Islamic leasing (Ijara) is on the rise

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A lease agreement is defined by Leaseurope as “a contract between a lessor and lessee, for the hire of a specific asset ... The lessee has possession and use of the asset on payment of specified rentals over a period.”

Leasing is often categorised as financial and operating leases. The US Equipment Leasing & Finance Association defines a “finance lease as a contract involving payment over an obligatory period, of specified sums, sufficient in total to amortise the capital outlay of the lessor and give some profit.”

In this case, all the risks and rewards pertaining to ownership are transferred from the lessor to the lessee, whether or not the title of the asset is transferred at the end of the lease term. The lease agreement here is set up to recover the capital pertaining to the cost of the equipment/asset as well as earn a return on the investment.

In contrast, an operating lease is any lease other than a financial lease in which all the risks and rewards pertaining to the ownership are not transferred to the lessee. The asset is not fully amortised during the period of the initial lease agreement which may normally not be withdrawn.

Most scholars distinguish between conventional leasing and Islamic leasing. Islamic leasing A.K.A. Ijara is governed by key Shariah principles, known as Fiqh al-Muamalat (Islamic rules on transactions), originating from Quran, Sunnah or Hadith.

Islamic leasing (Ijara) is a mode of Islamic finance contracts that has been growing globally in the banking and non-banking sector either directly or through independent subsidiaries. Islamic leasing (Ijara) is considered to be an asset-based rather than interest-based mode of financing compared to bank loans.

Ijara is commonly utilised by Islamic banks for medium to long-term asset-backed financing, particularly where profit rate risk requires long-term assets to be priced in variable rates.

Ijara offers a number of benefits for Islamic banks, such as a secured asset-backed transaction, thus reducing credit risks. Because of the good quality of the asset, the bank does not have to depend greatly on the creditworthiness of the lessee customer, since it always has the recourse of selling the asset in case of default.

Leasing, especially Islamic leases, has been popular due to its versatility and various applications such as Ijara, Ijara Munthahia Bittamleek, Ijara Mawsufa Fi al -Dhimma venture lease, agrilease, microleases and Sukuk Ijara.

Islamic leasing (Ijara). Muslim scholars define Islamic leasing or Ijara as an agreement between two parties, one being the owner of the asset who gives possession of the assets for the right of use “usufruct” of the other party, the hirer, on an agreed rental over a mutually agreed period.

The Accounting and Auditing Organisation for Islamic Financial Institutions – AAOIFI (FAS 8) also define it as “the ownership of the right to the benefit of using an asset in return for consideration”.

The owner is called a lessor (mu’ajir), the person who uses the property is known as a lessee or hirer (musta’jir), the subject matter is the usufruct of the property (manfa’ah), and the consideration refers to a rent (ujrah).

The difference between leasing and Ijara contract is that the latter does not contain any condition that makes the contract void under Shariah perspective. Basic principles of Ijara include:

- the subject matter of any transaction including the underlying assets must be Shariah compliant;
- the benefit of the Ijara contract must be doable and realistic and cannot be perishing by usage;
- all risks pertaining to ownership such as depreciation, insurance, maintenance of the asset must be borne by the lessor/owner during lease period;
- customer only bears usage-related risks; and
- under the Islamic Ijara, rent is the usage of the leased asset, and if the asset has been stolen, destroyed or temporarily out of order and not in use by the customer, the rental becomes void. In such situations rental is not charged from the lessee.

Traditionally, Ijara grew as a Shariah compliant alternative to operating lease. In this case, the ownership of the leased assets will remain with the bank at the end of the lease period.

Ijara Thumma Al Bai’ is a variation of the theme of purchase-and-leaseback transactions. There are two contracts involved in this concept. The first contract, an Ijara contract (leasing/renting), and the second contract, a Bai contract (purchase), are undertaken one after the other. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price. In effect, the lessor sells the product to the debtor, at an above market-price profit margin, in return for agreeing to receive the payment over a period of time.

The profit margin on the lease is equivalent to interest earned at a fixed rate of return. Interest-based late payment penalties are considered Riba and cannot be charged.
Islamic leasing is on the rise

Islamic leasing reached almost 9% of the total market size. The leasing market grew from almost E£2bn in 2013 to E£2.5bn in 2014 in the first five months (January to May). This is expected to grow further with the advent of law amendments that would allow Ijara in both the leasing and mortgage market.

The Egyptian government has announced recently law no.148 for the year 2001 that approves Ijara as a mode financing. The market is expected to grow by at least 25% upon finalising the executive regulations. This trend is evident in other mortgage markets that relied heavily on Ijara Muntahia Bittamleek (IMB), such as Europe.

Forward leases. Forward lease – better known as Ijara Mawsuфа Fi al-Dhimma – is a hybrid product that comprises both Istisna’a (Islamic project finance) and Ijara contracts. It entails an agreement to lease assets upon the asset being made available to the client at a future date. It usually applies to assets yet to be constructed, for which there needs to be a contractual agreement and the advanced payment of rentals to compensate the financier.

Normally, if the asset is not made available to the customer or is destroyed before delivery, then the customer has the right to a refund of any rent paid in advance.

This product has been growing in the GCC countries as a way to finance infrastructure project finance transactions.

For example, Queen Alia International Airport Project, Jordan: Istisna’a (Islamic Manufacturing) to be followed by Ijara Mawsufa Fi Al Zimah (Islamic forward lease) for US$100m.

SMES Islamic leasing. Access to financing for equipment continues to be a significant hurdle for small- and medium-sized enterprises (SMEs) in many countries. Islamic leasing is a viable alternative to traditional bank lending because it suits the needs for Shariah complaint SMEs, as well as requiring less up-front costs and collateral requirements. It can be advantageous for new businesses or SMEs that do not have enough cash savings for large down-payments or other sufficient assets that could be pledged as collateral for a loan.

The Islamic Corporation for the Development of the Private Sector (ICD), the private-sector arm of the Islamic Development Bank (IDB), has made several initiatives to support Shariah compliant products such as Ijara mainly for SMEs throughout the OIC member countries. This is made through its wholly-owned subsidiary, namely Ijara Management Company (IMC). The initiative has reached out to several regions such as Russia, GCC, Europe and Africa.

Micro leasing. Micro leasing is often a viable alternative for microfinance institutions (MFIs) in emerging countries to expand into micro and small enterprises (MSEs) longer-term asset financing and for borrowers who did not previously have access to asset financing.

Although group lending is common with MFIs, micro leases are often made on an individual basis and not to solidarity groups. This is because group members are sometimes reluctant to bear the increased risk of exposure to the larger lease sizes generally associated with asset financing.

Banks in several countries in Asia and Africa such as the Sudanese Bank of Khartoum currently rely heavily on Ijara as a tool for microfinance segments.

Agricultural leasing. Many developing economies also rely heavily on the agricultural sector, whose income is seasonal and can benefit from this kind of flexibility.

Leasing is a viable mode of financing for the agricultural sector. It often allows smallholder farmers to lease agriculture equipment or sub-rent agricultural land for a pre-defined rental that matches with their harvesting.

For example, the Wasil Foundation (Wasil), a non-profit organisation that aims to alleviate poverty through enterprise development in Pakistan, has won the 2014 Islamic Microfinance Challenge for its agricultural Ijara financing package due to its sustainability and positive impact on the lives of microfinance segments.

Venture lease. Venture lease (Ijara) is a creative financing vehicle for venture capitalists and venture leasing companies to finance early start-up business entrepreneurs or Microfinance, Small, and Medium Enterprises (MSMEs).

It is a hybrid structure of leasing and venture capital in which the lessor will lease assets in return for lease payments as well as seek warrants for stock to finance early start ups.

Warrants represent an option to purchase a certain number of shares (common or preferred) at a future date at a fixed price, which can be the price of the current round of financing or set at a premium to the current price per share. Warrants tend to be used in earlier stage
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Table 1: Venture lease/Ijara fund structure

<table>
<thead>
<tr>
<th>Venture lease fund</th>
<th>SPV (Lessor)</th>
<th>Investment</th>
<th>Income</th>
<th>Purchase price</th>
<th>Ownership</th>
<th>Lease</th>
<th>Rent/warrant</th>
<th>Start-up lessee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Leased assets</td>
<td>Leased assets</td>
<td>Parent company</td>
<td>Angel investors/venture capitalists</td>
<td>Victorian Fund</td>
<td>Angel investors/venture capitalists</td>
<td>Victorian Fund</td>
<td>Victorian Fund</td>
</tr>
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Deals to compensate an investor helping start-up companies to raise start-up financing (in lieu of or in addition to cash).

Venture leases often complement the equity venture capital required to be raised by MSMEs, thereby extending the time needed until the next round of financing. Venture leases allow MSMEs to improve its cash flow by acquiring or using equipment with a smaller upfront investment and by paying for them over a period of time.

In addition, venture leases allow MSMEs to pay for the acquisition or use of equipment with tomorrow’s money, i.e. money raised from future equity venture capital rounds.

Angel investors who seek Shariah compliant investments could implement this using an Islamic lease fund structure that invests in Shariah compliant leased assets. Thus, this structure often suits the need of this segment who often refrain from dealing with banks for Shariah reasons or otherwise.

Venture Islamic leases could be financed directly from the capital market in what is known as Sukuk Ijara.

Sukuk Ijara or venture lease fund. A typical structure of Islamic lease or Ijara-based funds involves financing structures that invest in leased assets that generate a return or cash flow that meet the lease payments of lessees.

Ijara funds could finance existing or start-up SME lessees depending on the investment criteria and appetite of the investor who could range from private equity to venture capitalists or angel investors.

Lease funds typically invest in finance leases rather than operating leases in which the assets are normally sold to the lessee or entrepreneur at the end of the lease period.

Similar to leases, the investor runs ownership risk in the underlying assets but tries to reduce the residual value risk by transferring ownership at the end of the lease term through Ijara Muntahia Bitamleq or Ijara Wa Iqtina. A lease fund manager or leasing company can act as an agent on behalf of the investors and is paid a fee for his services.

The fund manager usually invest in pools of Shariah compliant leased assets, which may be sold to either one or more special-purpose vehicles (SPV) owned by the venture fund. Alternatively, the fund manager could invest in a lease portfolio managed by specialised leasing company (lessor). In both cases, this company shall issue investment certificates representing a proportionate share of the underlying assets and the associated income stream.

The investment exit strategy for Ijara funds is usually underwritten by the product sponsor or leasing company, who will acquire asset holdings from the investor or arrange asset sales on a ‘matched’ basis with a lessee or, on a best efforts basis, through a vendor via a remarketing agreement (see Table 1).

Sukuk Ijara structures. Lease or Ijara is often a backbone for the Sukuk Ijara market in what is known as Sukuk Ijara. A Sukuk is an Islamic bond(s) or certificate of investment(s) backed by Shariah compliant tangible assets granting the holder beneficial ownership. Consequently, Sukuk holders are entitled to a share in the revenues generated by a proportionate share in the Sukuk assets.

Sukuk acts as a new source of liquidity and alternative funding source for leasing companies. Assets may include land, property, Ijara portfolios (rental receivables), Shariah compliant investments and tangible objects rather than consumables.

Sukuk Ijara is one of the most commonly used 14 types of Sukuk described in the AAOIFI Shariah standards, as it represents almost 70% of the global Sukuk issuances. It is the certificates of investment in a leased asset supported by underlying assets, usually by real estate or equipment, which generates future cash flows.

Sukuk Ijara, reflects the sale of the asset followed by the lease contract. It requires the originator or the party that requires the funding to sell his assets to the Sukuk Ijara investors. Thus, the Sukuk holders will have the claim on ownership/usufruct/services over the underlying asset throughout the tenor of the Sukuk while benefiting from income in the form of rental payment.

Examples of sovereign Sukuk include:

- Qatar Government issued Sukuk Ijara of the for Hamad Medical City US$700m; and
- the Republic of Turkey issued one of the earliest Sukuk Ijara under a sale-and-leaseback agreement for US$1.5bn.

The Sukuk assets used in this Sovereign issuance are comprised of government buildings used by the Ministry of Health and the Ministry of Food, Agriculture and Livestock.

Example of corporate Sukuk include:

- Baraka Group Leasing Company securitised its leased assets portfolio in three tranches to raise funds (E£500m-E£1bn); and
- Al Baraka Turk Bank and Tamweel – Shariah compliant true sale securitisation of portfolio of Ijara contracts.

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