Credit Enhancement in Ijara Transactions

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ABSTRACT

The last several years have seen a flurry of leasing company failures. As a result, new emphasis is being placed on credit enhancement procedures that seek to protect leasing investors against such failures. However, the rules of Islamic finance may restrict the use of certain types of credit support that are commonly used in conventional finance. This paper examines several types of credit support in conventional finance and corresponding or similar arrangements in Islamic finance. The analysis examines the use of related-party or third-party guarantees; the use of insurance, including residual-value insurance and takaful; over-collateralization and related strategies; and liquidity support.

I. INTRODUCTION

The Equipment Leasing and Finance Foundation recently acknowledged that a “perfect storm” has swept the U.S. equipment leasing industry. Nearly two dozen leasing companies, including large public companies such as Comdisco, UniCapital, and Finova have become bankrupt in the last several years. Thirty-two companies have left the leasing market during this period.1

In light of this environment, investors in leasing transactions have increasingly sought to mitigate risks through the use of credit enhancement devices. Conventional investors in leasing, such as U.S. banks and other financial institutions, have employed a range of enhancement methods including guarantees, insurance, and derivative contracts that may include options, swaps, and other mathematical models.

Investors in Islamic leasing transactions (ijara) are no less risk averse than other investors.2 However, Islamic investors may be somewhat more restricted in the use of credit enhancement or risk mitigation techniques.

A fundamental precept of Islamic finance is that a person who invests in an asset should bear the risks inherent in the asset in order to earn profits from its ownership.3 Risk mitigation, depending on the scope and structure of the provisions that are employed, may be inconsistent with bearing the risks of investment.4 When a party seeks to escape risks, the ensuing profits may be tainted by riba. Islamically, there is always a linking of risk and reward, so the question arises as to whether techniques that curtail risks are Islamically acceptable.

In this article, we analyze the diverse risks inherent in ijara, survey the restrictions that Islamic finance places on risk mitigation and credit enhancement techniques, and discuss types of risk management devices that may be acceptable to the Islamic investor in ijara.

II. RISK ASSESSMENT IN IJARA TRANSACTIONS

In 1963 Mehr and Hedges in their book Risk Management in the Business Enterprise proposed the following three basic rules for risk management:5

- Do not risk more than you can afford to lose
- Consider the odds
- Do not risk a lot for a little

Risk or uncertainty, referred to as gharar in Islam, is inherent in any financial transaction. Risk has been defined as an adverse deviation from a designed outcome that is expected or desired. It is a condition of the real world. The hadith literature notes that risk arises because of lack of knowledge (jahala) or uncertainty about an outcome.

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Fundamental to risk control is risk assessment. Islamic investors need not blindly accept whatever risks any investment may involve; rather, the Islamic investor, no less than the conventional investor, can assess the risks of a transaction relative to its potential rewards. Risk assessment is considered the front line of risk control.

The following is an overview of some significant elements of risk inherent in any *ijara* transaction. In fact, these risk elements are inherent in any leasing transaction, conventional or Islamic, and the methods of risk assessment that can assist the investor in controlling risk are also similar.

### A. Credit Risk

The bulk of the income from most leasing transactions is derived from the initial equipment lease. The financial capability of the initial lessee to satisfy its lease obligations is the most important criterion in determining the success of the transaction.

Companies are usually rated when they issue public debt so that investors can assess the risk. Rated companies are generally large in size. If the lessees have credit ratings issued by recognized rating agencies such as Moody’s or Standard and Poor’s, the credit rating will provide a good initial indication of the credit quality of the lessee. The credit ratings are not infallible, but reflect a fairly careful assessment of fixed credit criteria. Companies rated triple B and above are considered “investment-grade” and are generally accepted as having good credit. A leasing program may be structured to include investment-grade lessees in whole or in part in order to reduce the risk of default. But a number of large companies are not engaged in the public sale of debt and thus may not be rated by rating agencies. These companies can be assessed independently based on their balance sheet and credit history and can be included in a lease portfolio as “credit equivalent” to investment grade.

For companies without standard credit ratings, it may not be possible for the investor to assess the credit-worthiness of these companies based on the balance sheet alone when there are many lessees and the lease size is relatively small. However, the credit of a lease portfolio consisting of unrated lessees may be assessed by reviewing the overall track record of the lease originator. Lease originators maintain extensive data on lessees’ historical default and delinquency rates. If the lease originator deals with the same lessees on regular basis, or uses a standard form of credit review with a large number of lessees, a new portfolio can (at least in theory) be expected to perform approximately like similar lease portfolios. For this reason, rating agencies will frequently rate debt which is collateralized by lease pools even if the lessees are not rated companies.

Additional forms of credit support may also be available. Sometimes the lease originator or some other party may advance a portion of the equipment cost – say 5% or 10% – on a first loss basis, whereby any losses incurred by the portfolio are first charged against the capital of the lease originator. Of course, investors must recognize that there is a direct relationship between risk and yield, and that all forms of credit support have a cost.

From a credit point of view, leasing in some ways provides a better form of security than conventional secured debt. In the event of a lessee bankruptcy, the lessee must promptly determine whether to affirm the lease and continue paying rent or return the equipment. In the case of secured debt, the bankrupt party can sometimes delay making payments or turning over the collateral for months or even years.

### B. Residual Value Risk

Residual value is the income which may be earned from the equipment after the expiration of the initial lease term. Residual value may be earned in one of two ways. First, residual value may be earned by a renewal or extension of the lease by the original lessee, or a sale of the equipment at the end of the term to the original lessee. Second, if the equipment is returned at the end of the initial lease, residual value may be earned by selling or leasing the equipment in the secondary market place.

In the case of finance leases, where the lessee generally has a $1 purchase option or another below market value purchase option, the residual value will essentially belong to the lessee and the investor need not be concerned with residual value. In the case of fair market value (FMV) leases in which the lessee has no option to purchase or only has an option at FMV, residual value will be a significant element in achieving a satisfactory yield on the equipment.

Leasing industry statistics indicate that in half or more of all FMV leases, the initial lease is renewed or extended, or the equipment is purchased by the initial lessee. In addition, lease originators maintain extensive data on the renewal and extension rates of their existing lessees. These statistics are a very important indication of residual value realization and can help determine pricing when the lessor structures a bid for a leasing transaction.

If equipment does come off lease, the lease originator will be responsible for releasing or selling the equipment in the secondary market place. Most lease originators have a remarketing department which is responsible for remarketing the equipment and also maintain data on their remarketing realization. If the
equipment in a new portfolio is substantially the same as the equipment for which historical data is available, the historical data may give a good indication of future realization, subject of course to significant market changes. Additionally, certain technology consulting companies, such as the Gartner Group, provide appraisals of the projected future value of technology equipment. A careful review of industry data, lease originator data, and appraisal information can help the investor make a reasonable estimate of future residual value.

C. Risk of Damage or Loss

In a typical U.S. equipment lease, the risk of loss or damage to the equipment is shifted from the lessor to the lessee, and the lessee is required to maintain insurance to cover this risk. Similarly, in most U.S. equipment leases the obligation to maintain the equipment is shifted to the lessee.

However, in structuring an ijara program the onus is on the lessor to bear responsibility for loss or damage. Shari’a requires that the lessor, as owner of the equipment, must bear the risk of damage or destruction to the equipment. The ijara contract cannot require that the lessee shall bear these risks. To do so would violate the fundamental principle that the owner of a business or asset must bear the risks of the business or asset in order to enjoy the income therefrom. Avoiding such risks in the contract of ijara may involve riba.

As a practical matter, most commercial equipment leases involve equipment in locations quite remote from the lessor where the lessee has almost sole control and access. For example, how can a Texas-based lessor be expected to control the risk of loss or destruction of a piece of computer equipment (which the lessor has never seen) located in the office of the lessee in Salt Lake City?

An initial assessment may be made based upon the equipment type and the nature and history of the lessee. Certain types of equipment may be more easily damaged or more difficult to remove in the event of lessee default. Some lessees may be more prone than others to poor equipment maintenance or hand use. While the typical investor will not have access to such information, the leasing companies originating the transaction often keep such data. Moreover, as we will see in the next section, contractual servicing arrangements may be available to mitigate these risks.

III. APPLICATION OF CREDIT ENHANCEMENT TECHNIQUES

Having identified the basic risk elements in ijara, we now move on to explore shari’a restrictions and credit enhancement techniques that may fit within a shari’a framework.

As we have already noted, shari’a generally requires that in order to earn income from asset ownership, the investor must assume the risks of ownership. This general principle has led to certain restrictions on the use of capital protection devices in ijara transactions. Nonetheless, some techniques that are utilized to enhance the security of leasing transactions have been met with approval from various shari’a boards.

A. Performance or Commercial Risk Guarantees

Islamic law permits a second party to guarantee the obligations of another party (daman or kafala) with three important limitations. First and most important, the guarantee must be gratuitous, although the guarantor may recover out of pocket expenses not including the cost of capital. Second, the guarantor should be able to cancel the guarantee at any time before the obligation actually becomes due. Third, the guarantee must concern the payment of an obligation rather than contingent losses (the guarantee is not insurance).

Notwithstanding these limitations, third-party guarantees in the form of Islamic letters of credit or standby letters of credit are common in murabaha transactions. In the context of ijara, a third-party guarantee is often structured as a put option obtained from the bank in exchange for payment of rent. If the lessee at some future time should cease making payments, either because it concludes that the equipment being leased is not as valuable as the remaining installment payments or, more likely, because the purchaser has become insolvent, the lessee could “sell” the equipment to the bank in return for the bank taking over the remaining installment payments. The bank, of course, would have the right to recover its losses from the lessee, but in the event of insolvency such a right might not be meaningful. The bank in effect guarantees the payments to the lessor.

For its role in the transaction, the bank charges a fee which is typically added to the rental price of the equipment and is not paid separately by the lessee. To be acceptable for shari’a purposes, the fee should not be a percentage of the value of the contract but should be a stated fixed fee payment related to the actual services of the bank.
B. Protection Against Damage or Loss

Insurance against contingent loss (for example, a guarantee against loss of an asset as a result of casualty) is generally considered unacceptable in Islamic finance because it violates principles against gambling or maysir as prohibited in the Qur’an. Typical casualty insurance should be unacceptable for these reasons. This is particularly significant in the context of ijara transactions, since ijara requires that the risk of damage or destruction of the asset must be born by the lessor. In conventional finance, the risk of such losses is placed upon the lessee, and the lessee is in turn required to cover these risks with insurance.

However, other methods of transferring this risk exist. Shari’a does not preclude the lessor from entering into a contract with a third-party to engage in servicing activities with respect to the equipment. The servicing agreement may provide, for example, that the servicer must monitor and supervise the use of the equipment in such a way as to prevent damage or loss. Damage or loss that might be prevented by adequate precautions can effectively be transferred to the servicing party by appropriate contract provisions.

Shifting the risk of loss pursuant to a servicing agreement would not appear to violate the rule which requires lessors to retain the risk of loss under the lease. The servicer is not the same as the lessee, although in some cases it may be related to the lessee. Moreover, the risk of loss has effectively been shifted pursuant to separate contracts which are Islamically valid.

A contract provision whereby the servicer simply acts as insurer, guaranteeing against any catastrophe, might be considered insurance of the prohibited kind. However, the areas of risk can be tightly restricted by service provisions. It may also be possible to shift the ultimate risk of “no fault casualty” (such as a hurricane) by means of a put option embedded in the servicing agreement and compensated by the servicing fee paid to the servicer. Such a provision may not violate the rules concerning guarantees.

C. Residual Value Insurance or Guarantee

The principal techniques used for reducing residual value risk typically involve either guarantees of residual value issued by the originator of the leasing transactions (or perhaps some affiliate of the originator) or through obtaining residual value insurance from insurance companies specializing in such transactions. The insurance policy in most instances will have a deductible. Each of these risk mitigation devices may be problematic from a shari’a point of view.

A guarantee will typically not be issued without consideration unless the guarantor is affiliated with the ultimate lessee. Thus while affiliate guarantees may be acceptable, the lessee will often not have any parent which is willing to make such a guaranty. Third-party guarantees are usually in the form of a guarantee of principal investment or a certain return, both of which are presumptively unacceptable in Islamic finance. Residual value insurance might be available on a takaful basis in the future, but now there are only a small number of companies that issue residual value insurance, and none operate Islamically.

D. Derivative Contracts

The shari’a rules prohibiting gambling (gharar) and the Islamic principles linking reward with risk establish significant barriers to the creation of Islamically acceptable derivatives. Options, futures, forward contracts, and swaps all appear to be fundamentally unacceptable.

With certain modifications, however, some forms of option contracts may be acceptable to Islamic finance. One type of contract acceptable to some shari’a scholars is the ‘arbun, or the earnest money contract. Under such a contract, a buyer advances a down payment and agrees to pay an additional purchase price when the goods are delivered at some future date. The purchaser may however decide not to accept the goods in the future, in which case the seller keeps the down payment. While not universally accepted, the ‘arbun contract appears to be widely used in the Islamic finance industry. For example, ‘arbun contracts have been used to create principal protected equity funds in which the ‘arbun contract is effectively a forward option against an Islamic equity index.

In most respects the ‘arbun appears similar to a conventional option, although the ‘arbun can alternatively be viewed as a binding contract with a liquidated damages provision in the event the buyer fails to complete the transaction. The key restrictions that are imposed in the ‘arbun contract are that the seller must possess the goods to be sold throughout the ‘arbun period and that he cannot deal in them during this time. For example, in the case of an ‘arbun on stocks, the seller must possess specific stocks to be sold over the period of the ‘arbun. The purchaser apparently bears the risk of loss. Such contracts provide the opportunity for the application of significant risk mitigation techniques. In ijara transactions, the techniques used with derivatives can be applied to large leasing portfolios which consist of different types of equipment, risk, and lessees. We have not seen an attempt in this direction so far.

E. Over-Collateralization as a Credit Tool

A traditional method for investors to protect themselves against the risk of credit default on a portfolio of leases is over-collateralization. In general, the concept is that the portfolio of leases transferred to
the investor will have a total value in excess of the amount paid by the investor. The lease income then runs to
the investor until it realizes a specified rate of return, after which the excess yield on the portfolio reverts to
the seller. This is the classic structure used in the securitization of lease portfolios and usually involves
“tranches” of investor instruments with different priorities in the cash flows.

The “tranching” of cash flows – the ranking of priorities of one investor over another – is generally
inconsistent with the principles of Islamic finance. Preferred stock, like debt, is generally considered
impermissible. The fundamental concept of over-collateralization may imply a set of priority returns that are
not generally permissible under shari’a.

Nonetheless, certain forms of over-collateralization would appear to be consistent with the rules of
Islamic finance. For example, a form of over-collateralization can be achieved through the use of a sale
leaseback transaction containing a purchase option. The seller transfers assets with a value of $100 in
exchange for a payment of $80. Directly thereafter the assets are leased back to the seller for fixed lease
payments together with an option on the part of lessee to acquire the equipment at the end of the lease term
for a fixed price. The purchaser of the assets receives the benefit of over-collateralization in that he has
acquired the cash flow from more than $80 worth of assets at the inception of the transaction. The purchaser
has a bargain purchase which enhances his confidence that the lessee will in fact keep up its lease payments.
If all lease payments are properly made, the lessee eventually reacquires the equipment through the exercise
of its purchase option at the end of the lease term. The parties will have all achieved their appropriate returns.
If, for any reason, the lessee should default, or not exercise the purchase option, the purchaser/lessor
payments should be made by selling or leasing the excess assets purchased.

IV. THE USE OF SPECIAL PURPOSE VEHICLES FOR RISK MITIGATION

The difficulties surrounding credit enhancement in ijara transactions may in some cases be avoided
through the use of a special purpose vehicle (SPV) owned by an independent third party. Typically, the
independent third party would be the originator of the leasing transaction or another party involved in the
leasing business. The lease originator can establish a special purpose vehicle, that is, a subsidiary organized
solely for the purpose of a particular leasing transaction or set of transactions. In such an arrangement, an
investment company, operating on an Islamically acceptable basis, would purchase appropriate equipment
that complies with the precepts of shari’a. The investment company would then lease this equipment to the
SPV. The terms of the lease between the investment company and the SPV would be fully compliant with the
rules of Islamic finance. The SPV can in turn enter into subleases of the equipment and engage in credit
enhancement transactions such as credit guarantees or residual value insurance contracts. This transaction is
diagrammed in Figure 1.

**Figure 1: Special Purpose Vehicles**

Because the SPV engages in no transaction whereby it incurs liability to any party other than the
investment company (other than transactions related to its lease with the investment company) any credit
guarantees or insurance entered into by the SPV will indirectly benefit the investment company. Of course, if
the SPV were liable for the debts of the lease originator or other outside obligations, the benefit of these risk
mitigation devices might not be passed on to the investment company.

If properly structured and operated, the use of an SPV to mitigate risk would appear to be appropriate
under the principles of Islamic finance. However, it should be noted that certain trade-offs must be made.
First, the investment company should not control the operation of the SPV. Thus, the investment company,
even though it is the owner of the assets, must give up a significant measure of control over the assets. This
lack of control over the SPV may be a significant drawback.
A second important drawback is that the benefit of any risk mitigation devices will not run directly, by assignment or otherwise, to the investment company. If the investment company were to have the right to enforce the guarantees or insurance contracts, it would be engaging in an impermissible transaction. Thus, the investment company must rely upon the SPV (and perhaps, the parent of the SPV) to enforce the risk mitigation contracts.

These drawbacks, while real, may be acceptable. The SPV should be “bankruptcy remote” from its parent company. In other words, it should not be responsible for the obligations of its parent. Unless the SPV is operated in an improper manner, it should therefore have no significant obligations other than those with respect to the investment company. The investment company, which has the right to enforce its lease contracts on the SPV, will indirectly benefit from the risk mitigation.

V. CONCLUSION

Certain fundamental concepts of Islamic finance, including the linkage of asset risk to return and the prohibition against contingent contracts considered to involve gharar, limit the use of conventional credit enhancement devices in ijara. However, a number of mitigation techniques are still feasible. A variety of contractual devices, as discussed above, may give Islamic investors protection similar to that of conventional investors. Moreover, the use of a third-party SPV to intermediate between the Islamic investor and the various leasing risks may avoid the restrictions inherent in ijara. The third-party SPV should not itself be subject to restrictions in the use of credit enhancement techniques so that the Islamic investor may be benefited indirectly. However, to avail itself of a third-party SPV, the Islamic investor must give up a significant degree of control over the use and disposition of the assets.

2 In fact, it has been suggested that Islamic investors are even more risk averse than conventional investors. Approximately 80% of all the assets of Islamic banking institutions are held in secure, short-term murabaha transactions.
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