

## Case Study 1: *Ijara* Contract

### 1.1 LEARNING OUTCOMES

After working through Case Study 1 you should be able to do the following:

- Define the *Ijara* contract.
- Define the *Ijara wa Iqtina* contract.
- Distinguish a conventional loan from *Ijara*.
- Describe the elements of an *Ijara* transaction.
- Contrast *Ijara* with the other modes of Islamic finance.
- Identify the reasoning behind the *Sharia*'a rulings on *Ijara*.
- Describe the different forms of *Ijara*.
- Explain the practicalities of implementing *Ijara*.
- Identify the Arabic terminology used in *Ijara*.
- Describe the *Sharia*'a rulings on *Ijara*.
- Contrast conventional leasing with Islamic leasing.
- Explain the role that interest can play within an *Ijara* transaction.
- Identify problems associated with applying *Ijara*.
- Explain the importance of deferred sales within Islamic finance.
- Contrast the role of penalty defaults within conventional and Islamic finance.
- Explain how *Ijara* can be used for home finance.
- Define LIBOR and explain its application with an *Ijara* contract.
- Identify the deferred sale versus profit and loss share contracts.
- Test that you have fully understood the principles that underlie the *Ijara* contract.

### 1.2 ROLE OF *IJARA* IN ISLAMIC FINANCE

Those who take *riba* (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch.

*Qur'an Sura 2: 275–280*

#### Case Abstract

*Ijara* is an Arabic term, with origins in Islamic *Fiqh*, meaning to give something to rent. Leasing is a contract whereby usufruct rights to an asset are transferred by the owner, known as the lessor, to another person, known as the lessee, at an agreed-upon price, called the rent, and for an agreed-upon period of time, called the term of the lease. This case study describes the rationale and application of the *Ijara* financing technique. The example provided is that of car finance but it could have equally well have been applied to any physical capital asset used in business.

### 1.3 THE *IJARA* CONTRACT AS A MODE OF ISLAMIC FINANCE

#### 1.3.1 What is The *Ijara* Contract?

*Ijara* is an Islamic mode of finance adopted by Islamic banks. *Ijara* (leasing) is a medium to long-term method of financing capital equipment or property. Under this contract, the customer selects the capital equipment or property (assets) to be financed by the bank and the bank then purchases these assets from the manufacturer or supplier and then leases them to the customer for an agreed period.

In conformity with the *Sharia'a*, the owner of the assets (in this case the bank) must be paid rent (fixed or variable, as agreed by the lessor and lessee) and must exercise all the rights and obligations that are incidental to ownership such as maintaining, insuring and repairing the assets.

The lessee, on the other hand, obtains the use of the asset for the period of the lease subject to paying the rent. The lessee may assume the obligations, such as maintaining, insuring and repairing the asset, in return for a reduced rent.

#### 1.3.2 What is Car *Ijara*?

As mentioned above *Ijara* is basically the transfer of usufruct (defined below) of a fixed asset to another person for an agreed period, for an agreed consideration. Under a Car *Ijara* agreement the car will be rented to the customer for the period agreed at the time of contract. Upon completion of the lease period the customer in the Meezan case discussed below, gets ownership of the car against his initial security deposit.

Car *Ijara* is a *Sharia'a*-compliant car-leasing scheme. It is based on the principles of *Ijara* and is completely free from the element of interest. This product is designed for interest-averse individuals, looking for a car-financing scheme that helps in avoiding interest-based transactions. So Car *Ijara* is simply a rental agreement under which the car will be given to the customer in exchange for rent for a period, agreed at the time of the contract.

Meezan Bank, based in Pakistan and a pioneer in this area, purchases the car and rents it out to the customer for a period of three, four or five years. Upon completion of the lease period the customer gets ownership of the car against his initial security deposit.

Somewhat confusingly, the Meezan Car *Ijara* scheme has elements of *Ijara wa Iqtina* within it. In this case study I propose to follow the Meezan assumption in using *Ijara* in the sense that it involves car ownership at the end of the maturity of the deal. This is in line with *Sharia'a* methodology and terminology.

##### 1.3.2.1 What is *Usufruct*?

*Usufruct* is the right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility and advantage that it may produce, provided it be without altering the substance of the thing. Items without usufruct cannot be leased. It is necessary for a valid lease contract that the corpus of the leased asset remains in the ownership of the seller, and only its usufruct is transferred to the lessee.

#### 1.3.3 In what Sense is Car *Ijara* Interest Free?

In Car *Ijara*, the asset remains under the ownership and at the risk of the bank and the customer only pays the rental for the use of the asset, just like the rent of a house.

Under leasing or lease purchase, the Islamic financial institution buys the financed asset and retains the title through the life of the contract. The customer makes a series of lease payments over a specified period of time, and may have the option at the end to buy the item from the lessor (and owner) at a pre specified residual value.

Leasing was not originally a mode of financing. It was simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period and an agreed upon consideration. Leasing can be used as a mode of financing, in Islamic banks, as an alternative to conventional car financing. However, the consideration of leasing as a mode of financing should be based on certain conditions. It should be understood, by all using it as a mode of financing, that it is not sufficient to substitute the term 'interest' with the term 'rent', and use the term 'mortgage' instead of the term 'leased asset'. There must be a significant difference between leasing and an interest-bearing loan.

It is no secret that an Islamic bank or financial institution will take into consideration the same factors as a conventional bank when determining the rental payments and residual value. These would include the rate of inflation, the creditworthiness of the lessee, the opportunity cost value of the money (as reflected by market interest rates) and so on. An implicit 'interest rate' can trivially be calculated from the price, residual value, term of the lease and the lease payment. This fact is not hidden. Indeed Muslim customers are encouraged to 'shop around' and ensure that the Islamic financial institution is not implicitly charging an interest rate, which is in line with the conventional market.

In the final analysis, however, the difference is in the form of the contract. If the lease is structured in accordance with the various conditions within Islamic jurisprudence, it will contract no *riba* and ensure that it cannot contain such forbidden *riba* in the future (e. g., in terms of late payment fees, etc.).

### **1.3.4 What is the Difference between a Conventional Lease and an Islamic Lease?**

The most important financial difference between Islamic leasing and conventional leasing is that, with Islamic leasing, the leasing agency must own the leased object for the duration of the lease. Therefore, although leasing a car from a car manufacturer or car dealership may in principle be permitted for Muslims (if the contract satisfies the other conditions), Muslims should investigate further. In many cases, the car dealership may in fact use a bank or other financial intermediary to provide a loan for the present value of lease payments, and charge the customer interest on this loan. This would constitute the forbidden *riba*.

Scrupulous Islamic financial institutions ensure that the contract abides by all the restrictions set out in the *Sharia'a* (e. g., subleasing requires the permission of the lessor; late payment penalties must be handled very carefully to avoid *riba*, etc.).

The differences between conventional and Islamic financing schemes are described in the sections below.

#### ***1.3.4.1 Leasing versus Conventional Financing***

##### ***Conventional Financing***

The conventional financing schemes provide financing for purchasing a car; that is, in essence the financier is giving a loan and charging interest.

### *Islamic Financing*

The Islamic car financing – *Ijara* – is based on a lease contract. It is not a financing scheme; rather it is a lease contract. As mentioned earlier leasing is a contract whereby usufruct rights to an asset are transferred by the owner, known as the lessor, to another person, known as the lessee, at an agreed-upon price, called the rent, and for an agreed-upon period of time, called the term of lease.

#### **1.3.4.2 Rentals versus Instalments**

##### *Conventional Financing*

A conventional car financing scheme is actually an interest-based loan given by the financial institution, with interest being charged on the loan.

##### *Islamic Financing*

Islamic car financing is based on pure rentals. In Car *Ijara* the asset remains at the ownership and risk of the bank and the customer only pays the rental for use of the asset, just like the rent for a house.

#### **1.3.4.3 Ownership**

##### *Conventional Financing*

In conventional car financing, the car is purchased in the name of the buyer from the dealer.

##### *Islamic Financing*

Under *Ijara* the ownership remains with the bank; that is, the car is purchased from the dealer in the name of the bank. This is because it is one of the foremost conditions of the Islamic mode of leasing that an object cannot be leased out unless it is in the possession of the lessor.

#### **1.3.4.4 Risk/loss**

##### *Conventional Financing*

Since the car is bought in the name of the buyer in the traditional mode of car financing, the risk is immediately transferred to the buyer, whereas in the case of Islamic financing, this is not so.

##### *Islamic Financing*

The car is purchased in the name of the bank from the dealer and so the risk remains entirely with the bank. As the corpus of the leased property remains in the ownership of the lessor, all the liabilities and risks emerging from the ownership are borne by the lessor.

The lessee is responsible for any loss caused to the asset by misuse or negligence. The lessee can also be made liable for the wear and tear, which normally occurs during its use. But the lessee cannot be made liable for a loss caused by factors beyond his control. (The agreements

with traditional car financing generally do not differentiate between these two situations.) In a lease based on Islamic principles, both situations should be dealt with separately.

#### **1.3.4.5 Down-Payment versus Security Deposit**

##### *Conventional Financing*

Both the down-payment and the security deposit are one-time payments. The major difference occurs because the buyer can buy back the car against the security deposit in the case of *Ijara*, whereas in conventional banking the down-payment remains with the bank, and no buy-back of the car can occur against the down-payment.

##### *Islamic Financing*

With *Ijara* the buyer is required to keep a security deposit at the bank. There is a minimum and a maximum requirement for the security deposit. The requirement is different in the case of conventional car financing, where a down-payment is made by the buyer of the car.

#### **1.3.4.6 Return of the Car**

##### *Conventional Financing*

In a traditional car financing scheme, the customer takes out a loan to purchase the car, which he cannot return under any circumstances whatsoever, unless he pays off the loan.

##### *Islamic Financing*

In the Islamic mode of financing, the buyer has the right to return the car anytime during or at the end of the lease period. Since this is a lease agreement, and the lessee has been paying rentals, he can return the car to the bank and take back the security deposit any time he wishes.

#### **1.3.4.7 Termination of Contract**

The buyer of the car has the option and right to terminate the contract and return the car before the contract reaches its maturity in both the conventional and Islamic mode of car financing. The difference lies in the post-termination phase.

##### *Conventional Financing*

In the conventional car financing scheme, if the customer wants to terminate the contract the only option he has is to buy the car by paying the rest of the instalments.

##### *Islamic Financing*

In the Islamic car financing scheme, the customer has two options: either return the car and get back the security deposit or buy the car from the bank at the market value plus a certain percentage of spread for the bank.

### **1.3.4.8 Documentation Differences**

#### *Sequence/process*

Islam considers the procedure in which any transaction takes place as a significant factor in all modes of financing. The underlying difference between the Islamic and conventional modes of financing is that of the process. To Muslims, not only the end result but also the means to it are important.

If the result is correct and the steps are wrong, or vice versa, the entire process is deemed invalid, from a *Sharia'a* perspective. According to *Sharia'a* principles, lawful steps to lawful results are very important.

The most important financial difference between Islamic permitted leasing and conventional financial leasing is that the leasing agency must own the leased object for the duration of the lease. Ownership of the asset is the prerequisite for leasing out its usufruct. As mentioned, Islam places great emphasis on the sequencing.

### **1.3.5 The Meezan Bank Car Ijara Scheme**

Meezan Bank's Car *Ijara* has been designed according to the principles of Islam and is completely interest-free. Moreover the *Ijara* contract and other documentation also comply with *Sharia'a* requirements. In contrast, a conventional car financing scheme is actually an interest-based loan given by the financial institution with interest being charged on the loan. Also, in conventional car-leasing schemes, the lease contract is not in compliance with *Sharia'a* law and has *riba* and other un-Islamic elements in it.

#### **1.3.5.1 What Makes Car Ijara Unique?**

Some of the key characteristics of the Meezan Car *Ijara* are described in the following sections.

#### *Rights and Liabilities of Owner Versus User*

*Ijara* is an asset-based contract, that is, the lessor should have ownership of the asset during the life of the contract. Under *Sharia'a* law all ownership-related rights and liabilities should lie with the owners while all usage-related rights and liabilities should lie with the user.

A conventional lease contract does not distinguish between the nature of these liabilities and dumps all liabilities on the user. This is not permitted under the *Sharia'a*. Under *Ijara* all ownership-related risks lie with the bank and all usage related links lie with the user, thus making the lessor the true owner of the asset and making the income generated through the contract permissible (*halal*) for the Islamic bank.

#### *Continuation of Lease Rentals in the Case of Total Loss or Theft of Vehicle*

If the leased vehicle is stolen or completely destroyed the conventional leasing company would continue charging the lease holder rent until the settlement of the insurance claim. Under the Islamic system, however, rent is consideration for usage of the leased asset and, if the asset has been stolen or destroyed, the concept of rental becomes void. As such, in the above-mentioned eventualities, Meezan Bank does not charge the lease rental.

#### *Is there a Penalty for Late Payment of Rent? If so How is This Permissible Under the Sharia'a?*

In most conventional financial leases an extra monetary amount is charged if rent is not paid on time. This extra amount is considered as *riba* under the *Sharia'a* and is distinctly forbidden

(*haram*). The lessee may be asked to undertake that if he fails to pay rent on its due date, he will pay a certain amount to a charity that will be administered through the bank. For this purpose Meezan Bank maintains a charity fund where such amounts may be credited and disbursed for charitable purposes.

*What is the Insurance Arrangement under Car Ijara?*

Being the owner of the car, the bank will be responsible for insurance of the car and for paying the insurance premium. If *Takaful* (Islamic insurance) is not available, the insurance is done under the conventional system.

*Can the User Buy the Car Prior to the Termination of Rental Agreement?*

Yes. The rental agreement contains the purchase price schedule.

*Is the Product Approved by Meezan Bank's Sharia'a Board*

Yes. Car *Ijara* is designed under the supervision of Meezan Bank's *Sharia'a* Supervisory Board and is approved by the Board.

In order for any Islamic financing technique to be acceptable to the Islamic community it has to be endorsed by the appropriate *Sharia'a* Board who will provide a *Fatwa* (a religious ruling). The appendix to this case illustrates the *Fatwa* applicable to the Meezan Bank Car *Ijara* agreement.

*How do you Calculate the Rent on a New Car?*

To calculate the monthly rentals simply multiply the cost of the car with the factors given in Table 1.1.

For example if a customer is interested in a new car costing Rs. 300,000 for a tenure of five years and is willing to pay a 50% security deposit, the monthly rental would be  $\text{Rs. } 300,000 \times 0.014067 = \text{Rs. } 4220$  per month for five years.

*What if the Customer Wants to Buy a Second Hand Car?*

If a customer is interested in a car costing Rs. 300,000 for a tenure of five years and is willing to pay a 50% security deposit, the monthly rental can be calculated from Table 1.2. The monthly rental would be  $\text{Rs. } 300,000 \times 0.014230 = \text{Rs. } 4261$  per month for five years.

Table 1.3 demonstrates the difference between a Car *Ijara* and a conventional car lease.

**Table 1.1** Rental calculation for new cars

Security deposit (%)	3 years	4 years	5 years
15	0.030399	0.024789	0.021590
20	0.028821	0.023533	0.020515
25	0.027242	0.022277	0.019440
30	0.025664	0.021021	0.018366
35	0.024085	0.019765	0.017291
40	0.022507	0.018508	0.016216
45	0.020929	0.017252	0.015142
50	0.019350	0.015996	0.014067

Source: Meezan Bank

**Table 1.2** Rental calculation for used cars

Security deposit (%)	3 years	4 years	5 years
20	0.029412	0.023940	0.020726
25	0.027799	0.022660	0.019639
30	0.026186	0.021379	0.018552
35	0.024572	0.020099	0.017465
40	0.022959	0.018819	0.016378
45	0.021346	0.017539	0.015290
50	0.019732	0.016259	0.014230

Source: Meezan Bank

**Table 1.3** Difference between Car *Ijara* and a conventional lease

Conventional car leasing systems	Meezan Bank's Car <i>Ijara</i>
There are two types of contracts: a financing lease and a loan for car financing. Both of the contracts contain conditions that are not acceptable under the <i>Sharia'a</i>	The <i>Ijara</i> contract is binding under the <i>Sharia'a</i> and does not contain any conditions that make the contract void.
Financing leases contain conditions of hire purchase, which is not permissible under the <i>Sharia'a</i> . This makes the whole contract void.	
Car financing under a loan agreement contains conditions of interest. Interest is considered <i>riba</i> by the <i>Sharia'a</i> and this makes the condition void.	
In car financing schemes, the customer is responsible for any kind of loss or damage to the vehicle, irrespective of whether the circumstances are under his control or not.	All risks pertaining to ownership are borne by the bank. The bank will insure the vehicle and be responsible for any loss or damage to the vehicle caused by circumstances beyond the control of the customer, e. g., theft, loss/damage due to natural disasters like flood, earthquake etc. However, the customer will be responsible for any damage in the event of an accident.
If the insurance company does not compensate for the entire amount, the customer is liable to pay the balance.	
Upfront payments consist of Down-payment ranging from 15–20% minimum. 1st year's insurance premium. 1st monthly rental instalment.	A minimum of 20% deposit along with actual documentation and processing costs is paid with no other upfront payment.
Under conventional leasing/financing the vehicle is automatically transferred to the name of the customer.	At the end of the <i>Ijara</i> agreement the customer is not obligated to purchase the vehicle. Meezan Bank will make an offer to the customer to invite them to purchase the vehicle at the security deposit price. If the customer wants to receive his deposit back he may do so by returning the car to the bank.

Source: Meezan Bank

## 1.4 APPENDIX: *IJARA* FATWA

### **Meezan Bank**

#### **Car *Ijara***

Meezan Bank's Car *Ijara* is based on the Islamic principles of *Ijara*. This scheme has the following features:

Meezan Bank's Car *Ijara* has been structured to comply with the tenets of *Sharia'a* and has been developed in consultation with our *Sharia'a* Advisor, Dr Muhammad Imran Usmani. All the principles and rules pertaining to *Ijara* Agreements are strictly adhered to. It is therefore, an *Ijara* facility which is free of *Riba*.

Original shareholders and Investors' money will be used in the Car *Ijara* business of the bank.

Car *Ijara* is available in different tenors.

Meezan Bank may take a security deposit from the customer at the inception of the *Ijara*.

The customer will pay monthly rentals for use of the car obtained under the *Ijara* scheme.

All risks and rewards of ownership of assets will be vested in Meezan Bank.

All expenses of normal wear and tear will be borne by the customer.

Rentals under the scheme will be calculated such as to keep them in line with the leasing market.

The customer will undertake unilaterally that in case of early termination he will buy the asset at the particular price mentioned in that undertaking.

Meezan Bank will use the Agreement to Lease and Lease Agreement, which is approved by its Supervisory Board.

'... Resolved that the modus operandi defined above for Car *Ijara* is according to the dictate *Sharia'a* ...'

(Signed) \_\_\_\_\_

**Justice (Retired) Muhammad Taqi Usmani**

(Signed) \_\_\_\_\_


**Dr Abdul Sattar Abu Ghuddah**

(Signed) \_\_\_\_\_

**Dr Muhammad Imran Usmani**

## 1.5 CASE STUDY QUESTIONS

1. Outline the key differences between conventional leasing and Islamic leasing.

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2. How do insurance needs differ under conventional leasing and Islamic leasing?



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3. What are the key *Sharia'a* requirements for the *Ijara* contract?



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4. Would a Car *Ijara* be structured identically to a home purchase *Ijara*?



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5. Would non-Muslims consider Car *Ijara* schemes a serious alternative to conventional car finance schemes?



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6. Calculate the monthly rental payments when buying a new car, costing Rs. 300,000, for a term of four years, if the potential purchaser is willing to pay a 25% security deposit.



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7. Calculate the monthly rental payments when buying a new car, costing Rs. 400,000, for a term of three years, if the potential purchaser is willing to pay a 30% security deposit.




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8. Calculate the monthly rental payments when buying a new car, costing Rs. 500,000, for a term of five years, if the potential purchaser is willing to pay a 40% security deposit.

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9. Calculate the monthly rental payments when buying a new car, costing Rs. 350,000, for a term of three years, if the potential purchaser is willing to pay a 45% security deposit.

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10. Calculate the monthly rental payments when buying a new car, costing Rs. 600,000, for a term of four years, if the potential purchaser is willing to pay a 50% security deposit.

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11. Calculate the monthly rental payments when buying a new car, costing Rs. 400,000, for a term of five years, if the potential purchaser is willing to pay a 20% security deposit.

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12. Do you think that the *Meezan Car Ijara* contract is correctly named?

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