

## **Examining the Current Practice of Ijarah in Islamic Financial Institutions in Sri Lanka**

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**Abstract :** Most of the customers concern that there are no any differences between the Ijarah financing and leasing practice, both follow the same procedures. Therefore, the major objective of this study is to explore how Ijarah financing within the Sri Lankan context to remove the misconceptions as mentioned above. For this purpose, a representative sample of two Islamic Financial Institutions were selected, namely LOLC AL-Falah and Amana Bank PLC, in selected area of Akkaraipattu. The data were collected for this study, from both primary and secondary sources. The primary data were collected by conducting semi-structured interviews with the ‘ten’ practitioners, as well as ‘three’ Shari’ah experts of Sri Lanka are randomly selected. The secondary data were collected from records of selected IFIs, Magazines, Articles, books, Websites, and recent news publications. The current practice of ijarah was compared with both selected IFIs based shari’ah Framework, for that purpose, content analysis method/documentary was used for analyzing the compared aspects of both. The researchers identified the fact that, while practicing ijarah financing in selected institutions there are few differences only mismatch with shari’ah standard while most of the procedures are comply with shari’ah within 2 selected financial institutions. Also, this study tries to compare the system of leasing within conventional and Islamic financial institutions. The researchers can feel that, both systems are completely differ from each one in the ways of Interest +, Shari’ah compliance, and etc. Finally, the researchers point out that there are so many differences between Islamic and conventional side while practicing Ijarah where both they follow different procedures.

### **Introduction**

Islamic financial institution plays an important role around the world in financial transactions under the Shari’ah perspective. There are three main components namely Islamic banking, Islamic capital market, and Takāful are represent the Islamic financial system. The background of Islamic banking has been started from the period of Prophet Muhammad (SAW). The trade

was started by him with the partnership business (Mudharabah) from one country to another. Until now the Islamic finance has growing rapidly (Zainordin et al. 2016).

Recently the practice of Islamic banking in more than 85 countries with over 700 Islamic financial institutions implementing and offering Islamic banking and finance products and services. Sri Lanka is one of non-Islamic countries have legislation for the Islamic banking sector. Islamic finance was first introduced by Amana investment in year 1997, had become to be one of the growing financial sectors in Sri Lanka provide many kind of products such as, Musharakah (Partnership) Diminishing Partnership, Mudharabah (Passive Partnership), Bay AlMurabahah (Sales Contract at a Profit Mark-up), Ijarah (Leasing), Salam, Al-Istisna (Contract of Manufacture), Juālah, Wakalah, Takaful, Sukuk and among those products ijarah finance is introduced as an alternative of conventional leasing (Fawzer, 2016). It practice is going over 40 years since 1977 under the open economy policy, since then, number of lending institutions in the leasing industry have been increased. (Weerapana, 2007).

Most of the customers concern that Islamic leasing is very similar with conventional leasing and there is no any difference between the Ijarah and leasing practice (Abdullah & Dusuki), (Hameed, 2018) and both follow the same procedures. only the name and title are different. Hence, it is needed to examine the Ijarah Leasing practices in Sri Lanka in order to remove the misconceptions.

As our topic is about the current practice of Ijarah in Islamic Leasing Companies. Therefore, this research would explore the current practice of Ijarah-based contracts used by Islamic Financial Institutions. Within this concept, this study focused on Akkaraipattu area to conduct the research in perfect manner. Al Falah (LOLC) leasing company and Amana bank PLC in the area were selected exclusively for this study.

### **Research objective**

- To explore the current practice of Ijarah in Islamic financial institutions in Sri Lanka.

### **Research methodology**

This is an exploratory research where by the researchers intended to study the current practice of Ijarah in Sri Lanka, the researchers have employed the qualitative method of research. The data was gathered through both primary and secondary sources.

### **Primary data**

Primary data were collected by conducting interviews with the practitioner, and the customers of selected Islamic financial Institutions (LOLC Al-Falah and Amana bank PLC), as well as Shari'ah experts of Sri Lanka.

### **Secondary data**

The required secondary data were collected from annual reports of selected financial Institutions, and their procedural documents, magazines, Articles, Books, Websites, and recent news publications.

### **Research sample**

The target population for this study comprised from professionals from two financial institutions of Sri Lanka (LOLC Al-Falah, and Amana Bank PLC). As Amana is the full fledged Islamic financial institution and the one and only Islamic bank in Sri Lanka. LOLC Al-Falah is the subsidiary of LOLC group which is the largest finance group of company in Sri Lanka.

### **Research Analysis**

#### **Practice of Ijarah in Islamic financial Institutions**

Leasing can be defined as “a contract between two parties where one party (the lessor) provides an asset for usage to another party (the lessee) for a specified period of time, in return for specified payments” (Vinding, 2013), (Eis, 2012/15).

In Islamic banking system Ijarah contract based on profit sharing between the bank and the customer. Here Ijarah facility is provided by way of rent of usufruct of a vehicle, other equipment, house, machinery and the like. the corpus of the leasing object such as a vehicle, a house, or other equipment remains in the possession of the bank, with respect to its share and only its usufruct is transferred to the customer for an approved period, at an agreed consideration in Islamic system of finance, the word lease is used in the meaning of Ijarah (Razi, 2014).

There are two types of Ijarah is currently run at the Islamic financial institutions, named operating lease and financial lease. Among them operating lease is the only one which was used traditionally.

### **Operating lease:**

Operating lease is not tied with a purchase agreement. The Islamic financial institutions as the owner of the asset and usufruct, they lease out the usufruct of the asset for an agreed period and specified the rental amount to the consumer. Under the primary Ijarah structure, the customer doesn't intend to own the asset but his needs are only the benefit of the asset. After finishing the lease period, the asset remains with the Islamic financial institutions as the lessor (Hanif, 2016).

### **Financial lease/Ijarah Muntahiya Bittamleek:**

Islamic financial institution (owner of the property) leases out an asset/property to its customer at an agreed rental payment and particular (pre-determined) lease period under the financial lease contract. The lessee is promised to transfer the ownership of leased asset from the lessor at the end of the leased period through a separate sale agreement or gift (Treasurer, 2011).

In modern Islamic banking and finance a lease contract is considered a possible mode of financing, also it plays like an absolute alternative to conventional leasing. Three main modern applications of 'Ijarah are Ijarah thumma al-bay' (a lease contract ending with a sale), 'Ijarah muntahiya bittamleek' (leasing ending with ownership), and 'Ijarah mawsufah fi dhimmah' (forward lease) (Hassan, Kayed, & Oseni, 2013).

This was clearly illustrated in how Ijarah is implemented in Sri Lanka. For that, Practice of below mentioned aspects will be compared with the framework of Ijarah.

#### **1. Promise to lease**

An Ijarah contract is executed for an asset owned by the lessor or a usufruct owned by the sub-lessor. When the time of entering into ijarah contact both selected Islamic financial institutions promise to gift the leased vehicle or equipment to the lessee at the end of the lease period. And their promise makes at the commencement of the lease period. To make sure the promise, they prepare the document mentioned as promise to gift, and submit its copy to the customer, at the event of signing the lease agreement. As well as the original copy of the document will be assigned at the time of transferring the ownership of the leased property.

#### **2. Acquisition of the asset to be leased**

For the validity of an Ijarah contract concerning a specified asset, the leased contract should be proceeded by the acquisition of either the asset to be leased or the usufruct of the asset.

Before the Ijarah contract, the customer approaches the selected Islamic financial institutions to request for Ijarah financing. At the time, the IFI appoints the customer as an agent on behalf of them. Then, the IFI purchase the vehicle or equipment required for Ijarah leasing. This is the general procedure of leasing in selected financial institutions. But in practice, the selected IFIs implement Ijarah facility for three types:

**i. Brand new vehicle: -**

This is the type of unregistered vehicle. Means generally the selected IFIs purchase the vehicle directly from the supplier. Nevertheless, while they purchase the vehicle, 50% customer's contribution required by the IFIs out of the total cost of the vehicle, under the quid line of the central bank of Sri Lanka. (Issued under section 34 of the finance leasing Act, No.56 of 2000).

**ii. Ijarah part finance: -**

The vehicle belongs to third party in the event of Ijarah part finance. Therefore, the customer pays a portion of price of the vehicle to third party. Then, he approaches the IFI with request for Ijarah lease, for the balance portion of the price of the vehicle. In this situation, IFI contribute 70% from the total cost of the vehicle, balance 30% contribution must be bearing the customer under the financial leasing Act of central bank of Sri Lanka.

**iii. Ijarah lease back: -**

The customer sells his own asset to the Islamic financial institution on spot cash basis. At this time possession of the asset remains with the customer. While ownership transfer to the IFI. Then, customer enters in to an Ijarah contract with the IFIs for the same asset.

According to the above system, both selected financial institutions are followed the same process in their practice. But the only different is that, in the time of lease back, Amana Bank will not give the vehicle to the customer immediately. It will be assigned to the customer after twelve months from signing the Ijarah contract, since to eliminate the haram concept as 'buy al-inah'. But this procedure is not implemented in Al-Falah leasing company.

### **3. Concluding an Ijarah contract**

The period of Ijarah contract is specified at the commencement of the Ijarah contract. As well as the rental is collected from the lessee after delivery of leased asset. Selected both IFIs are same in these practices.

#### **4. Subject matter**

The leased asset must be capable of being used while preserving the asset, and the benefit from an Ijarah must be lawful in Shari'ah. Further the lessee must use the leased asset in a suitable manner and comply with conditions which are acceptable in Shari'ah. He must also avoid causing damage to the leased asset by misuse through misconduct or negligence.

#### **5. Determination of rental**

The rent payable by the lessee, determined in the commencement of the lease agreement. This amount will same for all the rental period. The rental amount will be determined according to their (IFIs) profit markup ration, and the price of the equipment/vehicle, as well as the quid line of central bank too. Above mentioned method is same in the selected IFIs. Nevertheless, Markup ratio may be differing between financial companies and Banks, because the quid line of central bank is different.

Ex: central bank's quid line to registered financial companies 13%-18% but registered Banks 15%-20%

#### **6. Guarantees and treatment of ijarah receivables**

Permissible security, of all kinds, may be taken to secure the rental payments or as security against misuse or negligence on the part of the lessee.

During the time of ijarah agreement, any mortgages are not considered as a security. The vehicle is used in the term of security. Further, the ijarah agreement should be signed by two witness, for the security purpose. If there is any delay in paying the rental, Amana bank will not claim any penalty charge whereas Al-Falah Islamic leasing company charges 4% out of the total amount payable-i.e. 3% for administration fee and 1% for charity account.

#### **7. Changes to the ijarah contract**

There are mainly two situations on which changes to the ijarah contract will occur.

##### **i. Early settlement: -**

In the process of early settlement, the ijarah contract ends, and the sale contract will be made to sell the stuff to the customer. This is the procedure that is progress in the above two institutions. However, as far as Al-Falah IFI is concerned in case the customer breaches the

contract, 10% penalty charged is to be paid for that. This amount is added to their profit. These two IFIs also intend to offer scheme rebates to their customers out of their profit under this circumstance.

**ii. Re settlement: -**

During this type of situation, ijarah contract which has already been made will not be fulfilled but there will be main changes only in the rental amount. These two companies adopt to above procedure. When it comes to some other changes, termination of the contract can be cited.

**8. Termination, expiry and renewal of the ijarah contract**

After the demise of the customer, considering the context as a permanent disabled, it will be terminated. The institution has the right to sell the equipment which were taken for ijarah and provide the capital amount of the customer to lessee's family members or else if the family members of the customer express their willingness, they will be given a chance to prosecute the ijarah contract only by changing the name of lessee indicated in the agreement.

As well as selected IFIs shall have the right to terminate the ijarah contract with respect to the leased property and to repossess the same without recourse to the process of law and the lessee shall have no right to agitate the matter in any circumstances if the leased property is repossessed by the IFIs on any of following grounds;

- a. Failure to pay the rental, charge or other sum payable on the due date of Payment;
- b. For a breach/ non-compliance of any of the term or conditions of the ijarah agreement or any other connected document relating to the lease;
- c. For any unreasonable or illegal use of the leased property by the lessee in the opinion of the institution;
- d. In the event of any proceeding, voluntary or involuntary, in bankruptcy, winding up or insolvency involving the lessee;
- e. In the event the lessee suffers any action or proceeding whereby any of his Properties, shall be assigned to any receiver, assignee any court of law, tribunal or government body

**9. Transfer of ownership**

At the end of the lease period, the ownership of the vehicle or equipment will be transferred to the customer. This will take place on the basis of Al-ijarah muntahiya bittamleek.

As far as financial lease is concerned, during the rental period, by paying a portion of the capital together with rental amount in installment basis, at the end of the lease period, the customer will have the ownership to use the subject matter.

### 10. Lessor and lessee

While the time of ijarah contract, the Islamic financial institutions plays role as lessor and the customer becomes as lessee, both have been well known about the subject matter of ijarah. If any damages made by customer, in the leased period, he must bear the responsibility of subject matter of ijarah.

### Differences among financial institutions

When the selected two financial institutions were asked about whether any different procedures are being followed among IFIs, only a few differences were noticed by the researchers. To make it clear further, it is being analyzed in keeping with these two selected FIs.

No	Factors	Amana Bank PLC	Al-Falah LC
01	Penalty charges	No charges	Charges added
02	Ceasing the vehicle	3 months	6 months
03	Profit markup	14%	17%

*(Source: survey data)*

These are a few differences existing among two selected Islamic Financial Institutions.

### Differences between conventional & Islamic FIs

There are some differences making a great impact on Islamic FIs and conventional FIs. The given below table explains this well.

No	Factors	Islamic FIs	Conventional FIs
01	Interest +	No	Yes
02	Shari'ah compliance	Yes	No
03	Structured payment	No	Yes
04	Contains conditions	No	Yes
05	Hidden charges	No	Yes

*(Source: survey data)*



Apart from this, offer ceasing any vehicle, conventional financial institution will add the money to the profit of the customer despite their balance instead of giving it to the customer by selling the vehicle. Immediately after purchasing the vehicle from the supplier, the ownership of the vehicle will be transferred to the customer. Then, customer rental has to be paid, this is not in accord with Shari'ah because owner is not supposed to pay the rent for his possession. If the vehicle meets with an accident, IFIs will not charge any rental until it is used again, but conventional FIs will charge the rental.

## Conclusion

This study aimed to explore current practice of Ijarah financing within the Sri Lankan context. For this purpose, a representative sample of two Islamic Financial Institutions were selected, namely LOLC AL-Falah and Amana Bank PLC, in selected area Akkaraipattu. For that, the current practice of ijarah was compared with both selected IFIs based on theory of ijarah Framework, and compared with conventional leasing process too. Content analysis method/documentary was used for analyzing the compared aspects of both selected IFIs. The finding of this study indicated that there were number of differences between 2 selected institutions while practicing ijarah such in case penalty charges, ceasing the vehicle, and Profit markup. But most of the practices were same according to shari'ah frame work between both selected IFIs. Also, this study tries to compare the system of leasing within conventional and Islamic financial institutions. The researchers can feel that, both systems are completely differ from each one in the ways of Interest +, Shari'ah compliance, structured payment, Contains conditions, and Hidden charges. Finally, the researchers point out that there are so many differences between Islamic and conventional side while practicing Ijarah where both they follow different procedures.

No	Aspect	Amana Bank	Al- Falah
1	Promise to lease	There is no issue	There is no issue
2	Acquisition of the asset to be leased	There is no issue	There is an issue
3	Concluding an ijarah contract	There is no issue	There is no issue
4	Subject matter of ijarah	There is an issue	There is an issue
5	Determination of rental	There is no issue	There is no issue

6	Guarantees and treatment of ijarah	There is no issue	There is an issue
7	Changes to the ijarah contract	There is no issue	There is an issue
8	Termination and expiry of ijarah	There is no issue	There is no issue
9	Transfer of the ownership	There is no issue	There is no issue
10	Lessor and lessee	There is no issue	There is no issue

(Source: survey data)

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