



# Islamic funding on UK commercial property - A bank's perspective

There is a group of potential property and business investors from the Middle East who, because of their Muslim faith, are not permitted, under what is known as "Shari'ah Law" to enter into loans where the borrower has to pay interest. Faced with that fact, many banks would erroneously reach the conclusion that Islamic financing arrangements are incompatible with UK conventional finance documents.

Not so. The purpose of this article is to examine as to what is required in order to comply with Shari'ah Law, how that is achieved and why a bank, in the event of default, is able to collapse the arrangements.

To be a Shari'ah compliant loan, the following principles need to apply:

- The loan must be free from a requirement by the borrower to pay interest. This does not however mean that Shari'ah Law prohibits the concept of borrowing - rather the reverse, provided the loan stimulates productivity in the economy, ie goods and services rather than the making of more money from money.
- The loan needs to demonstrate that the risks are shared fairly between the parties. A pre-determined return to the lender, regardless of whether the transaction makes a profit, will not be Shari'ah compliant.

- The loan must provide assistance to society by helping in the production of trade services and most commodities. Certain commodities are strictly banned, such as pork or alcohol.
- Finally, no part of the loan must allow uncertainty. Loans relating to certain speculative deals will therefore not be allowed.

So how does a bank enter into a loan arrangement which appears to be totally against UK lending principles, ie the payment of interest and the removal by the bank so far as possible, of risk?

A number of Islamic financing schemes exist. This article concentrates on the concept of lease financing, known as the Ijara Lease. There are two other schemes which involve either a structure requiring the lenders participating in the equity of the transaction ("Partnership Finance") or the lender purchasing the asset ("Asset Finance") back to back with a sale of the

asset to the borrower at an increased price (which reflects the interest otherwise payable), payment of such price being deferred. The former scheme imposes undue risk for a bank and the latter would give rise to double stamp duty as well as, in all probability, Capital Gains Tax.

The basic Ijara Lease scheme involves the bank acquiring the property, leasing it to the borrower in return for a rental payment and then transferring it to the borrower once all payments (i.e. interest) have been paid. The bank must be responsible for major repairs and insurance, thus sharing the risk. By way of a separate management agreement, the borrower can be appointed as managing agent for the bank and, in that capacity, undertake repairs/insurance, reclaiming the cost from the occupational tenant, assuming the tenant of the occupational lease permit the landlord to reclaim such cost from that tenant.

On the face of it, the basic Ijara Lease arrangements also have stamp duty problems. Further, would the bank want to own the asset in the first place?

A variant to the Ijara Lease scheme, approved last year by the Shari'ah Committee, overcomes the major hurdle of the bank being the owner. Instead, a special purpose vehicle (located in whatever tax efficient country is chosen) is formed to acquire the property (the "Owner"). It will enter into the following documents in order to provide the financing structure:

#### ■ The Ijara Lease

The Owner will lease the property to a further single purpose vehicle (the "Project Company") by way of an Ijara Lease. The Islamic investors will invest in the Project Company whereas shares in the Owner will be held by a third party (i.e. a service company), not the Islamic investors or the Project Company. Where the loan is to be, say, 75% of the purchase price of the property, the Project Company will be capitalised as to the remaining 25%.

#### ■ Managing Contractor Agreement

The Ijara Lease will make the Owner responsible for structural repairs and insurance. In order to ensure that this is in fact done by the Project Company, simultaneously with the Ijara Lease, the Owner will enter into a separate Managing Contractor Agreement with the Project Company in which the Project Company is described as the Managing Contractor and, as such, takes on these tasks.

#### ■ Put and Call Options

Two further documents are completed simultaneously, namely an Undertaking

to Purchase and an Undertaking to Sell. Effectively, these are respectively Put and Call Options. The Owner grants the Project Company the Call Option, thus giving the Project Company, in certain circumstances, the chance to purchase the property (and therefore sell the investment or re-pay the financings), and, back to back, the Project Company grants the Owner the Put Option which, again, can be exercised in certain circumstances, for example if there is a default under the Ijara Lease.

#### ■ Tax Matters Agreement

The final agreement to be entered into between the Owner and the Project Company simultaneously with the Ijara Lease goes under the heading of "Tax Matters Agreement". In effect, it covers a number of miscellaneous but important matters, namely:-

- The Owner declares that it is transferring the beneficial ownership of the property to the Project Company and that it will hold the property and the income arising from it in trust for the Project Company.
- The Owner is authorised to withdraw rent from the Project Company's rent account in order to cover payments due under the security documentation.
- Both parties acknowledge that the title to the property is held by the Owner subject to the lien of the security documents and other documents mentioned below.
- The parties state their position as to certain tax matters between them. For example, if applicable, a statement as to whom Capital Allowances should be available.

#### So how does a bank obtain good security?

- The bank will obtain a fixed first charge by way of legal mortgage on the property.
- The Owner obtains a debenture from the Project Company/ Managing Contractor.
- The bank will obtain a debenture from the Owner to charge the Ijara Lease, the Put and Call Options and the debenture in favour of the Owner.

Consequently, should the Owner be in default, the bank will be able to enforce its charge over the property and, as a result, be able to enforce the Owner's security over the Project Company in whom the beneficial interest of both the property and the shares of the Owner is vested.

#### Surely stamp duty and other taxes will arise?

The grant of the Ijara Lease will give rise to stamp duty. In order to reduce this amount, the term of the Ijara Lease (where the rent will be only a little below the market rent) should be made as long as realistically possible. However, a bank might agree to

decide not to have the Ijara Lease stamped or registered at H M Land Registry provided the bank can hold both the Lease and its counterpart. The Ijara Lease has the effect, if not the terminology, of being a Loan Agreement. It is not assignable unless the Owner (and therefore the bank agrees), and can be collapsed if the loan is in default. Likewise, if the Owner should sell the property, the Ijara Lease arrangements will cease to exist.

#### How does the screen of documents work in practice?

Key elements for any bank should be the ability to obtain sufficient rent so as to service the loan, to ensure that the property is insured adequately, and to collapse the arrangements if the Owner/Project Company are in default.

- Interest on the Loan. The occupational tenant will be paying its rent and service charge (if applicable) to the Project Company and the Project Company will then pay the Owner a rent which is equivalent to the quarterly interest that is due to the bank. The Project Company can retain the remainder of the rent.
- Insurance. The Owner, under the Ijara Lease, is required to insure the property.
- Forfeiture. In the Ijara Lease, the Owner (and therefore the bank under its charge) has wide powers to collapse the arrangements. If it does so, the Put and Call Options can also be determined by the Owner. Should the Ijara Lease be forfeited, then the Managing Contractor Agreement will also automatically terminate.

The default provisions in the Ijara Lease should contain all the default provisions which would otherwise appear in a Loan Agreement.

The result of the bank exercising its rights on default will cause the Ijara Lease arrangements to collapse and consequently the bank being left with a typical structure for the purpose of enforcement.

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