Real estate finance--Shari'ah-compliant transactions

Produced in partnership with K&L Gates LLP

Real estate is an increasingly important asset class for Islamic-compliant transactions and banks in the UK. Islamic-compliant finance has proved to be an alternative source of funds entering the UK real estate market as witnessed by such high-profile London real estate deals as the Chelsea Barracks and the Shard.

Real estate as an asset class for Islamic finance and hybrid structures

Islamic finance uses real estate as an investible, tangible asset class on which to base its financial structures. Since 2010 there has been a notable increase in the number of Islamic funds and Islamic banks providing mezzanine finance for real estate finance transactions.

In such structures:

- a conventional senior bank lends the majority of the debt on an interest payment basis
- the investors inject their equity, and
- the mezzanine finance tranche is put into the structure in an Islamic-compliant way

This type of hybrid structure is a way of accessing finance from Islamic funds and Islamic banks.

What is Islamic-compliant finance?

For information on Islamic finance in a general context, see Practice Notes: Key principles of Islamic finance and Sources of Shari'ah law.

The principles of Islamic finance will influence all aspects of an Islamic-compliant real estate finance transaction or the formation of an Islamic investment fund, as well as every aspect of the operation and conduct of the underlying real estate business.

Shari'ah compliance

In many real estate finance transactions, only one party may be concerned that the deal is Islamic-compliant. In that case, it is important that each party represents to the other that it is satisfied with the Islamic compliance from its viewpoint and will not seek to use a later finding of non-compliance as a reason to renege on the transaction. The representation is usually made in one of the main deal documents and should apply to all other documents and transactions between the parties.

The role of Shari'ah scholars

Over the last few decades, the mechanism that has evolved to provide comfort with respect to *Shari'ah* compliance is the *Shari'ah* supervisory board (*Shari'ah* board) of a financial institution or investor. *Shari'ah* boards are often comprised of a group of Islamic scholars. Frequently, they are comprised of one or more of the leading 'internationalist' scholars, some regional scholars, and some local scholars. The scholars usually consider the underlying structure of the transaction and the main deal documents in order to check that they comply with their institution's or investor's interpretation of *Shari'ah* principles. Often they will issue an opinion or *fatwa* confirming compliance and that the transaction may proceed.

Prohibited business activities

For real estate finance transactions, it is important to consider the activities of the tenants of the real estate which is being financed. This is because many large office buildings and complexes have tenants that engage in business activities that are not *Shari'ah*-compliant, such as retail branches of conventional banks, restaurants that serve pork or alcohol, or supermarkets or convenience stores that sell those products.

In the purest case, the entire building or complex would be an impermissible investment. However, most *Shari'ah* scholars have taken a pragmatic view. Rules have been developed that allow investment in these properties for certain impermissible uses. For example, if the branch bank serves a retail market, there are insufficient other banking opportunities in the defined area, and the branch bank occupies a small percentage of the property (say, 1% or less), some *Shari'ah* boards will permit the property acquisition and allow renewal of the lease to that branch bank. The development of these rules which permit investment in a small number of impermissible tenancies greatly expands the types and amounts of properties available for investment through Islamic finance.

Islamic real estate finance structures

The key Islamic-compliant finance structures used in real estate finance are:

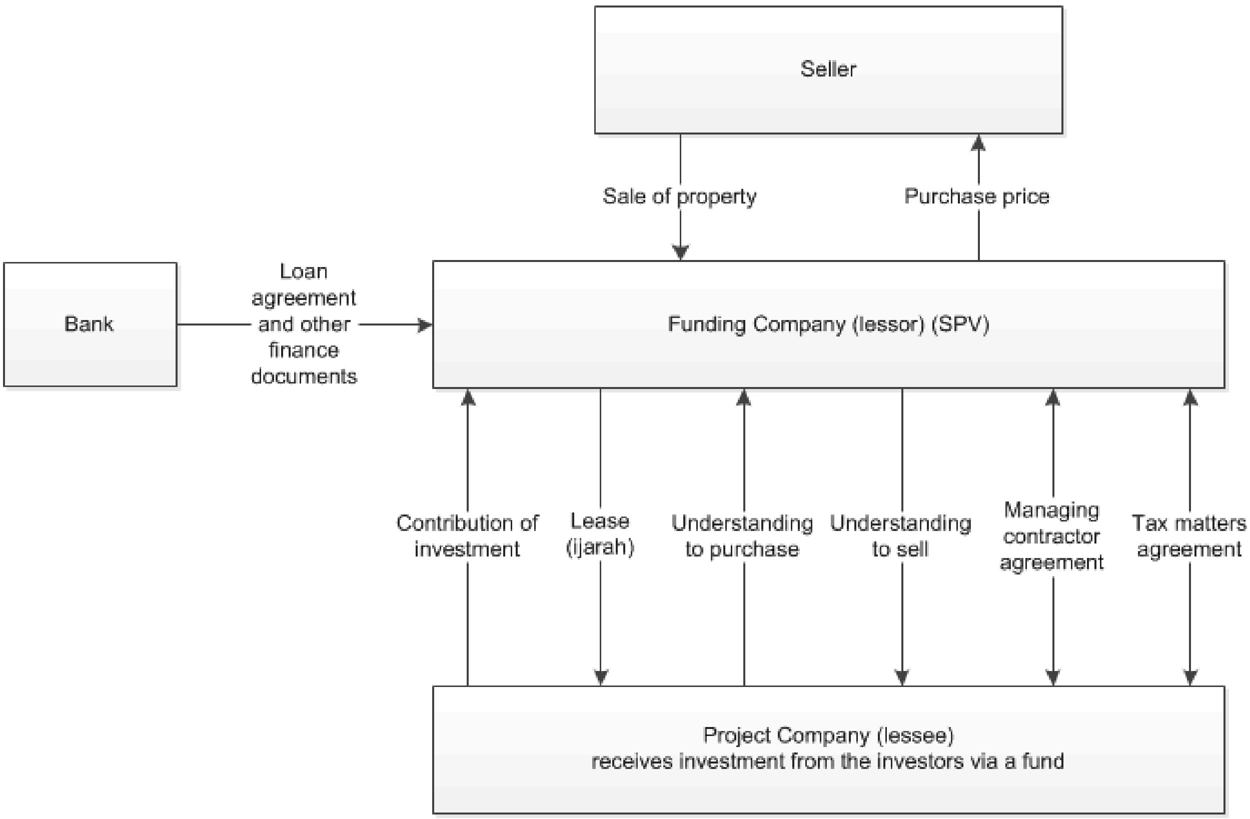
- the lease structure (*ijarah*)
- the sale at a mark-up structure (particularly *murabaha*), and
- the joint venture structures (*mudaraba* and *musharaka*)

Ijarah and *murabaha* are most commonly encountered.

Ijarah (lease) structures

A common acquisition and operating financing structure in Islamic real estate finance in Europe is the *ijarah* (lease). For information on *ijarah* in a general context, see Practice Note: Structure and key features of an Ijarah transaction.

Ijarah structure diagram



The investment

The investors make their investment into the project company (Project Company). For tax reasons, this investment is usually made through a fund and at least one entity is usually inserted in the structure between that fund and the Project Company.

Acquiring the property

A special purpose vehicle, the funding company (Funding Company), is established to acquire and hold title to the property in which the *Shari'ah*-compliant investment is to be made. The Project Company contributes its investment (eg 40% of the acquisition price) to the Funding Company. A conventional interest-bearing loan is made by the bank to the Funding Company (eg equal to 60% of the acquisition price). The Funding Company then acquires the property from the seller. (This example assumes 60% conventional interest-based financing and 40% contribution by the *Shari'ah*-compliant investors but these percentages will vary with each transaction.)

The lease

The Funding Company, as lessor, enters into an *ijarah* with the Project Company, as lessee. The rent payable under the *ijarah* is identical to the debt service on the conventional loan from the bank and provides the funds to pay that debt service.

The lease must be *Shari'ah*-compliant, including:

- the lessor must have ownership of the real estate prior to leasing it
- the lease period must be specified
- the real estate asset must continue to exist throughout the lease term, and
- the lessor must be responsible for maintaining and insuring the property--under *Shari'ah* principles, a lessor may not pass structural maintenance obligations or corresponding obligations such as the maintenance of buildings insurance to a lessee. This means that the typical fully repairing and insuring lease is prohibited

Future rents cannot be accelerated under a *Shari'ah*-compliant lease. Given that the outstanding principal is paid through the *ijarah*, an acceleration mechanism is necessary outside the *ijarah* itself. The understanding to purchase (or purchase undertaking) performs that function (it also mirrors all mandatory prepayment provisions of the bank loan). The bank, through the Funding Company, 'puts' the property to the Project Company at a strike price equal to the outstanding principal (and other outstanding amounts).

The Project Company may also want to sell the Property during the period that the loan is outstanding. The understanding to sell (or sale undertaking) provides the mechanism (and also mirrors the voluntary prepayment provisions of the bank loan).

Maintenance and insurance

Under *Shari'ah* rules, although a lessor cannot pass structural maintenance and insurance obligations to a lessee, it can hire another entity to perform those functions. In this case, the Funding Company hires the Project Company to perform those activities pursuant to the managing contractor agreement.

Tax

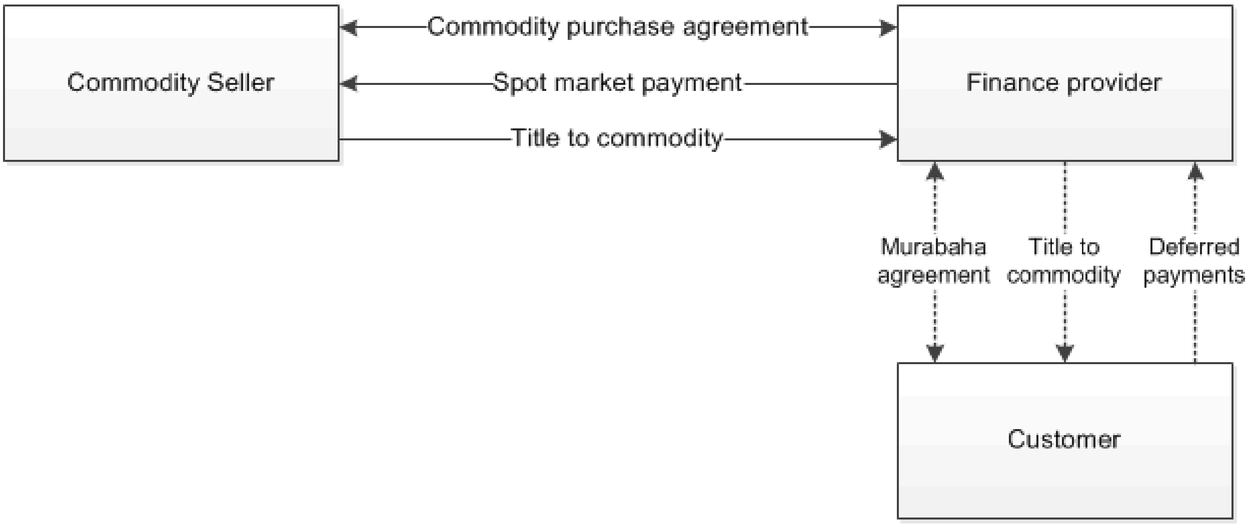
The tax matters agreement provides that the Project Company is the tax owner of the property and for income tax (and other) purposes, this is deemed to be a loan from the bank to the Project Company. The tax matters agreement outlines the components as between the conventional loan documentation and the *Shari'ah*-compliant leasing documentation.

Murabaha (sale at a mark-up) structures

Murabaha is a widely used sales structure. Most simply defined, it is a sale at a mark-up. The *murabaha* structure results in an entity obtaining a cash amount that it can then spend towards purchasing an asset such as real estate. In Europe, a number of property investors have used this structure as a banking tool to provide finance to investors purchasing real estate assets.

For information on *murabaha* in a general context, see Practice Notes: Structure of a murabaha transaction and Structure of a commodities murabaha transaction.

Murabaha structure



In the simple *murabaha*, a customer of a finance provider wants to purchase a commodity, piece of equipment, or other asset (the Commodity). The customer negotiates the terms of the purchase, including payment terms and precise specifications, with the third party vendor (the Commodity Seller). The customer then asks the finance provider to finance the purchase of the Commodity.

The customer and the finance provider enter into a *murabaha* agreement pursuant to which the finance provider agrees to supply to the customer a Commodity meeting the precise specifications that were negotiated with the Commodity Seller. The *murabaha* agreement will require the customer to make payment to the finance provider for that Commodity on a deferred purchase basis.

The finance provider, in turn, will enter into a commodity purchase agreement with the Commodity Seller and will purchase the Commodity from the Commodity Seller for immediate payment in full.

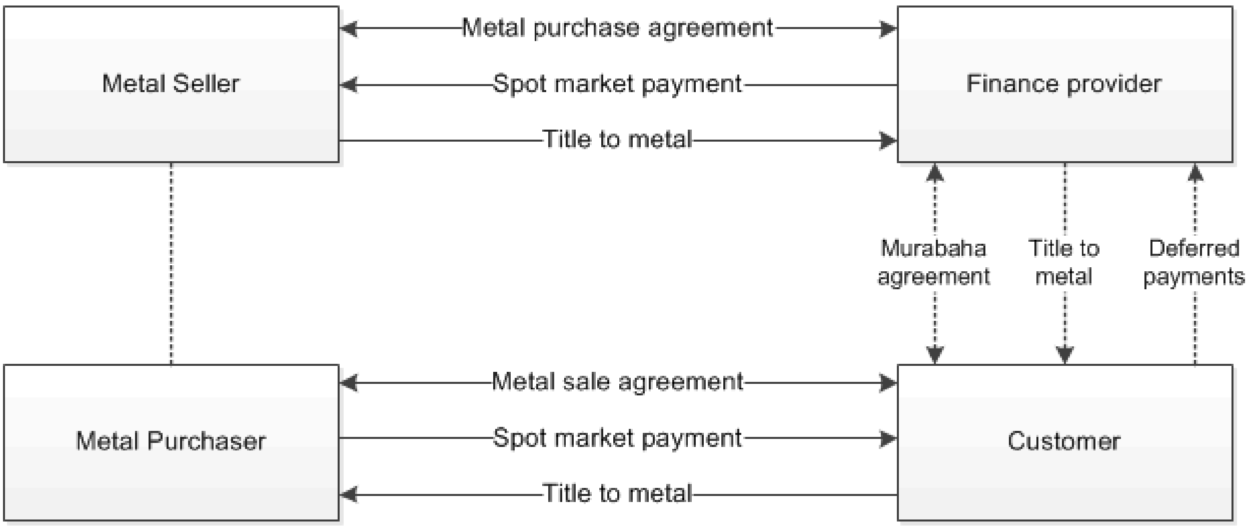
Upon accepting delivery of the Commodity, the finance provider will fulfil its obligations under the *murabaha* agreement by re-selling the Commodity to the customer. The key rules are:

- the finance provider must have ownership risk with respect to the Commodity, and
- the customer can, under most schools of Islamic jurisprudence, act as the agent for the finance provider in completing the arrangements between the finance provider and the Commodity Seller

In a real estate context, some banks (most notably UK and Irish banks) have offered *murabaha* by taking notional possession of a property's title at closing and then selling the property to the customer at a higher price.

If the bank does not want to, or cannot, acquire title to the property for regulatory reasons, then the bank appoints a transacting party to act as its acquiring agent. The acquiring agent then executes the sale in favour of the ultimate customer.

Working capital murabaha (also known as commodities murabaha)



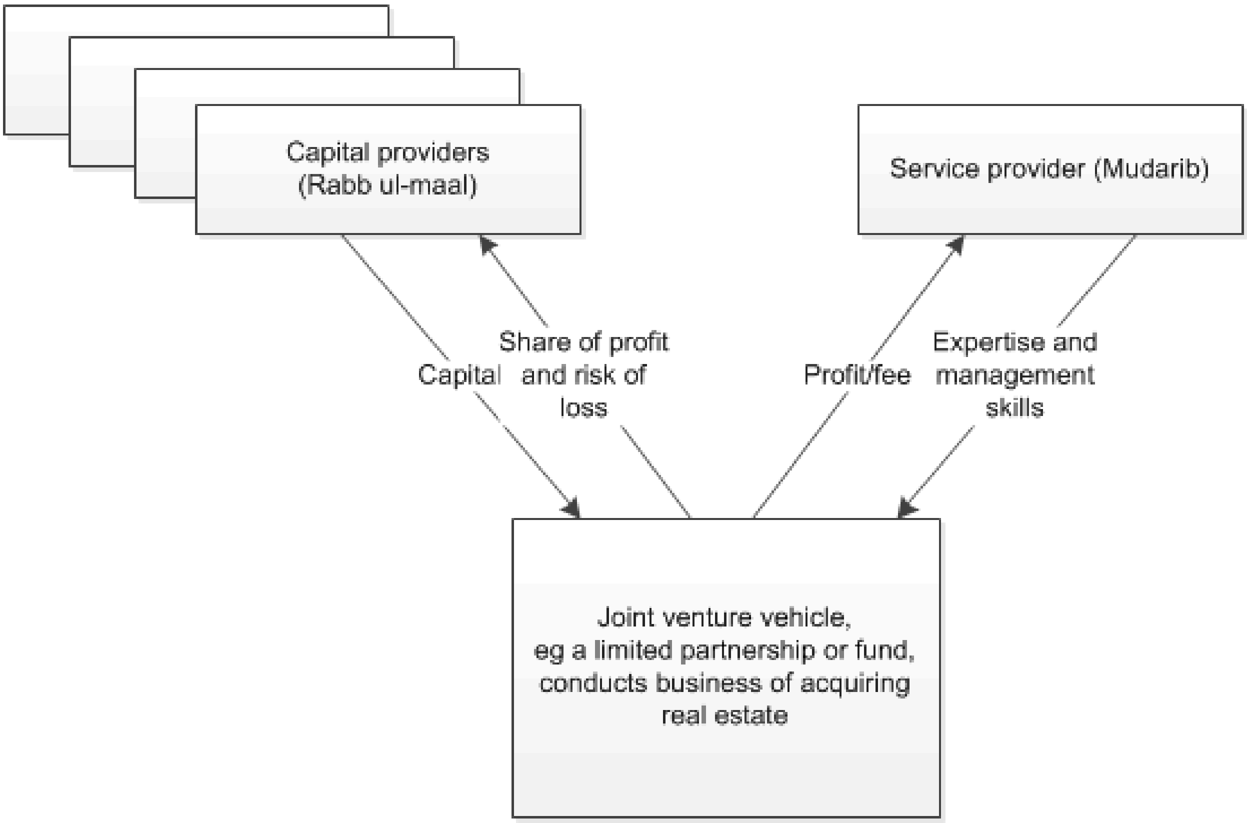
The transaction is identical to the *murabaha* transaction with an additional element in that the customer, upon taking title to the Commodity (here a permissible metal), immediately sells that metal to the Metal Purchaser for a cash payment at the same spot market price as obtained in the finance provider purchase of that metal from the Metal Seller (fees ignored). Metals usually constitute the assets which are subject to a working capital *murabaha* transaction. Any number of commodities could be used for this purpose, but the Islamic finance industry utilises metals for practical reasons. Gold cannot be used as the metal in such transactions as it is treated as a form of money. The Metal Purchaser and Metal Seller are frequently affiliates. The net result is that the customer ends up with cash equal to the spot market price of the metal and a deferred *murabaha* payment obligation to the finance provider in respect of that amount plus a profit factor. The cash is then used by the customer to purchase real estate.

Mudaraba (service provider--capital provider) structures

A *mudaraba* is a type of joint venture and is a key method for organising and acquiring real estate investments. For information on *mudaraba* in a general context, see Practice Note: Structure of a mudaraba transaction.

A *mudaraba* is most frequently formulated as a limited partnership, a limited liability company or a fund. The base structure involves one partner providing services and management (the *mudarib*). One can equate a *mudarib* to a fund manager. In that case, the *mudarib* may sub-contract its duties to an experienced real estate management professional. Usually, the *mudarib* does not provide cash or other in-kind capital. Some *Shari'ah* boards prohibit *mudarib* capital; all prohibit it without the consent of the other partner(s). The other partner(s) (the *rabb ul-maal*) provides capital, in cash or in kind, and generally may not interfere in the management or service component.

A simple mudaraba arrangement with multiple capital providers



Using conventional limited partnership agreements with a mudaraba

As a general matter, and with a few modifications, a conventional limited partnership agreement works well to structure a *mudaraba*. For example, while a capital provider may not interfere in the management function, most *Shari'ah* boards permit 'minority rights' protections such as are afforded to limited partners, and other rights are permissible in *mudarib* default, breach and infringement scenarios.

Acquiring the real estate and sharing in profits and losses

The partnership or fund then acquires real estate assets most commonly through *ijarah* or *murabaha* structures. Profit in a *mudaraba* is that amount that exceeds the capital after deduction of all allowable *mudaraba* expenses. Conversely, loss is the decrease in the *mudaraba* capital.

The critical *Shari'ah* rule pertaining to losses is that all losses are borne by the capital provider (the service provider has lost its services and is not seen as having incurred pecuniary losses).

Profit allocations must be specified, and must be pro rata (although formulas specifying different allocations upon satisfaction of hurdles have been accepted). Importantly, there can be no predetermined or conclusive profit allocation to any of the parties and arrangements allocating all profit to a single party are impermissible.

More difficult issues arise with respect to scenarios in which a clawback of distributions may be necessary, as with losses subsequent to distributions.

Musharaka (capital provider) structures

The term *musharaka* refers to a wide range of partnership or joint venture arrangements, eg:

- *al-sharika* is a partnership for profit
- *sharikat ul-amwaal* is a property partnership, and

- *al-musharaka* is a finance method derived from a partnership contract in which a bank participates with one or more clients

For information on *musharaka* in a general context, see Practice Note: Structure of a musharaka transaction.

In a *musharaka* real estate transaction each of the partners contributes capital, and there is significantly greater flexibility in allocating management responsibilities among partners than with *mudaraba*; joint rights of management are frequent and usual.

Limited partnership agreements are also useful models for structuring *musharaka* arrangements. Profit and loss definitions are mainly the same as with *mudaraba*, with some fundamental differences:

- profits may be allocated in accordance with a points system, and that points system may be structured to take account of the amount of capital contributed and the period of participation
- profit from a specific period in relation to the property may not be allocated to a specified partner, nor may a lump sum be allocated to a specific partner
- in the majority view, losses, up to the amount of a partner's capital contribution, must be distributed in accordance with the relative capital contributions of the partners
- a partner may not assume liability for the capital of another partner, including by way of guarantee