Islamic Financing in Commercial Real Estate Financing

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Steigende Erdöl- und Erdgaspreise haben in den arabischen Förderländern zu höheren Einnahmen geführt, die nicht nur im Inland in gigantische Immobilienprojekte investiert, sondern auch im Ausland angelegt werden. Stand bisher fast ausschließlich die USA im Fokus islamischer Investoren, so tragen die politischen Entwicklungen dazu bei, dass sich das Augenmerk der arabischen Anleger zunehmend auf Europa richtet. Lange Zeit verkannt, haben mittlerweile auch deutsche Immobilienfinanzierer das gewaltige Geschäftspotenzial erkannt und bieten korankonforme Produkte an. (Red.)

With the longest sustained oilprice rise in history, many Middle Eastern investors are looking to diversify the investment of their increased resources to generate alternative income streams. Many have turned to real estate due to its capital intensive and low volatility characteristics. This diversification of income has helped the United Arab Emirates (UAE) reduce its GDP dependency to the oil and gas sector. Dubai has been particularly successful in diversifying its economic base with the expansion of the tourism and real estate sectors. Indeed, the country managed to halve the oil and gas sector's contribution to its GDP from 10.6 per cent in 2000 to 5.1 per cent in 2005.

These investors, usually Islamic, are also very active on the European real estate scene, taking advantage of the low cost of debt to target prime assets in major European cities. Most often, Islamic investors require certain elements of the structure to comply with the teachings of the Quran. Islamic financing structures are not tied to any jurisdictions; however, they are commonplace in the real estate finance sector in Dubai and the UAE. Because of the weight of Islamic investors and the increasing influence of the Middle East in the global marketplace, Islamic finance is becoming more widespread and international banks have started to recognise this trend by offering Islamic products to a market estimated to be worth 400 billion US-dollars globally and growing at a fast pace.

Islamic finance is based around the Islamic faith and must comply with the rules of the Quran (Shariah Law). Contrarily to traditional banking, Islamic banking does not allow usury and this is sometimes interpreted to mean the charging or receiving of interest (riba') in certain situations. However, there are numerous Islamic financing structures to enable lenders and investors to comply with Shariah law, while still remaining competitive.

The most common Islamic financial instruments used to replace the interest rate mechanism are the Murabaha (cost-plus financing and the main focus of this article) and the Ijara (leasing) structures. Other commonly used structures include profit-sharing (Mudaraba), partnerships (Musharaka) and forward sales (Bai Salam). All these methods can be structured to respect Shariah law or be used to design more sophisticated transactions.

Murabaha (cost-plus financing)

Under this Islamic financial technique, the transaction is usually structured as a deferred acquisition, where either a Special Purpose Vehicle (SPV) held by a nominee or a bank purchases the asset from a third party on behalf of its client. In order to be Shariah compliant, Murabaha can only be used in the case of the purchase of an intended asset, thus refinancing is not generally possible under this method. Therefore, when refinancing an asset, other Islamic financing structures are more common, such as Ijara (leasing).

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In order for the above transaction to be Shariah compliant, the bank must first own the asset, before selling the asset to its client in fixed instalments or at purchase price plus a mark-up at loan maturity. In order to comply with Shariah law and avoid any uncertainty, loan terms, conditions and contractual obligations must be mutually agreed and fixed in advance. There are also different structures in Murabaha transactions such as the one detailed in figure 2.

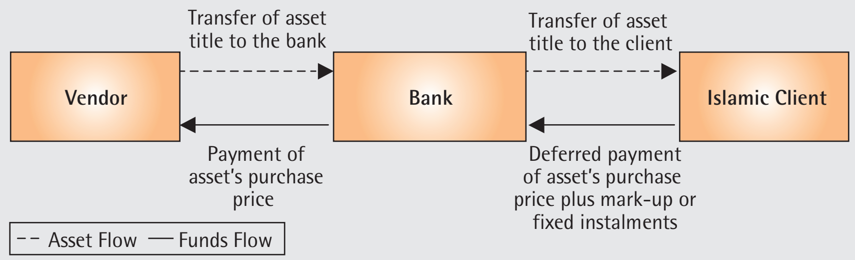
In this example, the Murabaha transaction is characterised by two "pillars", one representing the "Islamic" and the other representing the "non-Islamic" part of the transaction. The bank funding is injected in the "non-Islamic" pillar of the structure. The asset is then transferred to the Islamic pillar. However, no interest income streams are permitted to flow between the pillars. The flow of payments between the pillars is achieved through the Murabaha agreement. The equivalent to the Islamic pillar's equity contribution is a deposit (Arboun) placed with the non-Islamic pillar at the time of the Murabaha agreement. The non-Islamic pillar (including bank debt) is then paid back on the basis of the Murabaha agreement at original purchase cost plus mark-up, which may be in instalments, to avoid the charging of interest.

Hypo Real Estate Bank International AG, a member of Hypo Real Estate Group, has a strong track record in providing Shariah compliant financing to its clients. The bank has developed its know-how by structuring Islamic finance for its clients in European jurisdictions. In July 2007, the group completed its first transaction in Dubai in the United Arab Emirates. It provided 82.5 million dollar Shariah compliant financing to assist Pramerica Real Estate Investors in the purchase of the "European Business Centre", a mixed-use office building located in the Dubai Investment Park.

Pramerica Real Estate Investors' strategy with their acquisition of the European Business Centre is to attract small to mid-size European firms wishing to set-up operations in Dubai. Foreign companies with offices in free zones are only allowed to conduct business within the respective free zone, whereas companies located in the Dubai Investment Park can generally deal throughout the Emirates without such limitation.

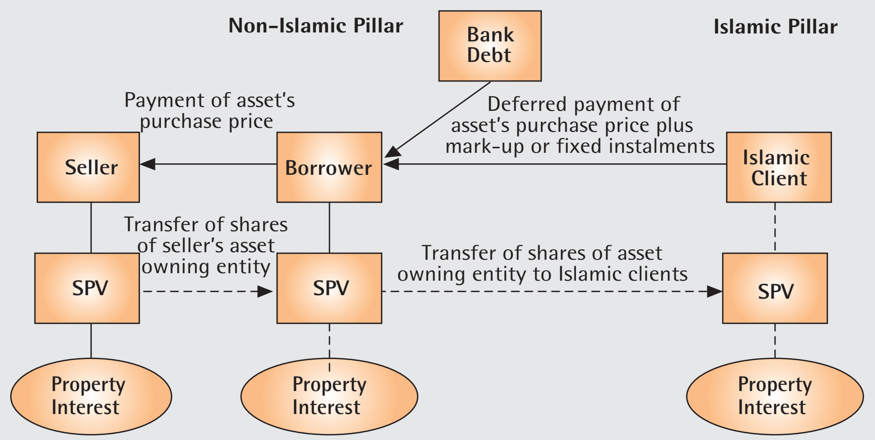
Structuring real estate finance even under Islamic principles is inevitably affected by the legal environment applica-

Figure 1: One example of a Murabaha financing



Notes:
- The bank must own the asset at the time of sale for the transaction to be Shariah compliant.
- The payment deferral time from the Islamic client to the bank is effectively the term of the loan.

Figure 2: The two pillars of Murabaha financing



ble to the real estate sector of the underlying country. Firstly the ownership rights must be thoroughly investigated as part of the due diligence process, since most land is only available for acquisition to UAE or GCC country nationals in the Emirate of Dubai. Indeed, land ownership is allowed without restrictions or on a 99 year leasehold only in "designated areas" and other free zones which have been approved by the ruler of Dubai.

Once the title issue is cleared, the bank will concentrate on obtaining security over the asset. A land mortgage can be registered with the Dubai Lands Department, giving the debtor possession of the land while the mortgagee will receive the proprietary rights over it. In practice, the mortgage enforcement process can take between twelve to 36 months as all cases are undertaken by a court sanctioned public auction, thus allowing mortgagors to appeal in higher courts.

Moreover, there are also complications in registering a mortgage in Dubai. Indeed, the Dubai Lands Department will only register land mortgages to banks licensed by the UAE Central Bank with a full banking license. Accordingly, a non-licensed lender normally cannot expect to obtain mortgage security in the UAE, unless through a UAE licensed bank acting as agent. In the context of a syndicated secured financing, a security trustee would be treated as an agent for UAE law purposes. Whilst there appears to be a view emerging that the agent could hold security on behalf of the original lenders and in effect act as a fronting bank, the view also seems to be that his agency would however probably not be accepted as extending to new lenders.

Furthermore, there are substantial costs involved in registering and de-registering land mortgages. In practice, this is often a major disincentive to the creation of this form of security. Given the practical and legal difficulties associated with perfecting and enforcing security over real property in Dubai, foreign banks will usually seek to mitigate the risks of enforcing their security through covenants and other provisions in the relevant facility agreement. The preference of local banks is to lend on a corporate basis rather than special purpose vehicles or otherwise lend to special purpose vehicle with the benefit of a parent company guarantee instead of taking mortgage security. Alternatively, banks can require a cash sweep of the excess cash flow to amortise the loan earlier.

Other forms of security seen in the commercial real estate market in Dubai include the assignment of rights under the leases or subleases granted to the tenants of a property, assignments of sale proceeds, assignment of collateral warranties/guarantees under building contracts and of insurances relating to the relevant property. Although a lender needs to carefully examine law, much reliance can be placed on these types of collateral. Dubai law does not recognise security over future assets so that security is not usually taken over cash deposited in UAE bank accounts as every time any new money was received into the account a new pledge would be required and every time money was withdrawn, the lenders would need to consent to such withdrawal.

Structures of Securitisation

As Islamic finance matures, the use of securitisation will continue to develop in Islamic real estate finance. The current demand for securitisation from Islamic investors is set to grow as real estate developers or investors want to raise funds in a cost effective way. In Islamic finance, Sukuks (Islamic bonds) are in many ways comparable to Commercial Mortgage Backed Securities. These asset backed Islamic bonds are structured as an exit for banks on top of an already existing Islamic structure such as Ijara (leasing), where the lease generates the coupon of the Islamic asset backed bond.

The development of innovative and sophisticated Islamic financial products by Islamic as well as international banks has made these products more competitive in the market and Hypo Real Estate Group believes that Islamic finance is starting to become an integral part of the global financial system and will play an increasingly important role in the financial markets. This vision of a bright future for Islamic finance is illustrated by the recent creation of a Dow Jones Islamic Index, which includes companies complying with the rules of the Quran and therefore not investing in weapons, alcohol, gambling... This view is further reinforced by the appearance of Shariah compliant hedge funds or derivatives products.