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# Islamic Finance: An Alternative Funding Source for the African Development Bank?

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The global financial crisis threatens to engulf most part of the world – including Regional Member Countries (RMCs) of the African Development Bank (AfDB). Growth forecasts have been downgraded significantly in recent months save for a few African countries. Nagging questions being asked are: how deep and for how long these difficulties will continue, which countries will be most affected and what are the contagion transmission channels? What will this mean for long term efforts by agencies like the AfDB to promote growth and poverty reduction in Africa? Will the credit crunch turn into a development crunch, or are there alternative funding sources? How should all stakeholders respond? One area that requires careful thought and dialogue is Islamic finance. Islamic finance has grown over the years, with total assets rising from USD150bn in the mid-1990s to exceed USD1 trillion in 2010. By end of 2012, the global Islamic finance assets will reach USD1.6 trillion, underpinned largely by an increase in the demand for Shari'ah ((Islamic jurisprudence)-compliant assets. By 2020, the value of Islamic financial assets is projected to surpass the USD 4 trillion mark (Karim, 2012). How can Islamic finance ameliorate the effects of the financial crisis on development finance? This Brief discusses the potential offered by Islamic Finance as a source of new funding for the African Development Bank Group. Africa has a quarter of the global Muslim population. Hence, the demand for Islamic finance should be strong.

## 1 Islamic Finance in Africa: What is the panorama?

Given the growing demand for Shari'ah-compliant products and services, it is expected that more financial institutions will offer Islamic finance products to meet customers' demand and requirements. Growth of Islamic finance in Africa will also be supported by encouraging demographics, as well as governments' continuous effort to introduce initiatives and put in place the necessary infrastructure for the development and growth of the industry.

In Africa, Sudan is the only country that has restructured its economy and financial system to be Shari'ah-compliant. However, the continent is witnessing encouraging growth of Islamic finance, underpinned by some of the factors outlined earlier not excluding: growing trade interactions with the Middle East, increasing demand for the ethical, risk-sharing approach offered by Islamic finance, and measures undertaken by some of the governments

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to reform their respective banking laws allowing Islamic finance institutions to set up and prosper. For example, reforms in some parts of the continent have made Africa, the third fastest-growing Islamic-Finance-region in the world after the Middle East and Asia. This will result in huge infrastructure requirements and investments, in turn increasing the demand for Islamic financing. Issuing Sukūk (Islamic bonds) will provide an opportunity to tap funds from the Middle East and Asia.

The number of middle-class Africans has tripled over the last 30 years to over 34.0% of the continent's population (AfDB, 2011). Strong economic growth, enhanced human resource development, and promotion/growth of the private sector are some of the factors that have caused the number to increase. This is expected to boost consumer spending and support the demand for retail banking products as well as insurance products. Besides amending the banking laws to accommodate Islamic banking, African governments are expected to undertake reviews of the insurance and capital markets which bode well for Islamic finance. Indeed, efforts by some African countries such as South Africa and Nigeria to promote and position themselves as Africa's Islamic finance hubs are welcome. There are a number of opportunities to be exploited (see Table 1).

However, there are a range of risks and challenges to Islamic finance expansion in Africa including the following:

- Lack of qualified/skilled personnel in Islamic finance inhibiting banking and financial authorities to become more familiar with the principles, practices, supervisory and regulatory requirements specific to Islamic finance;
- Lack of awareness of Islamic finance as an alternative to contribute to development management.
- Unlike South Africa, Senegal and The Gambia, several other countries are at various stages of drafting their respective regulatory frameworks for Islamic finance to take off and prosper thus placing Islamic banking on an equal footing with conventional banking;
- Lack of infrastructure such as Islamic money market to help provide liquidity in the Islamic banking system, as well as takaful (Islamic insurance) to protect investments of Islamic banks.
- In some African countries, political and economic instability make financing difficult including for the growth of small- and medium-scale enterprise (SME) loans and financing,
- Poverty is still high on the continent, especially in Sub-Saharan Africa (at 61%). At least 313 million Africans, or one-in-three Africans, can be defined as middle class (those earning bet-

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**Table 1 Africa: Opportunities for Islamic Finance**

| Market Player | Opportunities |
|---|---|
| Foreign Islamic financial institutions | Establishing Islamic banking and takaful operations in Africa. |
| Foreign investors | Overseeing Shari'ah investment in African assets/businesses and tapping into new funds and securitisation. |
| Local banks | Providing a range of Shari'ah-compliant investment products and services to investor the region. |
| Fund managers | Establishing Shari'ah-compliant funds as well as alternative assets |
| Local exchanges | Providing Islamic/Shari'ah-compliant listing platforms for various compliant instruments. |
| Local financial institutions | Provision by African-based financial institutions of Shari'ah-compliant services and products. |

ween USD2 and USD20 a day). However, only 123 million of these (those who are spending between USD4 and USD20 a day), can be considered economically stable. Income inequality is also very high (around 100,000 Africans had a net worth of USD800.0bn in 2008 - 60.0% of Africa's GDP) (AfDB, 2011); and

- Improving competitiveness in Africa is crucial to enhance private sector development (World Economic Forum et al., 2011).

## 2 Securitisation – what does it mean in Islamic finance?

Securitisation is a popular mechanism for raising debt in the conventional context. In Islamic finance, securitisation takes a fundamental role as an intermediation between the issuer and the investor - leveraging off the 'asset based' nature of the Islamic finance. Financial institutions and businesses use securitisation to fund their operations and to immediately realise the value of a cash-producing asset. The pool of assets is usually composed of assets such as financing, but can also be trade receivables or leases. In most cases, the originator/provider of assets expects a regular stream of payments. By pooling the assets, the payment streams can support principal payments on securities. The originator receives full value for assets rather than an extended payment stream spread out over time.

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In securitisation, the originator partly "deconstructs" itself by separating certain types of highly liquid and excellent quality assets from the risks generally associated with the originator. It can then use those assets to raise funds in the capital markets at a lower cost than it could have, with its associated risks, raised directly by issuing more debt or equity. The originator retains the savings generated by these lower costs, while investors in the securitised assets benefit by holding investments with lower risks.

A major concern for financial institutions relates to the acceptability the content of the "pool of assets"of the Shari'ah-compliant securitisation business rather than the actual process of pooling those assets. These financial institutions ensure that every asset in the pool is Shari'ah-complaint. Since the concern is on the nature of each asset on its own and not on the pool as a whole, most commonly securitised "conventional" assets may not be acceptable for a Shari'ah-compliant securitisation.

One of the most common securitisation in Islamic finance is the Sukūk. Sukūk (plural of sakk), or "Islamic bonds", are certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture. These assets may be in a specific project/investment activity. Although they share a similar process, structure and end result with conventional assets, there are a few key principles that must be adhered to for these securities to be Shari'ah-compliant. The differences are summarised in table 2 below:

**Table 2 Sukūk vs. Conventional Interest-bearing Instruments**

| Parameter | Sukūk | Conventional Interest-bearing Instruments |
|---|---|---|
| Issuer | A sukūk issuer shall be engaged in Shari'ah-compliant business activities | An issuer of conventional bonds is not limited in its business activities |
| Investor base | Enjoys a wider investor base from both Islamic and conventional investors | Conventional bonds can mainly tap conventional investors |
| Ownership | Investors take direct ownership of an underlying asset or pool of assets | A conventional bond is purely the financial debt of the issuer |
| Administrative cost | Additional fees in terms of legal and Shari'ah advisory fee | No additional administrative costs associated with conventional bond issues |
| Financing cost | A larger pool of sukūk investors creates more demand. Hence, may help to achieve slightly more competitive pricing | A comparatively smaller pool of conventional bond investors suggests that there is less demand for the instrument |

Issuing sukūk broadly involves: (a) origination of assets that are Shari'ah-compliant such as the subject matter of ijārah (leasing); (b) transfer of the assets to a special purpose entity (SPE) which acts as the issuer by packaging them into securities (sukūk); and (c) offering the securities to investors.

The use of sukūk to access western capital markets, and as a backbone element in the development of Islamic capital markets, is still one of the fastest growing areas in Islamic finance. Other regions of growth are the Gulf Cooperative Council and Asian countries (see Figure 1).

In recent years, Islamic securities have been structured utilising major infrastructure projects as underlying assets, giving investors beneficial ownership and entitling them to the underlying revenues or cash flows. This has proven to be a successful model of connecting the financial services sector back to the real economy wi-

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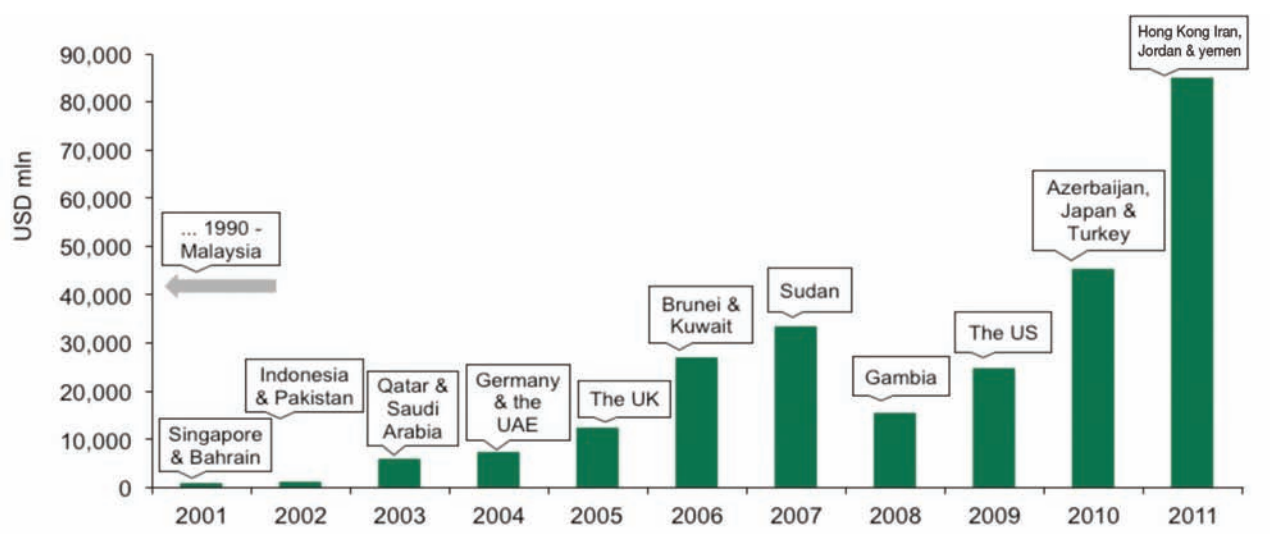
**Figure 1 Sukūk Market: Global Market Growth**




Source: KFHR/IFIS databases.

**"In conventional securitisations structure, the originator transfers the beneficial rights in or title to the assets to the issuer on behalf of the investors"**

thout the downside risks of conventional financial assets with a number of benefits for examples: funds are channelled to productive and beneficial projects, increased ratings compared to issuer stand alone rating due to bankruptcy remoteness; increased investor base to both conventional and Islamic investors, lower costs - with viable solution for infrastructure and project financing; and better liquidity.

While it may initially appear that sukūk structures that are not based on partnership interests have real assets at their core, a detailed analysis of the commercial terms and legal structure shows that, in fact, any one of the three following situations may exist:

(a) An asset-backed sukūk structure[1] that meets the requirements for being an asset-backed structure as assessed by a recognised external credit assessment institution (ECAI),

(b) An asset-based sukūk structure[2] with a repurchase undertaking (binding) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the sukūk whereby the capability of the originator to make the scheduled payments to the issuer is based on "pay-through" structures, since the income from the assets is paid to the investors through the issuer; and

(c) A so-called "pass-through" asset-based sukūk structure: a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the sukūk.

In conventional securitisations structure, the originator transfers the beneficial rights in or title to the assets to the issuer on behalf of the investors who do not hold such rights directly but have beneficial ownership through their legal relationship to the issuer. In many jurisdictions, however, including some in which sukūk issues may take place, there may be legal obstacles to setting up an appropriate type of SPE which can meet the conditions for the fiduciary responsibilities. In such legal environments, it may not be possible to transfer beneficial title in the assets to the investors, or to ensure that the investors are able to exercise these rights (for example, to repossess ijārah assets) in case of default. In such cases, it is not feasible to create a structure for issuing non-recourse asset-backed securities (ABS).[3]

## 3 An Overview of the Sukūk market as a source of new finance

The sukūk market provides a range of much needed fixed-income instruments for financial institutions and investors that seek Shari'ah-based alternative investment. Between 2001 and 2011 the primary market grew at a compound annual growth rate of 59.9% to reach USD85.1bn at the end of 2011. Sukūk issuance has made a remarkable expansion in 2011, outpacing 2010 estimates, seeing an increase of 90.2% at the end of 2011. Issuers include Islamic financial institutions, corporates and sovereigns in both the Asian and Middle Eastern regions. The rapid growth of the Shari'ah-compliant fixed income market coming at the back drop of the global financial crisis, underscores the strength and economic fundamentals of the sukūk market.

[1] In Islamic finance, asset-backed structures involve ownership rights in the underlying assets, whereas in conventional asset-backed structures the asset backing takes the form of collateral rights, not ownership rights.
[2] Asset-based structures in Islamic finance are found in cases where, given the applicable legal environment, the ownership rights over the underlying asset may not reliably result in an effective right of possession in case of default, and in consequence, the sukūk holders need to have a right of recourse to the originator in case of default.
[3] In this case, if the law permits, financial institutions may retain the ownership title of the assets.

South East Asia holds the largest share of sukūk issuances, representing 76.9% of the primary market in 2011, followed by the Middle East and North Africa region (23.0%). The year 2011 has seen a number of new jurisdictions open up to the sukūk market, among them potentially large Muslim markets including Jordan, Iran and Yemen (see figures 2 and 3).

Based on 2011 data, sukūk issuances were dominated by sovereign issuers (Table 3) looking to raise debt as a means of replenishing fiscal budgets for socio economic activity. On a year-on-year basis, corporate sukūk are up 167.6% to USD19.0bn issued in 2011 from the USD7.1bn issued in 2010.

## 4 Looking into the future: Recommending Islamic Finance as an opportunity for AfDB funding

Given the current global financial crisis, the AfDB may wish to seek an additional alternative source of funding to broaden the pool of funds

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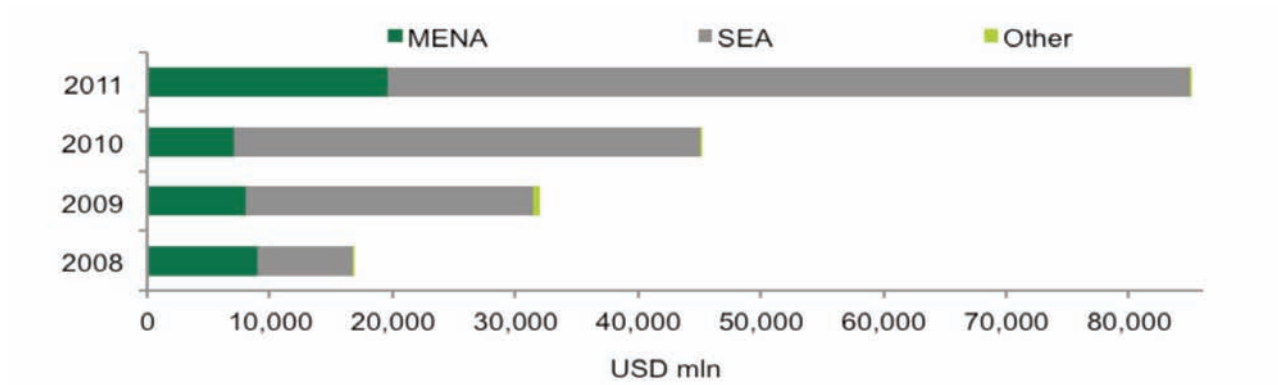
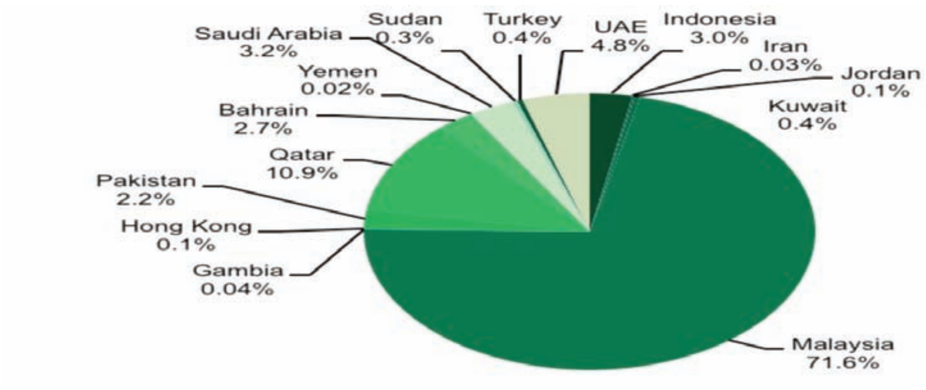
**Figure 2 Sukūk Issuance by Region (2011)**




Source: KFHR database.

**Figure 3 Sukūk Issuance by Domicile (2011)**




Source: KFHR database.

**Table 3 Selected Sukūk Issuances**

| Date issued | Issuer | Tenure | Return | Country | Amount | Underlying Asset |
|---|---|---|---|---|---|---|
| 9-Oct-2011 | Arabian Aramco Total Services Co. | 14 years | 6M SAIBOR + 95bps | Saudi Arabia | USD1bn | Issuer's rights to the underlying transactions documents to which it has benefit |
| 23-Feb- 2011 | GovCo Holdings Bhd | 10 years | 4.45% | Malaysia | MYR1.5bn | Shari'ah-compliant commodities |
| 25-May-2011 | Sharjah Islamic Bank | 5 years | 4.715% | UAE | USD400mn | Sukūk ijārah assets, investments and transaction documents |
| 5-Aug-2011 | Kencana Petroleum Bhd | 5 years | 3.90% | Malaysia | MYR500mn | The rights and entitlements under the Mudaraba (profit sharing and loss bearing) Venture |

**"tapping Islamic finance would provide AfDB with an opportunity to broaden its source of funding"**

that can be available for it to finance development projects in its regional member countries. Islamic finance provides such an opportunity. One of the major advantages of AfDB is its AAA rating. AfDB can make use of this high quality credit rating by issuing sukūk to mobilise funds at a low cost from investors who perhaps in the past were not among those targeted by the Bank. Currently, tapping Islamic finance would provide AfDB with an opportunity to broaden its source of funding that and further enhance its ability to fund more development projects in Africa. In particular, AfDB can issue sukūk to fund infrastructure projects in its regional member countries. Islamic finance offers real opportunities for new sources of funding for agencies such as the AfDB. Three issues need not be over-emphasised:

a) There is growth in Islamic finance for the Bank to take advantage off,
b) Islamic finance tends to be a low cost source; and
c) The industry handles satisfactorily a range of ethical investment issues including enhancing social inclusion, good financial governance and granting greater opportunity to the non-bankable poor.

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