

The 181st Meeting of the Shariah Advisory Council (SAC) of Bank Negara Malaysia

The SAC of Bank Negara Malaysia at its 181st meeting on 27 October 2017 ruled on the following:

1) Practice of insurance coverage for *ijarah* financing

SAC Ruling

SAC ruled that for the first year of *ijarah* financing, Islamic financial institutions (IFI) should ensure takaful be the first option for the coverage plan. IFIs are required to promote the subscription of takaful in the second year of financing and thereafter. Customers are given the flexibility to take up insurance under the following circumstances:

- i. Takaful protection is not offered in particular sectors or classes;
- ii. None of the available takaful operators approve the customer's application for takaful protection; or
- iii. The cost of insurance coverage is significantly more competitive compared to takaful.

SAC also agreed that in the case where the insurance coverage is subscribed based on the above circumstances, the amount of insurance premium may be included in the total *ijarah* financing.

Background

- Based on Shariah principle, Islamic financing should be covered by takaful protection plan. However, flexibility to obtain insurance may be given under certain circumstances. Nevertheless, since the asset in *ijarah* financing is owned by IFI, the responsibility to ensure that the asset is covered by takaful coverage is more apparent.

- The *Ijarah* Policy Document stipulates that the asset owner may obtain takaful coverage for managing risk related to damages and losses.

G 16.7 The lessor may mitigate specific risks relating to loss, damage or impairment of the leased asset through a takaful coverage.

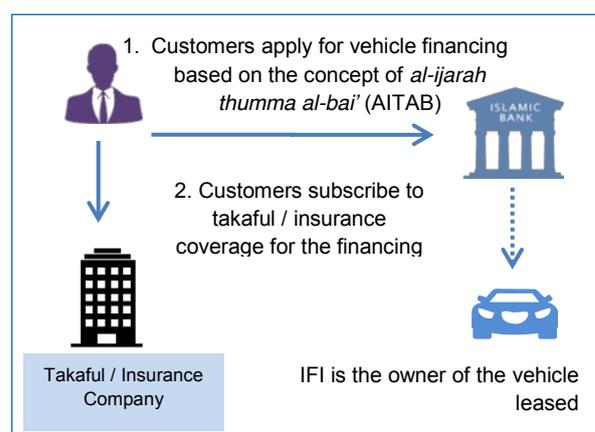
- In practice however, there have been cases where *ijarah* assets are covered by insurance, and not takaful.

Shariah issue

- *Is it permissible for ijarah financing to be covered by insurance?*

Illustration:

Relationship between financing and takaful/insurance coverage



Key Highlights of the SAC Discussion

What are the current practices relating to protection in ijarah financing?

- Most *ijarah* financing is covered by takaful.
- However, there are circumstances where customers opt for insurance coverage for *ijarah* financing specifically for vehicle hire-purchase. This approach is taken based on the following considerations:
 - i. It is at the liberty of the customers to choose either takaful or insurance coverage;
 - ii. In the case of the vehicle financing, auto dealers have dedicated panels of insurance partners;
 - iii. IFIs emphasise the need for takaful coverage only for the first year of financing, without stressing on the need for takaful coverage to be maintained in subsequent years;
 - iv. The large volume of customers makes it difficult for IFIs to keep track of the takaful coverage throughout the financing tenure. Moreover, the cost of coverage is fully borne by the customer; or
 - v. Insurance companies offer insurance at a more competitive price to customers.

Can ijarah assets be covered by insurance?

- In principle, *ijarah* assets should be covered by takaful. This will also strengthen the takaful industry and to promote the development of Islamic finance sector.
- However, there are situations where it is difficult for customers to acquire takaful coverage for *ijarah* asset. Hence, customers should be given the flexibility to subscribe to insurance based on the following factors:
 - i. Takaful protection is not offered in particular sectors or classes;
 - ii. None of the available takaful operators approve the customer's application for takaful protection; or
 - iii. The cost of insurance coverage is significantly more competitive compared to takaful.
- This approach takes into consideration the stage of readiness of takaful operators in offering certain products with specific underwriting expertise in certain risk classes.
- This is in accordance to the Hadith of Rasulullah PBUH:

فإذا أمرتكم بشيء فأتوا منه ما استطعتم ، وإذا نهيتكم عن شيء فدعوه¹

"Whenever I order you something, obey it the best as you could and whenever I forbid you from something, avoid it."

- This is also in accordance to the following fiqh maxim:

المشقة تجلب التيسير²

"Hardship begets facility"

¹ Muslim, *Sahih Muslim*, Dar al-Mughni, 1998, p. 698, hadis no. 412.

² Al-Suyuti, *Al-Ashbah wa al-Naza'ir*, Dar al-Kutub al-`Ilmiah, 1983, p. 76 - 77.

Can the insurance premium be included as part of the *ijarah* financing?

- As described above, there are certain situations when customers are given the flexibility to obtain insurance coverage for *ijarah* assets. In such cases, the premium amount may be included as part of the *ijarah* financing amount.

Are there any views that allow for *ijarah* assets to be covered by insurance where the cost of protection for insurance is more competitive compared to *takaful*?

- The Shariah Advisory Council of the Securities Commission Malaysia ruled that an *ijarah* asset shall be covered by *takaful* coverage. However, if the *takaful* company does not have the capacity for such coverage or if the *takaful* coverage is not commercially viable, the *ijarah* asset may be covered by conventional insurance³.

Basis of Ruling

- The *ijarah* financing and insurance contracts are two separate and distinct contracts. Therefore, there is no prohibition for the *ijarah* asset to be covered by insurance.
- The insurance coverage is to protect the lessee from any liability related to the risk of asset utilisation.
- It is difficult for IFIs to keep track of all customers. There will be legal implications if the requirement of protection plan for *ijarah* financing is confined to *takaful* only as customers may choose to subscribe to insurance over *takaful*.
- The flexibility in providing customers the option to choose insurance coverage takes into consideration a few factors including the state of readiness of *takaful* operators in offering products for all types of *ijarah* assets, underwriting expertise for *takaful* operators for certain risk classes and others.

³ Ruling of Shariah Advisory Council of Securities Commission, p. 38.

2) The party bearing the risk in cases where the takaful / insurance compensation is insufficient to cover the balance of the *ijarah* financing in the event of total loss

SAC Ruling

The SAC ruled that the customer may promise to bear the cost of damage of the leased asset in the event of total loss and bear the remaining amount of the *ijarah* financing. In this case, if the takaful / insurance compensation is insufficient to cover the balance of the *ijarah* financing, the customer shall be responsible to bear such amount as per the promise given.

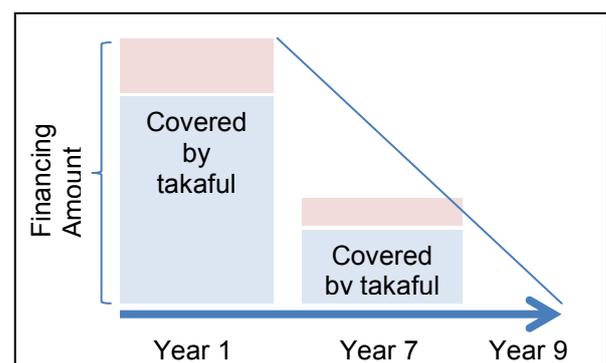
Background

- For the purpose of managing various risks related to the *ijarah* asset and its utilisation, the customer agrees to obtain takaful coverage, and in certain cases insurance.
- In the case of total loss, the takaful operator/insurance company will only compensate for the amount of loss based on the market value of the asset or the sum insured, whichever that is lower.
- In this case, there are situations where the compensation amount is inadequate to cover the remaining balance of the *ijarah* financing.

Shariah issues

- Who is responsible to bear the remaining balance of the *ijarah* financing in the case where the takaful / insurance compensation is insufficient to cover such amount?
- Factors to consider for the above issue are:
 - i. *Ijarah* asset belongs to the IFI.
 - ii. In the event of total loss, the sale contract (at the end of the financing) cannot be executed as the *ijarah* asset has no value or is nonexistent.

Illustration :
Difference between financing amount and takaful benefits



Key Highlights of the SAC Discussion

Is the concept of *wa`d* (promise) to bear the total loss in line with the objective of *ijarah* contract?

- Based on the discussions of classical scholars, the objective of an *ijarah* contract is for the lessee to enjoy the usufructs of the leased asset and the lessor in return receives the rental payment. Hence, the promise from the customer to bear the total loss of the *ijarah* asset is permissible as it does not affect the objectives of the *ijarah* contract.

What is the basis of allowing for customers to be responsible for the remaining balance of the *ijarah* financing?

- The basis of allowing the application of *wa`d* took into consideration the following factors:
 1. *Wa`d* is a concept that is accepted in Shariah and is widely applied in most financial products;
 2. Although the *ijarah* asset belongs to the lessor, the contracting parties may agree that the lessee bear the takaful/insurance cost. This arrangement does not contradict the objective of the *ijarah* contract;
 3. An *ijarah* asset especially the movable asset is in the possession and control of the lessee throughout the *ijarah* tenure. In this context, most of the risk is related to the usage of the *ijarah* asset by the lessee. Undeniably, there are circumstances where the damage is not caused by the negligence of the lessee.

Basis of Ruling

- Although the *ijarah* asset belongs to the lessor, the contracting parties may agree that the lessee shall bear the takaful/insurance cost. This arrangement does not contradict the objective of the *ijarah* contract. This is based on the hadith⁴:

المسلمون على شروطهم إلا شرطا أحل حراما أو حرم حلالا

“Muslims are bound by the conditions in which they agreed upon, except for the one that permits the haram (forbidden acts) and forbids the halal (permissible).”

This approach is also in line with the following fiqh maxim⁵:

الأصل رضى المتعاقدين ونتيجته هي ما التزمه بالتعاقد

“The original ruling for a contract is the consent of the contracting parties and its effect is based on what have become the rights and duties as agreed in the contract.”

- The documentation of the *ijarah* contract stipulates that the lessee agrees to acquire sufficient protection to cover the remaining amount of the *ijarah* financing at any particular time.
- This deliberation considered the commercial aspects of *ijarah* financing, where the determination of the rental price took into account the entire risk and liability of the contracting parties in agreeing to enter into the contract. The difficulty for the asset owner to ensure all lessees comply with the terms and conditions of the *ijarah* contract throughout the financing tenure is also taken into consideration.

⁴ Abu Daud, *Sunan Abi Daud*, Bait al-Afkar al-Dawliyyah, 1999, p. 398, hadis no. 3594.

⁵ Ahmad al-Zarqa', *Syarh al-Qawa'id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 482.

3) Types of damage that lead to termination of *ijarah* contract

SAC Ruling

The SAC ruled that the types of damages that affect the *ijarah* contract are permanent major defect that prevent the lessee from enjoying the entire usufruct of the *ijarah* asset. The effects of such damage are as follows:

- i. the *ijarah* contract is dissolved; or
- ii. the contracting parties may agree to continue with the *ijarah* contract by substituting the *ijarah* asset with a new one or repairing the existing asset.

Background

- The Shariah Standard on *Ijarah* outlines that the lessee is entitled to dissolve the *ijarah* contract or request for substitution or replacement of the leased asset in the case where a defect of the *ijarah* asset is discovered by the lessee after entering into the contract.

Shariah issue

- What are the damages that entitle the lessee the right to dissolve the *ijarah* contract?

Key Highlights of the SAC Discussion

What are the views of the classical scholars regarding the type of damage that entitles the lessee to dissolve/terminate the contract?

- Classical scholars view that the termination of *ijarah* contract may only be carried out in the case of major damage that deny the entire usufruct which is the subject of the contract⁶.

Basis of Ruling

- The lessee is entitled to terminate/dissolve the *ijarah* contract or request for a replacement of the asset in the case of a permanent major defect which prevents the lessee from enjoying the entire usufruct of the leased asset.
- This view is in line with the views of scholars, in the case where there is a defect to the *ijarah* asset which prevents the lessee from enjoying the usufruct of the asset during the *ijarah* tenure, the lessee has the right to dissolve the contract.

⁶ Wizarah al-Awqaf wa al-Syu'un al-Islamiyyah, *Al-Mawsu'ah al-Fiqhiyyah al-Kuwaitiyyah*, v. 1, p. 271.

4) The issue of *force majeure* in *ijarah* contract

SAC Ruling

The SAC agreed that the original ruling for the cost of maintenance and takaful/insurance coverage of an *ijarah* asset is the responsibility of the asset owner. Nevertheless, the contracting parties may negotiate and agree on the party who shall bear such costs including the cost of coverage in the cases of *force majeure*. In the event where the damage caused by *force majeure* is beyond the available takaful/insurance plan offered in the market, it is the responsibility of the IFI as asset owner to bear the loss.

Nevertheless, the burden of proof shall be upon the lessee. If the lessee fails to provide proof against his negligence, the lessee will be responsible for the damage of the *ijarah* asset.

Background

- Based on the policy document of *ijarah*, where the damage is due to *force majeure*, it is the responsibility of the asset owner to repair the *ijarah* asset.
- In this regard, the IFIs are exposed to the high risk pertaining to *force majeure* situation whereas the *ijarah* asset especially the moveable asset is within the possession and control of the lessee.

Shariah Issue

- To what extent shall the asset owner be responsible towards the *ijarah* asset in the *force majeure* situation?

Key Highlights of the SAC Discussion

What is meant by force majeure?

- An unavoidable event and beyond the reasonable control of the contracting parties which prevents parties from fulfilling any of their obligations under the contract. Examples of *force majeure* events are⁷:
- Act of God, such as earthquake, cyclone, floods, lightning, hurricanes and other natural calamities;
- Act of man, such as war (declared or undeclared), invasion, act of a foreign enemy, hostilities between nations, act of terrorism, strikes, civil insurrection or military usurped power, nuclear contamination, embargo and confiscation by government.

What are the implications of force majeure towards the industry?

- Following the discussion with the industry, there are issues raised related to *force majeure*:
 - i. Absence of a clear legal definition of *force majeure*;
 - ii. Lack of clarity in terms of the authoritative body to declare *force majeure* situations in case of its occurrence; and
 - iii. Currently there is no takaful operator which has the comprehensive underwriting expertise in the *force majeure* class.

⁷ World Bank Group, Force Majeure Clauses – Checklist and Sample Wording, the World Bank, <http://ppp.worldbank.org/ppp/library/force-majeure-clauses-checklist-and-sample-wording>, 19 Oktober 2017.

- Consequently, offering of *ijarah* based products by IFIs will be less competitive compared to other contracts such as *tawarruq* or conventional products. This is due to the following reasons:
 - a. IFIs are exposed to higher risk;
 - b. Potential moral hazard risks such as false claims by the customers;
 - c. Increase in operational cost such as documentation; and
 - d. Higher prices will be imposed on customers.

Basis of Ruling

- The ownership of an *ijarah* asset belongs to the lessor. Therefore, in the case where takaful and insurance are not offered for certain remote *force majeure* cases, the asset owner shall be responsible for the loss/damage.
- Based on the agreed conditions of the *ijarah* contract, the lessee/customer is responsible to acquire takaful/insurance coverage available in the market. This approach is based on the hadith of Rasulullah PBUH:

المسلمون على شروطهم إلا شرطا أحل حراما أو حرم حلالا⁸

“Muslims are bound by the conditions/terms in which they agreed upon, except for the one that permits the haram (forbidden acts) and forbids the halal (permissible).”

- There is an element of oppression and injustice towards the lessee if the lessee is obliged to acquire a takaful/insurance plan in which the risk coverage is not offered in the market.

This ruling is enforceable according to the enforceability date of the Policy Document of Ijarah.

⁸ Abu Daud, *Sunan Abi Daud*, Bait al-Afkar al-Dawliyyah, 1999, p. 398, hadis no. 3594.