

Islamic Commercial Property Lending

By Allan Griffiths

As a commercial property lender with more than 20 years' experience in conventional banking, my experience in joining an Islamic bank six months ago has proven to be fascinating and has brought with it an extremely steep learning curve!

Demand for Islamic Finance

My first surprise was to discover just how much demand there is for Islamic property finance. Several recent events appear to have combined to create a significant increase in demand for Islamic financial products:

Firstly, there is a strong political will in the UK to create a level playing field for Islamic finance. There appear to be three drivers for this:

1. The need to make almost 2 million Muslims in the UK feel more included in UK society.
2. A desire to ensure that the City of London maintains its dominance as a global financial centre.
3. A growing government need to access funding from Middle Eastern entities, leading to a need to issue Sukuk.

The first UK government Sukuk is currently scheduled to be issued sometime during 2008. Other practical measures so far taken by the government to encourage Islamic finance are the abolition of double stamp duty on Islamic mortgages and efforts to rectify the adverse effect of value added tax on Islamic financial products. The abolition of double stamp duty has been a significant move for Islamic property finance solutions.

Secondly, the US subprime debacle and the subsequent global aftermath have resulted in many conventional banks severely curtailing their lending activity in the property sector, which has caused many debt-driven investors to look for new sources of funding. One can't be involved in property finance without talking to the Jewish commu-

nity, and interestingly, my existing non-Muslim clients have all been very supportive and willing to use Islamic finance. A typical comment was, "It's economic. If the product works and the price is right, there is no reason why we wouldn't deal with you."

And finally, there is a very strong Muslim investor community in the UK who have had to borrow conventionally in the past just because there was no other alternative available to them. However, with the establishment of Islamic banks in the UK, and the availability of Islamic finance via windows of conventional banks, these investors are now provided with a choice. As a consequence, we are seeing many new opportunities from this source, not only for property finance but for a wide range of financial structures.

Development / Mezzanine Finance

In my past life as a conventional banker working for the London branches of overseas banks (which were mainly German), I was mostly involved in big-ticket senior debt transactions funding standing investment property and was hardly ever involved in equity or mezzanine arrangements or development finance.

As a consequence of Islamic ideas about risk sharing and because of the fact that Islamic banks currently have relatively small balance sheets compared to conventional banks, Islamic banks are much more interested in equity and mezzanine finance opportunities. From a personal point of view, I find this type of finance much more rewarding because it enables me to take a holistic approach and work in partnership with our customers. To state the obvious, every deal needs 100 percent funding from somewhere, but typically, there is a gap between the equity contribution our client can make out of his own funds and the level of senior debt available to him. Our job is to bridge that gap. It's no coincidence that the Bank of London and The Middle East logo is a stylised

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bridge. I think this approach is much appreciated by our customers, who generally say that they find it a refreshing change from the conventional approach, and it does give rise to some very interesting opportunities and challenges. For example, we are currently working on a transaction in which the senior debt is provided conventionally, and we take on a mezzanine tranche Islamically. It's also worth noting that a considerable amount of research and product development is taking place right now, so the range of available Shariah-compliant products and techniques is expanding all the time.

Property Funds

Another area of business which has huge potential for Islamic banks is the management of property funds to be set up and managed on behalf of clients. For example, in one case I am currently involved with, a public sector institution wants to invest in UK property. The company has a requirement for a regular steady income stream from the fund, but also wants an overall return of 8 percent per annum. In order to achieve this, we are planning to assemble a portfolio of core income-producing institutional-quality assets. The remainder of the fund will be used to fund equity positions in commercial developments in

prime town centre locations. This part of the fund will be geared to enhancing returns further. With oil at \$100-plus per barrel, the demand from Middle East entities for fund management and investment services in London looks set to increase substantially over the next few years.

Market View

Until recently, the UK commercial property market had seen an unprecedented period of sustained growth over the past decade or so. This had been underpinned, at least in part, by a low-inflation environment which was achieved in 1997 by transferring responsibility for setting interest rates from the Chancellor of the Exchequer to the Monetary Policy Committee of the Bank of England and, at the same time, setting the Monetary Policy Committee a monthly inflation target.

However, the sub-prime crisis mentioned earlier proved to be the shock which triggered a loss of confidence in UK commercial property values and a sharp reversal in yield trends occurred. This in turn caused many journalists to liberally use words such as "crash" and "slump." Whilst a downturn is always steeper than the upslope and therefore seemingly more alarming, it is nevertheless an integral feature of a cyclical market. We should never forget that the property market is inherently cyclical. If you believe that the upslope is a straight line which carries on forever, you will invariably lose money.

There is currently a lively debate amongst some of the market commentators as to whether the market has bottomed out or whether there is more bad news to follow. Nevertheless, it is the case that property in the UK at the moment looks cheap in comparison with other major European destinations and offers a substantial number of investment opportunities.

In the City of London, development activity continues at a high level, with some streets looking like large building sites, and it remains to be seen how robust tenant demand proves to be. My guess is that it will remain quite strong, because if it starts to weaken, some intended developments will just be mothballed until the next cycle.

The views represented in this paper are those of the author and do not necessarily represent those of BLME.