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Islamic real estate finance in detail

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In the second article in a four-part series, Juliette Kelly explains how a number of common contractual structures for Islamic real estate finance operate in practice.

In the first article of this series, we considered the underlying principles of Islamic real estate finance, including a brief outline of the most common contractual structures. This second article expands on some of the differing features of such structures in respect of title transfer, funds flow and risk. This is certainly not an exhaustive account of the structures. There have been several permutations explored over time (including combinations of structures) to take account of the specific requirements of the parties and introduce flexibility.

Murabaha

In a murabaha structure, the financier pays the purchase price to the seller and the financier acquires title to the property from the seller. The financier immediately transfers this to the customer for the fixed sale price (which is made up of the original cost plus a profit). It is possible for the customer to either pay the sale price in instalments over the repayment term or defer it entirely to the end of the financing term. As title passes to the customer immediately after the purchase by the financier, a legal charge is usually taken over the property to protect the repayment of the deferred sale price (see Figure 1). The commodity murabaha is based on the above structure, but it involves the trading of commodities (usually a non-precious metal) rather than the underlying property by the parties and the cash received from the commodity sale is used to purchase/refinance the property (see Figure 2).

Figure 1

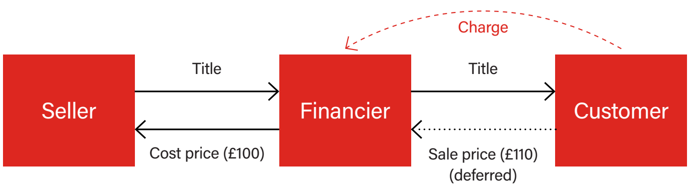
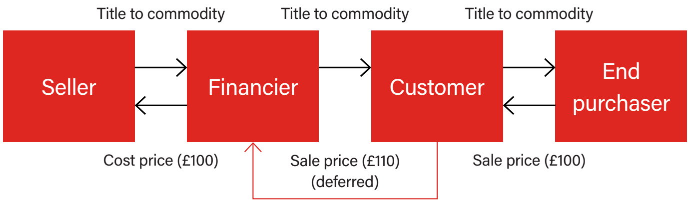


Figure 2



Ijara

Similar to the traditional murabaha above, the financier may agree to acquire the asset from the seller directly, but rather than immediately selling the property to the customer, it combines this with a lease (ijara) back to the customer (see Figure 3).

Figure 3

The financier is an owner and landlord of the property for the term of the ijara and therefore has ownership liabilities (for example, environmental) and retains responsibility for major maintenance at the property. This results in a different risk position to the murabaha structure and the financier will need to consider whether it is able to accept this. The risk can be mitigated by entering into an agreement with the customer or a third party agent which passes through responsibility for maintenance, repair and insurance to the agent.

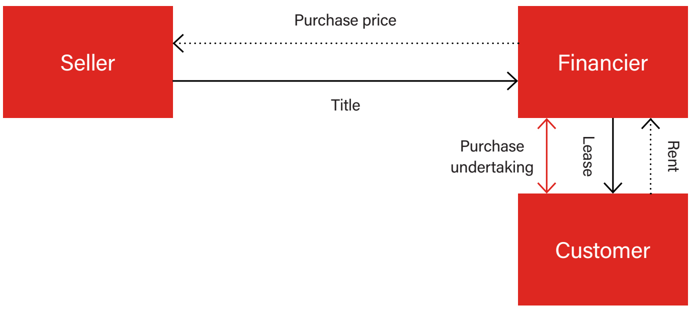
During the term of the ijara, fixed payments are made as rent (which typically represents an agreed profit plus a margin for the financier holding the property until the end of the term). These payments must be agreed at the outset, although it is widely accepted that payments may be reviewed and adjusted in accordance with any fluctuations in a conventional benchmark.

The ijara structure can be used where the customer has a right of occupation only, but it is more likely to be combined with an option for the customer to purchase the title to the property at the end of the term (known as an ijara wa iqtina) or with a diminishing musharaka (see below). There is no requirement for a charge over the property because the title is held by the financier and the customer's ownership is governed by the ijara lease (but security will often still be taken over the agreements).

Diminishing musharaka

The financier and customer co-own the property in question and the legal estate is held by the financier. The proportion of beneficial ownership held by each party in the property at the start of the financing reflects their respective financial contributions to the purchase of the property.

Figure 4



At the same time, the financier grants a lease of its beneficial interest in the property to the customer and the rental payments represent the financier's agreed profit and margin (which can be reviewed as set out in the ijara structure above) (see Figure 4). Each time a payment is made, the customer also purchases a share of the financier's interest in the property and so, over time, the proportion of the property owned by the customer will increase (see Figure 5).

Figure 5

When the customer has acquired all the financier's share in the property, legal title will be transferred to the customer and the lease terminated. However, for the period that title is held by the financier, the same considerations as set out above for ijara structures in respect of risk and management of the property apply.

Istisna'a

In an istisna'a structure, the customer commissions the financier to undertake the construction of the property and the financier will charge for this (the purchase price) and in parallel the financier commissions a third party contractor to undertake the construction (the sale price). The difference between these prices represents the profit for the financier.

Unlike the above structures, title to the property remains with the customer until the end of construction, at which point it transfers to the financier. This structure also typically requires the financier to enter into a direct contractual relationship with the contractor and take on additional risk of the credit and performance of the contractor, which may not be attractive to the financier.

The price payable for the product must be fixed at the outset with both parties but it does not need to be fully paid in advance. It can be paid in instalments or deferred in full to be paid on completion of construction.

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