

LEGAL ISSUES OF IJARAH CONTRACT AND RENT-TO-OWN SCHEME: AN ANALYSIS

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ABSTRACT

Rent-to-own scheme is one of the Islamic financing products which have been introduced based on the well-known and widely practiced Islamic concept of transaction, which is ijarah. The purpose of this concept paper is to explain the legal provisions that enable Islamic financial institutions to adopt rent-to-own; and to analyse the elements of ijarah as required by the Shariah are fulfilled in the rent-to-own scheme within the Malaysian context. Two legal issues were discussed, i.e., whether the Islamic banks are entitled to acquire the property and in the event of customer's death, who shall continue paying the rent to the bank. Few decided cases were discussed in order to illustrate issues that could arise in relation to practical legal aspects of ijarah in Malaysia. This paper concludes that the rent-to-own scheme is in line with Shariah. The Bank Negara Malaysia has issued several guidelines and regulations to further ensure that it is Shariah-compliant. Therefore, such kind of scheme can be utilized by the community, particularly given the benefits or maslahah that it gives to the community.

Keywords: Ijarah Contract, Rent-to-Own, Legal Analysis, Legal Issues, Islamic Finance.

INTRODUCTION

Ijarah comes from the word ajara which means “to recompense, compensate or give a consideration and return”. The word ujarah refer to rental payment while the word ajr refers to employee's wages. Ijarah primarily refers to rental and hire contract that employ the services of others. The practice of ijarah is evidenced in al-Quran and al Hadith. In al- Quran, verses such as al-Kahf: 77, al-Qasas:26 and al-Talaq:65 refer to the practice of ijarah and in al-Hadith, the report of “pay the employee his wages before the sweat of his brow dries up” reflects the employer and employee relationship. Aside from the practice of ijarah as an employment relationship, the Prophet's (PBUH) companions practiced ijarah for both the employment contract and the rental of property (Kamali, 2007).

To comply with the requirements of Shariah is a precondition to ensure that the financial products and services are legitimate to be offered by Islamic institutions and accepted by the customers. Establishing the necessary operating framework and infrastructure for an Islamic financial institution (IFI) is critical to ensuring that Islamic financial transactions are Shariah compliant. A regulation which is based on Shariah is structured to ensure Shariah compliance,

thereby enhancing the IFI's credibility and sustainability. The policy text is divided into two distinct sections: Shariah criteria and organizational criteria.

An *ijarah* is a contract that transfers ownership of a usufruct or service for a set period of time in exchange for a set amount of money. In Islamic financial transactions, there are two primary *ijarah* structures: primary *ijarah* and *ijarah* finance. The most common *ijarah* structure is one in which the customer has the objective to utilize the asset rather than commit to owning it. As a result, after the lease contract is completed or terminated, the lessor may continue to become the owner of the asset. *Ijarah* financing is intended to transfer asset ownership to the customer at the end of the lease term. To that end, the *ijarah* will be accompanied by supporting agreements and/or other contracts that will facilitate the changing of the ownership of the asset on the part of the IFI as lessor to the customer as lessee via the *hibah* (gift) or *bai'* (sale) processes, respectively.

The IFI would then come up with the best arrangement for an *ijarah* financing from start to finish, which may include the following arrangements in which any implementation of *wa'd* (promise) signifies either the customer's ultimate need become the owner of the assets or the IFI's intention to change ownership of the asset to the customer, or an arrangement to change the status of the ownership of the assets. To represent the customer's ultimate aim to become the owner of the asset while at the same time meeting the objects of the IFI to give effect to the change of ownership to the customer at the end of the *ijarah* term, the IFI may obtain any of the following means:

1. The customer or another party providing *wad* to procure the asset;
2. The IFI providing *wad* to sell the assets;
3. The IFI providing *wad* to furnish as *hibah*;
4. The IFI furnishing a *hibah* with conditions attached to it.

In such a situation, the IFI assists in ensuring the intention of both parties are realized, i.e. the customer in becoming the owner of the asset, and the IFI in changing the asset's ownership from its name to the name of the customer's, provided that such arrangement is independent of the *ijarah* finance contract.

Legal Aspects of Rent-To-Own

The previous Prime Minister introduced a rent-to-own scheme in Budget 2015. This scheme enables a person to rent an asset for an agreed tenure with the option to buy and own the asset at the end of the rental period for an agreed amount of the purchase price. The rent-to-own program was created in response to people's inability to purchase for residential purposes in the property market (Aziz et al., 2019). Historically, it was intended for low-income earners who were either unable to purchase a home or were not qualified for any type of housing loan. As a result, the houses in question were primarily from the Program Perumahan Rakyat (PPR), such as low- or moderate-cost housing units (Bhatt, 2017). However, according to a report by the Khazanah Research Institute, citizens of Malaysia from the income groups of low and middle-income are unable to purchase a home through this scheme (Ismail et al., 2015). Rent-to-own programs enable individuals to purchase property by renting it for a pre-determined duration. The tenant would then be given the choice to buy the property at the end of the rental period or at

a predetermined purchase value if they are able to secure financial support. While the purchase price is locked in, the tenant can increase his or her savings and improve his or her creditworthiness.

Rent-to-own was based on the Islamic concept of *ijarah*, in which a lessee rents an asset with the intent of purchasing it. *Ijarah* is an Islamic fiqh term that translates as "*to rent something*." The term '*ijarah*' means 'to hire a person's services in exchange for remuneration' in Islamic law. The lessor is known as *musta'jir*, while the lessee is known as *ajir*. There are a few legal provisions that allow for the use of *ijarah* (Malaysian State Bank, 2018). Section 29(1) of the Islamic Financial Services Act 2013 (IFSA) states that the Bank may specify Shariah-related standards for the conduct of business, affair, or activity by an institution that requires the Shariah Advisory Council to ascertain Islamic Law and to give effect to the advice or ruling. A similar explanation is provided in Section 33E (1) of the Development Financial Institutions Act 2002 (DFIA).

This policy document also includes conditions to be met, primarily to protect the consumers vide provisions in the Hire Purchase Act 1967, for instance provisions relating to repossession should be incorporated into the *ijarah* financing contract. Generally the purpose of this practice is to ensure that a customer covered by an *ijarah* financing contract receives equal protection as a customer covered by a Hire Purchase Act 1967 (HPA) in the event of repossession.

The HPA of Malaysia governs credit agreements for the purchase of consumer goods such as furniture, electrical appliances, and even automobiles. It further requires the customer to pay a deposit of at least 10% of the purchase price to the seller or dealer. After acquiring ownership of the assets from the seller, the bank and the customer would then execute a hire purchase agreement.

Shariah Requirements of Rent-To-Own

An *ijarah* is a lease contract that enables changing of ownership of an asset's right to enjoyment to another person for a specified term for a predefined consideration or a contract for the employing of a person's assistances for an identified period in interchange for a specified consideration, according to Shariah principles.

An *ijarah* is therefore a lease contract for the purpose of transferring the use of a specific asset to another person in exchange for a rental payment and a hire contract for the purpose of employing a person in exchange for remuneration paid in exchange for his or her services. The leased asset may be an existing and identifiable asset at the time the *ijarah* contract is signed, or it may be an asset that will be made available at an agreed-upon time in the future in accordance with predetermined specifications, which is known as *ijarah mawsufah fi zimmah* (Dieng, 2019).

Certain elements must be present in an *ijarah*. The contracting parties, who are the lessor and lessee, are the first component. Multiple lessors or lessees may be named in an *ijarah* contract. A party may also seek the assistance of a *wakil*, or agent to act on its behalf. If the asset is co-owned by more than one party, prior to leasing the asset, the consent of all co-owners must be obtained. The contracting parties shall be a human or a legal body with the legal capacity to execute an *ijarah* arrangement.

The second component is made up of *ijab* (offer) and *qabul* (acceptance). An *ijarah* contract is formed through an offer and acceptance process between the parties involved in the arrangement. Offers and acceptances may be made orally, in writing, or by any other means permitted by Shariah. Contracting parties are bound by the previously agreed-upon and Shariah-compliant terms and conditions of the *ijarah* contract. The third component is the asset and usufruct (right to enjoy). Most importantly, the asset and right to use in an *ijarah* contract must be allowed under the Shariah, valuable, existing, identifiable, accessible, deliverable, non-debt-based, and non-perishable (Lateef et al., 2017). These requirements, however, do not apply to an asset or usufruct when an *ijarah mawsufah fi zimmah* is entered into.

Last but not least, there's the rental. During the establishment of the *ijarah* contract, the parties should determine and decide on the rental. The contracting parties may mutually agree that the lessee will pay the rental in cash or in kind, in advance or deferred, in one lump sum or in daily, weekly, monthly, quarterly, semi-annual, or annual instalments. A minimum and maximum rental period must be established. The lessor may not raise the rental rate unilaterally. The contracting parties may agree unanimously to revise the rental of the leased asset from time to time. The lessor may receive the rental in advance and use it immediately (Malaysian State Bank, 2018).

Legal Issues on Rent-To-Own Product

There are legal issues on Rent to Own Product (Nor et al., 2021). The legal issues *inter alia*:

Whether IFSA 2013 Allows Bank to Acquire the Property in Ijarah

Islamic Financial Services Act 2013 (IFSA) is a law that modernizes Malaysia's laws governing the oversight and monitoring of financial institutions in order to confirm that these laws remain significant and compelling in order to preserve financial stability, promote comprehensive development in the financial sector and economy, and, in addition, to provide sufficient security. Additionally, this law empowers Bank Negara Malaysia with regulatory and supervisory authority to assist the country's financial development. This involves a higher focus on preventive measures to address the issues that can affect the interests of contributors and policyholders within financial institutions and the effective and accurate operational activities of monetary situations.

IFSA 2013 empowers banks to issue Shariah standards based on the unique characteristics of Shariah contracts. It is self-evident that Islamic banking must be guided by Shariah principles, be compliant with Malaysian law, and be enforceable in a court of law. The IFSA 2013 delves deeper into Bank Negara Malaysia's (BNM) role as Shariah controller. For example, section 29 of the IFSA 2013 requires BNM to establish Shariah-compliant standards and rules to assist IFIs in delegating banking and money-related functions. The IFSA 2013 carries out the statutory requirement to agree on guidelines and to monitor Shariah non-compliance risks. Additionally, the Act imposes severe penalties on IFIs that cause it harm.

Ijarah has also become a possibly the best recognized IFI funding contract for a large part of its financial instruments, such as the financing of property. Asset finance, vehicle financing

and project funding, for example. This means that customers can lease IFI assets based on *ijarah bi al tamlik* or *al-ijarah thumma bai* to possess or purchase *ijarah*-based assets based on *ijarah muntahiah bi al-tamlik* or *al-ijarah thumma al-bai'* (AITAB). Another products that combine the contract of *ijarah* and *musharakah* is the product namely *musharakah mutanaqisah* (Nor et al., 2019)

Pursuant to section 57 of the Islamic Financial Services Act 2013, the Bank may specify prudential standards to promote an institution's sound financial position or the integrity, professionalism, and expertise with which it conducts its business, affairs, and activities. Additionally, it is stated in section 47 of the Financial Services Act 2013 under the bank's authority to specify prudential standards.

Banking institutions can exercise caution when acquiring, holding, and renting immovable property in order to limit their exposure to the risks associated with such holdings. A banking institution has been granted the authority to hold immovable property and is permitted to acquire, hold, or rent immovable property for the purpose of conducting business, providing housing or other perks for employees, or satisfying debts. Before acquiring, holding, or renting any immovable property, the banking institution must obtain written approval from the Bank. When holding immovable property acquired in satisfaction of debts, a banking institution's total capital must not exceed 1%. As a result, the value of immovable property shall be determined in accordance with the Malaysian Financial Reporting Standards in effect (Malaysian State Bank, 2019).

The Financial Services Act 2013 is the primary legislation governing the traditional finance industry. Meanwhile, the Islamic Financial Services Act 2013 is the FSA's partner in the Islamic finance sector, having superseded previous regulations such as the Islamic Banking Act 1983 and the Takaful Act 1984.

Additionally, as stated in section 29 (1) of the IFSA, the bank may specify Shariah-related standards for conducting an institution's business, affair, or activity with the advice of the Shariah Advisory Council (SAC) and to give effect to the SAC's advice or rulings. Additionally, section 135 of the IFSA states that the bank may specify standards for financial service providers' business activities in order to ensure that the financial service provider is fair, responsible, and professional. The IFSA 2013 empowers the Bank to issue Shariah Standards based on the unique characteristics of each Shariah contract. Shariah-based guidelines are necessary in light of the fact that Islamic finance transactions should be carried out in accordance with the unique characteristics of various financial agreements, each of which has its own remarkable risk-reward profile (Malaysian State Bank, 2010).

To summarize, all Islamic banking must adhere to the IFSA 2013 and refrain from enforcing illegal transactions. As a result, Islamic banks are permitted to hold immovable property in accordance with section 57 of the IFSA 2013.

Death during Rental Period, Who Shall Continue to Pay to the Bank after Death?

The inability of one of the contracting parties to contract due to his or her death does not automatically terminate the contract. Legitimate heirs have the right to continue the alienation contract or not. When determining the appropriate remedial mechanism in the event of a customer's death, an IFI may consider several factors, including claiming a sum of money from

takaful (if any), protecting the outstanding obligations of deceased customers, or providing in the legal document for the financing of a special provision allowing the heirs to continue financing. Apart from that, if the estate's legitimate heirs elect to terminate the lease, IFI may recover and possess the asset of the ijarah transaction and subsequently terminate the lease agreement (Malaysian State Bank, 2018).

To ensure that IFIs can quickly engage legal beneficiaries regarding the continuation of alienation financing if the customer dies, IFIs will encourage clients to provide information about their legal beneficiary at the start of the ijarah financing. If the customer's rightful beneficiary chooses to terminate the loan in the event of the customer's death, the IFI may take over and dispose of the leased asset.

If the customer dies, the property is still legally in the name of the Bank and not regarded as the customer's legal assets. The customer can obtain real estate assets from this agreement by appointing a nominee at the beginning or at any point during the lease period. The customer may elect to take the term takaful to cover the purchase price of the Real Estate and Property will be given to the applicant's property or nominee (if any).

As for the example, what happens to the AITAB agreement in the event of a tenant's death? In the event that a personal representative obtains a governing power or a Probation Grant, the rights, ownership and interest will be vested in the personal representative who will assume the responsibility of the tenant. If not, the Bank reserves the right to recover the property after four months of payment failure.

Apart from death, the lessor bears responsibility and loss in the event of rental property destruction or loss. Similarly, the lessor's right to rent terminates if the rental property loses its use, utility, or function, unless the lessee is at fault or negligent. If the lessee violates any term of the ijarah contract, thereby contributing to the rental property's loss, he must pay compensation, but he cannot be obliged to pay rent indefinitely (Kamali, 2007).

Example of Cases Related To Ijarah: Tinta Press Sdn Bhd v Bank Islam (M) Bhd (1987) 2 MLJ 192

In the above-mentioned case, some printing equipment is leased by the plaintiff to the first defendant using Islamic Financial facility known as ijarah. The defendant defaulted the payment of the lease rent. Thus, the plaintiff brought a legal action to recover possession of equipment and also the rent. To enable possession of the equipment an ex-parte application for a mandatory injunction was made and it was accepted. The defendant attempted to set aside the mandatory injunction but was rejected. Defendant appealed.

The agreement in the case was found to be a lease agreement and the court further held that it is not a loan agreement based on the submission of affidavit evidence and documents. The judge also held that there was a clear breach of lease by the defendant and automatically the plaintiff was entitled to immediate possession of the equipment.

In this case it clearly shows that the court included the fact that the nature of the contract is a lease contract. The judge upheld that the plaintiff who is the lessor own the equipment. The defendant has no rights onto the equipment if the lessor owns the equipment until the full payment is made.

JRI Resources Sdn Bhd v Kuwait Finance House (Malaysia) Berhad (2019) MLJU 275

In this case, Kuwait Finance House (KFH) provided Islamic Facilities to JRI Resources (JRIR) which involves financing the lease of several vessels. Due to defaulting payments on Islamic Facilities, KFJH took legal action against JRIR in the High Court. In favour of KFJH, the High Court granted a summary judgement.

JRIR then appealed to the Court of Appeal and claimed that the High Court did not follow the rule under Shariah Advisory Council (SAC) in clause 2.8 of the *ijarah* agreement according to the Islamic Facilities. Under this clause, it states that, the maintenance of the vessels and the cost should be monitored and dealt by JRIR and it was parallel to section 56 and 57 of Central Bank of Malaysia Act 2009 (CBMA) in Shariah law. The court allowed the JRI's appeal and it was referred back to SAC. Under SAC, it was stated that the clause in *ijarah* agreement is shariah friendly. JRI continued to apply an application to Apex Court to determine whether section 56 and 57 of CBMA violates Article 121 of Federal Constitution.

It was held that, the decision on matters regarding Islamic Finance cannot be given based on SAC. Court has also clarified that civil courts are not able to adjudge on Islamic law matters. The matters can be referred to SAC but the court has the authority to apply Islamic law to the case.

In this case it clearly shows the role and the boundaries of the SAC's power. SAC has also become a constitutional mechanism to control and apply right Islamic law on Islamic Financial matters.

CONCLUSION

In conclusion, *ijarah* has emerged as a well-accepted financing arrangement between IFIs for a large number of its financial items such as property finance. The policy document mentioned previously also contains provisions ensuring that a consumer under an *ijarah* lending arrangement receives the same level of security in the event repossession becomes necessary in light of the Hire Purchase Act 1967.

The Quran establishes the lawfulness of the *ijarah* contract, which takes light from the Sunnah of Prophet Muhammad (PBUH), the agreement of Muslim jurists (*ijma*), and analogy (*qiyas*). Because the benefits of *ijarah* outweigh the disadvantages, this practice can be considered established. Not only that, but it also benefits both lessee and lessor.

Ijarah has universally been approved by companions and prominent thought leaders of the Prophet Muhammad (PBUH) from the recognized Islamic Law schools. Their opinion is that it is analogous with the requirement to use different articles (goods and services) to use the articles themselves. When contracts are allowed for the sale of such products and services, leases are also allowed on the grounds of social interest (*maslahah*) and necessary condition.

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