

Meeting Africa's infrastructure needs

According to the World Bank around US\$93 billion will be required annually to meet Africa's infrastructure needs until 2020. Taking into account the resources currently available to African governments, an infrastructure funding gap of US\$31 billion a year thus exists which must be bridged if the continent's infrastructure needs are to be met. CHUKS IBECHUKWU and CLEMENT FONDUFE explore new avenues of financing that could help African governments to meet this need.

With total global issuance of Sukuk for 2012 in excess of US\$130 billion and, according to recent numbers published by Kuwait Finance House Research, total global Sukuk issuances for the first half of 2013 already at US\$61.2 billion, it is no surprise that increasingly African governments are assessing Shariah compliant finance options, including tapping the Sukuk market, to contribute towards their long-term infrastructural funding requirements.

The international Sukuk market has expanded rapidly since its inception in 2001. But despite year-on-year growth in sovereign-related issuances, only two African countries — The Gambia and Sudan — are known to regularly issue sovereign Sukuk in their domestic markets and, to date, no African sovereign has come to market with an international Sukuk.

Nigeria and South Africa are among the ranks of African nations that have announced plans to issue sovereign Sukuk on the international markets in a move to attract investors from Asia and the Middle East and other investors that subscribe to the non-interest, profit-sharing investment philosophy underpinning Shariah compliant instruments. Demonstrating their commitment to promoting the growth of Islamic finance, earlier this year, their respective governments introduced measures to facilitate Sukuk issuance both domestically and on the international markets. The measures introduced by Nigeria and South Africa are laws and regulations that attempt to level the playing field for Shariah compliant instruments to ensure that a Sukuk will receive the same treatment from a tax and regulatory perspective that is no more or less favorable than the treatment given to an equivalent conventional product. The regulations introduced by Nigeria also detail the procedural requirements and Shariah principles that issuers of Sukuk in Nigeria must comply with.

Many market participants believe that it is only a matter of time before we see the first international Sukuk issued by an African sovereign. As we continue to monitor legal developments in Africa, we first of all take a brief look at the legislative and regulatory changes that were introduced in Nigeria and South Africa earlier this year to facilitate the issuance of Sukuk and some commonly cited challenges that they (and other African countries) may need to overcome in the process if Islamic financing is to become a viable financing option to fund development projects in Africa.

Nigeria — Securities and Exchange Commission Rules on Sukuk issuance in Nigeria

Islamic banking in Nigeria was established through the Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended). Following on from BOFIA, various rules and regulations specifically relating to Islamic banking and finance have been issued by relevant authorities in Nigeria. Among these are the guidelines issued by the Central Bank of Nigeria (CBN) in December 2010 for the establishment of Islamic windows or branches by conventional banks and other financial institutions and the guidelines it issued in June 2011 for the regulation and supervision of institutions offering non-interest financial services in Nigeria. There are now financial institutions in Nigeria that have been licensed by the CBN either to operate as a non-interest financial institution (Jaiz Bank, for example, the republic's first fully-fledged Islamic bank) or to operate a non-interest window (Stanbic IBTC Bank, for example). A national Shariah advisory board has also been established by the CBN with a remit to ensure that all Islamic financial activity in Nigeria is consistent with Shariah principles.

Nigeria announced its intention to issue a sovereign Sukuk in 2011 and earlier this year new rules were introduced by the Securities and Exchange Commission of Nigeria (SEC) to further this agenda.

The Rules on Sukuk Issuance in Nigeria (the 'Sukuk Rules') were approved by the SEC on the 28th February 2013 to regulate Sukuk that (a) are offered by SEC-regulated local or foreign entities; (b) are denominated in Nigerian naira or in foreign currencies; and (c) are listed, convertible, exchangeable, redeemable or otherwise. The Sukuk Rules also detail Shariah rulings and principles that must be applied by all issuers of Sukuk. The following are some of the provisions included in the Sukuk Rules that are particularly noteworthy:

- Any public company (including special purpose vehicles), state government, local government, government agency, multilateral agency is eligible to issue, offer or make an invitation for Sukuk with the approval of the SEC;
- Any issuer of Sukuk must comply with the same registration requirements in the SEC Rules and Regulations that are applicable to other conventional securities issued or offered for sale in Nigeria. If the issuer is a public company and the Sukuk is capable of being converted or exchanged into equity with the intention of being listed, the issuer must also comply with the listing requirements of the relevant securities exchange in Nigeria;
- Issuers must appoint a Shariah adviser that is registered and recognized by the SEC. The Shariah adviser will be responsible for (i) advising on all aspects of the Sukuk issuance (including documentation and structuring), (ii) issuing a Shariah certification that outlines the basis and rationale of the structure and the Shariah principles used and (iii) ensuring that all aspects relating to the Sukuk issuance comply with Shariah principles. The SEC will recognize as a Shariah adviser any Islamic development bank, a bank licensed by the CBN to operate as a

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non-interest bank or a fund manager licensed by the SEC to manage a Shariah compliant fund;

- The Shariah principles that must be observed for all Sukuk. The principles in the Sukuk Rules are the same general principles that underpin all other Islamic finance structures. Accordingly, in relation to the assets that will underpin a Sukuk, such assets must comply with the requirements of Shariah (which, for example, prohibit dealings or businesses involving alcohol, pork or pornography) and must be established and certain. In terms of the consideration to be paid by an issuer to acquire the underlying assets from the originator, the Sukuk Rules go on to specify that the purchase price must not exceed 1.51 times the market value of the assets;
- All Sukuk must be rated and the rating made available throughout the tenure of the issue;
- Sukuk programs must meet specified additional criteria, including with respect to the disclosure material and the tenure for the programs (which must not exceed two years);
- If approval is granted by the SEC for a Sukuk, the approval must be implemented within three months of the date of the approval, except if it is a Sukuk program or a Sukuk under a shelf registration, in which case the initial issuance must be made within two years of the date of the approval;
- All issuers must appoint a Sukuk trustee that is registered with the SEC; and
- The disclosure and other documents to be submitted with any application for SEC approval.

Since announcing its plans to issue a debut sovereign Sukuk on the international markets and adopting the Sukuk Rules, little observable progress has been made with the sovereign Sukuk and limited information on the proposed structure is publically available. However, there have been exciting developments on the state level in Nigeria. The southwestern state of Osun has this month begun

marketing Nigeria's first domestic Sukuk — a NGN10 billion (US\$61.43 million) seven-year Sukuk denominated in local currency, which, it is reported, will pay investors a fixed return of between 14.25% and 14.75%. According to the prospectus, the net proceeds of the issuance will go towards funding the construction of schools in Osun state, demonstrating the potential for Sukuk to be viable finance option for sub-Saharan government institutions to fund infrastructure and social projects at the state and national level. The Osun state Sukuk is understood to have been assigned an 'A' rating by Agosto & Co, a local credit rating agency, and will be listed on the Nigerian Stock Exchange.

South Africa — The Taxation Laws Amendment Act 24 of 2011

The National Treasury of South Africa announced its plans for a debut sovereign Sukuk last year. The country is reported to be considering a US dollar-denominated five-year Sukuk of between US\$500-700 million. The Sukuk was delayed in 2012 to allow the government sufficient time to review those aspects of South Africa's regulatory and tax regime that could result in adverse tax consequences for a sovereign Sukuk that do not affect conventional government bonds.

With the exception of certain provisions in the Income Tax Act 58 of 1962, as amended, there are no laws, rules or regulations that specifically regulate Islamic banking and finance in South Africa. The Income Tax Act previously recognized three forms of Shariah arrangements, which are described in the legislation as arrangements that are open for participation by members of the general public and are presented as compliant with Shariah law when members of the general public are invited to participate. These forms are the diminishing Musharakah, the Mudarabah and the Murabahah. The Income Tax Act seeks, for income tax purposes, to treat any returns attributable to these Shariah arrangements in a similar way to equivalent interest-bearing financial products.

On the 1st January 2013, the Taxation Laws Amendment Act 24 of 2011 came into force. This amendment act amended

section 24JA of the Income Tax Act by introducing similar taxation treatment specifically for sovereign Sukuk. Sukuk has now been defined within the Income Tax Act as:

"...a Shariah arrangement whereby:

- (a) the government of [South Africa] disposes of an interest in an asset to a trust; and
- (b) the disposal of the interest in the asset to the trust by the government is subject to an agreement in terms of which the government 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 to obtain the asset."

The government of South Africa has been working towards developing a model for its debut issuance that fits within the new regulatory framework. The structure that is expected to be used by the government is a Sukuk Ijarah, a structure commonly used by sovereign issuers which is based on leases and rents of underlying assets.

The amendment to the Income Tax Act is intended to ease the greater tax burden that otherwise would have affected a sovereign Sukuk in the following ways:

- Any disposal of assets by the government of South Africa in connection with a Sukuk offering, any acquisition by a trust vehicle of those assets and the reacquisition of those assets by the government at the end of the lease period, now will be disregarded for income tax purposes;
- Any yield on the underlying assets that accrues to the trust (which derives from the rental payments made by the government to the issuer on underlying assets) now will be taxed and will receive the same treatment as interest for income tax purposes;
- The income generated by the asset will flow-through automatically to the Sukukholders since the issuer/special purpose vehicle is a trust (if the issuer were a company, the income would be subject to dividend tax at a rate of 15%); and

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- The trust will be deemed not to be an “enterprise” and, therefore, will not be subject to any potential VAT charges.

Potential bumps on the road ahead

Alongside South Africa and Nigeria, other sub-Saharan African countries are known to have Islamic finance high on their agenda and those countries are at various stages of drafting and implementing regulatory changes that will allow them to issue Sukuk. The Capital Markets Authority of Kenya is reported to be currently structuring a regulatory and policy framework to govern the trade of Shariah compliant paper. Also, in Senegal, the government has announced that it is actively pursuing changes to its regulatory framework that will permit the country's first sales of Sukuk. It is important for the development of Islamic finance in the countries reviewing their regulatory regimes that any legislation that is eventually introduced places Islamic finance on an equal footing with conventional instruments.

Overcoming the various legal and regulatory hurdles, however, is not the only impediment to Sukuk issuance in Africa. Other factors have contributed in varying degrees to delay progress on this front, and African governments will need to find solutions to these challenges if they are to establish themselves as players in the global Sukuk market. Of these factors, some of the commonly cited ones include:

- Shortage of qualified/skilled personnel: With Islamic finance in its infancy in Africa, a shortage of qualified/skilled personnel in the various stages of structuring a Sukuk may result in delays in Sukuk issuance in Africa. Even in the jurisdictions that have implemented appropriate regulatory regimes, financial authorities will still need to invest in staff education and training to boost the number of skilled personnel that are familiar with the principles and practices that characterize Islamic finance, and the process for a Sukuk issuance in order to ensure that the financial authorities are capable of performing their supervisory and regulatory functions efficiently.

In the structuring process, originators and issuers will require the services of qualified religious scholars, who usually will sit on the Shariah supervisory board of an Islamic financial institution, to issue formal legal opinions or Fatwa on the Shariah compliance of the proposed structure and its adherence to internationally recognized regulatory and Shariah standards, AAOIFI. In the case of Nigeria, as mentioned earlier in this article, Shariah advisers must be registered and recognized with the SEC under the Sukuk Rules. The Sukuk Rules also require all Shariah principles and concepts applied in structuring a Sukuk issuance to be consistent with general Shariah rulings, principles and concepts as approved by AAOIFI or any other standard setter recognized by the SEC. For Sukuk and other Islamic finance products to take root in Nigeria and across Africa, measures therefore will need to be implemented by African governments to encourage and promote the registration of ‘full’ Islamic financial institutions and Islamic windows or branches of conventional financial institutions that have recognized Shariah scholars capable of (and qualified to) review and issue authoritative opinions on the Shariah aspects of Sukuk issuances.

- Underlying assets: Sovereign Sukuk are commonly structured as Sukuk Ijarah, which are based on leases and rents from public real estate assets such as hospitals or administrative buildings. If the proceeds of a Sukuk are to be used to finance the development and construction of an infrastructure project, a sovereign issuer will also have the option to use the project to back the Sukuk. Whatever the asset, assets underpinning a Sukuk must comply with the usual Shariah requirements applicable to Ijarah. Therefore, the ownership or benefit/ usufruct of the asset must be transferable to the issuer, the asset must continue to exist throughout the term of the Ijarah, and assets that are consumed in the process of usage cannot be leased. Depending on the Sukuk structure, there may also be

administrative or Shariah constraints that restrict the availability of suitable assets, which African governments must consider.

- Liquidity/rating: A factor that affects the global growth of the Sukuk market, and which African sovereigns also will need to contend with is the limited secondary trading of Sukuk. Although most Sukuk are structured as tradable instruments, liquidity remains low in this asset class due to the small volume of primary Sukuk issuance relative to conventional government bond issues. African governments will need to invest in infrastructure such as Islamic money markets to improve liquidity. An increasing number of global Sukuk are being rated and listed on international stock exchanges. Nigeria, South Africa and other sovereign Sukuk sponsors in Africa that have been assigned sovereign ratings may be able to increase liquidity of their Sukuk in this way.

Conclusion

In comparison to Asia and the Middle East, which continue to dominate global Sukuk issuance, Islamic finance is at the early stages of development in Africa. The general consensus, however, is that the Islamic finance opportunities in Africa are significant. The demand for infrastructure finance, increasing interaction with the Middle East and appetite from domestic and international investors seeking non-interest, profit-sharing financing options are among the key drivers. African governments are beginning to address the legal obstacles to Islamic finance by putting in place the necessary regulatory measures. However, having appropriate regulations in place alone is not sufficient. For any African country looking to establish itself as an Islamic finance hub of the future, that country must overcome a number of other challenges to create an environment conducive for Islamic finance to take root, including investing in education, capital markets infrastructure and political stability. (2)

Clement Fondufe is a partner and Chuks Ibechukwu is an associate at Latham & Watkins. They can be contacted at clement.fondufe@lw.com and chuks.ibeckukwu@lw.com, respectively.