

**IJARAH IN ISLAMIC LAW AND ITS APPLICATION IN  
ISLAMIC BANKS WITH SPECIAL REFERENCE TO AUTO  
FINANCING OF ASKARI COMMERCIAL BANK, LTD,  
(ISLAMIC BANKING DIVISION)**

Degree Programme : LL.M(CORPORATE LAW)



P-07030

*Submitted By*

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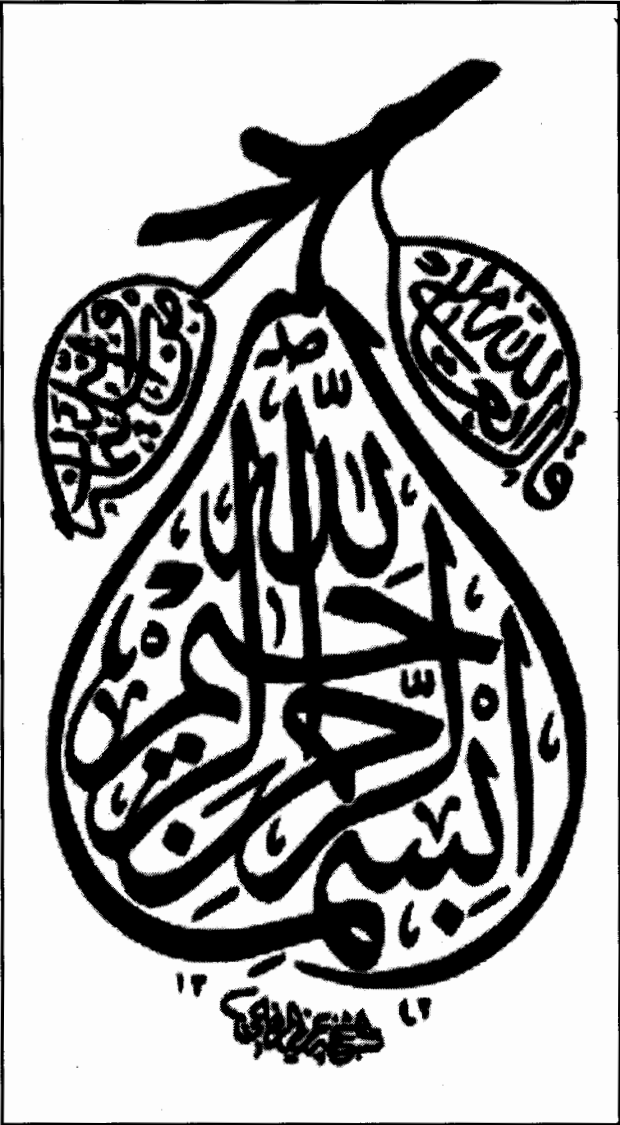
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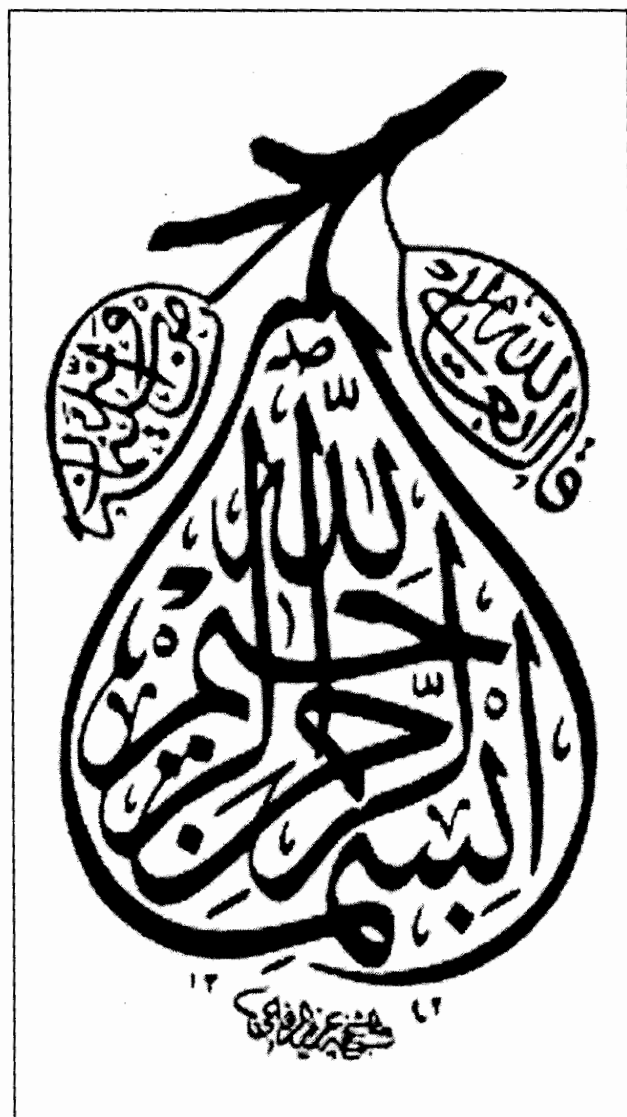
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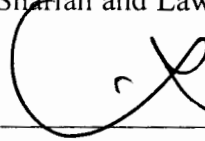
It is certified that we have read the thesis, submitted by Miss Ayisha Rasheed(Registration No. 112-FSL/LLM-CL/F05), titled "IJARAH IN ISLAMIC LAW AND ITS APPLICATION IN ISLAMIC BANKS, WITH SPECIAL REFERENCE TO AUTO FINANCING OF ASKARI COMMERCIAL BANK, LTD, (ISLAMIC BANKING DIVISION)", as a partial fulfillment for the award of degree of LL.M Corporate Law. We have evaluated the thesis and found it up to the requirement in its scope and quality for the award of degree.

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## **DEDICATION**

**Dedicated to the greatest leader of the humanity, i.e The Holy prophet(P.B.U.H) Who has been sent as a Mercy for the whole Universe(mankind, Jins and all that exists) and who set a model to imitate in all walks of life, be it religious, moral, social or economic.**

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The study could not have been possible without the active support of my family specially my grandmother and my mother who always encouraged me and provided me atmosphere to work in such research oriented project.



## **Abstract**

This thesis is an attempt to understand the Islamic banking system and its different modes, which are in practice in Islamic banks. The special focus in this thesis has remained on Islamic leasing/Ijarah and its different forms as being practiced by the Islamic banks and financial institutions.

Ijarah is one of the most popular and practicable mode of financing practiced by the Islamic financial institution and banks. The Islamic banks heavily rely on this mode in their financing activities because it brings a fixed and a guaranteed income to the bank and also partly due to the reason that it is comparatively a less risky mode.

Ijarah is a successful shariah alternative to leasing in conventional banks and leasing companies where the transaction only reflects the lending of money in conventional leasing, although the asset is involved in the transaction and is shown in the ownership of lessor, yet the lessor does not take any risk and liability with regard to the asset leased to the client. The lessor formulates and calculates the lease rentals in such a manner that the lessee pays the purchase price of asset along with the markup over the period of lease agreement.

Ijarah in Islam is an asset based transaction where the usufruct of an asset are transferred to the client at an agreed rental for a specified period. It is not a mode for providing money or liquidity to the client.

Although Ijarah as practiced in Islamic banks is largely shariah compliant, yet many objections have been raised by the shariah scholars on a number of practices. A major objection is that Islamic banks fix and calculate rentals with regard to

KIBOR(Karachi Inter Bank Offered Rate). In other words they use conventional interest rate as benchmark in Ijarah. Payment of extra amount as penalty for default has also been criticized on the ground that it does not enjoy shariah legitimacy. The rental principle includes amount as well as profit, thus banking Ijarah is more close to finance lease of conventional banks than operating lease of Islamic law.

The thesis highlights the distinct features of Islamic Ijarah and the areas of difference between conventional leasing and Islamic Ijarah. The thesis also devices a proper procedure of Ijarah financing which should be observed by the Islamic banks while practicing Ijarah. The practice of sale and lease back has also being criticized by the scholars.

Moreover, the issue of sale and lease back, issue of security deposit, issue of penalty for default, method of fixation of rentals, insurance/takaful arrangements and issue of securitization of Ijarah has also been thoroughly discussed in the light of shariah.

The thesis also contains a detailed account of the Ijarah bis Sayyarah(auto financing) mode of financing introduced by Askari Commercial Bank Ltd. through its Islamic Banking Division.

## **LIST OF ABBREVIATIONS**

ACBL	Askari Commercial Bank Limited.
AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions.
CIB	Central investigation Bureau
DBR	Debt Burden Ratio
FIR	First Information Report.
HP	Hire Purchase
HOCC	Head Office Credit Committee
IBD	Islamic Banking Division
IB-DCC	Islamic Banking Division Credit Committee
IBM	International Business Machines
IFI	Islamic Financial Institution.
IIUI	International Islamic University Islamabad
KIBOR	Karachi Inter Bank Offered Rate
LC	Letter of Credit
PLS	Profit and Loss Sharing
PBUH	Peace be upon Him
SLB	Sale and Lease Back

## CHAPTER 1

### INTRODUCTION TO ISLAMIC FINANCE:

Economics is a very important and vast field. A lot of work has been done in this field. Islam has its own Economic System, which differs from the Conventional Economic System. Islamic Economic System is based on the concept of “*Halal*” and “*Haram*” i.e. permissible and impermissible, but in the Conventional Economic System no such distinction exists.

Islam is a complete code of life for the whole of humanity till the day of eternity. It has given a complete economic system to its followers. It is not only a theoretic system rather it is capable of being practiced for which expertise in *Shariah* is required. By applying the injunctions of Islam, the society can benefit from the *Riba*-Free economy of Islam. The Islamic Economic System is aimed at preventing injustice in the acquisition and disposal of material resources in order to provide complete economic justice and equal opportunities to the society.

The Holy Prophet (P.B.U.H) established first Islamic State in Madina and in this newly founded State he also established “*Sooq-e-Madina*” to promote the economy in the light of teachings of Islam and to give relief to the citizens who were in the clutches of interest based economy of Jews in the city of Yasrab(Madina).<sup>1</sup> As it is commonly observed nowadays that without economic independence, the political independence cannot be achieved. Similar was the concept behind the establishment of *Sooq-e-Madina* because by establishing an

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<sup>1</sup> Council of Islamic Ideology, Elimination of Riba from the Economy and Islamic Modes of Financing, 2<sup>nd</sup> Revised and Enlarged Edition, Reprint 2002, p. 199.

Islamic State in *Madina* the Muslims had achieved political independence but they were yet in the clutches of Jews due to their economic dominance. So, the introduction of *Riba-Free Economy* was a step towards achieving financial independence.

The Islamic concept is that the laws are made to achieve the objectives of Shariah(*Maqasid-e-Shariah*), which according to Iman Al-Ghazali<sup>2</sup>, a Renowned Muslim Scholar are, as follows:-

1. Preservation and protection of religion. (Faith);
2. Preservation and protection of life;
3. Preservation and protection of progeny (family);
4. Preservation and protection of intellect;
5. Preservation and protection of wealth.

The fiscal laws are not an exception to it rather they are aimed at preserving and promoting “*Hifz ul Maal*” which is one of the objectives of *Shariah* as mentioned above.

Therefore all financial transactions must be in conformity with these *Maqasids*.”

#### 1- **Philosophy Of Islamic Finance And Islamic Banking:**

Islamic Banking and Islamic finance means, interest free economy i.e. interest cannot be paid or accepted and the philosophy behind interest free

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<sup>2</sup> Al-Ghazali. Al-Mustafa Fi Ilm al-usul. Tahqiq Muhammad Abal-Salam Abd al-Shafie, 1413H, (Beirut: Dar-al-Kutb al Ilmiyya)

economy is that the wealth should remain in circulation and shared by putting money to productive use and assuming risks<sup>3</sup>.

In the words of Mr. Justice(R) Taqi Usmani, “ *In the context of interest-free Banking, this philosophy aimed at establishing distributive justice free from all sorts of exploitation....., the instrument of interest has a constant tendency in favour of the rich and against the interest of common people. The rich industrialists, by borrowing huge amounts from the bank, utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of meager rate of interest, and this is also taken by them by adding it to the cost of their products. Therefore, looked at from the macro level, they pay nothing to the depositors. While in the extreme cases of losses which leads to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth*”.<sup>4</sup>

## 2- **Fundamental Principles of Islamic Finance.**

Conventional economic System/Conventional Banks have failed to achieve the philosophy of Islamic Economic System based on ideal Islamic principles of financing . These institutions have deadly violated some very basic principles of Islamic finance. Some of the basic Islamic financial principles<sup>5</sup> are as follows:-

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<sup>3</sup> Butterworths Editorial Staff, Islamic Banking And Finance, edn 1986, p. 69.

<sup>4</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, p. 239.

<sup>5</sup> Dr. Muhammd Tahir Mansuri, Islamic Law of Contracts and Business Transaction, p. 16.

- a) Any predefined payment over and above the actual amount/principal amount is prohibited and is called Riba in *Shariah*.

*“And Allah has permitted sale and prohibited Riba.”*<sup>6</sup>

- b) Making money from money is not allowed in *Shariah*.
- c) *Gharar* (uncertainty or speculation) is prohibited.
- d) *Qimar* (Gambling) and *Mayser* (games of chance) are also prohibited.

The Quran has prohibited this practice in the following words:

*“O you who believe; intoxication and gambling, dedication of stones, and divination by arrows are an abomination of Satan’s handiwork. Eschew such abomination, that you may prosper”*<sup>7</sup>

- e) PLS is encouraged by Islamic financial system; Provider and user of capital both should share the profit and loss/risk in the business. Islam promotes the notion of higher the risks and higher returns .As high-risk investment provides incentives to the entrepreneurs to maximize their efforts. According to well-settled principle of Islamic law.

*“Damage and benefit go together; fro example, he who derives benefit from a thing must also bear any damage from it”*.<sup>8</sup>

- f) The contract should be made by free mutual consent of the parties.

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<sup>6</sup> Al-Quran 2:275.

<sup>7</sup> Ibid, 5:90.

<sup>8</sup> Justice ® Dr. Tanzil-ur-Rehman, Kuliyyat-e-Shariat, p. 197

*“O you who believe, devour not your property among yourself by unlawful means except that it be trading by your mutual consent.”<sup>9</sup>*

- g) The transactions/Contract should be free from *Ghish* and *Khilabah*(fraud and cheating).

*“Woe to those that deal in fraud, those who, when they have to receive by measure exact full measure, but when they have to give by measure or weight to men, give less than due. Do they not think that they will be called to account on a Mighty day.”<sup>10</sup>*

- h) Permissibility of any transaction depends on its conformity with the objectives of *Shariah* (Maqasid-e-Shariah).

We may observe that the conventional banks do not observe most of the principles mentioned above. Practice of *riba*-based transactions caused great destruction to the socio-economic system of a society, that even conventional banks are being collapsed and banking institutions of non-Muslim countries are thinking to convert the conventional banking transaction into Islamic Banking System and many conventional banks if not fully converted, has opened windows to practice Islamic modes of financing.

It is a firm belief of Muslims that Islam is a complete code of life which governs every aspect of human life, be it religious, moral, social or economic. Allah (S.W.T) alone is the source of all the laws and Quran says in this regard;

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<sup>9</sup> Al-Quran 4:29

<sup>10</sup> Ibid, 83:1-6



“ The “*Hukm*” belongs to Allah”.<sup>11</sup>

Allah(S.W.T) commands according to the needs and nature of human beings. His commands related to human activities i.e. *Ibadat* (devoted acts) and *Muamalat* (civil transaction) are based on both fixed and unfixed/flexible rules, for example, *Ibadat* comes under the heading of fixed rules. These rules are unchangeable, stated explicitly in the text i.e. *Quran* and *Sunnah*, dealt in detail and are not subject to any change, rectification or modification over the time. There is no room for *Ijtihad* in this area of Allah’s commands.<sup>12</sup>

As far as the other area of command which is related to the transactions is concerned, is based on flexible rules. Allah (S.W.T) has provided sufficient liberty to deal with the transactions (*muamalat*). This is the area of *Ijtihad* as these rules are not stated explicitly in the text. These rules are changeable and are subject to modification and can be rectified according to the time, need and prevailing circumstances in the society provided that the basic principles of *Shariah* are not violated. Application of human reasoning is allowed in pursuance of the injunctions of *Islam* and within the limits prescribed by *Islam*<sup>13</sup>.

It is the duty of Muslim scholars to strive and exercise their efforts to extract rules of law/*shariah* to solve emerging issues pertaining to financial matters in the light of *Holy Quran, Sunnah’ Ijma*(consensus of opinion) and *Qyas*(Analogy). Application by a Muslim jurist/scholar of all his faculties to the

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<sup>11</sup> Al-Quran 40:12

<sup>12</sup> Imran Ahsan Khan Niazi, Theories of Islamic Law, p. 55

<sup>13</sup> Ibid

consideration of the authorities i.e. main sources of shariah with a view to find out what in all probabilities is the law/*divine law*, is called *Ijtihad*.<sup>14</sup> In this regard for the last many decades Muslim scholars, bankers and economists have put their efforts individually and collectively. On the basis of these efforts Islamic banking has started not only in some Muslim countries but even windows have been opened the by conventional banks in Muslim and non Muslim states. It is pointed out with great pleasure that even banks of some non-Muslim countries are preferring to provide services of Islamic banking.

Islamic financial institutions and banks aim at putting the Islamic economic philosophy into practice and to attain the socio-economic objects prescribed by *Shari'ah* for a society free from all sorts of exploitation. The fundamental object of *Islamic* financial system in an Islamic state is to establish distributive justice system.<sup>15</sup>

It is worth mentioning here that Islam in its economic system does not demand equality but justice. Therefore, it adopts such measures that the wealth should be distributed in the society on the basis of justice. Islamic economic system does not tolerate that the whole wealth of a state and its resources to be held in the control and use of limited people where one group of people may lead luxurious life and the large number of people in society are deprived of their basic

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<sup>14</sup> Dr. Muhammad Muslehudin, *Islam & Its Political System*, p. 119

<sup>15</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, p. 239

needs.<sup>16</sup>

Allah (S.W.T) Says in Holy Quran;

*“What Allah gave as booty (Fai) to His Messenger(Muhammad P.B.U.H) from the people of the townships, \_\_ It is for Allah, His Messenger(Muhammad P.B.U.H), the kindred (of Messenger Muhammad P.B.U.H), the orphans, Al-Masakin(the poor), and the warfarer, in order that it may not become a fortune used by the rich among you.”<sup>17</sup>*

To achieve its basic purpose, Islamic financial system imposes certain financial obligations on the rich Muslim members of the Islamic state, for example, Payment of *Zakat, Sadaqat, Ushr, Khums* and complete law of *inheritance* is also provided in detail.<sup>18</sup>

To protect the property of a citizen is one of the objectives of *Shariah* and to achieve this objective Islam also forbids taking the property of others through unlawful means i.e. theft, usurpation, embezzlement, bribery, money laundering, gambling, *Gharar* etc. Besides this, Islamic state (when thinks it necessary) can impose certain taxes for the need and welfare of the citizen.<sup>19</sup>

*“O you who believe, devour not your property among yourself by unlawful means except that it be trading by your mutual consent”.*<sup>20</sup>

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<sup>16</sup> Mulana Dr. Noor Muhammad Ghaffari, *Islam Ka Qanoon-e-Mahasil*, pp. 14-15.

<sup>17</sup> Al-Quran 7:59

<sup>18</sup> Mulana Dr. Noor Muhammad Ghaffari, *Islam Ka Qanoon-e-Mahasil*, p. 14

<sup>19</sup> *Ibid*, p. 15

<sup>20</sup> Al-Quran 4:29

### 3- Islamic Modes of Financing -An Alternative to Riba Based Financing.

#### 3.1- Introduction.

Finance is the backbone of any society and interest free financial system is the last resort to the world economic system, which is facing free financial crisis. It is the responsibility of scholars to save the world from financial crisis and ultimate destruction, caused by *Riba*- based economy. To abolish at once, the *Riba*-based transactions deeply rooted in financial system is somewhat difficult but not impossible. This may be rooted out by sincere efforts of scholars to interpret and present the solution provided by *Holy Quran* for definite Socio-Economic welfare of the world.<sup>21</sup>

“The banks are the financial institutions which deal with money and credit”<sup>22</sup>

The Basic function of the bank is the acceptance of money from depositors on lower rates of interest and lending money to the borrowers, in different forms on higher rates of interest.

In short, the basic function of the conventional bank is acceptance of deposits and lending money on interest. With the expansion of financial institutions, banking system and the rapid growth of industry, the banks and the financial institutions started to finance by lending money on interest basis on

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<sup>21</sup> Al-Haq, “sarmaya darana nizam ka bad tareen buhran, us kay asbab aur hal”, Moulana Muhammad Esa Mansuri, Chairman World Islamic Forum, London, 2008, December, p. 40.

<sup>22</sup> Prof. Muhammad Saeed Nasir, Banking Currency and Finance, p. 2.

larger scale to meet the big capital needs of industries, business entities and corporations.

On the contrary, when we talk about the *Islamic* banks, the first thing which comes in our minds is that the *Islamic Financial Institutions* or *Islamic Banks* is a platform where no interest based transaction can take place. The question also arises here that what would be an alternative to the *Riba*-based transactions of conventional banks.

The Muslim scholars are unanimous on the view that *Musharakah* and *Mudarabah* are ideal modes of financing.<sup>23</sup> Visible change in financial system and blessings of *Islamic* financial system may be achieved through practice of these ideal modes of financing by banks but difficulties and hurdles have also been considered by the scholars that may arise by converting the whole banking system into PLS arrangements at once.<sup>24</sup>

In *Islamic* Banks and IFIs, under interest free System, only PLS (Profit and loss sharing) saving accounts and PLS term deposits shall be accepted on profit and loss sharing basis.

Financing being one of the primary functions of *Islamic* banks and IFIs, is done through *Islamic* modes of financing in *Islamic* banks and IFIs. These *Islamic* modes of financing are the only solution to *Riba*-based transactions of conventional banks and financial institutions.

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<sup>23</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, pp. 19,20.

<sup>24</sup> *Ibid*, pp. 23-24.

It is pertinent to mention here that *Islam* does recognize the capital as a factor of production and earning profit on the capital to a reasonable extent. It is also worth mentioning here that how a renowned contemporary Muslim Scholar, *Justice® Muhammad Taqi Usmani* writes in his book about the important characteristics of *Islamic financing*.<sup>25</sup>

*“One of the most important characteristics of Islamic financing is that it is asset-backed financing. The conventional/capitalist concept of financing is that the banks and the financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject matter of trade, except in special cases. Money has no intrinsic utility; it is only a medium of exchange; Each unit of money is 100% equal to an other unit of the same denomination, therefore, there is no room for making profit through the exchange of these units inter-se. Profit is generated when some thing having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money(of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institution, financing in Islam is always based on illiquid assets which create real assets and inventories.*

*The real and ideal instruments of financing in Shari’ah are Musharakah and Mudarabah. When a financier contributes money on the basis of these two*

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<sup>25</sup> Ibid.

*instruments it is bound to be converted into the assets having intrinsic utility. Profits are generated through the sale of these real assets.*

*Financing on the basis of Salam and Istisna' also creates real assets. The financier in the case of Salam receives real goods and can make profit by selling them in the market. In the case of Istisna', financing is effected through manufacturing some real assets, as a reward of which the financier earns profit".<sup>26</sup>*

Keeping in view the legal, Fiscal and procedural constraints and difficulties faced by *Islamic* banks (who are in their age of infancy), it is very difficult for *Islamic* banks to fully adopt the PLS based system in their operations. *Islamic* banks and IFIs have shown inclination to other modes of financing which are less risky. The modes of financing most commonly used by *Islamic* banks are *Murabaha* and *Ijarah*. Modes other than the *Mushraka* and *Mudarabah* should be used only in case of dire need and that too with full observance of rules and principles prescribed by *Shariah*.<sup>27</sup> According to a well settled principle of *Islamic* law which governs the transactions under *Islamic* law, nothing can be prohibited unless it is proscribed by Allah and his messenger.<sup>28</sup>

### **3.2- Major Islamic Modes of Financing:**

The major *Islamic* modes of financing are as under:

*Musharaka*

*Mudaraba*

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<sup>26</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, pp. 19-20.

<sup>27</sup> *Ibid*, p. 241

<sup>28</sup> Ibn Taymiyyah, *Al-Fatawa al-Kubra*, Beirut: Dar al-Kutb al-Ilmiyyah, 1987, Vol. 29, pp. 16-18.

*Istisna*

*Salam*

*Bai-ul-Muajjal*

*Murabaha*

*Ijarah*

### **3.2.1- Musharikah.**

The term “*Musharakah*” is derived from Arabic word “*Shirakah*” , which means “Sharing”. “*Shirakah*” is much wider term used for different modes of sharing which are as under.<sup>29</sup>

#### **3.2.1.1- *Shirkat-ul milk (Proprietary partnership)***

Which means joint ownership of two or more persons in a particular asset.

This mode of *Shirkah* may come into operation either;

- (i) At the option of parties, for example, where two or more persons jointly purchase a property, is called *Shirkatul-milk*. Or,
- (ii) Automatically, without any action of the parties. For example, where after death of a person, all his legal heirs inherit his property.<sup>30</sup>

#### **3.2.1.2- *Shirkat-ul-aqd; (Contractual Partnership)***

It is a type of *Shirkah* where two or more persons come into relation of partnership through mutually agreed contract. It is further divided into three main kinds;<sup>31</sup>

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<sup>29</sup> Al-badai, vol. 6, p. 56, see also Al-mabsoot, vol. 11, p. 151.

<sup>30</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, p. 31



*Shirkat-ul-amwal*

*Shirkat-ul-amal*

*Shirkat-ul-wajooh.*

### 3.2.1.2.1- ***Shirkat-ul-amwal* (Investment Partnership)**

*Shirkat-ul-amwal* is that type of *Shirkat-ul-aqd* where all partners contribute some capital on profit and loss sharing basis.<sup>32</sup>

*Shirkat-ul-amwal* is further classified into two kinds,<sup>33</sup> i.e. *Shirkat-ul-Mufawada*, and *Shirkat-ul-Inan*. Where an amount and type of capital contributed by each partner of equal status is equal and profit and loss is also equally shared between them. Each partner works as an agent and helper of other partners. It is kind of *Shirkat-ul-amwal* called *Shirkat-ul-mufawada* and where the capital contributed by the partners, not necessarily of equal status, is not equal and profit and loss is shared according to the share contributed by each partner in the business is called “*Sharikat-ul-Inan*”.

The term *Musharakah* is used by Islamic banks and financial institutions for that type of *Shirkat-ul-amwal* (investment Partnership) where the bank and its client enter into the relationship of partnership by contributing capital and sharing the profit and loss. There is no fixed formula for sharing of profit and loss between the parties. However, profit is shared as agreed between the parties. “*The ratio for*

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<sup>31</sup> Ibid.

<sup>32</sup> Zuhaili, *Al-Fiqh al-islami Wa adillahtohu*, vol. 4, p. 794.

<sup>33</sup> Ibid, pp 796-801. see also Prof. Muhammad Saeed Nasir, *Introduction to Business*, p. 49

*profit for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him".<sup>34</sup>*

The losses must be shared strictly in ratio of capital invested by each of them. No increase or decrease is allowed. Principles of sharing of profit and loss in *Musharaka* mentioned in the Islamic legal maxim is given below.

*"Profit is based on the agreement of the parties but loss is always subject to the ratio of investment".<sup>35</sup>*

#### **3.2.1.2.2- Shirkat-UI-Amal:**

It is also called *Shirkat ul abdan, Shirkat -us-sanai or Shirkat ul taqabul* .<sup>36</sup>

It is a kind of *Shirkat-ul-Aqd* where all the partners join together to perform some act for their customers and distribute the profit earned through such service according to the agreed ratio. Generally, the profit is shared according to the quantity and quality of the work put into the business. Examples of *Shirkat-ul-amal* are tailors, technicians artisans and laborers etc, who join together to do the business.

#### **3.2.1.2.3- Shirkat-UI-Wujooh:**

It is a kind of *Shirkat-ul-Aqd* where men of principles, high integrity, honesty and good reputation jointly borrow loan and carry on the business on the

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<sup>34</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, p. 35

<sup>35</sup> *Ibid.* p. 38

<sup>36</sup> Zuhaili, *Al-Fiqh al-islami Wa adillahtohu*, vol. 4, p. 803.

basis of their good will or influence. Profit is distributed between them according to the agreed ratio.<sup>37</sup>

### **3.2.2- Mudarabah:**

*Mudarabah* is a kind of partnership where one partner participate with capital and the other with knowledge and skill. Partner who comes with capital is called *Rabb-ul-mal*. The other partner who works and manages the affairs of a business is called “*Mudarib*”. The profit accrued on such business is shared between *Rabb-ul-mal*(Owner of the capital) and *Mudarib*(Manager) on mutually agreed basis. While the loss is borne by the partner who provides the capital.<sup>38</sup>

### **3.2.3- Istisna.:**

*Istisna* is a contract of sale between the person who orders to manufacture goods and the manufacturer of goods who uses his own material required for manufacturing the goods with complete specification agreed on between the parties.<sup>39</sup>

It is a contract where the price is fixed with the mutual consent of the parties and may be paid in advance or with the delivery of goods in future or may be deferred to any time mutually agreed between the parties. *Istisna* may be used by Islamic banks and financial institutions as a mode of financing for construction of hospitals, universities, houses, bridges, roads and highways etc.<sup>40</sup>

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<sup>37</sup> Ibid P-801.

<sup>38</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, p.47.

<sup>39</sup> Zuhaili, Al-Fiqh al-islami Wa adillahtohu, vol. 4, p. 631..

<sup>40</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, pp. 195-200.

### 3.2.4- Salam:

*Salam* is a kind of sale contract where full price of goods is paid by the buyer in advance at the time of contract and delivery of the goods by the seller is to be made at the future date mutually agreed between the parties.<sup>41</sup> As a general rule the sale of goods which are not in possession of the seller is unlawful but the practice of *Bai-us-Salam* is validated as an exception to accommodate the farmers who have crops not ready for delivery but possession is obvious in future.

*Salam* is actually a mode of financing to help the small traders and farmers to meet their needs. Today, it may be used as mode of financing by Islamic banks and financial institutions at larger scale to finance, specially the manufacturer and agricultural sector etc.<sup>42</sup>

### 3.2.5- Bai-Al-Muajjal:

It is a kind of sale contract, used by Islamic Banks and Financial Institutions as a mode of financing where the goods are delivered to the buyer in advance but payment of price is deferred in to some future date. In *Bai-al-Muajjal* charging higher prices for goods if payment of price is deferred to future is allowed in shariah for being its trade transaction and not the loan transaction.<sup>43</sup>

### 3.2.6- Murabaha:

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<sup>41</sup> Zuhaili, *Al-Fiqh al-islami Wa adillahtohu*, vol. 4, p. 598.

<sup>42</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, p. 91.

<sup>43</sup> *Ibid*, p.102.

*Murabaha* is a kind of sale contract where the cost accrued on the purchase of asset and the profit or mark up earned is disclosed by the seller to the buyer. *Murabaha* is adopted by Islamic banks as a mode of financing where the bank finances the purchase of an asset on the request of its client and sells it to the client on disclosing the cost incurred on the purchase of asset on the profit which is also called mark up earned on the asset.

In *Murabaha* transaction payment may be made on spot or deferred to some future date mutually agreed between the parties. It is pertinent to mention here that *Murabaha* is valid only when the exact cost of a commodity can be ascertained. If it can not be ascertained then goods to be sold on simple sale basis which is also called *Bai-ul-Musawma*. The only difference between simple sale (*Bai-ul-Masawma*) and *Murabaha* is that in simple sale, the seller generally does not disclose the cost and price of goods. Whereas, in *Murabaha* the seller is bound to disclose the cost incurred on the purchase of goods and the profit mark up which he earns on such goods.<sup>44</sup>

Apparently, *Murabaha* transaction, where the mark up is charged by the seller, may not be different from the loan transaction where the interest is charged by the lender. Infact, *Murabaha* is a type of sale where the goods come into the possession of the bank who assumes the risk of loss and sells the goods on disclosure of its cost plus profit. Benefit charged by the banks in case of *Murabaha* is based on an Islamic legal maxim, which is as follows: "*Damage and benefit go together; for example, he who derives benefit from a thing must also*

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<sup>44</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, pp. 103-104.

*bear any damage from it*".<sup>45</sup> Whereas, in loan transaction, interest is charged on the loan and the bank does not bear any risk of loss.

### **3.2.7- Ijarah.:**

Ijarah is a contract of hiring the services of a person or a usufruct of an asset for the time specified and against consideration mutually agreed between the parties to the contract.<sup>46</sup> Ijarah as a mode of financing would thoroughly be discussed as topic of thesis in the coming chapters.

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<sup>45</sup> Justice ® Dr. Tanzil-ur-Rehman, *Kuliyat-e-Shariat*, p. 197

<sup>46</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, p. 157

## CHAPTER-II

### **Concept of Ijarah under Islamic Law**

#### **1- Introduction to Ijarah:**

Since the topic of this thesis is “*Ijarah in Islamic Law and its Application in Islamic Banks with Special Reference to Auto Financing of Askari Commercial Bank, Ltd. (Islamic Banking Division)*”, hence, after introducing other modes of financing, I will now focus on Ijarah and shall try to discuss the different aspects of Ijarah under the Islamic law in detail and shall also discuss the scheme introduced by the Askari Commercial Bank Ltd. (Islamic Banking Division) regarding Auto Financing.

*Ijarah* is a very important and one of the most commonly used interest free mode of financing. It is increasingly gaining importance in developed and developing countries of the world including Pakistan. *Ijarah* is practiced by banks and financial institutions throughout the world. It works as an alternative to leasing in conventional banks, so, stands synonyms to leasing.

#### **2- Meaning Of Ijarah:**

The word Ijarah is a legal term of Islamic Jurisprudence. Literally, Ijarah means to let something to some one on rent. In Shariah, it means to hire particular services of a person or usufruct of an asset for the specified time and against the consideration, mutually agreed between the parties to the contract<sup>1</sup>.

Meaning of Ijarah given by Justice® Taqi Usmani:-

Ijarah is a term of Islamic *Fiqh*. Lexically, it means, ‘to give something on rent’.

In Islamic Jurisprudence, the term Ijarah is used for two different situations. In the first

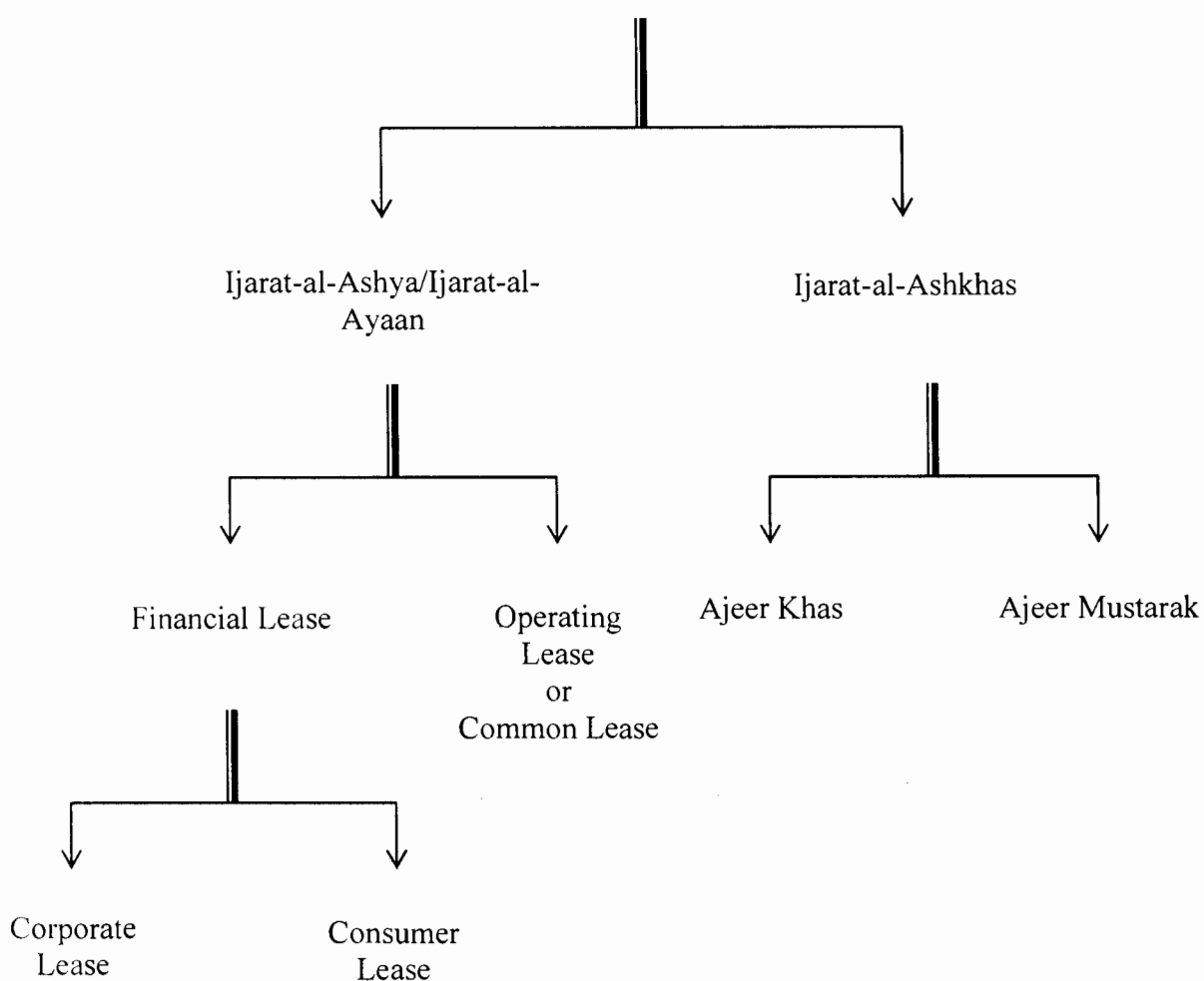
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<sup>1</sup> Dr. Muhammad Tahir Mansuri, Islamic Law of Contract and Business Transaction, p. 227.

place, it means “To employ the services of a person on wages given to him as a consideration for his hired services.”. The employer is called “mustajir” while the employee is called “aajir”<sup>2</sup>.

## Types of Ijarah

### Ijarah/Lease



<sup>2</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, p.157.



## 2.1- Types Of Ijarah:

From the meaning of Ijarah as given above, it appears that Ijarah in Islamic Jurisprudence is of two major types.<sup>3</sup>

- a) Ijarah-tul-Ashkhas or Ijarah-tul-Amaal:
- b) Ijarah-tul- Ayan or Ijarah-tul-Ashya

### 2.1.1- Ijarah Tul –Ashkhas Or Ijarah-tul- Amaal:

The **first** type of Ijarah is the one in which a person's services are hired, for instance the appointment of a servant etc. In Arabic, such type of Ijarah is called "*Ijarah-tul-Ashkhas*" or "*Ijarah-tul-Amaal*". In the English language it is termed as "employment".

The example of this type of Ijarah is the engagement of a lawyer for the purpose of defending a case or hiring an architect for the purpose of construction.

The person who hires the services is called employer and the person who serves is called employee, while in Arabic the person who hires the services is called *Mustajir* and the person who serves or hired for rendering services is called *ajir*. There are two types of *Ajir*,<sup>4</sup>

- a) *Ajir Khas* ; Empolyee.
- b) *Ajir Mushtarak* ; Independent contractor.

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<sup>3</sup> Al-Jaziri, Kitab al-Fiqh, ala al-Madhahib al-Arba,ah, Beirut: vol 3, p. 110.

<sup>4</sup> Ibid.

*Ajir Khas* is the employee who renders services for one person for a fixed period on payment of fixed wages.

*Aajir Mushtarak* is called independent contractor who works for a large number of people. For example tailor, laundry man and ironsmith etc.<sup>5</sup>

### **2.1.2- Ijarat –Al-Ayan:**

While the other type of *Ijarah* in which the usufruct of a specific thing is hired against a fixed amount of rent. In Arabic such a transaction is called *Ijarah-tal-Ayan* or *Ijarah Ijarah-tul-Asya* or *Ijarah-tul-Manfia*. While in English it is termed as leasing. The example of such a type of *Ijarah* may be the business of a rent a car or financing by a bank for leasing a motor car.

Both the above types of *Ijarah* have remained in practice since the time immemorial which continues up to the date. The last kind of *Ijarah* is now a days in practice in Islamic banks as a mode of financing with the changing circumstances and growing need of public at large and development of corporate sector. Leasing of the vehicles has become an independent and popular mode of financing, which the banks are now practicing.

*Ijarat –al-ayan* is further classified into two kinds.

- a- Operating lease/Service lease/consumer lease.

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<sup>5</sup> Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transaction*, p. 230.

b- Financial lease.

**2.1.2.1- Operating lease:**

Operating lease is also called as service lease or consumer lease. It is a kind of lease contract for use of something. This kind of lease does not end up with the transfer of leased asset to the lessee.<sup>6</sup> The only purpose of this type of lease is to acquire the usufruct of an asset and not the ownership of an asset. Ijarah is used as means of acquiring the usufruct of an asset. This is short term lease.

**2.1.2.2- Financial lease:**

Financial lease is that type of lease which normally ends up with transfer of ownership by lessor to the lessee.<sup>7</sup> Objective of financial lease is to serve the interest of both the parties to the contract i.e the objective of bank is to use the contract of lease as riba-free mode of financing and to earn the profit. The objective of lessee is to acquire the ownership of an asset through lease instead of buying or borrowing riba-based loans from the banks.

This type of lease is objectionable and needs rectification and modification to make it in conformity with the principles of Shariah. According to Islamic principles, it is not allowed to make two contracts in one contract.

Two contract i.e. contract of lease and contract of sale should be made separately through separate document. Jurists has provided an alternative to this transaction called Ijarah *Muntahia- Bil-tamleek*. (HP)

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<sup>6</sup> Dr. Mehmood Ahmed Ghazi, Islam mein Riba Ki Hurmaat aur bila Sood Sarmayakari, p. 27.

<sup>7</sup> Ibid.

3- **Definition Of Ijarah.** Ijarah has been defined by jurists of four major schools of thought under Islamic law.

**Ijarah is defined:**

According to the Jurists of Hanafi School of thought:-

*"It is a contract on usufructs for a known consideration".<sup>8</sup>*

According to the Jurists of Shafai School of thought:-

*"It is contract on a known and permissible benefit in exchange of a known return"<sup>9</sup>*

According to the Jurists of Maliki School of thought:-

*"It is an alienation of lawful usufructs for a fixed charge for a fixed period. For the Maliki Ibn Rushd says; Ijarah resembles a sale contract whereby price and use are exchanged."<sup>10</sup>*

According to the Jurists of Hanbali School of thought:-

*"Ijarah is contract for the lawful and defined use of a lawful and determined corporeal object for a specific period of time. It is also defined as providing a defined work for a fix price."<sup>11</sup>*

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<sup>8</sup> Kasni, Bada'i al-sana'i, vol. 4, P-174; Zayla'i, tabyin al-haqa'iq, vol. 5, p. 105. quoted by Dr. Muhammad Mansuri, Islamic Law of Contract and Business Transaction, p. 228.

<sup>9</sup> Shirbini, Mughni al-Muhtaj, Vol. 2, p. 332, quoted by Dr. Muhammad Masuri, Islamic Law of Contract and Business Transaction, p. 228.

<sup>10</sup> Ibn Qudamah, al-sharh al-kabir, vol. 4, p.2, quoted by Dr. Muhammad Masuri, Islamic Law of Contract and Business Transaction, p. 228.

<sup>11</sup> Bahuti, al-rawd al-murbi, p. 214, quoted by Dr. Muhammad Masuri, Islamic Law of Contract and Business Transaction, p. 228.

The important features of ijarah, which may be gathered from the above mentioned definitions of Ijarah are as follows.

- 1- The purpose of Ijarah is the transfer of usufruct only and not the transfer of ownership of lease asset.
- 2- The benefit (manfa) must be there in the contract of Ijarah either in the form of hiring the services of any expert or in the form of transfer of usufruct of an asset by the lessor to the lessee.
- 3- The benefit (manfa) must be in consideration of rent or wages agreed on between the parties.
- 4- The benefit (manfa) must be delivered to the lessee by the lessor.
- 5- The benefit must be lawful (permissible under Shariah), known and identified by the parties to the contract.
- 6- The contract of lease must be for the period specified and agreed by the parties to the contract.

#### 4- Legitimacy Of Ijarah:

Legitimacy of Ijarah is established by primary sources of Islamic law, i.e. Quran, Sunnah, Ijma, Qiyas and reasoning.<sup>12</sup>

##### 4.1- Quran:

- i- Allah says: “And if they suckle your (offspring) give them their recompense”<sup>13</sup>.

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<sup>12</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, Standard App. B: Basis of the Shariah Rulings, p. 151.

<sup>13</sup> Quran 65:6

ii- Said one of the (damsels): “O may father: engage him on wages. Truly the best of men for thee to employ in the man who is strong and trustworthy”<sup>14</sup>

#### 4.2- Sunnah:

i- Said the Holy prophet (s.a.w.s). “ Give wages of the person hired before his sweat dries up”<sup>15</sup>

ii- If some one hires a person, let him inform him about the wages he is to receive”<sup>16</sup>

iii- Hazrat Saad ibn-e-Abi Waqqas reported that in the age of Holy Prophet(s.a.w.s) the owners of the land used to let their lands on rent.<sup>17</sup>

#### 4.3- Ijma:

*“All the companions of the Holy Prophet ( s.a.w.s) unanimously held that Ijarah is a lawful contract. They themselves practiced all lawful forms of this contract. In the Shariah permissibility of Ijarah has been constructed on Istihsan, which is a departure from a rule of precedent. According to general rule of Islamic law of contract, an object, which does not exist at the time of contract, may not be sold. However, Ijarah is valid despite its being sale of the usufructs, which are non-existent at the time of contract. Analogy would, thus invalidate Ijarah, but Istihsan exceptionally validates it on the authority of the Sunnah and Ijma.”<sup>18</sup>*

Imam Sarakhsi stating the lawfulness of this contract writes:<sup>19</sup>

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<sup>14</sup> Quran, 28:26

<sup>15</sup> San`ani, al-salam. Vol.3, p. 81.

<sup>16</sup> Shawkani, nayal al-Awtar, vol. 5, p 292, see also sunnan ibn majah 2/817

<sup>17</sup> Nasai, Sunnan(Urdu) Karachi: Quran Mahal, n.d. vol.3, p. 60.

<sup>18</sup> Mansuri, Islamic Law of Contract and Business Transaction, p. 231

<sup>19</sup> Al-Sarakhsi, al mabsut vol. 15, p. 74.

The contract and dealings practiced before Islam are valid practices for us in absence of any text disapproving them. The Holy Prophet (s.a.w.s) was sent as Prophet and he saw the people practicing Ijarah and he approved that practice.

#### **4.4- Qiyas and Reasoning:**

Ijarah is permissible also on the touch stone of reasoning because it is quite evident that every body does not own a house to live in or a motor car to travel nor every body has the skill to construct a house or medically treat himself. Therefore, the members of the society require houses to live and for that purpose they have to hire houses on Ijarah. Similarly, if they fell ill they require the services of a medical practitioner who provide his services by charging fee. It is also to be seen that if one has more than one houses, the additional houses will be of no use for him, if the lease is held to be impermissible. Likewise, no body will specialize in medicine if he can not charge for the services he renders. In this way there will be no expertise and specialization in the society which is a sine quo non for the progress.<sup>20</sup> In the light of aforesaid, it can safely be concluded that Ijara is permissible on the touch stone of Qiyas and as well as reasoning.

#### **5- Reasons For Preference Of Ijarah As Mode Of Financing Over Other Modes Of Financing:**

As the contract of Ijarah serves both the parties i.e the lessor and the lessee. The lessee prefers it over the borrowing loans from banks to avoid riba-based transactions and also to avoid payment of tax to the government in case of buying the asset. The lessor i.e the bank prefers it over other modes of financing as lease is a less risky mode as leased asset remains in the ownership of lesser till the price and profit is received. If lessee fails

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<sup>20</sup> Kasani, Badi al-sanai, vol. 4, p. 219.

to pay, the lessor has the right to take the asset back and sell it to recover its capital.

Financial lease is used for corporate purposes and also for consumer purposes.

Ijarah is not originally a mode of financing but a normal business activity like sale, practiced from time immemorial by the society. Contract of Ijarah and contract of sale are governed through rules and principles which are basically very much similar to each other. Infact, in both the contracts, the transfer of something happens for consideration.

We may better understand the major difference between the two in form of a table

<b>Contract of sale</b>	<b>Contract of Ijarah</b>
<b>PARTIES:</b> Parties are called as seller and buyer.	In case of Ijarah parties are called as the Lessor and the lessee.
<b>CONSIDERATION:</b> Consideration is price.	Consideration is called rent or wages.
<b>PERIOD:</b> Transfer of something happens forever.	Transfer of something happens for a specified time.
<b>SUBJECT MATTER:</b> The subject matter of sale can be any valuable and lawful object.	The subject matter of Ijarah must not be consumable or raw material.
<b>FUTURE PERIOD:</b> Contract of sale for future period is not allowed. Things which are not in possession are not allowed to be sold.	Ijarah for future date is allowed on the condition that the rent shall be payable on the date of delivery of the asset.
<b>TRANSFER:</b> In sale corpus of property along with all rights and liabilities transfers to the purchaser.	In case of Ijarah the corpus of property remains in the ownership of the transferor/lessor and only usufruct of the property along with some rights and liabilities is transferred from lessor to the lessee.

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We may observe that on the face of it the transaction of ijarah and sale appear to be similar due to the reason that in both the transaction their should be two parties but the major difference between the two transactions is that, in the transaction of sale, the very ownership in the subject matter of sale passes on to the buyer, whereas, in a transaction of ijarah only the usufruct of an asset along with some rights and liabilities passes on to the lessee. Whereas, the ownership in the subject remains intact with the lessor.

As mentioned earlier that Ijarah is not originally a mode of financing but with expansion of industry and growth of banking system finance has become life blood of any business transaction and it is needed for carrying on every business. Keeping in view the need of time, the financial institutions and banks adopted it as an alternative to riba-based modes of financing. Ijarah is practiced by banks and financial institutions being not only the lawful transaction according to shariah but also a less risky mode of financing and beneficial for both of the parties involved in Ijarah transaction.

However, the permissibility of Ijarah as a mode of financing like any other business transaction depends essentially on that its terms and conditions conform to the principles of Shariah.

#### **6- Essentials of Ijarah:**

Like any other civil contract , Ijarah contract also requires for its validity some essential and substantial constituents. These essential constituents of contract of Ijarah are as follows:<sup>21</sup>

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<sup>21</sup> Zuhaili, al-fiqhul-islami wa Adillahtohu vol. 4, p.731

- 1- Parties to the contract of Ijarah, i.e. the lessor and the lessee. To constitute a contract of *Ijarah* it is necessary that there should be an unconditional offer and acceptance giving rise to the accrual of rights and liabilities to the parties to the contract.
- 2- Consent of both the parties to the contract of *Ijarah*. Consent of both the parties is essential.
- 3- Consideration of the contract of lease i.e rent or wages. The contract of Ijarah must be for a lawful(permissible under the Shariah) consideration and with lawful(permissible under the Shariah) object.

4- Period of contract.

Period of contract must be fixed and specified by the parties to the contract.<sup>22</sup> They may enter into short-term or long term period, according to the kind of Ijarah. Contract of Ijarah is governed by the number of basic rules and principles provided by Shariah. The list of these rules is not exhaustive, however, some of these rules and principles may be briefly discussed with regard to each basic constituent of Ijarah contract mentioned above as follows:

**7- Fundamentals Principles of Ijarah with Reference to Each Essential Constituent of Ijarah:**

Like any other civil contract, ijarah contract also requires for its validity , essential and substantial constituents.

**7.1- Lessor:**

The lessor is called “Mujir” in Arabic, is the owner of leased asset and remains the owner throughout the period of Ijarah. Lessor enjoys all the rights of ownership,

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<sup>22</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, Standard 4/1/2, p. 141

therefore, all the responsibilities pertaining to the ownership shall be borne by the lessor i.e payment of property tax, insurance expenses etc. The lessor bears all the risks attached to the asset.<sup>23</sup>

#### 7.2- Lessee:

The lessee is called Mustajir” in Arabic. Lessee is the user of property and not the owner of the leased asset. He is only entitled to utilize the usufruct transferred to him by the lessor. The lessee being the *Amin*/trustee of the leased asset is only liable to compensate any damage caused by his negligence or misuse of the leased asset.<sup>24</sup> He is not responsible for any harm caused to the leased asset without his negligence or by the factor beyond his control i.e. He is not responsible for the act of God(Force Majure). For example, Mr. Ibrahim has leased his house to Mr. Ahmad. Due to heavy rain a part of the house is damaged. The repairing expenses shall be borne by Mr. Ibrahim, the lessor and not by Mr. Ahmad, the lessee.

- According to *Shariah*, it is not necessary that the lessee should be one person only or an institution. Where two or more persons or institutions jointly own asset and give on lease, is called syndicate *Ijarah* and is allowed in *shariah*. The rent shall be distributed according to their respective shares in jointly owned property.<sup>25</sup>
- The lessor may sell the leased asset to a third party, other than the lessee, which results in transfer of title of ownership of leased asset with all the rights and liabilities of the lessor to the new owner of the leased asset .It is the moral obligation of the lessor to inform the lessee about such transaction for lessee’s

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<sup>23</sup> Ibid, Standard, 5/1/8, p. 142.

<sup>24</sup> Ibid, Standard, 7/1/4, p. 144.

<sup>25</sup> Ibid, Standard, 3/6, p. 140.

convenience and to save him from disturbance which may be caused to him due to transfer of ownership from original owner to new owner of leased asset.<sup>26</sup>

- As the lessee is only entitled to utilize the usufruct of the leased asset so he is only responsible for the liabilities related to the use of asset. For example, Mr. Ali/lessor leased his house to Mr. Umer/lessee who is responsible to pay water , electricity , phone and gas bills and all such expenses related to the use of the house shall be borne by Umer/lessee.
- The lessee must use the leased asset for the purpose specified, and according to the conditions laid down in the contract. If no such purpose or conditions are specified in the contract, the lessee should use the asset prudently, with due care diligence and according to the custom and usage of the area,<sup>27</sup> for example Ali has leased out his car to Umer for traveling. But he uses the car for loading heavy luggage which is not allowed by law and the custom.
- Liability of lessee to pay the rent starts with the handing over of the possession of the leased asset to the lessee and not with the start of use of leased asset by the lessee. For example Mr. Ali hired a Vehicle on lease from Mr. Umer .It remained in Mr. Ali' s garage . Mr. Ali has to pay the rent even he has not used the car..
- The lessee may enter into a sub lease contract with a party other than the owner of the asset for any rental but with express permission of the owner of leased asset.<sup>28</sup>

### **7.3- Subject Matter Of The Lease/Leased Asset:**

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<sup>26</sup> Ibid, Standard, 7/1/2, p. 144.

<sup>27</sup> Ibid, Standard, 5/1/4, p. 142.

<sup>28</sup> Ibid, Standard, 3/3, p. 140.

As we know that the contract of lease is not the contract of transfer of ownership but only the contract of usufruct of an asset. Hiring usufruct of an asset by the lessee and retention of ownership of such leased asset with the lessor for the whole period of the contract is the essence of the lease contract which demands that any thing which can not be used without consumption, can not be leased out.<sup>29</sup> As in case of leasing consumable things, the property does not remain in the ownership of the lessor/owner. The subject matter of the lease should not be the money, eatables, fuel and ammunitions etc. The philosophy behind the impermissibility of consumable things as subject matter of lease is that it defeats the basic purpose of Ijarah and results in delusion of the ownership of the leased asset.

- Transfer of perishable things will be dealt as loan transaction but not Ijarah and according to *Shariah* any excess over and above the loan is termed as *riba* which is vehemently prohibited in *Islam*..
- The leased asset must be hired for lawful purposes(permissible in *Shariah*),for example, hiring house for the purpose of gambling or manufacturing wine etc. is prohibited by *Shariah*. Likewise musical instruments are impermissible by *shariah* to be leased out.
- The subject matter of lease must be of valuable use and should be something which can be actually delivered to the lessee, that the required usufruct can be availed by the leased asset,<sup>30</sup> for example, to rent out a stray animal and a fish in the water in not allowed by *Shariah*.

#### 7.4- Rentals:

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<sup>29</sup> Ibid, Standard, 5/1/1, p. 142.

<sup>30</sup> Ibid, Appendix B, p. 153.

The rental of the leased asset must be:-<sup>31</sup>

1. fixed and known to the parties.
2. determined at the time of contract
3. for whole period of lease contract.

➤ But if the lease is for a long period and its not possible or not in the interest of parties to fix the rent of whole period at the time of contract. The parties may with mutual consent, fix different amounts of rent of different phases of the leased periods provided amount for each phase is specifically agreed up with mutual consent of the parties. In short, we can say that parties may agree on any rent by mutual consent and the only requirement is the fixation of rent for different phases of lease period specifically agreed upon by mutual consent of the parties. However, shariah has not laid down any permanent formula or method to fix the rentals.

➤ The Rental may be determined on the basis of the aggregate cost incurred on purchase of the asset by the lessor. In the long term lease, contemporary scholars have allowed that fixation of rent to be made linked with some variable benchmark,<sup>32</sup> for example, use of KIBOR as benchmark. KIBOR which stands for Karachi Inter Bank Offered Rate, is used in Pakistani banks as a benchmark to determine rent. Use of KIBOR as benchmark is criticized by some shariah scholars due to its resemblance with riba-based transactions.

➤ The lease contract where the rent is increased unilaterally by the lessor, is not permissible by shariah.

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<sup>31</sup> Ibid, Standard, 5/2/1, p. 140.

<sup>32</sup> Ibid, Standard, 5/2/3, p. 140.

- Payment of rent shall start with the delivery of an asset by the lessor to the lessee, even if the assets not used by the lessee after having possession of the asset. The rent may be paid in advance, before the delivery of an asset to the lessees but the amount so paid remain with lessor as on account payment and may be adjusted to words the rent after its being due.

#### **7.5- Lease Period:**

The period of lease contract must be fixed by the mutual consent of the parties.

The lease may be contracted for short term or long term period.<sup>33</sup>

- The period of lease shall commence from the date of delivery of an asset by the lessor to the lessee and not from the time of use of leased asset. The payment of rent by the lessee becomes due from the time when lessee gets the asset into his possession.

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<sup>33</sup> Zuhaili, al-fiqhul-islami wa Adillahtohu vol. 4, p.737

## CHAPTER III

### LEASING IN CONVENTIONAL BANKS

#### 1- Introduction:

Almost every person is involved in short-term rental arrangements in his daily life to meet his day to day needs i.e. hires a car or taxi or hires a hotel room for a day or so.

These rental arrangements are made by common people at individual level to meet their limited needs and for short period on payment of rent. The rental arrangements at larger scale and for longer period are also made by the corporate sector or big business entities for business use. These are infact, the extended rental arrangements; that extend to a year or more or whatever required and agreed upon by the parties on fixed periodical payments. The first payment usually becomes due as soon as the contract is signed by the parties. Further payment of an amount of installment and time of payment can be adjusted according to the circumstances and needs of the parties involved in the contract.<sup>1</sup>

The essence of the lease contract is to earn the benefit through the use of the leased asset and not to acquire the ownership of an asset. However, in some cases the lease agreement provides an option to the lessee to purchase the asset on termination of the contract of lease.<sup>2</sup>

Conventional Leasing is one of the most popular, highly significant mode of financing practiced by financial institutions and banks throughout the business world. Lease is distinguished from other modes of financing due to the fact that

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<sup>1</sup> R. Brealy and S. Myers, Principles of Corporate Finance, 5<sup>th</sup> edn., p. 739.

<sup>2</sup> Ibid, pp. 739-740



the lessee may get the benefits from an asset without lifting the heavy charges of buying an asset in lump sum and at the spot. There are many other good reasons that lease is preferred over other modes of financing.<sup>3</sup>

Leasing is infact an alternative to buying an asset or borrowing loan to purchase new asset. Lease being convenient, less risky and less expensive mode is preferred over other modes of financing and it serves the interest of both the parties involved in the contract of lease.

## **2- Definition Of Conventional Leasing:**

According to the international accounting standards committee:

“A leasing transaction is a commercial arrangement whereby an equipment owner conveys the right to use the equipment in return for payment by the equipment user for a specified rental over a pre-agreed period of time.”<sup>4</sup>

### **2.1- Parties To The Contract Of Lease:**

Parties to the contract of lease are;<sup>5</sup>

LESSOR: one who owns the leased asset

LESSEE: One who uses the leased asset.

### **2.2- Subject Matter Of The Contract Of Lease Is The Leased Asset.:**

Different kinds of assets can be leased out ; for example, computers trucks, air crafts and ships, electric power plants, nuclear fuel, zoo animals e.t.c.<sup>6</sup>

### **2.3- Consideration:**

Consideration for lease contract is a periodical payment which is termed as lease premium paid by the lessee to the lessor.<sup>7</sup>

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<sup>3</sup> Ross. Thompson. Christensen Westerfield. Jordan, Fundamentals of Corporate Finance, p.825.

<sup>4</sup> Richard Pike and Bill Neale, Corporate Finance and Investment, 3<sup>rd</sup> edn, p. 433.

<sup>5</sup> R. Brealy and S. Myers, Principles of Corporate Finance, 5<sup>th</sup> Edn., p.739.

<sup>6</sup>Ibid.

<sup>7</sup> Ross. Thompson, op.cit., p. 826

### 3- **Leasing By The Renowned Equipment Manufacturers:**

Some of the major sources of equipment manufactures are as under:-<sup>8</sup>

- GATX is the largest lessor of rail cars
- IBM is the largest lessor of computers
- Xerox is the largest lessor of photocopiers.
- The other major sources are the banks, merchant banks specialist leasing companies and many other financial institutions.

### 4- **General Terms and Conditions of Lease Agreement:**

The contract of lease is known as lease agreement, which contains generally but not limited to the following terms and conditions:<sup>9</sup>

- The amount of rent and mode of payment of these rental installments periodically.
- Nature of lease, whether the lease is terminable by either of the parties.
- Conditions under which contract is terminable by either party .
- Rights and liabilities of the parties involved in the lease contract.
- The whole period of the lease contract, which can run from a few hours to the expected economic life of the asset.
- Position of the leased asset at the termination of lease contract. Options available with regards to leased asset to be mentioned in lease agreement are as follows.
  - a) To return the leased asset to the lessor, or,
  - b) To sell the leased asset to the lessee, or,
  - c) To sell the leased asset to third party other than the lessee, or,
  - d) Renewal of lease contract.

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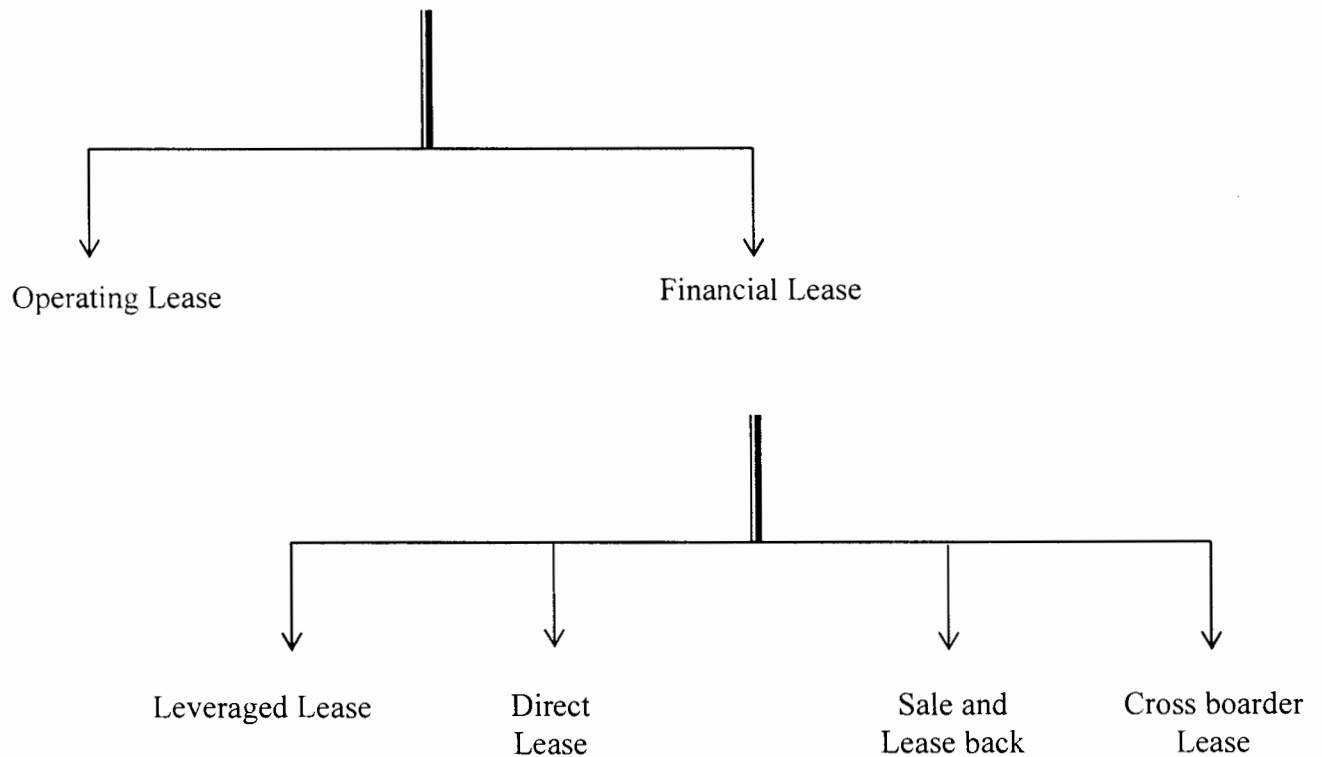
<sup>8</sup> R. Brealy and S. Myers, Principles of Corporate Finance, 5<sup>th</sup> edn. p.739.

<sup>9</sup> Ross. Thompson. Christensen Westerfield. Jordan, Fundamentals of Corporate Finance, p.826

- How to be adjusted the residual value of the leased asset. Residual value is the market value of an asset at the end of its leased term.
- Penalty in case of late payment of installments of rent or default.
- Penalty in case of early termination of lease contract by either party.

## 5- Types of Lease

### Lease



#### 5.1- Operating Lease:

Operating lease is also called service lease.<sup>10</sup> Operating lease is basically a rental agreement. The purpose of this lease is to get benefit from an asset by using

<sup>10</sup> D.J. Campsey, Eugene F. Brigham, Introduction to Financial Management, p.692.

it only and not getting the ownership of an asset. This form of leasing is usually short-term relative to the life of an asset by using it. Operating lease is non-full payment lease or partially amortized lease as the lease premiums which are paid periodically, does not provide for full recovery of the asset's cost. The lessor is liable to pay service, maintenance and insurance, expenses of the leased asset. Operating lease is terminable unilaterally by the lessee even before the terminating date of lease contract on giving notice to the lessor.<sup>11</sup>

Examples of operating lease, equipments including telephones, televisions , photocopiers, motor vehicles, computers, trucks etc. IBM is one of the pioneers of service lease contract.

#### **5.2- *Financial Lease:***

The financial lease which results normally in transfer of ownership from lessor to the lessee. It is a long term lease agreement that covers the economic life of the asset. It is not easily cancelable, and if cancelled by the lessee prior to the expiry date of lease contract, he has to face the substantial penalty charges, paid to the lessor by the lessee. Financial lease is called net lease, full-pay out leases or fully amortized lease as the lease premiums paid by the lessee provide for full recovery of the asset's cost. The lessee is responsible to pay tax and maintenance charges of an asset.<sup>12</sup>

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<sup>11</sup> Ibid. pp. 692, 693.

<sup>12</sup> Ibid, p. 693.

The Operating lease and the financial lease, both the types have their own distinctive features and financial applications which make them different from each other. Difference between two may be understood in a better way in the form of table given below.

**DIFFERENCE BETWEEN OPERATING LEASE AND FINANCIAL LEASE**

<b>OPERATING LEASE</b>	<b>FINANCIAL LEASE.</b>
It is a short-term lease.	It is long term lease.
Operating lease is essentially a periodic rental agreement; agreement to use only the leased asset.	Financial lease is an agreement of ownership without immediately paying cash for it.
It is partially amortized, does not fully recovers the asset's costs from premium paid by the lessee.	It is fully amortized, fully recovers the asset's costs from premium paid by the lessee.
It is cancelable unilaterally by the lessee prior to the expiry date of lease agreement.	It is non-cancelable prior to the expiry date of lease agreement.
The lessor is liable for the upkeep of leased asset i.e. responsible for maintenance, service and insurance expenses.	The lessee is responsible for the up keep of leased asset i.e. lessee is liable to pay maintenance, service and insurance charges.
The operating lease is the only type in itself.	It has many types and some are special types of financial leases.

Another distinctive feature of financial lease is its types, which also make it different from operating lease. These special types are as follows:<sup>13</sup>

<sup>13</sup> Graham Peirson, Rob Brown, Steve Easton, Peter Howard, Peirson and Bird's Business Finance, 7<sup>th</sup> Edn., p. 625.

- 1- Leveraged lease.
- 2- Direct lease.
- 3- Sale and lease back.
- 4- Cross- border lease

#### **5.2.1- Leveraged Lease:**

Leveraged leasing was introduced into the Australian capital market in mid 1970s. First lease of this type was negotiated in 1974. Since then this way of leasing is practiced to lease out many large and expensive assets. In leveraged lease, lessor borrows loan to buy the part of the purchase price of the heavy and expensive leased asset, by using the lease contract as security for the loan.<sup>14</sup>

Leverage lease involves three parties.

- 1- Lessor
- 2- Lessee
- 3- Lender/debt participator.

The loan which is borrowed by the lessor in leveraged lease is a non-recourse loan which means that the lessor is not responsible for its repayment and in case of default by the lessee, the lender has no recourse to the lessor. However, the lender has a first lien on the leased asset and he actually receives the lease

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<sup>14</sup> Ibid, p. 626.

premium received periodically from the lessee. The lender after deducting the principal amount and interest due, forwards the remaining amount to the lessor.<sup>15</sup>

### **5.2.2- Direct Lease:**

When the lessee wants to get a brand new assets he identifies the asset and make arrangements as an agent of the leasing companies of banks to buy it from the manufacturers directly and signs a contract of lease with lessor i.e bank or leasing company. This transaction is called direct leasing where three parties are involved, i.e.<sup>16</sup>

- 1- The lessor
- 2- The lessee
- 3- The manufacturer of the leased asset.

### **5.2.3- Sale and Lease Back:**

Sale and lease back is a kind of financial lease where the lessee sells an asset to the lessor and immediately leases it back. Sale and lease back is a type of a long-term lease and the term of lease will depend on the type of asset concerned. The lessee is responsible for payment of property taxes, service, maintenance and insurance expenses etc. In such like cases, the owner of the asset is in need of cash. He enters into the sale and lease back transaction for getting cash by utilizing his asset as security.<sup>17</sup> Agreement of sale and lease back is used as tool to get cash.

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<sup>15</sup> Ibid.

<sup>16</sup> R. Brealy and S. Myers, Principles of Corporate Finance, 5<sup>th</sup> edn., p. 740

<sup>17</sup> Graham Peirson, Rob Brown, Steve Easton, Peter Howard, Peirson and Bird's Business Finance, 7<sup>th</sup> edn., p. 626.

Subject matter of such lease transactions are, for example, office buildings, retail shops, hotels, motels, shopping centers, ware houses and factories etc.

#### **5.2.4- Cross Border Lease:**

Cross boarder lease transactions are done between the lessor and the lessee located in different parts of the world. Cross boarder leasing is encouraged by some countries as it guarantees benefits such as increase in exports of the countries.<sup>18</sup>

#### **6- Alleged Advantages And Disadvantages Of Leasing:**

Proponents of leasing have claimed number of economic advantages. They have also pointed out disadvantages of the leasing. However, most of the claimed advantages are debatable and are as such not recognized by the economists. A careful survey of institutions conducting leasing contracts show that only few elements create the economic advantages to the parties involved in the contract.

Major advantages of leasing recognized by the economists are as follows:

##### **6.1- Major Advantages:**

Major advantages of leasing recognized by the economists are as follows.

##### **6.1.1- Tax Benefits:**

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<sup>18</sup> Graham Peirson, Rob Brown, Steve Easton, Peter Howard, Peirson and Bird's Business Finance, 7<sup>th</sup> Edn., p.628



Taxes are the primary reason for growth of financing leasing. Leasing provides the tax shelter to the parties. *“The lessor owns the leased asset and deducts its depreciation from taxable income. If the lessor can make better use of depreciation tax shields than an asset’s user can, it may make sense for the leasing company to own the equipment and pass on some of the tax benefit to the lessee in form of low lease payment”*.<sup>19</sup>

#### **6.1.2- Reduction Of Uncertainty:**

Leasing avoids the risk of obsolescence, guards against changes in market conditions and situations where the future is uncertain. “ A lease contract is a method, that transfers the substantial uncertainty from the lessee to the lessor as to what the residual value of the asset will be at the end of lease contract . The transfer of such uncertainty to the lessor amounts to a form of insurance for the lessee”.<sup>20</sup>

#### **6.1.3- Low Transaction Costs:**

“It may be less costly and time-consuming to sign a lease contract then to enter into a long-term secured loan transaction.”<sup>21</sup>

*The other advantages and disadvantages of leasing are as follows:*

#### **6.2- Other Advantages:**

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<sup>19</sup> R. Brealy and S. Myers, Principles of Corporate Finance, 5<sup>th</sup> edn., p. 741

<sup>20</sup> Ross. Thompson. Christensen Westerfield. Jordan, Fundamentals of Corporate Finance, p. 842.

<sup>21</sup> R. Brealy and S. Myers, op.cit., p. 757

Leasing is more cost-effective way of acquiring an asset, as fixed rental payments are made in it.<sup>22</sup> Its profitable alternative to the interest based borrowing loans from banks or to buy an asset on immediate and on the spot payment.<sup>23</sup>

- Leasing provides long term financing at fixed rates, which in present economic scenario of the world is appreciated and preferred over the modes of financing by the business community all over the world.
- Leasing facilitates capital budgeting as lease rents are fixed for the whole term of the lease.<sup>24</sup>
- Leasing enables a company to convert its capital for alternative uses i.e. The lessee may use available capital for other projects. It increases the company's pool of working capital.<sup>25</sup>
- Leasing contains convenience as the period of lease and payment of rentals may be adjusted in accordance with the requirements of both the parties.
- Leasing is a hedge against inflation. In later years, in a leasing deal one is paying yesterday's currency units for the yesterday's purchase.<sup>26</sup>

### **6.3- Disadvantages:**

- There may not be available right to the residual value of the asset in leasing.<sup>27</sup>

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<sup>22</sup> Richard Pike and Bill Neale, *Corporate Finance and Investment*, 3<sup>rd</sup> Edn., p. 440.

<sup>23</sup> Ross. Thompson. Christensen Westerfield. Jordan, *Fundamentals of Corporate Finance*, p. 841.

<sup>24</sup> Richard Pike and Bill Neale, *op.cit.*, p.440.

<sup>25</sup> Ross. Thompson, *op.cit.*, p. 841.

<sup>26</sup> Richard Pike and Bill Neale, *op.cit.*, p.494

<sup>27</sup> *Ibid*, p. 841.

- In leasing the lessor may exploit the lessee's position in that if the business of the lessee is successful and value of business is attached with the use of that particular leased asset, the lessor may demand higher rental payments when lessee comes up for renewal of the leased period.
- In case if the lessee wants to change business operations due to some compulsive situations faced by the lessee and wants to terminate the lease contract, prior to the expiry date of the contract, it would be very difficult for the lessee to do so, specially when the lease contract contains the non-cancelable clause prior to the expiry date, otherwise he would have to face the penalty.

**7- Distinguishing Features Of Conventional Financial Leasing And Islamic Ijarah:**

There are some distinguishing features of conventional leasing and Islamic Ijarah, which make them different from each other.

CONVENTIONAL LEASE	IJARAH
In conventional lease two contracts i.e. contract of lease and contract of sale are made in one contract. In contract of lease, the ownership of leased asset is transferred, impliedly or expressly, by way of sale or gift by the lessor to the lessee through the contract of lease and not by the separate document of contract of sale. Contract of lease itself	According to Islamic law two contracts in one agreement are not allowed. This practice is called " <i>Safqatan -fi - Safqatin</i> " (two contracts in one agreement) and are considered defective in Islamic law. According to <i>Shariah</i> , contract of Ijarah is executed at first instance and both the parties are free to deal with the asset according to

<p>contains the condition of sale or gift at the end of lease period.</p>	<p>their free will . The lessor is free to take back or to enter into the contract of renewal of <i>Ijarah</i> contract or to sell it to third party or to the lessee. The lessee may purchase the asset at the end of the lease period through separate document of contract of sale. According to <i>Shariah</i> contract of lease should not itself contain the condition of sale or gift at the end of lease period. Two contracts should be made by free consent of the parties separately through separate documents.</p>
<p>Liabilities pertaining to the ownership of leased asset i.e responsibility of insurance is borne by the client/lessee.</p>	<p>Only the liabilities related to the use of leased asset are borne by the lessee in <i>Ijarah</i>. For example, liability to pay electricity, phone, water and gas bills etc. while the liabilities pertaining to the ownership of leased asset are borne by the lessor. For example, to pay property tax and insurance/Takaful charges etc.</p>
<p>In conventional lease, the payment of rental starts even before the delivery of leased asset to the lessee.</p>	<p>In <i>Ijarah</i> payment of rental starts with the delivery of required leased asset by the lessor to the lessee.</p>

**8- *Ijara wa iqtina* (H.P agreement) or *ijarah muntahia bi tamleek*; an alternative to conventional financial lease.:**

We may observe by the comparison made between the conventional financial lease and *Ijarah* that the important feature of conventional financial lease is that of two contracts i.e contract of lease and sale contract are made in one contract through the same agreement. The agreement of lease itself contains the condition of sale or gift at the end of lease period. Whereas two contracts in one agreement are not allowed according to the sayings of Holy Prophet( P.B.U.H).

- i- It is not permissible to combine two contracts into one agreement.<sup>28</sup>
- ii- It is narrated by Sayyidina Abdullah ibn Masud that Holy Prophet (s.a.w.a) said: *“To combine two contracts in one agreement is a form of Riba.”*<sup>29</sup>

According to shariah conditional contracts are not allowed and one transaction can't be made a pre-condition for another transaction, because each type of transaction/contract has unique legal implication and obligations.<sup>30</sup>

The rationale of impermissibility to make two contracts in one contract or making a transaction pre-condition for another transaction is to avoid uncertainty, confusion and contradictions which may arise due to the contingencies in the contracts. If there arise no such contradictions due to combination of contracts and legal implications and consequences do not conflict with each other but are

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<sup>28</sup> Mu, jam al-Tabrani al-Awsat 2/364, Hadith No: 16733

<sup>29</sup> Mawarid al-Zaman li-Haithamai 1/63 Hadith No: 163

<sup>30</sup> Munawar Iqbal, A guide to Islamic Finance, p. 50.

supportive and add strength then there is no problem in making two contracts in one and making conditional contracts.<sup>31</sup>

In case of lease contract keeping in view the different legal implications of both the contracts i.e. contract of lease and contract of sale, parties must enter into two separate contracts through separate documents , after the expiry of lease period. However, the *Shariah* Scholars, feeling the financial needs of Islamic Financial Institutions have provided an alternative solution to conventional financial lease. This arrangement is called *Ijarah Wa Iqtina* (Hire Purchase Agreement) and frequently practiced in Islamic banks and IFIs.<sup>32</sup>

#### **WHAT IS IJARAH WA IQTINA:**

“It is a combination of leasing of movable or immovable property with granting the lessee an option of eventually acquiring the object of the lessee.”<sup>33</sup>

“Under *Ijarah Wa Iqtina* arrangements the lessor , after entering into the lease agreement, signs a separate unilateral promise whereby he undertakes that if the lessee had paid all the amounts of rentals and wants to purchase the asset at a specified mutually accepted price, he will sell the leased asset to him for that price.”<sup>34</sup>

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<sup>31</sup> Ibid, pp.54-55.

<sup>32</sup> AAOIFI, 2003, *Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek*,: App. C, Definations pp. 151 and 158.

<sup>33</sup> Nabil a.Salih, *Unlawful Gain and Legitimate Profit in Islamic Law*, p. 122, as quoted by Dr. Tahir Mansuri in *Islamic Law of Contracts and Business Transactions* at p. 236.

<sup>34</sup> Justice Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, p. 176.

Once the lessor has made the unilateral promise and signed in a separate document, he is bound to fulfill it. Lessee has an option to buy the leased asset on the price mutually accepted by the parties at the end of the period after full payment of the rent according to the lease agreement.<sup>35</sup>

**8.1- Validity Of The Hire Purchase Agreement Depends On The Following Basic Conditions:<sup>36</sup>**

These two basic conditions are as under:

- 1- That the agreement of Ijarah should not contain itself the condition of making unilateral promise of sale or gift but such promise should be recorded in a separate document.
- 2- That the promise recorded separately should be unilateral and binding on the promisor only because the bilateral promises to enter into future contract is a full contract which binds both the parties and is not allowed in *Shariah* in the case of sale or gift.<sup>37</sup>

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<sup>35</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, Standard 8/2, p.146, see also app. B, p. 152.

<sup>36</sup> Justice Mufti Muhammad Taqi Usmani, An Introduction to Islamic Finance, p.176..

<sup>37</sup> Ibid, see also AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek standard 8, p. 146

## **CHAPTER 4**

### **APPLICATION OF IJARH IN ISLAMIC BANKS:**

Certain practices of the conventional banks with respect to lease are opposed to the principles of *Shariah* which can be made *Shariah* compliant by certain modifications. In this regard the *Shariah* Scholars have proposed some ways and means to make them *Shariah* compliant which shall be discussed hereinafter in some more detail.

#### **1. Issue of Sale & Lease Back.**

Sale & Lease back is a series of transaction where one party sells an asset to another party but then Leases it back. The transaction of Sale & Lease back is a kind of financial Lease practiced in banks & financial institution as a mode of financing where the bank purchases an asset from its client & then Lease it back to him. It is not an ideal mode of financing & should be opted only in exceptional cases & that too with full observance of principles of *Shariah*.

##### **1.1- Permissibility of Sale & Lease back in Shariah.**

Permissibility of Sale & Lease back, like any other transaction depends on whether the terms & conditions are in conformity with the basic principles of *Shariah*. To bring the Sale & Lease back transaction under the ambit of *Shariah*, the banks & financial institution must follow the below mentioned conditions/principles of *Shariah*:



1. That both the contracts i.e. contract of Sale & contract of Lease should be executed separately, unconditionally having no reference with each other. The agreement of Sale should not be executed with the condition of establishing *Ijarah* contract between the parties. As it is a well settled principle of *Shariah* that two mutually inconsistent contracts can't be combined together. Making two contracts in one agreement is called *Safaqatan fi Safqatin* which is defective & impermissible in shariah. It has been prohibited in the following saying of the Holy prophet (P.B.U.H). It is not permissible to combine two contracts into one agreement.<sup>1</sup> According to another Hadith of Holy Prophet (P.B.U.H). "To combine two contracts in one agreement is a form of *riba*".<sup>2</sup> Therefore, in sale & Lease back transaction, the contract of sale should not be executed with the condition of establishing *Ijarah* contract between the parties & both the contracts should be executed through separate documents having no reference of each other. Moreover, no condition in any contract be put that either bank will be obliged to sell the asset or the client will be obliged to buy. If the bank purchases the asset from the client on the condition that it will sell it back to him or if the client sells the asset to the bank on the condition that he will buy back the asset from the bank the contract turns into *Bai-ul-inah* (buy back agreement) which is impermissible in *Shariah*. These kinds of transactions are Legal devices (*Sharihiyal*) which attempt to circumvent the prohibition of *riba*. The sale & buy back

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<sup>1</sup> Mu,jam al-Tabrani al-Awsat 2/364, Hadith No: 16733.

<sup>2</sup>Mawarid Al-Zaman Li-Haithamai 1/63 Hadith No. 163, see also AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek,: App B, p. 152.

transaction is used as a device to borrow money from banks on *riba*.<sup>3</sup> To avoid resemblance with *Bai-ul-Inah* the Islamic banks should follow basic principles of *Shariah* in the Sale & lease back transactions.

### 1.2- Procedure followed by Islamic Banks in Sale & Lease back Transactions

In Banks and financial institutions, the transaction of Sale & Lease back is executed in two separate phases. In the first phase the bank buys an asset from the client & agreement of Sale is executed through separate document having no terms & conditions or link with reference to contract of *ijarah*. In second phase the agreement of *Ijarah* is executed through separate document having no conditions or link with reference to the contract of sale, previously executed between the parties.

### 1.3- Practice of Sale & Lease back in conventional banks.

It is pertinent to mention here that sale & lease back is a kind of financial lease practiced in conventional banks as a mode of financing. The real objective behind the transaction is to borrow money from the banks. Two contracts i.e. contract of sale and contract of lease are executed simultaneously and the lessee becomes the owner of the leased asset at the end of lease period. The sale and lease back transaction practiced in conventional banks is defective from *Shariah* point of view because two contracts i.e. sale and lease back are combined together so that one contract is made a pre-condition for another contract whereas the legal consequences of these contracts conflict with each

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<sup>3</sup> Zaki Badawi, *Nazariyyat al-Riba al-Muharram*, Cairo: Al-Majlis al-Ala le-Ri'ayah al Funun, 1940, p.203, pp359-360

other. Moreover, in conventional banks each contract is executed with the condition that either bank will be obliged to sell the asset to the client or the client will be obliged to buy back the asset. The transactions turns into *Bai-ul-Inah* which is, as discussed earlier, impermissible in *Shariah*.

## **CONCLUSION:**

The transaction of Sale and lease back due to its resemblance with Bai-ul-inah transaction is not considered an ideal mode of Financing. The Shariah advisors to the Islamic Financial Institution and banks approved it as a mode of financing with full observance of principles of *Shariah* and only in cases of dire need i.e. to attract the customers towards Islamic Banking System and to compete with conventional banks. To avoid the impression of *Bai-Ul-Inah*, the Ijarah contract should be executed for the period of one year only as the asset or price of the asset may change altogether in one year and possibility of resemblance with *Bai-ul-inah* vanishes away with the lapse of time.<sup>4</sup> This transaction should not be used as a device to borrow money from the banks.

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<sup>4</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, Standard 8/5, p. 146

## 2. Issue of Penalty for late payment.

In case of Ijarah, the bank and financial institutions face two major types of risks with respect to payments of leased asset i.e. risk of defaults/non-payment and risk of late payment.

Banks and financial institutions adopt some preventive measures to meet such risks. Conventional banks demand collaterals as security to meet the risk of non payment i.e. general guarantee may be given by the directors of the financial institutions. The banks may demand cash as security deposit, post-dated cheques and promisory notes in its favour to meet the risk of late payment. The conventional banks charge interest on daily basis. Though the loss caused by non payment or late payment of rentals may be recovered from collaterals deposited as security by the lessee. The contemporary *Shariah* scholars have come up with coercive measures to make the client feel his obligation of payment of rent to the bank in proper time.<sup>5</sup> The purpose of this measure is to avoid any kind of risk which may result in bankruptcy. This measure also ensures convenience and smooth running of the affairs of the banks.

*Shariah* Scholars have suggested the banks to take an undertaking from the client at the time of contract that if the client fails to pay the rentals in time, he shall pay some amount as penalty for charity purposes in the charity fund established by the bank.<sup>6</sup>

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<sup>5</sup> AAOIFI, 2003, *Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek*,: App B, p. 155

<sup>6</sup> *Ibid*, Standard, 6/4, p. 144. see also app. B, p. 154

## 2.1- Shariah Status of the penalty for late payment.

The amount collected by Islamic banks and financial institutions as penalty for late payment shall not become the income of banks and cannot be utilized in bank's expenditures. It will be used only for charity purposes and bank has no right to waive off the penalty to pay in charity once accepted by the client while in conventional banks and financial institutions the amount/interest collected as penalty becomes the bank's property and can be utilized by it in the manner it likes. The excessive interest charged as penalty can be waived off by the bank and client may become free of any obligation to pay interest as penalty.

Objection is raised on the permissibility of the practice of banks to oblige some one to give money in charity (*sadaqa*). As payment of *sadaqa* is one's personal matter and no one can oblige any one to pay *sadaqa* on his mistakes.

The permissibility of this practice has been argued by the jurists that *sadaqa* is paid either on committing mistakes against the rights of Allah (S.WT) (*Huquq Allah*) or on committing mistakes against the rights of people (*Huquq-ul-Ibad*). If someone has committed any mistake with respect to rights of Allah and obliged himself/herself to pay *sadaqa* for that mistake, no body on any forum in this world can compel that person to pay *sadaqa* while in case of any mistake committed with respect to the rights of people, if any person undertakes to pay some money for any harm caused by him to the people, the person will be duty bound to fulfill his promise and compensate that person against whom

the mistake has been committed by him. Likewise, the banks and financial institutions which deal in transactions where rights of public at large are involved, the bank by taking a preventive measure to save the people from any harm, may take a unilateral promise by which the client himself makes obliged to pay money in charity if he fails to pay the rentals in proper time.

Apart from the issue of permissibility of practice to oblige someone to pay in charity some other issues may arise with respect to the same practice, i.e.

1. Does this practice not render the contract a contingent contract which is impermissible by shariah?
2. Validity of the contract with a condition to pay the charity through bank.
3. The execution of an undertaking through court.
4. Waiver of charity in lieu of increase in the rent.

**2.2- Does this practice not render the contract a contingent contract which is impermissible in Shariah?**

Though it becomes a conditional contract where the bank obliged the client to undertake to pay in charity if he fails to pay the rentals in proper time but this condition is like demanding collaterals as security in Ijarah contract which adds, strength, supports and makes the contract effective. Therefore, the condition of giving money in charity is permissible. The objection on the issue of permissibility of a condition to give money in charity is based on a well settled principle of Islamic law which plays very important role

in settlement of Islamic transactions. According to this principle conditional contracts are not allowed. However, certain exceptions to this general rule are available where three types of conditions in a contract are declared permissible and justified by the scholars of Islamic Jurisprudence.

These three types of conditions are as under:-

1. A condition that is required by the very nature of the contract itself. For example, in contract of sale, handing over the thing sold on a condition of payment of price.
2. A condition that has gained permissibility on its being wide spread custom of area, for example, *Ijarah Bishart al-Qiradh* is not permissible according to principles of shariah but declared permissible by scholars due to its being wide spread custom.<sup>7</sup> According to Islamic legal maxims
  - “a general practice of the people acquires legal force, and must be acted upon.”<sup>8</sup>
  - “Custom is a source of judicial decision and to be taken as to established rule of law”<sup>9</sup>
  - “The Custom which is most widely prevalent and operative is to be relied on.”<sup>10</sup>
  - “Custom has force to made void a fact”<sup>11</sup>

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<sup>7</sup> Register Fatawa, Jamea Darul, Ulum Karachi, No: 823/59.

<sup>8</sup> Justice Dr. Tanzeelur Rehman, Kulliat-e-Shariat., p. 91.

<sup>9</sup> Ibid p. 84.

<sup>10</sup> Ibid p. 97.

<sup>11</sup> Ibid p. 96.

3. A condition that supports and adds strength to the contract. This condition is necessary for the effectiveness and smooth running of the transaction, for example, in case of ijarah the collaterals are demanded by the banks as security from the client.

### **2.3- Philosophy behind impermissibility of conditional contracts or combining two contracts in one deal.**

The rationale of impermissibility to make two contracts in one contract or making a transaction pre-condition for another transaction is to avoid uncertainty, confusion and contradictions which may arise due to the contingencies in the contracts. If there arise no such contradictions due to combination of contracts and legal implications and consequences do not conflict with each other but are supportive and add strength then there is no problem in making two contracts in one and making conditional contracts.<sup>12</sup>

### **2.4- Condition of Payment in charity through bank.**

Objection has also been raised on the validity of condition to pay the charity through bank. The contemporary *Shariah* scholars declared it permissible because of the same reason discussed earlier that this condition supports and adds strength to the contract. The only purpose of the condition to pay in charity through bank is to ascertain and ensure that client has given money in charity. The bank has put this condition as

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<sup>12</sup> Munawar Iqbal, A Guide to Islamic Finance, p. 54.



preventive measures to stop the client from default in payment and this measure works effectively when the bank itself collects the money as charity and gives it to the needy people.

#### 2.5- **The execution of an undertaking through court.**

There is difference of opinion among jurists on the issue of execution of an undertaking through court.

*Hanafi* Jurists have not allowed the execution of an undertaking through court. However, an eminent *Hanafi* Scholar, whose opinion is based on the view of Maliki Jurists,<sup>13</sup> has declared the permissibility of execution of an undertaking through court especially in financial matters.<sup>14</sup>

#### 2.6- **Waiver of Charity in lieu of increase in the rent.**

The amount of charity is not the income of bank but it is the property of poor people. The bank is not allowed to waive off the charity in any case, hence the waiving off charity in lieu of increase in the rent is impermissible.

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<sup>13</sup> Tahrir al-Kalam fi Masail al-Itizam, p.176.

<sup>14</sup> Imdad Al-Fatawa , Vol: 3, p. 495.

### 3- Issue of Security deposit and its status in *Shariah*.

In case of *Ijarah* the banks or financial institution, at the time of handing over the leased asset to the client may demand some percentage of the total price of leased asset in advance.

The amount so demanded is called advance money in conventional banks. It becomes the property of the bank according to the rules and regulations and is not returned to the client at any stage. As far as the Islamic banks and financial institutions are concerned, the amount so demanded is considered as security deposit and does not become the bank's property at any stage of the lease period. It will be treated differently by Islamic banks as from the conventional banks. AAOIFI standard provides permissible treatment with the cash demanded in advance by the banks. AAOIFI standard which deals with the issue of security deposit is as under.<sup>15</sup>

*“It is permissible for the institution to require the lessee/promisor(customer) to pay a sum of money to the institution to guarantee the customer's commitment to accepting a lease on the asset and the subsequent obligations, provided no amount is to be deducted from this sum except in proportion to the actual damage suffered by the institution. Thus, if the customer if the customer breaches his promise, he is charged either the difference between the cost of the asset intended to be leased and the total lease rentals for the asset which is leased to a third party, or, if the asset is sold, the different*

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<sup>15</sup> AAOIFI, 2003, *Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek*, Standard 2/3, p. 139, see also app. B. p. 154

*between its cost and the total selling price. The amount of money deposited by the customer as security for his commitment can be either held on trust in the custody of the institution in which case the latter can not invest it, or it may be held on an investment trust basis in which case the customer permits the institution to invest it on the basis of Mudarabah between the customer and the institution.*

In the light of above mentioned standard of AAOIFI, the shariah Status of the cash demanded as security deposit may be discussed from three aspects.<sup>16</sup>

- a. Objective/ use of the cash demanded in advance.
- b. Permissible transaction with the cash.
- c. The Fixation of installments of rentals.

### **3.1- Objective/ use of the cash demanded in advance.**

The sum of money demanded in advance will be used to guarantee the client's commitment to accept the lease contract and subsequent obligations in the contract of ijarah. The amount demanded as security deposit shall be kept with the bank as collateral and whenever actual damage is suffered by the bank due to client's failure to pay the rentals, or the contract of ijarah is terminated prior to period of termination and leased asset sold on lesser amount due to the client's default. The loss may be recovered and adjusted out of the amount kept with the bank as security deposit in proportion to the

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<sup>16</sup> Ibid.

actual damage suffered by the bank. The advance money may be used to recover the loss due to refusal of the lessee to accept lease or the contract can not be executed due to the reason /defaults attributed to the lessee. In short the sum of money deposited as security can be used to recover the loss which may occur due to the non-execution of contract for the reason or default attributed to the lessee or due to failure to pay the rentals or due to failure of any subsequent obligations arising out in the lease period.<sup>17</sup>

The AAOIFI standard provides the permissibility of taking earnest called URBOUN, in respect of lease at the time of execution of lease. This amount shall be treated as advance payment of the rental. The lessor may retain the URBOUN in case of non-execution of the *Ijarah* contract due to lessee's default or for any reason attributed to the lessee.<sup>18</sup>

### 3.1.1- **Hamish Jiddiyyah.**

Hamish Jiddiyyah means token Money. The bank at the of undertaking from the client that he will enter the lease agreement on the asset required by him, may demand some money from the client. Such payment made by the client shows his seriousness in the fulfillment of his promise. Any actual loss occurred to the banks in case of non-execution of *Ijarah* contract due to client's decline may be recovered from such amount paid by such client.<sup>19</sup>

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<sup>17</sup> Ibid. see also standard 6/5 p. 144.

<sup>18</sup> AAOIFI. 2003, Shariah Standard, on *Ijarah* and *Ijarah Muntahia Bittamleek*,: Standard 4/1/4, p. 141

<sup>19</sup> The Fatwa of Unified Shariah Board of al-Barakah No. (9/10)

### 3.1.2- **Difference Between Hamish Jiddiyah And The Security Deposit.**

The role of Hamish Jiddiyah is limited to the execution of Ijarah contract. Its purpose is to recover actual damage due to decline of execution of Ijarah contract by the lessee. Whereas the amount demanded nowadays as security deposit by the banks is used to recover all actual loss from the execution of contract up to the termination of contract of Ijarah.

### 3.2- **Permissible transaction with the cash.**

Two views about the treatment of cash.

- 1- The amount will be held by the banks or financial institutions as trust (Amanah) or investment trust.<sup>20</sup>
  - a- If amount is held as trust (Amanah) the bank will keep it separate and can't utilize it.
  - b- If the amount is held as investment trust, the amount will be kept in client's account and it will be invested on Musharka or Mudaraba basis.
- 2- Another view about cash is that it would be treated as loan (qard) the money will become the bank's property and bank can utilize it. The objection has been raised on this point of view because the contract may become conditional where the client provides the loan to the bank on the condition that bank will enter into ijarah contract with him. This transaction is called *Ijarah –bi- Shart-al-Qirad* which is

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<sup>20</sup> AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, Standard 2/3, p. 139.

not permissible as general principle of shariah. However, due to its being wide Spread custom it has been declared permissible by the jurists.<sup>21</sup>

### 3.3- **The Fixation of the rental installments.**

In conventional banks the advance money is treated as bank's property and it is never returned to the client at any stage. Whereas in Islamic banks it never becomes the property of bank and Islamic banks or financial institutions while fixing the rental installments can treat the security deposit in two ways, discussed as under:-

1. The security deposit may be treated and calculated as an advance payment of rental installments.<sup>22</sup>
2. The security deposit may be treated as loan and bank becomes the owner of this amount. The bank may fix installments in two ways i.e.,
  - a- the bank will calculate the rental installments as whole amount is spent on leased and asset by the bank itself and may fix the rental installments according to the total cost incurred on the leased asset.
  - b- The bank may not include the security deposit and may fix the installments according to the actual amount incurred on the purchase of leased asset.Objection has been raised on the above mentioned way that the ijarah facility is

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<sup>21</sup> Register Fatawa, Jamea Darul, Ulum Karachi, No: 823/59.

<sup>22</sup> AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, Standard 2/3, p. 139.

being provided on loan given by the client and any kind of financing on loan transaction amounts to *riba* and is impermissible. Contemporary Jurists answered to this objection by arguing that facility of *Ijarah* provided by the bank is not due the loan given by the client but due to the lesser amount spent by the bank on the purchase of leased asset. The bank fixed the installments according to his capital investment in the leased asset. The banks fix the rent in equilibrium with the market rate and not lesser than the market rate in consideration of the loan, they get from the client. Under basic principles of Islamic law, mutually agreed fixation of any rent is the discretionary power of the parties provided the rent is specific and known to each other. The transaction where the security deposit is treated as loan and rent is fixed as total amount incurred on the purchase of leased asset is spent by the bank itself, is not ideal but permissible under the light of above mentioned garments given by the jurists. Joint purchase of asset by the bank and the client and subsequently giving it to the client on *ijarah* is an alternative solution recommended by contemporary jurists to the above mentioned transactions. According to this solution the bank and the client jointly purchase an asset and they proportionally share in the ownership according to their proportionate investment. The documentary proof of joint purchase of asset may be prepared which indicates that the parties jointly own the asset and one party i.e. the bank has leased out his share to the other party i.e. client, for example, the bank and the client jointly purchased a car. The bank invested 80% of the total amount incurred on purchase of leased asset and the client invested 20%. The

bank gives the car to its co-owner on lease and gets the rent in proportion to its share.

It is pertinent to mention here that permissibility of joint purchase and giving it on lease to the co-owner is based on one of the basic principle of *Ijarah* where one person may give his share to co-owner on *Ijarah*.<sup>23</sup>

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<sup>23</sup> Justice® Taqi Usmani, An Introduction to Islamic Finance, p. 161.



#### 4. Issue of Fixed and Variable rentals And Use of KIBOR as Bench Mark to fix the rentals.

##### 4.1- Basic Rules of Rentals.

The AAOIFI Standard provides the following<sup>24</sup> rules regarding the rent.

- The leased rentals may be paid in form of cash, goods or benefit.
- The rentals must be specified and determined at the time of contract with the mutual consent of the parties, for the whole period of lease.
- The amount so specified may be paid either in lump sum or in installments.
- The amount of rent may be fixed or variable.
- It appears from the rules above mentioned that the rent must be specified and determined by the mutual consent of the parties at the time of contract. However, the amount of rent may be fixed or variable but the method to fix the rentals have been left to the discretion of parties as *Shariah* did not provide any particular or permanent formula for the fixation of rentals.<sup>25</sup>

##### 4.2- Methods for Fixation of Rental.

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<sup>24</sup> AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, Standard 5/2/1, p. 143.

<sup>25</sup> Ibid.

The amount of rentals may be fixed in the following ways recommended by *Shariah* scholars.

- To fix the amount of rentals in a way that no increase or decrease occurs in the rent for the whole period of lease.
- In long term lease agreements the financial institutions and banks do not opt to fix one amount for whole period of lease to save themselves from the loss which may occur due to the changes in market conditions from time to time. Keeping in view the market conditions, the financial institutions may fix different rates of rent for different phases of the lease period in three different ways.
- According to classical rules of Islamic *fiqh*, parties by mutual consent may agree:-
  - i. On specified proportionate increase in rent after a specified period i.e. 10% amount increase in rent, or,
  - ii. To enter into a short-term lease after which the parties can review the lease at new terms and conditions.
  - iii. In long term lease where the rentals are generally subject to changes, the contemporary *Shariah* scholars have permitted the charge of rent to be made linked to some variable benchmark, provided that rent for first period must be fixed.<sup>26</sup> The Objective/ use of the cash demanded in advance becomes the determining factor for

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<sup>26</sup> Ibid, Standard 5/2/3, p. 143.

the fixation of rentals for the subsequent period of lease must be well defined, well known and mutually agreed between the parties, so as to avoid any kind of dispute between the parties. To avoid any kind of uncertainty the benchmark must contain the maximum and minimum level of variations in rental amount for the whole period of lease.<sup>27</sup>

#### Examples of rent tied up with variable benchmark

Example 1. In case, if Government increases taxes on the leased asset, the lessor may increase the rent in same proportion.

Example 2. Annual increase in rent may tie up with the rate of inflation, for example, if there is increase of 5% in rate of inflation it will cause 5% increase in the rent as well.

Example 3. Use of KIBOR as benchmark to determine the rentals.

Some Islamic Bank and financial institution tie up the rentals with the rate of interest where the rate of interest is used as benchmark to determine the rental installment. In Pakistan KIBOR is used by Islamic banks as benchmark to determine the rentals of long-term lease where the lease period is divided in different periods.

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<sup>27</sup> Ibid, see also app. B, p. 154.

Since the rate of interest is subject to variations, limit of maximum and minimum rate of interest must be fixed to avoid uncertainty and dispute which may arise due to change in the rate of interest. Formula of rent with maximum and minimum limit of interest used by banks may be, for example, as under:

KIBOR+2% with the cap of 25% and floor of 10%

In case of lack in liquidity, the banks borrow money from each other. In this inter bank borrowing transactions the fixed rate of interest is charged on loan, which is called IBOR i.e inter bank offered rate. In Pakistan KIBOR i.e Karachi inter bank offered rate is used in inter bank loan transactions.

Use of KIBOR as benchmark has been criticized by some shariah scholars due to two major reasons.

- First reason of objection is that there arises resemblance with interest based transactions due to the use of KIBOR as benchmark for fixation of rentals in contract of *Ijarah*. In response to this objection the scholars argued that the major difference between Riba-based transactions and a valid *Ijarah* contract is that, in case of *ijarah*, the lessor assumes the risk of corpus whereas in riba-based transaction, banks do not bear any risk of loss. Therefore, the use of KIBOR only as a benchmark is acceptable and doesn't make the contract of lease impermissible as long as the other requirements of a valid contract are fulfilled.<sup>28</sup>

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<sup>28</sup> Justice® Taqi Usmani, *An Introduction to Islamic Finance*, p. 169.

- The second objection is based on the well settled principle of Islamic law that consideration in every contract must be known to the parties when they enter into contract and all transactions must be free from any kind of *Jahala* and *Gharar*. The rate of interest is subject to changes and the rental tied up with such an uncertain and unfixed rate of interest may lead to the dispute, and may cause unforeseen loss to the parties.<sup>29</sup>

In response to this objection the contemporary Shariah scholars argued that as far as the question of dispute is concerned, it may not arise where both the parties have agreed upon with mutual consent on a fixed and well defined formula for the fixation of rental amount and the risk of damage which may arise due to the uncertainty is subsided when a bench mark is subject to limit on both minimum and maximum levels. Therefore, *Shariah* scholars have allowed to use the rate of interest as benchmark to determine the rentals only for transitional period. With the expansion of Islamic Economy and rapid growth of Islamic Banking System, it is hoped by Shariah scholars that time may come when Islamic standard or formula will be established by Islamic banks and they will get rid of the riba-based formula.<sup>30</sup>

##### **5. Issue Of Different Relations Of The Parties At Different Stages.**

In case of *ijarah*, sometime the lessee himself is appointed by the lessor as an agent to purchase the asset intended to be leased. In this situation, the parties stand in

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<sup>29</sup> Ibid. p.170

<sup>30</sup> Ibid.

relationship of principal and agent at first stage. The role of the client is no more than an agent of the bank or financial institution. Rules of agency agreement are applied and the client purchases an asset on his principal's behalf. Relationship of lessor and lessee comes into existence after the client takes delivery of an asset from the supplier. Due to two different agreements, i.e. agreement of agency and agreement of ijarah between the same parties at different stages, different relations are established between the parties one after another. Parties are bound to perform the liabilities in two different capacities because both the agreements have their own legal implications and consequences. At first stage the client is only liable to perform the duties as an agent. At second stage, the relationship of lessor and the lessee comes into operation from the date when the client takes delivery of the leased asset from the supplier.<sup>31</sup>

Unlike Murabaha, in case of ijarah, the parties need not affect the contract after taking delivery of the asset. If the bank while appointing the client as agent has agreed to lease the asset with effect from the date of delivery, the lease will automatically start from that date without any additional procedure. The reason for this is that, in case of Ijarah, the asset remains under the risk and ownership of the lessor throughout the leasing period and the ownership is not transferred to the lessee.<sup>32</sup>

#### **6. Issue Of Expenses Consequent To Ownership.**

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<sup>31</sup> Ibid, Ps. 166-167. see also Sharaiah Standard on Ijarah, 3/7, p. 140.

<sup>32</sup> Ibid.

In case of ijarah, if the bank or financial institution purchases an asset intended to be leased from the supplier through an agent. The bank being the owner shall bear all the liabilities emanating from ownership of leased asset. The bank or the financial institution who purchases the asset and becomes the owner, is liable to pay all the expenses incurred in the process of its purchase. He is liable to pay expenses incurred on asset's import, its freight and custom duty etc. However, the bank may, and of course, keep in view at the time of fixation of rent, all the expenses incurred on the purchase of leased asset and can accordingly fix the installments.<sup>33</sup>

In conventional leasing where the client purchases an asset as an agent of the bank, is liable to pay the expenses incurred on the purchase of the asset, is defective from Shariah point of view, hence impermissible.<sup>34</sup>

#### **7. Issue Of Liabilities Of The Parties.**

According to basic principles of Ijarah under shariah, the lessee is liable only to compensate the loss caused by his negligence or misuse of leased asset. Conventional banks makes no distinction in both the situations and lessee is held liable for the loss even it is not caused due to his negligence or misuse of the leased asset.<sup>35</sup>

Unlike the Islamic banks the conventional banks make the lessee responsible for the liabilities emerging from the ownership of leased asset, for example, in conventional

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<sup>33</sup> Ibid, p. 167

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

banks, the lessee is liable to bear the expenses incurred on purchase of leased asset, maintenance expenses, and insurance charges etc. Islamic banks and IFI have come up with an alternative to conventional insurance arrangement, where the leased asset, is insured at the expense of the lessor and not the lessee, under the Islamic mode of insurance termed as takaful.<sup>36</sup>

However, the bank may and of course, keeps in view the expenses of Takaful and fixes the rental installments accordingly. It is done in fact, in accordance with the important principle of shariah that number of actions which are not exclusively approved by shariah but are considered approvable if they are inclusive with some actions.

Ibn Nujaim described the principle in these words, “A thing may not be permissible independently and by way of intention but it can become allowable inclusively.”<sup>37</sup>

#### 8. **Issue Of Securitization:**

At times it so happens that the banks, financial institutions and the governments require long term loans. For this purpose they issue bonds or certificates. Such bonds or certificates are infact certificates of loans and these are negotiable in the secondary market. The borrowers also make payments of interest on such loans. Since any amount payable or receivable over and above the actual amount of the loan falls under the definition of *Riba* and therefore, becomes impermissible (*Haram*). Moreover, the

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<sup>36</sup> Ibid. p.174.

<sup>37</sup> Sheikh Zain ul-Aabideen bin Ibrahim bin Nujaim, Al-Ashbah wa al-Nazair, Darul Ulum, Karachi, 1/326.



negotiations(sale purchase) of such certificates is also not permissible because under the Shariah no loan is salable. Such a situation necessitated that there should be some permissible alternate such *Riba* based certificates and bonds.

In this regard the *Islamic* Scholars have proposed the solutions that instead of such bonds or certificates Islamic *Sukuk* on the basis of *Musharikah* and *Mudaribah* may be introduced which should not only represent receivable loan whether they should be certificates in respect of ownership of the financial and corporate assets against which they are issued. Meaning thereby that negotiation of such certificates should mean the negotiation of a portion or portions of actual assets and whatever the profit or loss the institution may receive that should be proportionately distributed among the shareholders pro-rata and an institution/company issuing such *Sukuk* should be administratively responsible to maintain an account for disbursement of the profit and loss among the holder of certificates. Such an institution may charge a certain amount from the income of such certificates against administrative duty of disbursement of profit/loss on such certificates on account of service charges. On the basis of above proposal different type of *Sukuk* have been introduced namely *Musharikah Sukuk*, *Mudaribah Sukuk*, *Salam Sukuk* *Istisna Sukuk* and *Ijarah Sukuk*.

Here we will focus on the *Ijarah Sukuk* being the topic of this thesis.

#### 8.1- ***Securitization Of Ijarah/Ijarah Sukuk.***

***Securitization(Tawreeq):***<sup>38</sup>

*“Securitization is known in Arabic terminology as “Taskeek” and “Tasneed”(Securities). Securitization is a process of dividing ownership of tangible assets, usufructs or both into units of equal value and issue securities as per their value”*

“The concept of *ijarah* can be used for mobilizing funds for the development of long term infrastructure projects. This is possible through securitization of tangible assets such as airport, roads, buildings, schools and hospitals and offering *Sukuk* to a large number of institutional and individual investor. It is also possible to create a secondary market instrument for financier on the basis of *ijarah*.”<sup>39</sup>

Such an arrangement has a good potential of Securitization and it may be helpful in creating a secondary market for the financiers on the basis of *ijarah*. A lessor who has executed a contract of *ijarah*, may like to recover his cost of purchase of asset for the purpose of getting liquidity or for the purpose of earning profit. To achieve this purpose he has the option to sell the leased asset wholly or partially either to one party or number of persons. The purchase of the proportion of the asset can be on the basis of issuing certificates which may be called *Ijarah* certificates or *Sukuk*. Such certificate must indicate ownership of pro-rata undivided parts of the asset with all related rights and obligations.

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<sup>38</sup> AAOIFI, 2003, Shariah Standard, on investment sukook, app. D, Definitions, p. 312.

<sup>39</sup> Muhammad Ayub, Understanding Islamic Finance, p. 400.

“Hence, *ijarah Sukuk* are the securities representing ownership of well defined and known assets tied up to a lease contract, rental of which is the return payable to a *Sukuk* holders”.<sup>40</sup>

The difference between the *Islamic* Banking and the conventional banks may be visualized from the fact under the conventional banking the government may issue any interest based document like bonds, debentures or certificates without there being the real assets or projects just for the evidence of loans and as a consequence whereof the amount of loan may be spent for any purpose for instance governmental expenditures, political considerations or even on luxuries. Whereas the *Sukuk* under Islamic Banking System can only be issued against the real assets or projects and proceeds whereof can not be utilized on non productive expenditures as consequence whereof the inflation can be minimized. Moreover, by this mode of financing the real economy of the country flourishes because it results into the increase in domestic trade and business resulting in positive effects on the state economy.

#### 9. **Issue of Termination of Ijarah.**

*Tanseekh-e- Ijarah* or *Faskh –ul-Ijarah* means termination of *ijarah* or winding up of *ijarah*.

*Ijarah* contract may be terminated by the mutual consent of the parties but they must not agree on conditions which are against the basic principles of *Shariah*.<sup>41</sup> The

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<sup>40</sup> Ibid pp. 400-401.

unilateral termination is permissible only in exceptional situations i.e in case of force majeure, or in case of discovery of defection the leased asset which materially impairs its use or where the lessee contravenes any term of the contract.<sup>42</sup> It is not permissible to give an unrestricted power to the lessor to terminate the lease unilaterally on his whims as is done in some agreements by conventional banks.

#### 9.1- **Modes of Termination.**

Termination of lease may take place in number of ways.<sup>43</sup> These ways can be broadly classified into four major modes of termination discussed as under:-

- a. Automatic Termination.
- b. Voluntary termination by the mutual consent of the parties
- c. Termination on basis of options (khayarat) available under Islamic law.
- d. Termination by the order of the court.

##### 9.1.1- **Automatic Termination of Ijarah.**

Here some examples of cases are given where the contract of ijarah stands terminated automatically.<sup>44</sup>

- a. **Termination on total destruction of leased asset.**

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<sup>41</sup> Al-Fatawa al-Alamgiri Vol: 4, p. 416.

<sup>42</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, Standard 7/2/1, p. 145.

<sup>43</sup> Dr. Sharf bin Ala,sharif, Al-Ijarah al-waridah ala amal al-Insan. P. 65.

<sup>44</sup> Ibid.

In case of ijarah of some specified asset, the contract automatically stands terminated with the total destruction of leased asset because such destruction materially impairs the use of leased asset.<sup>45</sup>

**b. Termination on inability to enjoy the usufruct.**

The contract also terminates automatically where the lessee is unable to enjoy the usufruct due to the loss of benefit arising out of the leased asset.<sup>46</sup>

**c. Termination on death.**

There is a difference of opinion among the jurists of Islamic schools of thought on the issue of termination of lease by the death of either party thereto.<sup>47</sup>

According to Hanfi Jurists, if the parties to the contract entered into a contract as lessor and lessee and not as an agent to some one else, the ijarah contract stands terminated with the death of either party thereto. It is pertinent to mention here that contract of lease entered into by authorized agent will continue to be binding on the principal inspite of the death of the agent.<sup>48</sup>

According to Imam Shafi and majority of Jurists, the contracts does not terminate with the death of either party there to. However, the heirs of lessee may exercise their right to terminate the contract on proving the inability to bear the

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<sup>45</sup> Ibid, see also Standard 7/1/5, p. 145. Zuhaili, Al-Fiqh al-Islami wa adillahtohu, p. 781.

<sup>46</sup> AAOIFI, 2003, Shariah Standard, on Ijarah and Ijarah Muntahia Bittamleek, app. B, p. 155.

<sup>47</sup> Zain-ud-din Ibn Nujaim al-Hanafi, Al-bahr al-Raiq, Vol: p. 36.

<sup>48</sup> Ibid.

expenses of contract and on proving that the contract is the more beneficial for them.<sup>49</sup>

AAOIFI Standard adopted the above mentioned view of majority of Jurists in the following words.

*“An Ijarah contract does not terminate with the death of either party thereto. However, the heirs of the lessee may terminate the Ijarah contract if they can prove that the contract has become, as a result of the death of their legator, too onerous for their resources and in excess of their needs.”*<sup>50</sup>

**d. Termination on Sale of leased asset.**

In case where the lessor sells the leased asset to the lessee, the contract of ijarah between the parties terminates automatically.<sup>51</sup>

**e. Termination of contract on expiry of lease period.**

The ijarah contract stands terminated on expiry of the lease period but it may remain operative with mutual consent of the parties for any good cause or the contract of ijarah may be renewed for the period specified by mutual consent of the parties.<sup>52</sup>

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<sup>49</sup> Ibid, see also AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, app. B, p. 156.

<sup>50</sup> AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, Standard 7/2/3, p. 145..

<sup>51</sup> Ibid. Standard 7/1/1, p.144.

<sup>52</sup> Ibid. Standard 7/2/6, p.145.

### 9.1.2- **Voluntary termination by the mutual consent of the parties.**

In case of ijarah, parties may agree with mutual consent on any condition to terminate the contract but such condition must be in conformity to the basic principle of shariah. For example, termination of ijarah by way of iqala with mutual consent of the parties. Iqala is a term infact used in Islamic Jurisprudence for reversal of sale where a contract is rescinded with mutual consent of the parties soon after the execution of contract and before it begins to run likewise ijarah contract can be terminated by way of *Iqala* with mutual consent of the parties before it begin to run<sup>53</sup>.

### 9.1.3- **Termination of ijarah on the basis of options (Khayarat) available to the parties under Islamic law.**

Khayarat (plural of word Khiyar) means options. Options have been provided by the Muslim Jurists to protect a weaker party from being harmed. Islamic law of options are used as a tool to safeguard contracting parties against hasty decisions.<sup>54</sup>

There are five kinds of options available under Islamic law where the parties can ratify or terminate the contract. These options are termed as follows.<sup>55</sup>

- a.     Khiyar-al-shart                     (option of stipulation)
- b.     Khiyar-al-Ruyah                   (option of inspection)
- c.     Khiyar-al-Ayb                     (option of defect)

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<sup>53</sup> Zuhaili, Al-Fiqh al-Islami wa adillahtohu, p. 781.

<sup>54</sup> Dr. Tahir Mansuri, Islamic law of contracts and Business Transactitons, p. 163.

<sup>55</sup> Al-Dar-ul Mukhtar, Vol: 6 p.76.

d. Khiyar-al-Tayin (option of determination)

e. Khiyar-al-wasf (option of description)<sup>56</sup>

Options of defect and option of inspection have been provided by the shariah while the option of stipulation, option of determination and option of description are established through an agreement by consent of the parties.

**a. Khiyar-al-Shart (Option of Condition /Stipulation).**

In case of ijarah, at the time of contract any party may secure an option to terminate the contract. The parties who held this option must exercise it within stipulated time.<sup>57</sup>

**PERIOD OF KHIYAR-AL-SHART.**

The jurists are unanimous on the exercise of option within three days.<sup>58</sup> But there is difference of opinion among jurists on exercise of option beyond the period of three days.

Imam Yousuf, Imam Muhammad and Hanbali Jurists have allowed the exercise of option beyond the period of three days without any restriction of the maximum period.<sup>59</sup> Imam Abu Hanifah and Imam Shafi do not allow it for more

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<sup>56</sup> Zuhaili, *al-Fiqh al-Islami wa Adillatuhu*, vol. 4, p. 519.

<sup>57</sup> *Al-Dar-ul Mukhtar*, Vol: 6 p. 76.

<sup>58</sup> *Ibid.*

<sup>59</sup> *Ibn Qudaimah al-Mugni* vol: 3 p. 585



then three days<sup>60</sup> and with the lapse of stipulated time i.e. three days, the contract stands binding and can not be terminated on the basis of this option.

AAOIFI standard also provides Khiyar-al-shart to terminate the contract. It has adopted the view where no restriction of the maximum period is imposed by the jurists to exercise the option to terminate the contract.<sup>61</sup>

**b. Khiyar-al-Ruyah (Option of Inspection).**

In case if at the time of ijarah the leased asset is not present and the lessee has not examined it. He may secure an option to terminate the contract on the inspection of the leased asset. There is difference of opinion on the inspection or examination of leased asset after execution of the contract. Some jurists consider essential the examination of leased asset at the time of contract and any condition where the leased asset may be examined after the execution of contract, makes the contract batil(void). Hanfi jurists have allowed the option of examination after the execution of contract, where the lessee may accept or terminate the contract after examination. The holder of such option can only be the lessee and not the lessor.<sup>62</sup>

**c. Khiyar-al-Ayb (Option of Defect).**

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<sup>60</sup> Kasani Bada'i al-sana, i vol:5, p. 174.

<sup>61</sup> AAOIFI, 2003, Shariah Standard on Ijarah and Ijarah Muntahia Bittamleek, Standard 7/2/1, p. 145.

<sup>62</sup> Al-Dar-ul Mukhtar, Vol: 6 p. 76.

This option has been granted by Islamic law and parties need not to stipulate it in the contract. The lessee may exercise this option to terminate the contract on discovering any kind of defect in the leased asset.<sup>63</sup>

**d. Khiyar-al-Tayin (Option of Determination or ascertainment).**

One of the basic principles of ijarah is that the subject matter of lease must be known and determined at the time of contract. However, in case of genuine need the lessee may secure an option to ascertain or determine within a pre-stated time one object/asset out of two or more which are proposed to be leased assets. The lessee may ratify or terminate the contract on the basis of this option, known as *Khiyar-al-Ayb* or the option of determination. This option is available to the lessee only and not to the lessor.<sup>64</sup>

**9.1.4- Termination by the order of the Court.**

In case of any confusion or dispute between the parties to the contract, the matter may be referred to the court where the contract may be terminated on the decision of court.<sup>65</sup>

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<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

<sup>65</sup> Dr. Sharf bin Ala, sharif, Al-Ijarah al-waridah ala amal al-Insan. P. 65.

## CHAPTER 5

### SHARIAH COMPLIANT IJARAH FOR VEHICLES – A SCHEME INTRODUCED BY ISLAMIC BANKING DIVISOIN OF ASKARI COMMERCIAL BANK LIMITED.

The Islamic Banking Division of Askari Commercial Bank Limited has introduced Shariah Compliant Ijarah for vehicles (Askari Ijarah Bis Syarah ).The Ijarah transaction has been introduced as a financial arrangement where one party i.e. the lessor agrees to transfer the usufruct of the vehicle(s) to the other party i.e. lessee for a specified rent and on the terms and conditions mutually agreed between the parties.<sup>1</sup>

#### **The salient features of the said scheme are as under:**

The scheme includes:

- a) Vehicles Ijarah (lease) for personal use (Ijarah Bis Sayyarah) and;
- b) Commercial vehicle Ijarah (lease)

Under the scheme at “a”, Ijarah is provided for vehicle(s) for personal use of individuals/employees of corporate clients, while under scheme at “b” i.e. commercial vehicle Ijarah (lease), Ijarah of new commercial vehicles is provided to corporate commercial clients. As regards the Ijarah for personal use the facility is provided for new/used vehicle(s).<sup>2</sup> However, the used vehicle shall not be older

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<sup>1</sup> IBD Instruction Circular No. 1, Shariah Compliant Ijarah for vehicles, Askari Commercial Bank Ltd., Islamic Banking Division, p. 1.

<sup>2</sup> Ibid.

than five years, at the time of commencement of Ijarah and shall not be more than eight years, at the time of maturity of ijarah. Make of used vehicles is to be approved by the divisional Head of Islamic Banking Division, while under the commercial vehicle only new vehicles are provided to corporate/commercial clients.

The tenor of Ijarah under the scheme at “a” is from 3-7 years while under the scheme at “b” it is from 1-5 years.<sup>3</sup>

## 1. Terms and Conditions of the Scheme.

### 1.1- Security/Security Deposit:-<sup>4</sup>

1.1.1- **Exclusive ownership** of leased vehicle through its registration in the name of Askari Commercial Bank Ltd.

1.1.2- **Minimum security.** Minimum security deposit is required as per the following table. However, in case of higher security deposit, if required under State Bank of Pakistan’s Prudential Regulations, then the same applies.

### 1.1.3- New Vehicles

DISCRIPTION	MINIMUM SECURITY DEPOSIT
a- Car Jeep Imported( Askari Ijarah bis Sayyarah)	20%
b- Car/Jeep locally manufactured ( Askari Ijarah bis Sayyarah)	10%

<sup>3</sup> Ibid.

<sup>4</sup> Ibid.

c- Commercial Vehicle –Imported	40%
d- Commercial Vehicle-Locally manufactured	25%

#### 1.1.4- Used vehicles

Description	Minimum Security Deposit(locally Manufactured vehicles)	Minimum Security Deposit Imported Vehicles.
a- Same year model (not older than one year)	15%	25%
b- Two years older	20%	30%
c- Three years older	25%	35%
d- Four years and above	30%	45%

#### 1.2. Eligibility Criteria:<sup>5</sup>

##### 1.2.1- Debt burden ratio:

- a- **Individual cases:-** Debt burden ratio (DBR) not to exceed 50% of the monthly net take home income.
- b- **Co-applicant Cases:** Debt Burden Ratio(DBR) in case of co-applicant not to exceed 50% of total net take home “clubbed income”.

##### 1.2.2- Minimum length of service/experience in business.

- a- **For salaried individuals:** Six months in current job.
- b- **For business persons:** One year in present business.

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<sup>5</sup> Ibid, p. 2.

### 1.2.3- Age criteria:

- a- **For salaried individuals:** From 21 years up to 60 years (maximum 60 years and age at the time of maturity of lease period).
- b- **For business persons:** From 21 years up to 65 years(maximum 65 years and age at the time of maturity of Ijarah).

### 1.2.4- Verification of documents/particulars

In order to ensure the compliance with above mentioned eligibility criteria, the Bank verifies the customer's particulars/documents. The verification report is kept in customer's file.

### 1.3. Family income evaluation plan:<sup>6</sup>

1.3.1- **Co-applicant option.** Co-applicant option is also offered by the Bank in order to facilitate the customers. To enable them to meet the minimum criteria required to qualify for Askari Ijarah Bis Sayyarah . This also helps the customers in paying the monthly installments.

This aspect also covers minimum income and age criteria. This option is offered to “first blood relations”, i.e. parents, brothers(living together) and (unmarried living with his parents) subject to Debt Burden Ratio of 50%.

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<sup>6</sup> Ibid, p. 3.

#### **1.4. Facility to acquire more than one vehicle:<sup>7</sup>**

The bank looking into the profile of the applicant also offers more than one vehicles subject to DBR of 50%.

#### **1.5. Operating boundaries:<sup>8</sup>**

The areas where the scheme has been applied by the bank includes metropolitan areas of all those cities where Islamic Banking Branches of the bank are located, moreover the bank may approve extending facility to an applicant of any other area as well.

### **2- Pricing:<sup>9</sup>**

#### **2.1 Profit rates for Askari Ijarah Bis Sayyarah:<sup>10</sup>**

Regular profit rates on the product are approved/announced by the bank on a monthly basis. Keeping in view the current scenario, liquidity position, cost of funds etc.

#### **2.2 Profit rates for commercial vehicles:<sup>11</sup>**

Profit rate for the commercial vehicles are 01% above the regular profit rates for Askari Ijarah Bis Sayyarah.

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<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid, p. 4.

However, the competent authority of the bank may grant concession in the fixed ratio on a case to case basis.

### **2.3 Penalty on early termination:<sup>12</sup>**

Bank will charge 5% of outstanding amount of ijarah(lease) as incorporated in schedule of repayment.

### **3- Insurance, Accidents, Injuries and Indemnifications:<sup>13</sup>**

The bank/ Lessor itself as the owner or through its agent procures insurance coverage from reputable companies offering protection under the Islamic concept of Takaful. The vehicle has to be comprehensively insured (with a reputable Takaful company) against all insurable risks, which includes but not limited to fire, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism. Prior to delivery of the vehicle of the commencement of the lease, a copy of the insurance policy has to be provided by the lessor to the lessee.

### **4- Registration Charges:<sup>14</sup>**

Registration charges are to be paid by the bank and are to be recovered by the client in first monthly rental.

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<sup>12</sup> Ibid.

<sup>13</sup> Ibid

<sup>14</sup> Ibid.



**5- Lease Proposal and Approval:<sup>15</sup>**

The proposal is recommended by the concerned in-charge Consumer Finance/Branch Manager for the approval of:

- a- Ijarah bis Sayyarah, and commercial vehicle up to three years tenor- IB-DCC
- b- Vehicles above three years tenor – HOCC

(Duly recommended by IB-DCC)

**6- Maximum Ijarah (Lease) Limit:<sup>16</sup>**

Ijarah (lease) of vehicles is allowed up to a maximum amount of Rs. 5.00 million per vehicle. The competent authority of the bank may, however, entertain an application for ijarah of any additional amount.

**7- List Of Legal Documents Required:<sup>17</sup>**

The legal documents required in case of approval include the following.

- a. Ijarah(lease) facility agreement
- b. Demand promissory note
- c. Undertaking to lease

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid, p. 5.

<sup>17</sup> Ibid, p. 4.

- d. Undertaking to purchase leased vehicle at maturity/termination
- e. Undertaking and indemnity (General)
- f. Letter of authority to repossess vehicle.
- g. Rental schedule

The bank may however require some more documents in some particular cases.

#### **7.1- Ijarah(lease) Facility Agreement:**

After satisfying itself with the financial status of the client, the bank enters into a comprehensive agreement with him which is termed as Ijarah(lease) facility agreement. This agreement covers all terms and conditions according to which the transaction of ijarah will take place. This agreement is a detailed and comprehensive document among all the documents mentioned above.<sup>18</sup>

##### **7.1.1- Important Clauses Of Ijarah Facility Agreement:**

Ijarah (lease) facility agreement contains names of the parties i.e. lessee and lessor. It also sets out the purpose of the agreement and the definitions of the terms used therein. A declaration made by the parties to the effect that the lessor leases to the lessee and the lessee agrees to take on the lease, the vehicle described in the lease document is also part of the said agreement. The lease agreement also contains the amount which the lessee agrees to pay to the lessor as

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<sup>18</sup> Lease Agreement (Ijarah), Askari Commercial Bank Ltd., Islamic Banking Division.

security deposits to be applied in the absolute discretion of the lessor in respect of any rent in default under the lease agreement and the lessee shall have no right of set-off against such security deposit, but shall be entitled to return of the said deposit after deduction of any cost, charges or expenses at the end of the term of the lease under the lease agreement. The lease agreement also sets forth the terms and period of ijarah.<sup>19</sup>

#### **Security, Expenses, and Delivery of Vehicle etc.:-**

Under the heading of security, the lease agreement provides that the lessee shall execute post dated cheques for first 12 lease rentals and one for early purchase price and subsequently on each anniversary of the agreement, the lessee shall execute cheques for 12 lease rentals and one for early purchase price each time and that he will deposit with the lessor an amount equivalent to a certain percentage of the lease financing during the lease period without claiming any benefit or profit over the said deposit from the lessor subject to the condition that the said deposit shall be refunded/adjusted by the lessor at the time of termination of lessee subject to fulfillment of these terms and conditions of the agreement by the lessee. It is further provided in the agreement that the lessor shall have the right to use the amount of security so deposited by the lessee in any manner at its sole discretion without any objection from the lessee. Te lessee further undertakes to execute such further deeds and documents as may from time to time required by

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<sup>19</sup> Ibid. Clause 1-3.

the lessor for the purpose of fully securing and for perfecting the security created in favour of the lessor.<sup>20</sup>

The lessee also undertakes to execute a demand pro-note in favour of the lessor for the amount of lease rental receivable during the term of the lease.

The lease agreement also contains a provision whereby the lessee undertakes to pay the lesser the legal and the other ancillary expenses incurred by the lessor on preparation and execution of the lease agreement, its appendices.<sup>21</sup>

The lease agreement also contains a declaration regarding confirmation on the part of the lessee that the leased vehicle is of the required description and that he accepts the same. The delivery whereof he will obtain directly from the supplier.<sup>22</sup>

#### **Use of vehicle :**

There is yet another undertaking made by the lessee, in the lease agreement, whereby he undertakes to use the vehicle in the prescribed manner and not to violate any rule or regulation in this regard and he will not contravene the requirements of the insurance policy/Takaful. It is further provided in the said undertaking that the lessee officers/agents or servants of the lessor free and full

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<sup>20</sup> Ibid, Clause 4.

<sup>21</sup> Ibid, Clause 5.

<sup>22</sup> Ibid, Clause 8.

access to the vehicle during normal working hours to inspect, view and examine the state and condition of the vehicle and he also bear the cost of such inspection.<sup>23</sup>

**Payment of lease rentals:**

Clause 10 of the lease agreement relates to the payment of the lease rentals and it obligates the lessee to pay to the lessor lease rentals for the use of the vehicle. It also gives right to the lessor to revise the lease rentals in case where any cost relating to the lease borne by the lessor are increased, with the consent of the lessee and in case the parties fail to agree upon the revised lease rentals the lessor may terminate the lease in which eventuality the lessee shall purchase the vehicle at the applicable purchase price or return the vehicle to the lessor. The said clause of the lease agreement further provides that the lease rentals as of the date of execution of the agreement will remain fix for the first rental period and the lease rentals will be re-fixed at the end of each rental period on the benchmark(KIBOR).

Clause 10 of the agreement further provides that the lessee is obliged to pay lease rental and all other amounts due under the agreement irrespective of any circumstances provided that he is not deprived of the use of the vehicle for the purpose contemplated by the lease agreement.<sup>24</sup>

**Repair and Maintenance of Leased Asset:**

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<sup>23</sup> Ibid, Clause 9.

<sup>24</sup> Ibid, Clause 10.

The lease agreement obligates the lessee to bear expenses of ordinary maintenance and repair of the vehicle which is required for its continuous use. Whereas the major repair of the vehicle is the responsibility of the lessor. However, such major repairs are to be covered by the insurance/Takaful arrangements obtained by the lessor excepting the situations where such major repairs become due as a consequence of negligent behavior of the lessee. In this regard following table may be helpful in determining the responsibility of either side.<sup>25</sup>

**Table:**<sup>26</sup>

<b>Sr. No.</b>	<b>Description</b>	<b>Responsibility</b>
1.	Expenses related to ownership	Lessor
2.	Expenses related to use of Asset.	Lessee.
3.	Risks associated with the ownership	Lessor.
4.	Risk associated with the use of Asset.	Lessee.
5.	Third party liability in case of accident.	Lessee.
6.	Expenses and risks associated with ownership but caused due to gross negligence etc.	Lessee.

**Registration and title:**

<sup>25</sup> Ibid, Clause 11.

<sup>26</sup> Application form for Ijarah Bis Sayyarah, Askari Commercial Bank Ltd. Islamic Banking Division.

Under the lease agreement, the ownership of the vehicle rests in the lessor and vehicles stands registered in his name. However, payment of all taxes incidental to usage including the road tax, is sole responsibility of the lessee. The lessee is obliged not to use the vehicle contrary to the provisions of insurance policy/Takaful or in violation of any law or to do any act prejudicial to the right of ownership of the lessor.<sup>27</sup>

#### **Return Of Vehicle:**

The lease agreement also provides that at the end of the term of lease or upon its earlier termination the lessee shall return the vehicle in good operating condition, free from any physical damage, to the lessor. However, normal wear and tear proportionate to the usage is always expected.<sup>28</sup>

#### **Limitations of Liability:**

The lease agreement provides that when the lessee has taken the delivery of the vehicle and ascertained its suitability for his purpose then the lessor shall not be liable to the lessee for any loss, damage of any nature or kind sustained by the lessee resulting from any inadequacy for any purpose and any patent defect in the vehicle or from loss or any interruption of use thereof, any loss of business or profit consequential upon any defect of the vehicle of any nature whatsoever.<sup>29</sup>

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<sup>27</sup> Lease Agreement (Ijarah), Askari Commercial Bank Ltd., Islamic Banking Division., Clause 13

<sup>28</sup> Ibid, Clause 14.

<sup>29</sup> Ibid, Clause 15.

The lease agreement also protects the lessor in case he is prevented from carrying out any of the term of the agreement due to Force Majure. The agreement also holds the lessee responsible to forthwith pay all fees and taxes except any tax relating to the ownership of the asset levies and penalties under any law enforced for the time being.<sup>30</sup>

**Default and Termination:**

Clause 16 of the agreement relates to the default and termination as a consequence whereof the lessor may terminate the lease. It is also provided therein that each event of default and termination is several and independent from any other event of default and shall not be limited by reference to an other event of default and termination.<sup>31</sup>

**Partial and Total Loss of the Vehicle:**

This clause obligates the lessee to inform the lessor promptly and in any case within 15 days of any partial or total loss of the vehicle. In case of partial loss, in case the same is result of negligence of the lessee, he is liable to repair the damage and also to continue to pay the lease rentals regularly. In case of total loss of the vehicle the lease shall stand terminated and the lessor will be entitled to Insurance/Takaful proceeds payable by the Takaful company as result of total loss.

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<sup>30</sup> Ibid.

<sup>31</sup> Ibid, Clause 16



However, any loss not indemnified by the Takaful company will be made good by the lessee to the lessor.<sup>32</sup>

**Delayed payment:**

Clause 18 of the agreement imposes a penalty at the rate 24% per annum or fraction thereof on the delayed payment which are not made within a week after the demand form the lessor. It is stated by the lessor that the said amount of penalty will be used by the lessor for the purpose of charity approved by the Shariah advisor.<sup>33</sup>

Clause 18 of the agreement also provides that any failure or delay on the part of the lessor to exercise any power, right or remedy shall not operate as waiver thereof and that the remedy provided in the agreement or cumulative and not exclusive of any remedy provided by law. It also provides that applicable law in respect of lease agreement is the law of Pakistan and the recognized principles of Islamic law as determined by the Shariah Advisor.<sup>34</sup>

**Assignment:**

The agreement further provides that the lessor may assign all or any part of its right or transfer all or any part of its obligation/commitments under the agreement to any other person but the lessee can not do so without written consent

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<sup>32</sup> Ibid, Clause 17.

<sup>33</sup> Ibid, Clause 18.

<sup>34</sup> Ibid.

of the lessor. It is further provided therein that the lessor may disclose to a potential assignee or transferee or any other person may propose entering into contractual relations with the lessor in relation to the agreement.<sup>35</sup>

#### **7.1.2- Demand Promissory Note:<sup>36</sup>**

Promissory note has been defined in section 4 of Negotiable Instruments Act(XXVI of 1881)

*“Promissory Note”—A “Promissory Note” is an instrument in writing (not being a bank- note or a currency note) containing an unconditional undertaking, signed by the maker, to pay on demand or at a fixed or determinable future time a certain sum of money only to, or to the order of, a certain person, or bearer of the instrument”<sup>37</sup>.*

In other words it is a type of surety on the side of the lessee that he will pay such and such amount due on him. The reason why the lessor prefers to obtain a promissory note instead of a simple undertaking or agreement to pay is that in case of default in payment of the amount due, a suit for recovery on the basis of promissory note is filed directly in court of District Judge and is decided

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<sup>35</sup> Ibid, Clause 19.

<sup>36</sup> IBD Instruction Circular No. 1, Shariah Compliant Ijarah for vehicles, Askari Commercial Bank Ltd., Islamic Banking Division.

<sup>37</sup> Negotiable Instruments Act(XXVI of 1881), section 4.

summarily as provided in Order XXXVII of the Code of Civil Procedure, 1908. Whereas a suit on the basis of an undertaking or agreement to pay, has to be filed in the civil court of ordinary Jurisdiction and it being a regular civil suit may take years to conclude. Moreover in a suit on the basis of Negotiable Instruments like Promissory Note or cheque, the defendant can not enter appearance in the court and defend the suit as of right rather he has to obtain leave of the court to defend the suit. Such a privilege is not available to a plaintiff who files an ordinary civil suit. A suit for recovery on the basis of Promissory Note is, therefore, an efficacious and speedy remedy.<sup>38</sup>

The prescribed form issued by the ACBL-IB is placed as **Appendix “A”**

#### **7.1.3- Undertaking to lease:<sup>39</sup>**

Since the bank( lessor) does not possess the vehicle required by the lessee, rather it purchases it from the Market on his request, therefore, the lessor apprehending the risk that if after it' procurement of the required vehicle, the lessee declines to enter into the agreement of lease(Ijarah Bi Sayyara) requires the lessee to give an undertaking to the effect that he will surely enter into the lease agreement i. e Ijarah Bi Sayyarah with the lessor for the required vehicle.

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<sup>38</sup> Code of Civil Procedure, 1908, Order XXXVII.

<sup>39</sup> IBD Instruction Circular No. 1, Shariah Compliant Ijarah for vehicles, Askari Commercial Bank Ltd., Islamic Banking Division, p. 4.

#### **7.1.4- Undertaking To Purchase Leased Vehicle At Maturity/Termination:<sup>40</sup>**

Through this document, the lessee undertakes that he will be ready to purchase the vehicle, with the concurrence of the lessor, on the maturity/termination of the lease.(Ijarah-Bis-Sayyara). This is only a one sided undertaking meaning thereby that the lessor is not obliged to sell the vehicle to the lessee, but the lessee is bound to buy if the lessor is willing to sell the vehicle to him.

The prescribed form issued by the ACBL-IB is placed as **Appendix. .”B”**

#### **7.1.5- Undertaking And Indemnity:<sup>41</sup>**

This is a document whereby the lessee undertakes to indemnify the lessor that in case the CIB report form the State Bank of Pakistan is not satisfactory to the lessor, he will pay to the lessor the full amount of the penalty imposed by the SBP due to the provision of the Ijarah facility. This document further contains an undertaking by the lessee in favour of the lessor that in event of the termination of the lease agreement at the option of the lessor, he will purchase the vehicle or allow the lessor to dispose of the same in accordance with the terms of the Undertaking to purchase vehicle, executed by him, upon the termination of the lease agreement at the option of the bank. There is yet another undertaking given by the lessee which is embodied in this document. It is to the effect that the lessee

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<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

will indemnify the lessor against all proceeds , claims ,expenses, penalties and liabilities whatsoever which may be taken or made against or imposed upon the lessor by the SBP from time to time or are otherwise incurred by the bank due to the lessee's failure to comply with his above undertaking.

The prescribed form issued by the ACBL-IB is placed as **Appendix. .”C”**

#### **7.1.6- Letter Of Authority To Repossess Vehicle:<sup>42</sup>**

Through this document the lessee authorizes the lessor that upon happening of an event of default and termination as per clause 16 of the master lease agreement and his failure to return the vehicle to the lessor at its business premises as required by notice to him, the lessor (bank), its servants, agents or other representatives may enter on any of the lessee's premises or any other place or places where the vehicle may be found, for the purpose of taking possession of the vehicle and that the lessee is irrevocably appoints the lessor or any of its officers, agents or representatives as his(lessee' s) true and lawful attorney to execute such documents as may be necessary for the purpose of regaining possession of the vehicle and the accessories attached thereto and the lessee will pay the cost of such repossession including transportation, storage charges and any

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<sup>42</sup> Ibid.

other charges, that may be incurred in connection with such repossession. The prescribed form issued by the ACBL-IB is placed as **Appendix.”D”**

#### **7.1.7- Lease Rental Schedule:<sup>43</sup>**

After the execution of the lease, the lessor and the lessee are required to sign the rental schedule wherein the number of installments, the first month and the last month of the lease agreement are mentioned along with the amount due on each month. The prescribed specimen of such a rental Schedule is given below.

#### **8- Procedure of Ijarah Bis Sayyarah Applicable In Askari Commercial Bank Ltd.(Islamic Banking Division):**

A customer/lessee in order to obtain a vehicle under the scheme “Ijarah Bis Sayyarah” of Askari Commercial Bank Ltd.(Islamic Banking Division) has to submit an application form and other documents at Askari Commercial Bank Ltd.(Islamic Banking Division) with the request to enter into the said transaction of the bank. The concerned branch processes his application in order to determine as to whether the applicant qualifies for the said scheme and that he fulfills prescribed criteria fixed by the bank. The branch asks the customer to make availability of certain documents and financial statements to show his ability to pay back the proposed financed amount. The concerned section of the bank enters customers record in the system and generate the proposal. A credit summary is

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<sup>43</sup> Ibid.

then prepared to check the customer's eligibility. If the customer fails to fulfill any of the pre-requisite then the bank informs the customer accordingly and the proposal is rejected, the matter is closed and the documents of the customers are returned to him. In case the bank is satisfied with financial status of the customer, it refers the proposal with its recommendation to IBD for further necessary action. The concerned branch verifies the customer's address. The customer's CIB report is obtained from SBP in cases involving facility of Rs. 500,000 or more.<sup>44</sup>

Then the IBD contacts the customer's designated car dealers in order to obtain quotations invoice of the vehicle, and other relevant document. The quotations, credit summary, disbursement schedule and other necessary documents are submitted to IBD for approval. The Shariah Advisor of the IBD gives the approval of each case which is accorded by the designated committee of IBD. In case, the designated committee of the IBD disapprove the case, then the customer is informed accordingly and the file is closed. In case of approval the IBD delivers the sanctioned advise and other documents to the concerned branch for preparation of "Agreement to Lease", application form attachments and check list. The branch then contacts the customer and request the customer for the following namely<sup>45</sup>:-

- a. Security Deposits
- b. Non refundable processing charges covering Askari Bank's

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<sup>44</sup> Ijarah Manual of Bank Ltd., Islamic Banking Division, p. 9.

<sup>45</sup> Ibid.

- Cost of legal documents
- Cost of CIB report
- Cost of address verification

c. Documentation and registration charges.

However, it is also allowed to obtain cheque for documentation and registration upon delivery of leased asset. The branch gives a cheque receipt to the customer. The customer is asked to submit 36 or 48 or 60 (as the case may be) post dated cheques for rentals as per the terms of the lease agreement. These rentals are not charged to income of the Askari Commercial Bank Ltd. During the period between disbursement and delivery of the vehicle and are treated as an advance towards the lease agreement to be executed upon delivery of the vehicle. Customer is required to submit the executed documents to the branch.<sup>46</sup> The concerned section of the branch prepare and move the disbursement sheet to the Operations Department of the Branch for preparation of pay order after completion of documentation and clearance of customer cheques. A pay order is issued under a covering letter "Purchase Order" to the car dealer mentioning the vehicle etc. is Askari Commercial Bank Ltd.'s asset and should not be handed over to the

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<sup>46</sup> Ibid.



customer without express written permission of Askari Commercial Bank Ltd. It also contains instructions for the registration of the vehicle.<sup>47</sup>

The cheque for documentation charges received from the customer is deposited upon delivery of the vehicle. The dealer arranges for the registration of the vehicle in the Askari Commercial Bank Ltd.'s name and intimate the vehicle's engine and chassis No. to Askari Commercial Bank Ltd. Then the particulars of the vehicle are sent to a reputable company offering protection under the Islamic concept of Takaful for the Takaful coverage. The Askari Commercial Bank Ltd. as owner of the leased vehicle obtains insurance of the vehicle directly or through the customer appointing him as an agent of the bank. The cost of insurance is borne by the bank. However, the bank adds this cost to the total cost of the leased vehicle and accordingly charges rental from the customer. The concerned section of the Branch prepares the "Lease Agreement" which is to be signed by a customer. At this stage, the Branch requires the customer to issue a cheque covering the following expenses<sup>48</sup>:-

- a. Vehicle registration charges
- b. Government taxes
- c. Dealers service charges

The branch issues a receipt to the customer in this regard. As per practice the first rental of the lease has to be of a higher amount comprising the advance

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<sup>47</sup> Ibid.

<sup>48</sup> Ibid.

accumulated till that date and normal rental for that month. However, rest of the rental till the tenure of the lease remains the same. The delay delivers the vehicle to the customer upon receipt of "Delivery Order" issued by the bank and obtains a Vehicle Acceptance Letter duly signed by the customer. The original registration book along with all other relevant documents and a spare key are submitted/handed over to the bank. The branch retains the original Registration Book and a copy of the first page of the same is given to the customer.<sup>49</sup>

#### **9- Termination of the Lease Agreement:**

Upon completion of the lease agreement period and payment of all dues by customer the bank offers the customer to purchase the vehicle at the pre-agreed Lease Terminal Value. In case, customer agrees to purchase the vehicle, the Bank issues the invoice to the customer. The customer either pays through a cheque or instructs the bank to adjust the security against the purchased price of the vehicle. In case, the customer makes payment of amount of the invoice through a cheque, the Bank returns the customer security deposit. The customer signs the vehicle acceptance letter to confirm the receipt of the vehicle.<sup>50</sup>

#### **9.1- Premature Termination:**

In case the customer wishes to terminate the Ijarah Agreement before its maturity, he is required to contact the concerned Branch of the Bank with the

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<sup>49</sup> Ibid.

<sup>50</sup> Ibid.

request for premature termination. The Branch informs him about the premature termination sale price as per the lease Termination Schedule. The Branch then forward the application to the IBD for processing premature termination. The customer is asked to pay the termination fee to the Branch through cross cheque. After clearance of the cheque the Branch processes the termination. The Branch prepares the invoice of the vehicle in the name of the customers and hands over the document of the vehicle to the customer. The customer then signs the vehicle acceptance letter to confirm the receipt of the vehicle.<sup>51</sup>

#### **9.2- Death Of The Customer:**

In case the customer dies during tenor of the lease the Bank gives the following option<sup>52</sup> to his legal heirs:

- a. To continue with the lease, in which case the old lease agreement is terminated and a new lease agreement is signed.
- b. To terminate the lease by purchasing the vehicle.
- c. In case the legal heirs opt to return the vehicle, the Askari Commercial Bank Ltd. terminate the lease and sell the vehicle in the open market.

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<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

### **9.3- Return Of Vehicle:**

There is yet another option available to the customer i.e. to return the vehicle upon maturity of the lease period. In that case the Bank appoints a surveyor of the insurance/Takaful company to inspect the vehicle and report about the prevalent condition and value of the vehicle and cost required for its repairing maintenance. The Bank deducts the cost of repairing maintenance work from customer security deposit and pays the balance amount to him. The Bank then sells the vehicle in the open market.<sup>53</sup>

### **9.4- Loss Of The Leased Vehicle:**

In case of partial loss of vehicle, the customer is required to contact the Bank. The Bank then intimates the insurance company of the said fact. Whereas, in case of complete loss i.e. theft etc., the customer is required to submit the following documents<sup>54</sup> to the Bank for the settlement.

- a. Certified copy of the FIR
- b. Copy of registration book
- c. Copy of invoice.
- d. Original Excise file
- e. Letter of subrogation
- f. Claim form

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<sup>53</sup> Ibid.

<sup>54</sup> Ibid.

The Bank then forwards the documents to the concerned insurance company/takaful company along with original registration book and a claim form. The insurance company/takaful company then settles the claim as per the terms of the insurance policy.<sup>55</sup>

#### **9.5- Cost Of Insurance:**

As the ownership of the vehicle remains with the Bank, therefore, the Bank obtains the insurance of the vehicle either directly or through the customer by appointing him as an agent of the Bank. In the later case, the Bank and the customer signs an insurance agency agreement under which the Bank appoints the customer its agent to obtain insurance of the leased vehicle from the company of its choice offering Islamic takaful services which is also from the approved list of the Bank. The Bank adds the insurance cost to the total aggregate cost of the vehicle and accordingly charges the rental from the customer. in case of increase of the insurance cost, the Bank and the customer may agree to revise the rental for the next period during the currency of the lease agreement. However, if the customer does not agree, then the Bank has the right to increase rental ultimately or terminate the lease agreement after a period of every eighteen months from the execution of lease agreement, as per the provisions of the lease agreement of the

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<sup>55</sup> Ibid.

Bank. In case of termination, the customer is bound to purchase the vehicle from Bank at a value fixed in the undertaking to purchase.<sup>56</sup>

#### **10. Sale And Lease Back Transaction Practiced At Askari Commercial Bank Ltd.(IBD):**

The Islamic Banking Division of Askari Commercial Bank Ltd. yet offers another lease transaction known as (Sale and lease Back i.e. SLB Transaction ). A reference to this mode of financing has been given in the earlier portion of this thesis under the heading of objections on SLB Transaction practiced by conventional banks. In sale and lease back(SLB) transaction, customer requires finance for the asset already in the ownership of the customer.<sup>57</sup>

It is claim of the bank which infact is a Shariah view point that ideally SLB transaction should be avoided and this offer should not be offered to the customer in the initial interaction as regular financial solution. Rather SLB transaction should be used in exceptional cases and care should be taken to ensure that the transaction is genuine and is not merely for the sake of liquidity generation/overdraft facility or as a substitute of personal financing.<sup>58</sup>

However, in case of genuine need the process may be undertaken in following situations after due diligence.

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<sup>56</sup> Ibid.

<sup>57</sup> Shariah Guideline on Sale and Leaseback Transaction, Askari Commercial Bank Ltd., IBD, Dated, 11-10-2006, p. 1.

<sup>58</sup> Ibid.

## **10.1- Criteria Laid Down by Askari Commercial Bank Ltd.(IBD) for SLB**

### **Transactions:**

Sale and lease back is allowed in the following cases:

- a. Financing of newly imported vehicle
- b. Replacement from Conventional to Islamic Financing.

#### **a) Financing of newly imported vehicle:**

In case where the customer has already opened an LC through another bank (without agency agreement) and requires funds to retire the LC along with Islamic Lease Financing from ACBL-IB, SLB mechanism may be used.<sup>59</sup>

Here it is Important to note that the imported vehicle belongs to a customer and not to the bank, because in this case the LC opening bank has just acted as an agent for the importer(Customer) by opening the LC. Therefore, in order to lease the vehicle ACBL-IB needs to purchase the vehicle from the customer.<sup>60</sup>

#### **b) Replacement from conventional to Islamic Financing:**

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<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

The other case of financing where the customer has taken interest based loan/lease through a conventional bank and wishes to replace his liabilities with Islamic Leasing due to avoid unislamic practices SBL mechanism may be used.<sup>61</sup>

In such like cases the bank in the first instance verifies the genuineness of the transactions and ensures that the funds thus generated will be used to settle the outstanding conventional loans/lease. In this regard the bank obtain from the customer the bank statements, asset purchased receipt etc., in order to verify the genuineness of the requisite transaction the bank then get a specific approval of Shariah Advisor before credit approval and offering the facility to the customer.<sup>62</sup>

#### **10.2- Procedure of SLB Transactions Prescribed By Askari Commercial Bank Ltd. Islamic Banking Division (SLB):**

The following process of SLB transaction has been prescribed by the ACBL(IBD)

- a. General Process flow of SLB transaction for financing of newly imported vehicles:<sup>63</sup>**

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<sup>61</sup> Ibid., p.1-2.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid.



- a) “The customer has already opened a sight LC through another bank (without agency agreement) and approaches ACBL-IB for funds to retire the LC along with Islamic Lease Financing.
- b) After necessary credit and Shariah approval and shipment of goods ACBL-IB will confirm that the vehicle is in the risk and possession of the customer.( In this case the possession is usually constructive and could be established via Bill of Lading, as the customer has not taken the delivery of the vehicle). The vehicle must also be un-encumbered and free from any charge/liability.
- c) ACBL-IB will purchase the vehicle form the customer via an unconditional sale deed without any reference to future lease and make payment to the customer in his account at ACBL-IB.
- d) To ensure that the funds are used to settle outstanding liability, customer’s instruction will be taken for issuance of pay order favoring LC issuing bank through the customer’s account maintained at ACBL-IB.
- e) ACBL-IB will also appoint the customer(importer) its agent to pay relevant duties, taxes, transportation, and other charges to port authorities for realizing the vehicle.(Advance taxes like sales tax or

advance income tax etc. will be paid by the customer and could be adjusted in his normal business transactions.)

- f) After the sale deed, the customer will sign an “Undertaking to lease/Ijarah” to insure that he will lease the same asset via ACBL-IB.
- g) After clearance of vehicle determining the total cost of the vehicle, ACBL-IB will reimburse the amount that customer has paid as bank’s agent for the vehicle(in duties and taxes etc.)
- h) ACBL-IB and the customer enter into an “Islamic lease/Ijarah Agreement” and the lease rental start from the following month. In case the vehicle requires some times before it becomes operative/workable, a grace period should be given and the rentals will commence after its becoming in operation.
- i) The customer will sign an undertaking to purchase to ensure that he will purchase the vehicle upon the early termination/maturity of the lease period.
- j) Upon maturity/early termination of the lease the customer will offer to purchase the vehicle form ACBL-IB at the relevant price set out in the undertaking to purchase.

- k) The bank will accept the offer and ownership of the vehicle will transfer to the customer via a new sale contract.”

**b. General Process Flow of SLB For Replacement from Conventional To Islamic Financing:<sup>64</sup>**

- a) “The concerned Credit Manager/Branch Manager will verify the genuineness of the transaction and obtain the necessary credit and Shariah approval
- b) ACBL-IB will confirm that the vehicle is in the possession of the customer.(In this case the possession is usually physical as the customer is already using the vehicle.)
- c) ACBL-IB will purchase the vehicle form the customer via an unconditional sale deed without any reference to future lease and make payment to customer in his account at ACBL-IB. The sale deed should be reflective of the true value of the vehicle.
- d) To ensure that funds are used to settle the outstanding liability of the conventional bank, customer’s instructions will be taken for the issuance of the pay order in favour of the conventional bank through the customer’s account held at ACBL-IB.

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<sup>64</sup> Ibid.

- e) ACBL-IB and the customer will enter into Islamic Leasing/Ijarah agreement and the lease rentals will start from the following month. The vehicle must be in unencumbered and free from any charge/liability at this stage.
- f) The customer will sign an “Undertaking to purchase” to ensure that he will purchase the vehicle upon the early termination/maturity of the lease period.
- g) Upon maturity/early termination of the lease the customer will offer to purchase the vehicle from ACBL-IB at the relevant price set out in the undertaking to purchase.
- h) The bank will accept the offer and ownership of the vehicle will transfer to the customer via new sale contract.”

## CONCLUSION:

Unlike conventional Economic System, Islamic Economic System is based on the concept of *Halal* and *Haram*. This system was introduced in the newly established State of Madina so that its citizens could benefit from Riba-free Economy and make progress. The idea underlying the establishment of Islamic Financial System is to establish distributive justice system, free from all sorts of exploitation. The distinguishing features of conventional financing and Islamic financing is that under the later any predefined payment over the actual/principal amount is prohibited.

The financing comes under the ambit of *Muaamlat*(Civil transactions) and the rules prescribed by Shariah governing such transactions are flexible. This is the area of *Ijtihad* as these rules are not stated explicitly in the text. These rules are changeable and are subject to modification and can be rectified according to the time, need and prevailing circumstances in the society provided that the basic principles of *Shariah* are not violated.

Islamic mode of financing is the alternative to the Riba-based financing unlike the conventional financial institutions which deal in money and monetary papers only, Islamic Financial Institutions deal in illiquid assets which create real assets and inventories. There are different modes of Islamic financing which includes Mudarabah, Musharakah, Murabaha, Istisna and Ijarah etc. Although, Musharakah and Mudarabah are ideal modes of financing under the Shariah but due to fiscal and procedural constraints in practicing the above said modes of

financing. Nowadays most commonly practiced modes of financing by Islamic Financial Institutions and Islamic Banks are Murabaha and Ijarah.

Literally, Ijarah means to let something to some one on rent. In Shariah, it means to hire particular services of a person or usufruct of an asset for the specified time and against the consideration, mutually agreed between the parties to the contract.

There are two major types of Ijarah; one in which a person's services are hired like appointment of a servant while the other in which the usufruct of a specific asset is hired against a fixed amount of rent. The former is called *Ijarah-tul- amaal* while the later is called *Ijarah-tul-ayan*. The example of such a type of Ijarah may be the business of rent a car leasing of vehicles by the bank or financial institutions. The important features of Ijarah:

- The purpose of Ijarah is transfer of usufruct of an asset and not the transfer of ownership of an asset.
- The benefit must be there in the contract of Ijarah either in the form of hiring the services of any expert or in the form of transfer of usufruct of an asset by the lessor to the lessee.
- The benefit(*manfiah*) must be in consideration of rent or wages agreed on between the parties.
- The benefit(*manfiah*) must be delivered to the lessee by lessor.
- The benefit must be lawful(*permissible under Shariah*), known and identified by the parties to the contract.
- The contract of lease must be from the period specified and agreed by the parties to the contract.

The reason for preference of Ijarah over other modes of financing is that the contract of Ijarah serves both the parties i.e. lesser and lessee. Lessee prefers it over the borrowing loans from banks to avoid Riba-based transactions and also to avoid payment of tax to the government in case of buying the asset. Lessor i.e the bank prefers it over other modes of financing as lease is a less risky mode as leased asset remains in the ownership of lessor till the price and profit is received. If lessee fails to pay, the lessor has the right to take the asset back and sell it to recover its capital. Financial lease is used for corporate purposes and also for consumer purposes. Like other contracts, the essential constituents of Ijarah include parties of Ijarah, consent, consideration and duration of Ijarah.

Under the conventional leasing transaction, an equipment owner conveys the right to use the equipment in return for a specified payment by the equipment user for a specified rental over a pre-agreed period of time.

The major differences between the conventional contract of lease and contract of Ijarah under the Islamic law are that in conventional lease two contracts i.e. contract of lease and contract of sale are made in one contract but in contract of Ijarah under Islamic law, such a practice is not allowed. *Under the Islamic law contract of Ijarah is executed at the first instance and the parties are free to deal with the asset accordingly. The lessor may take back the leased asset or enter into the contract of renewal of Ijarah or to sell it to a third party. The lessee may purchase the asset at the end of lease period through a separate contract of sale. Under the Shariah, contract of Ijarah should not itself contain the condition of sale at the end of the lease period. The Ijarah is also distinguishable from the*

conventional lease because under the later the responsibility and all types of maintenance charges remains on the lessee. Unlike Ijarah contract in which only the liability related to use of asset are borne by the lessee. Like liability to pay utility bills whereas the liability pertaining to the use of the leased asset are borne by the lessor which include payment of property tax, insurance/takaful charges etc.

Under the conventional lease payment of rental starts even before the delivery of leased asset to the lessee unlike the Ijarah where the payment of rental starts with the delivery of leased asset. Under the conventional lease, the lessee is obliged to make good any loss accrued to the leased asset whether it is the result of Force Majure or his negligence but under the Ijarah the lessee only liable to indemnify losses which are result of his negligence and not Force Majure.

To avoid prohibition regarding entering into two contract one agreement, the Shariah Scholars have provided an alternative to conventional financial lease. Such an agreement is called Ijarah -wa -Iqtian(Hire purchase agreement) or Ijarah Muntahia -bit -Tamleek. Such type of Ijarah is a combination of leasing an asset with granting the lessee an option to eventually acquire the object of lease. In such a contract, the lessor after entering into the lease agreement signs a separate undertaking to the effect that in the event of the lessee having paid the full amount of rentals wishes to purchase the asset at a specified mutually accepted price, he will sell the leased asset to him for that price. The validity of such a hire purchase depends upon two conditions, namely:



- i) The agreement of Ijarah should not contain in itself condition for making unilateral promise of sale or gift rather it should be recorded in a separate document.
- ii) The promise recorded separately should be unilateral and binding on the promisor only.

Thus, by complying with the above two conditions the transaction of hire purchase can be brought in conformity with the Shariah. Nevertheless, it is not an ideal mode of financing and should be resorted to in cases of dire need. Certain practices of the conventional banks with respect to lease are opposed to the principles of *Shariah* which can be made *Shariah* compliant by certain modifications. In this regard the *Shariah* Scholars have proposed some ways and means to make them Shariah compliant.

Issue of penalty for the late payment, the conventional banks charge interest on daily basis on delayed payments of lease rental installments in order to guarantee payment of installments in time. Such a course of action is not approved by Shariah although the Islamic Financial Institutions dealing in Ijarah also face risk of non-payment. To overcome such a difficulty Sharaiah scholars have proposed the banks an undertaking form the client at the time of contract that in case of his failure to pay the rentals in time, he shall pay some amount as penalty for charity purposes in the charity fund established by the bank. Although, some Shariah scholars have objected to the levy of penalty on account of charity but the majority approved it.

**Issue of security deposit:**

Under the conventional lease the banks require the lessee to make payment of a certain percentage of the total price of the leased asset in advance(advance payment). It becomes the property of the bank, which is never returned to the client. However, the Islamic Banks consider this amount as a security deposit, which never becomes the property of the bank and is treated differently.

**Issue of fixed and variable rental:**

The rent or lease money must be specified and determined by the mutual consent of the parties at the time of contract. However the amount to be paid in each installment may be variable except the first installment shall always be fixed and specified. In long-term lease agreement the financial institutions/banks do not opt to fix one amount for the whole period of lease to save themselves from the loss which may occur due to the change in market conditions from time to time. In this regard they may fix different rates of rent for different phases of the lease period. Some Islamic tie up the rentals with the rate of interest where the rate of interest is used as benchmark to determine the rental installment. Use of KIBOR in Pakistan is an example in this regard. Such a formula for fixation of rentals has been criticized by some of the Shariah scholars on the ground of being similar to the riba-based formula. However, the majority has approved it for the time being/transitional period.

### **Termination of ijarah:**

Ijarah contract may be terminated by the mutual consent of the parties but they must not agree on conditions which are against the basic principles of shariah. The unilateral termination is permissible only in exceptional situations i.e in case of force majeure, or in case of discovery of defection the leased asset which materially impairs its use or where the lessee contravenes any term of the contract. However, it is not permissible to give an unrestricted power to the lessor to terminate the lease unilaterally on his whims as is done in some agreements by conventional banks.

The scheme entitled Ijarah-bis-Sayyarah introduced by the ACBL-IBD is a good example of Shariah compliant Ijarah for vehicles. Under this scheme vehicle(s), Ijarah for personal use and commercial vehicle Ijarah for corporate use has been introduced. The tenor of Ijarah is 3-7 years and 1-5 years respectively. In case of approval the following documentation is required.

- i-** Ijarah(lease) facility agreement
- ii-** Demand promissory note
- iii-** Undertaking to lease
- iv-** Undertaking to purchase leased vehicle at maturity/termination
- v-** Undertaking and indemnity (General)
- vi-** Letter of authority to repossess vehicle.
- vii-** Rental schedule

The bank/lessor is itself being the owner of vehicle procures comprehensive insurance/*takaful* coverage.

## **Recommendations.**

The following recommendations are made for improving the Islamic Banking system in the World.

- The number of Banks dealing in Islamic financing should considerably be increased and awareness campaign should be launched for the information of the general masses regarding the banks which are dealing in the Islamic finance and the products introduced by such banks should be made public.
- The role of shariah advisors should be enhanced and each transaction processed under the Islamic banking system should be made subject to the scrutiny and by such shariah advisors.
- In the area of consumer financing the Islamic banks should charge lower profit as compared to the conventional banks to make it more compatible.
- Islamic bank should prefer the transaction of Musarakah and Mudarabah wherever possible under the supervision of shariah advisor.
- The shariah advisor should keep strict eye on the allocation of funds and see how the capital of depositor is being invested and ensure that the money is being invested in such transaction which yield maximum profit. They should also keep a check that the banks do not discriminate in investing in investing their own money in more profitable business and the customer money in less profitable business.

- More and more research centers should be established for Islamic banking in different Muslim countries to pave way for establishing new Islamic banks and enhancing their existing capabilities.
  - Issues like security deposit and payment of penalty for late payment arising in the transaction of ijarah should be reviewed and by extensive research and study such solutions should be proposed which are fully shariah compliant.
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# APPENDICES

**DEMAND PROMISSORY NOTE**

Rs. \_\_\_\_\_

On demand we, \_\_\_\_\_, promise to pay Askari Bank Limited – Islamic Banking Branch, Islamabad, or order the sum of Rs. \_\_\_\_\_ for valuable consideration received.

Date : XYZ

\_\_\_\_\_  
For and on behalf of  
M/S ABC LIMITED

Witnesses:

1. \_\_\_\_\_  
Name  
Address  
N.I.C. No.

2. \_\_\_\_\_  
Name  
Address  
N.I.C. No.

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**UNDERTAKING TO PURCHASE  
LEASED ASSETS**

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**FROM**

**M/s ABC**

**TO**

**ASKARI BANK LIMITED –  
ISLAMIC BANKING**



## UNDERTAKING TO PURCHASE LEASED ASSETS

ISLAMIC BANKING BRANCH,  
Askari Bank Limited,  
Islamabad.

Dear Sirs

We refer to the Lease Agreement dated \_\_\_\_\_, ("Lease Agreement") between Askari Bank Limited - Islamic Banking (hereinafter referred to as the "Bank" which expression shall be deemed to mean and include where the context so requires its successors in interest and assigns) and ourselves.

NOW THEREFORE THIS LETTER WITNESSES AS FOLLOWS:

1. In consideration of your having entered into the Lease Agreement, we hereby agree and undertake that if you desire to terminate this Lease on account of any of the grounds mentioned in clause 15 of the Lease Agreement during the currency of the Lease, we shall purchase the Leased Asset at the Purchase Price mentioned herein below on the date of termination of lease (**Purchase Date**) in accordance with the schedule appearing herein below.
2. Failure on our part to immediately purchase the Leased Assets at the Purchase Price on the Purchase Date in accordance with the schedule given below within two (2) days of notification to do so by the Bank shall be deemed to constitute an event of default under this undertaking.
3. In the event of default by us you are authorized and entitled to exercise all rights and remedies to repossess the Leased Assets and selling it in the market to recover the Purchase Price and any other amounts payable under the Lease Agreement. We shall pay to you the difference (if any) between the price at which the Leased Asset(s) was sold by you and the Purchase Price relating to the date of termination of the lease along with any amounts payable under the Lease Agreement.

The first Month shall end on \_\_\_\_\_.

Sr. No.	Purchase Date	Purchase Price
1		Rs.

4. The capitalized terms used herein shall have the same meaning as attributed thereto in the Lease Agreement, unless defined otherwise.

Yours faithfully,

\_\_\_\_\_  
For and on behalf of  
M/S ABC

DATED

Askari Bank Limited,  
Islamic Banking Branch,  
Jinnah Avenue, Islamabad.

Dear Sirs

**UNDERTAKING AND INDEMNITY**

In consideration of your lease finance facilities ("Ijarah") to me/ us without receiving the CIB report from State Bank of Pakistan ("SBP"), we hereby irrevocably agree that in the event that the CIB report is not satisfactory to you, I shall:

1. Pay the full amount of the penalty imposed by the SBP due to the provision of the Ijarah facility to you due to the unsatisfactory CIB report.
2. I/ We agree to the termination of the Lease Agreement at the option of Askari Bank Limited-Islamic Banking Branch and I/ we undertake to purchase the vehicle (s) or allow Askari Bank Limited-Islamic Banking Branch to dispose the same in accordance with the terms of the undertaking to purchase vehicle (s) executed by me/ us upon the termination of Lease Agreement.
3. I/ we undertake to indemnify you against all proceedings, claims, expenses, penalties, and liabilities whatsoever which may be taken or made against or imposed upon you by State Bank of Pakistan from time to time or are otherwise incurred by you reason of my/ our failure to comply with my/ our undertaking set out herein above.

Yours faithfully,

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For and on behalf of  
**M/S ABC. LIMITED**

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**AUTHORITY LETTER TO REPOSSESS  
LEASED ASSET**

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**From**

**ABC**

**TO**

**ASKARI BANK LIMITED**  
*(Formerly Askari Commercial Bank Limited)*

**LETTER OF AUTHORITY TO REPOSSESS LEASED ASSETS**

To:  
Askari Bank Limited,  
Islamic Banking Branch,  
Jinnah Avenue, Islamabad.

Dear Sirs

We refer to Master Lease Agreement dated \_\_\_\_\_ (the "Lease Agreement") between the Lessor and ourselves in respect of all the assets to be leased up to the amount of Rs. 4.500 Million mention therein.

Upon the happening of an event of default and termination as per clause 15 of the Lease Agreement, and our failing to return the leased assets to the lessor at its business premises as required by a notice to us , we hare by authorize and empower the lessor, its servants, agents, or other representatives to enter on any of our premises. or any other place or places where the leased assets may be found, for the purpose of taking possession of the leased assets and we here by irrevocably appoint the lessor or any of its officers, agents or representatives as the our true and lawful attorneys to execute such document as may be necessary for the purpose of regaining possession of the assets and the accessories attached thereto.

We shall pay the costs of such repossession including transportation and storage charges and any other charges that may be incurred in connection with such repossession.

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For and on behalf of  
**ABC**

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