The need for adaptable *Sharīʿa* screening of stocks: A case study of equity REITs

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Attractiveness of Equity REITs

- Publicly traded companies that buy, develop, manage, maintain, and (rarely) sell real estate properties:
  - Must pay out at least 90% of net income as dividends
- Low correlation with other asset classes offers diversification benefits:
  - REIT stocks' correlation with S&P 500 (1/93— 10/01) = 0.24
- Very few failures, mostly due to excessive debt-leveraging
  - Islamic debt-screening should reduce that risk
- Consistently high dividend yield (6-7%) + capital gains

Prima facie Islamicity of Equity REITs

- REITs are capital market vehicles for owning real estate, and deriving income thereof. They give investment (diversification, management) and tax advantages over direct investment in real estate.
- Investors own REITs for their dividends: share prices rise relatively slowly due to distribution of dividends. They form a less speculative part of investment portfolios.
- Almost all the assets of equity REITs are in the form of real estate, held to generate rental income ➔ dividends

REIT asset composition ('000s $ end '01)

REIT name	Total Assets	Real Estate assets	% real estate
AMLI Residential Properties Trust	919002	879545(inc. part.)	95.70653818
Avalonbay Communities, Inc.	4664289	4390843	94.13745589
BRE Properties, Inc.	1875981	1818795	96.95167488
Equity residential properties Trust	12235625	11300709	92.35906625
Essex properties trust, Inc.	1329458	1207647	90.83754432
Home properties of New York, Inc.	2063789	1933514	93.68758143
Archstone Smith Trust	8549915	7869220	92.03857582
Glenborough Realty Trust, Inc.	1388403	1289929	92.90739072
Camden Property Trust	2449665	2410299	98.39300476
Cornerstone Realty Income Trust	980691	942712	96.12732247
United Dominion Realty, Inc.	3348091	3261301	97.40777655
Town and Country Trust	499370	483924	96.90690270
Apartment Inv. and Man. Co.	8316761	8261651	99.33736223

The special nature of REITs: Taxes + *Zakāh*

C.f. the discussion in Al-Qaradāwī, *Fiqh Al-Zakāh*, vol.1, Beirut: Al-Risāla Pub., 1999, pp. 523-8, 466-82:

- REIT shares are held mainly for rental/dividend income, not for trading. Thus, they do not seem appropriate for Drs. Abū Zahrah and Khallāf's classic view of stocks as عروض تجارة, subject to the *Zakāh* at 2.5% of market value
- Instead, the classic opinion of ᶜAbdul-Rahmān ᶜĪssa seems appropriate, and *Zakāh* on REIT shares should be paid as زكاة المستغلات, according to the chosen opinions

Potential *Sharīᶜa* concerns

- Debt/asset and debt/market-capitalization ratios, as conventionally measured, tend to be high (40-60++%) relative to commonly applied *Sharīᶜa-board* standards
- Some sector-specific REITs may lease properties to businesses deemed objectionable by *Sharīᶜa-boards* (e.g. retail REITs investing in local strip-malls that usually house grocery stores, restaurants or liquor stores; office buildings leased to banks or insurance companies; etc.)
- Interest-income is not an issue: virtually no liquid assets

Debt/asset ratio thought experiment

- *Sharīʿa* boards have approved real estate financing via *Murābaha* and/or *ʾIjāra* ➔ "Islamic-mortgagor-debt"
- Such financing can yield 90+% mortgage-debt/asset ratio
- Premise: A Muslim may invest by sharing in the equity component of a company that financed its mortgages Islamically, if other debts are minor
- Problem: Can we treat existing mortgage debts that were generated un-Islamically in the same manner?

Permissibility at inception vs. later

- Juristic rule: يغتفر في البقاء ما لا يغتفر في الإبتداء (*M.* #55) (one tolerates for the continuation of a contract things that would not be tolerated at its inception)
  - e.g. leasing or giving as gift an unidentified portion of a property is not allowed at inception, but a lease or gift of the unidentified portion remains intact if un-identification of the share (*shuyūᶜ*) ensued later (e.g. through third-party entitlement – *ʿistihqāq*)
  - Indeed, this is the rule based on which Shāfiᶜīs and Hanafīs allow the mortgagor to hold his mortgaged property (*Mawsūᶜah: Qabd*)
  - While not articulated, this rule is already at the heart of the financial screening ratios, since a Muslim entrepreneur is not allowed to borrow with interest, make an interest-bearing loan or deposit, etc., even within the specified screening ratios

Islamic vs. conventional mortgages

- Islamic *Murābaẖa*- and *ʿIjāra*-based mortgages produce legal documents and payment streams identical to those of a conventional mortgage (with the language of "mortgage", "borrower", "interest", etc.). This was approved by jurists (c.f. Al-Baraka 6^{th} Symposium *fatwā* #6/2, Algiers, 1990; HSBC *Sharīʿa* Committee, N.Y., 2002)

- The ownership structure, financial obligations, and legal documentation is therefore identical for the thought experiment of an Islamic REIT with Islamic mortgages and a conventional counterpart

- The existing secured/mortgage debt, together with a lien, can be viewed as mortgagee-ownership of the physical property's usufruct, payments being viewed as rent (c.f. Al-Baraka *fatwā* #6/4, Algiers, 1990; the Shāfiʿī legitimization of *Muzāraʿa* with both parties providing seeds as an *ʿijāra* and a loan of land – *Mughnī Al-Muhtāj*)

Buying shares in a REIT

- Second thought experiment: If a Muslim wishes to purchase a mortgaged property, he still needs to pay off its mortgage debt (release it from pawning)

- In that regard, the origin of the debt (an Islamic contract vs. a *Ribawī* loan) is irrelevant, since its repayment is required to have a clean title

- When a Muslim buys a share in the portfolio of pawned/mortgaged real estate, he inherits part of the associated debt through his equity position in the property, and not through the original forbidden loan. Persistence of the mortgage debt may be treated according to *M.* #55

- Other (unsecured) interest-bearing debts should be minor

Debts/assets ('000s $) end '01

REIT name	Total Debt	Mortgage debt	Total Assets	Debts/assets (%)	non-mortgage debts/assets (%)
AMLI Residential Properties Tr	405126	300876	919002	44.0832555	11.3438273
Avalonbay Communities, Inc.	2082769	447769	4664289	44.6535153	35.0535741
BRE Properties, Inc.	1008431	210431	1875981	53.7548621	42.5377443
Equity residential properties Tr	5742758	3286814	12235625	46.9347336	20.0720764
Essex properties trust, Inc.	638660	564201	1329458	48.0391257	5.6007034
Home properties of N.Y., Inc.	992858	960358	2063789	48.1085033	1.5747734
Archstone Smith Trust	3853012	2330533	8549915	45.0649159	17.8069490
Glenborough Realty Trust, Inc.	653014	588420	1388403	47.0334622	4.6523956
		Secured debt			non-secured debts/assets
Camden Property Trust	1207047	283157	2449665	49.2739619	37.7149529
Cornerstone Realty Income Tr	609600	554600	980691	62.1602523	5.6082905
United Dominion Realty, Inc.	2064197	974177	3348091	61.6529539	32.5564628
Town and Country Trust	475403	459403	499370	95.2005527	3.2040371
Apartment Inv. and Man. Co.	4637661	3433034	8316761	55.7628264	14.4843287

Worse picture with Debts/market cap – end '01

(all ratios shown as %)

REIT name	debt/full mcap	Non-mortgage Debt/full mcap	debt/float mcap	Non-mortgage debt/float mcap
AMLI Residential Properties Trust	90.1007996	23.1854000	90.1007996	23.1854000
Avalonbay Communities, Inc.	63.2554045	49.6562924	67.0078438	52.6020046
BRE Properties, Inc.	71.4174284	56.5146330	71.4174284	56.5146330
Equity residential properties Trust	73.8649933	31.5890531	73.8649933	31.5890531
Essex properties trust, Inc.	69.2882527	8.0780603	76.9015013	8.9656607
Home properties of N.Y., Inc.	141.8234042	4.6424168	172.1993737	5.6367372
Archstone Smith Trust	88.4917863	34.9666407	88.4917863	34.9666407
Glenborough Realty Trust, Inc.	124.7169198	12.3365881	134.1763526	13.2722841
		Non-secured Debt/full mcap		**Non-secured debt/float mcap**
Camden Property Trust	81.0309821	62.0222030	81.0309821	62.0222030
Cornerstone Realty Income Trust	113.6442790	10.2533388	120.1821902	10.8432094
United Dominion Realty, Inc.	144.6736715	76.3963882	144.6736715	76.3963882
Town and Country Trust	142.2904731	4.7888793	142.2904731	4.7888793
Apartment Inv. and Man. Co.	136.5293125	35.4633286	136.5293125	35.4633286

More problems with financial ratios:

- Arbitrariness and negative effects of the 1/3rd rule:
  - "A third is substantial" can be applied to too many ratios
  - Indeed, if the rationale behind the "license" is to prevent substantial lost opportunities for Muslim investors: shouldn't the 1/3rd rule apply to that potential loss?
  - Good sense dictates that in good times, the rule should be stricter, and in bad times, it should be more lax (بقدر الضرورة/الحاجة)
  - Otherwise, the rule forces Muslims in bad times to sell better companies that are more capable of borrowing
- Negative effects of using market cap as the denominator:
  - Forces Muslims to "buy high", as share prices and market capitalizations of companies rise, and "sell low" as they fall

If jurists do not approve a similar financial criterion

- Lawyers will create special-purpose vehicles (SPVs) to separate mortgage debts from the REIT equity and debt positions (as they currently separate Islamic mortgages from bank loans through SPVs)
- Such SPVs (UPREITs & DownREITs already developed for tax reasons) can pass the conventional DJII screens
- Let Muslims invest in the unspecified (*shāʾiʿ*) portion of the property owned by the SPVs
- Pass the hefty legal costs of creating and approving this procedure to the Muslim investors

Legal problems for lessee business screening: I

- The primary business of a REIT is <u>not</u> that of its tenants:
  – The REIT's primary business (owning and leasing properties) is lawful.
- The tenant extracts the property's usufruct (e.g. to run computers, sit, make telephone calls, etc.), but his business may be un-Islamic:
  – Imam ʿAhmad was reported to have said that he hated the consumption of wages paid to a worker who carried wine or pork to a Christian or Jew to consume, but that his wages should be paid. However, most jurists disagree, including in the Hanbalī school (*Al-Mawsūʿah Al-Fiqhiyyah*), based on the clear prohibition Text.
  – How about one who leased a bicycle to the worker who used it to carry the wine? He facilitated the worker's transportation of wine (forbidden), but did not himself transport it, can he take his rent? How about one who rented space to the bicycle rental shop? …

  … <u>How many degrees of separation do we need?</u>

  – There are no guarantees: a Christian drinking wine in rented property does not endanger it, and may be acting within his rights as owner of the leased property's usufruct. Every type of leased property may be used unlawfully, or – in some cases – sub-leased.

Problems for lessee business screening: II

- The above mentioned problems do not only apply to ownership of REITs, they apply to any co-ownership of real estate where leases are not severely restricted
- Numerous leasing-related *Fatwās* for KFH, Al-Baraka, and others seem to center on primary business of the lessee, and lessor's intent and knowledge, c.f. *ʿIjāra fatwas* on http://fatawa.al-islam.com, with varying degrees of deference to "avoidance of suspicions" ➔ invites layering of degrees of separation in leasing
- Insisting on infinite degrees of separation from un-Islamic activity would make investment impossible, including direct investment in real estate
- If it is just a matter of *n* degrees of separation, that invites lawyers to create such separation through SPVs, or re-package portfolios to make unlawful activities minor. As usual, investors pay the legal costs.

Cleansing dividends for (indirect) un-Islamic activity?

- It is interesting to note that jurists require cleansing of profits due to interest income of a corporation (directly unlawful), but do not require cleansing of excess profits due to acceptable levels of debt (indirectly unlawful)

- Applying the same principle (one degree of separation): (Juristic rule: "تبدل سبب الملك قائم مقام تبدل الذات", "a change in the cause/means of property ownership is equivalent to a change in the property itself"; *M.* #98), it may seem reasonable that if jurists allow ownership of any given REIT stock, no cleansing of dividends for (indirect) un-Islamic activity would be required

Concluding remarks

- We should not treat prior opinions as universally firm precedents, giving Muslims a substantial and unnecessary disadvantage in financial markets

- If two solutions result in logically, legally and financially equivalent positions, and either one of those positions is deemed acceptable, choose the less costly one

- In particular: anticipate the effects of new standards imposed on Muslim investors, and (strategically) minimize the dead-weight-loss of unnecessary legal fees