



**ISLAMIC REAL ESTATE INVESTMENT TRUSTS
IN MALAYSIA**

BY

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**A dissertation submitted in fulfilment of the requirement
for the degree of Master of Comparative Laws**

Kulliyyah of Laws

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ABSTRACT

This dissertation sheds light on the mechanism and practice of Islamic REITs in Malaysia. Islamic REITs have not received adequate attention from researchers in the field of Islamic banking and finance, which the researcher believes is an important area that needs more consideration. Structurally, there is no substantial difference between Islamic REITs and conventional REITs. Islamic REITs differ from their conventional counterpart mainly with regards to the former being required to adhere to Islamic investment guidelines and *Shari'ah* principals related to formation and operations.

The researcher made use of the comparative analytical approach with the aid of available data in the form of books, journals and reports as well as internet databases. The researcher observes that the Malaysian practice of both conventional and Islamic REITs have proven to be quite successful. Islamic REITs typically have relatively stable cash flows since almost all of their revenue is generated through rental payments. Islamic REITs also offer diverse advantages resulting from the establishment of *Shari'ah* compliant portfolios of high quality real estate with varying tenancy lengths and geographical locations.

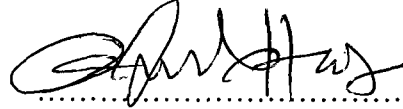
The research discussed some examples from the Islamic REITs in the market, and made a number of recommendations for enhancing the operation of Islamic REITs and their effectiveness. The researcher believes the *Guidelines for Islamic REITs* need to be more restrictive of tenants who engage in mixed activities. Also, those guidelines should emphasize on the purification of the revenues that are obtained from such activities. Regarding the practical implementation of Islamic REITs, the researcher recommends further studies to be conducted on this topic.

خلاصة البحث

تسلط هذه الدراسة الضوء على آلية عمل صناديق الاستثمار العقارية الإسلامية وتطبيقاتها. لم تحظ هذه الصناديق الاستثمارية بالاهتمام الكافي من الباحثين في مجال التمويل والمعاملات المالية الإسلامية، لذا يعتقد الباحث بأنها من أهم المجالات التي تحتاج إلى المزيد من الاهتمام. لا يوجد اختلاف كبير بين صناديق الاستثمار الإسلامية وصناديق الاستثمار العقارية التقليدية من الناحية الهيكلية، فالفرق بينهما يقع بصورة رئيسة في أن تشكيل صناديق الاستثمار العقارية الإسلامية يتطلب الالتزام بتعليمات اللائحة التنظيمية لصناديق الاستثمار العقارية ومبادئ الشريعة الإسلامية فيما يتعلق بناحية التشكيل والتشغيل. اعتمد الباحث على منهج التحليل المقارن مستندا إلى قاعدة بيانات متنوعة من كتب ومجلات وتقارير، فضلا عما هو متاح على الشبكة العنكبوتية (الإنترنت). لقد لاحظ الباحث أن التطبيق المالي لكلا النوعين من صناديق الاستثمار العقارية الإسلامية والتقليدية قد أثبت نجاحه، ويمكن القول إن صناديق الاستثمار العقارية الإسلامية ذات سيولة نقدية مستقرة نسبيا؛ إذ إن معظم دخلها متولد من دفعات الإيجار، هذا بجانب عرض صناديق الاستثمار العقارية الإسلامية لميزات متنوعة ناتجة من إنشاء محافظ استثمارية ذات نوعية عالية من العقارات المتغيرة في مدة إيجارها ومواقعها الجغرافية. ناقش الباحث بعض الأمثلة التطبيقية من صناديق الاستثمار العقارية الإسلامية المعمول بها في السوق وقدم عددا من التوصيات لتحسين عمل هذه الصناديق وزيادة فعاليتها. ويعتقد الباحث أن اللائحة التنظيمية لصناديق الاستثمار العقارية الإسلامية بحاجة لصرامة أكثر في تطبيقها على المستأجرين الذين يشتغلون في أنشطة مختلطة غرضها الأساسي حلال ولكن يشوبها بعض الحرام، هذا فضلا عن أن تلك التعليمات يجب تشديدها على تنقية العائدات المكتسبة من مثل هذه النشاطات، وتجدر الإشارة إلى أن الباحث يوصي فيما يتعلق بالتطبيق العملي لصناديق الاستثمار العقارية الإسلامية بإجراء دراسات إضافية على هذا الموضوع.

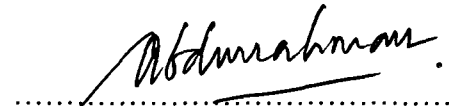
APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Comparative Laws.



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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degree at IIUM or other institutions.

SAIB M. RASHEED

Signature

Date.....

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ISLAMIC REAL ESTATE INVESTMENT TRUSTS IN MALAYSIA

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To my loving mother, the woman who has always been to me what an ideal - devoted and dedicated - mother and father could be; to my sibling *Suhaib*, whose brotherly tender care has greatly mitigated my loss of my dad at a tender age; and to *Muhaned*, my other beloved sibling, whose ready help and counsel have made the journey less thorny; and to my beloved wife.

TABLE OF CONTENTS

Abstract	iii
Approval Page.....	v
Declaration Page.....	vi
Copyright Page.....	vii
Acknowledgement	viii
List of Figures	xii
List of Cases	xiii
List of Statutes	xvi
List of Abbreviations	xv
Table of Transliteration.....	xv
CHAPTER 1: INTRODUCTION.....	1
Overview	1
Aim of Study	3
Problem Statement	3
Objectives of Study	4
Methodology	4
Scope and limitation of study.....	5
Hypothesis.....	5
Literature Review.....	6
Organization of Study	10
CHAPTER 2: HISTORICAL OVERVIEW OF “REITs”.....	12
2.1 Overview	12
2.1 Real Estate Investment Trusts.....	14
2.3 A Brief Historical Background of REITs’ concept.....	16
2.4 The concept of Units	18
2.5 The Differences between REITs & Portfolios	19
2.6 The Requirements of Being a REIT	20
2.6.1 Organizational Structure	21
2.6.2 Nature of Assets	21
2.6.3 Source of Income	22
2.6.4 Distribution of Income	22
2.6.5 Tax Treatment of REIT Shareholders	23
2.7 Forms of REIT	24
2.7.1 UPREIT Structure	25
2.7.2 DOWNREIT Structure.....	26
2.8 REITs’ Advantages	28
2.8.1 Diversification.....	28
2.8.2 Dividends of REITs	28

2.8.3 Liquidity	29
2.8.4 Investment Performance.....	29
2.8.5 Transparency and Governance.....	30
2.9 Types of REITs	31
2.9.1 Mortgage REITs.....	31
2.9.2 Equity REITs.....	31
2.9.3 Hybrid REITs	32
Conclusions	33

CHAPTER 3: REGULATORY FRAMEWORK OF REITS IN MALAYSIA 34

3.1 Overview	34
3.2 Nature of REITs	36
3.3 Operation of REIT.....	37
3.3.1 The Management Company	38
3.3.2 The Trustee.....	39
3.3.3 Property Manager.....	40
3.3.4 Investment Committee	40
3.4 The Deed of a REIT Fund	41
3.5 Operational Matters	42
3.5.1 Size of REIT.....	42
3.5.2 Distribution of Income	43
3.5.3 Conflict of Interest	43
3.5.4 Rebates and Soft Commission	44
3.5.5 Meetings of Unit Holders.....	45
3.5.6 Corporate Governance	45
3.6 Offerings and Issuance of Units of a REIT	45
3.6.1 Public Offerings and Listings.....	46
3.6.2 Issuance of Securities by a REIT	46
3.6.2.1 Issues of Units for Cash in Listed Funds	47
3.6.2.2 Rights Issues of Units in Listed Funds	47
3.6.2.3 Issuance for Financing Acquisitions.....	48
3.7 Investments of a REIT	48
3.8 Dealing in the Fund's Property	49
3.8.1 Acquisitions	50
3.8.2 Disposals	51
3.9 Investment in Single-Purpose Companies	51
3.10 Investments in Real Estate-Related Assets and Non-Real Estate-Related Assets	52
3.11 Investment in Deposits	52
3.12 Investment in Foreign Real Estates/ Markets.....	53
Conclusion.....	54

CHAPTER 4: SHARI'AH REQUIREMENTS of AN I-REITs..... 55

4.1 overview.....	55
4.2 Islamic-REITs Concept.....	56
4.3 Differences between Islamic and Conventional REITs	58
4.4 <i>Shari'ah</i> perspective on Islamic REITs	59
4.5 Stages of Investment Activity of REITs	59
4.6 Establishment of Islamic-REIT	60

4.6.1 <i>Shari'ah</i> Adaptation of Islamic-REIT Legal Status	61
4.6.2 <i>Shari'ah</i> perspective on I-REIT Components	65
4.6.3 <i>Shari'ah</i> Position of Units' Trading	66
4.7 <i>Shari'ah</i> -Compliant ASSESSMENT Process of I-REIT	67
4.7.1 Non-Permissible Rental Activities	68
4.7.2 Acquisition of Real Estate with Existing Tenants	69
4.7.3 Renting out to New Tenant.....	70
4.7.4 Investment Instruments of an I-REIT and insurance.....	71
4.7.5 Trading in Currency for Risk Manager	72
4.8 Juristic Justifications for Permitting Investment in Real Estate of Mixed Activities	73
4.8.1 Some <i>Fiqh</i> maxims	73
4.8.2 Analogy to some <i>Fiqh</i> rulings.....	75
4.8.3 Partnering with non-Muslims is permissible.....	77
4.8.4 ' <i>Umūm al-Balwā</i>	78
4.8.5 Change in <i>Hukum</i>	80
4.8.6 ' <i>Urf</i>	82
4.8.7 <i>Fasād al-Zamān and</i>	83
4.9 The basis for establishing the benchmark	83
4.9.1 Benchmark of one-third	84
4.9.2 Benchmark in <i>Ghabn</i> cases	85
4.10 The opinions of contemporary jurists	86
Conclusion	92
CHAPTER 5: STRUCTURES OF ISLAMIC-REITs IN MALAYSIA.....	93
5.1 Overview	93
5.2 Al-Aqar KPJ REIT.....	93
5.3 Al-Hadharah Bousted REIT.....	96
5.4 AXIS REIT	100
Conclusion.....	102
CHAPTER 6: CONCLUSION AND RECOMMENDATIONS	103
6.1 Conclusions	103
6.2 Recommendations	105

LIST OF FIGURES

<u>Figure No.</u>	<u>Page No.</u>
2.1	23
2.2	24
2.3	25
5.1	96
5.2	99
5.3	101

CHAPTER ONE

INTRODUCTION

1.1 OVERVIEW

Before 1960, real estate investment had always been attractive to small investors; however, there were many obstacles that prevented them from investing in this area, such as meagre capital, lack of experience and the difficulty of liquidity. Unfortunately, the investment tools that were available at that time could not solve this dilemma.

Eventually, the real estate investment trust (REIT) was created exclusively to hold real properties, mortgage-related assets, or both. This investment vehicle (i.e., the REIT) was first created in 1960 with legislation passed by the U.S. Congress.¹ The purpose of REIT legislation was to provide an opportunity for small investors to invest in real properties and to enjoy the same benefits provided to shareholders in investment trusts.² In order to make REITs more attractive, the U.S. Congress waived the corporate-level income tax on REITs if the investors (who are normally retail investors) met the conditions set by the tax laws governing REITs.

After the resounding success of REITs in the United States, many other countries all over the world sought to emulate the US's concept of REITs. At the forefront of these countries was the Netherlands, which passed legislation allowing for the creation of REITs and launched its first REIT in 1969. Australia followed, launching its first REIT in 1971 with supporting legislation. Thereafter, Belgium

¹ *Islamic Real Estate Investment Trust*, (Islamic Banking and Finance Institute Malaysia (IBFM), 21 May 2008), p. 7.

² Su Han Chan, John Erickson & Ko Wang, *Real Estate Investment Trusts*, (Oxford University Press, 2003), p. 3.

started to allow and create REITs in 1995. France did the same in 2003. Subsequently, this instrument made its way to the United Kingdom and Germany. Later on, the practice of REITs expanded to Hong Kong, Singapore and Malaysia.³

Currently, REITs are structured in two main forms. First, they can be structured as companies, as in the practice of the US and Europe. Second, REITs can be structured as a fund, such as the practice in Australia, Hong Kong, and Malaysia. Singapore is the only country that simultaneously allows both practices.

Malaysia always seeks to be at the forefront of global initiatives and efforts for establishing a viable, sustainable, and more feasible Islamic capital market to meet the needs of Muslims and to attract all investors regardless of their race or religion.⁴ For the purpose of expanding the Islamic capital market in Malaysia, the Securities Commission of Malaysia has introduced Islamic Real Estate Investment Trusts, or I-REITs, which are among the most recently developed investment opportunity in the Islamic capital market in Malaysia. I-REIT funds invest their portfolios in listed real estate securities that own and operate real estate such as commercial properties, retail properties, storage facilities, warehouses, and parking lots.

Structurally, however, there is no substantial difference between I-REITs and conventional REITs. Principally, I-REITs differ from conventional REITs due to the requirement that I-REITs strictly observe the *Guidelines for Islamic REITs* and *Shari'ah* principles. As a *Shari'ah*-compliant capital market instrument, I-REITs provide a unique opportunity for investors who seek to invest in real estate while complying with Islamic law.⁵

³ IBFM, *Islamic Real Estate Investment Trust*, p. 13.

⁴ Asyraf Wajdi Dusuki, "Practice and Prospect of Islamic Real Estate Investment Trusts (I-REIT) in Malaysia Islamic Capital Market" in *Islamic Capital Markets: Products, Regulation and Development*, edited by Salman Syed Ali (Saudi Arabia: Islamic Development Bank, 2008), p. 265.

⁵ Ibid.

To facilitate the development of I-REITs, the Securities Commission (hereinafter “SC”) has created guidelines on the issuance of I-REITs. Indeed, this is the first guideline of its kind in the global Islamic financial sector, providing *Shari’ah* guidance on this type of investment and business activity.⁶

1.2 AIM OF THE STUDY

The aim of this research is to examine the compliance Islamic REITs in Malaysia with *Shari’ah* principles through a study of the framework for Islamic REITs from the legal and *Shari’ah* perspectives. This requires a study of the established requirements for Islamic REITs as well as their mechanism for operation and administration in light of the *Guidelines for REITs* and the *Guidelines for Islamic-REITs*.

1.3 PROBLEM STATEMENT

This research sheds light on the creative Malaysian contribution in the Islamisation of the REITs concept, whereby the Securities Commission Malaysia took the initiative to issue the first guidelines on Islamic REITs in the world in order to propel the expansion of the Islamic capital market.

This study seeks to highlight the authenticity of the *Shari’ah* principles and the modernity of their practices through the Malaysian implementation of Islamic REITs. For this purpose, the current research will provide answers to the following questions:

- 1- What is the core of the conventional concept of REITs?
- 2- What did Malaysia add on to the conventional concept of REITs to make it comply with *Shari’ah* principles?

⁶ Ibid, p. 266.

- 3- How compliant is the Malaysian implementation of the Islamic REITs concept with *Shari'ah* principles?

1.4 OBJECTIVES OF THE STUDY

- 1- To evaluate whether the current Malaysian guidelines for Islamic REITs comply with *Shari'ah* principles;
- 2- To examine and analyze the organizational structure of Islamic REITs and the mechanism of implementation in Malaysia;
- 3- To make appropriate suggestions in relation to the implementation of Islamic REITs in Malaysia.

1.5 METHODOLOGY

In order to achieve the abovementioned objectives, the researcher examined REITs using two approaches to complete his research:

- 1- The researcher adopted an analytical approach to evaluate the REITs. This approach requires the analysis of the concept of REITs and its implementation from the conventional perspective as well as the *Shari'ah* perspective. Such an approach is qualified to provide an accurate and realistic picture of REITs.
- 2- The researcher also used a comparative approach to examine Islamic REITs by comparing Malaysia's *Guidelines for Islamic REITs* and the *Shari'ah* principles. This approach is useful in determining the extent to which the concept of Islamic REITs and its implementation in Malaysia is compliant with *Shari'ah* principles.

Furthermore, the present research is rooted in academic, library-based research, conducted with the aid of legal books, law journals, legal reports, and internet databases. It is to be noted that the researcher will not embark on an empirical study while undertaking this research.

1.6 SCOPE AND LIMITATION OF THE STUDY

This study provides a discussion on the regulatory and *Shari'ah* framework of Islamic REITs in Malaysia in light of the *Shari'ah* principles. This study also discusses various *Shari'ah* aspects of the Islamic REIT guidelines issued by the SC of Malaysia. The reason for limiting the discussion to these points is the fact that these guidelines are considered the first and only guidelines on Islamic REITs in the global Islamic sector. Thus, this study is concerned with classical Islamic juristic opinions and contemporary studies regarding the practice of Islamic REITs.

1.7 HYPOTHESES

The researcher, in conducting this research, will attempt to prove the following hypotheses in light of the *Shari'ah* principles:

1. The *Guidelines for Islamic REITs* issued by the SC of Malaysia comply with *Shari'ah* principles;
2. Though the *Shari'ah* guidelines on Islamic REITs in Malaysia are sufficient, there are several improvements that need to be made;
3. Islamic REITs are one of the most significant investment instruments that can propel the expansion of the Islamic capital market in Malaysia.

1.8 LITERATURE REVIEW

Many works have been written on real estate investment trusts. Authors have examined aspects of the real estate investment trust (hereinafter “REIT”) from conventional perspectives. Thus, there are a great number of authorities on the topic of REITs from the conventional perspective. For the purposes of this study, a select number of those works will be discussed as being pertinent to the central topic of this study. Authors who have written on this area include: Su Han Chan, John Erickson, Ko Wang, Austin J. Jaffe, C.F. Sirmans, Gaylon E. Greer, Michael D. Farrell, John P. Wiedemer, Ralph L. Block, John A. Mullaney, Richard Imperiale, Richard T. Garrigan, and John F.C. Parsons. In their works, they mention the most important aspects of REITs as a vital instrument of investment. Their discussions generally focus on the following:

1. Origins and evolution of REITs;
2. Process of investment in real estate;
3. Making decisions on behalf of the REIT;
4. Risks and future prospects of REITs.

Chan, Erickson and Wang⁷ discussed the various stages of the development of REITs, from the time of REITs’ inception to the present day practice of REITs. The authors extracted evidence on REIT valuation and performance and the lessons that investors and REIT managers need to take into consideration. Moreover, they summarized past experiences and synthesized evidence about REIT investments in a systematic way to provide guidance for future development of the REIT market.

⁷ Su Han Chan, John Erickson & Ko Wang, *Real Estate Investment Trusts Structure, Performance, and Investment Opportunities*, (Oxford University Press, Inc., 2003), p. 37.

Austin J. Jaffe and C.F. Sirmans⁸ provide a discussion on REITs from an economic and financial perspective. They introduce the real estate investment process. This process is a series of organized and coordinated steps that investors may follow to systematically analyze potential real estate investments in the real world. In addition, they briefly summarize the five principles of Real Estate Investment Decision Making as follows:

1. Real estate investment analysis is a systematic type of economic analysis.
2. Risk and return are closely related.
3. The goal of wealth maximization is accomplished with the optimal set of investments.
4. An analysis of the institutional environment of real estate is essential.
5. Real estate investment analysis is risk analysis.

Gaylon E. Greer and Michael D. Farrel⁹ focus their research and discussion on the concept that rational investors need a methodology for consistently ranking investment opportunities in order to pick between alternatives that, taken together, exceed available resources. Therefore, they focused on the problem of choosing between certain present benefits and uncertain future receipts from real estate investments. In these, and all other investment decisions, estimates of total cost and total benefit must be coupled with forecasts of the timing of disbursements and receipts. Rational decisions are then possible, based upon comparison of expected amounts and timing of receipts and expenditures and upon the degree of certainty with which expectations are held.

⁸ Austin J. Jaffe & C.F. Sirmans, *Fundamentals of Real Estate Investment*, (Prentice-Hall, Inc., 2nd Edition, 1989), p. 4.

⁹ Ibid, p. 7.

John P. Wiedemer¹⁰ provides general background information essential to successful real estate investment. From his viewpoint, sound real estate investment requires a working knowledge of many subjects that relate to real estate and that affect the value of real property investments. The more obvious subjects outlined by Wiedemer include the analysis of financial statements, the development of practical income and expense ratios, determining useful profitability ratios, and the calculation of present worth for future cash flow. In addition, a practical knowledge of the operational problems associated with any class, or classes, of real property investment is required.

C.F. Sirmans & Austin J. Jaffe¹¹ provide the investor with a framework for making investment decisions. This framework is referred to as the real estate investment process. In their viewpoint, the investment process forms the foundation of a real estate investment strategy. To estimate investment or market value, the real estate investor must analyze local real estate market conditions and make accurate forecasts. Therefore, the authors provide the techniques necessary for making real estate investment decisions.

On other hand, few works directly address REITs from the Islamic perspective. For example, there are only two articles about the implementation of Islamic REITs in Malaysia.¹² Therefore, we must refer to classical Islamic studies related to the topics of real estate as an investment. The lack of comprehensive research on Islamic REITs

¹⁰ John P. Wiedemer, *Real Estate Investment*, (Reston Publishing Company, Inc., 3rd edn., 1985), pp. 1-2.

¹¹ Austin J. Jaffe & C.F. Sirmans, *Fundamentals of Real Estate Investment*, (Prentice-Hall, Inc., 2nd edn., 1989), p. 8.

¹² Asyraf Wajdi Dusuki and Abdulazeem Abozaid, "Practice and Prospect of Islamic Real Estate Investment Trusts (I-REIT) in Malaysia Islamic Capital Market" in *Islamic Capital Markets: Products, Regulation and Development*.

is attributed to the modernity of the concept, as compared to conventional methods of real estate investment, which were well established a long time ago.

Dr. Asyraf Wajdi Dusuki¹³ provides insight into the practice and prospects of Islamic REITs in Malaysia. He examined the application and mechanism of Islamic REITs in light of Islamic REIT guidelines issued by the Malaysian Securities Commission. Moreover, he discussed in his paper that Islamic REITS have their own advantages and value, making Islamic REITs the instrument of choice in meeting specific investment interests and needs.

Abdulazeem Abozaid¹⁴ examined the Malaysian *Sharī'ah* guidelines for Islamic REITs. He focused his discussion on acquiring real estate with an existing tenant and renting out real estate to a new tenant. Finally, he concluded by refuting all the justifications claimed for validating the benchmarks of mixed activities.¹⁵ In addition, he suggests certain conditions for accepting existing tenants who engage in un-Islamic business practices.

Beside the articles by Dr. Asyraf Wajdi Dusuki and Abdulazeem Abozaid, the researcher did not come across any other writings that objectively discuss the topic of Islamic REITs. Most of the classical Islamic books provide juristic opinions on mutual funds. These views can be applied to Islamic REITs as they are a type of mutual fund. However, those works focused on the essential issues of Islamic investment funds such as:

- 1- *Sharī'ah* adaptation of Islamic investment funds;
- 2- *Sharī'ah* opinion on Islamic investment fund components;

¹³ Asyraf Wajdi Dusuki, p. 265.

¹⁴ Abdulazeem Abozaid, "Examining the Malaysian Sharī'ah Guidelines for Islamic REITs" in *Islamic Capital Markets: Products, Regulation and Development*, edited by Salman Syed Ali (Saudi Arabia: Islamic Development Bank, 2008), p. 281.

¹⁵ The core activities are permitted by the Sharī'ah while other activities occasionally contain a small extent of prohibited elements.

3- *Shari'ah* position on securities (Şukūk) trading.

Indeed, the majority of the abovementioned references treat REITs either directly from the conventional perspective, or indirectly from the Islamic perspective by modifying the conventional approach. Therefore, this dissertation seeks to establish a specialized analytical study of the regulatory framework of Islamic REITs from the *Shari'ah* perspective in light of the *Guidelines for REITs* and the *Guidelines for Islamic REITs* issued by the Securities Commission of Malaysia.

1.9 ORGANISATION OF STUDY

This study is divided into six main chapters; each chapter will be devoted to discussing issues within the purview of the research. Chapter One provides an introduction to the entire area of study, i.e., an overview of REITs and some of their unrivalled advantages in attracting small investors. The chapter outlines the objectives of the study, the scope of the research, and the research methodology as well as other foundational issues. Chapter Two provides a historical overview of the emergence of REITs in a comprehensive and concise manner. The origin, structure, and evolution of REITs from the conventional perspective are discussed. Chapter Three presents a review of the regulatory framework of Islamic REITs in Malaysia. Chapter Four provides the *Shari'ah* requirements for establishing Islamic REITs. The application and mechanics of Islamic REITs are examined in light of the *Shari'ah* principles and the opinions of Islamic jurists. Chapter Five illustrates the organizational structure of Islamic REITs in Malaysia based on actual practice, including a discussion of case studies. Finally, Chapter Six concludes the findings of this study and makes suggestions for future studies.

CHAPTER TWO

HISTORICAL OVERVIEW OF “REITs”

2.1 OVERVIEW

In general, investment means “a thing worth buying because it may be profitable or useful in the future.”¹ It may be defined as “the purchase of a financial product or other items of value with an expectation of a favourable future return.”² In financial terms, investing means the use of money with the hope of making more money, i.e., putting one’s liquid assets into a venture with the objective of making profits out of it. Thus, investment is essentially a choice between consumption in the present and consumption at a future time. Therefore, the most appropriate and comprehensive definition of investment is “present sacrifice for expected future benefit.”³ Because the present is relatively well-known and the future is uncertain, investment decisions represent certain sacrifice in exchange for uncertain benefits. In this sense, the investor should take certain risk in exchange for an expected yield.

In fact, there are many ways for individuals, groups, and companies to invest time and money in pursuit of a profitable return. No single type of investment is “best” for everyone; investors’ requirements vary with respect to the protection of capital, the percentage of expected revenues and the term of an investment. In other words, knowing the investor's objectives and constraints will determine the feasibility of the investment. In this regards, Austin J. Jaffe and C.F. Sirmans stated:

¹ <<http://www.askoxford.com>> (accessed 30 June, 2010)

² <<http://www.investorwords.com>> (accessed 14 June, 2010)

³ Austin J. Jaffe & C.F. Sirmans, *Fundamentals of Real Estate Investment*, (Prentice-Hall, Inc. 2nd Edition, 1989), 4.

Every investor should have an overall financial plan based on current financial resources and reasonable expectations of future financial position and income. It is important to prepare an investment plan that correlates with the other segment of the investor's financial plan and incorporates strategies and objectives to meet potential requirements and any legal restrictions.⁴

In fact, there is slight variation in investors' interests and objectives, because most of them seek to achieve the maximization of wealth with the least amount of risk. Unfortunately, some small investors are only looking forward to the profit of a venture only, and they do not pay enough attention to the risk involved. Therefore, most investors fall somewhere in-between these extremes. In other words, the investor's dilemma is how and when to compromise between high expected returns and low investment risks. However, an investor who concentrates on opportunities with high risks and high potential gain should be in position to accept large losses.⁵

In the economic system, there are three measurable returns: income, appreciation, and value gain. Some investments offer all three types while others provide them separately.⁶ Thus, based on a direct correlation between the risk and these types of return, an investor can differentiate between several alternatives of ventures. For small investors, the investments that offer all three types of return regularly and continuously are recommended, such as investments in the real estate sector.

In fact, real estate investment can provide all three types of return together or separately. For example, a mortgage loan can provide income only, and undeveloped land is the best investment for appreciation. As for value gain, it is better to invest in

⁴ Austin J. Jaffe & C.F. Sirmans, *Fundamentals of Real Estate Investment*, (Prentice-Hall, Inc. 2nd edn., 1989), 9.

⁵ *Real Estate Investment Trusts: The Low-Risk, High-Yield, Asset-Growth Opportunity*, (NYIF Corp, 1988), 5.

⁶ John P. Wiedemer, *Real Estate Investment*, (Reston Publishing Company, Inc., 3rd edn., 1985), 1-2.

the development of building lots. Finally, income-generating property, such as an office building, is the perfect way to gain all three types of measurable return.

Despite all the advantages of real estate investment, small investors have been unable to invest in this sector directly. Real estate investment requires a large capital, often beyond the means of small investors' savings. Therefore, there is only one way to enable small investors to invest in this sector, and that is with the use of real estate investment trusts, or REITs.

2.2 REAL ESTATE INVESTMENT TRUSTS

Before the creation of REITs, small investors faced a real challenge in light of the profusion of investment vehicles and the investors' lack of investment experience. Options have increased leverage for speculators. Stocks are the mainstay of investing, while bonds have always been the safe place to park investors' money. Mutual funds are considered one of the easiest vehicles for investors. Real estate is an option, but small investors could not invest their small surplus money in this sector directly. There is one type of investment that falls outside of these categories and that is often overlooked, and that is the REIT sector.

In general, *real estate investment trusts*, or REITs (pronounced "reets") are an investment vehicle that invests the pooled money of investors into real estate, providing a high level of dividend income with the potential of capital appreciation.

There are many specific definitions of REITS, as provided in the statutes of the various countries that have defined them. The Securities Commission of Malaysia defines REIT as "an investment vehicle that proposes to invest at least 50% of its total