



THE IMPLICATION OF FORWARD *IJĀRAH* IN  
MALAYSIA: PROSPECTS AND CHALLENGES.

BY

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for the degree of Master of Science in Islamic Banking and  
finance

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## ABSTRACT

One of the most successful of the Islamic Innovative Financial Product in recent years in the Middle East is forward *ijārah*. This concept is considered as one of the popular contracts that has been applied in various applications in the practice. Due to the success of this contract, the Islamic Financial Institutions in Malaysia has established the application of forward *ijārah* to their customers. The main product that has been offered is house financing either as a standalone product or as a supporting contact that is combined with others. This research paper therefore attempts to discuss the concept of forward *ijārah* and its implications. Specifically this study presents its legality, its various types (i.e. lease, usufructs, and human usufructs), its conditions and rules of the practice of forward *ijārah* according to Islamic Law. Moreover, the paper reviewed the opinions of different scholars regarding the permissibility of forward *ijārah* and also the comparison of forward *ijārah* to other modes of finance. It also discusses the governing law on forward *ijārah*. Besides, it also discusses a sample of legal documentation of forward *ijārah* contract. Furthermore, the paper discusses also some of the important issues surrounding the implementation of forward *ijārah*. Finally, this paper summarized the prospects and challenges of implementing forward *ijārah* in Islamic Financial Institutions nowadays. It also gives recommendation to move forward with forward *ijārah* in the Malaysian Islamic Financial industry.

**Keywords:** Forward *Ijārah*, Prospects, Challenges, Malaysia

## ملخص البحث

يُعتبر عقد الإجارة الموصوفة في الذمة، والتي تعرف على أنها: "عقد على منفعة مستقبلية بثمن حال"، إحدى أنجح أدوات التمويل الإسلامي وأكثرها شيوعاً بالشرق الأوسط في السنوات الأخيرة. ونظراً لنجاح هذا العقد وتطبيقاته المختلفة، بدأت المؤسسات المالية الإسلامية في ماليزيا بتطبيقه في معاملاتها، حيث تم تطبيق الإجارة الموصوفة بالذمة في البنوك الإسلامية لتمويل البيوت بشكل رئيسي، وذلك على شكل عقد مستقل أو من خلال دمجها بعقود أخرى.

تهدف هذه الدراسة للوقوف على مفهوم الإجارة الموصوفة بالذمة وتطبيقاتها المعاصرة، والبحث في مشروعية العقد وأنواعه وشروطه وقوانينه في الفقه الإسلامي. كما احتوت الدراسة على مراجعات لآراء الفقهاء حول مشروعية عقد الإجارة الموصوفة بالذمة، ومقارنتها بأدوات تمويل إسلامية أخرى. وقد ناقشت الدراسة أيضاً القوانين التشريعية لهذا العقد، بالإضافة إلى مناقشتها وثيقة قانونية لأحد البنوك لعقد الإجارة الموصوفة بالذمة. كما بحثت الدراسة أهم القضايا والتحديات التي تتعلق بهذا العقد. وقامت بتلخيص التحديات والآفاق التي تتعلق بتطبيق عقد الإجارة الموصوفة بالذمة في ماليزيا، وخرجت ببعض التوصيات لتطوير عمل هذا العقد.

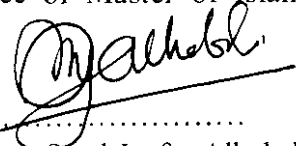
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


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## DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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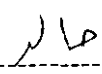
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## DEDICATION

*I dedicate this thesis to my loving parents.*

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## CHAPTER ONE

### INTRODUCTION

This chapter which provides the introduction of this research paper is divided into three sections. The first section provides the introduction, the background of the study, problem statement, objectives of the study, research questions, and motivation of the research, scope of the research, limitations of the research, significance of the study and organization of the research. The second section discusses the literature review related to the topic of this paper. The Third section focuses on the research methodology used in carrying out this research paper.

#### 1.1 SECTION ONE

##### 1.1.1 Introduction

The worldwide increase in demand for Islamic Banking has necessitated a comprehensive and in depth study of the products and services of Islamic Banking in order to educate customers about their options. It has also been a source of motivation for the Islamic Banking sector to offer new, innovative products to their clients. One of the most successful of these innovative *Shari'ah* compliant contracts in recent years in the Middle East is forward *ijārah* (Lakshmanan, 2010). This research paper attempts to discuss the concept of forward *ijārah* and its application in the Islamic Banking Industry alongside some interesting issues that arise in the actual day-to-day practice of forward *ijārah*. This mode of finance has been discussed by the scholars in the classical Islamic Fiqh literature,

which will form the basis of our understanding of the rules and conditions of the contract of forward *ijārah* as well as its practical applications.

The main objective of this research is to study the prospects and challenges of implementing the concept of forward *ijārah* to provide Islamic Banks in Malaysia with a recommendation of how to implement this contract. This study will highlight the concept of forward *ijārah*, its legality, its various types (lease, usufructs, and human usufructs), and its conditions and rules of the practice of forward *ijārah* according to Islamic Law.

Pertaining to this contract's legality, this research paper will highlight forward *ijārah's* legal rulings and conditions and its place in the heritage of Islamic law. In particular, it will highlight the opinions of different scholars regarding the permissibility of forward *ijārah*. A comparison of this mode of finance to other modes of finance such as *ijārah* and *istisnā* will also be discussed.

### **1.1.2 Background of the Study**

Islamic Banks have been operated in Malaysia for over 30 years. According to Bank Negara Malaysia (2013), there are 17 Islamic banks that operate in this country (Bank Negara Malaysia Website, 2013). The purpose of Islamic Banking is to serve their consumer's Islamic preferences by offering *Shari'ah* compliant products such as *Mudārabah*, *Mushārah*, *Murābahah*, and so on.

One of the most popular products nowadays is a leasing based product called *ijārah* (Tag El-Din and Abdullah, 2007). There are two different types of *ijārah* that have been widely practiced. The permissibility of any one of them would essentially depend on

whether the terms and conditions of the lease are in conformity with the *Shari'ah* principle (Chapra, 1998).

The first type of lease is an Operating Lease. This kind of leasing has been generally discussed by the Scholars of *Shari'ah* in classical *fiqh* literature leaving no doubt about its permissibility. In this type of lease, the owner of an asset, the lessor (*muajjir*, or *mukari*, مؤجر, مكارى), allows another party, the lessee (*musta'jir*, مستأجر), to have the use (*manfa'ah*, منفعة) of the leased asset (*ma'jūr*, مأجور) in return for compensation (*ajr* or *'iwad*, أجر, عوض). It is critical that the asset in question exist at the time of the signing of the contract (Abu Ghuddah, 2009).

The second type of lease is called a Financial Lease or Hire Purchase. This kind of leasing is a modernized version of a mode of financing commonly known as *ijārah wa- iqtina'*. A Financial Lease contract is a unique contract in that it combines a lease contract (*ijārah*) and a sale contract at different stages of a transaction (Abu Ghuddah, 2009). One main reason why this contract has become one of the most popular methods of financing is due to the fact that many people are not able to afford to buy expensive commodities such as a house or land on a cash basis. In practice, Islamic Banks nowadays use different terminologies to refer to the concept of Financial Leasing. For example, in Malaysia, this type of arrangement is commonly known as *al-ijārah thumma al-bay'* (AITAB) (Hassan, Muneeza and Yusoff, 2004).

However, Islamic financial institutions have started applying forward *Ijarah (al-ijārah al-mawsufah fi al-dhimmah)* to finance usufruct, which can be considered as the third type of *ijārah*. The application of this kind of *ijārah* came later than that of other types of leases. The reason for its late development is that it had become completely

settled in people's minds that a person must not rent what he does not possess or what he does not possess the usufruct of. This idea came from an analogy in which it was prohibited to sell what one does not possess (Nassar, 2009). Indeed, this basic rule is one of the controversial issues that the researcher is going to discuss in this paper.

The idea of forward *ijārah* is that it is a lease contract in which the assets involved do not exist at the time of signing the contract. Thus the usufruct can only be realized at a future date and likewise the rent can only be realized at a future date. However, there are many scholars who recognize this *ijārah* has a combination of *Salam* and *ijārah* contracts. However others have defined this contract as sale of future benefits for immediate cash or, alternatively, a *salam* contract for usufruct (Nassar, 2009). The main purpose of forward *ijārah* is to meet the needs of each party to the transaction. Those parties consist of the Islamic bank, the lessor, the lessee and the banking industry in general.

Middle Eastern Islamic Financial institutions have now begun applying forward *ijārah* to help people finance their purchases of services such as medical treatment, education, tourism (including *Umrah* and *Hajj*), communications, and so on (Lakshamanan, 2010).

The application of forward *ijārah* has now expanded to include a type of real estate leasing for buildings and development projects. Forward *Ijārah* in this arrangement involves is a form of lease which ends with transferring the ownership of the asset to the customer on maturity and upon meeting all its obligations under the forward *Ijārah* Contract. The property, which does not exist at the time of signing the forward *Ijārah* Contract, may be acquired by the bank under *Istisnā* Sale Contract or any other *Shari'ah* compliant mode of finance with the developer/contractors. At the end of the construction

period the property is delivered to the customer as per the terms of the lease agreement. At the end of the lease term (i.e. on maturity) and upon meeting all obligations under forward *Ijārah* Contract, the bank will transfer the ownership of the property to the customer for a token sale price under a separate sale contract. In practice, the concept of forward *ijārah* has also been adopted to issue *Sukuk* by combining both *Shari'ah* compliant contracts of *istisnā'* and *ijārah* (Muhammad al-Umrani, 2010). Thus, this research paper attempts to enrich the understanding of common practice of forward *ijārah*.

As per the previous discussion, forward *ijārah* is said to be different theoretically and practically. In theory, this contract is a combination between *Salam* and *ijārah* contracts while in practice, forward *ijārah* is the combination of *istisnā'* and *ijārah*. This is because *istisnā'* is an exchange contract wherein both the goods and the payment are specified before delivery to the buyer. In fact, *istisnā'* resembles *ijārah* in that both contain a request for work to be done and both contracts are dissolved upon the death of either party to the contract (Abu Guddah, 2009).

However, according to Nassar (2009) the difference between *istisnā'* and *ijārah* is the essential element of requesting the work found in *istisnā'*. If the nature of the task requires that the worker, for example, gets the material specified, he would obtain the material since he is more knowledgeable about the material pursuant to the job tasked of him, and the job orderer comes to the manufacturer empty-handed. In *ijārah*, the owner of a garment would come to the dyer with his own garment to be dyed; this is the difference between the two.

The differences between forward *ijārah* and *istisnā'* lie in the following points.



Firstly, it is permissible to pay a worker by installments in *ijārah* and *istisnā'*, but it is not allowed for forward *ijārah*, since it is a *Salam* contract of usufruct according to the most correct opinion, as was previously mentioned. Secondly, the subject matter of an *istisnā'* contract is actually the sale of a commodity that may or may not be consumable, while forward *ijārah* is actually a rental contract for the use of a commodity that must be non-consumable. Last but not least, the commodity manufactured in an *istisnā'* contract is the property of the job orderer, and it is only while the commodity is in the custody of the manufacturer is the manufacturer responsible for any damage to it. On the other hand, the ownership of the commodity in forward *ijārah* is not transferred to the renter; only the right to use of the usufruct is transferred.

There are several advantages of the practical application of forward *ijārah*. First, this contract is an alternative contract that is able to fulfill the needs of all the players involved in the transaction including the Islamic bank, the lessor, the lessee, and the banking industry. For example, suppose the lessor is the Islamic Bank, if it is sure of its ability to provide the needed asset. The bank may enter into a forward *ijārah* contract with the potential customer, and into *istisnā'* contract with the developer. Once the bank possess the property it will then, hand over the usufruct to the customer. (Abu Ghuddah, 2009).

The use of forward *ijārah* also fulfills the needs of the renter by guaranteeing the expected usufruct in contract, which is more reassuring to the renter than only a mere promise. Also, if the assets leased using forward *ijārah* were destroyed, the contract cannot be terminated. Rather, the lessor must provide a substitute in order to permit the renter to continue utilization of the usufruct (Nassar, 2009).

Moreover, by allowing the bank to collect advance installment from the customer as a compensation for a promised usufruct in the future, forward *ijārah* has allowed the banking industry to finance activities without contradicting the principles of *Shari'ah*. Thus, forward *ijārah* focuses on the usufruct for which the financing is done and obtained with an upfront payment, while the lessee enjoys the benefit of a delayed payment of the rental. All of these may happen even before the bank possesses the item or subject matter of the contract (Nassar. 2009)

The Islamic bank must take possession of the stipulated usufruct through forward *ijārah* and make an up-front payment to its actual provider. Then, it can enter into the contract of forward *ijārah* with its customer for a similar service that is parallel to the first contract without any contractual link between the contract with the customer and the contract it signed with the service provider. This allows it to avoid trading in debts by selling asset particularly before owning it (Usmani. 2002).

### **1.1.3 Problem Statement**

Islamic banking has gained popularity in many aspects including financial product innovations. Many scholars in Malaysia have debated about the applicability of different contracts such as the *musharakah mutanaqisah* financing concept in Islamic banking (See Mydin-Meera & Abdul-Razak, 2005; Osmani & Abdullah, 2010). Nevertheless, attention paid towards forward *ijārah* is significantly lacking and no study has been conducted to address the feasibility of issuing new products and services in Malaysia using the forward *ijārah* contract. Studies such as Anwar (2003) and Rosly (2001) have not taken the initiative to study the feasibility of forward *ijārah*.

Practically, forward *ijārah* is not widely practiced in Malaysia and the volume of its transactions is almost non-existent. Current statistics from RHB Islamic Bank shows that none of its financing activities have been contributed by forward *ijārah*. On the same note, other banks such as Maybank, Islamic Bank, Bank Islam Malaysia Berhad etc., do not offer forward *ijārah* in their list of financing products (see banks' annual reports).

Added to that, home financing in Malaysia has become a serious issue for the Islamic banking industry, and more discussion about suggesting new tools is increasing. Therefore, the research discovered forward *ijārah* as one of the tools of home financing in Middle East that can be suggested for Malaysian market. Hence, he takes the initiative to highlight and study its prospects and challenges in his research paper.

#### **1.1.4 Objectives of the Study**

This study specifically investigates the prospects and challenges of forward *ijārah* in Malaysia. For this purpose, three objectives are established:

- 1- To explore the conditions and rules of forward *ijārah* in the Islamic law of contracts and their practices.
- 2- To investigate the prospects and challenges pertaining to the implementation of forward *ijārah* in Malaysia.
- 3- To examine contributing factors and issues leading to the limited implementation of forward *ijārah* in Malaysia.

#### **1.1.5 Research Questions**

The main questions of this research are:

- a) What are the rules and condition of forward *ijārah*?
- b) What are the potential issues in the implementation of forward *ijārah* in Malaysia?
- c) What are the factors influencing the implementation of forward *ijārah* in Malaysia?

### **1.1.6 Motivation of Research**

There are many motivating factors that make the researcher conduct this study. First, the main motivating factor is the increasing use of this kind of contract in the Middle East. Hence, the researcher attempts to express the efficiency of this kind of contract as a mode of financing, especially home financing. Second, this contract is very beneficial in that it achieves the needs of all stakeholders, comprising of the Islamic bank, the lessor, the lessee, and the banking industry in general. Third, this study presents alternate ways for Islamic Banks in Malaysia to use this contract beside of some other contracts such as *murābahah*, *bay' bi thāman ajil* (BBA) and others. The fourth factor that motivates the researcher to conduct this paper is to find out possible ways to use this contract in Malaysia.

### **1.1.7 Scope and limitation of the Research**

The scope of this research paper emphasizes new products that Islamic banks offer according to the concept of *al-ijārah al-mawsūfa fi al-dhimmah*. Hence, the researcher will attempt to express the efficiency of this kind of contract as a mode of financing by studying the permissibility and the applicability of this contract.

The researcher will also analyze the most relevant laws and regulation in Malaysia. Furthermore, researcher also analyses articles, journals, books, internet resources and reports on International Islamic Banking and Finance regulations such as International Islamic Fiqh Academy and AAOIFI.

The main limitation of this research paper is time constraints. In conducting the interviews, this study emphasizes some stakeholders of Islamic banks in Malaysia such as academicians and bankers. For the purpose of this study only one bank was chosen as sample that is Maybank Islamic. Nonetheless, it is hoped that the single sample can still shed some light on how *al-ijārah al-mawsūfa fi al-dhimmah* has been practiced in Malaysia.

#### **1.1.8 Significance of the Study**

The study focuses on the importance of using forward *ijārah* as an alternative contract for customers and Islamic banks in Malaysia. The findings of this study will produce valuable information for the market of Islamic banking. Islamic banks operating in Malaysia may benefit from the experience of Middle Eastern practitioners of this kind of product which may help them create new services and products consistent with Malaysia's market environment. The findings of this research will provide customers with alternatives to choose when using the services of Islamic Banks. Additionally, regulators will also have alternative solutions for controversial products.

### **1.1.9 Organization of the Research**

The research will be divided into five chapters. Chapter 1 presents introduction of the study which briefly provides information about the topic and literature reviews of relevant works. The chapter also explains the research tools that will be used in this study including the concepts and methods. Chapter 2 reviews *Shari'ah*' perspective of forward *ijārah* and its rules, the definition of *ijārah* and its categories, the conditions and rules of forward *ijārah*, the comparison between forward *ijārah* and other contracts and the implication of *ijārah* and forward *ijārah* contract that has been currently offered by Islamic financial institutions. Chapter 3 presents the discussion about the legal perspective of forward *ijārah*, the conditions and rules for a valid contract and the legal issues in current implementation. Chapter 4 discusses problem and limitation in the implementation of forward *ijārah* and Chapter 5 summarizes the research, discusses the opportunity and prospective and provides recommendations and suggestions for future research.

## **1.2 SECTION TWO: LITERATURE REVIEW**

### **1.2.1 Introduction**

This section contains reviews of literature related to the topic of this research paper. The literature reviewed here can be divided into five parts. The first part pertains to those papers that deal with the concept of *ijārah* and its *Shari'ah* issues. The second part pertains to those papers that specifically focus on liability. Studies discussing the implications of the use of forward *ijārah* in the day-to-day operations of Islamic Financial Institutions are discussed in the third part. Fourthly, Papers that focus on Islamic bonds,

also known as *Sukuk*, under the contract of forward *ijārah* are presented in part four. Finally, the fifth part presents papers concerned with other instruments and their comparison with forward *ijārah*.

### 1.2.2 General Concept of *Ijārah*

In his paper about *ijārah*, Usmani (2008) explained the definition of *ijārah* and its categories based on the principles of Islamic Jurisprudence. He discussed the basic rules governing this transaction which is controlled by the rules of *Shari'ah*, as enumerated in Islamic *Fiqh*. Subsequently, he focused on *ijārah* as a contemporary mode of financing in today's Islamic financial institutions. Additionally he compared other transactions used in financing such as *Mudārabah*, *Murabāhah*, and so on. However, this study is limited to the concept and categories of *ijārah*. The application of forward *ijārah* was not discussed. Thus, the researcher attempts to cover the concept and types of forward *ijārah* as well as its past applications in the inherited books of *fiqh*.

The important issue that the researcher attempts to cover is the issues of the permissibility of forward *ijarah* according to the *Shari'ah*. "A *Shari'ah* Analysis of Issues in Islamic Leasing", Kamali (2007) conducted a fairly detailed examination of the *fiqh* rules pertaining to the contract of *ijārah*. He started his paper with the meaning of *ijārah* and then reviewed the opinions of leading schools of Islamic law of the basic conditions and requirements of this contract. He reviewed the two types of *ijārah* that are used in the market: operational leases and financial leases. The discussion then proceeded with a review of contractual options (*khiyarat*) and their relevance to *ijārah*, followed by a

discussion of the liabilities for losses and the insertion of penalty clauses in the *ijārah*, before finally concluding with the fiqh rules pertaining to the termination of this contract.

Another paper that focuses on the *Shari'ah* issues in *ijārah* is the study of International Financial Reporting Standards, known as IFRS (2011), under the title “*Shari'ah* Compliant Lessee and Lessor Issues”. This paper mainly discusses issues concerning the roles of the lessee and lessor in a contract of forward *ijārah*. The author discussed with the concept of one trade-based contract as defined by Bank Negara Malaysia. He then explained the several conditions that must be met when signing an *ijārah* contract and compared these conditions with those used historically. The most important issues discussed in the paper are the one that arise between the lessee and the lessor in current practice. The paper attempted to analyze the relationship between the lessee and the lessor. However, this research paper is going to study the relationship between both parties under the concept of forward *ijārah* specifically.

Similarly, M. Shariff and Abdul Rahman (2004) discuss the implications of *ijārah* on the accounting practices of Malaysian financial institutions. They argue that most of the previous studies on *ijārah* mainly focused on the fields of economics, law, and finance. So far, there had not been any in-depth study on accounting for *ijārah*. However, this study touches on the accounting treatment of forward *ijārah* has practiced by Malaysian financial institutions. The authors attempt to make a comparison between the International Accounting Standard on leasing (IAS 17), the accounting standard for *ijārah* (FAS 8) as developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Malaysian Accounting Standard on leasing (MASB 10).