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DIFFERENCES AND SIMILARITIES BETWEEN IJARA AND CONVENTIONAL OPERATING LEASE CONTRACTS

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OBJCETIVE

The objective of this study is to find out the similarities and differences between "Ijara " & conventional operating lease contracts.

The Origins of Leasing

Operating lease can be traced back to before 2000 BC. There is evidence that the Sumerians used a form of operating lease for agricultural implements and hand tools. There was a detailed regulation first drawn up in Roman times that distinguished between finance and operating lease. Operating lease of rolling stock dates back to the 1840s when leasing companies were known as wagon companies. The world's first registered leasing company, the Birmingham Wagon Company, was registered in 1855.

Conventional Leasing Contracts :

A conventional leasing contract is a contract between a Lessor and a Lessee for the hire of a specific asset. The lessor retains the ownership of the asset but the right to use the asset is given to the lessee for an agreed period of time in return for a series of payments paid by the lessee to the lessor.

An **Operating Lease** is a pure rental agreement with three distinctive features: (i) the cost of the asset is not fully amortized over the lease period, (ii) the lessor provides maintenance of the asset and (iii) the asset is usually returned to the lessor. Therefore, the lessee has the advantage of procuring an asset, utilizing it for its benefit and returning the same when it has served its purpose.

The features of an operating lease are different from that of a financial lease, and could be listed as:

1) Title to the asset must not automatically pass to the lessee as one of the conditions of the lease term.
2) The lease contract must not contain an option to purchase the asset at a bargain price.
3) The lease term must be for less than 75% of the economic life of that asset.
4) The present value of rental, or lease, payments excluding executory costs (insurance, maintenance, taxes, etc) must be less than 90% (not equal to) of the fair market value of the asset.

The rationale underlying these features is to determine the intent of the parties to a lease transaction. A lease that doesn't transfer all the benefits and liabilities associated with ownership is said to be an operating lease.

"Ijara" Contract

The term "**Ijara**" has been defined as a contract between two parties, the lessor and the lessee, where the lessee enjoys or reaps a specific service or benefit against a specified consideration or rent from the asset owned by the lessor. It is a lease agreement under which a certain asset is leased out by the lessor to a lessee against specific rent or rental for a fixed period.

Two fundamental principles of Islamic finance are:

I. It has to be asset-based financing:

The first fundamental principle of *Shariah* is that as opposed to conventional financial dealing, profit is generated when something having intrinsic utility is sold or offered for use. Money has no intrinsic value. As such dealing in money cannot generate profit unless converted into real assets.

II. There has to be an element of risk:

The second basic element of *Shariah* is that one cannot claim a profit or fee for a property/transaction, the risk of which was never borne by him.

In an *"Ijara"* contract the lessor maintains its ownership in the leased asset while transferring the right to use the asset, or usufruct, to an enterprise as the lessee, for an agreed period at an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the lessor including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee's misconduct or negligence.

"Ijara" is a contract of a known and proposed usufruct against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended.

METHODOLOGY

Various characteristics of leasing have been studied to identify similarities and differences between Conventional Operating Lease and "Ijara" contracts.

The hypothesis to be tested is:

There is no significant difference between "Ijara" and Conventional operating lease.

The methodology to be adopted is as follows:

The population for the subject study would be all the articles on the Internet and published material on the subject. The sample size would be 20 articles from the Internet and 3 chapters from different books that have been selected by purposeful sampling. Islamic banks are unwilling to supply actual "Ijara" contracts for comparative analysis.

SAMPLE CHARACTERISTICS

Out of 20 articles, 16 are related to "Ijara".100% of the authors gave the same opinions on the characteristics of "Ijara".

Four articles and three chapters are related to Conventional Lease. All are presenting the same characteristics of the Conventional Lease contract.

Various characteristics have been compared to identify similarities and differences between Conventional Operating Lease and "Ijara" contracts. These are as follows:

1. **Ownership:**

   Who owns the asset after the lease contract?

2. **Risk bearer:**

   After the agreement on lease contract, the risk of ownership lies with whom?

3. **Starting time for rental obligation:**

   When would the rental obligation start, after the agreement on lease contract?

4. **Usefulness of property:**

   What is the minimum useful life of the property?

5. **Penalty:**

   Can penalty be charged if lessee fails to fulfill the obligation?

6. **Repossession of an asset:**

   Is repossession of an asset allowed at predetermined/bargain price?

7. **Asset has value upon completion of leased period:**

   Does asset hold value upon completion of leased period?

8. **Premature termination:**

Is premature termination allowed if the lessee has violated or contravened the terms of the lease?

9. Effect of premature termination:

Are all the obligations that are still executory on both sides considered discharged as a result of premature termination?

10. Sale and lease back as one transaction:

Could sale and lease back be completed under one transaction?

11. Determinant of rent:

On what basis has rent been determined?

12. Equivalent to a sale:

Is lease equivalent to a sale?

RESULTS

After comprehensive review of the collected articles and books, the findings are as follows:

1) Ownership:

Conventional Lease : Leasing can provide financing for movable (industrial, transport and agricultural plant and equipment) or real estate assets, while at the same time allowing the creditor institution to retain ownership of the asset throughout the term of the contracts.

Ijara : "Muajjir" (lessor) is the owner of the leased property.

2) Risk bearer:

Conventional Lease : The lessor assumes and manages the risk of the asset.

Ijara : The risk and liabilities of ownership lie with the "Muajjir". The leased asset shall remain the risk of the "Muajjir" throughout the lease period. Any loss or harm caused by factors beyond the control of the "Mustajir" lessee shall be borne by the "Muajjir".

3) Starting time for rental obligation

Conventional Lease : The rental falls due from the date when the lessee accepted the goods.

Ijara : The rental falls due from the date of handing over the asset to "Mustajir".

4) Usefulness of property

Conventional Lease : The leased equipment must not be "limited use" property.

Ijara : It is a condition that the asset to be leased must be a non-fungible one which can be utilized more than once.

5) Penalty

Conventional Lease : Penalty can be charged to the lessee for delayed payment.

Ijara : Penalty can be charged to the lessee for delayed payment though the amount recovered is only to be used for charitable purposes by the lessor.

6) Repossession of an asset

Conventional Lease : The lease must not contain an option to purchase the asset at a bargain price.

Ijara : 1. There can't be two contracts in one contract. Since the purpose of "purchase bargain option" is entirely different than the purpose of transferring the usufructs of an asset. Inserting the clause of "purchase bargain option" serves the purpose of another contract. On the one hand it allows the lessee to avail the usufructs of the leased asset and on the other hand it also gives the right to the lessee to purchase the same leased asset, which is not allowed in Shariah.

7) Valuation upon completion of leased period:

Conventional Lease : The asset must have secondary value after the expiry of the primary lease term.

Ijara : A leased asset must have a value upon completion of the agreed leased period.

8) Premature termination of lease:

Conventional Lease : Lease can be terminated in the event that the lessee fails to meet his obligations, notably the obligation to pay rent. The lessor must then instigate legal proceedings involving the bringing of a claim, where equipment is concerned. Lessee can't terminate lease if contract does not contain cancellation clause.

Ijara : Premature termination of the lease is allowed provided that the lessee has violated or contravened the terms of the lease.

9) Effect of premature termination:

Conventional Lease : On termination of lease contract, all obligations that are still executory on both sides are discharged.

Ijara : From the time of termination, the lessee is not obliged for rental payment.

10) Sale and lease back as one transaction:

Conventional Lease : This transaction involves the sale of the property by one company to another which in turn leases the same property back to the original seller.

Ijara : Sale and lease back are allowed, but only as two separate transactions.

11) Determinant of rent:

Conventional Lease : Lessors consider market related forces while scheduling lease payments. The market rate of interest provides a basis for lease determination.

Ijara : Rent is determined by market given forces. In practice, the market rate of interest is used to determine the rental rate, although this is not explicitly stated.

12) Equivalent to a sale:

Conventional Lease : A manufacturer or dealer doesn't recognize any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Ijara : Leasing differs from sale in the way that it does not transfer the corpus or ownership of the property, which remains with the transferor.

The important fact is that under *Shariah* the leasing and sale/purchase transactions are two separate things and should not be mixed up in one contract, as both are independent and governed by separate rules.

The lease with promise to purchase and sale is different from the memorandum of sale. The rent paid by the lessee cannot, in any way, be considered as part of the price of the asset, rather it is the price of the service of the asset.

As described above, the leasing transaction simply denotes the transfer of the *usufruct* of a property from one person to another for an agreed-upon price called rent without transferring the corpus i.e. ownership of that asset.

Agreement to commence lease on some future date is allowed. However, the rent has to commence from the date of delivery. If the lessee has paid the price and the supplier delays delivery of the asset, then no rent is liable to be paid for the period of delay. It must be noted that future or forward sale in sale/purchase transaction is not permissible in Shariah. This is another major point , which differentiates leasing from a sale/purchase transaction under Shariah.

Conclusion

Table 1 summarizes the opinion of the experts and authorities on similarities and differences in terms of the conventional operating lease contract and "Ijara".

1 point is assigned to the category "Yes" if characteristics of the operating lease and "Ijara" are judged as different.

1 point is assigned to category "No" if characteristics of the two contracts are judged to be similar.

TABLE I SHOWING SIMILARITIES AND DIFFERENCES BETWEEN CHARACTERISTICS OF "IJARA " AND CONVENTIONAL OPERATING LEASE CONTRACTS

S.No.	Dimensions	Differences		Conformity with the hypothesis
		Yes	**No**	
1	Ownership	0	1	**Yes**
2	Risk bearer	0	1	**Yes**
3	Starting time for rental obligation	1	0	No
4	Usefulness of property	0	1	**Yes**
5	Penalty	0	1	**Yes**
6	Repossession of an asset	0	1	**Yes**
7	Asset has value upon completion of leased period	0	1	**Yes**
8	Premature termination	0	1	**Yes**
9	Effect of premature termination	0	1	**Yes**
10	Sale and lease back as one transaction	1	0	No
11	Determinant of rent	0	1	**Yes**
12	Equivalent of a sale	0	1	**Yes**
Total		**2**	**10**	

The above table shows that there is no significant difference between "Ijara" and conventional operating lease on the basis of the authors and experts opinions about the two instruments. In particular, rent is determined in both cases on the basis of the going market rate of interest.

Hence the hypothesis has been accepted.

ANNEXURE-1

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