

Shariah-compliant real estate investments – What kind of requirements do investors have?

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Overview

- Permissible Assets
- Financing of acquisitions in compliance with Shariah
- Shariah-compliant (German) lease contracts

Permissible Assets

- Real estate is a preferred asset class of Islamic investors
- Every real estate investment is allowed, unless it is prohibited by Shariah
- Direct or indirect investment via a real estate owning company (e.g. REIT)
- Screening of the tenants and their specific activities in the income producing property

Permissible Assets

- Screening at the industry level of the tenant: Prohibited activities:
 - ∅ Production, sale or distribution of alcoholic beverages
 - ∅ Production, sale or distribution of pork or pork-related products
 - ∅ Entertainment business (e.g. theatres, cinemas)
 - ∅ Adult entertainment
 - ∅ Gambling (e.g. casinos)
 - ∅ Production, sale or distribution of weapons
 - ∅ Non-Shariah compliant banking and insurance business
- In case of indirect investment: screening at the company level
 - ∅ Total interest bearing debt less than 33% of market capitalization
 - ∅ Interest income less than 5%
 - ∅ Accounts receivable less than 50% of total assets

Permissible Assets

- Up to 5% of income may derive from non compliant activities
- Non compliant income needs to be purified: donation to a charitable organization
- Preferred real estate classes should be:
 - Ø Office buildings
 - Ø Production facilities
 - Ø Infrastructure
 - Ø Retails stores
 - Ø Residential buildings
- Problematic are:
 - Ø Hotels
 - Ø Supermarkets

Financing of Acquisitions in Compliance with Shariah

- Sale-based financing
 - Ø Murabaha
- Lease-based financing
 - Ø Ijara
- Equity- / Partnership-based financing
 - Ø Musharaka

Murabaha



Murabaha

- Financier purchases asset from Vendor as directed by Client for € X; Client may act as agent for the Financier
- Client purchases asset from Financier for € X plus a mark-up of € Y, which is payable on a deferred payment basis
- The period covering the deferred payment is effectively the period of the financing
- Title to the asset is transferred to the Client at the time of purchase, but the Client will provide the same or other assets as collateral to the Financier for the period of the financing

Murabaha

- Murabaha may be extended, but extension or rollover may not result in price increase (Riba)
- No late payment penalty (Riba), but
 - Ø Acceleration of remaining instalments
 - Ø Donation to charity
- No pre-agreed early payment discount (Riba), but Financier may elect to give unilateral discount
- Remaining instalments may not be sold at a premium or discount (Riba)
- Commonly used for real estate finance, but RETT problem in Germany

Ijara



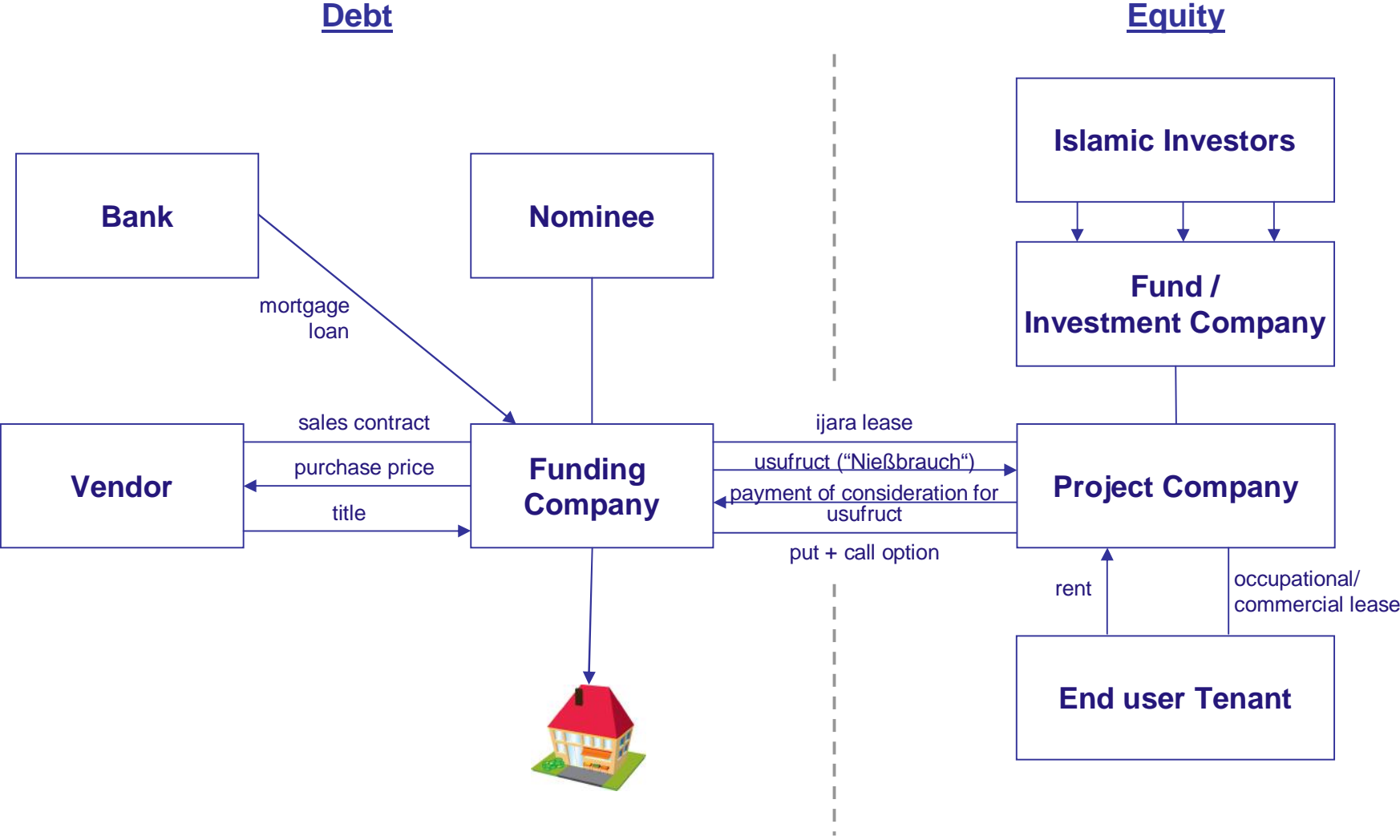
Ijara

- Financier purchases asset from Vendor as directed by Client
- Financier holds title during the financing
- Client pays pre-agreed rent to Financier for use of asset
- Client returns asset to Financier upon expiry of lease (operational lease)
- Or: Lessee acquires asset for a nominal amount upon expiry of lease through a put or a call option (acquisition finance)

Ijara

- Client usually acts as Financier's agent regarding insurance and maintenance of the leased asset
- No late payment penalty, but donation to charity (Riba)
- Sale-and-lease-back is permissible
- Sale and transfer of contract ("Vertragsübernahme") is permissible, sale and assignment of rent only is not permissible
- Commonly used for real estate finance and Sukuk securitizations

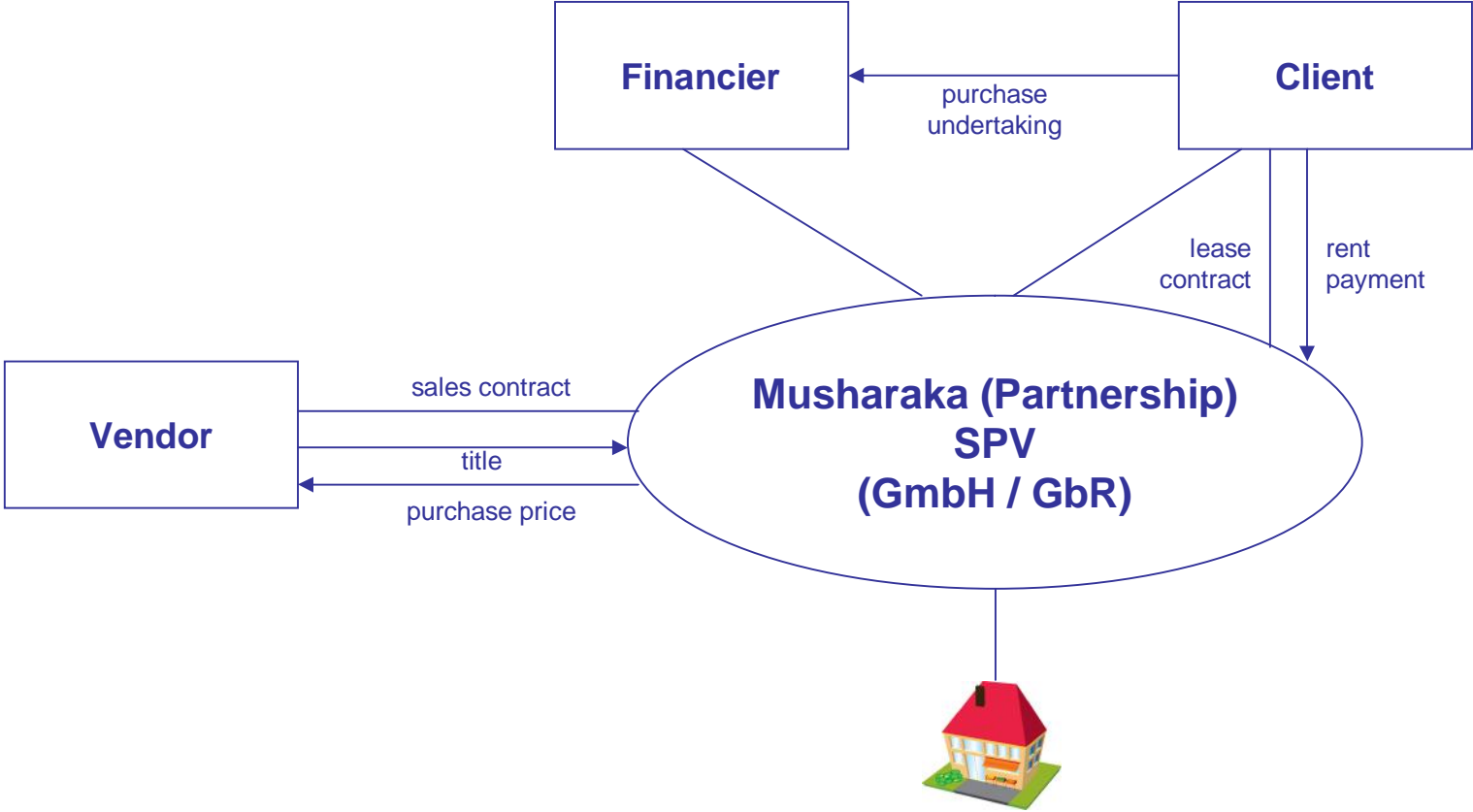
Leveraged Ijara



Leveraged Ijara

- Most commonly applied for debt financing
- Funding Company is an SPV and must be ultimately owned by a nominee
- Project Company becomes lessor and pays a consideration for the granting of the usufruct (“Nießbrauch”)
- Future rents under Ijara lease cannot be accelerated
- Put and Call option
- Security assignment of (future) rents from Project Company to Funding Company and onwards from Funding Company to Bank

Musharaka (Partnership)



Musharaka

- Literally “sharing”
- Cardinal rule: profits and losses must be shared in the same proportion
- No guaranteed profit or yield to one party only
- Financier and Client form a Musharaka Partnership (Civil law partnership or limited liability company)
- Contributions may be made in cash, in kind or by services provided
- Partners usually elect the Client to manage the partnership
- Partnership acquires the asset and leases it to the Client

Musharaka

- Financier and Client share profits and losses according to the agreed proportions
- Client buys out the Financier's shares in instalments over a period of time at a pre-agreed price ("diminishing musharaka")

Shariah compliant (German) lease contracts

- Real property or other tangible or non-tangible assets
- Shariah compliant tenant and tenant activities in the leased premises
- Contract must be pre-agreed, transparent and detailed
- Lessor must maintain legal and beneficial ownership and bear costs and risks related to the asset
 - Ø Land tax
 - Ø Maintenance of the basic structure of the building (“Dach und Fach”)
 - Ø Casualty insurance
- Tenant is responsible for all costs related to usage of the leased asset
- Tenant bears maintenance costs (other than basic structure), if agreed between the parties

Shariah compliant (German) lease contracts

- Late payment:
 - Ø No late payment interest (“Verzugszinsen”)
 - Ø But compensation of damages and payment to charity
- Obligation to pay rent ends if asset is destroyed
- Subleasing is permitted
- “Not yet Shariah compliant lease contract”
- Sale and transfer of contract (“Vertragsübernahme”) is permissible, sale and assignment of rent only is not permissible

Q & A

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