Chapter 19

Islamic-Compliant Financing of Commercial Real Estate

Jonathan Lawrence,

Partner, K&L Gates LLP

19.1 Introduction

CRE has been an increasingly important asset class for Islamic-compliant transactions and banks since the publication of the first edition of this book in 2006. During this period, Islamic-compliant finance has proved to be an alternative source of funds for investors entering the European CRE market, as highlighted by high-profile London CRE deals, such as development finance for The Shard, the Olympic Village, the Battersea Power Station regeneration and the redevelopment of Chelsea Barracks.

In the wake of Brexit, some parameters have changed in relation to Islamic-compliant investment in UK CRE:

- The immediate fall in the pound/US dollar exchange rate made the UK more attractive for those investors in US dollar pegged economies;
- Potential UK tax cuts and incentives were mooted to draw investment;
- A predicted short to mid-term decline in UK real estate values;
- Uncertain impact on the remaining EU economies.

However, most fundamentals of such investment have not changed:

- Islamic finance has never been governed by EU law in the UK or elsewhere;
- The UK has one of the most Islamic friendly legal environments with the most legislation of any of the EU countries to assist Islamic finance from a political and tax perspective;
- The English language, English law and the English courts remain attractions for overseas investors;
- The need to draw overseas investment to the UK became more important than ever.

In 2016, Islamic-compliant financing is on a growth trajectory, based on demographic trends, rising investible income levels and investment in European CRE by Middle Eastern investors led by relatively stable political and legal environments. Brexit may be a spur to further such investment rather than an impediment. In addition, non-Islamic CRE market participants are increasingly looking to Islamic financing structures to supplement conventional equity and debt funding.

It is estimated that 29.7% of the global population will likely be Muslim by 2050, against 23.2% in 2010. The proportion of Muslims in Europe is, at the time of writing, around 6% of the population and projected to be 8% by 2030. This creates a large market and consumer base to consider.

The level of harmonisation is increasing between conventional and Islamic banking regulation, thus eroding barriers to entry. There are further significant growth opportunities, given that the global penetration of Islamic banking is currently below 2% in CRE finance and *sukuk* (*Shari'ah-compliant* capital markets instruments) account for only approximately 1% of global bond issuance. Global assets of Islamic finance were estimated to be $2 trillion at the end of 2014, and have tripled since the start of the economic slowdown in 2007.

The UK has enjoyed an in-built advantage in its attempt to become the hub of Islamic finance in Europe, due to English law often being the governing law of international Islamic finance transactions. An Islamic finance transaction might involve a Swiss bank and a Middle Eastern counterparty, but they may well choose English law to structure their documentation, in order to give flexibility and certainty to both sides.

Successive UK governments have ensured that there is a level legislative and regulatory playing field for both Islamic and conventional financial products. In the UK, more than 20 banks offer Islamic financial services, of which five are fully Islamic-compliant, substantially more than any other European country. In June 2014, the UK government issued a sovereign *sukuk*, the first by a country outside the Islamic world. Rental payments on real estate provide the income for investors in the *sukuk* and it is underpinned by three central government properties.

The acceleration of international real estate investment by Middle East sovereign wealth funds, high net worth individuals, developers and real estate companies outside their own region is most clearly seen in the growth from a recent low of $2 billion in 2009 to $13 billion in 2013, itself a 86% increase over 2012. The biggest growth by investor type is amongst the sovereign wealth funds.

In 2014 and 2015, 44% of the investment went into London. The top four locations of London, Paris, Milan and Lyon were all European and accounted for two-thirds of the total, with US destinations further down the list.

Talk about rivalry over the location of an Islamic finance hub in Europe can be overstated. The UK, Luxembourg, Ireland, the Netherlands and other European locations are complementary to the Islamic finance industry by offering different advantages. The distinctiveness of London has arguably been enhanced by Brexit and investment opportunities increased. Luxembourg is already the leading non-Islamic domicile for Islamic-compliant investment funds and third largest globally behind Saudi Arabia and Malaysia. It is also a popular location for listing *sukuk* on the primary market. However Luxembourg does not have the direct investment targets of CRE and corporate opportunities that the UK possesses. Other popular EU real estate markets such as France, Germany and Italy may have interesting opportunities, but those jurisdictions suffer from tax and legislative hurdles to the use of Islamic finance techniques.

However, other EU countries continue to seek to attract Islamic finance and investment. For example, in 2010, Ireland introduced a tax neutrality regime for Islamic finance. Ireland has signed over 60 double tax treaties ensuring there is no double taxation for such structures (for example, treaties with Malaysia, Saudi Arabia and the United Arab Emirates). The Irish government has called an Irish government *sukuk* ''an option'' and Dublin is already well developed as a financial centre, with the Irish Stock Exchange having listed its first corporate *sukuk* in 2005. Nevertheless, Ireland has a Muslim population of only approximately 54,000, and this may hamper the development of the industry.

In October 2014, the Luxembourg government issued its own sovereign *sukuk*. Luxembourg, alongside Jersey and Ireland, is a key player in the European Islamic funds sector. However, Islamic-compliant real estate funds account for only 4% of the global market.

Turkey is a country to watch. Straddling Europe and Asia, its nearly 80 million population is over 99% Muslim. Companies are allowed to issue Islamic-compliant debt and Kuveyt Turk issued the first corporate *sukuk* by a European bank. It was listed on the London Stock Exchange.

19.2 CRE as an asset class

Real estate has been a primary focus of the Islamic finance industry since the 1990s. Islamic property investments began in the residential housing sector, but quickly moved to CRE, which now plays a large role in this sector throughout the world. Initial investments were, and continue to be, effected through investment fund structures. However, the emergence of the *sukuk* in 2003 saw significant changes in Islamic-compliant CRE finance.

To date, Islamic finance has viewed CRE as an investible, tangible asset class on which to base its financial structures. The focus has tended to be on prime or trophy assets: for example, hotels or large office headquarter buildings. There is increasing evidence that Chinese investors are aiming for the same type of properties, therefore Middle Eastern investors have been more willing to looking at real estate outside London in the UK.

At the time of writing, a low oil price is leading to mixed predictions about its effect on Middle Eastern CRE investors outside their home regions. Middle East investment was traditionally seen to rise in line with oil prices, as more surplus funds become available. However, it is also likely that the knock-on effect on GDP will be an important reminder of the need to diversify a country's revenue sources away from non-renewable energy. This could lead to an increase in overseas investment into real estate in the medium-to-long term in order to provide stability in an uncertain political and economic climate.

In addition, since 2010, Islamic funds and Islamic banks providing mezzanine finance have multiplied. 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 is a feasible way of ensuring that deals get done. The senior conventional bank and the Islamic-compliant mezzanine lender enter into an intercreditor agreement which governs the way each loan is treated and takes account of the Islamic sensibilities of the mezzanine lender.

Student accommodation has been a major target for Islamic funds, given the existence of rental guarantees, steady demand and upward only rental payments. Further developments may be seen in this sector due to a broadening view of social infrastructure to include health care, education and social housing sectors. Prime residential properties are still a focus, including the 2011 launch of an Islamic-compliant fund in the UK to offer Islamic investors exposure to this market.

It is worth considering what qualifies as Islamic-compliant finance, as Islamic or *Shari'ah*-compliant finance is a different animal than conventional finance. For example, the payment and receipt of interest are prohibited by the *Shari'ah*, making it impossible to lend against CRE in a conventional manner.

19.3 What is Islamic-compliant finance?

In summary, Islamic finance is the conduct of commercial and financial activities in accordance with the *Shari'ah*. The *Shari'ah* is Islamic religious law, as applied to commercial and financial activities. It is a combination of theology, religion and law. The *Shari'ah* is a guide to how a Muslim leads his or her life (it means, literally, ''the way'' or ''the right path'') and is the divine law to Muslims as revealed in the *Qur'an* and the *Sunna*.

Fiqh, literally, is the human understanding of that divine law; the practical rules of *Shari'ah* as determined by the *Shari'ah* scholars. The primary methodology used in this interpretation is *ijtihad* (literally, ''effort''), or legal reasoning, using the ''roots of the law'' (*usul al-fiqh*). The roots (*usul*) upon which Islamic jurisprudence are based, are the:

- *Qur'an*, being the holy book of Islam and the word of Allah (a word for God used in the context of Islam);
- *Sunna* of the Prophet Mohammed, which are the binding authority of his sayings and decisions;
- *Ijma*, or ''consensus'' of the community of scholars; and
- *Qiyas*, or deductions and reasoning by analogy.

The *Shari'ah* is comprised of principles and rules and, historically, its explanation and application has been largely oral. There are also a number of schools of Islamic jurisprudence (the four main schools of the largest branch of Islam (*Sunni*) are Hanafi, Hanbali, Maliki and Shafi). Historically, the different schools are frequently in conflict with respect to the application of the *Shari'ah* to different factual or structural situations. Even within a school there are variable interpretations, and there is considerable divergence between South East Asia (particularly Malaysia, Indonesia and Brunei) and the Middle East and Western Asia (particularly Pakistan).

As expounded by *Shari'ah* scholars over the last 1,400 years, and as applied to Islamic finance, the *Shari'ah* is a full body of law. It covers virtually every aspect of commerce and finance that is addressed by a mature body of secular law. Thus, for example, it addresses contracts, concepts of consideration, legal capacity, mutuality, sales, leasing, construction activities, partnerships and joint ventures of various types, guarantees, estates, equity and trust, litigation and many other activities and legal structures. As such, it will influence all aspects of an Islamic-compliant CRE finance transaction or the formation of an Islamic investment fund, as well as every aspect of the operation and conduct of a CRE business. However, Islamic finance transactions involving non-Islamic parties are governed by secular law, such as English or New York law.

19.4 *Shari'ah* supervisory boards and Islamic finance regulators

In many CRE finance transactions, only one party may care if 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.

However, the question remains as to how an investor that wants to make *Shari'ah*-compliant investments ensures that its investment is, in fact, in compliance. Most individuals do not have the expertise to make that determination for themselves. 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 (a ''*Shari'ah* board'' or a ''board'').

Most Islamic banks, financial institutions and CRE companies and many of the higher-net-worth families and individuals in the Islamic world have retained one or more *Shari'ah* scholars that comprise a *Shari'ah* board. Each board oversees the complete range of investment practices, and the principles, methodology and activities of operation of all aspects of the business, of the entity or individual that has retained that particular board. Each board is comprised of a different group of individual scholars. Each board renders determinations with respect to structures and undertakings that are confidential to the entity that retains that board, with the result that explanation of the *Shari'ah*, as applied in competitive financial markets, has occurred in isolated pockets rather than a manner that is coordinated across markets or even schools of Islamic jurisprudence.

Shari'ah boards may be comprised of one scholar or a group of scholars. Frequently, a board is comprised of one or more of the leading ''internationalist'' scholars, some regional scholars, and some local scholars. Frequently, the internationalist scholars (who most often populate the boards of the major banks and investment funds) have expertise and experience in sophisticated financial transactions in a wide range of jurisdictions throughout the world, including various secular tax and finance laws and other legal and regulatory regimes and the interplay between those regimes and the *Shari'ah* as applied and considered by specific investors.

The Bahrain-based Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) and the Kuala Lumpur-based Islamic Financial Services Board (IFSB) are strong forces in promoting greater uniformity across the schools and across the divide between South East Asian jurisdictions and Middle Eastern and Western Asian jurisdictions. AAOIFI standards prescribe additional international financial reporting standards to reflect the specifics of Islamic finance. The IFSB advises domestic regulators on how Islamic financial institutions should be managed and has published standards on stress testing, liquidity, management, capital adequacy and corporate governance. However, application of these standards is not uniform across countries.

In April 2012, AAOIFI introduced seven new standards for Islamic financial institutions addressing issues including financial rights, bankruptcy, capital protection and contract termination. As a greater number and variety of multinational conventional banks and investment banks enter, and expand their range within, the Islamic finance field, there will be increased pressure toward uniformity, if only to facilitate the implementation of internal policies and procedures of these institutions.

The board will perform a number of different roles including, typically, the following:

- participation in product development activities;
- review and approval of the fund or entity structure and its objectives, criteria and guidelines and issuance of a *fatwa* in respect thereof;
- review and approval of disclosure and offering documents and issuance of a *fatwa* in respect thereof;
- review, approval and oversight of investment and business operational structures and methodology, and issuance of a *fatwa* in respect thereof;
- ongoing review, oversight and approval of transactional or operational variances or applications to unique or changing circumstances; and
- annual audit of the operations of the fund or entity and issuance of an annual certification of *Shari'ah*-compliance.

A *fatwa* (singular; *fatawa* is the plural) is a written certification of a *Shari'ah* scholar or board. It has no binding legal effect under secular law in Europe. Over recent years, *fatawa* have been structured more like Anglo-American legal opinions, with discussion of the underlying *Shari'ah* precepts. It is common to see a copy of a more general *fatwa* reproduced in the offering circular of a *sukuk* issue.

19.5 *Shari'ah* principles

The outlook of the *Shari'ah* on finance is as a type of ''ethical investing''. It prohibits investment in, or the conduct of, businesses whose core activities:

- include the manufacture or distribution of alcoholic or pork products or, in the case of certain *Shari'ah* boards, firearms;
- have a significant involvement in gaming (gambling, including casinos), brokerage, interest-based banking or impermissible insurance;
- include certain types of entertainment elements (particularly pornography); or
- have impermissible amounts of interest-based indebtedness or interest income.

The activities referred to above are categorised as prohibited business activities. Some *Shari'ah* boards also include the growing, manufacture and distribution of tobacco within prohibited business activities. Some boards interpret the entertainment exclusion more broadly and include cinema and music generally because of the pornography elements of these industries. Hotels are often included because of the presence of alcohol in bars and mini-bars or in-room entertainment. Entities that have prohibited business activities may not be tenants in properties owned and leased by a *Shari'ah*-

compliant investor. These prohibitions fundamentally influence the nature and operations of funds and businesses.

Many large office buildings and complexes have tenants that engage in prohibited business activities, such as retail branches of conventional banks, restaurants that serve alcohol, or supermarkets or convenience stores that sell pork, wine and beer. In the purest case, the entire building or complex would be an impermissible investment. However, the *Shari'ah* scholars have taken a pragmatic view. Rules have been developed that allow investment in these properties for certain impermissible uses, such as those just mentioned. 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 as to de minimis impermissible tenancies greatly expanded the universe of properties available for investment.

A fundamental *Shari'ah* principle is the prohibition of *riba*, best known by its prohibition on the payment or receipt of interest. This rule affects every aspect of the manner in which a *Shari'ah*-compliant transaction is structured and implemented. In the securitisation field, it (and other principles) precludes pooling of conventional mortgages, credit card receivables, and all interest-bearing debt instruments.

In the area of joint ventures (including partnerships), numerous principles address allocation of work, profit and loss allocations and distributions and virtually all other operational matters. For example, as a general statement, all distributions of profits and losses must be pro rata. Preferred shares are not permissible. In certain types of partnerships (*mudaraba*), one person contributes services and another person contributes capital. If the arrangement suffers a loss, only the capital provider may be penalised in cash. In other types of partnerships (*Sharikat* and *musharaka*), work and capital contribution may be allocated over all partners with corresponding loss sharing. These rules affect CRE business and fund structures and many operational activities and, directly, *sukuk*.

Shari'ah principles in relation to leasing are of particular importance, because leasing is the primary tool used in the implementation of *Shari'ah*-compliant transactions. Examples include the requirement that a property lessor must maintain the leased property. The lessor may not pass structural maintenance obligations or corresponding obligations, such as the maintenance of buildings insurance, to a lessee. In short, the pervasive fully repairing and insuring lease is prohibited. The end-user tenant may not have prohibited business activities and the lease to the end-user tenant must itself be *Shari'ah*-compliant. These principles have a critical impact on Islamic securitisations.

As one would expect in light of the development of the *Shari'ah* in Middle Eastern societies that were so heavily focused on trading activities, the *Shari'ah* precepts applicable to sales are especially well refined. Leasing, in fact, is treated as a type of sale—sale of the temporary possession (or usufruct) of property. With only limited exceptions, one can sell only tangible assets. Debt cannot be sold, nor can other financial instruments that do not represent an ownership interest in tangible assets. Further, one cannot sell property that one does not own and possess. These principles have a major influence on the structure of Islamic bonds and securitisations. In addition, there are very particular rules addressing delivery, receipt, ownership, allocation of risk, downpayments and virtually all other aspects of sales transactions. These rules affect both the ability to create secondary markets and the tradability of securitisation instruments.

Shari'ah precepts that prohibit gambling and uncertainty also preclude most types of conventional insurance and investments in conventional insurance companies, although the unavailability of *takaful* (*Shari'ah*-compliant insurance) has led to some practical accommodations to the prohibition on the use of insurance.

19.6 Islamic CRE finance structures

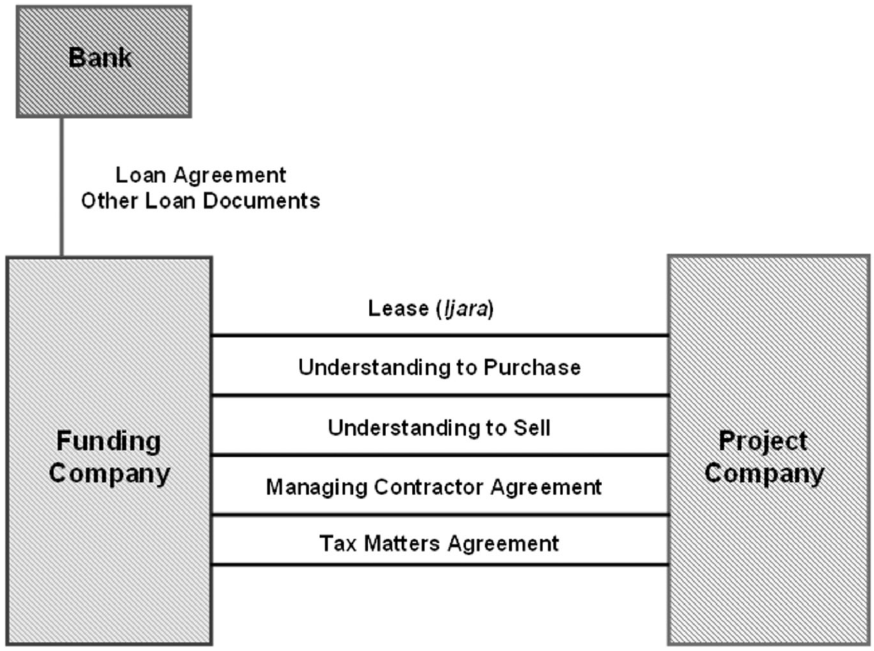
To help understand Islamic CRE financing, this Chapter will outline certain of the component structures of Islamic-compliant finance. These are primarily the lease (*ijara*) and sale (particularly *murabaha*) structures. Two structures, the *mudaraba* and *musharaka*, are joint venture structures. Each structure is briefly summarised in this section, and each of these structures is also the basis or a component of Islamic bond and securitisation structures.

19.6.1. Ijara (lease) structures

The predominant acquisition and operating financing structure in Islamic CRE finance in Europe is the *ijara* (lease). Figure 1 below, shows a basic leasing structure. This example assumes 60% conventional interest-based financing and 40% contribution by the *Shari'ah-compliant* investors; these percentages will vary with each transaction.

The investors make their investment into the ''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. A special purpose vehicle (SPV), the ''funding company'', is established to acquire and hold title to the property in which the *Shari'ah*-compliant investment is to be made (the property). The project company contributes its investment (40% of the acquisition price) to the funding company. A conventional interest-bearing loan is made by the ''bank'' to

Figure 1: Ijara Structure



the funding company (equal to 60% of the acquisition price). The funding company then acquires the property from the seller.

Then, the funding company enters into an *ijara* (lease) with the project company, as lessee. The rent payable under the *ijara* 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 CRE prior to leasing it;
- the lease period must be specified;
- the CRE asset must continue to exist throughout the lease term;
- the lessor must be responsible for maintaining and insuring the property.

Future rents cannot be accelerated under a *Shari'ah*-compliant lease. Given that the outstanding principal is paid through the *ijara*, an acceleration mechanism is necessary outside the *ijara* itself. The understanding to purchase 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 provides the mechanism (and also mirrors the voluntary prepayment provisions of the bank loan).

Under the *Shari'ah* rules noted above, and others, a lessor cannot pass structural maintenance and insurance obligations to a lessee. However, a lessor 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.

Finally, 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 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.

This structure is used in essentially all *Shari'ah*-compliant CRE transactions in Europe (with some relatively minor country variations, as appropriate, under relevant tax and CRE laws) and, as noted below, it is easily modified to effect a *Shari'ah*-compliant securitisation.

19.6.2 Murabaha (sale at a mark-up) structures

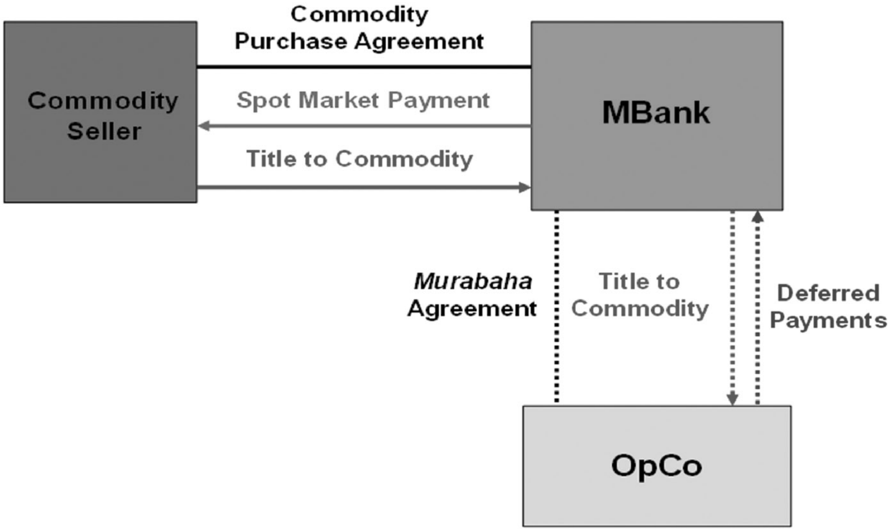
The *murabaha* structure results in OpCo obtaining a cash amount that it can then spend towards purchasing a CRE asset. In Europe, a number of property investors have used this structure as a banking tool, to finance investor purchases of CRE.

As a result, a *murabaha* is a widely used sales structure, and one that is used in some *sukuk* and in many working capital financings. Most simply defined, the *murabaha* is a sale at a mark-up. Figure 2 below, shows a simple *murabaha* transaction.

In the simple *murabaha*, ''OpCo'', a client of ''MBank'', wants to purchase a commodity, piece of equipment or other asset. OpCo negotiates the terms of the purchase, including payment terms and precise specifications, with the commodity seller. OpCo then asks MBank to finance the purchase of that asset.

OpCo and MBank enter into a *murabaha* agreement pursuant to which MBank agrees to supply to OpCo a commodity or asset meeting the precise specifications that were negotiated with the commodity seller. The *murabaha* agreement will require OpCo to make payment to MBank for that commodity on a deferred purchase basis.

Figure 2: Basic Murabaha Structure



MBank, 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.

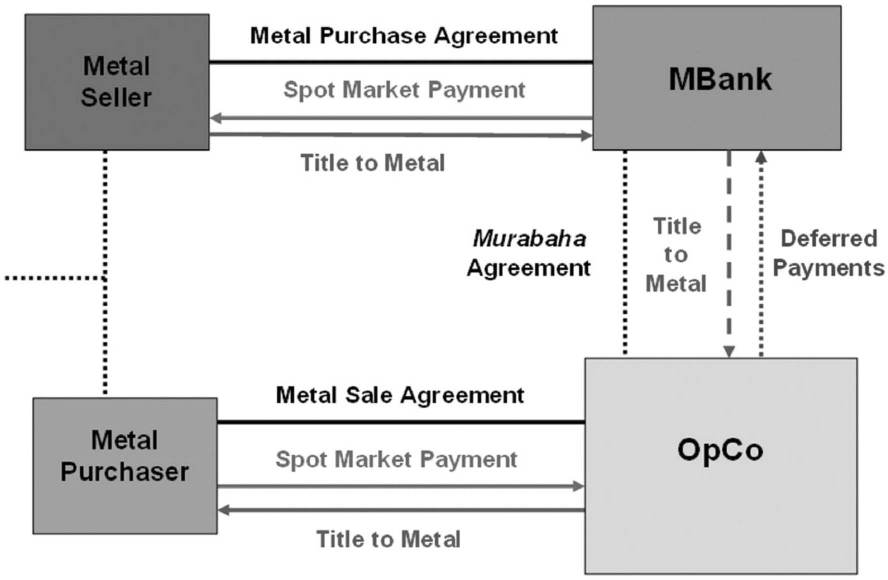
Upon accepting delivery of the commodity, MBank will fulfil its obligations under the *murabaha* agreement by re-selling the commodity to OpCo. While there are numerous other applicable rules, two are of particular note:

- MBank must have ownership risk with respect to the asset; and
- OpCo can, under most schools of Islamic jurisprudence at the present time, act as the agent for MBank in completing the arrangements between MBank and the commodity seller.

A working capital *murabaha* is shown in Figure 3. This structure is used, in variant forms, in *sukuk* structures.

The transaction, shown in Figure 3, is substantially identical to the *murabaha* transaction shown in Figure 2. The additional element is that OpCo, 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 MBank's purchase of that metal from the metal seller (fees ignored). The metal purchaser and metal seller are frequently affiliates. The net result is that OpCo ends up with cash equal to the spot market price of the metal and a deferred *murabaha* payment obligation to MBank in respect of that amount plus a profit factor.

Figure 3: Working Capital Murabaha



In the CRE context, 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 investor at a higher price.

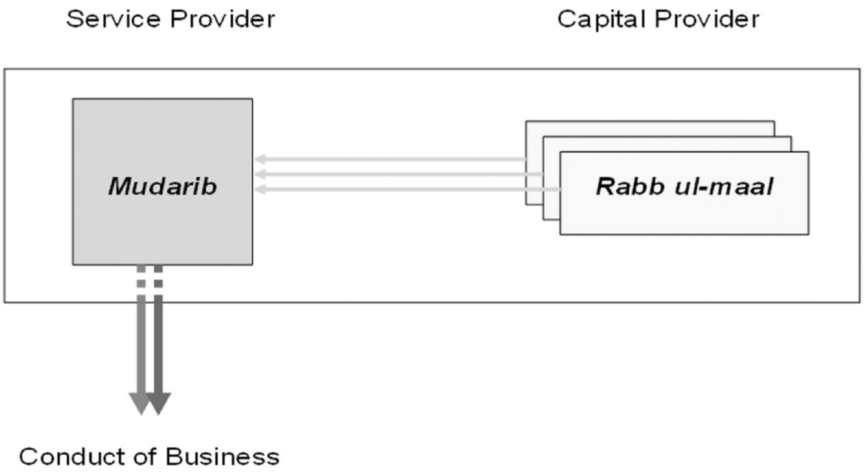
If the bank does not want to or cannot acquire title for regulatory reasons, then the bank appoints a transacting party to act as its acquiring agent. The agent then executes the sale in favour of the ultimate investor.

19.6.3 Mudaraba (service provider—capital provider) structures

A *mudaraba* is a type of joint venture and is a key method for organising and acquiring CRE investments. It 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 subcontract its duties to an experienced CRE 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 is shown in Figure 4.

As a general matter, and with a few modifications, a conventional limited partnership agreement works well to structure a *mudaraba*. For example,

Figure 4: Murabaha Structure



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.

The partnership or fund then acquires CRE assets, most commonly through *ijara* 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.

19.6.4 Muisharaka (capital provider) structures

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. The term *musharaka* refers to a wide range of partnership or joint venture arrangements. In a *musharaka*, each of the partners contributes capital, and there is significantly greater flexibility in allocating management responsibilities among partners; 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 or operation 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.

Shari'ah rules applicable to purchases and sales of interests (*hissas*) from one partner to another (as well as *murabaha* rules) form the basis for securitisation transactions involving *musharaka*.

19.7 The application of CRE finance structures in *sukuk*

Having reviewed some of the typical Islamic finance structures used in CRE acquisition and investment, the next section of this Chapter will consider how such structures have been adapted to develop the market for *sukuk* based on CRE assets. Although a number of significant *sukuk* transactions defaulted (or faced near default) with the advent of the GFC, with issuances of new instruments being very limited during this period, one of the most active areas of Islamic CRE finance, both before and after the GFC, has been *sukuk* issuance. Global annual *sukuk* sales peaked in 2012, and have since declined slightly.

19.8 Asset-based versus asset-backed

Structurally, *sukuk* can be broken into two types of transactions—asset-based or asset-backed. Asset-based issuances are sometimes referred to as ''Islamic bonds'', whilst asset-backed issuances are generally referred to as ''securitisations''. There have only been a limited number of *Shari'ah*-compliant securitisations, with the vast majority of *sukuk* issuances being asset-based transactions.

In both types of *sukuk*, the issuing entity (which will usually be an orphan SPV company, as used in CMBS transactions[1]) will issue certificates into the capital markets. The proceeds from the issuance will, depending upon the structure being utilised, either be used to purchase an asset (such as in an *ijara* structure), be invested (as in a *musharaka* or *wakala* structure) or purchase a portfolio of loans (as in a CMBS). It should be noted that in all these structures, the certificates issued are an indivisible ownership interest in the

[1] See further Ch.1.

assets of the issuing vehicle. This can cause some tax issues, which will be discussed below.

The difference between the asset-backed structures and asset-based structures lies in the type of credit risk which the investors are taking under each structure.

A *Shari'ah*-compliant securitisation is structurally similar to a conventional securitisation. The issuing vehicle issues certificates and uses the proceeds of the issuance to purchase a portfolio of assets (such as *Shari'ah*-compliant mortgages). The issuing vehicle declares security over this portfolio of assets, and in the event of a default, the security trustee enforces this security and may liquidate the assets. As with conventional securitisations, the investors will not have recourse to the seller of the assets on a default; their recourse will be limited to the assets of the issuing vehicle.

As such, the only structural difference between a *Shari'ah*-compliant securitisation and a conventional securitisation is the fact that the instruments are certificates evidencing an ownership right in the assets in relation to the former, rather than a debt instrument in relation to the latter. As discussed above, there have been a very limited number of *Shari'ah*-compliant securitisations issued (although a larger number have been structured), the most well known of which was the RMBS deal issued by Tamweel in 2008, under which a portfolio of *Shari'ah*-compliant mortgages originated by Tamweel was securitised.

Conversely and from a credit perspective, asset-based *sukuk* structures are most similar to a corporate bond. Islamic bonds are based upon the credit of an entity that is participating in the transaction (which may be the seller, guarantor or other credit support provider and will be referred to as the originator). On execution of the transaction, an asset will be sold to the issuing entity by the corporate, or, funds will be invested with the originator. This asset will generate an income for the issuing vehicle. This income will be generated from payments made by the originator under the contractual arrangements with the issuing entity. However, often there will not be any security over the assets of the issuing entity to secure the certificates (and even where transactions do include security over the assets, it may be that the value of this security is difficult to ascertain). Only a minority of *sukuk* are structured to give *sukuk* holders direct recourse to the underlying asset. The majority are structured so that, following a default, the only recourse is to require the originator to repurchase the income-generating asset (either at a fixed price where fixed-price undertakings are permitted by AAOIFI or at some other price as set out in the documents).

It should be noted that a large number of *sukuk* issued have essentially been capital raising exercises for the underlying corporate, albeit using CRE assets as a way to access this market. However, there have also been a number of *sukuk* transactions that have been used to raise capital for certain CRE and other projects.

Further, a *sukuk* issuance may be one element of a CRE financing. For example, a CMBS transaction could be executed which included both conventional bond financing as well as a tranche structured as a *sukuk*. There is increased market interest in the establishment of multi-funding platforms that incorporate tranches of conventional and Islamic finance and there is no reason why these structures cannot continue to be applied to the CRE market.

19.9 AAOIFI *sukuk* standard

Under the AAOIFI *sukuk* standard, *sukuk* are defined as certificates of equal value put to use as common shares and rights in tangible assets, usufructs and services or as equity in a project or investment activity. The AAOIFI standard carefully distinguishes *sukuk* from equity, notes and bonds. It emphasises that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects or investment activities. *Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying CRE leases) must be *Shari'ah-compliant* (the business or activity cannot engage in prohibited business activities, for example).

AAOIFI has specified 14 categories of permissible *sukuk*. In broad summary, they are securitisations:

- of an existing or to-be-acquired tangible asset (*ijara*);
- of an existing or to-be-acquired leasehold estate (*ijara*);
- of presales of services (*ijara*);
- of presales of the production of goods or commodities at a future date (*salam* (forward sale));
- to fund the cost of construction (*istisna'a* (construction contract));
- to fund the acquisition of goods for future sale (*murabaha*);
- to fund capital participation in a business or investment activity (*mudaraba* or *musharaka*); and
- to fund various asset acquisition and agency management (*wakala* (agency)), agricultural land cultivation, land management and orchard management activities.

A factor that had impinged upon the structuring and issuance of *sukuk* and *Shari'ah*-compliant CMBS transactions was the lack of *Shari'ah*-compliant hedging mechanisms and liquidity structures (which may both be required by rating agencies for a rated transaction). The issue of *Shari'ah*-compliant hedging mechanisms was rectified in March 2010, by the publication of the *Ta'Hawwut* Master Agreement by the International Swaps and Derivatives

Association and the International Islamic Financial Market. However, this development is still in its early stages compared to the conventional hedging market, and is taking time to consolidate. With regard to liquidity structures and other forms of credit enhancement (which in conventional transactions will be provided by facilities), various structures have been considered on a transaction by transaction basis.

Prohibitions on *riba* (interest), and on the sale of instruments that do not represent fractional undivided ownership interest in tangible assets, present a seemingly insurmountable problem for Islamic-compliant securitisation of conventional receivables, such as conventional mortgages, patent and other royalty payments, credit card receivables and the full range of other conventional receivables. Many of these receivables will never be made *Shari'ah*-compliant in and of themselves, but it seems likely that bifurcated structures will be developed to securitise these assets (just as conventional interest-based financing is used in most international *Shari'ah*-compliant CRE and private equity financings).

19.10 Tax and regulatory issues

One issue which needs careful consideration as part of the structuring of any *sukuk* transaction is whether the nature of a *sukuk* can raise any tax or regulatory concerns. These issues, by their very nature, differ across *sukuk* issuances, depending on the jurisdiction(s) of the issuing entity, of the assets and of the investors.

As discussed above, the certificates issued in a *sukuk* are ownership interests in the assets of the issuing vehicle rather than debt instruments. This can raise a number of unexpected tax issues. In a conventional securitisation, it is fundamental that the issuing vehicle be tax neutral. However, the nature of a *sukuk* may mean that this is not the case. The issuing vehicle may not receive the benefit of tax deductions for interest, as no interest is paid on the certificates.

Further, if the instrument is deemed to be an equity-like instrument rather than a debt instrument, transfers of the certificate may incur a transfer tax charge. Additionally, various stamp duty and land taxes may also be triggered in a CRE-based *sukuk* structure.

In a number of jurisdictions (such as the UK and Ireland), regulations have been introduced in order to ensure that *sukuk* structures are not taxed in a manner inconsistent with securitisations and other structured debt transactions. These regulations can take the form of deeming the cashflows under a *sukuk* to be equivalent to cashflows under a securitisation (for example, deeming periodic distribution payments to be payments of interest) and deeming the instruments to be debt rather than equity (and as such, removing the risk of transfer taxes being imposed).

Regarding the collective investment scheme issue, this needs to be considered on a case-by-case basis, as the market has yet to come to a position as to whether or not this is triggered.

19.11 Negotiability of instruments

When structuring a *sukuk*, it is important to understand the nature of the asset underlying the structure. Trading in debt above or below par would breach *riba* principles (being interest) and be impermissible. As such, where the assets underlying the *sukuk* are receivables, either the instruments could only be traded at par, or their transfer must be prohibited. These limitations are generally problematic in capital markets transactions, where the ability to trade freely is critical for the creation of liquidity. Many capital markets instruments are held through central clearing systems (such as Euroclear or Clearstream) which require the instruments to be negotiable and tradeable.

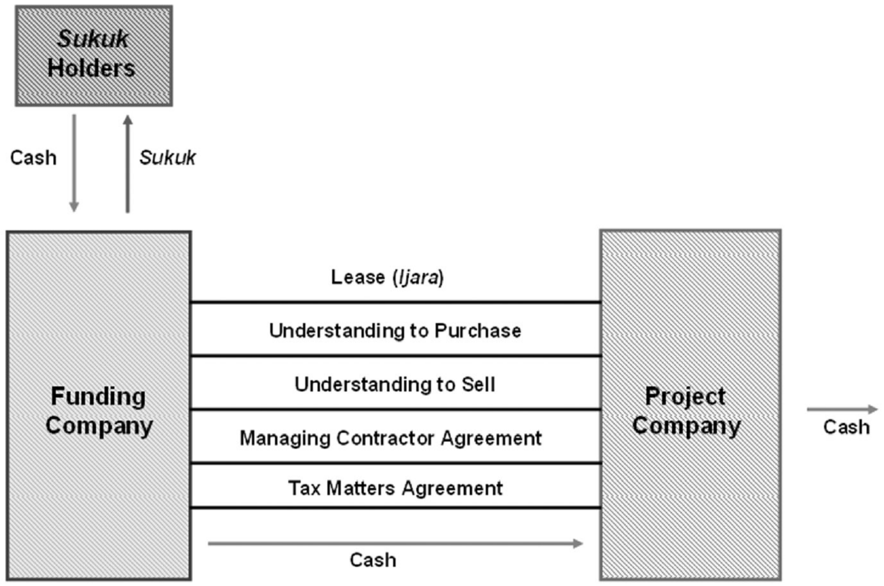
The resolution of the apparent *riba* issue lies in the fact that in a number of *sukuk* structures (such as an *ijara sukuk*) the underlying assets are tangible assets rather than debts and through the trust certificate structure (under which the assets are subject to a trust declared by the issuing vehicle in favour of a trustee to be held on trust for the holders of the certificates) the *sukuk* holders have an interest in a tangible asset. This structure means that these *sukuk* can be traded above or below par, and if required by investors, held in central clearing systems.

19.12 The *sukuk al-ijara*

The *ijara* structure that is so widely used in Islamic finance (see Figure 1) is readily adaptable to *sukuk* in a number of different ways. The simplest *sukuk* issuance utilising the *ijara* structure is shown in Figure 5. In Figure 5, the structure demonstrates the issuing entity issues *sukuk* into the capital markets and uses the proceeds to purchase an asset from the originator. It then leases the asset back to the originator. Often, the *sukuk* holders will not have a security interest in the asset (or, where they do have a security interest in the asset, it may be difficult to enforce). Each *sukuk* holder is entitled to receive the rental income generated under the lease pro rata to its ownership interest in the underlying CRE asset based on the *sukuk* held by it.

The above *sukuk al-ijara* structure in Figure 5 has been utilised in a large number of *sukuk* issuances across the globe, and is seen by some as the ''classic *sukuk*''.

Figure 5: Ijara Sukuk



In these structures, the rental stream from the *ijara* can be structured to produce a precise cash flow on the *sukuk* akin to conventional debt capital markets instruments. As such, the rate of return can be set as a fixed rate or a floating rate, and the capital return profile can be structured such that it is either through an amortisation schedule, a bullet repayment or a combination of partial amortisation with partial bullet repayment.

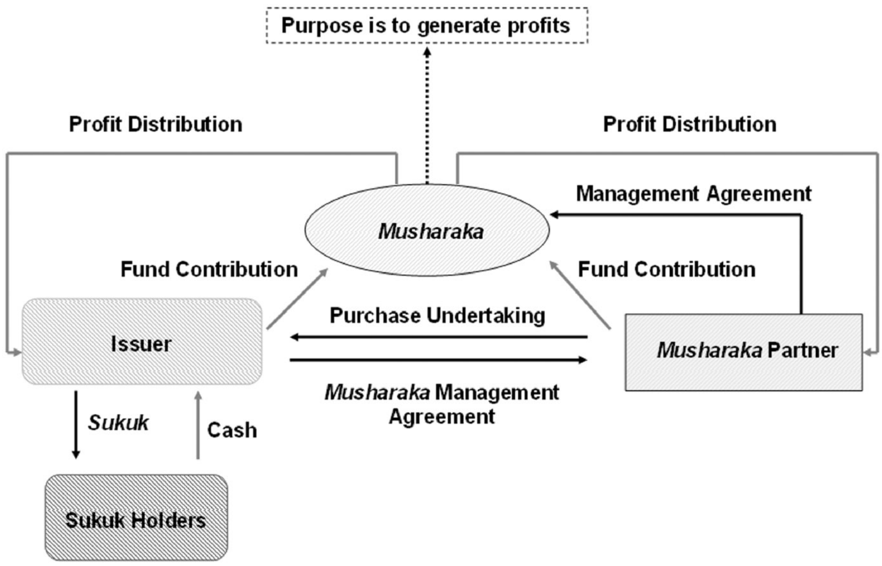
Where the structure involves a bullet repayment or partial bullet repayment at maturity, on the maturity of the certificates (or the occurrence of certain other events, such as an event of default), the originator will repurchase the asset at a price fixed at closing. This price will be equal to all amounts owing to the *sukuk* holders. Unlike some other structures, the scholars are comfortable with a fixed price purchase undertaking being used in *ijara* structures. This may be part of the reason why these structures are so popular in the *sukuk* market.

There are some limitations to the use of the *ijara sukuk*. For example, many originators do not own appropriate underlying assets that are subject to *Shari'ah*-compliant leases or can be made available for such leases during the *sukuk* term, and, as discussed above, in many jurisdictions, there are significant adverse tax consequences associated with the introduction of the assets into a *sukuk* structure. However, a number of authorities such as those in Ireland, France and the UK are keen to encourage the growth of Islamic finance within their jurisdictions and have worked with participants in the Islamic finance market to implement regulations to minimise tax issues in *sukuk* and other Islamic finance structures. In fact, London, Dublin and Paris are all keen to try and be the centres of Islamic finance in Europe and have petitioned their relevant tax authorities accordingly.

19.13 The *sukuk al-musharaka*

In the *sukuk al-musharaka*, the issuing entity enters into a joint venture or partnership arrangement, pursuant to a ''*musharaka* management agreement'', with the party seeking financing (the ''*musharaka* partner''). As noted above, each party may contribute capital to the *musharaka.* Each of the partners receives ''units'' or ''*hissas*'' in the *musharaka* in accordance with their respective capital contributions. The issuer's capital contribution is in cash, and equals the proceeds of the *sukuk* issuance. The contribution of the *musharaka* partner is usually an in-kind contribution of a tangible asset (such as a piece of CRE). A *musharaka* structure is depicted in Figure 6.

Figure 6: Sukuk al-Musharaka



The issuer and the *musharaka* partner enter into a purchase undertaking pursuant to which the issuer can require the *musharaka* partner to purchase designated units or *hissas* on specified dates either during the term of the *sukuk* or at maturity. Where units are purchased throughout the life of the transaction, the structure is referred to as a ''diminishing *musharaka*''. Economically, this is akin to an amortising bond. However, alternatively, the units may only be repurchased on maturity (or other certain events), in which case the *sukuk* is economically akin to a bond with a bullet repayment.

Under the *musharaka* structure, the issuing entity will receive profit distributions from the *musharaka* and the proceeds from sales of the *hissas*, which are then distributed to the *sukuk* holders in accordance with agreed formulae. Although profits and losses are required to be shared between the partners in accordance with their share of total units in the partnership, a number of *sukuk* transactions have been structured such that all profit has been paid to the issuing entity in priority to the *musharaka* partner, until such time as the issuing entities' contribution has been reduced to zero (and the *sukuk* holders have been repaid in full).

In 2008, AAOIFI issued guidelines (the *AAOIFI Guidelines*) which set out the parameters of how an exercise price under the purchase undertaking could be calculated. Prior to the issuance of the *AAOIFI Guidelines*, the exercise price would have been stipulated under the purchase undertaking as an amount equal to all amounts owing at the time of exercise to the *sukuk* holders. However, following the issuance of the *AAOIFI Guidelines*, where the purchaser under the purchase undertaking is the *musharaka* partner, the exercise price cannot be set at closing, but rather is required to be calculated on the basis of the market value of the assets on the date on which the purchase undertaking is exercised. As such, there is the risk that the exercise price may be less than the amounts owing to *sukuk* holders. Although structural mitigates can be built into a *sukuk* transaction utilising a *musharaka* structure (such as reserve funds and *Shari'ah*-compliant liquidity features) these may not entirely remove the risk of payment default under the certificates on the exercise of the purchase undertaking.

As such, the use of the *sukuk al musharaka* structure has declined in popularity following the issue of the *AAOIFI Guidelines*.

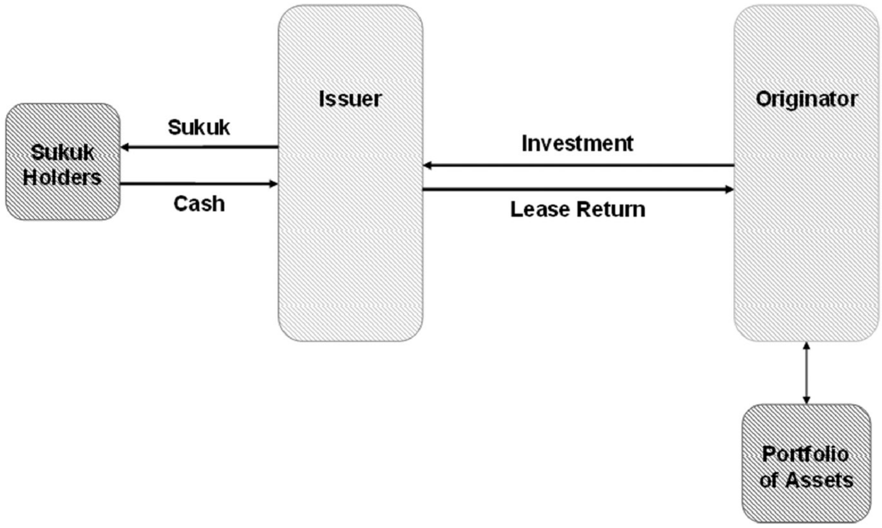
19.14 The *sukuk al-wakala*

One structure which has been utilised on *sukuk* transactions in the Middle East is the *sukuk al-wakala*. This financing structure has been used on a number of funding structures, incorporating both conventional and Islamic finance tranches.

In a *sukuk al-wakala*, the issuing entity as investor appoints the *wakeel* as agent to invest the proceeds of the issuance of certificates in accordance with the terms of a *wakala*. The *wakeel* will invest the funds in a portfolio of *Shari'ah*-compliant assets, which may be a portfolio of assets or parts of an asset already owned by the *wakeel*. At the outset, the parties to the *wakala* will agree the profit return to the issuing vehicle as investor. This profit return will be paid to the issuing vehicle periodically.

A *sukuk al-wakala* structure is shown in Figure 7.

Figure 7: Sukuk al-Wakala



Under a *wakala* structure, any profit is used to pay the profit return to the investor, with the remainder being retained by the *wakeel* as an incentive fee. However, there is a risk that the return generated on the assets may not be sufficient to pay the agreed profit return to the issuing entity, and as such, the *sukuk* holders may suffer a loss. Prior to the *AAOIFI Guidelines*, a guaranteed profit return structure was utilised in the market. However, following the issue of the *AAOIFI Guidelines*, the majority of scholars appear to be of the view that a fixed rate of profit return is not acceptable in a *sukuk al-wakala* structure.

Wakala structures have been considered in capital raisings by CRE companies, where the companies want to access conventional and *Shari'ah*-compliant financing. For example, in the case of a financing of a shopping mall, certain *Shari'ah*-compliant parts of the mall could be used as a base for a *wakala*, with the remainder funded by conventional financing.

19.15 The *sukuk al-istisna*

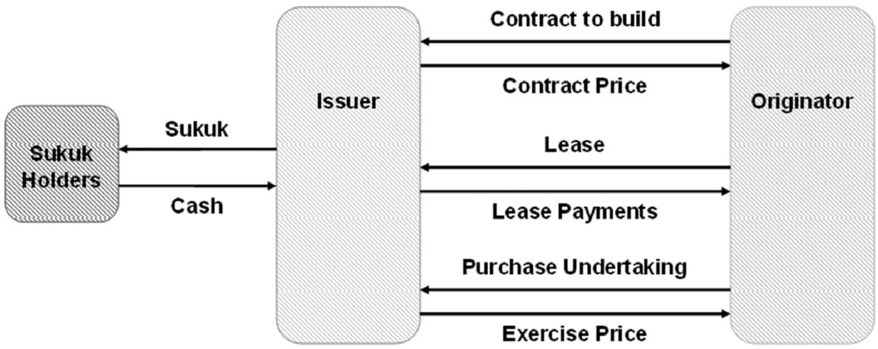
The *sukuk al-istisna* structure has been discussed as an option for project financing, where general bank debt or other forms of Islamic financing are not available. These structures are often referred to as ''Islamic project bonds''. However, the structure also has a number of characteristics which have limited its use by originators.

An *istisna* is essentially an order to a manufacturer to manufacture a specific asset for the purchaser. Under a *sukuk al-istisna*, the originator will agree to manufacture or construct certain assets and deliver those assets to the issuing entity in return for an amount equal to the proceeds of the issuance of certificates.

The issuing entity will then agree to lease the assets back to the originator under a forward lease agreement, under which it agrees to make rental payments to the issuing entity. On the maturity of the certificates or the occurrence of other events, such as an event of default, the originator will be required to purchase the assets from the issuing vehicle for an amount equal to amounts owed to the *sukuk* holders.

A *sukuk al-istisna* structure is shown in Figure 8.

Figure 8: Sukuk al-Istisna



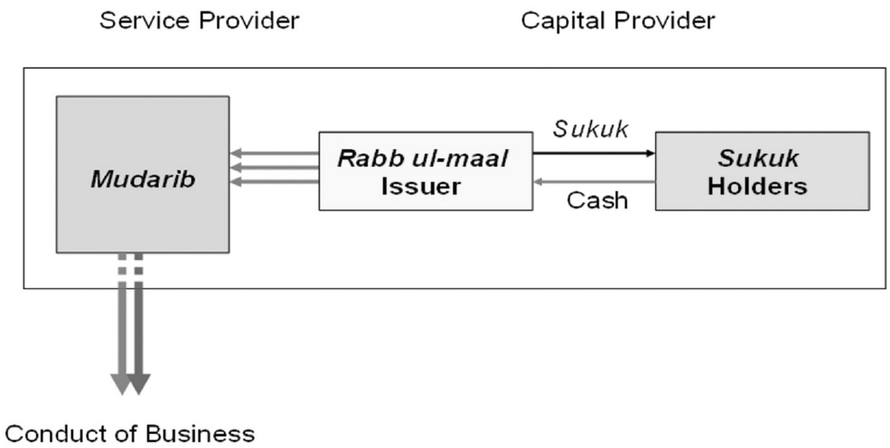
However, as discussed above, there are a number of characteristics relating to these structures. In an *istisna*, there is a construction phase, and then a rental phase. During both phases, the originator will pay periodic rental payments to the issuing entity. There are concerns that during the construction phase, the *sukuk* is only backed by receivables, and as such is not tradable, unless traded at par. Further, some scholars have shown concern about forward leasing, and there is the risk that if the assets are not constructed, any advance rental payments would need to be repaid to the originator.

In light of increased interest in project bonds, it will be interesting to see if these structures become more common, in particular in large multi-funding project finance transactions.

19.16 The *sukuk al-mudaraba*

The *mudaraba* structure may also be incorporated into a *sukuk* offering in a number of different variants of the *sukuk al-mudaraba*. A generalised generic form of a *sukuk al-mudaraba* is set forth in Figure 9.

Figure 9: Sukuk al-Mudaraba



The *sukuk al-mudaraba* is quite similar to the standard *mudaraba* structure presented in Figure 4. The *rabb ul-maal* issuer sells the *sukuk* to the *sukuk* holders and the proceeds of that issuance provide the capital for the *mudaraba*. The *mudarib* will conduct the business of the *mudaraba* as the provider of services. As noted above, this is similar to a limited partnership or limited liability company.

This *mudaraba* may constitute the only entity necessary for the conduct of the relevant business. Or, as is more likely in a complex project or undertaking, this *mudaraba* may enter into joint venture and/or other contractual arrangements with other parties. For example, in a complex project financing this *mudaraba* may enter into a further joint venture with a project sponsor in connection with the financing, construction and operation of the project.

Some of the primary structural considerations will focus, at each level of the transaction, on principles pertaining to allocation and distribution of profits and losses, and the permissibility of capital contributions by the *mudarib*.

A separate set of issues arise in any financing in which capital is needed periodically (these issues also affect other structures, such as the *musharaka*). Consider, for example, the construction of a large-scale project where the construction cycle extends over a period of years and there is no project income during that period. All involved parties will desire that there be certainty of capital availability throughout the construction period. Periodic *sukuk* issuances do not provide that certainty. An initial *sukuk* issuance for the full amount of the construction costs will provide that certainty, but is economically inefficient. The issuance proceeds in excess of immediate needs will be invested in short-term investments (such as *murabaha*) that have low rates of return. Further, the *sukuk* holders will probably expect periodic returns from the inception of the transaction. The project itself will be generating no income (it is in the construction phase) and the reinvestment income will be low. Payments on the *sukuk* during the construction and ramp-up phase are essentially self-funded by the *sukuk* holders.

There have been very few *sukuk al-mudaraba* issuances, and following the *AAOIFI Guidelines*, under which AAOIFI stated that the use of a fixed-price purchase undertaking was prohibited in *sukuk* structures, it is expected that these structures will remain rarely used.

19.17 The *sukuk al-murabaha*

One *sukuk* structure which probably has limited utility for CRE transactions, yet merits a short discussion, is the *sukuk al-murabaha.* There have been a limited number of *sukuk al-murabaha* when compared to other forms of *sukuk*; however, under certain circumstances, they may be attractive to parties in a capital raising transaction. These forms of *sukuk* generally raise capital for general purposes and are not linked to a specific CRE asset of the originator. However, the capital raised could be used by the originator for CRE purposes.

Figure 10 below shows a bond-type *sukuk*.

The *sukuk al-murabaha* is issued to the *sukuk* holders by the issuer. The *sukuk* represents a ‘‘participation interest’’ in the underlying *murabaha* transaction. The issuance proceeds are used to purchase a metal on the spot market, the metal is then sold to the originator on a deferred payment basis, and the originator sells the metal to the metal purchaser on the spot market. The net result is that the originator holds cash equal to the spot market price of the metal which it can use in its CRE operations and the originator has a deferred payment obligation on the *murabaha agreement* that is used to service the *sukuk*.

Figure 11 below, illustrates a *murabaha sukuk* in which the deferred *murabaha* payment obligations under a pool of *murabaha* transactions are pooled, and the issuer sells a *sukuk* based on that pool.

Under these *murabaha sukuk* structures, the party needing financing (the originator) obtains cash only by selling the tangible asset (the metal or other asset). Thus, on an ongoing basis, this *sukuk* does not represent an owner-

Figure 10: Sukuk al-Murabaha

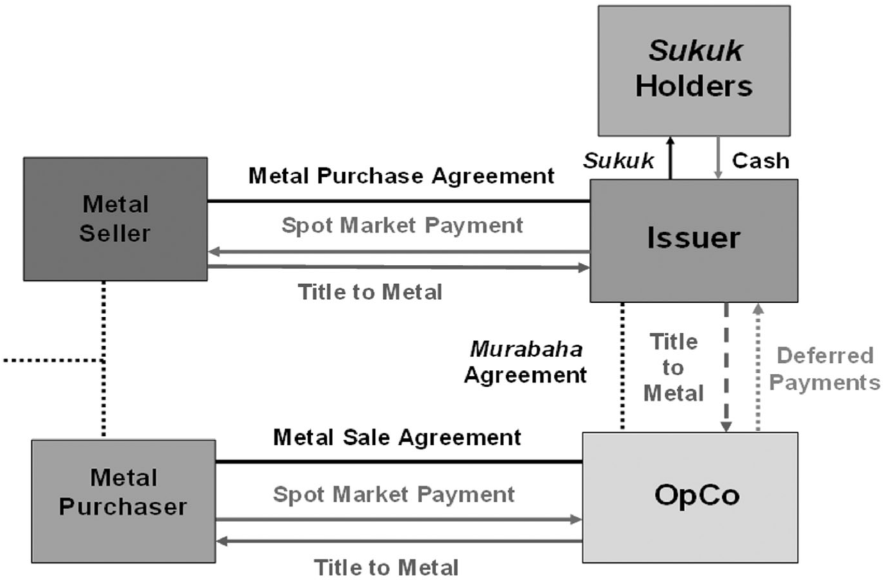
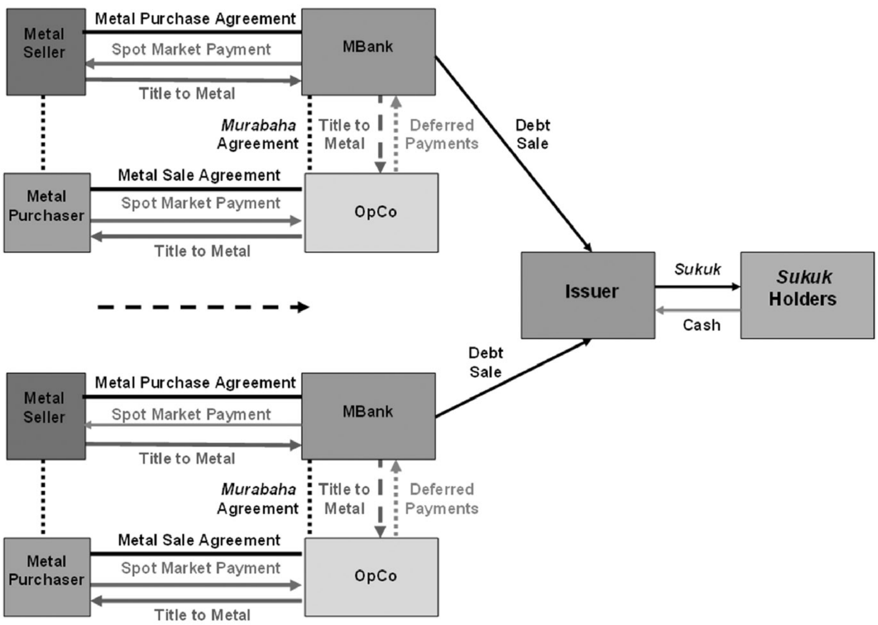


Figure 11: Sukuk al-Murabaha



ship interest in a tangible asset—it has been sold—and only the deferred debt obligation (a receivable) remains after sale of the asset.

As such, the assets underlying the *sukuk* are debts. One of the general principles of the *Shari'ah* is that debt cannot be traded except at par. As such, the certificates issued in a *sukuk al-musharaka* cannot be negotiable instruments and traded on the secondary market. This limits the possible investor base for these types of instruments. However, there have been a number of recent transactions which have utilised a *sukuk al-musharaka* structure where the investors have agreed to hold the assets for the term of the transaction.

Further, it is possible for a *sukuk* to have a number of underlying structures, including a *murabaha* structure, where the receivables derived from the *murabaha* are a small proportion of the overall structure.

It should be noted that the position of scholars in South East Asia is somewhat different to the position of scholars outside of that region. The South East Asian scholars accept that a *murabaha* may be used as the basis for a tradeable *sukuk*, making this structure a common feature of the capital markets in that region.

19.18 Conclusion

In 2016, the future for the Islamic finance market is difficult to predict, although the hope is that it will continue to grow and develop globally as a true alternative form of funding. Regulators have shown themselves willing to consider Islamic finance structures and equalise the tax position of Islamic finance structures with their equivalent conventional finance structures.

Regarding Islamic CRE finance, based on recent history, it is hoped that the markets continue to see strong growth in this market. Liquidity needs will focus CRE market players on Islamic finance as an alternative financing channel. Progress in product development, coupled with strong demand, should sharply accelerate growth in Islamic finance due to pent-up demand. For example, there is a forecast need for £1.3 trillion of project finance in GCC countries and £60 billion of mortgage finance in Saudi Arabia.

Conventional banks will, as set out in numerous Chapters throughout this book, increasingly focus on refinancing, de-risking, improving capital ratios and deleveraging. They will continue to vacate a significant part of the CRE finance field and Islamic finance can help to partly meet the remaining demand, with the result that Islamic finance and investment is poised to enter the mainstream of the global CRE market.

Regarding the *sukuk* market, recent *sukuk* defaults and lower issuance rates have led to a focus on the position of *sukuk* holders and, in particular, the rights they have to the underlying assets. This has, as discussed above, highlighted the distinction between asset-backed and asset-based structures, comparable to the rights of bondholders under secured and unsecured bonds. In asset-based *sukuk*, the holders can only require the originator to purchase the underlying *sukuk* assets and would have an unsecured debt claim against the originator from the payment of the purchase price after exercising their rights under the relevant purchase undertaking. This credit risk profile may not be what some investors expected. These are very encouraging signs for the continued growth of the Islamic finance capital markets and Islamic finance market as a whole.