Africa's funding alternative

The continent accounts for less than one percent of global sukuk issuance. This may be about to change

According to the United Nations, over the past seven years Africa's growth rate has been consistently above the global rate. That growth story appears set to continue; by 2023, eight of the fastest growing economies are projected to be in Africa. For such rapid growth to be sustainable, the continent inevitably requires greater industrialisation, which itself requires significant infrastructural development including both commercial (for example, power plants and distribution networks, roads, airports, rail and sea ports), and social (for example, hospitals, schools and agricultural projects) infrastructure. The continent's sizeable infrastructure gap requires a significant amount of investment – $93 billion according to the World Bank – in order to sustain its aggressive growth trajectory, and close the gap with the rest of the world. At this stage in Africa's development, the principal economic players in the infrastructure sector remain governments, parastatals, multilateral agencies, development financial institutions and a limited number of private sector companies.

> Uncertainty surrounding resource-based income is unlikely to abate in the near future

Governments all over the world generally finance their development and infrastructure budgets through tax and other revenues (including by borrowing from the capital markets through the issuance of various different types of financial paper). Owing to the continuing commodity price slump affecting the extractive industries, African governments are now receiving significantly less income from their traditional base of natural resources. As a result, alternative sources of finance are required to fund capital projects necessary to spur economic growth and diversify their economies. The uncertainty surrounding resource-based income is unlikely to abate in the near future, particularly given the slowing down of the Chinese economy: China's steady growth had previously helped to push demand for African resources to unprecedented levels. In addition, it is unclear whether and for how long the short-term downward pressure on oil prices due to the development of shale gas in the US and elsewhere, as well as the imminent arrival of Iranian oil into the global markets, will continue.

In the past, African governments have relied on traditional financiers such as export credit agencies, multilateral agencies, development financial institutions, commercial banks and private sector participants to cover their infrastructure costs. However, traditional sources of finance are finite and must fund other sectors, beyond infrastructure. Given the continent's massive infrastructure gap, the need to actively seek out alternative funding sources has become all the more urgent. As a result, several African countries have looked to the eurobond market, both for infrastructure development and otherwise. According to Standard Bank, sub-Saharan Africa saw a record $15 billion in bond issuances last year (of which $10.6 billion were sovereign issuances). Similarly, in recognition of the continent's significant Muslim population, and the considerable financial strength of Asia and the Middle East, there are a growing number of countries preparing legal frameworks for issuing *sukuk* and other shariah-compliant instruments to attract investment from those jurisdictions. We have already seen debut *sukuk* issuances from Senegal (100 billion CFA francs ($208 million) in June 2014) and South Africa ($500 million issue in September 2014).

In addition, and in spite of the effects of the recent downturn in oil prices, many of the Gulf Cooperation Council states have sovereign wealth funds that, over the years, have amassed significant wealth, which may also be deployed either through conventional financial products or shariah-compliant instruments.

Africa's sovereign sukuk

Rather than functioning as bonds which provide a fixed and pre-agreed return to the investor, *sukuk* are financial certificates that allow an investor to share in the profits deriving from the asset or activity that has been financed. The growth of *sukuk* as a financial instrument has predominantly been driven by Muslim countries, such as Malaysia and those that make up the Gulf Cooperation Council. The combination of a large Muslim population and a well-structured shariah banking system based on principles that are generally agreed within the Muslim community has enabled these countries to issue almost all of the *sukuk* to-date in a global market that is now in excess of $100 billion a year.

In comparison, *sukuk* issuances in Africa remain very low, at less than one percent of the global market. Although Gambia has been issuing short-term Islamic paper in its own currency for years, the debut issuances by Senegal and South Africa established *sukuk* as a credible additional market for African governments, many of which have now begun to adopt legal and regulatory modifications to create a framework for Islamic finance or shariah-compliant instruments. The success of the South African issuance (which was oversubscribed by over four times) and the recent Senegalese issuance, raised specifically to fund developmental projects, gives a strong indication of the depth of the investor pool. Other African countries are preparing to follow suit; Ivory Coast, Tunisia, Morocco, Nigeria and Kenya have all announced plans to issue *sukuk* in the near future.

Multilateral Islamic financing

Multilateral lenders have also begun to use Islamic finance instruments to fund infrastructure projects in Africa. The Islamic Development Bank (IDB) recently provided a shariah-compliant tranche as part of a much larger financing package for a $2.6 billion coal-fired independent power project near the port of Safi, Morocco. It also provided a $50 million facility to the Africa Finance Corporation (AFC), itself a multilateral agency that invests in infrastructure in the continent.

The inclusion of a shariah-compliant tranche in the Moroccan power project financing is significant in that it illustrates the possibility of blending Islamic finance with conventional finance facilities in the context of a multi-sourced infrastructure project. It is a model that may prove both useful and popular, particularly in countries with a proportionately high Muslim population that have both high demand for Islamic finance and a strong (or developing) Islamic banking system.

Similarly, it is envisaged that the IDB's $50 million line of financing to the AFC will be channelled toward developing projects (particularly infrastructural and agricultural endeavours) within IDB member countries, several of which are also AFC member states, in line with both organisations' goal of unlocking regional economic growth potential.

Creating frameworks for Islamic financial instruments

Unlike Asia and the Middle East, and despite the considerable size of its Muslim population, very little progress has been made in Africa in understanding shariah instruments, including their structural and documentation requirements. If the right frameworks are put in place, the proportion of shariah-compliant instruments used to finance development projects in Africa will only increase.

Countries like Senegal, where the population is over 95% Muslim and the framework for *sukuk* issuance has been successfully established and tested, stand to gain most from the development of the asset class. Although proportionately less than that of Senegal, the size of Nigeria's Muslim population and its ever-widening infrastructure gap also suggest that the *sukuk* market could be an ideal funding solution for the continent's largest economy. Nigeria also has introduced several legal and regulatory reforms to prepare a framework conducive to Islamic financing requirements.

Several other African countries have established, or are in the process of establishing, a framework to gain access to investors seeking to use shariah-compliant investment instruments. Tunisia's parliament, having passed a law regulating *sukuk* late in July 2014, has announced plans to issue the continent's largest ever *sukuk* programme by the end of this year. Morocco has also recently implemented an advanced securitisation framework that includes the flexibility to issue *sukuk*. This legislation is already strengthening the country's Islamic banking infrastructure: two of Morocco's biggest banks, Banque Marocaine de Commerce Extérieur and Banque Centrale Populaire, plan to launch Islamic banking subsidiaries and benefit from the new regime. The continued growth of Islamic finance in Morocco is likely to have a ripple-effect on the rest of francophone Africa, where Moroccan banks have extensive operations.

In east Africa, the populations of Kenya and Uganda are around or above 10% Muslim, while Tanzania's Muslim population is over 35%. The logical presumption that these countries would benefit from establishing a regulatory framework that supports shariah financial instruments is borne out in practice. Kenya's securities and equities regulator, the Capital Market Authority, has recently approved the country's Capital Market Master Plan. This plan includes the development of an Islamic capital market and provisions for shariah-compliant real-estate investment trusts as part of a new REITS framework. First Community Bank and Gulf African Bank, the two principal Kenyan Islamic banks which began operations in around 2008, are both growing rapidly. Meanwhile, Dubai Islamic Bank, one of the pioneers of Islamic banking, is preparing to launch in Kenya next year with a local partner in what will be its first African operation outside Sudan.

Tanzania's Amana Bank, which describes itself as 'the first fully shariah-compliant bank in Tanzania', continues to grow. According to a report last year by the IMF, Uganda is also amending banking regulations to allow for the creation of Islamic banks, triggering licence applications by three banks.

Apart from South Africa, there is not much activity around Islamic financing in the southern countries, mainly due to their significantly smaller Muslim populations. However, South Africa continues to adapt its legislation to give itself even greater access to Islamic finance.

South Africa's Taxation Laws Amendment Bill

Prior to its debut *sukuk* issuance last year, South Africa spent over two years amending the Income Tax Act 58 of 1962. This was to allow for the issuance of *sukuk* in addition to the three previously recognised forms of shariah instruments (the diminishing *musharaka*, the *mudaraba* and the *murabaha*); and to align the regulatory and tax treatment of sovereign *sukuk* with that of its conventional government bonds.

Following the deal's success, the Ministry of Finance, as part of its financial budget, announced plans to extend the reach of Islamic financing even further. Previously, *musharaka*, *mudaraba* and *murabaha* were described in the legislation as arrangements open for participation by members of the general public and were

Deal and legislation update

Countries that have issued sukuk based on recent legislative reforms	Countries establishing legislation to issue sukuk and/or introduce shariah-compliant instruments
Nigeria (Osun State) (2013)	Egypt
Senegal (2014)	Ivory Coast
South Africa (2014)	Kenya
	Mauritius
	Morocco
	Nigeria
	Tanzania
	Tunisia
	Uganda

> **Debut issuances by Senegal and South Africa established sukuk as a credible additional market for African governments**

presented as compliant with shariah law when members of the general public were invited to participate. However the Taxation Law Amendment Bill amends section 24JA of the Income Tax Act of 1962 to extend *sukuk* financing arrangements, and the related fiscal treatment to listed entities in addition to the government and its related entities. The new definition of *sukuk* will be as follows:

'…a Sharia arrangement whereby:

- the government of the Republic [of South Africa] or any public entity that is listed in Schedule 2 to the Public Finance Management Act disposes of an interest in an asset to a trust; and
- the disposal of the interest in the asset to the trust by the government or the public entity contemplated in paragraph (a) is subject to an agreement in terms of which the government or that public entity undertakes to reacquire on a future date from that trust the interest in the asset disposed of at a cost equal to the cost paid by the trust to the government or to that public entity to obtain the asset.'

The proposed changes take effect in 2016 and will provide listed companies with an alternative fundraising platform that receives the same fiscal treatment as conventional sources of finance.

Without the changes proposed by the government, *sukuk* would remain fiscally unattractive and inefficient from a costs perspective given their asset-backed nature. In practice, a successful *sukuk* issuance may require multiple asset transfers, each of which may result in a tax liability. Accordingly, if the proposed changes to the legislation were not put in place, the considerable potential tax burden for issuers of *sukuk* would have continued to rule it out as a credible funding source. The following additional amendments set out in the Taxation Laws Amendment Bill remove the tax liabilities associated with disposals and transfers of real assets in the context of *sukuk*:

'…where any *sukuk* is entered into –

- the trust is deemed not to have acquired the asset rom the government of the Republic [of South Africa] or the public entity that is listed in Schedule 2 to the Public Finance Management Act under the *sharia* arrangement;
- the government or that public entity is deemed not to have disposed of or reacquired the asset; and
- any consideration paid by the government or that public entity in respect of the use of the asset held by the trust is deemed to be interest as defined in section 24J(1).'

The changes that were initially made to Income Tax Act 58 of 1962 allowed the South African government to issue its debut sovereign *sukuk* (and arguably could have been interpreted to extend to parastatal entities, such as South African National Roads Agency, due to its governmental status). However the changes proposed by the Taxation Laws Amendment Bill clearly aim to open up an entirely new pool of finance to all listed entities, by permitting them to issue *sukuk* and removing any impediments to cost-effectiveness relating to the transfer of assets.

Looking ahead

While Islamic finance has seen some progress in Africa over the last few years, most of the work that has been done has been preparatory, and African countries have yet to reap the rewards for the seeds that have been sown. Africa's much-publicised growth story continues to cast it in a positive light, and the infrastructure required to support such economic growth will continue to provide ample opportunities for investment from Asia and the Middle East. This is particularly the case when such investment is made directly with, or comes with the support of, governments that see continued infrastructure development as critical to the well-being of their countries.

While the capital markets infrastructure for *sukuk* is developing steadily, best practice for implementation of a framework conducive to *sukuk* is constantly evolving. It is therefore imperative that the new frameworks being developed by countries aspiring to enter the *sukuk* market are consistent with prevailing global market practice. Indeed, any such framework should adopt and reflect the standards and practices in those countries where *sukuk* have been issued successfully.

In contrast to the measured development of Africa's *sukuk* market, its broader Islamic banking infrastructure is far behind where it should be, particularly considering the size of the continent's Muslim population. It is possible that the amelioration of Islamic banking frameworks through legal and regulatory reform, and continued investment in education around shariah-compliant instruments, will combine to promote Africa's status as a credible investment destination for Islamic finance. If so, and if the continent manages to take even a marginal proportion of a global *sukuk* market that is in excess of $100 billion a year, then Islamic finance could become a significant source of additional funding for Africa's needs, including to help close its infrastructure gap.

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Growth of Islamic finance in Morocco is likely to have a ripple-effect on the rest of francophone Africa