

**Islamic Finance *news***

**2006**

**GUIDE**

**January 2006**

# ISLAMIC FINANCE NEWS GUIDE 2006

Welcome to the inaugural and annual Islamic Finance news Guide.

Launched in October 2004, Islamic Finance news has quickly become the industry's leading publication with a global audience in excess of 12,500.

With the bi-weekly newsletter we focus on the latest trends and stories keeping you up-to-date. Therefore, we thought it would be a good idea to publish an annual report which reviews the year just past, in addition to previewing the year ahead.

We invited a select group of the industry's leading practitioners and academics from around the world to author relatively concise reports on either a particular industry or market sector. As with the newsletter, you'll not find these anywhere else.

In addition to these articles we have: 2005 News Briefs review, league tables, interviews, Takaful Briefs review, Best Islamic Banks Poll 2005 results and much more.

We hope you enjoy it.

## Major Changes

We're going weekly!

As from March this year Islamic Finance news will be available EVERY Friday morning. Therefore 50 issues per year instead of the current 25!

We will also be introducing a number of new sections within a new look format.

Subscription rates will increase from the end of March, but those who subscribe before then will not succumb to the new rates!!!

Finally, we'd like to thank all the contributors and advertisers for their support in putting together this Guide. We're already planning for the 2007 edition.

Wishing you all a safe and happy 2006.

Very best regards,



Andrew Morgan  
MD & Publisher

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# Overview of Islamic Equipment Leasing Industry in the GCC

By James Cracco

According to published reports, the GCC states' collective GDP in 2006 will reach US\$600 billion. At the same time, equipment leasing as a percentage of GDP stands at an average of 1.67% among the top 50 equipment leasing markets in the world. Those two facts together translate into the realization that the GCC is at least a US\$10 billion market in the waiting. The GCC and, in most cases, the rest of the Islamic world, is just beginning to realize the benefits of equipment leasing as businesses, governments and the financial markets look to assume their role in the US\$580 billion annual global equipment leasing market.

Indeed, it is somewhat of a paradox that the Islamic world – and the Middle East and the Gulf in particular – are one of the few remaining “frontiers” for equipment leasing. After all, it was in ancient Sumeria that the earliest known leases were recorded some 4,000 years ago! And while the prospects for equipment leasing are growing and bright, the fact is that the market in this region tends to think of leasing more in the context of real estate and personal automobiles. Equipment leasing is still a minority portion of most leasing activity. Part of this phenomenon is historical, in that large capital equipment demands in this area of the world were typically met with cash or conventional bank debt. However, the rapidly expanding and diversifying economies, along with the creation of a new range of capital formation structures and products (Islamic and conventional), signal that the basic underpinnings of a healthy and creative equipment leasing market are in place.

Given the newness of the market, Islamic leasing clearly has the opportunity to create a very strong footprint. Moreover, because Islamic and conventional leasing are so similar, those organizations that succeed in the Islamic marketplace will be well positioned to compete in the global market.

## Background

The key difference between Islamic finance and conventional finance is the role of interest. Interest (riba) is prohibited in Islamic finance. The ban on interest is based on the concept that money is not a commodity in itself that can be used to create profit. Rather, money should be used for buying and selling assets. The transfer of those assets, on the other hand, is a legitimate profit-making enterprise.

Unlike conventional finance, the payment stream of an obligation cannot be sold, because one may not create a debt out of a debt. The assets involved in the same transaction can be resold, however.

There are some other features of Islamic finance, as stipulated under the Islamic Shariah, which are different from conventional finance. The proscription on transactions related to prohibited (haram) asset classes (alcohol, tobacco, pork) is well known. The Islamic Shariah also forbids activities or practices that are speculative or create uncertainty (gharar).

## Ijarah, or the concept of Islamic leasing

Because Ijarah is rooted in the concept of an asset rental (even if the title will eventually pass or be sold to the lessee), there is no reference to “interest.” Any payments based on an interest rate – late fees, interim rent – are not permitted. That said, because Islamic leasing is based on the lessor owning the underlying asset, there is more commonality between conventional asset-based financing or leases than not. Islamic leasing offers lessor and lessee much of the same flexibility as does the conventional mode.

“Given the newness of the market, Islamic leasing clearly has the opportunity to create a very strong footprint”

Because the ownership of the underlying asset in an Ijarah/lease is held by the lessor, the right to ownership can be resold by the lessor together with the right to receive payment of the lease rentals.

In conventional leasing, the lessor is a passive financier and thus transfers all responsibilities for maintenance, insurance and taxes to the lessee (“Triple Net, Hell or High Water Lease”). Under Islamic leasing (rental of an asset), the lessor retains the responsibility for major maintenance, insurance and taxes. However, Islamic leasing does utilize several structures – the most common of which is to appoint the lessee as agent for the lessor – which ultimately and indirectly transfers the requirement for maintenance, taxes and insurance to the lessee.

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### Opportunities in Islamic leasing

Although there are many Islamic finance structures that can be used as leasing products, the core instruments should be Ijarah (equipment rental or operating lease, in conventional terms) and Ijarah wa iqtina (finance lease).

The normal progression of lease structures in new lease markets is that the operating lease follows the finance lease by some time in terms of use and popularity. Our experience at First Leasing Bank, for example, is that after 15 months of educating potential lessees on Ijarah leases, we are beginning to see serious interest.

Before Ijarah leases are prevalent, however, the market will first need to evolve to an “unencumbered” Ijarah wa iqtina lease as a standard. The unencumbered Ijarah wa iqtina lease is one that follows the norms established in more mature leasing markets, e.g. financing 100% of the equipment, relying on the asset value in addition to the financial statements, and only requiring additional security when the circumstances so warrant.

Whether Islamic or conventional, the majority of the equipment finance leases transacted in the GCC to date have been done by traditional banks that tend to conduct equipment leasing as an extension of their normal banking activities. It is not surprising, therefore, that the Murabahah is often the instrument of choice. A review of the available financial statements reveals that even the majority of the specialized leasing companies historically preferred Murabahah as the favoured “equipment lease.” (Commercial aircraft leases are a notable exception.)

The distinction between Murabahah and Ijarah is important because the two are often confused or the outcome is assumed to be identical. In fact, the Murabahah structure transfers title to the “lessee” at the beginning of the transaction and therefore the “lessor” has no further rights to sell or transfer the asset.

Recently, however, there is anecdotal evidence that the specialized leasing companies and some banks are increasing the use of Ijarah structures. The emergence of the asset-based Ijarah structure in the GCC is probably due to a combination of pressure from Shariah boards and because Ijarah is more liquid than Murabahah.

Even in the Ijarah structure, the typical traditional banking equipment lease requires a minimum down payment of 20% (or collateral of at least 125%), insistence on guarantees – both personal and corporate, and several other banking covenants not usually demanded as a matter of course in the global market. Equipment leasing as a 100% financed product (or without additional collateral) is currently a rarity in the GCC –

again regardless of whether structured by an Islamic or conventional bank. While in some countries there is legitimate concern that the security offered by the underlying asset is not satisfactorily secured and/or not well supported by the current legal system, there are clearly companies, governments, and lessees that merit “world standard” treatment. This excess collateral requirement, coupled with longer turnaround times, offers a great opportunity to efficient Islamic leasing companies and Islamic banks to establish a pre-eminent position in the equipment leasing market.

The full benefit of Islamic equipment leasing will be only realized with the widespread use of operating leases where lessors make real (and educated) equity investments (“residuals”) in equipment and assume true asset risk. Of course, that means that lessors will need to develop or tap into the secondary equipment market. With that development, lessors will truly add a unique product to the capital formation alternatives which, when properly managed, will ultimately increase the Islamic lessors' profitability.

“Islamic equipment lessors have a unique opportunity not only in the GCC but throughout the Islamic world to assume the position of leadership in the equipment leasing market”

The operating lease also works to the lessees' benefit. First and foremost, the lessee only pays for the asset for the time the assets are utilized – usually two to five years, depending on the asset. Moreover, it is possible for the lessee to retain a full range of options at the end of the initial lease term. Typically, those lessee options are to return the asset, purchase the asset, or renew the lease.

The reality is that if an entity is not interested in engaging in Ijarah/operating leases, that entity is not really in the equipment leasing business. Part of the road to Ijarah/operating leases is education – education of the potential lessees and, in some cases, education of investors and boards of directors. But the real commitment is that of the leasing company, who must invest the time and talent to truly understand the economic value and future value of the assets they choose to lease. And after all, what could be more consistent with Islamic finance risk sharing than a lessor taking a residual position in equipment?

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### Conclusion

Islamic equipment lessors have a unique opportunity not only in the GCC but throughout the Islamic world to assume the position of leadership in the equipment leasing market. Conversations about the role and future of Islamic finance invariably deal with the questions of how Islamic finance can "catch up" with conventional finance and/or how Islamic finance can emulate or offer an alternative product to conventional finance. In the equipment leasing arena, however, neither Islamic nor conventional lessors have established a dominant position in the marketplace. Those lessors that offer international market standard terms for Ijarah wa iqtina leases and move into Ijarah leases will not only enjoy the profits of those decisions, but continue to define the market – including the global market – for years to come.



The author is CEO of First Leasing Bank.

Bahrain-based First Leasing Bank was launched in October 2004 as the first company dedicated exclusively to equipment leasing throughout the GCC. First Leasing Bank concentrates

on middle market, middle ticket (US\$1 million to US\$10 million) transactions with operating leases (Ijarah) and finance leases (Ijarah wa iqtina) forming the core product offering. The bank will lease most capital asset classes including manufacturing and process machinery, printing presses, construction equipment, IT, power and water generation, telecoms, vehicle fleets, medical equipment and office furniture.

The founding shareholders are Ithmaar Bank (Bahrain), Overland Capital (US), Gulf Finance House (Bahrain) and Gulf Investment House (Kuwait). In October 2005, Abu Dhabi Investment House also acquired a stake in First Leasing Bank.