Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pp. 237-241

Applying *Waqf* Formula on a Global Basis

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ABSTRACT

Muslim minorities once enjoyed substantial donations from private and public agencies in the Persian Gulf region, but such gifts have recently tapered off. One reason is a desire by some donors to assure that good causes outlive the ability of any given donor to support them. This study covers the goals of a major agency that succeeds a formerly large donor in this transition. In New York, the Kuwait *Awqāf* Public Foundation (KAPF) is testing a project meant to support key American Islamic charities. The Islamic rules of *waqf* are very similar to American endowment practices. The project, for which KAPF engaged Al Manzil as advisor, entails relationships with a New York developer, the City of New York, the endowed entity, its constituents, and others. These points are covered, together with how this project is a durable, duplicable model.

I. INTRODUCTION

For many years, Muslim minorities enjoyed substantial donations from an array of private and public agencies in the Persian Gulf. Since the early 1990s the size and consistency of such gifts has tapered off. A variety of reasons have contributed to this decline, including more efficient giving programs in which donors seek out only the most needy, lower or less consistent oil revenues, and a desire to assure that good causes will outlive the ability of any given donor to support them. In this study, we will cover the goals of a major agency that succeeds a formerly large donor and marks its shift to endow Islamic centers and schools.

A properly structured endowment in the United States, for instance, might take initial shape as investment real estate. Depending upon market conditions or location, the investment may prove monetizable in a form that will increase long-term investment alternatives in support of the endowed institution. In New York, Kuwait *Awqāf* Public Foundation (KAPF) is testing what may prove to be the first of a series of projects meant to support key Islamic charities of substance throughout the United States.

The project, for which KAPF has engaged Al Manzil as advisor is the development of an $85 million apartment project on land belonging to the Islamic Cultural Center of New York (ICCNY). This complex relationship involves ICCNY as a ground lessor, KAPF as primary financial sponsor, a major New York developer as a partner in the to be developed property. The project's goal is to unlock value from the underlying land and deliver funds to complete ICCNY's school as well as to deliver a substantial operating subsidy to both ICCNY and the school.

This project, novel among U.S. Muslims for its scale, is a durable model that should prove replicable for the benefit of other communities in the coming years. Part of the message built into the presentation is that the model neither requires foreign donors or investors. Rather it requires a focused mission of the key parties blended with qualified experts.

II. GOALS OF KAPF

Among the many important goals of KAPF is the support of Islamic institutions on a global basis. KAPF does so through the collection of zakat, *sadaqat*, and other donations, as well as through the generation of investment revenues in *sharīᶜa*-compliant investments. The array of KAPF activities runs from local needs to the support of projects like ICCNY in New York.

KAPF was invited to support the ICCNY project by the Permanent Mission of Kuwait to the United Nations which for years had arranged donor support for ICCNY including construction of the main mosque and school and support for operations. Initially, the Mission anticipated that KAPF would donate funds to complete ICCNY's long planned school. Instead, KAPF reviewed the situation and proposed an investment that would be simultaneous with the completion of the school, allowing its ongoing endowment.

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Further analysis revealed that ICCNY controlled an additional plot of land adjacent to the school and mosque complex. Given both the shortages of land and apartments in New York, as well as the attractive location of the undeveloped parcel, ICCNY held a critical asset of value that would prove capable of unlocking value.

III. Capabilities of AMIFS/UBK

The team at Al-Manzil Islamic Financial Services (AMIFS), a division of the United Bank of Kuwait (UBK), is uniquely qualified to assist in this form of project. Historically, UBK has a real estate focused bank on the cutting edge of building Islamic financial services. The AMIFS New York team has extensive construction and development experience. In addition, AMIFS has secured a slew of U.S. regulatory approvals for Islamic financial structures. These have allowed AMIFS to launch an aggressive U.S. program of retail and commercial real estate finance structured according to the *sharīᶜa*, as well as to advise the IIBU (AMIFS London head office) on real estate investments including a REIT (real-estate investment trust) fund that complies with the *sharīᶜa*. This range of experience assures that AMIFS has the local contacts to assist KAPF in the execution of endowment programs that are based upon real estate investments.

IV. The Ambassador's Quandary

In the case of ICCNY, the center was a cooperative effort of the local Islamic community and the OIC members at the United Nations. ICCNY's start came with long range foresight by various OIC ambassadors in the 1960s. Over time, the primary supporter of ICCNY came to be the State of Kuwait through its Mission to the United Nations. But, Kuwait came to understand that ICCNY represented a noble long-term goal that was simultaneously unfulfilled and deserving of a broader base of support.

Ambassador Muhammad Abul Hassan knew he could secure funding to start the expansion of the ICCNY mission to include a school. So, with a major donation from Jabber, the Ambassador was able to erect the shell. Unfortunately, other members of the support group were unable to fund the completion of the school, let alone its future operations. At this stage, the Ambassador contacted KAPF to fund the project.

Following KAPF's analysis, AMIFS was engaged as their advisor.

V. The Growing Community Need

The process of creating endowments or *awqāf* is not top down. Rather it is flows with the current trend of Islamic community life in America. Not only are many new mosques opening throughout the country, but also those centers formed during the last thirty years are establishing Islamic schools. Two observations that any participant at ICCNY Friday prayers and other activities will make are that the mosque is used to capacity, and it has its own local community. With the latter comes a natural constituency for an Islamic school. Ensuring the long-term viability of this school requires an endowment or a *waqf*.

VI. The Process and Partnerships

A project of this magnitude has three levels. The first is between ICCNY and the developers. The second is between KAPF and the developers. The third is between the developers and the City.

The first is governed by a pre-development agreement between ICCNY and KAPF, and ultimately by the ground lease. The pre-development agreement assures ICCNY of a professionally executed plan to turn a parking lot into an apartment tower. The single most critical element of this agreement is the element of design control that it gives to ICCNY. Secondarily, it empowers KAPF to move on with minimal project interference.

Thirdly, the ICCNY/KAPF agreement allows for a ground lease between ICCNY and the developer. The ground lease means that rent income paid to ICCNY is not taxable. It is a key element of the deal that ICCNY is protected from tax exposure which would come from active participation, a tax term, in the development. The ground lease incorporates three major points that frame the relational points between ICCNY and the developer:

1. The lease term is 99 to 125 years and is subordinated to investors. This means that the developer can arrange a third party master lease investor for the project. Such an investor will demand the capacity to restructure the commercial project if anything should go wrong, hence subordination, and to be assured that the asset will not revert to the community before such time as the investor has been able to earn its return.

2. An initial ground lease payment will be made that will approximate the cost of building the school. The dollar value of this payment, in fact, approximates the cost of similar land acquisitions in today's market.
3. An annual ground lease payment will be made that will equal the operating costs and reserve requirements of the ICCNY as a whole. Again, the agreed rental rate equates to market conditions.

The second agreement entails the implementation of the pre-development guide. This is a classic U.S. law development agreement. It is modified on two levels. Not only are the pre-development guidelines (the KAPF ICCNY agreement) brought into the picture, but also the developer makes specific commitments to assure that the project is not despoiled by any non-Islamic features. This document, likely to be two inches thick will allow for every detail of executing the project in compliance with local law, budget and on time.

Once empowered by the development agreement, the developer will form the required structures to assure project execution. Among these will be the securing of various approvals from the City of New York and will be obliged to review key elements of the development agreement and ground lease with city authorities. In this project, the work benefits from existing rights that run from the property. In other transactions, a developer may be obliged to define rights and secure their approval where none existed. In our case, it means we can fast track the process compared to the two years that might otherwise be spent if no high rise residential rights attached to the property. Community boards and citizens groups may have the capacity to review the project and make suggestions.

VII. EXIT STRATEGIES FOR THE CORE INVESTMENT

Two years after the construction starts, leasing should take place. Given the demand for market rate rental and 80-20 apartments in the upper East side, it is believed that the project will lease up rapidly. Once it is stabilized, an entire new set of questions will arise. First, should KAPF retain the investment for the medium or long term? Assume for the moment that the answer to both terms is "no." This means that the development venture must have planned an exit strategy.

Foremost, the development venture includes a buy-sell agreement. This gives either KAPF or the American partner the capacity to buy the other out of the deal according to a specific formula. The formula is devised in a manner to prevent one party from cheating or gouging the other, and includes a third party appraisal as well as a minimum strike price below which the buy-sell cannot be invoked. The buyer is always bound by the original ground lease.

Alternatively, both parties could seek a market sale. In this case, the improved property is subject to the ground lease. Such a sale would seek to maximize revenues relative to the improved property. If proceeds are re-invested in a qualified property investment within 18 months, then the taxation of capital gains are deferred. This, of course, points to the alternative of reinvesting to support the same or other good causes discussed below.

The beauty of either sales scenario is that they are subject to the ground lease. On the one hand, KAPF and the investors may enjoy a gain. On the other hand, ICCNY continues, in perpetuity to benefit from ground rents supporting its operations.

Not infrequently a question arises in the U.S. context that refinancing is the best strategy to cash out of a project without triggering major tax events. The net effect can be very similar to a sale, but the actual fact is that KAPF remains an investor in the original project. For this project, taking advantage of 80-20 rules may unlock a prospectively *sharīʿa*-compliant refinancing strategy.

In our program, we are designing the project to conform to the 80-20 rules. These mean that 80% of the units will be market rent units and 20% will be reserved for low to moderate income persons, whose incomes must be within certain percentage bands of the local population. The units are identical to the other units and such tenants are dispersed throughout the building. The low to moderate tenants are subsidized through a favorable tax treatment and eligibility for tax favored municipal bond programs.

Before all and sundry complain that this could not be Islamic, let us examine a simple development within many municipal bond programs including New York where our project is located. It turns out that long-term net leases and synthetic leases are frequently approved for inclusion in such programs. In these cases, they are municipal lease pass-through obligations. These are equivalent to *sukuk* as applied to leases in the GCC and Malaysia.

In this scenario, we have built a project for $95 million. The state confirms compliance within its 80-20 rules and accepts the master or net lease as a suitable investment. The state next appraises the property, and let us say the value is $116 million. The state will now be prepared to buy the leasehold estate and lease from the existing lessor, paying a premium of $21 million. The existing financier will recover its invested capital, and the development partnership will receive $21 million (more than their initial investment) on a tax-deferred basis. The partnership will also enjoy continued sharing in the income.

VIII. Alternative Investments for the Proceeds

If all has gone well the exit strategies will have deposited up to $21 million in the hands of the KAPF and its partners. Now, the obvious alternative is to start over with a new real estate project. The choices are varied and must be matched to KAPF's long-term goals in the U.S. For instance, KAPF may not seek the level of involvement of development projects, either in U.S. commercial real estate or domestic Islamic programs. In such cases, investments in income oriented lease funds, Manzil pools, or other acceptable Islamic income oriented investments may be best. These would allow a definable annual income to be allocated to established projects.

Alternatively either balanced pools including equities, equities or real estate development would allow for capital growth with or without income.

KAPF likes the capacity to be flexible according to its own long-term goals as well as the specific needs of communities where KAPF wishes to be of assistance. KAPF has no preconceived notions but benefits from the fact that the array of Islamically acceptable investments continues to grow.

IX. A Model for Other Areas

KAPF and AMIFS share the goal to pool several leading *waqf* and donor groups to make a fund for North America and Europe. This would be complementary to the current IDB fund, which is geared toward poorer IDB member states with under-performing *awqāf*. The new fund would seek to develop properties in support of key Islamic centers and schools, assuring their cash flow and long-term viability. Here are three of the concepts that we are working on together or with other parties.

1. *Complicated U.S. Urban Areas*: The pattern of Muslim immigration and conversion in the U.S. should not surprise anyone. Muslims have gravitated toward the major immigration gateways, the key centers of learning and technology. As a result of AMIFS mosque and school programs, we have been approached by a number of sophisticated communities that have plans relating to public-private redevelopment programs, expansion of Islamic community services. This is precisely the mix of needs and opportunities that one might find in Boston, Chicago, or Los Angeles.
2. *Less Complicated U.S. Jurisdictions*: Secondary urban centers, Sunbelt, and Western U.S. locations typically enjoy less complicated real property investment issues. Whereas major urban areas may require tax incentives, condemnation, or other special assistance to make a project economically, these areas frequently have few barriers to entry. The trade off is that planning and marketing a project is more important.
3. *Globally*: In Europe, particularly the UK, AMIFS operates a similar program to support mosques and schools. KAPF is also interested in replicating these ideas in Europe. KAPF, the IDB, and Saudi *awqāf* have also embarked upon an exciting program to revitalize existing *awqāf* in the poorer member states of the IDB.

The modernization and re-generation of *waqf* application does not rely upon the success of a single deal in New York. But, that deal has each of the core elements that serve as a useful model elsewhere:

1. *Professional Investment Partners*: Although the ICCNY project is conceived to build an Islamic school and endow ICCNY's activities, the project is conceived with professional local market developers. The partners are found through a bidding process and assessed solely on their professional competence and their ability to put together the project.
2. *Local and International Financial Partners*: In the ICCNY project, KAPF seeds with its "international equity" a U.S. project. On the one hand, other international players which either share KAPF civic-commercial values or simply have commercial motivations, are ready to join in. On the other hand, the project is a well-conceived market transaction. That means that the U.S. development professional is desirous of investing in the deal, and is able convince domestic U.S. investors to join the deal, even if the structuring is completely Islamic.
3. *Public-Private Partnerships/Tax Incentives*: The ICCNY project does not take advantage of any specific public investments, but it benefits from two forms of tax incentive. Foremost, the project is located on the

border of a redevelopment zone, making it eligible for a staged tax abatement (no real estate taxes for five years, then easing up to full taxation by the 20th year). It also is structured to benefit from tax and financing incentives by blending into the tenancy 20% low or moderate-income households.

4. *Economically Viable Businesses*: The project is designed to fulfil a tiny part of a substantial shortage in apartment units. The location is well suited for the type of unit proposed and the costs are partially defined by ICCNY's low cost basis in the land. If KAPF and ICCNY did not pursue the use of this land, then the development partner would. It is simply good business.
5. *Marketable Investments*: Although property is not necessarily monetizable, one need only think back to the 1990s recession in the U.S., it is often marketable. In the case of the ICCNY project, an apartment building is typically the most marketable form of property. It could be sold, refinanced, traded for REIT shares, traded into a REIT, and so forth. Beyond this, the long-term strategy of our partnership does not preclude selling out the property and investing in liquid instruments.
6. *Renewable Resources*: One key aspect of this approach is that the financial resources of the various *waqf* and donor agencies may not be as deep as in the past. But, the desire and ability to do substantial good works remains. Therefore, these investment programs take a finite resource and make it a renewable, prospectively an infinite resource.

X. Conclusion

KAPF and AMIFS came together because of a simultaneous development of convergent programs. Each of our teams has the long-term strategic goal to support Islamic cultural institutions, mosques, schools, community centers, etc. Each proposed to do so with commercial solutions structured in conformance with the *sharīʿa*.

On the one hand, KAPF has the concern to use finite resources wisely and in a manner that makes them renewable. The KAPF team is geared to support Islamic institutions through its investment department by the establishment of *waqf* in places where KAPF might have previously donated money.

On the other hand, AMIFS has identified the fact that the domestic U.S. and European Islamic communities are grossly under-served in terms of physical plant and capital. Often communities can support medium to long-term capital plans, but lack the funding for short-term programs. The shortage of Islamic financial alternatives has meant that many plans for acquisition or expansion of Islamic facilities has been deferred. Or, when communities have turned to the conventional market, they have been gouged, often paying 200 to 300 basis point premiums to comparable funding for churches (in one case the premium was 1000 basis points.).

The facts that each of us was working on a case, each of us employed a high caliber professional team, made us a natural fit for the ICCNY project. As we systematize the lessons learned in this project, we will see a number of high quality programs and funds develop to assure that the Islamic communities of the West enjoy the facilities that their growth has mandated, and that these facilities are not financially at risk.

Ultimately, we believe that we are embarking on an exciting new area in both Islamic finance and Islamic community life and on a period in which we will see a greater flourishing of cultural and social services based upon improved planning and the coordination of a wider array of professional skills.