Islamic leasing is the ultimate form of interest-free asset-backed financing. It combines modern credit and financing techniques with traditional risk-reward sharing concepts and business ethics. Thus it can succeed today in the United States and the Middle East as an alternative to conventional leasing.

Modes of financing for commercial transactions were codified 14 centuries ago on the Arabian peninsula in ways that respected the religious principles of Islam, a dominant belief system emerging at that time. Commercial dealings commonly divide into 2 categories: (1) sale and trade and (2) investments and borrowings. For a practicing Muslim believer the injunction in the Holy Quran is clear: “… but Allah (swt-God) has permitted trade and forbidden riba” (v. 2:275).

Although the legal distinctions between the 2 types of dealings are quite clear in theory, in practice the ancient Arabs (as well as many Muslims today) were confused because an increase in the price of a credit sale over the price of a cash sale seemed identical to an increase (riba) in debt for delayed payments.

Likewise, many who examine conventional leasing as compared with Islamic leasing may not discern sharp differences on the surface. In fact, upon closer scrutiny one may discover many similarities between Islamic financial transactions and conventional financings—which is not overly surprising because many forms of conventional financings are rooted in Islamic practices from the 7th century CE (Gregorian Christian era; see the sidebar, Principles of Islamic Finance).

The intent of this paper is to lift the veil on Islamic leasing—one area of Islamic finance that is underdeveloped and not yet well understood—to demystify it, and to encourage the use of this flexible and powerful form of asset-backed financing by Muslims and non-Muslims alike.
Islamic jurisprudence (called *Shari'ah*) dictates that any lending or borrowing of money may only be done without any markup or increase (interest), that is, as a *qard hassan*, or “benevolent loan.” Therefore, fixed-rate lending in the form of bank or consumer loans, bonds, corporate debt instruments, and T-bills are prohibited transactions. To consummate a sale-trade transaction of goods, there are several approved Islamic contracts, which are further described in the Glossary of Islamic Financial Terms:

- *bai al- salam* (advance price paid with delivery later)
- *bai bithaman ajil* (deferred payment with delivery now)
- *murabaha* (cost-plus)
- *mudaraba* (entrepreneurship)
- *musharaka* (capital partnership financing)
- *istisna* (inventory or construction financing with progress payments)

In addition, 2 Islamic contracts pertain to rental of assets or goods:

- *ijara* (operating lease)
- *ijara muntahia bittamleek – ijara wa iqtina* (equity lease, which might conclude with a transfer of title of ownership)

The scope of this paper will address only these last 2 types of Islamic contracts. *Ijara* is a term from Islamic *fiqh* (jurisprudence), which literally means “to give something on rent.” *Ijara* applies in 2 situations: (1) employment of a person with wages given to him as consideration for his hired services, and (2) transfer of the usufruct (right of use) of property to another person in exchange for a rent claimed from him. A lessor is called *mustajir*, and the rent payable to the lessee is called *ujrah*.

While *sale* and *ijara* are similar, in a sale property is transferred entirely to the end user, whereas with *ijara* the corpus of the property remains with the transferor and only the usufruct transfers to the lessee or user. Taqi Usmani makes the point clear that originally Islamic *ijara* was *not* a mode of financing. Over time, however, a conventional practice evolved, influenced by tax concessions, whereby the rental of equipment to customers became a substitute for loan financing.

Although *ijara* and modern-day leasing share many similarities, the differences are crucial to an understanding of how to make leasing finance acceptable to Islamic clients and investors. The *Shari'ah* describes *ijara* as a normal business transaction distinct from *sale*: neither a financing modality nor a type of “loan” transaction. Provided that no *Shari'ah* principles are contravened, however, *ijara* may be utilized to achieve similar objectives to pure equipment financing.

### CHARACTERISTICS OF AN ISLAMIC LEASE

The following are basic characteristics of an Islamic lease:

- There is a contract between 2 parties whereby the owner of an asset transfers its usufruct to another person for an agreed-upon period for an agreed-upon consideration (rental).
- The subject of the lease must have value and cannot be fully consumed during the lease, because this would be deemed a loan instead that would violate *Shari’ah* proscriptions.
- Liabilities of ownership must remain with the lessor, and liabilities for use of the property are borne by the lessee. For example, in a real estate lease the lessee will bear the burden of water, electricity, and snow removal expenses while the lessor bears the property taxes and insurance costs.
- The lessor retains the risk of the leased asset throughout the lease term so that any harm or loss occurring from factors beyond the control of the lessee must be borne by the lessor. Hence, risk mitigation such as insurance
remains the chief responsibility of the lessor.
- The lessee is liable for every harm or loss caused by its negligence or misuse of the asset and shall compensate the lessor accordingly.
- The rental must be established at the time of contract for the entire lease period. Although the rental may vary during different time frames, the lessor may not adjust the rental after the lease commences. Any unilateral change in the rental or any clause allowing a price change at the discretion of the lessor would render the lease invalid.
- The lease period shall commence on the date when the lease asset is delivered; hence no rental payments are due prior to delivery. Shari’ah rules safeguard the interests of the lessee to avoid being charged rent in the absence of equipment. That rent would be viewed as purely interest charges related to an asset that the lessee does not own or possess.
- If the leased assets have lost their function and no repair is possible, the lease must terminate on the day such loss was caused (Usmani).

### Elements of an Ijara

According to the standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) of Bahrain as contained in Directive No. 8 (June 1997, and revised December 1998), a lease (ijara) contract must consist of the following minimum elements: (1) contract with offer and acceptance, (2) 2 parties whereby one is the legal owner (lessor) of the asset or good and the other is the rentor (lessee) with rights to use the owner’s asset, and (3) the object or asset, as described in the terms and conditions to include price, duration, upkeep and maintenance, and asset disposition at the end of lease.

Transfer of title may occur in any of 4 ways:
- Title passes as a gift.
- Title passes for a token payment (such as $1), or a specific payment amount (such as 10% of the original price).
- Title passes prior to the lease term end for payment equal to the remaining lease payments due under the contract (i.e., no discount).
- Title passes through gradual transfer as pro rata entitlement to title ownership, whereby final payment is a pre-agreed sum. That is, a percentage of the lease payment is deposited into a “savings fund,” and at the end of the lease term these funds are applied to an actual purchase.

### Fair-Market-Value Leases

A fair-market-value lease that mandates a lessee to purchase an asset would not be permissible under Shari’ah rules because the lessee cannot agree in advance to an unknown purchase price. However, a lessee might agree to an option to purchase the asset at the termination of the lease provided that the option describes in detail how a future price might be determined, such as the current market value of the then-depreciated asset, or 10% of the original price, whichever is higher.

It should be noted that AAOIFI’s advice to Islamic financial institutions does not carry guidance on usage of benefits from the assets: Issues of depreciation and tax advantages are all but ignored. In part, this circumstance results from a combination of (1) an absence of corporation taxation for locally domiciled companies in the Middle East and Near East regions and (2) a relatively underdeveloped accounting system.
regime to recognize depreciation charges for machinery and equipment on the balance sheet.

Hence, a driving force to utilize lease finance by Islamic companies is its provision of an unusual degree of flexibility in matching income derived from assets to third-party financing of those assets, rather than tax advantages or off-balance sheet treatment that such financing affords under conventional leasing.

It is noteworthy, however, that there are important distinctions between the conventional “finance lease” and the second type of Islamic lease—ijara wa iqtina—which is discussed next.

**DIFFERENCES BETWEEN A FINANCE LEASE AND ISLAMIC LEASE**

Typical finance leases in vogue are conditional sale transactions or disguised loans whereby the lessor (financial institution) purchases the asset through the lessee itself and the lease agreement provides for simultaneous transfer of title at the end of the lease term for $1, or a nominal amount. By contrast, Islamic principles prohibit both a forward sale transaction and inclusion of 2 commercial transactions in a single contract—rental of an assets plus its future sale.

To qualify as an ijara transaction, the lessor must first purchase the asset and take legal title. The lessor then may elect to rent that asset to the lessee. The final disposition of the leased asset should be treated as a separate transaction from the lease itself; the lessor may give the asset to the lessee as a gift, or sell it to the lessee at an agreed-upon price. However, the lessee does not have the right under the Islamic lease to force the lessor to transfer title, nor can the lessor impose a purchase price on the lessee as part of the Islamic lease contract.

Any financial advances (rental) prior to delivery of the asset are viewed under Shari'ah as “interest” or a premium over the allowable payment for the usufruct of that asset that may commence only upon its delivery to the lessee. As

**PRINCIPLES OF ISLAMIC FINANCE**

The basic framework for the Islamic financial system is a set of rules and laws, collectively referred to as Shari'ah (meaning “the way”), which govern economic, social, political, and cultural aspects of Islamic communities. Shari’ah originates from the rules dictated by the Holy Quran and its practices and explanations (called Sunnah) given by Prophet Muhammed (pbuh). Five salient features of Islamic finance are:

1. **Prohibition of interest.** Also called *riba* (literally means an excess or premium), this core principle is interpreted as any unjustifiable increase of capital, whether in loans or sales, or an unequal exchange of goods of differing qualities. Any positive, fixed, predetermined rate tied to the maturity and the amount of principal is considered to be riba and hence is prohibited. Generally, riba covers not only usury (high rate of interest) but also the charging of any level of interest. This prohibition is integrated with beliefs in social justice, equality, and private ownership of property. Islam encourages earning profits as a result of productive commercial activity and risk-taking rather than a result of guaranteed returns to capital irrespective of the commercial outcome.

2. **Risk sharing.** Because interest is prohibited, the providers of funds become investors instead of creditors in transactions. The supplier of capital becomes a partner alongside the entrepreneur: Both share the business risk in exchange for a share in the investment performance, or “profits.”

3. **Prohibition of hoarding and speculation.** The Islamic financial system rules out any activity such as hoarding and manipulation of supply/demand prices as well as transactions involving gambling, unknown risks, and unpredictable outcomes (such as derivatives and lotteries).

4. **Sanctity of contracts.** Islam recognizes commercial dealings in terms of the formal contractual relationship. Hence, there is moral duty to uphold one’s contractual obligations and to disclose full information. This requirement is intended to reduce uncertainty between the parties, minimize moral hazard, and eliminate exploitation of one party over another that can lead to disputes and wasted resources.

5. **Shari’ah approved activities.** Only those commercial and business activities that do not violate Shari’ah will qualify as legal and thus earn the blessings from Allah (swt-God), the ultimate source of all wealth. Specifically proscribed activities involve gambling, alcohol, casinos, armaments, and pork and related by-products.
Another aspect of financial leases not permitted under Shari’ah is the interest penalty imposed for delayed rental payments. An extra monetary charge, especially one geared to the time value of money, is strictly outlawed by Islamic rules as riba.

To avoid a misuse of the degree of latitude granted under Islamic finance for making late payments, a lessor may include in the lease a provision that a lessee shall pay a certain amount to a charity whenever it fails to pay rent installments on a due date. In this manner, an equitable balance is struck: The lessor is not unjustifiably enriched and the lessee has adequate incentive to maintain timely lease installments.

Some financial leases contain a condition that permits the lessor to terminate the lease and accelerate payment by the lessee for all rentals remaining in the lease term. Because the lessee is no longer enjoying the usufruct of the asset, additional rental payments are disallowed under Shari’ah and would be construed as prohibited interest payments under a “loan” arrangement.

**ANATOMY OF A LEASE FINANCING**

Typically, analysis of lease financing falls into 3 categories: (1) operational aspects and legal structure, (2) financial aspects and yield calculations, and (3) risk factors. To dissect an Islamic lease we must add a fourth dimension: religious or Shari’ah considerations.

If we recall that Islamic leasing from 700 CE predates conventional, modern-day leasing, then it is not so surprising that many elements described in the next 3 categories are identical concerns for conventional leasing and Islamic leasing.
The Islamic financial system consists of commercial and business activity divided into 2 main areas: trade (buying and selling) and investment (savings and ownership of assets).

**Trade** includes:
- murabaha – cost-plus sales
- bay bi’thaman’ ajil and bay’ salam – credit sales
- ijara – leasing
- musharaka and mudaraba – partnerships
- istisna – Islamic forwards or commission to manufacture

**Investment** includes:
- equities – shares in the assets of an enterprise
- real property – real estate, land, and buildings
- mutual funds – groupings of shares or securities issued by companies
- loans – qard al hassan, or benevolent loans, which may be at principal only and are to be repaid without any increase

**Murabaha (cost-plus sale).** This is a widely used instrument for short-term financing of goods or assets. In fact, nearly 75% of Islamic finance transactions employ this contract whereby the seller agrees to supply a buyer specific goods, commodities, or assets at an agreed price, date, and delivery location with a mutually negotiated margin. The seller may or may not have the item in inventory; however, the sale cannot be consummated unless the seller first takes legal ownership of the item prior to resale.

**Bay bi’thaman’ ajil (deferred payment or credit sales) and bay salam (deferred delivery or credit sale).** Bay bi’thaman’ ajil involves delivery on a spot basis of a purchase item with payment from buyer deferred according to an agreed-upon schedule. Payment may be made in future on a lump-sum or installment basis, provided there is no extra charge for the deferred time frame. Likewise, no “premium” or excess charges may be levied for late payment; however, penalties may be charged associated with collection of late payments. Bay salam involves payment on a spot basis with deferred delivery of the product at an agreed-upon time. Since the buyer does not have full use of the item to be acquired, there may be an adjustment to the selling price.

**Ijara (hire purchase or operating lease) and ijara w’iqtina (equity conditional sale).** Preference is for the ijara or operating lease form, whereby the owner of an asset rents out that asset (machinery, aircraft, ships, vehicles, and so on) to an end user (lessee) in exchange for a periodic payment over an agreed-upon term. At the end of the lease term, the title to that asset may transfer under separate agreement or as a gift. Transfer could result in an additional payment, which should be determined by market conditions at the time of sale. This is an increasingly popular form of Islamic financing and represents over 10% of all financing transactions.

**Ijara w’iqtina** involves joint ownership of an asset by the lessor and the lessee, whereby the lessee agrees to make periodic rental payments that include a payment applied toward the legal ownership of that asset. Typically, the lease installment combines a fair rental value for the assets plus an additional payment amount toward equity ownership. As the lessee’s ownership shares increases, its rental installment will decrease. Prior to commencement of the lease, the lessee may give a promise to purchase assets, yet actual transfer of title from lessor to lessee occurs by separate agreement after the conclusion of the lease term.

**Musharaka and mudaraba – partnerships.** Musharaka is a classical joint venture whereby the capital provider contributes financial capital and the entrepreneur contributes time, expertise, and managerial skills for an agreed-upon enterprise. The 2 parties share in the risks of the venture and the returns in any proportion accepted in advance. Islamic rules, however, recognize an equity between human capital and financial capital and so dictate that when losses occur the capital provider loses its capital and the entrepreneur loses only its time and efforts.

**Mudaraba** is a profit-sharing participation whereby the rabb al mal (provider of capital) agrees that the mudareb (agent-manager) will undertake a venture on its behalf. The agent-manager has limited liability against losses although it may earn a performance incentive or management fee. The terms of profit sharing are set in advance.

**Istisna – Islamic forwards or commission to manufacture.** These financing forms are rare and delicate because the sale of nonexistent products is forbidden in Islam. Istisna is an exception where the price is paid in installments as the goods are being manufactured (inventory financing) or being constructed (progress payments during construction). If the price to be prepaid in installments is lower than the final, finished product, istisna can be a useful tool for financing manufacturing or construction goods.
According to Shari’ah, only goods and tangible assets may be the subject of financing; therefore, no services may be bundled into a lease contract. Examine this aspect first. Shari’ah rules exist for the benefit of mankind as reminders of correct behavior, ethical values to guide actions, and divine injunctions revealed through the Holy Quran and Sunnah (speeches and habits of Prophet Muhammed [pbuh]) for happy and successful living. This guidance and these ethical values infuse all commercial dealings as well.

Exclusions

According to Shari’ah, only goods and tangible assets may be the subject of financing; therefore, no services may be bundled into a lease contract (and should be dealt with separately). Due to the prohibition on taking or paying interest on debt or loans, the source of capital for asset acquisition must be equity. Hence, the debt leverage so popular with conventional leasing is anathema.

As we have seen, ownership of an asset is coupled with responsibility for its maintenance and upkeep. Thus nearly all operational maintenance and related issues such as insurance are the responsibility of and must be assumed by the lessor. It is commonplace, in contrast, for conventional leases to contain so-called hell-or-high-water clauses, whereby responsibility for maintenance, repairs, and upkeep of leased equipment is transferred to the lessee and priced into the lease stream of payments to assure compliance by lessees.

Expenses related to normal wear-and-tear depreciation are typically exempted, however. The type of equipment as well as its intended use must be encompassed by legitimate boundaries; hence, gambling equipment is disallowed along with alcohol production, bottling, and transportation, as well as equipment used in other prohibited activities associated with pork, tobacco, and weapons of war.

EMERGENCE OF ISLAMIC LEASING

From the examples described in Table 1, it is apparent that leasing according to Islamic principles began to emerge in the early 1990s and presents an extremely flexible form of financing that applies to a wide variety of tangible assets.

It is worth noting that structuring Islamic leasing for aircraft acquired by national airlines in the Gulf Cooperation Council (GCC) region is gaining ground. One-off lease transactions were arranged by Chase Manhattan Bank and Citibank in the 1980s. More recently, very large lease funds are being established to accommodate the requirements of national airlines to upgrade their fleets of planes. Some examples:

- May 2000: HSBC – Amanah Financial and Global Islamic Unit arranged a lease for 2 Airbus A320-200s aircraft to Syrian Arab Airlines.
- February 2001: Kuwait Finance House financed 4 Airbus A320-200s aircraft for Kuwait Airlines Corp. under an ijarah contract valued at $200 million.
- June 2001: Boston Capital – ABC Islamic Asset Management Unit developed an innovative Islamic MultiFamily Property Development Fund for 115,000 apartments valued at $5 billion, which incorporated a $100 million ijarah financing facility.
- July 2001: GIB launched the Islamic Aircraft Leasing Co. to lease 15 to 20 airplanes to Arab national airlines valued at $450 million to $600 million.

### Table 1: EXAMPLES OF ISLAMIC LEASING TRANSACTIONS

<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Examples</th>
<th>Date</th>
<th>Size ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment and heavy machinery</td>
<td>Leasing Fund US</td>
<td>Est.5/94</td>
<td>$200</td>
</tr>
<tr>
<td>Computers and software</td>
<td>Wafra High Yield Leasing Fund I</td>
<td>Est.8/98</td>
<td>$46</td>
</tr>
<tr>
<td>Autos, trucks, vehicles</td>
<td>BMI Leasing I</td>
<td>Est.12/92</td>
<td>$4</td>
</tr>
<tr>
<td>Large machinery</td>
<td>TII Global Lease</td>
<td>Est.6/94</td>
<td>$30</td>
</tr>
<tr>
<td>Various</td>
<td>First ANZ Modaraba</td>
<td>Est.6/97</td>
<td>$7</td>
</tr>
<tr>
<td>Residential (homes)</td>
<td>Al Manzil USA</td>
<td>Est.11/99</td>
<td>$6.8</td>
</tr>
<tr>
<td>Aircraft (Airbus)</td>
<td>Kuwait Finance House</td>
<td>Est.2/01</td>
<td>$200</td>
</tr>
<tr>
<td>Real property (apartments)</td>
<td>Boston Capital – ABC Islamic Asset Mgmt.</td>
<td>Est.6/01</td>
<td>$100</td>
</tr>
<tr>
<td>Aircraft (A330-200s)</td>
<td>HSBC- UAE</td>
<td>Est.12/01</td>
<td>$100+</td>
</tr>
<tr>
<td>Leaseback securities</td>
<td>Bahrain Monetary Agency/IDB</td>
<td>Est.8/01</td>
<td>$100</td>
</tr>
</tbody>
</table>

8 JOURNAL OF EQUIPMENT LEASE FINANCING • SPRING 2003 • VOL. 21/NO. 1
By careful arrangement, Islamic leases may qualify for favorable IRS tax treatment as well if tax deductibility of lease installments is crucial to the lessee.

One innovative lease fund is being offered privately by a New York-based investment fund manager to Islamic investors. As we have seen, an Islamic investor is prohibited from buying or selling a debt instrument. This lease fund has transformed the lease rental stream into an Islamic lease certificate offered through a special purpose vehicle (SPV), whereby the investor owns a pro rata share in the leased assets and hence participates in the rental income attached to that leased asset (fig. 2).

LEGALITY OF ISLAMIC LEASING IN THE UNITED STATES

Dominant leasing companies should enjoy higher spreads than have been seen in the previous 5 years, due both to a withdrawal by some banks from the leasing forefront and to a reduction in the cost of long-term borrowing. The underlying principal reasons to use leasing—cash-flow benefits and a tax shelter for depreciation and rental expenses—are still present, especially among small and medium-size companies. According to the Equipment Leasing and Finance Foundation’s 2001 Small Business Survey, businesses rank their reasons to lease as:

- cash flow: 35%
- dollar value-added: 17%
- ease, convenience, and flexibility: 13%
- maintenance options and costs: 13%
- tax advantages: 13%
- avoidance of technology obsolescence: 9%

The high ranking given to positive reasons to lease, namely, off-balance sheet financing and flexible cash management (matching equipment earning power to financing costs), are objectives shared by proponents of Islamic leasing.

Fortunately, nothing in existing U.S. banking or securities laws currently prohibits Islamic leasing or seriously undercuts its principles. Under the Islamic economic system, both types of prevalent leases (ijara and ijara wa iqtina) can be arranged in the United States in a manner that conforms to Shari’ah laws. By careful arrangement, Islamic leases may qualify for favorable IRS tax treatment as well if tax deductibility of lease installments is crucial to the lessee.

U.S. leasing has evolved into a sophisticated financial product governed by extensive IRS and accounting regulations. To be sure, some regulations are contradictory to an Islamic lease without any debt: The IRS may impute a rate of interest on a capital lease relating to the markup portion for tax purposes. Also, typical accounting practices assume an amortization schedule based on the Rule of 72 or similar declining balance-interest portion calculations that do not apply within an Islamic lease. Some scholars insist that each lease payment contain equal portions of principal and yield (markup) within the rental payment spread of the lease term.

Figure 2

ANATOMY OF AN ISLAMIC LEASE CERTIFICATE

Cash Share in Rental Income

INVESTOR

ISLAMIC LEASE CERTIFICATE

EQUIPMENT MANUFACTURER SPECIAL PURPOSE VEHICLE (SPV) SPECIAL PURPOSE VEHICLE (SPV) SPECIAL PURPOSE VEHICLE (SPV) LESSEE-EQUIPMENT USER

Sale Bay’ bithaman ‘ajil installment sale Ijara master lease Sublease

LEASE ORIGINATOR
On the other hand, the leasing industry began in 1991 to package similar leases into a security instrument, such as securitization of home mortgages or consumer loans. This represents a potentially exciting new product area to be studied and adapted so as to make it a fully acceptable instrument under Islamic law. By creating a secondary market (through securitization) for securities backed by leased assets, the primary market for financing lease transactions can become even more attractive to institutional investors.

Even though Islamic finance rules forbid the sale of debt, a future income stream derived from an asset (such as a lease) may be bought and sold—either the title of the underlying asset or via a certificate that confers ownership to the rental stream. Thus investors can trade in asset-backed lease portfolios or hedge various lease terms and risk factors via securitizations of leases.

An essential element in Islamic financial dealings is justice for all parties. The Islamic economic system encourages trade, private property, free circulation of money, savings and investment, and fair commercial dealings. It also promotes equity and risk-sharing arrangements in business. Gambling and speculation are proscribed. Emphasis in business returns to profit sharing and productive reinvestment rather than debt service, collateral, and guaranties, along with tight controls on overhead expenses.

**LEASE VOLUME PROJECTIONS**

Figure 3 shows one estimate of the magnitude of the business opportunity in the United States that Islamic leasing represents.

Some leasing programs initiated by SAMAD Group of Dayton, Ohio, American Finance House of Pasadena, Calif., and HSBC of New York use Islamic leases structures for financing homes and autos. Although these programs are gaining in popularity, none is offered on a nationwide basis as yet.

**OBSTACLES TO RAPID GROWTH**

Despite the substantial opportunity to arrange asset-backed financing in accordance with Islamic principles for consumers and businesses alike, several major obstacles must be surmounted to realize this potential.

Regrettably, there is no generally accepted lease contract or standardized terminology in Arabic or in English. In the absence of a consensus among Islamic scholars, funding by investors of leasing transactions will likely remain curtailed. Without such standardization, moreover, securitization and through it the creation of a viable secondary market in lease portfolios cannot evolve easily. The standardized lease contract will need to be tested by lessees and lessors alike in difficult cases involving defaults.

Whereas civil laws apply in the jurisdiction of the lessor (or as set forth in the lease contract itself), certain disputes that arise in Islamic communities or in Middle Eastern countries may need to be referred to jurists knowledgeable about the Shari’ah for final resolution. For now, there is no such recognized, centralized body of jurists or tribunal.
Educating Prospective Lessees

Although there are some 1 billion Muslims worldwide, Islamic economic principles are neither well understood nor frequently practiced. Most educational programs do not contain courses on Islamic finance or interest-free economy that could provide background and orientation to Muslims, whether they approach commercial dealings as consumers or as business owners.

Given the lack of popular usage, confusion abounds relating to Islamic financial precepts. Many Muslims are unsure about the use of “fixed and variable interest” (riba) and, under what circumstances loans or debt instruments may be acceptable. Nonetheless, since it is possible to structure lease agreements so that issues about riba can be totally avoided, Muslims can realize their twin goals: (1) to benefit from using proven U.S. financing techniques that are tax-advantaged and (2) to adhere to religious injunctions to totally avoid totally Riba in commercial dealings.

As we have seen in figure 3, the potential for new volume of Islamic leasing in the United States is significant. Some 7 to 8 million Muslims reside in the United States; however, these prospective lessees must be educated first to build up the primary demand for the product. A movement toward a popular understanding how the Islamic alternative to leasing works would open an attractive leasing niche market that for now is underserved. Many prospective clients question whether finance leasing is simply another name for prohibited interest. Americans have become so conditioned to fixed-interest-rate financial products that they will need also to be shown that equity, non-interest-based financial products not only exist but can better serve their overall needs.

The dominance of interest-based leasing and the heavy dependence by lease funding sources on debt with fixed interest present a major challenge to the proponents of equity-based leasing. Those accustomed to the interest-based system will naturally resist any changes and will need to be convinced of the economic reasons for equity-based leasing.

Also, because of well-publicized financial disasters for investors in finance projects in Egypt, Pakistan, India, and the United Arab Emirates (BCCI, although not an Islamic bank), many investors and potential consumers of Islamic leasing may be reluctant to participate, especially during the formative stage. This skepticism can be overcome, eventually, by sincere efforts of Islamic funding sources, the investment performance and yield actually achieved (a track record), and by the fact of the longevity of the leasing enterprise.

SIGNS OF FUTURE SUCCESS FOR ISLAMIC LEASING

For many reasons, Islamic leasing can succeed today in the United States and throughout the Middle East as an alternative to conventional leasing.

- Islamic leasing principles are founded on a partnership between the lessor and the lessee. The Islamic lease promotes the idea of a working partnership (one provides the capital and the other provides the labor, skills, and markets) rather than simply a money-over-money financing transaction.

- Islamic leasing is based on a value of the capital goods or equipment itself. Hence, it is grounded in tangible property, which promotes a sense of safety and security, and, further, it reinforces financing production purposes rather than consumption purposes.

- Islamic leasing emphasizes the asset value and its income capabilities. By sharing equity capital and the business risk with the lessee, the lessor is entitled to share in a portion of the cash flow or income generated by the leased equipment.

- Islamic leasing (like conventional leasing) opens a new source of capital for the business venture, which may be kept off-balance sheet because the asset is not truly owned by the
lessee. Therefore, lease assets may not be taxable to the lessee under Shari’ah rules (refers to zakat assessments).

- Leasing using Islamic principles requires fair dealings, full disclosure, and honestly written contracts. An Islamic lease is concerned with delivery on time of specified equipment and just dealings between 2 parties, which may not include any serious injury to either party.

**CONCLUSION**

Islamic leasing in the United States is not entirely new, although it clearly is still evolving. An Islamic lease shares many essential characteristics with its conventional counterpart; however, certain common features, such as penalty clauses and allocation of insurance and maintenance costs, render existing leases unacceptable to Islamic lessees and investors. Islamic leasing is a creative new product in an otherwise mature industry. The average return of equity for owners of leasing companies fell in 1992 to 11.4% from 13.0% in 1991 and, by 1999 had risen only to 12.8% (median ROE). Moreover, the annual interest expense as a percentage of total leasing revenue held steady at about 33%. By adopting an Islamic leasing structure, conventional financial institutions can tap into huge reservoirs of Islamic equity funds seeking stable, secure, and liquid investments.

Moreover, because an Islamic leasing alternative involves no debt leverage, the Islamic lease can open an avenue to higher profitability by delivering an increase in the return on lessors’ equity up to a range of 15% to 18%, while lowering interest expenses to zero. Indeed, Islamic leasing in the United States has a bright future because it combines modern credit and financing techniques with traditional risk-reward sharing concepts and business ethics.

The author’s biography may be found on page 56.