

Shari'a Compliant Real Estate Financing

Introduction and general overview

The real estate market in the Middle East has seen a substantial cooling of activity since the global economic downturn at the end of 2008.

However, new levels of activity have begun during 2012 as the availability of finance has returned to the market and regional economies are starting to grow once again. The major driver of real estate expansion within the Middle East is being led by Saudi Arabia, Qatar and, to a lesser extent, Abu Dhabi. It is estimated, for example, that Saudi Arabia will need 1.2 million new homes by 2015 (Deutsche Bank AG research paper September 2010).

A noticeable trend in this activity is that real estate companies are once again looking at *Shari'a* compliant financing and investment structures as a key component of their requirements. This is due mainly to increased shareholder and governmental pressure.

A number of *Shari'a* compliant real estate funds have also recently been established to invest in real estate within the GCC. There is a general view that commercial real estate, having dropped in value by as much as 50% in Dubai, has reached the bottom of the market and new investors can seek to achieve good rental returns in future.

What distinguishes the *Shari'a* compliant commercial real estate

market is the requirement that, in addition to the financing for any property acquisition being Islamic, the tenants of the property and the tenancy agreements also need to be *Shari'a* compliant. As a result, a *Shari'a* compliant property company cannot have any tenants which are involved in conventional financing activities, non-*Takaful* insurance companies, sale or manufacture of alcohol (this may preclude a number of hotels as investment options), gambling, pornography and adult activities, tobacco sale and manufacture, arms manufacture or pork production and sale. The tenancy agreements need to have the essential elements of *Shari'a* compliance (these principles are outlined in our "Islamic Finance" Spring 2013 briefing) such as the rent being fixed or subject to a clearly defined formula for calculation to avoid uncertainty (*Gharrar*) and no interest (*Riba*) being payable as part of any late payment charges.

In addition to the challenges which are faced with structuring when entering into a *Shari'a* compliant financing deal, real estate transactions add to the complexity due to foreign ownership restrictions on land. Innovative structures and full comprehension of the regional laws determining ownership of real estate are essential to successfully implement a real estate financing structure in the Middle East.

Key issues

- Introduction and general overview
- Recent deals
- Islamic structuring
- Important structural considerations
- Innovative structures
- Other considerations
- Outlook

Recent deals

Clifford Chance is proud to be at the forefront of the *Shari'a* compliant real estate market. The team has won numerous awards for its achievements in the Islamic finance industry. Some of the recent Islamic real estate transactions on which Clifford Chance has advised on include:

- **Doha Festival City** - advising a syndicate of conventional and *Shari'a* compliant banks in Qatar including Commercial Bank of Qatar, Qatar National Bank, Barwa Bank, Qatar International Islamic Bank, Ahli Bank, Al Khalij Commercial Bank, International Bank of Qatar, in relation to a QAR3.7 billion multi tranche conventional and *Shari'a* compliant financing of the construction. The *Shari'a* financing tranche was structured on the basis of an *istisna'a* with a forward *ijara*.
- **Northgate financing** - advising Qatar National Bank S.A.Q., International Bank of Qatar

Q.S.C., Masraf al Rayan Q.S.C. and Barwa Bank Q.S.C. as the mandated lead arrangers on a QAR1 billion forward lease (*ijara*) facility to Northgate Company L.L.C. in Qatar. The transaction is to finance the construction and operation of a landmark multi-use property complex in Doha.

- **Aldar financing** - advising Abu Dhabi Commercial Bank PJSC in relation to a AED1.5 billion *ijara* facility to Aldar Properties PJSC, which was secured by a mortgage over a plot of land located in the Al Raha Beach development.
- **Chelsea Barracks** - advising Project Blue (Guernsey) Ltd (a joint venture of Qatari Diar and CPC Group) on the US\$2.5 billion syndicated funding (in the form of a diminishing *musharaka* sale and *ijara* lease structure) of its purchase of London's Chelsea Barracks, a 5.2 hectares area in the City of Westminster. This was a ground-breaking *Shari'a* compliant funding believed to be the largest ever Islamic financing of a UK or European property.
- **Al-Faisal Holding Company financing** - advising Citibank N.A. on a ground-breaking US\$850 million Islamic syndicated financing for Al-Faisal Holding Company W.L.L. Qatar. The transaction was for the development of twelve residential complexes and hotels in Qatar, involving a combination of conventional finance and Islamic lease and debt financing.
- **Sorouh real estate securitisation** - advising Citigroup Global Markets Limited on the first ever *Shari'a* compliant securitisation of instalment sales receivables from the sale by

Sorouh Real Estate PJSC of plots of land on the iconic Shams and Saraya Master Developments in Abu Dhabi. This was a non-recourse true sale securitisation.

- **United Development Company real estate development fund** - advising on the establishment of a *Shari'a* compliant real estate development fund and debt raising for United Development Company in Qatar, for the Qanat Quartier development on The Pearl, Qatar. The firm acted for the Sponsor in establishing the US\$300 million fund, and the legal structuring for the debt raising, using a US\$300 million revolving *musharaka*.
- **Nakheel Sukuk** - advising Nakheel Development Limited on a US\$3.52 billion *sukuk-al-ijara* which was listed on Dubai International Financial Exchange. This was the world's largest single *sukuk* issue.
- **Jabal Omar Development** - advising a syndicate of banks in Saudi Arabia including Al Rajhi Bank, Bank AlJazira, Bank Al Bilad, The National Commercial Bank, The Saudi British Bank and Saudi Hollandi Bank in relation to a SAR5 billion multi-tranche financing based on *wakala* and procurement structures with integrated forward lease (*ijara*) financing components for a mixed use hotel, retail and residential construction project in Makkah.

Islamic structuring

The manner in which an Islamic real estate transaction is structured will largely be determined by the nature of the real estate itself, particularly whether it is real estate development

or a completed property and the relevant ownership restrictions. *Shari'a* compliant real estate funding on a completed property is typically structured on the basis of a straightforward sale and leaseback (*ijara*) arrangement - the property company will sell the property to the Islamic banks, and which the property company will then lease the property back from the Islamic banks by paying a rental which replicates the economics of a conventional real estate financing arrangement. In European jurisdictions the lease (*ijara*) structure can pose tax structuring problems which may preclude its use but, as a general rule, there are no such issues in the Middle East.

The other *Shari'a* issues in relation to completed real estate are predominantly associated with the use of the underlying property and its tenants. Where a property is being acquired by either a *Shari'a* compliant real estate fund or is to be purchased by an Islamic bank as part of a sale and leaseback financing it will not be possible where the property or a significant tenant is involved in *haram* activity. This poses issues for *Shari'a* compliant real estate funds in particular as profitable investments such as hotels are problematic due to the potential sale of alcohol and/or pork products and reliable tenants such as conventional banks or insurance companies are not acceptable. Careful consideration is required by the managers of such *Shari'a* compliant real estate funds and structures can be established for either reducing the impact of the *haram* activity below a level where it will be acceptable to the *Shari'a* advisors of the fund or isolating the income from the *haram* activity so that the fund is not impacted by it.

For real estate developments the most widely used technique for structuring is to combine the use of an *istisna'a* arrangement (or a variation thereof) with an *ijara* arrangement.

Istisna'a - a traditional *istisna'a* is, in essence, a sale contract whereby one party undertakes to construct a specific asset according to certain agreed specifications. The price of the asset and the date of delivery are specified at the outset. The liability of the purchaser to pay the price and the liability of the developer to deliver the assets are deferred to a future specified date or, in the case of payment, the instalment dates.

Although traditional *istisna'a* contracts have been used successfully for real estate developments, they require the financiers to enter into a construction contract directly with the contractor. This fundamentally changes the risk profile of financing the development for the financiers who, by entering into a direct contractual relationship with the contractor, would be taking an additional risk in the form of the credit and performance risk of the contractor itself. As a consequence, the use of

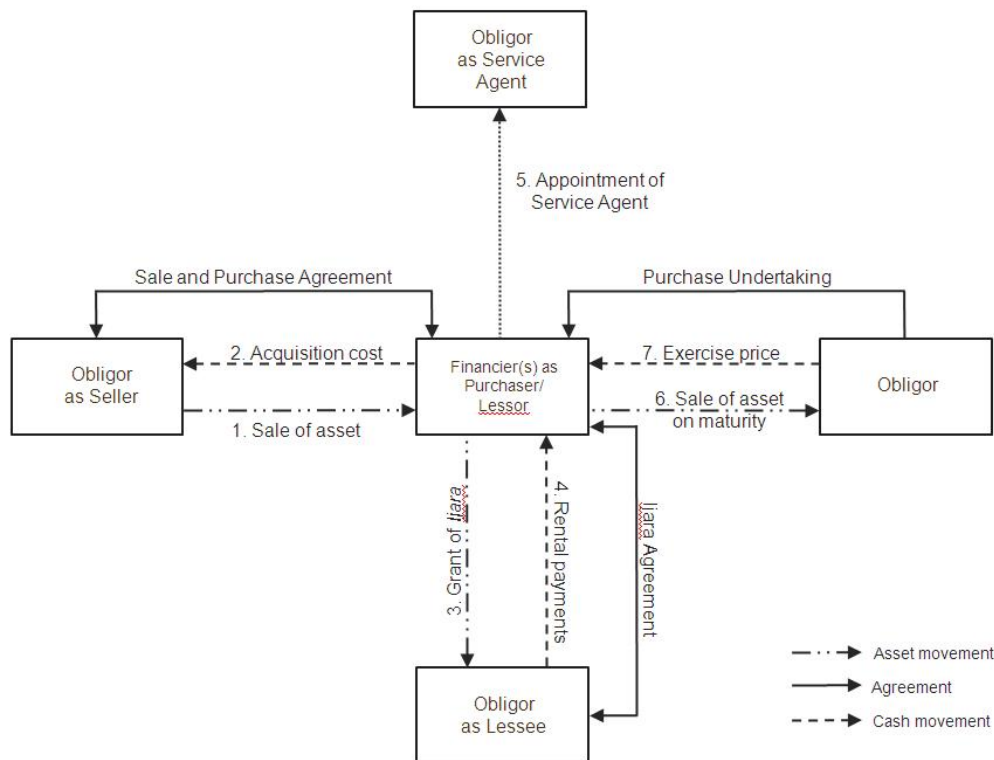
the traditional *istisna'a* has become increasingly avoided and the market has moved favourably towards the sub-contracting and procurement variants with a view to mitigating such risks.

The use of an *istisna'a* arrangement raises a number of issues which the financiers will need to consider:

- title to the property will be transferred to the financiers upon delivery - this is typically stated to occur only at property completion, with partial delivery of completed towers (for example) not permitted. The financiers will then be responsible for all rights and obligations associated with ownership, for example, the obligation to effect insurance and the risk associated with loss, environmental liability and third party claims;
- the *istisna'a* will not provide a return to the financiers - it is therefore necessary to combine its use with that of another product (typically *ijara* - see below);

- where the real estate company fails to deliver the property (either by the agreed delivery date or at all), or the property is damaged or destroyed prior to delivery or the real estate company is otherwise in breach of its obligations, the remedies available to the financiers need to be carefully considered; and
- the interaction of the 'financing structure' (pursuant to which the financiers agree to provide financing and 'pay' for the costs of construction of the property) and the traditional construction arrangements may give rise to warranty issues, tax and/or accounting concerns.

Ijara - is the Islamic equivalent of a lease and is a hybrid between the operational lease and the financing/capital lease. It offers the certainty of regular payments throughout the life of the financing with the flexibility of tailoring payment instalments in a manner that allows for financiers to achieve a profit margin structure comparable to that of conventional financiers.



The traditional *ijara* involves the lease of an existing physical property and is typically used, in the form of a sale and leaseback arrangement, for the purposes of financing a completed property. For the purposes of property developments, and in order to enable the financiers to receive a return during the construction period, certain scholars have permitted the use of a forward lease arrangement (known as *ijara mawsufah fi al thima* or *ijara fil thimma*), whereby 'advance' rental payments are made prior to property completion and 'actual' rental payments commence from property completion. The strict proviso attached by the scholars to the use of forward lease structures is that, if delivery of the property never occurs (and therefore the lessee never has the benefit of that property), the lessor (i.e. the financiers) must refund all advance rental payments that have been made to it by the lessee (i.e. the real estate company). This obviously presents an unsatisfactory scenario

for the financiers and increases the importance of clear remedies under other elements of an Islamic real estate finance structure (see commentary above regarding *istisna'a* arrangements).

Ijara combined with istisna'a - the *ijara* is typically combined with the *istisna'a*, such that:

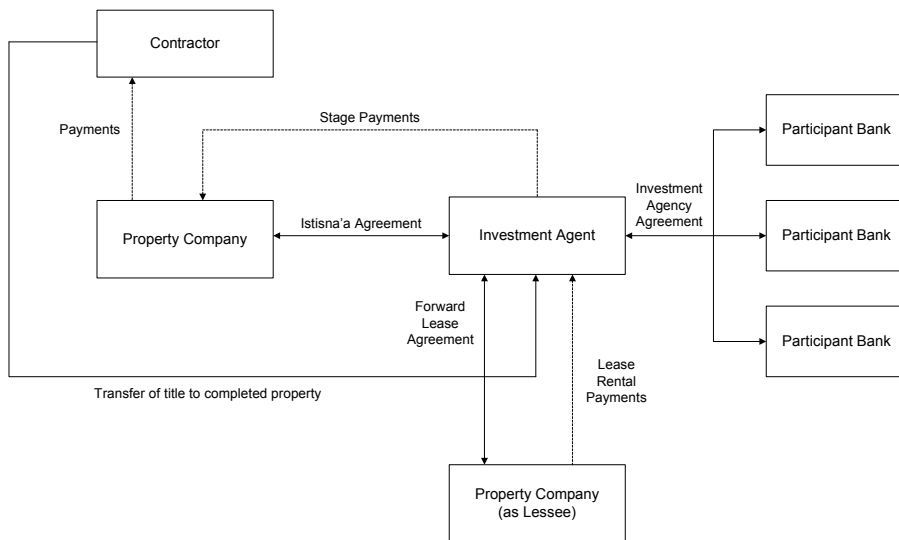
- an *istisna'a* contract acts as the funding instrument whereby payments are made by the financiers to the real estate company during the construction period - this occurs in the same manner as utilisations / drawdowns would be effected in a conventional property development financing and is often subject to exactly the same kind of conditions and milestones;
- an *ijara* or *ijara mawsufah fi al thima* enables the financiers to generate a return from the property development which replicates the economics of the

arrangements typically associated with conventional property development financing. Whilst the forward lease arrangement is normally entered into at the same time as the *istisna'a* contract (i.e. at a time when there is no physical property in existence and its construction is being commissioned), actual leasing itself does not commence until the property has been delivered;

- once the property has been delivered and leasing has commenced, service arrangements become effective whereby the financiers appoint the real estate company as its service agent in order to (among other things) insure the property, to be responsible for major maintenance and manage other ownership-related tasks; and
- any purchase and sale undertaking arrangements (documenting termination and

prepayment rights) also become effective once the property has been delivered.

Set out below is a diagrammatical overview of how a combination of the *istisna'a* contract and *ijara mawsufah fi al thima* structure would typically work:



prohibition on ownership of property by a financial institution. However, ownership issues arise where the Islamic bank is required to own real estate outside of the areas designated for ownership by non-UAE / GCC individuals or entities and the Islamic bank has such shareholders

over a certain time period to be registered with the applicable real estate register. The costs involved with such registration and the additional perfection requirements can be prohibitive to financings being possible over a certain term.

In Dubai, the Land Department considers a lease of 10 years or more to be a 'long-term' lease and to therefore constitute a "*right in rem*" which requires registration in order to be valid. In Abu Dhabi, a recent law confirms that all leases over 25 years are "*rights in rem*" and must therefore be registered at the Land Registration Department.

Acceleration

In a default scenario due to an event of default of the lessee or otherwise, the financiers will typically have the benefit of a purchase undertaking from the project company which serves as a method of accelerating payment on an *ijara*-based Islamic tranche. The financiers may exercise their rights under the purchase undertaking and require the project company to purchase the leased assets for an exercise price (typically equal to the aggregate of all amounts outstanding under the Islamic tranche). The actual transfer of title to the assets will often not take place until the exercise price has been paid to the financiers and the Islamic debt satisfied in full. However, by exercising the purchase undertaking the financiers will have a claim against the project company for an amount that is immediately due and payable and will thus have a claim in the proceeds of any security package available on the wider project financing.

Total Loss

If the property is destroyed, damaged beyond repair or otherwise completely lost *Shari'a* requires that the lease

Important structural considerations

Ownership issues

The *Shari'a* compliant financing structures outlined above require title to the property to vest in the Islamic bank at some stage when acting as lessor under the lease (*ijara*). The issues which arise are related to the ability of the Islamic bank to own title to the property and the means of title transfer together with associated registration costs.

In the UAE it is possible for Islamic banks to own real estate as a result of Federal Law no. 6 of 1985 (Regarding Islamic Banks, Financial Institutions and Investment Companies) which exempts Islamic banks from the usual

as this may lead to the Islamic bank being unable to own the property or hold any rights akin to ownership in the property.

Using Dubai as an example, Law No.7 of 2006 states that non-GCC nationals (which includes companies that are not 100 per cent. owned by GCC Nationals) are only allowed to own freehold interests, nor rights of *musataha*, usufruct or long-term leasehold interests except in areas designated by the Ruler of Dubai. Any Islamic bank involved in a standard *ijara* sale and leaseback transaction outside of the designated areas will have structuring issues should it have any non-GCC shareholders.

Registration

A further issue for *Ijara* based structures is the requirement in certain GCC jurisdictions for a lease

arrangements be terminated with immediate effect upon such occurrence and that any purchase undertaking in respect of the property becomes ineffective as a result. In order to mitigate this risk, the financiers typically appoint the property company as their service agent / service provider and require it, in such capacity, to maintain insurances in respect of the full replacement value of the property. Upon the occurrence of a total loss, the property company (as service agent or service provider) will be under an obligation, within a certain timeframe, to provide the financiers with the proceeds of the insurance. In the event that the proceeds are less than the full replacement value of the property, the property company will have failed to comply with its strict insurance obligations (as service agent or service provider) and will be liable to indemnify the financiers for any shortfall.

Innovative structures

Despite the obvious popularity, and suitability, of the *ijara* to Islamic real estate financings, a key concern with its use is that, upon an insolvency of the property company, the courts in certain GCC jurisdictions (e.g. Saudi Arabia) may find that either (i) the lease arrangement is a 'disguised' loan agreement and therefore not compliant with *Shari'a* or that (ii) the fixed lease rental payments are in excess of the market rate for a similar property and thus order the rental payments to be reduced or refunded accordingly.

These risks have, on some transactions, prompted financiers to look at alternative ways of restructuring the basis of their compensation through *ijara* arrangements which are combined

with purchase and/or sale arrangements. For example, under a co-ownership structure it is possible throughout the term of the *ijara* for the financiers to sell incremental units of their ownership interest in the property to the property company (diminishing *musharaka*). As, and when, portions are sold to the property company the financiers will continue to lease to the property company a decreasing share of the property, with payment streams under the lease and the purchase undertaking being structured accordingly. However, where the ownership interest in the property and/or the *ijara* require registration it is logistically difficult in some GCC jurisdictions to register co-ownership of a property and the costs involved may be prohibitive.

Tax considerations

It should be noted that transfers of title to the property, first from the contractor to the financiers and then (upon repayment of the facilities) from the financiers to the property company, may have tax implications which need to be carefully examined on a jurisdiction-by-jurisdiction basis. Additionally, thought will also need to be given to whether the lease payments themselves would be subject to withholding tax and indeed whether the lease payments should be accounted for as a debt financing arrangement or otherwise both for the property company (in terms of amortisation of the leased assets and for tax deductibility of the lease payments) and for the financiers (in terms of accounting for rental payments).

Outlook

As the property market within the GCC emerges from the downturn in activity following the financial crises it is anticipated that the demand for real

estate finance will grow considerably. It is likely that a large part of this growth is going to be within the Islamic financing of real estate. Whilst the market as a whole has seen relatively low levels of activity over the past year there have been a number of real estate "mega projects" which are proceeding and being financed on *Shari'a* structures. As *Shari'a* financing structures require an asset to form the basis of the financing, property has traditionally been a popular area for Islamic banks and as the property market continues to recover more Islamic financing will occur as the bank's balance sheets become healthier and their appetite for exposure to real estate assets grows.

Saudi Arabia has announced new laws reforming the mortgage, finance and the court system. The Registered Real Estate Mortgage Law was passed on 31 August 2012 and amongst other things, provides a new framework for security over real estate, including a provision for second ranking mortgages, and processes for both assignment and termination. The consensus reaction seems to be that there will be no overnight revolution as far as the markets are concerned, but this is an important evolutionary step in the right direction.

The award of the world cup to Qatar for 2022 will mean a large number of real estate projects in terms of the stadia required to host the matches and also the hotels and apartments which will be required for the expected influx of fans. It is anticipated that a large proportion of the financing for such real estate projects in Qatar will come from regional banks and that Islamic banks will be major contributors. However, a number of Islamic banks do not have the capital available to solely fund some of the major real estate projects

which will be required for the event and it is anticipated that a number of financings will involve co-operation between Islamic and conventional institutions.

A financing which involves both conventional and Islamic real estate finance leads to a number of important structuring issues. For example, most conventional real estate financing structures are based on a mortgage over the applicable real estate whereas most *Shari'a* financing structures will involve the

Islamic bank in owning the real estate which raises a conflict between the availability of the property as security. This will usually involve the use of an intercreditor agreement between the respective financiers and consideration being given as to what will happen on an event of default or a total loss of the property.

Another potential area of growth will be in the *sukuk* market. The use of real estate in *sukuk* issuances is quite common and the market provides an alternative area of capital for real

estate companies. The lease *ijara* structures which are outlined above can be readily incorporated into *sukuk-al-ijara* structures which are both attractive to investors and raise no issues of *Shari'a* compliance as the *sukuk* has fully tangible assets upon which it is based. *Sukuk* are an ideal alternative to conventional real estate financing structures and provide strong real estate companies with access to a very different investor base.

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