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SHARIYAH
REVIEW BUREAU

CAPITAL GOODS FINANCE:

Unlocking intelligent value with Ijara

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SHARIA ADVISOR LICENSED BY
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What is Capital Goods Financing?

Capital goods financing (CGF) is a type of financing used by businesses to obtain capital goods needed to grow their business. CGF involves paying a regular charge for the use of an asset over an agreed period of time, thus avoiding the full cost of buying the asset outright. CGF falls under asset financing. It is likely that when small businesses are starting up or expanding, investment is required into a number of assets.

These investments can put a strain on a company, however asset finance can help raise the necessary capital for a large one-off payment through a number of different options such as leasing, short-term finance, turnaround finance, asset refinance and more. Thus, asset finance is a broad category that refers to funding assets over an agreed period of time, in return for regular payments. Some key benefits include spreading the cost of investment, reducing demands on valuable capital and reducing the cash flow impact of purchasing outright.

Asset finance can be used in a surprisingly wide range of applications. Most typically we find businesses wanting to fund things such as vehicles, construction equipment or IT kit. But there are many examples of less mainstream uses such as medical equipment, furniture, and mobile classrooms[1]. The industry tends to refer to assets as 'hard' or 'soft'. Traditionally, the market was focused on hard assets, i.e. durable physical equipment, which tend to be machinery or 'things with wheels'.

Some examples of hard assets are:

- Buses
- Trucks
- Materials handling equipment
- Printing presses
- Cars
- Tractors
- Manufacturing equipment

Today, asset financing is also available on what are known as 'soft assets' which are items with a low intrinsic open market resale value. Unlike the 'hard assets' mentioned above where the funder has some security in the physical asset, these are generally viewed as unsecured and so the credit profile of the organisation will take greater importance.

Examples of soft assets are:

- IT & communications equipment
- Security systems
- Catering equipment
- Vending machines
- Software
- Gym equipment

1 https://maxxia.co.uk/blog/asset-finance-explained/

Benefits of CGF

1. Securing the use of assets

Purchasing assets outright can be expensive, risky, and can hold a company back from expansion. CGF provides a viable option to acquire the assets without excessive expenditures. With CGF, both the lenders (banks and financial institutions) and the borrowers (businesses) benefit from the structure. Asset financing is safer for lenders than lending a traditional loan.

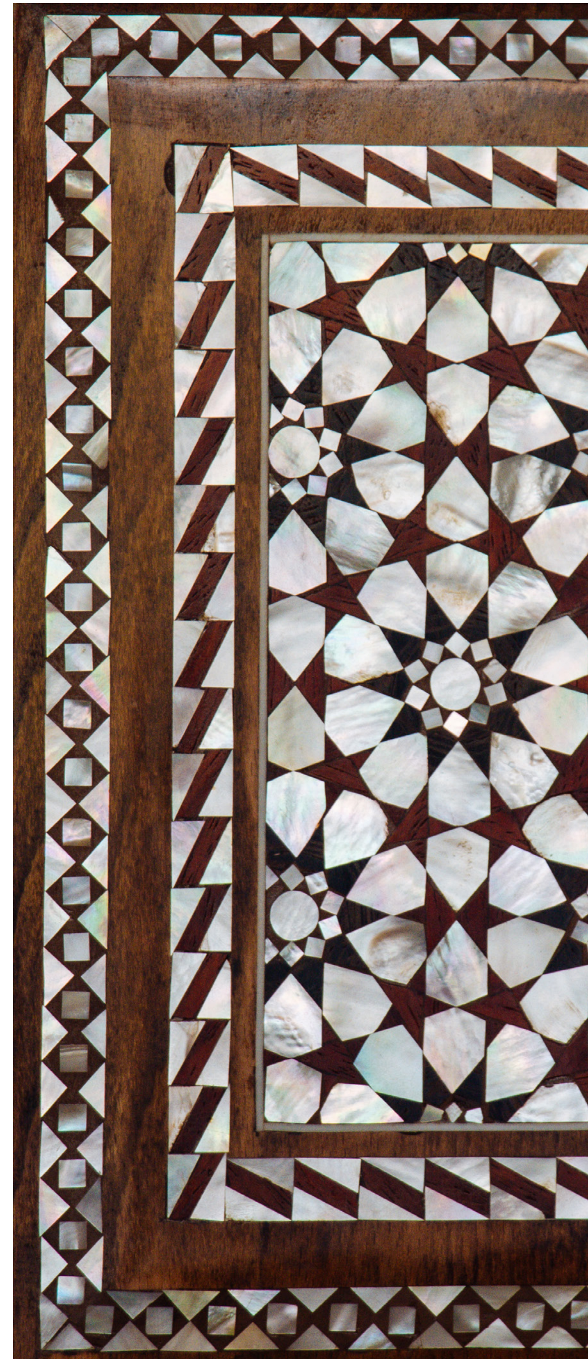
A traditional loan requires the lending of a large sum of funds that a bank hopes they will get back. When the bank lends assets out, they know they will be able to at least recover the value of the asset's worth. In addition, if borrowers fail to make payments, the assets can be seized by the lender.

2. Securing a loan through assets

CGF also involves a business looking to secure a loan by using the assets from their balance sheet pledged as collateral. Companies will use CGF in place of traditional financing because the lending is determined by the value of the assets rather than the creditworthiness of a company.

If the company were to default on their loans, their assets would be seized. Assets pledged against such loans can include property, plant and equipment, inventory, accounts receivable, and short-term investments.

CGF is commonly used for short-term funding needs to increase cash and working capital. The funds will be put towards a number of items, such as employee wages, payments to suppliers, and other short-term needs. The loans are typically easier and faster to obtain, which makes it attractive to all companies. With fewer covenants and restraints, they are more flexible to use. The loans are usually accompanied by a fixed interest rate, which helps the company with managing its budgets and cash flow.



The Different Types of CGF

There are several types of CGFs:

1. Hire Purchase (or lease purchase)

Hire Purchase (HP) is one of the common CGF products. In this structure, the Hire Purchase provider retains ownership of the asset to be leased over the term of the agreement and leases it to the business for agreed regular fixed payments. Businesses may make a larger initial payment followed by smaller payments on an agreed schedule. At the end of the agreed period, the business can choose to buy ownership of the item with a further payment[2].

Hire Purchase allows the customer to benefit from the immediate use of an asset over an agreed term, while repaying the cost in installments. During the life of the agreement the full value of the asset appears on the customer's balance sheet. The asset on HP is shown as if it was purchased i.e. the cost of the asset goes on the balance sheet and it is depreciated. An element of the rental is treated as a business expense and passed through the profit and loss account. The finance charge is normally an allowable tax deduction. The hire purchase amount due is shown as a liability on the balance sheet, which is reduced by the HP payments (excluding the interest element). Ownership is maintained by the financier until the final payment is made and at the end of the agreement, the business can choose to keep the asset or return it[3].

2 Woollsey, N. (n.d.), A simple guide to asset finance
3 https://www.whiteoakuk.com/blog/4-types-of-asset-finance

2. Finance lease (or capital lease)

A finance lease (also known as a capital lease or a sales lease) is a type of lease in which a finance company is typically the legal owner of the asset for the duration of the lease, while the lessee not only has operating control over the asset, but also some share of the economic risks and returns from the change in the valuation of the underlying asset.

A finance lease is mainly a method of raising long-term finance to pay for assets. It provides the lessor with full recovery of its investment and a reasonable profit over the initial binding lease term. In this type of lease, the lessor retains ownership of the equipment, but transfers to the lessee substantially all of the risks and rewards of ownership of the asset. The lessee is responsible for the insurance, registration and maintenance of the equipment. To summarise, the commercial arrangements are as follows:

- the lessee (customer or borrower) will select an asset (equipment, software);
- the lessor (finance company) will purchase that asset;
- the lessee will have use of that asset during the lease;
- the lessee will pay a series of rentals or installments for the use of that asset;
- the lessor will recover a large part or all of the cost of the asset plus earn interest from the rentals paid by the lessee;
- the lessee has the option to acquire ownership of the asset (e.g. paying the last rental, or bargain option purchase price);

A finance lease has similar financial characteristics to hire purchase agreements. The usual outcome is that the lessee will become the owner of the asset at the end of the lease, but has different accounting treatments and tax implications.

Since a finance lease is capitalized, both assets and liabilities in the balance sheet increase. As a consequence, working capital stays the same, but the debt/equity ratio increases, creating additional leverage[1]. Finance lease expenses are allocated between interest expense and principal value much like a bond or loan; therefore, in a statement of cash flows, part of the lease payments are reported under operating cash flow and part under financing cash flow. Therefore, operating cash flow increases. Under operating lease conditions, lease obligations are not recognized; therefore, leverage ratios are understated and ratios of return (ROE and ROA) are overstated.

1 The key IFRS criterion is: If "substantially all the risks and rewards" of ownership are transferred to the lessee then it is a finance lease. If it is not a finance lease then it is an operating lease. The transfer of risk to the lessee may be shown by lease terms such as an option for the lessee to buy the asset at a low price (typically the residual value) at the end of the lease. The nature of the asset (whether it is likely to be used by anyone other than the lessee), the length of the lease term (whether it covers most of the useful life of the asset), and the present value of lease payments (whether they cover the cost of the asset) may also be factors.

3. Equipment Leasing

Equipment leasing is very similar to finance leasing, in that the provider buys the equipment required and the provider then rents this for a regular fixed fee over an agreed period. Once that period ends, the business can choose to extend the lease, upgrade the item, buy it at an agreed sum or simply return it to the provider.

Unlike hire purchase, maintenance and servicing costs for equipment leasing are down to the provider, meaning that the business doesn't need to worry about this element. As an operating cost, equipment leasing can be offset against gross profit as usual.

4. Operating Leasing

Operating leasing is very similar to equipment leasing but tends to be used for specialist equipment or machinery that the business may not want to use for the full duration of the useful life of the asset or has no interest in buying permanently.

Operating leasing is basically renting an item over a short or medium term, with rental costs based on the length of time the asset is required. This type of financing is often cheaper than equipment leasing as the business only pays for the calculated value of the item over the limited lease time agreed[4]. This facility is suitable if the borrower will not need the equipment for its entire working life. Payments appear on the profit and loss account and as the asset is only kept for a defined period, the value of the asset and corresponding finance liability does not appear on the balance sheet. The finance company will take the asset back at the end of the agreement[5].

The basic features that differentiate an operating lease from a financial lease are related to whether the lessor or the lessee takes on the risk of ownership of the leased assets. In fact operating leases do not put the lessee in the position of a virtual owner, the lessee is simply using the asset for an agreed period. There is always dependence on the lessee's commitment to pay and as a result, what the lessor takes is asset-based. In contrast to a financial lease, the rate- of- return in an operating lease is dependent upon the asset value, performance, or costs relating to the asset and is always a matter of probabilities and uncertainty.

4 Woollsey, N. (n.d.), A simple guide to asset finance
5 https://www.whiteoakuk.com/blog/4-types-of-asset-finance

The Shariah non-compliant risks in conventional CGF

Conventional Capital Goods Financing bears the following Shariah non-compliance risks:

1. Contract combination

It is common practice in conventional financing that multiple obligations are executed and entered into through one agreement connecting all obligations. Any arrangement whereby the hire and purchase are combined or obliged in one contract is not Shariah compliant.

The AAOIFI Shariah Standards state:

It is permissible in Shari'ah to combine more than one contract in one set, without imposing one contract as a condition in the other, and provided that each contract is permissible on its own. Combining contracts in this manner is acceptable unless it encounters a Shari'ah restriction that entails its prohibition on exceptional basis.

This is based on the following prophetic narrations:

Abd Allah bin `Amr narrated "The Messenger of Allah said: "The provision of a loan combined with a sale is not permitted, nor are two conditions relating to one transaction, nor the profit arising from something which is not in one's charge, nor selling what is not in your possession." (al-Tirmidhi)

Ibn Mas`ud narrated "The Messenger of Allah forbade two sales in one sale". (Musnad Ahmad)

However, giving an option to purchase in the same agreement and not an obligation is acceptable. This would technically mean that the sale would be executed as a result of another contract and transaction.

2. Transfer of all risks to lessee

One of the major concerns with conventional asset financing is the transfer of all risks to the lessee. For the Shariah compliance of any asset-based financing based on Ijarah or lease, the lessor – as owner – must bear the risk and liability of structural maintenance.

The AAOIFI Shariah Standard on Ijarah states:

"The lessor may not stipulate that the lessee will undertake the major maintenance of the asset that is required to keep it in the condition necessary to provide the contractual benefits under the lease. The lessor may delegate to the lessee the task of carrying out such maintenance at the lessor's cost. The lessee should carry out operating or periodical (ordinary) maintenance."

3. Full rental liability in all scenarios

At times, conventional asset financing makes the customer liable for rental payment in all scenarios, even when the asset is destroyed without their fault or negligence. The AAOIFI Shariah Standards state:

"In case of total destruction of the leased asset, the Ijarah contract is terminated if it is concluded on an identified asset. In such a case, it may not be stipulated that the rest of the installments should be paid.

The leased asset in the possession of the lessee is held by the lessee in a fiduciary capacity on behalf of the lessor. The lessee will not be held liable for any damage or destruction of the leased asset unless such damage or destruction is a result of misconduct or negligence on the part of the lessee. In this case, he is obliged to replace the asset if it is replaceable; otherwise, he is liable for the amount of the damage to be determined by valuation."

4. Late payment treatment

Conventional asset financing products generally have late payment fees upon default. It is not permissible to profit or commercialise default in this manner. The AAOIFI Shariah Standards state:

"No increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee."

It is permissible that the lessee undertakes to pay a late payment fee to cover actual expenses incurred in the default, with the residual amount being donated to charity.

Shariah Compliant Capital Goods Financing

One of the most popular Shariah products for CGF is Ijarah wal-Iqtina' (lease and acquisition). This is structured using a couple of independent contracts. The Shariah structure is similar to conventional HPs and financial leases, albeit with a few differences. Ijarah wal-Iqtina' is primarily developed using Ijarah (leasing). Ijarah is almost identical to an operating lease which involves the owner of the asset transferring the *manfa'ah* (usufruct) of the asset to another person to use for an agreed period and for an agreed rent. The ownership of the leased equipment remains in the hand of the lessor. To understand Ijarah wal-Iqtina', it is a requirement to understand Ijarah.

Cornerstones of Ijarah

Besides the conditions of sanity, adolescence, freedom and mutual consent of the contracting parties, the following conditions must be met for an Ijarah contract to be valid:

1. The goods rented should be present and capable of being handed over to the lessor after the completion of the contract of hire;

2. The usufruct of the goods or services being hired should have sufficient economic value in substance at the time of entering into the equipment lease. If the object does not have economic value, then the rent can only be required once the object has economic value. In other words, the progress payment structure may not be available. Further, rent cannot be collected until the equipment is in the lessee's possession. At times, a variant of Ijarah called *Ijarah Mawsufah Fil Dhimma* is used to collect early rent.

3. The rent must be fixed during the entire lease term; any change in the rent would require entering into a new lease. There is no prohibition against raising or lowering the rent, but any such increase or decrease must be specifically set out under the terms of a new lease. According to the jurists, rent will be due when the following conditions are met:

   a. Complete acquisition or attainment of the usufruct of the hired goods/capital equipment; or

   b. Ability of the lessee to use the usufruct of the hired goods (even though the lessee may opt not to utilize it);

The actual term of the lease must be set out in the agreement.

1. The usufruct of the hired article must be specified. Specification of the usufruct takes place through:

   a. The period of the use of usufruct;
   b. The purpose of the hired goods;
   c. Rent (its nature and amount);

2. The article being hired should be physically fit for hire;

3. The lessor should hand the hired article over to the lessee in its complete form and shape;

4. The lessor must have full possession and ownership of the article he is hiring out;

5. The Existence of the hired article should continue throughout the contract period;

6. The benefit for an Ijarah must be lawful according to the Shariah[6].

Benefits of Ijarah

Ijarah financing has the following benefits:

- Ijarah conserves the Lessee' capital since it allows up to 100% financing.

- Ijarah gives the Lessee the right to access the equipment on payment of the first installment. This is important as it is the access and use (and not ownership) of equipment that generates income. (Ijarah is a form of asset finance, which has the benefit of using assets without the requirements of ownership. The lessee acquires the asset he needs without borrowing on interest and receives the benefits of use while the lessor receives the value of regular rental payments for a specified period plus the residual value of the asset.

6 The Law and Practice of Islamic Banking and Finance by Dr. Nik Norzrul Thani; Mohamed Ridza Mohamed Abdullah; and Megat Hizaini Hassan. (2003)

- Ijarah arrangements aid corporate planning and budgeting by allowing the negotiation of flexible terms.

- Ijarah is not considered debt financing so it does not appear on the Lessee' Balance Sheet as a liability. This method of "off-balance-sheet" financing means that it is not included in the debt ratios used to determine financing limits. This allows the Lessee to enter into other lease financing arrangements without impacting their overall debt rating.

- All payments towards Ijarah contracts are treated as operating expenses and are therefore, fully tax-deductible. Leasing thus offers tax-advantages to for-profit operations.

- Many types of equipment (i.e. computers) become obsolete before the end of their actual economic life. Ijarah contracts allow the transfer of risk from the Lessee to the Lessor in exchange for a higher lease rate. This higher rate can be viewed as insurance against obsolescence.

- If the equipment is used for a relatively short period of time, it may be more profitable to lease than to buy.

- If the equipment is used for a long period, but has a very poor resale value, leasing avoids having to account for and depreciate the equipment under normal accounting principles.

Ijarah wal-Iqtina' (lease and acquisition)

This structure has several names such as: Ijarah wal-Iqtina' (lease and acquisition), Ijarah thummal Bay' (Ijarah thereafter Sale), Ijarah al-Mutanahia bitamleek (Ijarah ending with transfer of ownership).

This structure works by parties entering into contracts that come serially into effect with the purpose of conducting a lease/sale transaction. The first contract is an Ijarah that outlines the terms for leasing over a fixed period. Upon expiry of the leasing period, the lessee enters into a second contract to acquire the goods from the lessor. The method of transferring title in the leased asset from the lessor to the lessee must be evidenced in a document separate from the Ijarah contract document using one of the following methods:

- By means of a promise to sell for a token or other consideration or by accelerating the payment of the remaining amount of rental or by paying the market value of the leased property;

- A promise to give it as a gift (for no consideration) or in other words as a Hibah; or

- A promise to give it as a gift, contingent upon the payment of the remaining installments.

The separate document evidencing transfer of title cannot be taken as an integral part of the Ijarah contract. A master agreement may be drawn up covering a number of Ijarah transactions between the bank and the customer and setting out the general terms and conditions of agreement between the two parties. In this case, there may either be a separate lease contract for each transaction in a specific written document signed by the two parties or alternatively, the two parties may exchange notices of offer and acceptance by referring to the terms and conditions in the master agreement.

During the lease period of the Ijarah wal-Iqtina', the lessor's investment in the asset can be amortized while the lessee's equity can be protected by the ability to call for title to be transferred from the lessor to the lessee at anytime during the lease term upon payment of a purchase price amount.

Also, if the price of the asset is paid to the lessee instead of the supplier, there must be an agency (Wakalah) agreement between the parties prior to the lease agreement that gives authority to the lessee to purchase the asset on behalf of the bank. If the asset is destroyed before its delivery to the lessee in useable form, the loss will be that of the Islamic bank and not of the agent. Therefore, the risk of the asset will be that of the bank, as long as the client serves as its agent for purchase of the asset while in a conventional lease all risks are borne by the lessee[7].

7 https://www.lexology.com/library/detail.aspx?g=be7a48b3-566d-46c6-9641-bb537d2879b0

Ijarah wal-Iqtina’ Structure

A typical Ijarah wal-Iqtina’ structure involves the following flow:

1. The customer approaches the Islamic bank to finance under Ijarah wal-Iqtina’.

2. There is a sale undertaking and purchase undertaking to ensure the lessee purchases the asset at the end of the term.

3. The Lessor appoints the Lessee to purchase the asset via an investment agency agreement.

4. The Lessor takes title to the asset and leases it to the Lessee.

5. The Lessee enters into a Service Agency Agreement to carry out any of the tasks required by the owner.

6. The Lessee pays lease to the Lessor.

7. At the end of the term, the Lessor sells the asset to the Lessee in an independent contract.

   Numerous Islamic banks offer Ijarah wal-Iqtina’ in this manner. They usually have the following two structures:

   i. A lease contract with a promise to grant (Hiba) the asset to the lessee after paying all the rental installments whereby the grant must be in a separate contact.

   ii. A lease contract with a promise to sell asset to the lessee in exchange of a nominal or actual price at the end of the lease period after paying all the rental installments agreed upon.

Conclusion

Conventional capital goods financing involves various structures and financing products. Whilst some are clearly interest-bearing loans, others involve hire purchase contracts. Many such conventional financial leases, hire-purchase agreements have Shariah non-compliance risks such as contract combinations, late payment fees, transfer of all risks to lessee.

The Shariah compliant structure for capital goods financing is through Ijarah wal-Iqtina'. This structure involves two separate agreements; initially, the financier and the customer will enter into a lease, and upon maturity, the financier either gifts the capital goods or sells the capital goods to the customer.

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Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyze, comment and build upon the arguments expressed.

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