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Regulations And Fiscal Incentives Could Speed Islamic Finance Development In Africa

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Given its significant funding and infrastructure needs, Africa could benefit significantly from the development of an Islamic finance industry, in our view. Widening fiscal deficits and large infrastructure gaps will likely create multibillion-dollar additional financing needs over the next decade. To date, African sovereigns have issued only about $1 billion of sukuk instruments, compared with global sukuk issuance of an average $100 billion per year over the past five years (see chart 1). While the market has barely started to take shape in Africa, we believe African sukuk issuance could offer diversification benefits for Islamic investors and additional options to conventional debt issuance for African governments.

Overview

- We believe the development of an Islamic finance industry could help Africa fund its significant infrastructure needs.
- However, we think governments will take time to introduce new regulation and fiscal adjustments to foster African sukuk markets, increase investment options for potential investors, and attract a pool of Islamic liquidity.
- The involvement of major multilateral institutions could accelerate the development of African sukuk issuance, in our view.

Experience in South Africa and Senegal has shown that a significant amount of time can elapse between a government's announcement of intent to issue sukuk and their effective issuance, as governments gauge market interests and try to address the legal hurdles and cost of issuance. However, increasing technical assistance by the Islamic Development Bank (IDB) and Islamic Corporation for the Development of the Private Sector (ICD), are gradually facilitating sovereign sukuk issues in the region. We believe that a growing interest in Islamic finance could encourage some North African countries, as well as sub-Saharan countries Cote d'Ivoire, Nigeria, and Kenya, which have fairly well developed capital markets by regional standard, to issue sukuk in the future.

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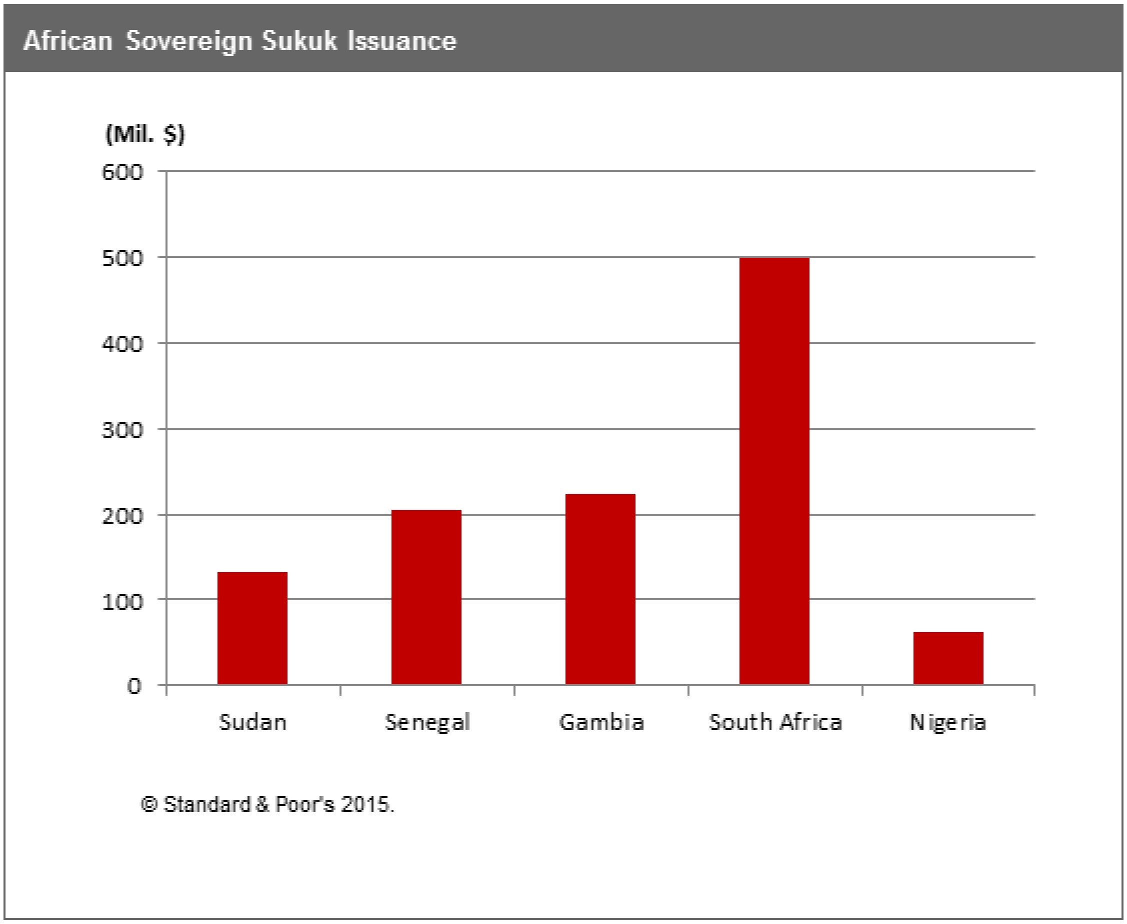
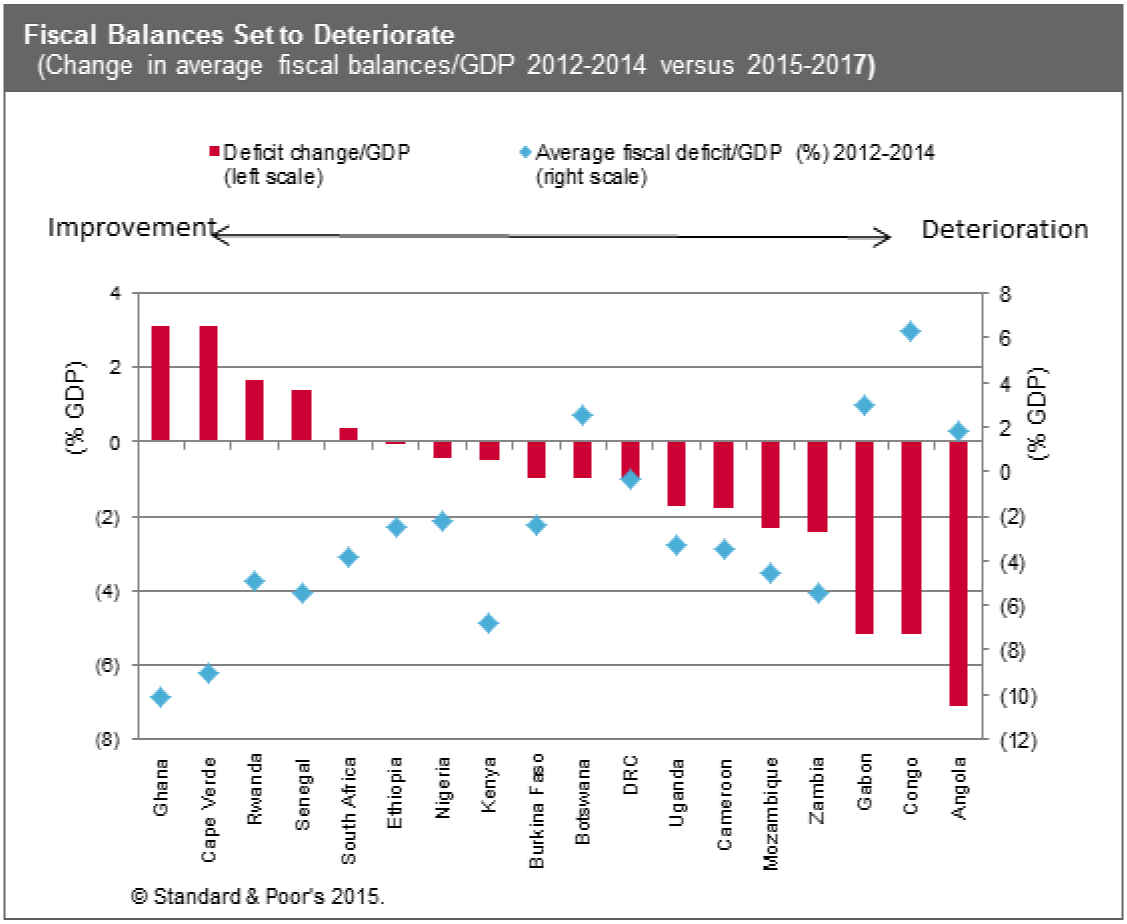
Chart 1



African Sovereigns Face Growing Financing Needs

Standard & Poor's Ratings Services' projections point to a deterioration in public finances across most of Africa between 2015 and 2017 compared with 2012-2014 (see chart 2). We expect that fiscal deficits will widen by more than 1% of GDP and gross government debt will increase by more than 6% of GDP on average over the next three years for two main reasons. First, expenditure is likely to increase in the face of high development and infrastructure needs. Second, growth in revenue bases is likely to be slow, not least due to declining commodity prices (for further details see "Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns," published on Feb. 11, 2015, on RatingsDirect). But whether or not a sovereign receives the majority of its revenue from commodities, governments across sub-Saharan Africa are deploying policies aimed at increasing the productive capacity of their economies to secure long-term growth. This requires significant capital investment in infrastructure projects over long periods, such as to ensure consistent and fair-priced power supply to transportation networks that can facilitate foreign trade. As such, capital expenditures across the continent face continuous upward momentum. In Kenya, Uganda, and Zambia, for example, significant railway projects are under way to improve regional trade and provide export facilities for otherwise land-locked producers.

Chart 2



Development And Diversification Opportunities

We believe Africa could benefit from Islamic finance in the same way that Malaysia has in South East Asia. The principles of Sharia or Islamic law are well suited to financing the real economy and developing infrastructure projects, in our view. In Malaysia, sukuk issues helped develop transport and utilities' capacity, which had long-lasting benefits. They can also have a domino effect on economic growth prospects by enabling private initiatives and lowering the cost of doing business. The availability of assets or the potential to create assets acceptable under the Sharia law through infrastructure projects could potentially also support Islamic finance in Africa. Senegal led the way in 2014 by issuing the equivalent of a $200 million sukuk to finance its infrastructure projects pipeline. The successful launch of this landmark sukuk in sub-Saharan Africa could prompt others, notably Cote d'Ivoire but also Nigeria and Kenya to enter the market, in our view. Other countries, such as Gambia and Sudan have issued small-ticket sukuk in the past.

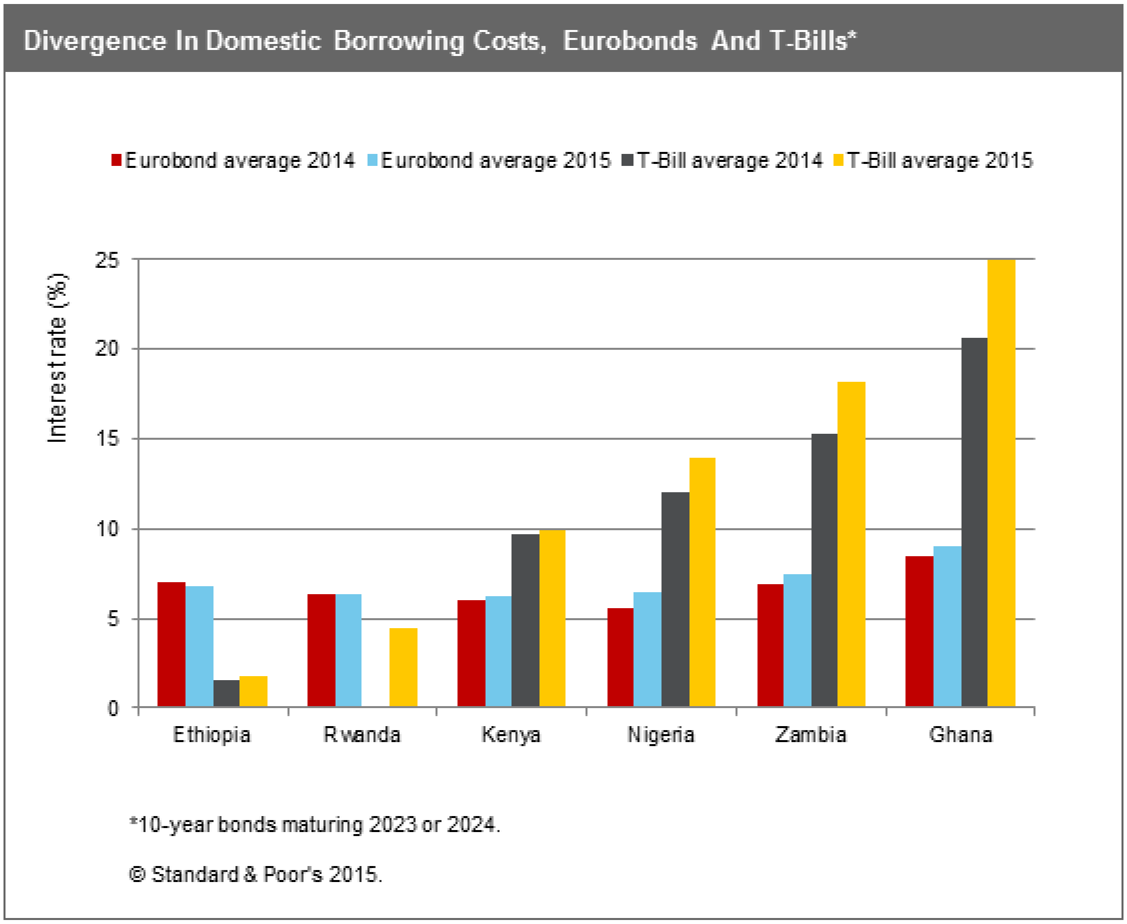
We believe Cote d'Ivoire, Nigeria, and Kenya are well positioned for future domestic sukuk issuance because they have relatively well developed capital markets by regional standards. This could support the development of a regional sukuk market designed to aid tangible infrastructure development linked to continued high economic growth. We forecast GDP growth will average 6.25% among these three countries over the next three years. Cote d'Ivoire, the largest and fastest growing economy and home to the largest debt capital market in the West African Economic and Monetary Union (WAEMU), has already announced its intention to issue sukuk and become an Islamic finance hub,

What's more, some of these countries have accessed the Eurobond market successfully in the recent past and are planning to expand their investor base beyond conventional borders by tapping existing Islamic liquidity.

Governments in Kenya and Zambia have more recently sought external financing through conventional Eurobond issuance to help pay for infrastructure projects and for more general budgetary financing. However, debt financing, be it domestic or external, is increasingly expensive for many African governments. While we expect that sukuk would attract by and large the same pricing characteristics as conventional debt, we believe its issuance in foreign currency could appeal to a significant pool of Sharia-compliant liquidity, which we estimate at more than $500 billion. African sukuk could add both yield and diversification value for investors, in our view.

In countries with relatively well developed debt capital markets by regional standards, domestic debt issuance can be a valuable source of financing. But it is becoming more expensive as high policy rates, designed to tame inflationary expectations, are passed through into high T-Bill interest rates. The cost of external issuance is also increasing, partly driven by factors outside a government's control, such as concerns over global liquidity (see chart 3). However, for larger issuers, external issuance can provide a significantly cheaper option than domestic markets. We therefore think that sukuk could be an attractive diversification tool for foreign currency issuers, assuming that the pricing would be the same as conventional debt. Over the past few years, we have seen a narrowing of the differential between sukuk and conventional bond pricing, as the market is becoming more familiar with sukuk and structures are increasingly standardized.

Chart 3



Sovereign sukuk issues, like conventional debt issues, can also establish a benchmark for the development of their domestic capital markets, which in turn facilitate private issuance. In many regional markets, financial institutions' funding profiles constrain their ability to finance the private sector. However, sukuk offer an opportunity for banks to term out their liabilities, which could in turn help foster the private sector's contribution to overall economic growth.

A Bottom-Up Or Top-Down Approach

There are two ways to develop Islamic finance, in our view. Some countries have been able to attract institutional investors to fund large projects. That has been the case of Malaysia, which managed to fund its development plan by accessing institutional funds, with careful planning. The participation of corporates in sukuk issuance has spurred the creation of Islamic assets, which in turn led to the development of Islamic financial institutions, takaful, and Islamic asset managers.

Other countries could choose a more "bottom up" approach, relying on their Muslim population to foster the development of projects to accommodate their ethical preferences. Nigeria is home to the largest Muslim population in Africa: at least 50% of the estimated 160 million Nigerians are Muslim. We think this approach requires the involvement of financial institutions and regulators to offer a system that can stand the test of time.

Adopting the latter approach in Africa could be time-consuming and slow down the pace of asset creation that is essential for financial institutions to grow, in our view. Hence, we believe that African countries are likely to foster institutional participation through corporate issuance in the face of huge infrastructure needs. What's more, sukuk fit well in terms of the nature of asset generation and maturity to fund these projects. On the investor side, the projects meet the ethical characteristics and address the development needs of countries, while they also provide stable and long-term investment opportunities.

Legislation Gaps Are Slowing Market Entry

Given the apparently ripe environment for Islamic finance in Africa, what is slowing its development? We believe legislation gaps are the main causes of delay between a country's intent to issue and its effective issuance of sukuk. The success of Malaysia as a hub for Islamic finance lies, among other things, in the strong regulatory framework to support the sector's growth. Malaysia also moved quickly in 2009 to address the standardization of instruments and interpretation of Sharia law.

Tax regimes are equally important to consider when encouraging sukuk issuance. Sharia-compliant instruments require equal treatment with conventional instruments for investors to consider them. Malaysia introduced various tax incentives that made Islamic finance a cheaper economic alternative for institutions to raise funding.

In Africa, by contrast, four years elapsed between South Africa's initial announcement that it would enter the sukuk market and its actual launch. The government had to amend legislation to accommodate sukuk issuance. Additional provisions have been introduced in the country's tax code to enable equivalent tax treatment of sharia-compliant instruments with conventional or interest-bearing instruments. Tunisia and Morocco have also finalized legal frameworks to support sukuk issuance, while Egypt is still in the process of developing a system.

In Senegal, while sukuk were exempted from any tax, we note that the government did not introduce any specific regulatory framework applicable to Islamic finance. Senegal state sukuk were issued based on existing financial legislation applicable to investment vehicles. The regulatory framework applicable to conventional finance is applicable to all eight countries of the comprising the WAEMU zone--Benin, Burkina Faso, Cote d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo. We believe that neighboring countries in WAEMU are likely to use the same framework should they issue sukuk. We think that other WAEMU zone countries that plan to issue sukuk in the future will adopt the same tax treatment as Senegal to encourage sukuk investors and support cross-border financing.

Increasing Technical Assistance From Major Issuers Should Aid Sukuk Issuance

We view the increasing involvement of major Islamic investors such as IDB and affiliated ICD, as well as central banks as important support in developing Islamic finance in Africa. The IDB has partnered with Senegal and the institutions in place to help establish the necessary framework to issue sukuk. We understand that the Senegalese sukuk is the first of a series that will be issued by West African states and supported by the IDB and ICD. Such initiatives can benefit the development of a regional Islamic debt market, as did the creation of the Bourse Regionale des Valeurs Mobilieres, WAEMU's regional stock exchange. In addition, the central bank of West African States (BCEAO) has agreed that banks may use sukuk issued by Senegal in their repurchase transactions to encourage banks to invest in sukuk.

What's more, various central banks, including the central bank of Nigeria in 2010 created the International Islamic Liquidity Management to provide Islamic financial institutions with liquidity management instruments. This could facilitate the establishment of Nigeria-based Islamic financial institutions.

The Way Forward

The continent's development needs, as well as its large Muslim population, present a real opportunity for Islamic finance to develop over the next decade, in our view. Developments in Malaysia could become a model in accessing alternative funding sources to finance economic developments. Senegal and South Africa have attracted both domestic and global investors through sukuk issues. However, the definition of a clear sukuk framework and tax incentives could be key to further attract investors on a lasting basis. For example, we see South Africa as a serious contender to attract liquidity given that the country's banking system benefits from a strong regulatory framework.

Related Research

- Global Sukuk Issuance Stalls In 2015 As Major Issuer Exits The Market, July 7, 2015
- Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns, Feb. 11, 2015
- Standard & Poor's Revises Its Crude Oil And Natural Gas Price & Recovery Assumptions, March 26, 2015
- Basel III Requirements Could Strengthen Islamic Banks' Liquidity Management, March 31, 2015

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