

SOVEREIGN SUKUK IN AFRICA: A DEVELOPING LANDSCAPE

On 24 September 2014, the Republic of South Africa (RSA) issued its inaugural US\$500 million sukuk which was hoped by many commentators to be the catalyst to allow a US\$-denominated African asset-based sukuk market to develop. The expectation was that the RSA's international sukuk would pave the way for future sovereign Islamic financings in Africa, as well as opening the Islamic financial markets to other governmental entities, financial institutions and corporate entities seeking new sources of funding through the international capital markets.

As the National Treasury of the RSA remarked at the time: "The decision to issue an Islamic bond has been informed by a drive to broaden the investor base and to set a benchmark for state-owned companies seeking diversified sources of funding for infrastructure development." The issuance highlighted the diversified investor base, consisting of 59% from the Middle East and Asia, 25% from Europe, 8% from the United States and the balance from the rest of the world.

Whilst the RSA's US\$-denominated sukuk represented a significant milestone in the development of sovereign sukuk in Africa, its impact for the evolution of an international sukuk market in the wider African continent has been slower than some commentators had expected. Notwithstanding recent local currency issuances by, amongst others, the Republic of Côte d'Ivoire, the Republic of Senegal, the Togolese Republic and the Federal Republic of Nigeria, further international sukuk issuances from African sovereigns have not been as frequent as had been expected, with the corollary that the corporate sukuk market has not developed as quickly as anticipated.

While the different legal systems across Africa understandably pose a challenge to achieving market consistency in structures, and whilst in the short term certain African governments may favour smaller local currency issuances, the RSA's inaugural US\$-denominated sukuk issuance demonstrated how a sukuk structure can be developed to overcome structuring challenges arising under domestic laws and provide an alternative international funding platform for governments at a time of significant development and infrastructure investment need across Africa.

In this article, we take a look at why Shari'a-compliant funding through sukuk issuances should still be a priority as an important liquidity and funding source

Key issues:

- Sukuk as a source of funding
- Growth in sukuk funding infrastructure development
- Sukuk structural variations across Africa
- The outlook for sukuk in Africa.

in Africa, and highlight how entities such as the Islamic Corporation for the Development of the Private Sector (ICD), an Islamic multilateral financial institution for the development of the private sector, are actively supporting the development of the market. We also briefly overview a number of the structures that have been seen to date in the market; these reflect a lack of homogeneity, which may reflect the future direction of the development of the market in Africa.

The potential role of sukuk in funding infrastructure development

There is growing potential for Africa's developing sukuk market to help achieve the continent's funding requirements for its extensive infrastructure development. For many African countries, "non-traditional" sources of infrastructure and development finance, such as sukuk, could prove to be very significant in expanding the infrastructure and development finance space. Islamic finance (and the issuance of sukuk) has become one of the fastest growing segments of the global financial system and its instruments have been used to finance infrastructure development in, amongst others, the Republic of Malaysia, the Republic of Indonesia, the United Arab Emirates and the other countries of the Gulf Cooperation Council (GCC).

However, these developments must be set against increasing fiscal pressure on African governments due to the receipt of lower revenues as a result of depressed commodity exports, meaning that additional revenues need to be directed towards servicing existing debt. According to the World Bank, growth in sub-Saharan Africa slowed markedly in 2016 to 1.5% and is projected to recover only moderately in 2017 to 2.6%. Expectations are that growth will continue to strengthen through 2018, but are dependent on improvements in commodity prices and domestic economic and political conditions.

In turn, Standard & Poor's estimates that the average fiscal deficit of rated sub-Saharan African sovereigns was 5% of Gross Domestic Product (GDP) in 2016 and just over 4% of GDP (so far) in 2017, compared with an average of 4.6% for 2014 and 2015.

Accordingly, at a time of ongoing fiscal deficits, sukuk could provide the means for governments across Africa to further diversify their funding sources and focus on domestic funding and domestic projects.

In this regard, the continuing interest and support of African governments will play a crucial role in catalysing market developments. Legislative developments by certain African governments since 2014, such as the Federal Republic of Nigeria, the Republic of Kenya and Uganda, are very much welcomed, and this trend has also been prevalent in Northern Africa, particularly in the Kingdom of Morocco and Tunisia. It is recognised that there is currently a lack of a clear legal and tax regime in many African countries to support the development of a sukuk market (which requires a fairly robust legal framework) and that governments need to address several "legal hurdles" to issuing sukuk. For example, in South Africa, the government's proactive amendments to legal and tax laws enabled the country to be in a position to issue its inaugural sukuk.

A welcome development has been the role and involvement of multilateral financial institutions, such as (amongst others) the ICD, in providing technical help to advance the issuance of African sovereign sukuk, it being recognised that, despite strong growth in the Middle East and South-East Asia, Islamic finance has lagged in Africa, home to a quarter of the world's Muslims. This is

reinforced by opportunities in Africa attracting more investment from Middle Eastern countries (and a desire by investors in global sukuk to maximise the diversification of their investment portfolios).

One size may not fit all – structural variations across Africa

The legal and tax infrastructure across Africa is not consistent and that is borne out by an analysis of the different legal structures that have been used to issue sukuk in Africa to date. Moreover, notwithstanding the use of familiar Islamic finance principles in these transactions (for example, ijara), what is clear is that a "one size fits all" approach may not be achievable and that often, structures that have been used in previous international sukuk issuances by sovereigns have to be (in some cases heavily) tailored to the local legal and tax system prevailing in Africa. In this regard, we briefly analyse the RSA sukuk and the Republic of Senegal sukuk, which demonstrate how the domestic legal landscape in each country directed the end structure of each issuance.

The RSA sukuk

The RSA sukuk No. 1 Trust (the RSA Trust) was established in the RSA in August 2014 by GMG Corporate Fiduciary Services Proprietary Limited as its founder. A letter of authority from the Master of the High Court in Pretoria authorised ZAR Sovereign Capital Fund Proprietary Limited (the Trustee), a special purpose vehicle established in the RSA, to act as Trustee of the Trust in accordance with the South African Trust Property Control Act 1988. The Trust acts through the Trustee for the purposes of the issuance of the sukuk and the entry into the transaction documents.

The issuance was structured as a participation in a sale and lease-back of government-owned infrastructure assets. The proceeds of the issuance of the sukuk were used by the Trustee to purchase from the RSA (acting through the Minister of Water Affairs) a personal usufruct right in certain infrastructure assets located in the RSA. These assets were leased back to the RSA (as lessee) by the Trustee (as lessor) for the term of the sukuk and are to be repurchased by the RSA upon redemption of the sukuk. The sukuk represent an undivided beneficial ownership interest in the Trustee's rights under the transaction documents, including the right to receive rental payments under the lease and the right to receive the purchase price for the repurchase of the assets upon redemption of the sukuk. Payments of rental under the lease are intended to fund the profit due under the sukuk on a biannual basis, and the final rental payments under the lease, together with the principal amount payable by the RSA for the repurchase of the assets, are intended to fund the redemption amount payable under the sukuk.

The Republic of Senegal sukuk

The Republic of Senegal's issuance was structured using securitisation legal principles, with a transfer of assets including a usufruct over governmental building complexes to a securitisation fund which then leased back the buildings to the Senegalese government and funded the purchase of the assets by issuing to investors "units" in the securitisation fund. As the securitisation fund is a form of co-ownership of the underlying assets as a matter of Senegalese law, the "units" are basically equivalent to a beneficial interest in a trust. However, the use of securitisation techniques results in an instrument which, at least structurally, is an asset-backed (rather than an asset-based) security.

The utilisation of legal models based on domestic legal frameworks for asset-backed products, as for the Republic of Senegal, is significant as it demonstrates potential avenues for structuring fixed income instruments in line with the requirements of Shari'a using existing legal concepts in the local jurisdiction, which will avoid any material (and time-consuming) legislative change. For example, many civil law countries exploring how to allow domestic issuers to tap the international sukuk market may strongly prefer using or adapting such existing legal frameworks instead of using structures better suited to either the GCC or Malaysian markets, which may require legislative reform.

Importantly, in respect of each of the RSA sukuk and the Republic of Senegal sukuk, notwithstanding the legal segregation of the assets (in the RSA sukuk, the establishment of the Trust in full compliance with South African law also resulted in the local segregation of the assets), any return for the investors depends purely on the timely performance of the relevant sovereign rather than on the real performance of the assets (the government, in each case, is the only entity entitled to own the relevant assets or the securitised receivable, respectively). Therefore, in the context of these sovereign issuances, any distinction between asset-backed and asset-based securities is of little practical consequence.

Conclusion

Even though the number of African countries issuing sukuk has increased over the past three years, there is further potential to leverage and nurture Islamic finance through the issuance of sovereign and corporate sukuk. Whilst some countries have managed to issue sukuk within the context of their local legal and tax laws, in other cases, specific legislation has been prepared to facilitate the development of the local (and international) market. What is clear is that sukuk issued by African sovereigns may not be uniform in structure. In light of the need for increased development and infrastructure finance, and diversifying sources of development and infrastructure finance, the efforts of multilateral financial institutions, local governments and key industry stakeholders to support the growth of the market will continue to remain important.

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