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Corporate *Ijārah* Financing: A Case of an Islamic Commercial Bank

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Abstract. The Islamic banking industry facilitates both consumer and corporate clients by providing needed capital through different modes of financing. The pre-requisites of financing the corporate clients are generally different from that of the individual customers. This study discusses a detailed narrative of how a corporate customer, Sufi oil, availed financing from Bank Islami through *ijārah* mode of financing in a Sharī'ah compliant way. It discusses step by step procedure of dealing with corporate client starting from the first stage when a representative of the firm visited the Bank Islami and discussed the firm needs and the possible procedure and mode of financing. The study provide a comprehensive insight in the internal procedures involved in evaluating each and every client. Different branches and their respective role and responsibilities at the branch level and their interaction with the Head Office have been highlighted. The study has also briefly discussed various risks that may encounter the transaction and the manner in which the perceived risks have been mitigated.

The focus of the study is to differentiate the corporate *ijārah* from the consumer *ijārah* in terms of both documentation and procedure. The repayment schedule for the case is also described in detail along with the rent that the Bank Islami would be getting by leasing any vehicle to the corporate entity.

KAUJIE Classification: J0, K5
JEL Classification: G2

INTRODUCTION

Ijārah is an Islamic mode of financing and usually refers to a leasing contract of property or usable assets, such as land, plant ,office automation, motor vehicle etc., which are leased to a client for a steam of rental and purchase payment, ending with a transfer of ownership to the lessee by way of sale or gift. Broadly, it may be consumer *ijārah* or corporate *ijārah*. Corporate *Ijārah* involves fulfillment of comprehensive procedural and documentation formalities than the consumer *ijārah* financing. The latter, for example, may only require CNIC copy,

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proof of Income other than salary, utility bills, salary slip or pension book in case of retired person, from, the client. But corporate *ijārah* requires evidence about the principal and subsidiary places of operation of the business, financial worth, value of total assets, business turn over administrative hierarchy as required by SECP, departmentalization, Business, credit history, receipt and payment returns and so on.

The Customer's Need of *Ijārah*

This case study highlights the *ijārah* transaction concluded between Peshawar Based Sufi Oil and Bank Islami. Sufi Oil was established at Hayatabad almost a decade ago. After successful operation in the local market, the firm fell obliged to explore international market. In view of its geographic proximity and similarity of social indicators index, Afghanistan was considered as a good beginning point as a market for its products.

A careful internal estimate revealed that hired transport to Afghanistan would be too costly and inefficient and may nip the initiative in the bud. The financial depth of the firm, on the other hand, could not allow for its owned transport. Recent history of leasing vehicles from Banks for management encouraged the firm to approach Bank Islami for provision of the required facility. The firm approached its Sharī'ah Consultant and prepared a case for leasing the transport vehicle as per guidelines recommended by him.

Interaction with the Bank

The Chief Accountant, duely authorized by the firm, visited the Bank Islami for initial ascertainment of the *ijārah*. After initial inquiry with the Front Desk Officer, the applicant was guided to meet the *ijārah* Manager (IM) of the bank. The Chief Accountant placed two requests before IM; (i) Financing the purchase of vehicles in strict compliance of the principles of Sharī'ah and (ii) Opening of Letter Of Credit (LC) worth Rs:100 million, so that import of the requisite raw material for vegetable cooking oil from Malaysia be facilitated. The *ijārah* manager explained as to how the corporate *ijārah* financing is different from consumer *ijārah* financing, in terms of detailed documentation, legal formalities, and associated risks. During the first interview with IM, the representative of the firm was asked to furnish accounts' statements of the firm so that a general impression about the financial health of the firm is taken and further processing is facilitated.

The documents revealed that hither to the firm had already availed two cars, one Alto Suzuki and one Honda Civic, on lease, and an application for two more cars was under process and had opened 3 LCs with different banks; one of which is just got mature and the other two were payable. As required by the bank, the firm submitted a balance sheet and income statement of the firm, audited by a chartered accountant. After evaluation of these documents by the Head Office of the bank, the applicant was asked to provide;

i. Request letter on firm's letter head;
ii. Financial Tax Returns;
iii. CNICs of the members of the board of directors; and
iv. Credit Resolution passed by the Board of Directors [BoD approved by the SECP]. Contrary

to the assessment of Area Manager and Risk Management Unit, who observed mis-match between assets and liabilities of the firm, the IM made recommendations to the Head Office (HO) for further evaluation of the case.

Qualitative Asessment

To supplement the quantitative assessment of the firm as reported in the financial and other documents of the firm, the bank also made some qualitative assessment. The IM inquired from the branch manager about the validity, authenticity, and appropriateness of the accounts and other financial statements as provided by the client. The Area Manager endorsed the authenticity of these documents. The probe into the social reputation of the directors revealed them to be "trust worthy" as they also rendered their property to the United Nations office in Pakistan, and were having handsome monthly return, which also favored them to be recorded as "safe and sound".

Documents Analysis

To beef up the security of proposed financing, the IM asked the Registrar of the firm to submit report from Credit Information Bureau (CIB) of the State Bank of Pakistan, Form A, and H, and other Registration related documents of the firm. The Risk Management Unit (RMU) of the bank asked the client to submit sanction of every loan realized by the firm. The eCIB report revealed that the firm was indebted to the extent of Rs. 300 million in two separate loans. The volume of these loans was not in consonance to the overall assets and operations of the firm. The Credit Processor, therefore asked the IM to obtain complete information about all their loans. The client was also asked to submit financial return for several years as a single year return as provided by the client was not enough to assess the actual financial depth. In response to these observations, the client submitted financial reports for previous several years. Details of loans showed that the client had previously borrowed Rs 140 million from Bank Islami, and Rs 90 Million and Rs 40 Million from two other banks.

Sanction letters for each LC of the client pointed out that the limit of LC and its payment schedule were continuous and therefore it was difficult to provide a separate sanction letter for every LC under the time constraint. The plea was accepted and the client was asked to provide fully documented account of the loans limit, amount realized by the firm, loan paid and the balance left. As asked for by the bank, the firm provided form H and Registration Form but not Form A and Form 29. IM asked the client to submit these forms and sanction letters before the Resolution of Credit could be passed by the Board Of Directors of the firm. The RMU reduced all the information so far provided by the firm to a proforma so that the firm strengths and weaknesses could be ascertained at a glance.

The client submitted the remaining documents in about twenty days. IM, in consultation with the CIU, RMU and other relevant offices scanned these documents and submitted to Head Office for a favorable consideration. In about two weeks time the product manager, RMU and business manager confirmed the approval of financing and approval letter was duly sent to IM. Consequently, the IM conveyed approval to the client for further proceeding in the case.

Acquisition of Vehicles from Authorized Manufacturer/Distributor

According to the specification of vehicles as required by the client the bank contacted Hino-Pak Peshawar to arrange for the desired vehicles. The total value of five trucks amounted to PKR 60 million - each had a cost of PKR 12 million. The customer was asked to make 30% down payment as agreed under the contract. The tenure of this *ijārah* financing was five years, a list of Payment Schedule annexed.

Prior to the delivery and possession of the vehicles, the bank concluded a standard detailed contract with the client in which all the perceived risks were covered, namely:

i. The supply risk, which occurs when the supplier delivered the vehicles which do not meet the specified quality and hence may result in rejection of the asset by the client.

ii. Price risks may occur in case of breach of contract by the client who may refuse to take possession of the asset. The lessor may suffer a loss equal to the difference between the amount receivable on account of total rentals and the selling price of such asset which may even be less than the purchased price.

iii. Settlement risk which may occur when the lessee is unable to service the lease rentals when it is due.

iv. Rate of return risk which occurs due to fluctuations in the market owing to higher return demanded by the investment account holders/investors as compared to return on lease.

v. *Takāful* which occurs when there is insufficient *takāful* to cover any mishap during the delivery and rental period.

vi. Legal risk accruing to the lessor when the asset purchased is not of desired quality, specification, is defective. When the lessee refuses to accept such defective goods, the lessor may incur cost on account of litigation, loss of claim, etc.

vii. Assets Impairment Risk may occur when the asset get destroyed due not to the misconduct of the lessee. In such a case the lessor has to provide an alternate asset or pay the balance rentals.

viii. Default risk is caused when bankruptcy occurs to the lessee. In such a situation the lessor may repossess the asset and sell it to any other party to recover its purchased price. Profit due on account of remaining rentals may however be lost.

CONCLUDING REMARKS

The costumer had a network within the country for oil distribution and the *ijārah* is utilized to expand its businesses. The customer approached Bank Islami for facilitating the company to meet its transportation needs in Sharī‘ah compliant way. Before entering into the *ijārah* contract, the firm operated only in local market, while after getting vehicles on from the Bank Islami, the company started distributing its products in Afghanistan. It was also planning to extend to Iran and central Asia. So, overall the transaction had a positive impact on the business. Further, the company avoided *ribā* based conventional banking and availed an Islamic mode of business.

TEACHING NOTES

a) Learning Objectives:
After discussing the case, it is aimed to be achieved the following in class objectives:

- To explain overall process of *ijārah*
- To explain the requirements of processing a corporate client Case.
- To explain the different issues that may arise during processing the *ijārah* Case
- To explain the repayment procedure for a period of 5 years

b) Suitability of the Case
This is case is suitable for:

- Undergraduate and graduate students taking courses in Islamic Banking and finance
- Trainees interested in understanding how Bank Islami facilitate corporate clients through *ijārah*
- Sharī'ah scholar's interested in understanding in applied process of *ijārah*
- Credit Officers/Loan Officers/Retail Banking Officers working on the Seat newly inducted in Islamic Banking Industry

d) Assignment Questions
1) How many stakeholders are involved in the case of *ijārah* with corporate client? Identify and discuss their roles.
2) In your opinion what an alternative Islamic mode could the bank and the corporate client use to fulfill the same need of both bank and the client? Comparatively analyze *ijārah* and your proposed alternative Islamic mode.
3) What happens when a corporate client requests for early maturity of the facility availed?
4) Justify the Sharī'ah compliance of Terminal Values on early termination?
6) Explain the repayment behavior of the customer for a period of 05 years?
e) Analysis

1) How many stakeholders are involved in the case of *ijārah* with corporate client? Identify and discuss their roles.
Hint: In this case of *ijārah* we see different roles of the Bank, customer:, SECP, SBP, Pak

Hino Trucks, CA Firm, NADRA and currier companies, and avenues where bank make investment and parties looking for financing from the bank. However the theoretical model of *ijārah* only defines the role of bank, Party/customer and the supplier/distributor from whom the machinery will be bought through *ijārah* financing.

2) In your opinion what an alternative Islamic mode could the bank and investment account holder use to fulfill the same need of both bank and investment account holder? Comparatively analyze the *muḍārabah* and your proposed alternative Islamic mode.

Hint: The bank could use *mushārakah* or the participatory mode for financing. According to many Sharī'ah scholars, the originality of business is to be run jointly in form of *shirkah*, because customer feels more Sharī'ah compliance in service, as in that case any type of risk would be distributed between bank and the corporate client. However banks avoid this form of services due to following reasons:

- Liberty of bank can be affected as the client becomes a partner in the machinery that is brought for running his business and utilize the transport as per his need after approval from the second partner i.e. Bank. Every time an approval of Bank and Client will be compulsory for using the machinery. While in *ijārah*, the Vehicle belong to one owner and the rent is paid only by the Lessee on monthly or quarterly basis.

- Liberty of the client can be affected as the Bank becomes a partner in the machinery that is brought for running the business of the client and thus a new partner is added in the business operations. While in *ijārah*, the Vehicle belong to one owner and the rent is paid only by the Lessee on monthly or quarterly basis.

- Financing Machinery on basis of *mushārakah* is less profitable for bank as compare to *ijārah*, because in *ijārah* bank is entitled to earn profit as per market rate; but in *mushārakah* , the bank can earn profit on its own share only.

- In case of *ijārah*, Losses will be borne by the owner only, while in *mushārakah* every partner is liable to bear loss according to their portion of capital.

- Financing a machinery on basis of *mushārakah* is complex as compared to *ijārah*

3) What happens when a corporate client request for early maturity of the facility availed?

Hint: If an *ijārah* facility was availed for five years and the customer request for early maturity after 03 years, then the profit that is earned by an Bank Islami will be considered as the total profit and recalculation of the whole facility be made as the customer is violating the agreement, so 2% of the terminal amount will be taken from him along with principal amount remaining only,. The rest of 02 years profit will not be taken from the client.

4) Justify the Sharī'ah compliance of Terminal Value on Pre mature Termination Charges?

Answer: in case of early payment the customer will be charged extra amount in account of price of leased asset, because the bank and client enter into a separate sale contract where parties are free to fix agreed price regardless its worth and quantity which may be differ from the quantity promised by bank at the beginning of the *ijārah* contract.

5) Calculate the repayment behavior of the corporate client for 05 years:

TABLE 1
Calculation for repayment behavior of the corporate client for 05 years

	Date	March 21,2018	
	Customer		Sufi Oil
	Account Number		2765-1
	Vehicle Description		Truck
	Vehicle Price		10,104,633/-
	Security Deposit		3,000,000/-
	Profit Rate		14%

Installments	Due Date	Rentals	Terminal Value
1	3/21/2018	185,468	10,790,017
2	4/21/2018	185,468	10,681,981
3	5/21/2018	185,468	10,572,763
4	6/21/2018	185,468	10,462,351
5	7/21/2018	185,468	10,350,731
6	8/21/2018	185,468	10,237,890
7	9/21/2018	185,468	10,123,813
8	10/21/2018	185,468	10,008,487
9	11/21/2018	185,468	9,891,897
10	12/21/2018	185,468	9,774,030
11	1/21/2019	185,468	9,654,870
12	2/21/2019	185,468	9,759,405
13	3/21/2019	185,468	9,640,157
14	4/21/2019	185,468	9,519,602
15	5/21/2019	185,468	9,397,725
16	6/21/2019	185,468	9,274,511
17	7/21/2019	185,468	9,149,945
18	8/21/2019	185,468	9,024,011
19	9/21/2019	185,468	8,896,695
20	10/21/2019	185,468	8,767,980
21	11/21/2019	185,468	8,637,852
22	12/21/2019	185,468	8,506,293
23	1/21/2020	185,468	8,373,288
24	2/21/2020	185,468	8,441,321
25	3/21/2020	185,468	8,307,661
26	4/21/2020	185,468	8,172,531
27	5/21/2020	185,468	8,035,915
28	6/21/2020	185,468	7,897,796
29	7/21/2020	185,468	7,758,157
30	8/21/2020	185,468	7,616,982
31	9/21/2020	185,468	7,474,252

TABLE 1
Continue..

	Date		March 21,2018
	Customer		Sufi Oil
	Account Number		2765-1
	Vehicle Description		Truck
	Vehicle Price		10,104,633/-
	Security Deposit		3,000,000/-
	Profit Rate		14%

Installments	Due Date	Rentals	Terminal Value
32	10/21/2020	185,468	7,329,950
33	11/21/2020	185,468	7,184,059
34	12/21/2020	185,468	7,036,560
35	1/21/2021	185,468	6,887,436
36	2/21/2021	185,468	6,918,918
37	3/21/2021	185,468	6,768,545
38	4/21/2021	185,468	6,616,514
39	5/21/2021	185,468	6,462,807
40	6/21/2021	185,468	6,307,405
41	7/21/2021	185,468	6,150,288
42	8/21/2021	185,468	5,991,438
43	9/21/2021	185,468	5,830,834
44	10/21/2021	185,468	5,668,457
45	11/21/2021	185,468	5,504,288
46	12/21/2021	185,468	5,338,306
47	1/21/2022	185,468	5,170,490
48	2/21/2022	185,468	4,164,850
49	3/21/2022	185,468	4,995,156
50	4/21/2022	185,468	4,823,587
51	5/21/2022	185,468	4,650,122
52	6/21/2022	185,468	4,474,739
53	7/21/2022	185,468	4,297,417
54	8/21/2022	185,468	4,118,134
55	9/21/2022	185,468	3,936,868
56	10/21/2022	185,468	3,753,597
57	11/21/2022	185,468	3,568,297
58	12/21/2022	185,468	3,380,946
59	1/21/2023	185,468	3,191,522
60	2/21/2023	185,468	3,000,000
Total		**11,128,080**	

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