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# A Shari‘ah Analysis of Issues in Islamic Leasing<sup>1</sup>

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*Abstract:* This essay is presented in two parts and several sections. The first part provides a fairly detailed examination of the *fiqh* rules pertaining to the contract of *ijarah*. It begins with the definition of *ijarah* and reviews the leading schools of Islamic law on the basic conditions and requirements of this contract. This is followed by a review of the two varieties of *ijarah* known to the market, namely operational lease, and financial lease. The discussion proceeds with a review of contractual options (*khiyarat*) and their relevance to *ijarah*, liability for loss and insertion of penalty clauses in the *ijarah*, and then the *fiqh* rules pertaining to the termination of this contract.

The second part deals with the *sukuk* (bonds) in general and the Islamic bonds in particular. It also discusses potential benefits of Islamic bonds and their effects on economic development and examines experts' opinions on issues of concern to Islamic bonds that have drawn the attention of commentators. A brief review of some recent issuances of Islamic bonds is followed by a discussion of hybrid assets in the *sukuk*.

## 1. Introductory Remarks

This essay is presented in two parts, one of which provides an exposition of the *fiqh* rules pertaining to *ijarah*, and the other addresses market developments and Shari‘ah-related issues in *ijarah* bonds. The discussion starts with a review of the concept and definition of *ijarah*, its basic requirements and conditions of validity according to the leading schools of *fiqh*. This is followed by a brief discussion of the two forms of *ijarah*, namely operational lease and financial lease, drawing attention to the fact that financial leasing and securitization of *ijarah* do not find a precedent in the works of *fiqh*. The succeeding sections expound the *fiqh* rules pertaining to contractual stipulations, and the relevance of options (*khiyarat*) to *ijarah*, liability for loss, penalty for default, and the termination of *ijarah*.

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The second part on developments in the *sukuk* market introduces the *sukuk* and then provides a more detailed discussion of *ijarah* bonds. The discussion highlights the potential benefits of Islamic bonds in reference to mobilization of funds that can stimulate economic development and serve therefore the *maslahah* (welfare, interest) of the people. The discussion proceeds with a review of expert opinion including some *fiqh* academy resolutions on issues of concern to Islamic bonds and commentators response to some of those issues. This is followed by a brief review of some recent bonds issues, the development of hybrid assets in *sukuk*, and a conclusion.

## 2. The Contract of *Ijarah*

*Ijarah* derives from the root word *ajara* – to recompense, compensate or give a consideration and return. *Ajr* refers to a worker's wage, and *ujrah* to rental payment. In its juristic usage, *ijarah* primarily refers to both a rental as well as a hire contract that engages the services of persons. In its current usage *ijarah* also occurs in two types, namely operational lease and financial lease, the latter is known as *ijarah wa iqtina'*.

*Ijarah* is validated by the Qur'an, Sunnah, and general consensus (*ijma'*). Several verses are found in the Qur'an (al-Kahf, 77; al-Qasas, 26; al-Talaq, 65-6) on the worker's entitlement to a wage where references are also made to the practices of previous Prophets on *ijarah*, thus indicating that *ijarah* represents an instance of continuity in the Qur'an of the laws of previous nations. References also occur in *hadith* to *ijarah* and the employer-employee relations, including, for example, the instruction, in symbolic terms, to the employer to "pay the employee his wages before the sweat of his brow dries up". Whereas the Qur'an and Sunnah only refer to *ijarah* as an employment contract, the companions of the Prophet practiced *ijarah*, in the sense of employment as well as rental of real property. The validity of *ijarah* is thus upheld by conclusive *ijma'* of the companions, as well as general custom (*'urf*) among Muslims that prevails to this day<sup>(1)</sup>.

The *fiqh* texts provide elaborate details on *ijarah* which stop short nevertheless of offering a blueprint for the modern applications of this contract, especially as a mode of contemporary finance. This essay explores aspects of *fiqh* on *ijarah* that are of relevance also to contemporary applications of this contract.

Scholars of the four schools of Islamic law have differed somewhat on the precise definition of *ijarah*. All the *madhahib* are in agreement however, that *ijarah* is a contract of the sale of known and specified benefits or services in return for compensation<sup>(2)</sup>. Minor variations that occur in the definition of *ijarah* may be summarized as follows: Whereas the Maliki and Hanbali definitions of *ijarah* qualify benefits and services into lawful benefits and services (*manfa'ah mubahah*) that would preclude unlawful objects and activities, other schools subsume this qualification under the conditions and requirements of *ijarah*. Another stipulation of the Hanbali definition is

(1) See for details Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, Lahore: Faran Academy, n.d, II, 166; Wahbah al-Zuhayli, *Al-Fiqh al-Islami wa Adillatuh*, 3rd edn. Damascus: Dar al-Fikr, 1409/1989, IV, 130; Abd al-Wahhab Abu Sulayman, *'Aqd al-Ijarah* 19-21 (n.6); 'Ali al-Khafif, 485 (see note 2).

(2) Muwaffaq al-Din Ibn Qudamah, *al-Mughni*, n.8 below, VI, 12; Abu Sulayman (next note 6) *'Aqd al-Ijarah*, 18, Ali al-Khafif, *Ahkam al-Mu'malat al-Shar'iyah*, Bahrain, Bank al-Baraka, n.d., 485; 'Abdullah 'Alawi Haji Hasan, *Sales and Contracts in Early Islamic Commercial Law*, Islamabad: Islamic Research Institute, 1984, 155.



that the benefit or service materializes in the future. For if it existed at the time of contract, it would resemble sale, whereas *ijarah* only yields its benefits over a specified period in the future. The Maliki definition further stipulates that the consideration (*'iwad*) in *ijarah* does not emanate from the usufruct thereof. This is deemed necessary in order to differentiate *ijarah* from agricultural sharecropping contracts and orchard farming (*muzara'ah* and *musaqah*) wherein the *'iwad* is given out of the benefits (*manfa'ah*) that obtain in them<sup>(3)</sup>.

To say that *ijarah* is the sale of benefits differentiates it from sale proper, gift and charity (*bay'*, *hibah*, *sadaqah*) which consist of the transfer of the capital asset as a whole and not only of its benefits. *Ijarah* is thus a sale of benefits, or usufruct, usually of durable goods. Reference is also made in the precise determination of what may or may not be suitable for *ijarah* to the prevailing custom, which is also applicable to the mode of payment, whether of wages or rental, as to how they are paid. Consideration in *ijarah* is normally payable toward the end of a specified period, be it a week, month or year, as the benefit of *ijarah* usually materializes over a period of time. Yet Custom may change this and determine that the benefit of *ijarah* be paid for in advance.<sup>(4)</sup> Custom also determines the manner how the usufruct is derived in *ijarah*. A tenant is thus expected to live in the rented place and use it for familiar purposes of living and not outside the customary expectations of proper usage for that purpose<sup>(5)</sup>.

Since *ijarah* is a variety of sale, it is lawful in everything that can lawfully be bought and sold, and the rules of Shari'ah pertaining to sale are also generally applicable to *ijarah*. The *fuqaha'* have, however, singled out basically two things, namely the human being, and the *waqf* property which cannot be sold but can be made the valid subject matter of *ijarah*.<sup>(6)</sup> Furthermore, since *ijarah* is a variety of sale, anything that can be paid as a price (*thaman*) in sale can also be given as consideration in *ijarah*.

Most of the rules relating to the contract of sale, such as those pertaining to sanity, adolescence and consent of the contracting parties without which no contract can come into existence also apply to *ijarah*. Other rules of sale that apply to *ijarah* include options (*khiyarat*) such as *khiyar al-ru'yah* (option of viewing), *khiyar al-'ayb* and *khiyar al-shar'i* (option of defect, and option of condition), revocation (*faskh*), and *iqalah* (termination by mutual agreement), but not pre-emption (*shuf'ah*). The Shafi'is also disallow *khiyar al-shari* in *ijarah*. In a defective *ijarah* (*ijarah fasidah*) the fair rent or wage (*ajr al-mithl*) but not the one specified in contract would be applicable. Since *ijarah* transfers the ownership of usufruct from the lessor to the lessee, the former must not only own the assets involved but also be able to transfer the ownership of its benefits to the lessee<sup>(7)</sup>. It is also a requirement of a valid *ijarah* that the capital asset

(3) Cf. **Abd al-Rahman al-Jaziri**, *Kitab al-Fiqh 'ala al-Madhahib al-Arba'ah*, Cairo, Al-Maktabah al-Tawfiqiyah, n.d. III, 86-90.

(4) Cf. **Al-Jaziri**, *Kitab al-Fiqh 'ala al-Madhahib al-Arba'ah*, n.3, III, 97.

(5) *Id.*, III, 104.

(6) **Mansur Ibn Yunus al-Buhuti**, *Kashaf al-Qina'an Min al-Iqna'*, ed. Mustafa Hilal, Riyadh: Maktabat al-Nasr al-Hadithah, n.d. III, 561; **'Abd al-Wahhab Abu Sulayman**, *'Aqd al-ijarah Masdar min Masadir al-Tamwil al-Islamiyah*, Jeddah: Islamic Research and Training Institute, 1413/1992, 27.

(7) **Ali al-Khafif**, *Ahkam Mu'amalat al-Shar'iyah*, n.2, 487.

survives and does not perish with the *ijarah*. This would preclude items such as food, fuel and money which cannot be used unless they are consumed altogether.

Other conditions required in a valid *ijarah* are that the two sides of the exchange must both be known and specified in such a way that eliminates the possibility of disagreement and dispute; that the usufruct in question has a financial or market value; and also that it does not involve indulgence in *haram* activities and substances<sup>(8)</sup>. Objects such as a dead carcass, pork, wine, and prohibited activities such as usury, prostitution and gambling may not be the subject either of sale or *ijarah*.

Moreover, *ijarah* like sale involves exchange of values on both sides. The usufruct in *ijarah* may thus be sold for money, another object of value, or indeed another usufruct such as rental of a house in exchange for the rental of another house. This is the majority position although the Hanafis have held that the counter values of *ijarah* should not be of the same genus. The reason given that the benefits of *ijarah* are non-existent on both sides at the time of contract, and since *ijarah* is a form of sale, if both the counter values are of the same genus, it would resemble deferred sale (*bay' bi'l-nasi'ah*) on both sides, which is not permissible<sup>(9)</sup>. Deferment is allowed according to the majority of jurists of one of the counter values in sale, such as in *salam* or *bay' bi-thaman ajil* (BBA) but not of both sides of the bargain.

Leasing is used as a mode of financing by Islamic financial institutions with the purpose of enabling customers to use durable goods and equipment such as ships, aircraft, heavy machines and plants in productive enterprises without having to buy them. In a simple *ijarah* that does not involve securitization of the *ijarah* receivables, the customer or the lessee, pays a certain amount in cash as rental of the leased asset over a period of time. Since the Islamic bank or financial institution acquires the desired asset only when a client requests it and commits himself to enter into a lease contract with the bank, the bank can make a profit by setting the rent at a level that covers, over the lease period, the purchase price as well as a return in line with the current rate of mark-up *murabahah*. The lease is usually for a time long enough to cover the life of the asset. The banks are usually not interested in the asset itself and the contract generally provides for sale or gift of the asset to the lessee at the end of the contract period. This is *ijarah-wa-iqtina'*, or a lease ending up with the lessee owning the asset. This form of *ijarah* is widely practiced as it is akin to *murabahah* and suits the banks' role as financial intermediaries.

The Syariah Advisory Council (SAC) of the Securities Commission of Malaysia has noted that financial leasing is not a new contract but an extension of the contract of *ijarah* and a mechanism that develops the same concept into a mode of financing. Moreover, the sale of usufruct which is a feature of financial lease is lawful and Islamic jurisprudence recognises it as *mal*. The SAC thus noted that "financial lease without a

(8) Muwaffaq al-Din Ibn Qudamah al-Maqdisi, *al-Mughni*, Beirut: Dar al-Kitab al-Jadid, 1403/1983, VI, 12. Mohammad Abu Zahrah, *al-Milkiyah wa Nazariyat al-'Aqd fi'l-Shari'ah*, Cairo: Dar al-Fikr, n.d., 272; Shams al-Din al-Ramli, *Nihayat al-Muhtaj* (see n.22), IV, 6.

(9) Fakh al-Din 'Uthman al-Zayla'i, *Tabyin al-Haq 'iq Sharh Kanz al-Daqa'iq*, 2nd edn. Beirut: Dar al-Ma'rifah, V, 106; al-Jaziri, *Kitab al-Fiqh*, n.3, III, 93; Abu Sulayman, *'Aqd al-Ijarah* n. 6, p.30.



penalty clause does not contradict *Syariah*<sup>(10)</sup>. The SAC further noted that in their calculation of the rental, the leasing companies take a similar approach, which is based on the value of the asset, rate of charge or return, and the period of financing, The main difference being that an operational lease does not offer an option to the lessee to buy the leased asset.

Notwithstanding its general acceptance in Islamic banks, some aspects of financial leasing are not fully *Shari'ah* compliant and need to be reviewed and rectified. One of these is concerned with assignment of lease without the transfer of ownership. The lessor can sell the leased property to a third party in which case the relation of lessor and lessee shall be established between the new owner and the lessee. However, assignment of the lease itself for a monetary consideration without assigning ownership of the leased asset is not valid. The difference being that in the latter case the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive rent of the asset only. This kind of assignment is acceptable in *Shari'ah* only where no monetary consideration is involved. For example, a lessor can assign his right to claim rent from the lessee to his brother or friend as a gift. Similarly, he can assign this right to any one of his creditors to set off his debt out of the rent receivables. But if the lessor wishes to sell this right for a price, he would be indulging in the sale of money (the amount of rentals) for money which would be tantamount to *riba*<sup>(11)</sup>.

Unlike sale which under the scholastic *fiqh* cannot be effected for a future date, *ijarah* for a future date is permissible. The lease period, and also the lessor's entitlement to rent, however, commence from the date on which the leased asset is delivered to the lessee, regardless as to whether the lessee has started using it or not. This enables both the lessor and lessee to make preparation plans ahead over a longer period of time. The rent or any part thereof may be payable in advance before delivery of the asset to the lessee, but the amount so collected by the lessor remains with him as payment on account that is adjustable against the actual rent. Jointly owned property by two or more persons can be leased out and the rent is distributed among them in proportion to their respective share in the property. A joint owner of a property may also lease out his part to his partner but not to an outsider without an agreement with his partner/s first. The lessee may not use the leased asset for purposes other than those specified in the lease agreement. If no such purpose has been specified in the lease agreement, the asset may be used for any purpose that is deemed customary and normal.

### 3. Two Modes of Lease Financing

The *fiqh* discourse does not envisage *ijarah* as a mode of financing, but a transaction for the transfer of usufruct from person to person for an agreed consideration and period. Yet as earlier noted, in financial leasing, *ijarah* is basically used as a substitute to long term lending on the basis of interest. The lessee thus acquires the equipment he needs without borrowing on interest but resorts to leasing as an alternative. Leasing companies

(10) Securities Commission of Malaysia, *Resolutions of the Securities Commission*, Syariah Advisory Council, Kuala Lumpur, 2002, 69.

(11) Cf., Muhammad Taqi Uthmani, no. 14, *Introduction to Islamic Finance*, 172.

and Islamic banks often lease objects such as plants and machinery to business firms and entrepreneurs who may be unable to buy them for their production purposes<sup>(12)</sup>.

In a financial lease, Islamic banks and institutions are usually not interested in the asset itself, yet the option remains open for them to retain ownership of the item, sell or lease it to another client. Financial leasing has become popular due to tax advantages as the rental can be offset against corporate tax by the lessee, including *zakah*. Since the client renting the equipment is not its owner, any wealth assessment for *zakah* will not include the item in question.

The critics say that financial leasing basically boils down to a form of disguised security agreement since it transfers to the lessee all the risks associated with ownership. The long-term and binding nature of financial lease add to the weight of that problem. Even when the leased object is eventually made into a free gift or given at a nominal price, it does not address the issue that the residual value is predetermined and built into the lease payments which may prove to be unjust. For the lessee loses the asset as well as the extra payments he may have made in the event he dies or is unable to continue the lease payments. To address this problem, it is suggested that the lease agreement should not bind the lessee to acquire ownership of the asset as this would tie up one agreement with another and make the one a pre-condition of the other. However, the lessor is at liberty to sign another contract with the lessee at the end of the lease period, just as he may also make a unilateral promise to sell, or make a gift of the leased asset to the lessee at the end of the lease period. In this way the lessee would still have the option whether or not he wishes to acquire ownership of the leased asset<sup>(13)</sup>.

In some cases the lease commences on the very day the lessee receives the price irrespective of whether he has taken delivery of the asset. The lessee's liability for rent thus begins prior to taking delivery of the leased asset. This contravenes one of requirements of *ijarah* as it amounts to charging rent on the money given to the customer, and it is tantamount to interest. If the supplier has delayed delivery after receiving the price, the lessee should not be liable for the rent of the period of delay.

Furthermore, when the lessee himself has been entrusted with the purchase of the leased asset, two separate relations come into play between the institution and the client one after the other. In the first instance, the client is an agent (*wakil*) of the institution to purchase the asset on the latter's behalf. The lessor-lessee relationship has not yet come into operation at this stage. The second stage begins from the date when the client takes delivery from the supplier. It is only then that the lessor-lessee relation begins within the context of *ijarah*. During the first stage, the client cannot be held liable for the

(12) Cf. **Husayn Hamid Hassan**, *al-Istithmar al-Islami wa Turuq Tammiliyah*, Bank Dubai al-Islami, (in-house publication) 1997, 60. In Malaysia this variation has been further extended in the form of what is known as *ijarah thumma al-bay'* (*ijarah* then sale) which means that two separate contracts are concluded, namely *ijarah* and sale: upon expiry of the lease period the lessee enters into a second contract to purchase the leased asset from the lessor.

(13) Cf. **Muhammad Nejatullah Siddiqi**, *Riba (Interest) and Rationale of its Prohibition*. Jeddah: IRTI, Islamic Development Bank, 2004, 62; **Mohammad Muzafar**, "Ijarah: Financing on the Basis of Hire-Purchase and Leasing" *Encyclopedia of Islamic Banking*, 137; **Liaqat Ali Khan Niazi**, *Islamic Law of Contract*, Lahore, 298; **Derek Weist** "Issues in Islamic Leasing" London: New Horizon, June 1997, 7.



obligations of the lessee as he only acts as a trustee and agent. But when he takes delivery of the assets, he also acquires the role of the lessee<sup>(14)</sup>.

#### 4. Liability for Loss

Since the lessor, in a financial lease, bears ownership responsibilities, in the event the asset is destroyed during the lease period, he alone stands to suffer the loss. Similarly if the leased asset loses its utility and function without the lessee's fault or negligence, the lessor's entitlement to rent discontinues. This may also be said to be one of the differences between *ijarah* and conventional leasing, as the latter entitles the lessor to receive rent even if the lessee could not obtain any benefit from the leased asset.

Long term leases with fixed rent may be liable to market fluctuations of rent and inflation which may present loss-incurring factors for the lessor. To prevent excessive uncertainty in this regard, the lessor may insert a condition in the lease that the rent may be reviewed or made renewable on new terms at specified intervals. This would be tantamount to what is now known as floating *ijarah*, as opposed to fixed rate *ijarah*.

If the lessee contravenes any of the terms of the agreement, he may be held liable for compensation of the loss caused, but he cannot be compelled to pay the rent of the remaining period. The lease asset normally reverts to the lessor when the lease is terminated. Should there be no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. Hence any stipulation which gives the lessor unrestricted power to terminate the lease would be contrary to *Shari'ah*. Similarly, any clause which obligates the lessee to payment of rent for the remaining of the lease period would be *ultra vires* the *Shari'ah*.

If the leased asset has totally lost its utility and function, accidentally destroyed, or its usufruct value substantially reduced and no restoration or repair is feasible, the lease terminates as of the day of the loss of its utility. However, in modern practice, the leased assets are usually insured against such contingencies, in which case, it may be unnecessary to insert additional stipulations in the lease contract.

The lessee's control over the leased article is in the nature of a trust (*amanah*) which means he is not liable for loss and damage that occurs through normal use of the leased object. But he is liable to pay compensation when he violates the terms of the trust and uses the leased article contrary to what is normal and customary, or when proved deliberately negligent and abusive<sup>(15)</sup>.

Financial lease agreements often stipulate a penalty if the lessee defaults on payment. Uthmani observed that a penalty of this kind is not valid in an Islamic lease. The reason given is that the rent after it becomes due is a debt payable by the lessee and a monetary charge on it is tantamount to *riba*. A stipulation may, however, be inserted in the *ijarah* agreement making late payment by the lessee over a period of time liable

(14) Cf. Muhammad Taqi Uthmani, *Introduction to Islamic Finance*, Karachi, Pakistan, Idaratul-Ma'arif, 1999, 165.

(15) al-Khafif, *Ahkam Mu'amalat al-Shar'iyah*, n.2, 491.



to a certain amount of charity. This may provide a deterrent to late payment even though it does not compensate the lessor for his opportunity cost over the period of default<sup>(16)</sup>.

The SAC of the Securities Commission of Malaysia, has held that late payment in an operating or a financial lease may be subject to a one per cent penalty, which may not, however, be compounded. In holding this position the SAC actually followed an earlier resolution of its sister organization, namely the *Shari'ah* Advisory Council of the Central Bank (Bank Negara) of Malaysia, which had also approved imposition of a flat one per cent penalty per annum<sup>(17)</sup>.

In a subsequent resolution of the SAC (8 November 2000) the issue of default on payment was addressed more widely, that is, with reference to all Islamic financing transactions, under the rubric of substitution of compensation (*ta'wid*). Thus it was held that imposing *ta'wid* is permissible 1) for arrears of due payments, 2) for failure to pay after the due date, 3) for early settlement before due date in Islamic financing products that are based on contracts of exchange (*'uqud mu'awadat*) including Islamic debt securities. *Ta'wid* can be imposed after it is found that deliberate delay in payment (*mumatalah*) is present on the part of the payee to settle the payment of principal or profit. The rate of *ta'wid* on late payment of profit is one per cent per annum of the arrears which may not be compounded. Where the *ta'wid* rate on payment of the principal is based on the prevailing market rate in the Islamic inter bank money market; it too may not be compounded.

The SAC resolution added that "the imposition of *ta'wid*, or *shart jaza'f*" is penalty agreed upon by the *'aqd* parties as compensation that can rightfully be claimed by the creditor, when the debtor fails or is late in meeting his obligation to pay back the loan. Payment by way of *ta'wid* may not in any case exceed the total amount of the outstanding balance<sup>(18)</sup>. The *Shari'ah* evidence cited for this resolution refers to two *hadiths*, and a ruling of *qiyas* (analogy) as follows:

- Procrastination by the affluent is injustice (*matl al-ghani zulm*).
- Harm may neither be inflicted nor reciprocated (*la darar wa la dirara fi'l-Islam*).

This last *hadith* is moreover supported by the legal maxim that "harm must be eliminated (*al-darar yuzal*)".

*Qiyas*: delay in due payment is seen to be analogous to *ghashb* (usurpation) and the usurper may, in the Shafi'i and Hanbali schools, be held liable to compensate the owner for his loss. The *'illah* or effective cause that is in common between *ghashb* and *mumatalah* is "obstructing the use of property and exploiting it in a tyrannical way".

The Fiqh Academy of the Organisation of Islamic Conference, in its resolution 66 (1992) authorised imposition of liquidated damages and penalty in *istisna'*

(16) Uthmani, *Introduction to Islamic Finance*, n. 14, 171-72; see also Ali Arsalan Tariq *Managing Financial Risks of Sukuk Structures*, unpublished *Master of Science Dissertation at Loughborough University*, UK, 2004.

(17) SAC 20th Meeting, 14 July, 1999, see Securities Commission of Malaysia, n. 10, 102.

(18) Securities Commission of Malaysia, n. 10, 103.

(manufacturing contract) on the basis of a prior agreement between the contracting parties. This is when the parties agree and stipulate in their contract a sum that shall be payable in the event one party fails to discharge or delay his contractual obligation<sup>(19)</sup>. The evidence quoted in support of this ruling is the Bukhari *hadith* narrated by Ibn Sirin that a man said to an owner of animals for hire: "prepare one of your animals for me to travel; should I not hire it on such and such a date, I shall pay you 100 dirhams", and he did not go on that day. Judge Shurayh Ibn Harith ruled in this case that "whoever imposes a condition upon himself voluntarily, he must abide by it"<sup>(20)</sup>. Another renowned *hadith* similarly declares that "Muslims are bound by their stipulations unless it be a condition that renders a *haram* into *halal* or vice versa – *al-Muslimuna 'ala shurutihim...*". Mustafa al-Zarqa has observed concerning compensation (*ta'wid*) that it is payable for losses the parties incur in a business transaction due to waste or disruption of business. Due to the change of circumstances people may need to insert a condition on *ta'wid* in contracts to secure their economic interests in which case they are bound by their stipulations<sup>(21)</sup>. The present writer concurs.

### 5. Options and Stipulations (*Khiyarat*)

Each of the parties in an operational lease has the right to insert stipulations in the contract such as the option of condition (*khiyar al-shari*) according to which the option stipulator can duly exercise it and dissolve the lease. This kind of option is limited to three days according to the majority view. The Shafi'is validate insertion of *khiyar al-shart* in sale but not in *ijarah*<sup>(22)</sup>. The parties to an operational lease or a financial lease and their representatives may thus, according to the majority, but not the Shafi'is, choose to insert stipulations that reflect new market realities and such other matters as timing of fulfillment of their contractual obligations. Similarly both the lessor and lessee, or their agents, have the right to stipulate the option of viewing (*khiyar al-ru'yah*) which would entitle them to dissolve their contract after seeing the leased object, if they have not seen it at the time of contract. Furthermore, under the option of defect (*khiyar al-'ayb*), if the lessee finds any defect in the leased object, he is entitled to dissolve the contract provided the defect in question is such as to obstruct normal enjoyment of the leased article.

The lessee himself or anyone else with his permission may utilise the leased article with or without payment. If the leased asset is likely to be differently used by different users, the lessee may not sub-lease the leased asset without the permission of lessor. If the sub-lease rental is equal or less than the original rent, and the asset is used for similar purposes, all the leading *madhahib* agree on the permissibility of sub-leasing. However, opinions vary in the event where the sub-lease rental is higher than the original rent. Whereas the Shafi'i and Hanbali schools allow this, Imam Abu Hanifah has held that the surplus should be given in charity, but allows it if the sub-lessee has enhanced the assets in some way<sup>(23)</sup>. Notwithstanding the pious caliber of Abu Hanifah's

(19) **Majma' al-Fiqh li Rabitah al-'Alam al Islami**. *Qararat Majma' al-Fiqh al-Islami*, Jeddah, 1975.

(20) **al-Bukhari**, *Fath al-Bari Sharh Sahih al-Bukhari*, Kitab al-Shurut (Book of Conditions), vol. V, 354.

(21) **Mustafa al-Zarqa**, *al-Madkhal al-Fiqhi al-'Amm: al-Fiqh al-Islami fi Thawbihi al-Jadid*, Damascus: Dar al-Fikr, 1968, III, 386.

(22) **Shams al-Din al-Ramli**, *Nihayat al-Muhtaj ila Sharh al-Minhaj*, Cairo, 1386/1967 IV, 6; **Abu Sulayman**, *'Aqd al-Ijarah*, n.6, 40.

(23) Cf., **al-Khafif**, *Ahkam*, n.2, 490-91.



view, the Shafi'i and Hanbali view would appear to be closer to the present market reality and custom and may therefore be followed.

## 6. Revocation (*Faskh*) of *Ijarah*

Since the principal purpose of *ijarah* is to enable the lessee to enjoy the usufruct of the leased object, the majority of schools, excepting the Hanafis, allow revocation (*faskh*) of *ijarah* in basically one situation only, which is when the leased article loses its utility and benefit. The majority consequently do not allow revocation of *ijarah* on grounds of any personal disability that befalls the lessor or the lessee. Hence a lease contract may not be revoked on any other ground<sup>(24)</sup>.

The Hanafis also permit revocation of *ijarah* on ground of disabilities affecting the parties even when the leased item remains intact. Revocation is thus allowed of the lease, for example, of a shop if prior to taking occupancy, the lessee loses all his merchandise. Similarly, when someone hires a chef for an event which is, however, unexpectedly postponed or cancelled, the hire contract may be revoked. Disagreement among the schools has also arisen over the dissolution of *ijarah* in the event of death of one of the contracting parties. The majority of schools maintain that *ijarah* remains intact even after the death of one of the contracting parties and hold that their legal heirs would inherit the contract. The latter would consequently step into the shoes of their deceased relative and would consequently be bound to honor the contract. The Hanafis maintain, on the other hand, that the contract is dissolved upon the death of one of the contracting parties. This is because usufruct according to the Hanafis is a *manfa'ah* (benefit) which is not *mal* and therefore not inheritable. Transfer of ownership by way of sale, gift and inheritance also does not vitiate the *ijarah*, which according to the majority including the Hanafis survives the transfer and the new owner must observe it until the end of its period<sup>(25)</sup>.

*Ijarah* basically expires when its period of validity comes to an end unless it be for a reason that necessitates its extension beyond the due date. Thus when the hire period of an animal or a vehicle comes to end during the continuation of a journey they have been hired for, the *ijarah* continues until the time the carrier reaches destination.

As already noted *ijarah* that is subject to option of stipulation, option of defect or option of viewing comes to an end with the due exercise of these options<sup>(26)</sup>.

## 7. Islamic Bonds or *Sukuk*

*Sakk* (pl. *sukuk*) in Arabic lexicology derives from the idea of striking one's seal on a document signifying a covenant or conveyance of rights and obligations. The word is also used for minting coins. In its present usage, *sukuk* refer to certificates or financial securities that represent a proportional or undivided interest in an asset, or pool of assets, and the claim embodied in *sukuk* is not simply claim to a cash flow but an ownership

(24) Ibn Qudamah, *al-Mughni*, n.8, VI, 20; Abu Sulayman, *'Aqd al-Ijarah*, n.6, 75.

(25) Ibn Rushd, *Bidayat al-Mujtahid*, n.1, II, 288; Ali al-Khafif, *Ahkam al-Mu'amalat al-Milkiyah*, n.2, 502; Abu Sulayman, *'Aqd al-Ijarah*, n.6, 76.

(26) Al-Khafif, *Ahkam*, n.2, 503-504.

claim. This also differentiates *sukuk* from conventional bonds as the latter proceed over interest bearing securities, whereas *sukuk* are basically investment certificates consisting of ownership claims in a pool of assets. The aim is to sell the assets and recover its value from subscription, in which case the holders of the certificates become owners of the assets. The primary condition of *sukuk* is the existence of assets on the balance sheet of the government, the monetary authority, corporate body or bank which wants to mobilize its financial resources. *Shari'ah* considerations dictate that the pool of assets should not solely comprise debts from Islamic financial contracts such as *murabahah* and *istisna'* but have a dominantly asset based component such as *ijarah*, *mudarabah* and *salam*.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) released in November 2002 a document on *Shari'ah* standards concerning *sukuk*. The document provides that "Investment *sukuk* are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting them to use as planned, common title to shares and rights to tangible assets, usufructs and services, or equity of a given project of a special investment activity"<sup>(27)</sup>.

Zero-coupon *sukuk*, as they are known, are debt financing but non-tradable *sukuk* which are created where the assets to be mobilized do not exist yet. The purpose would be to create more assets on the balance sheet of a company. However, certificates of this nature would not readily be tradable because of *Shari'ah* restrictions on sale of debts (except for Malaysia and Indonesia). The primary asset pools to be generated would partake of *istisna'* and instalment purchase/sale contracts that create debt-bearing obligations. The certificates on these debts are known as fixed rate zero coupon *sukuk* and they are generally deemed to be *Shari'ah* compliant<sup>(28)</sup>.

*Sukuk* may be divided into two types: *sukuk* that yield pre-determined returns, and *sukuk* based on profit and loss sharing. *sukuk al-ijarah* are a prime example of certificates that yield pre-determined returns. So far *sukuk al-ijarah* has been the dominant type of *sukuk* issued, although *salam sukuk* has also been used for similar purposes and it is being actively promoted by the government of Bahrain<sup>(29)</sup>. Part of the motivation to promote these new tools has been to replace the commodity *murabahah* transactions so commonly used by Islamic banks to generate liquidity. *Ijarah* bonds are "securities of equal denomination for each issue, representing physical durable assets that are tied to an *ijarah* contract as defined by *Shari'ah*"<sup>(30)</sup>.

*Ijarah* bonds represent leased assets without actually relating the bond holders to any corporate body or institution. For instance, an aircraft leased to an airline company can be represented in bonds and owned by a thousand different bond holders, each of them individually and independently collecting their periodic rent from the airline company without having to associate with other bondholders. They are, in other words,

(27) *Exposure Draft of AAOIFI Shari'ah Standard No. 18, November 2002, p.4.*

(28) Cf., **Tariq** "Managing Financial Risks of *Sukuk*," no. 16, 22.

(29) The *salam sukuk* of Bahrain are monthly issues and are non-tradable. So far over 40 issues of these *salam sukuk* have been issued and each oversubscribed.

(30) **Monzer Kahf**, "The Use of Assets *Ijarah* Bond for Bridging the Budget Gap," *Islamic Economic Studies*, vol. 4, n.2, May 1997, 82.



not owners of a share in a company that owns the leased airline, but simply a sharing owner of one thousandth of the aircraft itself. The bondholders receive steady income that is even more risk averse than common stock, due to the fixed and predetermined nature of their rental cash flow.

*Ijarah* bonds are nevertheless exposed to risks arising from general market conditions, price movements of real assets, the ability of the lessee to pay the rental installments, maintenance and insurance costs. This might mean that the expected return on some forms of *ijarah* bonds may not be precisely predetermined and fixed. The fixed rental may thus represent a maximum that is subject to certain deductions. Pure *ijarah sukuk* are usually issued on the basis of stand-alone assets identified on the balance sheet. The assets can be parcels of land to be leased, equipment such as aircraft and ships. The rental rates on these *sukuk* can be both fixed and floating depending on the particular originator and contract<sup>(31)</sup>.

There is scope, of course, for introducing *mudarabah* and *musharakah* bonds although these are more likely to be designated as notes since the returns will be variable rather than fixed-unlike the *ijarah* and *salam* certificates which are predetermined. *Mudarabah* and *musharakah* bonds have, in fact, been introduced by many countries as well as the IDB.

Securitization is commonly used as a risk management tool as well as an instrument of monetization of illiquid and untapped assets. It helps to decrease funding risks by diversifying the sources of funds. Securitization can generate gains for both financial institutions and investors. The investors are enabled to make their investment decisions almost independently of the credit standing of the originator and focus instead on the degree of protection provided by the SPV (special purpose vehicle) to meet the investment target.

*Ijarah*-based securitization starts with the identification of a suitable underlying asset, which must be capable of both sale and leasing. The process normally starts with the lessor/originator selling the leased asset to the SPV. The latter then enters into a lease contract with the originator. The lease contract creates income in the form of rental payments in favor of the SPV. The SPV then issues *sukuk al-ijarah* that are supposed to represent an undivided proportionate ownership in favor of its holders over the leased asset. At the end of the lease period, which also signifies maturity of the *sukuk*, the issuer will redeem the *sukuk* from the holders, effectively by buying back the underlying assets.

Securitization of *ijarah* gained momentum in the last few years with the issuance initially of the Malaysian Global *Sukuk* of USD600 million in June 2002. This was followed with the USD700 million State of Qatar Islamic *Sukuk* in 2003, and the USD250 million Bahrain Monetary Agency's *Ijarah sukuk* in early 2004. Saudi Arabia, Pakistan and the IDB etc., have added to the list. In June 2004 the Department of Civil Aviation of UAE mandated the Dubai Islamic Bank to issue USD750 million *sukuk al-*

(31) Cf., Nathif J. Adam and Abdul Kader Thomas, *Islamic Bond, Your Guide to Issuing, Structuring and Investing in Sukuk*. London: Euromoney Books, 2004, 117; Tariq, "Managing Financial Risks." n.16, 21.

*ijarah* to raise funding for the expansion of Dubai International Airport. Indonesia is reported to be issuing "part of its planned USD2 billion in overseas bonds in 2005 in the Islamic format"<sup>(32)</sup>. All the issues introduced so far were highly successful and well received in the Middle East, Europe and beyond. Yet the relatively low number of issues has been a restrictive factor on overall liquidity in the market, and the situation is not helped by the fact that investors were inclined to hold on to their investments<sup>(33)</sup>.

The successful reception of *ijarah* bonds and its world-wide Shari'ah compliance endorsement is partly due to the fact that they avoid the somewhat controversial *bay' al-dayn* mode of asset securitization. A distinction of note to be drawn is between lease-based securitization, and debt-based securitization, which makes the former acceptable generally whereas reservations tend to persist in the Middle East and Gulf regions over the acceptance in Shari'ah of the latter, although it is accepted in Southeast Asian countries that adhere to the Shafi'i *madhhab*.

In a 2004 Euromoney Islamic Banking and Finance Summit held in Kuala Lumpur<sup>(34)</sup>, commentators confirmed that *murabahah* and *bay' bi-thamam 'ajil* continued to be in focus but that *sukuk*, although limited in supply and institution bound, is the most sought after product. The overall size of Islamic finance worldwide was estimated at USD250 billion and according to a subsequent *Asian Wall Street Journal* estimate, 270 billion comprising *murabahah* transactions in short-term market operations, equity-based real estate and hedge funds, retail finance products like mortgages, car financing etc, adding, however, that Islamic bonds were yet to be fully developed. It was further noted that only 20 per cent of Muslim population in GCC countries buy Islamic products. The focus in the future should be on real estate investment trust (REIT) and real estate investment funds which have wider retail appeal and distribution. In her keynote address, Dr. Zeti Aziz, Governor of Central Bank Malaysia called for exploring the prospects of "creation of an Islamic Universal Bond. Interested countries and selected institutions could sell their assets to a special purpose vehicle, which, in turn, would lease back the assets to the countries. Proceeds could then be transferred to the participating countries for the general purposes of economic development"<sup>(35)</sup>.

In February 1988, the Fiqh Academy of the Organisation of Islamic Conference considered, at the request of delegates from Jordan, Pakistan and Malaysia, the question of Islamic investment certificates at their fourth annual plenary session held in Jeddah. The Academy held that the Shari'ah encourages documentation of contracts as stipulated in sura 2:282 of the Qur'an:

*"When you deal with each other in transactions involving future obligations over a fixed period of time, reduce them to writing... It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves."*

(32) *The Asia Wall Street Journal*, December 22, 2004, M1.

(33) Cf., **Tariq**, "Managing Financial Risks of Sukuk," n. 16, 29.

(34) See newspaper articles on Euromoney Asian Islamic Banking and Finance Summit by **B.K. Sidhu** "Systematic Standard Needed," and "Have Innovative Products. Players Urged" by **Hamish Hamid**, *The Star*, Kuala Lumpur 22 September 2004, quoting **Khalid Yusuf**, Dubai International Financial Centre, Islamic Finance Director, and **Iqbal Khan**, Dubai based Amanah Finance CEO, 22 September 2004, p.5; see also *The Asian Wall Street Journal*, December 22, 2004, Money and Investing M1.

(35) Id., p.6 report by **C.S. Tan** "Zeti: Set up efforts for progressive Islamic financial system."



The Fiqh Academy thus held in its decision number (5), 1988:

*"Any collection of assets can be represented in a written note or bond, and the bond or note can be sold at the market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts"*<sup>(36)</sup>.

**Some of the salient features, and *maslahah*-oriented benefits, of *ijarah* and *ijarah* bonds** may be summarized as follows:

a) As already noted, *ijarah* bonds do not represent debt; they represent undivided ownership in the leased asset. They are as such participatory trust certificates that resemble equities. Since the *sukuk* are neither debt nor monetary instruments, Islamic legal difficulties that accrue the sale of debts or money do not arise in this case. The *sukuk* would, however, lose their Shari'ah compliance without a share in ownership of the asset.

b) The determining factor of the cost of *ijarah* financing is the benchmark rate used by the lessor to assess his required return. The market reference used is the London Inter-Bank Offer Rate (LIBOR) over which a competitive premium is added. The Shari'ah compliance of this has often been questioned especially with reference to the floating rate return distributed to the certificate holders. One could assume that the interest rate on loans of the same maturity is used as a benchmark rate. However, it could be different for at least two reasons. First, being asset-backed, *ijarah* may be considered less risky than a term loan of the same maturity, and as such, a lower benchmark rate would be in order. Second, the lessor, as owner of the asset, may be willing, under the same circumstances, to pass on a part of these benefits to the lessee in the form of lower lease payment<sup>(37)</sup>. Having said this, it should be noted that in the case of *ijarah* bonds, LIBOR serves only as a market reference for the returns whereas the intrinsic value of return arises from the rentals pertaining to the leasing arrangements with the originator and SPV.

c) The fact that the lessor remains legal owner of the leased assets places him in a secure position without any need for collaterals. This is a significant advantage especially in countries where the law relating to collaterals may have loopholes which hinder bank lending. But the main criticism of collateral-based lending at a fixed predetermined rate of interest is that it is inherently conservative. It favors the rich and those who are already in business, and is only indirectly concerned with the success of the venture it finances. Conventional financing appears to be collaterally overstretched and more of the same can only make it more selective and difficult for those who do not qualify. In contrast, since leasing companies are not deposit takers, they tend to be less

(36) Quoted in Adam and Abdul Kader, *Islamic Bonds*, n.31, 4-5.

(37) Cf., Javed Hussain and Sharifa Marafi, "The Role of Islamic Finance for industrial projects in the State of Kuwait." *Conference paper presented at the Fifth International Conference on Islamic Economics and Finance, Bahrain, 7-9 October 2003*, Vol. II of conference papers, 682; Tariq "Managing Financial Risks," n.16, 41.

tightly regulated than banks and finance companies<sup>(38)</sup>. Leasing offers the advantage of not requiring collateral and thus of simpler repossession procedures since ownership of the asset lies with the lessor. The lessor is only exposed to a low level credit risk from the lessee as the lease transaction is, by definition, asset-backed.

d) Since the lessor purchases the required equipment often at the request of the lessee and obtains it directly from the supplier, the possibility of misuse of funds and assets is minimized. Leasing is thus not only asset-backed but also purpose-driven and can contribute to long term economically beneficial investment.

e) Relatively simple documentation keeps transaction costs down, allowing leasing companies to achieve high leasing volume more efficiently. Lower costs are also to some extent a corollary of the fact that leasing is backed by its own assets, which make it independent of collateral taking procedures<sup>(39)</sup>.

f) *Ijarah* is also a flexible facility since the lease payments can be short-term or long-term. Financing and pricing can be on a fixed or floating basis, unlike fixed-term or fixed-date trading contracts such as *murabahah* and *istisna'*. A rent might fluctuate in line with changes in the markets. However, the price of a sold item may not be adjusted upwards or downwards once the sale is complete, even if the payment of price is deferred. It is partly due to the flexibility of *ijarah* that this facility has experienced a rapid growth.

Until a few years ago, floating rate *ijarah* was not seen to be Shari'ah compliant as it was thought that the originator could only guarantee rents or returns on fixed return underlying assets. But fixed rate *sukuk* face many market risks. To match the market requirement of *sukuk* to be a floating rate on one hand, and the Shari'ah requirement of rents to be fixed rate on the other, a solution was found, which was to base the *ijarah* bonds on a master *ijarah* agreement with several subordinate *ijarah* agreements. In the subordinate *ijarah* contract the rents were revised semi annually in accordance with the market benchmark. This method ensured that the rent was fixed for six months and floating at the same time. Major *ijarah* bond issues in the Middle East, Gulf and Malaysia are based on this variant. This method abated, partially at least, the market risks concerning the fixed rate *ijarah* bonds<sup>(40)</sup>.

g) Another reason for the rapid growth of *ijarah*-based financing is its close similarity with conventional leasing, hence resulting in the enforceability of the conventional lease contracts in the Gulf region and Southeast Asia. The question of enforcement is likely to be problematic with regard to other interest-based financial contracts in the courts of some Gulf countries<sup>(41)</sup>.

(38) Cf., Ibrahim Warde, "Islamic Finance: A Quarter-Century Assessment," in *Proceedings of the Fourth Harvard University Forum on Islamic Finance*, September 30–October 1, 2000, 194; Mohammad Muzaffar, "*Ijarah*: Financing on the Basis of Hire Purchase and Leasing," *Encyclopedia of Islamic Banking and Insurance*, 143.

(39) Cf., Nafel as-Hathal, "Innovation in *Ijarah* Financing", *Conference paper presented at Labuan International Summit on Islamic Financial & Investment Instruments*, 16-18 January, 1997, 4.

(40) Cf., Tariq, "Managing Financial Risks," n.16, 50.

(41) Cf., Adam and AbdulKader, *Islamic Bonds*, n.31, 27.



*Sukuk* certificates also serve to replicate the functions of conventional bonds in respect of resource mobilization and liquidity management as well as providing stable sources of income for investors. However, *sukuk* differ from conventional bonds in that *sukuk* do not proceed on interest rates.

Investing in *sukuk* also facilitate the funding of trade and production of tangible assets. *Sukuk* are as such linked with real sector activities and are not likely to create short-term speculative movement of funds and potential financial crises. Moreover, in their capacity as owners, *ijarah sukuk* holders are entitled to information on the use of their investment, nature of the underlying assets and information that would otherwise be redundant in conventional bonds. This is likely to encourage greater market discipline.

## 8. Hybrid Islamic Bonds

The underlying pool of assets in *sukuk* can comprise of *istisna'* and *murabahah* receivables as well as *ijarah*. Having a mixed portfolio of assets of different classes may indeed allow for greater mobilization of funds. For without pooling together *murabahah* and *istisna'* with *ijarah*, the former two would normally be inaccessible to securitization on their own.

In July 2004, the Islamic Development Bank issued a USD400 million hybrid *sukuk* for the global market under a new name, *sukuk al-istithmar*. This was the first instance of Islamic securitization that comprised a plurality of instruments in its underlying pool of assets. Previous issues of global *sukuk* had relied on revenue from leases of real estate assets mainly in the form of *ijarah* bonds.

The IDB *Sukuk* consisted of real *ijarah*-based, and also debt-based assets (*murabahah* and *istisna'*). Yet the asset portfolio was so structured so as to be dominated by the *ijarah*-based portion which represented 66 percent of the total. It was also considered that *ijarah* assets should always constitute more than 50 per cent of the portfolio. Due to the fact that the IDB portfolio comprises *murabahah* and *istisna'* receivables, the return on these certificates could only be pre-determined and fixed (at 3.625% per annum) payable at six monthly intervals until August 2008 when they will be redeemed in full<sup>(42)</sup>.

In juridical terms, the IDB experiment may be said to represent an instance of the *fiqhi* concept of *talfiq*, or patching up, which pieces together different rules, and in the present case, financial instruments, in order to arrive at a desirable solutions, which in the present case means a unified marketable formula. The three components of the IDB *sukuk al-istithmar*, namely *ijarah*, *murabahah* and *istithmar* are all sub-varieties of sale and also belong to the general category of contracts of exchange (*'uqud al-mu'awadah*) that involve exchange of values. The three differ, however, in respect of their own requirements and conditions. Whereas *murabahah* belongs to the category of fiduciary contracts (*'uqud al-amanah*), *ijarah* and *istisna'* do not fall under that category. Furthermore, *ijarah* is sale of usufruct (*manafi'*) while the other two contracts involve

(42) Upon closing the deal, the IDB issue had an asset base comprising 65.8 per cent *Sukuk al-ijarah*, *murabahah* receivables represented 30.73 percent and *sukuk al-istisna'*, 3.4 per cent.

sale of objects (*a'yan*) and they differ in their subsidiary details. It would be difficult to combine these three into one mode or formula in their true (*haqiqi*) capacities in the primary market, and it is the function mainly of securitization that the logic of *talfiq* finds its foothold in the *sukuk al-istithmar*.

The present writer is not aware whether anyone involved in structuring the IDB *sukuk al-istithmar* had actually mentioned *talfiq* as a framework and formula, but it seems that the idea fits in.

*Talfiq* can be an innovative instrument, or one that can be squarely placed under rubric of imitation and *taqlid*, depending on its component segments and its outcome. *Talfiq* has in the past been used as a formula by which to patch together a whole or a part of the ruling of one *madhhab* with another, or the opinion of one individual jurist with another within or outside the existing *madhahib* in order to reach an appropriate ruling or a way out of rigidity that may have been caused by adherence to the ruling of a single *madhhab*. The IDB experiment could be said to manifest a kind of piecing together of different contracts into a single product. *Talfiq* has in this instance been used as a tool of modern financial engineering in reference to Islamic bonds.

Lastly, mixed asset bonds could be used as a means by which to reduce over-reliance on debt-based *murabahah* and BBA bonds that claim the lion share of the Southeast Asian Islamic bonds market. The latter can try perhaps to combine *murabahah* and BBA contracts with *ijarah* and other asset-backed contracts when such might present a feasible alternative. The Middle East and Gulf markets will most likely, on the other hand, follow the IDB formula on a wider scale and in this way the existing gulf between the Middle East and Southeast Asian approaches on the application of *bay' al-dayn* to Islamic bonds can be gradually reduced.

## Conclusion

The basic advantages of *ijarah* and how it can be used to avoid some of the controversial features of *bay' al-'inah* and *bay' al-dayn* have generated much interest in *ijarah*-based financing and *sukuk* in recent years. *Ijarah* can also be used as an incentive to economic development as it is usually long term and offers potential for stimulating productive industries. The fact that *ijarah* is not dependent on collaterals also means that it has greater in-built stability to contain inflationary pressures in the economy.

As a method of financing, *ijarah* is still in its early stages of development and there is much scope in Malaysia, the Middle East, and Asia to further expand its applications for project financing. It seems that only a handful of Muslim countries have hitherto utilized *ijarah* bonds and the dominant majority of Muslim countries have not yet begun utilizing *ijarah* bonds for mobilization of assets in secondary markets. This is reflected in the recent suggestion by the Governor of the Central Bank of Malaysia for introduction of an Islamic universal bond, preferably *ijarah*-based, with the participation of developing countries the revenue from which could be used for project financing in the participating countries. *Ijarah* can also be utilized as a substitute to the somewhat excessively utilized *bay' al-mu'ajjal* and *murabahah* in the Islamic bonds market.



Our analysis of the Shari'ah-related issues pertaining to *ijarah*-based financing also suggests that there are basically no major departures from Shari'ah principles in the contemporary applications of this contract. Some of the issues to which attention has been drawn in this essay have featured in the existing literature on *ijarah* and the quest continues for better solutions. With regard to financial leasing, the main critique is that the *ijarah* certificates should represent a portion of the bearer's ownership in the leased assets and not a mere sale of the right to charge rent. This is not also an insurmountable issue.

Issues pertaining to compensation, or imposition of penalty for default, also call for attention but this too is a matter of correct observance of Shari'ah provisions and insertion of suitable clauses in the lease contract so as to curb unfair practices that burden the lessee with unwarranted demands. Another issue raised is over the obligatory manner of committing the lessee to acquire ownership of the leased asset at the end of the contract period. This practice is inconsistent, as explained earlier, with the requirements of Islamic law. For stipulation of such terms in the original lease not only amounts to combining two contracts in one (known as *al-safqah fi safqatayn*), but can also lead to injustice. There is no objection to drawing a basic memorandum of understanding, or exchange of promises, between the parties that would help secure the desired purposes of the parties, provided it does not bind the lessee to acquire ownership. The lessor may also make a unilateral commitment to offer the lessee an option to buy the leased assets at the end. For those who accept the legality of traded options from the Islamic perspective, one may suggest perhaps that the lessor may offer a put option to the lessee to sell the leased assets to the latter at the end of the contract period. The option so provided would only commit the lessor but would not bind the lessee to exercise the option.<sup>(43)</sup> Since a traded option is a separate contract in any case, this would overcome the issue of combining two bargains into one. One may also suggest that the lessor should in such a case absorb the costs of the put option and offer it in the form, as it is, of a unilateral commitment upon himself.

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(43) Further details on the permissibility or otherwise of traded options from the Shari'ah perspective can be found in **M.H. Kamali**, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge. Islamic Texts Society, 2001: Idem "Islamic Commercial Law: An Analysis of Options" *The American J. of Islamic Social Sciences*, vol. 14, no. 3, pp: 17-37.

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