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LEASING INDUSTRY IN THE ISLAMIC WORLD – CHALLENGES AND OPPORTUNITIES

Vintila Georgeta,
Barbu Teodora,
Nedelescu Mihai*

Abstract

The leasing it's a form of financing through rent by the specialized financial companies in this operations, of some machines, equipments and some companies goods of the motivation to resort at this form of trade it's in the specific of some operations that they achieve or in the fact that they don't have sufficient founds of they own and borrowed to buy them.

Having in view the multitude of ways to buy or to get only the utilization right of an asset (the leasing, the acquisition with cash from one's own founds, the acquisition through a loan, the acquisition with the payment in rate) the beneficiary has to do a deep analyze of this sources. During this analyze, the most important factor has to be taken in consideration, it's the cost of each way.

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The leasing represents a private financing way that can be analyzed like a loan and the cost of this financing source can be evaluated under the form of a financial rate. It's applied the present equality values of the equivalent financing sum principle (the acquisition and the assembly cost of the loaned equipment = **E**) and the treasure outputs for the future payments for the annual rent (**CH**) and the residual value (**VR**). At equality, in present day, of the two treasure flows (equivalent input and effective output) it's been calculated the actuarial cost of the leasing as a internal efficiency rate (**Kl**).

* Georgeta Vintilă is Professor of Finances at the Academy of Economic Studies in Bucharest.
Teodora Barbu is Professor of Money and Banking at the academy of Economic Studies in Bucharest.
Mihai Nedelescu is Associate Professor of Finances at the Romanian American University in Bucharest.

The leasing cost brings in a natural way and the fiscal effects of this financing. The rent is a deductible expense from the profit tax payment. The part about the repayment of the loaned equipment doesn't constitutes a fiscal economy for the leasing beneficiary, but for the leasing purveyor, in consequently, the leasing beneficiary is not the owner of the loaned good and it's recording an opportunity cost, determinate by the loss of the tax economy for the repayment (**A**) of the loaned equipment.

$$E = \sum_{t=1}^{n} \frac{(1-\tau)*CH_t + \tau * A}{(1+K_l)^t} + \frac{VR}{(1+K_l)^m}$$

τ = the profit tax rate

t = 1,..., n years of availability of the leasing contract

m = n + 1

In this conditions, the leasing costs (**Kl**) it's the solution for the upstairs equation that is been calculated after the methodology of the internal efficiency rate. The leasing cost for the beneficiary (**lodger**) it's the efficiency rate for the purveyor.

The decision to choose for the leasing, in report with a banking or bond loan, it's fundamental on the net present value (**VAN**), calculated after the relation:

$$\mathbf{VAN} = \sum_{t=1}^{n} \frac{CF_t}{(1+r)^t} - \frac{VR}{(1+r)^m}$$

Since it's not payable the acquisition cost of the loaned good, in the **VAN** formula it's not included the diminution of the investment value (**I**). There for, the cash flows (**CF_t**) will be determined in accordance with the future profits and the paid rent (the rent it's a deductive expense from the profit payment). The residual value (**VR**) it's paid in the m year, before the end of the life circle (**n**) of the loaned good. The present value it's compared with the loan one, for analyzing witch of this financing sources it's more advantageous.

The selection of financing sources of investments it's very complex as, besides the main criteria about the capital secured cost, acts a series of restrictions for the access at the capital market, the financial situation of the company, the motivation of the leading personnel of the company. If we refer to the last condition, if the employer of the company has all the assets, then he owns the business and he is responsible for all the decisions, good or bad. In this conditions, he will not approve the capital increase through the sale of new assets to the public. If it doesn't have the possibility to buy himself, then he will prefer other financing sources.

There for, the access to the bond loans doesn't have than a low number of companies, respectively the ones that offer a sufficient guarantee for thus pledges in presence of the public, in plus, the bond loan it's very complicated from the formality's point of view.

Most of the companies are not in the stock market and they don't have the possibility to negotiate the titles through the stock market. So, it doesn't have any other way but the auto financing the usual banking loan, the leasing or the assets sale.

"What is this "Islamic" leasing and how is it any different than what we are doing now?" The fact is that Islamic leasing, and what I will call, for want of better terminology "conventional" leasing, are very nearly the same. In fact, there are many more similarities between the two than differences. From a practical standpoint, there are really only three distinctive differences between the Islamic and the conventional lease:

1. *In the Islamic lease, interest related characteristics are removed. That means things like late fees, interim rents, and interest accumulation on money deposits are eliminated from the contract. It does not mean elimination of "profit". Profit is an integral part of almost all Islamic financial transactions.*

2. *There are some restrictions on the assets and/or on asset use. Islamic principles typically would prohibit involvement in areas involving such things as alcohol, tobacco, conventional finance, or pork products. The lease of assets used in connection with these industries/items would be prohibited.*

3. *The Islamic lease calls for the lessor to take real responsibilities in the ownership of the Asset. This becomes, in fact, the main difference. The conventional lease tries to contractually move the lessor as far away from asset responsibilities as possible. The Islamic lease insists that the lessor assume certain basic responsibilities as the owner of the asset.*

These three differences are minor, but important distinctions in the contractual arrangement between lessor and lessee. However, the ultimate documentation package leaves the Islamic lessor and the conventional lessor on relatively equal footing from a practical and economic standpoint.

An example of this is an Islamically designed leasing Fund that ILIC is involved in. This Fund is one of a series, and the other Funds in the series are all conventional. Because of exposure limits, these funds often join together in the financing of a single transaction. However, rather than confuse the lessee with different documentation, the Islamic documents are routinely used for ALL the funds. This is a practical and economic recognition of the equality between the conventional and the Islamic lease.

The International Leasing & Investment Co (ILIC) was organized in mid 1999 as the first large ticket, general asset Islamic leasing company in the world. While its business focus is in the Islamic countries, specifically the member countries of the Islamic Development Bank, its range of business activity is worldwide, stretching from Indonesia in the East to the United States in the West. Originally capitalized with US $50 million, ILIC effectively controls assets of nearly half a billion dollars.

One of the mandates of ILIC as a company, is to develop the practice and use of Islamic leasing worldwide. This mandate is manifested in the Company's aggressive development of new leasing companies throughout the world. Because of this activity, ILIC is in a unique position to see and assess the potential for Islamic leasing.

So now you may ask yourself another question: "If the Islamic and conventional lease are so similar, why can't I just go ahead and used my conventional leases—what difference does it make?" The answer to that questions lies within the fundamentals of Islam. Simply stated, a contractual arrangement that does not include these differences is not acceptable under Islamic principles, and is therefore "haram", or prohibited to the Muslim practitioner. Small as they may seem, they are critical differences.

To the practicing Muslim, the principles of Islam are more than just a guide, but are rather a divine dictate that must be followed. To the Muslim, these principles outline a course of living that lead to happiness, a harmonious community, and a thriving economy. The principles must be followed with exactness, however, and thus the practicing Muslim will preferentially use Islamic finance whenever it is available.

Islamic lease versatility

The Islamic lease is the most versatile of the Islamic financial products, and this makes the Islamic lease the instrument of choice for many financial transactions. This versatility within the realm of Islamic finance finds the lease used in many instances that would commonly find a different type of instrument were the same transaction done conventionally. This means that within Islamic finance, the lease will be used for a higher percentage of the overall transactions, than would be found in the conventional world.

The source of this versatility is found in two areas:

- *the rules that govern Islamic financial transactions, and;*
- *in the basic nature of the lease.*

One of the basic principles of Islamic finance is that money is not to be treated as an "asset" or "commodity". Money is looked at simply as a medium of exchange, and not as object in and of itself. Thus, In Islamic financial, an asset, other than money, must be at the base of the transaction. This asset may be bought and sold and debt generated as a result of such activity. But the money itself may not. Since it is NOT viewed as a commodity, money, including money (debt) obligations, is not able to be sold once they are originated. This means that in most Islamic financial transactions, once the underlying asset is sold, the seller and holder of any debt generated by the sale may not re-sell the obligation. It must be held through maturity by the original holder of the debt.

In conventional finance, re-sale of debt is a common practice, and constitutes the basis for conventional secondary market activity. Such activity is not allowed under Islamic financial rules.

The Islamic lease, however, provides a different opportunity. In the lease transaction, the money obligation is tied to the asset and to its use. The financier, as Lessor, retains ownership of the asset during the term of the lease, and this ownership interest, together with the obligation to pay lease payments on the use of the asset, MAY be transferred, in whole or in part at any time during the lease. This effectively provides the only viable secondary market vehicle available to Islamic finance. This also provides a huge incentive for Islamic financial institutions to use the lease as the structure of choice in Islamic financial transactions.

A second incentive for use of the lease over other Islamic financial instruments rests with the nature of the lease transactions itself. In most Islamic transactions, an asset is sold and ownership is transferred. When this transfer takes place, the money obligation becomes set (remember, there is no interest in an Islamic transactions, so interest characteristics are not present in the structure of the transaction). The conventional characteristics associated with interest, such as the potential for a variable rate and late payment interest, are not allowed. Once again, we see the versatility of the Islamic lease come to the front. Since the lease effectively runs from period to period, allowance may be made to adjust the lease payment prior to the beginning of each such period. This adjustment may be legitimately formulated to work very similar to the conventional adjustable rate.

To these special issues of versatility is added the natural flexibility of the lease transaction, and when taken as a whole, provide the practitioners of Islamic finance strong incentive to use the lease as the instrument of choice whenever possible.

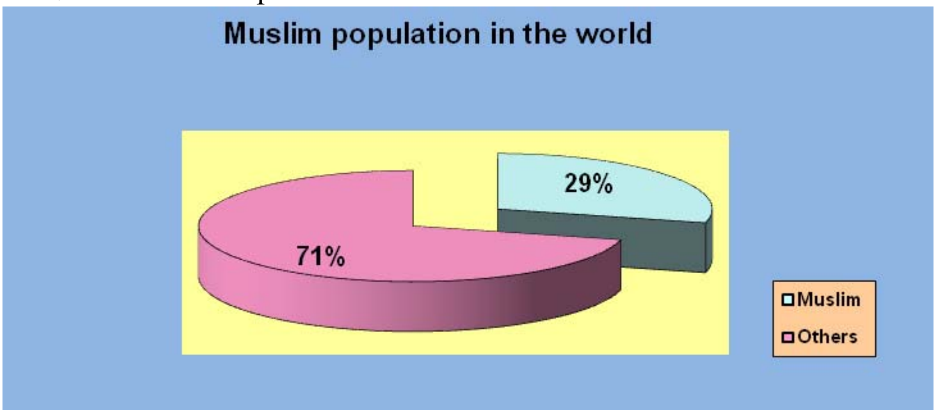
From a real world situation, the practices of Islamic finance are in a resurgence. Much of the Muslim world is currently served through conventional financial institutions. However, the growth and development of Islamic financial institutions and products has led to a quickly increasing Islamic financial marketplace, and those who hope to compete in this marketplace in the future will have to provide products and services that are compatible with Islamic principles.

"Well," you may ask, "Why do I need to worry about this at all?" The answer to this question lays in the demographics of the world population figures. Let's take a look at those numbers, first from an overview standpoint.

There are approximately 6.5 billion people in the world. Depending on whose estimate you use, up to 29% of those people are Muslim. That means that over 1.6 billion people one quarter of the world's population adhere to the principles of Islam. As a general rule, if these people are given a choice, they would have the preference to use Islamic financial products, including Islamic leasing, over conventional methods of finance. Thus, with an offering of Islamic leasing, one-quarter of the world becomes a market with preferential inclinations towards the way you are doing business.

Regionally, these numbers obviously change, with certain parts of the world having much heavier concentrations than others. However, even in markets like the United Kingdom (2.7% Muslim) and the United States (3.75% Muslim), the total Muslim population still provides a tidy market share potential to draw from.

For example in the US marketplace, 3.75% of the leasing market represents over US $7.5 billion in potential business. In the UK market, that 2.7% represents over US $500 million in potential market share.



UN statistic's 2007

Using the statistical information from the Euromoney World Leasing Yearbook 2004, and combining this with the demographic estimates of Muslim population, a sampling of market potential looks something like this:

Market Potential of Islamic Finance			
Country	**Lease Volume (US $ Bln)**	**Muslims as a Percentage of Total Population**	**Representative Lease Volume (US $ Bln)**
US	204.00	3.75%	**7.65**
France	22.23	10.00%	**2.22**
Germany	39.77	3.70%	**1.47**
Morocco	0.54	99.00%	**0.53**
Turkey	1.32	99.80%	**1.31**
Italy	22.35	2.40%	**0.53**
United Kingdom	19.07	2.70%	**0.51**
Russia	2.00	19.00%	**0.38**
Pakistan	0.37	97.00%	**0.35**
Nigeria	0.37	70.00%	**0.25**
Netherlands	4.66	5.40%	**0.25**

Saudi Arabia	0.22	100.00%	**0.22**
Canada	10.44	2.00%	**0.20**
Switzerland	6.11	3.10%	**0.18**
Sweden	5.88	3.10%	**0.18**
Malaysia	0.28	59.00%	**0.16**
India	1.00	14.00%	**0.14**
Bangladesh	0.14	88.30%	**0.12**
Spain	9.30	1.20%	**0.11**
Belgium	**2.89**	**3.60%**	**0.10**

* Euromoney World Leasing Yearbook 2004

Certainly, this is an acknowledged simplification of the marketplace. It is, however, also a limited view of the real marketplace and opportunity that exists. Because many of the countries that have heavy Muslim populations are also developing countries, with uncertain reporting methods available for the various economic activities that occur, much of the leasing activity that happens in these countries goes unreported.

It is important to note, however, that the market potential exists not only in the countries with predominately Muslim populations, but also in those areas where the Muslim population represents a relatively small portion of the total population. Revisiting the United States market gives a prime example of this, where, as pointed out, the representative lease volume for a relatively small percentage of the population still equals over $7.5 billion in potential business! And remember, this is the “extra” edge that would be available to an Islamic leasing company.

Such a company does not do business just with Muslims, but is able to compete against other leasing companies in the general leasing market, whether Islamic or conventional, for all leasing business that is available.

Business expansion

Islamic leasing also offers an opportunity for a leasing company to dynamically expand their business opportunities. In most of the developed countries, the market share of leasing versus other modes of financing is relatively stable. For example, in the United States market, approximately 1/3 of all capital equipment acquisitions have been made through the use of leasing. This statistic has remained relatively constant for the 25 years that I have been involved in the leasing industry.

So what happens if you want to expand your business? To have dynamic growth? You have, in fact, only a limited number of options:

✍ *You can increase the share that leasing commands in the over-all capital asset markets.* This, obviously, is very difficult to do in a mature market—

as shown by the fact that no one in the US seems to have been able to accomplish it—at least over the last 25 years. This may be a very realistic approach in a developing economy. Remember, though, that many of these developing markets have heavy Muslim populations that will demand the use of Islamic financial products.

- *You can take market share away from someone else.* This is the more typical way that growth occurs for an individual company. It is also the most "dangerous" for a leasing company. Typically, this approach requires tactics designed to lure existing customers away from whomever they are currently doing business. These tactics often incorporate things like easier credit standards, lower rates, etc., each of which may potentially have negative effect on the leasing company's portfolio and business viability. Targeting a "preferential" group of the economy, such as the Muslim population, may allow a company to dynamically gain additional market share simply by offering a compatible product, and not by resorting to portfolio threatening tactics.
- *You can wait for the economy to grow.* A growing economy offers limited growth potential for the leasing industry. Assuming that market penetrations remains somewhat constant, the total volume of leasing business should expand with the general growth of the economy. However, this phenomena rarely, if ever, produces the opportunity for dynamic growth, and the leasing company that looks to expand its share of business through only this means will have a long and frustrating wait.
- *You can expand into new and/or less developed markets.* For the leasing company that is not afraid of the international environment, this may be the most attractive alternative to dynamic company expansion. Developing markets offer huge opportunity, and growth potentially can be quickly realized. Once again, however, many of the most attractive opportunities for such expansion occur in countries dominated by Muslim populations.

Islamic capital

Companies operating in the realm of Islamic leasing also have an additional advantage, and that is the ability to tap into the Islamic capital markets. An estimated US $380 billion in underutilized capital exists in this marketplace, and this capital is looking for a worthy "home" in Islamically compatible investments. And, since many of the oil producing countries of the world are Islamic, this capital base, fuelled by the booming oil economy, continues to grow.

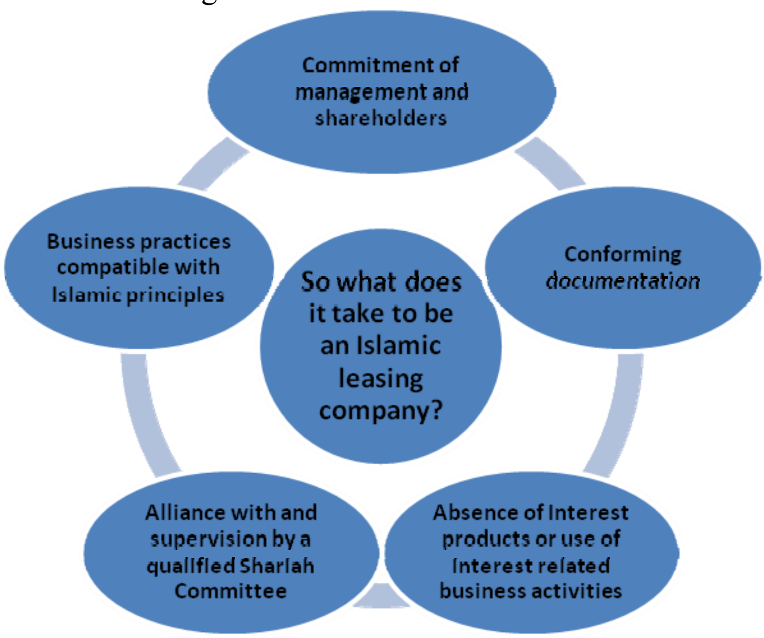
Islamic finance

Entering into the arena of Islamic leasing should be approached like any other new venture or modification of business focus. Such changes, to be successful, typically require a firm management commitment and a dedicated effort of company resources.

To make such a transition, you must have a thorough understand of exactly what you are trying to accomplish, and how Islamic leasing can help you accomplish it. You must also be willing to make the commitments required for such a change, and then be willing to take the necessary steps to qualify as an Islamic lessor. The changes required demand a clear understanding of Islamic finance and the underlying governing principles. These changes involve, among other things, changes in documentation, staff training, and a modification to business practices.

Getting expert advice early in such a transition is essential. In entering new markets, it may be prudent to partner with an existing Islamic financial institution or leasing company and/or to obtain expert consulting advice.

In this regard, Islamic financial institutions, including Islamic leasing companies, typically work with a ”Shariah Committee”. The Shariah Committee is a group of Islamic scholars who provide guidance to the company’s business activities and practices. The Shariah Committee will review and give input into standard documentation, products, and, as necessary, individual transaction structure and other business activity, to ensure compliance with Islamic principles. Affiliating with a Shariah Committee will be a necessary step in a transition or expansion to Islamic leasing.



For those companies who are not willing and/or able to make the commitments necessary to present Islamic leasing on their own, another avenue may also be available. Coordination with an existing Islamic lessor, through a brokerage arrangement or some other relationship, may allow the company to reap fee income from Islamic transactions.

It is important, in these relationships, to bringing the Islamic lessor into a transaction early.

This will ensure that the deal is properly structured to meet Islamic rules, and will preserve the needs and desires of the client for an Islamic transaction.

There are compelling reasons for a financial services company to become involved in Islamic leasing. As the most versatile of the Islamic financial products, the Islamic lease is assuming an ever-increasing role in the arena of Islamic and world finance. The world demographics add to this compulsion by demonstrating that one-quarter of the world's population can be assumed to have a preference towards the use of Islamic financial products. Companies that wish to enhance and dynamically expand their business scope, would do well to consider the vast potential of the Islamic leasing marketplace.

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