Islamic Finance, Middle East and North Africa Hot Topics
Private equity trends in Africa

Private equity houses and investors are focusing more and more on the African continent (North Africa and Sub-Saharan Africa). There used to be only 12 private equity houses targeting investments in this part of the world in the 1990s. However, the number of interested players has grown in recent years and there are now more than 200 private equity houses that employ different strategies when investing in this region.

Some private equity houses adopt a more general investment approach, and search for any opportunities that may meet their general investment criteria; whilst others are more selective and choose to specialise in and focus on a particular country and/or industry sector.

The appetite for investments is clearly spurred by the anticipated progress and development of the African continent. Demographically, Africa’s population is expected to boom to 2.4 billion people in 2050, matched by an estimated GDP of USD 2.6 trillion. The middle class population is expected to rise to 0.4 billion people in 2020 and growing exponentially to 1.1 billion people by 2060. Coupled with demands for a better socio-economic environment and lifestyle, these factors open up a lot of opportunities in the healthcare, fast-moving consumer goods, insurance and financial services industries, drawing the interest of well-known private equity houses like Carlyle, Abraaj, ECP, Wendel, Actis and many others. The value of current deals may be below the USD 50 million mark, but high returns (driven by growth) are expected.

Mauritius has been the preferred holding location for private equity investments in Africa for the last 30 years. However, Luxembourg (being part of the EU) also has an important role to play given the increasing interest in attracting European investors to partake in the growth of private equity in Africa. Luxembourg’s legal, regulatory and tax frameworks make it a very attractive hub for the structuring of SPVs and/or funds for European investors that invest into Africa.

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Implementation of IFSB-15 and its effect on Islamic Banks

The 2008 financial crisis caused an unprecedented turmoil in the financial markets. The resulting regulatory response towards the whole financial system that had prevailed for the previous decades has been significant. This also arguably raised a keen interest among investors in Islamic Finance products that are more real-asset oriented.

Unlike conventional financial institutions, the business of Sharia-compliant banks is not explicitly covered by the Basel III regulatory framework. To remediate this gap, the Islamic Financial Services Board (IFSB) has issued specific capital standards for institutions offering Islamic financial services. These guidelines aim to address the specific features of Sharia-compliant products and assess their inherent risks in order to quantify the adequate capital requirements.

The basic principle of Islamic Finance is that risks have to be shared fairly between the bank and the debtor. This means that where a conventional bank solely faces credit risk on a loan, a Sharia-compliant bank would be exposed to both credit and market risks on a non-binding Murâbahah. The IFSB’s “Revised capital standard for institutions offering Islamic financial services” (IFSB-15) attempts to bridge this gap and sets out rules on how to quantify capital requirements and meet operational expectations for each specific Sharia-compliant financial instrument.

IFSB-15 is not legally binding but can be considered instead to be a set of best practices to assist banks and authorities in handling the specificities of Sharia-compliant transactions. IFSB-15 does not (yet) cover liquidity risk management or advanced approaches for credit, market and operational risk management as developed in the Basel III framework. Institutions are free to develop their own internal models for these areas. This should not constitute a major concern in Luxembourg as most institutions adopt a simple approach.

IFSB-15 will be implemented with effect from 1st January 2015 and will complement the existing regulatory framework. However, it is not entirely clear how (and if) supervisors will implement the transitional arrangement and new requirements for Sharia-compliant activities. We will keep you informed of any developments in this area.

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Fund Distribution in the Middle East

Countries in the Middle East have heterogeneous fund distribution regimes. The lack of uniform regulations is a structural weakness that hinders fund distribution and marketing as well as the growth of the industry in the region.

In recent years, some countries have introduced regulations which have made the cross-border distribution of foreign funds in the Middle East even more restrictive. For instance, Saudi Arabia’s Capital Market Authority (CMA) only allows foreign investment funds to be marketed and advertised in Saudi Arabia via authorised persons licensed by the CMA. Similarly, the United Arab Emirates (UAE) has implemented its Investment Funds Regulation, transferring the regulatory responsibility for the licensing and marketing of investment funds in the UAE (excluding that in the Dubai International Financial Centre, which is governed by its own regulatory regime) from the UAE Central Bank to the Securities and Commodities Authority (SCA). The promotion of foreign funds in the UAE may only be done through a locally licensed placement agent with the approval of the SCA or, in some cases, through the fund manager’s local representative office. The SCA has also increased the fees to obtain approval for the promotion and distribution of foreign funds in the UAE and imposed new due diligence and disclosure requirements for foreign fund distributors in the UAE.

The mere registration or creation of a fund in a Middle Eastern country does not automatically allow the fund to be marketed and distributed to investors in the region. Unlike in Europe, the UCITS or AIFM regimes have not been replicated in the Middle East region and asset managers have to comply with disparate local regulations and obtain separate approvals in the countries where they want to distribute their funds. In this respect, the creation of a fund passport for the Middle East would reduce regulatory red tape, spur the development of the region’s fund management industry and support growth across the region. The development of a Middle Eastern fund passport will take time, and based on recent regulatory trends in the region, is unlikely to be achieved in the near future. In the interim, asset managers may wish to consider (if they are not already doing so) tapping into more accessible investor pools by using UCITS or AIFM channels to promote their funds in markets outside the Middle East. In this respect, Luxembourg is a natural choice for a cross-border fund distribution hub given its political and economic stability, its favourable regulatory and fiscal environment and its track record as Europe’s largest investment fund centre and second-largest worldwide after the United States.

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Use of Islamic Finance instruments in the Middle East

Most transactions that are undertaken in a Sharia-compliant manner (in compliance with Islamic religious requirements) seek to achieve economic outcomes which are similar to the economic outcomes achieved by conventional finance. However, to achieve these economic outcomes, Islamic Finance transactions typically require more steps than the equivalent conventional financial transactions. The additional steps required by Islamic Finance may give rise to a number of tax complications including (but not restricted to) multiple layers of transfer taxes and/or early crystallisation of tax on income or capital gains. Such additional tax leakage may make Islamic Finance instruments prohibitively expensive to implement.

In countries such as Malaysia and the United Kingdom, local tax legislation has been modified to level the playing field (from a tax perspective) between Islamic and conventional finance. In Luxembourg, whilst there has not been any significant change in local tax legislation, circulars have been issued to clarify the Luxembourg tax treatment that should be accorded to certain Islamic Finance instruments. However, despite the Middle East being the largest Islamic Finance market in 2013 (with countries such as Saudi Arabia, the United Arab Emirates, Kuwait, Qatar and Bahrain being listed in the top 10 largest Islamic Finance economies during the year*), the tax laws in the region currently only cater to tax issues arising from conventional finance and provide limited (if any) guidance on the taxation of such instruments and transactions. In addition, there is a distinct lack of special tax regimes or tax incentives that specifically address the tax issues (let alone alleviate additional tax leakages if any) that may arise on the use of Islamic Finance instruments.

Tax treatment generally accorded to Islamic Finance instruments

The corporate tax treatment generally accorded to Islamic Finance instruments is set out below:

• Profits received by a lending party that is a local tax resident will be subject to tax in accordance with local rules. Profits remitted to a lending party that is a non-tax resident is generally treated as interest and (where applicable) is subject to withholding tax accordingly.

• The profit element payable by the borrowing party will receive the same treatment as interest. These interest payments are generally deductible for tax purposes, subject to local thin capitalisation and/or interest restriction rules.

• Tax applies to any gains that are realised on the transfer of assets and properties. The taxation of gains cannot be deferred even if the transferor ultimately re-acquires the assets and/or properties under the same Islamic Finance arrangement.

• The transfers of assets and properties to facilitate an Islamic Finance arrangement are separately viewed on a transaction-by-transaction basis, and not regarded as part of a wider financing arrangement. Accordingly, transfer taxes (particularly those relating to real property) may apply multiple times.

• Different or multiple tax treatments may arise depending on the tax classification of the underlying nature of each component to a transaction structure in an Islamic Finance compliant manner.

* Source: ICD Thomson Reuters Islamic Finance Development Report 2013
In some Middle Eastern countries, alternative or additional tax rules may apply depending on the profile of the taxpayer. For instance, in Saudi Arabia, Zakat* rules will also apply to the extent a company is (partially or wholly) owned by Saudi nationals or nationals of the Gulf Co-operation Council. Under these Zakat rules, an asymmetric tax treatment may be accorded to Islamic Finance instruments such as the sukuk. More specifically, if a sukuk is not structured properly, a one sided Zakat exposure may arise as the lender is unable to claim the sukuk principal amount as a deduction from its Zakat base, but the borrower is required to subject the same sukuk principal amount to Zakat.

Tax issues arising from the use of Islamic Finance instruments

Whilst the application of current tax laws in the Middle East on relatively simple Islamic Finance transactions such as commodity Murâbahah or salaam may generally yield the same taxable results as those corresponding to their conventional finance equivalents, the application of these tax laws in more complex transactions such as sukuk may lead to prohibitive tax costs which make the transaction economically infeasible. These costs usually pertain to tax leakages that arise on the transfer of assets associated with the issue of sukuk (and the asymmetric Zakat treatment noted above), even though (as part of the Islamic Finance arrangements implemented) these transactions are ultimately reversed and the assets are returned to their original owners.

Furthermore and as mentioned above, the transfers of assets and properties to facilitate an Islamic Finance arrangement in certain countries may give rise to transfer taxes (particularly those relating to real property) multiple times.

* Zakat is a religious tax that is legally imposed in certain Middle Eastern countries

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Conclusion

The tax implications arising from the use of Islamic Finance instruments in the Middle East are not necessarily straightforward and should be analysed on a case-by-case basis. The current tax laws in the region provide limited guidance and/or do not specify the tax treatment applicable for Islamic Finance instruments; and there are also limited (if any) case precedents to rely on. In certain circumstances, the use of Islamic Finance instruments may result in additional taxes as compared to the use of their economic equivalents in conventional finance. This challenge is further compounded by the need to educate both tax practitioners and tax authorities in the region and it may well be some time before further progress can be seen on the Islamic Finance tax front in the Middle East. That said, there is a glimmer of hope as the tax authorities in Qatar and Saudi Arabia have been open to discussion on these matters and there is an ongoing dialogue between PwC and these authorities to determine how best to tackle this complicated issue.

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