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# **ISLAMIC HOUSE FINANCING IN MALAYSIA**

## **CASE STUDY OF LEASING –I LINE IN HSBC AMANAH**

**By**

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### **ABSTRACT**

*This paper attempts to examine the practice of leasing agreement that was conducted in HSBC Amanah Malaysia, whether the process based on Islamic transaction. Leasing – I Line is the product that offers by HSBC Amanah as a ways of Islamic house financing based on Ijarah (Lease). In the practice of Leasing-I Line there is no transfer of ownership and the lease asset remain the bank's property.*

## **CHAPTER I**

### **INTRODUCTION**

#### **1.1. Background**

Islamic financing institutions have experienced and grow significantly in this current time as there is an increase of Muslim's interest in using Shariah-based modes of financing. This rise in demand of Islamic financing among Muslim society is due to the awareness and the overwhelming of feeling guilty under the sins of usury. The existence of the Islamic banking is too meet the financial need of Muslim society who desired in interest free based transaction as Islam prohibited the involvement of usury (riba) in any economic activity.

Nowadays Ijarah is a broad used concept that majority jurists unanimous in the acceptance as one of the Islamic financial instrument as oppose to other instruments such as Bai Bithamanil Ajil (BBA) and the controversial Bai' Eenah. The concept of ijarah itself is a rent with acquisition where the Islamic bank purchases the property at first and become the owner of the property, then the bank lease it out to the customer at an agreed monthly price. A portion of each monthly payment goes towards ownership, until the customer owns 100%.

Owning a house is everyone's dream due to the prominence of its function as one of the basic needs of human life. Various ways have been done to meet this necessity by building their own, purchasing or renting from others. However, the increase of the house price is something unavoidable by the time. From this argument, HSBC Amanah as Islamic financing institutions offers a solution to overcome these problems by proposing a way of house leasing based on Shariah compliant. The

Leasing-I Line is Islamic financial instrument which created by HSBC Amanah under Ijarah (lease).

HSBC Amanah is the global financing institutions that provide Islamic financial services which broadly established in many countries. The presence of HSBC Amanah is to offer the comprehensive financial products that corresponding to the requirement of Shariah. One of its achievements is to receive a reward as the best international Islamic bank by Euromoney magazine in 2010, as one of the prestigious Islamic finance event which held annually. The study will address in the case of Malaysia.

The detail information stated in the agreement such as compensation for late payment or loss of and damage to lease asset will be observed to ensure that no party harmed or no element of fraud in the transaction involved.

## **1.2.Objective of the study**

It is to assure whether Leasing-I Line house financing which practiced by HSBC Amanah is truly relied on the Shariah based and fulfill the requirement of Islamic transaction which eliminate interest and uncertainty as mentioned in the Quran and hadist.

## **1.3.Organization of the study**

The remainder of this study will be organized as follows. Chapter 2, makes literature review and discuss Ijarah and Leasing-I Line financing in HSBC Amanah. Chapter 3, will explore the issue and challenges which elaborate the issue in Shariah compliant contract and the challenges in rectifying current practice. Some concluding remarks and recommendation will be represented in section 4.

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 Definition of Ijarah**

Linguistically, Ijarah comes from Arabic root word ajara, means ‘to rent out’, ‘lease out’. Some say the original word is the noun ujarah, meaning ‘a rental payment’. Technically, it is defined as an exchange contract for transfer of benefit or usufruct in return for compensation. Ijarah is a binding contract and, therefore, it cannot be terminated unilaterally. However, it can be legally terminated if an option to annual is stipulated at the time of the contract or in case of legal excuses.

The definition mention by HSBC Amanah, Ijarah is letting on lease and sale of definite usufruct of any asset in exchange of definite reward. It refers to a contract of land or other asset leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. The arrangement is under the Islamic banks lease equipment, buildings or other facilities to a client, against an agreed rental. The lessee generally also has an option to purchase the leased asset. However, the OIC Islamic Fiqh Academy has recognized ijarah as a Shariah compliant mode of Islamic banking.

Moreover, Muhammad Hashim kamali, mentioned in his paper about A Shariah Analysis of Issues in Islamic Leasing that Ijarah is like sale which involves exchange values on both sides. However, the Shariah Advisory Council of the Securities Commission of Malaysia has noted that financial leasing is not a new contract but an extension of the contract of ijarah and a mechanism that develops the same concept into a mode of financing.

## **2.2 Legitimacy Of Ijarah Contract**

The legality of Ijarah is deduced from the Quran, Sunnah of the prophet Muhammad (SAW) and the consensus of the Muslim jurists (ijma'). Several verses can be quoted as evidence of Ijarah, on of it surah 28: 267. Also the sunnah mention, Abdullah bin Umar narrates: "Allah's apostle gave the land of khaibar to the Jews to work on and cultivate and take half of its yield." Ibnu Umar adde, "the land was used to be rented for a certain portion (of its yield)." Sahih Bukhari.

## **2.3 Features of Ijarah Contract in HSBC Amanah**

Ijarah is a contract that comprises several principal features namely the usufruct and services, asset, ownership and usage rights and liabilities, lease period and rental amount.

### *Illustration: Pertinent Elements of the Agreement*

An HSBC Amanah agreed to provide financing facility to lease an asset to the customer. The facility specified the period, schedule of lease payments and a rental rate for the lease. The customer can decide on the type of asset which the HSBC Amanah will agree and lease using the above facility. Although a leasing facility has been approved, the lease agreement should specify the type of asset as well as the appropriate rental rate.

In this case, pre-determined rental rates should be indicative for the different types of assets as the HSBC Amanah will assume the relevant risk exposures for each type of asset. The lease agreement is then executed between the customer and the HSBC Amanah only when the purpose of the leased asset, type of leased asset, lease payment schedules, rental rate, lease period as well as whether the asset is to be transferred to the lessee at the end of the lease tenor or otherwise, have been determined.

## 2.4 Rules of Leasing ( Ijarah)

According to Sheikh Muhammad Taqi Usmani, there are some rules of leasing or Ijarah contract, such as :

1. The subject of lease must have a valuable use.
2. The period of lease must be determined in clear terms.
3. The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement.
4. The lessee is liable to compensate the lessor for every harm the leased asset caused by any misuse or negligence on the part of the lessee.
5. The rental must be determined at the time of contract for the whole period of lease.
6. The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.
7. If the leased asset has totally lost the function for which it was leased, and no repair is possible, the lease shall terminate on the day on which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset as it was immediately before the loss.

Furthermore, the most important rules associated with the Ijarah, it is not permitted to delay the payment, or make a substitution for the form of payment agreed upon, or shift responsibility for payment to a third party or to a source of expected income, or call an absolution of responsibility payment of the rent. Ibnu Rushd mentioned that,

*“One of the conditions of forward ijarah, according to Malik, is that payment be immediate, in order to avoid sale of a debt for a debt.”*

The Maliki School considers it an obligatory condition for the validity of a forward Ijarah contract that payment be received immediately upon enactment of the contract. For the delay payment means that the transaction turns into the sale of a debt for a debt and the activation of lingering obligations on each party vis-à-vis the other, which is prohibited. There is an exception, however, if the renter has begun to make use of property, in that case, delay of payment is allowed since it is no longer a delayed transfer by both parties.

Dr. ‘Abd al- Sattar Abu Ghuddah mentioned a dissenting view about delayed payment in forward Ijarah contracts in his paper, “Parameters for Leasing Services and the Applications of Forward Ijarah Contracts. He indicated that the AAOIFI Shariah Standards favored the view that it is permissible to delay payment even when the contract is formulated using the term Salam. Dr. Abu Ghuddah did not express his personal opinion on the matter.

The opinion of Dr. Nazih Hammad: in a paper that he wrote on forward Ijarah is, he stated that the favor of the Hanbali view that forward Ijarah contracts are permissible without the requirement that payment be submitted on the spot, when the contract is enacted using the term Ijarah and the like and the terms Salam and Salaf are avoided. This makes life easier for people, lightens their burdens and removes hardship from them regarding the types of financial transactions they need.

AAOIFI referred to forward ijarah contracts and the permissibility of delayed payment for them in its Shariah standard no. 9 specifically for ijarah and ijarah ending in ownership, article 3, points 3 and 5.



## 2.5 Malaysian Islamic Bank

Malaysia has been adopted the application of Ijarah mawsufah fi al- zimmah concept in financing for house under construction based on Musharakah Mutanaqisah. In this financing product, the customer and the Islamic financial institution share the rights over the asset under construction based on Musyarakah Mutanaqisah contract. The Islamic financial institution then leases its portion to the customer under the contract of Ijarah mawsufah fi al- zimmah as the leased asset is still under construction. The customer pays advanced rent during the construction period of the asset. Upon completion of the asset, the customer will continue to pay full rent for enjoyment of the usufruct of the asset.

Resolution:

*The SAC, in its 68<sup>th</sup> meeting dated 24 May 2007, has resolved that the application of ijarah mawsufah fi al- zimmah in financing for house under construction using musharakah mutanaqisah contract is permissible.*

Ijarah House Financing is one of the innovation and issues in product development. The scheme of Ijarah house financing for HSBC Amanah is illustrated as follows :

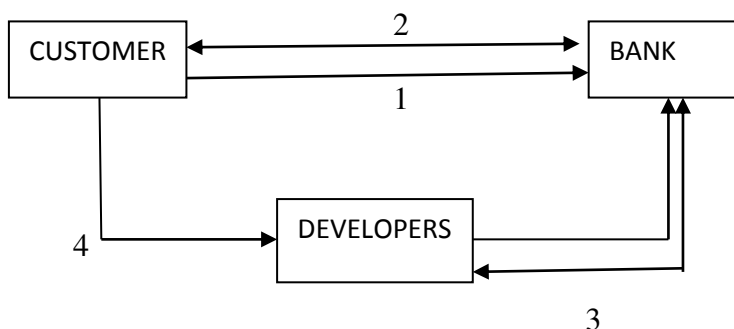


Figure . Ijarah House Financing Scheme in HSBC Amanah

The above figure will be explain as follows :

1. Customer enters into a lease agreement with the bank (or forward lease agreement) to lease the house
2. There will be a lease agreement between the customer and the bank for an agreed lease rental with a transfer of the asset to the customer at the end of financing
3. The developer enters into a Parallel Istisna Agreement with the Bank to construct and deliver the house in consideration for a Istisna Purchase Price (principal).
4. The customer shall approach the developer to check the asset.

## **2.6 Overview of HSBC Amanah**

HSBC Amanah is the global Islamic banking division of the HSBC group, responsible for the development of Islamic banking products for distribution to customers of the HSBC Group. It was established in 1998 and has regional offices in the UK, Saudi Arabia, the UAE, Malaysia, Indonesia, Bangladesh and Brunei. At HSBC, they constantly strive to provide financial solutions that meet the requirements of their customers around the world. HSBC Amanah offers Islamic banking solutions which combine their financial expertise with the customer endure values. Customers can experience the global coverage and convenience of banking with HSBC without compromising the principles of the Shariah (Islamic law).

All the HSBC Amanah products and services are developed in consultation with an approved by the Islamic and Shariah scholars on HSBC Amanah's Shariah Committee. This process of product development, fund segregation and Shariah review ensures that HSBC Amanah's Islamic products are free of interest and within the guidelines for commerce, finance and investment that are prescribed by the Shariah.

According to the HSBC Amanah which regards to charging for any late payment is, they charge an administration fee for any late or partial payments but this cannot be charged to cover opportunity cost. It can be charged in order to encourage financial responsibility and to cover administrative expenses. This charging is not an interest, and does not reflect the interest rate. If the fee paid is more than their actual expenses incurred, we will donate the excess to a public charity of our choice under guidance from their Shariah Supervisory Committee.

How is ijarah financing different from conventional lending? Isn't it simply re-labeling interest as profit? Ijarah can be defined as a contract "to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him." In other words, the term Ijarah is comparable to a conventional leasing mode of financing. The customer pay rent for the use of property, instead of paying interest on the loan amount. Bank purchase the property either from seller, or the customer in the case of refinance. And then lease it to you over an agreed term.

The distinguishing feature of this mode is that the assets remain the property of HSBC Amanah. Over the term of the finance, bank becomes the landlord and customer assumes the role of tenant. It mentioned in the contract for Lease Asset To Remain Bank's Property clause :

*"Nothing in this offer letter and the Leasing-I Contract shall confer in the Customer any right or property or interest in or to the lease asset which shall remain the Bank's property and the Customer shall have no right or interest therein otherwise than as a bailee"*

During this period, customer makes monthly payments which consist of a contribution towards the purchase price of the property (capital) and rental payments.

## **CHAPTER 3**

### **ISSUE AND CHALLENGES**

#### **3.1. Introduction**

This section devote for analyzing the features and conditions stipulated in HSBC Amanah Leasing-i Line with respect to basic principle of ijarah provided by Shariah rule. The practice of ijarah contracts that inline or not with Shariah will be identified here. Some challenges faced by banks in order to rectify the incorrect practice (in the light of Shariah) may also be supplied at the end of this section.

Some aspects of financial leasing are not fully Shari'ah compliant and need to be reviewed and rectified. One of these is concerned with assignment of lease without the transfer of ownership (Kamali, 2007). The lessor can sell the leased asset to the third party, whereas the relation of the lessor and the lessee shall be established between the new owner and the lessee. But the assignment of the lease itself for a monetary consideration without assigning ownership of the leased asset is not valid.

The difference is that the latter case of the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive rent of the asset only. This assignment is acceptable in Shariah only where no monetary consideration is involved. For example in the agreement contract, which depict the loss of and damage to lease asset, mentioned as follows:

During the financial lease, the lessor has the ownership responsibility. If the asset is destroyed during the lease period, the lessor alone stands to suffer the loss. Similarly, if the leased asset loses its utility and function without the lessee's fault or negligence, the lessor's entitlement to rent is stopped. This is one of the differences

between ijarah and conventional leasing, as the latter render the lessor to receive rent even if the lessee could not obtain any benefit from the leased asset.

In addition, terms of rental and lease commencement date are specifically determines at the beginning of leasing contract. This feature is in line with one of basic principle of ijarah which is known term and duration of contract. Besides, HSBC Amanah only offers Leasing-i Line for house financing which is asset backed arrangement. As according to Taqi Usmani (n.d) lease cannot be affect in respect to fungible asset such as money, and perishable items like vegetable because their use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. As loan is concern all exchange must be in equal basis. Hence, any rent charged on this invalid lease shall be interest charged on a loan. In short, product offer under Leasing-i Line is inconformity with Shariah.

### **3.2. Issue in Shariah Compliant contract:**

#### **3.2.1. Lease Rental Computation**

HSBC Amanah calculate rental payment for Leasing-i Line by tying up purchase price of the asset to lease rental rate (rate of interest) so that they (bank) can cover the cost of assets as well as obtain extra gain from fluctuation of rate.

The formula is depicted as follows :

$$PMT = \frac{PRC \{1 + (r \times N)\}}{12N}$$

Where,  $PMT$  = Lease Rental

$PRC$  = Bank's Purchase Rental

$N$  = Lease Term (in years)

$R$  = Lease Rental Rate per annum (in decimals)

This practice indeed against Shariah rules since it involves element of riba which is rate of interest. However, some Shariah scholar allowed and approved this practice by bench marking the rate of interest. For instance, bank fixed the benchmark at 15%, if the market interest rise above 15%, customer will have to pay 15% only and if interest fall below benchmark, let say 10%, customer must pay according to benchmark. As rate of interest is concern, element of riba still prevails whether it is use as a benchmark or not. Thus, rate of interest must be removed from any financial contract since Quran provide clear injunction of riba in various occasions. For example, Allah SWT prohibits riba and declares war against those commit and consume riba in (Surah al- Baqarah2:278-281).

Beside, the formula uses in calculating rental payment also involves element of gharar (uncertainty). The fluctuation of rental rate creates uncertainty in rental payment. It means that the fluctuation of rate make the rental charge remain unknown. This is actually against one basic principle of ijarah which is rental price must be known to both lessor and lessee at the beginning of contract. Predetermine rental does not mean bank (lessor) can only charge fixed amount of rental to be paid during rental term. For instance, bank may increase rental rate 10% per month as long as it is stipulated in the contract.

Some Shariah scholar view that fluctuation of rental rate are not directly related to two reasons of prohibition of gharar in leasing which are creating dispute among parties involve and intentionally creating loss to one party due to lack of information in rental price. They claim that fluctuating rates did not encourage dispute between lessor and lessee since the contract is sign with mutual consent. Aside from mutually consent features, a contract must also confirm to Shariah rule to be fully Islamic. Besides, this group of scholar claims that benchmarking can lessen the loss bear by both bank and

client. As discuss before, benchmarking involve element of riba, hence it is automatically violate general Shariah principle in transaction.

### **3.2.2. Capital and Operating Expenditure of Lease Assets**

There are four clauses provided under this heading. The first clause stated that all capital expenditure such as maintenance, repair, takaful coverage and other expenses of lease assets bear by bank as lessor and owner of asset. Second clause explains that all kind of operating expenses such as manufacturer recommended preventive maintenance should be borne by customer as lessee of asset. These two clauses indeed follows Shariah principle of ijarah which capital expenditure remain with owner of capital while all cost to usurp benefit from capital bear by lessee.

However, third clause transfers the responsibility of bank in catering all capital expenditure to client. This transfer is done as bank appoint customer as its agent (use wakalah concept) to settle capital expenditure on behalf of bank but with customer's own money. Consequently, forth clause prohibits customer from claiming any capital expenditure or else bank will charge additional rental fees in amount of capital expenditure paid by bank in advance. Therefore, third and forth clauses clearly violate compulsory Shariah principle of ijarah as it neutralize the effect of first two clauses. Other than that, wakalah contract will complicate the role of customer whether to serve as an agent for the bank or lessee for lease asset of bank.

### **3.2.3. Indemnity and Exclusion**

In HSBC leasing-I line, lessee must agree to compensate the bank against all actions, claims, damages, penalties arise within rental term. This condition is impose to cover any loss bank might incur if client refuse to sign leasing contract after bank purchase the asset or if client fail to pay rent in agreed term and duration.

Besides, there are two clauses in the exclusion parts that contradict to Shariah principle. The clauses are as follows:

(b) No liability shall attach to the Bank either in contract or in tort for loss, injury or damage sustained by the Customer or by any third parties by reason of any latent or apparent defect in any lease asset under the Leasing-i Contract and the Bank shall not be liable to indemnify the Customer in respect of any claim made against the Customer by any third parties for any such loss, injury or damage

(c) The Bank shall not be responsible or liable for any delay in delivery or non-delivery by the supplier/manufacturer of any lease asset under the Leasing-i Contract.

These conditions basically against Shariah principle since it violate principle of ownership. In leasing, ownership, all liability and loss of asset remain with lessor. HSBC Amanah practices leasing as it is maintaining ownership of lease asset but transfer all the liability and loss to the lessee regardless whether the lost incur by client negligence or not. For instance, bank as lessor, can purchased asset from the supplier through his agent.

In practice, bank will appoint customer as its agent to purchase the asset. It means that customer act as trustee at this stage. Hence, bank is liable to pay all the expenses incurred in the process of its purchase and its import. Consequently, bank is liable to pay the freight and the customs duty etc. Then, customer will act as lessee only if he/she takes delivery of the asset. Delivery which enables usufruct entails that if any casual incident occurs and prevents usufruct of the leased without being due to the act of the lessee, should be corrected by the lessor, such as refurbishment of the residence or removal of any defect that hampers dwelling (Abdul Sattar Abu Ghuddah,n.d).



### **3.3. Challenges in Rectifying Current Practice**

All Islamic bank and bank which offer Islamic instrument like HSBC Amanah faces several challenges in order to ensure their practice in accordance with Shariah. Some of challenges are as follows:

1. The variations of opinion of fiqh scholars which are usually the member of Shariah advisory council bring variation of rules and degree of Shariah compliant practice by bank. One bank have incentive to hire fiqh scholar that views have suit their practice without considering whether it is really in accordance with Shariah.
2. Standardization of auditing and accounting standard are much needed. For example, The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is establish to provide guideline regarding that matter. However, banks have option whether to follows the AAOIFI guideline or not. Hence, AAOIFI must gain more authority so that it can govern all Islamic Financial Institutions operations (assuming all AAOIFI guideline inconformity with Shariah)
3. Dual banking practice can be a challenge in ensuring practice of Shariah based instrument. For instance, Malaysia practice dual banking system thus all bank that offer Islamic instrument must abide by Banking and Financial Institutions Act 1989 (BAFIA). As HSBC Amanah is not full fledges Islamic bank, it will also abide by conventional banking act in Malaysia. Thus, mixture of interest free and interest based bank regulation will hinder the implementation of Shariah rule governing contract of ijarah in particular.

## **CHAPTER 4**

### **CONCLUSION AND RECOMMENDATION**

#### **4.1. Conclusion**

An as Islamic house financing, Ijarah is still in its early stage of development in HSBC Amanah. Leasing-I Line instrument is made to meet the need of customer to rent the house that they want to occupy.

There is no transfer of ownership in Leasing-I Line contract, the lease asset remain the bank's property. During the period of lease, the bank becomes the landlord and the customer becomes the tenant. The customer makes monthly payments which consist of a contribution towards the purchase price of the property (capital) and rental payments.

Some of the issues which have been drawn in this study have featured in the existing literature on Ijarah and search continues for better solution. With regard to financial leasing, the main critique is that Leasing-I Line contract should represent a portion of the bearer's ownership in the leased asset.

#### **4.2. Recommendation**

Issue pertaining to compensation or imposition of penalty default, require for attention but it is also a matter of correct observance of Shariah provision and insertion of suitable clauses in the lease contract. This is act conducted in order to curb unfair practices that burden the lessee with unwarranted demands.

HSBC Amanah as a lessor should try to absorb the cost to put option and offer it in the form of unilateral commitment upon himself. The lessor may also make a unilateral commitment to offer the lessee to purchase the asset at the end of the lease.

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