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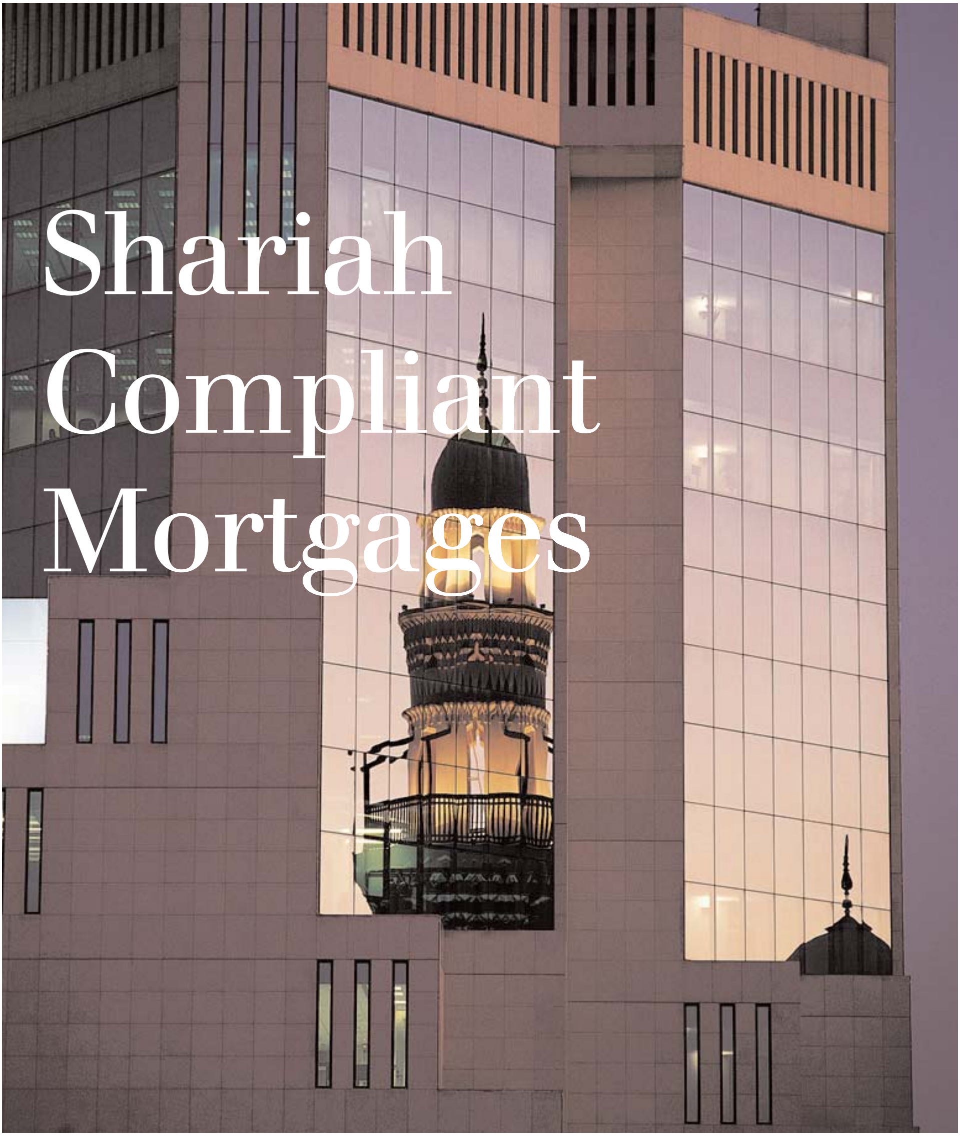

Shariah Compliant Mortgages

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Introduction

This brochure provides a brief outline of our Islamic finance practice, and provides some introductory information on Shariah compliant mortgages in England and Wales.

Islamic finance is a key developing international practice area for Lovells. This has led to the development of an experienced and highly specialised team of lawyers throughout our extensive network of international offices. We work on some of the most significant deals in the market.

We have been advising clients since the early days of the Islamic finance market. Our global presence means we are well placed to provide a fully integrated and efficient service irrespective of the jurisdictions involved. This enables our clients to exploit more global opportunities and the more complex Islamic financing solutions which are coming to the market.

With 27 offices in 18 countries throughout the world, Lovells delivers the breadth of experience and depth of expertise you expect from a successful, international law firm.

All our lawyers - more than 1,600 and counting - have an incisive awareness of commercial priorities, ensuring we give you practical solutions that make business sense.

Our particularly strong commitment to collaboration - both internally and with our clients - underpins our ability to work with you in finding the ways forward that best suit your circumstances and objectives.

In addition to London, we provide full service Islamic finance advice from our offices in Frankfurt, New York, Moscow, Singapore and Tokyo. We are able to provide expertise across the Middle East and North African (MENA) region through close ties with leading regional law firms.

Shariah compliant mortgages - a brief overview

INTRODUCTION

London has become one of the largest international centres for Islamic finance outside the Middle East and North Africa Region. This is hardly surprising with a permanent Muslim community estimated to exceed 2.5million and with up to 500,000 temporary residents including students and visitors.

Shariah compliant asset management services, institutional funds and liquidity management facilities can all be found based in London. However, the sector is evolving and Islamic compatible products aimed at the retail sector are being developed. This brochure concentrates on the Shariah compliant mortgage market, an area that is developing and whose market is predicted to grow to £9,200 million in terms of balances outstanding. The recent abolition of double stamp duty (see below) has particularly promoted the growth of the market.

SHARIAH COMPLIANT MORTGAGES

Under Shariah, the making or receiving of interest-bearing loans is prohibited (*for more on this area see Lovells publication - Shariah, Sukuk and Securitisatio*n). Consequently, the conventional mortgages provided by high street banks in the UK are not available to those Muslims who follow their faith strictly. There are, however, mortgage structures available in the market that enable property purchases to be made in accordance with Shariah.

In essence there are two different types of structure that Shariah compliant mortgages may take:

1. **Murabaha contract**

   Shariah compliant mortgages were initially based on the Murabaha contract. In a modern context, Murabaha involves the purchase of an asset/commodity by a financial institution at the request of a customer. This customer then purchases the asset/commodity from the financial institution under a deferred payment arrangement designed to cover the costs of purchasing the asset/commodity with a pre-agreed upon profit mark-up. The mark-up constitutes the bank's profit and has been widely used as a substitute for the charging of interest by institutions that wish to adapt interest-based banking to Islamic requirements. The calculation of the mark-up may be in the form of a fixed lump sum or it may be a calculated as a percentage of the financed amount.

   The following flow-chart illustrates the application of this technique to mortgages:

The Customer identifies a property and agrees all terms of the purchase with the vendor. The Customer requests the Islamic mortgage provider to purchase the property and then sell it to the Customer at the cost price plus a declared mark-up.

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The Islamic mortgage provider purchases the property directly from the vendor and immediately sells it to the Customer with a fixed mark-up-profit (this is calculated on the property value, length of finance, payment terms and amount of deposit).

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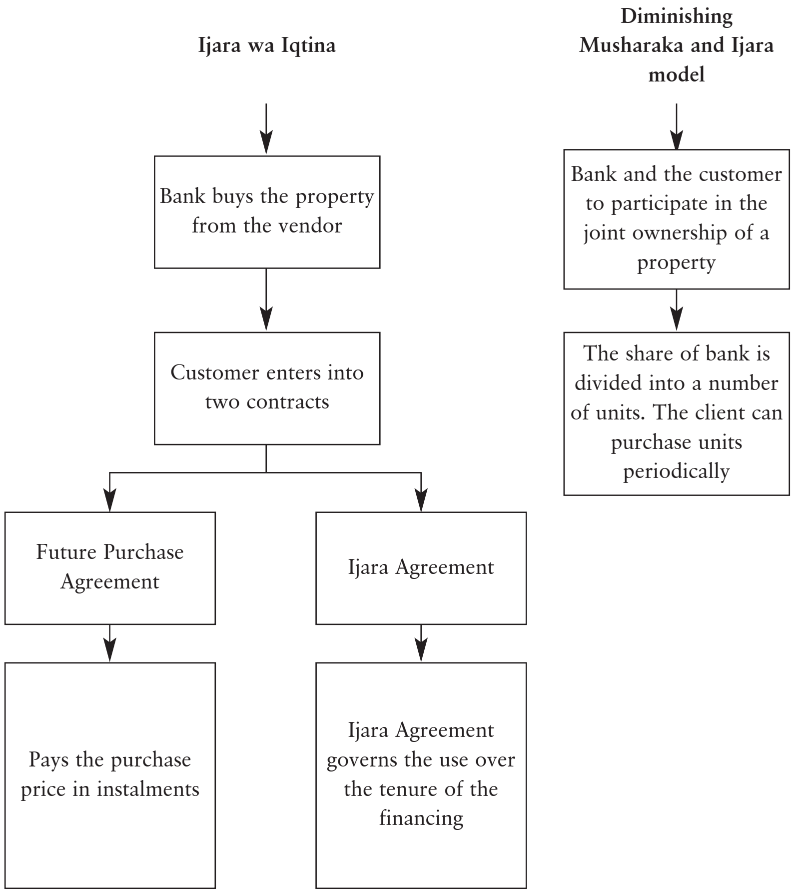
The Customer repays the Islamic mortgage provider the initial price and the agreed mark-up (the customer's first payment to the Islamic mortgage provider in instalments is made on the date of completion and is usually a minimum of 20% of the purchase price).

2. **Ijara contract**

Ijara is fast becoming the most popular method of property finance. It is a more flexible scheme than Murabaha as it enables the customer to repay the mortgage early with one payment, or to make additional "overpayments" during the life of the mortgage, thus reducing the length of the mortgage.

Ijara shares many characteristics with lease financing and hire-purchase arrangements. It involves a lessor (usually a financial institution) purchasing an asset and renting it to a lessee for a specific time period at an agreed rent, or receiving a share of the profits generated by the asset.

There are two main types of model under the Ijara structure. The first involves a longer term lease that usually ends with the transfer of ownership of the asset to the lessee (*Ijara wa lqtina*), similar to a modern finance lease. The second type of lease is for a shorter term and will usually end with the financial institution retaining ownership of the asset, in a manner similar to an operating lease. The rental income from this second type of lease will take into account the depreciation of the asset. Islamic mortgage technology may utilise either of the two Ijara structures. Under the Ijara structure the bank and customer jointly own a property and the customer buys out the banks share over time) as illustrated by the diagram overleaf:



Description of Ijara wa Iqtina

- The Ijara wa Iqtina leasing method is the most common of the two types of Ijara contract.
- The customer identifies the property to be purchased and agrees the price with the vendor in line with a conventional mortgage.

- The Islamic mortgage provider purchases the property and enters into a future purchase agreement with the customer. The purchase price between the mortgage provider and the customer is the same price as the original purchase price.
- The customer simultaneously enters into a lease with the mortgage provider which details the customer's right to occupy the property during the tenure of financing.
- The customer pays the mortgage provider monthly payments, which are calculated so that part is applied towards the purchase of the property from the mortgage provider and part of it is rent.
- The payments are fixed every 12 months. Every year the rent and repayments are reassessed and are likely to vary.
- Customers may purchase the property from the mortgage provider at any time by paying the bank the balance of the purchase price.

DEVELOPMENTS

Having developed the necessary legal structures, there are still a number of hurdles which need to be overcome for the market to fully develop:

(a) under current regulations on lease agreements, the product has to be 100% risk weighted whereas a conventional mortgage has a risk weighting of only 50% and;

(b) unlike a conventional mortgage, the proposed product under English law would require two sets of solicitors as there are two conveyances. Islamic institutions however, are seeking an exemption from the requirements to have a second set of solicitors.

The obstacles hindering growth in this sector are surmountable. Double stamp duty was one such obstacle that has recently been overcome. Double stamp duty was payable due to the fact that the Shariah compliant structures involve a double conveyance (one at the time of the purchase from the current vendor and another when the property is transferred to the client when the finance has been repaid). Historically, this has made Shariah compliant mortgages prohibitively expensive, but the law has recently been amended to reflect the reality of the scheme and only a single stamp duty charge is now payable.

CONCLUSION

The chances of success for Shariah compliant mortgage providers are bright in western markets where capital markets are liquid, transparent and regulated. For example, recently the US agency Freddie Mac recognised the importance of Islamic mortgages by underwriting and securitising them. There is great potential for Islamic mortgages particularly in the UK, where a sizeable Muslim community in the middle and high income brackets can be found.

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Lovells international presence means that we can deliver experienced Islamic finance capability across our substantial network of offices. Some of our key personnel are:

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