

Issues in The Use of *Ijara* as Islamic Mode of Financing

BURHAN ALI SHAH

School of Management Sciences Quaid I Azam University Islamabad

Email: burhanali@qau.edu.pk

GHULAM SHABBIR KHAN NIAZI

Professor, University of Lahore, Islamabad Campus, Islamabad

MUHAMMAD IBRAHIM KHAN

Institute of Business Studies and Leadership

Abdul Wali Khan University Mardan

Abstract

This paper attempts to examine issues in the current use of Ijara/leasing as an Islamic mode of financing based on the model agreements/documents used by Islamic banks for Ijara financing. The model agreements are selected as a fundamental source of information owing to the terms and conditions that define the basis of relationship between the bank as lessor and the customer as lessee. Precisely, the practical application of Ijara/leasing is based on these agreements. Primarily a qualitative research, exploratory in nature, was undertaken to explore the application of Ijara by Islamic banks in Pakistan. Data were collected in form of model agreements/documents from the website of State Bank of Pakistan (SBP) and two Islamic banks. Qualitative content analysis was applied to analyze the model agreements using an inductive approach in order to identify problems/issues in the use of Ijara by Islamic banks. Six major problems/discrepancies (issues) were identified in the current use of Ijara. However, these issues have been highlighted for more clarification through further research that may obtain more knowledgeable opinion of Shari'ah scholars regarding these problems (issues) in the application of Ijara.

Keywords: *Ijara, Islamic Banks, Agreements, Lessor, Lessee.*

Introduction

Ijara or leasing has always been a popular business model being used conventionally as well as Islamically. Conventional leasing has two major types including capital or finance lease and operating lease. However, capital or finance lease is not considered permissible by *Shari'ah* (El-Din & Abdullah, 2007) but only operating lease is accepted as an Islamic mode of financing popularly known as *Ijara*. It was introduced as an alternate to conventional leasing. It is one of the most famous forms of Islamic financing. Islamic banks use *Ijara* to provide financing of various maturity to customers (Naqvi & Perveen, 2014). However, practically the current use of *Ijara* as mode of Islamic financing resembles conventional leasing in many respects. Therefore, it is important to examine the current use of *Ijara* as Islamic mode of financing in order to identify problems/doubts, if there are any, in its use from *Shari'ah* perspective. Though Islamic banks have been popularly using *Ijara/leasing* as *Shari'ah* compliant mode of financing, the current practices of *Ijara/leasing* have not been critically investigated from *Shari'ah* perspective, so far. Therefore, the current paper attempts to examine the current use of *Ijara/leasing* as an Islamic mode of financing based on the model agreements/documents used by Islamic banks for *Ijara* financing. The model agreements are selected for analysis owing to the terms and conditions that define the basis of relationship between the bank as lessor and the customer as lessee. Precisely, the practical application of *Ijara/leasing* is based on

these agreements. Therefore, an analysis of these agreements can prove helpful in identifying problems and issues in the current use of *Ijara*/leasing by Islamic banks. Hence, the current study may prove helpful in identifying deviations in current use of *Ijara*/leasing, if there are any. It is worth mentioning that previously no research attempted to examine the model agreements or principal documents which are not so conveniently available to academic researchers. This is another significant aspect of the current study. The study may prove beneficial to the policy makers in making *Ijara* more acceptable from *Shari'ah* perspective.

Literature Survey

Islamic modes of financing are generally divided into two types i.e. *Shari'ah* based financing and *Shari'ah* compliant financing. In *Shari'ah* compliant financing the return is "predetermined and fixed", but within *Shari'ah* constraints. *Ijarah* belongs to the *Shari'ah* compliant group that also includes *Murabaha*, *Salam*, *Istisna*, and diminishing *Musharaka* (Hanif & Iqbal, 2010; Hanif, 2014; Farooq & Ahmed, 2015). *Ijara* or leasing is the "sale of the usufruct" of an asset "for a specified time" and for the purpose of earning "a specified and lawful return or consideration" (El-Gamal, 2000, p.13; Usmani, 2007, p.158, 163; Ayub, 2013, p.279; Naqvi & Perveen, 2014; Fatima, 2016).

Ijara/leasing is fundamentally not a mode of financing (Usmani, 2007, p.158; Ayub, 2013, p. 287) but is an ordinary business activity similar to sale. Nevertheless, owing to certain practical reasons including "tax concessions", the financial institutions facilitates their customers through leasing them various types of "assets and equipment". Similarly, leasing is applied by Islamic banks, particularly owing to the "asset-based nature of investments in Islamic finance" (Ayub, 2013, p. 287; Usmani, 2007, p.158). Practically the "modern financial" leasing used in banks covers the whole economic life of the asset starting from the date of payment by the bank (lessor) to the vendor directly or via the lessee, regardless of the supply of the subject asset to the lessee. The bank covers the entire "cost of the asset" along with return leaving no more stake "in the asset". Conversely, the lessee becomes liable for the rent even before taking the physical possession of the asset but assuming the risk of ownership (Ayub, 2013, p. 288; Usmani, 2007, p.164). The lessee can buy the asset at an already set "price or at its market value", and even before the expiry of the lease term usually paying "an extra amount" to the bank "as fine/ liquidated damages". However, the lease cannot be terminated prior to the maturity of the lease term without the mutual agreement of the two parties. Nevertheless, if the lessee fails to make payment in time, "the lessor" can repossess the asset without the involvement of any court decision. However, in such case or even "in case of delay in payment of the installments compound interest" is usually charged making "the end result of financial lease" more cruel and unfair than the absolute buying of the asset by the customer on installment basis (Ayub, 2013, p. 288). Practically, the bank as lessor needs to purchase the asset, which in return entails certain responsibilities on the part of the bank including "marketing" knowledge, asset maintenance and "bearing" all related costs. However, any such lease arrangements that discharge the bank from these responsibilities is against the principles of *Shari'ah* and need to be circumvented. It is tantamount to financial leasing that is illegitimate in *Shari'ah* (El-Din & Abdullah, 2007).

However, in operating lease or *Ijarah*, ownership of the asset is held by the owner/lessor and the asset is handed over to the lessee against rental payments for utilizing it. It means that only the "usufruct" of the asset is transferred to the lessee but the ownership of the asset is held by the owner/lessor (Usmani, 2002, p.158; El-Din & Abdullah, 2007; Ayub, 2013, p. 289; Fatima, 2016). The asset is handed over back to the owner/lessor on completion of the lease term. Operating lease is believed "fully compatible with *Shari'ah*" subject to meeting other *Shari'ah* requirements (Ayub, 2013, p. 289; Usmani, 2002, p.175).

However, a new form of *Ijara* came into being as an attractive financing facility, popularly known as *Ijarah wa-iqtina'* also known *al-ijarah thumma al-bai'* that integrates a "lease and sale" deals in one contract both operating distinctly. First, lease agreement is implemented in which the lessee pays periodic rents to the

lessor over a defined lease period. On completion of the lease term, the lessee can buy the asset “from the owner/lessor” at a mutually settled price. However, the “purchase price” is required to be defined based on “the value of the” asset, “market condition, and necessary profit to the bank”. However, determining the price of the asset in advance i.e. at the start “of the hire purchase agreement” is not permitted by the *Shari’ah*. Conversely, the lessee is free to buy the asset or “return it to the financial institution”. Hence there is no compulsion on the lessee to buy the asset, “avoiding a preconditioned contract, which is forbidden by *Shari’ah*” (El-Din & Abdullah, 2007).

In practice, the Islamic bank purchases an asset as per request and requirements of a customer who undertakes to take over the asset on lease. The bank does not intend to hold the asset back and set the term of lease so that to cover the whole economic life of the asset. On completion of the lease term, the asset is either sold or gifted to the lessee. The bank adjusts the rent incorporating a profit and recovering the cost of the asset over the lease period enabling the lessee to acquire the asset on maturity of the lease term conveniently. This is “*Ijarah-wa-iqtina*” popularly used by the “banks as financial intermediaries”. Such type of arrangement transmits the ownership risks to the lessee and is criticized for being similar to a covert long term debt contract (Kamali, 2007). The ownership of the leased asset is assigned to the lessee either through a free gift or at a nominal price. In either case the residual value is calculated in advance and is recovered as part of the lease rentals/instalment leading to exploitation of the lessee if he/she is no more able to pay the lease rentals/instalments due to any uncontrollable reasons. In such case, the lessee may “lose the asset as well as the extra payments made” in lieu of the residual value as part of the already paid lease rentals, which is against the principles of justice (Kamali, 2007). However, this issue can be resolved if the lessee is not bound to own “the asset” as a pre-condition of the lease agreement making the lease agreement independent of any other agreement. Conversely the lessor may be allowed “to sign another contract with the lessee” on completion of the lease term for selling or gifting “the asset to the lessee” at maturity “of the lease period”. Similarly, “the lessor may enter into a separate unilateral promise to sell the leased asset” to the lessee on completion of the lease term. It means that the lessee should be given a free choice to own the “leased asset” or not (Ayub, 2013, p. 290; Kamali, 2007).

Further, rent is not allowed to be charged before handing over the asset to the lessee and if even the delivery is delayed by the supplier the lessee is not bound to pay any rent. The lease, in fact, commences from the time of physically handing over “the asset to the lessee” (Kamali, 2007; Usmani, 2007, 165; Ayub, 2013, p. 289). If the leased asset stops working without any “fault or negligence” of the lessee, the payment of rent to the lessor is also stopped in such case (Kamali, 2007; Usmani, 2007, p.169). The lessee must look after the leased asset as *amanah* and is not responsible for any “loss and damage that occurs through normal use of the leased object”. However, if the lessee is found guilty of negligence and/or misuse of the leased asset, in such case he/she is bound to compensate the lessor (Kamali, 2007; Usmani, 2007, p.161, 167).

However, in *Ijarah wa iqtina*, the lessor undertakes to offer the asset to the lessee on maturity “of the lease” term “at a pre-determined residual value”. Such “promise” is nevertheless obligatory for “the lessor only” whereas the lessee is free to either buy the asset on completion “of the lease” term or return it to the lessor/owner (Usmani, 2007, p.176; Ayub, 2013, 290; El-Gamal, 2000, p.14). It is also called “*Ijarah Muntahia-bi-Tamleek*”. In this case also an Islamic bank usually buys an asset after receiving request from a customer for acquiring the “asset on a lease”. The ownership of the asset is shifted to the customer at maturity of the lease period through an independent “sale or gift contract”. Nevertheless, ownership of the leased asset can be devolved through one of the three methods including (a) promising to sell the asset for a nominal or “other consideration” or by expediting the payment of remaining outstanding balance or through “paying the market value of the leased property”; (b) through promising to gift the asset on completion of the lease term; (c) through promise to gift contingent upon occurrence of certain event, for instance, “payment of the remaining installments” (AAOIFI, 2004–5a, Standard on *Ijarah*, clauses 8/1–8/4, 8/6, 8/7, p. 146, 156; Ayub, 2013, p.292). Nevertheless, the transfer of ownership in any case should not be made a pre-condition to the *Ijarah* agreement. “The promise should be unilateral and binding on the

promisor” only whereas the lessee should be free to decide whether to acquire the ownership or not. In such case separate contract may be concluded accordingly (Ayub, 2013, p.292). However, the conventional hire–purchase arrangement cannot be considered *Shari’ah* compliant only by calling it “*Ijarah Muntahia-bi-Tamleek* or *Ijarah-wa-Iqtina*”. Nonetheless, it is accepted, if the Islamic banks follow the *Shari’ah* requirements in its true spirit (Ayub, 2013, p.294). Conversely the conventional hire–purchase may not be allowed due to the assimilation of both the lease and sale conditions in the original contract at the very beginning (Ayub, 2013, p.292). *Ijarah wa iqtina* also called *al-Ijarah thumma al-bai* is different from such leasing that results in transferring the ownership to the lessee on completion of the lease period. In such type of leasing the lessee pays the price of the asset incorporated in the rental payments resulting in the transfer of the ownership to the lessee as “*hibah*”, on completion of the lease tenure. This type of leasing is normally used “as a mode of financing” (El-Din & Abdullah, 2007).

El-Din and Abdullah (2007) differentiated the Islamic hire purchase from conventional one on the basis of their respective principles. Conventionally hire purchase is used as an ordinary interest based loan, thus creating a “debtor and creditor relationship between the bank and customer”. However, in Islamic banking hire purchase is used as a financing tool leading to “sale and purchase” deal between the bank and the customer. Similarly, the nature of agreements is different in the two types of hire purchases. There is only one “standard agreement” used in conventional hire purchase, whereas in Islamic hire purchase two separate agreements are used i.e. “hiring agreement (‘*aqad ijarah*) and sale and purchase agreement (‘*aqad bai*’). Further, in Islamic hire-purchase, the owner is liable for the “basic and structural maintenance” of the asset, whereas the customer is accountable for the “operational and routine maintenance” of the asset. Conversely, in conventional hire purchase, the customer is required to bear all types of expenses associated with the asset. Practically, an asset is hired in “conventional hire purchase with an option to purchase” it on expiry of the lease term. However, in Islamic hire purchase two dealings take place respectively. In the first step *ijarah* (leasing) is undertaken followed by *bai*’ (sale and purchase) agreement. Essentially, however, the banks avoid accepting the responsibility of ownership of the assets and therefore do not observe the *ijarah* principles, in letter and spirit.

Islamic banks need to own the asset before giving it on lease to the customer. In fact, the ownership determines the respective “rights and liabilities” of the bank and the customer in the “hire-purchase agreement”. For instance, as “an owner, the bank” needs to purchase “the asset, bearing all costs associated therewith”. Consequently, a bank virtually departs “from its basic nature as financial intermediary” in order to become owner of the asset. Incidentally, the banks need to bear “more risks, liabilities, and responsibilities” owing to ownership of the asset, which the banks usually “avoid as much as possible”. However, any such lease agreement that discharges the bank from these responsibilities is against the principles of *Shari’ah* and need to be circumvented. It is tantamount to financial leasing that is illegitimate in *Shari’ah* (El-Din & Abdullah, 2007).

In case of Islamic hire purchase, two separate agreements are signed. First, *Ijara*/leasing agreement is reached upon that is followed by sale and purchase agreement required to be effected at the completion of the lease period defined in the *Ijara*/leasing agreement. It may also be accomplished earlier if the hirer/lessee desires to acquire the asset before the maturity of the lease period. However, if the ownership is transferred by selling the asset to the lessee, it is ordinarily at a token money acceptable to both the parties. Nevertheless, commonly, the “last installment is considered as purchase price” resulting in an automatic exercise of the “option to purchase” the asset by the hirer/lessee. It is practically doubtful that they i.e. the “bank and customer are aware” and know to execute a sale transaction through paying the last installment by the customer. Therefore, the mechanism of transferring the ownership to the hirer/lessee should be clearly stated, “understood” and mutually acceptable to both the parties (El-Din & Abdullah, 2007).

In *Ijarah*, all major costs and “basic liabilities” related to the asset are the responsibilities of the owner in order to keep the leased asset fit for providing the desired services to the lessee/hirer. Conversely, the normal day to day “maintenance” is the obligation of the lessee/hirer in order to keep the subject asset

properly working (El-Din & Abdullah, 2007). Nevertheless, in contemporary Islamic hire purchase all “maintenance responsibility” is shifted to the hirer and “the bank only acts as a financier” on the pretext that the “ultimate” goal of the hirer/lessee “in hire purchase is to own” the asset, on expiry of the lease term rather than to hold it for a specific “period of time” only. Thus, it is justified to shift all the maintenance cost to the hirer for using the asset. However, the hirer can “sue the bank if the asset” is faulty and fails to provide the desired services to the lessee. On the other hand, if the lessee “repairs the defective asset”, he/she is eligible to recover such expenses “from the bank”. Nevertheless, if any defect/fault is occurred due to the hirer’s negligence, then the hirer is accountable to “bear the cost of repairing the asset”. After all, this all does not appear to be wholly “*Shari’ah* compliant”. *Shari’ah* requires the owner to bear the cost “for maintaining the leased asset”. However, practically, all such obligations are shifted to “the hirer” against the *Shari’ah* guidelines. Though, some *Shari’ah* scholars approve such practice on the basis of “*uruf* (local custom) and market practice in Malaysia”.

The “*Shari’ah* advisors and scholars” declared that assigning “all maintenance responsibilities” to the owner is cumbersome and may be shared in such a way that the leased asset remains fit to provide the “specified benefits” as per nature of “the *Ijarah*” (El-Din & Abdullah, 2007). Generally, the insurance/*takaful* coverage, of the leased asset is “the responsibility of the owner”/lessor (Usmani, 2007, p.174; El-Din & Abdullah, 2007). However, the cost of insurance is usually shifted to the “hirer or customer”. Practically, the insurance/*takaful* cost is paid by “the owner” only “during the first year” but is added to “the rental payments”. Afterwards, the hirer/lessee pays the cost of insurance/*takaful*. This practice has been approved by majority of the Muslim “jurists in Malaysia” on the pretext that “the purpose of taking insurance” is to obtain cover against “any risks” that may hit “a user of the asset”. Thus, damages/losses “to the asset or injury to the third party” occurring due to the “negligence” of the user “shall necessarily be his responsibility”. Hence, it is rational to bind the hirer to bear the cost of insurance/*takaful* coverage (El-Din & Abdullah, 2007). Conversely, if the owner bears “the insurance coverage”, this cost can be included in the price of the asset (Shirazi, 1993).

Imposition of penalty on the lessee in case of delay in paying installments, is not justified according to the principles of *Shari’ah* because rent once due is equivalent to debt and adding any additional financial charge to it is “*Riba*” prohibited by the holy Quran” (Usmani, 2007, p.171; El-Din & Abdullah, 2007). Nevertheless, such practice may encourage the untrustworthy customers to intentionally delay the payment of installments leading to increased rate of default and exploitation by the lessee. Thus, the banks may bind the hirer to pay “penalty for delay in payments of installments”. However, the penalty charged must not be made part of “the banks’ income and should be used only for charity” (Usmani, 2007, p.172; El-Din & Abdullah, 2007). Nevertheless, the penalty should not be imposed as a general rule irrespective of considering the case of genuine defaulter who may not repay due to uncontrollable reasons (El-Din & Abdullah, 2007).

After this brief review of literature, it is observed that minimal attention has been paid to the analysis of current usage of *Ijara*/leasing by Islamic banks, particularly in Pakistan. Likewise, no research examined the content of the agreements/documents used by Islamic banks for *Ijara* financing. Therefore, this paper attempts to fill this academic vacuum and provide direction to future research.

Materials and Methods

This is primarily a qualitative research intending to explore and analyze the use of *Ijara* as a mode of financing by Islamic banks in Pakistan. This research is exploratory in nature. Exploratory research is applied to a “very new” topic or when little is known about it. It is primarily concerned with “little understood issue or phenomenon and develop preliminary ideas about it” providing foundation for precise research questions (Neuman, 2014, p.38). Exploratory research is practically a “flexible design” and is applied to discover “little-understood situations” or pursuing “new insights” or to evaluate “phenomena in a

new light” (Robson, 2002, p.59). In fact, exploratory research can be initiated to better understand “the nature of the problem”, if little research has been carried out about it (Sekaran, 2006, p.119). Exploratory research can also be undertaken in a situation where “some facts are known, but more information is needed for developing a viable theoretical framework” in order to better understand “the phenomena of interest and advancing knowledge through subsequent theory building and hypothesis testing” (Sekaran, 2006, P.120). Thus, the exploratory method is applicable to this research as the problem under investigation is relatively understood but is explored from a new perspective (Ghauri & Gronhaug 2002, cited by Zamil, 2014, p.195). Precisely, Islamic banking is no more a new field of research. It is now more than 50 years old if recognized with the establishment of Mit Gamar (Egypt) in 1963 as the first Islamic bank. However, there has always been criticism against their *Shari'ah* compliance status. Hence, an exploratory approach is appropriate to be applied. Thus, the paper under review is initiated to discover the use of *Ijara* as a mode of financing by the Islamic banks from *Shari'ah* perspective.

Population and Sampling

This research was instigated to explore problems/discrepancies (issues) in the current usage of *Ijara* as a mode of Islamic financing. However, the current use of *Ijara* was reviewed with the help of the model agreements/documents used by Islamic banks for *Ijara*/leasing financing. So, the model agreements/documents of *Ijara*/leasing used by Islamic banks may be considered the population (Bryman, 2012, P.11) for this study. Nevertheless, the model agreements of *Ijara*/leasing were found available only on the SBP website and two Islamic banks based on purposive cum convenience sampling. The two Islamic banks are referred to as Bank I and Bank II in order to keep their confidentiality. Purposive sampling is considered appropriate for “exploratory research” (Neuman, 2002, p.273-274).

Data Collection and Analysis

The model agreements of *Ijara*/leasing were found available only on SBP website and copies of principal agreements used for Islamic modes of financing were obtained from Bank-I and Bank-II.

The current research applied an inductive approach to explore problems in the use of *Ijara* as a mode of Islamic financing (Saunders et al., 2009, p.124). In order to identify the problems/issues in the use of *Ijara* as a mode of Islamic financing, this research applied qualitative content analysis to examine the model agreements of *Ijara*/leasing developed by SBP and two Islamic banks working in Pakistan. Content analysis is an adaptable research method that may be applied in numerous research scenarios in different academic areas (White & Marsh, 2006). It is also called “a method of analyzing documents” (Elo & Kyngas, 2008). Therefore, content analysis was used for analysing the model agreements and documents of Islamic banks during the course of current study. In order to explore the possible problems/issues in the use of *Ijara*, the information available in the model agreements/documents needed to be systematically arranged for the purpose of analysis. In such situation, content analysis was considered a useful “set of procedures for collecting and organizing this information”. Thus, the content analysis (review) of the model agreements/documents was undertaken for identifying all the major problems/discrepancies (issues).

The contents of various documents/instruments were thoroughly reviewed and analyzed as suggested by the content analysis approach (Elo & Kyngas, 2008) and a number of issues were explored in the use of *Ijara* as a mode of financing by Islamic banks on the basis of the model agreements/principal documents. The problems/issues were pointed out in the model agreements/documents inductively but more on the basis of *Shari'ah* guidelines and theory of Islamic banking. In fact, the respective clauses/sections of the model agreements were appraised in order to identify possible problems/issues (Saunders et al., 2009, p.117). The relevant clauses/ sections including the “key phrases and text” indicating doubts/discrepancies (issues), or otherwise appearing important were written down. The process was iterative in nature as more than one document/agreement were read through to observe the “similarities in expressing the same concept” (White & Marsh, 2006). Six major problems/ discrepancies (issues) were pointed out in the use of *Ijara* as a mode

of financing. The problems/discrepancies (issues) detected in the use of *Ijara* that may be clarified through further research.

Figure 1 diagrammatically shows the data collection and qualitative content analysis used during this study.

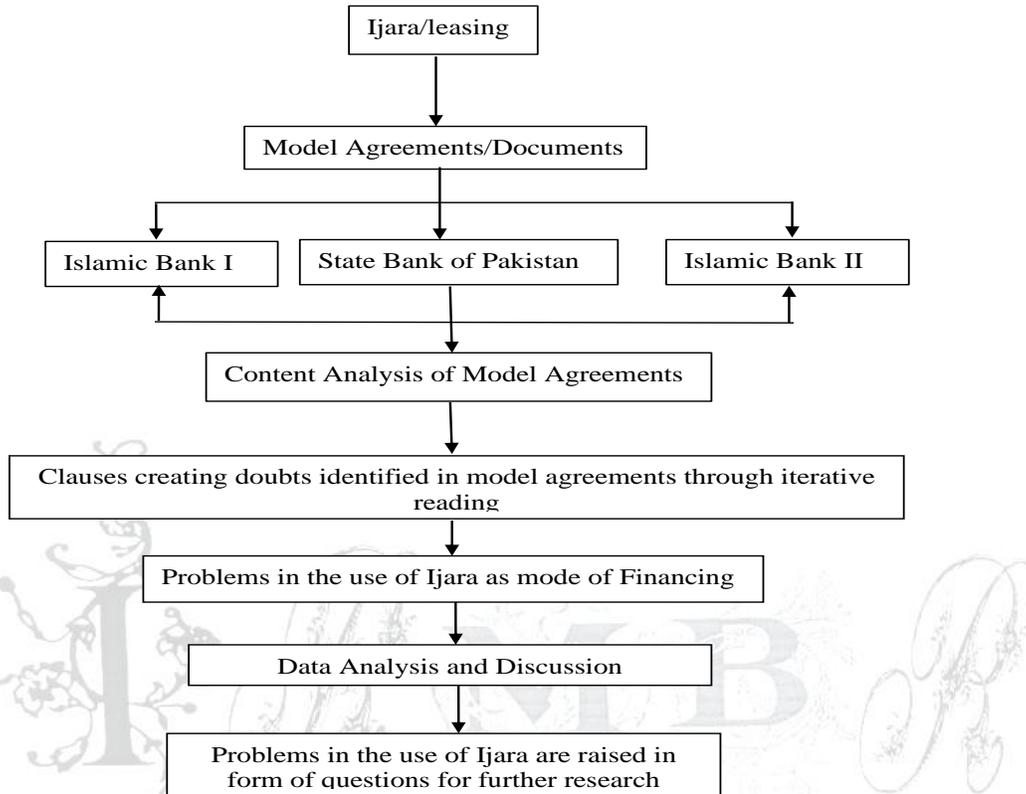


Figure 1: Data Collection and Analysis

An in-depth analysis of the model agreements/documents is undertaken in the light of *Shari'ah* principles using content analysis so that doubts/discrepancies (issues) can be explored in the current use of *Ijara* as Islamic mode of financing. Several observations that need to be examined through further research in order to clarify their *Shari'ah* conformability, or otherwise. Therefore, these doubts/discrepancies (issues) are highlighted at the end of the next section for further research that can solicit the *Shari'ah* position related to these doubts/discrepancies with reference to the use of *Ijara* as Islamic mode of financing.

Content Analysis of Model Agreements used for *Ijara/Leasing*

Leasing is an arrangement in which the lessor, rents an asset to another person (the lessee) for use. It is the handing over of the usufruct of an asset to the other party for receiving rent. In leasing, “the corpus” of the asset is held by the owner (the lessor) but only its “usufruct” is handed over to the lessee. However, consumable items including “money, edibles, fuel, etc.” are not allowed to be leased (Usmani, 2002, p.111; Ayub, 2013, p. 281) because the ownership in such items does not remain intact.

The lessor (bank) “acting on the written request of the lessee” acquires the desired asset and “leases the same to the lessee” (SBP, Model Lease Agreement, Clause, 1.01). However, if the leased assets is purchased by the lessor from the lessee before or concurrent with the execution of the lease, the lessee must

undertake that (i) such assets are clear of all liens, encumbrances or other charges; (ii) the transfer of such assets to the lessor does not violate any contract to which the lessee is a party and (iii) the lessee has the requisite power and authority to transfer or sell such assets to the lessor (SBP, Model Lease Agreement, Clause, 8.01-g).

Further, failure on the part of the lessee to lease the assets purchased by the lessor for such purpose is considered to “be an event of default”, binding the lessee to buy “the asset from the bank at the purchase price” that is equal to the “total amount together with all other costs, charges, expenses and damages etc. incurred by the bank” in order to acquire, register and insure “the asset”. In such situation, the lessor can also “sell the asset in the market” to realize “the purchase price and any other amounts payable” (Bank I, Lease Facility Agreement-Written Request for Purchase of Assets).

Similarly, in case of “cancellation of the lease by the lessor due to any reasons during the currency of the lease” the lessee is bound to buy “the leased assets” at a defined purchase price on “the date immediately preceding the date of termination of the Lease”. However, if the lessee fails to pay the purchase price by the given date, the lessor can “take immediate possession of the assets together with the registration certificate, permit or other” related documents from the lessee (SBP, Model Lease Agreement, Lease Document # 4, Undertaking). Further, if the lessee defaults, the lessor can repossess and sell the leased assets to realize the purchase price and any other due amounts. However, if the leased asset is sold on a price less than the defined purchase price along with any other due amounts, the lessee is bound to pay the difference to the lessor (Bank I, Lease facility Agreement-Undertaking to Purchase Leased Assets, and Written Request for Purchase of Assets; Bank II, *Ijara* (Lease) Agreement, Undertaking).

Normally, the “amount of security deposit” is “adjusted towards the residual value at the end of the lease period”, or the “amount of residual value” is paid “by the lessee at the end of the lease period” (SBP, Model Lease Agreement, Lease Document # 2- Schedule). On expiry of the lease term, the bank offers to the lessee “an option to purchase the *Ijarah* asset after the expiry of the *Ijarah* period and upon the full and final payment of all dues outstanding in respect of the lease of the *Ijarah* assets”. The sale price of the *Ijarah* assets is also fixed in the undertaking (Bank II, *Ijara* (Lease) Agreement-Sale of Leased Asset at Residual Value). In another document, it is stated that the lessee makes an offer to buy the asset from the lessor and consequently the lessor (bank) accepts the offer and confirms that “the leased asset is available with” the lessee “at the time of signing” the “acceptance” (Bank I, Lease facility Agreement- Sale Deed).

On the other hand, it is stated that the bank has offered an *Ijarah* facility to the customer, of a certain amount and on a specific date and the customer availing the said facility acquired the desired/prescribed asset and has completely paid all the *Ijarah* rents and now nothing is outstanding against him/her/them. The bank is the only “and absolute owner of the asset”, and “as a gesture of good-will, the bank has gifted the leased asset to the customer” (Bank I, Lease facility Agreement-Gift Deed).

It is worth noting that the sale/gift deed/documents are already part of the lease agreements/documents and signed at the time of lease agreement, as it is stated that “all relevant portions of the agreement & appendices must be filled in and witnesses must be furnished at the time of execution of the agreement” (Bank I, General Guidelines on Lease Facility Agreement). It is observed that the bank does not intend to hold the asset back and make the lease period long enough to cover the whole economic life of the asset and sells or gifts the asset to the lessee on expiry of the lease tenure. The bank adjusts the rent incorporating a profit and recovering the cost of the leased assets over the lease period like “*Murabahah*” enabling the lessee to acquire the asset on completion of the lease term. This is “*Ijarah-wa-igtina*” popularly used by the “banks as financial intermediaries” (Kamali, 2007, p.6). The banks calculate the residual value of the leased asset in advance and recover it as part of the lease rentals/instalments with “no further interest” in keeping the assets. So the title of the asset is assigned to the lessee either through a “gift or at a nominal price” or pre-determined price or “market value” (Ayub, 2013, p. 288; Kamali, 2007, p.6). However, the lessee is required to indemnify the lessor (bank) against all types of accidents and injuries, “damages and

losses occurring to any person or property” due to the “storage, handling, use or operation of the assets by the lessee” (SBP, Model Lease Agreement, Clause, 10.03; Bank I, Lease facility Agreement, 12.01).

After detail analysis of contents of the model agreements the following problems/discrepancies (issues) are summarized and highlighted for clarification from *Shari'ah* perspective through further research.

- (i) Bank can buy an asset from the customer and then can lease it back to the customer (lessee) as lessor. Is it correct from *Shari'ah* perspective?
- (ii) The customer is bound to purchase the asset from the bank if he/she fails to lease it after being purchased by the bank. If the bank sells such asset in the market at a price less than the desired price, the customer (potential lessee) would pay the difference between the actual sale price realized and the desired “price and any other amounts payable”. Do the *Sharia* principles allow such practice, even though the realized price is determined by the market?
- (iii) If the lessor (bank) cancels “the lease during the currency of the lease” the lessee is bound to purchase the asset from the lessor (bank). Is it correct from *Shari'ah* perspective?
- (iv) An asset is leased to the customer with the understanding that the asset will be transferred (sold at an already agreed price/gifted) to the lessee by the bank at the end of the lease period after complete repayment of the *Ijara* facility/rentals. For this purpose, the price of the leased asset may be fixed in advance (at the time of the undertaking), apparently at the time of signing of the lease agreement. Do the *Shari'ah* principles allow such an *Ijara*/leasing practice by Islamic banks? Further, do the *Shari'ah* principles allow fixing the price of the leased asset in advance, apparently at the point of signing of the lease agreement?
- (v) How is such an *Ijara*/leasing different from a sale on instalment basis, in which the asset is transferred to the buyer and in this case the asset is also transferred to the customer at the end of the lease period and the lessee is required to indemnify the lessor (bank) against all types of accidents and injuries, damages and losses occurring to any person or property due to the storage, handling, use or operation of the assets by the lessee, even if occurrence of such accidents are beyond the control of the lessee? (i.e. The lessor does not assume any risks).
- (vi) Do the *Shari'ah* principles allow indemnifying the lessor (bank) against all types of accidents and injuries, damages and losses happening to any person or property due to the storage, handling, use or operation of the leased assets by the lessee, even if occurrence of such accidents are beyond the control of the lessee?

Conclusion and Recommendations

It is worth noting that *Ijara*/leasing is one of the major business areas of Islamic banks that needs to be operated according to the letter and spirit of *Ijara*/leasing. Apparently, the bank may be compensated by the customer if he/she backs out of leasing the asset acquired by the bank on his/her request, but only upto the extent of actual loss. However, if the bank sells the subject asset in the market at a price defined by the market forces of demand and supply, then such loss, if there is any, should not be shifted to the customer (the potential lessee). All the assets commonly acquired through *Ijara*/leasing, are usually well known from the market demand. So the Islamic banks may develop proper mechanism/arrangements with manufacturers/suppliers of such types of assets (machineries/vehicles) and if any customer refuses to lease the asset already acquired by the bank, the bank should postpone the delivery till another customer requests for such an asset. It is also possible that Islamic banks organize their show rooms for certain specific types of assets (machineries/vehicles) i.e. every Islamic bank may opt for a specific industry and should deal only in such business. It needs to be noted that it is an inflationary era and the prices usually follows an increasing trend with the passage of time. So, if the bank needs to wait for some time, in extreme case, the bank may earn a good return in form of price appreciation of the assets already booked but not leased due to back out by the customer.

The transfer of the ownership to the lessee is permissible only up to the extent of a unilateral promise but not as pre-condition to the lease agreement. However, practically almost all *Ijara*/leasing are ended with the transfer of ownership of the leased assets to the lessee reflecting the transfer of ownership as a precondition to the leasing for all practical purposes putting its *Shari'ah* acceptability in question. Further, the general indemnifying clause incorporated in the *Ijara*/leasing agreement appears to be another blow to the *Shari'ah* acceptability of the *Ijara*/leasing. According to *Shari'ah* the ownership related risk/expenses are the responsibility of the lessor/owner and shifting of such risk/expenses to the lessee is subject to negligence on the part of the lessee. However, such doubtful practice may be eliminated with the application of instalment based sales or diminishing *Musharakah* instead of naming them *Ijara*/leasing as almost all the features of sale are observed in the current use of *Ijara*/leasing. It is worth mentioning that these and other such issues (questions) in the practices of *Ijara*/leasing may better be clarified by consulting relevant *Shari'ah* scholars' through further research in future.

References

- AAOIFI. (2004–5a). *Shari'ah Standards*.
- Ayub, M. (2013). *Understanding Islamic Finance*. New York, NY: John Wiley & Sons, Ltd.
- Bryman, A. (2012). *Social Research Methods, 4th Edition*. Oxford University Press Inc., New York.
- El-Din, S. I., & Abdullah, N. I. (2007). Issues of implementing Islamic hire purchase in dual banking systems: Malaysia's experience. *Thunderbird International Business Review*, 49 (2), 225-249.
- El-Gamal, M. A. (2000). *A basic guide to contemporary Islamic banking and finance* (Vol. 1). Houston, TX: Rice University.
- Elo, S., & Kyngäs, H. (2008). The qualitative content analysis process. *Journal of advanced nursing*, 62(1), 107-115.
- Farooq, M., & Ahmed, M. M. (2015). Murabaha Financing in Pakistan: A Practical Islamic Banking Aspect. *Al-Idah 31 (Dec., 2015)*, 188-198.
- Fatima, M. (2016). Differences and similarities between *Ijara* and conventional operating lease contracts. *Market Forces*, 1(4).
- Hanif, M. (2014). Differences and similarities in Islamic and conventional banking. *International Journal of Business and Social Science*, 2 (2), 166-175.
- Hanif, M., & Iqbal, A. (2010). Islamic Financing and Business Framework: A Survey. *European Journal of Social Sciences*, 15(4), 475-489.
- Kamali, M. H. (2007). A *Shari'ah* Analysis of Issues in Islamic Leasing. *Islamic Economics*, 20(1), 3-22.
- Naqvi, N. A., & Perveen, A. (2014). Analysis of Growth of *Ijara* Investment in Pakistan (A case study on Meezan Bank). *KASBIT, Business Journal*, 7(2), 21-34.
- Neuman, L. W. (2014). *Social research methods: Qualitative and quantitative approaches (7th Edition)*. Pearson Education Limited, Edinburgh Gate, Harlow Essex, CM20 2JE, England.
- Robson, C. (2002). *Real World Research* (2nd edition). Blackwell Oxford.
- Saunders, M. & Lewis, P. Thornhill, A., (2009). *Research Methods for Business Students, 5th Edition*. Pearson Education Limited, Edinburgh Gate, Harlow Essex CM20 2JE, England.
- Sekaran, U. (2006). *Research methods for business: A skill building approach, 4th Edition*. John Wiley & Sons, Inc., 605, Third Avenue, New York, NY 10158-0012.
- Shirazi, H. (1993). Hire purchase in Iran. *American Journal of Islamic Finance*, 4(1), 9–10.
- Usmani, T. M. (2007). *An Introduction to Islamic Finance*. Idaratul Ma'arif, Karachi.
- White, M. D., & Marsh, E. E. (2006). Content analysis: A flexible methodology. *Library trends*, 55(1), 22-45.
- Zamil, N. A. M. (2014). *An empirical investigation into the problems and challenges facing Islamic banking in Malaysia* (Doctoral dissertation, Cardiff University).