



**INSPIRATION OF ISLAMIC  
BANKING MODEL FOR SHIP  
FINANCING**



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## Introduction

- Many countries around the world have become heavily dependent on international trade to power their respective nation's economic growth.
- Demand for shipping services have started to pick up again, in line with ever-expanding trade volume and reach.
- However, shipping companies have found difficulty in finding financing from financial institutions
- Only a few financial institutions count shipping as a significant industry in their portfolio.

## Cont..d

- Debt financing has long been established as the conventional method of ship financing.
- Over the years, Islamic structures in ship financing has become increasingly popular.
- Islamic finance structures such as *Ijarah* and *Ijarah Sukuk* are very adaptable to shipping finance, especially as it involves a charter and leasing component.

# IJARAH

## GENERAL PRINCIPLES

- Ijarah basically means an usufruct (*manfa'ah*) type of contract whereby an owner (Lessor or *Muajjir*) leases out an asset or equipment to a client (Lessee or *Musta'jir*) at an agreed rental fee (*ujrah*) for pre-determined lease period upon the contract (*'aqd*). The ownership of the leased asset or equipment remains in the hands of a Lessor.
- *Ijarah* could be:
  - *Ijarah al-manafi'* (leasing) for example ' I let you this house'
  - *Ijarah al-'amal* (hiring) for example 'I hire you to build this house for me'
- In modern practice, *Ijarah* can be:

Operating lease

Financial lease

# SALIENT FEATURES OF IJARAH

## SUBJECT MATTER

- *Ijarah* is about transfer of usufruct. Therefore, the object must have usufruct and is lawful for utilization.
- Asset must be non consumable, and capable of being utilized according to Shariah and reality.
- The Lessor owns the usufruct. A permission shall be obtained from the real owner for execution if it belongs to another party.
- Usufruct shall be well known and identified in a manner that abrogates ambiguity and uncertainty
- Liabilities and risks incidental to ownership will reside with the Lessor
- Liabilities and risks incidental to the utilization of the leased asset will reside with the Lessee – eg. payment of bills etc.

## Cont..d

- *Ijarah* can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the Lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the Lessee.

Source : Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI, 2003: 140-157)

- The Lessor can sell the leased asset provided it does not hinder the Lessee to take benefit from the asset. The new owner would be entitled to receive the rentals.

## PERIOD

- Period of the lease must be in clear terms for the first term of lease, and for future renewable terms.
- It can be determined based on month- to- month basis.
- The lease must be agreed for a fixed time.

## PRICE AND RENTAL

- Usufruct of the object that can be evaluated in terms of money and intended to be utilized according to the contract.
- Rental can be in any manner agreed upon (cash, kinds or benefit).
- Rental may be fixed or floating.
- Method of payment is based on agreement.  
(lump-sum, by installments, in advance or progressive)

## Cont..d

- Rental which is floating and determined according to a certain benchmark must be clearly indicated in formula because it becomes the determining factor for the rentals of the remaining periods.
- This benchmark should be subject to a ceiling, on both maximum and minimum levels.
- The two parties may agree to amend the rentals of future periods.

# LESSOR COMMITMENTS

## DELIVERY OF LEASED ASSET

- The Lessor is obliged to enable the Lessee to utilize the usufruct of the contracted asset i.e. by delivering the asset to him up to the end of the contract period.
- Delivery includes accessories of the leased asset without which the intended usufruct is not possible as per the prevailing practice.
- Delivery which enables usufruct entails that if any casual incident occurs and prevents usufruct of the leased without being due to the act of the Lessee, should be corrected by the Lessor, such as refurbishment of the residence or removal of any defect that hampers dwelling.

# LESSEE COMMITMENTS

## UTILIZATION OF THE LEASED ASSETS

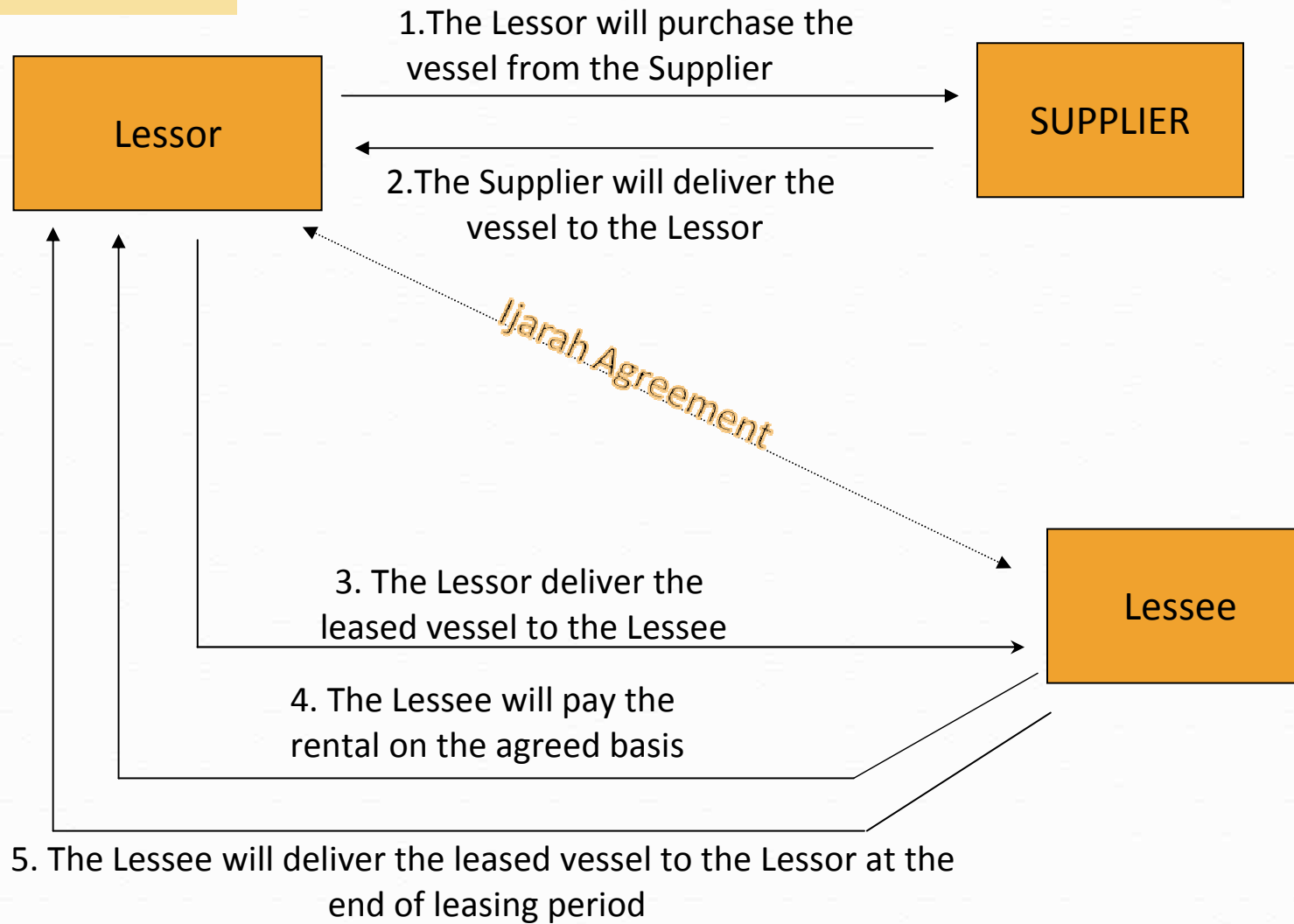
- The Lessee shall use of asset (*Ayn*) in accordance with condition, custom and preserving it.
- Jurists agree that the Lessee is committed to observe in using the asset (*Ayn*) for what it is prepared for. The conditions stipulated in the contract should be respected and if there is no such conditions, custom and practice should be observed.
- The Lessee is entitled to utilize the contracted for usufruct fully or partially but not more than what is agreed upon.
- The Lessee should repair any defect of the asset (*Ayn*) which resulted due to his use. It is well known that the leased asset (*Ayn*) is a trust in the hands of the Lessee.

# MODE OF IJARAH (IJARAH)

## FIRST MODE - OPERATING LEASE

- The Bank leases an asset to a customer in certain specific time.
- The asset will remain as the property of the bank.
- At the end of the period the lesser will deliver back the asset to the bank.

# Illustration

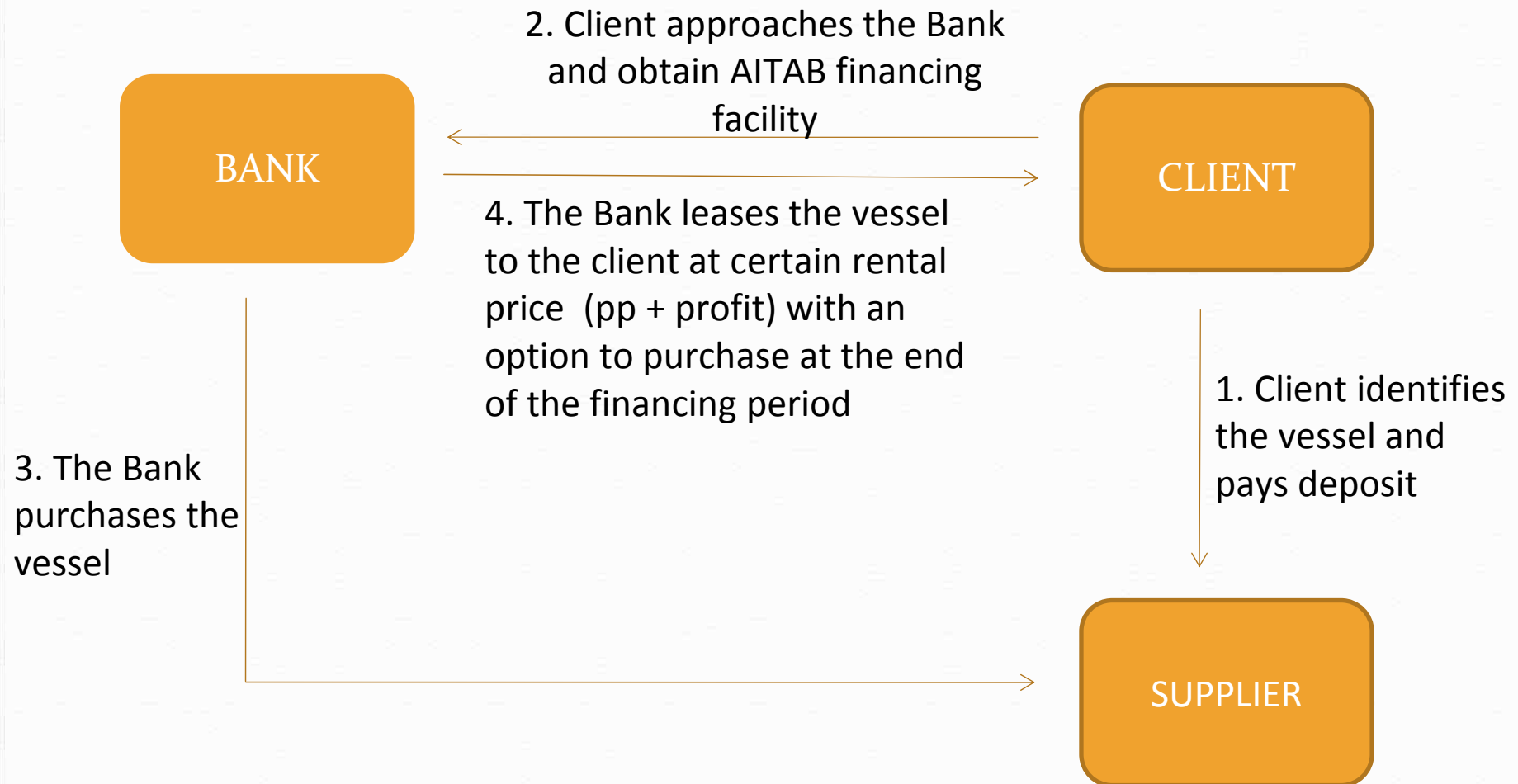


# MODE OF IJARAH

## SECOND MODE – FINANCIAL LEASE/*AL IJARAH THUMMA AL BAI'* (AITAB)

- It is combination of various contracts i.e the contract of *Ijarah* (hiring/renting) and the contract of *Al-Bai'* (sale and purchase)
- The modus operandi are as follows:
  - The Bank purchases the vessel from the vessel supplier.
  - The Bank then lease the vessel to the customer at agreed consideration (fixed or floating).
  - An option to purchase given to the client.
  - Transfer of the vessel to the client.

## Modus Operandi



## TRANSFERRING OF THE ASSET TO THE CLIENT

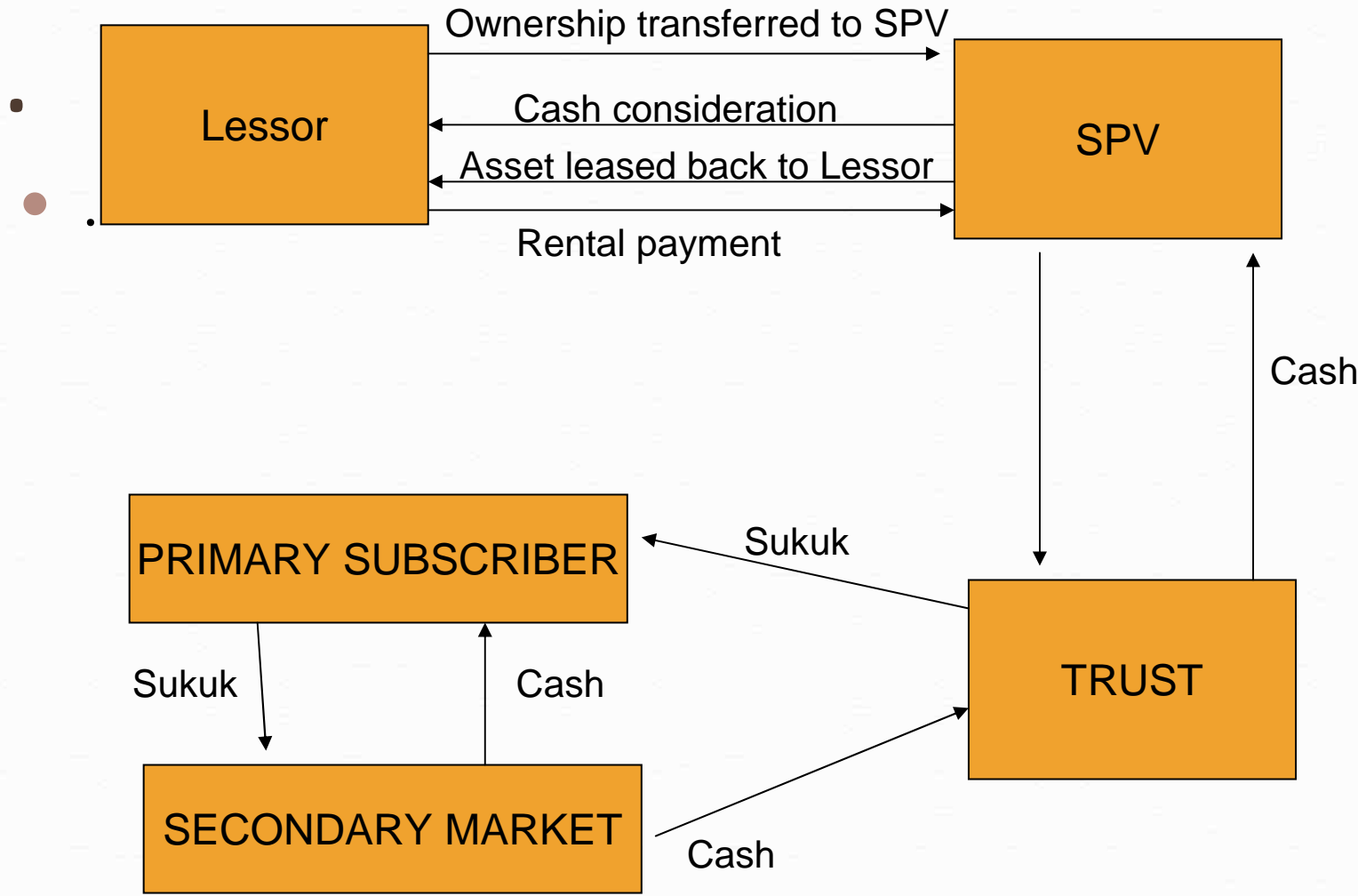
- It can be done in various ways.
  - 1) A promise to make a gift (*Hibah*); or
  - 2) A promise as a gift, contingent upon payment of the remaining installments; or
  - 3) A promise to sell for a token or other consideration.
- All these contracts must be documented separately from the *Ijarah* contract document.

# MODE OF IJARAH (*SUKUK IJARAH*)

- An additional product from Islamic finance sector.
- *Sukuk* are commonly described as Islamic bonds, trust certificates or Islamic securities and are structured and traded in the capital market in accordance with the requirement of Shariah.
- It represents ownership of equal shares in a rented real estate or the usufruct of the vessel. It give their owners the right to own the vessel, receive the rent and dispose of their *sukuk* in a manner that does not affect the right of the Lessee, i.e. they are tradable. The holders of such *sukuk* bear all cost of maintenance of and damage to the vessel.

## Cont..d

- As regards to the procedure for issuance of *Ijarah Sukuk*, a *Single Purpose Vehicle* (SPV) is created to purchase the asset(s) that issues sukuk to the investor, enabling it to make payment for purchasing the asset. The asset is then leased to third party for its use. The Lessee makes periodic rental payments to the SPV that in return distributes the same to the sukuk holders.
- *Ijarah sukuk* are completely negotiable and can be traded in the secondary markets.



# ISSUES :

## 1. MAINTENANCE OF THE LEASED ASSET

- It is not permissible to stipulate that maintenance should be carried by the Lessee, because this results to ambiguity of rental, so *Ijarah* would be void by this condition as agreed by all schools of jurisprudence.
- The Lessor is committed to refurbish the vessel and repair any defects which hamper its dwelling.

- As a major principle in this aspect is that the Lessor may not stipulate on the Lessee to make maintenance for any defects of the leased asset. If the contract included such a condition, it would be void due to ambiguity.
- Following cases are excluded:
  - a) Operating maintenance: which is a requirement for smooth use of the leased asset (*Ayn*) continuously (such as oil for machinery and equipment).
  - b) Periodical maintenance: which is necessary for sustaining the capability of the asset to provided usufruct.
  - c) Established maintenance which is described and quantified in the contract or common practice, whether that maintenance is mere work or with specified parts and materials, because such items are considered as rentals which are given due consideration.

## Cont..d

- In case the Lessor gave the Lessee permission in the contract or afterward to make certain repairs on the asset, he may undertake such repairs, and may revert to the Lessor to reimburse his expenses unless the latter had stipulated to not to revert to him.  
However if the Lessee undertook the maintenance of the leased asset without the Lessor's permission, the former has no right to revert to him, and hence he is considered as a donor.

## MAINTENANCE WORK

Maintenance works may be divided into following categories

- 1) Maintenance required for proper operation of machinery or equipment
  - It is work by applying equipment operation instructions along with requirements for revision and follow up of readings of temperature water, oils, etc. meters.
  - In addition to their inspection to verify during operation hours and their calibration, if needed.
  - All these works are the responsibility of the Lessee, because they are necessary for the utilization of the leased asset usufruct and not for enabling of its usufruct.

## Cont..d

### 2) Preventive maintenance

- Which include specific works ,which should be done on specific dates, in which certain parts of the equipment are calibrated and some replaced, even if they are still proper to use.
- These are the responsibility of the Lessee as per the contract in general because they fall within what is required for utilization of usufruct and not for enabling usufruct, or necessitated for optimum usufruct and not its source or origin, based on some branches of jurisprudence and common practice.

## ISSUES :

### 2. PAYMENT OF RENTAL PROFIT IN ADVANCE

- Acceptance of advanced payment is permissible from Shariah point of view but it should be based on the justification that it is an advanced payment of the rental value and not the profit value of lease (as regarding relationship with the Lessee), as this consideration is an internal element which concerns the owner Lessor, because the lease payment is an indivisible whole – from Shariah point of view – so it shall not be divided into principal and profit, because profit in Shariah is a result of purchase and sale of goods, and the excess price is know as the profit.

## Cont..d

- However in case of lease all payments are considered rental which may be advanced partially or wholly (which is a part of the overall rental), also it may be installed, or deferred till the leased usufruct is used.

## ISSUES :

### 3. INSURANCE

- It is Shariah permissible for the Lessor to stipulate that Lessee is to insure the equipment at Islamic insurance companies, and such insurance is based on the principle of installments donation.

## ISSUES :

### 4. TERMINATION OF IJARAH

- Either by the expiry of the terms, or by rescission or total destruction of the subject matter; or
- The destruction of the asset to the extent that no benefit can be derived from it.

## ISSUES :

### 5. DEFAULT (LATE) OF PAYMENT

Question : Can the Lessor impose penalty in default cases?

Answer : Yes, except on exceptional cases with valid excuse  
( in constraint circumstances)

- Should be indulged with some leniencies

وَإِنْ كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ وَأَنْ تَصَدَّقُوا خَيْرٌ لَّكُمْ إِنْ كُنْتُمْ تَعْلَمُونَ

“And if he (the debtor) is in constraint, then he must be given respite until he is well of (al-Baqarah: 280)

## Malaysian practice

- Considered as *ta'widh* (compensation) to the bank. (SAC of BNM & SC)
- compared the delay in paying off a debt with *ghasb* (usurpation) for both of them are an act of obstructing the use of property and exploiting it in a tyrannical way
- 1% and cannot be compounded

## International practice

- Charging of interest and given to charity

## ISSUES :

### 6. DELAY IN DELIVERY

- Lessor is not responsible for any delay by the Supplier.
- Lessee should be the one who is responsible to arrange the delivery of the asset.
- The delay does not diminish the Lessee's obligation to pay the rental.

## ISSUES :

### 7. DEFAULT AND ITS EFFECT

- The Lessor can terminate the contract and can recover:
  - a) Next rental due and all other rentals outstanding;
  - b) To take possession of the asset or demand its return;
  - c) To terminate the lease agreement without prejudice to the Lessor's right and remedies;
  - d) To demand from the Lessee the Agreed Loss Value.

# CONCLUSION

- Ultimately, much depends on the amount and exposure of risk that shipping companies are willing to take in exchange for a suitable source of financing.
- Undoubtedly, concerns would stem from the depreciating nature of the assets involved, high maintenance costs and higher operational risks due to the moveable nature of the assets.
- The lack of liquidity in conventional markets has opened doors for Islamic finance to make its mark in ship financing.

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