

Islamic finance and real estate in France

A White Paper



Understand: take action

Acknowledgments

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Foreword

For Paris to develop as a financial hub, a framework that permits Islamic capital to be invested in the economy has to be created if we are to attract more foreign capital.

The overall purpose is to facilitate the investment in France of capital held by international investors – regardless of whether they wish to invest along traditional lines or prefer a specific framework, as with Islamic capital. This objective reinforces the wider support for the financing of projects run by French companies and local communities, particularly in the real estate sector; and the growth of France's economy.

Paris Europlace's Islamic Finance Commission has, at the behest of the authorities, helped to define a legal and tax framework that should enable French and foreign financial institutions to offer their clients Shariah-compliant financing and investment products in much the same manner as they currently offer traditional financial products.

In support of this, tax and regulatory guidelines on Islamic finance products have been published, and new guidelines could be published soon.

Islamic finance and real estate in France sets out the principles of Islamic finance, describes how they apply to real estate and puts forward concrete proposals within the French legal framework to develop the attractiveness of France in this area.

This White Paper represents a decisive stage in the development of Islamic finance in France. Everyone who has contributed – and who continues to contribute – deserves the warmest of thanks. Particular congratulations go to Norton Rose Group and DTZ Asset Management, who, together with a number of other firms, banks and financial operators, have played an active role in gathering and disseminating this information.

Although the authorities have not been able to assess all the proposals made, the initiative deserves to be strongly welcomed and encouraged. Adding further to the efforts of many, it will supplement the work undertaken in France over the last three years on this issue.

We hope that this White Paper will persuade a wide audience of the opportunities offered by Islamic finance.

Thierry Dissaux
Special Adviser to the Head of the French Treasury
Financial Affairs and Islamic Finance

Preamble DTZ Asset Management

DTZ Asset Management specialises in real estate asset management on behalf of third parties and advises domestic and international clients on their investment strategies. In this capacity, we are ideally placed to observe new investment preferences.

In 2008, the reforms of the Grenelle Environment Forum and the growing interest of firms in sustainable development prompted us at DTZ¹ to create a dialogue with the real estate divisions of major companies clarifying questions and expectations around sustainable development as it applies to real estate. From this dialogue we formulated proposals, summarised in The White Paper on Sustainable Real Estate.

In the same manner, DTZ Asset Management now wishes to contribute to the understanding of Islamic finance as it applies to real estate. Our presence in the Middle East since 1975 has helped us to become familiar at an early stage with this form of ethical finance. The French government, aware of growing interest in this form of financing, is seeking to develop the Islamic finance market in France; we can act as facilitator, taking into account the wishes and constraints of market participants who wish to place religious principles at the heart of their investment strategy. The workshops – organised with representatives of companies, consultancy and professional service firms, public bodies and religious leaders – have enabled us to formulate proposals to meet the needs of anyone operating in this market.

The development of a French Islamic finance market in real estate may require adaptations to France's legal and tax framework. We have, accordingly, teamed up with the international legal practice Norton Rose LLP, which has a proven track record in Islamic finance expertise.

We are pleased to present this White Paper, Islamic finance and real estate in France, which will, we hope, help to clarify the concerns of people operating in this market and suggest practical means to facilitate the development of Islamic finance in France.

Patrice Genre
Managing Director

¹ DTZ Holdings plc, listed on the London stock exchange (10,000 staff in 43 countries and 148 cities).

Preamble Norton Rose LLP

Norton Rose Group is a leading international legal practice with offices across Europe, the Middle East and Asia Pacific. The Group comprises Norton Rose LLP, Norton Rose Australia, Norton Rose Canada, Norton Rose South Africa and their respective affiliates, and has 2500 lawyers in 38 offices worldwide. Leading Canadian law firm Macleod Dixon will join Norton Rose Group on 1st January 2012.

We have a long history in banking and finance, so, naturally, were one of the first legal practices to take an interest in Islamic finance. Today, we have one of the largest practices in the field. More than 50 lawyers across the Group's offices advise Islamic financial institutions, traditional banks, large companies and governmental organisations.

We are innovators in Islamic finance. Our teams were part of the establishment of the first Islamic retail bank network in the West and have for many years advised the UK government on taxation to be applied to Shariah-compliant transactions in the UK. We have also been involved in a number of Shariah-compliant structured financing transactions in the Gulf States and in the UK and Asia.

Recognising the emergence of a European Islamic finance industry and France's role in it, our Paris lawyers – specialists in business law, finance and taxation – participated early on in thinking through the development of the French market and the spread of this new method of ethical financing.

In the course of a number of Shariah-compliant real estate acquisitions, we worked together with DTZ Asset Management. Our common interests led us to join forces to consider how to develop Islamic finance; in late 2009, we organised a series of workshops bringing together experts to analyse what adaptations might be necessary to the French legal and tax framework in order to promote its expansion.

This collaboration resulted in the White Paper, Islamic finance and real estate in France, which we are delighted to present to you today in its English version. We hope that it will shed new light on Islamic finance and facilitate its expansion in our country.

Laurence Toxé
Avocat au Barreau de Paris - Partner

Introduction

Islamic finance has become a widely debated topic in France: in 2008, the Senate Finance Committee organised two roundtables to gain an insight into the activities of the French financial industry in the Islamic finance market and determine which legal and tax reforms should be adopted to facilitate its development.² In the ensuing months, Paris Europlace published a report,³ the objective of which was to give the financial centre of Paris the edge in this market, notably in the face of competition from London. Then, in November 2009, the Ministry of Finance hosted a conference on this theme.⁴

Islamic finance is of such interest to the authorities because it is now an inescapable reality. Whatever reservations some may have concerning this alternative form of finance, the issue is no longer one of knowing whether we should be for or against its development, but of finding the tools to structure it as well as possible in France and to see to it that the French Islamic finance market can compete with, or even supplant, the London market.

The French Islamic finance market is still in its infancy and has, until now, been driven by investment in the corporate real estate sector (offices, warehouses and shops) and potential extension into residential real estate.⁵ The first Shariah-compliant real estate transactions were carried out by Middle Eastern institutional investors starting in 2003.⁶

The Ministry of the Economy and Finance is now actively promoting the development of this market. Against this background, corporate real estate consultancy firm DTZ Asset Management and international legal practice Norton Rose LLP set out to assess these first few years of French market activity involving Islamic finance in the real estate sector. Six workshops were held from November to December 2009, in which investors, religious experts, political representatives, lawyers, notaries, bankers and multinational firms were all able to have their say and to respond to the following questions: Which transactions have been successful? What are the current obstacles? Which legal and tax tools do operators lack? What are these professionals' expectations in relation to the French market?

Islamic finance and real estate in France provides an overview of the proposals of the workshop participants and gives a new perspective to anyone interested in the real estate aspects of Islamic finance. It has a dual purpose: to establish a status report on current practices in Islamic finance; and to formulate proposals intended to facilitate development of the French market.

We hope that this collective work – which has enabled practitioners to compare their ideas and investors to air the tangible concerns that they need to address – will contribute to the development of this new market.

² Jean Arthuis, *La finance islamique en France: quelles perspectives?* Information report No 329 (2007–2008) on behalf of the Finance Committee, submitted to the Senate on 14 May 2008.

³ E Jouini and O Pastré, *Jouini & Pastré Report, Enjeux et opportunités du développement de la finance islamique pour la place de Paris*, Paris Europlace, December 2008.

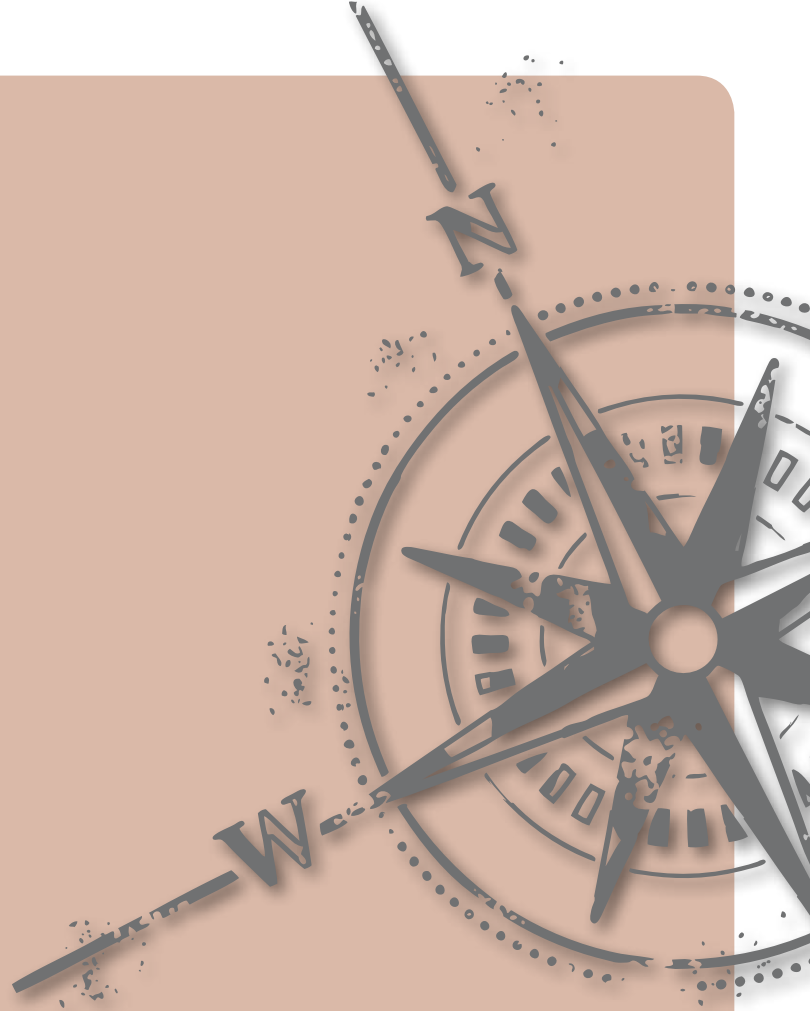
⁴ Premier Cercle/Norton Rose conference on the theme: *Islamic finance, what are the opportunities for French companies?* 3 November 2009.

⁵ Real estate assets are particularly suited to the specific nature of Islamic finance, as explained in chapter 2.2.

⁶ According to DTZ's observations.

Chapter 1

A White Paper



What is Islamic finance?

1. What is Islamic finance?

1.1. Finance with an Islamic religious preference

A few introductory remarks should be made on the subject of Islamic finance. The micro-economic notion of preference is an interesting starting point.

1.1.1. Finance and preferences

- The notion of preference

The micro-economic theory states that individuals develop preferences during their lifetime which determine their choices and actions. With regard to finance and asset allocation, an economic agent expresses preferences in terms of risk exposure, investment horizon, types of asset or geographic location. These preferences and their weighting define a set of constraints,⁷ demarcating a field of possibles on the basis of which the economic agent acts.⁸

- Non-financial preferences

Although most investors ultimately only aim to optimise the risk/return ratio where return is understood solely in the financial sense of the word, some investors may wish to factor non-financial criteria into the calculation of an investment's performance – such as environmental conservation, respect for human rights and dignity, or complying with philosophical or religious principles. While this attitude is less common, it is no less genuine and is the defining criterion in the arena of 'alternative finance'.

- Islamic finance and religious preference

Islamic finance belongs to this last category and may be defined as finance structured around a religious preference – a religious preference that complies with the principles of Islam.

1.1.2. From Islamic law to Islamic finance

- Compliance with Koranic law

For Muslims, the principles of Islam are explained by Islamic law or Shariah. As defined by Abdel Maoula Chaar, Shariah is “a set of standards, values and rules that aim to ensure that Man leads his life according to divine will”.⁹ It proposes a link between the spiritual and worldly aspects of human existence, indicating

⁷ The notion of constraint is to be understood here in its mathematical sense, namely as an element that surrounds, circumscribes and demarcates a field of possibles.

⁸ See Retour sur dix ans d'investissement immobilier en France, Insights No 9, DTZ Research Paris, September 2009, pp. 3–8.

⁹ A M Chaar, Charia: Principes directeurs et stratégie, in La finance islamique à la française, un moteur pour l'économie, une alternative éthique, supervised by J-P Laramée, Secure Finance, 2008, p. 34.

how these spheres are organised and coexist. In other words, “it constitutes the practical component of Islam and governs as much the expression of faith in God (prayer, fasting, ablutions, etc.) as Man’s political, social and economic interactions.”¹⁰ Consequently, Shariah cannot be reduced to a set of prohibitions and obligations that must be respected by believers; for Muslims, it is a means of – the original path to – salvation.

- Sources of Islamic law

Shariah is underpinned by a body of texts including the Koran, the *Sunna* and the *Fiqh*.

Muslims regard the Koran, their first sacred source, not as an interpretation of the word of God but as the literal transcription of the divine word.

The second source of Muslim law, the *Sunna*, brings together the comments and interpretations of the Prophet, the appointed interpreter of the Koran, on the sacred book. It is composed of *Ahadith*.¹¹ The *Sunna* is both a moral and a legal work. It lays down the legal system for numerous commercial instruments and techniques, from which flow the rules governing Islamic banking and financial products.

The *Fiqh* gathers together the explanations debated following the death of the Prophet and on which there is consensus. The *Fiqh* is Islamic legal jurisprudence as construed by Shariah scholars through a process of analogy (*Qiyas*), legal preference (*Istihsan*), general interest (*Istislah*) and customs and traditions (*urf*). ‘When the entire community of specialists acknowledges the validity of one of the opinions derived using these techniques, it will have force of law. This process, known as *Ijma*, is of paramount importance, as the opinion giving access to this status becomes, in turn, a source of law on the basis of which rules can be derived.’¹² When consensus is reached on the interpretation of a precise point, this will have force of law, thus sustaining Shariah.

- Islamic finance, application in finance under Islamic law

Islamic finance seeks to comply with aspects of Islamic law related to commercial and financial transactions. Its scope is in practice far more extensive than that, in keeping with a religious system that proposes a particular worldly and spiritual order, a point we will return to later.

¹⁰ Ibid. p. 35.

¹¹ A Hadith (plural Ahadith) denotes a narration from the Prophet Muhammad and, by extension, a collection that contains all the traditions related to the words and deeds of the Prophet and his companions, generally referred to as the ‘traditions of the Prophet’.

¹² A M Chaar, op. cit. pp. 39–40.

1.1.3. Differences and similarities between Islamic and traditional finance

- Islamic finance, a special model?

All religious systems have their own reasoning and internal consistency. Does it follow that Islamic finance is necessarily incompatible with conventional finance? Historically, Islamic finance has been seen as somewhat at odds with capitalist finance and the socialist system, as ‘a third way’. The gap is not necessarily that wide: although some national economies are organised primarily according to the principles of Islam, Islamic finance often coexists alongside traditional finance; the borders between the two have a tendency to become blurred. Some countries – such as Malaysia, Lebanon, Turkey, Iran, the Gulf States and the UK – have also amended their legislation, enabling them to have a dual system where traditional finance rubs shoulders with Islamic finance. Major international banks, such as HSBC, Citigroup and Deutsche Bank, have developed Shariah-compliant financial products or have created subsidiaries specialising in this market. From this standpoint, Islamic finance is a form of finance with an alternative preference; it just so happens that this preference is Islamic, in the same way that other investors may favour an environmental preference.

- Islamic finance and socially responsible investment

Islamic finance is therefore not unrelated to socially responsible investing (SRI), which highlights a set of preferences intrinsically linked to ideologies (and therefore excluding sectors such as arms, pornography and tobacco, which are deemed to be morally reprehensible, and investing in projects that comply with the principles of sustainable development). Historically, the link between SRI and religion is also recognised: “SRI as it is practised today can trace its roots back to approaches motivated by the Christian faith, whether Catholic or Protestant (...) In France, the first two ethical funds were launched with Christian religious investors in mind.”¹³

Yet this religious background has all too often ended up becoming blurred. Religious preferences have become secularised: the justifications for displayed preferences no longer refer to a specific religious system but to a social morality or even an ethic devoid of religious reference. A striking example is French legislation on interest rates. Although it specifies a legal limit on interest rates charged to private individuals, it has freed itself from the religious justification of the ban on usury – a ban whose roots can be traced back to the Old Testament.¹⁴

Thus, although the issue of justification is avoided and only the concrete consequences for the investment –which sectors to exclude? which to favour? which packages? – are relevant, Islamic finance (structured by a religious preference) and SRI are not mutually exclusive; they may even converge. Islamic finance may then be regarded as a component of ethical finance. In practice, this similarity is not so evident:

¹³ Novethic, Finance islamique et ISR: convergence possible? Novethic, May 2009, p. 5, the two funds being Nouvelle Stratégie 50, launched in 1983, and Hymnos, launched in 1989, ‘specifically to meet the demand of religious congregations’.

¹⁴ ‘And if thy brother be waxen poor, and fallen in decay with thee; then thou shalt relieve him: yea, though he be a stranger, or a sojourner; that he may live with thee. Take thou no usury of him, or increase.’ Old Testament, Leviticus, 25:35–37.

Novethic comments, rightly, that although “Islamic finance and SRI are compatible, [...] they do not converge naturally, as firstly they do not draw on the same expertise and secondly they do not target the same clients.”¹⁵

- A move towards Islamic finance without an ideology or exclusively Islamic substratum?

This theoretical convergence between religious finance and SRI, along with the natural tendency of the markets to adopt best practice, suggests that it is possible to design a form of finance that would respect the preferences and certain modalities of Islamic finance without referring exclusively to Islam. This would be a standardised form of finance, underpinned by universal foundations, freed from strict religious reference. The advantage of this ‘thinning process’ is obvious: to make preferences less suspect, at least outwardly, of being tainted with ideology and bias and so more likely to please the great majority, beyond the usual divisions of religious identities.

1.2. Spirit, principles and instances of Islamic finance

Islamic finance is frequently described from a practical, operational viewpoint, focusing on the constraints, restrictions and modus operandi of this form of finance. It is important to remember that Islamic finance stems from a theological vision endowed with a specific coherence. The constraints, restrictions and modus operandi are the practical consequences of a complex theological system whose rules of interpretation have been constantly evolving since the seventh century. Of course, the intention here is not to present the Islamic theological system. The discussion below will mention just a few key aspects that underpin Islamic finance.

1.2.1. The spirit of Islamic finance

- God, society and the individual

First and foremost, the Koran specifies that God is the owner of natural resources. Man is but the temporary beneficiary, the momentary user. True, he may use them, but he also has the obligation to make sure that resources are preserved for future generations. Individuals therefore find themselves immediately in a relationship with a superior power, firstly with God, but also with the human community. As in any religious system, the individual only has meaning in relation to a whole. This perspective defines what Louis Dumont calls a ‘holistic’ system.¹⁶ Consequently, the issue of solidarity; aid for the destitute; and, more generally, the economic and spiritual development of communities are all at the heart of the preoccupations of Islam. This holistic reasoning differs considerably from the solipsistic reasoning that prevails in traditional finance, in which the individual’s satisfaction is key.

¹⁵ Novethic, op. cit., p. 19.

¹⁶ See L. Dumont, *Essais sur l’individualisme. Une perspective anthropologique sur l’idéologie moderne*, Paris, Le Seuil, 1985.

- A different economic rationale

When they are applied to commercial and investment transactions, Islamic principles influence the economic rationale: “Although in ‘traditional’ finance the norm that governs decisions taken by an economic agent is the optimisation of the risk/return ratio of its investments, profitability is neither the sole nor the main decision criterion for Islamic operators.” The economic calculation includes, *inter alia*, the general interest. Furthermore, the purpose of the investment is taken into account and must satisfy certain norms.

- An approach based on the sharing of profits and losses

The Islamic approach has a major impact on the relationship between lender and borrower, compared with traditional finance: it offers contractual fairness. Risk management is shared between parties. This dilution of the risk taking is carried out in the form of the players’ participation in the ownership of the asset. This risk sharing implies, in certain types of contract, sharing of the profits and losses.

1.2.2. The five principles of Islamic finance

There are five principles underpinning Islamic finance. The first three create prohibitions while the other two define the practices.

- *Gharar* and *Maysir*

Islam prohibits the presence of uncertainty (*gharar*) and speculation (*maysir*) in a contract or sale.

As Abdel Maoula Chaar notes, “...the term *gharar* [...] is extremely difficult to translate. Its Arabic root, *taghreer*, means ‘putting one’s assets in danger without knowing it’. The word itself has connotations of ‘uncertainty’, ‘risk’, ‘going astray’ and ‘deception’. There is *gharar* in a business transaction when the consequences are concealed or unclear.”¹⁷ The prohibition of *gharar* proscribes any uncertainty about the performance of a contractual obligation.

Qimar or *maysir* refers to any form of contract in which the right of the contracting parties depends on a random event. This principle is found in games of chance and betting. *Maysir* actually comes from the Arabic adjective *yasir* meaning ‘easy’. Before the advent of Islam, Arabs regarded these games as an easy way of winning money.

This dual prohibition of uncertainty and speculation logically leads to a ban on hazardous and dangerous speculation.

¹⁷ A M Chaar, *Charia: Principes directeurs et stratégie*, in *La finance islamique à la française, un moteur pour l’économie, une alternative éthique*, supervised by J-P Laramée, *Secure Finance*, 2008, p. 33.

- Prohibition of *riba*

One of the principles of Islamic finance is the prohibition of *riba*. The term *riba* derives from the verb *raba*, meaning 'to increase'. It refers simultaneously to the notion of interest rates (value added to initial capital) and usury. This principle prohibits excessive and unjustified gain generated by an imbalanced transaction. It is the theory of excess (*riba al-fadl*) and surplus resulting from the stipulation of a term that unfairly benefits a party (*riba al-nasia*).

- Rule of *haram* or illicit sectors

Islam prohibits certain activities, and Islamic finance is duty-bound to respect these prohibitions. The rule of *haram* therefore proscribes engaging in activities associated with games of chance, tobacco, pornography, alcohol, the pork industry, offensive arms and the leisure industry. Once again, the restriction of financial activity to certain areas of activity is not specific to Islamic finance; it merely alters the scope of what is considered acceptable and what justifies the illicit nature of a thing.

- Obligation to share profits and losses

The three preceding negative principles have as a consequence two positive principles. The first is to organise the sharing of profits and losses. The ban on lending money in return for interest (*riba*) and on speculation (*maysir*) forces the investor or financial backer to behave like an entrepreneur. By being remunerated according to the performance of underlying assets, they are also exposed to any losses. Ultimately, their status is akin to a shareholder or sleeping partner.

- Tangible asset backing

The second positive principle is the need for tangible asset backing of investments. Islamic finance requires that investors become involved in the real economy, preventing to some extent the disconnection observed at the present time between financial markets and economic reality.

Thus, the principles of Islamic finance express a desire to promote social justice and fairness as well as the freedom to do business and an attitude of moderation.

1.2.3. Shariah Boards

- Validation bodies

Islamic finance cannot exist without *ethical compliance committees* (also known as Shariah supervisory boards). These committees play a key role in the development and monitoring of compliance of Shariah-compliant products and their follow-up and assisting with Islamic finance activities.

Members of Shariah Boards must have twofold, or even threefold, expertise: they must be acknowledged as having expertise in religious interpretation and must fully understand the mechanisms that help structure financial products; they must also have an understanding of the legal and tax context in which their opinions are expressed.

Shariah Boards issue opinions (*fatwa*) on the compliance of products with Shariah; these products are monitored on a daily basis by an audit committee placed under their supervision. The Shariah Boards may be internal or external to banking and investment structures.

As they have the power to invalidate a decision taken by a bank's board of directors, the Shariah Boards represent a major body of power, or even counter-power. Their opinions have such a decisive commercial and strategic impact that their members have to possess operational skills in addition to their religious expertise.

The composition of Shariah Boards is also a key component of the bank's marketing policy. The high profile of committee members denotes credibility and quality in the eyes of the bank's clients, who place a high degree of confidence in internationally known and respected figures. However, there is a relatively small circle of people who are indeed competent and recognised at an international level compared with the growing needs of banks.

- Differing interpretations

The absence of any international authority and the multiplicity of Shariah Boards means that their members may at times express different sympathies and interpretations. Geographically, there are two centres for the interpretation of Koranic law: the Persian Gulf and South-East Asia.

- A tendency to converge

There is, however, a growing tendency to converge. The number of people qualified to sit on these validation bodies is low and the number of requests for ruling on the Islamic nature of banking and financial products has increased. As a result, Shariah scholars now often sit simultaneously on several Shariah Boards, thereby helping to keep to a minimum the disparity in expressed opinions.

Furthermore, regulatory bodies are gradually being set up, helping to standardise practice. Set up in February 1990, the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) has defined accounting and Shariah-compliant standards for Islamic financial institutions, while the Islamic Financial Services Board (IFSB) establishes prudential rules and guiding principles targeted at those involved in Islamic finance, including banks, insurance companies and operators in the capital markets. It is important to emphasise that the AAOIFI and IFSB standards are not mandatory. The Shariah Boards

at Islamic banks may therefore have different – and at times even contradictory – interpretations from those adopted by scholars on regulatory bodies. Nevertheless, the AAOIFI standards are generally those adopted by the banks of the Gulf Cooperation Council (GCC).¹⁸

1.3. Islamic finance in history

1.3.1. A brief history of Islamic finance

- Genesis of Islamic finance

Given that the Koran sets out for believers the social and economic order to adopt, one can trace Islamic finance back to the seventh century.

However, the modern formalising of Islamic finance really developed in the 1940s and was driven by Shariah scholars who “theorised the possibility of creating an alternative financial system to traditional finance that complied with the teachings of the Koran”.¹⁹ Early instances in a more concrete form appeared from the 1950s onwards with, for example, the creation of the Pilgrims’ Administration and Fund (Tabung Haji) in Malaysia in 1956. The Jouini & Pastré Report recalls that “in 1970 the creation of the Organisation of the Islamic Conference (OIC) bringing together a large number of Muslim countries put the economic precepts of Islam back on the agenda. In 1973, in the wake of the quadrupling of oil prices and the Arab oil embargo, the OIC decided to set up the Islamic Development Bank (IsDB). Based in Jeddah in Saudi Arabia, this institution paved the way for a system of mutual aid founded on Islamic principles. The Dubai Islamic Bank (DIB) – the first Islamic private all-purpose bank – was founded two years later in 1975. The first Islamic insurance company, Islamic Insurance Company of Sudan,²⁰ emerged on the scene in 1979.”

- Growth years (late 1970s to late 1990s)

Islamic finance witnessed a phase of substantial growth over the next two decades: Islamic financial institutions and products grew in number, the volume of assets managed in compliance with Islamic law increased, while operators extended their geographical scope, venturing outside the Middle East, first into South-East Asia, then into North Africa from the 1980s onwards.

During this period, certain major international banking groups positioned themselves in this market, opening Islamic subsidiaries. HSBC set up HSBC Amanah in 1998, while Deutsche Bank and Citigroup began offering Shariah-compliant financial products.

¹⁸ The Gulf Cooperation Council (GCC) includes Saudi Arabia, Bahrain, Qatar, Oman, the United Arab Emirates and Kuwait.

¹⁹ O Pastré and K Gecheva, La finance islamique à la croisée des chemins, Les nouvelles frontières de la finance, in *Revue d'économie financière*, No 92, 2/2008, p. 199.

²⁰ E Jouini and O Pastré, Jouini and Pastré Report, Enjeux et opportunités du développement de la finance islamique pour la place de Paris, Paris Europlace, December 2008, p. 43.

In the UK, the authorities sought to facilitate the development of Islamic finance in the early 2000s. The first requests for Islamic bank approval were submitted during the same period, opening the door to the creation of several dedicated banks offering Islamic products, including The Islamic Bank of Britain (2004) and the European Islamic Investment Bank (2005).

- Islamic finance at the dawn of the third millennium

In the early 2000s, several factors had a major impact on the development of Islamic finance.

International unrest and sustained growth in the emerging markets sparked a rapid rise in the price of oil, causing an exponential increase in revenues of the oil-producing countries in the Middle East. This situation enabled several oil-producing countries to take advantage of a highly surplus balance of payments.

This situation, of a sudden hike in oil prices, was not unprecedented and had already been observed after the oil shocks of 1973 and 1979. Yet, as noted by O Pastré and K Gecheva, the impact was not the same: "The allocation of capital invested abroad by the oil-exporting countries underwent a radical change. Foreign direct investment (FDI) and portfolio investments represented nearly half of the current account surplus of the oil-producing countries in 2005. But in the 1980s the share of these assets was negligible in the flow of foreign capital from the oil-producing countries."²¹

The allocation of this capital invested abroad was significantly modified following the 9/11 attacks and subsequent US foreign policy: investors in the Middle East repatriated some of the capital invested in the United States in order to reallocate part of it to Europe and the emerging markets.

On an international scale, this change of asset allocation helped to strengthen a sense of identity among investors in the Middle East. Islamic finance benefited from this evolution: since 2003, the number of Islamic funds worldwide has risen sharply, from around 200 to nearly 700 in 2009, while we have witnessed the opening of new Islamic banks, such as Noor Islamic Bank (Dubai), established in January 2008 with share capital of \$1 billion, and Al Inma Bank (Saudi Arabia), created in 2006 with share capital of around \$3 billion.

Furthermore, the interest in Islamic capital is no longer solely a matter for Muslim countries: Islamic finance has experienced a boom in western Europe and more specifically in the UK over the last 10 years.

The current financial crisis has in all likelihood intensified the desire to tap this oil windfall.

²¹ O Pastré and K Gecheva, La finance islamique à la croisée des chemins, Les nouvelles frontières de la finance, Revue d'économie financière, No 92, 2/2008, p. 203.

1.3.2. Industrialised countries faced with Islamic finance

- Islamic finance and macro-economic imbalances

During its development, Islamic finance has also benefited from macro-economic imbalances between certain emerging markets and industrialised nations. The financial and economic crisis that began in 2007 has made them obvious. To put it simply, while some emerging markets (notably China and the oil-producing countries) have stockpiled considerable monetary reserves over the years, thanks to an increasingly large oil surplus and high savings rates, some industrialised nations, headed by the United States, have tended to finance their growth using foreign capital. The economic crisis has forced governments of the industrialised nations to embark on economic redeployment policies, although, faced with the markets' concerns surrounding the viability of sovereign debt, many European states have implemented restrictive budgetary policies. To meet the large capital requirements of European states, it is natural to veer towards financing originating from countries with a surplus balance of payments. It then transpires that part of this capital is subject to a religious preference. Given the scale of Islamic capital, governments of industrialised countries are compelled to exercise a degree of pragmatism.

- A more resistant form of Islamic finance?

Furthermore, the financial crisis has highlighted certain problems affecting the financial system and the abuses resulting from particular market activities; modifications to the international financial system are currently under consideration. The upheaval caused by the crisis has called into question previously prevailing practices and has aroused fresh interest in alternative forms of finance, including Islamic finance. This renewed interest is especially keen as Shariah-compliant products have tended to be more resilient to the collapse of the markets. If we compare the S&P 500 index with the S&P 500 Shariah index,²² we observe an obvious correlation between movements in both indices as well as better resistance of the Shariah index since the financial crisis. The obligation for investments to be backed by tangible assets and the ban on speculation (*Maysir*) have prevented investors from being exposed to toxic assets, which have been at the heart of the global financial crisis.

Islamic finance does not, however, remain off-market; the correlation between both indices was maintained during the crisis period and the S&P 500 Shariah index plummeted after the end of 2007. The impact of the financial crisis was all the more significant on the Islamic finance market as the underlying assets were exposed to depreciation, led by real estate assets. The average return on Shariah-compliant real estate funds fell from 28 per cent in 2007 to 13 per cent in 2008.

²² The S&P 500 Shariah index is the Shariah version of the S&P 500 index, which reflects the price trend of the top 500 US-listed companies.

The announcement made in early December 2009 concerning Dubai World's difficulty in paying its debt, part of which was structured by the issue of Islamic bonds (*Sukuk*), shows that Islamic finance also experiences the ups and downs of the market and is not immune from risk-taking and instability. However, to think that 'the crisis in the emirate weakens the credibility of Islamic finance'²³ is to misunderstand what Islamic finance is about.

- Opportunities and win-win solutions

Islamic finance generates opportunities and solutions at both macro-economic and micro-economic level.

At the macro-economic level, there are, on the one hand, Middle Eastern investors who, not having local economies capable of satisfactorily absorbing their vast savings surplus in full, look towards the European and North American economies in order to safeguard their funds; on the other hand, there are the industrialised countries that have very large financing requirements and a financial industry eager for additional capital to invest. Access to a share of this financial windfall is conditioned by one constraint: satisfying a set of rules – those of Islamic finance. The realism displayed by the governments of western European countries today facilitates the integration of Islamic finance into their economies.

At a micro-economic level, Islamic finance has demonstrated its relevance as regards return, invalidating, at the same time, the idea that imposing ethical criteria on investment would restrain the yields obtained. This observation makes Islamic finance appealing to investors guided by personal religious preferences as well as to more conventional investors motivated by optimising the risk/return ratio.

1.3.3. Islamic finance and secularism

It seems difficult a priori to mention Islamic finance without referring to Islam and, more generally, to the religious sphere. Consequently, would the introduction of Islamic finance in France infringe the principle of secularism, the founding principle of French society?

- The principle of secularism in France

Article 1 of the 1958 Constitution states that "France shall be an indivisible, secular, democratic and social Republic. It shall ensure the equality of all citizens before the law, without distinction of origin, race or religion. It shall respect all beliefs."²⁴ The principle of secularism implies an organisation of state services exempt from any reference to religion, in which the state maintains an impartial position with regard to each religious tradition and practice. Thus, the French state must not demonstrate a religious preference through the adopted legislation or conduct of its representatives.

²³ M Roche, La crise dans l'émirat ébranle la crédibilité de la finance islamique, article published in Le Monde, 1 December 2009.

²⁴ See www.legifrance.gouv.fr/html/constitution/constitution.htm.

- Secularism and private law

On the other hand, citizens have the option of expressing and demonstrating religious preferences by acting in accordance with them, subject to compliance with applicable law. These preferences may form the essential criteria of a transaction, in which two private parties enter into agreements based on their preferences, regardless of whether they are religious, philosophical or artistic. The principle of secularism, which guides the running of state institutions, does not, therefore, have an impact on the content of contractual agreements concluded between two private parties.

- Islamic finance covered by two normative frameworks

Of course, a contract under private law must be in keeping with the framework of French legislation. We must therefore ask ourselves whether the operation of Islamic finance is compatible with national legislation, not in its structuring with the principle of secularism, but rather from the viewpoint of the tools this form of finance needs in order to function. The UK authorities have already responded positively to this question by adopting specific – notably fiscal – measures aimed at ensuring the tax impartiality of certain Islamic financing deals in relation to conventional financing transactions fulfilling the same purpose.²⁵ In France, the position that seems to have prevailed is that “[French] substantive law helped create and distribute products compatible with Koranic law”, while also emphasising that there was “legal and tax friction” that could be dealt with “by simple reforms that are not necessarily legislative”.²⁶

Furthermore, as previously indicated, the religious conformity of a Shariah-compliant financial product depends above all on the opinion of the Shariah Board.

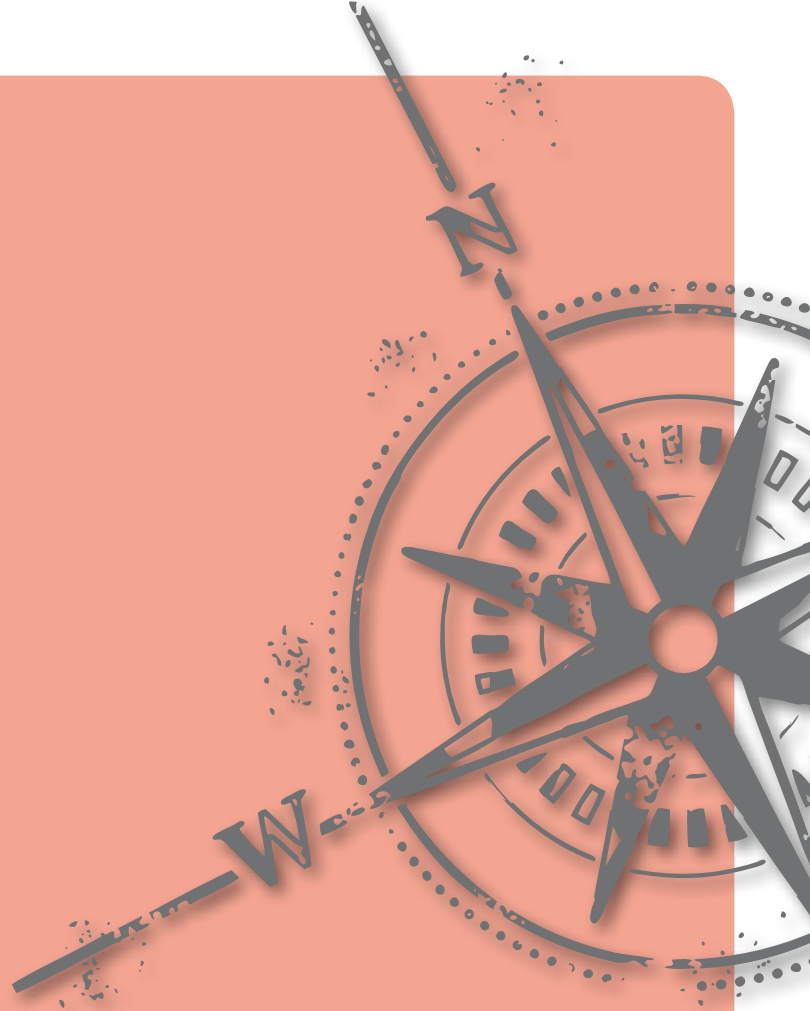
Thus, to be applicable in France, Islamic finance must comply with two separate normative authorities, each providing its own normative framework with national substantive law on the one hand and the religious corpus on which the religious experts rely in order to issue their *fatwa* on ethical conformity on the other. In order to function, the latter normative authority must absolutely operate within the broader framework proposed by French substantive law.

²⁵ The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 clarified the tax treatment of Sukuk.

²⁶ Information report by the Senate, 2008, p.9.

Chapter 2

A White Paper



**A global market with
major potential, still
untapped in France**

2. A global market with major potential, still untapped in France

2.1. Islamic finance market

2.1.1. Clout and geography of Islamic finance

- Clout of Islamic finance

Many different figures have been circulated regarding the size of the Islamic finance market. The Jouini & Pastré Report estimates, for example, that it represents around €700 billion and should be worth some \$1,300 billion by 2020. In 2006, the rating agency Standard & Poor's suggested a figure of nearly \$4,200 billion. This figure is based on two premises: firstly, that the developing, emerging and developed countries attain banking service penetration of 50, 75 and 100 per cent respectively; secondly, that all deposits placed by Muslims are subject to Shariah-compliant investments. Consequently, this figure is put forward as the absolute theoretical limit – without incorporating, however, the idea that non-Muslims may be interested in Islamic finance.

Regardless of the accuracy of the figures put forward, the Islamic finance market has grown considerably in the last few years, with an average annual growth rate of Islamic assets of between 10 and 15 per cent since 2000.²⁷ Its size means that it can no longer be ignored.

- Geographic distribution of Islamic finance

The Islamic finance market divides into two major geographic areas: the Middle East; and South-East Asia (including Malaysia). In 2007, according to estimates from International Financial Services London (IFSL), Iran represented 38 per cent of global Islamic outstandings, with \$235 billion, followed by Saudi Arabia (14 per cent market share at \$92 billion) and Malaysia (market share of just over 10 per cent).

With \$18 billion in Islamic outstandings, i.e. 3 per cent of global outstandings, the UK is Europe's leading financial centre for Islamic finance. In Europe, the UK is generally thought of as the trailblazer in this market: the first Islamic bank, Islamic Bank of Britain, opened there in 2004. For its part, Germany has taken initiatives involving the Islamic bond market (*Sukuk*)²⁸ and Islamic insurance and reinsurance products (*Takaful*), and approval of an Islamic deposit bank has been granted to Kuveyt Türk Participation Bank.

- The future of Islamic finance

What could the future hold for Islamic finance? For more than 30 years, the price of oil has followed an upward trend; it is likely that, faced with the demand from emerging markets for fossil-based energy sources and the drying-up of oil reserves, oil prices will remain high. The oil-exporting countries of the

²⁷ O Pastré and K Gecheva, La finance islamique à la croisée des chemins, Les nouvelles frontières de la finance, in Revue d'économie financière, No 92, 2/2008, p. 204.

²⁸ In 2004 the German federal state of Saxony-Anhalt issued a €100 million bond in Sukuk form.

Middle East are therefore certain to benefit from substantial oil revenue. This money will fuel the Islamic finance market for as long as its owners regard Islam as a factor shaping their choices.

2.1.2. France and Islamic finance

- Continental Europe intends to catch up

The preceding figures underline the extent to which continental Europe has remained for so long on the fringe of the Islamic finance market, despite its mature financial industry. However, in the last two years, for reasons mentioned above, the authorities of several countries and a number of players in the private sector – notably HSBC Amanah, Société Générale, BNP Paribas, Allianz Global Investors, Deutsche Bank and UBS – have started to create better means of gaining access to Islamically-financed capital and are now better able to offer solutions tailored to investors seeking Shariah-compliant products.

- France comes out in favour of Islamic finance

The French authorities are now seeking to compete with the UK to become the European leader in Islamic finance. Minister of the Economy Christine Lagarde confirmed this on 25 March 2010 when she said, “France wishes to promote the development of Islamic finance and, along with other European financial centres, become the preferred point for receiving capital of Islamic origin in Europe and in the euro zone in particular.”

- France’s advantages

France can claim at least two major advantages over the UK. Firstly, it is in the euro zone. It can therefore offer investors in the Middle East better protection against the risk of depreciating assets due to exchange rate fluctuations – even though the euro zone is at the moment experiencing difficulties associated with the indebtedness of some Member States and the lack of coordination of national budgetary and fiscal policies. Secondly, the French real estate investment market is mature, diversified and liquid.

The initial regulatory advances and the desire shown by the authorities to promote this alternative form of finance encourage us to believe that the Paris market may quite soon be just as attractive as London.

2.1.3. Islamic finance: which players, which products?

- Commercial banks – key players

In 2006, according to IFSL estimates, three-quarters of Islamic finance assets were shown on the balance sheets of commercial banks and more than one-tenth on those of investment banks. Nevertheless, the situation of financial institutions and banks holding Shariah-compliant assets varies depending on the country and the nature of the products on offer.

- Can Islamic finance exist alongside conventional finance?

Although a few countries such as Malaysia and Iran have financial and banking markets largely organised in compliance with Shariah, in most cases Islamic banks exist alongside conventional banks. Few Islamic banks are able to function alone on large-scale, international financing projects, making coexistence with conventional banks all the more necessary.

Since the 1990s, a number of conventional banks have set up subsidiaries to attract investors interested in Shariah-compliant products. HSBC opened Amanah Finance in Dubai in 1998; UBS established *Noriba* Bank in Bahrain in 2002; and BNP Paribas set up an Islamic banking unit in Bahrain in 2003. Other banks have developed dedicated in-house departments, offering both Shariah-compliant and conventional products. This is true of Dresdner Bank AG, ABN Amro, Barclays, Société Générale and Cacib (formerly Calyon).

- A mutually beneficial coexistence

The players in the Islamic finance market may therefore be the same as those in conventional finance. Islamic finance players may also be interested in assets traditionally belonging to the conventional finance market. This was the case in 2004 when, as part of a Shariah-compliant LBO deal, the French manufacturer of fitted kitchens and bathroom furniture Vogica came under the control of an investment fund (originating in the First Islamic Investment Bank); similarly, UK manufacturer Aston Martin was bought out in 2007 by a consortium led by two Islamic financial institutions (Investment Dar Company (TID) and Al-Deem Investments) for £479 million. In other words, the systems are not impervious to one another. High-profile projects such as these do not always obey economic logic, of course, which explains why these transactions might have experienced a few management problems during the market turnaround.

As public and private organisations in France seek to structure financing for high-calibre projects – notably through major Government initiatives such as Grand Paris, Grand Emprunt, Plan Campus – there will be opportunities to demonstrate this closeness between the two systems.

2.2. Islamic finance and real estate

2.2.1. Real estate: an asset class compatible with Islamic finance

Islamic finance is not an abstract concept: it concerns specific, concrete reality – investments, transactions, acquisition of an interest in companies and projects – which is subject to a set of rules and principles (the exclusion of some industry segments; the prohibition of certain types of financial arrangement; the requirement for backing by tangible assets). Real estate assets appear to be quite compatible with these requirements. There are three reasons for this.

- A tangible asset

Islamic law requires that financial activity be linked to genuine economic activity, in other words, you have to back an investment with a tangible asset. Real estate assets are, plainly, tangible. Real estate investment therefore meets this obligation.

- Compatibility with debt capacity

Islamic finance imposes a maximum level of indebtedness on the target company of less than or equal to 33 per cent, defined by analogy with widely accepted practice when creating indices. This maximum amount allows the company to develop, while also avoiding committing to excessive risks that may jeopardise its existence and so go against the prohibition of speculation and risk – *maysir* (or uncertainty – *gharar*). Provided the investment relates to the purchase of a direct real estate asset and not of the company holding the asset, this obligation is not a problem for the real estate investor.

- A lawful activity

Islamic finance prohibits any unlawful activity – *haram*. This prohibition is easy to respect, given that the rule of *haram* does not relate to the real estate asset itself; it involves a restriction on the income generated by operating the asset. The lessee's activity conducted in the leased property must comply with the rules of Islam.

For these three reasons, the real estate market is an appealing option to investors seeking to abide by Shariah. The steep increase in volume of Shariah-compliant real estate projects since the early 2000s highlights this compatibility and appeal.

2.2.2. Key mechanisms of Islamic real estate investment

Several key legal mechanisms underlie Shariah-compliant real estate transactions. These mechanisms are summarised below and discussed in greater detail in chapter 4.

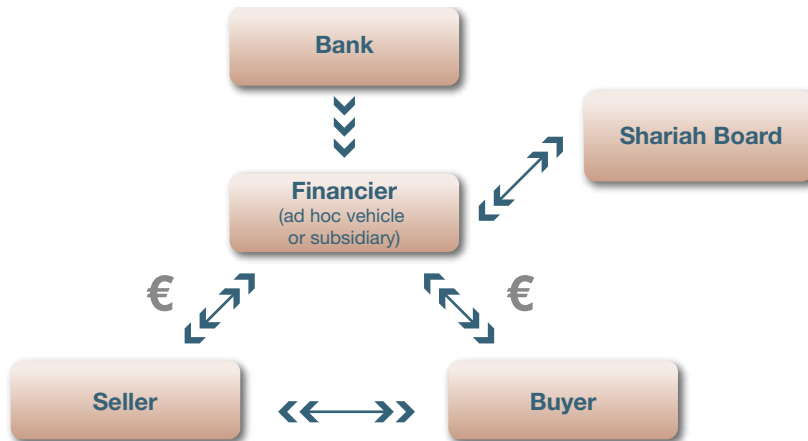
Key instruments	Description and use	Legal structures under French law liable to be used
<i>Murabaha</i>	Contract of sale, under the terms of which a seller sells an asset to a financial intermediary, which then sells it on by instalments to an end buyer at a marked-up price.	Transaction analysed as two successive contracts: a cash sale contract between the seller and the financial intermediary; followed by an instalment sale contract concluded between the financial intermediary and the end buyer.

<i>Ijara</i>	Contract under which an entity makes a real estate asset available to a client for a specific period in return for the payment of rent. The <i>Ijara contract</i> may be accompanied by a commitment to sell or an option to buy, exercisable on the expiry date or during the contract.	Mechanism that is similar to finance leasing (<i>crédit-bail</i>) governed by articles L 313-7 et seq. of the Monetary and Financial Code, location-accession ('rent-to-own') governed by law No. 84-595 of 12 July 1984 defining real estate ownership, and hire purchase.
<i>Istisna'</i>	Construction contract under the terms of which a client asks a third party to build a property for him in return for a price payable in advance, on completion or in instalments. Ownership of the property to be constructed must be transferred to the client on completion.	Mechanism that is fairly similar to buying off-plan (<i>vente en l'état futur d'achèvement</i>) governed by articles 1691-1 et seq. of the Civil Code and L 261-1 and R 261-1 et seq. of the Construction and Habitation Code.
<i>Mudaraba</i>	Investment technique in the form of a partnership contract between an investor (<i>Rab al-maal</i>), contributor of capital, and an entrepreneur (<i>Mudarib</i>) who provides his expertise. The contributed funds are invested in Shariah-compliant transactions and the profits generated are shared and distributed between investor and entrepreneur according to an apportionment agreed on signing the contract.	The structure closest to the principles of <i>Mudaraba</i> is an undertaking for collective investment in real estate (<i>organisme de placement collectif dans l'immobilier, OPCl</i>), governed by articles L 214-89 to L 214-146 and R 214-160 to R 214-222 of the Monetary and Financial Code.
<i>Musharaka Moutanakissa</i>	A variant of <i>Musharaka</i> , this is a technique whereby the financier's participation in the partnership with the investor decreases as his participation in the <i>Musharaka</i> is transferred to the investor and his initial investment is repaid, as well as any return.	Similar to a non-trading real estate investment company with gradual ownership (<i>société civile immobilière d'accession progressive à la propriété, SCIAPP</i>), governed by articles L 443-6-2 to L 443-6-12 and R 443-9-4 of the Construction and Habitation Code.
<i>Sukuk</i>	Hybrid financial securities, the return on which is indexed to the performance of one or more underlying assets held by the issuer.	Tracking bonds or non-voting shares (article L 228-37 of the Commercial Code), the return on which paid to holders may be indexed to the economic performance of assets held by the issuer.

- Parties involved in a Shariah-compliant real estate transaction

Whether for *Ijara* or *Murabaha*, the collaboration of several parties is required. The diagram below illustrates how each party is involved in the three stages of the transaction.

Involvement of the various parties



Source : DTZ

Note that the parties to a Shariah-compliant transaction are the same as those involved in a conventional real estate transaction, with the notable exception of two additional parties: the Shariah Board, which must rule on the validity as regards Shariah of the arrangement being considered fairly upstream of the transaction so as not to block it at a later stage; and the financial intermediary which provides the instalment purchase contract.

Furthermore, the complex structure of a Shariah-compliant transaction strengthens the influence of certain parties, notably legal and tax specialists, who must also work within the legal constraints of the various jurisdictions affected in the transaction.

2.2.3. Islamic finance applied to real estate: the situation in France

- A fledgling Islamic real estate market

In France, the Shariah-compliant real estate market is still in its infancy. The first Shariah-compliant real estate transactions were only carried out in 2003.

There are no exact statistics, but it can reasonably be estimated that the combined volume of Shariah-compliant real estate investments carried out in France between 2003 and 2008 represents just under €3 billion, for around 50 transactions (unit assets).

The largest transaction was the acquisition of the luxurious Paris Conference Centre for nearly €450 million in 2007 by the Qatari fund, Barwa Real Estate. This was part of a project to convert the building into a top-end hotel and business centre in partnership with the Peninsula brand.

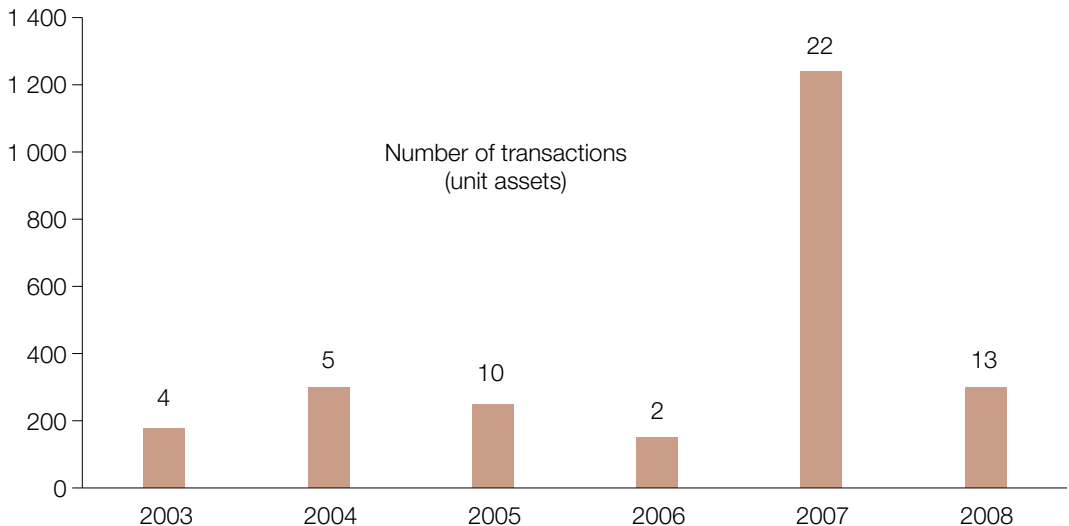
- Middle Eastern investors on the lookout...

The development of Shariah-compliant real estate transactions has been concomitant with the increase in real estate investment from the Middle East. Indeed, between 2000 and 2007, investments made by Middle Eastern investors in European corporate real estate increased six-fold, jumping from €500 million in 2000 to over €3 billion in 2007, including €1.4 billion in the UK and €800 million in France.

- ...for a mature French real estate investment market

Investment from the Middle East, Shariah-compliant or not, should continue to increase in the years ahead. The French real estate market boasts a number of clear advantages that attract these investors, as shown in the table below. The market depth, liquidity, product diversity and the professionalism of its operators have already attracted nearly €3 billion of investment in tertiary real estate, with over 40 deals, despite the tendency for Islamic investors and institutions to carry out transactions between themselves.

Shariah-compliant real estate financing



Volume of real estate investment in France originating from the Middle East

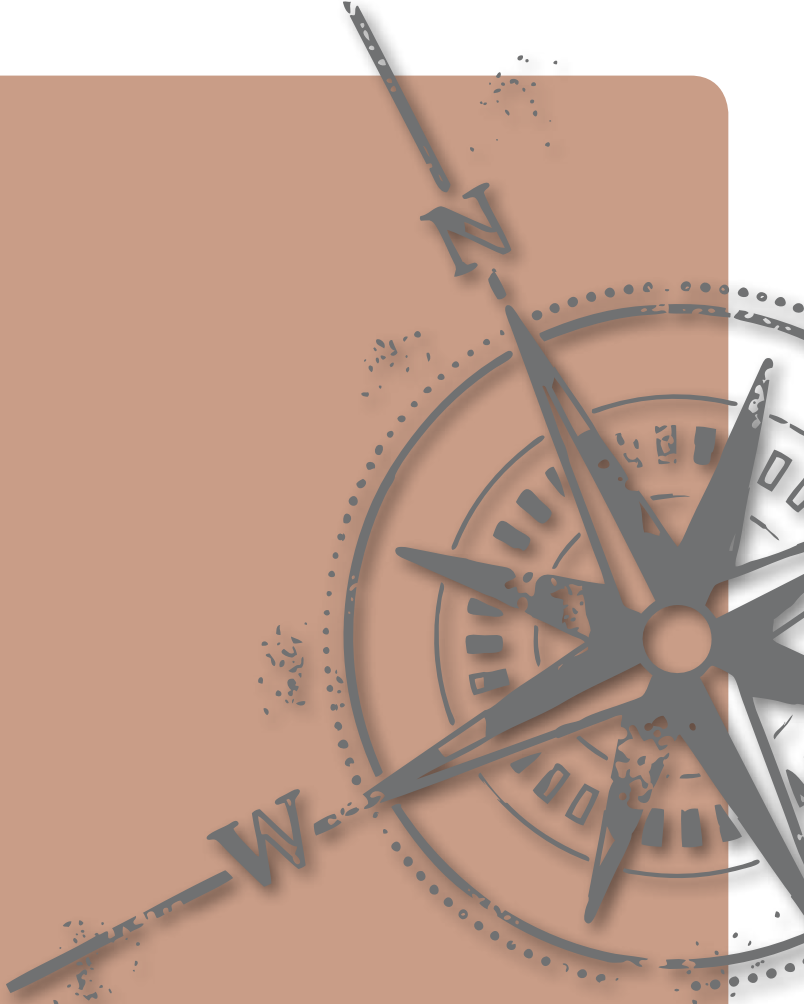
Bank	Unit real estate transactions	Volume in millions of euros
Qatar banking institution	>10	900
Qatar investment fund 1	<10	600
Dubai banking institution	<10	100
Qatar investment fund 2	>10	300
Bahrain investment fund	<10	200
Qatar investment fund 3	<10	700
	>40	>2 800

Source: DTZ based on estimates

Chapter 3

A White Paper

Islamic finance practices and parties' expectations



3. Islamic finance practices and parties' expectations

Banking, finance and legal professionals, together with Shariah scholars and representatives from the authorities, met at a series of Islamic finance workshops between October and December 2009. The workshops, organised by the corporate real estate consultancy firm DTZ Asset Management and the international legal practice Norton Rose LLP, provided a forum to exchange experiences in Islamic finance, understand potential obstacles and formulate clear proposals for the future development of Islamic finance in France. A summary of proceedings is documented below.

3.1. Is France prepared to embrace Islamic finance?

3.1.1. An obvious political desire, but with mixed results

- A clear desire

There is strong political determination that the French Islamic finance market should be able to compete with that of the UK. The Minister of the Economy, Christine Lagarde, has repeatedly expressed this desire at private seminars (e.g. the Islamic Finance Forum and Euromoney) and annual Europlace meetings. The Islamic Finance Commission, set up within Paris Europlace, is analysing legal and fiscal hindrances and the Ministry of the Economy and Finance is undertaking market consultations with a view to drafting new tax guidelines on Islamic finance. In autumn 2009, the Ministry appointed Thierry Dissaux as its preferred – and sole – point of contact for issues concerning Islamic finance.

Furthermore, the French authorities, in particular the Autorité des Marchés Financiers (AMF), were encouraged to take a position on Islamic finance following questions raised by investors and fund managers concerning undertakings for collective investment in transferable securities (UCITS) and *Sukuk*. Discussions followed on whether to change the French law on fiduciary transfers (*fiducie*) in order to clarify the *Sukuk*²⁹ regime and its restrictions, and a comparison made of the French legal framework with international practice, particularly the UK.

- The temptation of the UK model

The UK is frequently held up as an example. London is Europe's leading Islamic finance hub, but should this model be followed in France? Islamic finance in the UK, based on common law, developed in response to the immigrant Muslim population's demand for local management of their savings.

²⁹ In its decision No 2009-589 of 14 October 2009, the Constitutional Council sanctioned article 16 of a private member's bill aimed at promoting SMEs' access to credit and improving the functioning of the financial markets. The Constitutional Council considered that this article, related to the law on *fiducie* and aimed at adapting the *fiducie* law regime to allow the issuance of *Sukuk* in France, constituted a rider, i.e. a provision having no connection with the original subject matter of the bill.

The French situation is completely different. The Civil Code has applied since it was established by Napoleon Bonaparte on 2 March 1804 and capital flows to North African countries originate from Muslim household savings.

Replicating the UK model is not necessarily the right solution. The French market will only be able to develop if supply matches demand. French demand for Shariah-compliant banking products is difficult to estimate, however, and French banks remain reticent. Although market data is sparse, several reports and polls show the existence of a genuine market with strong potential. In addition to research developed in the Jouini & Pastré Report on behalf of Europlace,³⁰ a poll was carried out by the French Institute of Public Opinion (Institut français d'opinion publique, IFOP) in 2008 of 530 people living in France who claimed to be Muslim. Conducted on behalf of the Association d'Innovation pour le Développement Economique et Immobilier (AIDIMM) and the Islamic Finance Advisory & Assurance Services (IFAAS), this poll concluded that: "47% of Muslims living in France would be interested in a savings contract and 55% in loans that respect Islamic ethics." The poll also revealed that the latter would "definitely or probably be willing to accept an additional cost compared with conventional lending".

- Institutional obstacles

The findings, however, fall short of the authorities' expectations. In the commercial real estate sector alone, only about 40 Shariah-compliant deals have been carried out in France in the last six years, totalling around €3 billion. Although these transactions highlight the existence of French expertise in sectors compatible with Islamic finance principles, market development is slow compared with the UK, which is the European leader in Islamic finance with around €10 billion in Islamic assets.³¹

Is this the result of a problem with supply and demand, structuring an embryonic market, or institutional obstacles? With regard to the latter point, it has been emphasised that the determination shown by the Ministry of the Economy and Finance has not always been consistently followed by all government institutions. While certain senators have displayed a keen interest in Islamic finance, notably through the work of the Finance Committee and its Chairman, Jean Arthuis,³² National Assembly deputies' ideas on the subject are not so well formed. Whereas deputies are elected by direct electoral suffrage, senators are elected by indirect universal suffrage; it is no doubt easier to adopt a position in favour of Islamic finance when in less direct contact with voters.

However, an ambivalent, wait-and-see stance could well be highly detrimental to the development of the French market. France is in direct competition with the UK and must also deal with growing competition in neighbouring countries such as Germany, Spain and Luxembourg. To escape this institutional impasse, deputies have to appreciate the benefits France could derive from a mature French Islamic finance market.

³⁰ Ibid. footnote 3

³¹ Estimates by The Banker for 2007.

³² J Arthuis stated that he had discovered Islamic finance in March 2007 on a trip to the Gulf States. The Senate organised a conference on this subject the following year.

A number of documents have been published on Islamic finance, many referenced in this White Paper, but workshop participants unanimously agreed that an educational paper on Islamic finance should be prepared specifically for members of the French Parliament. A report could be commissioned by, for example, the National Assembly's Finance Committee, to explore the positive impact of Islamic finance on regional economies. Alternative financing methods could appeal to locally elected members who are likely to seek fresh sources of funding given the international economic crisis and government deficits.

Proposition

Promote Islamic finance through a Parliamentary report on the potential benefits of a mature and innovative Islamic finance market for France and its regions.

3.1.2. Globally perplexed investors

- Genuine interest or opportunism?

During a symposium organised on 3 November 2009 at Bercy on Islamic finance,³³ the Minister of the Economy, Christine Lagarde, pointed out once again that by adopting a position in favour of Islamic finance, France was not acting out of opportunism but from intrinsic interest in this form of finance. This clarification was made because the Minister was fully aware that certain investors would be suspicious of France's late adoption of this position, even though Islamic finance has existed for more than two decades. Whatever the authorities' true motivation, arguments have been put forward that the recent economic and financial crisis could be a positive factor in developing the Islamic finance market in France. Four comments can be made in this respect.

Firstly, products compatible with Islamic principles have, by and large, been more resilient in the collapsing financial markets, a factor to be observed when formulating investment strategy and assessing product risk and performance.

Secondly, Islamic finance is sometimes presented as an alternative to conventional finance, both in terms of products and governance.³⁴ If the current economic and financial crisis is seen as the result of structural problems affecting conventional finance, then this lends new grounds of legitimacy to Islamic finance, which could appear, at least in part, to be a source of new structuring principles. This viewpoint was given prominence by Lagarde in the declaration for new international regulations.³⁵

³³ The 'Islamic finance, what are the opportunities for French companies?' conference, organised by Premier Cercle, in association with The Wall Street Journal Europe, was held at the Ministry of the Economy and Finance on 3 November 2009.

³⁴ Although from the viewpoint of structuring principles Islamic finance displays distinctive characteristics in relation to conventional finance, a number of specialists have shown how Islamic finance is able to 'coexist' with conventional finance, particularly in the special file of the *Revue Echanges* of June 2009, and Hervé de Charrette's contribution. Islamic finance is therefore not necessarily incompatible, in principle, with conventional finance as the notion of 'alternative' might suggest.

³⁵ Within the framework of the G20 conferences, Christine Lagarde stated: 'The principles that we are defending in favour of international regulation are at the heart of Islamic finance.'

Thirdly, the contraction of the debt market since 2007 and the economic stimulus packages promoted by various governments have widened the gap between the supply and demand of financing. Under these conditions, people in charge of project financing may be tempted to look for alternatives to traditional financing, especially via sovereign funds of Muslim countries. However, it must be remembered that Islamic investors in the Middle East have not been spared the negative impact of the crisis on their assets. Despite the absence of toxic assets on their balance sheets, these investors have experienced depreciation across the entire real estate market. The dollar, in which oil is traded, has sharply depreciated in recent months, particularly against the euro, and the investment capacity of Middle Eastern sovereign funds in the euro zone has declined.

Lastly, the financial crisis has resulted in the collapse of the real estate market, both residential and commercial. In the United States and Europe, rental values have plummeted and reduced corporate demand has forced down sale price expectations. The creation of a Shariah-compliant financial product could attract new Muslim investors to the French real estate market, particularly the residential sector.

- Secularism

Investors have shown concerns about France's ability to reconcile the potential incompatibility between Islamic finance and secularism, the founding principle of the French democratic model.

It was reiterated during the workshops that there is no contradiction between Islamic finance and the principle of secularism in theory, as the latter excludes religious considerations from political or administrative power, and religion is relegated to the private sphere. Islamic financial transactions are structured so as to relegate them to the private sphere, so there is no conflict with the secular principle. However, Islamic finance continues to be identified in public debate as a threat to secularism.³⁶

Islamic investors can but observe the conflicting discourse that gives the impression of a 'schizophrenic' France, torn between a desire to welcome new investors and its difficulty in finding a place for religion in society. Faced with these paradoxical signals, investors view the French market with caution.

Proposition

Create a structure to unite private initiatives which promote the Islamic finance industry in France.

The subject of Islamic finance is, and will remain, a delicate topic. Its practical method and application must be quickly demonstrated in order to escape the ideological and theological discussions.

The challenge is to develop a representative voice for this nascent industry. Well-known French figures should support initiatives to encourage greater public understanding. The French Institute of Islamic Finance, founded by the former Minister of Foreign Affairs, Hervé de

³⁶ We can quote, for example, a point of view published in *Le Monde* of 20 November 2009 under the provocative title 'La finance islamique menace la laïcité française' ('Islamic finance threatens French secularism') to which Hervé de Charrette, the former Minister of Foreign Affairs, responded with a text entitled 'Non à une nouvelle diabolisation de l'Islam, oui à la finance islamique dans l'intérêt de notre pays !' ('No to the new demonisation of Islam, yes to Islamic finance in the interest of our country!') published on www.oumma.com on 6 January 2010.

Charrette, could be a suitable platform for carrying out this work through raising awareness and uniting forces around a common vision of Islamic finance in France.

- Terminological malaise

The terms 'Islam' and 'Islamic' arouse associations in France that are sometimes negative. Numerous anecdotes were mentioned during the workshops on the semantic shifts, slips of the tongue and confusion with the adjectives 'Islamic' and 'Islamist' and on associations made between Islam and terrorism. Could this explain the reluctance to make clear and public declarations in favour of Islamic finance, due to the reputational risk of being accused of defending Islamism, terrorism or money laundering?

For banks declaring a position in favour of Islamic finance, the risk would be loss of clients. For politicians, the risk would be loss of voters. Although no published study currently allows us accurately to assess the impact of this risk, it acts as a brake on the development of Islamic financial products in France. In such a context, the position adopted by the Minister of the Economy in favour of Islamic finance seems courageous. Nevertheless, current discussions on the subject organised by the Ministry of the Economy and Finance only concern specialists and the subject is rarely reported in the general press.

- In favour of clear discourse

Faced with the terminological malaise, what is the best way of 'selling' Islamic finance from a marketing perspective? Should we continue to use the expression 'Islamic finance', or should we use terms such as 'ethical finance', 'alternative finance' or even 'Mohammedan finance'?

The workshop participants were hesitant about removing, or even reducing, the reference to Islam in favour of a more 'sellable' concept to the general public. If the aim is to stimulate demand for a product, the essential criterion of which is its adherence to the prescriptions of Islam, attempting to erase this link seems absurd. Using the term 'ethical', for example, would be to dismiss the specific nature and history of this form of finance, even though it belongs to the same moral spectrum as ethical finance. The question is whether Islamic finance is a form of finance that can be accepted.

Furthermore, it was emphasised during the workshops that it is too late to change the terminology. The expression 'Islamic finance' has already been embraced by the authorities. Any change in terminology at this stage would deprive Islamic financial parties of that achieved so far. Discussions on Islamic finance have, until now, largely been a matter for the specialists, investors and bankers that the government wanted to see carry out direct investments. The French authorities have rarely adopted a position on subjects intended for the general public.

The workshop participants repeatedly expressed that it is imperative that the politicians and authorities develop an educational, and

Proposition

Demonstrate the depth of the national and regional market in a high-quality communication plan directed at international investors.

calm, discourse on Islamic finance to enable the market to tailor its products for the French economy. Islamic finance must be shown to be at the service of the real economy, assisting entrepreneurs in their search for capital and funding. A high-quality, consistent communication plan should be implemented by the local authorities showing that real projects can be delivered with the new financing methods, which the traditional banks are no longer willing or able to provide. There is no shortage, after all, of national and regional infrastructure, energy and capital projects (e.g. Grand Emprunt, Grand Paris, Plan Campus) from the authorities and SME networks.

3.1.3. ... and cautious when faced with the legal and tax context

- Investors confronted with a less familiar legal environment

To Islamic investors, the French market may appear harder to access than other markets because it is based on civil law, rather than the common law principles which underpin systems in the UK, Gulf States and Malaysia.³⁷ Investors will therefore require a greater degree of immersion in French legal traditions.

This also applies to Shariah scholars sitting on Shariah Boards, more often than not educated at English-speaking universities.

Note that some North and West African countries such as Algeria, Morocco, Tunisia and Senegal have legal systems based on a tradition of civil law. Some of the workshop participants concluded, therefore, that the development of the Islamic finance market in countries with a tradition of civil law would benefit from the tools developed for organising the Islamic finance market in France.

- Investors confronted with 'cost' factors

Islamic investors are confronted with a number of additional costs that penalise their activities and curb the development of an Islamic finance market in France. The additional costs arise from various sources:

> Additional cost associated with legal structuring

Islamic finance relies heavily on legal structures due to the use of ad hoc vehicles that comply with both national regulatory constraints and Shariah. This generates set-up and management fees, resulting in additional costs compared with conventional arrangements.

> Additional cost associated with tax friction

The increase in the number of these structures may cause tax friction. The Ministry of the Economy and Finance have issued tax regulations in order to reduce this so that Islamic financing is not penalised in tax terms in relation to conventional financing where the end purpose is the same.

³⁷ Civil law can trace its roots back to Roman law and constitutes a complete system of codified rules. Common law is essentially built on the teachings of case law.

➤ Additional cost associated with transferring risks

Certain Islamic finance contracts include the sharing of losses and profits between creditor and debtor. This implies a transfer of risk from the debtor to the creditor. This increased risk taking on the part of the creditor, usually a credit institution, is inevitably passed on to the debtor, who will therefore pay an additional cost compared with a transaction structured via conventional financing.

➤ Additional cost associated with monitoring compliance

Setting up a standing Shariah Board in a bank, or the occasional use of an independent committee, for Islamic financing transactions will also entail additional costs compared with conventional arrangements. Indeed, it is common for members of Shariah Boards to receive a monthly fee as well as remuneration case-by-case for large transactions, bearing in mind that members of independent committees are remunerated for each deal on which they are consulted, at rates which have sometimes been criticised.

It is also common for banks to call on the services of auditors specialising in Islamic finance to audit transactions once they have been completed, so as to ensure that they comply with the principles of Shariah. Remuneration of these auditors, which would not occur as part of a conventional arrangement, must also be factored in to the overall cost of the Islamic financing transaction.

➤ Risk of damage to reputation

Another cost to be taken into consideration is the consequence, if any, of reputation damage following positioning in this market: if a conventional bank operating in France decided to broaden its offering to include Shariah-compliant products, would it risk damaging its reputation? The reluctance of conventional banks to enter this niche market could be explained by such a reputational risk assessment. In concrete terms, banks could lose existing or potential clients by positioning themselves in the Islamic financial products market. This hypothesis is, however, difficult to verify: banks based in France have not expressed an opinion on the subject and no relevant study has been published.

For banks, the difficulty lies in considering this potential risk in light of a first entrant position, which would give them a definite comparative advantage. In other words, being first in a nascent market makes it possible to gain loyal clients and a reputation, together with an additional volume of activity that should compensate for any loss of clients.

➤ Additional cost associated with the novelty of Islamic finance products

As with any new product, the conception and distribution of Islamic finance products will inevitably entail additional costs associated with the lack of economies of scale. Furthermore, in the specific case of Islamic finance, the launch of such products requires access to experts capable of analysing them and validating their Shariah-compliant nature. These experts are currently few and far between and still need training in, for example, the specific nature of civil law as opposed to common law.

- Problems leading to additional costs: what is the price elasticity of Islamic finance?

The workshops were unable to put a figure on these various additional costs. The participants emphasised that each Shariah-compliant transaction is different and that it would not be relevant to put forward an average additional cost figure for Islamic financing compared with conventional financing. The low volume of transactions due to the infancy of the Islamic finance market does not currently enable us to obtain sufficient critical mass to provide relevant indications of these additional costs.

However, the issue of additional costs conceals an even more fundamental issue: the price elasticity of Islamic finance. If Islamic finance ends up being more expensive than conventional finance, would end consumers be willing to pay this additional cost? Consumer sensitivity to price is what defines price elasticity.³⁸ Of course, price elasticity is not constant in time and in all countries; the specific context has to be considered.

The workshop participants emphasised the fact that, in the case of public-private partnerships (PPPs), Islamic financing is, of necessity, in strict competition with conventional financing in terms of price. In a call for tenders, the state would definitely have difficulty accepting a more costly solution on the grounds that it is Shariah-compliant. However, in a situation in which conventional investors are lacking, the authorities would be more receptive to other sources of financing.

There is more leeway for considering criteria other than price in the case of private projects. However, it has not been proved that price elasticity is greater for Islamic finance. The workshop participants commented that financiers and consumers alike demanded competitive products and returns compared with those of conventional finance. And if Islamic products are more expensive to purchase in the first instance, the expected returns must frequently be greater, which ultimately makes Middle Eastern investors like any other investors.

3.2. Lessons learnt

3.2.1. What is the potential size of the Islamic finance market in France?

It is difficult to answer this question simply. The Jouini & Pastré Report³⁹ assesses the potential Islamic finance market in France based on three development scenarios, depending on the more or less active policy conducted by the French government (see table below). Both authors consider that in the scenario of a 'sustained opening' as regards Islamic finance, the market could represent a total of €120 billion in assets. According to Jouini and Pastré, this amount is conditioned by the implementation of 10 structuring measures both to attract Islamic investors and to develop the retail market in France.

³⁸ In the case of Islamic finance, the additional cost that consumers are prepared to pay to obtain a Sharia-compliant product could be interpreted as the ethical cost, insofar as there is an ethical benefit which justifies the additional cost paid.

³⁹ Ibid. footnote 3.

Estimate of the potential Islamic finance market in France

€ billions	S1: Status quo	S2: Low-key opening	S3: Sustained opening
Total Islamic assets	10	60	120
of which:			
Islamic FDI	10	56	113
Retail market	0	4	7

Source: Report by E Jouini and O Pastré for Europlace (2009)

Both these economists estimate the potential Islamic finance market in France by grouping together types of assets with foreign direct investment (FDI), including the various asset classes (equities, bonds, real estate, private equity, etc.), on the one hand and 'Islamic' savings markets and retail banks on the other hand.

The proposed estimates presuppose the existence of an Islamic retail banking market, which is not necessarily in evidence. Furthermore, the 'sustained opening' scenario limits the scope of Islamic finance to Muslims, whether private individuals or institutions. There is no evidence to suggest, however, that non-Muslims are not interested in these alternative products. Lastly, as regards the quantitative aspect, we may wonder about the relevance of the hypothesis that clients targeted by Islamic finance are no different from any other clients in terms of asset allocation or consumption of financial products.

In reality, the potential market depends not only on the extent to which France opens up, but also on the objectives the authorities seek to achieve by adapting, where appropriate, the normative framework. These objectives can be grouped together in three possible scenarios.

- Possible scenarios for the French market

- Scenario 1: A market for foreign investors

One hypothesis is that the French Islamic finance market concerns, or should concern, only foreign investors wishing to invest in France within the framework of structures that comply with Shariah principles. We tend to consider that the main investors meeting this criterion are those in the Middle East whose cash stems from petrodollars. This assumption is not completely absurd: the increase in the price of oil has clearly favoured the expansion of Islamic finance in the oil-producing countries, yet, with the notable exception of Malaysia, the bulk of Islamic outstandings are located in the oil-producing countries of the Middle East. The potential size of the French Islamic finance market will therefore depend on France's ability to tap this Islamic capital.

➤ Scenario 2: A market for all Muslims in France

A second scenario could be the development of an Islamic finance market targeted at companies and private individuals living in France, a market that would rely on Islamic banking products marketed by conventional and/or Islamic banks. In this scenario, the 'natural target' for the marketing of these products is, of course, the Muslim population in France. This is difficult to estimate; the figures advanced by various researchers, institutes and policymakers range from 3.7 to 7 million people.⁴⁰

The size of the market would therefore depend on the ability of banks to tap these clients' assets.

➤ Scenario 3: A market for all

If Islamic products are competitive and incorporate the qualitative criteria appreciated by non-Muslims, it would be possible that they would become consumers. In other words, the Islamic preference is no longer the determining factor. This scenario would increase the potential market ten-fold and would only be limited by the savings of households in France. Non-Muslim, Chinese clients represent one of the biggest customer segments for some Islamic banks in Malaysia, for example.

• Presence of Islamic retail banks in France

The issue of potential market size conceals a more basic question which Islamic investors want to be answered: which scenario is favoured in France today? It appears that France has opted for scenario 1, following the example of Luxembourg, which has taken steps to attract Islamic capital, particularly in fund creation and management, yet unlike the UK, which has permitted the development of Islamic banks on its soil (scenario 2), more often than not used solely by the Muslim population.

However, the workshop participants expressed reservations about the French choice. They believed that Islamic investors need a local market to develop their capital collection and financing activity and so perpetuate their presence in France, particularly as the French market offers privileged access to the euro zone. In other words, in the French non-separatist context, they seemed to prefer scenario 3.

• A sufficient number of experts?

There can be no Islamic finance in France without competent human resources to manage the specific nature of its products. The dearth of specialists may seriously curb market development. Conscious of this limitation, and mindful of the international expansion of this market, French universities have recently been training a few dozen specialists a year in Islamic finance (e.g. universities syllabuses at Strasbourg and Paris-Dauphine, dedicated module at ESC Reims and ESC Lille Management Schools). These courses do not provide Shariah scholar training, but familiarise financiers and lawyers with the technical details of Islamic finance.

⁴⁰ The major variance in estimations of France's Muslim population is explained firstly by the fact that public statistics on religion or ethnic origins are banned in France, and secondly by the meaning given to the 'Muslim' category. In 2003 the demographer Michèle Tribalat, of the National Institute for Demographic Studies (Institut National d'Etudes Démographiques, INED) estimated France's Muslim population at 3.7 million; however, in October 2009 the Central Institute of Islam Archives in Germany put the figure at 5.5 million. By way of comparison, on its website www.statistics.gov.uk, the UK's Office for National Statistics estimates the UK's Muslim population at 1.6 million.

This issue also applies to scholars: Shariah-compliant products will have to be validated by Shariah scholars who must be competent in both Islamic and French law. Today there are few competent and accredited scholars who are able to sit on Shariah Boards to give a ruling on products marketed in France. The difference between the French civil law environment and Middle Eastern common law systems, limits the ability of experts located in these countries to apply their expertise in France.

Consequently, it is of strategic interest for France to ensure the emergence of a class of French experts who can bring their expertise and new ideas to the table, enabling organised professional development of Islamic finance Shariah Boards.

Proposition

Facilitate the emergence of a class of French experts through the development of professional certifications and specialised degrees in Islamic finance recognised in the French market and by international Islamic organisations.

3.2.2. The Shariah Boards in question

- Interpretative plurality and consensus of Shariah Boards

The role of the Shariah Board is to give a verdict on whether a transaction is Shariah-compliant by issuing an opinion (*fatwa*). The interpretative plurality of the Shariah Boards was raised and identified as a potential obstacle to its development. Some workshop participants were worried that the diversity of schools, rites and doctrines of the Muslim tradition led to an interpretative pluralism that will hinder the development of Islamic finance in France. For example, is it possible that a Shariah Board consulted by some bank or other will invalidate an opinion issued by a previous Board, obliging the bank to reclassify a product already being marketed? If interpretative differences exist, how do we implement standards related to Islamic conformity which evidently would favour the development of products and financing in accordance with the rules of Islam? What is the reality of these interpretative differences? What are the conditions necessary for interpretative convergence?

► Independence of the Shariah Boards

Experts assessing compliance with Shariah law must be free and prepared to abandon an opinion when faced with a stronger argument. The more Shariah scholars are attached to a particular tradition and school, together with their doctrines and specific theological and interpretative positioning, the less convergence there will be. The same applies if Shariah scholars are subject to external pressure, in whatever form, preventing them from expressing a point of view that may be deemed to be unorthodox. Experts' intellectual independence is therefore a prerequisite for the convergence of views.

The independence of Shariah Boards should free them from suspicion of only serving the interests of the institution that consults them. The experts are fully aware that a product labelled 'Shariah-compliant' will be marketed as such to the public. The experts are an instrument, a cog, a token of confidence, in the

marketing process. In this situation, Shariah scholars must be particularly vigilant that their image is not used against their will. The best way to achieve this is to ensure and accept their independence and to monitor the continued management of products to which they commit themselves via Shariah advisers.

➤ Existence of an institutional framework

Shariah Boards should be overseen by supervisory institutional convergence structures. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) plays precisely this role, set up in 1990 with the objective of “preparing Shariah-compliant, governance and ethical standards for the Islamic financial institutions and industry” within an “independent and non-profit international Islamic institution”.⁴¹

Another model is that of Malaysia, the leading Islamic finance market, where the convergence process has been devolved to the central bank, which rules on what does or does not comply with the rules of Shariah.⁴² Another convergence organisation is the Islamic Financial Services Board (IFSB), which has set itself the objective of “promoting and increasing the soundness and stability of the Islamic financial services industry by proposing global prudential standards and guiding principles for industry”.⁴³

The French regulatory authorities have everything to gain in assimilating the framework implemented by these international Islamic finance institutions. They could, however, take a more proactive approach in order to develop a reference system that follows international standards.

Proposition

To develop a market framework for full compliancy of Islamic products on different levels, accounting, regulation, ethical and governance along with the international standards.

- Shariah Boards in the French legal environment

There is the issue of Shariah Board liability with regard to regulatory bodies and civil and criminal law.

➤ Regulators faced with the issue of liability of Shariah Boards

The Bank of France grants approval to the chairmen and chief executives of banks. In the case of an Islamic bank, French regulators are confronted with the new situation of Shariah Boards, whose place in the banks’ organisation raises problems for regulators. If the opinions of the Shariah Board are a determining factor from an operational point of view, should such boards be required to obtain the same approval granted to officers by the Bank of France? However, the Bank of France cannot grant approval to a religious body. The solution might be to demonstrate the absence of a decisive operational role played by such committees, reducing their action to a consultative role. Yet it is not certain that a reduction in committees’ powers to a ‘consulting’ body will be acceptable to their members. How then do we overcome this deadlock?

⁴¹ See the AAOIFI website at www.aaofi.com/overview.html.

⁴² Regarding the notion of the link between institutional structures and consensus, see Stefan Collignon, *Deliberation and stochastic consensus*, Unpublished papers, Sant’Anna School for Advanced Studies, Pisa, December 2008. Available at www.stefanocollignon.de.

⁴³ See www.ifsb.org.

➤ Civil and criminal liability of Shariah Boards

Regardless of the nature of the link between Shariah Boards and the general management of banks, the board members commit themselves collectively by ruling on compliance with Shariah. In this way, they potentially subject themselves to liability. How can such potential liability be classified as a matter of law and what are its ramifications? Would it be possible for a customer of a bank who was sold an Islamic product to institute proceedings against the Shariah Board for failure to comply with the rules of Shariah? If so, what would happen? Could banks calling on the services of Shariah Boards sue their “service providers” for non-fulfilment of commitments or poor assessments of the Islamic compliance of a product following, for example, its reclassification by a new service provider?

Certain questions can be addressed immediately. Firstly, the opinion of a Shariah Board, whether originating from a state, national or independent institution, is only legally binding on the party that issues it. In this respect, a Shariah Board is comparable to a rating agency.

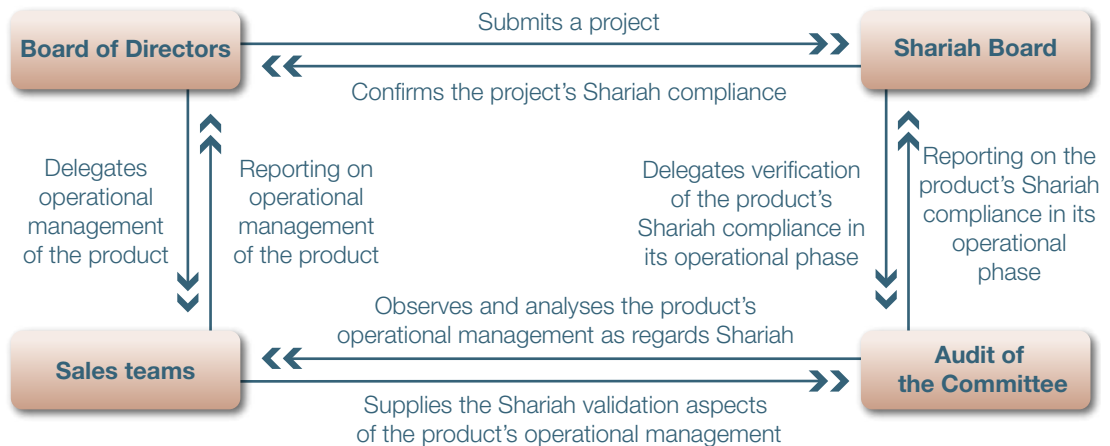
From the standpoint of Islam, this also holds true insofar as in this religious tradition it is considered that neither a body nor a Shariah scholar holds the truth and, in this respect, it falls to believers whether or not to abide by the opinions issued by experts in Islamic law. In the Gulf States, for example, a client cannot sue a Shariah scholar on account of the opinion he has issued. Furthermore, the relationship between a Shariah Board and its bank forms the subject of a contract. Therefore, if the board fails in its contractual obligations, the bank may, where appropriate, sue it.

In theory, a person could also ask a court to give a verdict on the financial loss and/or moral damage suffered after purchasing a product sold as compliant with the rules of Islam, even though this product turns out not to be. In practice, this means that the court would have to call on the services of religious experts to rule on Shariah compliance. There is a strong chance that the presiding judge of the court would refuse this and declare himself incompetent in the matter, limiting himself to a mere review of the contractual clauses. This was the solution adopted in England in the judgment delivered by the Court of Appeal *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004). The Court of Appeal specified that national law applicable to a contract cannot be subordinated to the principles of Shariah. It is likely that the French courts would adopt a comparable position if faced with a similar issue.⁴⁴

These considerations emphasise how important it is to clarify the role and status of Shariah Boards, as the diagram below tries to explain. What are the links with the financial institution's board of directors? Can the board influence the operational conduct of business, particularly on commercial matters? Similarly, when the Shariah Board uses the services of an audit committee to assist it with its compliance task, how can this audit board carry out analysis, reporting and validation work in accordance with the prevailing rules of Shariah?

⁴⁴ *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd and others*, comments by Potter LJ, [2004] EWCA Civ 19, [2004] 4 All ER 1072.

Board of directors and Shariah Board: who does what?



- Matching Shariah scholar to institution

If the image of Shariah Boards is dependent on the quality, intellectual integrity and reputation of its members, the issue of how to create such boards in France raises a number of problems.

Firstly, investors and bankers unfamiliar with Islamic finance are concerned about assessing Shariah scholars' level of expertise. The creation of independent groups such as ACERFI and COFFIS⁴⁵ should help in this regard.

Secondly, the lack of understanding of the French language may act as a barrier. Shariah scholars must demonstrate some familiarity with the French context, particularly the civil law tradition. Shariah scholars in the Gulf might therefore be reluctant to sit on Shariah Boards in France, for example. The provision by French universities of training in Islamic finance should partly overcome this difficulty, but not in the short term.

Lastly, the leading international Shariah scholars remain fairly unknown outside of a small circle of specialists. Consequently, their moral authority has little impact with the general public. A transparent market must be created, with a marketing policy that is fully understood. Shariah scholars must be brought out of obscurity by using local intermediaries who, even though less specialised in the subject, are better known by the French-speaking public and are more accessible.

⁴⁵ ACERFI is a French-speaking ethical and compliance committee, a non-profit association comprising scholars of Islamic religious sciences, supported by legal and tax specialists and experts in finance and asset management who are members of AIDIMM. The French Islamic Finance Council (Conseil Français de la Finance islamique, COFFIS) is its equivalent with an approach more geared towards certification and commercial labelling with respect to private clients.

> Institutionalisation of Shariah Boards

In France, independent Islamic institutions already exist and act as forums where consensus can be reached. Would the Islamic finance market benefit from a single, or national, institution in charge of finding solutions that brings together Shariah scholars and experts? Unlike Malaysia or Sudan, the central bank cannot play this role. The Bank of France's remit does not include ruling on the Shariah nature of financial products or proposing standards for compliance – this would conflict with the French principle of secularism.

Would such a national representative institution be desirable? There is no agreement on this: some advocate centralisation, considering that – following the example of Malaysia – this would lead de facto to the harmonisation and standardisation of the rules, a positive process for the development of Islamic finance. Others consider, however, that centralisation tends to hold back innovation, thus justifying a preference for independent Shariah Boards.

We must leave this decision to each project sponsor in their steps towards responsibility and transparency. In the end, clients will judge the appropriateness of an ethical compliance model in their acceptance or rejection of the product.

Proposition

Develop a market reference for the conformity of Islamic products to international regulations and standards of accounting, ethics and corporate governance.

3.3. Escaping from the vicious circle of mutual reproach to the virtuous circle of the niche market

3.3.1. Who will take the first step?

- The authorities?

It is clear that the development of Islamic finance calls for the French tax and legal framework to be adapted to take into account the constraints of Islamic finance. It came to light during the workshops that, for many reasons, the two do not match up in France. The issue is whether French legislation should be adapted to the needs of Islamic finance market players or whether the onus on them to adapt their way of doing things in accordance with local regulations and restrictions in order to penetrate the French market.

Steps were taken to adapt the French framework to the needs of Islamic finance in the form of two tax guidelines published on 25 February 2009 and the attempted amendment of the fiduciary law regime in summer 2009.

The French authorities intend to continue to refine the proposed framework, extending the analysis to other products. The Ministry of Economy and Finance has been carrying out market consultations with a view to issuing fiscal guidelines. Four products have been commented in tax regulations issued in August 2010 (*Murabaha*, *Ijara*, *Sukuk* and *Istisnaa*) and three others are under preparation (*Salam*, *Wakala*, *Muraraba*). This work is being carried out in strict observance of the principle of secularism (which imposes impartiality on the part of the authorities as regards religious issues) and the principle of equality of treatment of all taxpayers. This approach, agreed by both the authorities and those operating in the Islamic finance market, aims to define a framework as close as possible to that of conventional finance, but not more favourable.

- Islamic banks and Shariah Boards?

Should Islamic banks and Shariah Boards consider adapting their own practices? The specific French nature of the applicable law, the expectations of the local Muslim population and the cultural and political framework make it impossible simply to replicate products and methods used elsewhere. The opinions expressed by Shariah scholars must be in keeping with the French legal framework. The banks must therefore devise a French-style Islamic bank model resulting from a genuine understanding of the basic principles of the French framework and current practices, which should also be innovative.

- Investors?

According to workshop participants, Islamic finance players have a general wait-and-see attitude towards France. They are keeping a close eye on how the Islamic finance market is developing and would be willing to enter it once the tax and legal uncertainties have been removed.

The development of the market will depend on convincing investors that the market is ready. The responsibility for this lies with the authorities, professionals and clients (see chart below). It is by no means clear which arguments will be convincing. Whether an Islamic financial product is operational? In other words, whether it is secure, simple and reproducible? Shariah-compliant real estate transactions have already been carried out, but with sophisticated and, at times costly, legal structures.

Vicious circle of reproach: Who will start?



3.3.2. Which products will facilitate development of the market

The Islamic products offered must be feasible and operational, but what form should they take? Several possibilities have been mentioned.

- *Sukuk*?

The debate on Islamic finance in France seems to have focused for some time on the question of the development of the *Sukuk* market, perhaps because of the apparent similarity of this Islamic product to conventional bonds, although in reality it is more akin to co-ownership rights backed by underlying assets than to debt securities.

The interest of Islamic investors in *Sukuk* issued by top-rated companies is indisputable judging by the *Sukuk* issued by GE Capital at the end of 2009. This transaction consisted of the issuance of \$500 million through a *Sukuk Ijara* due in five years and backed by aeronautical assets leased on a long-term basis. The market is also looking closely at the *Sukuk* which will be issued by Total as a financing technique for its refinery in Djoubail.

- Private-public projects?

Also under consideration are the mechanisms used to develop Islamic finance. In this respect, public-private partnerships (PPPs) have been mentioned. In Europe, no Shariah-compliant PPP financing has been carried out to date.

The question was raised at the workshops as to whether Shariah-compliant PPPs could be an adequate means to promote the rapid expansion of Islamic finance.

Reservations have been raised about this possibility, as PPPs form the subject of calls for tender. A Shariah-compliant PPP must satisfy the terms of reference of a call for tenders while also representing a competitive alternative compared with the competition (sine qua non condition for being awarded a tender). Shariah-compliant projects require the creation of numerous legal entities and a more complex, less flexible financial structure in the case of refinancing. Under these conditions, the exit price of a Shariah-compliant PPP tends to be higher and so less competitive, without necessarily representing an obvious competitive edge from the authorities' viewpoint.

Furthermore, a Shariah-compliant financial structure requires the approval of a Shariah Board while respecting the relatively short periods imposed by the terms of reference for responding to calls for tender of a PPP. These periods could be shortened if the structures were standardised but, in actual fact, PPP standards are few and far between. They frequently involve complex legal arrangements, and members of Shariah Boards must have time to analyse them before giving their opinion.

- Private projects?

Proposition

Emerge from the “circle of blame” by selecting test projects from local authorities with genuine needs in infrastructure or local investment for SME, in order to obtain a true operational model.

The development of Islamic finance would benefit from the completion of a symbolic deal demonstrating, both to potential investors and to the authorities, the feasibility and legal stability of the tools implemented, their simplicity and the economic viability of such a deal. Since this signal is unlikely to be given for a PPP, for the reasons mentioned above, this initiative will have to come from the private sector.

For example, Islamic finance could develop on the basis of a low-scale private project linked to sustainable development. For example, the financing of wind turbines or solar panels, or a consensual project driven by a high-growth sector.

Chapter 4

A White Paper

Tools and structuring of Islamic financing: legal and tax aspects



4. Tools and structuring of Islamic financing: legal and tax aspects

4.1. Purchase/resale contract or *Murabaha*

4.1.1. Definition under Shariah

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines *Murabaha* in annex D to Shari'a Standard No 8 as being:

"...the sale of an asset for a price equal to the purchase price plus a margin defined and approved by the parties. This profit margin may be a percentage of the sale price or a fixed amount."

Murabaha takes the form of a three-party structure in which the owner of a movable or immovable asset (the seller) sells the asset to a financial intermediary (the financier) at a fixed price, who in turn sells it to the end buyer (the client) for a price equal to the acquisition price plus a mark-up.

The price payable by the client is generally settled by means of deferred payment. *Murabaha* without deferred payment, which is no different from a conventional cash sale with a margin, poses few legal and tax problems. We shall concentrate here on *Murabaha* with deferred payment when it relates to a real estate asset.



The *Murabaha contract* is flexible and adaptable, making it the most popular instrument used by Islamic financial institutions. However, concerns have been raised, for example, about the mechanism for indexing the resale price.

- Main validity conditions of *Murabaha* with regard to Shariah

The main validity conditions of *Murabaha* with regard to Shariah are as follows:

- a- the movable or immovable asset forming the subject of the sale must be defined and comply with Shariah;⁴⁶
- b- the acquisition price and margin must be known to the client;

⁴⁶ This implies that the sale cannot relate to real estate with a purpose or use that does not comply with the rules of Shariah: casinos, shops selling alcohol, pork, pork-derivative products or items for pornographic use, brothels, etc.

- c- the margin must be known when concluding the *Murabaha contract*. This margin may be:
 - 1- a fixed sum; or
 - 2- a percentage of the acquisition price; or
 - 3- an indexed formula that permits calculation of the margin at the time the *Murabaha contract* is concluded;
- d- the seller and the client must not be the same person or legal entity;
- e- the movable or immovable asset must exist at the time the *Murabaha contract* is concluded;
- f- two successive transfers of title to the asset must take place: the first transfer between the seller and the financier; and the second between the financier and the client;
- g- the financier must have acquired title to the asset before selling it to the client;
- h- lastly, the financier may request that the client provides a deposit, guarantee or any other security at the time of the second resale transaction in order to guarantee payment of the instalment price.
 - Option of concluding a *Murabaha* framework contract

To finance the purchase of a number of movable or immovable assets, it is possible for financier and client to conclude a *Murabaha* framework contract intended to cover multiple transactions with different margins for each transaction.

The formula “resale price = purchase price + margin” is regarded as sufficient, even if the margin is not known when signing the *Murabaha* framework contract.

4.1.2. Transposition of *Murabaha* into French law

- Legal definition

With regard to French civil law, *Murabaha* is seen as two successive contracts: a cash sale contract concluded between seller and financier; followed by an instalment sale contract concluded between financier and client.

The sale is an agreement under which a seller is obliged to deliver an item and an acquirer is obliged to pay for it. Its legal effect is produced through the sole exchange of consent as soon as the parties reach agreement on the item and price, regardless of whether the item has been delivered or the price paid.⁴⁷

⁴⁷ Article 1583 of the Civil Code.

When the sale is for cash, the buyer immediately acquires title and settles the acquisition price immediately.

When an instalment sale is involved, the buyer immediately acquires title to the asset sold, but only pays for it in instalments or in full at a future time.

With regard to real estate, both these successive sales are generally carried out on the same day in front of a notary.

The difference between the resale price paid by the client and the purchase price paid by the financier (called “Profit” in the new version of the tax guideline commenting on *Murabaha* published dated 23 July 2010) is broken down into a margin, where appropriate, realised by the financier in return for its intermediation (called “Commission”) as well as an income for the deferred payment to which the financier has agreed as part of the resale to the client (Income).

It is the collection of this Income by the financier that justifies the immediate resale of the asset to the client at a much higher price than the acquisition price paid by the financier shortly before and differentiates *Murabaha* from a conventional loan agreement. The amount of the financier’s income or the method of calculation is laid down in the instalment resale contract and does not vary during the period of the agreed deferred payment.

- *Murabaha* and banking law

- Banking transaction and monopoly

When *Murabaha* includes a resale with commission and deferred payment, and does not consist of a single cash purchase/resale transaction with a margin, it is comparable to a credit transaction agreed by the financier in favour of the client.

In this context, *Murabaha* falls within the scope of the French banking monopoly, which reserves banking transactions for credit institutions,⁴⁸ subject to certain legal exceptions.⁴⁹ This position has been confirmed by the Committee of Credit Institutions and Investment Companies (Comité des établissements de crédit et des entreprises d’investissement, CECEI), now the Prudential Supervisory Authority (Autorité de Contrôle Prudentiel, ACP) since the merger of the banking and insurance regulators.

Although *Murabaha* transactions are reserved for credit institutions if carried out on a habitual basis (i.e. when two banking transactions are involved), it is possible to set up an investment vehicle for a single banking transaction. In practice, *Murabaha* real estate transactions have – until now – been carried out in France in such a way.

⁴⁸ Article L 511-5 of the Monetary and Financial Code.

⁴⁹ Articles L 511-6 and L 511-7 of the Monetary and Financial Code.



This structure presents a number of drawbacks. Although experts can overcome these, *Murabaha* transactions become more complex, longer to implement and more costly to manage nevertheless.

One such problem stems from shareholders of the investment company not wishing to be sued in the event of bankruptcy proceedings against the company. In order to limit the risk of recourse from other third-party creditors, shareholders can be insistent that the company does not handle any activity other than reselling the real estate asset to the end buyer.

➤ Problems concerning shareholders and management of ad hoc investment companies

Insofar as lenders, whether French or France-based foreign credit institutions, have not wanted to own the capital or management of these investment companies, and in light of the Shariah ban preventing the end buyer (or companies of its group) from being shareholders of these structures, practitioners have frequently used foreign orphan companies as shareholders and deal arrangers in order to run them.

Although it has enabled a number of deals to be carried out in France since the early 2000s, this practice will hinder any large-scale development of Islamic finance in the real estate investment sector in France. Firstly, it generates additional costs associated with the creation and management of these orphan structures and the investment companies formed in order to avoid falling foul of the French banking monopoly. Secondly, it does not allow such investments to be streamlined in having them made by the same legal entity.

Proposition

The ACP, or legislator, should make adjustments to permit a legal entity other than a French credit institution, or one located in France, to hold a majority shareholding in several ad hoc investment companies that have realised, or are on the verge of realising, a sale/instalment resale transaction of real estate, financed in major part by a credit institution.

The problem we are faced with today is whether a company that does not have credit institution status can hold majority interests in multiple investment companies, each of which carries out a single purchase/resale transaction meeting the requirements of *Murabaha*.

If such a holding was regarded as improper with regards to the French banking monopoly, and confirmed by the Bank of France via the ACP, this would automatically close the door to real estate investment professionals such as asset managers or venture capitalists who might have wanted to take an active part in the rapid expansion of Islamic finance in France.

There are two principal observations:

- Firstly, such *Murabaha* transactions are, in any event, always backed by banks providing the credit necessary to make the first acquisition of the real estate asset from its original owner.
- Secondly, these Islamic real estate investment professionals are willing to act as arrangers of these *Murabaha* transactions on behalf of end buyers wishing to comply with the principles of Shariah and to accept the specific risks that credit institutions do not seem prepared to take on for the time being, associated with the creation, holding and management of these ad hoc investment companies.

The establishment of a specific legal regime for this type of professional should be considered if we wish to permit their development in France.

- Tax regime applicable to purchase/resale in instalments transactions

Although *Murabaha* real estate transactions have been carried out by investors based on the general principles of taxation since 2003, the desire to develop and secure these large-scale transactions resulted in the tax authorities accommodating professionals' requests for official confirmation of the *Murabaha* transaction regime. An initial guideline was published on 25 February 2009, but subsequent work on the subject of Islamic finance has led the authorities to consider the publication of a second guideline to replace the first. Without modifying the original principles, this new version, which was published in August 2010 (dated 23 July 2010) displays a more refined appreciation by the tax authorities of the problems encountered.

The main tax difficulties with *Murabaha* real estate transactions are as follows:

➤ Transfer duty and VAT

From a tax standpoint, *Murabaha* is characterised by a double transfer of ownership.

In the case of movable assets, the existence of such a double transfer may result in additional management issues or cash flow expenses (VAT), but only rarely does it make the transaction economically unviable.

However, in the case of real property located in France or the units or shares in a real estate investment company holding mainly French real estate assets, the tax friction of registration fees (5.09% of the sale price of a property, 5% on the units or shares in real estate investment companies) generated by this double transfer becomes prohibitive. This is why *Murabaha* transactions involving French real estate assets have, since 2003, relied on the property dealer regime which exempts the registration fee (excluding land registration tax) on the first transfer.

Whereas the UK had to amend its tax legislation to make *Murabaha* real estate transactions possible,⁵⁰ France already had an instrument that allows transactions of this type to be carried out in its legal and tax arsenal.

⁵⁰ Finance Act 2003, Part 4: Stamp Duty Tax, Section 73.

However, property dealer status was subject to the observance of strict formalities and compliance with conditions imposed by case law (the customary and speculative nature of transactions in particular) which were barely compatible with the use of ad hoc investment companies (which were generally imposed by lending financial institutions which generally prohibit such an ad hoc company from carrying out more than one transaction).

The guideline of 25 February 2009 simplified matters by stipulating that, subject to compliance with certain anti-abuse conditions aimed at ensuring that the mechanism is not misused, the transaction could be placed under the property dealer regime, notwithstanding the fact that the customary and speculative conditions are not observed.

Current events have, however, come to the rescue of professionals as the property dealer regime was scrapped under the amending finance law of 9 March 2010 and replaced by a more straightforward, professional buyer-reseller regime exempted from registration fees (excluding land registration tax in the event of a property sale) on the first transfer, subject to the simple condition of undertaking to resell the real estate asset within five years. This modification to the legislation has made previous case law related to property dealers (speculative and customary conditions) irrelevant.

The transactions carried out by the financial intermediary have therefore become pure real estate transactions subject to the ordinary legal regime, which has itself evolved as a consequence of the reform of VAT on real estate (the effect of which is to dissociate the analysis of real estate transactions from the standpoint of VAT and registration fees). We are now able to identify the following different situations:

- *Murabaha* transactions related to real estate completed or totally rebuilt in the last five years (regardless of the number of intervening sales since completion or reconstruction): VAT is applicable ipso jure to the sale price of each transfer when the sale is made by a VAT-registered party (i.e. an entrepreneur);⁵¹ registration fee is also due at the reduced rate (i.e. land registration tax of 0.715%) by the acquirer on each acquisition, which makes it pointless for the financier to use the buyer-reseller regime;
- *Murabaha* transactions related to real estate completed or rebuilt more than five years ago: in this case the transaction is exempted from VAT but each transferor may decide to opt for VAT, subject to being VAT-registered (i.e. an entrepreneur); the option will entail the payment of VAT, which will apply either to the total sale price or to the gain only (in the event of option by a transferor that has not deducted the VAT encumbering the acquisition); registration fee is also applicable (5.09% if purchasing the real estate or 5% on shares in real estate investment companies). Under these conditions, the financial intermediary has an interest in opting for the purchase-resale regime in order to exempt the first transfer from registration fees (excluding land registration tax in the event of sale of real estate), in return for the commitment to resell within five years;

⁵¹ Conversely, the sale of such real estate by a party not subject to VAT such as a private individual avoids VAT, except on the assumption of a sale of real estate acquired off-plan (vente en l'état futur d'achèvement) or as a sale in instalments.

- *Murabaha* transactions related to shares in (non-transparent) real estate investment companies: in this case VAT is never applicable; registration fee may be avoided on the first sale by using the buyer-reseller regime, in return for the commitment to resell within five years. There is no tax leakage, due to the absence of land registration tax on transfers of real estate investment companies.

> Business tax

The real estate (or shares in the real estate investment company) will constitute inventory of the financial intermediary, resulting in the following consequences as regards French business tax (contribution économique territoriale, CET):⁵²

- in accordance with the rules of article 1586 sexies of the General Tax Code, the reference turnover and the added value will be calculated according to the financier's status (credit institution, 95% owned subsidiary of a credit institution, other);
- to determine the tax based on real estate (cotisation foncière des entreprises, CFE), real estate acquired by the financier for the purpose of its resale does not in principle constitute fixed assets and is not therefore taken into account in its tax base.

> Treatment of income and commission

Furthermore, the existence of a resale price combining any commission of the credit institution and income representing the consideration for the deferred payment was likely to generate problems in terms of the basis for registration fees as well as the treatment of the transaction from the standpoint of corporation tax. Could the deferred payment be comparable to interest (and treated as such) for the financier and client? What should be the cost price of the real estate in the client's accounts, and how should the depreciation followed by the capital gain or loss on resale of the real estate be assessed?

The following solutions have been adopted in the guideline dated 23 July 2010 on the *Murabaha* regime:

o A *Murabaha* transaction must meet the following conditions:

- 1- the contractual documents must clearly state that the financier is acquiring the asset in order to resell it, shortly thereafter or within a period not exceeding six months, to its client, which is its principal;
- 2- the same documents must indicate the total acquisition price of the asset payable by the client. They must also allow, for accounting and tax purposes, to identify clearly: the acquisition price of the asset payable by the financier, the financier's Commission and the financier's Income (the latter constituting the sole consideration for the deferred payment granted to the client);

⁵² Tax that replaced *taxe professionnelle* with effect from 1 January 2010.

- 3- the payment of the Income must be spread over time. It must be known and accepted by both parties to the contract by means of a repayment schedule annexed to the same contract, making a distinction between the repayment of the acquisition price, the payment of the Income and the payment of the Commission;
- 4- the Income must be expressly designated as being the consideration for the ongoing service rendered by the financier to the client until the end of the transaction and resulting in the deferred payment granted to the latter. For example, a clause outlining the financier's Income may be inserted such as "the consideration for the deferred payment granted to the acquirer by the seller, the acquirer being obliged to pay the seller the financier's Income until the date of actual payment of the price in full";
- 5- the contract between the financier and client must explicitly mention that the transaction in question is effected in accordance with the legal and tax framework defined by the guideline.

Furthermore, in order for the transactions in question to benefit from the provisions of the guideline, the financier must have credit institution status under the terms, inter alia, of articles L 511-5 and L 511-10 of the Monetary and Financial Code and/or be an investment company or else fall within the scope of one of the exceptions organised by this code.

While we believe that the initial conditions related to the transaction seem justified (except perhaps the extreme formalism which may be reflected in the appended documentation), the conditions related to the financier are perplexing. This is because the tax regime of a product is rarely defined in relation to the capacity of the party carrying out the transaction: for example, the regime applicable to finance leasing (crédit-bail) exists independently. The carrying out of several finance leasing transactions by an operator that does not qualify as a credit institution is without doubt wrong from the standpoint of banking regulations, but even so such an operator is not disqualified from the benefits of the leasing regime. We see the concern surrounding the development of the market reflected in these precautions.

o Once these conditions have been met, the following regime will then be guaranteed, due to the binding nature of the fiscal guidelines on the authorities:

It will be acknowledged that, in economic terms, the Income represents the remuneration for deferred payment and is therefore comparable, for tax purposes, to the interest due during such period in the framework of conventional financing, while the Commission will be treated as acquisition costs, resulting in the following:

- 1- the financier's Income will be deducted from the sale price of the asset by the financier, and from the purchase price of the asset by the client; these restated prices will then be used for the purposes of:

- calculating the capital gain realised by the financier at the time of the resale;
 - recording the asset in the client's accounts and in so doing, its depreciation and subsequent cost price in the event of resale;
- 2- the Commission will be comparable, for tax purposes, to the acquisition costs (and treated as such, i.e. incorporated to or deducted from the purchase price of the asset, at the taxpayer's option) for the purposes of determining the depreciation and capital gains in respect of the asset;
 - 3- the financier's Income and the Commission as well as the costs related specifically to the first transfer (land registration tax, registrar and notary fees) will be excluded from the basis of the registration fee collected under the conditions of ordinary law at the time of resale of the real estate asset to the client;
 - 4- the Income will be spread by the financier over the period of the deferred payment, regardless of the payments made, at a frequency strictly identical to that applied to recording the transaction for accounting purposes and in accordance with the repayment schedule annexed to the contract; in parallel, the client will deduct these payments at the same frequency and under the same conditions;
 - 5- if the financier is based abroad, the sums payable by the client will be treated for tax purposes, to the extent of the Income, as interest and will be exempted from the deduction provided for in III of article 125A of the General Tax Code, unless these sums are paid in an uncooperative state or territory within the meaning of article 238-0 of the same code.

Ultimately, the only remaining problem is likely to be associated with the friction generated by retention of land registration tax on the first transfer (between the seller and the financier).

While the cost represented by such double taxation could be accepted in the past by investors for large transactions with the prospect of significant capital gains, there is a risk that this would completely nullify the effect in medium-sized or minor transactions, in particular for private individuals, since this tax is in addition to already high set-up costs.

In order to avoid this exemption running to the benefit of pure real estate professionals who do not carry out any *Murabaha* transactions, which would obviously not be justified, this mechanism could be reserved for credit institutions or their subsidiaries in which they have a controlling interest when carrying out a single transaction, or only benefit purchase-resale transactions taking place within a very short time frame, with most of the price payable in fixed instalments.

Proposition

In order to permit equal treatment of conventional and Islamic financing transactions with the same economic effect, it is important to eliminate the friction resulting from the subjection to land registration tax of each of the two real estate transfers required for a *Murabaha* transaction on real property assets. Registration for a fixed cost of the acquisition of the real property by the financial intermediary would be particularly desirable in order to guarantee that Islamic finance on real estate can develop, regardless of the size of the contemplated transaction, subject only to such conditions as are necessary for such regime not to be abused.

4.1.3. Key problem areas encountered in *Murabaha* transactions involving real estate assets

Apart from the legal structuring restrictions under French law detailed in 4.1.2 above, the key problem areas encountered in *Murabaha* real estate transactions are connected with either certain rules of French law or certain restrictions imposed under Shariah:

- With regard to French law
 - Risks related to holding title to the real estate by the financial intermediary

○ Liability of the owner

By virtue of its acquisition of real estate from the original owner, the financial intermediary incurs the risks associated with its capacity of holding title to such real estate, in particular in terms of liability, as the risks pertaining to the property (total or partial destruction, loss, etc.) rest of necessity with the owner.

However, the financial investor may take out insurance to safeguard against the risks related to ownership of the real estate.

If Shariah-compliant insurance cannot be put in place, the Shariah Boards will generally accept that this may be replaced by conventional insurance.

○ Concealed defects guarantee

The financial intermediary also incurs the risks associated with its capacity as reseller of the real estate with regard to the warranty against latent guarantee.

Although Shariah prohibits the financier and the client from deciding contractually that the risks pertaining to the property will rest with client before he acquires title to the property, the financier may insert a total absence of liability or limited liability clause in the *Murabaha contract*.

Thus the AAOIFI accepts that a clause covering the resale by the financier to the client may be included in the *Murabaha contract* on an “as is where is” basis. In other words, the end buyer takes possession and acquires title to the real estate resold by the financial intermediary in the condition in which the latter received it from the original owner.

Provided the financial intermediary is not deemed to be a real estate professional, it is also possible, under French law, to limit the scope of its latent defects warranty.⁵³

A seller who is a real estate professional is nonetheless presumed to know the concealed defects of the sold property and cannot take advantage of a limitative or exclusive latent defects warranty clause with regard to the acquirer who is not himself a real estate professional.⁵⁴ Conversely, a seller who is a real estate professional may invoke such a clause if the acquirer is a professional with the same speciality.

As it turns out, case law has for many years classed property dealers as “professionals”,⁵⁵ so that until now, when the financier resells the real estate acquired from the original owner to the client, he has been unable to exonerate himself from providing the client with a warranty against latent defects. Although the property dealer tax regime has now been abolished, it is more than likely that this case law will continue to be applied to the buyer-reseller acting in a professional capacity within the meaning of tax legislation.

The financier may certainly attempt to insure its risk in respect of the warranty against latent defects – it will again be necessary to find an insurer prepared to do this – to say nothing of the additional cost that this represents compared with a conventional transaction.

In addition, we may consider whether the principle of subjecting the financier to the warranty against latent defects in a purchase/resale in instalments transaction involving real estate which, above all, is analogous to a credit transaction. As emphasised in the Jouini & Pastré Report,⁵⁶ this does not make any sense in *Murabaha* transactions.

► Compliance with the urban pre-emptive right

The urban pre-emptive right is the option granted to a local municipality or other local public area to acquire, as a matter of priority, real estate put up for sale⁵⁷ in specific predefined areas for the purpose of carrying out transactions of general interest. It ranks prior to pre-emptive and preferential rights of which private individuals may be beneficiaries.

Proposition

It is necessary to provide that, in the case of purchase/instalment resale transactions in which the initial acquisition of the real property is financed principally by a credit institution, the financier can be freed from the warranty against latent defects, which would be borne in its entirety by the initial owner of the real property sold.

⁵³ Articles 1641 et seq. of the Civil Code.

⁵⁴ Cass. 3rd Civ. 23 June 1971, No 69-14446, Bull. civ. III No 403; Cass. com. 23 November 1999, No 96-17637: RJDA 3/00 No 255.

⁵⁵ Cass. 3rd Civ. 3 January 1984, No 81-14326, Bull. civ. III No 4 (a real estate dealer that, having purchased an apartment building, resells it in lots was regarded as ‘professional’); Cass. 3rd Civ. 13 November 2003, No 00-22309: RJDA 3/04 No 292.

⁵⁶ *Ibid.* footnote 3.

⁵⁷ Under article L 213-1 of the Town Planning Code (Code de l’urbanisme), any immovable property or group of shares giving entitlement to ownership or possession of immovable property or a part thereof, whether or not constructed, where transferred for valuable consideration in any form whatsoever, will in particular be subject to the pre-emptive right.

Proposition

It would be desirable, if it is not possible to create an exception for the instalment resale of the real property from the requirement to file a request for a DIA, to permit this second request to be processed automatically at the same time as the first request, in order to reduce to two months the maximum period for the decision to pre-empt or not to be made by the local authorities as to whether or not to exercise the pre-emption right.

When the sale of real estate is subject to an urban pre-emptive right, the notarial deed cannot be signed before a notice of intention to dispose of real estate (déclaration d'intention d'aliéner, DIA) has been filed and the municipality has waived its pre-emptive right. In practice, it is the notary who, on behalf of the original owner of the real estate, takes care of the formalities imposed by law by sending the DIA, prepared on an official form, to the mayor of the municipality concerned. This notice includes, inter alia, an indication of the price and conditions of the planned sale.

The municipality has two months from receipt of the DIA to notify the owner of its refusal to acquire the property, its decision to exercise its pre-emptive right at the specified price or its offer to acquire at another price. The absence of a reply from the municipality within two months is tantamount to a refusal to acquire. If the municipality waives its pre-emptive right, the owner may sell the property at the price and conditions stated in the DIA over the next five years.⁵⁸

It therefore follows that in a transaction involving the purchase/resale of real estate in instalments, filing two successive DIAs could have a detrimental impact on the timetable of the transaction since the procedure could potentially last four months.

- With regard to Shariah

- Compliance with the conditions of form and substance of contracts

Shariah attaches particular importance to the form and substance of contracts.

With regard to *Murabaha*, it is imperative that the parties to the transaction comply with certain rules which, from the standpoint of Shariah, are regarded as essential.

Thus, in a *Murabaha* transaction, the overriding condition is to ensure that the real estate is only sold to the end buyer once ownership has been transferred to the financial intermediary.

The *Murabaha contract* must also contain all the specifications of the sale.

It is also necessary to check that the real estate has actually been purchased from a third party and not from the end buyer.

⁵⁸ Only the price may be revised during this five-year period, solely in line with the INSEE cost of construction index.

Lastly, as the margin must be known when concluding the *Murabaha contract*, the transposition of variable rate financing as part of a *Murabaha* transaction cannot be considered.

In the event of failure to comply with any of the essential rules of *Murabaha*, the penalty will be the disqualification of the *Murabaha* transaction⁵⁹ under Shariah. In this case, the financial investor, if subject to Shariah, will be unable to receive the margin or a share of the profit comparable to interest within the scope of this transaction, such profit having to be repaid in full to a charitable organisation.

- Real estate forming the subject of the *Murabaha* transaction must have been built

The real estate forming the subject of the *Murabaha* transaction must exist when the *Murabaha contract* is concluded.

In practice, this means that, in a real estate construction context, the parties may not conclude a *Murabaha contract* before the construction has been completed. Other types of contract will be more suitable in such a case.

- Promise to purchase and rescission by the end buyer

To safeguard its interests and ensure that the end buyer will actually purchase the real estate, the financier may ask the client to grant it a promise to purchase. This cannot be bilateral under Shariah.

We should emphasise that the AAOIFI does not accept a combination of contracts; it is not possible to stipulate an interdependency clause linking the purchase and resale transactions in the acquisition contract concluded between the original owner and the financial intermediary. In practice, to limit the risk of the financial intermediary finding itself in a position where it holds real estate that the end buyer no longer wishes to purchase, the end buyer may agree to sign an undertaking to purchase for the financial intermediary with an indemnity for immobilisation of funds before the financial intermediary itself grants a promise to purchase in favour of the original owner, with or without an indemnity for immobilisation of funds.

- The acquisition of the real estate by the financial intermediary must be prior to its resale

From the standpoint of Shariah, it is imperative that the financial intermediary acquires title to the real estate before reselling it to the end buyer. This implies that in a *Murabaha* transaction, unlike a conventional financing transaction where the client may sign all the documents at the same time, the financial intermediary must ensure that the end buyer does not sign any document having the effect of transferring title to the real estate before this such estate has become the property of the financial intermediary.

Proposition

A charitable organisation or fund should be created in France to promote the development of Islamic finance for professional and private parties, funded by the amounts resulting from transactions disqualified under Shariah.

⁵⁹ Shari'a Standards No 8, *Murabaha to the Purchase Orderer*, 2/2/3.

It is recommended that:

- the legal structure of contracts be established such that any possibility of error in the chronology of transfers of title is minimised; and
 - the financial intermediary informs its staff of the risks that may arise if this chronology is not respected.
- Period within which the resale must take place

Under a *Murabaha contract*, the transaction involving resale of the real estate by the financial intermediary to the end buyer must take place either immediately after the acquisition of title to the property from the principal owner or at a later date.

Under Shariah, the time lag between the purchase and resale does not disqualify the *Murabaha* transaction if the financier purchased the property with the sole aim of reselling it to the client.

In practice, however, in view of the legal risks incurred by the financial intermediary during this period (set out above) the parties to the transaction involving resale in instalments of the real estate should ensure that this occurs within a very short time period after the original acquisition.

➤ Penalty clauses

Although Shariah does not prohibit the stipulation of a penal clause in the resale by instalments contract in the event of late payment by the end buyer, it does require, however, that the sums received in respect thereof must be repaid to a charitable organisation.

In order to take this rule into account, practitioners may, where applicable, stipulate in the contract a higher sales price for the real estate and that the end buyer will be entitled to a discount on the acquisition price if there are no incidents of late payment on his part.

Under Shariah, the amount of this discount is at the discretion of the financial intermediary, who is entitled to refrain from consulting the end buyer on this issue.

➤ Early payment

As the resale price of the real estate by the financial intermediary to the end buyer is fixed in advance, and the conditions applicable to the payment in instalments are clearly set out in the *Murabaha contract*, there is an issue as to whether the end buyer is able to request a discount on the resale price if he pays this price in full in advance, i.e. before the due dates for payment of the resale price in instalments provided for in the contract.

In practice, a clause is generally inserted in the *Murabaha contract* in order to specify either the amount or the percentage of the discount granted in the event of early payment of the resale price in full. However, under Shariah, it is the financier that is free to choose whether or not to offer such a discount to the client.

When the financier is not the actual lender of the funds enabling the acquisition of the real estate from the original owner, the discretion left to the financier under Shariah on this matter will, in practice, be limited by the conditions granted by the lending bank to the financier under the loan agreement granted to the latter party.

In practice, financiers are currently more frequently confronted with instances of late payment by the client due to the economic crisis than with requests for early payment. This raises the problem of the necessary refinancing, in accordance with Shariah-compliant procedures that are frequently difficult to find without any penalising tax friction, of a *Murabaha* transaction in which the lender was not the financier.

➤ Insurance of the real estate by the end buyer, if possible in accordance with Shariah

Due to the deferred payment granted by the financier within the framework of the resale in instalments of the real estate to the end buyer, the financial intermediary must ensure, under the terms of the resale contract, that the end buyer takes out insurance in respect of the purchased real estate.

In principle, this insurance must be Shariah-compliant. However, if it is not possible to take out a Shariah-compliant insurance policy offering a satisfactory level of cover, it is generally accepted by Shariah Boards that this may be replaced by conventional insurance.

4.2. Leasing agreement or *Ijara*

4.2.1 Definition under Shariah

Ijara can be defined as a contract under which a credit institution places a specific tangible movable or immovable asset, identified and owned by such institution, at a client's disposal for rental purposes.

From the standpoint of Shariah, *Ijara* is a sale of *Intifah* (which is similar to usufruct under French law).

The *Ijara* product may be structured in different ways and combined with other types of contract. The most popular forms of *Ijara* are:

- *Ijara* (also known as *Ijara Tachghilia*), which is similar to an operating lease;
- *Ijara* with a purchase option, which may take the form of *Ijara Muntahia Bittamlik* (leasing with the right to acquire the leased asset on expiry of the lease) or *Ijara Wa Iqtina* (similar to a hire-purchase agreement).

4.2.2 Multiple uses of *Ijara*

An *Ijara contract* is one of the most 'pure' under Shariah law and is also one of the most popular Islamic products on account of its flexibility.

This structure is particularly suited to project financing and long-term financing (10 to 15 years).

Admittedly, *Ijara* implies a major responsibility on the part of the lessor, who remains the owner of the asset until, where applicable, the purchase option is exercised. However, such title to the asset means that the lessor does not have to recover the leased asset from the borrower's assets if the latter defaults, because the lessor benefits from the ultimate security: ownership.

Ijara has many uses: operating leases, finance leasing (*crédit-bail*), refinancing in the form of sale and leaseback or disposal of real property rights to an ad hoc legal vehicle within the framework of a *Sukuk* issue (*Sukuk al Ijara* being the most common form of *Sukuk*).

Many opportunities therefore exist for developing *Ijara* in terms of real estate in France given the numerous large-scale projects announced (Grand Paris, Plan Campus). The recent increase in sale and leaseback transactions leads us to think that, here too, there is a considerable wealth of Shariah-compliant financing opportunities for French companies in serious need of cash in this period of crisis.

The stock of French real estate for redevelopment is sizeable and an *Ijara* transaction related to real estate assets could be the perfect opportunity to launch the first *Sukuk* issue on the French market.

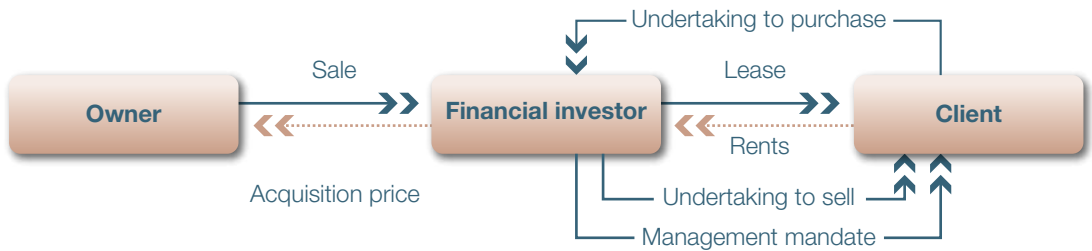
Given the absence of specific legal problems concerning *Ijara Tachghilia* under French law, we will focus on *Ijara Muntahia Bittamlik* and *Ijara Wa Iqtina* in the context of the acquisition of real estate assets by private individuals.

4.2.3 Definition of *Ijara Muntahia Bittamlik* under Shariah

Ijara Muntahia Bittamlik (IMB) is an *Ijara* contract containing an option for the client to acquire ownership.⁶⁰

The client gives an undertaking to the financial investor to rent a specific property if the investor purchases it. Following the purchase of the property by the financial investor, the client and the financial investor sign the IMB contract. The client also signs an undertaking to purchase the property in favour of the financial investor; similarly, the financial investor signs an undertaking to sell the property in favour of its client.

⁶⁰ AAOIFI Shari'a Standards No 9, *Ijarah* and *Ijarah Muntahia Bittamleek*.



The undertakings to purchase/sell are unilateral and must be recorded in separate and distinct documents of the IMB contract.

Generally speaking, a management mandate is also concluded between the client and the financial investor under which the client is appointed as the financial investor's authorised agent for the purposes of managing the property and carrying out major repairs.

4.2.4 Main conditions of validity of *Ijara Muntahia Bittamlik* under Shariah

The main conditions of validity of *Ijara Muntahia Bittamlik* under Shariah are as follows:

- the financial investor must acquire title to the property before signing the *Ijara* contract. The financial investor and the client may, however, sign a framework contract, the terms of which will be applicable to the *Ijara* transaction;
- it is not necessary for the financial investor to register the property in its name in order to be able to let it. However, if title to the property is not registered in the name of the financial investor, it must have in its possession a deed or document confirming payment of the price to the seller before concluding the IMB contract;
- the IMB contract and the promise to sell must be recorded in two separate and distinct documents;
- the property forming the subject of the IMB contract must be used in compliance with Shariah;
- the client must be in a position to know the amount of rent it will have to pay during the term of the IMB contract. If the rent is not fixed, it is necessary that, at the very least, the rent for the initial period is determined at the time of signing the contract. The amounts for subsequent periods must be calculated on the basis of a clear formula. In the event of variable rent, a minimum and maximum rent must be stated in the contract;⁶¹

⁶¹ By way of illustration, we would emphasise insofar as it is conceivable, from the standpoint of Shariah, that the monthly rent is indexed to an interest rate that fluctuates over time (such as Euribor or the construction index), which may be likened to an unknown monthly rent, with the rental period usually divided into regular intervals. At the end of each period, the financial investor must (i) inform the client of the amount of rent for the new period (to be calculated by reference to the index applied) and (ii) ask it to confirm its acceptance. If the client refuses the new rent, the financial investor is then entitled to compel the client to acquire the real estate by exercising its undertaking to buy.

- increasing the amount of rent due is not permitted if the client has not paid on the due date, just as it is prohibited from shortening the term of the tenancy agreement;
- the IMB contract may not stipulate that the tenant has the obligation to continue paying rent even if the property is totally destroyed. In the event of partial destruction, the tenant must be entitled to terminate the tenancy agreement or to request a rent reduction;
- major repairs, namely the repairs required so that the client can use the property, are the responsibility of the financial investor as the owner of the real estate asset;
- two types of deposit may be received by the financial investor:
 - *Hamish Jiddiyah*

The financial investor is entitled to ask its client to pay a sum of money as a deposit to guarantee the proper fulfilment by the financial investor of its obligations under the terms of the IMB contract.

- *Urboun*

Similarly, the financial investor may ask its client to pay a sum of money as a deposit to guarantee performance by the client of the contract, known as the *Urboun*. However, this sum forms an integral part of the rent and will therefore be deducted from the amount of rent due. But the financial investor will be entitled to confiscate the *Urboun* in the event that the client does not fulfil its obligations under the IMB contract.

The financial investor may also ask the client to insure the leased property. If the client is unable to obtain Shariah-compliant insurance, it may insure the property under a conventional insurance policy.

4.2.5 Transposition of *Ijara Muntahia Bittamlik* into French law

In French law, *Ijara Muntahia Bittamlik* related to real estate assets is similar to a real property finance lease (crédit-bail immobilier) structure.

However, certain characteristics specific to the real property finance lease (crédit-bail immobilier) structure will have to be adjusted so that Shariah-compliant IMB transactions can be carried out in respect of real estate assets located in France.⁶²

⁶² Cf., inter alia, G Saint-Marc, Finance islamique et droit français, roundtables organised by the Senate's Finance Committee of 14 May 2008; M El Khoury, Techniques de financement islamique, une discipline peu connue en France, Banque et Droit, 1 September 2003, No 92, p. 17; P Grangereau and M Haroun, Financements de projets et financements islamiques; Quelques réflexions prospectives pour des financements en pays de droit civil, Banque et Droit, 1 September 2004, No 97, p. 52; J Charlin, Fiducie, sukuk et autres murabaha ou ijara – A propos de la finance islamique, JCP Entreprise et Affaires, No 41, 8 October 2009, 1946; F Bourabiat and A Patel, La finance islamique: convergences éthiques et pratiques pour l'accèsion à la propriété et les investissements responsables, extrait du livre La finance islamique à la française, un moteur pour l'économie, une alternative éthique, Secure Finance, 2008, p. 231.

- Legal regime applicable to real property finance leasing

Real property finance leasing is a technique for financing real estate whereby a bank, finance company or company carrying out a standalone transaction (the lessor) acquires real estate for business use in order to lease it to a natural person or legal entity subject to taxation under a professional tax regime or under corporation tax (the lessee); such lessee also having the option of becoming the owner of the leased real estate for a – usually low – residual value at the end of the lease by invoking a unilateral undertaking to sell (purchase option) granted by the lessor in its favour.⁶³

From a legal viewpoint, a real property finance leasing contract therefore consists of: (i) the leasing contract in respect of real estate for business use concluded between lessor and lessee; accompanied by (ii) a unilateral undertaking to sell the leased real estate granted by the lessor in favour of the lessee.

➤ Nature of the real estate forming the subject of a leasing transaction

Article L 313-7 2°, paragraph 1, of the Monetary and Financial Code stipulates that the leased real estate forming the subject of the lease must be for “business use”.⁶⁴ The definition of real estate for business use is very broad as it not only encompasses real estate designated for an industrial or commercial activity, but also extends to real estate leased to professional service providers or to occasional or institutional investors, provided it is subleased to third parties for a consideration.

➤ Main characteristics of the real property finance leasing contract

A finance leasing contract is a *sui generis* contract that includes, inter alia, provisions related to the leasing of real estate, the acquisition of such real estate and the financing of the real estate acquisition.

A real property finance leasing contract is similar to the rental of real estate but it cannot be entirely classed as leasing because it is accompanied by an option to purchase the real estate forming the subject of the contract at a residual value at the end of the contract. There is, therefore, added to the provisions related to the leasing of real estate and the financing of the acquisition of such real estate by the lessee a unilateral undertaking to sell from the lessor in favour of the lessee.

This unilateral undertaking to sell was acknowledged in eight leading cases decided by the Court of Cassation (the highest French court for civil and commercial matters) on 10 June 1980,⁶⁵ which still stand to this day, as playing an essential part in a leasing contract.

⁶³ Under article L 313-7 2°, paragraph 1, of the Monetary and Financial Code, “transactions whereby a company leases real estate for business use, purchased by it or constructed on its behalf, where such transactions, regardless of their description, enable tenants to become owners of all or part of the leased real estate, at the latest on expiry of the tenancy agreement, whether by transfer in execution of a unilateral undertaking to sell, by direct or indirect acquisition of title to the land on which the leased real estate has been constructed or by transfer ipso jure of ownership of the buildings constructed on the land belonging to said tenant” will be deemed to be real estate leasing transactions.

⁶⁴ See footnote 63 above.

⁶⁵ Cass. 3rd civ., 10 June 1980, No 78-11032, Sté Union de crédit-bail immobilier Unibail v. Sté Groupement foncier français.

The Court of Cassation also ruled that a real property finance leasing agreement is a special legal institution essentially relating to the acquisition of the leased property.⁶⁶ Therefore, the provisions specific to the status of commercial leases covered by Decree No 53-960 of 30 September 1953 do not apply to leasing contracts since the sums paid by the lessee are not analysed as a simple rent that guarantees the use of the leased property, but rather constitute the financial consideration enabling the lessee to acquire the leasehold for a residual value.

In practice, at the end of the lease, the lessee has the following options:

- to return the leased real estate to the lessor;
- to remain the lessee of the real estate and conclude a new lease with the lessor; or
- to acquire the real estate at its residual value fixed at the outset in the leasing contract by exercising the purchase option granted to the lessee.

Generally speaking, in this last scenario, the exercise of the purchase option by the lessee results in the purchase of the real estate for the amount originally provided for in the leasing contract, less rental payments already made.

Lastly, in accordance with the provisions of article L 313-9, paragraph 2, of the Monetary and Financial Code,⁶⁷ the lessee has the option of unilaterally terminating the lease. In practice, this option is generally accompanied by the obligation imposed on the lessee to pay the lessor compensation in respect of the termination when exercising such unilateral termination option.

- Tax regime applicable to real estate leasing

The real estate leasing regime is highly stable from a tax standpoint and poses few problems.

> Registration

A real estate leasing contract with a term of more than 12 years is subject to land registration tax based on the aggregated amount of rent (excluding advance rent corresponding to financial charges).

Failure to carry out such registration formalities will render the acquisition of the real estate by the lessee's exercising of the purchase option subject to registration fee on the real value of the real estate rather than on the price expressed in the option, which would deprive the transaction of one of the main advantages of this finance leasing scheme.

The lessor therefore bears the standard registration fee at the time of acquisition of the real estate (in practice, though, the lease frequently relates to new real estate to which VAT is applicable and recovered by the lessor if it exercises the option to subject rent to VAT, which only leaves the land registration tax),

⁶⁶ Cass. 3rd civ., 10 June 1980, No 79-13330, SARL Epipress v. SA Bail-Investissement: Bull. civ. III No 114.

⁶⁷ Under article L 313-9, paragraph 2, of the Monetary and Financial Code, "These contracts stipulate, on pain of nullity, the conditions under which they may, where applicable, be terminated at the request of the lessee."

whereas the lessee will only bear the registration fee on the residual value when exercising the option. Lastly, if the lessee wishes to exercise the purchase option even though it still has a significant value, which is likely to occur when the lessee wishes to sell its real estate before expiry of the contract, it will then probably choose to transfer its rights under the lease, rather than exercise the option and sell the real estate, this latter solution being less tax-efficient.

> Direct taxes

The tax regime on real estate leasing contracts has been reformed to reflect the financial nature of the transaction.

Rent constitutes operating income for the lessor taxable on an ongoing basis as the service is provided. The real estate is depreciated in the hands of the lessor, either under the conditions of ordinary law or, as an option, according to the financial method over the term of the contract. In this case, the annual depreciation allowance is the fraction of rent acquired with respect to the financial year, which reflects writing off capital invested to acquire the real estate. If an option is not made for the financial method, the lessor may deduct a provision to anticipate the book loss to be incurred at the time of exercise of the option for a price below the net book value. If opting for financial depreciation, this provision is constituted only if the price of the purchase option is less than the value of the land. The capital gain or loss resulting from exercising the option is included in the lessor's taxable profit.

With regard to the lessee, the rent is, in principle, fully deductible. However, when the price of exercising the option is less than the cost of acquiring the land by the lessor, the fraction of rent equal to the difference observed between these two sums is excluded from the deductible expenses at the end of the contract. However, special rules exist for real estate which were built after 31 December 1995 and are mainly allocated to office use in Ile-de-France.⁶⁸ The deduction of the portion of rent corresponding to the amortisation of the investment cost is then limited to the amortisation that the lessee could have applied had it been the owner of the real estate. If the real estate is not acquired at the end of the contract, any portions of rent not deducted during the leasing period are deducted from the taxable profit.

When the purchase option is exercised, a reinstatement must be applied when determining the lessee's tax profit in respect of the exercised option, in order to place it in a situation identical to that if it had acquired the real estate from the outset. Thus a reinstatement is applied that is equal to the difference between: (i) the value of the real estate when signing the contract, less the option price; and (ii) the amortisation that the lessee could have deducted if it had been the owner. The real estate is recorded as an asset of the lessee for the acquisition price plus reinstatements applied, broken down into the price of the land and the price of the building, and may be depreciated under the conditions of ordinary law (excluding the land).

⁶⁸ Without being located in an urban regeneration zone or regional aid zone.

➤ Residual tax problems in structures complying with Shariah principles:

A number of problems should be resolved in the new tax guideline to be published on *Ijara*.

Firstly, it is problematic under Shariah rules that the purchase option granted in addition to *Ijara* appears in the same contract as the *Ijara* (rule banning grouping of contracts, see below). The new tax guideline stipulates that even if the purchase option in favour of the client appears in a contract separate from the leasing contract, this does not constitute an obstacle to the transaction being qualified as a finance lease (*crédit-bail*) or a lease with purchase option (*location assortie d'une option d'achat*) from a tax standpoint. This is as long as both contracts, being signed concomitantly, form part of the same contractual unit, subject once again to the capacity of the lessor (credit institution or a company benefiting from one of the exceptions to the banking monopoly provided for in the Monetary and Financial Code).

Secondly, doubts could have surfaced about the possibility of the *Ijara* transaction benefiting from the registration fee based on the option price (and not on the market value of the real estate), in the case of a single leasing contract given the existence of a separate option to buy, or the possibility of subsequent price adjustment. Here too, the guideline confirms the effective application of this preferred regime, subject to compliance with the banking monopoly.

➤ Opportunities created by French tax law with respect to financing and refinancing backed by real estate: sale and leaseback

The amending finance law of 20 April 2009⁶⁹ makes provision for a regime that staggers the taxation of capital gains recorded during real estate lease-back transactions carried out before 31 December 2012. Thus, when a company sells to a leasing company real estate designated for industrial, commercial or agricultural use, of which it may take immediate possession under a leasing contract, the amount of the capital gain on the sale may be divided equally over complete financial years during the term of the leasing contract for up to 15 years (in lieu of immediate taxation at the full rate, which would make the transaction economically unviable).

With regard to registration fees, these transactions are also subject to land registration tax or a registration fee at the reduced rate of 0.715%.⁷⁰

Furthermore, disposals or additions of real estate assets (real estate, real estate leasing contracts or units and shares held in real estate investment companies) to a listed real estate investment company (*société d'investissements immobiliers cotées*, SIIC) or an investment company with variable capital investing primarily in real estate (*société de placement à prépondérance immobilière à capital variable*, SPPICAV), or to their subsidiaries, whether or not followed by a leaseback of these assets by their transferors or contributors (very often the case in practice), also benefit from a taxation regime at a reduced rate of 19%,⁷¹ known as SIIC 2, provided the SPPICAV or its subsidiary undertakes to retain the assets thus transferred

⁶⁹ Amending finance law No 2009-431 of 20 April 2009 for 2009.

⁷⁰ Article 1594F quinquies H of the General Tax Code.

⁷¹ Plus, where applicable, social security contributions of 3.3%, i.e. an overall rate of 19.67%.

or added for five years (same tax regime as for SIICs). This regime is also applicable to disposals of real estate assets made to a leasing company which in turns leases the asset to a SIIC, a SPPICAV or its subsidiaries under a finance lease. The commitment to retain must be made in the deed of acquisition or contribution and be appended by the transferee and transferor companies to their tax returns. Failure to comply with the commitment to retain is sanctioned by a penalty equal to 25% of the acquisition price of the real estate. The same penalty is applicable if the transferee company is a subsidiary of the SPPICAV that does not remain in the exemption regime for at least five years. This reduced-rate regime applies to transactions carried out on or before 31 December 2011, unless extended before then to a later date.

> *Ijara and Sukuk*

The transfer of a real estate portfolio always entails problems concerning capital gains taxation and transfer duty. Where the aim of a disposal is the long-term transfer of an asset to an investor (standard example of the disposal of a real estate portfolio to a SIIC or a real estate collective investment fund (organisme de placement collectif immobilier, OPCI), whereby the investor bears the risk and receives the rewards of any subsequent fluctuation in the value of this portfolio, then the principle of taxation (adjusted, where applicable, as an incentive as recalled above) is normal. Conversely, if the disposal is only carried out to secure a loan, or if the disposal of the asset is carried out to form the underlying of a *Sukuk*, then any resulting significant tax friction will put an end to these transactions.

The UK government made major headway in 2009 by authorising the sale of real estate exempt from capital gains and transfer duty when these assets are the underlying assets in *Sukuk* transactions (and bond issues in general) and are followed by the return of the real estate asset to the assets of the beneficial borrower.

In France, the introduction of *fiducie* has opened up attractive prospects in French tax law by permitting the transfer of an asset free of tax (except for land registration tax to a fiduciary estate), subject to the later return of the asset to the assets of its original owner. Within the framework of Islamic finance, in the absence of a possible conventional loan, we should consider implementing a mechanism that allows provisional tax-exempt disposals to be carried out, subject to returning the assets to the original owner, mindful of the many legal difficulties this may cause.

Proposition

In order to permit *Sukuk* transactions linked to French real property assets, it would be desirable to consider a regime analogous to the recent UK provisions and the *fiducie* regime permitting the temporary transfer of real property assets free of taxation.

4.2.6 Key problem areas encountered as regards *Ijara Muntahia Bittamlik* related to real estate assets

- With regard to French law

- Finance leasing: a credit transaction

Under the Monetary and Financial Code, leasing transactions are regarded as credit transactions.⁷²

This implies that if they were to be carried out on a regular basis, IMB transactions related to real estate assets based on the real estate leasing regime would be reserved solely for credit institutions.

- Limitations as regards cross-promises

Real estate finance leasing under French law is characterised by the existence of the sole undertaking to sell (purchase option) granted by the financial institution to its lessee, such that it is sufficient for the lessee to exercise its option to buy in order to acquire the real estate asset.

The use of cross-promises to buy and sell, although sometimes practised, raises complex legal issues under French law and must be used with caution, because the sale in favour of the lessee must remain an option for, rather than an obligation on, the lessee.

As the rules of Islamic finance on IMB provide for the implementation of cross-promises in terms of separate documents, we must therefore keep in mind these restrictions of French law within the framework of structuring Shariah-compliant leasing transactions in order to avoid any risk of reclassification being applied to the contract in the event of dispute between the parties.

- With regard to Shariah

- Prohibition of 'grouping of contracts'

Under French law, to come under the leasing regime, the leasing contract must include a unilateral undertaking to sell on the part of the lessor, giving the lessee the option of acquiring all or part of the leased real estate.⁷³

However, under Shariah, IMB is analysed above all as a leasing contract. Therefore, from a purely formal point of view, the leasing contract must not contain provisions related to the purchase of the leased real estate at the risk of distorting the leasing contract.

This is why most Shariah scholars consider that the structuring of IMB is possible so long as two distinctly separate contracts are clearly concluded between the lessee and the lessor: an undertaking to sell on the one hand, and a leasing contract on the other.

⁷² Article L 313-1 of the Monetary and Financial Code.

⁷³ Cass. Com. 30 May 1989, No 88-11445, Bull. civ. IV, No 167.

Although from a practical standpoint it is certainly possible to provide for two distinct documents, i.e., a leasing contract and a unilateral undertaking to sell, within the framework of the same real estate leasing transaction, the legal risk is significant. Under prevailing case law⁷⁴, the legal regime applicable to finance leasing is held not to be applicable in the event of dispute between the parties.

➤ Rescheduling of payments

The rescheduling of payments is possible in a finance leasing contract.

However, this is not conceivable under Shariah, unless the rescheduling does not result in any increase in the amount of rent due.

The utmost attention must therefore be paid to the drafting of this type of clause in real estate leasing contracts that are supposed⁷⁴ to be Shariah compliant.

➤ Penalties for late payment

In real estate leasing, the contract frequently makes provision for penalties for late payment of rent. These penalties are paid by the lessee to the lessor.

This is not possible in an IMB contract as the fixed penalty is similar to an interest rate. In addition, the Muslim philosophy disapproves of any stipulation in a financial contract that penalises a bona fide debtor already in difficulty.⁷⁵

However, Shariah scholars can envisage accepting the possibility of an IMB contract stipulating a (fixed or variable) penalty clause, provided the penalties received are paid to charitable organisations.

➤ Major repairs

In a real estate leasing contract, it is frequently provided that the lessee will bear the cost of the major repairs referred to in article 606 of the Civil Code on the real estate that is the subject of the finance lease.

Such agreement by the lessee to bear the cost is inconceivable under Shariah, since an IMB is analysed above all as a leasing contract and in this respect the major repairs, as defined in article 606 of the Civil Code,⁷⁶ can only be assumed of by the lessor.

Proposition

Effect a legislative precision expressly permitting the conclusion of finance leasing transactions by simultaneous signature of a lease agreement and a unilateral purchase option, so long as the two documents refer mutually to each other and indicate expressly that they are to be placed under the finance leasing regime. However, this supposes that Shariah Boards are ready to accept that the two documents refer to each other.

⁷⁴ See footnote 73.

⁷⁵ J. Lasserre Capdeville, *La finance islamique: une finance douteuse?* Revue de Droit bancaire et financier, No 5, September 2009, study 32.

⁷⁶ Article 606 of the Civil Code: "Major repairs are those to main walls and vaults, the restoring of entire beams and of entire coverings; that of dams and retaining and enclosing walls in their entirety. All other repairs are maintenance."

Contractual adjustments may, however, be considered to reconcile the positions of each, subject of course to validation by the competent Shariah Board. Thus it could, for example, be contemplated, in order to comply with this prescription under Shariah, while also transferring to the lessee the costs associated with the major repairs under article 606 of the Civil Code, stipulating in the contract to make the exercise of the purchase option by the lessee dependent on the payment in full, at the time of exercising the option, of the charges related to the real estate forming the subject of the finance lease, including the charges associated with article 606.

➤ Accelerated payment of rent

In conventional real estate leasing, the contract frequently provides clauses enabling the lessor to require the lessee to pay the balance of the rent instalments before their respective due dates if certain events occur.

Under Shariah, such acceleration is not permitted if the lessee is not at fault. This is the case, for example, in the event of the occurrence of an unforeseeable and irresistible event of force majeure.

Here too, however, contractual adjustments may be considered depending on the position adopted by the Shariah Board called to express an opinion on the IMB transaction.

➤ Indexation clauses

As the validity of indexation clauses is under discussion among Shariah scholars, it seems preferable to make provision for a fixed rate of increase at the time of the conclusion of the IMB contract.

If it is not possible to reach agreement with the client on such a clause, an alternative to be explored by the parties would be to provide that the amount of rent may be modified – where applicable, subject to predetermined lower and upper limits – on due dates agreed when signing the contract.

4.3. Residential real estate

The acquisition of real estate by private individuals is generally structured in Islamic finance either via *Ijara Wa Iqtina* (similar to a hire-purchase plan) or using *Musharaka Moutanakissa* (degressive partnership agreement).

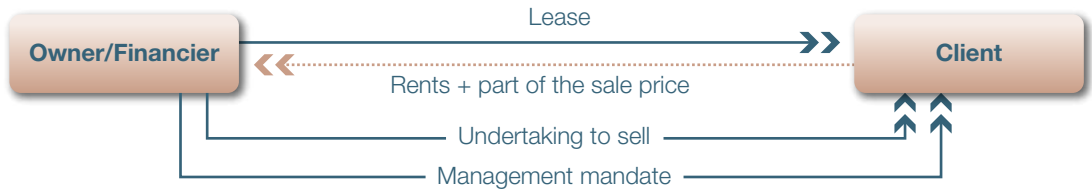
It is on the basis of one of these Shariah-compliant structures that the home purchase plan has emerged in the UK,⁷⁷ a flagship retail product developed by the Financial Services Authority (FSA).

It should also be noted that the acquisition of residential real estate may also be financed by *Murabaha* under the principles referred to in 4.1 above, even though certain difficulties, such as no possibility of being backed by variable rate financing or refinancing this type of structure, will create practical problems.

⁷⁷ Documentation placed online by the FSA on the Home Purchase Plan: www.moneymadeclear.fsa.gov.uk/pdfs/home_purchase_plans.pdf.

4.3.1. Definition of *Ijara Wa Iqtina*

Ijara Wa Iqtina is based on an *ijara* contract with an option to transfer ownership of the leased real estate to the tenant as the rent and part of the acquisition price is paid. A management mandate is also frequently associated with the basic scheme so that the financier can delegate to its client any major repairs to be carried out on the real estate for its account.



4.3.2. Definition of *Musharaka Moutanakissa*

The AAOIFI defines *Musharaka* as “a contractual partnership (called *Sharika al-Aqd*) consisting of a contract between two parties that combines their assets, work or commitments with the aim of making profits”.⁷⁸

In practice, *Musharaka* more often than not takes either of the following forms:

- *Musharaka Sabita* (fixed)

Within the framework of *Musharaka Sabita*, the credit institution and the client remain partners until expiry of the contract binding them.

- *Musharaka Moutanakissa* (degressive)

Within the framework of *Musharaka Moutanakissa*, the credit institution gradually withdraws from the partnership in accordance with the contractual stipulations. The financier’s participation in the *Musharaka Moutanakissa* is therefore reduced as its initial investment is repaid along, where applicable, with the corresponding remuneration.

⁷⁸ Shari’a Standards No 12, *Sharika (Musharaka)* and modern corporations, paragraph 2/1.

4.3.3. Transposition of *Ijara Wa Iqtina* into French law

- Rent-to-own (location-accession)

> Legal regime

Ijara Wa Iqtina is related to the rent-to-own (location-accession) scheme instituted by law No 84-595 of 12 July 1984. The aim of the scheme is to enable tenants to become owners of their home at the end of a tenancy.

The rent-to-own scheme is a contract under which a seller gives an undertaking to a tenant to transfer – if the buyer subsequently demonstrates the desire to do so and following a period of possession for valuable consideration – ownership of all or part of a property against payment in instalments or deferred payment of the sale price and the payment of a fee until the date the option is exercised. The fee is the consideration for the tenant's right to possess the home and his personal right to the transfer of ownership of the property.⁷⁹

A natural person or legal entity therefore concludes with the owner of a home for residential or mixed use a rent-to-own contract under the terms of which such owner undertakes to sell the lodging to the lessee at the end of a tenancy. In return, the person or entity pays the owner a fee that includes the rent and part of the price for acquiring the home.

At the end of the tenancy, either the person or entity wishes to acquire the property and so exercises the option to buy at the price agreed in the rent-to-own contract (in which case the amount paid is deducted from the portion of the price already paid to the seller in the form of the fee) or they do not wish to buy (in which case this portion is reimbursed).

However, the basic problem preventing transposition of the rent-to-own scheme vehicle into the French law of *Ijara Wa Iqtina* stems from the fact that the provisions of the law of 12 July 1984 are a matter of public policy and that violation thereof results in the nullity of the agreement. This does not leave any leeway for any necessary adjustments with regard to either the rules of Shariah or their interpretation by the Shariah Boards.

Furthermore, rent-to-own is based on the principle of the tenant's free determination, at the end of a tenancy, whether or not to exercise the purchase option to him by the owner. The risk that therefore burdens the owner of not being able to sell his real estate, at the end of the rent-to-own contract, to the tenant and having to return to the tenant the share of the sale price already paid, explains this scheme's current lack of appeal to major players in the French residential real estate market.

⁷⁹ Article 1 of law No 84-595 of 12 July 1984 defining the rent-to-own immovable property scheme.

It is unlikely that French or France-based foreign credit institutions will show interest in such a scheme as part of a Shariah-compliant property ownership product targeted at private individuals, bearing in mind that their clients could not only refuse to acquire the real estate they had purchased at their request, but also that they could be forced to bear any capital losses recorded for such real estate between their respective dates of acquisition and resale on the market. From the credit institution's point of view, the exercise of the option would have to be virtually certain.

> Tax regime

The tax regime applicable to the rent-to-own scheme flows from the consequences of the existence of two distinct periods: a rental period accompanied by a unilateral undertaking to sell, followed, where applicable, by a sale, each subject to its own specific tax regime. From the standpoint of VAT and transfer duty, the contract may however be regarded in its entirety as a sale under certain conditions, which makes the regime applicable to this contract particularly attractive.

- Direct taxes

The fee paid during the rental period constitutes the consideration for the right to undisturbed possession on the one hand, and the right to transfer ownership of the real estate as provided for by law on the other hand.

The portion of the fee corresponding to the rent constitutes revenue from land when the transferor is a private individual acting within the framework of the management of his personal assets, or pure and simple operating income if the real estate is booked in a company's balance sheet, whether or not the company is a real estate professional.

The fraction of the fee representing the consideration for the tenant's personal right to the transfer of ownership constitutes a down payment on the sale price, which is not immediately taxable and will only be taxed at the time of transfer of ownership. Indeed, if the contract is terminated or the option not exercised, the transferor is obliged to reimburse these sums to the buyer within a maximum period of three months, this reimbursement being guaranteed by a bank guarantee or by the buyer's lien.

The gain realised at the time of exercise of the option is subject to the personal capital gains regime where the transferor is a private individual or to the business capital gains regime if the real estate is recorded under an enterprise's assets.

We should emphasise that if the real estate constitutes a fixed asset, it may be depreciated. But where the transferor is a real estate professional (real estate dealer or developer) or a financier, the real estate will probably form part of its real estate stock rather than fixed assets, despite its prior use for leasing purposes.

- VAT and registration fees

Contracts which do not provide for an increase in the indemnity amount follow the regime applicable to real estate leasing followed by sale of real estate. Before the exercise of the purchase option, the agreement is therefore subject to the tax regime applicable to real estate leasing contracts and so is VAT-exempt without the possibility of opting for the payment of such tax (residential real estate).

Upon exercise of the option, the sale of the real estate is taxable under the conditions of ordinary law. Within the framework of new provisions on VAT applicable to real estate, the sale, where it relates to real estate rebuilt or completed less than five years earlier, regardless of the number of intervening sales, is *ipso jure* subject to VAT. The seller is therefore liable for VAT. The registration fee is limited to the land registration tax at the rate of 0.715%, paid by the acquirer. In the event of a sale of real estate that is more than five years old, the sale is VAT-exempt, unless the seller opts to pay VAT, which will be unfavourable as the end acquirer does not recover VAT. Registration fee is due at the rate of 5.09%, whether or not VAT is applicable.

Article 11 of law No 84-595 provides that the seller may obtain compensation if the rent-to-own contract is terminated by the tenant or if he does not exercise the option on the agreed date. In the first case, the compensation may not exceed 2% of the price of the real estate and, in the second, 1% of this price. But when the transaction relates to real estate falling within the scope of VAT applicable to real estate, the parties may stipulate that the amount of this combined compensation is increased to 3% of the price of the real estate. Under these conditions, the law then provides that the rent-to-own contract is regarded as a sale from the beginning for the application of VAT and registration fees.

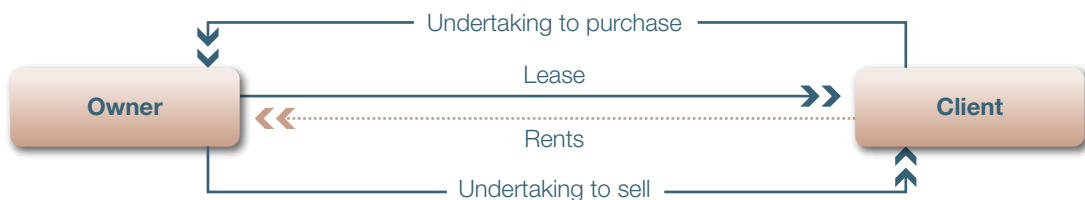
Lastly, in all cases the friction resulting as regards registration fees from the double transfer may, where applicable, be avoided by the commitment to resell given by the seller if acting in the capacity of a financial intermediary between seller and client.

- Hire purchase (location-vente)

> Legal regime

Hire purchase is a mixed contract that combines a lease with a sale.

In its conventional sense, hire purchase is leasing which, at the end of a period of possession during which payments are made as rent, is accompanied by an automatic transfer of ownership in favour of the tenant-acquirer in execution of the bilateral undertaking to sell included in the contract.



Although no French legislation directly regulates hire purchase, the practice is not prohibited. On the contrary, legislation on consumer credit⁸⁰ and real estate credit⁸¹ refers to this type of agreement, subjecting it to the rules introduced to protect consumers.

Thus, in application of articles L 312-24 to L 312-31 of the Consumer Code, hire-purchase contracts must be preceded by an offer subject to identical forms and having a content similar to that of a loan agreement: identity of the parties, nature and purpose of the contract, date and conditions for making the real estate available, amount of initial payments and rent and, where applicable, indexation terms and conditions. The submission of the offer obliges the landlord to keep it fully intact for a minimum period of 30 days. The tenant may only accept the offer 10 days after receiving it.

The rental period is essentially governed by the law applicable to leasing.⁸²

The leasing of property is covered by the provisions of ordinary law in the Civil Code, as well as specific legislation for when the real estate is an apartment building.⁸³

The question is whether the distinctive nature of hire purchase means that special legislation, such as that applicable to leases of dwellings (tenancy agreements), is not applicable, and that only the ordinary regime relating to leasing is applicable.

With respect to subjecting hire purchase to tenancy agreement status, the Court of Cassation has delivered two conflicting judgments. In the first, dated 13 June 2001, the Third Civil Division quashed the decision of a Court of Appeal that had refused to apply the law of 6 July 1989 to a hire-purchase contract on the grounds that this law "...covering public policy governs the rental period of the contract accompanied by an undertaking to sell".⁸⁴ In the second judgment of 28 October 2003, the same Division affirmed that the appeal judges could have inferred, based on their own interpretation of the intention of the parties "that the tenancy agreement was incidental to the undertaking to sell" in order to reject application of the law of 6 July 1989.⁸⁵

The subjection of hire purchase to the ordinary provisions of leasing law, excluding application of the special legislation relating to tenancy agreements, is therefore not clear.

Furthermore, the hire purchase scheme does not guarantee that the rental will necessarily be transformed into a sale, either because the tenant does not exercise the option in the case of a lease with a purchase option, or because during the rental period the non-payment of rent results in the termination of the hire-purchase contract.

⁸⁰ Articles L 311-1 et seq. of the Consumer Code.

⁸¹ Articles L 312-1 et seq. of the Consumer Code.

⁸² The judgment of the Court of Cassation of 7 February 1977, which acknowledges that hire purchase is pure and simple leasing, leads to this solution (Com. 7 February 1977, No 75-11716, D. 1978. 702).

⁸³ For example, law No 89-462 of 6 July 1989 in respect of a lease/tenancy agreement related to real estate for residential use or residential and business use.

⁸⁴ Civ. 3rd, 13 June 2001, No 99-17585, Bull. civ. III, No 75, RJDA 2001, No 949, AJDI 2001. 798, obs. Beaugendre.

⁸⁵ Civ. 3rd, 28 October 2003, No 02-14486.

In the first case, the parties may, in principle, freely determine the consequences of the failure to exercise the option.

On the other hand, the Consumer Code governs the consequences of non-payment of rent by the tenant during a hire-purchase contract.

Under article L 312-29, paragraph 1, of the Consumer Code, overdue rent and, without prejudice to the application of article 1152 of the Civil Code, compensation fixed by decree that is less than or equal to 2% of the share of the payments corresponding to the capital value of the real estate to be made until the date specified for the transfer of ownership,⁸⁶ may be claimed from the tenant.

However, under paragraph 2 of article L 312-29 of the Consumer Code, the landlord may only demand the handover of the real estate after reimbursement of the portion of the sums paid corresponding to the capital value of this real estate.

No compensation and cost other than those referred to above may be borne by the tenant. However, the landlord may, in the event of default, claim reimbursement from him on justification of the taxable expenses incurred by such default, to the exclusion of any fixed reimbursement of collection charges.

> Tax regime

From a tax standpoint, the problem raised by hire purchase is the absence of a dedicated tax regime, as this contract does not fall within any specifically defined regime. Hire purchase has a hybrid nature because it is both a rental and a sale. It may therefore be analysed as a sale by instalments or as a rental with an option to purchase. Confirmation of the regime to be applied is needed so that this product can be used on a large scale, particularly among private individuals. An applicable tax regime could be inspired by that surrounding rent-to-own schemes referred to above, which has the advantage, particularly with regards transfer duty and VAT, of classifying the contract as a sale when it is concluded, subject to certain conditions aimed at making it likely that the option to buy will be exercised.

4.3.4. Transposition of *Musharaka Moutanakissa* into French law

Under a home purchase plan in the UK, the bank and the client jointly purchase real estate. At the outset, the client contributes a percentage of the amount of real estate and the bank contributes the remainder to cover the total acquisition price. The client then gradually, over the years, buys back the share owned by the bank and at the same time pays it rent for the use of the share of the real estate that he does not own. Once the bank's share has been bought back in full, ownership is transferred and the end client becomes the sole owner of the real estate.

⁸⁶ Article R 312-4 of the Consumer Code.

- The SCIAPP

In France, a structure along the lines of that implemented in the UK under the home purchase plan has been devised to enable gradual ownership of social housing, the extension of which to all residential real estate has been considered by a number of authors.⁸⁷

Established by the law of 13 July 2006 concerning the national commitment towards housing,⁸⁸ the non-trading real estate investment company for gradual property ownership (société civile immobilière d'accession progressive à la propriété, SCIAPP) is a form of non-trading company created by the legislator that enables tenants of public sector housing (habitations à loyers modérés, HLM) gradually to acquire ownership of their homes.⁸⁹

➤ Legal regime

Under article L 443-6-2 of the Construction and Habitation Code, the aim of such SCIAPPs is to own, manage and maintain apartment buildings that have received a contribution from the HLM organisation, to be divided into fractions for rental by private individuals whose resources, on taking up occupancy, do not exceed the limits set in application of the provisions of article L 441-1 of the same code and, where appropriate, allocated as ownership by the partners of the SCIAPP.

The various partners make cash contributions. The HLM organisation or a government-controlled corporation makes a contribution in kind in respect of an apartment building valued by the national property service.⁹⁰

The SCIAPP's assets are primarily composed of an apartment building for residential or mixed use, contributed at the time of formation of the company by an HLM organisation. Its capital is divided into shares representing apartments. Private individuals who wish to acquire an apartment but do not have the necessary funds immediately subscribe for shares of their tenanted apartment and thus become partners of the company.

From time to time, and at least once a year, the HLM organisation is obliged to offer its partners the sale of a portion of the company's shares corresponding to their apartment. When they have acquired all the shares corresponding to their apartment, the tenants become owners. They then withdraw from the company and the shares corresponding to the apartment are cancelled.

⁸⁷ In this sense: F Bourabiat and A Patel, *La finance islamique: convergences éthiques et pratiques pour l'accession à la propriété et les investissements responsables*, extract from *La finance islamique à la française, un moteur pour l'économie, une alternative éthique*, Secure Finance, 2008, p. 231; G. Lembo, *La SCIAPP: nouvel instrument juridique français, 100% Charia-compatible, Droit et Patrimoine*, 2010, No 188; Interview of H Latrache, Secretary-General of AIDIMM, published on 20 April 2007 on the website of RIBH, the Islamic finance journal: ribhf.fr.wordpress.com/2007/04/20/interview-de-hakim-latrache-secretaire-general-de-l%E2%80%99association-aidimm/; File: innovative property ownership schemes, article published on the AIDIMM website: [www.aidimm.com/articles/dossier-formules-innovantes-d-accession-](http://www.aidimm.com/articles/dossier-formules-innovantes-d-accession-a-la-proprieete_40.html)

[a-la-proprieete_40.html](http://www.aidimm.com/articles/recherche-de-solutions-sans-frais-d-interets-bancaires_16.html); Research into solutions without bank interest charges, article published on the AIDIMM website: www.aidimm.com/articles/recherche-de-solutions-sans-frais-d-interets-bancaires_16.html.

⁸⁸ Law No 2006-872 of 13 July 2006 related to the national housing commitment.

⁸⁹ The legislative provisions governing this new form of company have been integrated in articles L 443-6-2 to L 443-6-12 of the Construction and Habitation Code. The decree of 26 January 2009 related to the articles of incorporation of SCIAPPs also supplemented the mechanism by incorporating a model based on standard articles of incorporation of SCIAPPs appended to article R 443-9-4 of the same code.

⁹⁰ Article L 443-6-4 of the Construction and Habitation Code.

The tenants are not forced to remain a partner in the company, as they have the option of requesting, at any time, that the HLM organisation buy back their shares while also retaining the benefit of the tenancy agreement for their apartment.

➤ Tax regime

SCIAPPs do not have a specific tax regime. They are similar to transparent property companies (*sociétés d'attribution*) and are in the same way fiscally transparent. To promote the creation of SCIAPPs, specific tax provisions are planned but are related to the goal of facilitating the social housing of such companies. The General Tax Code also authorises regions and departmental administrative districts to exempt from additional tax on registration fees and land registration tax all sales, except for the first sale, of each share representing a fraction of the apartment buildings.

• Alternatives

The law on fiduciary transactions (*fiducie*) should also permit the implementation of attractive schemes as it would help to organise what lies at the heart of *Musharaka Moutanakissa*, namely the gradual transfer of rights to an underlying asset between the fiduciary (financial intermediary) and the client. Nevertheless, in the current state of tax law, the transfer of rights pursuant to a fiduciary transfer follows the same regime as the underlying asset and so would result in the application of prohibitive transfer duty on the sale of apartment buildings.

Alternative structures are therefore currently being considered in order to devise a *sui generis* contract replicating the transfer of the financial intermediary's uncharacterised rights to the acquirer, but many legal and tax obstacles remain (particularly concerning the law on tenancy agreements).

4.3.5. Future prospects

It can be seen from the preceding discussion that the precise outline of the legal regime that would enable both *Ijara Wa Iqtina* and *Musharaka Moutanakissa* to be transposed into French law as regards residential real estate is yet to be defined.

Broadening the SCIAPP across the entire residential real estate sector does not necessarily meet the objective being sought, given the cumbersome management (15 to 30 years) of a multitude of SCIAPPs for banks keen to launch into this market. The obligation to buy back shares would also be a constant burden on banks while they are not subject to the same requirements concerning investment in rental property as the HLM organisations.

The Jouini & Pastré Report proposed making hire purchase a contract having a distinct legal category by modelling it on the finance leasing structure.⁹¹

⁹¹ Ibid. footnote 3.

We are more inclined to think that a flexible hire-purchase scheme modelled, for tax purposes, on the rent-to-own scheme would probably be easier to develop, especially as hire purchase has completely fallen outside the tenancy agreement regime since the judgment of 28 August 2003.

4.4. Real estate investment funds

The Islamic investment product market has grown significantly since the beginning of the 2000s. At the end of December 2008, the company Failaka counted nearly 365 Shariah-compliant funds in the Gulf region alone.⁹²

Islamic investment funds generally take the form of *Mudaraba*,⁹³ issuing shares or units subscribed for by investors.

4.4.1. Definition of *Mudaraba* under Shariah

Mudaraba is a contract under which a party (the *Rab Al-Maal*) makes a capital contribution, while another party (the *Mudarib*) makes an industrial contribution, i.e. contributes its expertise. Each party's share in the profits generated by the project is determined by mutual agreement. However, any loss is borne solely by the party contributing the capital, unless the loss results from negligence on the part of the *Mudarib* or breach of the terms of the contract binding it to the *Rab Al-Maal*.

There are two forms of *Mudaraba*:⁹⁴

- unlimited *Mudaraba*

This is a contract under which the *Rab Al-Maal* allows the *Mudarib* to administer the funds without any restriction.

- limited *Mudaraba*

This is a contract under which the *Rab Al-Maal* restricts the sphere of activity of the *Mudarib*.

The *Rab Al-Maal* may have the *Mudarib* issue guarantees in order to protect itself against any poor performance of the *Mudaraba contract* or negligence on the part of the *Mudarib*.⁹⁵ We should point out, however, that the *Mudarib* cannot be required to guarantee the financial results of the *Mudaraba*.

⁹² ACERFI website: www.acerfi.org/articles/les-fonds-de-placement-shariah-compliant_49.html#Ancre4.

⁹³ An investment fund may also be set up within the framework of a *Wakala* agreement, in which case the person or entity responsible for making the investments (the *Wakil*) acts as an authorised agent on behalf of the investment fund and, indirectly, of the investors. Along the lines of a *Mudaraba* transaction, the *Wakil* invests investors' funds on their behalf. The *Wakil* may then be remunerated on the basis of fixed fees and/or an amount indexed to the performance of invested funds. Nevertheless, *Wakala* seems more difficult to adapt to the French legal framework, in particular insofar as our concepts of authorised agent and broker do not recognise the holding of assets on behalf of others.

⁹⁴ AAOIFI, Shari'a Standard No 13, *Mudaraba*, point 5.

⁹⁵ AAOIFI, Shari'a Standard No 13, *Mudaraba*, point 6.

- Principal conditions of validity of *Mudaraba* under Shariah

The AAOIFI recommends compliance with a number of rules for the transaction to be deemed Shariah-compliant.

➤ Capital contributions⁹⁶

In principle, the capital contribution must be effected by the delivery of a sum of money. However, the capital contribution may be made by the delivery of a tangible asset, in which case it must be valued by an expert.

However, the contribution cannot consist of a debt whose debtor would be the *Mudarib* or any other person.

The capital must be put, either wholly or in part, at the disposal of the *Mudarib* for the contract to be recognised as valid.

➤ Profit distribution⁹⁷

The profit allocation mechanism must be clearly defined to eliminate any risk of uncertainty and ambiguity.

Such allocation must be effected as a function of a percentage of the realised profit.

In theory, it is not possible to combine the collection of a share of profit and fees in *Mudaraba*. However, it is conceivable to conclude a separate contract between the parties stipulating the exercise of a specific activity that is not included in the *Mudaraba contract* and gives rise to the payment of a fee.

➤ Duties of the *Mudarib*⁹⁸

The asset management contract must mention the fund manager's obligation to discharge its duties by demonstrating reasonable business caution.

The fund manager must also act in the interests of the fund that it represents.

➤ Principle of equality of treatment between all investors

The principles of Shariah require the equality of treatment between all investors. This implies that there must not be priority of payment of profit. A difference in treatment may, however, exist as regards non-pecuniary rights (such as voting rights).

⁹⁶ AAOIFI, Shari'a Standard No 13, *Mudaraba*, point 7.

⁹⁷ AAOIFI, Shari'a Standard No 13, *Mudaraba*, point 8.

⁹⁸ AAOIFI, Shari'a Standard No 13, *Mudaraba*, point 9.

➤ Financial ratios to be respected

Within the framework of *Mudaraba*, investments made by the fund manager on behalf of the fund must comply with the principles of Shariah and certain financial ratios.

Thus, in order to determine whether a company can form the subject of a compliant investment, Shariah scholars are duty bound to examine the financial resources on the basis of which the company derives its revenue.

For example, according to the Compliance Committee of the Dow Jones Islamic Market, investment in a company must be ruled out where:

- 1- the total amount of debt divided by the average market capitalisation value during the last 12 months exceeds 33%;
- 2- the total amount of available cash divided by the average market capitalisation value during the last 12 months exceeds 33%;
- 3- the total amount of accounts receivable due divided by the average market capitalisation value during the last 12 months exceeds 33%.

Furthermore, the miniscule share of dividends that may have been generated by illicit activities must undergo a purification process carried out by the fund manager under the supervision of the Shariah Board.

• Role of the Shariah Board

➤ At the time of fund creation

A Shariah Board is responsible for studying and validating the Shariah compliance of the products issued.

Generally speaking, the contractual conditions binding the fund to its future investors must comply with the principles of Islamic finance. Furthermore, the account maintenance and fund management procedures must not use prohibited processes.⁹⁹

With regard to portfolio composition, all the investments selected must comply with Islamic ethics. Companies carrying on their activities in *Haram*¹⁰⁰ sectors are not regarded as investment targets compatible with Islamic law. However, the Shariah Board of each investment fund remains free to issue its own opinion on whether or not the activity of this or that company is compatible with the principles of Shariah.

⁹⁹ Examples of prohibited processes: remuneration of the fund's cash, implementing prohibited hedging instruments, etc.

¹⁰⁰ Investment is therefore excluded in companies whose core business relates to the following sectors: tobacco, alcohol, pork-based products, conventional financial services, arms and defence, gambling and leisure (casinos, games of chance, cinema, pornography, music, etc.).

After verifying the compliance of the aforementioned criteria, the Shariah Board will issue a *fatwa*, which will then allow the management company to offer such products to its clients, highlighting their compliance. Generally speaking, the Shariah scholars in the Shariah Board will be named in the fund's prospectus sent to investors, along with the text of the *fatwa*.

➤ During the life of the fund

The Shariah Board also plays a decisive role during the life of the fund, as management companies must subject themselves to a series of compliance checks throughout the fund's life.

○ Regular audit of the fund

Performing a regular audit assures investors of the fund's ongoing compliance. The auditors must ensure that all the aforementioned rules are correctly applied and that the fund's general operating conditions are not likely to call its legality into question with regard to Shariah.

○ Purification of 'illicit' income

A portion of the income realised by a Shariah-compliant fund at the end of each accounting year must be paid to an institution officially recognised as serving the public interest.¹⁰¹ This is because Shariah scholars consider that, despite the application of various sectorial and financial filters, income from eligible companies continues, in spite of everything, to be tainted by a remainder of 'impure' products that cannot be totally eliminated by applying filters. A symbolic, albeit compulsory, purification must therefore be carried out annually by the fund's management company.¹⁰²

4.4.2 Transposition of *Mudaraba* into French law

Under French law, a real estate collective investment fund (*organisme de placement collectif dans l'immobilier*, OPCI) is the structure closest to the principles of *Mudaraba* outlined above: on the one hand, there are the unitholder investors (*Rab al-Maal*) and, on the other, there is the management company, together with its representatives or fund managers (*Mudarib*), who will endeavour to make the capital entrusted to them grow, while also ensuring that investments comply with the rules of Shariah.

• Origin of OPCIs and applicable regulations

OPCIs were created by the ordinance of 13 October 2005¹⁰³ to complement the range of savings products offered to private individuals and institutional investors (which had already been fostered by the successful creation of listed real estate investment companies (*sociétés d'investissement immobilier cotées*, SIICs))

¹⁰¹ In France, the AMF has acknowledged the right of Sharia-compliant funds to purify the impure portion of their dividends by making donations of up to 10% of their capital gains to institutions officially recognised as serving the public interest, such as the Institut du Monde Arabe (cf. the AMF's position dated 17 July 2007, Non-financial criteria for selecting securities: cases of UCITS declaring themselves to be in conformity with Islamic law).

¹⁰² The most common practice observed by the management companies of Shariah-compliant funds is to purify up to 5% of the total income realised at the end of each accounting year.

¹⁰³ Ordinance No 2005-1278 of 13 October 2005 defining the legal regime applicable to OPCIs and the procedures for transforming SCPIs into OPCIs. OPCIs were established by the same ordinance, resulting in the addition of articles L 214-89 to L 214-146, devoted to them, in the Monetary and Financial Code. A year later, law No 2006-1770 of 30 December 2006 ratified this ordinance.

and ultimately to replace real estate investment companies (sociétés civiles de placement immobilier, SCPIs).¹⁰⁴ They are characterised by better liquidity and are targeted at both the retail and the institutional markets.

The decree of 6 December 2006¹⁰⁵ then defined the rules for the composition of assets of OPCIs. These provisions were supplemented by those of the AMF General Regulations.¹⁰⁶ In application of such regulations, the AMF adopted, on 6 January 2009, two instructions: one related to the approval procedures and periodic reporting of OPCIs¹⁰⁷ and the other to the full prospectus of OPCIs approved by the AMF.¹⁰⁸

Although to our knowledge the AMF has not yet approved a Shariah-compliant OPCI, it has already had the opportunity to adopt a position on the compatibility of Islamic principles with the regulations applicable to undertakings for collective investment in transferable securities (UCITS) following the submission of an application for approval of a purportedly Shariah-compliant UCITS. The AMF notice of 17 July 2007¹⁰⁹ therefore authorises UCITS:

- to use non-financial selection criteria (by developing, for example, index fund management based on a Sharia-compliant index: Dow Jones Islamic Index, FTSE Islamic Global Index, S&P Shariah Index, etc.);
- to purify the impure portion of their dividends by making donations of up to 10% to institutions officially recognised as serving the public interest; and
- to use the services of a Shariah Board, subject to its not contravening the management company's autonomy.

On this basis, BNP Paribas obtained approval of a Shariah-compliant (non-real estate) fund in July 2007. In February 2008, SGAM obtained approval of two Shariah-compliant funds marketed in Réunion.¹¹⁰

- Legal regime

- Constitution of an OPCI

A distinction is made between two types of OPCI in terms of their legal form:

- real estate investment fund (fonds de placement immobilier, FPI)

An FPI is a co-ownership of transferable securities that issues units. Unitholders do not have any of

¹⁰⁴ Article 66 II-1° of law No 2006-1770 of 30 December 2006 ultimately decided to allow OPCIs and SCPIs to coexist.

¹⁰⁵ The provisions of decree No 2006-1542 of 6 December 2006 defining the rules of composition and operation of OPCIs and amending the Insurance Code and the Monetary and Financial Code were codified in articles R 214-160 to R 214-222 of the Monetary and Financial Code.

¹⁰⁶ Articles 424-1 to 424-73 of the AMF General Regulations.

¹⁰⁷ Instruction No 2009-01 of 6 January 2009.

¹⁰⁸ Instruction No 2009-02 of 6 January 2009.

¹⁰⁹ AMF notice of 17 July 2007, Non-financial criteria for selecting securities: cases of UCITS declaring themselves to comply with Islamic law; T. Bonneau, *Loi islamique*, *Revue de Droit bancaire et financier*, No 6, November 2007, comm. 237.

¹¹⁰ Saint Marc (G), *La finance islamique: une alternative pour financer l'économie française?* *Bulletin Joly Bourse*, 1 April 2009, No 2, p. 153.

the rights conferred on shareholders. The FPI is managed by a corporation, known as a “portfolio management company”, approved by the AMF.

- investment company with variable capital investing primarily in real estate (société à prépondérance immobilière à capital variable, SPPICAV)

A SPPICAV is a limited company with variable capital (société anonyme à capital variable) and has legal personality based on the SICAV model. It issues shares as it receives requests for subscription.

In terms of targeted investors, we can also differentiate between OPCIs:

- under ordinary law (retail OPCIs);
- with streamlined operating rules (OPCI RFA) reserved for qualified investors, with or without leverage (EL).

The aim of these organisations is to invest in real estate which they lease, or have built for the purpose of leasing, whether directly or indirectly owned, including off-plan. Such real estate assets cannot, however, be acquired exclusively with a view to resale. They are prohibited from trading as property dealers. However, they can manage financial instruments and deposits on an ancillary basis.

If provided for by the articles of incorporation of a SPPICAV or the regulations of an FPI, an OPCIs assets may be divided into two or more subfunds. Each subfund has separate accounting and gives rise to the issuance of one or more categories of units or shares representing only the assets allocated to it. In theory, the assets of a specific subfund do not answer for the debts, commitments and obligations of other subfunds. This permits the coexistence of conventional investors and investors complying with the rules of Shariah in the same vehicle, albeit at the cost of complexity.

The creation of an OPCIs is subject to approval issued by the AMF following review of its application file.¹¹¹

> Main participants

The creation and management of an OPCIs involves three main parties. Alongside the traditional management participants, including the management company and the custodian, real estate valuers play an important part in calculating the value of the real estate assets owned by the OPCIs. A fourth party, the supervisory board, inherited from SCPIs, is also present in the FPI.

o Management company

OPCIs are managed by a portfolio management company falling under articles L 532-9 to L 532-9-3 of the Monetary and Financial Code.

¹¹¹ Article L 214-91 of the Monetary and Financial Code.

Resources:

The management company must have dedicated and sufficient material and technical resources appropriate to the nature of the real estate assets and financial instruments under management.¹¹² With respect to financial resources, the minimum amount of capital of an OPCI management company is €225,000.¹¹³

The management company must also have a compliance and internal control system helping to manage risks and conflicts of interest, monitoring the operational risks inherent in its activities¹¹⁴ and complying with the rules of good conduct imposed by the Monetary and Financial Code and the AMF General Regulations. It must, *inter alia*, act in the exclusive interest of the OPCI's unitholders or shareholders and also implement a system for combating money laundering.¹¹⁵

However, there is nothing to prevent a Shariah Board from being added to this system, provided it acts in compliance with the legislation applicable to OPCIs and the rules issued by the AMF.

Tasks:

The management company mainly carries out: (i) prospecting of capital and search for real estate assets; (ii) rental and technical management of buildings owned by the OPCI; (iii) financial management of the OPCI; (iv) administrative and accounting management of the OPCI; (v) calculation and publication of the net asset value; (vi) reporting to unitholders; and (vii) compliance with statutory obligations.

It also represents the FPI with respect to third parties and may go to court to defend and enforce unit holders' rights or interests.¹¹⁶

Liability:

The SPPICAV and the management company are liable, individually or jointly and severally, towards third parties and shareholders for infringements of the legislative and regulatory provisions applicable to SPPICAVs, violation of the company's articles of incorporation and their own faults.

When it manages an FPI, the management company is liable towards third parties and unitholders for infringements of the legislative and regulatory provisions applicable to FPIs, violation of the fund's regulations and its own faults. The violation of a statutory, regulatory or professional obligation subjects the management company to various penalties. It may incur disciplinary or pecuniary sanctions ordered by the AMF's enforcement committee, as well as penal sanctions and/or tort liability towards unitholders.

These regulatory provisions are along the same lines as the principles of Muslim ethics set out previously under *Mudaraba*.

¹¹² Article 315-63 of the AMF General Regulations.

¹¹³ Article 315-62 of the AMF General Regulations.

¹¹⁴ Articles 315-63 and 315-64 of the AMF General Regulations.

¹¹⁵ Article 315-60 of the AMF General Regulations.

¹¹⁶ Article L 214-133 of the Monetary and Financial Code.

o Custodian

OPCI assets are placed with a custodian for safekeeping. Appointed by the OPCI, the custodian is a credit institution or investment company authorised to exercise custody or financial instrument administration services. Its registered office must be located in France and be separate from that of the OPCI, management company and real estate valuer.¹¹⁷ It must be named in the OPCI's prospectus.

Resources: ¹¹⁸

The custodian must have sufficient financial, human and technical resources to exercise its remit and take appropriate measures to ensure that transactions are secure. It must act in the exclusive interest of the unitholders.

Tasks:

The custodian of the OPCI is vested not only with the general custody and control tasks common to all custodians of undertakings for collective investment,¹¹⁹ but also with specific tasks stemming from the nature of the assets owned.¹²⁰

The custodian's tasks include the: (i) custody of the OPCI's assets, other than real estate; (ii) monitoring of the inventory of real estate assets eligible for the assets of an OPCI as well as the OPCI's other assets; (iii) monitoring of the legality of decisions taken by the SPPICAV and the management company of the FPI; and (iv) custody and monitoring of the OPCI's accounts receivable.

Liability:

The custodian of an OPCI incurs penalties in the event of breaches of its statutory, regulatory or professional obligations. Where appropriate, it is subject to liability under civil and/or criminal law and incurs pecuniary or disciplinary sanctions ordered by the AMF's Enforcement Committee. In the case of an FPI, it must be observed that there is no joint and several liability with the management company, as the custodian is not a co-founder of the OPCI.

o Valuers

The legislator made provision for the involvement of two valuers, who may be natural persons or legal entities.¹²¹

The real estate valuers are appointed by the management company for a period of four years. Their appointment is subject to AMF approval.¹²² They must meet the experience, competence and organisation criteria appropriate to their duties in real estate asset valuation.¹²³

They are connected to the management company by written contract containing a number of compulsory instructions.¹²⁴

¹¹⁷ Article L 214-117 of the Monetary and Financial Code.

¹¹⁸ Article L 214-117 of the Monetary and Financial Code.

¹¹⁹ Articles 323-1 et seq. of the AMF General Regulations.

¹²⁰ Article L 214-18 of the Monetary and Financial Code.

¹²¹ Article L 214-111 of the Monetary and Financial Code.

¹²² Article L 214-114 of the Monetary and Financial Code.

¹²³ Article L 214-112 of the Monetary and Financial Code.

¹²⁴ Article 315-70 of the AMF General Regulations.

Resources:

Valuers act jointly with and independently of one another.¹²⁵ They must implement a procedure that enables them to flag difficulties encountered in the management company to the custodian, as well as to the statutory auditor of the financial statements and the AMF.¹²⁶ They are also bound by professional secrecy.¹²⁷

For its part, the management company must make all the necessary arrangements so that valuers can fulfil their remit¹²⁸ and provide them with all useful documents, information and means of investigation.¹²⁹

Tasks:

At least four times a year and at quarterly intervals, each asset is valued by the valuer, bearing in mind that one of the valuers establishes the value of the asset while the other carries out a critical analysis of such value. Once a year, each asset forms the subject of a real estate valuation, each valuer carrying out the real estate valuation of the same asset on an alternating basis from one financial year to the next. At the financial year-end, the valuers establish, jointly and under their responsibility, a written summary report on the completion of their task.¹³⁰ This report is sent to the OPCl, management company, custodian, statutory auditor and any unitholder or shareholder on request.

The valuers may delegate part of their work to a third party, subject to prior agreement from the management company.¹³¹

Liability:

The real estate valuers are liable towards the SPPICAV, management company and custodian for the prejudicial consequences of errors and negligence committed while carrying out their task.¹³² They may be subject to tort liability under the conditions of ordinary law. Furthermore, they may incur pecuniary and disciplinary sanctions ordered by the AMF enforcement committee as well as, where appropriate, penal sanctions.

- Investment criteria

An OPCl's assets are broken down into three distinct components: real estate assets; non-real estate assets; and cash.¹³³

The real estate component must represent at least 60% of the OPCl's assets (with a maximum of 90% for retail OPCls, 95% for OPCl RFAs without leverage, and no maximum for OPCl RFA with leverage).

The components are defined differently for SPPICAVs and FPIs.

¹²⁵ Article L 214-111 of the Monetary and Financial Code.

¹²⁶ Article 424-27 of the AMF General Regulations.

¹²⁷ Article L 214-113 of the Monetary and Financial Code.

¹²⁸ Article L 214-111, paragraph 2, of the Monetary and Financial Code.

¹²⁹ Article L 214-116 of the Monetary and Financial Code.

¹³⁰ Article L 214-111 of the Monetary and Financial Code.

¹³¹ Article 315-71 of the AMF General Regulations.

¹³² Article L 214-115 of the Monetary and Financial Code.

¹³³ Article L214-92 of the Monetary and Financial Code

SPPICAV's assets must include at least 51% of properties built or acquired in view of their rental, related rights *in rem*, shares in unlisted real estate companies with unlimited liability that are not subject to corporation tax (subject to the significant control test), shares in unlisted real estate companies with limited liability (subject to the significant control test), and shares, units or rights of French OPCIs or their foreign equivalent. The balance of 9% of the real estate assets (difference between 51 and 60%) may be made up of shares in listed real estate companies.

In the case of FPIs, the real estate component of 60% should be made up of properties built or acquired for the purpose of their rental and related rights *in rem*, shares in unlisted partnerships not subject to corporation tax (subject to the significant control test) and FPI units and units or rights in similar foreign funds.

Retail OPCI and OPCI RFA without EL should have a minimum of 20% of properties and right *in rem* within the real estate component.

The non-real estate asset component may represent up to 30% of the OPCIs' assets. These may be listed securities (equity securities, debt securities, funds shares or units) and financial derivatives instruments and shares or units of French UCITS or foreign UCITS authorized in France.

Lastly, the cash component (deposits, cash or cash equivalents) must represent between 10 and 40% of the OPCIs' assets. OPCIs RFA without leverage are allowed to have a cash component of a maximum of 5%, whereas OPCIs RFA with leverage may have no cash component at all.

- Indebtness ratios

An OPCI may contract loans for up to 40% of the value of its real estate assets¹³⁴ to finance transactions falling within its corporate objects or to temporarily meet requests for redemption of units.

OPCIs RFA (streamlined operating rules) with no leverage remain bound by the obligations of retail OPCIs in terms of indebtedness (40% ratio). OPCI RFA with leverage have no constraints at all (except contractually to their investors, as they decide) in terms of leverage.

An OPCI also has the option of contracting cash loans of up to 10% of the value of its non-real estate assets.¹³⁵ There is no limit for OPCI RFA with EL.

- Diversification of risks

OPCIs (except OPCI RFA) should invest at all times in at least five different properties.

¹³⁴ Article L 214-93 of the Monetary and Financial Code.

¹³⁵ Article L 214-95 of the Monetary and Financial Code.

- Tax regime applicable to OPCIs

FPIs and SPPICAVs are subject to distinct tax regimes resulting from the nature of their legal form (an FPI is a co-ownership without legal personality whereas a SPPICAV is a company). However, these regimes display the same principle that already governed the regime implemented for SIICs, which consists in placing the taxation of the vehicle at the level of the unitholder or shareholder, in return for the major obligation imposed on the OPCi to make an annual distribution of a percentage of its income and capital gains.

- Tax regime applicable to FPIs

An FPI is a co-ownership of real estate assets, transferable securities and cash. Due to its lack of legal personality, it falls outside the scope of corporation tax: it is a transparent entity whose unitholders are taxed as though they had themselves received the income. However, taxation only occurs when this income is distributed, and up to the amount of this distribution.

FPIs are subject to a legal obligation to distribute up to:

- at least 85% of the rental income, less a optional (and notional) reduction of up to 1.5% of the cost price of the real estate equvaling to the depreciation of the properties;
- 85% of the capital gains realised on the real estate assets or partnership shares.

Unitholders are taxed according to the nature of the income they receive (rental income, investment income or capital gains on the disposal of real estate assets realised by the FPI) and their specific tax regime (personal, corporation or non-resident).

The FPI has been rarely used to date – to our knowledge, none has been approved – due to the foreseeable problems with monitoring different flows, which existing software has difficulty processing. These problems would be far greater in an international context and the resulting regime applicable to FPIs would be less favourable to foreign investors. The rental income and capital gains on real estate disposals would be taxable in France in most cases without the tax treaties providing much protection in this connection as the vast majority grant France the right to tax income and capital gains related to real estate located in France.

We therefore focus on the opportunities offered by SPPICAVs.

- Tax regime applicable to SPPICAVs

The tax regime applicable to SPPICAVs closely resembles that of SIICs. As it is a company, it falls within the scope of corporation tax, but is exempted by an express provision. Unlike SIICs, however, which may have a sector taxable under ordinary law, SPPICAVs are completely exempt from corporation tax, subject to complying with their distribution obligations.

Therefore, rental income, capital gains on asset disposals and dividends from subsidiaries under the same tax regime are exempt from corporation tax provided they are distributed for an amount of 85%

(less a deduction of up to 1.5% of the cost price of the real estate as the case may be), 50% and 100% respectively within a period of five months effective from the end of the financial year (capital gains on asset disposals may be distributed within a period of five months effective from the second financial year following that of the realisation of the capital gain). The income on assets held in the portfolio is also completely exempt without being subject to a distribution obligation for tax purposes.¹³⁶

If companies subject to corporation tax are converted into SPPICAVs, the consequences should be the same as if a company ceases trading, but extenuating rules apply which stipulate the taxation of all unrealised capital gains on buildings and other real estate assets in the form of an exit tax at the reduced rate of 19%, which may be paid over four years. There is no penalty for leaving the regime. The subsidiaries of SPPICAVs that are at least 95% directly or indirectly owned, have the corporate purposes of a real estate company and are subject to corporation tax may opt for the same regime, against payment of the same exit tax.

o Taxation of dividends paid by SPPICAVs

A shareholder of a SPPICAV that is a French legal entity is taxed at the corporation tax rate under the conditions of ordinary law, without benefiting from the exemption of the parent-subsidary regime.

A shareholder that is a natural person resident in France is taxed at the sliding scale of income tax under the conditions of ordinary law (without the benefit of the 40% allowance¹³⁷), plus social security contributions of 13.5% in both cases.

With regard to the dividends distributed by a SPPICAV to shareholders not resident in France, they are subject to withholding tax of 25%, or 21%¹³⁷ for dividends received by natural persons domiciled in a member state of the European Union, Iceland or Norway, subject to more favourable tax treaties. As an OPCl is completely exempt from corporation tax, however, it cannot take advantage of the capacity as “resident” within the meaning of most of the tax treaties signed by France. The main international tax treaties are therefore being amended to enable the introduction of a reduced rate in favour of distributions made by OPCls (as has just been done in the United States) but, pending this, taxation at the rate of 25% (or 21%)¹³⁷ will continue to be applicable in the majority of cases.

o Capital gains realised by the shareholder on the sale of SPPICAV shares

Capital gains realised by shareholders that are French legal entities are taxable at the statutory rate of corporation tax (33.33%).

Capital gains realised by private individuals who are resident in France are taxed at the rate of 19%. These capital gains are also subject to social security contributions at the rate of 13.5% (applicable from the first euro).

¹³⁶ Unless a natural person holds more than 10% of the SPPICAV's capital, in which case this shareholder is taxed.

¹³⁷ as modified by 4th draft rectificative finance bill for 2011, subject to further modifications upon final vote.

Lastly, capital gains realised by shareholders not resident in France do not fall within the scope of French capital gains tax if such non-resident shareholders, whether private individuals or legal entities, own less than 10% of the SPPICAV's capital. Above this threshold, capital gains are taxable at the rate of 33.33% (19% if the shareholder is a private individual residing in the European Union, Iceland or Norway), subject to the international tax treaties. These treaties must be analysed case by case to determine whether they are able to modify these taxation rules.

o Registration fees

The sale of OPCl units or shares is exempted from the 5% registration fee, unless:

- the acquirer who is a private individual owns or will own more than 10% of the OPCl units or shares following the acquisition, either directly, whether solely or jointly with members of his household, or indirectly through companies in the same family group;
- the acquirer that is a legal entity or fund owns or will own more than 20% of the OPCl units or shares following its acquisition.

o 3% tax

SPPICAVs other than those subject to streamlined operating rules and similar foreign vehicles will, subject to certain conditions, be automatically exempted from the 3% tax.

SPPICAVs not exempted by law will therefore be subject to the rules of ordinary law (exemption subject to compliance with certain reporting obligations regarding the identity and tax residency of direct and indirect shareholders holding a shareholding a superior to 1% of the share capital).

4.4.3. Key problem areas liable to be encountered in *Mudaraba* involving real estate assets

The key problem areas liable to be encountered in *Mudaraba* real estate transactions are linked to either the legal system specific to OPCIs or certain limits imposed under Shariah.

- With regard to French law

► Terms of intervention by the Shariah Board

In common with conventional OPCIs, Shariah-compliant funds will have to be structured in accordance with the Monetary and Financial Code and the regulations issued by the AMF.

In particular, it will be necessary to define very precisely the terms of intervention by the Shariah Board within the framework of the management company's corporate governance. The board will therefore have to be integrated as best as possible in the management company's compliance and internal control system, without the AMF's being able to consider that this results in the creation of a separate management body.

➤ Equal treatment of investors

The principles of Shariah require that investors are treated equally.

It is therefore necessary that investors holding the same class of assets are treated similarly throughout the life of the OPCl. The Shariah Boards will therefore have to determine whether this rule can be reconciled with the creation of more than one sub-fund in the same OPCl.

➤ Probable extension of the AMF's position on UCITS to OPCIs

Given the constraints imposed by Shariah as regards purifying income deemed to be 'illicit', it is likely that the AMF will adopt positions similar to those in its notice of 17 July 2007 on UCITS, authorising donations of up to 10% to institutions officially recognised as serving the public interest.

• With regard to Shariah

➤ Nature of investments made by a Shariah-compliant OPCl

As real estate is, by nature, Shariah-compliant, the question of the 'illegality' of the OPCl's activities should not arise. However, it will be necessary to ensure that investments made by the OPCl do not contain *Haram* elements and that such prohibition is stated in the articles of incorporation of the SPPICAV and in the FPI's regulations.

➤ Use of auditors specialising in Islamic finance

The use of auditors specialising in Islamic finance to verify compliance with the application of Shariah throughout the life of the OPCl will have to be very clearly defined with respect to the rules issued by the AMF on compliance, internal control and operational risk management.

However, there is every reason to believe that, although some reluctance and restrictions are to be expected on both sides, a market practice will quickly emerge in this respect.

➤ Observance of gearing ratios

As an OPCl's gearing may go up to 40% of the value of its real estate assets (and even more for OPCIS RFA with leverage), i.e. above the limit authorised by Shariah, it will be necessary to ensure in every Shariah-compliant OPCl that its leverage is limited to 33%. This restriction will have to be adopted by the management company as part of the elaboration of its investment criteria. This limit may also be lowered even further by a Shariah Board whose position would be more restrictive.

Proposition

The AMF should specify whether it is ready to extend to OPCl the position it adopted on 17 July 2007 with respect to OPCVM.

➤ Procedures for making investments

To remain Shariah-compliant, the OPCl must use only investment vehicles that comply with the principles of Islamic finance. Therefore, in the context of making its investments, any conventional interest-based arrangement will have to be banned. Nevertheless, the Shariah Boards will have to decide whether they are willing to accept one or more conventional sub-funds coexisting alongside Shariah-compliant sub-funds in the same OPCl.

Proposals of DTZ and NORTON ROSE

We have adopted 10 of the proposals suggested by the workshop participants. These are targeted at specialists in this industry and, above all, political, economic and institutional players who will play a part in the development of this new industry.

Proposal 1

To promote Islamic finance by means of a parliamentary report on the potential benefits of a mature, innovative French Islamic finance market for France and its regions.

Why	To gain a better understanding both of players' expectations and of their desire to participate in real terms in economic development, particularly in the regions of France.
How	By studying the various mechanisms for participating in Islamic finance with its more sustainable and ethically responsible approach.
Who	On the initiative of a deputy or the National Assembly's Finance Committee in consultation with senators.

Proposal 2

To implement a structure to unify the private initiatives promoting the Islamic finance industry in France.

Why	To gain a common vision of the future of Islamic finance in France and of the relationships to be forged with the main areas of expertise and Islamic capital.
How	By capitalising on the energy deployed by the various French players, from the professional and academic world, to grass-roots entities and private or non-profit organisations.
Who	Coordinated by a structure such as the Institut Français de la Finance Islamique (IFFI), headed by the former Minister of Foreign Affairs, Hervé de Charrette, also Chairman of the Franco-Arab Chamber of Commerce

Proposal 3

To demonstrate the depth of the national and regional markets, as well as the ability to respond ambitiously with a communication plan targeted at international investors.

Why	To develop a tailored and coordinated communication strategy highlighting the collective approach of French players.
How	By facilitating the adjustment of sectors of Shariah-compliant financing as part of the projects referred to in the White Paper.
Who	On the initiative of various local authorities promoting French projects such as Grand Paris, Plan Campus, Grand Emprunt or other regional projects which are, by nature, compatible with the expectations of Islamic investors.

Proposal 4

To create a class of French experts by developing professional qualifications and specialist training in Islamic finance recognised by the French market and by international Islamic organisations.

Why	To develop a centre of excellence for French-style Islamic finance accessible to all on the basis of various academic profiles and professional experience.
How	By implementing, in partnership with the leading internationally recognised Islamic finance institutes, professional training courses tailored to the French market, making it possible to obtain recognised qualifications at both national and international level.
Who	Driven by training organisations and institutions of higher education (universities, grandes écoles) in the selection and adaptation of a training programme for future French experts in Islamic finance and, more generally, in business ethics (socially responsible investing (SRI) and corporate social responsibility (CSR)).

Proposal 5

To develop a local reference system for compliance of Islamic products as regards accountancy, regulations, ethics and corporate governance with ongoing international standards.

Why	To adapt French standards for Islamic financial institutions.
How	With a charter of accounting, financial and ethical rules applicable to products and services to be marketed in France.
Who	On the initiative of local financial organisations such as Paris Europlace, the French Banking Federation (FBF), the Insurance & 'Mutuelle' Supervisory Authority (Autorité de Contrôle des Assurances et des Mutuelles, ACAM), etc., together with other corporate governance and ethical organisations such as Novethic.

Proposal 6

To establish a French corporate governance model for Shariah Boards with rules of business ethics in accordance with international standards and market transparency practices.

Why	To establish a platform for best practice and recommendations in light of international experience on the development of Islamic finance, taking into consideration the French situation.
How	By extending the market practices adopted in Paris on corporate governance, separation of tasks and functions, conflicts of interest, and by taking all the parties involved in this new market into account.
Who	Driven by recognised figures in the French Islamic world beyond schools of jurisprudence.

Proposal 7

To escape the 'circle of blame' by selecting one or more trial projects with regional authorities, with genuine local infrastructure needs or investment in favour of SMEs, in order to make the operational model more reliable and pool development efforts.

Why	To test the relevance of an innovative investment and real estate financing package using sources of Islamic capital, make the operational model more reliable and pool the development efforts of the various players.
How	By taking advantage of innovative PPP-type packages and relying, for example, on local investment funds that comply with the principles of Shariah.
Who	Within the framework of developing tertiary and residential buildings or renewable energy infrastructures, between a real estate developer and Islamic investors, under the watchful eye of a local authority.

Proposal 8

To promote the development of *Murabaha* in France.

- By allowing a legal entity other than a French or France-based foreign credit institution to hold controlling interests in several ad hoc investment companies having carried out, or being on the verge of carrying out, a transaction involving the purchase/resale in instalments of real estate predominantly financed by a credit institution.
- By removing the friction that results from the collection of land registration tax on each of the two real estate transfers required by any *Murabaha* transaction involving real estate assets.
- By stipulating that, in transactions involving purchase/resale in instalments in which the original acquisition of the real estate is predominantly financed by a credit institution, the financial intermediary (reseller) may be exempted from the warranty of latent defects for which the original owner of the sold real estate would then be fully liable.
- By waiving the DIA filing procedure, or at the very least by allowing the second DIA to be automatically processed at the same time as the first, for a transaction involving the resale in instalments of real estate.
- By setting up a charitable organisation or donation fund in France in order, for example, to promote the development of access to Islamic finance in France for businesses and private individuals that could therefore receive the sums resulting from transactions disqualified under Shariah.

Proposal 9

To promote the development of *Ijara* in France.

- By allowing leasing transactions to be concluded by the concomitant signing of a leasing contract and a unilateral undertaking to sell, provided both these documents make reference to each other and expressly indicate the intention of being placed under the real estate leasing regime.
 - By making the Shariah Boards accept that it will be possible for the leasing contract and the unilateral undertaking to sell to make reference to each other.
 - In order to enable *Sukuk* transactions backed by French real estate assets to be carried out, it would be desirable to initiate a reflection process on a regime inspired by the recent UK provisions and the fiduciary transfer structure (*fiducie*) permitting the temporary tax-exempt transfer of real estate assets.
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Proposal 10

To promote the development of *Mudaraba* in France.

- By requesting the AMF to stipulate that its position adopted on 17 July 2007 concerning UCITS also applies to OPCIs.
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Summary of the 10 propositions of the white paper

For the sake of clarity, the propositions have been listed in 5 buckets:

- * Communication bucket: towards the French decision makers, national and international institutionals
- * Governance bucket: in order to reach the most adapted normalised framework within the French environment
- * Training bucket: in order to raise awareness among the general public but also to attract new talents
- * Products & services bucket: in order to demonstrate practically with what and how things can get started
- * Legal & fiscal bucket: in order to achieve to the first results regarding the French amendments of the local regulation to be regarded as a neutral policy

B. Legal & fiscal bucket

- B1. To favour the development of *murabaha* contracts
 - Thru participations holdings in SPVs
 - No double taxation on duties and no need of the two pre-emption rights
- B2. To favour the development of *ijara* contracts
 - Credit-bail contracts with leases and concurrent unilateral purchase undertaking in a *Sharia*-compliant way
- B3. To favour the development of *mudaraba* contracts (especially for OPCV vehicles)

C. Products & services bucket

- C1. To exit the « circle of blame » by selecting different key test projects with the local authorities in need of infrastructure works or SME equity investment enabling a better operating model leveraging on the development efforts of the many players

A. Communication bucket

- A1. To promote Islamic Finance thanks to a parliamentary report highlighting the potential benefits for the French regions
- A2. To demonstrate the width of the market and the capacity on the sell side to meet the demand thanks to a communication plan towards the international investors.

D. Governance bucket

- D1. To develop a market framework for full compliancy of Islamic products on different levels, accounting, regulation, ethical and governance along with the international standards
- D2. To foster un French governance model of the different ethical compliance committee with market practices in terms of transparency

E. Training bucket

- E1. To put in place an institution that gathers all private initiatives towards the promotion of the Islamic finance industry in France
- E2. To develop a new class of French experts thanks to new professional certifications and specialized trainings recognized by the French market and international Islamic organizations.

Conclusion

We hope that this White Paper has allowed readers – real estate professionals, bankers, investors, entrepreneurs, policymakers, lawyers, consultants, civil servants, insurers, advertising executives or private individuals – to benefit from the knowledge shared by key players in French Islamic finance during the 2009 workshops, whom we thank for participating.

We also hope that this White Paper helps to promote a better understanding of Islamic finance and its challenges, away from the controversy that sometimes surrounds it, and shows strong evidence of applications of Islamic finance in the French real estate sector, that could grow exponentially following clarification of the tax situation.

The 10 proposals we have formulated must be quickly implemented to enable French companies and local authorities to diversify their sources of financing in this fraught global economic and financial environment, and Islamic investors to participate in the major projects that will materialise in France over the next decade.

We truly believe that a true model of French-style Islamic finance will spring from the multiplicity of transactions carried out under French law.

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Glossary

Ijara contract

Pure leasing contract under which a financial institution purchases equipment or real estate and leases it to a private individual or company that will make periodic payments throughout the contract. For reasons of simplification, the term *Ijara* frequently denotes the *Ijara Wa Iqtina* contract. The *Ijara contract* may be accompanied by an undertaking to sell or an option to purchase exercisable on expiry of or during the contract. The practice makes a distinction between *Ijara Muntahia Bittamleek* (leasing with transfer of ownership of the leased real estate at the end of the contract) and *Ijara Wa Iqtina* (leasing with transfer of ownership in stages during the life of the contract).¹³⁸

Istisna contract

Contract derived from the As-Salem contract under which one party (Moustasni'i) asks another party (Sani'i) to manufacture or build a piece of work in return for remuneration payable in advance, in instalments or on completion. This contract is popular in the industrial sector. The items must be able to be manufactured and the purpose, date and place of delivery must be specified in the contract.¹³⁹

Mudaraba contract

Form of partnership where one party contributes the funds (*Rab Al-Maal*) and the other (*Mudarib*) the experience, expertise and management. The profit realised is shared between the two partners on a basis agreed in advance but any capital loss is borne solely by the financial backer.¹⁴⁰

Murabaha contract

Sale contract under the terms of which a seller sells an asset to a financial intermediary which then resells it in instalments to an end buyer at a mark-up.

Musharaka contract

Term of business transactions law, such as a conventional deed of partnership. Several contributors finance a company and share the profits based on a predefined rate, while the losses are distributed among them, commensurate with their capital contribution. The principle underlying this type of contract is that under which, in Islam, losses may be incurred only in respect of things to which a contribution has been made. The management of the company may be effected by all, part or any one of the contributors.¹⁴¹

Musharaka Moutanakissa contract

This contract may be used to purchase real estate. The financial institution's share in the purchased real estate diminishes with the capital payments made by the client in addition to the payment of rent, the objective being ultimately to transfer ownership of the real estate (or of the company's capital) to the client.¹⁴²

¹³⁸ Source: AIDIMM, Islamic Finance Training Glossary, 2010.

¹³⁹ Ibid. footnote 138.

¹⁴⁰ Ibid. footnote 138.

¹⁴¹ Ibid. footnote 138.

¹⁴² Ibid. footnote 138.

Fatwa

Legal consultation given by a religious authority, the decision or decree resulting therefrom.¹⁴³

Islamic finance

The Islamic financial system is governed by legal/ethical principles drawn from Shariah (Koran and *Sunna*) and making reference to moral values. Islamic finance therefore encourages asset management and a financial system that is more ethical, based on a different notion of work, money and business contracts. Justice, fairness, sharing of losses and profits among the contracting parties are the elements that particularly characterise Islamic finance. It rejects the idea of fixed remuneration dissociated from the return on the financed asset, and the use of interest is therefore prohibited. The main obligation of any financial transaction must be based on a tangible asset (or a service) that is itself dependent on an industry segment, respecting the religious prohibitions so as to enable the sharing of losses and profits generated by this asset.¹⁴⁴

Fiqh

Islamic jurisprudence.

Gharar

This term can be translated as risk or uncertainty. *Gharar* arises when the subject-matter of a contract is ambiguous, uncertain or dependent on future uncontrollable events. When assessing *Gharar*, a contract may be deemed not to comply with the principles of Islamic finance. It is, inter alia, by virtue of these criteria that the commercial insurance contract (motor, home, etc.) is deemed illicit by Shariah scholars.¹⁴⁵

Hadith

Literally means conversation or narrative. It denotes the Prophet Muhammad's deeds and words, which were initially reported orally by an uninterrupted chain of transmitters then gathered and recorded in compendia. The most important were created in the ninth century (third century of Islam). The *Ahadith* are a source of rules and teachings for Muslims that supplement and specify the meaning of the Koranic message.¹⁴⁶

Halal

Everything that is lawful with regard to Shariah.

Haram

Refers to the activities, professions, contracts and transactions explicitly prohibited by the Koran or *Sunna*.¹⁴⁷

¹⁴³ Source: E Jouini and O Pastré, *La Finance Islamique, une solution à la crise?* Economica, February 2009.

¹⁴⁴ *Ibid.* footnote 138.

¹⁴⁵ *Ibid.* footnote 138.

¹⁴⁶ *Ibid.* footnote 138.

¹⁴⁷ Source: *La finance islamique à la française, un moteur pour l'économie, une alternative éthique*, supervised by J-P Laramée, Secure Finance, 2008.

Ijma

Consensus of scholars (Ulema); *Ijma* is one of the sources of Muslim law.

Istihsan

Method of legal preference used by Shariah scholars to determine solutions to specific problems.

Istislah

Method of general interest used by Shariah scholars to determine solutions to specific problems.

Maysir

Illicit act of betting or becoming involved in games of chance without the net creation of wealth through work.¹⁴⁸

Mudarib

Manager or entrepreneur partner in a *Mudaraba contract*.¹⁴⁹

Qiyas

Reasoning by analogy used by Shariah scholars to determine solutions to specific problems.

Rab Al-Maal

Investor or owner of the monetary capital in a *Mudaraba contract*.¹⁵⁰

Riba

The term '*Riba*' is derived from the verb '*Arba*' meaning 'to make grow'. Technically, it can be defined as a surplus or gain prejudicing one of the contracting parties to a loan or forward currency trade (*Riba Al-Nasia*) or an unequal exchange of foodstuffs (*Riba Al-Fadl*). The overwhelming majority of Shariah scholars are unanimous in the formal prohibition of any interest rate and usury.¹⁵¹

Riba Al-Fadl

Sale or exchange of goods in return for another good of the same kind, with a surplus. A term used in trade, it covers all transactions involving cash payment and immediate delivery of goods. It also refers to all the business practices leading to exploitation, by either the buyer or the seller, due to dishonesty, fraud or unfair exchanges.¹⁵²

Riba Al-Nasia

Has the root '*Nasa*', meaning postpone, defer or wait. It is the sum paid either for the use of borrowed capital or as consideration for rescheduling of a debt payment. The prohibition of *Riba Al-Nasia* bans the act of fixing in advance a positive return or interest on a loan as compensation for the delay.¹⁵³

¹⁴⁸ Ibid. footnote 148.

¹⁴⁹ Ibid. footnote 148.

¹⁵⁰ Ibid. footnote 148.

¹⁵¹ Ibid. footnote 138.

¹⁵² Ibid. footnote 138.

¹⁵³ Ibid. footnote 138.

Shariah

This term alludes to the right path, the Islamic way, followed by believers on their journey through Islam. It denotes, by extension, all the Islamic precepts (normative structure of texts) that meet the objectives and purposes of such universal path and with which Muslims must comply.¹⁵⁴

Shariah Boards

Advisory committee comprising specialists in Islamic law to express an opinion on whether the proposed financial products comply with Shariah and ensure that the bank complies with Islamic ethics (Souloukiat).

Sunna

Sunna literally means direction. The second source of Islam legislation after the Koran, the *Sunna* is translated by some Ulema as the prophetic way, methodology and tradition. It denotes everything that is related in word, deed, approval or innate behaviour of the Prophet Muhammad that could serve as an argument for legal prescription of Muslim law.

Sukuk

Hybrid financial securities whose return is indexed to the performance of one or more underlying assets held by the issuer.

Takaful

Insurance taking the form of cooperative insurance with pooling of funds based on the mutual insurance principle. This system is underpinned by the principles of mutual assistance (ta'awun) and voluntary contribution (tarrabu), in which the risk is shared jointly and willingly by a group of participants.

Tawarruq

Literally means 'monetisation'. The term is used to describe a method of financing similar to double *Murabaha*, where the underlying commodity in the contract is not required by the borrower. This commodity is acquired by the debtor on the basis of deferred repayment contracted with a bank, then immediately resold by the borrower to a third party, effectively resulting in 'monetisation' of the underlying.¹⁵⁵

Urf

Method of customs and traditions used by Shariah scholars to find solutions to specific problems.

Wakala

Agency agreement that generally includes a clause related to the payment of commission to an agent operating on behalf of a principal.¹⁵⁶

¹⁵⁴ Source: AIDIMM, Islamic Finance Training Glossary, 2010.

¹⁵⁵ Ibid. footnote 148.

¹⁵⁶ Ibid. footnote 148.

Koranic references

- Prohibition of *Riba* (interest)

Surah II Al-Baqarah, Verses 275 to 280:

275. *“Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) – Such are rightful owners of the Fire. They will abide therein.”*

276. *“Allah hath blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.”*

277. *“Lo! those who believe and do good works and establish worship and pay the poor-due, their reward is with their Lord and there shall no fear come upon them neither shall they grieve.”*

278. *“O ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if ye are (in truth) believers.”*

279. *“And if ye do not, then be warned of war (against you) from Allah and His messenger. And if ye repent, then ye have your principal (without interest). Wrong not, and ye shall not be wronged.”*

280. *“And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did not know.”*

Surah III Al-E-Imran, Verse 130:

“O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful.”

Surah IV An-Nisa, Verse 161:

“And of their taking usury when they were forbidden it, and of their devouring people’s wealth by false pretences, We have prepared for those of them who disbelieve a painful doom.”

Surah XXX Al-Room, Verse 39:

“That which ye give in usury in order that it may increase on (other) people’s property hath no increase with Allah; but that which ye give in charity, seeking Allah’s Countenance, hath increase manifold.”

Surah LV Ar-Rahman, Verse 9:

“But observe the measure strictly, nor fall short thereof.”

Hadith reported by Ubida b. al-Simit:

“Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand.” (Cf. Sahih Muslim, ‘L’authentique *Hadith* interprété par Nawawi’, Édition Dar el kutub, Beirut, Lebanon 1995, Book 11, p. 12)

Hadith reported by Abu Huraira:

“‘Avoid the seven great destructive sins.’ They (the people!) asked, ‘O Allah’s Apostle! What are they?’ He said, ‘To join partners in worship with Allah; to practise sorcery; to kill the life which Allah has forbidden except for a just cause (according to Islamic law); to eat up usury (Riba), to eat up the property of an orphan; to give one’s back to the enemy and fleeing from the battlefield at the time of fighting and to accuse chaste women who never even think of anything touching chastity and are good believers.’” (Cf. Sahih Al-Bukhari and Sahih Muslim)

Hadith reported by Abdullah Bin Handala:

“The practice of Riba is more serious than 36 crimes of fornication.” (Collection of the Imam Ahmd)

Hadith reported by Jabir Ibn Abdullah:

“The Prophet (peace be upon him) banished all those practising Riba, the contracting parties and their accomplices (their scribes and witnesses).” (Cf. Sahih Muslim, No 1598)

Hadith reported by Ibn Mas’ud:

“The Prophet cursed he who takes usury and he who gives it.” (Cf. Sahih Al-Bukhari, No 5032)

- Prohibition of *Maysir* (speculation)

Surah V Al-Maeda, Verses 90 and 91:

90. O ye who believe! Strong drink and games of chance and idols and divining arrows are only an infamy of Satan’s handiwork. Leave it aside in order that ye may succeed.

91. Satan seeketh only to cast among you enmity and hatred by means of strong drink and games of chance, and to turn you from remembrance of Allah and from (His) worship. Will ye then have done?

- Prohibition of *Gharar* (uncertainty)

***Hadith* reported by Ahmad and Ibn Majah under the authority of Abu Al Khudriy:**

“The Prophet has forbidden the purchase of the unborn animal in its mother’s womb, the sale of the milk in the udder without measurement, the purchase of spoils of war before their distribution, the purchase of charities before their receipt, and the purchase of the catch of a diver.”

Source: *Le Saint Coran et la traduction en langue française du sens de ses versets*, Maison Islamique Internationale pour les Sciences Qur’anique, French translation revised by the General Presidency of the Islamic Scientific Research Divisions, IFTA, Preaching and Religious Guidance, Kingdom of Saudi Arabia.



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