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

1. Customers apply for vehicle financing based on the concept of *al-ijarah thumma al-bai’* (AiTAB)

2. Customers subscribe to takaful / insurance coverage for the financing

IFI is the owner of the vehicle leased

Takaful / Insurance Company
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:
  1. It is at the liberty of the customers to choose either takaful or insurance coverage;
  2. In the case of the vehicle financing, auto dealers have dedicated panels of insurance partners;
  3. 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;
  4. 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
  5. 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:
  1. Takaful protection is not offered in particular sectors or classes;
  2. None of the available takaful operators approve the customer's application for takaful protection; or
  3. 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:

> فَإِذَا أَمْرَتُكُم بِشَيْءٍ فَأْتُوا مِنْهَا مَا آمَضَنَّ مَنْ أَسْتَطَعْتُمْ، وَإِذَا نَهَيْتُكُم عِنْدَنَا بِشَيْءٍ فَأْتُوا مِنْهَا فَدْعَوْهُ

> “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:

> المِشْقَةُ تُجْلِبُ الرَّيْحَةَ

> “Hardship begets facility”

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

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.

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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 hadith:

> المسلمون على شروطهم إلا شرط 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 maxim:

> الأصل رضى المتعاقدين ونتيجته هي ما التزماه 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.

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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 contract\(^6\).

**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.

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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 are:
  - 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.

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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:

- IFIs are exposed to higher risk;
- Potential moral hazard risks such as false claims by the customers;
- Increase in operational cost such as documentation; and
- 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 شرطهم إلا شرطا أحل حراما أو حرم حلالا

> “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.*

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