

Review

Ijarah Muntahia Bittamleek (IMB): A risk management perspective

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Abstract

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The objective of this paper is to comprehensively review and analyze Ijarah Muntahia Bittamleek (IMB) product as offered by Islamic banks from Risk Management perspective. The paper is structured to first briefly present an overview of Ijarah Muntahia Bittamleek (IMB) financing, along with a detailed review of its structure and mechanisms illustrating how a typical IBM operates. The paper then lists the various models of IMB financing as implemented across jurisdictions in practice, and studies the various forms of documentations as used by Islamic banks in offering this financing product. Subsequently, the paper provides a critical insight into the various issues and challenges that arise from the current practices. The differences in treatments by various banks in possible outcomes of default, termination, early settlement, etc are also elaborated upon and scrutinized. The discussion is finally analyzed from the perspective of Maqasid Shariah and whether the industry's current practice violates or upholds its principles. The paper ends with concluding points and references.

Keywords: Finance, Risk Management, Islamic bank, Risk, IBM,

INTRODUCTION

Having a shelter is a basic necessity for human life. Everyone needs a shelter for rest, sleep, comfort and protection from sun and rain. It is a place to dwell in comfort with family. Therefore, owning a good home is an aspiration of everyone. People fulfill this need by building a home on their own, purchasing it or renting it from others and those who cannot afford to buy a house at lump sum bank/mortgage houses come in to the picture to bridge the gap. Islamic financial institutions have introduced a number of Shari'ah-compliant modes for home financing such as al-Bay' Bithaman Ajil (BBA), Musharakah Mutanaqisah Partnership (MMP) contracts and Ijarah Muntahia Bittamleek. (Meera and Razak, 2005). Many previous works (Meera 2005, Rosely 2005) discussed various controversies involved with BBA particularly related whether this financing is Shariah

compliant. In other hand, Musharakah Mutanaqisah and IMB have been widely acknowledged and accepted by Shariah scholars.

Islamic finance unlike conventional finance is governed by Shariah rules that prohibit interest-based transactions. Islamic financial transactions are also required to be accompanied by genuine underlying trade and business activities that generate fair and legitimate profits. This reinforces the close link between financial and productive flows which underpin Islamic finance, thereby insulating the Islamic financial system from risks associated with excessive leverage and speculative financial activities.

This paper aims to analyze these one of these two structures of desirable home financing, Ijarah Muntahia Bittamleek, from the Risk Management perspective for

Islamic Banks.

Definition and characteristics of Ijarah

Ijarah has been conceptually understood as a contract of exchange where one party enjoys the benefit arising from employment by another party in return for a consideration for the services rendered and from the use of an asset. Scholars of the four schools of Islamic jurisprudence (Shafi'ie, Maliki, Hanbali and Hanafi) have cited various definitions of the contract of Ijarah. In brief, these definitions agree on the fact that the contract of Ijarah is a contract on using the benefits or services in return for compensation.

Literally, Ijarah means to give something on rent. As a term of Islamic fiqh, Ijarah can also refer to wages paid to a person in consideration of the services rendered by him. In the context of Islamic banking, Ijarah can be defined as a process by which the "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her". Ijarah has been conceptually understood as a contract of exchange in which one party enjoys the benefit arising from employment by another party in return for a consideration for the services rendered and from the use of an asset. This classical definition was the basis of many of the contracts of exchange even before the times of the Prophet and was popular amongst the fuqaha as documented in much of the literature. Since that time, the operation of these contracts developed to a higher level of sophistication during the period of the companions of the Prophet. However, the basis of operation remained confined to simple Ijarah contracts.

The basic feature of the Ijarah contract has been that it is a contract of exchange between one to another party (hereinafter called one-to-one Ijarah). For example, one party is given the right to use the services of a person or of a given asset from another party for a consideration. This contract has not involved the transfer of ownership to the other party as there has been no intention to purchase or to own the Ijarah object by the interested party. Over time, however, this concept has developed into transactions with more complex features that give rise to variations from the basic structure of the Ijarah transactions. The distinguishing feature of this mode is that the assets remain the property of the Islamic bank to put them up for rent every time the lease period terminates so that they do not remain unutilized for long periods of time. Furthermore, there are some conditions that Ijarah transactions need to follow in order to be in consonance with the principles of Islamic finance. These conditions are mainly concerned with the object leased, the contract and the maintenance of the leased assets.

Basically, the lease contract must state the lease period clearly. Renewal terms must also be stated clearly, and things like the rentals for all subsequent

years, after the first year, should not contain clauses like "left to the sole discretion of the lessor and the like. It is also a condition that the subject of the contract must actually and legally be attainable. It is not permissible to lease something that cannot be delivered. Furthermore, it is permissible for the two parties to agree during the lease period to review the lease period or the rental or both. That is because the lease contract occurs periodically unlike the sale contract where the transfer of ownership is immediate. Part of the conditions also state that the lessor bears the liabilities when leasing the asset such as damage, payment of premium cost and basic maintenance. There is no objection to authorizing the lessee to undertake all the above but the costs thereof must be borne by the lessor or owner.

The AAOIFI's standard classifies Ijarah as Operating Ijarah and Ijarah Muntahia Bittamleek. The main criterion used in the classification is whether the lease includes a promise that the legal title in the leased asset will pass to the lessee at the end of the lease term. The AAOIFI's standard on Ijarah states that when a lease does not include a promise that a legal title will pass to the lessee, it is classified as Operating Ijarah and if there is a promise it is Ijarah Muntahia Bittamleek. In essence, the subtle difference between Ijarah and Ijarah Muntahia Bittamleek lies in the pre-existence of that promise whereby a lease concludes with the legal title passing to the lessee through either: (i) gift (transfer of legal title for no consideration); (ii) token consideration or other amount as specified in the lease; (iii) transfer prior to the end of a lease for a price equivalent to the remaining Ijarah installments; or (iv) a gradual transfer of the legal title (sale) of the leased asset.

Risk associated with Ijarah Muntahia Bittamleek contract

Investors in Ijara and Ijarah Muntahia Bittamleek are no less risk averse than other investors. However, Islamic investors may be somewhat more restricted in the use of credit enhancement or risk mitigation techniques. A fundamental precept of Islamic finance is that a person who invests in an asset should bear the risks inherent in the asset in order to earn profits from its ownership. Risk mitigation, depending on the scope and structure of the provisions that are employed, may be inconsistent with bearing the risks of investment. When a party seeks to escape risks, the ensuing profits may be tainted by riba. Islamically, there is always a linking of risk and reward, so the question arises as to whether techniques that curtail risks are Islamically acceptable.

In this section, paper analyzes the diverse risks inherent in Ijarah Muntahia Bittamleek, survey the restrictions that Islamic finance places on risk mitigation and credit enhancement techniques, and discuss types of risk management devices that may be acceptable to the

the Islamic investor in Ijarah Muntahia Bittamleek

The following is an overview of some significant elements of risk inherent in any Ijarah Muntahia Bittamleek transaction. For the easier understanding of which risk is associated with contract, contract has been observed through different stages.

Agreement to lease

In stage 1, Customer requests IIFS (the Lessor) to purchase a specified asset. Customer enters into a memorandum of understanding (Agreement to Lease) with an IIFS requesting the IIFS to purchase a specified kind of asset with a promise to lease. The IIFS should first purchase the asset prior to execution of an Ijarah contract. Asset can be purchased from customer and subsequently leased back to the customer (Sale and Leaseback). IIFS obtains price quotations from suppliers or appoint a purchasing agent (Agent). The Agent can be the customer or a person having blood / marital relationship with the customer. If Agent is a company owned by customer, the company should not be owned more than 1/3 by the customer IIFS executes an agency contract with the Agent.

Risk that appears in this stage is supply risk as part of operational risk. Supplier has to deliver the asset and must be able to meet the specified quality (risk may be associated with low quality assets). When the Lessor acquires an asset which is already on lease, it has to sign a 'new' leasing contract with the existing Lessee based on existing terms which may not necessarily be better than the Lessor's existing contracts. The appointment of customer (or his/ her relations) as Agent may give rise to conflict of interest or such purchase not being conducted on arms length basis which may result in manipulation of price (risk associated with fraud).

Order/Receipt of asset

In stage 2, the IIFS takes possession or 'constructive possession' of the assets and subsequently offers the asset for lease to customer. IIFS is responsible for the risks associated with the asset.

This stage is associated with two types of risks. The first is price risk as component of market risk. When the customer opts not to fulfill the promise or agreement to lease, the IIFS has to lease (or sell) at lease rentals (or a selling price) which can be lower than the original total rentals (or selling price) to the original customer (low asset value). As Risk Mitigation that IIFS may requests is 'hamish jiddiyah' or security deposit; to guarantee the customer's commitment to lease the asset. The IIFS can deduct the difference between the total lease rentals (or a selling price to a 3rd party) and cost of the asset when customer breaches the Agreement to Lease.

The second risk that appears in this stage is legal risk as part of operational risk. It is associated with claims on the remaining amount of damages in the event that hamish jiddiyah is insufficient (litigation cost, loss of claims).

Contract

In stage 3, the customer (as Lessee) executes an Ijarah Muntahia Bittamleek Contract contract with an IIFS (as Lessor) requesting the Lessor to acquire an asset or acquire the usufruct of an existing assets which the customer wishes to take on lease. The contract can be drawn via a Master Agreement (to be followed by execution of multiple confirmations of offer and acceptance of individual Ijarah transactions) or individual contracts. Contract is binding and cannot be cancelled unilaterally. The lease period should commence from the date of execution unless the parties agreed on a specified future commencement date (future Ijarah). Future Ijarah is allowed provided that the lease rentals are payable by the Lessee after the leased asset is delivered to the Lessee. The Contract should specify:

- Transfer of the usufruct to the Lessee for an agreed period at an agreed consideration
- The leased asset must have a valuable use
- The leased asset must be fully identified by the contracting parties
- The purpose or intended use of the leased asset by the Lessee must be lawful / Shari'a compliant and in normal course of utilization (purpose which is not within normal course requires consent of the lessor)
- The lease rental must be determined at the time of contract for the whole period of lease. The lease rental may be paid by cash, kind (goods) or usufruct.

The rental must be specified, either in a lump sum payment in advance or in arrears; or in installments over duration of the lease. The rental can be fixed or variable. The lessor can sell the leased asset without consent of the Lessee.

This stage of contract will involve all three major risks. Firstly, Settlement Risk as a part of Credit Risk. Customer is unable to service the lease rental as and when it falls due. This inability can be due to variable lease rentals that may distress the customer's ability to pay (loss of rental receivables). Risk Mitigation that IIFS may apply involves request for "urbun" from customer and deduct for damages. The "urbun" can also be taken as an advance payment of lease rental. Alternatively, the IIFS as the owner has the right to repossess the assets. In addition the IIFS may use cap/floor to limit price movement.

Secondly, Rate of Return Risk as component of Market Risk. Long-term Ijarah (Muntahia Bittamleek) with fixed rental is susceptible to changes in market conditions, e.g. higher return demanded by investors (low

investment return). Risk Mitigation may be an option of renewable short term leases with price reflex subject to mutual consent or adopts variable lease rentals which are determined according to a certain benchmark (e.g. rate of interest). In addition The IIFS can enter into a lease contract with a condition that the lease rental shall be increased according to a specified proportion after a specified period (like one year).

Lastly, Takaful/Insurance Risk, Shariah Compliance Risk, and Reputational Risk as main components of Operational Risk. Takaful or Insurance Risk may appear if there is insufficient takaful to cover the mishap during the delivery and rental period (higher cost). Shariah Compliance Risk is compliance with Shariah principles in terms of usage, operations, risk bearer and ownership transfer (non recognition of income). Reputational Risk occurs when the leased asset is used for unlawful – non-Shariah compliance purpose (withdrawal risk).

Reject/Defective goods

Stages 4 of contract give an option to the lessee to reject goods delivered that are not within specifications and demand for goods that conform to the specification. When it comes to lessor's obligation, the lessor is responsible for defects throughout the Ijarah (Muntahia Bittamleek) period unless such defects are due to lessee's misconduct or negligence. The leased asset in the possession of the Lessee is held in a fiduciary capacity. When the usufruct of a leased asset is wholly or partially destroyed due to nature or not the Lessee's misconduct, the Lessee may terminate the Ijarah (Muntahia Bittamleek) contract or renegotiate the rental based on the prevailing market rate. As for the lessee's obligation, when the usufruct of a leased asset is wholly or partially destroyed as a result of the lessee's misconduct, the lessee is obliged to restore / repair the leased asset.

There are two operational risks which are involved with this stage of contract: Legal Risk and Asset Impairment Risk. The first is related to the claims against Lessee that refuses to pay for the damaged goods (litigation cost, loss of claims). Risk Mitigation could be in the way that the IIFS (lessor) may appoint the Lessee as its purchasing agent to ensure that the goods purchased by lessor are within the lessee's specifications. However, this practice may lead to Business Risk and Shariah Compliance Risk.

The second, Asset Impairment Risk, appears when the leased asset is destroyed (not due to lessee's misconduct). In this case the lessor has to provide an alternative asset and failing to do so the lessee can terminate the lease without paying rentals for the remaining duration of the contract (additional cost, low investment return). Risk Mitigation may involve lessor insuring the leased asset (cost to be borne by the lessor)

for damages. The insurance cost can be included as part of the fixed lease rental and cannot be charged separately to the lessee.

Early Settlement (The customer makes an early settlement and the IIFS gives rebate to customer due to custom practice; exposes the IIFS to lower return (Business Risk))

The contract can be terminated by mutual consent. Unilateral termination is allowed in cases of force majeure, defect in the leased asset that materially impairs its use, total destruction of the leased asset or when a termination option is stipulated in the contract. When the leased asset is returned by the lessee without the lessor's consent, lessee is obligated to continue paying the lease rental and the lessor cannot lease the asset to another lessee.

Default

Default in payment is when the lessee who is in a solvent state fails to honor the payment when due.

In a situation where IIFS is legally allowed to repossess the goods without initiating bankruptcy order, IIFS can sell or lease the asset to a 3rd party to recover the selling price of the goods.

Late payment, penalty charges or price increase is not allowed.

Any extension or rescheduling of payment can be done without additional charges or price increase.

This stage of contract involves four potential risks. As part of Credit Risk the Asset Repossession Risk and Rental Acceleration Risk may appear. In the case of Asset Repossession Risk the leased asset which is in the possession of the customer cannot be located/repossessed. If repossessed, the asset cannot be sold or leased to another party (loss of assets). Rental Acceleration Risk is related to inability to recover the future rentals that are 'accelerated' or declared immediately due upon default by the Lessee (loss of invested capital). As part of Operational risk the Legal risk and Business risk may emerge. Legal risk is associated with IIFS taking legal action when the asset cannot be repossessed (litigation cost, loss of claims). Business Risk may rise as new leasing arrangement may generate lower returns that the rental or may differ when there is early repossession by the bank. In addition, there may be risk associated with disposal of leased asset after repossession at a price which is not sufficient to recover the amount due (low investment return).

Maturity

The Agreement Lease is not binding on the Lessee but

the Lessor is unilaterally binding to transfer ownership in the leased asset to the Lessee. The option to transfer of legal title /ownership of the leased asset must be documented separately from the Ijarah contract and be effected via one of the following methods:

- gift or token consideration
- final installment of lease rental

In last stage of the contract two risks may come into view. Firstly, Residual Value Risk as component of Credit risk. Residual Value Risk may rise in the event that the customer decides not to proceed with the purchase; the IIFS will bear the potential loss due to the fair value of the asset fall below its residual value estimated at lease inception (low fair value). Secondly, Quality Risk as a part of Operational risk. Under Ijarah Muntahia Bittamleek Contract, the Lessee normally pays lease rentals higher than the prevailing rate as a consideration of the lessor's promise to transfer ownership at the end of the lease period. When the asset is permanently impaired and the lessee cannot purchase the asset, the lessor may be required to refund the "purchase price" to the lessee. The rental payment in excess of market rate can be regarded as 'purchase price' paid in advance (low investment return).

Other types of (Operational) risks related to Ijarah Muntahia Bittamleek

While a major operational risks exposure during the purchase and holding of the assets is elaborated in previous section, other operational risk aspects include the following:

- Shariah compliance risk (SR); the Islamic banks need to ensure that the asset will be used in a Shariah compliant manner. Otherwise, it is exposed to non-recognition of the lease income as non-permissible.
- Fiduciary risk (FR); major maintenance is the responsibility of an Islamic bank as a lessor, as directed by AAOIFI Shariah standards (2008). In addition to that, it is the duty of the lessor to ensure that the usufruct is intact, and this is not possible unless the asset is maintained and kept safe so that the lessor may be entitled to the rentals in consideration for the usufruct. Thus, deficiencies in maintaining such responsibility can be deemed to be sources of FR in Ijarah contract.
- People risk (PR); lessor is not allowed to increase the rental due, in case of delay of payment by the lessee, this is what AAOIFI (2008) clearly exemplifies. Misunderstanding of this principle by the staff is a source of losses caused by PR, because the income generated from this, is not permissible from Shariah point of view.
- Legal risk (LR); the Islamic bank may be exposed to legal risk in respect of the enforcement of its contractual right to repossess the asset in case of default or misconduct by the lessee. This may be the case particularly when the asset is a house or apartment that

is the lessee's home, and the lessee enjoys protection as a tenant.

- Technology risks (TR); may occur due to an incompatibility of the new accounting software or losses of information on the leased assets due to external security breaches.

Application of hedging credit enhancement techniques for Ijarah Muntahia Bittamleek

Having identified the basic risks in Ijarah Muntahia Bittamleek, the following section explores Shariah restrictions and credit enhancement techniques that may fit within a Shariah framework. Shariah generally requires that in order to earn income from asset ownership, the investor must assume the risks of ownership. This general principle has led to certain restrictions on the use of capital protection devices in Ijarah Muntahia Bittamleek transactions. Nonetheless, some techniques that are utilized to enhance the security of leasing transactions have been met with approval from various Shariah boards.

Performance or commercial risk guarantees

Islamic law permits a second party to guarantee the obligations of another party (daman or kafala) with three important limitations. First and most important, the guarantee must be gratuitous, although the guarantor may recover out of pocket expenses not including the cost of capital. Second, the guarantor should be able to cancel the guarantee at any time before the obligation actually becomes due. Third, the guarantee must concern the payment of an obligation rather than contingent losses (the guarantee is not insurance).

Notwithstanding these limitations, third-party guarantees in the form of Islamic letters of credit or standby letters of credit are common in murabaha transactions. In the context of Ijarah Muntahia Bittamleek, a third-party guarantee is often structured as a put option obtained from the bank in exchange for payment of rent. If the lessee at some future time should cease making payments, either because it concludes that the equipment being leased is not as valuable as the remaining installment payments or, more likely, because the purchaser has become insolvent, the lessee could "sell" the equipment to the bank in return for the bank taking over the remaining installment payments. The bank, of course, would have the right to recover its losses from the lessee, but in the event of insolvency such a right might not be meaningful. The bank in effect guarantees the payments to the lessor.

For its role in the transaction, the bank charges a fee which is typically added to the rental price of the equipment and is not paid separately by the lessee. To

be acceptable for Shariah purposes, the fee should not be a percentage of the value of the contract but should be a stated fixed fee payment related to the actual services of the bank.

Protection against damage or loss

Insurance against contingent loss (for example, a guarantee against loss of an asset as a result of casualty) is generally considered unacceptable in Islamic finance because it violates principles against gambling or *maysir* as prohibited in the Qur'an. Typical casualty insurance should be unacceptable for these reasons. This is particularly significant in the context of *Ijarah Muntahia Bittamleek* transactions, since *ijara* requires that the risk of damage or destruction of the asset must be borne by the lessor. In conventional finance, the risk of such losses is placed upon the lessee, and the lessee is in turn required to cover these risks with insurance. However, other methods of transferring this risk exist. Shariah does not preclude the lessor from entering into a contract with a third-party to engage in servicing activities with respect to the equipment. The servicing agreement may provide, for example, that the servicer must monitor and supervise the use of the equipment in such a way as to prevent damage or loss. Damage or loss that might be prevented by adequate precautions can effectively be transferred to the servicing party by appropriate contract provisions.

Shifting the risk of loss pursuant to a servicing agreement would not appear to violate the rule which requires lessors to retain the risk of loss under the lease. The servicer is not the same as the lessee, although in some cases it may be related to the lessee. Moreover, the risk of loss has effectively been shifted pursuant to separate contracts which are Islamically valid.

A contract provision whereby the servicer simply acts as insurer, guaranteeing against any catastrophe, might be considered insurance of the prohibited kind. However, the areas of risk can be tightly restricted by service provisions. It may also be possible to shift the ultimate risk of "no fault casualty" (such as a hurricane) by means of a put option embedded in the servicing agreement and compensated by the servicing fee paid to the servicer. Such a provision may not violate the rules concerning guarantees.

Residual value insurance or guarantee

The principal techniques used for reducing residual value risk typically involve either guarantees of residual value issued by the originator of the leasing transactions (or perhaps some affiliate of the originator) or through obtaining residual value insurance from insurance companies specializing in such transactions. The

insurance policy in most instances will have a deductible. Each of these risk mitigation devices may be problematic from a Shariah point of view.

A guarantee will typically not be issued without consideration unless the guarantor is affiliated with the ultimate lessee. Thus while affiliate guarantees may be acceptable, the lessee will often not have any parent which is willing to make such a guaranty. Third-party guarantees are usually in the form of a guarantee of principal investment or a certain return, both of which are presumptively unacceptable in Islamic finance. Residual value insurance might be available on a *takaful* basis in the future, but now there are only a small number of companies that issue residual value insurance, and none operate Islamically.

Derivative contracts

The Shariah rules prohibiting gambling (*gharar*) and the Islamic principles linking reward with risk establish significant barriers to the creation of Islamically acceptable derivatives. Options, futures, forward contracts, and swaps all appear to be fundamentally unacceptable.

With certain modifications, however, some forms of option contracts may be acceptable to Islamic finance. One type of contract acceptable to some Shariah scholars is the *urbun*, or the earnest money contract. Under such a contract, a buyer advances a down payment and agrees to pay an additional purchase price when the goods are delivered at some future date. The purchaser may however decide not to accept the goods in the future, in which case the seller keeps the down payment. While not universally accepted, the *urbun* contract appears to be widely used in the Islamic finance industry. For example, *urbun* contracts have been used to create principal protected equity funds in which the *urbun* contract is effectively a forward option against an Islamic equity index.

In most respects the *urbun* appears similar to a conventional option; although the *urbun* can alternatively be viewed as a binding contract with a liquidated damages provision in the event the buyer fails to complete the transaction. The key restrictions that are imposed in the *urbun* contract are that the seller must possess the goods to be sold throughout the *urbun* period and that he cannot deal in them during this time. For example, in the case of an *urbun* on stocks, the seller must possess specific stocks to be sold over the period of the *urbun*. The purchaser apparently bears the risk of loss. Such contracts provide the opportunity for the application of significant risk mitigation techniques. In *Ijarah Muntahia Bittamleek* transactions, the techniques used with derivatives can be applied to large leasing portfolios which consist of different types of equipment, risk, and lessees.

CONCLUSION

One contradiction found in the literature should be mentioned: a rental paid in *ijârah muntahia bittamleek* implicitly includes the cost of the asset which serves to buy the leased asset. If this asset is no longer operational, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recommends that the bank refunds to the lessee the difference between the rent agreed and a prevailing rental for the same asset (because the lessee hoped to become the owner of the asset) (Ayub (2007)). The Islamic Financial Services Board (2005a) adopts the same attitude. It recommends that the bank refunds the additional amounts (capital payments) included in the *ijarah muntahia bittamleek* lease rentals, above the amount equal to a rental found in an operating *ijarah* for the same asset. However, this poses a problem. It goes against the spirit of *ijarah*, because the part of rental paid for taking ownership in the future has no contractual justification.

In other words, the lease and transfer of ownership are mixed together; they are no longer independent. It seems that this arrangement more closely resembles a diminishing *musharakah*. It is been noted that there is a tendency among banks to use *wa'ad* (purchase undertaking). Using *wa'ad* defeats the spirit of "pure" Islamic Finance and the underlying principle of profit-and-loss sharing, as it creates debt by which the interests of banks are protected at the expense of customers. A study by ISRA assert that if we do IMB properly, if we handle the laws and everything related to this product, then this product can kill conventional products.

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