are
deemed legitimate in the eyes of *Shari'a*. All the risk and liabilities
emerging from the ownership of the asset are to be borne by the lessor
(bank) while the liabilities arising from the use of the leased assets are to
be borne by the lessee (customer).

✧ In Islamic leasing or *ijara*, the leased asset remains in the risk of the lessor
throughout the *ijara* period, in the sense that any loss, damage or loss
caused by the factors beyond the control of the lessee shall be borne by the
lessor.

✧ The lessor has to bear two types of risk

  o **Market risk**: In a true leasing business, the lessor acquires the lease
    asset prior to securing any leasing contracts. Thus the lease asset is
    subject to price risk, the risk that the lessor is not able to profitably
    lease out the asset
Operational risk: Maintenance costs can sometimes exceed rental income thereby resulting in a loss to the lessor

Hence, from a Shari’a perspective, one critical factor in determining the permissibility of any ijara arrangement is whether the lessor actually bears risks expected of a true lessor (ownership risks and maintenance costs)

Specific risks of the lessor relating to the physical damage, theft and/or loss on destruction of the leased asset may be covered by Islamic insurance or takaful. The lessor (bank) may include the cost of takaful premium in the ijara rental. Any escalation in the takaful premium may also trigger rent adjustment if it is specified in the ijara.

Recourse to takaful is permissible as it involves risk sharing as opposed to risk transfer in conventional insurance system.

It has been observed that some Islamic banks may go for conventional insurance that involves complete transfer of risk to the insurance company and at the same time include the insurance costs in the ijara rentals. The result is risk-less cash flows for the bank. Needless to say, such whole-scale risk transfer is not permissible and brings its returns dangerously close to riba.

Gharar in Contractual Structure

Standard texts of fiqh mention about inadmissibility of “two contracts in one” on the grounds of excessive gharar. This essentially stresses the need to avoid unduly complex contractual mechanisms and structures involving multiple interdependent and interrelated contracts. Combining several contracts such as adding a sale contract to the original ijara contract or stipulating options in the ijara contract may cause the complexity.

There are divergent views in this regard. Arguably, in a structure where the sale or option (promise) is in the nature of a separate or side agreement, not linked to the ijara agreement, there is no room for gharar caused by interdependence.
However, a sale contract that is now added to the original *ijara* transforms it into a highly controversial mechanism. The sale agreement is essentially a forward agreement, if it involves a mutual promise by both bank and its customer to sell and buy respectively in future. Classical jurists have always objected to forward agreements on various fiqh grounds including the involvement of excessive gharar. Unilateral promises, as distinct from mutual promises, have more general acceptance. There is however, lesser agreement on whether the promise is binding on the promisor (bank). When it is binding, it takes the form of a financial option for the promisee-customer.

**Forward Ijara**

- We know by now that forward sales are prohibited under *Shari'a* law but on the other hand, forward agreements in *ijara* are acceptable. *Ijara* for a future date is allowed given that the rent will be paid only after the asset is delivered to the customer.

**Fixed and Floating Rates**

- In *ijara*, the leasing rate or the rental must be known at the time of contracting. The rates must be predetermined for the whole period of *ijara*.
- However, since it is risky for banks and financial institutions to set a fixed rent for the whole period due to the volatility of market conditions it is possible to divide the *ijara* period into several smaller intervals with varying but predetermined rates. Thus, a floating rate *ijara* is admissible provided such a rate for each of the phases is specially agreed upon at the time of affecting an *ijara*.
- Another option also available for the bank or financial institution is to set a short-term *Ijara* contract that may be renewed. Both parties are not obliged to accept the new terms and have the freedom to refuse the new contract.
Floating rate *ijara* may be desirable considering the changing market and economic conditions, especially if the *ijara* period is relatively long. Floating rate *ijara* may be made possible by inserting a rent adjustment clause in the *ijara* contract. The rate adjustment may be in the nature of a specified rent escalation at the end of an interval of say, six months or one year; or may be indexed to a macroeconomic indicator, such as, consumer price index (CPI) or even a benchmark interest rate, such as, the London Inter Bank Offering Rate (LIBOR).

More important however, is the possible existence of prohibited excessive gharar in the contract due to indeterminateness of the leasing rate at the time of contracting, since the value of index cannot be predicted in advance.

**Default Risk and its Mitigation**

- *Ijara* rental, like *murabaha* installment becomes a debt on the customer after it becomes due. Therefore, it is subject to all the rules prescribed for defaults and delinquencies in repayment of debt. We have discussed the problem in the context of *murabaha* before. The solution is similar too.
- The bank or financial institution is not allowed to charge the customer an additional amount in case of delays in payment of the rentals since it is considered Riba. As a result, Islamic scholars have found a solution in order to prevent consequences resulting from the misuse of this prohibition. They suggested that the customer could be asked to pay a certain amount to charity.
- The charity amount may vary according to the period of default, and may be calculated at percent per annum basis.

**Nature of Asset**

- It is important to note that *ijara* is permissible only in case of a certain category of assets. Money and consumables are not leasable assets.
If money or consumables are leased, such contract will be deemed to be a loan and subject to rules of riba.

The leased asset must be specified and identified by the parties.

**Asset Securitization**
- Since the lessor owns the leased asset, he can sell the asset (whole or part) to a third party and may replace the seller in the rights and obligation of the lessor with regard to the purchased part of the asset.

**Termination of Ijara**
- If the lessee breaches any term of the agreement, the lessor has the right to terminate the *ijara* contract unilaterally.
- However, if there is no breach on the part of the lessee, the *ijara* cannot be terminated without mutual consent.
- Conventional financial leases at times provide for an option for the lessor to terminate the lease unilaterally. *Ijara* on the other hand, allows for stipulating an option for either or both the parties to confirm or rescind the contract. Such stipulated option is valid for a specified option period under the framework of al-khiyar.
- However, in a conventional lease, in case of termination of the lease, even at the option of the lessor, the rental for the remaining time periods becomes due on the lessee. This is not permissible in case of *ijara*. A logical consequence of termination of *ijara* is that the asset reverts back to the lessor. The lessee is required to pay rental as due up to the date of termination.
- If the termination has been affected due to the misuse or negligence on the part of the lessee, he may also be asked to compensate the lessor for the loss caused by such misuse or negligence.