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Title of the work: **SUKUK AS A TOOL TOWARDS DEVELOPMENT: HOW KENYA CAN USE SUKUK AS ALTERNATIVE SOURCE OF FUNDING DEVELOPMENT PROJECTS**

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Dr. Peter Munyi, The University of Nairobi

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Lastly, I dedicate this Thesis to my loving and supportive family and friends without whom I would never have been able to do this. I especially dedicate this paper to my husband and daughter whose encouragement and support I have enjoyed.

LIST OF ABBREVIATIONS

AAOIFI - Accounting and Auditing Organization of Islamic Financial Institutions

CBK - Central Bank of Kenya

CMA - Capital Markets Authority

IMF - International Monetary Fund

ICT – Information Communication and Technology

NSE - Nairobi Stock exchange

PLS - Profit and Loss Sharing

UK - United Kingdom

PPP-Public Private Partnership

GDP – Gross Domestic Product

OECD - Organization of Economic Cooperation and Development

UNCTAD – United Nations Conference on Trade and Development

GCC – Gulf Cooperation Council

IIFM - International Islamic Financial Market

IFSB - Islamic Financial Services Board

SDG - Sustainable Development Goals

CIS - Collective Investment Schemes

LIST OF STATUTES AND REGULATIONS

Banking Act

Public Private Partnership Act

Capital Markets Act

Central Bank Act

Central Depository Act

Public Finance Management Act

Value Added Tax Act

Income Tax Act

Finance Act

FOREIGN STATUTES AND REGULATIONS

Stamp Duty Land Tax (UK)

Corporation Tax Act 2009 (UK)

Finance Act 2009 (UK)

Financial Services and Markets Act 2000 (Regulated Activities) (UK)

Government Alternative Finance Regulations 2014(UK)

National Loans Act 1968(UK)

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CHAPTER ONE

1.1. INTRODUCTION

Globally, the growing demand for development, especially infrastructure development, is not proportional to the available funds to finance such development. The Organization of Economic Cooperation and Development (OECD) projects that a global estimated sum of USD 71 Trillion would be required by 2030 for investments in road, rail, telecommunication, electricity and water infrastructure, without taking into account seaports, airports and social infrastructure.[1] The World Economic Forum, on the other hand, estimates the present global infrastructure demand presently as USD 4 Trillion in annual expenditure.[2] The African Development Bank on the other hand estimates that the financing required to close Africa's infrastructure deficit amounts to USD 93 billion annually till the year 2020.[3]

Closer home, the World Bank reports that Kenya's infrastructure financing deficit is at USD 2.1 Billion annually, and this accordingly poses a serious constraint to growth and overall development.[4] The current budgetary allocation for infrastructure projects is inadequate to attain the development goals. The International Budget Partnership[5], in its review of Kenya's 2016/2017 budget, found that the total spending for 2016/17 rose to Ksh 2.05 trillion and out of this, the

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1 Della Croce, Juan Yermo, 'Institutional investors and infrastructure financing' (2013) OECD Working Papers on Finance, Insurance and Private Pensions, No.36, < http://www.oecd.org/daf/fin/private-pensions/WP_36_InstitutionalInvestorsAndInfrastructureFinancing.pdf> accessed 17th January 2017

2 World Economic Forum, 'Strategic Infrastructure Steps to Prepare and Accelerate Public-Private Partnerships' (2013) <http://www3.weforum.org/docs/AF13/WEF_AF13_Strategic_Infrastructure_Initiative.pdf > accessed on 17th January 2017

3 African Development Bank, 'Infrastructure Deficit and Opportunities in Africa' (2010) Economic Brief Volume1 (2010) < https://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/ECON%20Brief_Infrastructure%20Deficit%20and%20Opportunities%20in%20Africa_Vol%201%20Issue%202.pdf> accessed 17th January 2017

4 The World Bank, 'Private Investors to Raise Stake in Financing Kenya's Infrastructure' (2012) < http://www.worldbank.org/en/news/press-release/2012/11/15/private-investors-raise-stake-financing-kenyas-infrastructure> accessed on 17th January 2017

5 The International Budget Partnership is a global civil society group that uses budget analysis and advocacy as a tool to improve effective governance and reduce poverty.

government collected Ksh 1.50 trillion in revenue leaving a deficit of roughly Ksh 555.4 billion, which is 6 percent smaller than the 2015/16 budgetary deficit.[6]

Also noteworthy is that the share of the budget allocated to infrastructure was reduced from 27 to 25 percent.[7] Despite this reduction, infrastructure still accounted for a largest share of the total development expenditure.[8]

According to the Draft 2019 Budget Policy Statement Note[9], it was predicted that overall spending will increase to Ksh. 2.70 trillion up from Kshs. 2.51 trillion in 2018. The same document states that in 2017/2018 revenue collection was Kshs1.8 Trillion while total expenditure was Kshs 2.5 Trillion hence a budgetary deficit of nearly Kshs 700 Billion.

A lot of emphasis is placed on infrastructure development because infrastructure plays a critical role in economic development by improving accessibility, enabling both domestic and international trade, which is pertinent to globalization, telecommunication, and overall improvement of the quality of life.[10] Kenya's Vision 2030 also places infrastructure as an economic pillar and an enabler for sustained economic growth, development and poverty reduction.[11] In order to bridge this financing deficit, Kenya will require almost USD 4 Billion[12] per annum over the next decade, which is about 20% of the GDP.[13] Nonetheless, this gap in funding can be addressed significantly by raising additional finance through innovative financing models.

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6 IBP, Kenya: Analysis of Budget Policy Statement 2016. Accessed on 17th January 2017 at < https://www.internationalbudget.org/wp-content/uploads/kenya-2016-budget-policy-statement-analysis.pdf>

7 ibid

8 IBP Kenya, 'Analysis of the Budget Review and Outlook Paper' (2016) < http://www.internationalbudget.org/publications/kenya-budget-review-and-outlook-paper-analysis/> accessed on 17th January 2017

9 This is a Government policy document that spells out policy goals, strategic priorities and a summary of Government's spending plans, as a basis of preparing the FY 2019/20 budget.

10 See n 3

11 The Vision 2030 Second Medium Term Plan 2013-2017. It states that infrastructure lowers the cost of doing business; improves security; improves livelihoods and the country's global competitiveness. Implementation of programmes and projects will focus on accessibility, quality, their functionality, job creation, disaster preparedness and protection of the environment.

12 20 percent of GDP

13 Cecilia M. Briceño-Garmendia Maria Shkaratan, "Kenya's Infrastructure A Continental Perspective" The World Bank Policy Research Working Paper 5596

There has been innovation in the Islamic finance sector that has led to the development and introduction of "Sukuk" as an instrument for raising capital. Sukuk are often referred to as Islamic bonds because they are tradable securities just like bonds.[14] The fundamental difference between the conventional bond and Sukuk is that while the conventional bond represents a debt obligation owed by the issuer to the holder, Sukuk represents beneficial ownership in the underlying asset. A Sukuk issued on behalf of a sovereign entity is classified as a sovereign Sukuk.

Since 2001, the world has seen steady growth of the global Sukuk market attracting great interest from the wider international community. Raising funds through Sukuk has become an integral part of Islamic finance and has seen the financing of huge infrastructure development plans, especially around the Gulf Cooperation Council, Asian and European regions.[15] Some projects that can be financed through Sukuk are housing projects, hospitals, water sanitation plants, trains, airports, seaports etc. Sukuk as a capital markets instruments can also be utilized to finance Public-Private Partnerships.

In the context of capital raising, Sukuk works as follows: the originator, who could be a government entity, creates a Special Purpose Vehicle which will acquire the subject asset such as land or building from the originator. Thereafter, the Special Purpose Vehicle converts the value of the asset into Sukuk shares which it issues and sells to its investors. The purchasers of the Sukuk shares are called "Sukukholders". The Special Purpose Vehicle, on behalf of the Sukukholders, develops the asset and arranges to lease the assets back to the originator who pays the Sukukholders the lease income[16]. Eventually, after the lapse of the lease period and maturity of the Sukuk, the

[14] According to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Sukuk is 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 investment activity'*

[15] London's skyscraper, The Shard, the Athletes' Village for the Olympic Games in 2012 and Battersea Power Station redevelopment, have been funded with the sukuk finance model. In Saudi Arabia, several large quantity Sukuk have been issued. Notable are the Saudi Aramco-Total Refining and Petrochemical's SAR3.75 billion sukuk issued in September 2011 to partly finance the USD14 billion Jubail refinery project; the Saudi General Authority of Civil Aviation's (GACA) SAR15 billion (USD4 billion) Sukuk issued to finance the expansion of the King Abdulaziz International Airport in Jeddah; and Saudi Electricity Global Sukuk Company's $500,000,000 Sukuk issued on 04 April 2012 for a five year period is expected to mature on 3rd April *2017*.

[16] In Sukuk, the fixed interest of a conventional bond is replaced by fixed lease income.

originator acquires back the asset from the Special Purpose Vehicle either at a nominal or no price at all on termination of the lease.

Through this kind of arrangement, the government will have procured a public facility, e.g housing project, hospital, power plant, water sanitation plant and so many such facilities using the financing of the Sukuk model and the investors, through the lease back, recoup their investments and profits.

As expounded in the preceding paragraphs, on the one hand is the need for attainment of developmental goals and on the other, is the financial shortcoming developing countries like Kenya. How can Kenya bridge this gap? This proposal seeks to highlight the use of Sukuk as an alternative means of raising capital for developmental projects.

1.2.BACKGROUND TO THE PROBLEM

Each and every year during the budget reading, the government is heard deploring about the shortage of funds for developmental projects. The issue of the budgetary shortfall takes centre stage. The shortage of funds, though realistic, can be filled if only the government could look into alternative sources of funding. Lately, Islamic financing models such as Sukuk have gained quite some credibility and the impact is clearly visible from countries like Malaysia,[17] Kuwait[18] and Indonesia.[19] Luxembourg and England have also looked into that direction and issued sovereign Sukuk.[20] These countries have embraced the Sukuk model of financing to bridge their funding gaps and raise capital for financing infrastructure projects.

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.[21] Sukuk can be utilized as an innovative instrument, especially for infrastructure development, to mobilize resources to finance development projects. The resources mobilized can

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17 The first Sukuk were issued by Malaysia in 2000. It is the world’s largest Sukuk market with 68.9% or USD62 billion (RM213 billion) of the global outstanding Sukuk as at end-2007 having been originated in Malaysia

18 Issued its first sovereign Sukuk in 2001.

19 Indonesia’s Islamic bond market is the second largest in emerging East Asia in terms of size.

20 Britain was the first country outside the Islamic world to issue sovereign *Sukuk* in June 2014. The Sukuk is set to mature on 22 July 2019. Luxembourg issued its first Sukuk in September 2014

21 Muhammad Al-Amine, Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation (Brill's Arab and Islamic Law 2011)

be used to fund projects that will help Kenya attain its goals under the Vision 2030.[22] Water and sanitation projects, sustainable and affordable energy and housing are some of the projects which need urgent resource allocation if Kenya were to attain its Vision 2030 goals.

Despite the fact that nearly 27% of the national budget has been allocated to transport, energy, water and sanitation, and environment-related infrastructure, Kenya's infrastructure remains insufficiently developed.[23] The Vision 2030 Second Medium Term Plan 2013-2017 estimates Kenya's infrastructure spending needs at about USD 4 billion per year. The plan also cites lack of adequate funding being a factor that has slowed down infrastructure development.

1.3.STATEMENT OF THE PROBLEM

There is a serious gap in financing developmental projects such as road, rail and air transport infrastructure, energy, housing, environment, water and sanitation in Kenya[24]. This gap can be filled by introducing alternative instruments for raising capital such as the issuance of sovereign Sukuk into Kenya's financial sector and creating a legal framework that will govern and regulate sovereign Sukuk.

This paper examines the potentials for using sovereign Sukuk as a tool for capital raising and infrastructural development in Kenya and discusses the structure of Sukuk, challenges faced in the issuance of Sukuk and the success or viability of Sukuk as a tool for raising funds for infrastructure development. This paper will also examine whether the legal and regulatory environment is conducive for the issuance of sovereign Sukuk.

1.4.JUSTIFICATION OF THE STUDY

Kenya, like all other developing countries, has infrastructure development as one of its main agenda. More often than not, Kenya has seen itself incurring huge debts to finance these projects. Debts which attract huge interest rates, tie down the country's little resources for many years. [25]

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22 The Kenya Vision 2030 is the national long-term development policy that aims to transform Kenya into a newly industrializing, middle-income country by 2030.

23 African Development Bank Group, Kenya-Country Strategy Paper 2014-2018 (2014) < https://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/2014-2018_-_Kenya_Country_Strategy_Paper.pdf> accessed on 17th January 2017

24 ibid

25 International Monetary Fund, Kenya: Debt Sustainability Analysis' IMF Country Report No. 16/85, (2016)

In the long run, these debts metamorphosize into economic burdens to the developing country. As at June 2015, Kenya's total domestic debt stood at Kshs. 1,420,444 million while its external debt stood at Ksh. 1,423,252 million.[26]

A few examples of the ongoing projects that are loan financed by loans from the African Development Bank are the Thwake multi-purpose dam for US$97 million, US$120 million for the Outer Ring road, US $123 million for the Mombasa-Mariakani Highway upgrading project and USD 115 million for a wind power project in Lake Turkana region and many such projects.[27] This is aside from the US$ 600 Million loan from China[28] for other infrastructure projects.

Presently, Kenya lies within the safer bounds on debt levels, according to International Monetary Fund.[29] However, economists have warned that there are risks associated with the changing funding patterns that could see the country's debt levels rise. The National Treasury has also been cautioned on over-borrowing, which is feared could plunge the country into a severe debt crisis in the absence of alternative measures.[30]

Taking into account the huge infrastructural deficit facing Kenya, and the challenges being faced by the Government due to shortage of funds, it has become imperative for the Governments and corporates to access alternative financing techniques to meet their capital development needs.

The alternative is Sukuk. There are several reasons why Sukuk are becoming attractive financing instruments. Principally, Sukuk offer an ideal way of financing large projects for public utility that would otherwise not have been possible to achieve. Sukuk offer long-term financing solutions and are securitized financing instruments with tangible assets. Finally, the risk angle of Sukuk is considered fairly low as the Sukuk are asset based and as such the real value of the asset is ascertainable as opposed to the debt based conventional bond.

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26 The National Treasury, Annual Public Debt Management Report 2014/2015 (2016)

27This data is available on the ADB website <https://www.afdb.org/en/news-and-events/article/afdb-and-kenya-sign-agreements-for-financing-infrastructure-projects-12767/> accessed on 17th January 2017

28 Felix Njini, 'Kenya Says in Final Stages of Arranging $600 Million China Loan' Bloomberg (Kenya 14 April 2016) accessed on 16th January 2017

29 Ibid

30 The Treasury, Annual Public Debt Management Report 2014: 2015 January 2016

1.5.STATEMENT OF OBJECTIVE

The main objective of the research paper is to establish the viability of sovereign Sukuk as an alternative source of government funding for infrastructure development projects in Kenya.

Under this main objective, this research paper will also seek to establish whether there are Legislative gaps in Kenya's regulatory framework in dealing with Sukuk and to propose considerations for governing the domain of sovereign Sukuk.

In order to meet the main objective, a number of research questions are formulated and these are presented in the next section.

1.6.RESEARCH QUESTIONS

The main research question to be addressed by this paper is: are sovereign Sukuk viable as an alternative source of government funding for infrastructure development projects in Kenya?

To answer this question the following five sub-questions are formulated:

(a) What are Sukuks and the principles that guide Sukuk issuance?
(b) What is the place of Sukuks in Kenya's capital market framework?
(c) Are Sukuks a viable alternative source of funding to development projects in Kenya?
(d) What experience can be drawn for Kenya from the United Kingdom's legal framework on Sukuks?
(e) What pertinent issues to address in formulating laws to govern the issuance of sovereign Sukuk?

1.7. CONCEPTUAL FRAMEWORK

Sukuk is an Islamic finance instrument and like all Islamic finance instruments, it has to be adherent to the strict principles of Shariah.[31]

The Islamic economic system differs substantially from the conventional one as it is goes beyond the pure financial and economic sphere. The most important foundation of Islamic Finance is the Shariah which provides a religious framework as well as social and ethical boundaries for Islamic finance. The foundation of Islamic Banking is based on the Islamic faith, explicitly stating that the

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[31] Shariah literary means "the way" and it is generally understood to be the body of Islamic religious law.

operations of Islamic finance must stay within the limits of Islamic Law in action as well as in deeds. 'Shari' ah' – an Arabic word meaning 'way to the source of life' is used to refer to legal system of keeping with the code of conduct and behaviour called by the Holy Qur'an.

It is therefore evident that Islamic finance cannot be discussed without going into the entire philosophy of the religion behind it. The *Quran* and *Sunnah* dictate every aspect of the life of a Muslim, and that includes economic activities, and sets down mandatory guidelines that govern the kind of economic activities to be engaged in by Muslims. Consequently, an economic module that is borne out of this religious philosophy will definitely have objectives and characteristics vastly different from conventional economic modules. The area of Islamic finance is guided by the *Quran*, *Sunnah*, *Hadith* and most importantly *Fiqh*.[32] The combination of these four bodies of Islamic law gives the moral principles, concepts and rules that underpin the essence of Islamic finance.

Islamic finance system revolves around three main principles. The first and most elementary principle of Islamic financing is the prohibition of usury (interest). This prohibition is based on the Quranic verse: "*Trade is like usury, but God hath permitted trade and forbidden usury"*.[33] Usury has been prohibited in Islam for the sole reason that it leads to the exploitation of the needy which in turn leads to social injustice and economic inefficiency resulting in discouraging tangible growth and promoting social and economic inequalities and consequently inciting social instability.[34]

Secondly, the Quran also prohibits investment in certain ventures that are considered *haram*.[35] These include the prohibition of investment in businesses related to alcohol, pork products, gambling, pornography, and weapons. It follows then, that the assets underpinning the Sukuk should not involve these prohibited businesses.[36]

32 In Islamic jurisprudence, Fiqh refers to the science of study of divine law.
33 Qur'an-Surat Al-Baqara verse 275
34 Al-Saeed K, "Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations" (Theses, Durham University) http://etheses.dur.ac.uk/3502/ accessed on 24th November 2016
35 Haram means that which is forbidden in Islam.
36 Craig Nethercott and David Eisenberg, Islamic Finance Law and Practice (1st Edn OUP 2012)

Third, Shariah compliant investment must apportion risk between the parties involved. This is important as Islam seeks to promote economic justice and morally sounds economic activities. Parties engage in any economic activity must share the risks of the venture and apportion the profit appropriately.[37]

1.8.RESEARCH METHODOLOGY

Based on the objectives of the study, this research is desktop based. This involves the review of secondary data. This data is utilized in the conduct of this research. Secondary data is data that has already been collected by other researchers on the subject matter and is typically available in written, typed or in electronic forms. It is further classified in terms of its source; either internal or external.

Secondary data in the form of reports from the Ministry of Finance, Central Bank of Kenya and the Treasury is reviewed to find out whether Sukuk has ever been considered as an alternative source of funding. To enrich the study, the research also utilizes books and academic journals from various jurisdictions to enable the researcher draw comparatives.

This study being entirely based on secondary data is prompted by the fact it would otherwise be impossible for the researcher to collect primary data on the impact of infrastructure Sukuk on the economic development of countries around the globe ranging from the United Kingdom, Luxembourg, Malaysia and Indonesia. Therefore the use of selected data that on economic and social development indicators is thought to be vital for the analysis of the study.

1.9.LIMITATIONS OF THE STUDY

The first limitation is the inadequacy of data on Sukuk. The data for empirical research in Sukuk is extremely limited compared to the data available for conventional bonds. This is especially the case for research in Sukuk application in developing countries and specifically Kenya. The bulk of the data available is from countries like United Kingdom, Malaysia, Luxembourg, Indonesia and the Middle East. While this data is instructive in answering the question of how Sukuk works.

[37] Muhammad Al-Amine, Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation (Brill's Arab and Islamic Law 2011)

It does very little in terms of giving an ample context on the operation of Sukuk in developing countries like Kenya.

The lack of prior research on Sukuk in developing countries, especially in Africa also limits the scope of this research. This is probably attributable to the lack of experience by these countries in Sukuk issuance. The concept of Sukuk is new in Africa but is gradually catching up. Countries like Senegal and Nigeria are at their infancy stage of Sukuk issuance.[38]

Aside from this, the second limitation is the varied view among scholars, researchers, and regulators globally on how the basic principles of Islamic finance should be interpreted in the context of Sukuk. The data available varies from jurisdiction to jurisdiction depending on the social, economic and market circumstances. Countries like Malaysia have a more developed Sukuk market and the data available is quite vast. The shariah principles applied in the Malaysian context is very stringent as compared to emerging Sukuk markets like the United Kingdom and Luxembourg. The lack of standardization of the shariah principles exposes this study to various points of view which the author has to take note of and present.

1.10. LITERATURE REVIEW

With the rapid expansion of the global Islamic finance sector, there has not been a lot of writing about this topic and a vast majority of the available limited literature is attributable to the United Kingdom, the Middle East, Luxembourg, Indonesia and Malaysia. The literature covers the vastness of the subject; from structures to Shariah compliance issues to viability. A wide array of statistics has also been analyzed. This analysis differs from region to region because of the differences in the level of development of regulatory and legal regimes and Shariah governance frameworks. There is a stark contrast between the implementation of Sukuk in Malaysia and Indonesia on one hand and the United Kingdom and Luxembourg on the other hand. The former

[38] Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation COMCEC; The Role of Sukuk in Islamic Capital Markets, COMCEC Coordination Office 2018. Accessed on 2nd August 2019 at << http://www.sbb.gov.tr/wp-content/uploads/2018/11/The_Role_of_Sukuk_in_Islamic_Capital_Markets .pdf>

have a more elaborate structure as opposed to the latter, who being the only European Countries that have issued sovereign Sukuks, are implemented at a much smaller scale.

The vast majority of literature on Sukuk can be classified into three broad categories.[39] The first category comprises of literature that revolves around the of Shariah perspective of the underlying theoretical nature of Sukuk.

According to Mohamed Taqi[40] Sukuk issuances replicate the structure of conventional bonds in terms of the right to a fixed returns and the guarantee of repayment of principal but are different in the sense that the returns on Sukuk is generated from an underlying asset and not from the obligation to pay interest.

Abdullah[41] posits that any lawful business- in the context Islamic Shariah- must involve some level of risk and that Islam prohibits one to profit from an investment if they bear no risk on its outcome. Zaher & Winbergen[42] on the other hand found that adherence to Islamic Shariah considerably simplifies the structuring Sukuk. These authors support their opinion by claiming that Shariah compliance encompasses a clear allocation of property rights which to them is a great consideration given the inherent nature of Sukuk being asset based or asset backed. Nourah[43] adopts the contrary view and posits that structuring complex Sukuk develops a better compliance issuance and that the complex features work to achieve better Sharia compliance.

Chambers[44] delves into the difference between asset based Sukuk and asset backed Sukuk. He posits that asset backed Sukuk, though being rare, as the only truly Shariah compliant Sukuk

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39 Muhamed Zulkhibri, A synthesis of theoretical and empirical research on Sukuk
Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia
Accessed at https://pdf.sciencedirectassets.com/305925/1-s2.0-S2214845015X00056/1-s2.0-S2214845015000368

40 Muhammad Taqi, Sukuk and their contemporary applications 2008. Accessed on 2nd August 2019 at <http://Sukuk.net/library/education/MuftiTaqiSukukpaper.pdf>

41 Abdullah A, Asset-Based vs Asset-Backed Sukuk, (2012 3(4) I.C.R. 751.

42 Zaher S and Winbergen S, Sukuk Defaults: on Distress Resolution in Islamic Finance

43 Nourah M, A Critical Analysis of Asset-Backed Sukuk from Sharia Perspective and Observed Risk Mitigation Process in Sukuk Structure: A Case Study in Saudi Arabia. Accessed at < http://etheses.dur.ac.uk/12297/1/Final_Draft_7000.pdf?DDD2+> on 4th August 2017.

44 Chambers J, A Comparative Study of Conventional Bonds and Islamic Sukuk and their Use of the Trust Instrument

structure as it has the requisite risk sharing characteristic of Shariah compliant products because it has no guaranteed income stream. He argues that if the asset backing the Sukuk is utilized optimally the Sukuk holders profit and if it performs badly then the loss are shared.

Maurer[45] takes a similar view and postulates that asset based Sukuk only bear the form of a Shariah-compliant instrument, but not the substance. His argument is based on the fact that in an asset based Sukuk, the underlying property is not legally transferred to the Special Purpose Vehicle (SPV) issuing the Sukuk but rather remains with the originator. Further, he states that since the property in the underlying asset is not transferred to the SPV, the returns are not tied to the venture or asset itself but to the obligations of the originator. He states that any risk or loss on the underlying asset is only borne by originator and not the individual investors-which goes against the principles of risk-sharing in Islamic finance.

El-Gamal[46] suggests that the fact that asset backed Sukuk are far much more utilized as compared to asset based Sukuk raises crucial questions as to the purpose of Sukuk. They seek to inquire whether the asset based Sukuk was developed to be a truly Shariah compliant financial tool or is it simply a mechanism to allow Islamic institutions access funds they would otherwise not access. Their answer is that investors seek the brand shariah compliant regardless of true shariah compliance. They also posit that the Accounting and Auditing Organisation for Islamic Financial Institutions[47] (AAOIFI) has had to moderate some of its principles order to accommodate the modern market.

Sawkat M, Uddin H and Humayun K[48] on their part point out that the success of Islamic finance depends on both satisfying faith and economics. They then make a finding that among the key

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[45] Bill Maurer, ‘Form versus substance: AAOIFI projects and Islamic fundamentals in the case of Sukuk’ (2010) 1(1) J.I.A.B.R. 32

[46] Mahmoud A. El-Gamal, Islamic Finance: Law, Economics and Practice. Cambridge University Press 2006.

[47] The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry.

[48] Sawkat M, Uddin H and Humayun K, Sukuk As A Financial Asset: A Review AAFSJ 2018 Vol: 22 Issue <https://www.abacademies.org/articles/Sukuk-as-a-financial-asset-a-review-7134.html>

challenges facing is the prevalent scholarly disagreements among the shariah experts on the guiding principles that inhibits standardization of Sukuk contracts. A similar view is shared by Malik and Mustafa[49] who perceive that the merging matters of faith and financial restrict Islamic finance from being fully implemented especially in non-Muslim countries.

The above literature captures the Shariah perspective of the underlying nature of Sukuk. It appears to suggest that in order to ensure the benefits of integration of the Islamic financial sphere with the conventional financial sphere in a globalized economy, there must be a modern approach to the traditional Shariah-compliant transactions.

The second categorization comprises of literature that focuses on the operational aspects of Sukuk with respect to issuance and structure. This includes legal and regulatory considerations, and, innovation in Sukuk.

The literature also highlights the unresolved issue of the harmonization in Shari'ah and the need to have a credible standard set for sound Islamic accounting, which can be adopted for Sukuk issuance. Zukhibri[50] argues that investments in Sukuk give rise to a number of accounting and reporting issues related to accounting recognition, measurement and disclosures. He also argues that a sound accounting and reporting standard for Islamic financial instruments is the main requirement for a well-regulated Islamic financial market that meet the requirements of Shari'ah-compliant and market practicality.

Abdelkhaleq and Richardson[51] argue that the lack of standardization gives rise to legal challenges to issuing Sukuk in non-Islamic jurisdictions and that a strong effort to improve and provide an ideal accounting standard is necessary for enhancing reliable financial statements.

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49 Malik S, Malik A and Mustafa W, Controversies that make Islamic banking controversial: An analysis of issues and challenges. *American Journal of Social and Management Sciences*, *2011. Accessed at* <https://www.scihub.org/AJSMS/PDF/2011/1/AJSMS-2-1-41-46.pdf> on 3rd August 2019

50 Zukhibri M, A synthesis of theoretical and empirical research on Sukuk. Accessed at < http://www.elsevier.com/journals/borsa-istanbul-review/2214-8450> on 3rd August 2019

51 Abdel-Khaleq, A., & Richardson, C. (2007). New horizons for Islamic securities: emerging trends in Sukuk offerings. Chicago Journal of International Law, 7(2), 409–425

Rahman[52] suggests that a proper development of the Sukuk market requires a well-regulated Islamic financial instrument that is in accordance with Islamic accounting regulations. He also emphasizes that it requires a sound accounting and reporting standard for Islamic financial instruments that meet the requirements of Shariah.

Jobst, Kunzel, Mills and Sy[53] write that the divergence in the legal and regulatory framework in the Sukuk market weighs against Sukuk from a cost-benefit analysis. They posit that the Sukuk's unique structuring considerations can lead to additional costs while its rigid guidelines limit fiscal flexibility. This according to the authors, makes the structuring and issuance costs of Sukuk higher than they are for a standard security.

Terebessy[54] argues that structuring ṣukuk to imitate the conventional bonds exposes the Sukuk investors to risks that are nearly identical to the risks facing buyers of the conventional bonds and highlights the risk of default in particular. He advises that Sukuk have to be structured in a genuinely risk-sharing format so as to enhance investor protection. He also argues that in a proper risk-sharing arrangement, the risk of default does not arise in the first place.

According to the AAOIFI Sukuk Investment Standard 17, there are fourteen types of Shariah structures in Sukuk securitisation, and each of those structures follows a different type of sale contract that underlies the Sukuk securitisation. This raises the question of how to identify, evaluate and measure the risks of Sukuk, and develop methods for how to manage these risks.

This research has also found a third emerging category of literature which focuses on the viability of Sukuk as alternative sources of bridging the budgetary deficit for funding government projects. Sukuk can play a significant role in bridging the budgetary deficit in both the long and the short term, through its ability to mobilize resources and finance development projects. In this regard,

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52 Rahman, A. R. (2003). Accounting regulatory issues on investments in Islamic bonds. International Journal of Islamic Financial Services, 4(4),20–35

53 Jobst, A; Kunzel, P; Paul Mills, P; Sy, A (2008). Islamic bond issuance: what sovereign debt managers need to know? International Journal of Islamic and Middle Eastern Finance and Management, 1(4), 330–344.

54 Terebessy L, Benefits of Risk-Sharing in the Structuring of Sukuk ICR 2.3. accessed at <https://www.icrjournal.org/icr/index.php/icr/article/view/159/154> on 7th May 2019.

Adam and Thomas[55] argue that while Sukuk are the peak of innovation in Islamic finance the full potential of the Sukuk range of securities is far from being realized. This includes how to identify eligible assets, set up SPVs (Special Purpose Vehicles), credit enhancement, and the challenges and opportunities in the Sukuk market. The authors discuss the methods of structuring (eligible assets, investment vehicles, undertakings and credit enhancement) sovereign or corporate Sukuk issues and at the same time differentiate conventional bonds and the development of the sovereign and corporate Sukuk. The authors argue for the utilization of sovereign Sukuk in leasing finance, hedging and risk transference, banking and liquidity management, real estate and Real Estate Investment Trusts (REITs) regulation, and legal and taxation issues.

Siddiqui and Daruwalla [56] highlight the predominant nature of Sukuk and their application in the sovereign Sukuk market. The authors argue for the viability of governments financing a fraction of the budgets through domestic Sukuk issuance.[57]

Jaffer assesses how Sukuk can benefit the global economy. He explores the nature of Sukuk and their viability as an alternative instrument for fund raising to conventional bonds in global markets and concludes that Sukuk provide an enormous pool of capital that can be utilized productively to fund sustainable and equitable economic development. [58]

Amaliah and Aspiranti[59] posit that the traditional tools provide temporary solutions for the problem of the general budget deficit, but it causes the growth of its expenditures, creates inflation, and increase the public burden on current and future generations, as a result of its Ribatism (interest rate) and inflation. So, Islamic instruments (Sukuk) are the most appropriate in financing the budget deficit

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55 Adam Nathif and Thomas Abdulkadir, “Islamic Bonds; Your Guide To Issuing, Structuring and Investing in Sukuk” London: Euromoney Books. p15.

56 Shahzad Siddiqui and Parvez Daruwalla Sovereign Sukuk: Reconsideration, Realignment and the End of Shari'a Arbitrage? 2010, London: Euromoney Books. p6-30

57 Nevi Danila and Stie Malangkucecwara, Modelling retail Sukuk in Indonesia, mimeo (2010)

58 Sohail Jaffer, Global Growth, Opportunities and Challenges in the Sukuk Market 2000, London: Euromoney Books. Pages 11-65.

59 Ima Amaliah, Tasya Aspiranti, “State Sukuk Potential in Reducing Indonesia Budget Deficit, 2009-2015” Journal of Economics, Business & Accountancy Vol 20, No 1 (2017) pages 21 – 30.

Abdulghafar[60] examines the risks attributable to Sukuk as a financing option for public private partnerships and finds that amongst the many benefits that Sukuk offer, the most important one is that it is less risky than the conventional methods of financing public private partnerships. He argues that the risk is evenly distributed between the originators, the Sukuk holders and the SPV hence more attractive in finance such large-scale projects.

Zawya[61] confirms that Sukuk are becoming an increasingly important Islamic financial instrument in both Muslim and non-Muslim countries. Sukuk have also become a significant tool for raising finance effectively and efficiently in term of the allocation and mobilization of resources on international capital markets

Smaoiu and Nechi[62] posit that the development of Sukuk markets will promote financial inclusion and contribute to the deepening of financial markets. They argue that the development of Sukuk has, to some extent, promoted financial inclusion by eliminating the negative effects of religious self-exclusion by pooling in the savings of devout Muslims who are not willing to invest in interest-based bonds. This, they argue, will stimulate investment and hence economic growth. The authors caution that theirs is only a suggestive one and recommend future research to examine the impact of Sukuk market development on various measures of financial inclusion "and study the effect of the lack of financial inclusion on economic growth, poverty reduction, or income inequality".

Other writers like Araar,[63] and, Mujahid and Engku[64] advance an argument that Sukuk as Shariah-compliant instruments have an obligation to consider social goals such as sustainable development. Araar considers Sukuk as a tool for the promotion of social and economic justice and stimulate economic development.

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60 Abdulghafar I, Public Private Partnerships: lesson from Sukuk, 2014. Accessed at < https://www.researchgate.net/publication/260163883>

61 Thomson Reuters Zawya. (2015). Sukuk perceptions and forecast study 2014. Thomson Reuters

62 Houcem Smaouia, Salem Nechib, Does Sukuk Market Development Spur Economic Growth? 2017

63 Araar M, Islamic Finance Based on Sukuk Approach: The Roadmap for Economic Development 2016.

64 Mujahid and Engku, Potential Role of Social Impact Bond and Socially Responsible Investment Sukuk as Financial Tools that Can Help Address Issues of Poverty and Socio-Economic Insecurity, Intellectual Discourse, Special Issue, 2016. Accessed at < https://pdfs.semanticscholar.org/e21e/5eea5d3bd6fb2d233a852fdc47bdd744ae99.pdf> on 3rd August 2019

Mujahid and Engku on their part posit that Islamic finance in general seeks to employ funds in a way that conforms to higher moral and ethical standards in that they also take into account the social returns from the practice that is compliant with their beliefs and ethical values.

Lastly, the AAOIFI standards on Sukuk[65] are also crucial in the discourse on Sukuk. The main aim of this standard, as captured in the preface, "is to elaborate the Shariah rules for the issuance and trading of Sukuk as well as the elaboration of their types, characteristics, Shariah regulations and the conditions for the issuance of Sukuk and dealings in them for trading by Islamic financial institutions. The organization's mandate is to oversee the implementation and adherence to Shariah law by its member institutions. There has been great debate on whether contemporary Sukuk issuances are adherent to the AAOIFI Shariah standards.[66] The AAOIFI standards are derived from shariah principles of Islamic finance and also provide rules pertaining to ethics, accounting and auditing to all the Islamic financial institutions.

1.11. HYPOTHESIS

For the purpose of this research, the fundamental hypothesis is that:

1. Sovereign Sukuk are an ideal and sufficient tool for alternative funding for developmental projects by government; and,
2. A clear legal and regulatory framework is necessary to establish sovereign Sukuk in order to reap maximum benefits from it.

1.12. CHAPTER BREAKDOWN

This research contains seven chapters broken down as follows:

Chapter One provides the background to the research. It also introduces the research question being investigated. The justification for the study and the conceptual framework are also provided in this

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65 Shariah Standard Number 17

66 Zohra Jabeen, Sukuk: Shari'a and Regulatory Implications *(* London: LAP Lambert Academic Publishing 2010 at p6-25)

chapter. This chapter also contains research objectives, the research questions and lays out a review of the literature available on the matter.

Chapter Two provides an in depth introduction to Sukuk as an Islamic finance model. It delves into the historical development of Sukuk and its shariah underpinnings. The chapter also discusses the different types of Sukuk and differentiates between Sukuk and its more conventional equivalent, the bond. Lastly, this chapter examines the principles that guide Sukuk issuance and identifies some of the more common Sukuk structures.

Chapter Three examines Sukuk within the Kenyan capital market's framework. It identifies some of the regulatory set-backs that hinder the issuance of Sukuk in Kenya including the pertinent question of incorporating Islamic accounting standards. Lastly, this chapter discusses how sovereign Sukuk can be used as a tool for raising capital.

In Chapter Four the question whether Sukuk are viable as an alternative source of funding development projects in Kenya is discussed. In discussing this question, Kenya's infrastructure needs vis-à-vis the debt status as at 2018 is outlined, followed by a discussion on how Sukuk could be used to bridge the budgetary deficit.

Chapter Five is an analysis of Sukuk issuance in the United Kingdom with a view to draw lessons from its experience for a country such as Kenya that may consider issuing a Sukuk. The United Kingdom issued its first sovereign Sukuk in 2014 after an elaborate process of reviewing existing laws and formulating them in a manner that would be accommodative of Sukuk. The first UK Sukuk matured in July 2019 and there is speculation that another Sukuk will be floated in 2020.

Chapter Six points out the pertinent issues to address while formulating laws to govern the issuance of sovereign Sukuk. It draws the reader's attention to the specific clauses that have to be formulated in Sukuk laws in order for it to be operative. These clauses address substantive considerations such as the mandate to use public assets to back Sukuk issuance; establishment and governance of Sukuk SPV; limitation on the structure of Sukuk; dispute resolution; apportionment of operation costs and maintenance of the underlying asset; and, compliance with Sharia principles.

The last chapter of this research summarizes the discussions in the preceding chapters and makes recommendations towards the attainment of the objectives.

CHAPTER 2: SUKUKS AND THEIR UNDERLYING PRINCIPLES

2.1 Introduction

The Arabic word *Sukuk* is the plural of the word *sakk*, meaning cheques, deed or order of payment.[67] They are written notes depicting financial obligation or an order to pay. Their history shall be discussed later in this chapter. A number of formal definitions of Sukuk exist.

The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI)[68] under Shari'a Standard No. 17 on Investment Sukuk defines Sukuk as:

> "*Certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity*".

The International Islamic Financial Market (IIFM)[69] defines Sukuk as:

> "*a commercial paper that provides an investor with ownership in an underlying asset*".

Lastly, the Islamic Financial Services Board's (IFSB)[70] definition of Sukuk is as follows:

> "*Sukuk (plural of sakk), frequently referred to as "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 (such as a Mudarabah). These assets may be in a specific project or investment activity in accordance with Shariah rules and principles*".

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67 M. A. Khan, "Islamic Economics and Finance: A Glossary" (Routledge: London, 2003), p.163; S. Cakir and F. Raei, Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk? (IMF Working Paper 07/237) (Washington: International Monetary Fund, 2007), p.3.

68 The AAIOFI is a nonprofit organization established in March 1991 to maintain and promote Sharia standards in the Islamic financial industry. Since its establishment," it has been supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry worldwide

69 IIFM is a standard-setting body of the Islamic financial services industry focusing on standardization of Islamic financial contracts and products.

70 IFSB is also a standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

From the definitions above, Sukuk are shariah compliant investment certificates of ownership representing a share in a tangible asset. Each sakk represents an undivided share in the ownership of the asset underlying the investment. These Sukuk are structured in accordance with the Islamic shariah principles and geared towards the maximization of profits and aversion of risk, gharar.

From these definitions, it is clear that an investor in a Sukuk does not own a debt obligation owed by the bond issuer, but instead owns a piece of the asset that's linked to the investment. This means that Sukuk holders, unlike bond holders, receive a portion of the earnings generated by the asset.

Sukuk may be issued by sovereign and corporate entities to finance their activities. Similar to bonds, Sukuk have a maturity date with often a regular stream of income over the life of the certificate, along with a final bullet payment at maturity.[71]

The aim of Sukuk is to provide alternative source of funding to the conventional bond which is not compliant with shariah.

2.2 Difference between Sukuk and the conventional bond

More often than not, Sukuk are equated to bonds in the conventional capital market.[72] There is a fundamental difference between the two aside from the basic one, being that Sukuk are shariah compliant while bonds are not.

The first, and most obvious, difference is that while a Sukuk represents ownership of a share of the asset underlying the investment, the conventional bond represents a debt obligation on the part of the issuer. It is the ownership of a share in the underlying asset that captures the uniqueness of Sukuk as compared with the debt obligation created by conventional bonds. Sukuk represent aggregate and undivided shares of ownership in a tangible asset as it relates to a specific project or a specific investment activity.

Consequently, Sukuk holders are entitled to a share in the revenues generated by the Sukuk assets. The sale of Sukuk relates to the sale of a proportionate share in the assets. When you sell Sukuk, you are selling ownership in the assets backing them. The sale of bonds is the sale of debt.

[71] Natalie Schoon, "Islamic Asset Management: An Asset Class on its Own?" Edinburgh University Press, (2001)
[72] Ibid

Secondly, Sukuk are different from conventional bonds because the latter do not include the risk sharing element which is an important component of Islamic finance.

Thirdly, the value of Sukuk may appreciate in tandem with the value of the asset underlying the Sukuk. If the asset raises in value, then the value of the ownership of that asset, backed by the Sukuk, increases.[73] Bonds do not have this characteristic. Increase in revenue from a bond is the direct result of the fixed interest rather than in any kind of tangible increase in value.

Fourth, Sukuk are priced according to the value of the assets backing them. Bond pricing is based on credit rating. [74]

Despite the fact that Sukuk and bonds are different in nature, this does not mean that they do not have few similarities. The first similarity is that both Sukuk and bonds can be traded in the financial market. Secondly, both Sukuk and bonds have maturity dates during which time returns are paid off and rights extinguished.

2.3 Historical development of Sukuk

The origin of the word "*sakk*" traces back to the early Islamic Caliphates where a *Sukuk* were used to represent financial obligations originating from trade and other commercial activities. The earliest Sukuk ever issued can be traced back to the period of 7th Century AD during which papers representing financial obligations originating from trade and other commercial activities were issued between merchants.[75]

The custom of exchanging Sukuk as representing financial obligations originated from the adherence to the commands in Holy Qur'an, which encourages fixing contracts in writing. In Quran, God commands that:

> "*When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing…It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves'*.[76]

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73 Mohamed Al-Amine, "Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation" (Brill's Arab and Islamic Law 2011)
74 Ibid
75 Latham & Watkins, The Sukuk Handbook: A Guide To Structuring Sukuk
76 Surat Al-Baqara verse 282

This custom of exchanging sakk was spread through trade between merchants of Arab origin who travelled between the Middle East and Europe. The English word '*cheque'* appears to have been derived from the Arabic word *sakk.*[77]

Early examples of the use of Sukuk can be traced back to the Umayyad Dynasty[78] under the rule of Khalifah al-Marwan ibn al-Hakam where soldiers and civil servants were paid in the form of *Sukuk* redeemable for cash and commodities such as grain.

The use of Sukuk by sovereign issuers to raise funding for governments can be traced back to the Ottoman Empire[79] in 1775 where it issued Sukuk to fund its budget deficit after its defeat by the Russians. The government securitized the tobacco custom collection, in which the investors received returns for the rest of their life. In essence, the Ottoman government borrowed money against future income on tobacco customs levies to fund its budget deficit.[80]

Even though Sukuk were used from the early periods of Islam, they gained their current status much later.

2.4 The re-emergence of Sukuk

The development of Sukuk as a capital market instrument can be attributed to the predominance of the conventional bond in the capital market, bearing in mind that these bonds were not attractive to Muslims because of their inherent shariah non-compliance. The predominance of the conventional bond triggered the interest of Muslim experts to come up with a prototype that would extend the same financial utility of the conventional bond but within the confines of shariah. This, arguably, paved the way for the invention of an alternative to meet the needs of Islamic issuers and investors who are not allowed under the Shariah principles to invest in conventional bonds.

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77 Scott Morrison, 'Scott Morrison' *The Barrister* < http://www.barristermagazine.com/barrister/index. php ?id=550> accessed on 22nd February 2017

78 The Umayyad Dynasty ruled from 661-750 CE

79 The Ottoman Empire ruled from 1301-1922.

80 Naveed Mohammed, "A History of Islamic Finance" (2015) <https://www.islamicfinance.com /2015/02/ an-overview-of-the-history-of-islamic-finance/#_ftn3> accessed on 22nd February 2017.

As late as 1988, the Council of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC)[81] in its Fourth Session held in Jeddah, Kingdom of Saudi Arabia conceptualized the modern day Sukuk. The council defined Sukuk as:

"investment instruments which allocate the [mudarabah] capital by floating certificates, as an evidence of capital ownership, on the basis of shares of equal value, registered in the name of the owner, as joint owners of shares in the venture capital or whatever shape it may take, in proportion to . . . each one's share therein.[82]

This conference seems to have kick started the issuance of Sukuk in the Middle East and South East Asia regions. Malaysia issued its first corporate Sukuk in 1990 for the sum equivalent of $30 million.[83] Since then Sukuk have been used by both the corporate sector and states for raising alternative financing and have been growing in popularity.

It is at the dawn of the millennium that Sukuk robustly took off. From 2000 onwards, a number of institutions started issuing Sukuk and the Sukuk market took off from there. Sukuk have become indispensable Islamic financial instruments in raising funds for long-term project financing. Over this time, the Sukuk market has dramatically grown up to become one of the fastest emerging alternative instruments and a significant capital markets tool which are increasingly used by governments, government-held entities and corporations, not only in the Middle East and South East Asia, but in a number of other countries across the globe.

Owing to the rapid expansion of the Sukuk market, the need for regulation, standardization and monitoring of adherence to Islamic shariah principles arose. In 2003, the AAOIFI issued its shariah standard number 17 on investment Sukuk. The aim of these guidelines is to facilitate the trade in Sukuk and create rules to safeguard shariah-compliance of each Sukuk structure.

Despite the fact that Sukuk have been in existence since the revelation of Islam, it is remarkable they only became a prominent feature in Islamic capital market in the 20th century, a period when

81 The OIC is the second largest inter-governmental organization after the United Nations with a membership of 57 states spread over four continents. The Organization is the collective voice of the Muslim world and issues pronouncements on various aspects of Islamic faith including commercial transactions.

82 International Islamic Fiqh Academy, Resolutions and Recommendations of the Council of the Islamic Fiqh Academy, 1985-2000 (Jeddah, Saudi Arabia: Islamic Development Bank, 2000), 61-62.

83 Malaysia's first issue was Shell MDS issue in 1990 was worth RM125.0 million.

most Islamic Banks globally were established. Even then, Shari'ah-compliant financial products were not a mainstream play until the 21st century, a time of unprecedented growth exemplified in the sovereign Sukuk issuances by Malaysia, the State of Qatar, the Republic of Pakistan and the Emirate of Dubai.

Global Sukuk issuances are projected to hit US$250 billion by 2020.[84] The anticipated surge in issuances is attributed to the potential demand for Sukuk surpassing supply, and marks the re-emergence of Sukuks as instruments for raising debt capital and finance.

2.5 Shariah underpinnings, and basic principles of Sukuk issuance

Like all Islamic finance instruments, Sukuk issues principally have to be compliant with the shariah underpinnings,[85] and basic principles of trade and finance under Islamic law. The main shariah principles that are relevant to the discourse on Sukuk are the following[86]

The first is prohibition on the charging of interest (or *riba*). The prohibition of interest is one of four major prohibitions that define the structuring of *Sukuk*. Charging interest on lending money is prohibited by the Quran. Shariah requires that any return on money provided by the financier be earned by way of profit derived from a commercial risk taken by the financier. Any risk free or guaranteed return on a loan or investment will constitute Riba and therefore will be prohibited.

The second underpinning is prohibition on the engagement in business such as prostitution, alcohol or pork. The assets underlying the Sukuk must be Shari'ah-compliant and therefore cannot be related, for example, to prostitution or to the production or sale of pornographic material, alcohol or pork.

The third is prohibition on uncertainty-*gharar.* The Qur'an prohibits. Muslims from participating in ambiguous and uncertain transactions. [87]According to Islamic Sharia, parties to any business

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84 Thomson Reuters-Sukuk Perceptions Forecast Study 2017

85 Shariah simply means 'the way' and comprises of the body of Islamic religious law that governs religious rituals as well as all other aspects of day-to-day of a Muslim.

86 Linklaters, "Shari'a-compliant Securities (Sukuk)" (2012) < https://www.islamicfinance.com/wp-content/uploads/2015/06/Linklaters-Sharia-Compliant-Securities-Sukuk.pdf>

87 Quran in Surat-Al-Bakarah, 2:188 and Surat Al-Nisa, 4:29

transaction should have a proper control over the business so that profit and loss will be equally shared.

The final one is prohibition on gambling and speculation-*maisir*. The Quran[88] strictly prohibits all forms of gambling. Gambling/*maisir* is referred to the easy acquisition of wealth by sheer chance for example earning through lotteries, lotto and casinos. Gambling and games of chance revolve around earning a reward out of pre-meditated risk-taking.

With respect to the underlying principles for all Sukuk issuances, these are five and as follows: first, the Sukuk issuance must be used for Shariah compliant activities.[89] This emanates from the very nature of Sukuk as Islamic finance instruments and in that regard, must comply with the Islamic Shariah guidelines set out in the preceding part of this chapter. The second principle is that the fund raised must be used to finance tangible assets.[90] Specificity of assets is important, since Sukuk, unlike conventional bonds, cannot be used for general financial needs of the issuer. The third principle is that income received by Sukukholders must be derived from the cash flows generated by the underlying asset. This is closely linked to the above principle in that Islamic Shariah forbids the trading of money for money. Shariah prefers trade in tangible assets as opposed to enabling traders gain quick returns on money alone. The fourth principle is that Sukukholders have a right to the ownership of the underlying asset and its cash-flows during the pendency of the Sukuk transaction. In a Sukuk arrangement, each of the investors has an undivided interest in the underlying assets and is therefore entitled to share jointly the related returns and cashflow as each Sukuk represents a proportional ownership of the underlying asset. The final principle is that there needs to be a clear and transparent allocation of rights and obligations of all parties to the transaction, in particular the originator and Sukukholders as they are the main parties to the Sukuk transaction.

2.6 Types of Sukuk

The essence of Sukuk is to provide Sharia compliant instruments for investment which do not involve payment of interest or excessive uncertainty. The Sukuk market has been a primary area

88 Quran in Surat-Al-Bakarah, 2:219 and Al-Maidah, 5:93

89 Investment must avoid prohibited investment such as pornography, alcohol, prostitution, gambling and pork.

90 It is forbidden to trade money for money as it is likened to usury.

of growth, providing an opportunity for the short, medium and long term investment of funds by Muslim investors. There has been an increase in Sukuk issuance by sovereign and corporate entities which has been propelled not only by the desire of institutions to raise funds in a Sharia compliant manner but also by investor demand for such products.

Sukuk are categorized based on their intended purpose. The AAOIFI has approved fourteen Sukuk structures[91] that are shariah compliant. The structure is uniform for both corporate and sovereign issuers and both must comply with the guidelines set for each type of Sukuk.

At the very minimum, the choice of Sukuk type will depend on two main factors. The first is the character of the underlying asset and the second is the targeted investor base.

This research focusses on sovereign Sukuk structures that will enable government to bridge the funding gap for development projects. The most commonly used Sukuk structures by sovereign issuers are ijara, mudaraba and musharaka.

The ijara Sukuk is the most common type of Sukuk structure and is considered to be the quintessential Sukuk structure from which all other Sukuk structures are derived[92]. Ijara means lease and as such, Sukuk ijara are tied up to a lease contract. Under this structure, ownership of the underlying asset is transferred from the originator to Special Purpose Vehicle (SPV), which then issues to investors Sukuk certificates representing undivided ownership interests in such assets. The asset is then leased back to the originator by the SPV for a specified term, which is typically commensurate with the term of the certificates. Each Sukukholder is entitled to receive the rentals generated under the lease pro rata to its ownership interest in the underlying asset. On the date of commencement, the originator will enter into a purchase undertaking which gives the right to the SPV to oblige the originator to purchase the assets following a Sukuk dissolution event or on scheduled maturity, at a price equal to the principal amount plus any accrued but unpaid periodic distribution amounts. The money received by the SPV will be used to pay the dissolution amount due to investors under the Sukuk. Since the payments under the Sukuk are dependent on payments to the SPV by the originator under the relevant ijara contract and purchase undertaking,

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91 AAOIFI standard number 17

92 Latham & Watkins, "The Sukuk Handbook: A Guide To Structuring Sukuk" (Second Edition) < https://www.lw.com/thoughtLeadership/guide-to-structurings-sukuk> accessed on 3rd May 2018

in a similar manner to a corporate bond, the Sukukholders are assuming the credit risk of the originator.

In the event of default by the originator to purchase back the asset, the sukuholders have a right to dispose off the asset to offset their investment.[93] In the event the Sukuk is not asset backed, the Sukukholders, in a default scenario, have a contractual claim against the originator for non-payment of the purchase price for the assets in accordance with the purchase undertaking.[94]

The mudaraba Sukuk is based on a common Islamic finance structure where one partner provides capital to another who uses its expertise and labour to invest the capital in return for a pre-agreed share of the profit generated. Thus, in the context of Sukuk, an SPV is usually established to issue the Sukuk and contribute the proceeds raised from the investors as mudaraba capital. The originator of the Sukuk contributes expertise, labour and possibly cash, serves as *mudarib* and manages the capital. Any profits generated by the mudaraba are divided between the SPV and the originator in accordance with a pre-agreed profit-sharing ratios set out in the mudaraba agreement. The SPV uses the profits it receives from the mudaraba to make payments of the periodic distribution amounts due under the Sukuk.

A musharaka Sukuk is based on an arrangement that entails the contribution of capital (either in cash or in kind) by two or more partners to the partnership. The musharaka partners share the profits in prearranged ratios. These are certificates of equal value of ownership issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing business activities on the basis of a partnership contract so that the certificate holders become the owners of the project as per their respective shares.

2.7 Chapter Conclusion

The intrinsic features of Sukuk have been highlighted in this chapter, and a background of what Sukuk is and its origins given. The fact that Sukuk is a financial product does very little in terms of detaching it from being based on the Islamic faith. Given its religious origins, and the

93 Zaher S and Winbergen S, "Sukuk Defaults: on Distress Resolution in Islamic Finance" (2013) <https:// papers.tinbergen.nl/13087.pdf> accessed on 3rd May 2018

94 Ibid

difference that lies between and conventional bonds, Sukuk has to strictly adhere to the provisions of the Islamic shariah principles highlighted.

CHAPTER THREE: SUKUK IN THE CAPITAL MARKET'S REGULATORY FRAMEWORK IN KENYA

3.1 Introduction

The ultimate goal of this chapter is to examine the nature of the regulatory framework that would be required for the introduction of sovereign Sukuk in Kenya. Ideally, this discussion cannot kick-off without properly examining the current legal framework underpinning Islamic finance in Kenya. This will then introduce the discussion on how the current framework facilitates or undermines the issuance of sovereign Sukuk and what changes would be necessary to remedy the situation. As a starting point, consideration will be given to the regulatory framework covering Islamic finance generally before narrowing down to Islamic finance capital markets where Sukuk falls under.

Aspects such as the applicability of shariah principles will be looked at closely with a view to establishing whether Sukuk can operate within the current regulatory framework. The overall uplifting of this sector will ensure the expansion of the capital market beyond the basic conventional products, and the positive implications for broader capital market activity will also contribute to the overall growth of the financial services industry.

3.2 Analysis of Kenya's Capital Market Laws from an Islamic Finance perspective

Developing countries face significant financial shortcomings when it comes to financing SDG related projects. Sukuk provides an alternative to bridging the glaring financial gap. The emergence of Sukuk has been a significant development in Islamic capital markets in recent years. Funds raised through Sukuk can be allocated in an efficient and transparent way to infrastructure initiatives and other large-scale projects related to SDGs.[95] Sukuk issuance aids in the mobilization of financial resources from the private sector and to incentivize the private capital to invest in

95 The Islamic Development Bank Group, 'Islamic Finance and Socio Economic Development: Role of Capital Markets', (2018) <http://www.oicexchanges.org/docs/11th-forum-meeting-presentations/4---islamic-finance-structures-for-capital-markets-mr-saleh-jelassi-director-of-country-gateway-office-in-turkey-idb.pdf accessed 23 May 2018

public infrastructure development.[96]

Trends across the world reveal that Islamic finance has grown rapidly at an estimated 10-12% annually.[97] The World Bank estimates the Islamic finance market to be roughly $2 trillion[98] with expectations of market size to be $3.4 trillion by the end of 2018[99]. Most of this activity is concentrated in the Middle East, Indonesia and Malaysia all accounting for about 68% of the total capital raised from Sukuk. These countries enjoy that privilege substantially due to their huge Muslim populations. The demand for these products is high hence the huge turnover as compared to other regions where the Muslim population is not as big.

In Kenya, the Muslim population is a paltry 4.5 million according to the 2009 census.[100] Despite this, there has been a steady growth in the Islamic finance industry in Kenya. The country currently has two fully-fledged Islamic banks and several other conventional banks with Islamic windows offering Islamic banking products and services.[101] Other aspects of Islamic finance that have taken root in Kenya are the Takaful insurances[102] and Collective Investment Schemes (CIS).[103] The capital markets sector has seen introduction of Islamic bonds in the form of corporate Sukuk. The Capital Markets Authority however firmly believes that the pillars for the future development of Islamic finance in Kenya have been firmly laid. This belief is pegged on the diverse number of

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96 Rami Abdelkafi, Houssem Eddine Bedoui, 'Challenges in Infrastructure Financing Through Sukuk Issuance' (2016) <http://www.irti.org/English/Research/Documents/WP/449.pdf > accessed on 23 May 2018

97 This growth covers both bank and non-bank financial institutions, capital markets, money markets and takaful insurance.

98 World Bank, Islamic Development Bank Group, Global Report on Islamic Finance : Islamic Finance - A Catalyst for Shared Prosperity? (2017) <https://openknowledge.worldbank.org/handle/10986/25738> accessed on 23 may 2018

99 Naveed M, 'The Size of the Islamic Finance Market', (2014). Available at <https://www.islamicfinance.com/2014/12/size-islamic-finance-market-vs-conventional-finance/> accessed 24 May 2018

100 Kenya National Bureau of Statistics, <https://www.knbs.or.ke/religious-affiliation/> accessed on 23 May 2018

101 The Central Bank of Kenya (CBK) licensed two Islamic banks - Gulf African Bank (GAB) and First Community Bank (FCB), while various other banks are offering Shariah compliant services and products through "Islamic Windows".

102 Takaful refers to islamic insurance and is primarily based on the principle of mutual assistance. Takaful is the Islamic alternative to the conventional insurances which contradict the strict principles of Shariah law.

103 These refer to schemes where individuals pool their resources for purposes of investing in a particular investment and share the profits as agreed. Islamic CIS have the additional requirement of complying with Shariah principles.

products that have been introduced to the sector. These developments have contributed to formerly unbanked Kenyans to have access to a wider variety of financial services adding to the wealth creation in the economy.

All these aspects of Islamic finance exist under the prevailing laws that govern the conventional finance sector. These laws are not consolidated under one statute but are scattered across a number of legal instruments in the finance sector. There is need to enact legislation governing Islamic finance so as to bring out the full essence of the sector.

There is the argument out there that Islamic finance in Kenya will remain a dormant sector because of the lack of proper legislation to govern it. Presently, the sector cannot come to vibrancy due to the limiting regulatory framework that does not appreciate the intrinsic foundation of Islamic finance, which is Islamic shariah.[104]

Financing under Islamic Sharia requires a strict adherence to the religious doctrines of Islam which includes forbiddance in charging interest, fraud, deception, trading in unnecessary uncertainty and trading in forbidden items like alcohol, pork and pornographic material. Any law that aims at facilitating Islamic finance will have to adhere to these bare minimum requirements.

The capital market in Kenya is governed by the Capital Markets Act[105] and Regulations thereto. This Act together with its Regulations are geared towards promoting, regulating and facilitating the development of an orderly, fair and efficient capital markets in Kenya. The Capital Markets Authority has focused its efforts on two fronts, namely: establishing the supporting institutional, policy and regulatory environment; and widening the product base.

The second applicable law is the Central Depository Act[106] which provides the framework for clearing, settlement and registration activities for the securities markets.[107] It has established the Central Depository and Settlement Cooperation[108]. This Act's primary goal is to diminish the use

[104] The underlying principles of Islamic finance are drawn from the Quran and other sources of shariah.
[105] CAP. 485A of the Laws of Kenya and enacted in 1989
[106] Act No. 4 of 2000
[107] The central depository system provides a centralized system for the transfer and registration of securities in electronic format without the necessity of physical certificates.
[108] The Central Depository & Settlement Corporation Limited (CDSC) is a limited liability Company approved by the Capital Markets Authority to provide automated clearing, delivery and settlement facilities

of paper certificates that declare title of shares by introducing a central depository within which change of ownership is done electronically. It does so through the establishment of central depositories, immobilization and dematerialization of securities, securities accounts, records and confidentiality.[109]

The third statute is the Public Finance Management Act, 2012.[110] This statute defines the word "Sukuk" as certificates of equal value, representing undivided shares in ownership of tangible or intangible assets, usufruct of assets; services or an investment activity, structured in conformity with Islamic law. The Act further provides under Sections 205 3(A) and (B) that Sukuk bond may be used to raise money within or outside Kenya in Kenya Shillings or any other currency or medium of exchange and that the Cabinet Secretary for Finance may make regulations for raising money by issuing a Sukuk bond. These amendments, which were introduced through the Finance Act of 2017[111], will allow the government to issue Islamic bonds, or Sukuk, as an alternative funding source.

Last is the Finance Act[112] which exempts Sukuk products from value added tax. This Act also amended Sections 2 of the Value Added Tax Act and Income Tax Act to define Islamic finance arrangement as financial arrangements structured in line with Islamic law. Under these amendments, the term interest is widened in its definition to include returns from Islamic finance arrangements. The amendment also sees the term financial returns to include returns paid or received from Sukuk or other Islamic finance arrangement.

The above set of statutes collectively represent the framework under which Sukuk are required to operate. Despite the above statutes, a study on the Development of Islamic Capital Markets in Kenya conducted by the CMA revealed several challenges and gaps that needed to be addressed

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in respect of transactions carried out at Nairobi Securities Exchange as well as holding of listed and non-listed securities including other documents of title on behalf of investors.

[109] The Act has modernized the securities trading in Kenya and is credited for the improved performance of the capital market for the last decade.

[110] It was enacted in 2012. This Act provides guidelines for the effective management of public finances by the national and county governments; the oversight responsibility of Parliament and county assemblies; the different responsibilities of government entities and other bodies, and for connected purposes.

[111] This is an act of parliament that amends various laws relating to taxation.

[112] Act No. 15 of 2017

in order to make Sukuk a significant player in capital markets.[113]

It is trite that Kenya's capital market has played an important role in mobilizing funds and facilitating economic development in the past. Finance raised from Government bond trading in for the 2017/2018 period increased to Kshs 492 billion from the Kshs 403 billion recorded in 2016/17.[114] However, in order to meet the development financing requirements of Kenya's economy great demands will be placed on the capital market. There is therefore the need to expand the conventional capital market product base to include innovative products like sovereign Sukuk so as to be able to support the economic, financial and commercial goals of the country.[115]

3.3 Regulatory Hindrance to the Issuance of Sovereign Sukuk under Kenyan laws

As highlighted above, despite the numerous laws that have been formulated to attempt Sukuk regulation, Sukuk have been impeded by several factors. The first challenge relates to the regulation of Sukuk by conventional laws. The Kenya's capital market, as the world over, is governed primarily by the conventional finance system which primarily consists of the Capital Markets Act, Capital Markets Regulations and the Central Depositories Act. Inevitably, Sukuk would also be governed by the same laws and regulations that govern conventional finance. The existing laws do not favour the peculiar features of Sukuk and several issues arise when applying conventional laws to Sukuk.

First, Islam forbids riba,[116] trading in gharar,[117] maisir,[118] and gains obtained from trading in haram products deemed incompatible with shariah like alcohol, pork and pornography. The prohibition of gharar has more to do with the underlying commercial risks and the indispensable elements of the contract between the contracting parties, such as a lack of clarity or opaqueness with regards to the price, time of delivery, subject matter, and so forth. Thus, the rights and obligations linked to the investment must be transparent and clear. Another pertinent principle in Islamic finance is

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113 Capital Markets Authority, Proposed Intervention Measures Targeted At Boosting The Development Of Islamic Capital Markets In Kenya , (CMA 2011)

114 Capital Markets Authority, Annual Report & Financial Statements for the Year Ended 30 June 2018

115 CMA, Proposed Intervention Measures Targeted At Boosting The Development Of Islamic Capital Markets In Kenya 2011

116 Riba refers to interest

117 Gharar means trading in haram activities such as trading in uncertainty or unnecessary risk in contracts

118 Maysir is the terms used to refer to trades in which the outcome is entirely dependent on chance or speculation

that investors ought to share risks and rewards associated with investment itself.[119] The legal framework therefore has to take cognizance of these conditions. Part of it also has to acknowledge the profit and loss, and risk sharing aspects of Islamic finance take centre stage in Sukuk structuring.

Challenges therefore arise because of Islamic law, which is the fulcrum of Sukuk, is not compatible with existing conventional laws.[120] These compatibility challenges appear to have been foreseen by the government as evidenced by the rush to amend various laws to accommodate the issuance of Sukuk. As a reactionary measure, the Value Added Tax Act, Income Tax Act and Public Finance Act were amended in order to have a conducive, albeit cosmetic, semblance of regulation for Sukuk.

Further, due to the peculiar nature of Sukuk as asset backed bonds, there is need for a comprehensive and efficient set of laws that govern the issuance, transfer and maturity of Sukuk. This would automatically cover any grey areas and capture the risk of ambiguity that would arise in the event of conflict. This would also be indispensable in demarcating and assigning rights and the obligations of each party to the Sukuk undertaking. A primary aspect of Sukuk issuance that must be captured in the laws is a provision empowering the state to use its public assets as underlying assets for the Sukuk issuance. The United Kingdom has done so by enacting the Government Alternative Finance Arrangement Regulations (GAFAR) which empowered Her Majesty's Treasury to utilize public assets in its Sukuk issuance.[121]

The second main challenge with respect to Sukuk lies in taxation. Essentially, Sukuk are issued based on an underlying asset. These assets are usually subjected to prohibitively high taxes whenever they are transferred between parties. To illustrate, an ordinary Sukuk issuance will have at least three taxable stages. The first stage is when the originator transfers its asset to the lease-

119 International Bank for Reconstruction and Development / World Bank, 'Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective' (2017) <http://documents.worldbank.org/curated/pt/907001497472893193/pdf/P161573-06-14-2017-1497472889089.pdf> accessed on 25 May 2018

120 Tariqullah K, Elsiefy E & Kyoung L, 'Legal and Regulatory Issues in Issuing Sukuk in Muslim-minority countries: Lessons from Developed Countries' Experience' <swfa2015.uno.edu/G_Islamic_Finance_I/p201.docx> accessed on 25 May 2018

121 The Regulations define the available arrangements to include transfer to a company a qualifying interest in land under the provisions of the Regulations.

back issuer (SPV). In the process of sale, asset transfer, registration and acquisition, stamp duty tax[122] will be incurred. The second stage is when the issuer leases the asset. The rental income will be subject to Residential Rental Income Tax, as it is considered income of transaction. The last stage is at maturity, the underlying asset will be transferred by the SPV back to the originator. The transfer process would also incur stamp duty. All these stages of taxation make Sukuk less attractive as compared to the bond. It is therefore imperative that certain exemptions on the existing tax laws be put in place to make Sukuk at par with the conventional bond.

The third challenge is the lack of unanimity with regard to the standards for Shariah compliance.[123] The lack of standardization applies in twofold. The first relates to the lack of standardization in Sukuk documentation and the second relates to the lack of standardization in interpretation of Shariah regarding Sukuk. This raises the risk factors and increases uncertainty among the investors. The long term effect is that both Sukuk issuers and investors end up refraining from the Sukuk market.[124] A viable solution to this conundrum would be to have a central shariah advisory body that will streamline issuance of shariah compliant products.

Despite the three challenges outlined above, Sukuk, remains one of the most promising fronts for financing infrastructure development without incurring the extra burdens of interests from development loans and the other conditionalities that come with the said loans. This is illustrated by the fact that global Sukuk issuance is expected to reach USD 250 billion by 2020 while the outstanding Sukuk is expected to grow to USD 907 billion by 2020.[125] Furthermore, several Muslim and non-Muslim[126] countries have preferred to adopt Sukuk as alternatives for raising

122 Under the provisions of the Stamp Duty Act

123 Jobst Andreas, 'The Economics of Islamic Finance & Securitisation' IMF Working Paper WP/07/117(2007) < https://www.imf.org/external/pubs/ft/wp/2007/wp07117.pdf> accessed on 25 May 2018

124 Ahmet Ulusoy and Mehmet Ela, "Lack of Standardization in Sukuk Market" (2017) <https://www.researchgate.net/publication/318787697_Lack_of_Standardization_in_Sukuk_Market> accessed May 23 2018

125 Thomson Reuters, Sukuk perceptions and forecast study 2014, <https://www.zawya.com/mena/en/story/Thomson_Reuters_Announces_2015_Findings_of_Annual_Sukuk_Perceptions_and_Forecast_Report_at_WIBC_2014-ZAWYA20141204081246/ > accessed on 23rd May 2018.

126 This applies to both developed and developing countries.

finance over the conventional finance methods such as loans. Among these countries are Turkey, United Kingdom and Luxemburg.[127]

The United Kingdom became the first western country to issue a sovereign Sukuk in June 2014. This Sukuk is worth GBP 200 million and matured on 22 July 2019.[128] The issuance of this Sukuk was enabled by the amendment of the UK Finance Act of 2008 to include alternative finance arrangements.[129] This law was enacted to grant and alter certain duties, taxes, and charges, and to make provisions in connection with finance. It also gave a wide mandate to the Treasury to formulate regulations for raising money through alternative finance arrangements. Later, in 2014, the Government Alternative Finance Arrangements Regulations were promulgated to complement the provisions in the Finance Act of 2008. It is through this legislation that the first Sukuk was issued.

Luxembourg's initial sovereign Sukuk was issued in October 2014 following the enactment of Law Number 6631, Authorization for Transfer of Three Buildings for their Rental and Repurchase Law on July 12, 2014. This piece of legislation enabled the government to use three of its buildings as the underlying assets for Sukuk transactions. Further, the government also undertook amendments of its tax laws to grant differential tax treatment to Sharia-compliant products in order to put conventional and Islamic finance on the same footing.

Turkey's entry into the Sukuk market came a little earlier than UK's and Luxembourg's. Its first sovereign Sukuk issuance came in September 2012. This entry was facilitated by the amendments to the existing laws on Public Finance and Debt Management[130] in 2012 which enabled the Turkish Treasury to launch its first Sukuk issuances in domestic and international markets. The amendment under Article 7/A explicitly authorized the minister in charge of the Turkish Treasury to establish special purpose vehicles known as "asset leasing companies" to issue asset backed Sukuk.

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127 Muhamed Zulkhibri, 'A synthesis of theoretical and empirical research on Sukuk' (2015) <https://ac.els-cdn.com/S2214845015000368/1-s2.0-S2214845015000368-main.pdf?_tid=6a7a0aeb-2477-42b0-bccd-ebae69ee4b7d&acdnat=1527343547_dc70ecd25abdfd459b9b17609e556a77 > accessed on 23rd May 2018

128 Financial Times Report available at <https://www.ft.com/content/7c89467e-fc4e-11e3-98b8-00144feab7de>

129 A term applied in the UK Finance Acts to certain lending arrangements that comply with Islamic law

130 Law No. 4749

One commonality between the UK, Luxembourg and Turkey is that the amendment of their existing laws was necessary in order to have a conducive environment for Sukuk issuance. From the three examples, it is notable that in order to be effective, the legal framework will be required to be drafted to ensure compliance with relevant Shari'ah principles, while reflecting the distinctive features of Sukuk from a legal, accounting, and public debt management perspective. Definitive laws will provide governance and accounting structures that will monitor all facets of Sukuk application.

3.4 Incorporation of Islamic accounting principles

Sukuk, being a Shariah based product, require the application of Shariah principles of accounting to guide aspects relating to issuance, securitization, measurement and disclosures. These principles are derived from Shariah law sources such as the Quran, Hadith and Sunnah.[131] Therefore, a unique set of structures, different from the conventional accounting standards, are required to govern Sukuk. Among these structures are accounting principles that comply with the tenets of Shariah. To illustrate this point, it is prudent to give an example of how different Sukuk are from the conventional bond and why it is impossible to maintain similar accounting standards for the two. First, a conventional bond signifies a debt obligation where the borrower agrees to make payment of interest and principal to the holders of the bonds. It is simply a relationship between debtors and creditors on a loan-based contract where interest charges are applied as a reward for granting a loan.[132] The payment of interest is not allowed in Islam. Sukuk on the other hand represents a proportionate beneficial ownership in the underlying asset.

Since the multi-fold growth in Sukuk issuances in the global capital markets arena, there has been a pressing need for standardized Shariah compliant accounting standards. The AAOIFI has formulated accounting standards applicable to a wide array of Islamic finance products. Of interest to this discussion is Financial Accounting Standard No. 17 on Sukuk. These accounting standards stem from shariah concepts and are developed based on shariah requirements. Nevertheless, these

131 These are the three main sources of shariah law.

132 Mohamed S, Rusnah M, Alwin G, 'Malaysian Sukuk: Issues in Accounting Standard' (2008) <https://www.researchgate.net/publication/263969584> accessed 25 May 2018

regulations also need to be at par with modern accounting environment to make them competitive and relevant for modern day application.

The AAOIFI has set a total of fifty six standards governing areas of auditing, accounting, corporate governance, ethics and sharia for Islamic financial institutions. These standards, however, are not mandatory or automatic in application but advisory. The AAOIFI has taken significant steps to encourage the adoption and enforcement of its standards by Islamic financial institutions worldwide.

3.5 Chapter conclusion

The examination above reveals that there is need for concerted efforts to improve on Islamic finance within the Kenyan capital markets so that it develops in tandem with other areas of the market.[133] The Islamic capital market is one such sector that has grown significantly over the past two decades.[134]

However, Kenya's capital market despite being ripe to accommodate the issuance of sovereign Sukuk contains hindrances in that the legislation present in the area is not fully compliant with Islamic finance principles. This is notwithstanding several amendments and changes made to the relevant set of legislations. As such Kenya's capital market framework remains inadequate for issuance of Sukuk. As Hamat[135] has argued, Shariah based products require specific accounting standards and that a well regulated Islamic financial market requires a sound accounting and reporting standard for Islamic financial instruments that meet the requirements of Shariah needs to be incorporated in the laws. This will enable Sukuk issuance to exist within a well regulating accounting framework.

133 Capital Markets Authority, Proposed Intervention Measures Targeted At Boosting The Development Of Islamic Capital Markets In Kenya , (2011) page 2

134 Ibid

135 Hamat M, 'Accounting Issues in the Operation of Islamic Banking' (1994)

CHAPTER FOUR

VIABILITY OF SOVEREIGN SUKUK AS AN ALTERNATIVE SOURCE OF FUNDING FOR DEVELOPMENT PROJECTS IN KENYA

4.1 Introduction

The preceding chapter of this research cover Kenya's capital markets regulatory framework vis-a-vis issuance of Sukuk and whether the same would auger well in Kenya's capital markets setting hence setting the stage for the discussion on the viability of Sukuk as an all-encompassing source of funding for development projects.

The main purpose of this chapter is to consider the viability of Sukuk as a self-sufficient and viable mechanism of raising capital by governments in Kenya. It does so by among others examining Kenya's infrastructure needs, the country's debt, the advantages that Sukuk's have over conventional bonds.

Between 1970 and 2000, the African continent received USD540 billion in loans and paid back some USD550 billion in principal and interest. But at the end of this period it still owed USD295 billion.[136] Despite incurring the highest rates of borrowing, African economies have grown slower than in other developing countries.[137]

High debt servicing throws developing countries into a debt trap, depriving them of the resources needed to secure long term economic development and build up strong social and physical infrastructures. Unsustainable debt begets deep economic crisis, with dramatic social consequences for their populations. An increase in debt servicing obligations leads to an increase recurrent expenditure and a congestion on development spending.

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136 Economic Development in Africa Report 2016 - Debt Dynamics and Development Finance in Africa (2016) (UNCTAD/ALDC/AFRICA/2016) accessed at <https://unctad.org/en/PublicationsLibrary/aldcafrica2016_en.pdf> on 25th May 2018

137 Ibid

4.2 Kenya's Infrastructure Needs

Kenya's Vision 2030[138] recognizes infrastructure development as critical for socio-economic transformation. Physical infrastructure consisting of roads and rail transport networks, energy and healthcare, are deemed to be enablers for sustained development of the economy identified under the economic pillar.[139]

The World Development Report 1994[140] defines infrastructure to include public utilities such as telecommunications, roads, railways, airports and water transport systems. These are categorized as the core infrastructure which is required for economic development. Broadly, this infrastructure can be classified into two categories based on the nature of the infrastructure in question i.e. economic and social infrastructure. Economic infrastructure includes infrastructure that directly supports economic activities and demonstrated by those basic facilities and services which directly benefit the process of production and distribution in an economy. On the other hands, social infrastructure refers to the amenities that are geared towards achieving certain social objectives and are planned to provide social services which are commonly offered by public enterprises such as schools, car parking and water services.

Economic infrastructure is vital for economic growth as it plays a key role in improving market competitiveness, facilitating trade and integrating developing countries to the rest of the world. Transport infrastructure opens up unconnected regions to trade & investment and improves access to goods, services and employment opportunities. This in turn leads to sustainable growth and development of the economy. This study will focus on transport, energy, ICT and water and sanitation as the main frontiers for economic development.

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138 A long term development roadmap to the Kenya's economic development by 2030. Its aim can be summarized as transforming Kenya into "a newly-industrialising, middle income country.

139 Physical Infrastructure Sector MTEF Report 2010/11 – 2012/13 accessed at <http://www.treasury.go.ke/component/jdownloads/send/89-2010/52-physical-infrastructure-sector.html?option=com_jdownloads> on 4th October 2018

140 World Development Report 1994: Infrastructure for Development <http://oemmndcbldboiebfnladdacbdfmadadm/https://openknowledge.worldbank.org/bitstream/handle/10986/5977/WDR%201994%20-%20English.pdf > accessed on 4th October 2018

The World Bank's Africa Infrastructure Country Diagnostics Report[141] posits that Kenya's greatest infrastructure challenge lies in the energy sector and transport. Further, the Report finds that in order to address Kenya's infrastructure deficit, a sustained expenditure of almost USD4 billion per year over the next decade would be required. This amounts to about 20 percent of GDP, a fact that is predicted to pose a huge challenge for Kenya's economy.[142]

Frost & Sullivan,[143] in its 2015 report on Kenya, reveals that an estimated sum of USD55.6 billion in investment into infrastructure development, majority of which will focus on telecommunications and power generation. It further goes ahead to state that out of this figure, an estimated USD5.14 billion has been dedicated to road project investment in Kenya will go a long way in enhancing road connectivity and opening up the market for more business.

Kenya's annual budget for the year 2018/2019 is estimated to be Kshs. 2.55 trillion,[144] This sum is significantly higher than the 2017/2018 budget. Out of this, the government's Big Four Agenda[145] have been allocated Kshs. 1.065 trillion. The Big Four are manufacturing, housing, health and food security. The remaining Kshs. 1.485 trillion is budgeted towards the government's recurrent expenditure and other key sectors.

Road infrastructure has been allocated Ksh.121.7 billio out of which 34.2 billion, nearly 30%, is Foreign financed, while the railway sector has been allocated Kshs. 87.4 billion. The energy sector bagged an estimated Kshs 46.7 billion for projects like geothermal development, installation of transformers and substations, for rural electrification and oil and gas exploration and distribution. Information, communication and technology sector was allocated Ksh 22.1billion while water and sanitation is estimated Ksh 60.4 billion.

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141 AICD Country Report, Kenya's Infrastructure: A Continental Perspective. <http://documents.worldbank.org/curated/en/677331468209960394/pdf/623890WP0P12420ry0report0Image0Bank.pdf> Accessed on 4th October 2018

142 Ibid

143 African Infrastructure Tracker: Kenya < http://www.frost.com/sublib/display-report.do?id=9841-00-2B-00-00 > accessed on 4th October 2018

144 2018 Budget Policy Statement <http://www.treasury.go.ke/component/jdownloads/send/195-budget-policy-statement/732-2018-budget-policy-statement.html> accessed on 26th September 2018

145 On 12th December 2017, His Excellency President Uhuru Kenyatta announced his new plan, the 'Big Four', which will guide the development agenda of the country in the period 2018-2022.

The above analysis points at the high cost of infrastructure required for economic development. This is justified by the fact that adequate infrastructure provision is a prerequisite for the country to achieve the intended objective of economic growth.

The current financing mechanism for infrastructure in Kenya can be grouped in two categories: domestic and external loans on one hand and tax revenue on the other. Tax revenue collection is not sufficient to cover government budget hence the need for loans to close this budgetary deficit.

The deficiency of domestic funding and the often stringent terms of external funding has led to countries exploring other avenues of sourcing for funds for development projects. The role of the private sector is growing exponentially given the rise in Public Private Partnerships (PPPs) and Private Participation in Infrastructure (PPI).

It is evident that investment in infrastructure requires heavy capital outlay. Most African countries depend on developed countries and development institutions for grants and loans to finance infrastructure development in Transport, energy, water and sanitation and ICT. As a result of this dependency countries remain indebted for many years. In addition, such loans are often tied in the sense that their use and expense are conditioned on targeted objectives. This limits the choices of investment options available to the African governments in the infrastructure space.

4.3 Kenya's Budgetary Deficit and Public Debt as at 2018

Most recently, the issue of Kenya's budget deficits has occupied the national debate, drawing attention to the related issue of public debt. The government's balance sheets have come under close scrutiny and dominated headlines in the recent years due to the ballooning debt. It is trite that a lot of resources need to be availed for a government to fund its developmental goals effectively. These funds are derived mainly from tax revenue and if not sufficient, loans are taken to bridge the gap between revenue and expenditure needs. With time, these loans accumulate huge interests hence further denting the government's balance sheets even further because more resources will be diverted to repaying these debts. Kenya's public debt as at June 2018 was estimated to be Ksh 5.04 trillion. Public debt is defined as the totality of debt owed by the public sector and has two main components, namely domestic and external debt.[146] Public debt is often expressed as a ratio of GDP and is used as an indicator of the ability of a government to meet its future obligations.

[146] Annual Public Debt Management Report 2015/2016

The funds incurred through debt go towards public spending and fill holes in the budget. It is an important tool for bridging budgetary deficit and enabler for government to meet its obligations.

As at end June 2018, Kenya's outstanding total public debt outlay, including publicly guaranteed debt, stood at Ksh 5.04 trillion with domestic and external debt each accounting for 49.1% and 50.9%.[147] This is compared o the debt of Ksh 4.40 trillion at end June 2017 while at June 2016[148], the public debt amounted to Ksh 3.61 trillion and Ksh 2.84 trillion at end June 2015.[149] This shows a trend of increase in both domestic and external debt over the years by at least 12 %.

It is important to illustrate the extent of this increase by breaking down the figures in terms of the GDP. In GDP terms, the total public debt was 57.1 %, while domestic debt was 27.5% with external debt accounting for 27.3% in 2018. The total public debt was 57.1% as a per cent of GDP as at end June 2018 which is slightly lower compared to 57.5% as at end June 2017. Domestic debt, on the other hand was 28.0 per cent of GDP compared to 27.6 per cent in 2017,while external debt stood at 29.0 per cent of GDP, compared to 30.0per cent of GDP in June 2017.[150]

The Annual Public Debt Management Report of 2015/2016 foresaw that public and publicly guaranteed external debt stock would continue to rise over the last five years, increasing to Ksh 1.79 trillion in June 2016 from Ksh 1.42 trillion in June 2015[151]. The report projected that the public debt will rise to Ksh 3.76 trillion in June 2017, and further to Ksh 5.32 Trillion in June 2020. This prediction has come to reality.

147 Annual Public Debt Management Report 2018

148 Ibid

149 ibid

150 Ibid

151 This represents a rise of 26.2 per cent. The Treasury attributes this increase to disbursements from commercial syndicated loans, multilateral and bilateral creditors as well as foreign exchange rate movements.

Kenya's main lenders are the World Bank, [152] commercial banks[153] and China.[154] Other multilateral and bilateral creditors lending the country include the African Development Bank, Japan, France and IMF.

Lastly, the report states that the outstanding on-lent loans[155] increased by 1.5 % from Ksh 0.81 trillion by June 2017 to Ksh 0.83 trillion as at the end June 2018. The Treasury attributed this increase to new on-lent loans to transport, energy, roads and water sectors where Ksh 0.36 trillion accounted for Standard Gauge Railway (SGR) and to revive the airline industry. According to the IMF[156], Kenya's public debt has increased over the years with most of the new debt going into financing its infrastructure needs to boost sustainable growth.

Despite the above, the Treasury claims that Kenya's public debt is within sustainable levels and well within the 50% limit of GDP in Net Present Value terms in line with Public Finance Management Act regulations[157] and the requirements of the East Africa Community convergence criteria.

There is a divergent view from the IMF that the country's excessive borrowing amid huge revenue deficit for the economy is worrying and warned that it will reach a point where the debt is not manageable especially when the deficit continues to rise.

The state of affairs of Kenya's debt suggests that borrowing may not be a sustainable source of funding to among others, for infrastrucuture development projects. This then necessitates the need for consideration for sovereign Sukuk as an alternative source of funding.

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152 27.4 per cent

153 24.1 per

154 17.4 per cent

155 According to the Annual Public Debt Management Report 2015/2016, on-lending is defined as an arrangement where the Government through the National Treasury contracts loans from external or domestic sources and in turn lends to public enterprises.

156International Monetary Fund 2016 Country Report accessed at <https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1725.pdf> on 26th September 2018

157 Public Finance Regulations of 2015 under Part XIV

4.4 Viability of sovereign Sukuk as an alternative source of funding for development projects

The need for funding for development projects by developing countries is manifest. Developing nations have a large demand for infrastructure projects, such as schools, hospitals, roads, water and electricity.[158] Most of these infrastructure projects are large in scale and capacity, involve multiple stakeholders and require intricate financial arrangements and formulation of complex legal documentations. The biggest challenge is always the financial resources required to fund the projects. Unfortunately, developing nations do not have sufficient revenues to fund these types of projects which are vital for sustainable development. Kenya, as one such country, faces similar revenue challenges and chronic budget deficits which causes so many well intentioned projects to fail to materialize.

OECD statistics reveal that across the globe, investments on infrastructure projects[159] will require USD 71 trillion by 2030.[160] Out of this estimated figures, the IFC estimates that USD 21 trillion of those investments would be needed by emerging markets such as developing countries. Bielenberg[161] on the other hand estimates that, to close the financing gap for the SDG-related goal, investments of USD 93 trillion would be needed in sustainable infrastructure projects during 2015-2030, with the bulk going to the energy sector (USD 40 trillion or 43 per cent), followed by transport (USD 27 trillion or 29 per cent), water and waste (USD 19 trillion or 20.4 per cent) and telecom (USD 7 trillion or 7.5 per cent).

Despite the wide gap in the figures, both these approximation point to one thing: that the achievement of developmental goals is resource extensive. It is usually the government's primary responsibility to provide public infrastructure[162], however its huge financial component makes it

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158 These are the pertinent projects for developing nations to put them at par with the developed ones.
159 The sectors referred to are transportation, telecommunication, electricity and water.
160 Fostering Investment in Infrastructure Lessons learned from OECD Investment Policy Reviews January 2015 <https://www.oecd.org/daf/inv/investment-policy/Fostering-Investment-in-Infrastructure.pdf> accessed on 26th September 2018
161Bielenberg, Aaron, Mike Kerlin, Jeremy Oppenheim, and Melissa Roberts, "Financing Change: How to Mobilize Private-Sector Financing for Sustainable Infrastructure, McKinsey Center for Business and Environment, McKinsey & Company" 2016.
162 Patel Bhattacharya "Infrastructure in India: The economics of transition from public to private provision", Journal of Comparative Economics 2010 <https://www.researchgate.net/publication/222520072_Infrastructure_in_India_The_economics_of_transition_from_public_to_private_provision> accessed on 27th September 2018.

impossible to rely only on national budgets. This raises the need to supplement national budget with capital that can be provided by the private sector. [163]

Traditionally, the most preferred source of revenue for funding these projects has always been loans from development agencies, multinational banks, donor funding and funding drawn from the public sector. The role of these sources of funding in filling the resource gaps has become limited due the large investments needed, budgetary constraints and deficits that governments of developing nations face.

Most of these funding extensions are issued with high interest rates which have to repaid by the concerned developing nation-hence defeating the reason for the borrowing in the first place.[164] The high interest rates become burdensome for these nations, forcing them to dig deeper into their dry pockets to repay them. The main shortcoming of debt-financing is the disconnect between the loan repayments and the risk of the project and cash flow of the asset on another side. Sukuk offers the advantage using risk sharing financial instruments to financing infrastructure projects hence cutting off the current trend of creating and accumulation of debt.[165]

This has led to nations seeking out alternative sources of funding to fund these projects. Predominantly, Sukuk have been recognized as a viable financing method for infrastructure projects in developing nations. Sukuk, owing to their dynamic and adaptable nature have become an integral part of the global infrastructure financing[166] system.

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163 Chen A, "A new perspective on infrastructure financing in Asia" Pacific-Basin Finance Journal, 10(3), 227-242 (2002).

164 Between 1970 and 2000, the African continent received $540 billion in loans and paid back some $550 billion in principal and interest. But at the end of this period it still owed $295 billion according to UNCTAD report Economic Development in Africa Report 2016 - Debt Dynamics and Development Finance in Africa (2016) (UNCTAD/ALDC/AFRICA/2016) accessed at <https://unctad.org/en/PublicationsLibrary/aldcafrica2016_en.pdf> on 25th May 2018

165 Davood Manzoor, Majid Karimirizi, Ali Mostafavisan, "Financing infrastructure projects based on risk sharing model: Istisna Sukuk" (2017) Journal of Emerging Economies and Islamic Research 5(3) 2017 pages 72-84

166 Infrastructure Project finance is defined as structured long-term financing of infrastructure, industrial projects and public services with limited recourse to the sponsors, where project debt is repaid from future cash flow generated by the project once operational.

Sukuk are used as instruments of liquidity for financing various projects by governments and corporate entities in many Muslim and non-Muslim countries across the globe.[167] Financing modules that are based on Sukuk structures allow developing economies to meet their liquidity demands without using interest-based financing methods.[168] The interest-free nature of Sukuk makes it more attractive to developing nations that have suffered financially under the conventional interest-based loan extensions. Fundamentally, the structuring of Sukuk as asset based securities ensures that public expenditure is under control since availability of finance without tangible assets is limited.

Sukuk have numerous advantages with respect to financing government expenditure on infrastructure projects over conventional bonds.[169]

The first distinguishing factor which sets Sukuk apart from its conventional counterpart, the bond, is that is based on the concepts of risk sharing and socio-economic development.[170] The risk sharing element brings on board a sense of security hence giving confidence to the investors to partake in the issuance. Unlike interest bearing debt securities, Sukuk do not commit issuers to pay profits without regard to the performance of the underlying assets.

Secondly, Sukuk are more viable for infrastructure as they are asset–backed securities. A distinguishing feature of 'asset-backed' ṣukuk is that ṣukuk holders are paid dividends generated by underlying productive assets that also serve as collateral. These assets are either real (property), debts (financial receivables), or a combination of the two. The asset-backed nature of Islamic financing provides a better funding match for infrastructure projects than traditional lenders. The

167 Ahlidin Malikov, "How Do Sovereign Sukuk Impact on the Economic Growth of Developing Countries? An Analysis of the Infrastructure Sector" (2017) <https://www.researchgate.net/profile/Ahliddin_Malikov/publication/316753079_How_Do_Sovereign_Sukuk_Impact_on_the_Economic_Growth_of_Developing_Countries_An_Analysis_of_the_Infrastructure_Sector/links/5a37847e45851532e832c0b0/How-Do-Sovereign-Sukuk-Impact-on-the-Economic-Growth-of-Developing-Countries-An-Analysis-of-the-Infrastructure-Sector.pdf?origin=publication_detail> accessed on 27th July 2018

168 Iqbal M. & Khan T, "Financing public expenditure: An Islamic perspective" Occasional Paper No 7 (2004) IRTI

169 Abdou Diaw, "Public sector funding and debt management: A case for GDP-linked Sukuk" 2011.

170 Azlin, N, "Sukuk as a means of project financing" (2013) INCEIF

link between the underlying asset`s revenue and investor`s return makes the venture more transparent and guarantees a steady and predictable cashflow over a long period of time.[171]

Third, Sukuk has emerged as a competent alternative to conventional debt financing large projects due to its applicability over a long-term**.** The long-term nature of Sukuk makes it more suitable for infrastructure finance as typically, infrastructure projects require long term financing methods. In developing countries like Kenya, such a financing option offers the tying up of capital over a longer period and stable, intermittent and predictable cash flow.

Fourth, Sukuk operates through the creation of SPVs, usually companies, hence provides better transparency thereby reducing risks of corruption and wastage as assets must be put to work in order to generate income for investors instead of disappearing into the hands of corrupt government officials. Kenya, like many other developing countries, loses a big portion of public funds to corruption and abuse of state funds. The devastating impact of corruption is that funds meant for public utility are siphoned off abroad, embezzled and misappropriated hence the debt remains on the country's balance sheet and accruing high interest charges year after year.

The fifth advantage is from an economic development perspective. Sovereign Sukuk issuance can also serve financial inclusion objectives as it will provide investment opportunities to investors who have a tendency to abstain from interest bearing securities hence underserved by the government .

In Kenya, where the Islamic financial industry represents a small segment of the banking sector, regular Sukuk issuance by the government provides this segment with access to shariah compliant investment options , which can also be used as collateral in accessing the central bank's liquidity facilities.[172] The advantages of Sukuk stated above should be enough to entice Kenya and other developing countries to start exploring Sukuk as a viable option for

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171 Ibid, note 168

172 Emre Balibek, "Establishing a Legal Framework for Sovereign Sukuk Issuance:A Public Debt Management Perspective"(2017) <http://documents.worldbank.org/curated/en/907001497472893193/pdf/P161573-06-14-2017-1497472889089.pdf > accessed on 10th April 2019

financing infrastructure projects. This would not be exceedingly difficult given that infrastructure projects are generally shariah compliant. Infrastructure does not fall in the category of activities that contravene shariah law. A good example of how Sukuk would be applied in infrastructure development is that there is the creation of a SPV that would invest in an infrastructure project eg. a water desalination plant, with the plant as the asset underlying the investment. The SPV would use the income generated from the asset to pay the investors for their investment for a certain period of time whereafter, the asset would revert to the government.

4.5 Chapter conclusion

This chapter demonstrates that Sukuk, in its various structures, provide a viable alternative for financing infrastructure. The public sector alone cannot provide sufficient resources to develop the necessary infrastructure for economic development. The involvement of the private sector in infrastructure financing is the only way to mobilize additional resources for infrastructure development.

Sukuk provide an ideal way of financing large infrastructure projects that would otherwise not be possible for developing countries to fund, as viable alternatives to public debt and budgetary provisions. In these cases, Sukuk offer a more viable alternative for financing such projects without governments falling into interest-based debt. Primarily, Islamic finance is based on two major concepts: risk sharing and socio-economic development. Viewed from this perspective, Sukuk issuances in infrastructure projects require risk sharing on the one hand and a contribution to the social and economic growth of developing countries on the other.[173] The use of Sukuk to fund large projects therefore means that investors in Sukuk are incentivized to help economies develop by creating and producing rather than by consuming or manipulating others. Islamic finance is based on principles of fairness and justice which are achieved by avoiding Riba.

173 Azlin, N, "Sukuk as a means of project financing" (2013). INCEIF

CHAPTER FIVE

EXPERIENCE OF THE UNITED KINGDOM LEGAL FRAMEWORK ON SOVEREIGN SUKUK

5.1 Introduction

The United Kingdom issued its first sovereign Sukuk in 2014 through Her Majesty's Treasury's wholly owned subsidiary HM Treasury UK Sovereign Sukuk PLC for the value of GBP 200 million. This Sukuk matured on 22 July 2019,[174] having received an overwhelming demand from sovereign wealth funds, central banks and domestic and international financial institutions. This issuance was eleven times over-subscribed. The UK Sukuk received investors from the Middle East and Asian countries who are already leaders in global Sukuk issuances.

This issuance was a culmination of years of concerted efforts to place the United Kingdom as a global financial hub. The City of London has been providing financial intermediation and support to the Islamic financial services industry since its emergence in the mid Seventies.[175] It is during this period that interest grew in investors to structure their UK investments in a more Shari'a-compliant manner to serve a wider portfolio of investments.

Aside from this, the Sukuk issuance achieved financial inclusion and opened the bonds market to a wider range of investors especially Muslims who were previously excluded from participating in the capital markets by virtue of their religious beliefs.

In order to gear up for its first Sukuk issuance, the government established the Islamic Finance Task Force in March 2013.[176] The task force's mandate was to help to build upon London's status as the Western hub for Islamic finance by showcasing the UK as the preferred choice for the

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174 The profit rate on the Sukuk has been set at 2.036% in line with the yield on gilts of similar maturity.
175 Global Islamic Finance Report 2015 accessed at <https://www.sedcocapital.com/sites/default/files/download s/english.pdf>
176 The Taskforce's main objective is to use Islamic finance to facilitate inward investment and strengthen the UK economy. Accessed on <https://www.gov.uk/government/news/government-launches-first-islamic-finance-task-force--2> on 3rd August 2019.

Muslim world to invest in and do business with. Its objectives include engaging with the United Kingdom Islamic Finance Secretariat and others to promote and raise the international profile of the industry and to use Islamic finance to facilitate inward investment and strengthen the UK economy.

This paper discusses the experience of Sukuk in the UK. The choice of the UK as a good comparative because of the nascent similarities in the legal system between Kenya the UK. The Kenyan legal system borrows heavily from the English legal system due to the decades of the British administration and colonialism.

5.2 Structure of Sukuk issued in the United Kingdom

Her Majesty's Treasury structured the Sukuk such that it would be similar to the government gilt.[177] The transaction documents were held to be Shari'a compliant by Bait Al-Mashura Finance Consultations Company, Shariah Committee of CIMB Islamic Bank Berhad, The Executive Shariah Committee of HSBC Saudi Arabia Limited and Standard Chartered Bank Shariah Supervisory Committee.

Britain's sovereign Sukuk was structured as an Al-Ijara Sukuk- which is the most common structure for sovereign Sukuk. The subscriptions from the issue were used to acquire the lease of the underlying asset from The Secretary of Department for Communities and Local Government. The properties were then sub-leased back to government in return for periodic rental payments which were to be used by the issuer to fund its distributions to the Sukuk holders. Sukuk al-Ijarah is the most common Sukuk structure and is most preferred because of its simplicity and versatility. The Ijara structure of Sukuk is deemed as the classical Sukuk structure from which all other Sukuk structures have developed. In the Islamic finance industry, the term "ijara" means a "lease".

In order to generate returns for investors, all Sukuk structures rely upon either the performance of an underlying asset or a contractual arrangement with respect to that asset. The ijara is particularly useful in this respect as it can be used in a manner that provides for regular payments throughout

[177]These are fixed-interest loan securities issued by the UK government. UK's government gilts are usually issued in a very simple format using short-form documentation and few risk factors.

the life of a financing arrangement, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. In addition, the use of a purchase undertaking is widely accepted in the context of Sukuk al-ijara without Shari'a objections. These characteristics make ijara relatively straightforward to adapt for use in the underlying structure for a Sukuk issuance.

5.3 Legislative Framework

Generally, Islamic finance products in the UK are not given any preferential treatment as compared to conventional instruments. As such, all existing legislation and regulations apply. The UK's strategic approach has been to provide a level playing field for Islamic finance products and conventional financial products. In order to achieve this, the UK has strategically evaluated and responded to any unequal treatment between the two by introducing remedial legislation and regulations.[178]

While the UK has not enacted specific legislation addressing Sukuk or even the wider topic of Islamic finance, it has made significant steps to adjust the unfair taxation of Sukuk to place them on a level playing field with conventional debt instruments. Certain amendments have been made to existing laws and regulations specifically to facilitate Islamic finance transactions in the UK. The most important changes have been to the tax laws which have been amended to provide for certain shariah-compliant finance arrangements to be taxed in the same manner as conventional equivalents under the alternative finance arrangements regime.

The following are the Laws that have been amended to facilitate the issuance of Sukuk in the United Kingdom:

5.3.1 Stamp Duty Land Tax Act

The UK government amended its Stamp Duty Land Tax Act in 2003 to remove the double-taxation that would arise when the Sukuk SPV purchases property from the Originator and later resells it back to the same Originator.

[178] John Dewar and Munib Hussain, "Getting the Deal Through: Islamic Finance & Markets" (*2018*) accessed at<https://www.lexology.com/gtdt/tool/workareas/report/islamic-finance-and-markets/chapter/united-kingdom> accessed on 2nd August 2019.

5.3.2 Corporation Tax Act 2009

Corporation Tax Act 2009[179] covers the topic of Alternative Finance Products. Under this law, the alternative finance regime structures are taxed in the same manner as their conventional equivalents and has been extended to provide that Sukuk be taxed in a similar manner to conventional bonds. This has been achieved by providing that, where the arrangements meet certain conditions[180], they are liable to the exemptions under the Act.

5.3.3 Finance Act 2009

In addition to the Corporation Act, the Finance Act 2009 amends the law to classify Sukuk as tax-exempt loan capital for stamp duty and stamp duty reserve tax purposes. This Act provides relief from stamp duty land tax for Sukuk- as alternative finance investment bonds and allows existing corporation tax and income tax rules on Islamic finance arrangements to be amended by regulation

5.3.4 Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2018

There is also the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2018 which came into force on July 11, 2018. This Order amends the definition of the term Alternative Finance Investment Bonds in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The effect of this amendment is that alternative finance investment bonds, such as Sukuk, would be permitted to trade on multilateral trading facilities or organized trading facilities and ensure alternative finance investment bonds are treated in the same way as conventional bonds for trading purposes.

5.3.5 Government Alternative Finance Regulations 2014

These regulations were made under the provisions of Section 157 of the Finance Act 2008 and came into effect on 16 June 2014. Section 2 of these regulations align Sukuk fundraising with the requirements of the National Loans Act 1968 and have enabled the Treasury to raise money through arrangements which do not involve the payment of interest, but which equate in substance to transactions which do involve the payment of interest.

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[179] This Chapter provides for alternative finance arrangements between companies and financial institutions to be treated as loan relationships.

[180]As per Chapter 6 of Part 6Sections 503 to 508 of the Corporations Act.

5.3.6 National Loans Act 1968

This Act, which is the primary debt management law, gives Her Majesty's Treasury the power to raise money under section 12 for various reasons enumerated thereunder. Notably, it provides that the Treasury may raise any money which the Treasury considers it expedient to raise for the purpose of promoting sound monetary conditions in the United Kingdom on such terms and conditions as the Treasury think fit, and money so raised shall be paid into the National Loans Fund. An example of such payments includes payments to certificate holders and any indemnities which the Treasury may need to give in connection with alternative finance arrangements.

The above demonstrate how legal regimes need to adapt in order for an Islamic finance market to emerge and flourish.

5.4 Challenges facing Sukuk issuance in the United Kingdom

As a starting point, it should be mentioned, European governments have no problems in raising funds through the issue of conventional bonds, and therefore significant Sukuk issuances on their part should not be expected.[181] In fact, the UKs offering of Sukuk could be construed as a government initiative to set a benchmark for corporate Sukuk offerings and promote Sukuk as a form of Socially Responsible Investment. It could also be construed as an integral scheme for promoting the UK as a global centre of Islamic finance.[182] The following are some of the challenges faced in the issuance of Sukuk in the United Kingdom:

5.4.1 Legal framework

Presently, the biggest hindrance to the growth of Sukuk is the legal regimes under which Sukuk operate. Most legal regimes disadvantage Sukuk as compared with conventional bonds on several fronts on account of their inherent nature. First; the issuance of Sukuk requires the issuing entity to transfer the underlying asset to a Special Purpose Vehicle which will be the Sukuk issuer. This

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181 Piotrowski Darius, (Challenges and Barriers To The Development Of Sukuk In The European Capital Market" (2017) < https://iises.net/proceedings/8th-economics-finance-conference-london/table-of-content/detail?cid=48&iid=006&rid=7695> accessed on 3rd August 2019

182 Piotrowski D, "Government strategies based on Sukuk issues" (2017) <https://www.researchgate.net/publication/306231867> accessed on 3rd August 2019

process of transfer of the underlying asset to the Special Purpose Vehicle attracts stamp duties and other taxes as a result. Secondly, at the maturity of the Sukuk, the underlying asset will also attract stamp duties and other taxes when it is reverting back to the issuer.

Unless the issuing state amends it tax and land transfer laws, as the UK has done, to exempt Sukuk issuances from hefty taxes, Sukuk will remain disadvantaged as compared to the conventional Bond. Malaysia has set the global benchmark for enacting tax, land transfer laws that do not penalize Sukuk issuances hence why 70% of global Sukuk issuances are attributed to the Malaysian market.

The UK Government's £200 million sovereign Sukuk issuance was possible because of the UK's amendment to the law which removed the tax barriers that had previously rendered Shari'ah-compliant financial products less tax-efficient than their conventional counterparts.

5.4.2 Shariah standardization

Another major challenge is that of Shariah standardization. Sukuk being an Islamic finance tool relies highly on Islamic shariah interpretation. Sukuk transactions require a pronouncement by Shariah scholars in order to provide issuers and investors with comfort that a Sukuk instrument is fully Shariah compliant. Such endorsements, however, are subject to different interpretations depending on the applied school of thought.[183]

Though the UK does not have a centralized Shairah advisory board, in future, and with growth of the Sukuk issuances, it would be prudent to establish a central Shariah advisory board. The Malaysian government has established a centralized Shariah Advisory Council[184] which ensures all Sukuk issued in Malaysia is compliant with nationally accepted Shariah principles. Increasing standardization stabilizes the market and safeguards investor confidence.

183 In late 2007 and early 2009, the Sukuk market faltered slightly owing to a debate sparked by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI issued a divisive statement questioning the Shari'ah-compliance of some Sukuk structures.
184 This operates under the Securities Commission of Malaysia.

Uncertainty regarding the compliance of Sukuk construction and the terms and conditions of Sukuk issuances with the sharia law is another factor imposing certain limitations of the development of the market.

This risk associated with the vagueness and variability of legal interpretations of sharia schools, or conflicts between court judgements based on civil or common law and the sharia-based principles poses certain limitations of the development of the market.[185] A good example of how Sukuk is subjected to various interpretations is the questioning of the compliance with sharia of a staggering 85% of Sukuk issued by Persian Gulf entities by scholars including the then Chairman of the AAOIFI, Sheikh Taqi Usmani on 2007. Sheikh Taqi criticized that most of the Sukuk products in the market were not fully compliant with Shariah, thus require an urgent review.[186]

5.4.3 Investor protection

The third challenge pertains to the protection of the investor's investment in the event of a default. Sukuk are very unique in their structure and obviously, Sukuk instruments are not secured in the conventional terms. Sukuk holders have the advantage of the underlying Sukuk asset.

The determinant of the level of investor protection in default circumstances is the structure of the Sukuk and the question of whether Sukuk holders have a claim against the underlying assets depends on how the Sukuk is structured.

5.4.4 Small investor base

Although a report by Deloitte[187] on Sukuk reveals that the United Kingdom has the greatest potential among European countries for the development of a Sukuk market, the report also reveals that most enterprises are not aware of the existence of Sukuk. In reaching this conclusion,

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185 Al-Bashir, M., Al-Amine, "Global Sukuk and Islamic Securitization Market. Financial Engineering and Product Innovation" (2012). https://brill.com/view/book /9789004207448/B9789004207448-s001.xml> accessed on 3rd August 2019

186 International Islamic Financial Market, "Sukuk Report. A comprehensive study of the Global Sukuk Market" (2009) < http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%282nd%20Edition%29%20A%20Comprehensive%20Study%20of%20the%20Global%20Sukuk%20Market_0.pdf> accessed on 3rd August 2019

187 Deloitte, "Corporate Sukuk in Europe. Alternative Financing for Investment Project" (2015) <https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/financial-services/me_Islamic-finance_corporate-Sukuk-in-europe.pdf> accessed on 3rd August 2019

Deloitte’s study considered the social, legal, tax regimes and the general policy environment of the European region. The lack of investor awareness on Sukuk can be attributed to Sukuk being a product of Islamic Finance and most investors associate it with the religious and spiritual aspects of Islam. As such, this lack of substantial Muslim population greatly hinders the growth of Sukuk and the same is likely to stall were in not for the UK government’s initiative.

5.4.5 Complexity of Sukuk structures

Sukuk’s complex structure also poses a barrier to the development of the Sukuk market, both on the European and global scale.[188] The complexity of a Sukuk structure can be demonstrated through the various levels of transferring assets between the Originator and the Special Purposes Vehicle and the underlying agreements that secure the rights and obligations of each party at several stages of the Sukuk life. There is also the incidental processes such as valuation of the underlying asset, assessment of taxation and administrative costs.

A closer examination of Her Majesty’s Treasury's documents related to the Sukuk issuance made by the British government in 2014 illustrates the complexity and intensive scale of work that went into the process.[189] Most of the labour was dedicated to the complex ownership structure underlying the Sukuk. It is this distinctness and considerable complexity of the construction of those Islamic instruments that poses as a stumbling block to its growth.

5.5 Chapter conclusion

In conclusion, it is evident that the UK became the first government from the western world to tap into the nascent market of Sukuk by floating and selling a GBP 200 million Sukuk in June 2014. The issuance of this sovereign Sukuk by the United Kingdom sets positive benchmark that corporates can borrow from in structuring their own Sukuk. In addition to that, this issuance opened the door for other non-Muslim countries like Luxembourg and Hong Kong to follow suit

[188] Jobst Andreas, Kunzel Mills, “Islamic Bond Issuance - What Sovereign Debt Managers Need to Know?” IMF Policy Discussion Paper, PDP08/3 (2008).

[189] Piotrowski Darius, “Challenges and Barriers To The Development Of Sukuk In The European Capital Market” < https://iises.net/proceedings/8th-economics-finance-conference-london/table-of-content/detail?cid=48&iid=006&rid=7695> Accessed on 3rd August 2019

and issue their own Sukuk. Outside the South East Asian and Middle East, there is very little activity in Sukuk in comparison.

Not only did the UK Sukuk issuance pave the way for more Sukuk issuances in the future, it has also served as a learning tool from which valuable lessons have been drawn and real challenges conceptualized based on the UK's unique socio-economic platform.

According to Piotrowski,[190] there is need to channel more effort in investor awareness and focus on giving potential investors the right information on Sukuk. Also, in light of the specific nature of Islamic financial instruments, the efforts of sector representatives should also be aimed at increasing the number and competence of advisors servicing transactions in the legal and financial scope. Financial and promotional support granted by state authorities or trading markets to several corporate Sukuk issues could prove extremely useful to market development.

190 Ibid

CHAPTER SIX

EMERGING CONSIDERATIONS IN FORMULATION OF LAWS TO GOVERN SUKUK

6.1.Introduction

It has become the trend worldwide that governments are increasingly seeking out alternative finance arrangements to raise capital for development projects and Sukuk is emerging as a sustainable option to meet government's financing requirements. The laws presently cover the conventional debt-based bond securities and clearly define all aspects of the conventional debt securities. In order to compete with the conventional securities, the playing field has to be leveled for Sukuk to play a matching role in the market. Part of the efforts in doing so requires an overhaul of the legislative framework to accommodate Sukuk.

It trite that while the cash flows from Sukuk issuance are similar to those of the conventional bond, the striking differences in the underlying structure of Sukuk all for a careful reassessment of the existing laws.[191] It is this structural difference that has led countries to amend their legislation to enable the issuance of Sukuk.

6.2 Points to consider when formulating laws to govern sukuk

This research narrows its focus to sovereign Sukuk as a tool for raising funds for financing public project and as such, there is need to highlight certain considerations that have to be made while considering the subject of amendment to the existing legal framework to facilitate Sovereign Sukuk in its role as a tool for public debt management. The issuance of Sukuk requires the presence of certain pertinent considerations to be made in the legal framework. These are:

6.2.1 The mandate to use public assets to back Sukuk issuance

As explained in the preceding paragraphs, Sukuk issuance are either asset based or asset backed. This peculiar feature of Sukuk requires that the asset underlying the Sukuk is transferred to the SPV. In the case of Sovereign Sukuk, this means that the government, or government body, will have to transfer a public asset to form the basis of the Sukuk issuance. There is need to have law

191 Balibek Emer, "Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective" <http://documents.worldbank. org/curated/en /9070014974 72893193/pdf/P1615 73-06-14-2017-1497472889089.pdf> accessed on 4th August 2019

authorizing the government, through the relevant agency to transfer ownership of government property to the SPV. The mandate has to be an unequivocal mandate to use government owned property as the basis for Sukuk issuance.

The United Kingdom has made such provision under Section 157 of its Finance Act and the Government Alternative Finance Arrangement Regulations (GAFAR). The Finance Act empowers the UK Treasury to make regulations to govern the government's raising of money through alternative finance arrangements.[192] The regulation expressly allows the Treasury or the state secretary to transfer to the Sukuk SPV, "a qualifying interest in land and to enter into a leaseback agreement for the purpose of generating income or gains, on the condition that the interest is transferred back to the government."

Luxembourg also has similar provisions in it Sukuk Law, Law Number 6631. This law is unique in the sense that it has set aside three government properties as underlying assets instead of defining general rules for eligible assets. This law permits the government to sell these assets to public limited companies, and lease them back, on the condition that ownership is returned back to the government after a five -year period.

Turkey and Indonesia also followed this pattern and enacted laws that expressly permit the governments to use public property as underlying assets in Sukuk transactions. The latter's Sukuk law[193] provides the government with an unequivocal mandate to use state owned assets, including lands, buildings, and others, as the basis for issuance. The Finance Minister is given the authority to sell or lease government property for a period of maximum sixty years.

Turkey on the other hand has amended its Public Debt Management Law to authorize the Minister in charge of the Treasury to use tangible and intangible assets owned by public entities as underlying assets.

These examples demonstrate why it is important to have the law define expressly the government's right to use public assets as underlying assets for Sukuk issuance.

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[192] Alternative Finance Arrangements are defined in the Act arrangements which in the Treasury's opinion— (a) equate in substance to a loan, deposit or other transaction of a kind that generally involves the payment of interest (including the issuance of government securities), but (b) achieve a similar effect to such a transaction without including provision for the payment of interest

[193] Under Articles 10 of the State Shariah Bond Law, Law No.19/2008

6.2.2 The establishment and governance of Sukuk SPV

The setting up and management of the SPV is another consideration that has to be taken into account in establishing the legal framework for Sukuk. Under any of the Sukuk structures, a Special Purpose Vehicle must be incorporated to play three crucial roles i.e. that of issuer at the issuance stage, trustee as a representative of the Sukuk holders, lessee when it leases the asset to the government. The underlying public asset is transferred to the SPV to generate the cash flow needed to the Sukukholders. The common thread in all the Sukuk structures is that great power is placed in the hand of the SPV. It not only oversees the execution of the Sukuk issuance, it also ensures adherence and compliance with the set Shariah standards of governance and accounting. As such, the mechanism of establishment and governance of the SPV is a pertinent question to address in the law.

By their very nature, the Sukuk SPV is established solely for the purpose of issuing Sukuk and does not engage in any other business. Its mandate and scope of engagement should be clearly defined to preclude it from trading in any other business other than the Sukuk. Aside from this, there needs to be clear provision in the law to enable the government through the SPV to isolate its Sukuk programs from other conventional issuances that involve payment of interest to lenders.[194]

The UK has established the UK Her Majesty's Treasury Sovereign Sukuk PLC while Luxembourg has the Luxembourg Treasury Securities SA which are both wholly owned by their respective governments. The structure of incorporation of the SPV is the same for both.

The UK Sukuk SPV was established under Regulation 3 of the Government Alternative Finance Arrangement Regulations (GAFAR) which provides that the SPV will be incorporated under the Companies Act. The staff of the SPV comprises of staff drawn from the UK Treasury and other government departments. Though it is a distinct corporation, it operates as a subsidiary of the Treasury and even draws its administrative costs from the UK Treasury.[195]

194 Balibek Emer, "Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective" <http://documents.worldbank. org/curated/en /9070014974 72893193/pdf/P1615 73-06-14-2017-1497472889089.pdf> accessed on 4th August 2019 on

195 Ibid

Indonesia has more elaborate provisions on its Sukuk SPVs. Presently Indonesia has three Sukuk SPVs namely Perusahaan Penerbit SBSN (1, 2 and 3)[196]. These regulations define the mandate, powers, management structure and accounting standards to be employed by the SPV.

The point for consideration is that the SPVs discussed in the above examples were all created based on unequivocal provisions of the law. It would be necessary for any country considering Sukuk issuance to formulate laws that clearly define the mandate, governance structure and scope of power to be exercised by the SPV.

6.2.3 Limitation on the structure of Sukuk

It is pertinent for government to list the types of Sukuk structures they deem fit for its market. Kenya, being a country that is considering issuing its first, needs to carefully scrutinize the different types of Sukuk structures available and select a few that are easy to implement and execute. Some Sukuk structures are very complex and would require more specific amendments to be made in the law in order to actualize. The more basic Sukuk structures like Sukuk Ijara may not require very detailed amendments.

The decision as to which types of Sukuk structures should be preferred and how to define them in the legislation depends on the needs of a country and the level development of its Sukuk market. The UK GAFAR regulations leaves it up to Her Majesty's Treasury to decide which Sukuk structures to be implemented but yet compels that the structure must have a lease-back arrangement. This essentially limits the Sukuk structure to Ijara.

6.2.4 Dispute resolution

Another consideration to be made when designing a legal framework for Sukuk is dispute resolution. The law also needs to address the issue of how disputes arising from Sukuk will be resolved and what rights and remedies are availabale to all the players in the Sukuk structure. An adequate dispute resolution mechanism will give investors the confidence to invest in the Sukuk.

Common disputes that arise include non-payment of service fee by government, failure of the SPV to maintain Sukuk asset, total loss or destruction of the Sukuk asset. One particular risk that

[196] Which are all established in line with Government Sukuk Regulation Number 57/2008.

investors are exposed to is the risk of destruction of assets during the life of the Sukuk but before redemption.

6.2.5 Apportionment of operational cost and maintenance of the underlying asset

The Sukuk structure gives rise to several incidental cost which need to be catered for by either the Originator, the Issuer and/or the SPV. These operational costs include the cost of transfer of the assets between the government and the SPV, the cost of the management and maintenance of the underlying assets. Unless the law apportions these costs carefully to the necessary party, there would be significant chaos which can potentially make the entire issuance more costly.

The UK law does not define the how costs are to be apportioned. Its approach is that these issues are covered in the underlying agreements wherein the obligations of each party is well negotiated and defined. Luxembourg has also taken a similar approach and its legislations also do not provide for the operational issues and as such also leave it to the underlying Sukuk contracts.[197]

6.2.6 Compliance with Shariah principles

Sukuk being an Islamic finance product must strictly adhere to the applicable Shariah principles. Therefore, the legal framework must reflect this requirement by stipulating that all Sukuk issuances must be deemed to be Shariah adherent. This is even more important for countries governed by secular laws that are divergent with Islamic Shariah. Further, such a provision in the law will give investors a guarantee that the Sukuk floated is in compliance with Islamic Shariah principles.

The law also need to define the role of *fatwa* in the whole process. *Fatwa* are simply declarations by Islamic scholars on topical issues.[198] Occasionally, the opinion of Islamic scholars is sought on issues of compliance with Sharia. The issue of *fatwa* is often problematic as they are issued *ad hoc* on a case to case basis and vary significantly from one jurisdiction. The law has to be clear on whether *fatwa* will be considered when dealing with the question of compliance with Shariah principles even though most Islamic finance institutions obtain opinions from their internal team

197 Ibid
198 Fatwa reflect the opinions of scholars on the shariah compliance of Sukuk structures.

of scholars as to whether the proposed transaction is in compliance with their individual standards Shariah compliance.

The legislation in Countries like the UK and Luxembourg do not mention Sharia principles neither do they provide any guarantee to investors on the compliance with Islamic Shariah.[199]

6.3 Chapter conclusion

Although the structure and format preferred varies from country to country and highly depends on the on the needs of a country and the level development of its Sukuk market, it can be concluded that there are certain key provisions that have to be captured in the legislations as discussed above. These provisions have to be crafted carefully in order to capture the essence of the various forms of Sukuk while at the same time avoiding rigidity and allowing future growth. The proposed laws not only have to comply with relevant Islamic principles, they also have to reflect the unique characteristics of Sukuk from an operational perspective.

[199] It is worthy to highlight that these countries are not predominantly Islamic nations hence the avoidance of guarantees on Shariah compliance.

CHAPTER SEVEN

OVERALL CONCLUSIONS AND RECOMMENDATIONS

7.1.Introduction

Development is at the heart of every country's agenda. Kenya is a developing country with ambitions to attain middle-income economy status and enhance its position on the global development index. To achieve this, Kenya has formulated a development blue print known as the Vision 2030[200] which is the country's development roadmap. Whether it is economic or human development, the attainment of development requires dedication of substantial funds to implement. Some of the key development areas are health, sanitation, road, rail and sea transport network, communication, technology and energy.

The fact that infrastructure development is a key pillar for progress and a critical enabler for productivity and sustainable economic growth cannot be gainsaid. Infrastructure development will contribute immensely to human development, poverty reduction and the attainment of Kenya's goals to become middle income country.[201] Adequate infrastructure is essential for productivity and growth and transport in particular is a driver of development.[202]

Kenya's 2016/2017 budgetary allocation for infrastructure projects is Kshs.367 Billion[203], nearly 30% of the National Budget. This huge allocation to the infrastructure sector comes in recognition of the fact that Kenya's inadequate infrastructure was an impediment to its progress toward improved domestic and international trade, living standards, poverty reduction and investment.[204] Nonetheless, this huge allocation is inadequate to attain the development goals going by the estimation of World Bank. According to the World Bank, Kenya will require almost USD 4

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200 The Kenya Vision 2030 is the national long-term development policy that aims to transform Kenya into a newly industrializing, middle-income country by 2030.

201 John Kinuthia and Jason Lakin, Kenya: Analysis of the 2016/17 National Budget Estimates, June 2016

202 Stern, N. (1991), "The Determinants of Growth," Economic Journal, Royal Economic Society, vol. 101 (404), pp. 122–133, January

203 Annual budget 2016/2017

204 African Development Bank Group, Kenya-Country Strategy Paper 2014-2018 (2014) < https://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/2014-2018_-_Kenya_Country_Strategy_Paper.pdf> accessed on 17th January 2017

Billion[205] per annum over the next decade to address the infrastructure financing deficit.[206] At present, treasury projects a budget deficit amounting to Ksh. 398.1billion which is expected to be funded by domestic borrowing amounting to Ksh. 223 Billion and external borrowing of Ksh. 4 billion.

Clearly, it is not the lack of a development roadmap that has impeded Kenya's development goals but rather the shortage of funds. The shortage of funds can be addressed if the government taps into alternative sources of funding.

Lately, Islamic financing models such as Sukuk have gained quite some credibility as sources of alternative capital raising and the impact is clearly visible from countries like Malaysia[207], Kuwait[208] Luxembourg, England and Indonesia[209] which have embraced the Islamic models of financing to bridge their funding gaps.

Sukuk can be utilized as innovative instruments, especially for infrastructure development, to mobilize resources to finance development projects. The resources can be used to fund projects that will help Kenya attain its goals under the Vision 2030. Sukuk have established an enviable niche in Islamic capital markets sector. Its position derives from the fact that they are the closest instrument to the conventional bond and as such deliver on the functionality and purpose of a bond but structured in compliance with Islamic shariah. Both Sukuk and the conventional bond, as capital markets instruments, provide access to a vast and growing demand for capital. The two are complimentary, with each catering to unique caliber of investors.

This research paper examines the potentials for using Sukuk as a tool for capital raising for infrastructural development in Kenya and discusses the recent Sukuk issuances globally as

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205 The Vision 2030 Second Medium Term Plan 2013-2017 estimates Kenya's infrastructure spending needs at about USD 4 billion per year. The plan also cites lack of adequate funding being a factor that has slowed down infrastructure development

206 The World Bank Policy Research Working Paper 5596 Kenya's Infrastructure A Continental Perspective Cecilia M. Briceño-Garmendia Maria Shkaratan

207 The first Sukuk were issued by Malaysia in 2000. It is the world's largest Sukuk market with 68.9% or USD62 billion (RM213 billion) of the global outstanding Sukuk as at end-2007 having been originated in Malaysia

208 Issued its first sovereign Sukuk in 2001.

209 Indonesia's Islamic bond market is the second largest in emerging East Asia in terms of size.

benchmark on the viability of Sukuk as a tool to bridge the infrastructure funding deficit. Evidence has demonstrated that it has been instrumental in the finance of several projects around the word. In the recent years, several countries which had hitherto not considered this method of financing have been embracing it to bridge their funding gap.

7.2.Recommendations

Kenya places a high premium on infrastructure projects as seen from the budgetary allocation on infrastructure over the last five years. Infrastructure projects such as power plants, roads, airport, schools, electricity, water systems and telecommunications are the main foundations of modern economy. Every expenditure on infrastructure projects can yield an outcome far exceeding the initial expenditure. For example, when establishing a power plant, it will not generate only employment directly through the construction and operation of the power plant, but it will also increase the number consumers. This in turn can result in higher growth rate.

In the recent past, governments look to Sukuk as an attractive financing solution to the mainstream borrowing from the international markets. The evidence of this is that the proportion of sovereign Sukuk is greater than 50% of the total Sukuk issued around the world.[210]

Kenya, has since the enactment of the Public Private Partnership Act in 2013, used PPPs to deliver public facilities. Sukuk are an ideal structure to finance PPPs, especially infrastructure projects given their tangible asset base as well as recurring revenue. The beauty of Sukuk, is that they can be structured to cater for every unique purpose and depending on the underlying asset and available investment.

Some of the considerations that can be made in order to facilitate the development of Sukuk in Kenya are discussed below:

7.2.1. Facilitative Legal Framework

For Sukuk to emerge as a viable tool for financing in Kenya, a more facilitative legal and regulatory framework will be required to be adopted. Without facilitative laws and regulations, the issuance

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210 Bank Al-Khair, " Sovereign's Infrastructure Projects; Financing Solutions" (2015) <http://pubdocs.worldbank.org/en/241031448479778427/pdf/islamic-finance-2015-11-18-Ayman-Sej--iny.pdf>

of Sukuk will be stifled. Sukuk, like Islamic finance, emerges from the principles of Islamic Shariah and are underpinned by the quranic standards of acceptability.

Further, tax and capital markets legislations are important in government securities and will need a total review of the existing legislation, with a view to identify deficiencies and to devise remedies and to create a framework for Sukuk operation.

One of the ways in which the current legislation hinders development of Sukuk is through the existing tax laws which require stamp duty[211] and Capital Gains Taxes[212] to be paid on the transfer of the underlying Sukuk asset. These two sets of taxes are required to be paid twice; first upon transfer of the underlying asset to the Sukuk SPV and second from the Sukuk SPV to the originator. These taxes are exorbitant and make Sukuk less attractive as compared to its conventional equivalent, the bond. In order to level the playing field, some of the applicable taxes ought to be waived.

One of the primary reasons that Malaysia continues to account for more than 60 percent of global Sukuk issuances is because its government enacted tax, land transfer and registration laws do not penalize Sukuk issuances in comparison with conventional bond issuances. [213]

A number of countries have been eager to follow suit in their desire to develop an Islamic finance market and have enacted legislation to pave the way for Sukuk issuances. For example, the UK's Finance Act 2009, which received royal assent on 21 July 2009, removed the tax barriers which had made Islamic financial products less tax-efficient than their conventional counterparts. The enactment of this legislation helped the UK Government to issue its first sovereign Sukuk-which also became the first of its kind by a European sovereign state[214]. The Government of the

[211] As per the Stamp Duty Act CAP, Stamp Duty is calculated at 4% of the value of the underlying asset.
[212] Provided for under the Income Tax Act through amendments to the existing Act and is calculated at 12.5% of the value of the underlying asset.
[213] Latham & Watkins, The Sukuk Handbook: A Guide To Structuring Sukuk, 2nd Edn 2015. Accessed at <https://www.lw.com/thoughtLeadership/guide-to-structurings-Sukuk-2015> on 3rd August 2019.
[214] Michael A, Financial Services Authority; Islamic Finance in the UK: Regulation and Challenges, 2007. Accessed on 4th August 2019 at <https://www.isfin.net/sites/isfin.com/files/islamic_finance_in_the_uk.pdf>

Other countries that made changes to their legal framework to make Sukuk issuances comparable to conventional bonds include Hong Kong, Japan and Singapore[215]. The primary focus of these legislation is to eliminate differential treatment in the taxation of Sukuk and traditional bonds in order to level the playing field, so that Sukuk can compete with conventional bond in the capital market.

7.2.2. Shariah Standardization

Shariah standardization has become the crux of most the emerging literature surrounding Sukuk. Sukuk being an Islamic finance tool relies highly on Islamic shariah interpretation. Sukuk transactions require a pronouncement by shariah scholars in order to provide issuers and investors with comfort that a Sukuk instrument is fully shariah compliant. Such endorsements, however, are subject to different interpretations depending on the applied school of thought.

The reason why it is important to have a Sukuk standardization is to harmonize the applicable shariah standards which underpin Sukuk issuance. Sukuk transactions often involves the seeking of legal pronouncements from Islamic scholars on the shariah compliance of the structure and issuance of Sukuk. This provides issuers and investors with comfort that a Sukuk instrument is in fact shariah compliant. More often than not, these pronouncements are subject to different Islamic interpretations depending on the school of thought applied.[216]

The divergence in opinion can potentially create instability in the market, which ultimately hamper the uptake for Sukuk products. In order to avert differences on shariah compliance, a unified code of rules and regulations should be developed to which the majority of shariah advisors agree upon.

7.2.3. Establishment of Sukuk Authority

One of the ways in which a state can achieve shariah standardization is by establishing a central body whose role is to ensure shariah standardization. In order to actualize shariah standardization, it would be prudent to establish an authority that will be tasked with setting the guidelines,

215 Hong Kong enacted new laws in July 2013 thus enabling it to issue its first Sukuk of US$16 billion in September 2014.
216 Latham & Watkins, The Sukuk Handbook: A Guide To Structuring Sukuk, 2nd Edn 2015. Accessed at <https://www.lw.com/thoughtLeadership/guide-to-structurings-Sukuk-2015> on 3rd August 2019.

standardizing the documentation pertaining to the Sukuk, monitoring and resolving disputes arising from Sukuk. A Sukuk authority would assist in vetting and authorizing Sukuk issuances and most importantly ensure adherence with Islamic shariah principles.

Most importantly, the authority would play the role of supervisor and regulator and such ensure discipline, control and the development of Sukuk market. In the discharge of this regulatory and supervisory framework, the proposed authority would streamline issues of licensing of Sukuk intermediaries, acceptable market conduct, shariah compliance requirements, registration and licensing of Sukuk advisers; disclosure, corporate governance and transparency requirements.[217]

Malaysia leads the best example on how its government has attempted to address the question of shariah standardization by establishing a shariah supervisory board that is mandated to ensure that every Sukuk issued in Malaysia is in full compliance with the nationally accepted shariah principles.

7.2.4. Skill and Capacity Development

Kenya is a country governed by secular laws and in addition to that, it is not a Muslim-majority country where the principles of Islamic finance are ingrained in the day to day business dealings of its populace. As a result of this, there is need to have a comprehensive knowledge and skill enhancement on the subject of Sukuk ranging from Sukuk conceptualization, project assessment issuance, monitoring and completion.

Most of the investment and finance advisors in Kenya are trained in the conventional market product. This also reflects the trend globally where there is a global shortage of experienced professionals in the Islamic finance sector.[218] There is need for more training and development of skill set that will see an increase in the number of Sukuk advisors in the country.

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217 Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation COMCEC; The Role of Sukuk in Islamic Capital Markets, COMCEC Coordination Office 2018. Accessed on 4th August 2019 at << http://www.sbb.gov.tr/wp-content/uploads/2018/11/The_Role_of_Sukuk_in_Islamic_Capital_Markets .pdf>

218 Michael A, Financial Services Authority; Islamic Finance in the UK: Regulation and Challenges, 2007. Accessed on 4th August 2019 at <https://www.isfin.net/sites/isfin.com/files/islamic_finance_in_the_uk.pdf>

7.3. Conclusion

Infrastructure is at the core of every developing country's agenda. A lot of emphasis is placed on infrastructure development by global organizations like the World Bank, International Monetary Fund, World Trade Organizations and the United Nations through the Sustainable Development Goals. Given its importance, developing states are forced to place infrastructure development front and centre of its national agenda in order to achieve sustainable economic growth. Indeed, huge amounts of funds are required in infrastructure development which governments in those countries cannot fund from their own budgets. This budgetary deficit is usually bridged through loans from both domestic and international institutions, which loans come at exorbitant interest rates and stringent conditions. Therefore, there is need for a better alternative to conventional debt instruments which have proven inefficient in leading developing countries out of debt and on the path to development.

The preceding chapters of this paper propose Sukuk as an alternative to these loans and hence a better means for financing infrastructure development. Sukuk are the Islamic alternative to the conventional bond with the main difference between conventional bond and an Islamic bond being that, conventional bond is not backed by any asset but Islamic bond is backed by a tangible asset.[219] Using Sukuk, many countries have raised sizeable funds to finance their public projects. This has been true in the case of Malaysia, UAE, Indonesia, Bahrain and Saudi Arabia.

In the short time-span that Sukuk have been utilized, they have proved to play an important role in the development of the countries that have utilized them. Malaysia is the global leader of sovereign Sukuks issuance and is the first country in the world to issue its first Sukuk in 2002 for the sum of USD 600 million. The issuance of Sovereign Sukuks is not limited to Muslim nations only; non-mulsim states have also issued their fair share of Sukuks for example Luxembourg, Germany, United Kingdom and France which ended up being oversubscribed. Luxembourg is the

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219 Ashfaq A , Muhammad Z , Salman M , Saqib U, Infrastructure projects financing. An alternative to debt financing, IOSR Journal of Business and Management (IOSR-JBM) Volume 15, Issue 5 (Jan. 2014), PP 48-52 accessed at https://www.researchgate.net/publication/331701395 on 30th March 2019

first non-Islamic State to issue Euro-denominated Sukuk in the Eurozone and has enacted in 2014 a law for the purpose to issue the first sovereign Sukuk. Likewise, Sukuk issuance is also not limited to developing countries only, it has also been utilized by developed countries to raise funds to finance the public sector projects.

The ballooning public debt has been a major issue of concern for every developing country that has to be addressed. Debt is brought up by government borrowings from domestic and foreign financial sectors to meet its expenditure. As explained in the preceding chapters, public debt servicing throws developing countries into a perpetual debt trap, depriving them of the resources needed to secure long term economic development and build up strong social and physical infrastructures. Unsustainable debt begets deeper economic crisis, with dramatic social consequences for their populations. An increase in debt servicing obligations leads to an increase recurrent expenditure and a congestion on development spending. Governments can fulfill their fiscal deficits by issuing sovereign Sukuks as the most viable option in the in the long run.
Sukuk structures offer a better alternative to the conventional financing which is based on interest. Two reasons come to mind. First, Sukuk are based on real tangible assets, as such they are expected to enhance the stability of the financial institutions and markets.[220] This feature ensures a stronger connection between the financial sector and the real sector of the economy and renders the system less prone to speculative activities which are the cause of many financial crises.[221] The second reason is that, financing government expenditure through Sukuk can potentially discipline public expenditure as availability of finance without an asset will be very limited.[222]

In its totality, Sukuk is the best alternative to debt-financing and offer a better model of financing large scale infrastructure projects. However, in order for it to work well in the Kenyan context,

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220 Abdou D,Obiyathulla I, Ahcene L, Public Sector Funding and Debt Management: A Case for GDP-Linked Sukuk 2011 <http://oemmndcbldboiebfnladdacbdfmadadm/https://www.researchgate.net/profile/Abdou_Diaw/publication/321758766_Public_Sector_Funding_and_Debt_Management_A_Case_for_GDP_linked_Sukuk/links/5ae19b0baca272fdaf8dff90/Public-Sector-Funding-and-Debt-Management-A-Case-for-GDP-linked-Sukuk.pdf?origin=publication_detail> accessed at 30th March 2019

221 Ibid

222 Ibid

significant changes have to be introduced in the legislative framework. As discussed in the preceding chapters, amendment in the taxation and capital markets frame work complemented by adequate debt management legislation which will allow for the treatment of Sukuk on the same footing as conventional bonds will be a starting point on the implementation of Sukuk funded projects.

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