

## ***Sukuk Ijarah: To What Extent They Comply or Contradict the Ijarah Contract and Bay' Inah?***

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### **ABSTRACT**

The purpose of this paper is to identify and compare the characteristics and rulings of Ijarah contract, the contract of *'inah* and *sukuk ijarah*. The identification of their characteristics and rulings is a necessity to determine whether these contracts are similar to, or different from one another, and the extent of their compliance with the shariah. Furthermore, if the characteristics of these contracts could be ascertained, the rulings could be extended to the actual contracts in practice. This study analyses the characteristics and rulings of ijarah and *'inah* contracts based on views of Hanafis, Malikis, Shafi'is and Hanbalis. The findings are then compared with the characteristics of *sukuk ijarah* as standardized by AAOIFI. The analysis is also focused on the terms and conditions of SenaiDesaru Express Berhad (SDEB) as an example of *sukuk ijarah* practice. The result suggests that *sukuk ijarah* as defined by AAOIFI has some differences from the original ijarah contract. *Sukuk ijarah* also has a few characteristics of ijarah contract. To certain extent, *Sukuk ijarah* has similarities with the *'inah* contract. This study suggests that the terms represented in a particular contract may not truly represent the real characteristics of an original shariah contract. A particular contract may contain characteristics belong to different form of contracts. It may even be undesirably similar to the characteristics of the controversial contract of *'inah*.

*Keywords: Bay' inah, contract, ijarah, sukuk*

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### **INTRODUCTION**

Malaysia International Islamic Financial Centre (MIFC) has recently observed that *sukuk* has experienced tremendous development with an average of 40% annual growth rate. Although the report showed a

decline in 2008 due to the market turmoil, *sukuk* prospects has since remained strong. Malaysia has been recognized as a leading nation in the issuance and origination of *sukuk* in global market, representing 61% of total global *sukuk* by the end of 2008 (MIFC 2012). The total global *sukuk* issuance has increased from just US\$1 billion at the end of 2001 to US\$136 billion as of 30<sup>th</sup> of June 2009, a compounded annual average growth rate or CAGR of 88% (IIFM, 2011). Although the *sukuk* structure is claimed to be in accordance with the Islamic contractual rules and principles such as *musharakah*, *ijarah*, *mudarabah*, *istisna* and *salam*, these have been criticized as not in full compliance with the *Shari'ah* (Islamic law). Other critics have claimed that the *sukuk* structure is actually similar to the substance of other controversial contracts, the *bay' inah*. To what extent this assertion is true? This paper shall highlight these issues in one of the types of *sukuk* that is *ijarah sukuk*. The characteristics of *ijarah sukuk* as standardized by AAOIFI will first be clarified. Then, the *ijarah* contract as deliberated by traditional Muslim jurists will be analysed. Subsequently, this paper shall further discuss the rulings and juristic opinions on *bay' inah*. Henceforth, analysis shall be made on the terms and conditions of Senai Desaru Express Sdn Bhd (SDEB) which is claimed to be based on *ijarah* contract. The collective analyses shall clarify the characteristics of these contracts and the extent of compliance or contradiction with the characteristic of *ijarah* contract as pronounced by the traditional jurists.

## **SUKUK IJARAH AND IJARAH CONTRACT: AN ANALYSIS**

Generally, AAOIFI Shariah Standards define *sukuk* as:

*“...certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity.”*

Furthermore, *ijarahsukuk* is defined as:

*“Certificates of equal value, issued by the owner of a leased asset, or a tangible asset to be leased by promise, or issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets.” (AAOIFI Shariah Standard 2010)*

These definitions suggest that *ijarah sukuk* represent the *sukuk* holders' prospective ownership over the assets, hence raising the issues whether these definitions comply with the *ijarah* contract according to classical jurists' exposition.

The *ijarah sukuk* are claimed to be structured based on the Islamic contract of *ijarah*. Henceforth the characteristics and elements of *ijarah* shall be discussed. Majority of jurists agree that an *ijarah*

contract involves the exchange of the usufruct with remuneration (Afandi, 2003; Al-Zuhayli, 2002a; Al-Sharbini, 1997; Al-Bahuti, 1997). The offer and acceptance should use the term of *ijarah* or *kira'* which represents the intention to rent the property. Al-Bahuti (1997) asserts that the [*ijarah*] contract should be based on the corpus because it is the subject matter and originator of the usufruct. The contract can use the term 'sale' but it should be associated with the term '*naf'*' or usufruct. In this case the seller can say 'I sold you the usufruct of this house' (Bahuti, 1997).

However, some Shafi'is and Hanafis jurists postulate that *ijarah* contract cannot be concluded with the term 'sale' (Al-Shirbini, 1997; Al-Shirazi, 1996; Al-Mawsili). The reason is that the usufruct is associated with the term '*ijarah*' (Al-Shirbini, 1997; Al-Shirazi, 1996; Al-Mawsili). The term *ijarah* is viewed as contradicting the term 'sale' because the latter shows the possession of the corpus of the property. While, *ijarah* is the possession of the usufruct which is not yet exist.(Al-Shirbini, 1997; Al-Shirazi, 1996; Al-Mawsili). Moreover, the subject matter of sale must exist at the time of concluding the contract. However, the usufruct is an abstract term denoting the utilization of the property usufruct in the future even if its existence is subject to the existence of the corpus. Therefore, the strong view of the said jurists agree with the use of the term '*ajjartukamanfa'ah*' or 'I rent you the usufruct [of this house]' in order to constitute a valid *ijarah* contract (Al-Shirbini, 1997; Al-Shirazi, 1996).

The majority of jurists agree with the conditions that the contract must be with the purpose of exchange and that the amount of rent should be defined (Al-Shirazi, 1996; Al-Qarafi, 1994; Al-Bahuti, 1997; Al-Shirbini, 1997; Al-Quduri, 1997). Therefore, it is not permissible if the contract is agreed without stating the exchange value (Al-Shirazi, 1996; Al-Qarafi, 1994). This condition is supported by the *hadith* reported by Sa'id al-Khudri.a. that the Prophet said: '*whoever hires or rents, he must know the rental amount.*' (Al-Shirazi, 1996) This *hadith* is classified as a valid *hadith*, but an exception is as stated by Khudri, that it is *Sahihmawquf*<sup>1</sup>(Al-Zayla'i, undated). However, according to Kamali it can be a 'valid proof and basis of judgment' (Kamali, 2005)

The usufruct must be known in terms of the substance, the proportion as well as the duration of the lease (Al-Shirazi, 1996; Al-Qarafi, 1994; Al-Shirbini, 1997; Al-Bahuti, 1997; Al-Sarakhsi). According to some scholars, those terms are similar to that of a sale contract. The rationale is that selling of usufruct is similar to sale contract It can be governed by the rules of sale contract. Therefore, the contract is not valid unless all the specifications stated above are known (Al-Shirazi, 1996; Al-Qarafi, 1994). For example, Al-Mawsili states that duration of house rent should be stated (Al-Mawsili, undated). Otherwise, the rental will only be covered for the first month and the rest will no longer be considered valid (Al-Mawsili, undated). The property from which the usufruct is derived also should be defined

(Al-Shirazi, 1996). The activities of a rented land should be specified, such as the lease of the land for agriculture. However, if someone rents a house, it is not a condition to specify the type of activities to be done in the house (Al-Quduri, 1997). Among other conditions are, the usufruct must be: a property of value, permissible (Al-Qarafi, 1994), not perishable by use (IbnQudamah, 1997) and validly possessed by the owner (Al-Qarafi, 1994). The payment is for the usufruct and not for the corpus of the asset (Al-Qarafi, 1994). It must also be capable of delivery to the buyer (Al-Qarafi, 1994).

#### **BAY' 'INAH IN ISLAMIC LEGAL TREATIES**

According to Al-Hattab, "*Al-'Inah* with *kasrah* under '*ain* is the act from '*aun* (help), because the seller intends to help the buyer in securing what he wants or intends" (Al-Hattab, undated). Imam Malik termed this transaction as *bay' bi'aynihi* as he stated: "One man sells a man a slave for an amount of 100 dinar with deferred price. Then he buys the slave back with an instant price less than the price that he sold. "This is not right" (Al-Hattab, undated). In other words, *Bay' al-'inah* is the selling of something for a deferred price, then the sold item is bought from the buyer with a lesser price; and the payment is made on the spot (IbnQudamah 1997, p.40). In general, it refers to the advancement in the acceptance of the subject matter of contract but payment is deferred (Al-Matruk, 1992).

Jurists differ in their opinions regarding this type of sale. The majority of jurists from

the Hanafi, Hanbali and Maliki schools do not allow '*inah* sale because of the suspicion that this transaction involves an element of usury (*riba*) and uses a *hilah* (trick) to hide it (Al-Zayla'i; IbnTaymiyyah, 2005; Abadi, 1969; IbnRushd, 1986; Al-Bahuti; IbnQudamah, 1997; SC; BNM, 2007). Therefore, if the intention is to get liquidity, but the apparent form is sale, they described this contract as fictitious. Hence not permissible. According to them, this sale is a way (*zari'ah*) or a legal trick (*hilah*) to legitimize *riba* (Al-Zayla'i; IbnTaymiyyah, 2005; Abadi, 1969; IbnRushd, 1986; Al-Bahuti; IbnQudamah, 1997). They base their argument on the case of Zayd ibn Arqam with 'A'isha (mAbpwh):

*"Al'Aliyabinti 'Ayfa' said: the wife of Zayd, the mother of his child and I visited 'A'isha, then the mother of his child said: 'I sold a slave to ZaydibnArqam in exchange for 800 dirhams deferred, then I bought him back for 600 dirhams in cash", 'A'isha said: "Woe to what you sold and what you bought, tell Zayd that he has voided his fighting with the Prophet (pbuh) unless he repents." (Al-Shafi'i, 2001; Al-Zuhayli)*

Al-Shafi'i, as proponent of the sale '*inah*, criticised this hadith as not being confirmed (*thabit*) from 'A'isha (Al-Shafi'i, 2001; Al-Zuhayli). He further commented that "even if it is true that this hadith emanates from 'A'isha, she actually criticised the selling of the slave without

knowing the duration to pay the deferred payment (Al-Shafi'i, 2001; Al-Zuhayli). This is the reason why this transaction is not valid." (Al-Shafi'i, 2001; Al-Zuhayli). Imam Shafi'i further argued that this hadith showed the divided opinions among the companions on this matter, hence this matter is open for ijtihad. (Al-Shafi'i 2001; Al-Zuhayli). Besides, Shafi'is, the Zahiris also support the permissibility of *'inah* sale based on the general permissibility in the Qur'an which states:

*"Allah hath permitted trade and forbidden usury"*

(Al-Baqarah:275)

However, Imam Nawawi highlighted some of Shafi'i jurists' view that this form of transaction can be invalid if the practice has become customary, to the extent that the practice has been understood as the second contract is subject to the first contract (Al-Nawawi, 1991). IbnHumam from Hanafi School argues that the defect (*fasad*) is in the undeserved profit from the sale and buying back. In other words, the profit gained from this kind of transaction is not just (IbnHumam, 2003). Imam Al-Sarakhsi says, the buyer can buy the subject with a lesser price if he or she finds a defect. On the other hand, if there is no defect, then buying the subject back with a lesser price is not allowed because it amounts to unjust profit (IbnHumam, 2003). Those who oppose this transaction also base their ruling on the hadith of the Prophet (IbnTaymiyyah, 2005) which translates as follows,

*"When people are miserly with their dinars and dirhams, trade in 'ina, follows the tails of cows, and desert the striving in the cause of Allah. Allah will send unto them a suffering that he will never lift until they rediscover their religion".*

(Al-Zayla'i; Al-Zuhayli)

Al-Zayla'i points out, that this hadith according to Imam Ahmad is a valid hadith, as it is transmitted through a reliable chain of narrators (Al-Zayla'i, undated). Therefore, this hadith can be a strong justification for the non-permissibility of *'inah* transaction (Al-Zayla'i, undated). Some Hanafi jurists, for example Imam Abu Yusuf, state that *Al-'Inah* is permissible and those who practice this will get the reward (IbnAbidin, undated). However, Imam Muhammad states that this sale is not permissible (IbnAbidin, undated). Other Hanafi writings, which exclude the views of Imam Abu Yusuf, indicate that the most preferable views is that this transaction is not permissible (ShamsiahMohamad, 2007). Similarly, IbnTaymiyyah rules that this contract is not valid (IbnTaymiyyah, 2005). He states that this contract is *riba* based on the views of the companions and the majority jurists (IbnTaymiyyah, 2005). In justifying that this transaction is not permissible, he cites the hadith of Zayd ibn Arqam which has been criticized by Imam Shafi'i as stated above.

Contemporary scholars have divided views on this issue. The Malaysian Shariah Advisory Council accepts this form of

transaction as permissible based on the view of the Shafi'is and Zahiris that "the contract was valued by what is disclosed and one's *niyyah* (intention) was for Allah to judge" (Securities Commission). They also justify the validity of this contract relying on the fulfilment of the elements and conditions of a valid contract (Securities Commission). This form of buying and selling is accepted as primary principles defined under a set of Guidelines as sale with immediate repurchase. The Guidelines state as follows:

*'... a contract which involves the sale and buy back transaction of an asset by a seller. A seller will sell the asset to a buyer on a cash basis. The seller will immediately buy back the same asset on a deferred payment basis at a price that is higher than the cash price. It can also be applied when a seller sells the asset to a buyer on a deferred basis. The seller will later buy back the same asset on cash basis at a price which is lower than the deferred price'.*

(Appendix 1, Guidelines of Islamic Securities 2004)

Other contemporary views regard this contract as not permissible. They base their argument on the economic substance of the contract in view of its structure mimicking a loan with interest. Rosly and Sanusi criticize this structure by describing this practice as amounting to a loan and 'the difference between the two prices' representing interest (Rosly and Sanusi 2001). Usmani, in his

judgment on Riba, criticizes the practice as "to make fun of the original concept." (Usmani, 1999). Chammas also asserts that:

*"A loan in the form of a sale, called inah (façade) because it is a sale in appearance only. This is accomplished by one's buying back what one has sold for a lower price than that for which one originally sold it. The difference, ostensibly profit, is actually a loan".*

(2006, p.ix)

The above arguments suggest that the majority of contemporary scholars agree with the majority of classical jurists' view on the non-permissibility of 'inah. However, some Malaysian scholars take different approach by allowing 'inah for regional transaction due to the need of the people and the market, as evidenced in the structure of *sukuk* discussed in the following.

#### **SUKUK IJARAH IN PRACTICE: A RESEMBLANCE TO CONTROVERSIAL 'INAH**

*Ijarah Sukuk* Senai Desaru Express Berhad (SDEB) are Islamic securities issued as Medium-term Notes (MTNs).<sup>2</sup> These Islamic MTNs consist of Senior Islamic MTNs (Senior IMTNs), with nominal value of up to RM1,890 million pursuant to Senior IMTNs Programme; and Junior IMTNs of up to RM 3,690 million in nominal value pursuant to the Junior IMTN programme. These *sukuk* are issued under the principles of *ijarah* as approved by the *Shari'ah* Advisory Council (SAC) of the SC (SC Shariah Resolution).

These sukuk were issued in 2010 with the purpose to early redeem the BaIDS<sup>3</sup> of up to RM1, 460.0 million in nominal value in full (Private Term and Condition, 2010). The tenure of the facility is different between the senior IMTN Programme and Junior IMTN Programme. The tenure for senior IMTN Programme is twenty and a half years from the date of first issuance of this instrument (PTC). On the other hand, the tenure for Junior IMTN Programme is twenty eight years from the date of first issuance of the Junior IMTNs with the final maturity date not exceeding 30<sup>th</sup> June 2038 (PTC).

In this transaction, the trustee shall purchase the identified asset from the SDEB on behalf of the *sukuk* holders. This is affected by way of 'transfer of the beneficial ownership' of the Identified Assets pursuant to a purchase agreement for a purchase price Private Term and condition (PTC of SDEB). The 'transfer of the beneficial ownership' indicates that the transferee has the right to use the usufruct of the asset. The purchase price will be equivalent to the redemption value of the *Bay' Bithaman Ajil* Islamic Debt Securities (BaIDS) (PTC of SDEB, p.5), which according to Rosly, is made at par value (2005). The trustee as well as the lessor agree to lease the identified assets to SDEB at a pre-determined rental amount. The trustee on behalf of the *sukuk* holders will receive the *ijarah* payment from the lease during the tenure of *ijarah* agreement. In this situation, the lessee or obligor leases his or her own asset within certain period. Subsequently, he or she repossesses the asset 'upon any declaration of an event of

default or upon the occurrence of an early redemption of all the outstanding *sukuk*' (PTC of SDEB).

The trustee uses the *sukuk* payment from the *sukuk* holders to pay the purchase price of the assets (PTC of SDEB). The lessee also pays the rental to the trustee who receives the payment on behalf of the *sukuk* holders. The payment is made during the tenure of *ijarah* agreement. In the event of default or upon the occurrence of an early redemption of all the outstanding *sukuk*, the SDEB as the obligor shall undertake to purchase the trust assets from the *sukuk* holders at the exercise price. The exercise prices in these *sukuk* come in various transactions as mentioned below (PTC of SDEB):

- (i) In the Sale Undertaking upon maturity, the Exercise Price shall be equal to nominal value of RM1 plus the relevant Ownership Expenses to be reimbursed by the *Sukuk* holders to SDEB under the Service Agency Agreement.
- (ii) In relation to a Purchase Undertaking upon occurrence of the Early Redemption, the Exercise Price shall be equal to the Senior IMTNs Accreted Value or Junior IMTNs Accreted Value, as defined under 2(z)(5), whichever applicable plus the relevant Ownership Expenses to be reimbursed by the *Sukuk* holders to SDEB under the service Agency Agreement.
- (iii) In relation to a Purchase Undertaking upon any declaration of an Event of Default, the Exercise Price shall be equal to the Senior IMTNs Accreted

Value or Junior IMTNs Accreted Value, whichever applicable, plus Ownership Expenses to be reimbursed by the *Sukuk* holders to SDEB under the Service Agency Agreement.

These exercise prices, as some scholars opined, do include the element of guaranteeing the capital. In the case of *ijarah*, the charge should not be made at par in view of the promise to purchase at par value will lead to *shari'ah* risk. The value of the property might increase or decrease depending on the types of assets (Yahya, 2008). Therefore, the value should be marked to the market price (Yahya, 2008). Nevertheless, the actual objective is still criticised in view of its structure that suggests 'the turns *sukuk* into instruments that completely resemble interest-bearing bonds in their economic effect.' (Bouheraoua, Sairally & Hasan, 2012). In other words, the *sukuk* instrument, intended to act as an alternative to interest bearing bonds, may not serve this purpose due to the effect of the transaction similar to the one in the conventional instrument. In addition, if the originator's re-purchase value is based on the exercise price as defined previously, this practice suggests high similarity to the transaction of *'inah*. The recent study supports this view and claims that the transaction, 'though may not be explicitly deemed as *riba*, it can be identified as *riba's* little sibling.' (Bouheraoua, Sairally and Hasan, 2012)

## CONCLUSION

Based on the AAOIFI definition, there seems to be certain prevalent contradictions in the *ijarah* contract which relates to ownership over the asset. In practice, *ijarahsukuk* might have some characteristics of *ijarah* contract because the transaction involves the right to use the usufruct of the asset. However, to a certain extent, similarity with *bay' 'inah* is apparent in a situation where a buyer re-leases the asset to the originator, and after a certain period re-sells it to the originator. This practice suggests that the leasee does not utilize the usufruct because the asset at all material time is under the possession of the originator, during the whole of the transaction. Therefore, it is not impossible to question the intention of the parties. Furthermore, the analysis on SDEB *ijarahsukuk* reveals the evidence of contradiction. It calls for the *sukuk* structure to be reviewed to ensure that the name applied represents the substance of the contract. Henceforth, the most important task is to consolidate common Islamic regulatory standards to ascertain that the transaction of *sukukijarah* is fully in compliance with the *Shari'ah* in the future.

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## ENDNOTES

<sup>1</sup> Sahihmawquf hadith is the hadith that has its own strength and can be presumed to have been authorized by the Prophet pbuh – See Kamali, M. (2009) *A Textbook of Hadith Studies* (United Kingdom: The Islamic Foundation) p.159.

<sup>2</sup> “MTNs are debt papers issued on a medium-term basis, with tenures of more than 1 year and redeemable at par on maturity. They may carry fixed or floating rate coupons. Islamic MTNs provide semi-annual dividends depending on the structure used. This type of instrument was introduced to bridge the gap between short-term CPs and long-term corporate bonds. They differ from corporate bonds in that they are sold in relatively small amounts, or either on a continuous or on an intermittent basis. All else being equal, the coupon rate on MTNs will be higher than for other short-term notes, reflective of the longer duration of these papers. This type of debt programme is used by a company to obtain a constant stream of cashflow from its debt issuance. It allows a company to tailor its debt issuance to meet its financing needs, only tapping the market for funds as and when required. MTNs allow a company to register with the SC only once, instead of for every issue with differing maturities.”- BNM & SC (2009) *Malaysian Debt Securities and Sukuk Market: A Guide for Issuers & Investors* (Kuala Lumpur:BNM:SC) p.23; Private Term and Condition of *IjarahSukukSenaiDesaru Expressway Berhad* (SDEB) available at <http://www.sc.com.my/SC/download1.asp?docId=892&docType=PTC> (accessed on 8<sup>th</sup> of May 2011)

<sup>3</sup> This is the outstanding Islamic debt securities issued by SDEB.