SUKUK: AN ALTERNATIVE FOR INFRASTRUCTURAL DEVELOPMENT IN NIGERIA

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General Overview of Islamic Finance

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Agenda

1. Introduction and Background
2. Stylized Facts about Islamic Finance
3. Growth Drivers of Islamic Finance
4. Comparison of Islamic and Conventional Finance
5. Macroeconomic Implications of Islamic Finance
6. Conclusions and Policy Implications
7. Key Instruments of Islamic Finance

• Introduction and Background

• Concept

- Islamic finance is a financial system that is in agreement with the principles of Shari'ah.
- Islamic finance is a comprehensive system, capable of serving the full spectrum of the society. It has appropriate tools and mechanisms to mobilize funds and serve the society.

Components of Islamic Finance

- Islamic Bank
- Islamic banking is the branch of Islamic finance that has seen the most growth to date.
- Takaful
- The Takaful system as an alternative to conventional insurance embodies the elements of shared responsibility, common benefit and mutual solidarity. Every policyholder pays his subscription in order to assist those among them who need assistance.

Components of Islamic Finance Cont'd...

- Islamic Capital Market
- Islamic capital market is critical for the sustainable development of the Islamic finance industry. The key components of an Islamic capital market are Shari'ah-compliant stocks, Islamic funds and Sukuk/Islamic investment certificates.

Historical Background of Islamic Finance

- Despite being seen as a modern phenomenon, Islamic finance is as old as the religion itself with its principles primarily derived from the Quran, which was revealed some 1440 years ago.
- The modern Islamic finance industry emerged around second half of the 20th century after Muslim economists who envisioned alternatives to conventional Western economics intensified their research and conferences trying to actualize what was seems to be impossible.
- Consequently, their effort led for the following landmark and historical achievements:

Historical Background of Islamic Finance cont’d

- 1962 – Sweeping changes in the Banking and Companies ordinance in Pakistan
- 1963 – Establishment of the Mit Ghamr in Egypt
- 1969 – Tabung Hajj in Malaysia
- 1972 – the Mit Ghamr project became part of Nasr social Bank
- 1975 – IDB was established to foster economic development among member countries
- 1975 – DIB was established as the first full-fledged Islamic commercial Bank

Historical Background of Islamic Finance cont’d

- In 1979, the first Islamic insurance (or takaful) company — the Islamic Insurance Company of Sudan — was established.
- In 1990, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created to establish industry accounting and auditing standards.
- In 2011 central Bank of Nigeria issued a license for the first full fledged Islamic Bank in the country, i.e. Jaiz Bank Plc.
- Current size ranges from USD 1.88 trillion to USD 2.1 trillion and it is expected to reach USD 3.4 trillion by the end of 2018

Key Principles of Islamic Finance

- Islamic economics and finance derive from immutable principles rooted in the rulings of the *Shari'ah* legal code.
- Unlike legal systems that are limited to secular aspects of daily life, *Shari'ah* jurisprudence does not distinguish between religious and other aspects of life, including transactions falling under either the political, economic, or social sphere (*muamalat*).
- In Islamic economics, productive human activity is mandatory. Islam does not endorse every human wish, and it prohibits on moral grounds activities related to tobacco and other drugs, alcohol, pork products, gambling involving money and non-money assets (*maysir*), speculation, pornography, and armaments and destructive weapons.

Three Principles Govern Islamic Finance

1. Principle of equity:

- Is the rationale for the prohibition of predetermined payments (riba), with a view to protecting the weaker contracting party in a financial transaction.
- *Riba* (interest) means an increase in wealth that is not related to engaging in a productive activity.
- Also, the basis for prohibiting excessive uncertainty (gharar) as manifested by contract ambiguity or elusiveness of payoff, so iinformation asymmetry is reduced to the barest minimum otherwise the presence of gharar would nullify the contract.
- Its also the basis of wealth distribution in islam where 2.5 percent levy is imposed on cash or in-kind wealth (zakat), on all Muslims who meet specific minimum levels of income and wealth to assist the less fortunate and foster social solidarity.

2. Principle of participation:

- This principle lies at the heart of Islamic finance as it ensures that increase in wealth accrue from productive activities.
- Ensures capital is rewarded for participating in a productive activity equitably.
- This is accordance to the key *Shari'ah* ruling that "**reward (that is, profit) comes with risk taking**,"
- It ensures investment return were earned in tandem with risk-taking and not with the mere passage of time as in *riba* (Interest payments)
- Its also the basis for legitimizing return on capital by risk-taking.
- It is the basis for determination of the return ex post based on asset performance or project productivity, thereby ensuring a link between financing activities and real activities.

3. Principle of ownership:

- This principle is derived from the following shariah rulings that:

  i. “You do not sell what you do not own” (for example, short-selling).

  ii. “you cannot be dispossessed of a property except on the basis of right”

- The principle was the basis for preservation and respect for property rights, as well as upholding contractual obligations by underscoring the sanctity of contracts.
- Islamic finance has, thus, come to be known as asset-based financing, forging a robust link between finance and the real economy.

Key Instruments of Islamic Finance

- Islamic finance instruments, unlike the instruments of conventional finance, uses financing modes falling under one of the three categories:

    1. Profit-and-loss sharing (PLS)
    2. Non-PLS contracts
    3. Fee-based products

PLS Financing Products

1. ***Musharakah:*** a contract of joint partnership where two or more partners provide capital to finance a project or own real estate or movable assets, either on a permanent or diminishing basis. Profits are distributed according to pre-agreed ratios while losses are shared in proportion to capital contribution.
2. ***Mudarabah:*** a profit-sharing and loss-bearing contract where one party supplies funding (financier as principal) and the other provides effort and management expertise (*mudarib* or entrepreneur as agent) with a view to generating a profit. The share in profits is determined by mutual agreement but losses, if any, are borne entirely by the financier, unless they result from the *mudarib's* negligence, misconduct, or breach of contract terms.

Non-PLS Financing Products

- Most common in practice, generally used to finance consumer and corporate credit, as well as asset rental and manufacturing, they are:

1. ***Murabaḥah****:* is a deferred payment sale transaction where the intention is to facilitate the acquisition of goods and not to exchange money for more money (or monetary equivalents) over a period of time.

2. ***Ijārah*** is a contract of sale of the right to use an asset for a period of time. It is essentially a lease contract, whereby the leaser must own the leased asset for the entire lease period. Since ownership remains with the leaser, the asset can be repossessed in case of nonpayment by the lessee.

3. ***Salam*** **(deferred delivery sale)** is a form of forward agreement where delivery occurs at a future date in exchange for spot payment with the condition that payment of the price be made in full at the time of initiating the contract, or else the outcome is a debt-against-debt sale, which is strictly prohibited under Shari'ah. The subject matter, price, quantity, and date and place of delivery should be precisely specified in the contract.

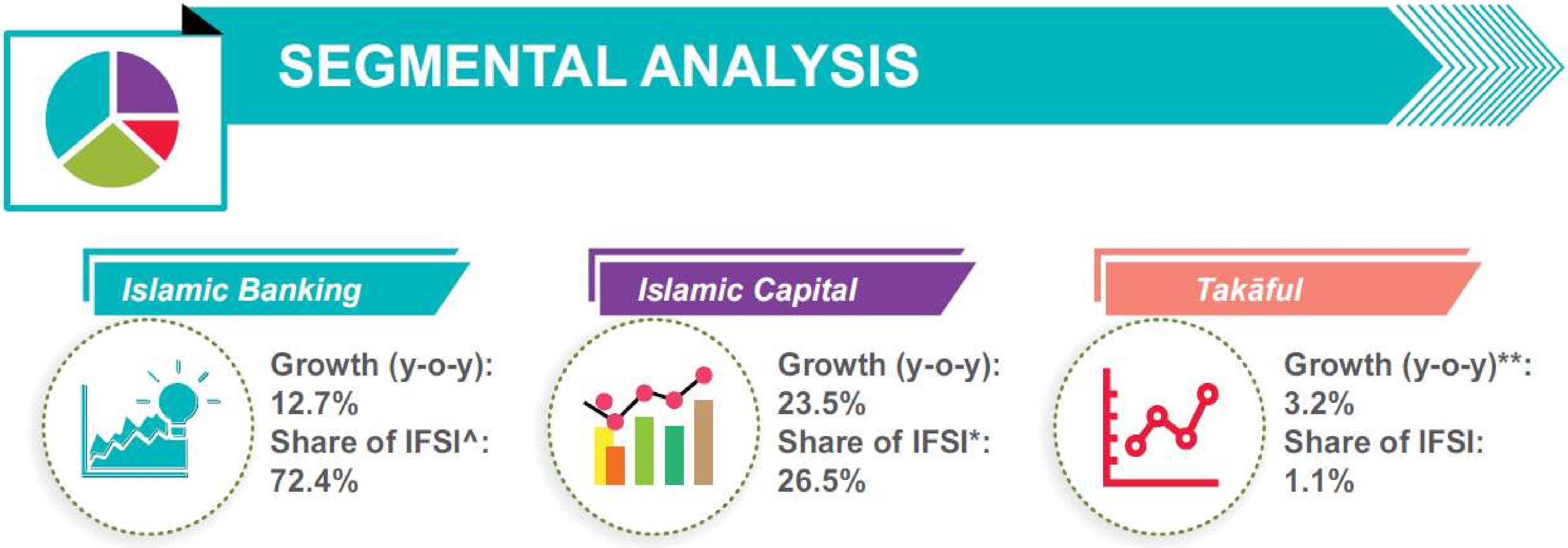
4. ***Istisna'*** **(manufacture/construction sale):** is a contract in which a commodity can be transacted before it comes into existence. Its unique feature is that nothing may be exchanged on the spot or at the time of contracting, the obligations of both parties are in the future.

Fee-Based Products

- Fee-based services include bank transfers, issuing letters of credit and guarantees, credit cards, and offering collection and safe-custody services, mostly used in trade financing.
- They are usually auxiliary to other modes of financing and are based on *Wakalah* (agency), *Kafalah* (guarantee) and *Ju'ala* (rendering a service)
- ***Wakalah*** results from the bank acting as the agent of a customer in a trade transaction or issuing a letter of credit facility.
- ***Kafalah*** is a financial guarantee whereby the bank gives a pledge to a creditor on behalf of the debtor to cover fines or any other personal liability. It is widely used in conjunction with other financing modes or documentary credits.
- ***Ju'ala*** is essentially an *ijarah* contract that is applicable for rendering a specified service as opposed to the manufacturing of a product.

Stylized Facts about Islamic Finance

Recent Development in the Global Islamic Financial Institutions Industry



^ *Islamic banking data as at end 3Q19.*
* *Islamic capital market share comprise ṣukūk and Islamic funds assets as at end 2019.*
** *Takāful as at end 2018*

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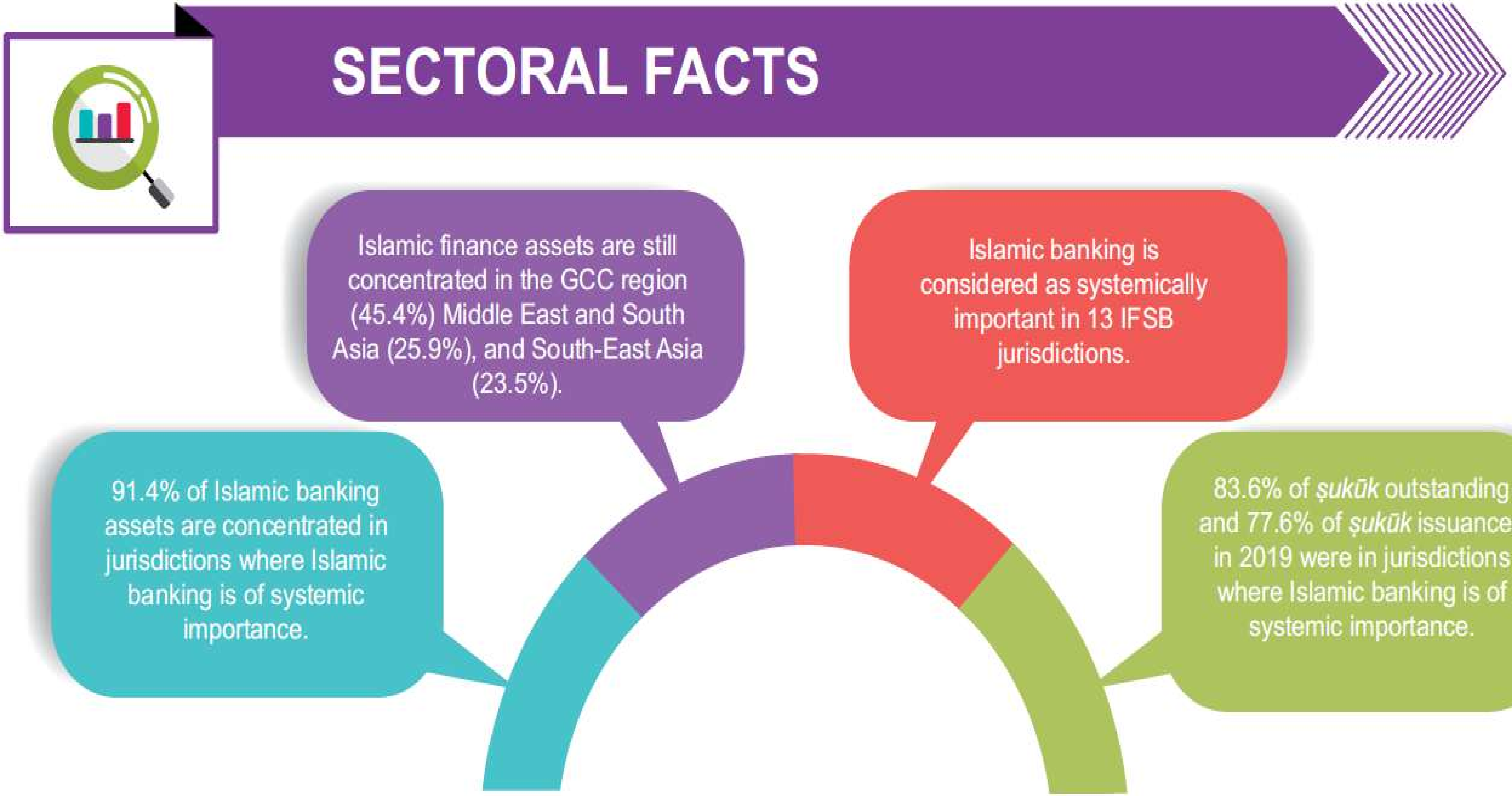
SECTORAL FACTS
Islamic finance assets are still concentrated in the GCC region (45.4%) Middle East and South Asia (25.9%), and South-East Asia (23.5%).
Islamic banking is considered as systemically important in 13 IFSB jurisdictions.
91.4% of Islamic banking assets are concentrated in jurisdictions where Islamic banking is of systemic importance.
83.6% of *ṣukūk* outstanding and 77.6% of *ṣukūk* issuances in 2019 were in jurisdictions where Islamic banking is of systemic importance.

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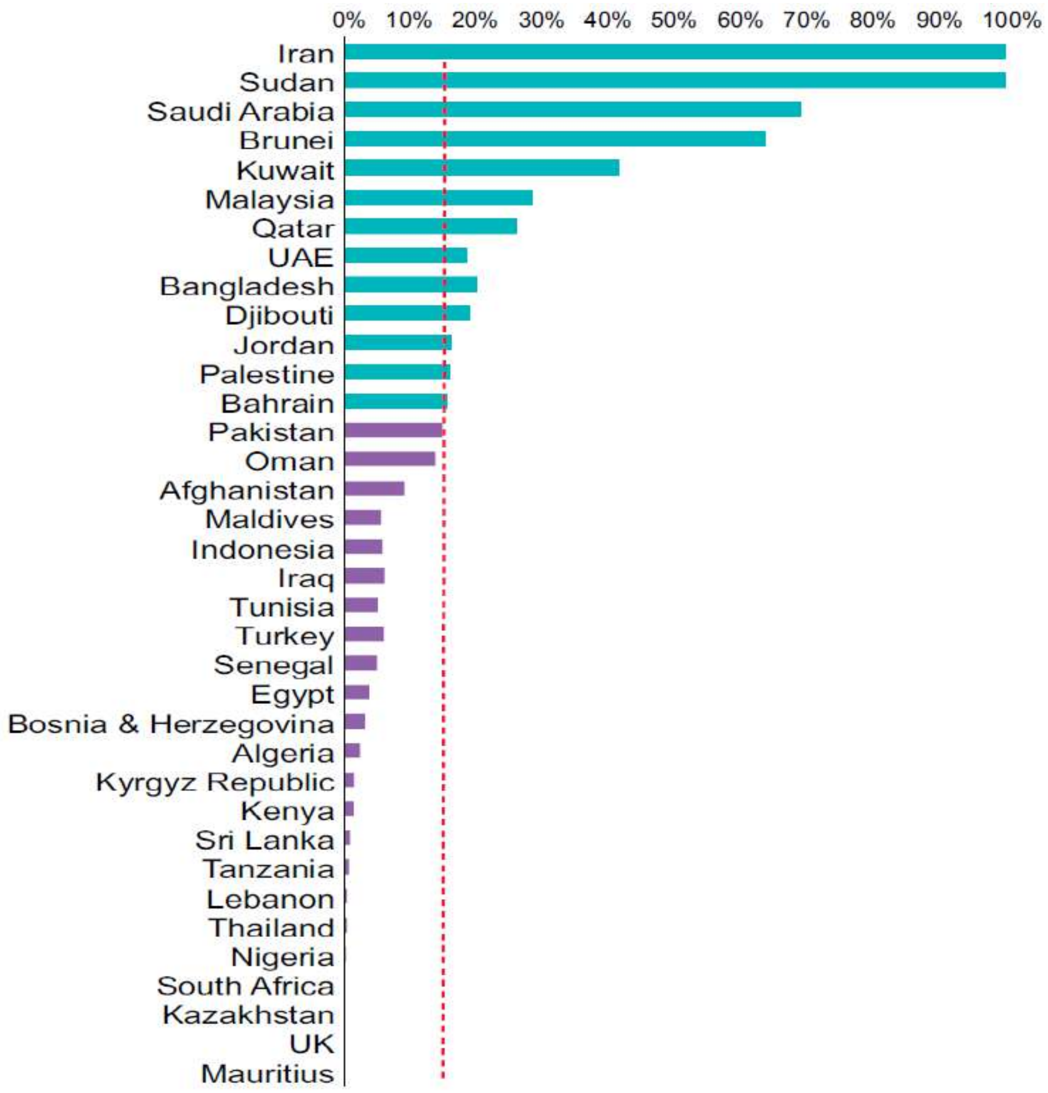
Jurisdictions where Islamic Banking (IFSI) has reached a systemic Importance Level



Iran, Sudan, Saudi, Brunei, Kuwait, Malaysia, Qatar, UAE, Bangladesh, Djabouti, Jordan, Palestine, Bahrain and Pakistan has all reached systemic importance level in Islamic Financial System

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Growth Drivers of Islamic Finance

- The growing need of Muslims for a Shari'ah-compliant financial system.
- The growing population of Muslims in different regions of the world.
- Economic growth in the MENA region.
- Political support.
- Better regulatory framework.
- Levelling playing field between the Islamic and Conventional finance.

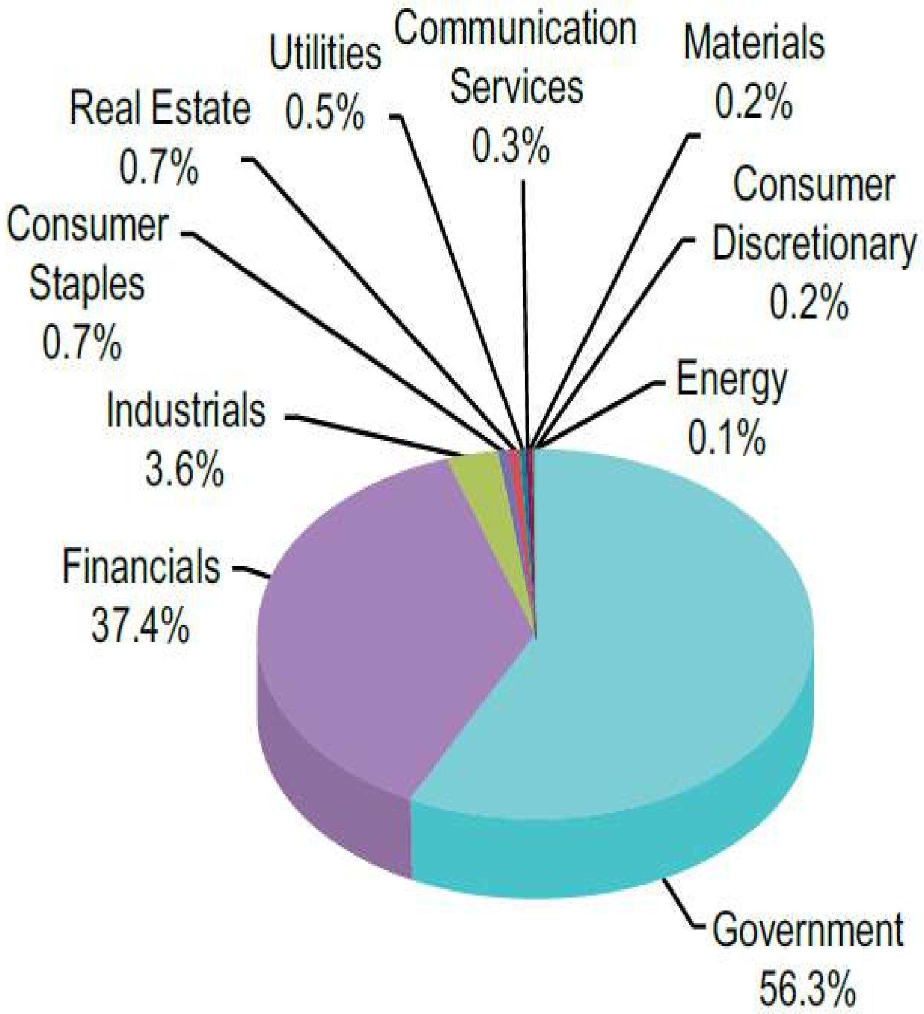
Developments in the Sukuk Market

- The first sukuk was issued by a Malaysian company in 1990.
- **Malaysia** was the main driver of the sukuk market in the early years; followed by Bahrain, who entered the market in mid-2001.
- The first sukuk issued by a Western government was by the State of Saxony-Anhalt of Germany in 2004.
- US$ 1 trillion sukuk issuance milestone was reached in 2018
- Sovereign issuers continue to lead the *ṣukūk* market: Sovereign - 56% , Corporate - 36% and Multilateral Institutions – 8% (IFSB 2020)
- Issuences of Green Sukuk by Malaysia in 2017, 2018 and 2019. by IsDB, UAE and Indonesia in 2019.
- First blockchain-based micro-sukuk in Indonesia in 2018 and 2019

Global *Ṣukūk* Issuances and *Ṣukūk* Outstanding Trends (2004–19)

- **The *ṣukūk* market experienced double-digit growth in 2019 (CAGR of 26% from 2004 to 2019)**
- **The strong growth was supported primarily by increases in issuance in Malaysia, Saudi Arabia, Qatar and Turkey.**
- **The robust issuance in 2019 marks the fourth consecutive year of expansion of the *ṣukūk* market.**
- **Sukuk market is now the fastest-growing segment in the IFSI.**

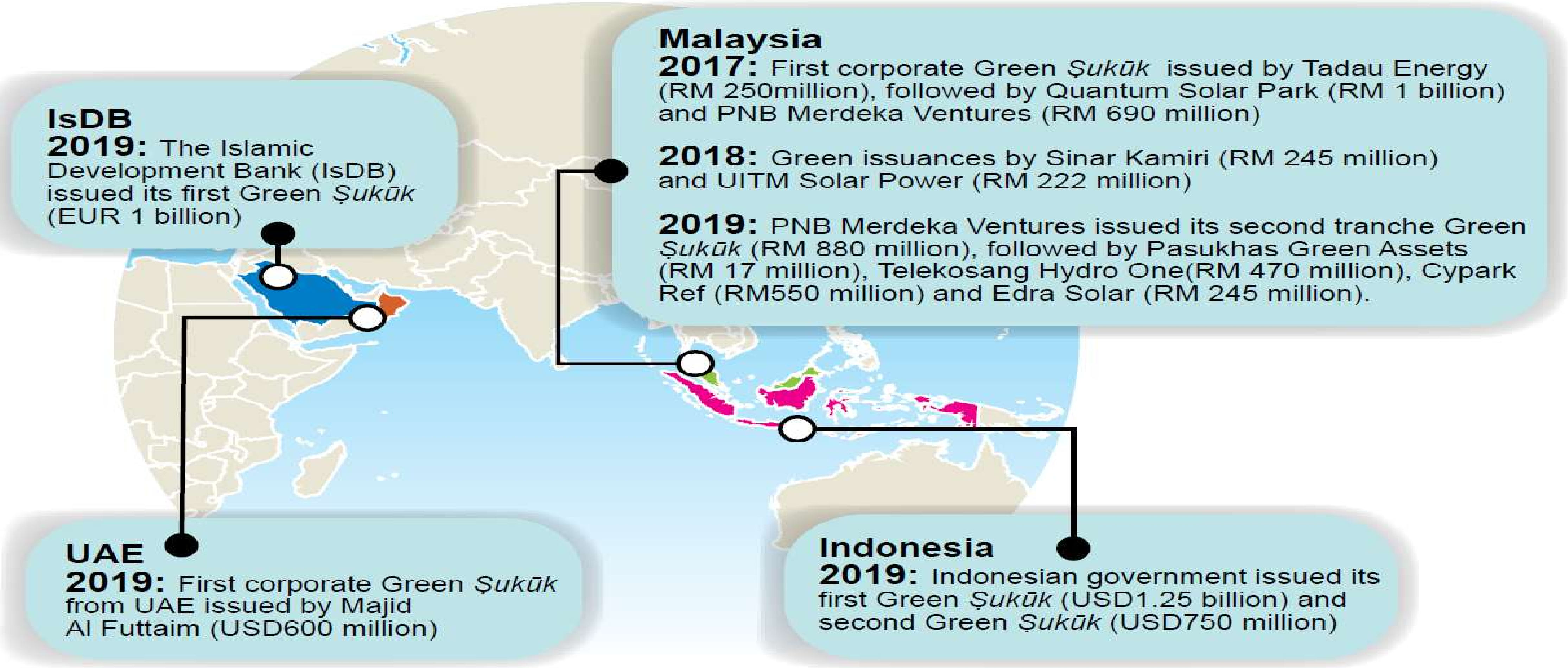
Global *Ṣukūk* Issuances by Sector (2019)



- Issuences are dominated by Governments – 56.3%
- Followed by Corporate Financial Institutions – 37.4%
- Industrial companies – 3.6%
- Development in other sectors such as real estates, utilities and communications was still sluggish suggesting that more has to be done to mobilise funding for these sectors using sukuk.

Islamic Finance Dev. Report 2019

Green Sukuk Issuences



Sukuk Issuances in Nigeria

- Sub-national sukuk of 11.4 Billion was issued by Osun State in 2013 for construction of schools
- Federal Government (Sovereign) of 100 Billion Naira was issued in 2017 for roads construction. Another 100 billion in 2018 and 150 Billion Naira in 2020.
- The last issue (150 bill) received a high level of subscription of N669.124 billion representing a subscription level of 446% (DMO 2020)