

Sukuk as a Tool for Infrastructural Development in Nigeria

Majeed Oladele Oladunjoye¹

Abstract

Islamic finance is a method of financing based on the principles of Islamic law (shariah) and has several structures that can be adopted to suit various means of financing depending on the circumstances including Murabaha, Takaful, Ijarah, Wakala, etc. It has equally been instrumental in the finance of several projects around the world. Lately, several countries which had hitherto not considered this method of financing have been embracing it to bridge their funding gaps. The Securities and Exchange Commission in Nigeria recently promulgated Rules on Sukuk issuance to jumpstart Islamic Finance transactions which facilitated the issuance of the first State Sukuk in Nigeria by the Osun State Government through the Osun Sukuk Company Plc; a wholly owned Special Purpose Company (SPC) of the State. This article examines the potentials for using Islamic finance, particularly Sukuk as a tool for capital raising and infrastructural development in Nigeria and discusses the recent Sukuk issuance by the Osun State of Nigeria under their ₦60 Billion Debt Issuance Programme. The Structure of the Sukuk, challenges faced during the issuance and other issues are discussed.

Keywords: Islamic Finance; Sukuk; Osun State; Nigeria and Osun Sukuk Company Plc

1. Introduction

Considering the huge infrastructural deficit facing Nigeria, and the challenges being faced by the Federal Government of Nigeria due to a decline in oil revenue amongst other related issues, it has become imperative for State Governments and corporates to access alternative financing techniques to meet their capital development needs.

¹ LLM; Kola Awodein & Co, 6th Floor, UBA House, 57, Marina Lagos.

Capital can be raised by way of debt or equity. However, activities in the equities market in Nigeria have slowed down considerably from the levels seen during the equities boom of 2004 – 2008. This has compelled corporates and governments to embrace the debt market by floating bonds. From 1960 to November 2013, there have been 80 corporate bond issuances in Nigeria² and 34 state and local bond issuances;³ with state bond issuances dominating the market in recent times.

This article examines the potentials for using Islamic finance, particularly Sukuk as a tool for capital raising and infrastructural development in Nigeria and discusses the recent Sukuk issuance by the Osun State of Nigeria under their ₦60 Billion Debt Issuance Programme.

2. What is Islamic Finance?

Islamic finance is a fast growing sphere of the global/international finance industry which has grown exponentially with assets estimated to have exceeded US\$1trillion from a base of US\$10 billion in the mid-1970.⁴

Islamic finance is a form of financing based on the principles of Islamic law (Shariah) and several Islamic finance products/structures have been utilised in the international markets including Murabaha, Ijara, Sukuk, Wakala, Takaful etc. A brief analysis of these structures is provided below:

2.1 Murabaha – This is a form of credit that enables customers to make a purchase without having to take out an interest-bearing loan. Rather, the bank buys an item and sells it to the customer on a deferred payment basis.

The price will include a profit margin agreed by both Parties with the repayment mechanism specified in the Contract. This structure is commonly used in Trade Finance arrangements.

2.2 Ijarah – A lease agreement whereby a bank buys an item for a customer and then leases it to him over an agreed period of time with the bank earning a profit from the rentals.

² See <http://www.sec.gov.ng/corporate-bonds-issued-%281960-to-2013%29.html> accessed on 16th Dec 2013

³<http://www.sec.gov.ng/states-and-local-government-bonds-issued-%281978-to-date%29.html> accessed on 16th Dec 2013

⁴ Islamic Finance Information Service website accessed on 13th December 2013

- 2.3 **Takaful** – This provides Mutual protection of assets and property and offers joint risk sharing in the event of a loss by one of the participants. In the case of loss to any one group, the loss is met from the collected funds.
- 2.4 **Wakala** – An agency contract whereby a representative is appointed to undertake transactions on another person's behalf. The agent is entitled to receive a pre-determined fee irrespective of whether or not he is able to accomplish the assigned task to the satisfaction of the principal.

3. Sukuk as a tool of Islamic Finance

Sukuk provides access to a vast and growing Islamic liquidity pool in addition to the conventional debt.⁵ Sukuk are commonly referred to as Islamic Bonds. However, this representation is not altogether correct. Rather, Sukuk can be defined as certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investments.⁶ In simple terms, Sukuk can best be called trust certificates.

According to the Rules and Regulations of the Securities and Exchange Commission (SEC Rules 2013), Sukuk refers to investment certificates or notes of equal value which evidences undivided interest/ownership of tangible assets, usufructs and services or investment in the assets of particular projects or special investment activity using shariah principles and concepts and approved by the SEC.⁷

Under a sukuk structure, returns to sukuk holders (Investors) represent rights to receive payments from a trade transaction or ownership of a particular asset or business venture. However, the returns to conventional bondholders represent the right to receive interest for borrowed monies.⁸

⁵ Sukuk in Takaful Investment Its 2013 Mohammed Al Sharaf, MBA, Business Development Manager – Thomson Reuters available at <http://www.takafulprimer.com/pdf/summit2013/mohammed-sukuk-intakaful-investment.pdf>

⁶ AAOIFI SS17

⁷ Sec Rule 569

⁸ Sukuk – Islamic Capital Market Series Introductory Page by Kuwait Finance House.

Traditional bonds are not allowed in Shariah-compliant transactions due to their interest based nature as interest is prohibited in Islamic law as aforesaid.⁹ It is important to note that the underlying asset for a sukuk issuance must itself be Shariah-compliant. For example, a building does not qualify as an underlying asset for sukuk issuance if the major tenant will be a producer of alcohol.

The United Kingdom government recently announced plans to issue its first sovereign sukuk. According to the Prime Minister of the United Kingdom; David Cameron,¹⁰ he wants London to stand alongside Dubai and Kuala Lumpur as one of the greatest capitals of Islamic Finance in the world. London is already the biggest centre for Islamic Finance outside the Islamic world.

Malaysia is the biggest issuer of sukuk followed by Saudi Arabia.¹¹ Saudi Arabia issued sukuk worth about \$10.5 billion in 2012 representing an increase of 278% over 2011. Despite this, it is worthy of note that demand continues to dwarf supply. Ernst & Young estimated the total demand for sukuk from the conventional as well as the Islamic Investors in Saudi Arabia at around US\$300 billion in 2012 compared to US\$132 billion in 2011.

Sovereigns issue sukuk for several reasons including fund raising, establishment of a credit rating, liquidity instrument and monetary policy tool and for setting a benchmark for the Islamic Finance Industry (i.e. to price corporate bonds).

4. Sukuk Structures

Sukuks can be issued under different structures to accommodate the dynamics of different transactions. Some of these structures include:

- 4.1 **Salam:** a structure based on spot payment with future delivery of asset.
- 4.2 **Ijarah:** a sukuk structure involving the sale and lease-back of assets in existence e.g. real estate, plant & machinery, aircraft, ships. Other tangible assets can also be structured as a master lease/sub lease.

⁹ Ground Rules for Sukuk Issuance by Shamsiah Mohama, Mohd Fadhly Md Yusoff and Abdul Aziz Qassar in Sukuk – Islamic Capital Market Series Chapter 3 page 41

¹⁰ Speaking at the World Islamic Economic Forum available at <https://www.gov.uk/government/speeches/world-islamic-economic-forum-prime-ministers-speech> accessed on 22nd November 2013

¹¹ Saudi Sunrise : The next frontier for Islamic Finance : Islamic Finance News 21st August 2013

- 4.3 **Mudaraba:** a partnership / fund management contract between an investor (Rab-ul-mal) and a manager (Mudarib).
- 4.4 **Musharaka:** sukuk structure involving a partnership between the Special Purpose Company (SPC) and obligor to jointly own either ready assets or to construct/manufacture assets (real estate/project financing).
- 4.5 **Murabaha:** sukuk structure based on a cost plus financing contract whereby the asset is delivered now with a deferred payment.

The Ijarah and Murabaha have been the most popular of these structures with about 638 and 748 Issues respectively and about \$90bn and \$130bn worth of issuances respectively as at September 2012.

The Securities and Exchange Commission (“the Commission”) ¹² explicitly recognizes the following structures under Rule 571 of the SEC Rules:

- Sukuk Ijarah – (lease contract)
- Sukuk Musharakah– (sharing contract)
- Sukuk Istisnah– (exchange contract)
- Sukuk Murabahah– (financing contract)

5. Legal Framework for the Issuance of Sukuk in Nigeria

Several Laws regulate the issuance of sukuk in Nigeria including the Investments and Securities Act 2007, the SEC Rules and the state law authorizing the sukuk issuance. The Commission in recognition of the development of Islamic finance introduced new rules on February 8, 2013 to regulate the issuance of sukuk in Nigeria. Rule 572 of the SEC Rules provides that all public companies (including SPV's), state governments, local governments, and Government agencies as well as multilateral agencies are eligible to issue, offer or make an invitation of sukuk upon seeking the Commission's approval.

The Rules apply to:

- i. sukuk which are offered by local or foreign entities that are within the regulatory purview of the Commission;

¹² The Securities and Exchange Commission is the government agency mandated to regulate and develop the Nigerian capital market.

- ii. sukuk which are denominated in Naira or in foreign currencies; and
- iii. sukuk which are listed, convertible, exchangeable, redeemable or otherwise.¹³

From the wording of Rule 572, sukuks issued by private companies appear not to fall within the regulatory purview of the SEC. In a similar vein, a strict interpretation of Rule 567 will suggest that bonds issued by private companies will not be regulated by the SEC as Rule 567 specifically mentions only bonds issued by public companies, foreign public companies and supranational bodies. However, the SEC will exercise its supervisory powers over any instrument issued to the public by private or public companies.

In addition to the advisers who advise on bond issuances,¹⁴ an issuer of sukuk must appoint a Shariah adviser who shall:

- advise on all aspects of the sukuk including documentation and structuring;
- issue shariah certification which outlines the basis and rationale of the structure and mechanism of the sukuk issue, the applicable shariah principles used for the sukuk issue and relevant shariah matters relating to the documentation of the sukuk issue;
- ensure that the applicable shariah principles and any relevant resolutions and rulings endorsed are complied with; and
- Apply ijtihad (reasoning) to ensure all aspects relating to sukuk issuance are in compliance with shariah principles.¹⁵

6. Osun Sukuk Company Plc.'s Sukuk Al -Ijarah - Blazing the Trail

The Government of Osun State ("OSG") through a wholly owned Special Purpose Company, Osun Sukuk Company Plc issued on the 8th of October, 2013 the first sukuk in Sub-Saharan Africa worth ₦11.4 billion (\$70.6 million) under the Osun State ₦60 Billion Debt Issuance Programme to fund the development of 20 High Schools, 2 Middle Schools and 2 Elementary Schools in Osun State.

The sukuk was issued at a rate of 14.75% per annum at ₦ 1,000 per unit and matures on 08 October, 2020.

¹³ Rule 570(1) of the SEC Rules

¹⁴ These include the Issuing Houses, brokers, reporting accountants, rating agencies legal advisers etc.

¹⁵ Rule 574 of the SEC Rules

The sukuk issuance was completed within a year with the sukuk being listed on the floor of the Nigerian Stock Exchange in January 2014 after the SEC's "no-objection" to the basis of allotment was received on December 3, 2013 although certain delays were faced during the course of the transaction particularly whilst awaiting the SEC's approval of the Sukuk Rules.

It is worthy of note that the Pension Funds Administrators (PFA'S) were disallowed from investing in the sukuk as the National Pension Commission (NPC) maintained that existing regulations on the investment of pension assets did not explicitly provide for pension fund investment in Islamic financial instruments such as the Sukuk.¹⁶

The issue which was rated A by Augusto & Co was successful subscribed to by domestic investors with the price set through a book building process that lasted for 10 days.

7. Structure of the Sukuk

7.1. Osun Sukuk Company Plc

The SPC; Osun Sukuk Company Plc is a wholly owned Special Purpose Company of the Osun State Government incorporated with an authorised share capital of ₦1, 000,000.00 (One Million Naira) with Ninety Nine Percent of the shares held by the Osun State Government and One percent held in trust by the Attorney General of Osun State on behalf of the State.¹⁷ The company was set up within 2 weeks.

The sukuk was structured as an Al-Ijarah; with the Osun Sukuk Company Plc. issuing sukuk certificates to the investors. The sukuk investors' payment for the certificates represents the cost of construction of the schools.

In accordance with Islamic law principles, each certificate represents an undivided beneficial ownership interest in the sukuk assets (i.e. the Schools). The sukuk assets are however held in trust for the sukuk investors by the Issuer.

¹⁶ It was argued by the Issuer that the sukuk being a government security backed by an ISPO qualifies as an allowable instrument for the PFAs to invest in

¹⁷ Under Nigerian Law, every company must have at least 2 shareholders. See Section 18 of the CAMA

Holders of the Certificates have no recourse to any assets of the Issuer other than the sukuk assets. Since the sukuk holders are the owners of the asset (schools), they are free to trade the certificates in the secondary market.

The land upon which the schools will be built was transferred by the OSG to the SPC and a Certificate of Title (Certificate of Occupancy) was issued to the SPC. Considering that the SPC is a wholly owned company of the OSG, approvals for the transfer such as governor's consent were fast tracked.

The Issuer under an Agency Agreement, appointed the OSG as its agent to *inter alia* engage a construction company to construct the schools, obtain all government approvals, manage the operational and financial aspects of the construction for a prescribed fee and transferred the agreed cost of construction to the OSG.

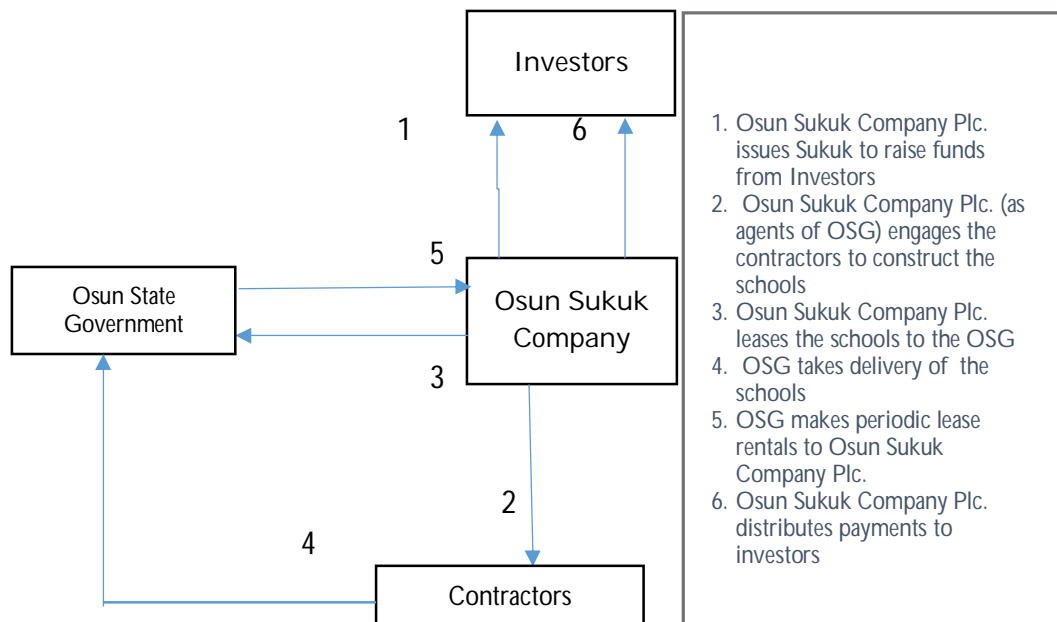
The SPC forward leases the schools to the State Government against rental payments which will be remitted to the Issuer to make distributions to the sukuk investors; thus earning income for the investors during the construction of the schools.

A Purchase Undertaking was executed by the OSG in favour of the Issuer to give assurances that at the end of the lease/maturity of the Sukuk or upon the occurrence of an event of default or early termination of the lease under the Ijara Agreement, the OSG will purchase the sukuk assets; with the purchase price being used by the Issuer to redeem the sukuk certificates at maturity.

The Purchase Undertaking is essential in Islamic Finance as it creates a debt obligation on the part of the OSG which eliminates market risk on the part of the investors. A Sale Undertaking was also executed by the Issuer in favour of the OSG in like manner.

As required by the SEC, the transaction was signed off on by Dr. Mohamed El-Gari, Prof Monzer Kahf and Prof. M.L Bashar as Shariah Advisers.

8. Pictorial Representation of the Osun Sukuk Plc. Issuance



9. Sukuk – What Lies Ahead

The issuance of the first state sukuk by Osun Sukuk Company Plc attests to the huge potentials for Islamic Finance in Nigeria.

The Central Bank of Nigeria (CBN) has so far registered Jaiz Bank Plc. to provide full Islamic Banking Services and has licensed Stanbic IBTC Plc to operate an Islamic Banking Window. In addition, Sterling Bank Plc has also been given an approval in principle to operate an Islamic Banking Window.

It is projected that many sukuk will be issued over the course of 2014 across traditional Islamic and non Islamic countries such as the United Kingdom.

With the right team of professional advisers, it is clear that focusing on substance over form can contribute significantly to the rapid development of the Nigerian economy through the issuance of Islamic Finance products. Nigeria should not miss out on this opportunity.

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