



AbdulJaami, PLLC

International Commercial Transactions

Fala Serío: Winning the Global Competition for Capital Investment

Islamic Finance is increasingly being used to fund real estate investments in places as far apart as the U.S.A and Japan. In some ways, Islamic Finance is similar to investing in a socially responsible manner. However, Islamic financiers avoid *riba* (interest) and undue uncertainty. Islamic Finance is usually compatible with the laws and regulations of most jurisdictions. Jurisdictions such as the U.K. and the Cayman Islands have taken steps to attract Islamic Finance. Serious Brazilian real estate investors should consider the benefits of attracting Islamic Finance.

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When a leading Connecticut-based real estate private equity and development firm needed help with a \$233 million condominium conversion project in 2006, a \$45 million capital infusion from Global Securities House, a \$1.8 billion Kuwaiti real estate investment advisory, was welcomed as an excellent way to pay back a bridge equity loan. According to The Wall Street Journal, only \$30 million went toward the bridge loan.

On November 20, 2007, Forbes.com reported that “the first real estate transaction compliant with Islamic law was struck in Japan.” Kuwait-based Boubyan Bank entered into a \$40 million partnership to buy three Tokyo office buildings. The bank committed less than 5% of its \$350 million global real estate fund.

These two deals, completed worlds away from each other, have several things in common:

1. Serious investors were able to grab hold of serious capital – minimum capital infusion: \$10 million.
2. Experienced professionals stepped outside of their comfort zones and embraced creative solutions that work.
3. New to Islamic Finance, qualified employers of capital “[warmed] up rapidly to what is believed to be a \$400 billion market.” *Japan Developing Yen For Islamic Finance*, Forbes.com

Socially Responsible Investing...with a *Twist*

Many people view Islamic Finance as socially responsible investing...with a twist. In the context of real estate, Islamic Finance investors will focus on the use that the property will be put to. For example, a property that is used for the production or sale of alcohol, pornography, or gambling would probably not be financeable using Islamic Finance. This is basically identical to what is known as socially responsible or socially conscious investing.

Similar to a socially responsible investor, an Islamic Finance provider will refrain from investing in an investment that is clearly intended to benefit from the harming of a third party through fraud or deceit. An Islamic Finance provider is likely to go further and also avoid transactions that have unduly uncertain outcomes. In the real estate context, an example of an unduly uncertain outcome might be a project where it is extremely unclear whether necessary building permits will actually be obtained.

The *twist* that differentiates Islamic Finance from socially responsible investing is the unwillingness to earn conventional interest. Islamic Finance providers avoid taking risk-free returns paid solely as compensation for the use of their capital. A simple illustration might be helpful: whereas a conventional investor might put \$100 into a savings account and earn 4% annually, an Islamic Finance provider might instead take that same \$100 and invest it into equity securities.

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This avoidance of conventional risk-free returns stems from the Islamic prohibition on *riba* (pronounced ree-bah), which literally means increase – the “increase” that a creditor receives from a debtor for allowing the debtor time to repay the debt. So *riba* is the equivalent of conventional interest.

Core Structures in Islamic Finance Commercial Real Estate Transactions

Despite their unwillingness to earn conventional interest, Islamic Finance providers enjoy earning profits and do so by focusing on trade-based investment structures that carefully allocate risk and return. In the real estate investment context, two basic structures are: (1) purchase and sale with a mark-up; and (2) purchase and lease-back. These structures may be used independently, combined with each other, or combined with other structures. This fosters creative structuring that helps deals to get done.

The purchase and sale with mark-up structure, known as *murabaha* (pronounced moo-rah-bah-ha), works as follows: the investor will purchase an asset (for, let’s say, \$100), and then sell that same asset to the real estate entrepreneur for some agreed mark-up (\$100+\$20). The parties will then agree on when the entrepreneur will pay the purchase price and the mark-up (\$100+\$20), and whether fixed payments will be due over the lifetime of the investment or only at the end of the investment.

The second structure, the purchase and lease-back structure, known as *ijara* (pronounced ee-jah-rah), is familiar to many commercial real estate investors as the sale lease-back. An investor will purchase an asset, and then lease the asset to entrepreneur who makes lease payments to investor. The investor and entrepreneur can agree that lease payments may vary based on set criteria. The result is that, over the life of the investment, the *ijara* structure can be more flexible than the *murabaha* structure which requires fixed payments.

While at the core, the above structures are relatively simple, they can be and are used as foundations for the implementation of the latest financial techniques. For example, Islamic Finance providers use the *ijara* structure to produce securitized products. The financiers create a special purpose vehicle that purchases and holds title to an asset (let’s say a shopping mall). Through the SPV, the financiers issue trust certificates that each represent some degree of ownership in the shopping mall. The SPV then leases the shopping mall to tenants and collects the lease payments. Holders of trust certificates receive a portion of the collected lease payments based on their share in the ownership of the shopping mall.

The SPV trust certificates are known as *sukuks* or “Islamic bonds,” and have been accepted by markets worldwide. The growth potential of the *sukuk* market cannot be understated: in 2003, *sukuk* issuance was approximately \$8 billion. By 2007, the *sukuk* market was estimated to be \$70 billion and is expected to double in size to \$140 billion by 2010.

Race to Attract Islamic Finance

The race to attract Islamic Finance is on. The Financial Times quoted Ken Livingstone, mayor of London, as saying, “It is highly important for London that it becomes a world centre for Islamic finance. It is...practically important for London with the increasing wealth of the Gulf and other Islamic states.” *Boost for London as Islamic finance capital*, Financial Times, March 21, 2007.

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For the most part, Islamic Finance is compatible with the laws and regulations that are already in place in most jurisdictions. For example, in December 1997, the U.S. Office of the Comptroller of the Currency (OCC) issued an Interpretive Letter (#806) approving the use of an Islamic Finance lease structure in the U.S. In November 1999, the OCC issued Interpretive Letter #867 approving the use of a *murabaha* financing facility. The OCC confirmed that these structures, as defined in the Interpretive Letters, were compatible with U.S. law and regulation.

Some jurisdictions, in an effort to gain a competitive edge, have adjusted, or are in the process of adjusting, their legal regimes to facilitate Islamic Finance. The U.K., for example, made some adjustments in its tax law to encourage *sukuk* issuers to choose London over other financial centers. Not content to stay home while everyone else parties, in November 2007, the U.K. published the *Government sterling sukuk issuance: a consultation*, that had as its goal “[seeking] views on the potential for the Government to become an issuer of sterling Islamic financial instruments.”

The Cayman Islands is another jurisdiction that is at the forefront of the race to attract Islamic Finance. Perhaps taking advantage of a less extensive bureaucracy, in 2007, the Cayman Islands introduced registration and issuance certification that is both in English and in Arabic. The regulatory progressiveness of the Cayman Islands appears to be paying-off. In April 2007, the Dar Al-Arkan Real Estate Development Company, one of Saudi Arabia’s top real estate developers, structured and registered a \$600 million *Sukuk Al-Ijara* in the Cayman Islands. According to Islamic Banking and Finance News, “the issuance was heavily oversubscribed, with many Western investors, especially hedge funds, attracted to the diversification and strong asset backing provided by the rated Islamic bond.” *Offshore Hubs Lure Islamic Finance Business*, Islamic Banking and Finance News, January 1, 2007.

Conclusion

As Brazil continues to grow in attractiveness to foreign investors, Brazilian entrepreneurs and professional employers of capital should continue to focus on accessing long-term capital that benefits Brazil as a whole. Financial solutions that moderate the impact of correlated markets are particularly key when financing long-lived assets such as real estate. If they are not already doing so, serious Brazilian real estate investors should investigate whether Islamic Finance is such a solution.

If you have found this Islamic finance article to be helpful, please forward the link to a friend or colleague.

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