

ISLAMIC FINANCE DRIVES NEW DEVELOPMENT IN AFRICA

Opportunities for Islamic finance abound across Africa, as development proceeds apace across the continent. Africa is fast becoming an important contributor to the global economy, with growth expected to be at 5.3% in 2014. However, productivity continues to be hampered by factors such as an infrastructure gap of USD48 bln per year. At the same time, low numbers of people who currently enjoy access to credit and bank accounts present an opportunity for Islamic financial institutions to capture the potential market for retail banking and small business financing across the continent.

15 May 2014

Islamic Finance in Africa: Significant opportunities to support Africa's funding gaps while enhancing the region's financial inclusion

Africa is rapidly emerging as an important contributor to the global economy and the continent's GDP is expected to grow by 5.3% in 2014¹. However, infrastructure deficit has been a major constraint in enhancing Africa's productivity and according to the Infrastructure Consortium for Africa (ICA)², the continent faces an infrastructure financing gap of USD48bln per year. In this regard, the global Islamic finance industry has tremendous opportunities to support Africa's funding needs given the abundance of liquidity in the key Islamic finance hubs of GCC and Malaysia. The recent wave of interest in Islamic finance among a number of African jurisdictions including Nigeria, Kenya, Tunisia, Mauritius, South Africa, among others, further make Islamic financing a viable option to support Africa's emergence as a key economic and financial region in the global markets.

The Islamic finance industry in Africa, despite being largely fragmented and nascent in the region, is fast gaining interest of the various stakeholders including central banks, regulatory authorities, international Islamic financial institutions as well as the local demographics. Currently, Africa accounts for 2.4% of global

Islamic banking assets (1H2013), 0.6% of sukuk outstanding (1Q14) and 2.8% of Islamic fund management assets (end-2013). However, the outlook for the Islamic finance industry in Africa looks bright as a number of African governments are making necessary changes to the regulatory and policy framework to support growth of the industry on the back of expectations of a strong demand. During the first quarter of 2014, the Islamic finance mandate in Africa got reaffirmations from the jurisdictions of Mauritania, Morocco, Senegal, South Africa and Libya who have introduced or are in final stages of introducing Islamic finance legislations which would enable the provision of Islamic banking services in the respective countries while also opening doors for sovereign sukuk issuances.

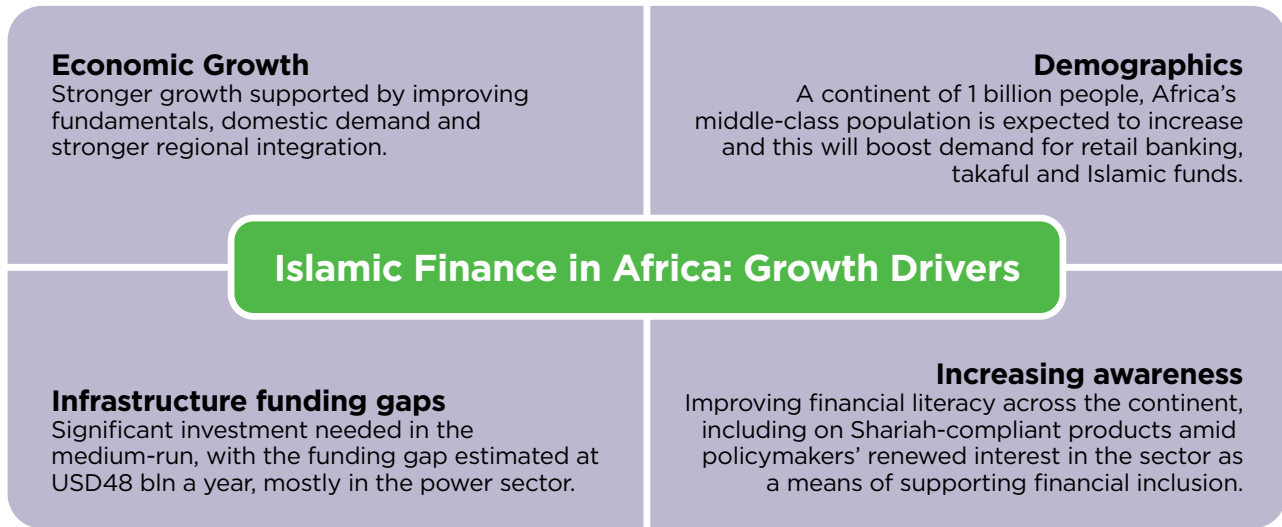
Islamic finance has tremendous potentials to at least partly support the funding gaps in Africa while enhancing the financial inclusion rates in the region. Islamic finance offers an alternative financing mechanism to support the large infrastructure investment needs in Africa. In addition, it provides government institutions an alternative financing mechanism to support the country's capital expenditure needs. On the other hand, infrastructure projects also appeal to Islamic banks and investors due to its links with the real economy. This is because the principles of Shariah, which govern Islamic finance, critically emphasise the role of real-asset financing. Therefore, infrastructure development projects and competitive Islamic financing solutions provide a win-win situation for the industry's stakeholders.

¹ African Development Bank (2014)

² ICA members include the G8 countries, the World Bank Group, the African Development Bank Group, the European Commission, the European Investment Bank and the Development Bank of Southern Africa.

Islamic Finance Growth Drivers in Africa

Source: KFH Research Limited

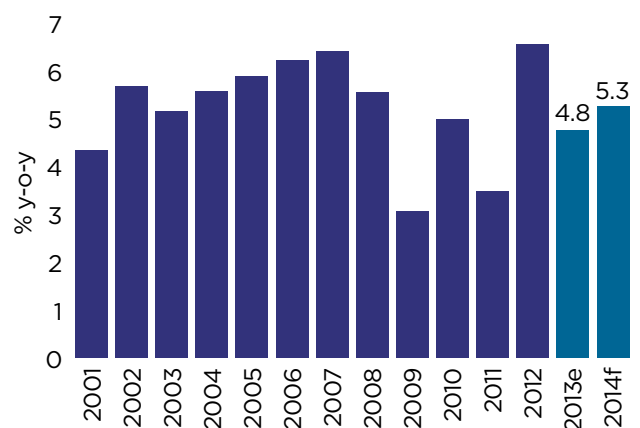


**Africa's Economic Outlook 2014:
Stronger growth supported by
improving economic fundamentals**

Africa is rapidly emerging as an important contributor to the world's economic and financial system. The continent's economic growth has remained resilient in 2013, growing by an estimated 4.8%³, supported by firm commodity prices amid a recovery in the global economy. As per the African Economic Outlook (2013) Report by the African Development Bank (AfDB), while this is a moderation compared to the 6.6% growth in 2012, it reflects fairly solid fundamentals in the region as the 2012 growth figures were abnormally high due to the resumption of oil production in Libya. Excluding Libya, growth in Africa in 2012 was about 4.2%⁴. Based on the same report, in 2014, Africa's economic growth is projected to strengthen further to 5.3%, supported by robust domestic demand which is boosted through private consumption and both public and private investments.

Africa: Real GDP Growth (2000 - 2014F)

Source: African Economic Outlook 2013, KFH Research Limited



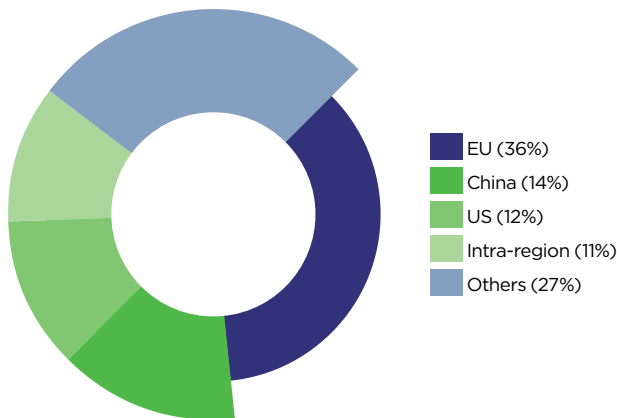
³ African Economic Outlook (2013)

⁴ ibid

Africa has developed strong trade relationships over the years with some of the world's largest economic zones. African countries export primarily commodities in raw or processed forms, including oil & gas, metals and agriculture commodities. Since 2009, China is Africa's main trading partner with nearly 14% of its exports destined to the country in 2012, overtaking the US which accounted for a 12% exports share. By region, Europe has always been a major trading partner and this has been further enhanced following the Economic Partnership Agreements (EPAs) between the European Union and Africa, designed to help African countries integrate into the world economy. The EU-27 region was destined for 36% of African exports in 2012.

Africa Exports by Destination

Source: UNCTAD (2012), KFH Research Limited



A number of foreign companies are also increasingly being involved in investments in Africa. External financial flows reached a new record high of USD186.3bln in 2012. In a study involving 322 major infrastructure projects across the continent, it is found that 17% of these projects were owned by companies from the US or Europe⁵. Investments from China are

also increasing. The study highlighted that in terms of construction work, 37% are being built by US and European firms and 12% by firms from China. Other countries with infrastructure building interests in Africa include Japan, South Korea, Brazil and Australia.

Trade and investment relationships between the liquidity abundant Islamic finance hub of the Gulf Cooperation Council (GCC) and Africa are also rapidly expanding. Between 2000-2010, the GCC exports to Africa grew by an average of 14.7% a year and imports increased by an average of 27.5%⁶. Based on latest statistics available, the annual trade relationship between the GCC countries and Africa was almost USD35bln. Investors from the GCC have also been recently investing in business in African countries.

Similarly, Malaysia is also a major investor in Africa. According to the UNCTAD , Malaysia's FDI flows into Africa were worth nearly USD3.5bln in 2011, ranking it as the world's third highest jurisdiction investing into Africa, behind France and the United States. Similarly, Malaysia's FDI stock in Africa was worth USD19.3bln in 2011 which ranked it fourth behind France, United States and the United Kingdom. This makes Malaysia as Asia's top investor in Africa. Malaysia's investments into Africa are mainly energy-driven and the Malaysian oil giant Petronas is active in a number of African countries including Egypt, Zimbabwe, and South Africa. Recently, Malaysian investments have also expanded into other sectors in Africa such as telecommunications, banking and finance, infrastructure and property development, manufacturing, power generation, and others.

The fast expanding trade and investment relationships between the Islamic finance hubs of GCC and Malaysia with Africa,

⁵ Deloitte: African Construction Trends Report (2013)

⁶ Gulf Research Centre

⁷ UNCTAD's Special Report on Global Investment Trends Monitor (March 2013)

provides Islamic finance players tremendous opportunities to capture such business flows given the growing interest in Islamic finance in these markets.

Africa’s Infrastructure Needs and Funding Gaps: Sukuk as a viable instrument

Africa’s economic stride has been substantially supported by infrastructure development and according to a report by the World Bank, infrastructure development will need to play an even greater role if the continent’s development targets are to be reached. In several African countries, infrastructure is a major constraint on doing business, and is found to depress firm productivity by almost 40%. The Infrastructure Consortium for Africa (ICA) estimates African governments spend approximately USD45bln per year on infrastructure development while the cost of addressing Africa’s infrastructure deficit is around USD93bln per year. This leaves a funding gap of nearly USD48bln per annum. Among the various sectors, Africa’s largest infrastructure deficit is to be found in the power generation sector which accounts for nearly 40% of the total infrastructure spending needs in the continent. To give an example, the 48 countries of Sub-Saharan Africa (with a

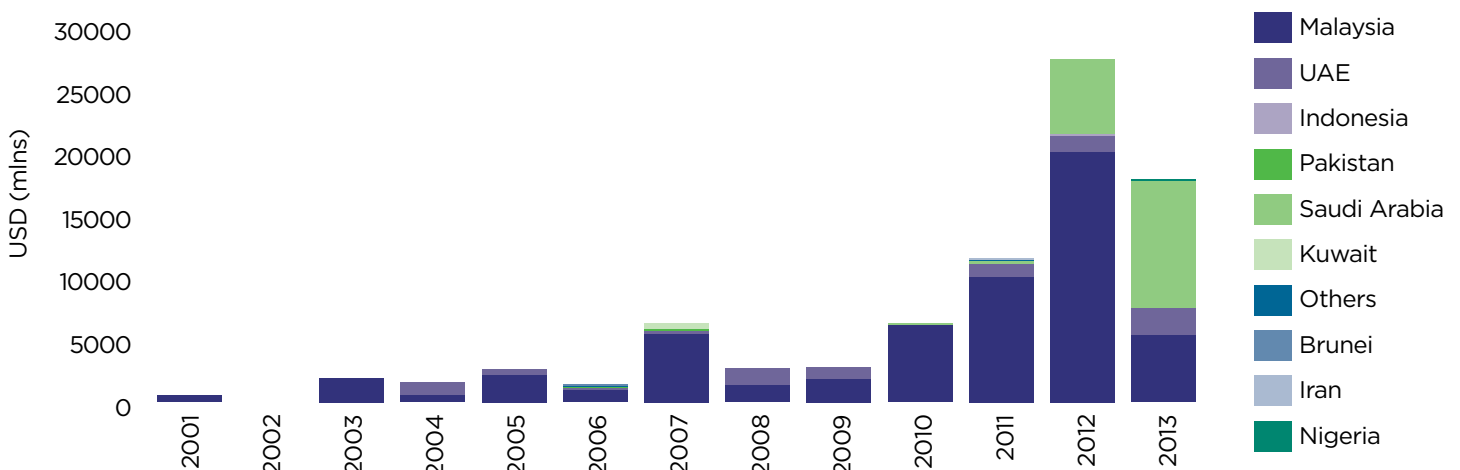
“The Infrastructure Consortium for Africa (ICA) estimates African governments spend approximately USD45bln per year on infrastructure development while the cost of addressing Africa’s infrastructure deficit is around USD93bln per year.”

combined population of 800 million) generate roughly the same amount of power as Spain (with a population of 45 million)⁸.

Sukuk instruments are a natural fit for the African market and hold great potential amid unprecedented funding needs for infrastructure building across the continent. For more than a decade, infrastructure sukuk has been well-utilised in the GCC and Malaysia. The infrastructure sukuk market has witnessed issuances by sovereigns, corporates and government-related entities bearing different tenures, different Shariah-compliant structures, guaranteed / non-guaranteed structures as well as variability in terms of the returns offered. Infrastructure sukuk can be structured using

Infrastructure Sukuk Issuances by Country in USD Mlns 2001-2013

Source: IFIS, Zawya, Bloomberg, KFH Research Limited



⁸ World Bank: Factsheet – Infrastructure in Sub Saharan Africa

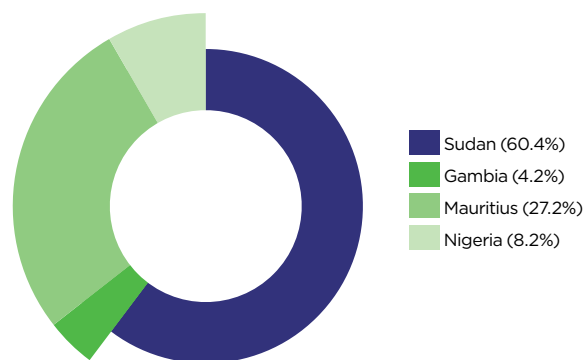
various types of Shariah contractual principles, the most common being Murabahah, Ijarah and Musharakah. Sukuk have also played a crucial role in financing the infrastructure sector with proceeds raised from issuances being utilised for both public and private projects. Between 2001 and 2013, a total of USD84.3bln worth of infrastructure sukuk have been issued by more than 10 different countries.

Sukuk provide a Shariah-compliant alternative to the conventional capital market, which makes it attractive to potential issuers in Africa and investors alike. In the next few years, Africa is likely to tap the sukuk market to support projects in the power, transportation and other development projects. Moreover, sukuk being Shariah-compliant instruments can play a major role in connecting Shariah compliant liquidity inflows from the liquidity-abundant oil-rich Muslim economies and other major Islamic international trade economies.

Recent developments in the sukuk sector in Africa were mainly on the regulatory side, with governments' endeavouring to provide a more enabling environment for capital market developments including Islamic capital markets (particularly sukuk). As at end-1Q14, sukuk outstanding in African countries amounted to USD1.7bln, which represents just 0.6% of total global sukuk outstanding. Of these, Sudan accounts for about 60.4% while the other three countries are Mauritius, Nigeria and Gambia. Nevertheless, the favourable regulatory environment, demand for infrastructure funding and recovery in global growth will lead to more sukuk issuances from the continent. In 2014, sovereign sukuk issuances in the pipeline include those from Tunisia, Morocco, South Africa, Senegal, Egypt and Mauritania. Nigeria debuted last year when its state of Osun issued an Ijarah sukuk for financing amounting to NGN10bln (USD62mln) while Kenya is also considering using sukuk as an option to meet its sovereign funding needs.

Africa: Sukuk Outstanding by Country (as at end-1Q14)

Source: KFH Research Limited



Selected Sovereign African Sukuk announced in the pipeline, as at 30th April 2014

Issuer	Currency	Expected Size (in USD mlns)
Government of Tunisia	TND	435
Government of Senegal	USD	200
Ministry of Finance - Egypt	USD	2000
Government of South Africa	USD	750
Government of Morocco	USD	750
Central Bank of Mauritania	USD	300

Source: KFH Research Limited

**Africa’s low financial inclusion rates:
Opportunities for Islamic Banking and
Microfinance Services**

Financial inclusion is another key potential area for Islamic finance in Africa. An international comparison of private credit to GDP - a main indicator of financial depth - shows the ratio of private credit to GDP averaged 24% of GDP in Sub-Saharan Africa in 2010 and 39% in North Africa, compared with 77% for all other developing economies, and 172% for high income economies⁹. Based on the World Bank’s Global Financial Index, less than 5% of individuals aged 15 and above are likely to borrow from a formal financial institution in Sub-Saharan Africa and the Middle East and North Africa. Family and friends tend to be the main source of borrowing funds in these regions. In a World Bank report released in 2012¹⁰, the findings indicate that less than a quarter of adults in Africa have an account with a formal financial institution and that many adults in Africa use informal methods to save and borrow. Similarly, the majority of small and medium enterprises in Africa are unbanked and access to finance is a major obstacle. Compared with other developing economies, high-growth small and medium enterprises in Africa are less likely to use formal financing, which suggest greater roles could be played

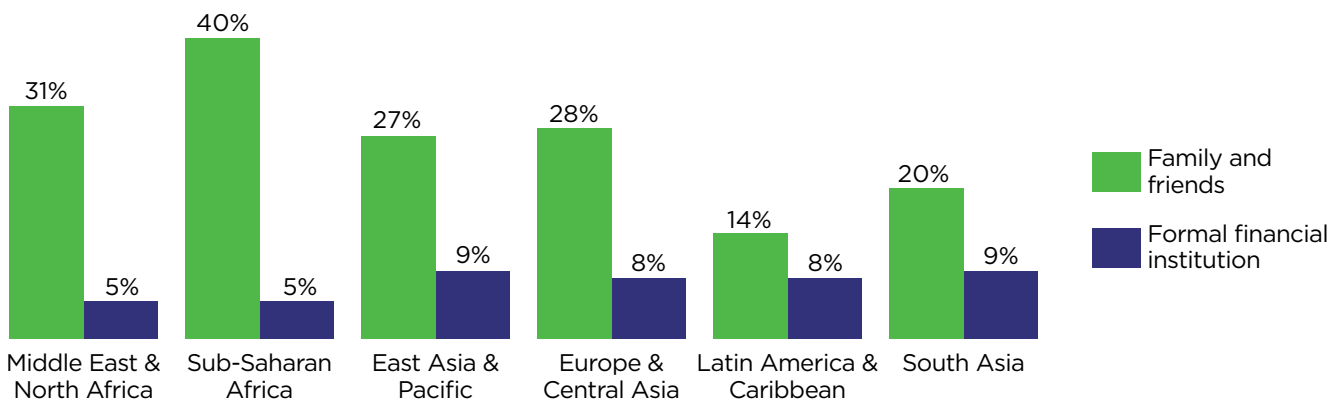
by the formal financial systems in serving the needs of enterprises with growth opportunities.

In this regard, Islamic banking players have abundant opportunities to tap into a largely unpenetrated African financial market by providing Shariah-compliant financing facilities, in particular to the retail and the SME clientele, while enhancing financial inclusion through microfinance facilities. Currently, there are approximately 38 Islamic financial institutions operating in Africa. Opportunities for Islamic banks in Africa include in offering retail products given the low rates of financial inclusion among the adult population (less than a quarter of adults have a bank account at a formal financial institution in Africa as per

“An international comparison of private credit to GDP - a main indicator of financial depth - shows the ratio of private credit to GDP averaged 24% of GDP in Sub-Saharan Africa in 2010 and 39% in North Africa, compared with 77% for all other developing economies, and 172% for high income economies⁹”

**Sources of Funding by Region for
Individuals aged 15 & above (%)**

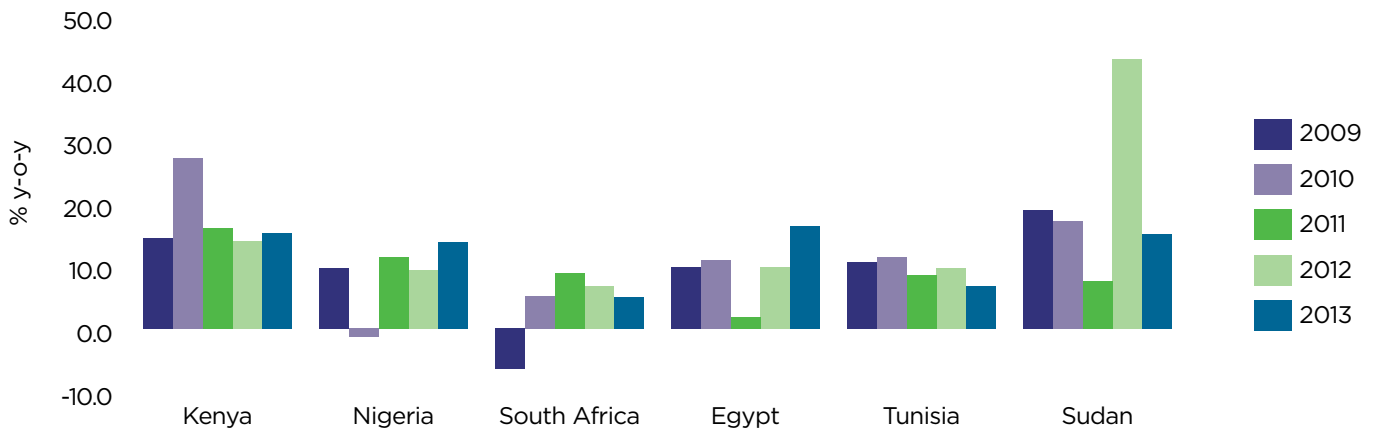
Source: World Bank Global Index (2011), KFH Research Limited



This survey covers developing countries only

**Total Assets Overall Banking Sector
in Selected Countries: Growth Trend**

Source: Central banks, KFH Research Limited



Note: Assets of commercial banks. For Kenya and Tunisia, 2013 refers to assets as at June 2013.

the World Bank). There are also tremendous opportunities to provide financial services to the Small and Medium Enterprises which remain largely unbanked. Earlier studies have also indicated the presence of segments of the population in African countries such as Nigeria, Somalia and Senegal that refrain from utilising financial services which are not aligned with their religious beliefs. For example, Nigeria has a huge Muslim population of over 80 million or 50.1% of the total Nigerian population (based on 2012 estimates) and represents the 6th largest Muslim population of the world. This population represents a natural market for Islamic banking services.

Opportunities for Growth

Global development agencies such as the African Development Bank, the World Bank and the United Nations have regularly highlighted the need for Africa to improve its infrastructure to facilitate goods and labour mobility, increase competitiveness and attract foreign direct investment. At present, infrastructure funding gap amounts to approximately USD48bln annually, mainly in the power and

transportation sectors. Islamic finance has tremendous potentials to help Africa meet its infrastructure funding gaps through Shariah-compliant financing facilities as well as through the use of infrastructure sukuk. Currently, the continent has some presence in the global Islamic capital markets, in particular sukuk. African countries that have issued sukuk include Sudan, Nigeria, Mauritius and Gambia. Moving forward, pipeline issuers include South Africa, Senegal, Tunisia, Morocco and Mauritania. Africa's infrastructure financing needs will make sukuk increasingly viable, especially if countries are keen to attract funds from the liquidity abundant Middle East region where the Islamic finance sector is fast gaining traction.

The Islamic banking sector in Africa also has abundant opportunities supported by Africa's large and underserved Muslim population and increasing awareness of Shariah-compliant products. Notably, the Islamic banking sector in countries such as Kenya and South Africa have marketed products to non-Muslims as well, increasing the sectors outreach. A number of international Islamic banks have begun to

set up Islamic banking operations in African countries including Kenya, Egypt and Nigeria.

These potentials are, in part, the factors driving numerous efforts undertaken by various multilateral bodies such as the African Development Bank (AfDB), Islamic Financial Services Board (IFSB), Islamic Development Bank (IDB) and its affiliated groups in supporting African governments' efforts to diversify funding through Islamic capital markets and other forms of syndicated financing facilities.

The African Development Bank (AfDB), in its aims to spur sustainable economic development and social progress in its regional member countries, has undertaken various efforts to support the efforts to develop Islamic finance. Apart from training and capacity building programmes, in 2013, the AfDB inked a Memorandum of Understanding (MoU) with the International Islamic Liquidity Management Corporation to build robust partnership to promote liquidity management, which in part will potentially spur the development of sukuk market in the region.

“This year, the IFSB is hosting its 11th annual summit in Mauritius, the first time for its annual event to be held in Africa.”

The Islamic Development Bank (IDB) has been actively involved in supporting African governments' efforts to diversify funding through Islamic capital markets as well as through equity participation in Islamic banking and financial institutions across many African nations. The IDB recently organised a 2-day High Level Regional Forum (HLRF) for 17 sub-Saharan African countries, held in Senegal

during 27th to 28th January 2014. As of October 2013, the IDB Group had approved financing worth USD8.403bln for these 17 countries that participated in the HLRF.

The Islamic Financial Services Board (IFSB) is another multilateral entity which has played its due role in promoting standards and practices of Islamic finance in Africa. This year, the IFSB is hosting its 11th annual summit in Mauritius, the first time for its annual event to be held in Africa. The theme for this year's annual summit is “New Markets and Frontiers for Islamic Finance: Innovation and the Regulatory Perimeter”. IFSB also held a seminar entitled “The Role of Islamic Finance in the Development of Africa” in September 2012. A number of IFSB's members hail from Africa from countries such as Nigeria, Egypt, Sudan, Mauritius, Zambia, Senegal, Tunisia and Kenya. The event marks another important milestone to the region and is expected to raise greater awareness and lead to greater momentum to elevate the Islamic finance industry in the region a greater height. In conjunction with this event, Bank Negara Malaysia is organising a Business Forum on 20th May 2014, from 11.00am to 1.00pm at Le Meridien Ile Maurice, Mauritius. Themed “Islamic Finance and African Infrastructure Development”, this event brings together panelists from various region and business sector to discuss on the opportunities and challenges of the African infrastructure development, and provide valuable insights on how Islamic finance as an alternative financing can support the funding gaps in the region.

The measures undertaken by various stakeholders, coupled with the natural advantages offered by Africa, are likely to lead to stronger growth of the Islamic finance industry in the region.

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