

## **THE USE OF ASSETS *IJARA* BONDS FOR BRIDGING THE BUDGET GAP**

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*A shari'ah compatible fixed-return financial instrument is needed in an Islamic economy. This paper explores the potential of ijara (renting)-based financial instruments to meet this need. The paper proposes ijara-bonds as marketable Islamic financial instruments for resource mobilization in the public sector as well as an instrument for monetary policy. Private companies can equally use the ijara-bonds for resource mobilization.*

This paper aims at presenting the idea of assets *ijara* bonds (AIBs)<sup>1</sup> and how such bonds can be used by governments as an alternative means of borrowing funds from the public.

The paper consists of four sections. Section one deals with the assumptions under which the AIBs shall be discussed. Section two will analyze the *ijara* contract and discuss the *shari'ah* foundation of the AIBs. The third section defines AIBs and studies their different forms. Finally, section four will discuss the characteristics and economics of AIBs and compare them with other securities.

### **1. ASSUMPTIONS**

In order to restrict the discussion in this paper to the limits that serve the stated objectives, we have to make a few necessary assumptions:

1. We assume existence of a deficit in the budget, but without discussing its causes or nature. A deficit may be attributed to shortage of financial

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<sup>1</sup> Assets *Ijara* Bonds can be differentiated from Services *Ijara* Bonds. Since the *ijara* contract in *shari'ah* is essentially the same for physical durable assets and for human labor, both kinds of *ijara* contracts can be securitized respectively, in the form of Assets *Ijara* Bonds and Service *Ijara* Bonds (such as Certificates of Education). In fact, a third form of *ijara* bonds can also be devised based on an *ijara* contract that involves services of assets along with their operators. In this form of AIBs, the lessee gets services such as telephone for the production of which machines, equipments and man-hours are needed.

resources or high public expenditure or both. This paper does not attempt to study budget deficit itself.

2. The government has many durable assets that are used in the process of performing governmental functions, performed either under current or capital account of the budget. In other words, the government already owns buildings, bridges, airports, seaports etc., that are actually used by the government in the process of providing its services to the community.

Furthermore, the government continues the process of construction and/or acquisition of durable fixed assets, including infrastructure, for the purpose of improving its services to the community and fulfilling the social, political and economic aims of the society and its government.

This means that there are a number of fixed durable assets presently owned by the government that can be sold and leased back. Additionally, there are also many projects for constructing or acquiring new durable assets which can be purchased by investors and then leased to the government.

Furthermore, for the purpose of this paper, it does not matter whether such durable assets are used for the production of marketable goods and services or simply for the non-income generating governmental activities. In other words, it does not matter whether durable assets are income generating or not.

3. To supplement the second assumption, it shall also be assumed that most of the major projects for infrastructure and public services such as roads, bridges, airports, communication installations, electricity, water sewerage etc. are undertaken by the government, and their expenses are charged in the budget.
4. There are sufficient savings available within the society that can finance the budget deficit. These savings can be mobilized by innovative approaches, and that utilization of such savings for the benefit of bridging the budget gap will not adversely affect the private sector's activities and functions.
5. The paper shall not discuss the shortage of foreign exchange. In other words, it is assumed that either there is no need for foreign financial resources at all, or that the government has sufficient foreign exchange with it from its own sources and does not need financing for budget deficit in terms of foreign exchange.

Equivalently, it may be assumed that the local currency is fully convertible and is supported by sufficient amount of exports (of goods and services), to the extent that the government does not face any foreign exchange problem, nor does it anticipate that mobilization of resources for bridging the budget deficit gap would cause a shortage in foreign exchange. By this assumption, we avoid any foreign exchange complications related to the mobilization of financial resources for the

government; which are common to the proposed idea of AIBs and other means of resource mobilization.

## 2. SHARI'AH FOUNDATIONS OF ASSETS IJARA BONDS

The *ijara* contract in *shari'ah* is quite flexible and is open to the incorporation of additional conditions. This flexibility may be used to evolve different forms of contracts that may suit different purposes.

Without going into detailed discussions of the legal conditions of parties to the *ijara* contract, its format, the asset leased and the amount of rent, one may easily compare *ijara* with *bay'* (sale). An *ijara* contract does not require the beneficiary of the usufruct of the asset to pay the price of that asset. All that the beneficiary pays is the price (rent) of usufruct.

Furthermore, the usufruct of an asset is derived over time and is usually defined in terms of units of time. If an *ijara* contract is a sale contract whose subject is usufruct as *fuqaha* usually say, the usufruct is only measured by time and, therefore, we can have an unlimited consecutive number of periods in which *ijara* contract can be defined. We can alter the conditions of *ijara*, if that is desirable at the beginning of each period.

The important condition in an *ijara* contract is that both the leased asset and the amount of rent be clearly known to both parties at the time of the contract. Once the subject matters of the contract, rent and asset, are known, an *ijara* can be contracted on a building that is going to be constructed, as long as it is fully described in the contract. The *ijara* can be defined for any length of period and can be made renewable for as long as the asset exists.

### 2.1 Sale of the Leased Asset

*Ijara* contract in *shari'ah* does not restrict the right of lessor to sell the leased asset. Since the lessor remains the owner, the fact that the asset is leased to somebody else does not restrict the owner's right of disposition of the asset in any form as long as it does not hinder the delivery of the usufruct to the lessee. In other words, the leased asset can be sold, provided the new owner will honor the existing *ijara* contract.

All schools of jurisprudence are explicit on the point that a purchaser of a leased asset must honor the *ijara* contract. The Hanbalites add that the new owner deserves the rent for the rest of the *ijara* period, on the ground that the purchaser of such an asset stands in the position of its seller (previous owner) who deserved the payment of the rent for the remaining period of *ijara*.<sup>2</sup> This characteristic of *ijara* is

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<sup>2</sup> Al Bahuti, *Sharah Muntaha al Iradat*, Madinah Munawarah: Salafyah Printers, Vol. 2, p.

essential for securitization of leased assets because it accommodates the negotiability of the AIBs.

## 2.2 Independence of Ownership

An asset whose ownership is shared by many people can be leased, either individually by each owner leasing his/her owned share of the asset, or it can be leased by all owners together in one contract and under the same conditions. In the previous case, the lessee has the right to the usufruct of the same share of the assets that the owner/lessor had.

Persons who share the ownership of a leased asset can dispose of their property by, say, selling it to new owners individually or collectively as they may desire. In other words, the owner of a share of an asset represented by an AIB can sell that share, or part of it, to a new person independently of the other owners. This characteristic of *ijara* also facilitates securitization of leased assets and allows benefitting from the market conditions with regards to the negotiability of the bonds.

## 2.3 Timing of Rent Payment

*Ijara* contract unlike sale, is flexible on the timing of the payment of rent. For instance, payment can be made coinciding with the units of time in which the usufructs of the asset are defined. For instance, it could be at the beginning or at the end of each period of the lease and rent may be payable monthly, yearly, etc., as per the terms of the agreement.

The rent payment could also be unrelated to the periods of usufruct. For instance, an asset may be given on lease for 10 years, but payment of rent may be spread over a period of 12 years, or vice versa. Additionally, the payment of rent may begin before, or after, the beginning of lease. For example, we may take an *ijara* contract of a bridge whose construction takes 3 years, at a cost of \$10 million. The bridge is leased to the government for 24 years, after the construction is completed, at a total rent of \$24.3 million (=24 x \$1,012,50). The payment of rents may be spread over 27 years at a rate of 0.9 million per year beginning from the end of the first year, i.e. the bond holders make a 9% yearly return on their investment.

## 2.4 Ijara of Non-existing Assets

*Shari'ah* does not require that the asset-subject of *ijara* contract, should be in existence at the time of the contract. In other words, one may lease an asset that is

only described and defined in detail at the time of the contract. Such an asset may be existing in a place that is far away from the place of the contract (such as a building in another town), or it may be an asset that is only described and does not exist at all at the time of contract (such as leasing of an airplane that is to be manufactured). The important and necessary conditions in this connection are that (a) the asset should be clearly described in a way that does not create any ambiguity or controversy about it, and (b) the lessor should normally be able to acquire, construct or buy the leased asset by the time set for its delivery to the lessee. In other words, he (the lessor) should be able to fully carry out the commitment made in the lease contract.

### **2.5 Period of Ijara**

*Ijara* contract is not restricted to short, medium or long term. It can be set to any term, as long as the asset which is the subject of the *ijara* contract remains in existence and renders its usufruct for the duration of the contract. For instance, assets for which suitable amortization schedule could be made, may be given on lease for a period of, say, a year renewable permanently because the assets are replenished through the amortization funds. Similarly, for land, the *ijara* may be for one year renewable on a permanent basis.

### **2.6 Determination of Rent**

In an *ijara* contract, it is necessary that rent must be known. There may be many ways to put a known rent into an *ijara* contract. For instance, actual rent payable by the lessee may be increasing, decreasing or constant as long as the formula for increments, or subtractions, are known at the beginning of the renewal period for which the increase or decrease applies, or at the time of contract.

Also the rent may be determined for the first period. For each subsequent period, rent may be related to a variable that will be known before the beginning of the renewal period, such as a periodically announced price index, or rate of return on capital or any other variable.

## 2.7 Combination of *Ijara* and *Wakalah*

An *ijara* contract is open for combination with the *wakalah* contract. This provides flexibility in implementation of AIBs. For instance, the bond holders may charge the beneficiary of the usufruct, i.e. the lessee, with the task of construction or acquisition (purchase) of the asset that is to be given to the user on an *ijara* contract.

## 2.8 Insurance and Maintenance Expenses

In the *ijara* contract, the lessor is required, according to *shari'ah*, to keep the leased asset in a shape that allows the lessee to extract from it the contracted usufruct. It implies that maintenance expenditures related to the basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be taken care of by the lessee. The example of the latter is oiling and lubricating of machines.

Maintenance expenses that fall on the part of the owner are of two kinds. First, predictable periodical or quasi - periodical expenses such as an overhaul of the leased machine after a certain number of hours of work or operation. These and similar expenses that can be predicted in advance, may actually be charged to the lessee as a part of the rent. In other words, all predictable maintenance and insurance expenses can be included in the rent in such a way that rent would then consist of cash payment made by the lessee to the owner plus pre-determined maintenance and insurance expenses made by the lessee on behalf of the owner. The *ijara* contract accommodates such a condition i.e., the *shari'ah* permits making the lessee responsible for all predictable maintenance and insurance expenses of the asset.

There may be some maintenance expenses which are not predictable. There may also be unpredictable changes in the cost of insurance. Such expenses are also the responsibility of the owner. This means that the *ijara* contract is not totally risk-free, but undoubtedly it is a low-risk investment, specially because most unpredictable maintenance are usually insurable.

One should keep in mind that for the success of *ijara* bonds, we need to minimize the interference of the bondholders with both the asset itself and the lessee; so that we allow the bonds to serve as financial instruments qualified for all kinds of transactions in the financial markets. Fortunately, the *shari'ah* offers adequate flexibility in the *ijara* contract. Any maintenance or insurance expenses, for which the owners may remain responsible, can be undertaken by the lessee for implementation on the basis of *wakalah* i.e. on behalf of the owner, and the owner (bondholder) then will be charged by the lessee for the outlays the latter makes for this kind of maintenance and insurance expenditures.

In brief, although the AIBs are not completely risk free, these can be designed in such a way that their risk is minimal.

## 2.9 Securitization of Assets Subject to *Ijara* Contract

The idea of an *ijara* bond stems, as we will see in section three, from the ability of transforming leased assets into financial assets. Securitization means putting certain income generating physical assets as a base of, or a guarantee for, the issuance of securities that are financial assets.<sup>3</sup>

The Islamic *shari'ah* encourages documentation of contracts (the Holy Qur'an, 2:282). Both the ownership of an asset and the *ijara* contract should preferably be documented. These documents can play the role of securities and thereby become financial assets.

However, a financial asset is always looked at in the *shari'ah* in association with the asset(s) it represents, i.e., a security cannot be considered as totally or completely separable from the assets it represents. In its 4th Annual Plenary Meeting, the OIC *Fiqh* Academy, while discussing *sanadat al muqaradah*, put forward an important and essential rule that clarifies the position of *shari'ah* about securitization.

Decision No.5 of the 4th Annual Plenary Session of the OIC *Fiqh* Academy, held in Jeddah 18-23/6/1408H (6-11/2/1988G), asserts that (a) any combination of assets can be represented in a written note or bond, and (b) this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts. Furthermore, the decision clearly mentions that assets that can be grouped together for the purpose of securitization may consist of any combination of the following four types of assets:

- i) physical assets,
- ii) financial rights (such as the usufruct in *ijara*),
- iii) interpersonal debts, and
- iv) money.<sup>4</sup>

<sup>3</sup> Miles, Adrian (1993), "An Introduction to Securitization of Lease" in Adrian Hombrook, *Studies in Leasing Law and Tax*, London: Euromoney Publications, p.15.

<sup>4</sup> The OIC Islamic Fiqh Academy *Resolutions and Recommendations*, pp. 60-63. The above mentioned resolution requires that if the majority of securitized assets is in the form of money and debts, the negotiability of the representing security must follow the rules of currency exchange and transfer of debts as known in *shari'ah*. This essentially means that debts and money can only be exchanged at a price equal to their face value.

### 3. DEFINITION AND FORMS OF ASSETS IJARA BONDS

#### 3.1 Definition of AIBs

Keeping in mind the basic features of *ijara* contract and observations given in the previous section, we can now define AIBs as follows:

“The AIBs are securities of equal denomination for each issue, representing physical durable assets that are tied to an *ijara* contract as defined in the *shari‘ah*”.

The basic feature of the AIBs is that they represent leased assets, without implying any relationship among their owners, i.e., without relating the bondholders to any common organization, company or institution. For instance, an aircraft leased to an airline can be represented in bonds and owned by a thousand different bondholders, each one of them, individually and independently, presents his/her bond(s) to the airline company and collects the periodic rent without having to have any relation with other bondholders. In other words, the AIB holders are not an owner of a share in a company that owns the leased airplane, but simply a sharing owner, who only owns one thousandth or more of the plane itself.

#### 3.2 Forms of Ijara Bonds

There may be multiple forms of AIBs depending on the nature of the asset and the method and procedure of issuance of the bonds.

1. In the simplest form, the AIB is based on a leased asset, say a real estate leased to the Ministry of Education to be used as a school, and the conditions of the lease are stated on the title of the lease document itself. This title becomes an AIBs which can be sold and bought in the market at a market price that is formulated through the interaction of the market forces.

Now, instead of having one title let us say that thousand bonds (titles) are issued whereby each title or bond represents the ownership of only one thousandth of that real estate that is leased to the Ministry of Education. The bond entitles its holder to one thousandth of the periodical rental, that is determined in the *ijara* contract, whose main features are mentioned on the bond itself. These bonds (titles) may be issued, e.g., by the Real Estate Recording Division of a municipality.

2. More sophisticated forms of AIBs can be considered by including financial intermediaries. Let us suppose that the Ministry of Defense needs a training field to be used by its training program. A suitable piece of land in a certain suitable location is needed. The Ministry of Defense



resorts to an Islamic bank to prepare an issue of AIBs that allows the Ministry to acquire the needed plot. The Islamic bank buys the plot for 10 million Dinar and rents it to the Ministry of Defense for 900,000 Dinars a year. At the same time, the bank issues 1,000 AIBs, each bond represents 1000th of the plot and entitles its owner to 900 Dinars per year as rent. The *ijara* contract has a period of ten years after which the contract will be renewed perpetually each time for ten years. The Islamic bank makes an issuance commission of say 5%, as a premium above the purchase price of the land, i.e., the bank sells the bonds at 10500 Dinars each.

In this form of AIBs, the bondholders own the land that is rented, and they are entitled to the rent at the above mentioned rate. The issuer of the bonds is the financial intermediary, not the Division of Real Estate Recording, nor the beneficiary of the lease.

3. Let us now suppose that in the above mentioned case, the Ministry of Defense decides to undertake the task of issuing the bonds at its own, without resorting to a financial intermediary, and it does not have the money to buy the land, and transferring its ownership to the bond holders.

The Ministry of Defense begins with issuing AIBs for the specific purpose of acquiring the land, whose purchase price is 10 million Dinars. The bonds, now, contain a new clause permitting the Ministry, on *wakalah* basis, to collect the funds from the buyers of the bonds, and to purchase the lot on their behalf. In this case, the issuer of the bonds becomes the beneficiary of the *ijara* contract, i.e. the user of the asset. Each bondholder has the same right to ownership and to a share to the total rent which equals one thousandth each (on the assumption of 1000 bonds). There will be no premium paid to a financial intermediary, although the Ministry of Defense may take some contractual compensation for its work on behalf of the savers/purchasers of bonds.

4. The fourth form of AIBs may be one in which the lessee desires to own the leased asset, so that at the end of the *ijara* contract, the lessee would not worry about any further rent payment.

Obviously, this kind of arrangement applies only to assets whose productive life goes beyond the terms of the lease. There are two ways, or sub forms, through which this objective can be achieved.

- a) The leased contract may be drawn with a promise from the bondholder to the lessee to relinquish the asset at the end of the lease term. The Islamic *Fiqh* Academy rules that “a promise is binding from the religious point of view except in case of an acceptable excuse. It is also binding in judicial courts if the promise was dependent on reasons and the promise incurred

some cost as a result of the promise”<sup>5</sup>. Furthermore, the *Fiqh* Academy’s rejection, of the idea of binding mutual promises from the two parties in a sale contract, was justified by the fact that such mutual binding promises are “similar to offer and acceptance in a sale contract itself” and a sale contract requires that the seller must have owned what he/she is selling. This condition is apparently satisfied in our case, i.e., the lessor owns the leased assets and has the full right to sell it to the lessee, or to anybody else, as we noticed earlier.

One may have to concede the fact that this form of AIBs with a promise of sale at the end of the lease contract is similar to installment sale. However, this similarity alone is not sufficient to justify its rejection, as it provides additional protection to the bondholder/lessor in preserving ownership right and delivery till the end of the lease term.

- b) The same objective can also be achieved by another method derived from the combination of *ijara and istisna’* contracts. The *istisna’* contract allows to sell any material in which manufacturing or craftsmanship is an ingredient<sup>6</sup>. It also offers a flexibility of having the dates of delivery and a payment determined by contractors freely, together or separate from each other, and without having the condition that the seller necessarily be the manufacturer of the assets that are being sold in *istisna’* contract.

Hence an AIB can be formulated so that the bondholder may sell an asset of the same description and conditions as would be the leased asset at the end of the lease term, and for a delivery due at the end of the lease term too. When delivery is due “and the lease is over”, the bondholder/seller in *istisna’* would deliver the asset, then released from the lease contract, to the buyer, or former lessee. Conditions of *istisna’* can be added on the lease contract itself, so that the bond represents both contracts although they are theoretically two separate contracts, and not necessarily related to the same asset<sup>7</sup>.

5. Another form of AIB may be a bond with variable return, in which the

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<sup>5</sup> Decision No. 2 of the Fifth Annual Session of the Islamic *Fiqh* Academy held in Kuwait, 1-6 Jumad Awwal, 1409H. The OIC Islamic *Fiqh* Academy Decisions and Resolutions 1406H-1409H, p.90.

<sup>6</sup> Obviously this applies to most assets that are subject to asset *Ijara* bonds except land as in previous example of a shooting range. However, if land has construction on it such as office building, “including the land”, an *istisna’* contract may apply to it. See *Istisna’ Contract and its Contemporary Applications*, Al-Zarqa, Sh. Mustafa (1995), IRTI/IDB, Jeddah.

<sup>7</sup> This is so because *istisna’* is defined as a contract on an object that is only described but not physically determined or necessarily in existence at the time of the contract.

periodic rent may be increasing/decreasing or related to a variable, such as a lagged consumer price index that can be known before the beginning of each rental period.

This form of AIB is based on the idea that an *ijara* contract may be understood as to consist of several consecutive contracts, one after the other, and the parties to the contract can determine, or re-negotiate, the conditions of each contract provided this is done before the beginning of the period of each consecutive contract. This idea is in conformity with the *shari'ah*.

6. The sixth form of AIB is one in which the lessor, at the end of the lease term, loses interest in the asset, either because of the expiry of its productive life, or because of certain legal arrangements.

Certain assets have limited productive life, after which they may not have even scrap value, and in some cases they may become a burden on the owner. Hence, the lessee may be doing the bondholders a favor by accepting to dispose of such useless and valueless assets<sup>8</sup>. Another reason for loss of interest by the bondholders, at the end of the lease term, is when the contract itself requires that the asset becomes due to a third party, such as a bridge, built on a concessional basis by the Government, and the terms of the concession require that, at the end of the lease period, the bridge becomes a public property, open for all traffic<sup>9</sup>.

A similar legal arrangement applies to *awqaf* land<sup>10</sup>. This arrangement is called "*al hukr*". Since *awqaf* land cannot be sold to any private party according to *shari'ah*, *al hukr* arrangement is a long term lease of an *waqf* land, whereby the lessee may make construction on the land and derive its usufruct exclusively for the whole period of the contract<sup>11</sup>. A bondholder may be the owner of a structure built on *awqaf* land of which the bondholders are the beneficiary of *al hukr* arrangement for, say, 50 years; the ownership of the structure will be delivered to the *awqaf*, as the rent of the fiftieth year. The structure owned by the bondholders for this period is also leased to the government as headquarters of say, a university campus. In this case, the leased asset cease to be owned by the landholders at the

<sup>8</sup> One may imagine certain cases where the ownership of an expired asset may in fact become a burden and the lessee would make a favor to the lessor by accepting to dispose of it. A simple example of that would be the lease of tires of planes or cars, where no one would like to take responsibility of them after their productive life.

<sup>9</sup> This may be related to another known *shari'ah* principle called *eqta' al irfaq* in which the Government may allow a private party to use certain public property, say a piece of land permanently or for a given number of years. A temporary "*Eqta' al Irfaq*" may require that construction on that land go to the public property at the end of the given period.

<sup>10</sup> It may also apply to privately owned property by mutual agreement, see *Fiqh Encyclopedia*, the Ministry of *Awqaf* of Kuwait, vol. 18, p. 54.

<sup>11</sup> The word *al hukr* means exclusivity.

end of the *al hukr* period which coincide with the lease period.

#### **4. CHARACTERISTICS AND ECONOMICS OF ASSETS IJARA BONDS**

##### **4.1 Characteristics of AIBs**

The characteristics of an AIB stem out of its nature and from contractual relationship defined in *ijara* contract governing it. These can be summarized in the following:

1. AIBs are securities representing the ownership of well defined, existing and well known assets, that are tied-up to a lease contract. This means that AIBs can be traded in the market at a price determined by the market forces. Hence, the bond's price rises with the market appreciation of the assets it represents and vice versa.

Market prices of AIBs are, therefore, subject to the interplay of the market forces that effect their supply and demand. This includes, *inter alia*, the general market conditions in the economy and in the financial market, the opportunity cost (current and expected return on new financing), prices of real investment assets and economic trends in the specific market related to securities and AIBs, etc.

The AIBs are also subject to risks related to the ability and desirability of the lessee to pay the rental installments. Moreover, these are also subject to real market risks arising from potential changes in assets' pricing and in maintenance and insurance costs.

However, certain forms of AIBs can be devised in such a way that minimizes the real market risk in both areas, or even eliminate it entirely, as has been discussed above.

The expected return on AIBs will depend on the market forces. If the current and expected returns of fresh investment increase, AIBs, with their pre-determined and fix return fall in order to bring the market in equilibrium in terms of the rates of return on already existing assets which are the bonds and on fresh investment, given the degree of risk and other variables.

2. Furthermore, the expected net return on some forms of AIBs may not be completely fixed and determined in advance, since there might be some maintenance and insurance expenses that are not perfectly determined in advance. Consequently, in such cases, the rate of rent given in the contractual relationship represented by the bond, represents a maximum return subject to deduction of this kind of maintenance and insurance expenditures.

3. AIBs are completely negotiable and can be traded on the secondary financial markets. Subject to market conditions, these bonds will offer a high degree of liquidity and therefore, have both the characteristics and necessary conditions for functioning as successful securities.
4. AIBs will offer high degree of flexibility from the point of view of their issuance management and marketability. These bonds can be issued by the central government, provincial government, municipalities, *awqaf* or any other asset users, private or public. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.

AIB can also accommodate a variety of special conditions such as *wakalah* or some administrative restrictions on the use of the asset. This gives more amenability and manageability to the AIBs.

These bonds are also flexible from the point of view of their response to different kinds of financing needs. These can be used for financing such mute infrastructure projects that do not generate returns. These bonds can also be used for financing income generating projects such as electricity generation or communications. Additionally, they can also be used to finance government administrative services as a substitute of acquiring the services producing assets such as government administrative buildings and equipment. AIBs offer clean and out-of-the-balance-sheet form of financing, that allows the assets' users to expand their activities, without putting excess pressure on their balance sheets, i.e., by devoting all their financial resources to the operation of their activities.

5. The AIBs, by their amenability to a variety of legal conditions generate multiple forms of bonds, thus making these suitable tools for financing investment through financial markets.

Additionally, leases may be bundled together by an Islamic financial intermediary and transformed into new securities, to be utilized for mobilization of funds.

## 5. ECONOMICS OF ASSETS IJARA BONDS

It is difficult to discuss the economics of all forms of *ijara* bonds at once. Therefore, we will select three extreme cases of *ijara* bonds and discuss their economics in comparison with other securities that may be available in the market.

Imagine a one-rent payment AIB for which the investors put 1000 Dinars to buy the bond, that entitles them to ownership of 1000th of one-million-Dinar asset, and to a one time payment rent of 900 Dinars due at the end of a ten year lease<sup>12</sup>.

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<sup>12</sup> The example of this form of AIBs is formulated so that the bond fulfills the requirements of the OIC *Fiqh* Academy, that for sale of a group of assets consisting of real assets and

Assume also that the asset is permanent such as a plot of land for construction.

This bond is comparable to a zero-coupon bond, assuming that prices of land and its rentability are constant<sup>13</sup>. The market price of this form of *ijara* bond depends on current and expected rates of return on financial assets. Let us take the rate of interest, in a society that has both Islamic instruments as well as interest-bearing instruments and interest based transactions. Under these assumptions, the price of the AIB will be:

$$\frac{1000 + 9}{(1 - i)^n} \text{Error! Switch argument not specified.}$$

(*i* = interest rate, and *n* = number of years to maturity), i.e., like a zero coupon bond, the price of this form of AIB is the total of the asset's price plus the amount of the rental debt discounted by the interest rate for the remaining period of the lease until the due date of the rental payment.

The second form considered here is an AIB in which asset is permanent, while the payment of the rent is periodical. At the end of every year, a rental payment is due. Assume also an *ijara* contract that is continuously renewable. This form of bond is similar to a long term treasury bond, assuming that the prices of the assets are constant, that provides a periodical return while preserving the cash value of the treasury bond fixed.

The essential difference between this AIB and a common stock is that stocks have variable return that depend on the economic activity, performance and productivity of a particular firm, in addition to the general economic conditions in the country and outside, while an AIB has a pre-determined and fixed return in relation to the face value of the bond. However, both AIBs and common stocks represent real assets that are usually affected by market pricing and market forces. In other words, while this form of AIB represents a share in one, known and existing real asset, the common stocks represent shares in ownership of a firm that embodies its potential, management, history and anticipated future.

On the other hand, this form of AIBs differ from treasury bonds due to the fact that the former represents a real asset that is subject to market pricing (although we assume it constant for simplicity and comparison, keeping in mind that this assumption is not sustainable in real markets), and the latter represents pure debt on the government. Consequently, this form of AIB is affected by both financial and real market factors, i.e., by the market pricing of the assets involved, as well as by the return of financial assets (which is used as a deflator in determining the market

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debts at a price different from the face value, the majority should be real assets.

<sup>13</sup> Such as a land tied to a long term *Ijara* whose rent is payable every ten years.

price of both the treasury bond and AIBs).

The third form of AIB represents situations where the leased asset loses its value at the end of the lease period, because of its nature or the legalities mentioned earlier. This form of AIB is similar to an installment sale in which the seller (bondholder) receives back equal installments or annuities for a given number of years in return for the present value that equals the current investment made by the seller for purchasing (or rented by the bondholder) the asset. However, while ownership of the asset in installment sale is transferred to the buyer, it remains in the hands of the AIB holders until the payment of the last installment.

### 5.1 AIBs and *Sanadat al Muqaradah*

In the form that is approved by the OIC Islamic *Fiqh* Academy in its Fourth Annual Meeting of 1408H<sup>14</sup>, *sanadat al muqaradah* are, in fact, common stocks, however, not having a voting right. Thus the owner of *sanadat al muqaradah* is an owner of a share in the company and is affected by its activity and potentials of the firm, as well as the general economic conditions.

On the other hand, the owner of an AIB has a limited contractual relationship with the user of the assets, that entitles him to the periodical rent, and the asset at the end of the lease, being the owner of the leased asset. Therefore, the latter's income is not affected by the purpose for which the company or the users obtains the assets. This implies that AIBs are much less riskier than *sanadat al muqaradah*.

Additionally, while the proceeds of the sale of *sanadat al muqaradah* represent an item in the assets side of the company's balance sheet (the *sanadat* are an item of its equity), the proceeds of the sale of AIB remain on the balance sheet of bondholders only and do not affect either side of balance sheet of the users. Furthermore, the return of *sanadat al muqaradah* is unpredictable and may be unstable, while the return of AIB entails a high degree of stability and predictability because it is predetermined.<sup>15</sup>

## 6. USE OF ASSETS IJARA BONDS IN OPEN MARKET OPERATIONS

The *ijara* bonds are more amenable to be used in open market operations by an Islamic central bank as compared to both common stocks and *sanadat al muqaradah*. An Islamic central bank does not use debt-based bonds for its open

<sup>14</sup> Decision No.5 of the OIC Islamic *Fiqh* Academy for the year 1408H. See the *Journal of the OIC Islamic Fiqh Academy*, Vol. 4, No. 3, pp. 2161- 2165.

<sup>15</sup> Except for a small part of the owner's cost which is the unpredictable and uninsurable maintenance expenses.

market operations, simply because either such bonds do not exist in the Islamic economy, or are not subject to market pricing. This amenability arises from the characteristics mentioned earlier, specially the predictability of return and the sensitivity of bond prices to the prevailing rate of return in the financial market. On the other hand, common stocks and *sanadat al muqaradah* embody a performance risk of the concerned companies, and therefore, have commercial risk in addition to the financial risk.

This makes AIBs, specially those issued by the government and carefully formulated in a way that minimizes the effect of assets' price and maintenance cost on the market price of the bonds, a superior instrument for open market operations by the Islamic central bank. In addition, *ijara* bonds issued against assets leased to the government (central and local) are an Islamic economy's perfect substitute for the prohibited treasury bonds.



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