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An Introduction to Islamic Finance Legal Structuring in the Nigerian Capital Markets

Introduction

Nigeria has recorded growth in its Islamic financing industry. Albeit, the industry is nascent with an estimated size of nearly United States Dollars (**USD**) 2.3 billion in 2021. The burgeoning field of Islamic finance offers ethical (*halal*) investment and financing products which are compliant with *Shariah* (Islamic Law) principles.

This article focuses mainly on Islamic finance in the Nigerian capital markets and the principles to consider when structuring transactions. The four principles that form the foundation of Islamic finance are (a) risk-sharing, (b) avoidance of *riba* (prohibition of interest), (c) *gharar* (avoidance of "chance" and "deception") and (d) engagement in business activities which are considered *haram* (forbidden or proscribed).

Risk-sharing at a basic level underpins the abundance of permissible profit-loss sharing contracts. The key term is "*mudarabah"* which calls for a financing institution to share in the profits and loss of the enterprise that it finances. The prohibition of *riba* in Islamic law is premised on the understanding that money is essentially a measure of value rather than an asset in itself. Thus, earning profit/interest on money alone (for instance, on plain loans or debt securities without any underlying asset) is prohibited as it is considered usurious and exploitative. For *gharar,* chance and gambling are shunned in Islamic finance systems. All Islamic finance products must comply with the tenets of Islam as contained in the Holy Qur'an and Sunnah, otherwise such product which is not compliant is considered *haram*. These four principles exclude contemporary banking and capital market products including interest, derivatives and hedge funds, and considers them antithetical to Islamic law.

Currently, the most visibly successful Islamic finance product offered in Nigeria today is the *Sukuk* bond. It accounts for over 60% of the total amount invested in Islamic finance products in Nigeria today. The mandatory tie to underlying assets, with proof of ownership or beneficial ownership of the asset, is the major element distinguishing *Sukuk* bonds from conventional bonds. There is also, no guarantee of profit to the investors in *Sukuk* bonds, as the return on their investment is not standalone but hinged on the performance of the underlying assets.

The potential for growth is enormous. For example, the Islamic finance market in Malaysia, which has less than 20% of Nigeria's population, is worth over Malaysian Ringgit 2.31 trillion (approximately USD516 billion), which is over 224% of the current size of the Nigerian market. Basic principles of Islamic finance in the Nigerian capital market and highlights of relevant provisions of Securities and Exchange Commission (the "**Commission**") Rules and Regulation 2013 (as amended) (the "**SEC Rules**") are considered below.

Islamic Finance -- Capital Market Products

Islamic finance in the Nigerian capital market has witnessed an upward trajectory considering modern changes and swift adoption of its products by eligible investors in the market. A wide array of Islamic compliant securities now exist in the Nigerian capital market. The securities include Islamic law-compliant stocks, *halal* or Islamic mutual funds, *Sukuk* bonds amongst others. Generally, Islamic finance products and components in investments, project financing, venture capital services, capital financing models continue to grow in reach and sophistication.

The diverse Islamic finance products or securities can be structured as any one or more of equity financing, debt (or, to be truly accurate, fixed-income) financing, securitization and unit trust funds. Islamic equity financing is structured based on the fundamentals principles of *Mudharabah* (profit-sharing) and *Musharakah* (profit and loss sharing). Islamic debt-financing is structured using contemporaneous underlying contracts (*uqud al-muáwadat*) accruing certain rights, such as sale and purchase contracts.

Islamic equity-financing products are typically, structured using "*uqud al-ishtirak*" contracts, that is, profit-sharing contracts which are mostly in the nature of partnerships. Both the issuer and investors of the securities are entitled to share in the profits generated by the business venture and/or the loss.

Islamic debt-financing products contrast sharply in structure with conventional debt-financing products. Interest is the major basis for debt financing in conventional debt finance markets, but Islamic law shuns interest and consider it usurious (*riba*). Therefore, Islamic debt-financing is mainly structured using underlying contracts of exchange known as "*uqud al-mu'awadat*". Issuers in the Islamic debt market must have an identifiable project or underlying asset or investment which the debt securities would be structured around. The most common Islamic product categories are labelled *ijarah* (lease financing), *murabahah* (mark-up trade), *bai's-salam* (advance purchase) and *istisna'* (purchase order).

Recurrent Terms and Categories

The Islamic capital market products discussed above can be structured and issued using commercial contracts acceptable under traditional Islamic legal principles and adapting conventional finance principles which are not antithetical to Islamic law.

Musharakah

This is a profit-loss sharing type of financing. *Musharakah* may involve in effect either a partnership or joint ownership of the business venture. *Musharakah* may be limited in its scope to a specific undertaking, whereby different rights and profits accrue to the various parties and each party acts merely as an agent (but not a guarantor) of the other party, This limited *Musharakah* is otherwise referred to as *shirkat al-inan.* On the other hand, the arrangement may be unlimited where all participants rank equally and each partner acts as both an agent and guarantor of the other. The unlimited *Musharakah* is referred to as *Mufawadah*.

Generally, *Musharakah* is structured as a partnership where two or more persons come together as partners and provide capital to finance a given project on a pre-determined basis (permanent or diminishing). Diminishing *Musharakah* (*Mutanaqisa*) occurs where one of the partners buys the share of the other partner until the title to the underlying asset is completely transferred to the buying partner. In *Musharakah,* parties share both profits and losses and bear equally the associated risks. Although the profits may be distributed in pre-agreed ratios, losses are shared in proportion to capital contribution.

Mudarabah

The *Mudarabah* principle is a form of partnership where one party provides funding (whether as financier or as principal) while the other party (known as the *Mudarib*) provides expertise and efforts. The profits sharing is based on mutual agreement between the parties, but losses are borne entirely by the principal/financier, except the loses are a result from the misconduct, breach or negligence of the *Mudarib*. Asset management financing and unit trust funds are sometimes structured as *Mudarabah* where one party provides the funds and "sleeps" while the other party oversees, manages and coordinates the project or assets.

Murabahah

This is a common Islamic sale transaction also used in asset financing. It is in principle a sale based on an agreed profit margin. It is usually structured as a deferred payment sale transaction with the intention to finance and facilitate the purchase of goods. For instance, an Islamic bank may purchase goods and deliver them to a third party who defers the payment to a date agreed by the parties. The price to be paid by the deferring party is determined at the point of signing the *Murabahah* agreement.

Also, *Murabahah* can be in the form of a financing arrangement known as *Tawarruq*, where a person in need of cash purchases commodities on a deferred payment basis for a higher value and further resells the commodities to a third-party for cash. This structure is typically used to manage liquidity deficits and risk.

Bai' s-salam

This is essentially a forward sale contract where the delivery of the goods purchased under the contract occurs at an appointed future date, but payment is made at the time of contract. The key elements of *Salam are* the payment of full price at the inception of the contract and the certainty of price, object, quantity, date and place of delivery. In order to reduce exposure to credit risk, in a circumstance, where the delivery obligation is likely to be defaulted, the investor or buyer may ask for a financial guarantee, performance bond, or third-party guarantee which must be compliant with the principles of *Shariah*.

Istisnaa'

Istisnaa' financing is provided in the form of advance installment payments made to a contractor in a building project or to a manufacturer who manufactures machineries or equipment. Upon completion of the project, the asset is delivered to the purchasing party based on the contractual agreement. *Istisnaa'* can be used by both construction and manufacturing companies to finance their projects and supplies.

Ijarah

This is similar to a contract of the sale of the right to use a given asset for a period of time. *Ijarah* is essentially a lease contract which permits one party to use an asset owned by another party over a specified period of time and for an agreed sum. Under an *Ijarah,* the lessee enjoys the benefit of the leased asset for the entire lease period while the lessor retains the ownership. Majority of *Ijarah* transactions typically, take the form of hire-purchase arrangements.

Wakalah

This is a contract used mainly to structure agency transactions between the principal (*muwakkil*) and the agent (*wakil*). The agent is appointed to undertake a well-defined transaction on behalf of the principal, while being entitled to earn an agreed fee for the performance of the transaction.

Regulation of the Nigerian Islamic Capital Markets

Just like the conventional capital markets, SEC regulates the Islamic capital markets and approves of the range of securities issued therein. Other sector regulators such as the Central Bank of Nigeria ("CBN") and the National Insurance Commission may also regulate issuers in their respective sectors seeking to adopt any of the Islamic financing options. The CBN through the issuance of its guidelines and policies on non-interest banking and SEC have played active roles in this regard.

The principal statutes applicable to the Islamic capital markets include the Investments and Securities Act, 2007 (as amended) and the SEC Rules. Other applicable legislation includes the Companies and Allied Matters Act 2020 which generally regulates all the registered business ventures in Nigeria. A number of initiatives have been introduced by the SEC to support the Islamic finance market in Nigeria.

Some of them are as follows: (i) the regulation for *Sukuk* offerings which facilitated the first *Sukuk* issuance in the market Osun *Sukuk* in October 2013; (ii) the development of a 10-year (2015-2025) Islamic Capital Market Masterplan with strategic recommendations projecting that Islamic finance products will contribute about 25% to the total capital market capitalization; (iii) developing SEC Rules including provisions on Islamic unit trust fund management; and (iv) collaboration with the Debt Management Office on the issuance of the first Nigeria Sovereign Sukuk in 2017.

Conclusion

The use and acceptance of Islamic finance products in Nigeria has widened significantly. Islamic finance has experienced exponential growth in recent times in the Nigerian capital market. As at 2021, there were at least six non-Interest/ethical funds with total assets under management of over ₦6.5billion, and there are more Islamic compliant funds in the pipeline.

It is essential for players in the Nigerian capital markets to have a full understanding of the operational principles of Islamic finance as expatiated above, particularly in light of increased regulation by the Commission and higher demands and prospects of Islamic financing products.

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