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Islamic Banking and Economic Infrastructure Development – Kenya's Prospects

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Islamic Banking and Economic Infrastructure Development – Kenya's Prospects

By Wahida Mohammed*

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Abstract

The high profile of infrastructure and access to related services in the communiqués of the World Bank (WB) and the International Monetary Fund (IMF) at their annual meetings of 2014 underscores the importance of infrastructure development worldwide. And nowhere is the lack of adequate infrastructure more crucial and potentially transformational than in Sub-Saharan Africa. A gap of around US\$ 31 billion¹ exists per year that must be bridged if Africa's infrastructure needs are to be met. Taking into account the resources currently available for infrastructure development to African governments the need for innovative project financing schemes becomes quite apparent. One area of possible innovation is the use of Islamic finance or sharia-compliant financing for infrastructure development. Research on this type of financing has been conducted predominantly in Islamic countries and in developed countries. The purpose of this paper therefore is to explore from a non-Islamic developing country's perspective the prospects of using Islamic finance for infrastructure development. It aims to identify the conditions necessary in terms of an analysis current practice, gauge the understanding of Kenyan stakeholders as well as identify possible barriers that may be impeding Islamic infrastructure financing in Kenya. Three case studies of infrastructure projects drawn from Africa that have utilised Islamic financing mechanisms are conducted in order to answer research question one. Two cycles of a Delphi study were also conducted where interviews and questionnaires are used to gather the views and opinions of an expert panel to answer question two and three.

¹ Chuks Ibechukwu and Clement Fondufe -Meeting africa's infrastructure needs

This paper presents an overview of both conventional and Islamic project financing in infrastructure development followed by the presentation and discussion of the research findings. Trends to watch and policy recommendation aimed at facilitating the implementation of Islamic project financing in Kenya infrastructure development are also discussed. It is expected that the results of this research will facilitate the harnessing of Islamic financial resources in the development of infrastructure projects not only in Kenya but in Sub Saharan Africa as well.

Key Words: Infrastructure, Islamic finance, sharia-compliance, Delphi study, Case studies, barriers

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Acronyms & abbreviations

AFDB	African Development Bank
BOAD	Banque Ouest Africaine De Developppment
CBAO	Compagnie Bancaire De Lafrique Occidentale
CBN	Central Bank of Nigeria
CMA	Capital Markets Authority
DCT	Doraleh Container Terminal
DRC	Democratic Republic Of Congo
EAC	East Africa Community
FMO	Netherlands Development Finance Company
FTZ	Free Trade Zone
GCC	Gulf Cooperation Council
GOK	Government Of Kenya
ICT	Information And Communications Technology
IFC	International Finance Cooperation
KISCOL	Kwale International Sugar Co. Ltd
KRA	Kenya Revenue Authority
LAPSSET	Lamu Port South Sudan Ethiopia Transit Corridor
LFTZ	Lekki Free Trade Zone
MOF	Ministry Of Finance
NSC	North South Corridor
ODF	Official Development Financing
PMO	Project Management Office
PPI	Private Participation in Infrastructure Projects

PPP	Public Private Partnership
SADC	South Africa Development Community
SGR	Standard Gauge Railway
SPC	Special Purpose Company
SPV	Special Purpose Vehicle
TEU	Twenty Foot Equivalent Units
USD	United States Dollars
WAEMU	West African Monetary Union

Islamic Finance Terms

TERM	TRANSLATION
Aqd	A contract based on Islamic law
Fatwa	A legal opinion/decree based on Islamic law
Ijara	A hiring or renting of an asset to gain benefit of its usufruct
Istisna	An order to produce a specific asset
Kafalah	A guarantee scheme given by insurer to a third party in order to fulfill obligation of second party
Mudaraba	Cooperation between two parties which the first party gives 100% equity to the second party as the executor and only profit will be shared based on agreement
Murabaha	Mark-up sale which both parties (seller and buyer) know the cost price
Musawama	Mark-up sale without knowing the precise cost price
Musharaka	Partnership or joint venture which two or more parties share equity in an agreement that profit and losses will be shared together
Riba	Interest
Shariah opinion	Shariah compliant statement
Sukuk	Islamic investment certificate or bond

Introduction

1.1 Research Background

The Kenyan government's Vision 2030² identifies infrastructure as an enabler of Kenya's transformation and confers the responsibility for public infrastructure provision based on the particular sector of infrastructure and the level of infrastructure utilisation.

The LAPSSET Project estimated to cost USD 29.24 billion and expected growth rate 8% to 10% of GDP is the first game changer Infrastructure Project that the Government of Kenya has initiated and prepared under this strategic framework. The Standard Gauge Railway (SGR) project is another flagship project under vision 2030 flagship that comprises of a 609Km long line costing about USD 3.8 billion and expected to be operational by year 2017. Other projects envisages under Kenya's Vision 2030 are Thika Super highway and the greater Nairobi commuter rail project costing USD 325 million that includes the laying of the new track linking Jomo Kenyatta International Airport (JKIA) and the Nairobi central business district. To these projects Kenya has allocated USD 1.4 billion to the SGR, USD 13.2 million for ports and USD 213.9 million for geothermal power development. All these projects are a manifestation of the Government of Kenya orientation towards investment in large infrastructure projects as key drivers of economic development. However, there exists a huge infrastructure budgetary deficit thus calling for devising alternative financing means. With this regard, tapping into the private sector through PPP could be an alternative financing model. The projects have to a large extent been financed through Chinese investment and PPI arrangements necessitated by the need of generating more capital and reducing the pressure on the GoK budget which for most part cover sectors and sub-sectors that national governments and ODF fail to. For instance in the top

² Development blue print for the year 2008-2030

five trends in the changing landscape of African infrastructure financing³ report, PPI is cited as a major contributor to the telecom sector with 64.1 percent of PPI going to this sector; electricity receiving 18.6 percent of the PPI, seaports 9.6 percent, and the last 7.6 percent being split between six other sectors.

On the private sector side Standard Bank's CFC Stanbic has led the debt arranging for the 60MW Kinangop Wind Park plant. The sponsors are African Infrastructure Investment Fund 2 (AIIF2), and Norfund, the Norwegian investment fund for developing countries, both of whom are providing USD 60 million of the capex in equity. This deal is particularly interesting as it is the first independent large-scale wind farm to reach financial close in Sub-Saharan Africa (outside South Africa). The deal is also significant because of the absence of development financing or multilateral risk support, making it a ground-breaking commercial bank financing with sovereign off take risk.

The Greenfield sugar plantation, a sugar refinery and an 18MW cogeneration plant run on bagasse (a by-product of cane) will also be the first of its kind in Kenya, situated 80km to the south of Mombasa. On completion the project will have a capacity of 3,000 tons of cane per day, and will put power back into the Kenyan power grid. The sponsor is Kwale International Sugar Company Limited ("KISCOL"), a joint partnership between the sugar trading Pabari family and Mauritian sugar miller Omni cane. A

consortium of 12 banks led by the PTA Bank and Standard Bank's Stanbic agreed financing of USD 120 million, split into USD 100 million over a nine-year tenor and the remaining USD 20 million over a 12-year tenor. The debt to equity split was 60/40. Standard Mauritius provided USD 15 million, Standard Bank Kenya provided USD 22.5 million, and local development bank PTA provided USD 20 million. The balance was split between a combination of Mauritian and Kenyan banks.

IFC, a member of the World Bank Group, is investing Euro 20.7 million and is arranging Euro 20.7 million loan from Standard Bank to finance the development of a power plant to meet Kenya's energy needs in terms of fuelling the economy, job creation and boost growth. Independent Power Project (IPP) by Gulf Power Ltd⁴ will use this loan to create and sell all output to the national distributor, Kenya Power and Lighting Company, increasing the supply of electricity in the country. The 80 megawatt Gulf Power plant will use heavy fuel oil (HFO), to help diversify Kenya's electricity away from hydropower. Gulf Power is owned by Gulf Energy Limited, an oil and gas trading company, and by Noora Power Limited; both companies incorporated in Kenya. Total cost for the Gulf power plant is estimated at Euro 83 million. Clearly then despite its narrow scope PPI is contributing significantly to Kenya's infrastructure. The review of these projects present the most striking feature of changing share of financing offered by

³ <http://www.brookings.edu/blogs/africa-in-focus/posts/2015/04/08-financing-africa-infrastructure-sy>

⁴ <http://ifcext.ifc.org/ifcext/pressroom/ifcpressroom.nsf/0/A098FDAC2900BF6085257AB000427182>



traditional, non-traditional partners and private sector sources; which may pose great opportunities as well as challenges for the country.

1.2 Research Problem

According to The African Development Bank, Africa's annual infrastructure requirements are estimated at USD 93 billion⁵, that is about 15% of Africa's GDP. Actual investments in infrastructure total USD 45 billion annually, with more than half funded by the public sector. About a third of this gap can be met through operational optimisation, reducing the gap to USD 31 billion: - 5% of GDP. PPPs can theoretically only represent 40% of the optimised gap that is USD 12 billion annually or about 2% of GDP. At the same time traditional financing mechanisms appear to be ill-suited towards bridging infrastructural gap ; while the new economic environment seem to be alive with new and multiple stakeholders. Multilateral agencies are currently the key financiers of infrastructure in Africa followed by international Commercial Banks with Export Credit agencies focusing only on extractive deals and sovereign deals. Regional Development Banks also support infrastructure development but in foreign currency and tend to be constrained by size. Local commercial banks are constrained by their balance sheet size, prudential ratios, liquidity cost and perhaps credibility. Another perpetual weakness is the short-term and expensive nature of lending confined to resource-rich countries. New approaches need therefore be considered in order to raise new

infrastructure financing as well as capitalize on current financing. Policymakers, private sector actors, multilateral banks, and other stakeholders need to be aware of the complexities surrounding infrastructure financing, how it is shifting and how they need to adapt if meeting infrastructure needs is the end game. Innovative financing is therefore of key importance.

One of the areas of innovation is the implementation of financing that is compliant to Islamic religious principles. It is important to note here that Islamic financial assets have grown at double-digit rates during the past decade, from about US\$200 billion in 2003 to an estimated US\$1.8 trillion at the end of 2013 (Ernst & Young 2014; IFSB 2014; and Oliver Wyman 2009). However, these assets are still concentrated in the Gulf Cooperation Council (GCC) countries, Iran, and Malaysia. But this is not to say that the Gok and other African countries have not started exploring Islamic financing of infrastructure projects which should be an easy match considering that generally infrastructure projects are *shariah* compliant in the sense that : Activities of infrastructure project development do not in general contravene *shariah* law, there is a creation of assets that conform to the Islamic financing concept of an asset-based system or an asset-backed system, there is a possibility of revenue generation via toll roads, ports or power plants and private sector enterprises participate in infrastructure provision under the PPP scheme can help establish the Special Purpose Companies (SPC); a pre requisite for Islamic financing. As such, what remains therefore is to raise questions aimed at identifying the conditions necessary for the successful

⁵ http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/ECON%20Brief_Infrastructure%20Deficit%20and%20Opportunities%20in%20Africa_Vol%201%20Issue%202.pdf

Islamic project financing implementation of Kenyan Infrastructure projects.

1.4 Research Aim and Objectives

The aim of this research is to identify the conditions necessary for the implementation of Islamic project financing for Kenyan infrastructure projects. More specifically, the paper seeks

- 1) What are the current practices of Islamic financing of African infrastructure projects?
- 2) What understanding do Kenyan infrastructure stakeholders have of Islamic infrastructure financing?
- 3) What are the possible barriers that may be impeding the implementation of Islamic financing of Kenyan infrastructure projects?

Literature Review

Islamic infrastructure financing refers to the provision of financial services for the development of infrastructure projects in accordance to Islamic jurisprudence (*Shari'ah*). *Shari'ah* bans interest (*Riba*), products with excessive uncertainty (*Gharar*), gambling (*Maysir*), short selling, as well as financing of prohibited activities that are considered harmful to society.

It also requires parties to honour principles of fair treatment and the sanctity of contracts. Transactions must be underpinned by real economic activities and assets. There is also the sharing of profit as well as risk. Islamic finance products may be classified into Debt-like financing structures; Profit-and-loss-sharing(PLS)-like financing and Services (Hussain, Shahmoradi, and Turk 2015)

Torrisi (2009) defines public infrastructure based on its attributes and functions as a capital good (provided in large units). This definition originates from the size of investment expenditure and is characterised by long duration, technical indivisibility and a high capital-output ratio. Although public infrastructure provision is usually a government responsibility (Patel & Bhattacharya, 2010), it requires huge funds and cannot solely rely only on national budgets. Thus the need to supplement national budget with capital that can be provided by the private sector (Chen, 2002). 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. Infrastructure project financing is not a new technique. It has evolved from financing natural resource infrastructure projects to public infrastructure projects (Finnerty, 2007). Each phase of the infrastructure project life cycle ranging from planning to design & construction to operations & maintenance to demolition & refurbishment requires financing. The construction

phase demands the highest level of financing, while the operations and maintenance phases may generate income that brings about a return on the capital.

The core proposition of Islamic finance draws from the inherent features and the values that it brings to the economy and the tremendous potential that it offers in supporting sustainable economic growth and in safeguarding financial stability. These core propositions are derived from the *Shariah*, which dictates that Islamic financial transactions must be supported by underlying productive activities. *Shariah* rulings ensure a close link between financial transactions and the real economy. That innovation and intermediation in Islamic finance remains aligned to generating productive economic activities. There is also a strong discouragement against excessive risk undertakings and a prohibition against speculative elements. The rulings also serve to insulate the Islamic financial system from excessive leverage, which in turn contributes towards promoting financial stability and its long-term sustainability. These fundamental elements resonate with the call for banking to focus on its core function of providing financial services that add value to the real economy.

This decade has witnessed a dramatic transformation of the Islamic financial landscape. It has been marked by sustained rapid growth and the widening of its geographical reach, resulting in more diverse Islamic financial institutions and the generation of a wide spectrum of innovative products, particularly in the high-growth segment of the *sukuk* market. Islamic

finance has also evolved from being domestic-centric to become increasingly internationalised. In this dynamic environment, the scope of the Islamic finance business has expanded from simple retail and trade financing to include private equity, project finance-sukuk origination and issuance, as well as fund and wealth management products.

2.1 Islamic Infrastructure Financing: Modes and Instruments

Broadly, there are two ways in which Islamic banks and other Islamic financial institutions can mobilize private savings for public sector projects related to infrastructure. The first way is based on profit sharing and can be applied to projects capable of yielding measurable monetary returns such as toll taxed highway projects. Funds mobilised in this framework can be rewarded by a percentage share of the actual returns. Secondly, funds can be mobilized by selling at a higher than cost price services / benefits of certain infrastructures which are 'purchased' on deferred payment from the private sector which builds them for the government in expectation of good returns on their investments. Thus an airport can be built by a private company, local or foreign, and sold or rented to the government which pays the instalments due out of money collected as airport tax and landing fees. It may be noted that whereas the returns to the investor in the first mentioned way is variable, in the second case it is predetermined.

The main devised financial instruments under the two aforementioned frameworks in Islamic finance are:



2.1.1 Sharing modes and instruments

Mudaraba and *Musharaka* generally yield variable returns and do not guarantee the capital invested. *Mudaraba* refers to non-voting or passive partnership. This is similar to equity finance whereby one party provides funds while the other provides expertise and management. *Musharaka* on the other hand refers to full partnership or a joint venture whereby both the financial institution and providers of funds can participate in the management of the project. With these modes of financing, accrued profits are shared on a pre-agreed basis. These instruments differ in various respects from the simple models presented in the theoretical literature noted above. But the essence remains the same. Funds are mobilized by selling certificates whose owners can expect an annual return. Some of them are negotiable so there is, theoretically at least, a possibility of making capital gains. The returns are linked either to certain projects or to growth in a broad sector of the economy.

The fund user is the government which builds the infrastructure and the fund suppliers are the people who have savings to invest with the mediator being the Islamic banks and other financial institutions. Once the government issues a particular sharing certificate the Islamic bank or other Islamic financial institutions buy using funds accumulated in their investment accounts. The government's obligation to pay yearly dividends and or capital is effected to the banks and Islamic financial institutions only. At the same time the public transacts only with the Islamic banks and other financial institutions. This implies that a secondary market dealing in such certificates

can develop where those who do not wish to keep the certificate till maturity can sell with a possibility of launching profit-sharing certificates which bear no maturity date. They are perpetual in nature with the government being the perpetual *mudarib* or partner, the holder of certificate being the financier (*Rab al Ma*) for the period he decides to hold it. Certificate owners can transact in the market making capital gains or losses. Annual profit are disbursed to the holders of the certificate on due dates. For convenience, the government in this instance also will only deal with institutions, banks, investment companies, brokerage houses etc. The public may realize their claims through these institutions. The proceeds of these perpetual certificates will have to be invested in revenue yielding government activities that are perpetual in nature.

2.2.2 Instruments yielding predetermined returns

These have been devised on the basis of *Ijara* (leasing) *Istisna* (Manufacturing contracts) *Salam* (Prepaid contracts for agricultural products) or *Murabaha* (Cost-plus or markup sales). Under the *Murabaha* contract the profit mark-up must be agreed to before the deal closes and cannot be changed. However a more versatile variation of the *murabaha* contract is the *tawarrug* structure where following its acquisition of the goods from the Islamic financiers, the client will appoint an agent (usually the same Islamic financier) to sell the goods to a third party and thereby receive the cash. Under these structures the Islamic financial institution that markets the instrument appears in the middle of a tri-partite relationship linking the ultimate user/buyer and the producer or seller. The

financial paper sold to public by the Islamic financial institution bears the promise of a pre-determined return as rent or price instalment. Generally, most of these papers are not negotiable hence do not have a secondary market. But theoreticians are suggesting ways and means of making them negotiable. This is especially applicable to rent sharing certificates since a buyer of such a certificate is acquiring a share in the ownership of a real asset, and an equal share in the net rented income of that asset for the term of the lease (say 'n' years). Such financial instrument, *shariah* wise, is fully negotiable. This may also apply to some *istisna* based certificates whose suitability is based on the high permissibility for the contractor in *istisna* to subcontract.

2.2 *Sukuk*

Sukuk plural of *Sakk* (Islamic bond) is simply a certificate issued in the collective legal or beneficial and undivided share in the ownership of tangible assets whereby the certificate holders receive an income derived from the asset. It can be placed on top of any Islamic structure but traditionally has been combined with the *ijara* structures, because they are based on the undivided pro-rata ownership of the underlying leased asset and are freely tradable at par, premium or discount. There are different types of *sukuk* under Islamic finance namely:

Sukuk al ijara is used for large longer term financing and its structure mimics the leasing contract as the basis for the returns paid to investors who are the owners of the underlying asset. Here the investors not only share in the benefit from the lease rentals but

share in the risk as well. The structure commences with the originator establishing the Special Purpose Vehicle (SPV) that purchases certain tangible assets from the originator by issuing *sukuk* to the *sukuk* holders set at a pre determined purchase price. Next the originator and SPV will enter into a lease agreement for a fixed period of time, where the SPV will receive periodical rental payments from the originator which in turn will be used (until maturity date) to make periodic returns to the *Sukuk* holders. Due to various legal impediments the ownership of the underlying asset is not transferred to the *Sukuk* holder but is instead held in trust by the SPV.

Sukuk al Istisna on the other hand is a financial instrument where contract funds are advanced to pay for supplies and labour costs. Once the project is complete the full ownership of the facilities is immediately transferred to the public authority, against the deferred sale-price that would normally cover not only the construction cost but also a profit. These advances are repaid using revenue from the project. To introduce bonds based on *Istisna* a parallel *istisna* is generally used where the financier enters into a contract with a sub contractor who actually builds the facility being financed. To use *Istisna* a public authority or the private company commissioning the project provides details of the specifications and timing of the schemes. The financier then sets these out in tender documents. Bidding contractors are then expected to specify how they intend to sell completed parts of the project over time and the amount of each payment instalment that includes an element of profit. Certificates representing debt obligations are



issued. This interest free Deferred Price Certificates of indebtedness (DPCs) represent the deferred price of the public authority's debt. Their total face-value is equivalent to the total deferred price. It is important to note here that a debt in *Shariah* may not be exchanged (bought and sold) at a price different from its face value but it may be transferred (endorsed) at face value to a third party.

Sukuk al salam is meant for short term financing of underlying assets and is based on spot sale (*salam*) or deferred delivery sale (*bai al salam*) where the investor agrees to deliver a specific asset which will be sold to the client at an agreed profit margin. *Salam sukuk* are certificates of equal value issued for the purpose of mobilising *Salam* capital so that the goods to be delivered on the basis of *Salam* come to the ownership of the certificate holders. The issuer of the certificates is a seller of the goods of *Salam*; the subscribers are the buyers of the goods, while the funds realised from subscription are the purchase price (*Salam* capital) of the goods. The holders of *Salam* certificates are the owners of the *Salam* goods and are entitled to the sale price of the certificates or the sale price of the *Salam* goods sold through a parallel *Salam*, if any. *Salam-based* securities may be created and sold by an SPV under which the funds mobilised from investors are paid as an advance to the SPV in return for a promise to deliver a commodity at a future date. SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and

hence to the holders of the *Sukuk*. All standard *shariah* requirements that apply to *Salam* also apply to *Salam sukuk*, such as, full payment by the buyer at the time of effecting the sale, standardised nature of underlying asset, clear enumeration of quantity, quality, date and place of delivery of the asset and the like. Another of the *Shariah* conditions relating to *Salam*, as well as for creation of *Salam sukuk*, is the requirement that the purchased goods are not re-sold before actual possession at maturity since such transactions amount to selling of debt. This constraint renders the *Salam* instrument illiquid and hence somewhat less attractive to investors. Thus, an investor will buy a *Salam* certificate if he expects prices of the underlying commodity to be higher on the maturity date.

Sukuk al mudarabah is structured through the *Mudarabah* contract where both the originator and the SPV will be partners in a profit and loss sharing contract. According to *Shariah* this implies that the periodic payments to the *Sukuk* holders cannot be fixed neither can the principal amount be guaranteed at maturity. However if the originator at maturity buys back the underlying asset for a price equal to the principal amount of the *Sukuk* holders regardless of possible appreciation or depreciation of the assets ; this does guarantee the principal amount. However it is a deviation from what is permissible by *Sharia*. In this type of instrument the originator acts as the managing partner contributing labour, skills and expertise. The SPV will act as *Rabbulmal* contributing financial investment gained through issuing certificates to the *Sukuk* holders; who will

be paid an agreed percentage of realised revenues. At maturity the managing partner will buy the units in the *mudarabah* from the *Sukuk* holders through the SPV. Shamil Bank of Bahrain raised 360 million Saudi Riyal investment capital through the Al Ehsa Special Realty Mudaraba, representing an investment participation in a land development transaction with a real estate development company in the Kingdom of Saudi Arabia. The investment objective of the *Mudaraba* is to provide investors with annual returns arising from participation in the funding of a land financing transaction. Profits due to investors will be accrued on the basis of returns attained from investing the subscriptions.

Sukuk al Musharaka are investment *sukuk* that represent ownership of *Musharaka* equity. It does not differ from the *Mudaraba sukuk* except in the organisation of the relationship between the party issuing such *sukuk* and holders of these *sukuk*, whereby the party issuing *sukuk* forms a committee from the holders of the *sukuk* who can be referred to in investment decisions (AAOIFI). A corporate entity and the Special Purpose Vehicle (SPV) enters into a *Musharaka* Arrangement for a fixed period and an agreed profit-sharing ratio. It also undertakes to buy *Musharaka* shares of the SPV on a periodic basis. *Musharaka Sukuk* are used for mobilizing the funds for establishing a new project or developing an existing one or financing a business activity on the basis of partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. These *Musharaka*

certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

In the case of *Sukuk al Murabaha* the issuer of the certificate is the seller of the *Murabaha* commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the *Murabaha* commodity and are entitled to its final sale price upon the re-sale of the Commodity. The possibility of having legally acceptable *Murabaha-based sukuk* is only feasible in the primary market. The negotiability of these *Sukuk* or their trading at the secondary market is not permitted by shariah, as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt on a deferred basis, which will result in *riba*. Despite being debt instruments, the *Murabaha Sukuk* could be negotiable if they are the smaller part of a package or a portfolio, the larger part of which is constituted of negotiable instruments such as *Mudaraba*, *Musharaka*, or *Ijara Sukuk*.

Considering the fact that *Sukuk* issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified *Sukuk* – hybrid or mixed asset *Sukuk* is emerging in the market. In the hybrid *Sukuk*, the underlying pool of assets can comprise of *Istisna*, *Murabaha* receivables as well as *Ijara*. Having a portfolio of assets comprising of different classes allows for a greater mobilisation of funds. However, as *Murabaha* and *Istisna* contracts cannot be traded on secondary markets as securitised



instruments at least 51 percent of the pool in a hybrid *Sukuk* must comprise of *Sukuk* tradable in the market such as an *Ijara Sukuk*. The return on *Murabaha* and *Istisna* certificates can only be a pre-determined fixed rate of return. The structure of a hybrid *Sukuk* involves the Islamic finance originator transfers tangible assets as well as *Murabaha* deals to the SPV. The SPV then issues certificates of participation to the *Sukuk* holders and receives funds which are used by the Islamic finance originator to purchase assets from the SPV over an agreed period of time. Investors receive fixed payment of return on the assets.

2.3.1 **Sukuk** versus Conventional bonds,

Conventional Bonds: are defined as long-term debt instruments that are issued by corporations and

government. These bonds generate two cash flows for investors: The face value which is a fixed amount of funds that bond issuer is obligated to pay to bondholders when the bond is matured and the coupon (interest) which is a fixed amount of funds that bond issuer is obligated to pay to the bondholders periodically until the bond matures. These cash flows are independent of the amount of profit or loss that bond issuer has earned from utilizing the funds that was raised through issuing bonds. *Sukuk* on the other hand as defined by AAIOFI are certificates of equal value that represent proportion ownership of an existing asset or a pool of diversified assets, and a pledge against existing or future cash flow from these assets, for a specified periods of time, where the risk and return associated with cash flows generated by the underlying assets pass *Sukuk* holders.

Table 1: Comparison between *sukuk* and a conventional bond

Sukuk	Conventional Bonds
It is a claim on ownership of asset and cash flow	It is a claim is on debt instrument
The return is expected/estimated from underlying asset	The return (interest) is pre-determined
It provides periodic stream of income similar	It provides periodic stream of income similar
There is a possibility of capital appreciation	The return is fixed and cannot vary with the performance of bond issuer.
The return on invested capital is not guaranteed	The issuer is obligated to pay at maturity.
The contract is based on seller-buyer relationship	The contract is based on borrower –lender relationship
The return may be fixed or variable rates	The return may is a fixed rate

2.4 Islamic Finance and participatory financing

Whilst Islamic finance has all the ingredients and the potential to meet the needs of the global economy, the channelling of funds to productive activities in Islamic finance is largely being carried out through non-participatory contracts, that includes the mark-up sale (*Murabahah*) and the lease-based (*Ijarah*) structures, which are essential for financing trade and the purchase of assets. Such contracts are similar to lending instruments which expose the Islamic financial institutions mostly to credit risk elements. Non risk-sharing contracts can contribute to the future growth of Islamic finance. A wider use of risk-sharing transactions under participatory finance models have significant scope in evolving a broader representation of Islamic financial products that will spur the next phase of industry growth and development. This includes participatory or equity-based contracts such as *Mudarabah* and *Musharakah* that support entrepreneurship ventures. Equity-based models in Islamic financial solutions have also been observed in the *sukuk* segment, with *Shariah* structures evolving from predominantly *Ijarah* and *murabahah* structures to *musharakah* partnerships as well as convertible and exchangeable trusts.

The development of participatory Islamic finance contracts on a broader scale offers particular potential in efforts to reinforce the link between finance and the real economy. Several elements of risk-and profit-sharing participatory contracts support this. For instance profit-sharing and loss-bearing are

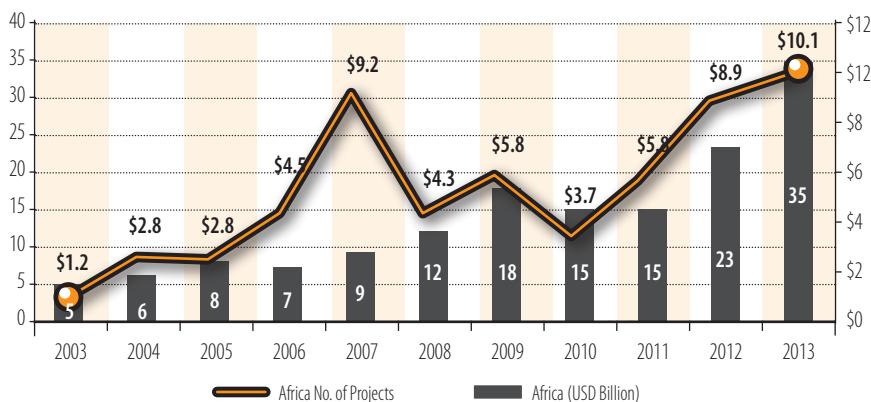
clearly identified and agreed based on the contractual agreements between the financier and the entrepreneur, strong emphasis is placed on the value creation and economic viability of productive efforts that create new wealth. In equity-based contracts, the financial intermediation is directed towards promoting entrepreneurship where clearly defined risk-and profit-sharing characteristics of the Islamic financial transaction provide strong incentives for both parties to contribute to the success of the investment. This also provides the foundation for a long-term trust-based relationship, and a clear interest for the financial institutions to undertake the appropriate due diligence to ensure that the returns are commensurate with the risks being assumed. Aspects of governance and risk management thus strongly underpin these contracts because such contracts demand higher standards of disclosure and transparency to be observed, which in turn act to strengthen market discipline.

2.5 Infrastructure financing in Africa

Between 2003 and 2013: Sub-Saharan Africa closed 158 project finance deals with debt totalling USD 59 billion. Although this represented only 3% of the global project finance market: over 2003-2013 an unprecedented growth rate is exhibited. (Figure 1).

From the data, 21 Sub Saharan African countries had one or more project finance deals in the last 10 years. Top countries were Nigeria (USD 17 billion), Ghana (USD 11 billion), South Africa (USD 10 billion) and Angola (USD 4 billion) thereby accounting for 70% of Sub Saharan Africa's total top the regional league

Figure 1: Africa Growth in Project Finance 2003-2013



tables due to a few jumbo extractive transactions such as the financing of the Jubilee oil field in Ghana. Top countries in terms of deal volume and non extractive projects are South Africa (USD 9.03 million), Nigeria (USD 7.47 million), Kenya (USD 1.16 million) and Ivory Coast (USD 996 million). On average over the 2003-2013 period, infrastructure project finance represented only USD 1 billion, versus the potential of USD 12 billion per year. Regionally the West African Economic and Monetary Union (WAEMU) closed 14 transactions over 2003-2013 totalling USD 2.7 billion representing 4% of Africa project finance volume. ([Appendix 1](#)). The EAC region completed 12 project finance deals in 2003-2013, totalling to slightly above USD 2.7 billion (5% of Sub-Saharan Africa deal volume), most of which are infrastructure. ([Appendix 2](#)).

2.6 Islamic infrastructure financing in Africa

Islamic finance in Africa remains small, although it has potential given the continents demographic structure and potential for financial deepening. As of end-2012, about 38 Islamic finance institutions—comprising commercial banks, investment banks, and *takaful* (insurance) operators—were operating in Africa. Out of this, 21 operate in North Africa, Mauritania and Sudan, and 17 in Sub-Saharan Africa. Botswana, Kenya, Gambia, Guinea, Liberia, Niger, Nigeria, South Africa, Mauritius, Senegal and Tanzania have Islamic banking activities. There is also scope for development in Zambia, Uganda, Malawi, Ghana and Ethiopia. Africa's large infrastructure needs provide an opportunity for *Sukuk* issuance. For instance, the issuance of a *Shariah* - compliant bond by Osun state in Nigeria has started a trend in favor of *sukuk*. It set

the pace for the issuance of Senegal's *sukuk* valued at USD 200 million and the 2014 South African *Sukuk* of USD 500 million. Four countries have considerable potential for becoming a regional hub of Islamic finance activities

2.6.1 South Africa

In 2014, the Standard Bank Group acted as joint lead manager on the National Treasury of South Africa's debut *Sukuk* in the international capital markets. The USD 500million 5.75-year *Sukuk* is the largest *Sukuk* issuance from sub-Saharan Africa and only the third *Sukuk* to be issued by a non-Islamic country. The *Sukuk* will be used to fund South Africa's National Revenue Fund. It also creates a benchmark for the market which will assist state-owned companies to access diversified sources of funding from Islamic investors. The resounding success of the transaction positions South Africa as a future hub for Islamic finance in Africa.

2.6.2 Nigeria

Nigeria's Osun State issued a 10 billion naira (\$62 million) *sukuk* in 2013 yielding 14.75 percent . This is the first Islamic bond from a major economy in sub-Saharan Africa. The cocoa-producing, southwestern state of Osun received 11.4 billion naira in total subscriptions for its seven-year paper, from asset managers and Islamic funds.

2.6.3 Kenya

Kenya has set its ambition of becoming the Islamic finance hub of East Africa by leveraging first mover

advantage in this niche market within the region. Towards this end The Capital Markets Authority (CMA) has been focusing its efforts on two fronts, namely: establishing the supporting institutional, policy and regulatory environment and widening of the *shariah*-compliant products and services base. Some of the actions that have been put into play by the CMA:

- Round table meeting held in October 2011 to share the findings of a research study and solicit input in the development of a roadmap towards Kenya's Islamic Capital Markets policy and subsequent regulatory framework.
- In October 2012, another stakeholder meeting was held to explore the issuance of and opportunities provided by *Sukuk* in tapping international investment and by December 2012 CMA had facilitated the training of relevant officers in structuring and regulation of *Sukuk* in Malaysia. Kenya is expected to issue its first *Sukuk* in the year ending June 2016.
- Adoption of a Policy Concept Note by CMA in 2013 developed proposals for the establishment of a National Sharia Advisory Council that is expected to establish a framework benchmarked against international standards; facilitate informed decision making by market participants; foster market integrity through the timely disclosure of relevant and reliable information as well as enhance the consistent application of *Sharia* rulings within the capital market.



- CMA is also working towards the creation of a level playing field between Islamic and conventional products and services by ensuring neutrality in the current tax regime governing Islamic securities transactions through collaboration with the Ministry of Finance (MoF) – Treasury and the Kenya Revenue Authority (KRA). This is aimed at accelerating the process of addressing current tax provisions that may be potentially inhibiting the development of the Islamic capital market.
- Further, in order to develop an implementation road map for Islamic finance reforms, a scoping exercise was carried out by Islamic Finance

Council (UK) in mid-2014. This exercise proposed inter alia the establishment of a Project Management Office (PMO) that will help design and coordinate a range of interventions to enhance Islamic finance markets in Kenya. These include the development of a regulatory framework; design and delivery of capacity building programmes for financial sector regulators and market players; establishment of a *Shariah* governance framework for Islamic finance in Kenya; support of domestic and international communications and market awareness raising activities. This PMO was made operational in August 2015.

Research Design

3.1 Case studies and Delphi Study

During the study, case studies were conducted in order to answer research question one which is to investigate the current phenomenon of Islamic financing transactions of African infrastructure projects. The main criterion for the selection of a project for the case study was that the infrastructure project is located in Africa is using *shariah* scheme transactions.

The reviewed project was guided by (1) an explanation of the project's background including the project's progress; (2) the involvement of an Islamic financier in the project; (3) the type of Islamic financing transaction used in the project; (4) the Islamic financing transaction process in the project; and (5) the obstacles that occurred during the financing process. The Lekki Port Project, The Doraleh Container Terminal (DCT) Project and the Kenitra Power Plant Project are analysed in this research. In addition two rounds of the Delphi method in this research. The first round (Delphi Round 1) involved face-to-face interviews which gathered and explored the panel members' knowledge and experiences. In the Delphi round 2 cycle the panel members were asked to rate statements on a Likert-type scale and to provide comments. A total of 24 invitations and questionnaires were sent 19 responses were gathered in this round.

3.4 Panel Member Selection

In order to create a successful mix, it was recommended that different types of panellists are selected (Linstone & Turoff, 1975). The first type of panelist is a stakeholder who is or will be directly affected. The second type is an expert who has an applicable specialty or relevant financial institutional experience. The third type is a facilitator who has skills in clarifying, organizing, synthesizing or stimulating the concept (Linstone & Turoff, 1975). In the present study, the panel members consisted of people who worked for a transport companies, Actuarial Society of Kenya, Islamic and Conventional banks (with and without Islamic



Banking windows). Panel members were also chosen based on their expertise, institution and position in their institution. Although there is no ideal set number of panel members (Bowles, 1999; Hallowell & Gambatese, 2010; Okoli & Pawlowski, 2004; Skulmoski, Hartman & Krahn, 2007), the number of participants influences the research reliability, which is considered low when the number of participants is less than six. It is recommended in the literature that the number of panel members should be maintained

at more than twelve in order to increase the reliability (Murphy et al., 1998) and the present study followed this guideline. The panel members were recruited by invitation and the snowball or referral technique. The snowball technique might affect voluntary participation, because the invited person might ask for the identity of the referee and feel bound to participate in order to honor the referee (Brace-Govan, 2004); however, the issue of voluntary participation in this research was not significant.

Case Study and Delphi Results

4.1 Case study results

4.1.1 Lekki Port Project, Nigeria

Lekki Port will sit on 90 hectares of land and is set to become operational in 2018. When completed, it is envisaged that Lekki Port Container Terminal alone will have a handling capacity of 2.5 million Twenty-foot Equivalent Units (TEUs) with a quay length of 1,200 metres, an initial draft of 14 metres, with the potential for further dredging to 16.5metres.

Project Financing

The Lekki Port Project is a PPP (Public Private Partnership) project which at completion will cost USD 1.5 billion. Its shareholders are the Tolaram Group of Singapore (61.85%), Nigeria Port Authority (NPA) on behalf of the Federal Government of Nigeria (19.65%) and Lagos State Government (18.50%) The Tolaram Group, Singapore (61.85%) is funded by 6 (six) Financial institutions namely: African Development Bank (AfDB), European Investment Bank (EIB), Standard Chartered Bank, Rand Merchant Bank (RMB), Standard Bank and African Finance Corporation (AFC) while the Nigeria Port Authority (NPA) is funded by a loan from the Islamic Development bank (IsDB) of USD150 million that as per normal IsDB terms and conditions attracted a one off service charge fee of between 1.5% and 4%. "The NPA is both regulator and equity partner in this venture.

On 21 April 2011, LPLE entered into a Concession Agreement with NPA for the rights to build and operate a deep-sea port in Ibeju Lekki, Nigeria. This Concession is granted under the Nigerian Ports Authority Act 2004. This forms the legal and regulatory basis for the construction and operation of Port@Lekki. The Lekki Port LFTZ Enterprise (LPLE), a special purpose vehicle promoted by the Tolaram Group, is expected to comprise 3 shareholders: the Nigerian Port Authority (NPA), the Lagos State Government and an Investment Holding Company incorporated to hold the non-Nigerian governmental interests in LPLE. The share of Tolaram Group is in the form of 45 years lease, after which the ownership will be



transferred to the federal government of Nigeria and Lagos state government respectively.

4.1.2 The Doraleh Container Terminal (DCT) Project ,Djibouti

Doraleh Container Terminal (DCT) project is Greenfield terminal located in Doraleh, Djibouti. The 30-year concession project involves the development and maintenance of a container port which has a total length of 2 kilometres. The project has a net worth of \$396 million represents the first PPP financing style in the country. Djibouti port has a monopoly positioning for the imports and exports from Ethiopia therefore having an estimated capacity of handling 1.5 millions TEU annually. The port is also very competitive due to the fact that it is strategically positioned on the east-west main lanes for the large shipment traffic.

Project Financing

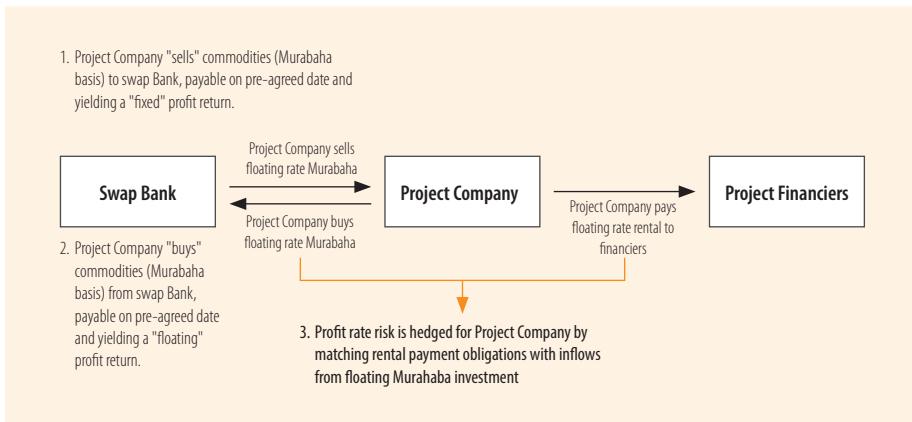
The financial structure of the DCT project consists of a unique co-financing scenario of a total of seven financing institutions; The Islamic tranche raised \$1660 million with the main institutions being: Dubai Islamic Bank (DIB), Bank of London and Middle East, Standard Chartered Bank, West LB AG and Islamic Development Bank. The conventional Tranche raise \$103 million with main institutions being African

Development Bank and Proparco. The structure of the DCT financing is designed to ensure compliance with the Sharia principles at the same time satisfying the commercial requirements of the government and other stakeholders. The financing structure of the DCT project was designed to give a reflection of "debt type" financing profile to ensure Sharia compliance. In the profit sharing rationale above, three stake holders were involved; Swap Bank, Project Company and the financiers of the projects.

1. The project company sells commodities under Murabaha to swap Bank on a pre-agreed date and the yielding fixed profit return. The company also buys the commodities at a later date and yields a floating profit return.
2. The project company paid the floating rate rental to the project financiers.
3. The profit rate risk is hedged for Project Company by matching rental payment obligations with inflow from floating *Murabaha* investment.

The following diagram gives the structure of the Islamic profit rate swap facility;

Figure 2: Structure of Islamic Profit rate swap facility



Three *Shariah* concepts were used to structure the financing structure;

- **Musharaka (Partnership):** two or more partners pool their resources together to undertake a commercial venture through joint ownership of assets. Through this concept, DCT project financiers agreed to produce the assets together and commit them jointly to make respective capital contributions. *Musharaka* was used to raise capital through contributions and paid to DCT which were drawn down under the western financing arrangements.
- **Istisna:** a contractual agreement for developing assets and allowing advance cash payment while assets are delivered in the future. Partners appointed DCT as a procurer to initiate

construction process as the assets are delivered at the end of the project.

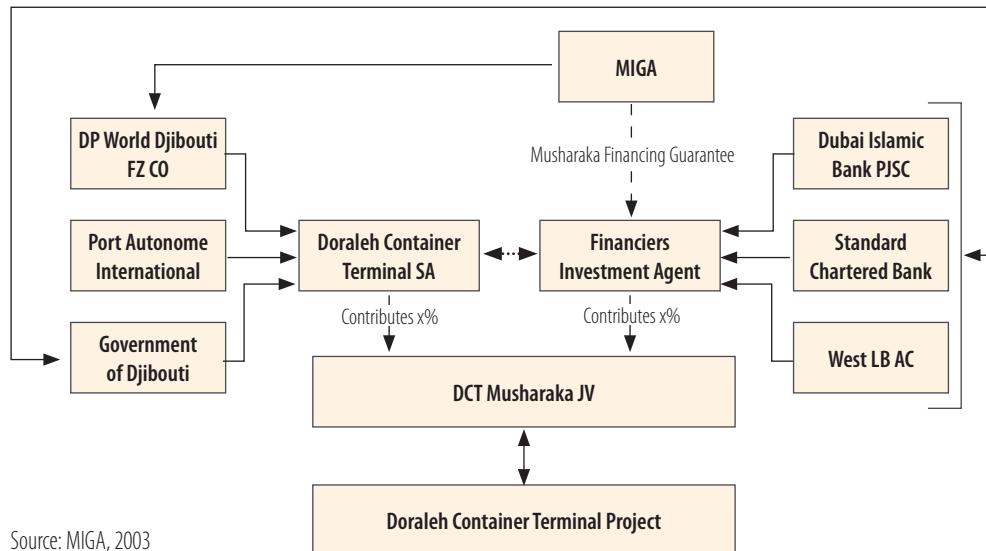
- **Ijara:** in this agreement, the asset usage rights are leased by the owner to the other party in exchange of rental payments.

Additionally, there was an agreement of a purchase and sale undertaking. In purchase undertaking, the financiers sell their co-ownership interest to the DCT in an event of dissolution.

On the other hand, the sales undertaking allowed DCT to have rights to buy out its project financiers (partners) in return of paying its full contribution.

The following diagram indicates a clear financing structure for the DCT project:

Figure 3: Financing structure of the DCT project



Source: MIGA, 2003

The DCT project is a demonstration of how to blend Islamic and conventional infrastructure financing to satisfy all parties involved. Similarly, it is easy to replicate the DCT financing structure in African countries and save the costs associated with poor infrastructure development.

The DCT project faced a number of financing challenges which include political interference, poor financial terms for lender, Lack of knowledge to the lenders reduced their interest in investing in DCT.

However, a Multilateral Investment Guarantee Agency (MIGA) provided a unique umbrella against all the risks improved the risk –returns profiles for the

project. MIGA Assisted in the following ways;

- Investment protection and prompt claims payment through deterring harmful actions and resolving disputes.
- Improving financial terms and conditions for investors through;
 - a. Lowering borrowing costs
 - b. Accessing funding
 - c. Helping to structure project financing

MIGA agreed to cover for the termination payment under *Istisna* in case of incomplete construction as detailed under the original lease schedule.

4.1.3 Kenitra Power Plant Project Morocco

The plant is located at Kenitra, Région de Gharb-Chrarda-Beni Hssen, and 40 kilometers north of Rabat, is owned and will be operated by Office National De L'électricité (ONE); a State owned corporation. The contractor is GE Energy (USA) and its consortium partner, Cegelec, a subsidiary of Vinci Energies (construction) of France). The plant has a capacity of producing 300-315Mw of electricity.

Project Financing

The project was funded to the tune of US \$248Million with IDB participation of US \$197.6 Million over tenure: 20 Years via *Murabaha* - Instalment Sale Operation. The co-funder was The Government of Morocco which provided USD\$ 50.4 Million. The IsDB components procured via International Competitive Bidding gas turbines with alternators, mechanical and electrical auxiliaries, control and command equipment as well as spare parts.

Summary

There is scanty information available on the specifics of African infrastructure projects that have been financed using Islamic financing instruments. However a comparison of the case study projects indicates that the financing scheme process involving the international Islamic finance institutions seem more complex than the process involving conventional institutions. It

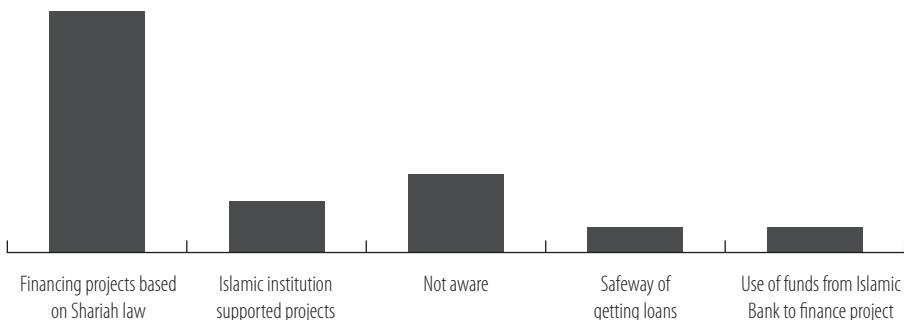
is likely that this is due to the projects being owned by their respective governments because as per Islamic Financing Principles the financing process in the government-initiated projects is considered as two-step financing: - the financing delivered to the government and the government then assigns the state-owned enterprise to operate the project. This contrasts with conventional project financing where the cash flow of the project is not separated from the government or the state-owned enterprise/corporate accounts. Also in line with Islamic Financing principles the infrastructure projects are expected to generate revenues which in the future may provide a return on the initial investment. An interesting outcome of the case studies is IsDB increasing participation in the financing of infrastructure projects in Africa.

4.2 Delphi Round 1 Results

4.2.1 Stakeholders' understanding of Islamic project financing in Kenyan infrastructure

From the interviews analysis, most of the panel members mentioned the concept of infrastructure project financing based on *Sharia* law and Islamic Institution supported projects. However, 19% of the panel members indicated having no understanding of what Islamic Financing of Infrastructure Projects entailed.

Figure 4: Understanding of islamic financing of infrastructure development projects

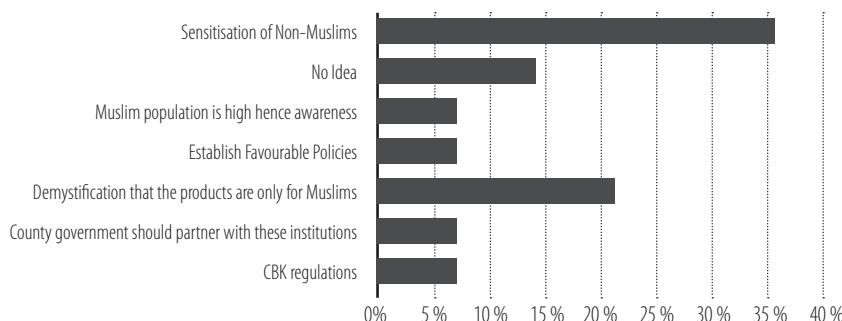


4.2.2 Potential of Islamic project financing implementation in Kenyan infrastructure development

Six themes emerged from the interviews with regards to the panel members' views on the potential of Islamic project financing in Kenya. Figure 5 presents the themes and the percentage of panel members who expressed views on each theme. Most of the panel members believed that sensitisation of non

Muslims and the de-mystification that the products are only for Muslims posed as the greatest enablers. Some mention is made of the existence of domestic Islamic finance investors and international investors from Middle Eastern countries but with a caveat that they are invited by the County Governments of North Eastern Province. A statement that is not substantiated with any proof.

Figure5: Opportunities for the implementation of Islamic Financing in Kenya

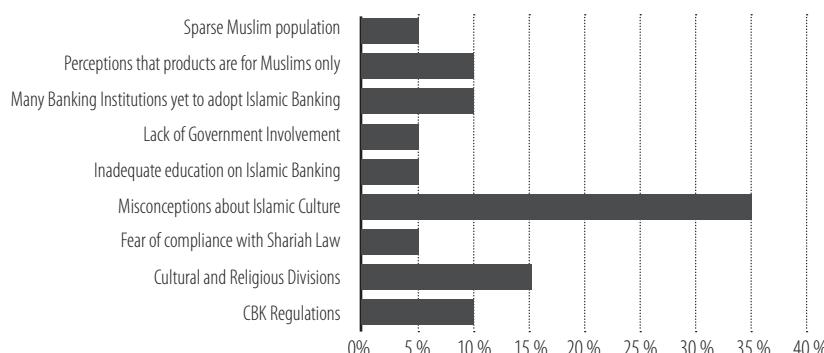


Although 75% of the panel members believed that there is a good opportunity for implementing Islamic financing of infrastructure projects in Kenya; however African success stories of state issued *sukuks* and on the lessons drawn the same were not issued. 56% of the panel members reported not being aware of any GoK efforts towards the implementation of Islamic project financing in infrastructure. Efforts cited by those who are aware of GoK efforts ranged from licensing of Islamic Banks, creation of level playing ground and interestingly the issuance of Islamic Bonds (*Sukuk*) where the GoK was said to have approached Middle Eastern and domestic investors. 94% of the panel members indicated that Islamic financing is more advantageous than conventional financing when used in the development of infrastructure projects. The highest rated advantages being no or lower interest rates, nil penalties and win-win position for all parties. However communal ownership of assets, risk sharing and religious acceptance of the products by at least 10 million Kenyan Muslims were some of the expected advantages that were not mentioned.

4.2.3 Barriers to Islamic project financing implementation in Kenyan infrastructure

The interview analysis identified 9 themes as possible barriers to the implementation of Islamic project financing of Kenyan infrastructure projects. Figure 6 presents the themes and the percentage of panel members who expressed an opinion on each theme. The issue that was most frequently cited as a barrier was related to the misconceptions about Islamic culture. CBK regulations were mentioned by 10% of the panellists who expressed concern that the government policies and regulations may be affecting the implementation of Islamic project financing in Kenya's infrastructure development. They believed that the government should support, commit and guarantee Islamic project financing of Kenyan infrastructure projects. The understanding of Islamic finance transactions, the capability of Islamic financial institutions, and the investors' behaviours and characteristics did not however feature in any of the responses as possible barriers.

Figure 6: Barriers to Islamic project financing implementation in Kenyan infrastructure





In terms of understanding Islamic financial transactions, it was expected that panel members would make reference to the existence of different perceptions or interpretations of Islamic financial instruments due to the use of the Arabic language in Islamic financial transactions which makes it difficult for the non-Arab speaking stakeholders to understand when compared to conventional financing. Considering that this was not done could very well be

an indication of the panel members' limited exposure to Islamic finance terminologies.

4.3 Results of Delphi Round 2

The output of the questionnaires was tabulated and analysed. A consensus was said to have been met if the rate totalled to more than 51 % (for the Strongly Agree and Agree indicators).

Table 2: Assessment of the infrastructure project stakeholders' knowledge of Islamic project financing.

Consensus	Consensus Disagreement
Project is an asset based or asset backed investment scheme that generates income based on risk, profit /loss sharing	Islamic project financing in infrastructure is an investment through a special purpose company (SPC)
84% panellists agreed that Islamic Finance provision is not limited to Islamic Banks	
94% of the panellists concurred that Non Islamic financiers can co- finance the project so long as it is <i>shariah</i> compliant	
95% of the panellists expressed the need for the enhancement of education and skills in Islamic financing of infrastructure development projects	
85% of the panellists reached a consensus on the need for the GoK to develop favourable policies	
90% of the panellists stated that there is a need for the GoK to partner with Islamic financial institutions and investors	
63% of the panellists indicated that there was potential of Islamic Project financing of long yield period projects.	

Table 3: Assessment of the level of consensus among infrastructure stakeholders on scheme and process of Islamic infrastructure financing.

Consensus	Consensus Disagreement
84 % of the panellists reached a consensus that Islamic Financial Products should have <i>Sharia</i> compliance endorsement from a National <i>Sharia</i> Board	The division of financial losses based on contributions
90 % reached a consensus that project evaluation should be conducted regularly to ensure <i>Sharia</i> compliance	Definition of the <i>Mudaraba</i> financing scheme
90% of the panellists agreed that <i>Musharaka</i> consists of equity financing	The return on <i>Jara</i> being based on infrastructure rental agreement for operational and maintenance phases.
73% of the panellists agreed that equity financing return for Islamic Finance Transactions is based on pre arranged profit sharing arrangement on revenues gained during the operational and maintenance phase of the infrastructure	57% of the respondents indicated that they had no idea whether <i>sukuk</i> could be considered as debt or equity financing
<i>Istisna</i> and <i>Jara</i> are considered as debt financing in Islamic project financing	Possibility of financing new infrastructure with <i>Sukuk</i>
74% of the expert panel agreed that <i>Sukuk</i> is an equity if <i>Musharaka</i> or <i>Mudaraba</i> are included in the transaction structure	89% of the respondents have no idea whether <i>Murabaha</i> and <i>Musawama</i> can be considered as mode of financing nor what they entail
53% consented that <i>Sukuk</i> is a debt financing instrument if <i>Istisna</i> or <i>Jara</i> are included in the transaction structure	
74% of the panellists agreed that <i>Kafalah</i> in Islamic Financing of infrastructure is needed to mitigate risk	
Both land and built infrastructure can be used as collateral /underlying asset in Islamic project financing	
Consensus was reached that if one Islamic Financial Institutions cannot fully finance a whole infrastructure project then it is possible to syndicate with several other Islamic financiers, non Islamic Financiers and use several Islamic financial transactions	



4.3.3 Obtaining consensus with regards to the supporting laws, regulations and institutions

Consensus	Consensus Disagreement
58% of the expert panel concurred on the need for the development and implementation of favourable laws and policies	Current laws and regulations relating to Islamic Project Financing are sufficient
58% of the panellists indicated the need for tax incentives to be put in place	
85% of the panellists expressed the need for regular training, workshops and conferences on Islamic Project Financing	
94% of the expert panel agreed that brand building and industry engagement between the GoK, Infrastructure developers, local and international investors was needed	
90% of the panellists agreed to the establishment of a National Shariah Board	
74% of the panellists concurred about the need for greater dissemination of information of GoK efforts towards facilitating Islamic financing of infrastructure projects	
63% of the expert panel agreed to the establishment of <i>Shariah</i> Advisors apprenticeship programmes and linkages to international panel of experts and institutions	

Summary of Delphi results

Overall, the Delphi study revealed consensus agreement among the panel members on a wide range of statements about Islamic project financing in Kenyan infrastructure projects. However, there were 8 consensus disagreements related to whether Islamic project financing entailed investment through a special purpose company (SPC); the division of financial losses based on contributions; definition of

the *Mudaraba* financing scheme; whether the return on *Ijara* was based on infrastructure rental agreement during operational and maintenance phases; whether *sukuk* could be considered as debt or equity financing and its use in financing new infrastructure; definitions of *Murabaha* and *Musawama* and sufficiency of Kenyan laws and regulations relating to Islamic Project Financing.

Summary of Results

Current practices in Islamic financing implementation in African infrastructure projects

The agreements most used to finance the infrastructure projects reviewed in this study include *murabaha* (Kenitra Power Plant project) and *musharaka*, *Istisna*, *Ijara* (Doraleh Container Terminal Project-DCT). It is important to note here that *Murabaha* and *musharaka* agreements that are established between an SPV and Islamic bank are considered as working capital in infrastructure project financing (Usmani, 2002) due to their short term nature.

The transactions used in *murabaha* agreements are usually designed to provide parts of an infrastructure asset. In addition we note that domestic Islamic financial institutions have limited capacity to finance infrastructure projects. However, the source of finance can be from source as long as it is sharia-compliant and that it is possible to establish a syndicate of several financiers (or Islamic banks) to finance infrastructure projects as well as co-finance a transaction with non-Islamic financial institutions. This is as evidenced by the Lekki and DCT project financed through a combination of Islamic and conventional banks. However, in such arrangements, all transactions have to be shariah-compliant.

Kenyan infrastructure project stakeholders' understanding of Islamic project financing

In the interviews and questionnaires conducted in the Delphi study, the panel members presented their understanding on shariah-compliant infrastructure projects, sharia-compliant financing schemes, the basic principles of Islamic finance, the concept of the Islamic financing schemes, the concept of infrastructure project financing, the concept of Islamic project financing in infrastructure and the sources of Islamic project financing in infrastructure. However with regards to the panel members' knowledge on more detailed topics on Islamic finance transactions and sources of Islamic finance, there was great divergence



in their statements, especially in the context of *murabaha* and *musawama* arrangements. Panel members agreed that *murabaha* and *musawama* are considered as sales transactions in Islamic Finance and that they were not debt transactions despite the fact that the statement in the questionnaire itself indicated that payment was said to be on a deferred basis. The latter view differs from the principles of *murabaha* and *musawama*. *Musharaka* or *mudaraba* are the ideal modes of financing in the Islamic economy; however, when difficulties occur in practical situations it is permissible to use *murabaha* or *musawama* on a deferred payment basis (Usmani, 2002). The disagreement among the panel members on various aspects of *murabaha* and *musawama* point towards the limited knowledge of Islamic finance among bankers and infrastructure stakeholders in Kenya. There was very little knowledge exhibited with regards to whether *Sukuk* was either equity or debt financing and whether it was possible to finance new infrastructure using *Sukuk*. The stakeholders' knowledge on *Kafala* fared slightly better.

This study indicates that stakeholders understand the terms when translated from the Arabic but are not aware of the essential principles of Islamic financing of infrastructure projects behind these terms. The use of Arabic terminology in Islamic finance although it did not come out clearly from the study appears to be one of the issues that 'mystifies' and creates a barrier to the implementation of Islamic project financing in infrastructure projects in non Arab speaking countries such as Kenya. It can be argued therefore that there is

no need to use Arabic terminology, that it might be easier for Kenyan infrastructure project stakeholders to understand the concepts if English and Kiswahili is used as long as the financing concept is shariah-compliant

Barriers to Islamic project financing in Kenyan infrastructure projects

Islamic finance is deemed to be expensive. This fact is corroborated by the case study of Lekki Project which utilised a loan financing scheme that attracts huge transaction costs paid by the SPV in terms of 1.5%-4% one off administration fees and notary fees that are necessary for every *aqd* (Contract) made between the SPV and the bank. Another fee that can affect the cash flow of the SPV is profit that is paid up-front during the construction phase. But this would make the transaction not to be compliant to *shariah* principles because Islamic finance defines that no payment should be made when the asset has not yet been delivered to the SPV. These high cost of transactions and where applicable the non compliance to *shariah* principles does deter stakeholders from making use of Islamic financing despite the fact that there may be other considerations that are usually taken into account when making the choice between Islamic finance such as the desire to avoid *riba* (interest) by Islamic investors. The need for development and implementation of policies aimed at reducing Islamic finance transaction costs cannot therefore be downplayed.

A similar opinion was also evident in the Delphi Round 1 interview results. Some panel members

mentioned that the cost of the funds in Islamic finance is high simply because Islamic finance comprises of equity authorisation scheme and the cost of equity is generally higher than the cost of debt. Further, in Kenya, every aqd-transaction will be subject to taxation which also increases the transaction fees. It is important to note therefore that the GoK is working towards the distinguishing of tax liabilities for Islamic finance transactions which is in tandem to the consensus that Islamic financial transactions cost need to be reduced. Investors especially those savvy in the conventional mode prefer to receive high returns in a short period while investing in favourable and secure projects. However during the construction phase investors may not receive any returns as per Islamic financing principles while in a *musharaka* Islamic financing scheme they will receive their share of profit but must also be willing to suffer loss. This furthers the resistance to the implementation of Islamic financing of infrastructure projects in Kenya. Resistance was also identified from the perspective of cultural acceptance—that Islamic finance is for Muslims only possibly because most Kenyans including infrastructure stakeholders are not knowledgeable on Islamic financing. Better communication and knowledge of Islamic infrastructure financing products can increase the acceptance of the products. However the dissemination of Islamic financial knowledge is only at infancy stage; currently being taught only at Umma University and at the Kenya School of Monetary Studies. Therefore there is a need of spearheading an increase in the dissemination of not just Islamic finance knowledge but also in the setting up of centers

that specialize in Islamic infrastructure financing. From the study there emerges the need for Islamic financier need to identify a SPV who is experienced not only in the infrastructure project business but also well versed with *sharia* compliant financing schemes. In addition there is limited understanding by domestic Islamic financiers and other investors of the infrastructure business. Delays such as those experienced in the structuring of *Sukuk* due to the need for new legal documentation, legal opinion of *sharia* jurists and the creation of SPV are a further hindrance in the use of Islamic Financing for infrastructure development.

Nonetheless, the general consensus from this study is that the opportunity for Islamic infrastructure financing in Kenya and the rest of Africa are significant. The increasing interaction with the Middle East and appetite from domestic and international investors seeking non-interest, profit sharing financing options were cited as key drivers. The expert panel stressed the need for the GoK to address legal obstacles by putting in place the necessary regulatory measures because in the face of massive infrastructure financing needs, the consensus was that there is no alternative but to actively seek alternative sources of financing.

In conclusion, Islamic Financing of infrastructure projects is far from being the default financing mechanism in the Kenyan market, but it is an available alternative. In any growing Islamic financing market like Kenya, the volume and size of deals and who is doing the issuing are trends that are important to watch because they will be



an indication of market trajectory. For example as the *sukuk* market matures, it is expected that there will be a shift from issuances almost exclusively by large governmental or quasi-governmental entities to smaller or more purely private sector issuers. There are some indications that this is beginning, and from the perspective of international developers and potential investors alike, the private sector in Kenya is ahead of the government with some companies such as Kuruwitu Ventures; listed on the Nairobi Securities Exchange, already issuing the Sharia compliant bonds as indicated in its 2014 end of year results. Gulf African Bank Ltd is also set to issue a closed Sukuk. A second trend to watch will be the increasing maturity of Islamic Infrastructure Financing instruments. This is because until maturities routinely approach those of conventional loans, many Kenyan infrastructure projects will not be

able to use Islamic finance structures. Another trend worth monitoring is the level of political support for Islamic infrastructure financing in general evidenced by the adjustment of laws to level the playing field. Kenya's pronouncement of becoming a regional Islamic Financial hub does in this regard represent a significant development. It will be interesting to see if this can be achieved because a regional market will not only make it easier to attract capital from other Gulf states; it will also lead to the standardisation of Islamic Financial Instruments in the country. The final trend to watch and it is one that may seem a little counter intuitive; the difficulty of establishing Islamic financial transactions which is currently a barrier to the expansion of the Islamic Finance market as a whole; but as transactions become more common and more familiar, the market should be able to look forward to more frequent and routine transactions.

Conclusion

Notwithstanding its presence in Kenya, Islamic finance is still at a nascent stage of development. The share of Islamic banks is still small, and the Islamic capital market is just about to emerge .Infrastructure project stakeholders in Kenya have varying degrees of understanding of the Islamic project financing concept and its implementation in infrastructure projects. For most part their understanding focuses more on the Islamic finance concepts and/or the infrastructure project financing concept, rather than on the concept of Islamic infrastructure project financing.

As demonstrated in this study, it is important that this integrated concept be understood comprehensively by all infrastructure project stakeholders. There are also some plausible issues that may be hampering the implementation of Islamic financing of infrastructure projects the most notable ones being the perceived 'mystification' of the Islamic culture and conventional investors' behaviour/ characteristics of being profit-oriented mind-set and risk averse. Yet, there are some factors that can be emphasised and developed to support the implementation of Islamic project financing of Kenyan infrastructure projects. For instance Kenyan infrastructure projects usually undergo due diligence to ensure financial feasibility; a key requirement under Islamic financing principles. To enhance this proper risk management studies should also be conducted in tandem in order to achieve a fair proportion for profit and loss sharing as per the terms of Islamic Financing contracts. Government supported schemes such as the development of Islamic finance 'friendly' tax incentives need to be fast tracked. Lastly, regular training and workshops on the integrated concepts of Islamic finance and Islamic infrastructure financing need to be conducted to build the capacity of all infrastructure project stakeholders. More importantly though is that the demand for innovative products to finance infrastructure in Kenya is likely to increase in the coming years; meaning that Kenya will need to be in a position capable of creating these innovative products aimed at attracting new capital domestically, from the Gulf and other Muslim countries not only for the short term but for the long term as well. This can only happen if the floodgates to Islamic infrastructure financing are ably opened.

Policy Recommendations

From the findings of the study the following recommendations are proposed:

- Need for a clear cut means for coordination and collaboration among different sources of infrastructural funds. The government needs to play a central role here by providing leadership in engaging policy makers, regional infrastructure experts, traditional investors, and non-traditional investors. At the same time African stakeholders and traditional multilateral agencies need to be made knowledgeable enough so that they can make a positive and constructive response to the opportunities offered by Islamic infrastructure financing. It is only through genuine collaboration across the board that the Kenyan infrastructure development industry will benefit from Islamic Finance.
- Need for a review and of setting standards for the Islamic financing of infrastructure investments based on global best practices. A role that can perhaps be effectively undertaken by the proposed National Shariah board
- The need to sensitization on Islamic infrastructure financing schemes stakeholders in Kenya I order to impact knowledge and skills mainly in the areas such as deal development/packaging and project structuring/financing need to be addressed.
- There is need therefore to put in place mechanisms aimed at enhancing investors' confidence in the country and its infrastructure development plans for the Kenya's *sukuk* issuances in future to have longer tenors and be fully subscribed.
- Islamic infrastructure financing schemes has been criticised for being somewhat document intensive. This emanates from the fact that for *shariah* compliance purposes, some obligations of the financing structure are broken out into separate undertakings, frequently of a unilateral nature. This does result in higher transaction costs. The proposed National *Shariah* board could therefore be tasked to standardize documentation and requirements aimed at purposefully making the cost of Islamic Project financing reasonable.

- Need for development of adequate *takaful* (Islamic insurance) products that are capable of providing a means of security and /or compensation against Islamic infrastructure financed projects potential risks.
- A comprehensive strategy to develop the domestic Islamic Infrastructure financing market need also be put in place. The recently established PMO could therefore, focus on developing the necessary infrastructure, including promoting true Securitization, enhanced clarity over investors' rights, as well as step up the sovereign *Sukuk* issuance in order to provide a benchmark for the private sector.
- A substantial and participatory review of the supervisory and regulatory instruments that are impacting on the development and application of Islamic infrastructure finance instruments is required. For instance, Legal, regulatory and supervisory framework will need to be adjusted to accord greater clarity and to foster the sound and orderly growth of risk-sharing structures and activities, both in terms of the funding and the assets-side of Islamic banks.
- Equally important in ensuring the institutional soundness of Islamic financial institutions is the need for robust liquidity management. Today, Islamic financial institutions operating are confronted with the challenge of managing their liquidity positions effectively; the limited supply of high quality Shariah-compliant liquid instruments being the reason most commonly cited which also affects the efficient cross-border diversification of financial flows. It is therefore our hope that the Central Bank of Kenya can become a member of the International Islamic Liquidity Management Corporation (IILM whose mandate includes facilitation of issuance of high-quality liquid *sukuks*, promotion of more efficient cross-border liquidity management of Islamic financial institutions and facilitation of Islamic financial institutions in meeting the international requirements on liquidity.

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Appendices

APPENDIX 1: Project finance in WAEMU

Year	Country	Project Name	Sector	Project Debt (\$ m)
2004	Mali	Loul gold mine	Mining	82
2005	Burkina Faso	Youga gold mine	Mining	34
2005	Cote d'Ivoire	Baobab CI40 oil field	Oil & Gas	80
2006	Cote d'Ivoire	Mana gold mine	Mining	20
2007	Senegal	Blaise Diagne airport	Transport	493
2008	Cote d'Ivoire	Afren oil & gas aquisition	Oil & Gas	205
2008	Senegal	Sabodala gold mine	Mining	130
2010	Cote d'Ivoire	Baobab oil field	Oil & Gas	207
2010	Senegal	Dakar Diamniadio toll road	Transport	132
2012	Cote d'Ivoire	Azito IPP expansion	Power	450
2012	Cote d'Ivoire	IHS tower aquisition	Telcom	100
2013	Cote d'Ivoire	Ciprel IPP	Power	331
2013	Cote d'Ivoire	SECI CI27 gas field expansion	Oil & Gas	200
2013	Senegal	Sendou IPP	Power	206
Total		14 Projects		2,670

(Source Project for infrastructure for Africa-The World Bank)

APPENDIX 2: Project finance in EAC

Year	Country	No. of Projects	Project Name	Sector	Project Debt (\$ m)
2004	Kenya	1	Magadi High Purity Soda Ash Plant Project	Power	55
2006	Kenya	1	Kwale Mineral Sand Project	Mining	200
2007	Uganda	1	Bujagali Hydro Power Project	Power	867
2008	Tanzania	1	Celtel Expansion Project	Telcom	340
2009	Kenya	1	Aga Khan Nairobi Hospital Project	PPP	160

Year	Country	No. of Projects	Project Name	Sector	Project Debt (\$ m)
2010	Kenya	1	OI Karia III Expansion Plant Project	Power	110
2011	Kenya	1	Kenya Gulf Power Plant Project	Power	310
2012	Kenya	1	OI Karia III Expansion Plant Project	Power	71
2012	Kenya	1	Triumph Oil Power Generating Project	Power	101
2013	Kenya	1	Kinangop Wind Plant Project	Power	150
2013	Kenya	1	Kwale Sugar Project	Industrials	200
2013	Tanzania	1	African Barrick Gold Bulyanhulu Gold Mine Project	Mining	142
Total		12	Project		2,670

APPENDIX 5: EXPERT PANEL DETAILS

Delphi Round 1 expert Panel

	Interviewee	Interviewer	Entity
1	Esther Mogeni	Alwy	FCB Westlands
2	Nasif Mahmoud Saad	Alwy	First Community Bank
3	Julius G. Mihuko	Alwy	CBA
4	Godfrey Muhanji	Alwy	Greenspan Investment Ltd
5	Huldah Mkunu	Mandela	Longyun Garments
6	Abdirahman Jari	Mandela	Barclays La-Riba Dep
7	Francis Maende	Mandela	Coop Bank – Digo Road
8	Wycliffe Makori	Mandela	Eco Bank – Jomo Kenyatta
9	Swabir Swale	Mandela	FCB
10	Abdulkadir Hassan	Collins	BG East Africa
11	Edward Sila	Collins	Unilever Kenya Ltd
12	KM Mulandi	Collins	China Co. Road Construction
13	Infrastructure User	Collins	Truck owner



Delphi Round 2 expert panel

	Interviewee	Institution	Position
1	Huldah Mkunu	Longyun Garments	Accountant
2	Wycliffe Makori	Eco Bank	Branch Manager
3	Swabir Swale	FCB	Loans Officer
4	Abdirahman Jari	Barclays	Marketing Manager
5	Francis Maende	Coop Bank	Branch Manager
6	Abdulrahman Magoda	Barclays La	Section Manager
7	Mohamed Khatib	Diamond Trust Bank	Branch Manager
8	Benard Towett	Chase Bank	Credit Manager
9	Anwar Ahmed Abeid	Bajber Transporters Ltd	Director
10	Mustafa Ramadhan Karama	AK Commodities Ltd	General Manager
11	Paul Miriti	Remu Bank	Intern
12	Ahmed Al	Big EA-Business	COO
13	Saeed Ali	Business and BG	Operations Manager
14	Abdulkadir Hassan	Big EA-Business	Manager
15		Truckers Kenya Ltd	Truck Owner
16	Edward Sila	Unilever Kenya Ltd	
17	KM Mulandi	Construction Company	Team leader
18	Sam Adian	Admira Limited	Director
19	Edwin Gekone	The Actural Society of Kenya	Member- Financial Analyst



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