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Law and Practice

Contributed by ENSafrica

Contents

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Author

Angela Itzikowitz is an executive in ENSafrica's banking and finance department. She specialises in banking and financial market regulation, including finance and regulatory reform, card and related electronic payment instruments, derivatives, loan agreements, collective investment schemes, insurance, money laundering and debt origination and securitisation. Angela has participated in a number of financial market initiatives in Asia in collaboration with colleagues from Beijing, Shanghai, Hong Kong and India. She also acts for a number of European banks, asset managers and investment advisers. Angela is a professor in banking and financial markets law at the University of the Witwatersrand and she teaches at Queen Mary College, the University of London, on legal aspects of international finance. She is the author of the Law of South Africa Banking and Financial Markets, has co-authored a number of books and has published numerous articles in local and foreign journals. She is fluent in English, Afrikaans and German and speaks South Sotho and Mandarin.

1. Loan Market Panorama

1.1 The Impact of Recent Economic Cycles and the Regulatory Environment

Electricity supply constraints, severe drought conditions which have weighed heavily on the agricultural sector and other structural problems continue to impede economic growth in South Africa. In addition, domestic inflation and a poor export performance and labour market have compounded existing problems. Political developments, including a cabinet reshuffle, have exacerbated exchange rate volatility and increased investor concerns and fears of a sovereign debt downgrade to junk status. Ordinary South Africans remain financially constrained, with many struggling to meet everyday expenses. As a result of economic and household financial pressures, South Africans continue to turn to various forms of borrowing to supplement their daily expenses and overall purchasing behaviour.

The *PWC Major Banks Analysis* for the reporting period that ended 30 June 2018 indicates a resilient growth in loans and advances by banks of 9.5% for the six months to June 2018 and 7.9% from 30 June 2017 to 30 June 2018. This growth is driven by corporate and investment banking, which outperforms retail and instalment credit growth. The rand/dollar exchange rate has significantly weakened and it should be noted that some of this growth would have been derived from offshore operations.

Industry mortgages appear to show positive growth likely originating from non-banks operating in the financial services sector. Margins on mortgages are considerably lower than other lending portfolios, and given the uncertain outlook for the residential property market, there is a negative outlook for mortgage lending growth in the short term.

Whilst demand for credit cards continues due to higher average margins, a slight slowdown in instalment sale credit and finance leases has been noted. This is partly due to the fact that these loan categories are sensitive to modest increases in the interest rate cycle.

The National Credit Regulator's quarterly *Credit Bureau Monitor* (for Q2 - June 2018) indicates that the percentage of consumers with poor credit records had decreased by 0.02% with 38.9% of consumers having poor records by the end of June 2018, while consumers classified as being in "good standing" increased by 0.2% year on year with 61.1% of consumers being in good standing.

A number of retail banks have had large fines imposed on them by the Financial Intelligence Centre, established in terms of the Financial Intelligence Centre Act, 2001, for failing to comply with South Africa's anti-money laundering legislation.

It is expected that major bank margins will continue to experience pressure given the continued increase in minimum capital ratios over the Basel III implementation period and the persisting uncertainty in the macroeconomic and domestic economy.

1.2 The High-yield Market

Unlike US and European bond markets, high-yield corporate bonds are a recent occurrence in the South African market.

South Africa's bond market has been dealt a heavy blow from the default of insolvent First Tech Group's ZAR925 million First Strut bond, partly due to fraud. The general view is that this will not hold back the bond market's longer-term development as it merely brings home the fact that high yield equals higher risk. South Africa will probably have a sizeable high-yield market ten years from now, but better legal protection is needed, as well as a process ensuring that the assets do in fact exist.

1.3 Alternative Credit Providers

Banks have tightened their lending criteria due to factors such as rating agencies' downgrades, increasing consumer debt, tax implications and price hikes. Most borrowers can no longer obtain the favourable lending terms that they could in the past. However, borrowers in the resources and allied sectors continue to attract favourable terms. There has also been an increase in debt covenant defaults.

It has been estimated that 50% of borrowers have experienced delays in obtaining bank finance, which has caused them to lose out on deals or to obtain less favourable financing terms. There is therefore a willingness in the market to pay a premium for faster credit decisions and an access facility with flexible repayment terms as opposed to monthly instalments typically required by the banks.

South Africa has experienced an increase in investors applying for short-term, or "bridging" finance, from non-bank credit providers, in anticipation of a bank loan or transfer of property due to banks' conservative lending practices and slow turnaround times. This has resulted in a significant growth in alternative credit providers. The South African legislation, which adopts a functional approach to regulation, conduces to the extension of credit by non-bank institutions.

1.4 Evolution of Banking and Finance Techniques

Peer-to-peer online lending platforms and loans offered via mobile phones have entered the South African lending market. Credit cards offering attractive loyalty programmes are also on the increase and many South Africans have more than one credit card.

1.5 Recent or Expected Legal, Tax, Regulatory or Other Developments

Lending is regulated in terms of the National Credit Act 34 of 2005 (the "**NCA**"), which adopts a functional approach to regulation, ie any person or entity extending credit would, subject to certain exemptions, be regulated under the NCA.

The NCA has limited application to juristic-person borrowers (which includes companies) and provisions relating to marketing, over-indebtedness and reckless credit do not apply to juristic persons.

The NCA has no application to juristic persons with an asset value or annual turnover that equals or exceeds ZAR1 million, nor does it apply to juristic persons with an asset value or annual turnover of less than ZAR1 million which is a mortgagor under a mortgage agreement or a borrower under a credit transaction in terms of which the principal debt outstanding equals or exceeds ZAR250,000.

From a regulatory perspective, the National Credit Regulations, 2006, were amended in 2015 to impose stricter requirements when conducting pre-loan affordability assessments under the NCA. In our experience, this has had a significant impact on the lending market and lenders who originate loans over the phone or electronically have had to augment their processes in order to comply with the new lending criteria. All credit providers, as of November 2016, have to register as credit providers with the National Credit Regulator as the threshold limits for registration have been reduced to a principal debt outstanding of nil from the previous ZAR500,000. The Regulations to the NCA dealing with interest and fees have been revised and the cap on interest rates has been reduced.

The National Credit Bill 30 of 2018 has also been published for comment. The Bill aims to provide for capped debt intervention to promote a change in the borrowing and spending habits of an over-indebted society. The debt intervention procedures will be available for over-indebted consumers who earn less than ZAR7,500 per month, and entails that such a consumer's debt obligations will be suspended for a period of maximum 24 months, to allow the consumer time to recover financially. If, despite all obligations being suspended for 24 months, the consumer can still not resolve the situation, the obligations of the consumer will be extinguished. The Bill further provides for mandatory credit life insurance on all credit agreements for longer than six months but no more than ZAR50,000 in value to prevent lower income groups from falling into over-indebtedness due to changes in their financial circumstances. The Bill also aims to further limit the widespread abuse of consumers by unscrupulous lenders and to allow for simpler and more rigorous enforcement of the Act by, amongst others, providing for criminal prosecution of persons who contravene the Act.

The regulation of financial institutions in South Africa is in the process of being comprehensively overhauled and to this end the Financial Sector Regulation Act 9 of 2017 has been promulgated ("**FSRA**"), with a phased implementation plan. The FSRA establishes the Prudential Authority which is charged with prudential regulation, and the Financial Sector Conduct Authority as the market conduct authority, which oversees market conduct. The object of this Act is to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in South Africa, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes (amongst others) financial stability, the safety and soundness of financial institutions and the fair treatment and protection of financial customers.

The Insurance Act 18 of 2017 has also been promulgated with a phased implementation plan. This Act provides for a legal framework for the prudential regulation and supervision of insurance business in the South Africa, and also intends to promote the maintenance of a fair, safe and stable insurance market. The Act further introduces a legal framework for micro insurance to promote financial inclusion.

The Conduct of Financial Institutions Bill is expected to be published for comment in 2018 or 2019 and it is envisaged that this will constitute a shift towards a centralised licensing model from the current sectoral-based licensing model.

2. Authorisation

2.1 Requirements for Authorisation to Provide Financing to a Company

Lending is regulated in terms of the NCA, and both banks and non-banks that extend credit would be obliged to register as credit providers in terms of that Act. There is no regular feature or minimum threshold requirement and, subject to any applicable exemption, a one-off loan would trigger registration.

The NCA does not apply to juristic-person borrowers (companies, partnerships and trusts with three or more trustees or if the trustee is itself a juristic person) that have an asset value or annual turnover which equals or exceeds ZAR1 million, nor does it apply to juristic persons with an asset value or annual turnover of less than ZAR1 million where the agreement is a mortgage agreement or a credit transaction where the principal debt outstanding equals or exceeds ZAR250,000.

The NCA has limited application to juristic-person borrowers and provisions relating to marketing, and over-indebtedness and reckless credit do not apply to such persons in terms of which the principal debt outstanding equals or exceeds ZAR250,000.

3. Structuring and Documentation Considerations

3.1 Restrictions on Foreign Lenders Granting Loans

There are no significant impediments on cross-border lending other than exchange-control regulation which is administered by the Financial Surveillance Department of the South African Reserve Bank. No South African resident may incur an obligation to a non-resident except with the Department of the South African Reserve Bank's approval, which must be obtained in advance of the relevant obligation being incurred.

In addition, the NCA would be applicable where the loan could be said to "have an effect within the Republic" of South Africa, and foreign lenders would then be required to register as credit providers under the Act. (See **2.1 Requirements for Authorisation to Provide Financing to a Company**.)

3.2 Restrictions on Foreign Lenders Granting Security

Guarantees are commonly used in South Africa. The prior approval of the Financial Surveillance Department of the South African Reserve Bank would be required if any guarantee is given by a local entity in favour of a non-resident entity or for the obligations of a non-resident entity.

Where guarantees are used in loan transactions and the guarantor is a company related or inter-related to the borrower, such guarantee would constitute "financial assistance" which is subject to the provisions of the Companies Act, 2008 (sections 44 and 45). These sections require the appropriate board and shareholder resolutions for such financial assistance to be competent and valid, and the company's constitutional documents must not prohibit such assistance.

3.3 Restrictions and Controls on Foreign Currency Exchange

South African residents are subject to South African exchange control restrictions, implemented by the Financial Surveillance Department of the South African Reserve Bank (the "Reserve Bank"), which restrict the outflow of capital from South Africa. The Reserve Bank has delegated the power to authorised dealers or authorised dealers with limited authority (certain South African banks, money remitters and some branches of foreign banks) to oversee and regulate this function on its behalf and are the only entities permitted to effect an offshore currency transaction for a South African resident.

Exchange controls are applicable to all cross-border transactions irrespective of size, and a South African resident individual cannot transfer money offshore or buy foreign currency without a tax clearance certificate from the South African Revenue Service which exceeds the annual discretionary allowance of the South African resident individual. There are set limits to the amount of rand a South African resident individual can transfer offshore or convert into a foreign currency. These thresholds currently permit a South African individual to repatriate funds from South Africa under an annual discretionary allowance in the amount of ZAR1 million per calendar year and a foreign investment allowance in the amount of ZAR10 million per calendar year (subject to the requirements for the use of the foreign investment allowance being met).

Under the exchange control regulations there are no limitations as to how much money can be brought into South Africa, but there are limitations on the amount that can be repatriated from South Africa.

3.4 Agent and Trust Concepts

The agency concept is well recognised in South Africa and an agency arrangement created under the law of another country is generally recognised in South Africa.

In a syndicated loan or funding structure, lenders can appoint one of the finance parties to perform the purely administrative role of facility agent. Provision can then be made in the relevant security documents to authorise such agent to enforce rights on behalf of the other lenders in South African courts on the instruction of the relevant parties.

The trust concept is also recognised in South Africa as is a trust created under the law of another jurisdiction. A security trustee can enforce its contractual rights in South African courts.

There are, however, impediments to the use of the agent or trust concept in security structures. For a security to be valid, it is a requirement under South African law that the grantor of the security has a valid principal obligation (ie not an accessory obligation) towards the beneficiary of the security. This legal requirement is foreign in terms of the concept of security trustee and it is unclear whether security can validly be created in favour of a security trustee acting as trustee for a group of lenders.

Section 54 of the Deeds Registries Act, 1937 makes it unlawful for a bond to be registered in the name of any person acting as an agent for a principal. There is a risk under South African law that a security trustee can be seen as an agent for the lender in relation to the security, with the result that the security would not validly have been created. It follows that the security trustee or agent structure is not an appropriate mechanism to hold security for a fluctuating creditor class where the obligations are secured by mortgage bonds and notarial bonds.

The creation of a parallel debt obligation, equal to the obligation owed to the lenders, between the borrower and the security trustee is an alternative structure utilised in South Africa to address these problems where the security is granted in favour of the security trustee for the parallel debt obligation.

Fluctuating creditor classes in secured lending transactions are, however, more often addressed via the use of a special purpose vehicle ("**SPV**") to house the security provided for the benefit of the lenders. In such structure, a security SPV is established to grant the lenders a guarantee for the obligations of the borrower. A primary obligation is thus placed on the security SPV to pay the lenders on demand upon default. The security SPV is, in turn, indemnified by the borrower against any claims from the lenders in terms of the guarantee and the borrower secures this indemnity with security interests in its various assets.

A third method of granting security is to grant such security in favour of the lenders jointly and severally. This structure has not been tested by the South African courts and is not commonly used due to its complexity and the associated risks, including the risk of an invalid splitting of claims.

3.5 Loan Transfer Mechanisms

Secured debt trades are common in South Africa. The rights in the associated security package are usually transferred by means of cession. If these include rights under mortgage bonds or notarial bonds, the cession must be registered in the relevant Deeds Registry.

The debtor's consent to the transfer is required where only part of a debt is transferred, unless the document giving rise to the debt expressly permits such partial debt transfer without consent.

If a security SPV structure has been used (discussed in **3.4 Agent and Trust Concepts**), the transferring party usually transfers the rights under the guarantee granted by the security SPV to the extent of the debt transferred. Often, however, the guarantee stipulates that it is granted for the benefit of all holders of the debt for which the guarantee was granted, including transferees.

3.6 Debt Buy-back

To date, debt buy-back has not been a feature of the South African market. However, provided that the underlying agreement permits a debt buy-back and there is compliance with financial assistance requirements in terms of the Companies Act, 2008, where apposite, there are no legal impediments to a debt buy-back.

3.7 Public Acquisition Finance

Where the acquisition pertains to shares in a listed entity, such as by way of a scheme of arrangement, “certain funds” are often required as a “guarantee” for the shareholders participating in the scheme. This has also been utilised in cross-border acquisitions where the bidder is required to establish its ability to fund the transaction at the time of making the bid.

The use of short-form or long-form commitment letters and the requirement of full documentation vary from deal to deal. In general, however, detailed term sheets are utilised, coupled with the facility documentation and security documents.

Commitment letters and acquisition agreements are not publicly filed in the Republic of South Africa and may never become public at any point. These documents are usually subject to extensive confidentiality undertakings.

4. Tax

4.1 Withholding Tax

The repayment of capital will not be subject to any withholding tax. However, the payment of interest will be subject to interest withholding tax on the basis that the Income Tax Act, 1962 (“**Income Tax Act**”) does levy a withholding tax on interest from a South African source paid to or for the benefit of a non-resident at a final withholding tax rate of 15%. “Interest” includes any related finance charges, any discount or any premium received by the lender in respect of the financial instrument including any form of compensation payable by the South African borrower to the foreign lender which arises from the advance of the financial instrument. The rate of taxation is, however, subject to the provisions of the applicable double taxation agreement between South Africa and the country in which the funder is resident and subject to the foreign lender adhering to the prescribed declaration and undertaking requirements. The liability for the withholding tax rests with the foreign funder whilst the South African borrower has the duty to withhold the tax and pay it over to the South African Revenue Service. The interest will be exempt from withholding tax if it is paid by the government of South Africa (national, provincial or local sphere); any bank; or a headquarter company, in respect of financial assistance where the headquarter company directly or indirectly holds 10% of the equity and voting rights.

4.2 Other Taxes, Duties, Charges or Tax Considerations

No tax consequences will arise from the advance of a loan from a foreign funder to a South African borrower or upon the repayment and redemption of the loan provided that the loan is settled in full. The Income Tax Act does have in place specific anti-avoidance provisions for loans that have equity features, resulting in the interest on the loan being recharacterised as dividends *in specie* and treated as dividends for tax purposes. If the anti-avoidance provisions are triggered, the interest will be subject to dividends withholding tax (instead of withholding tax on interest) at the rate of 20%, and the South African borrower will be prohibited from claiming a deduction of the interest paid to the foreign funder. The rate of taxation is again subject to the applicable double taxation agreement between South Africa and the country in which the funder is resident and subject to the foreign lender adhering to the prescribed declaration and undertaking requirements. However, these provisions are only triggered if the loan instrument has prescribed “quasi-equity” features and either the interest on the loan instrument is deemed to be “hybrid-interest” or the loan instrument itself is deemed to be a “hybrid-debt instrument”.

Consideration would also need to be given to the transfer pricing provisions as contained in the Income Tax Act that regulate both the rate of interest that may be charged on the loan and the quantum of debt (thin capitalisation) that may be introduced into South Africa where the lender is a connected person in relation to the borrower.

If security is required to be extended in respect of the loan, there are nominal registration fees payable for the registration of certain security such as bonds as well as hypothecation of intellectual property. Mortgage bonds and notarial bonds can only be prepared by conveyancers and notaries respectively, and these professionals are entitled to charge fees in accordance with a tariff.

The acquisition of a foreign loan by a South African borrower is subject to the South African borrower obtaining prior exchange control approval from the Financial Surveillance Department of the South African Reserve Bank, ie the loan capital cannot be advanced to the South African borrower in the absence of prior exchange control approval being obtained. Approval is required for the repayment of the capital, interest and all ancillary finance charges in order for the South African borrower to repatriate these payments to the foreign lender. If any security is extended in respect of the loan in the form of a third party guarantee, where such security provider is a South African resident, exchange control approval will also be required for the extension of such security. South African exchange control regulations also prescribe thresholds on the interest levied on the inward foreign loan facility.

Fees may also be payable to the court for security which requires a court order for enforcement (see further **5 Guarantees and Security**).

4.3 Usury Laws

South Africa no longer has a dedicated Usury Act, this having been repealed and replaced by the NCA. One of the functions of the Financial Surveillance Department of the South African Reserve Bank, however, is to regulate cross-border lending, and it has the discretion to refuse approval for a transaction if it deems the interest to be excessive.

The common law *in duplum* rule is part of South African law, and it provides that arrear (unpaid) interest ceases running as soon as it equals the amount of the principal outstanding.

Lending transactions with natural person borrowers are subject to maximum prescribed interest as set out in the NCA.

5. Guarantees and Security

5.1 Assets Typically Available and Forms of Security

The assets available as collateral to lenders can be subdivided into the following categories: immovable property; tangible movable property; financial instruments; claims and receivables; cash deposits; and intellectual property.

Immovable property

Immovable property, or real estate, is mainly comprised of land as well as the resources on it, such as minerals and plants. Buildings or other tangible assets annexed to the land in such a manner that they cannot be removed without substantial physical damage (to the land or the asset itself) are also considered to be immovable property.

Typical forms of security

Security over immovable property must be by way of hypothecation, ie a mortgage, executed in accordance with the formalities set out in the Deeds Registries Act,1937.

Formalities

A mortgage over immovable property is executed by way of a mortgage bond. The mortgage bond is perfected when it is registered at the deeds registry where the immovable property is registered. This is the only method of perfecting security over immovable property.

Tangible movable property

Tangible movable property is typically any property that is not immovable, ie it can be moved around without any serious damage to itself. Movable property may be further classified into tangible property, which is property which has material existence such that it can be touched, as distinct from intangible or immaterial property such as intellectual property, securities and book debts (discussed below).

Typical forms of security

Security over tangible movable property may be taken in any one of the following ways:

- *Pledge:* A pledge is a type of encumbrance over movable property which involves the delivery of the property to the lender with the borrower retaining ownership of the pledged property.
- *Notarial bonds:* Notarial bonds are classified into special notarial bonds ("**SNB**") and general notarial bonds ("**GNB**"). An SNB is a mortgage created over specific property (sometimes specifically identified) in accordance with the provisions of the Security by Means of Movable Property Act, 1993 and it confers a real right of security over the property without the need to deliver the encumbered property to the lender. A GNB is a mortgage over movable property. Like an SNB, the encumbered property is not delivered to the lender; unlike an SNB, however, a GNB does not make the lender a secured creditor until the mortgaged property has been attached.
- *Landlord's hypothec:* This form of security is available to a landlord as security for arrear rental, and it creates an encumbrance over the tenant's movable property on the let premises, which the landlord may attach and sell in execution to satisfy payment of the arrear rental.
- *Special deeds of mortgage:* SNBs and GNBs are not competent forms of security over all tangible movable assets. Security over an aircraft is created by way of a mortgage in the form prescribed in the Recognition of Rights in Aircraft Act, 1993 and the Mortgaging of Aircraft Regulations, 1997. Security over a ship is created in accordance with the form prescribed in the Ship Registration Act, 1998.

Formalities

- *Pledge:* An agreement (written or oral) between the lender and the borrower for delivery of possession of the movable property to the lender and subsequent delivery by the borrower to the lender constitutes a valid pledge.
- *Notarial bonds:* There are no statutory formalities for the creation of a GNB. A notary public prepares the bond, and the owner or the notary public with a power of attorney executes the bond. The GNB will usually contain an acknowledgement of debt by the borrower as well as a declaration by the borrower in which he/she binds the movable property in favour of the lender as security for the acknowledged debt. The GNB must be registered with the deeds registry within three months of its execution.

An SNB is a written document setting out a description of the encumbered property in a manner that makes the property readily recognisable and identifiable. Besides the property description requirement, there is no prescribed format for an SNB, but it must be registered with the deeds registry within three months of execution. (See **7 Bankruptcy and Insolvency**.)

- *Landlord's hypothec:* There are no prescribed formalities for this hypothec.
- *Special deeds of mortgage:* A mortgage over an aircraft is created by the Commissioner for Civil Aviation by way of a recordal in a register as well as payment of a prescribed fee.

A deed of mortgage over a ship is registered with the Registrar of Ships in the South African Ships Register.

Financial instruments

This category of assets is mainly comprised of securities (or shares), including securities in securitised debt.

Typical forms of security

- *Cession and pledge:* Security, in respect of materialised securities, is created by way of a security cession agreement which is, in effect, a pledge of intangible rights. Delivery of the share certificate is not a requirement for a valid pledge in South African law.

The Financial Markets Act, 2012 prescribes formalities for the pledging of uncertificated securities held in a securities account. It is, however, not possible to pledge the actual securities account, and the practice is to flag the securities in the securities register.

A cession may take one of two forms: a cession in *securitatem debiti* (ie a security cession) in terms of which ownership of the assets is retained by the borrower *qua* cedent (transferor); or an out-and-out cession in terms of which the title in the property is transferred to the lender (*qua* cessionary), subject to the condition that the lender will cede back title to the borrower upon discharge of his/her obligations.

Formalities

Security over shares or securities that are evidenced by a certificate or are conferred by a security cession that is in effect a pledge of intangible rights and, in the case of uncertificated securities, the securities account of the borrower, is flagged. The Financial Markets Act, 2012 requires security over listed securities to be perfected by way of an entry in the central securities account.

Intellectual property

This category of assets is comprised of copyrights, designs, patents and trade marks.

Typical forms of security

- *Copyright:* Security over a copyright is taken by way of a security cession.
- *Designs:* Security over a registered design can be acquired by a security cession or by hypothecation as set out in the Designs Act, 1993 (the latter process prevents the proprietor from licensing the design to a third party).
- *Patents:* A security cession or hypothecation in terms of the Patents Act, 1978 will confer security over a patent.
- *Trade marks:* A security cession or hypothecation in terms of the Trade Marks Act, 1993 will confer security over a trade mark.

Formalities

A security cession will confer security over all intellectual property. The hypothecation process for registered designs, patents and trade marks are all similar (although set out in different statutes). A hypothecation is recorded in writing and lodged with the Companies and Intellectual Property Commissioner ("**Commissioner**"), and is accompanied by a prescribed form to record the hypothecation. All registered proprietors, as well as persons with other interests in the registered intellectual property, are required to be served with a copy of the application and proof of service must be furnished to the Commissioner.

Cash deposits and other claims over receivables

This class of assets comprises mainly contractual rights such as a right to a cash deposit in a bank account, book debts and insurance claims.

Typical forms of security

Security over cash deposits, receivables and other contractual rights is created by way of a security cession.

Formalities

A security cession is sufficient to confer security over a contractual right and no further formalities are required.

Costs and timing

Bond registration (ie a mortgage, GNB or SNB) is performed by certain professionals who charge a fee in accordance with a tariff, although the costs are usually negotiable. The costs depend, among other things, on the capital sum involved. The registration of a bond is usually complete within ten to 12 working days from the date on which it was lodged.

The cost of establishing security over all the other assets will depend on the professional fees. There is no set timing.

5.2 Floating Charges or Other Universal or Similar Security Interests

South African law does not recognise the concept of a general security interest over all present and future assets of a borrower. GNBs or SNBs may, however, confer security over a class of intangible property.

5.3 Downstream, Upstream and Cross-stream Guarantees

It is legally permissible for affiliated entities to guarantee each other's debts. That is, a holding company may guarantee the debts of its subsidiary (ie downstream) and vice versa (ie upstream), and subsidiaries of the same holding company may also guarantee each other's debts (ie cross-stream). Upstream guarantees are treated as distributions and downstream cross-stream guarantees as financial assistance. The provision of financial assistance generally requires a board resolution as well as a special resolution by the shareholders and must not be prohibited by the constitutive documents. Additionally, the board is required to carry out a solvency and liquidity assessment before authorising the provision of financial assistance. A distribution requires approval by the board of directors pursuant to, among other things, a solvency and liquidity assessment.

The fiduciary duties of directors require that directors authorise only transactions that are in the best interest of the company (with each company being treated as a distinct legal entity, as separate from its affiliates).

5.4 Restrictions on Target

A company may grant financial assistance (which includes provision of security, including a guarantee) for the subscription of its shares. (See **5.3 Downstream, Upstream and Cross-stream Guarantees**.)

5.5 Other Restrictions

A company's constitutive documents may impose further formalities or restrictions on the granting of security. Other than the restrictions highlighted above, there are no further restrictions of which we are aware.

5.6 Release of Typical Forms of Security

Security is treated as accessory to the principal obligation, and once the principal obligation is discharged, the security is automatically released. A specific form of security may, however, require further acts in order for the security to be released. Registered security (such as mortgage bonds) also requires deregistration. The parties may also contractually impose additional formalities.

5.7 Rules Governing the Priority of Competing Security Interests

The general rule governing competing security interests in the same asset is that the security granted first takes priority in law, and the subsequent creditors' interest is limited to the debtor's reversionary right in the secured property.

The priority of competing security interests may be varied by contractual or structural subordination or in terms of an intercreditor arrangement. Subordination may usually take one of three forms: (a) contractual subordination, either between the debtors and the creditors, the creditors *inter se* or for the benefit of a third party, (b) intercreditor agreement between lenders regulating the manner in which they will enforce their rights, and (c) subordination which results from priority being given to the creditors of the subsidiary over those of the holding company.

The liquidator of an insolvent borrower is obliged to have regard to existing subordination agreements.

6. Enforcement

6.1 Circumstances in Which a Secured Lender Can Enforce Its Collateral

Default on the underlying principal obligation is a sufficient condition for the lender to enforce its collateral.

The general restriction on enforcement against loans and collateral is that self-help is prohibited and a court judgment is required for the creditor to take possession of the secured assets. For mortgage bonds and GNBs, the creditor is required to take possession of the encumbered asset and obtain a court order for the attachment and sale in execution of the assets for the satisfaction of the debt, and an agreement to vary this requirement (known as a *parate executie* clause) is invalid in respect of immovable property. Certain types of security such as a pledge, SNB or security cession may, however, be enforced without the involvement of the courts.

6.2 Foreign Law and Jurisdiction

South African law recognises a foreign choice of law clause, although South African law applies to a security document granting security over movable, or immovable, property situated in South Africa and a South African court would not recognise a foreign choice of law clause in such a case.

While the substantive issues will be governed by the choice of law, procedural issues will be governed by the curial law (ie unless otherwise stated, will be presumed to be the law of the place where the arbitration or litigation takes place).

South African law also recognises judgments of foreign courts in terms of the Enforcement of Foreign Civil Judgments Act, 1988, provided that, amongst other things, the laws are not contrary to the South African Constitution or public policy.

South African law has adopted the restrictive approach to sovereign immunity, and a foreign sovereign may waive its immunity tacitly or by agreement.

6.3 A Judgment Given by a Foreign Court

South African courts recognise the judgments of foreign courts subject to certain caveats (see **6.2 Foreign Law and Jurisdiction**).

Arbitration is a popular and widely used method of resolving commercial disputes and is governed by the Arbitration Act, 1965. Most arbitration is domestic, although there is increasing international arbitration activity in South Africa. The Arbitration Act, 1965 applies to both domestic and international arbitration.

While South Africa is not a party to the ICSID Convention, it acceded to the New York Convention without reservation in 1976 and promulgated the Recognition and Enforcement of Foreign Arbitral Awards Act, 1977. In terms of this act, foreign arbitral awards may be made an order of the South African courts and enforced in the same manner as any domestic judgment provided certain authentication and procedural requirements are met. South African courts generally do not interfere with an arbitral findings.

The Constitutional Court of South Africa has recently extended the enforcement of foreign judgments to include those handed down by international courts and tribunals.

6.4 A Foreign Lender's Ability to Enforce Its Rights

The restrictions mentioned in **6.1 Circumstances in Which a Secured Lender Can Enforce Its Collateral** aside, there are no other matters which would impact enforcement of a loan or security agreement by a foreign lender.

7. Bankruptcy and Insolvency

7.1 Company Rescue or Reorganisation Procedures Outside of Insolvency

The Companies Act, 2008 makes provision for business rescue proceedings and compromise. The board of a company that is financially distressed (and not under liquidation proceedings) may adopt and file a resolution with the Commission to commence business rescue proceedings if it appears that there is a prospect that the proceedings will rescue the company from insolvency (the South African terminology for bankruptcy). A creditor may apply to court to terminate business rescue proceedings if it can show that the proceedings have no prospect of succeeding. The commencement of business rescue proceedings places a moratorium on all claims effective from the date on which it is filed.

A compromise commences with a proposal by the board of a company (which is under business rescue) to some or all of its creditors for a compromise or arrangement of its financial obligations. At least 75% of the creditors to whom the proposal is directed should vote in its favour in order for it to be adopted.

7.2 Impact of Insolvency Processes

An insolvency results in a concursus, ie a freezing of all claims against the estate of the insolvent. This would then prevent a lender from enforcing its loan claim against the insolvent or realising any security and would also prevent the lender from calling up any guarantee that the lender may have from the insolvent. Accordingly, there is indeed a moratorium that will prevent or delay creditors from enforcing their security and the creditor will now be obliged to realise its claim and security according to the provisions of the South African insolvency laws. However, this will not prevent creditors from taking steps against any third party if the security that the lender holds for its claim against the insolvent was given by any third party and not the insolvent.

The Insolvency Act, 1936 places a moratorium on legal proceedings against the debtor once insolvency proceedings have commenced. The Insolvency Act enables a creditor that holds securities as defined in the Financial Markets Act, 2012, a bill of exchange or a financial instrument or a foreign financial instrument as defined in the Financial Sector Regulation Act, to realise such security after giving notice in writing to the Master and to the trustee and before the second meeting of creditors.

When a creditor has realised its security it must pay the net proceeds of the realisation to the trustee, or if there is no trustee, to the Master and then the creditor can claim its payment provided its claim was proved and admitted and the trustee or the Master is satisfied that the claim was in fact secured by the security which was realised.

The business rescue provisions of the Companies Act, 2008 provide that once business rescue proceedings have commenced, a temporary moratorium is imposed on the rights of claimants, whether these are secured or unsecured. The business rescue practitioner may suspend the obligations of the company for the duration of the business rescue proceedings. The Companies Act also imposes a moratorium on legal proceedings against the debtor once business rescue proceedings have commenced.

7.3 The Order Creditors Are Paid on Insolvency

The creditors are ranked in the order of secured, preferent and concurrent. Secured creditors are those that hold security in the form of a mortgage, GNB, SNB and pledge or property which subject to a landlord's hypothec, and that have perfected such security. Secured creditors are settled from the proceeds of the liquidation the assets over which they hold security. Once secured creditors have been settled, what remains of the estate is a free residue, which is allocated to the preferent claims. Preferent claims include the costs associated with the liquidation; employee salaries; taxes and other statutory payments as well as creditors with GNBs which were not perfected. Concurrent claims would include any balances which remain outstanding from proved secured claims (and which have not been waived), claims which have been subordinated to concurrent creditors and shareholders.

7.4 Concept of Equitable Subordination

Although the subordination of claims is recognised in South African law, we do not have a concept of equitable subordination.

7.5 Risk Areas for Lenders

Aside from the moratorium on all claims against the insolvent estate, certain transactions made by an insolvent debtor may be set aside in terms of the Insolvency Act 1936 even if such transactions were made prior to the debtor's insolvency. These include dispositions without value, voidable preferences and undue preference to creditors.

A bond (mortgage or SNB) registered to secure a debt incurred two months after the debt was incurred will not confer any preference if the debtor becomes insolvent within six months of the bond being registered.

The Insolvency Act 1936 provides that all creditors that have proved claims against an insolvent estate are liable to pay a contribution if the free residue of an insolvent estate is insufficient to defray the necessary costs and expenses of the insolvency.

8. Project Finance

8.1 Introduction to Project Finance

South African project finance typically cover the areas of oil and gas, mining, industrials, telecoms, power, road and transportation, and public-private partnerships.

Research published by the World Bank indicates that between 2003 and 2013, South African project finance deal volumes were valued at USD10 billion, placing South Africa in the top three countries in Africa in terms of project finance deal volumes. South Africa also had the largest number of deals of any country in Africa, in respect of both extractive and non-extractive projects.

The number of public-private partnerships has increased. Public-private partnership transactions cover a wide range of sectors, including transport, office accommodation, healthcare, eco-tourism, social development and correctional services. The largest public-private partnerships have been concluded in the health sector, with five public-private partnerships in South Africa having been implemented to date and one in Lesotho (based on the South African model). Concessions in the roads and toll road sector are increasing.

In South Africa, there is no single act or enactment dealing specifically with project finance but there are various statutes which have a bearing on project finance (some of which are discussed below). Protection of property rights is entrenched in the Constitution of the Republic, 1996 and will further be regulated by the Protection of Investment Act, 2015 (although this has not yet been brought into force).

8.2 Overview of Public-private Partnership Transactions

There is no single enactment dealing specifically with public-private partnerships; however, there is a vast array of legislation and regulations, on both a municipal and national level, that may be relevant to public-private partnership transactions, depending on the nature of the transaction, the parties and the specific industry or sector for which the public-private partnership is planned.

The Public Finance Management Act, 1999 ("PFMA") requires special mention. It provides a clear and transparent framework for government and the private sector to enter into public-private partnerships. The PFMA's purpose is to regulate financial management in the national government and provincial governments and to ensure that all revenue, expenditure, assets and liabilities of those governments are managed efficiently and effectively. It sets out clear requirements in respect of public-private partnership transactions in terms of, inter alia, procurement procedures and restrictions in respect of borrowing monies by certain government entities. In terms of the PFMA, a public entity may not borrow money or issue a guarantee, indemnity or security, or enter into any other transaction that binds or may bind that institution to any future financial commitment unless such borrowing, guarantee, indemnity, security or other transaction is authorised by the PFMA and by other legislation not in conflict with it. The PFMA authorises the sponsor to borrow money or issue a guarantee, indemnity or security, or enter into any other transaction that binds or may bind the sponsor to any future financial commitment through its accounting authority which, in sponsor's case, is the board of directors and obliges a public entity that plans to enter into certain transactions to notify the National Treasury in advance and to seek the written approval of the relevant minister for such a transaction. These transactions are:

- establishment or participation in the establishment of a company;
- participation in a significant partnership, trust, unincorporated joint venture or similar arrangement;
- acquisition or disposal of a significant shareholding in a company;
- acquisition or disposal of a significant asset;
- commencement or cessation of a significant business activity; and
- a significant change in the nature or extent of its interest in a significant partnership, trust, unincorporated joint venture or similar arrangement.

The general rule applicable to an entity that is an organ of state, acting as a sponsor, for example, is that when it contracts for goods or services, it must do so in accordance with a system that is fair, equitable, transparent, competitive and cost-effective. For a contract of significant scale, this would normally entail a competitive tender process.

Certain transactions may be voidable at the instance of the public entity and may also constitute a criminal offence by the person purporting to enter into such transaction on behalf of the public entity.

The government has a policy of broad-based black economic empowerment which is defined in the Broad-Based Black Economic Empowerment Act, 2003 ("B-BBEE Act"), as "the empowerment of all black people including women, workers, youth, people with disabilities and people living in rural areas through diverse but integrated socio-economic strategies".

The B-BBEE Act provides that every organ of state and public entity must, as far as is reasonably possible, apply any code of good practice issued in terms of the B-BBEE Act when it, among other things, develops and implements a preferential procurement policy and develops criteria for entering into partnerships with the private sector.

The Promotion of Administrative Justice Act, 2000 ("PAJA") gives effect to section 33 of the Constitution, the right to just administrative action, ie administrative action that is lawful, reasonable and procedurally fair. When the sponsor (or the project company), makes a decision (or fails to make a decision) in the course of exercising a public power or performing a public function in terms of legislation, and the decision adversely affects a person's rights and has a direct, external legal effect, the decision constitutes administrative action subject to PAJA. PAJA also requires procedural fairness in respect of administrative action, which includes the right to request and obtain reasons for a decision.

8.3 Government Approvals, Taxes, Fees or Other Charges

The relevance of any government approval or the payment of any taxes, fees or charges is largely dependent on the nature and location of the project in question, as well as the project company and the lenders to the project company as well as other parties to the transaction.

Generally, commercial project finance transactions between private parties will not require any government approvals. However, where a party to a transaction is a government department, or where the project relates to a natural resource or other regulated industry in South Africa, government approvals may be required, depending on the applicable legislation.

The Mineral and Petroleum Resources Royalty Act, 2008 requires a person to pay a royalty in respect of the transfer of a mineral resource extracted from within South Africa.

Transactional documentations generally do not need to be filed with any government body or to otherwise comply with any legal formalities, unless prescribed by statute. For example, there are special formalities in respect of mortgage bonds, SNBs and GNBs (see **5.1 Assets Typically Available and Forms of Security**) and notarial long-term lease agreements in excess of ten years. The terms of the documentation must also not be inconsistent with South African law and must not be against public policy.

For a discussion on the usual governing law provisions for transactional documentation, see **6.2 Foreign Law and Jurisdiction**.

8.4 The Responsible Government Body

Oil and gas

The primary law regulating oil and gas is the Mineral and Petroleum Resources Development Act 28 of 2002, which came into force on 1 May 2004 ("MPRDA").

The government body responsible for the regulation of the development of oil and gas is the Petroleum Agency of South Africa ("PASA"). PASA promotes the development of and exploration for onshore and offshore oil and gas resources on behalf of government and regulates the exploitation and production of the national petroleum.

PASA's role is advisory and administrative in nature and includes receiving and evaluating applications for petroleum permits and rights and making recommendations to the Minister of Mineral Resources on such applications as well as observing compliance with permits and rights. The Minister of Mineral Resources is empowered to grant or refuse applications for rights and permits and rights including reconnaissance permits, technical co-operation permits, exploration rights and production rights.

Power

The primary laws regulating the power sector in South Africa is the National Energy Regulator Act 40 of 2004 ("NERA"), the Electricity Regulation Act 4 of 2006 ("ERA"), and the National Energy Act 34 of 2008 ("NEA").

The NERA established the National Energy Regulator ("NERSA") to regulate the electricity, piped-gas and petroleum pipeline industries. The purpose of the ERA is to, inter alia, establish a national regulatory framework for the electricity supply industry, to make NERSA the custodian and enforcer of the national electricity regulatory framework and to provide for licences and registration as the manner in which generation, transmission, distribution, trading and the import and export of electricity are regulated. The NEA seeks to ensure that diverse energy resources are available to the South African economy (in sustainable quantities and at affordable prices) to support economic growth, and provides for energy planning including increased generation and consumption of renewable energies and adequate investment in, and appropriate upkeep of and access to, energy infrastructure.

Mining

The primary law regulating mining in South Africa is the MPRDA. However, a number of relevant statutes have been enacted that regulate the mining section, including:

- Mineral and Petroleum Resources Royalty Act 28 of 2008.
- Mining Titles Registration Act 16 of 1967.
- Precious Metals Act 37 of 2005.
- Diamonds Act 56 of 1986.
- Mine Health and Safety Act 29 of 1996.
- National Environmental Management Act 107 of 1998.

- National Water Act 36 of 1998.
- Spatial Planning and Land Use Management Act 16 of 2013 (in respect of land use planning, which includes zoning for prospecting and mining operations) and the relevant provincial and municipal regulations and bye-laws.

The primary regulator of the mining industry in South Africa is the Department of Mineral Resources ("DMR"). The main function of the DMR is to regulate matters relating to mineral and petroleum resources under the MPRDA.

The Department of Water and Sanitation ("DWS") regulates waste water discharges that may affect a water resource.

8.5 The Main Issues When Structuring Deals

A special purpose entity (a privately owned limited liability company that is ring-fenced as a single-purpose vehicle) is generally created for each project. As a special purpose entity, the project company has no assets other than the project, shielding other assets owned by a project sponsor from the detrimental effects of a project failure. Capital contribution commitments by the owners of the project company are sometimes necessary to ensure that the project is financially sound, or to assure the lenders of the sponsors' commitment. Projects are generally funded by lenders on a project finance and limited recourse basis although there is no restriction on projects being funded through the capital markets or through bonds being issued or by other means.

In certain instances, realised and unrealised gains or losses on foreign currency exchange items are subject to normal income tax under the South African tax regulation. In addition, South Africa's Exchange Control Regulations administered by the South African Reserve Bank control business transactions between residents and non-residents. In particular, South African companies are generally not permitted to export capital from South Africa, hold foreign currency (unless in permitted foreign currency accounts after obtaining prior exchange control approval) or incur indebtedness denominated in foreign currencies without the prior approval of the South African Reserve Bank or an Authorised Dealer of the South African Reserve Bank.

Generally speaking, there are no restrictions on a foreign company having ownership in a South African project company. From an exchange control perspective, however, the foreign company will have to acquire the shares in the South African project company for a market-related consideration. However, the requirements of a specific project or tender under which the project company will operate may place certain foreign ownership restrictions on the project company and require that the project company is held, to some extent, by South African citizens.

Important to mention in this regard is the government's Broad-Based Black Economic Empowerment (B-BBEE) Policy. The B-BBEE Policy is consistent with section 217(2) of the Constitution of the Republic of South Africa (which permits the allocation of preferences for historically disadvantaged persons in the public procurement context) and is defined in the B-BBEE Act as "the empowerment of all black people including women, workers, youth, people with disabilities and people living in rural areas through diverse but integrated socio-economic strategies". The importance of this is that the participation of B-BBEE companies in South African project companies is often a requirement.

8.6 Typical Financing Sources and Structures for Project Financings

In the South African market, projects are typically funded by lenders on a project finance and limited recourse basis. There is, however, no restriction on projects being funded through the capital markets, export credit agencies or through bonds being issued. The basis on which the limited recourse financing will be provided is on a specific debt to equity ratio. The debt required for the project will be provided by international and local commercial banks and/or development finance institutions (collectively referred to as the "Lenders") and the equity will be provided by the project shareholders/sponsors. The equity contributions by the project shareholders/sponsors are necessary to ensure that the project is financially sound and to assure the Lenders that the project shareholders/sponsors are committed to the project.

In a limited recourse financing, the Lenders would typically require that a special purpose vehicle (a privately owned, limited liability company that is ring-fenced with a single purpose) is set up for a project. A special purpose vehicle would thus shield other assets owned by a project shareholders/sponsors from the detrimental effects of a project failure. As a special purpose entity, the project company will have no assets other than those in respect of the project and the Lenders are assured that the project company will only be partaking in the project and related matters.

In addition to limited recourse financing, other types of financing sources include project bonds and export credit agency financings. Project bonds open up an alternative debt funding avenue to source financing for infrastructure-related projects and offer an opportunity for institutional investors to participate in infrastructure projects through listed, tradable securities that can offer superior risk-adjusted returns.

An export credit agency is a financial institution that offers financing to domestic companies for international export operations and other activities. Export credit agencies encourage international trade by assisting in risk mitigation in exporting to foreign countries as well as underwriting political and commercial risks associated with overseas investments.

8.7 The Acquisition and Export of Natural Resources

The state exercises sovereignty over natural resources (mineral and petroleum resources, water and land) and regulates the entitlement to each differently, although the concept of private ownership of natural resources in South Africa has developed incrementally over the last few decades.

However, the right to private property, protected in the Constitution of the Republic, 1996, may not impede the state from taking legislative and other measures to achieve land, water and related reform, in order to redress the results of past racial discrimination, and the traditional concepts of property and ownership have developed to accommodate the need for state oversight in respect of certain natural resources, in terms of which the state has become the custodian of these resources on behalf of the public. This has changed the traditional concept of property and ownership over natural resources. For example, the National Water Act, 1998 makes the state the public trustee of the nation's water resources and the Mineral and Petroleum Resources Development Act, 2002 extinguished private ownership of mineral rights and replaced it with a system of state grants of the right to prospect and mine.

Royalties and taxes are payable on the extraction of natural resources (see **8.3 Government Approvals, Taxes, Fees or Other Charges**).

There is no bar to foreign parties acquiring such titles generally, except for such parties' compliance with all requirements for grant of title. Title of ownership to land is privately transferable. While no limitations are placed on transfer to foreign parties, President Jacob Zuma in his state-of-the-nation address in February 2015 alluded to a legislative enactment which would prohibit foreigners from owning land in South Africa, ie foreigners would be eligible for long-term leases. However, it remains to be seen whether such a restriction will in fact be legislated for.

Mineral and petroleum resources are not subject to export restrictions (except in the case of diamonds and precious metals). South Africa also has a number of laws that govern the movement, trade or export of certain plants and species.

Environmental licences and permits are generally personal in nature, ie the licence forms a relationship between the state and the rights holder, although, in respect of a mining right, the right is a limited real right by virtue of legislation.

8.8 Environmental, Health and Safety Laws

Environmental

South Africa has a progressive environmental regulatory framework. The right to an environment that is not harmful to one's health or well-being is protected in the Constitution of the Republic of South Africa, 1996. This right is supported by environmental legislation, chief of which is the National Environmental Management Act, 1998. Environmental rights and duties can also be enforced through the common law, which is mainly based on Roman-Dutch law.

The Department of Environmental Affairs is the authority with the primary responsibility for enforcing environmental legislation nationally and which is responsible at a national level for environmental authorisations. It performs its functions taking into consideration other specialist environmental departments' recommendations. Each of South Africa's nine provinces also has provincial authorities which play a role.

Mine health and safety

The Department of Minerals Resources regulates health and safety at mines.

The principal legislation governing mine health and safety is the Mine Health and Safety Act, 1996 (and its regulations). The Act promotes health and safety by providing for investigations, inquiries and inquests into accidents that occur at the mines and places certain obligations on mines to, inter alia, mitigate safety risk. The Act also introduced a Mine Health and Safety Inspectorate, which is responsible for the monitoring and enforcement of the Act at the mines.

9. Islamic Finance

9.1 Overview of the Development of Islamic Finance

South Africa currently has one dedicated Islamic bank, namely Al Baraka Bank. Some of the major banks do, however, offer Islamic banking products and various asset managers also offer Shari'a-compliant investment products.

The National Treasury has taken measures to promote Islamic finance, including amendments to the Income Tax Act to make provision for parity of treatment between conventional banking products and Islamic banking products.

9.2 Regulatory and Tax Framework for the Provision of Islamic Finance

The Income Tax Act makes provision for parity of treatment between conventional banking products and Islamic banking products.

The South African government concluded its debut sukuk bond issuance in the international capital markets in September 2014. Currently, a sukuk is accessible only to government and state-owned entities, which allows such entities an opportunity to mobilise and finance their very large infrastructure programmes. The scope of the sukuk has recently been extended to listed entities.

There is evidence of continued demand for Islamic assets by both Islamic and conventional investors, particularly as sukuk instruments have become better understood in South Africa.

One of the major banks currently offers takaful insurance as part of its Islamic finance product offering.

9.3 Main Shari'a-compliant Products

The main Shari'a-compliant products are sukuk and takaful. Sukuk are equity certificates which represent beneficial ownership in a pool of assets over a specified period of time.

Takaful is Islamic insurance in which the payment by a policyholder is treated as a donation rather than a premium. Takaful is a co-operative insurance scheme and it is not the aim that a profit be generated from the pool of assets.

9.4 Claims of Sukuk Holders in Insolvency or Restructuring Proceedings

One of the aims of Shari'a law is to prevent insolvency and restructuring and as such there have been no reported insolvency proceedings. Sukuk is neither entirely an equity instrument nor entirely a debt instrument. However, sukuk appears to be more akin to an equity instrument as it provides for an ownership share in the specific underlying assets.

9.5 Recent Notable Cases

There have not been any reported cases dealing with the application of Shari'a law, jurisdictional issues or conflicts of law in the banking and finance sector.

ENSafrica
The MARC | Tower 1
129 Rivonia Road
Sandton
Johannesburg
2196

Tel: +27 11 269 7600
Email: info@ENSafrica.com
Web: www.ENSafrica.com