Ijara (Islamic Leasing) in the context of Islamic Finance

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Overview

Other than serving domestic Muslim clients, exporting institutions may find it prudent to use Islamic finance so as to curry favour in Islamic markets, thereby easing entry or enhancing business.

Basic Principles

To the outside Islamic Finance may seem like a complete fraud. "Isn't it just converting interest into capital gains?" I hear you say. Well of course there are instances of re-engineering of interest into "mark-ups" with the necessary opinion shopping for favourable opinions of Islamic scholars but there are three basic principles: the absence of interest, usury or *Riba* is prohibited; profit and loss sharing on the principle of no pain no gain; social and ethical features avoiding undesirable investments and enhancing trade.

The prohibition of *Riba* has parallels in the usury laws in many Western countries or a ban on excessive interest. Profit and loss sharing deemed by many to be "pure" Islamic banking is similar to venture capital finance, non-recourse project finance or ordinary equity investment. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital. It involves investing but not lending. Just as in tax management, numerous products have been developed to meet the letter but not necessarily the spirit of the regulations. Early Islamic investors were content to enter into zero-coupon bonds or discounted Treasury bills and receive the interest foregone in the form of capital gains. Just as such locked-in capital gains is now regarded as interest for tax purposes, simply converting interest to capital gains is increasingly unacceptable to the Shariah authorities. Nevertheless, it is estimated that 85 per cent of Islamic banking as practised involves some form of pre-determination of profit or "mark-up".

For some institutions, appearances may be important in terms of being seen to be Islamic in the eyes of their customers, shareholders and regulators. However, even when there is a guaranteed return generated through a "mark-up" scheme, the linking to an underlying trade transaction is deemed "a good thing".

Beyond the question of interest and profit and loss sharing is the ethical issue. Islamic investments exclude tobacco, alcohol, gaming and other "undesirable" sectors. But Islamic investors are motivated in their choice of investments by much the same criteria as their Western counterparts and the search for acceptable investments is balanced by natural risk-aversion.

There is no Islam-wide authority that determines what is *Hallal* (acceptable) and what is *Haram* (prohibited) and there is a danger that some will go around "opinion-hunting" to get Islamic approval for their schemes.

Key Islamic Financial Instruments

Mudaraba

The capital provider invests through an entrepreneur borrower. Profits are shared on a pre-agreed basis but losses, if any, however, are wholly suffered by the investor. This financing structure looks like non-recourse project finance. Profits can be divided in any proportion between the two contracting parties as agreed upon at the time of the contract; but losses, if any, will fall on the financier only. Mudaraba can also be regarded as a form Fund Management.

Musharaka

Financing through equity participation is called Musharaka. Here the partners or shareholders use their capital through a joint venture to generate a profit. Profits or losses will be split between the shareholders according to some pre-agreed formula. For many, Mudaraba and Musharaka represent the desired forms of Islamic banking even though their current use is not dominant.

Murabaha

The majority of Islamic financial transactions do not involve a share of profit but incorporate a locked-in return. Most are "mark-up" structures such as Murabaha which has the lion's share of such transactions.

In a Murabaha, the bank finances the purchase of an asset by buying it on behalf of its client. The bank then adds a "mark-up" in its sale price to its client who pays on a deferred basis. There is supposed to be a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods. And there has to be a genuine item involved which requires purchasing and financing.

Istisnaa

This is appropriate for financing a project where nothing exists when the funds are provided.

Ijara

Another form of 'mark-up' structure, Ijara is an Islamic form of leasing. Here the bank buys capital equipment or property and leases it out under instalment plans to end-users. As in conventional leasing there may be an option to buy the goods at the end of the Ijara built into the contracts - Ijara wa Iqtina. The instalments consist of rental for use and part-payment.

The customer selects the asset to be financed and the bank then purchases it from the supplier and leases it to the customer for an agreed period. Refinancing of assets owned by the client in a sale and leaseback arrangement is allowed under certain circumstances. The bank being the owner of the asset is paid rent, fixed or variable as agreed by the parties. The rental amount is often linked to Libor.

The bank must exercise all the lessor's rights and obligations such as maintenance, insurance and repair. The lessee gets the use of the asset for the period of the lease subject to payment of rent. The lessee may assume the obligations such as maintenance etc. for a reduced rent.

The fact that there is a real good to be financed means that it is the most Shariah compliant of the "mark-up" products.

Conclusion

Whilst Islamic bankers have sought to avoid business risk through Murabaha and Ijara, the essential element of most such deals is the linking to a genuine identifiable trade transaction. Islamic finance seekers thus have to open themselves up to their banks even more then their Western counterparts and can only obtain finance for genuine needs. General-purpose finance or borrowing for consumption purposes, overdrafts and swing lines do not exist or are treated sceptically. Profit and loss sharing Musharaka and Mudaraba are more difficult to obtain. But such business is not unknown in Western banking. It is called Investment banking.

There are counterparts in almost all forms of Islamic banking in Western banking. There are Islamic versions of Repos, Leasing, Unit Trusts, Hire Purchase, Equity investments, Venture Capital and Non-recourse project finance. There are also non-Islamic parallels with Ethical investment fund management. Islamic finance is not a different form of finance. It is just a special case.

Perhaps replacing Arabic terminology, such as "Ijara" with "leasing" or "Musharaka" with "equity participation", will lead to a greater understanding of Islamic finance and Western banks are increasingly competing to provide Islamic banking and financial services.

About the author

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