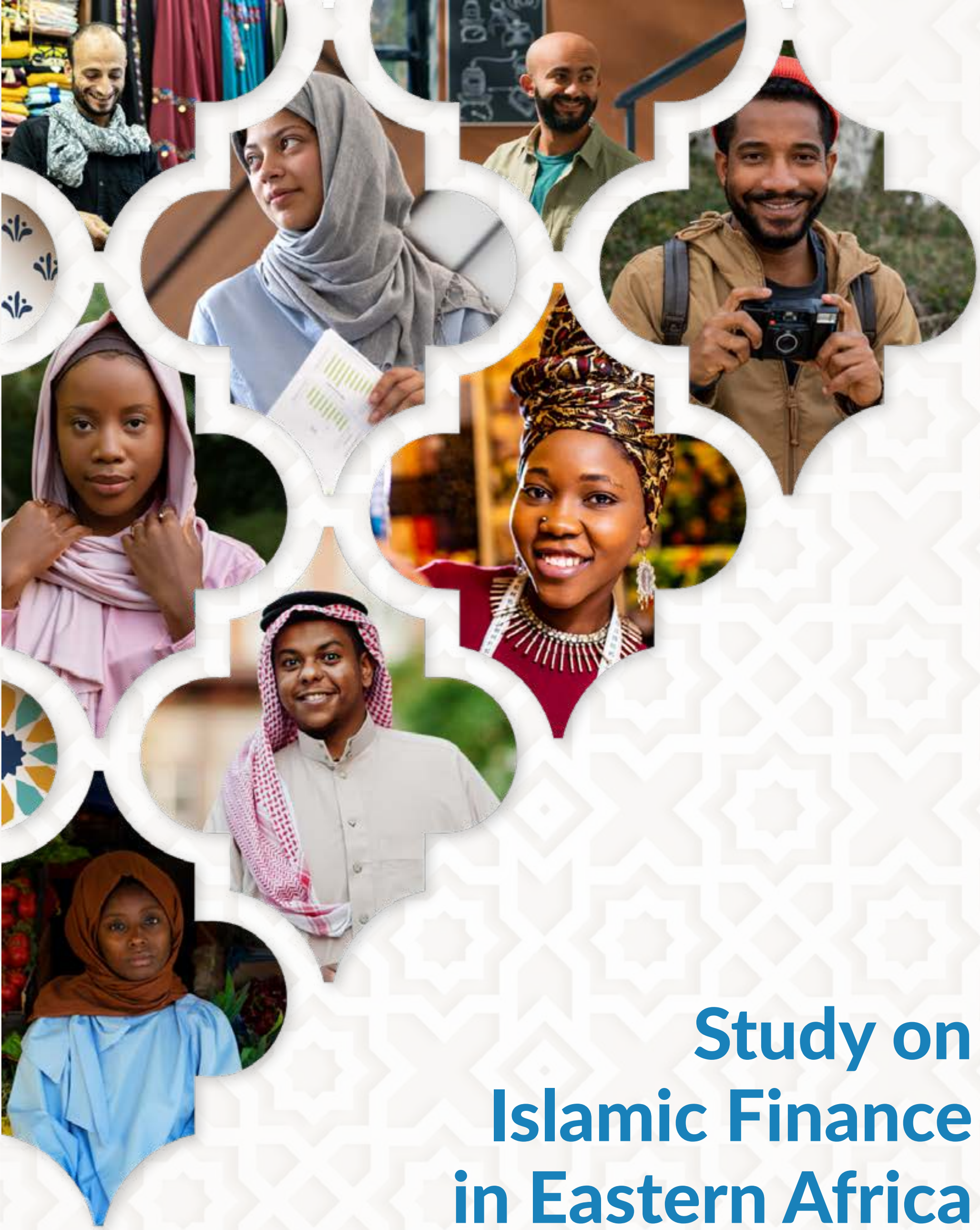

Study on Islamic Finance in Eastern Africa

United Nations
Economic Commission for Africa

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United Nations Economic Commission for Africa
Sub-Regional Office for Eastern Africa
Kigali – Rwanda

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Abbreviations

AAOIFI:	Accounting and Auditing Organisation for Islamic Financial Institutions
AfCFTA:	African Continental Free Trade Area
AMF:	Financial Markets Authority
ARDL:	Autoregressive Distributed Lag
DCB:	Djiboutian Central Bank
DRC:	Democratic Republic of Congo
ECA/SRO-EA:	Economic Commission for Africa Sub-Regional Office for Eastern Africa
ESG:	Environmental, Social and Governance
FDI:	Foreign Direct Investment
GAB:	Gulf African Bank
GCC:	Gulf Cooperation Council
GCIBFI:	General Council of Islamic Banks and Financial Institutions
GDP:	Gross Domestic Product
GIC:	Government Investment Certificates
HSBC:	Hong-Kong and Shanghai Banking Corporation
ICSOE:	Intergovernmental Committee of Senior Officials and Experts
IFSB:	Islamic Financial Services Board
IFPMO:	Islamic Finance Project Management Office
IFSI:	Islamic Financial Service Industry
IICRCA:	International Islamic Centre for Reconciliation and Commercial Arbitration
IIMM:	Islamic Interbank Money Market
IIRA:	International Islamic Rating Agency
ITFC:	International Islamic Trade Finance Corporation
IsDB:	Islamic Development Bank
KCB:	Kenya Commercial Bank
MDGs:	Millennium Development Goals
MESA:	Middle East and South Asia

ODA:	Official Development Assistance
OIC:	Organisation of Islamic Conference
OLS:	Ordinary Least Squares
ROA:	Return on Asset
ROE:	Return on Equity
SEA:	South-East Asia
SME:	Small and Medium Enterprise
SRI:	Socially Responsible Investment
UAE:	United Arab Emirates
UK:	United Kingdom
UNECA:	United Nations Economic Commission for Africa
US$:	United States Dollar
USA:	United States of America
VAR:	Vector Autoregressive model
VAT:	Value Added Tax

1 INTRODUCTION

1. INTRODUCTION

The practice of ribã[1] is forbidden by Islam. According to Islamic laws (Sharia), it is not allowed to charge any interest on money lent to someone. This prohibition originates during the Middle Ages in the Arab peninsula (Martens, 2021). However, the concept of modern Islamic finance was launched in the 1940s under the impulse of the Pakistani Sunni theologian Sayyid Abul Ala Maududi. In its main contribution, titled "*The Economic Problem of Man and Its Islamic Solution*"[2], he indicated that Islamic finance would form a third way between capitalism and communism, which aims to establish a fairer economic order.

Over the past decades, Islamic finance had a significant expansion across the world. The total assets of financial institutions offering Islamic products and services have grown by almost 25% a year over the past decade[3] to reach US$2.7 trillion[4] in 2020. Recognising the growing importance of Islamic banking and the growing demand for financial services that meet ethical standards, an increasing number of major international banks have opened Islamic banking "windows" tailored to the needs of Islamic investors from a global Muslim population of over 1 billion, including 11 million Muslims in Europe and 6 million in the USA[5]. An important share of Islamic banking clients are also non-Muslims who are attracted by what they perceive as ethical financial principles of Sharia-compliant banking.

The growing number of financial institutions offering Islamic financial services and products, combined with the increasing size of the total asset of these institutions, represents a great financing opportunity for the world economy. This is particularly true for East African countries which struggle to finance the development and industrialisation of their economy. Indeed, the African Development Bank estimates the need for infrastructure financing in Africa to

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1 Ribã is an Arabic word which refers to usury or interest.

2 Maududi, S.A.A. (1947). The Economic Problem of Man and Its Islamic Solution. Lahore, Pakistan: Islamic Publications, 1975; original ourdou edition, 1947.

3 East Africa Bank. (2022). Islamic Banking. Accessed from https://eastafricabank.com/islamic-banking/

4 https://www.ifsb.org/sec03.php

5 East Africa Bank. (2022). Islamic Banking. Accessed from https://eastafricabank.com/islamic-banking/

be between US$130 and 170 billion per year[6], of which in 2016 commitment from all financing sources reached only US$62.5 billion. This created a financing gap between US$67.6 billion to US$107.5 billion. A large part of this financing gap in infrastructure is in East Africa.

It is important for East African countries to properly design policies that enable them to attract Islamic financial institutions and investments into their economies. The countries of the region, therefore, need to have an in-depth understanding of Islamic finance, its rules, standards, requirements, and investment criteria to design an appropriate legal and regulatory framework that meets these requirements. This is the high-level objective of this study launched by ECA/SRO-EA on Islamic finance.

This report presents the results as well as the recommendations of the study performed by the consultant. After this introduction, the second part will focus on some definitions and generalities of Islamic finance. This part of the report will also discuss the worldwide evolution and trend in Islamic finance development. The third part will review and analyse the current state of Islamic finance in Eastern Africa, whereas the fourth part of the report will analyse the link between Islamic finance, financing needs, and the development of the sub-region's economies. The fifth part of the report will discuss, in addition to the sector regulatory requirements, the skills, competencies gaps, and other constraints in the sector in the context of Eastern African economies. The last part will conclude the report by providing policy recommendations.

[6] African Economic Outlook. (2018). Chapter 3 - Africa's infrastructure: Great potential but little impact on inclusive growth, African Development Bank Report.

Woman using her phone in the street.
Photo Credit: GettyImages/ PICHA Stock

2 DEFINITIONS AND GENERALITIES OF ISLAMIC FINANCE

2. DEFINITIONS AND GENERALITIES OF ISLAMIC FINANCE

This part of the report provides an overview and general information on Islamic finance as well as its evolution and integration into the world financial architecture over the past decades.

2.1 Definitions and functioning of Islamic finance

Islamic finance is a set of financing techniques under Islamic law. Today it represents a new model of Sharia-based finances. According to Investopedia[7], Islamic finance refers to how businesses and individuals raise capital under Sharia or Islamic law. It also refers to the types of investments permissible under this form of law. Islamic finance can be seen as a unique form of socially responsible investment. This sub-branch of finance is a burgeoning field.

According to Sharia, interest or usury is forbidden. As highlighted by Martens (2021), this prohibition of interest originated during the Middle Ages in the Arab peninsula. However, the concept of modern Islamic finance was launched in the 1940s under the impulse of the Pakistani Sunni theologian Sayyid Abul Ala Maududi. The key principle of Islamic finance is that the owner of a project and the investors or lenders should share the profits and losses of the investment based on pre-agreed proportions (Hassan and Soumaré, 2015; Soumaré, 2009; Waemustafa and Sukri, 2016). This means that the return and the risk of a project are shared between the owner and the investors. The profit-loss sharing proportions between the investor and the project owner are determined upfront at the inception of the contract when the agreement is signed. A general principle is that as the investor is seen as a partner contributing to the capital of the project, the profit and loss could be shared based on the share of the capital owned by each partner or their estimated contribution to the project's execution. This is the base of the ethical standards of this type of finance, which represents an alternative to traditional finance that had experienced several difficulties over the successive crisis, particularly during the 2008-2009 financial crisis. A central concept in Islamic banking and finance is justice, which is achieved mainly through the risk-sharing approach

[7] Investopedia. (2024). Working with Islamic Finance. Accessed from https://www.investopedia.com/articles/07/islamic_investing.asp

(Dridi and Hasan, 2011; Soumaré, 2009). In addition, the investment universe for Islamic finance is restricted and limited to socially responsible investments.

The main principles of Islamic finance are:

- Wealth must be generated from legitimate trade and asset-based investment (The use of money to make money is expressly forbidden).
- Investment should also have a social and ethical benefit (per Islamic laws) to the wider society beyond pure return.
- Risk should be shared.
- All harmful activities (haram) should be avoided.

The following activities are prohibited[8]:

- Charging and receiving interest (riba). Making a straight interest charge, irrespective of the performance of the underlying assets is against the principle of risk sharing, partnership, and justice.
- Investments in businesses dealing with alcohol, gambling, drugs, pork, pornography, or anything else that the Sharia considers unlawful or undesirable (haram).
- Uncertainty with speculation, or extreme risk. This is seen as being akin to gambling. Mutual insurance (which relates to uncertainty) is permitted if it is related to reasonable, unavoidable business risk. It is based upon the principle of shared responsibility for shared financial security, and that members contribute to a mutual fund, not for profit, but in case one of the members suffers misfortune.
- Uncertainty about the subject matter and terms of contracts – this includes a prohibition on selling something that does not belong to the seller. This means that complex derivative instruments and conventional short sales or sales on margin are also prohibited under Islamic finance.

[8] ACCA Global. (2024). Introduction to Islamic Finance. Accessed from https://www.accaglobal.com/gb/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/introduction-to-islamic-finance.html#:~:text=The%20main%20principles%20of%20Islamic,wider%20society%20beyond%20pure%20return.

As discussed above, charging interest is not permitted under Sharia. Hence, when Islamic banks lend money to a company or an individual, they must earn their profits by other means. This can be done through a profit-loss sharing of the assets in which the loan is invested or can be done via fees earned by the bank for services provided. The main feature of Sharia is that when commercial loans are made, the lender must share the risk. If this is not the case then any amount received over the principal of the loan will be regarded as interest.

Main Islamic finance instruments and products

Several instruments and products have been designed to be Shariah-compliant and used by Islamic financial institutions. These are mainly:

- ***Murabaha***: It is a form of trade credit to acquire an asset that avoids the payment of interest. Instead of charging interest on the credit, the bank earns profits differently. Indeed, the asset to be acquired is bought directly by the bank, which sells it to its clients on a deferred basis at a price that includes an agreed markup for profit. The markup is fixed in advance and cannot be increased, even if the client does not take the goods within the time agreed in the contract. Payment can be done through equal installments. Thus, the bank is exposed to business risk because if its customer does not take the goods, no increase in the markup is allowed and the goods, belonging to the bank, might fall in value.

- ***Ijara:*** It is a lease finance agreement whereby the bank buys an item for a customer and then leases it back over a specific period at an agreed amount. Ownership of the asset remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable.

  One interesting use of *Ijara* is by Emirates Airlines, which regularly uses *Ijara* to finance its expansion. Another example of the *Ijara* structure is seen in Islamic mortgages. In 2003, the Hongkong and Shanghai Banking Corporation (HSBC) was the first United Kingdom (UK) clearing bank to offer mortgages in the UK designed to comply with

Sharia[9]. Under HSBC's Islamic mortgage, the bank purchases a house and then leases or rents it back to the customer. The customer makes regular payments to cover the rental for occupying or otherwise using the property, insurance premiums to safeguard the property, and also amounts to pay back the sum borrowed. At the end of the mortgage, the title to the property can be transferred to the customer.

- ***Ijara-wa-iqtina:*** It is similar to Ijara. However, it includes an option for the client to buy the asset at the end of the contract.
- ***Istisna:*** It is a contract by which the bank agrees to manufacture or build an asset for the client who undertakes to pay for it on terms agreed in advance. The bank may sign another contract with a manufacturer or constructor with the same technical characteristics as the contract signed with the client. In this case, the bank will pay a lower amount to the builder or manufacturer and requires delivery before the date on which it has agreed with its client.
- ***Mudaraba:*** It is like equity finance in which both parties (the bank and the customer) share any profits. The bank provides the capital, and the borrower uses its expertise and knowledge to invest the capital. Profits are then shared according to the upfront agreement signed. As with equity investment, there is no certainty on the success of the investment, this exposes the bank to significant investment risk.
- ***Musharaka:*** It is a joint venture or investment partnership between two parties. Both parties provide the financing capital for projects and are both fully involved in the management of the project. The profits are shared in agreed proportions. Normally, losses would be shared based on the equity's share contribution to the venture. As both parties are closely involved in the ongoing management of the project, banks do not often use *Musharaka*.
- ***Sukuk:*** This is a debt security. Unlike non-Islamic bonds, Islamic bonds, or *Sukuk*, cannot bear interest and the *Sukuk* holders must have a proprietary interest in the assets which are being financed.

[9] ACCA Global. (2024). Introduction to Islamic Finance. Accessed from https://www.accaglobal.com/gb/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/introduction-to-islamic-finance.html#:~:text=The%20main%20principles%20of%20Islamic,wider%20society%20beyond%20pure%20return.

The *Sukuk* holders are remunerated with the profits generated by the assets financed with the amount collected. Most *Sukuk* are 'asset-based'. However, there are 'non-asset-backed' *Sukuk* for which investors are remunerated through a share of ownership of the cash flows but not of the assets themselves.

- ***Qard Hasan:*** This is a loan without interest or profit. It is more like assistance than trade credit. This approach is rarely used by commercial banks. On the other hand, it can be used in specific situations (in the event a company or individual faces difficulties).

- ***Salam:*** This is a contract that provides prepayment of goods delivered later. Ideally, under Sharia laws, no sale is possible if the goods do not exist at the time of the contract. However, this type of sale, which is an exception, is authorised if the exhaustive list of the goods is provided in the contract with a clearly defined fixed delivery date. This type of sale generally involves physical goods, excluding gold and silver, which are considered monetary values.

- ***Tawarruq:*** A reverse *Murabaha*. This is a financial technique that makes it possible to obtain financing for a loan by buying in installments a property held by the bank. The customers then authorise the bank to sell on their behalf, their share in the property to a third party in a cash sale and then deposit the proceeds of the sale into their account.

- ***Wakala:*** Under this contract, the client owns the capital invested, appoints an Islamic bank as an agent, and pays an expert commission to remunerate the work of managing the funds by the bank.

- ***Wadiah:*** This is a trust agreement whereby the bank holds the funds of depositors who wish to place their funds in custody without any benefit. It is a non-profit participation deposit account that the bank provides to individuals and legal entities that meet the policies and requirements of the bank.

- ***Takaful:*** This is Islamic insurance. This takes the form of cooperative insurance with pooling of funds, according to the principle of mutual assistance. In the *Takaful* system, members are both insurers and policyholders. Traditional insurance is prohibited in Islam as it contains several haram elements such as *riba*.

Key differences between Islamic finance and conventional finance

The principles of Islamic finance are the base of the main differences between Islamic finance and conventional finance. The functioning of Islamic finance products and instruments, which are Sharia-compliant, has been designed by integrating the principles of Islamic finance. In practice, Islamic finance offers the same type of products as conventional finance. However, the main differences are related to the approach used to provide remuneration to the bank. In traditional finance banks, the remuneration is provided with interest charges whereas, in Islamic finance, the remuneration is mostly done through the sharing of the profit generated by the asset or investment financed by the amount provided by the bank or investor.

2.2 Worldwide evolution and trend in Islamic finance development

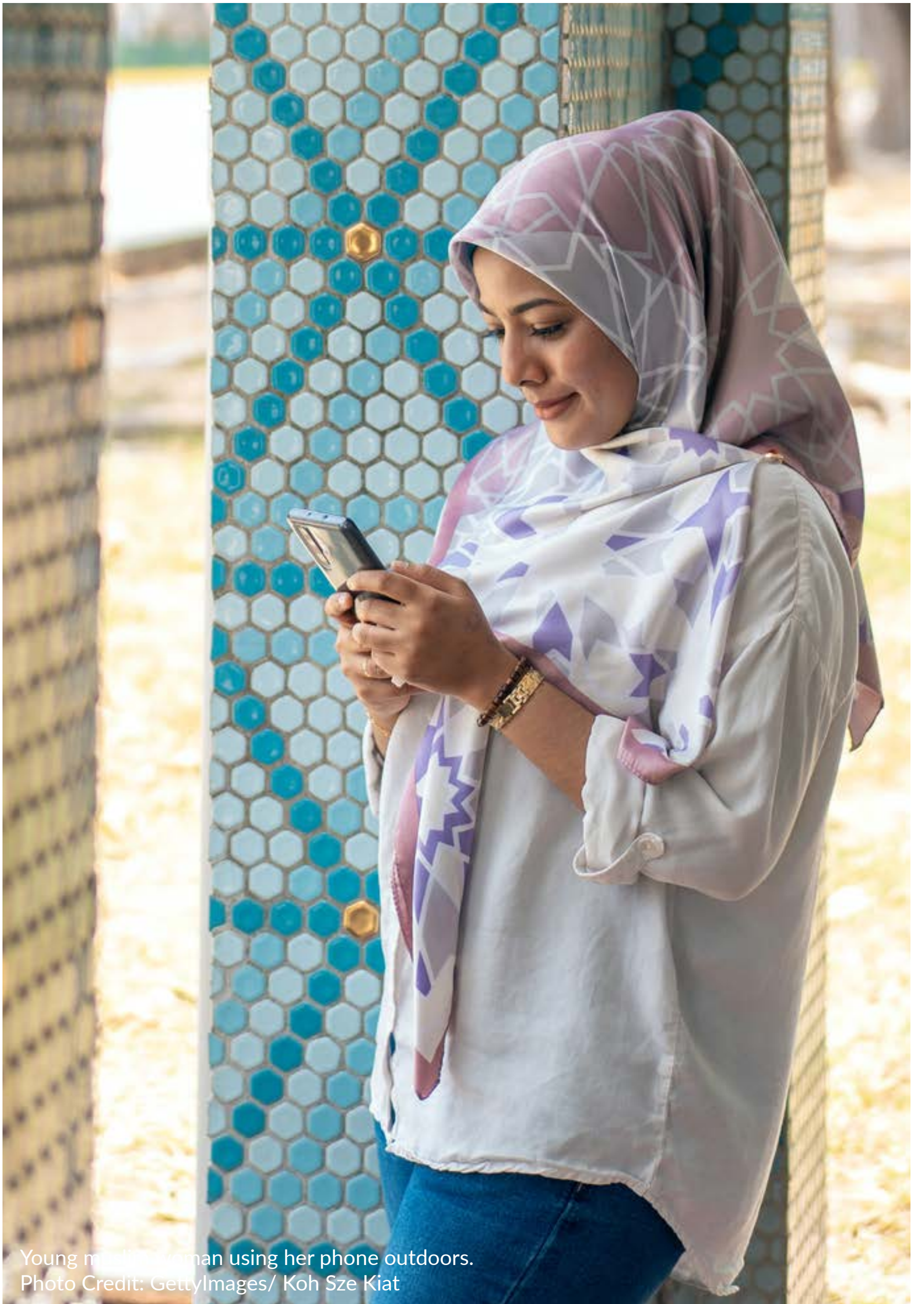
2.2.1 Origin of Islamic finance and its spread over the world

As mentioned in the introduction, the concepts and principles used within Islamic finance are linked to Sharia laws and originated from the Middle Ages in the Arab peninsula (Martens, 2021). However, these were conceptualised into modern finance concepts in the 1940s by Maududi (1947).

The first financial institution close to an Islamic bank was opened in Malaysia (the Perbadanan Wang Simpanan Bakal-Bakal Haji) for the financing of the Hajj organisation in 1956. However, it was in Egypt, in 1963, that the very first Islamic bank was born to integrate Islam into its activities (Gelbard et al., 2014). This bank was closed in 1968 following political tensions.

In 1970, with the creation of the Organisation of Islamic Conference (OIC), the idea to establish Islamic banking was discussed with the adoption of a common text in this regard. Following this decision, the Islamic Development Bank (IsDB) was created in 1975. This was followed by private initiatives such as the Dubai Islamic Bank, the Kuwait Finance House in 1977, and the Dar Al-Maal Al-Islami in 1981.

In 1983, Malaysia adopted a legal framework promoting Islamic finance and Islamic bank. This legal framework then allowed the Malaysian State to



Young muslim woman using her phone outdoors.
Photo Credit: GettyImages/ Koh Sze Kiat

issue Sharia-compliant debt securities, namely the Government Investment Certificates (GIC). The same year, the Islam Bank Malaysia Berhad was created. In 1984, the Malaysian government put in place legal provisions for the exercise of Islamic insurance.

Between 1984 and 1985, Sudan, Iran, and Pakistan Islamised their banking sector. It should be noted that Malaysia is one of the pioneer countries in Islamic finance. Indeed, the year 1994 marked the creation of the very first Islamic interbank market in Malaysia, the Islamic Interbank Money Market (IIMM). This country is also the first to have issued Sukuk, which is an Islamic debt security.

Development of Islamic finance in the Western world

The Islamic finance sector has attracted the interest of European banks since the mid-1980s, with several large multinational financial institutions such as HSBC and Citigroup opening Islamic windows with Islamic finance-based assets (Adel, 2010). In the UK, five Islamic banks are in operation and 22 others offering Islamic financial instruments. In addition, the London Stock Exchange is an international centre for the issuance of Sukuk (Islamic securities). Markets for Islamic financial products also exist in Germany, France, and Denmark. In 2009, there were Islamic financial institutions in more than fifty (50) countries around the world (Chong and Liu, 2009). This number has increased to more than eighty (80) countries as of 2022.

The development of Islamic finance in France is due to strong support from the French authorities, who have set up an appropriate and friendly environment for this type of finance in this country. In December 2007, Paris EUROPLACE, the organisation that promotes the city's role as a financial centre, established the Islamic Finance Commission. Since then, the Financial Markets Authority (Autorité des marchés financiers - AMF) has published two notices authorising the listing of Sharia-compliant investment funds and Sukuk. As such, the Paris Stock Exchange has created a Sukuk segment and four tax regulations (relating to Murabaha, Sukuk, Ijara, and Istisna) published and conferred equal treatment tax with conventional financial products (European Central Bank Report, 2013)[10].

[10] Filippo di Mauro, Pierluigi Caristi, Stéphane Couderc, Angela Di Maria, Lauren Ho, Baljeet Kaur Grewal, Sergio Masciantonio, Steven Ongena and Sajjad Zaher. (2013). Islamic Finance in Europe. European Central Bank occasional paper series No. 146/June2013. Accessed from https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp146.pdf

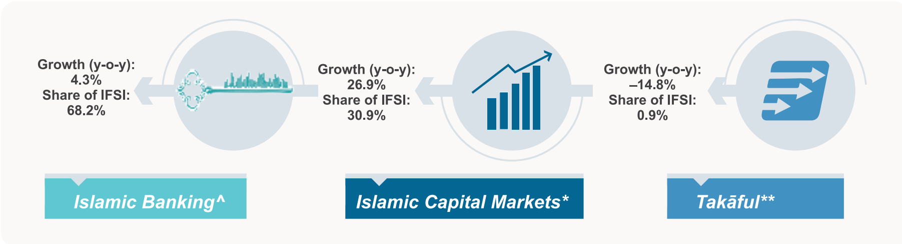
Germany was the first western country to tap into the Islamic capital market when the federal state of Saxony-Anhalt issued its first Islamic bond (Sukuk) in 2004. The issuance was met with strong demand and was fully subscribed; 60% of the issue went to investors from Bahrain and the United Arab Emirates and the remaining 40% to European investors, notably in France and Germany. The Euro100 million Ijarah Sukuk (Islamic sale-leaseback debt instrument) was fully repaid in 2009 (European Central Bank Report, 2013).

The UK has one of the most advanced Islamic financial markets in the western world and is rapidly becoming a key destination for foreign Sharia-compliant institutions. The country is home to the first fully Sharia-compliant western retail bank and as of 2013 had five genuine Islamic banks. Islamic finance activities started in the UK in the 1980s when the London Metal Exchange offered Sharia-compliant demand deposit facilities based on Murabaha (European Central Bank Report, 2013). With the increasing number of Islamic banking windows in traditional banks in western countries to satisfy the needs of the increasing Muslim population in these countries, it is clear that both (traditional and Islamic) banking systems are complementary. As several Muslims are excluded from the traditional finance system because of their religious beliefs, Islamic finance in these countries tries to fill this gap by providing Sharia-compliant financial services to allow these Muslims to have access to financial services.

As of today, Islamic finance is composed of three main sectors: i) Islamic banking sector; ii) Islamic capital market; and iii) Islamic insurance sector (Takaful). In 2020, globally, the total asset of Islamic finance (in all three main sectors) was US$2.70 trillion[11]. The total asset of the Islamic financial service industry (IFSI) grew by 10.7% in 2020 despite the COVID-19 outbreak. As presented in Figure 1 below, the main component of the IFSI is the Islamic banking sector representing 68.2% of the total asset of the whole system. This is followed by Islamic capital markets representing 30.9% of the total IFSI asset. The Takaful is the least developed component with only 0.9% of the total asset.

[11] IFSB (2021): https://www.ifsb.org/sec03.php

Figure 1: Sectoral analysis of IFSI (2020)



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

2.2.2 Trend in the Islamic banking sector

The table below presents the evolution of selected indicators for the Islamic banking sector from 2013 to 2021. Over the period, there was a significant increase in the total asset of the sector from US$1.2 trillion to US$1.7 trillion, representing a 42% cumulative increase despite the decrease of 29.2% observed from 2017 to 2018. Over the same period, the number of Islamic banks in the world remained stable at 169 although it fluctuated within the period and reached 190 banks, its highest number, at end of 2017. The number of branches decreased over the period from 28,717 to 15,595 representing a 45.6% decrease. This decrease in the number of branches is consistent with the general trend observed in the number of branches in the entire banking sector, mainly explained by the fact that several bank branches closed following the increase in banking digitalisation and online banking.

Although the number of Islamic banks remained at the same level of 169 from 2013 to 2021, the number of Islamic banking windows[12] experienced a significant increase over the period from 83 in 2013 to 284 in 2021. This represents a 242.2% increase over the period, reflecting the high penetration of Islamic finance within the conventional banking system. This trend also reflects the interest of the conventional banking system and the clients in Islamic finance principles.

[12] Islamic banking windows refer to windows offering some Islamic finance products and services in conventional banks. In other words, an Islamic bank is entirely operated using Islamic principles, while an Islamic window refers to services and products that are based on Islamic principles that are provided by a conventional bank. These are commercial conventional banks that offer Islamic banking services through dedicated windows.

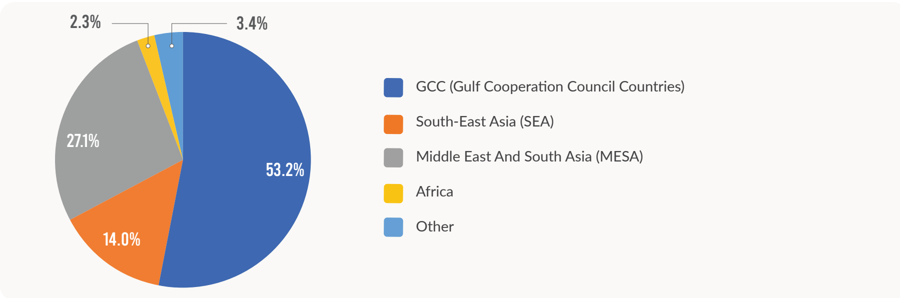
Table 1: Selected indicators of the Islamic banking sector from 2013 to 2021

	2013 Q4	2014 Q4	2015 Q4	2016 Q4	2017 Q4	2018 Q4	2019 Q4	2020 Q4	2021 Q4
Total assets - US$ billion	1,167.7	1,281.6	1,332.2	1,530.8	1,684.4	1,191.8	1,326.6	1,505.4	1,665.4
Total Sharī`ah-compliant financing (excluding interbank financing) -US$ billion	752.8	809.6	854.3	999.0	1,020.5	823.0	899.3	1,016.1	1,122.9
Total funding/ liabilities -US$ billion	1,066.8	1,180.9	1,239.5	1,400.7	1,548.9	1,065.8	1,145.8	1,299.4	1,421.8
Number of Islamic banks	169	171	175	182	190	161	154	180	169
Number of Islamic banking windows	83	85	85	83	83	84	133	232	284
Number of branches in Islamic banks	28,717	28,790	29,858	29,904	29,718	13,392	13,674	14,225	15,595
Number of employees in Islamic banks	350,100	364,485	390,126	386,554	389,253	294,111	293,622	311,918	334,995

Source: IFSB (Islamic Financial Services Board): https://www.ifsb.org/psifi_05.php

The Islamic banking sector is largely concentrated in Gulf Cooperation Council (GCC) counties made of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. As shown in the graph below, in 2020, 53.2% of the Islamic banking sector's total asset was concentrated in these countries. The second largest concentration region is the Middle East and South Asia (MESA) with a 27.1% share of the total asset in 2020. Africa is part of the regions of the world where the Islamic banking sector exhibited the least development. Indeed, in 2020, only 2.3% of Islamic banking assets were located in Africa.

Figure 2: Geographic distribution of the Islamic banking sector's asset in 2020

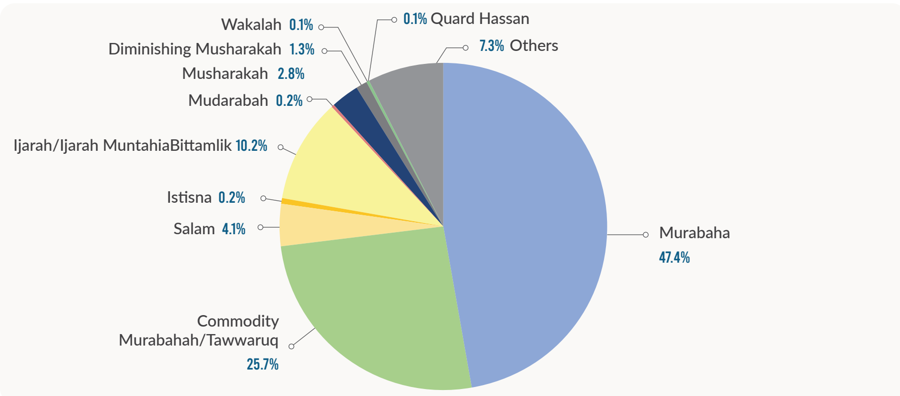


Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Murabaha is the main product offered by the banking sector

The main financing products offered by the Islamic banking sector is the Murabaha and the commodity Murabaha or Tawwaruq, which represented together 72.1% of the financing in 2021 as summarised in the graph below. With 47.4% of the financing share in 2021, Murabaha represents the main financing product followed by the commodity Murabaha or Tawwaruq with 24.7% of the total financing in 2021. The third financing product offered by the Islamic banking sector is Ijara which had a 10.2% share in 2021. The other products are relatively very little. Together, they offered 17.7% of the financing in 2021.

Figure 3: Banking asset distribution by product in 2021

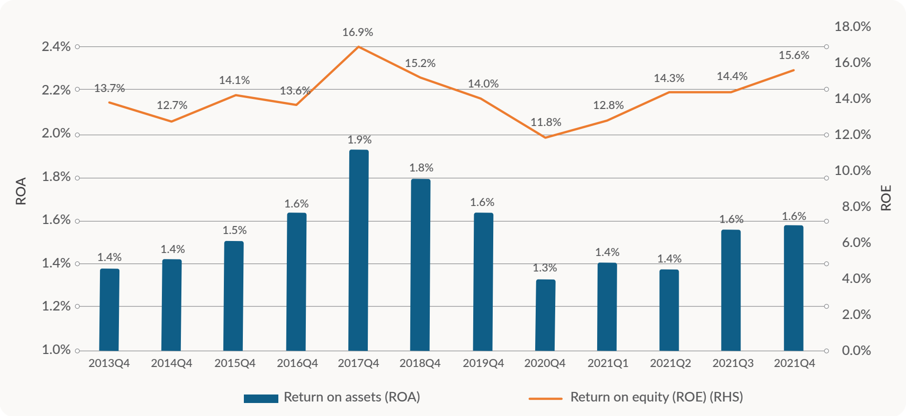


Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

The highly profitable banking sector

As summarised in the graph below, the Return on Equity (ROE) of the sector increased from 13.7% in 2013 to 15.6% in 2021 after reaching its highest level of 16.9% in 2017. As for the Return on Asset (ROA), it increased from 1.4% in 2013 to 1.6% in 2021 after reaching 1.9% in 2017. This means that, within the banking industry, Islamic banks were among the top performers. For instance, in 2020, the Islamic banking industry's average ROE of 11.8% was higher than the average ROE of the top 80% global performers in the banking industry, which exhibited an average ROE below 10% (McKinsey, 2021).

Figure 4: Performance of the Islamic banking sector from 2013 to 2021



Source: IFSB (Islamic Financial Services Board): https://www.ifsb.org/psifi_05.php

2.2.3 Trend in the Islamic capital market sector

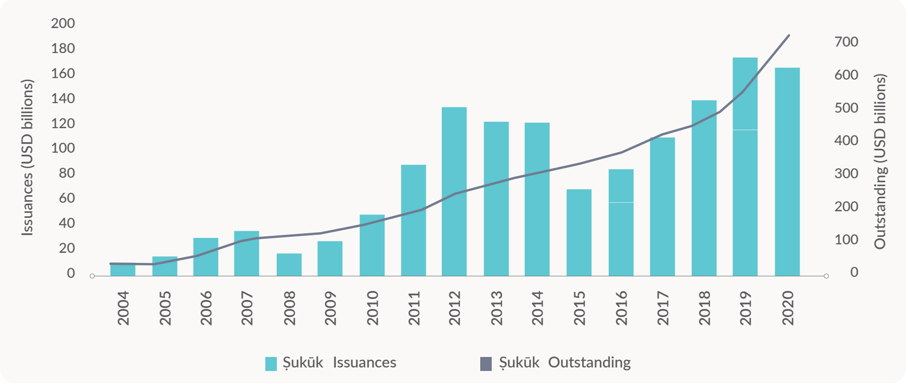
The Islamic capital market has experienced significant and rapid development over the last two decades and represents a growing market. The annual growth rate is estimated to be between 10 – 12% over the last decade (Alawode, 2015; IFSB, 2021). As summarised in Figure 5 below, the annual issuance of Sukuk increased from close to US$10 billion in 2014 to more than US$140 billion in 2020. However, this represents a non-material share (0.11%) of the global bond market, which was estimated at US$128.3 trillion in August 2020[13]. The total outstanding Sukuk increased from close to US$10 billion in 2004 to US$703 billion in 2020.

The Sukuk market proved to be fairly resilient in 2020 despite the unprecedented and wide-ranging impact of the global pandemic. Ṣukuk outstanding continued its growth trend to reach US$703 billion in 2020 (see graph below). Notwithstanding the initial shock of the pandemic on financial markets early in 2020, Sukuk markets recovered quickly, with the impact of the crisis manifesting unevenly across countries. The overall Sukuk issuances

[13] International Capital Market Association (ICMA). (2024). Bond Market Size. Accessed from https://www.icmagroup.org/market-practice-and-regulatory-policy/secondary-markets/bond-market-size/#:~:text=As%20of%20August%202020%2C%20ICMA,outstanding%2C%20is%20approximately%20%24128.3tn

by the end of 2020 proved to be relatively strong, with total issuances worth US$163.4 billion. While this represents a 4% drop from the US$171.1 billion of issuances in the previous year, the Sukuk market has remained relatively robust, with higher total annual issuances than in the years before 2019.

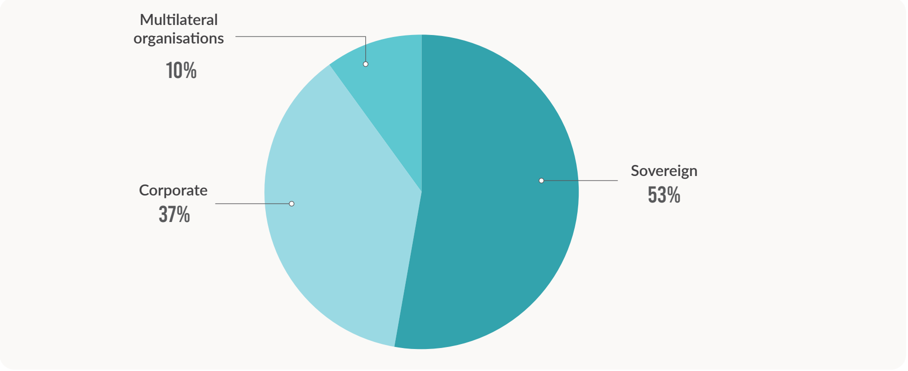
Figure 5: Trend in the size of the Islamic capital market from 2004 to 2020



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Sovereign issuances dominate the Sukuk market. For instance, as presented in the graph below, in 2020, sovereign issuances made up about 53% of total issuance, followed by 37% from corporates and 10% from multilateral organisations.

Figure 6: Sukuk issuance by issuer type (2020)



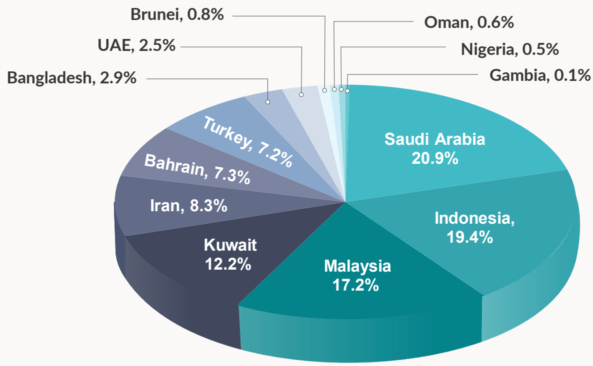
Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Woman selling vegetables on street market.
Photo Credit: GettyImages/ hadynyah

In a reversal from 2019[14], Saudi Arabia was the biggest sovereign issuer in 2020, followed by Indonesia, Malaysia, and Kuwait with 20.9%, 19.4%, 17.2%, and 12.2% respectively, of the total issuance of the year as shown by the graph below. This reversal reflects a drop in sovereign issuances from Malaysia as well as Indonesia, while issuances from Saudi Arabia and Kuwait remained largely consistent with the previous year. There was also an increase in sovereign issuances from Bahrain, Turkey, the UAE (United Arab Emirates), and Iran compared to the previous year, while Oman and Nigeria returned to the Sukuk market in 2020 with sovereign issuances. Conversely, there were no sovereign issuances from Qatar in 2020, and Brunei and Bangladesh experienced a slight drop in issuances[15].

Sovereign Sukuk issuance by African countries continues to be non-material. In 2020, Nigeria and Gambia, the main African countries Sukuk issuers, together accounted for only 0.6% of the total Sukuk issuance of the year.

Figure 7: Sovereign Sukuk issuance by the jurisdiction of the originator (2020)



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

In 2020, Malaysia continued to be the largest corporate issuer in terms of the overall volume of issuances, followed by the UAE, Saudi Arabia, and Turkey as summarised in Figure 8 below with shares of 47.3%, 16.2%, 14.2%, and 10.8%

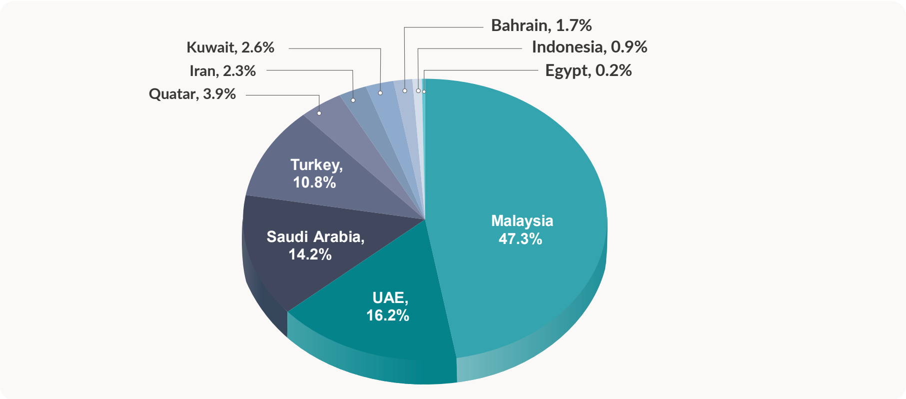
[14] 2019 sovereign issuance by country: Malaysia 23%, Indonesia 21%, Saudi Arabia 20%, Kuwait 11% (IFSB, 2021).

[15] *IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf*

respectively compared to 2019 figures made of Malaysia (59%), Turkey (14%), UAE (14%) and Saudi Arabia (5%).

The only African country with corporate issuance among the top issuers was Egypt with only 0.2% of the total volume issued.

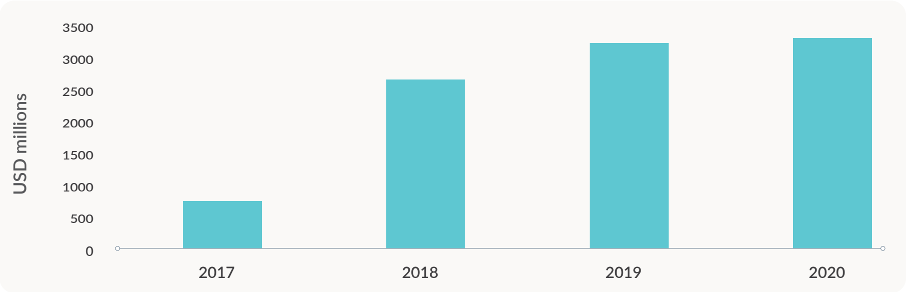
Figure 8: Corporate Sukuk issuance by the jurisdiction of the originator (2020)



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Green and SRI (Socially Responsible Investment) Sukuk also experienced a significant increase as exhibited in Figure 9. In 2020, the green and SRI-related Sukuk issuances reached more than US$3000 million from a volume below US$1000 million in 2017.

Figure 9: Green Sukuk issuance from 2017 to 2020



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

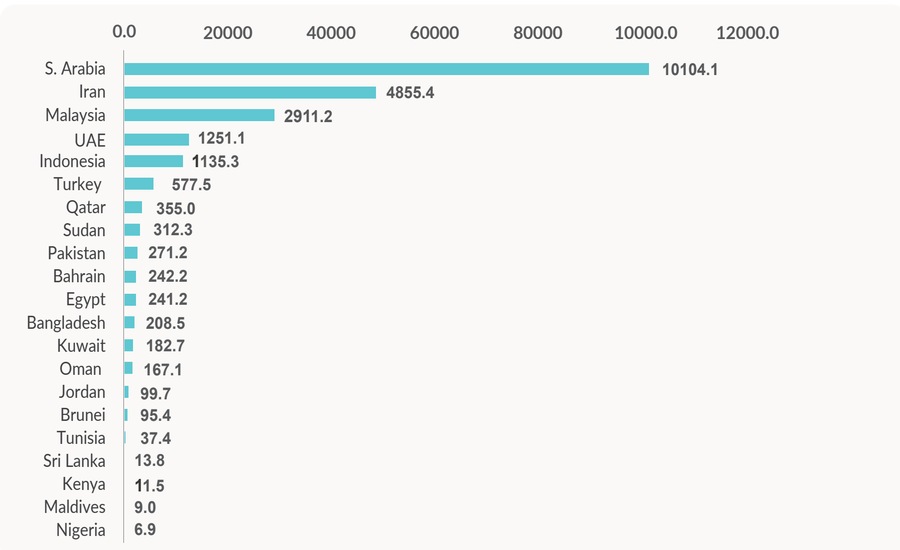
2.2.4 Trend in the Islamic insurance market (Takaful)

The Islamic insurance market is relatively less developed compared to the banking and capital market. However, it was experiencing solid growth before the COVID-19 pandemic, with total direct written premiums in 2019 up by 3% from 2018[16].

According to IFSB (2021), the key growth drivers were non-life insurance in advanced markets, and both life and non-life insurance in China. On the life side, premium growth in advanced markets slowed to 1.3%, though with wide divergences by country; whereas in the emerging markets it increased to 5.6%, after a fall of 2% in 2018 – in both years driven by developments in China.

In terms of the geographic distribution of the premium, Saudi Arabia and Iran are the largest Takaful markets by a considerable margin, and both are entirely Islamic as presented in the graph below.

Figure 10: Takaful contribution by jurisdiction (US$ million) in 2019



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

[16] *IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf*

Over the last decades, Islamic finance has shown significant development over the world. Although its market is mostly concentrated within Islamic countries, particularly in Gulf Cooperation Council (GCC) countries, there is significant development and increase in the other countries. Malaysia is a key pioneer of Islamic finance and dominates the Sukuk market.

This significant development of Islamic finance represents a great financing opportunity for sovereigns and corporates, particularly in Africa where this type of finance shows relatively low development.

3 THE CURRENT STATE OF ISLAMIC FINANCE IN EASTERN AFRICA

3. THE CURRENT STATE OF ISLAMIC FINANCE IN EASTERN AFRICA

This part of the report focuses on Islamic finance in Eastern Africa. Its potential benefits and demerits as well as its impact on financial inclusion in the region are also discussed.

3.1 Islamic finance in Eastern Africa

Quick overview of Islamic finance implementation genesis in selected Eastern African countries

In Somalia, the first Islamic financial institution was founded in 1998. The first Islamic bank in Somalia is Amal Bank. However, a crisis shook Somalia and it was left without a financial system. It is only since 2009 that the country has recovered. The country now has several Islamic banks (Ngono, 2021). In 2015, the country welcomed its first takaful insurance company, First Somali Takaful & Re-Takaful.

Islamic banking emerged in Kenya with Barclays launching Islamic banking products in December 2005. The sector later expanded with the introduction of two Islamic banks, First Community Bank in 2007 and Gulf African Bank (GAB) in 2008 (Gelbard et al., 2014). Other conventional banks such as Kenya Commercial Bank now offer Sharia-compliant products through special Islamic windows. In 2010, through the Finance Act, the Kenyan authorities amended section 45 of the Central Bank of Kenya Act to allow the Central Bank, as the fiscal agent of the government, to recognise the payment of a return rather than interest on government securities, thus opening up the specter of Sharia-compliant investments in the country (Ndung'u, 2011). In 2017, the Kenyan government established new measures allowing it to issue Sukuk. The then Finance Minister, Henry Rotich, outlined the state's ambitions for Islamic finance in the 2017-2018 budget, aiming to revamp the laws governing Islamic finance to issue a first Sukuk in the 2017 fiscal year. The country has set up an organisation: the Islamic Finance Project Management Office (IFPMO) to coordinate and monitor its efforts in developing the appropriate regulations. In 2015, the Kenyan government introduced new regulations, allowing conventional insurers to enter the takaful domain. However, the law requires companies to set up separate takaful units whose operational management is ensured by a committee approved by a board of religious studies[17].

In 2008, Tanzania authorised Kenya Commercial Bank (KCB), for the establishment in the country of an "Amana Islamic" branch, specialising in Islamic banking. It is the very first bank offering Islamic financial services in the country. The country still lacks a legal and regulatory framework to respond to Islamic banking as well as the resolution of legal disputes arising from Islamic banking. This could be seen as an impediment to the progress of Islamic banking in Tanzania. However, Tanzania, like Kenya, recognises the enormous potential of Islamic finance[18].

In Ethiopia, an interest-free banking system like Islamic finance was first allowed in 2011 under the existing conventional banking system. Decision number SBB/72/2019 of the National Bank of Ethiopia has enabled full and independent interest-free banking activities for the very first time in the country. This decision stipulates that all regulatory and supervisory requirements, except the National Bank's decision on the interest rate, will apply to Islamic banks. Accordingly, all National Bank guidelines issued to regulate "conventional" banks apply to Islamic banks, subject to appropriate modifications (Oumer, 2021).

In Uganda, the Financial Institutions Act 2004 was amended in 2016 to allow companies and banks to offer Islamic finance banking services. The intention was to pave the way for the inclusion of Islamic banking in the Ugandan financial sector[19]. The amendments include exemptions offered to licensed Islamic financial institutions with respect to restrictions on engaging in commerce and unauthorised activities in conventional banks. Subsequently, the Bank of Uganda issued the Financial Institutions (Islamic Banking) Regulations in February 2018 to address the specific technical aspects of Islamic finance and to operationalise the amendments relating to Islamic banking in the Financial Institutions Act 2004. According to the Bank of Uganda, this regulation covers

[17] Financial Afrik. (2017). Kenya paves the way for Islamic finance. Accessed from https://www.financialafrik.com/2017/04/03/le-kenya-ouvre-la-voie-a-la-finance-islamique/

[18] Gulf Times. (2018). East Africa rides the Islamic finance train; Uganda next to join. Accessed from https://www.gulf-times.com/story/597555/East-Africa-rides-the-Islamic-finance-train-Uganda

[19] IFLR1000. (2016). Islamic finance in Uganda under the Financial Institutions Amendment Act 2016. Accessed from https://www.iflr1000.com/NewsAndAnalysis/islamic-finance-in-uganda-under-the-financial-institutions-amendment-act-2016/Index/6032

the “how” and the “what” for the licensing and regulation of Islamic banking. It introduces a condition that apart from the specific exemptions granted in the amended Financial Institutions Act 2004, Islamic financial institutions are still required to comply with all existing regulatory requirements.

In Rwanda, the first Islamic financial institution was launched in 2016 and it was an Islamic microfinance institution[20].

In Djibouti, it is through the creation of the Saba Islamic Bank (renamed Saba African Bank in 2018), that Islamic finance was introduced into the Djiboutian financial environment. At that time, there was still no regulatory framework allowing the development of Islamic financial services. However, the Djiboutian Central Bank (DCB) tolerated the opening of this bank. That bank was governed, at the time, by the laws and rules of conventional banks. Following its creation, three other banks were approved by the Central Bank of Djibouti in 2008 for Salaam Islamic Bank (funded with Somalian and Djiboutian capital), in 2009 for Dahabshiil Bank International, which became East African Bank in 2015 –, and in 2010 for Shoura Bank, owned by Egyptian investors (which ceased operations in 2016). This enthusiasm for Islamic finance caught the attention of the Djiboutian government, which in 2011 adopted a regulatory and institutional framework specific to Islamic finance. This regulatory framework is constituted by the law establishing Islamic banks (Law n°116/AN/11/6th L of January 22, 2011), supplemented by Instructions, and Law n°119/AN/11/6th L relating to the constitution and control of credit institutions and financial auxiliaries. It is provided in article 8 of instruction n°2012 of November 5, 2012, relating to the conditions of establishment of Islamic banks, that any conventional bank wishing to open a branch of Islamic finance must separate its assets, its operations, and its management of ordinary banking operations.

Islamic finance at its first stage of development in East Africa

The financial sector in Eastern African countries is underdeveloped but has been growing rapidly in the past two decades. New products have been introduced and financial institutions are playing an increasing role in financial intermediation, including cross-border financial flows (Gelbard et al., 2014).

[20]Gulf Times. (2018). East Africa rides the Islamic finance train; Uganda next to join. Accessed from https://www.gulf-times.com/story/597555/East-Africa-rides-the-Islamic-finance-train-Uganda

This development of the financial sector is also supported by the increase in the number of commercial bank branches per 100,000 adults from 2004 to 2020 as summarised in table 2. In most countries, this figure has almost doubled over the period. Despite the significant increase in the metric, in all countries of the region, except Djibouti, Kenya, Rwanda and Seychelles, it remains below Sub-Saharan Africa and the world average.

Table 2: Trend of the number of commercial bank branches per 100,000 adults in selected Eastern African countries (2004-2020)

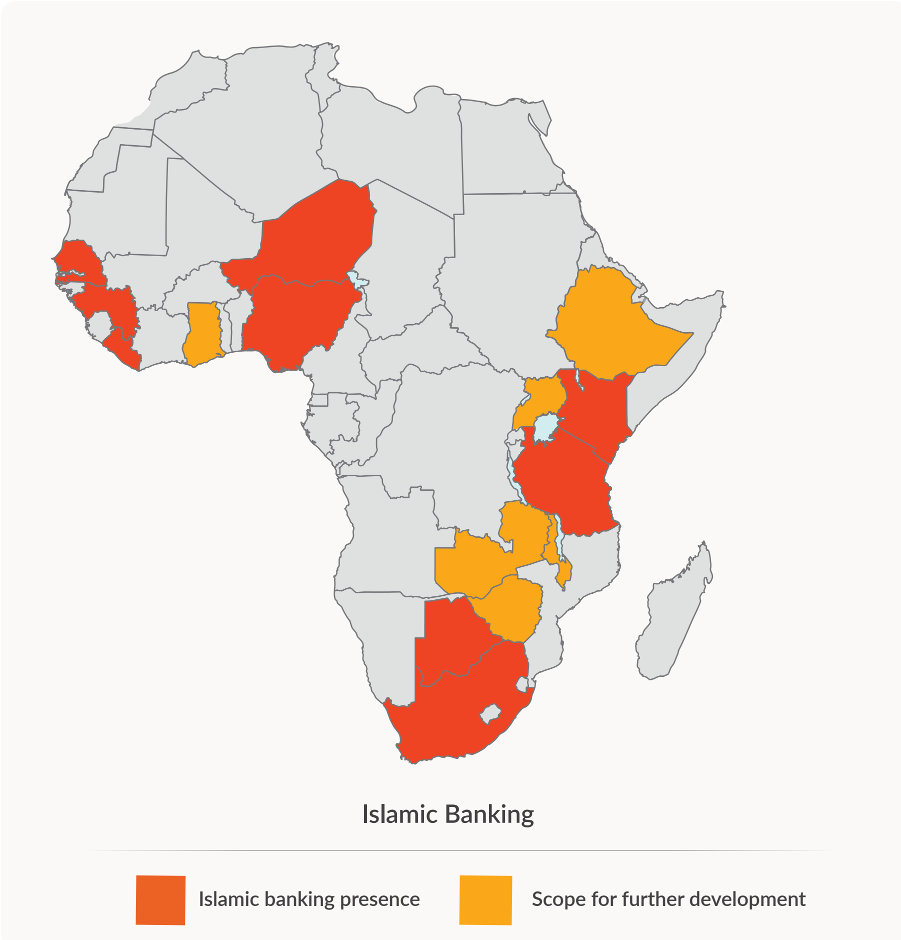
	2004	2009	2014	2015	2016	2017	2020
Burundi	1.6	2.09	3.2	3.23	3.22		
DRC	0.46	0.48	0.79	1.03	0.84	0.87	
Comoros	0.58	1.26	2.87	2.79	3.14	3.06	3.58
Djibouti	2.11	3.45	5.32	5.99	5.87	7.26	8.54
Ethiopia	0.84	1.33					
Kenya	2.7	4.36	5.48	5.59	5.37	5.21	4.67
Madagascar	1.12	1.41	1.9	2.06	2.2	2.32	2.51
Rwanda	0.4	5	5.94	6.22	6.28	6.18	4.59
South Sudan		0.68	1.9	1.62	1.65	1.46	1.45
Seychelles	42.36	46.32	54.04	54.36	53.72	53.18	46.63
Tanzania		1.84	2.3				
Uganda	1.15	2.42	3.05	3.03	2.88	2.67	2.45
Sub-Saharan Africa	1.49	2.84	4.12	4.545	4.36	4.44	4.52
World	9.68	11.075	12.22	11.59	12.28	11.68	10.78

Source: World Development Indicators

Despite this significant and rapid development of the financial sector in the region, Islamic finance remains relatively small. Indeed, in 2012, Gelbard et al. (2014) estimated that only Kenya and Tanzania had Islamic banking institutions. And there was scope for development in Uganda and Ethiopia (Figure 11).

Contemporary business people working.
Photo Credit: GettyImages/ FS-Stock

Figure 11: Islamic banking in sub-Sharan Africa at the end of 2012



Source: Gelbard et al. (2014)

Based on Faye et al. (2013) estimates summarised in the table below, in 2012, only Djibouti, Kenya, and Tanzania had Islamic finance institutions among East African countries. Djibouti had four (4) full-fledged Islamic bank institutions. Kenya had two (2) full-fledged Islamic banks, and five (5) commercial banks with Islamic windows. Tanzania had one (1) full-fledged Islamic bank and four (4) commercial banks with Islamic windows. In total, sixteen (16) Islamic finance institutions were located in Eastern Africa in 2012. This represented 14% of all Islamic finance institutions in Africa, making the sub-region one of the African regions with the highest number of Islamic financial institutions. At that time, no Islamic insurance companies and Islamic microfinance institutions were located in Eastern Africa.

Table 3: Overview of Islamic finance in Africa (2012)

Country	Muslim population, million (2011 estimates, unless otherwise specified)	% Muslim (2011 estimates, unless otherwise specified)	Islamic banks		Banks with Islamic windows		Licensed commercial banks		Islamic insurance companies (Takaful operators or companies)		Islamic funds[c]		Islamic microfinance services providers		Islamic fin. services provide (total)
			Number	Year of reference	Number	Year of reference	Number	Year of reference	Number	Year of reference	Number	Year of reference	Number	Year of reference	
North Africa			9		5		127		11		0		0		25
Algeria	35.05	99	2	2012			20	2012	1	2010					3
Egypt	75.32	90	3	2012	1	2010	39	2011	4	2010					8
Libya	6.53 (2012)	97 (2012)	0	2012			16	2012	2	2008					2
Mauritania	3.36	100	2	2012			12	2011	2	2008					4
Morocco	31.99	99	0	2012	4	2010	19	2010	0	2010					4
Tunisia	10.52	98	2	2012			21	2012	2	2010					4
West Africa			6		1		126		4		0		3		14
Cameroon													1	2012	1
Gambia	1.66	90	1	2012			14	2012	1	2008					2
Ghana	4.01 (2012)	15.9 (2012)	0[a]	2010	0	2012	27	2012	2	2012					2
Guinea	9.25	85	2	2012			12	2010							2
Liberia	0.47	12.2	0	2012			9	2012							0
Mali	13.08	90	0	2010			13	2012					1	2007	1
Nigeria	85.06 (2012)	50	1	2011	1	2011	21	2012					1	2012	3
Niger	13.66	92	1	2012			10	2012							1
Senegal	12.19	95	1	2012	0	2012	20	2012	1	2008					2
Eastern Africa			39		9		112		15		0		2		65
Djibouti	0.73	94	4	2012	0	2009	7	2012							4
Kenya	4.30 (2012)	10 (2012)	2	2012	5	2012	43	2012							7
Sudan (Rep. of)	30.86 (2010)	71.4 (2010)	32	2010			32	2010	15	2008			2[b]	2013	49
Tanzania	15.26 (2012)	35 (2012)	1	2012	4	2012	30	2012							5
Southern Africa			2		3		93		3		4		0		12
Mauritius	0.22	16.6	1	2011	1	2010	20	2012							2
South Africa	0.73 (2012)	1.5 (2012)	1	2012	2	2012	73	2012	3	2010	4	2013			10
TOTAL			56		18		458		33		4		5		116

Source: Faye et al. (2013)

Since 2012, in terms of Islamic finance in Eastern African countries, things have significantly evolved with an increased number of these types of financial institutions. As summarised in the table below from our compilation by using several sources, the number of financial institutions that offer Sharia-compliant financial services and products in the region has moved from 16 in 2012 to at least 84[21] in 2022. This represents a 425% increase over the period. The full list of the 84 financial institutions is available in annex 1.

[21] The list of Islamic finance institutions in East Africa may not be exhaustive.

Table 4: Number of Islamic finance institutions in selected Eastern African countries (2022)

	Full-fledged Islamic Banks	Islamic bank windows	Micro finance	Takaful	Total
Burundi	0	2	0	0	2
Djibouti	3	3	1	1	8
Ethiopia	5	14		4	23
Kenya	6	9	2	2	19
Rwanda			1		1
Seychelles	1	0	0	0	1
Somalia	13	1	0	5	19
Tanzania	1	6	0	0	7
Uganda	1	0	2	1	4
Total	30	35	6	13	84

Source: Author's compilation from various sources

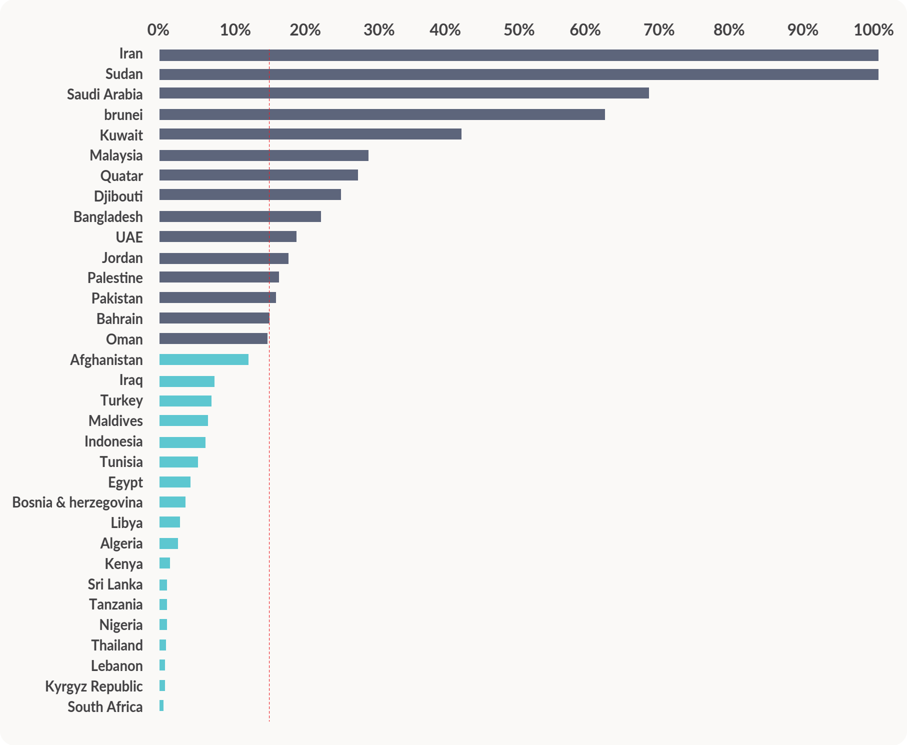
The 84 Islamic finance institutions in Eastern Africa as of 2022 were made up of 30 (35.7%) full-fledged Islamic banks, 35 (41.7%) Islamic bank windows, 6 (7.1%) Islamic microfinance institutions, and 13 (15.5%) Islamic insurance companies. The higher number of Islamic bank windows in the region was consistent with the trend observed worldwide with the fact that more and more conventional banks were offering blended financial services and products, including Sharia-compliant services and products.

From Table 4, countries with high Islamic finance institutions concentration were, in this rank order, Ethiopia with 23 institutions, Somalia and Kenya with 19 entities each.

Djibouti with the highest share of Islamic banking assets in the region

The figure below provides the total asset share of Islamic banking in total banking assets in the main Islamic banking countries in the world. Only Djibouti and Kenya were listed among the main Islamic banking countries in the world.

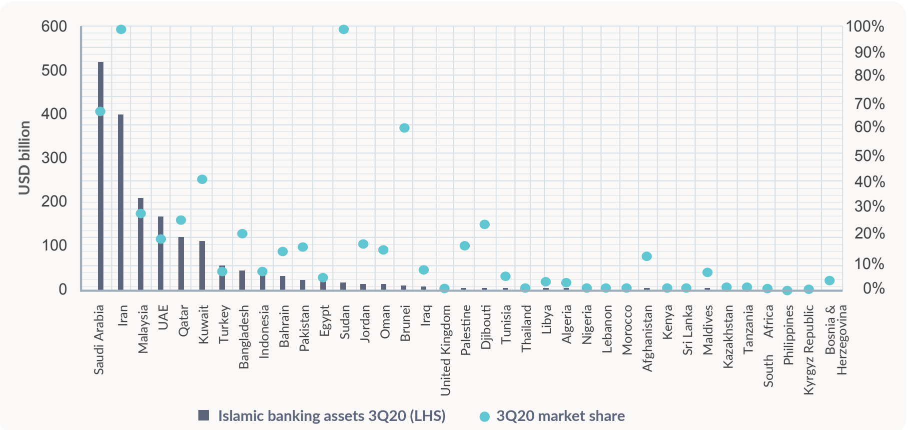
Figure 12: Islamic banking share in total banking assets by main country (3Q 2020)



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Figure 13 presents the total asset of Islamic banking (in US$) and its share in total banking assets in the main Islamic banking countries in the world. It shows that, in 2020, Djibouti was the leading country in the region in terms of Islamic banking's assets and market share. Indeed, as of quarter three 2020, the total asset of Islamic banking in Djibouti was below US$ 1 billion, representing approximately 25% of the total banking asset and the Islamic banks captured close to 25% of the banking sector's market. The second country in the region in terms of Islamic banking assets was Kenya with very low Islamic banking assets representing 1% of the total banking asset which experienced a decline from 1.4% in quarter three 2019. The Islamic banking sector also captured a negligible share of the Kenyan banking market.

Figure 13: Islamic banking asset (US$) and market share (%) by main country (3Q 2020)

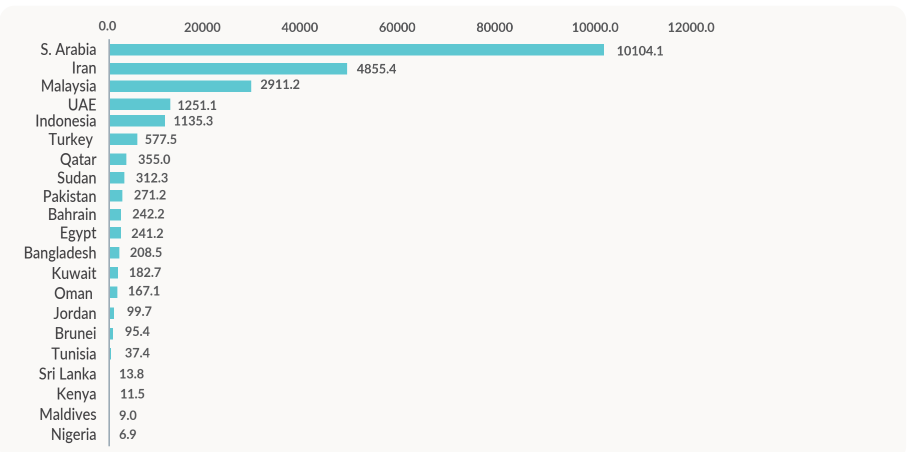


Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Kenya is the leading Takaful market in Eastern Africa

Figures 14 and 15 below provide the gross contribution of Islamic insurance in the main Islamic insurance countries in the world. Only Kenya from Eastern Africa appears in this list.

Figure 14: Takaful gross contributions by main jurisdiction (US$ million) (2019)

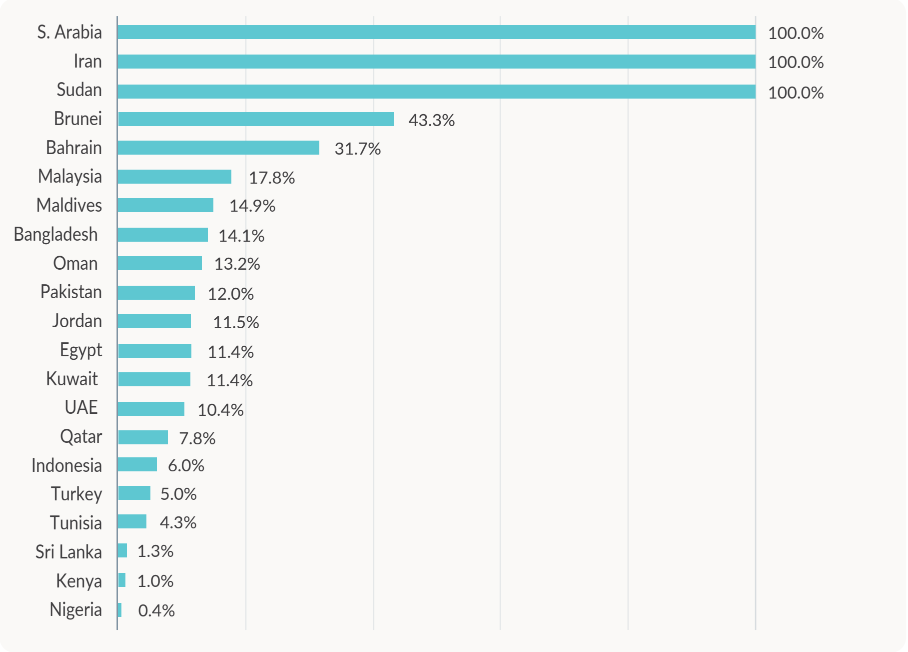


Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

Muslim woman working on laptop at home.
Photo Credit: GettyImages/ Viktor Cvetkovic

In 2019, takaful gross contribution in Kenya was US$ 11.5 million representing only 1% of the total insurance market gross contribution in the country.

Figure 15: Takaful gross contributions/Total sector gross contributions (%) in 2019



Source: IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf

There is not sufficient data to fully assess the current state of Islamic finance in the region. However, the few data available and discussed above show that despite the increase observed in the number of Islamic finance institutions since 2012, Islamic finance's total assets and market shares in Eastern African countries are very small. This means that Islamic finance is least developed in Eastern African countries although the region has a high proportion of the Muslim population in Sub-Sahara Africa.

3.2 Islamic finance and financial inclusion in Eastern Africa

Financial inclusion is an important topic and a high priority for governments' agendas (Brekke, 2018), particularly in African countries. This is also a discussion topic for Muslims worldwide. Research has pointed out that Muslims worldwide are less included in the formal financial system than non-Muslims, but there is less knowledge about the extent to which religious norms (most importantly the ban on interest on money) lead to financial exclusion among Muslims in the West (Brekke, 2018). For instance, a study of 29,000 people in 29 countries found that Muslims are less likely to have bank accounts than non-Muslims, partly for religious reasons (Beck and Brown, 2011). The fact that conventional banks do not generally offer Sharia-compliant financial services and products may be part of the reasons that explain why Muslims have limited access to conventional banks. According to a survey conducted by Brekke (2018) in Norway, almost 90% of Muslims in the sample agree or strongly agree with the statement that conventional banks provide interest-based loans, which are forbidden in Islam. The same percentage agree or strongly agree that it is a problem for them that Sharia-compliant products are not available in Norway. This means that there could be a significant share of Muslims who are reluctant to open an account in a conventional bank for religious reasons. For these Muslims, Islamic finance institutions can address the issue of their exclusion from the financial system.

In addition, there is evidence that the Muslim population is more and more attracted by Sharia-compliant financial products and services. For instance, Oralbaeva et al. (2020) supported the rapid growth of Islamic finance in the USA and Europe by: i) the dynamically increasing number of Muslims in the USA and Europe for financial services and transactions made under Sharia principles is constantly growing; and ii) the increasing number of Muslims in these countries. According to Alawode (2015), Islamic finance can help to meet the needs of those who do not currently use conventional finance because of religious reasons. It can help reduce the overall gap in access to finance since non-Muslims are not prohibited from using Islamic financial services. Although there is no evidence for such a statement in the Eastern Africa region, observation from Norway and USA may be applicable for Muslims in this region.

According to the data extracted from the World Population Review, summarised in table 5, the consolidated population of Eastern African countries is estimated in 2022 to be 479,702,392 of which 115,628,959 (24.1%) are

Muslims representing 5.7% of the worldwide Muslim population. This means that approximatively, 1 out of 4 inhabitants in Eastern Africa is Muslim. All the countries in the region have a relatively important share of Muslims. The share of the Muslim population is less than 10% in only two countries, namely Rwanda and Seychelles. Unlike Rwanda and Seychelles, the size of the Muslim population is relatively important in all the other countries with Somalia, Comoros, and Djibouti showing the high concentration of Muslim population in the region, representing 99.8%, 98.3%, and 97% respectively, of their total population.

Table 5: Estimates of the Muslim population in Eastern African countries in 2022

Country	Muslim Population	Total population 2022	Share of Muslim population (%)	Share of worldwide Muslim population (%)
Burundi	1 288 958	12 889 576	10.0%	0.1%
Comoros	822 549	836 774	98.3%	0.0%
Djibouti	1 087 224	1 120 849	97.0%	0.1%
DRC	9 901 021	99 010 212	10.0%	0.5%
Eritrea	1 613 606	3 684 032	43.8%	0.1%
Ethiopia	41 825 794	123 379 924	33.9%	2.0%
Kenya	6 051 079	54 027 487	11.2%	0.3%
Madagascar	2 961 171	29 611 714	10.0%	0.1%
Rwanda	661 282	13 776 698	4.8%	0.0%
Seychelles	1 178	107 118	1.1%	0.0%
Somalia	17 562 316	17 597 511	99.8%	0.9%
South Sudan	2 182 633	10 913 164	20.0%	0.1%
Uganda	6 614 942	47 249 585	14.0%	0.3%
Tanzania	23 055 207	65 497 748	35.2%	1.1%
Total East Africa	**115 628 959**	**479 702 392**	**24.1%**	**5.7%**

Source: World Population Review and author's calculations

From the discussion above, the development of Islamic finance in Eastern Africa could address the issue of the Muslims who do not have an account in the conventional banking system for religious reasons. As Muslims represent a significant share of the Eastern African population, they could represent an important share of the region's population that will have access to the financial system with the development of Islamic finance. On this basis, it is clear that the development of Islamic finance in the region can improve financial inclusion.

3.3 Potential benefits and demerits of Islamic finance in the region

Islamic finance as ethical finance offers several benefits. These are linked to the principles of Islamic finance and can be summarised as follows:

- Improvement of financial inclusion in the region as discussed in the previous section. By expanding the range of financial products, Islamic finance could help improve financial access and foster the inclusion of those deprived of financial services. Islamic finance helps promote financial sector development and broadens financial inclusion.
- Islamic finance emphasises partnership-style financing, which could be useful in improving access to finance for the poor and small businesses.
- Mobilisation of additional outside financing by attracting financing from Arab countries or private investors in the Middle East.
- Islamic finance can improve sustainable development in Eastern African countries through its justice and fairness principles. Indeed, Islamic finance offers benefits for economic growth, reducing poverty, and fostering shared prosperity. Moreover, the foundation of the Islamic banking model is based on a profit-sharing principle, whereby the risk is shared by the bank and the customer. This system of financial intermediation could contribute to a more equitable distribution of income and wealth in the region.
- Islamic finance can significantly contribute to economic development, given its direct link to physical assets and the real economy. The use of profit-and-loss sharing arrangements encourages the provision of financial support to productive enterprises (linked to physical and tangible production) that can increase output and generate jobs. The emphasis on tangible assets ensures the industry supports only transactions that serve a real purpose, thus discouraging financial speculation.

- It can help to strengthen financial stability in the region. Speculative transactions are sources of instability and, by nature, misallocation of capital. Islamic banks are prohibited from carrying out such activities, rather they focus on the deployment of capital to the real economy, to promote socio-economic justice. Without speculation, the financial system could partly avoid the crisis resulting from speculation. This was the case in 2008. As the 2008 global financial crisis ravaged financial systems around the world, Islamic financial institutions were relatively untouched, protected by their fundamental operating principles of risk-sharing and the avoidance of leverage and speculative financial products (Alawode, 2015, Belkhir et al., 2019; Grira et al., 2016).

- Transparency: Islamic banking is about conducting business fairly and transparently. This could bring more transparency to Eastern African finances and business through a full understanding of risks and costs associated with the products and services provided.

Islamic finance offers some significant benefits. However, it is also subject to some constraints which are summarised as follows:

- Most notably increase in transaction costs and difficulties involved in supervising and monitoring. By design, Islamic finance instruments are more expensive than conventional financing instruments offering the same services, wherever both are available. The sharing of risks and returns means that investors would demand credible evidence of the viability and return on investment. This raises the cost of intermediation from information asymmetry between investors and entrepreneurs and requires more scrutiny of an investment's return by banks as an intermediary relative to conventional collateralised lending (Gelbard et al., 2014).

- The increased cost of doing business with the extra compliance required for the Islamic finance institutions.

- Issue of standardisation and consistent legal/regulatory framework. One of the main problems in Islamic finance is linked to the different legal interpretations of principles across jurisdictions. For instance, some Islamic finance products approved in Malaysia are not accepted in Middle East countries (Gelbard et al., 2014). These prevent standardisation and carry the risk that a negative signal about the products being Sharia-compliant could affect them.

- Islamic finance entities are exposed to risk and cannot use some hedging strategies to minimise risk as these are prohibited.

- Some Islamic products may not be compatible with international financial regulations. This may pose challenges for Eastern African countries to integrate this type of finance into the existing conventional finance.

While Islamic finance could bring significant benefits for people/customers, investors, and business owners, and contribute significantly to economic development in Eastern African countries, it has several disadvantages. These disadvantages are more on the side of Islamic financial institutions for which the intermediation business is costly and could be more difficult to operate in an asymmetrical context compared to the conventional financial system.

Islamic finance is at an earlier stage of development in Eastern Africa. Although it has shown rapid growth over the last decades with the number of institutions having moved from 16 in 2012 to at least 84 in 2022, it remains relatively small. In addition, the current level of Islamic finance in the region is not aligned with the structure of the region's population made up of 24.1% of Muslims. This means that there is room for Islamic finance to grow in the region. The development and the growth of this alternative finance in the region will help to improve financial inclusion, to strengthen the financial system of the region, and significantly contribute to the economic development of the region with increasing available financing. This alternative finance represents financing opportunities for the governments and the companies of the region. For example, as discussed above, the Sukuk market is experiencing rapid growth and penetration worldwide. However, so far, only one country in the region (Kenya) has issued Sukuk bonds. Other countries and corporates of the region can leverage the Sukuk market to mobilise more resources to finance their development and industrialisation.

4

ISLAMIC FINANCE AND ECONOMIC FINANCING IN EASTERN AFRICA

4. ISLAMIC FINANCE AND ECONOMIC FINANCING IN EASTERN AFRICA

This section of the report focuses on the leverage Islamic finance can provide in the economic financing of the Eastern Africa region as well as the role this alternative financial system can play in promoting intra-regional trade in goods and services in the context of AfCFTA.

4.1 Role and impact of Islamic finance on SMEs' development and growth in the region

SMEs play an important role in economic growth worldwide. This role is particularly significant for African economies. According to the World Bank[22], SMEs account for the majority of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90% of businesses and more than 50% of employment worldwide. Formal SMEs contribute up to 40% of national income (GDP) in emerging economies. In addition, in emerging economies, most formal jobs (7 out of 10) are created by SMEs. Studies highlight that in developed and developing economies, SMEs contribute on average 60% of formal employment in the manufacturing sector (Ayyagari et al., 2007; UNECA, 2020). This figure is higher in African countries where SMEs are responsible for about 75% of formal employment creation in the manufacturing sector (Ayyagari et al., 2007; UNECA, 2020).

This observation remains the same in Eastern African countries. For instance, in Tanzania, SMEs' contribution to GDP is estimated to be about one-third. It is also estimated to provide about 20% of the formal labour force in the country. In Kenya, SMEs provide almost 74% of the country's total employment and contribute to 24.5% of the country's GDP (Kira, 2013). The impact of SMEs on African economies including Eastern African economies would be higher if the informal sector is included as a large share of the SMEs in Africa are in the informal sector.

[22] World Bank. (2019). Small and Medium Enterprises (SMEs) Finance: Improving SMEs access to finance and finding innovative solutions to unlock sources of capital. Accessed from https://www.worldbank.org/en/topic/smefinance#:~:text=SMEs%20account%20for%20the%20majority,(GDP)%20in%20emerging%20economies (accessed on 12 September 2022).

Despite the significant role of SMEs in Eastern African economies, they do not have easy access to financing from the traditional financial sector (Soumaré, 2022; UNECA, 2020). The financing gaps of SMEs in Africa are estimated to be massive, about US$330 billion[23]. The banking industry prefers to lend to large corporates for many reasons. For instance, the business of a large corporation is often run by professionals and they have a management team that comes with some name recognition. Additionally, big corporates keep more timely and accurate business and financial information. This is not the case for small businesses, which typically do not keep proper financial records and are often run by inexperienced managers (Raji, 2021). Moreover, unlike SMEs, large corporates can easily provide collateral to support financing requests to banks (Soumaré, 2022).

Islamic finance can lead to SME development and growth by addressing their financing needs

Various studies[24] have analysed the role of Islamic finance on the development and growth of SMEs in the world. All these studies highlight the positive impact and critical role Islamic finance can play to foster SME development and growth. Islamic finance as an alternative financing system with ethical principles could positively impact the business growth and development of SMEs. The main channel through which this can happen in the region is by addressing their financial needs as this remains one of the main issues they face in the region. By addressing their financing needs, viable SMEs could easily extend their activities through the increase and improvement of their production means and capability. Moreover, additional financing could help them target an increasing share of their domestic and regional market.

Like the conventional banking system, the Islamic banking system can provide alternative financing sources to the economy, particularly to SMEs to address their financing needs. Islamic finance not only offers an alternative source of long-term financing for developmental projects but also has inherent characteristics

[23] Stellenbosch Institute for Advanced Study. (2022). Can fintech help to close the financing gap for small and medium size enterprises in Africa? Accessed from https://stias.ac.za/2022/05/can-fintech-help-to-close-the-financing-gap-for-small-and-medium-size-enterprises-in-africa/

[24] Abdinur and Ondes (2022), Abdulkadir (2016), Aysan et al., (2016), Grira et al., (2019), Yussuf (2016), among many others.


Muslim man transacting through mobile phone.
Photo Credit: GettyImages/ FG Trade

and principles that catalyse real economic development. Through its inherent ethical, sustainable, environmentally, and socially responsible approach that further promotes risk sharing, Islamic finance connects the financial sector with the real economy[25].

Based on its principles made of ethical financing, Islamic banks are more inclined to provide financing to SMEs compared to conventional banks. This affirmation is supported by some studies. Indeed, in the case of Turkey, by using pooled OLS and fixed-effects estimators, Aysan et al. (2016) found that Islamic banks (known as participation banks in Turkey) are more inclined toward financing SMEs than conventional banks. They also found that the quality of Islamic banks' SME loan portfolios was comparable to that of conventional banks. Benbekhti et al., (2021), by adopting the Vector Autoregressive model (VAR) on monthly data (2009-2017), revealed that Islamic finance was a golden opportunity and a sufficient alternative financial source for SMEs in Turkey. Abdinur and Ondes (2022) also found that in the case of Somalia, SME owners and workers believe that Islamic financing had helped their businesses obtain the funds needed for their growth and expansion beyond existing markets. The study also suggested that there was a positive relationship between Islamic financing and business performance. Yussuf (2017), with data from SMEs in Nairobi, Kenya, found the positive effect of Islamic banking on the financial performance of SMEs and that Islamic banking had led to their growth financially. He also concluded that Islamic banking offers SMEs different banking products from conventional banking products. Furthermore, he highlighted that Islamic banking had ensured equitable access to credit for businesses to grow.

Islamic finance and SME's financing – opportunities and challenges

As discussed above, Islamic finance, as an alternative short-term and long-term financing source, represents an opportunity for SMEs to support their growth and development. Abdulkadir (2016) stated that Islamic finance constitutes a stimulant for financial inclusion across Africa and it is becoming an important source of financial capital for small companies and individuals. However, some challenges can prevent Islamic banking to finance SMEs. Like the conventional

[25] FSD Africa. (2024). The role of Islamic finance in promoting Kenya's real economy. Accessed from https://www.fsdafrica.org/news/the-role-of-islamic-finance-in-promoting-kenyas-real-economy/

banking system, the main challenge faced by Islamic banking is information asymmetry, a common feature that hinders lending to SMEs. For Islamic banks, the information asymmetry issue is critical as they do not charge any interest but share profits and losses with the business owners. How can these banks have the right information on the companies' profitability or return to share it according to the terms of the contract? The governments can play a role in decreasing the asymmetric information by acting as a strategic partner for an Islamic bank to identify potential SMEs. Other challenges are linked to poor and inexperienced SME management, the lack of knowledge of Islamic finance and its products, and the lack of legal and regulatory framework in which Islamic banking can finance SMEs in Eastern Africa without facing major legal risks.

Eastern African governments should work with SMEs and private and development partners to address most of these challenges to allow Islamic banks to play their role of financing the economy, particularly SMEs to support their development and growth.

In summary, Islamic banking plays a critical role in the SME segment of the economy by addressing part of their short-term and long-term financial needs through the offer of alternative financing products. Eastern African countries can leverage the development of Islamic finance in the region to support the development and the growth of their SMEs, which constitutes an important component of their economies.

4.2 Potential and capacity of Islamic financial institutions to finance industrialisation in Eastern African countries

Eastern African economies have a variety of great investment opportunities and strengths that should attract investors. The realisation of such investment opportunities can foster the region's industrialisation. However, the financing of these opportunities remains one of the main challenges faced by the countries of the region to foster their industrial enterprise. Despite the existence of these investment opportunities, the region struggles to attract significant financing to support the realisation of these investments. Indeed, the domestic financial system does not offer significant financing to support the regions' industrialisation. In addition, the region seems to be less attractive for foreign direct investments (FDI). For instance, from 2000 to 2019, although FDI attracted by the region has increased, the region captured only 0.3%

of worldwide FDI flows and 13.3% of FDI flows in Africa (UNECA, 2021). Moreover, FDI flows attracted by several countries (for example DRC, South Sudan, Uganda, and Tanzania) in the region, are resources seeking FDI, which are known to be less productive and less efficient in terms of industrialisation and their impact on economic growth and development. This type of FDI targets natural resource extraction without any domestic primary transformation.

Studies (For example, Abduh and Omar, 2012; Yazdan and Dastan, 2013; Yazdan and Sadr, 2012; Yusof and Bahlous, 2013) on the nexus between Islamic banking and economic growth are abundant in the literature. They attempt to assess the role of Islamic banks' financing in fostering economic growth in the short and long run. All these studies conclude that there is a significant relationship between Islamic banking and economic development, growth, and performance. However, there are only a few studies that examine the relationship between Islamic finance/banking and industrialisation. These studies found a positive relationship between Islamic finance and industrial enterprise, particularly in countries where Islamic banking is more developed such as Malaysia. For instance, Setyowati (2019) found that Islamic bank deposits and financing contribute significantly to boosting industrial production in Indonesia. Bougatef et al. (2020), by using the autoregressive distributed lag (ARDL) approach and Toda and Yamamoto causality test on the monthly data set for Malaysia from 2010 to 2018, found that Islamic finance had a key role in boosting Malaysia's industrial production in the short run as well as in the long run.

From these experiences, it seems that Islamic finance could have a positive impact on East Africa's industrialisation in the short and long run. This can be achieved through several channels such as the pillars of Islamic finance. Indeed, Islamic finance has three key driving pillars which are: (i) financial inclusion, (ii) spur economic activities through enterprise financing; and (iii) infrastructure financing (Dey and Jin, 2018). Through its inherent ethical, sustainable, environmentally, and socially responsible approach, which further promotes risk sharing, Islamic finance connects the financial sector with the real economy. In addition, Islamic finance offers an alternative source of long-term financing for developmental projects and infrastructures. In that vein, Islamic finance represents an opportunity for the region's economies to finance their industrial enterprise. This can be achieved through the following three main channels:

Muslim studying financial statements.
Photo Credit: Shutterstock/ Trams

- **Fostering inclusive capital markets** – Islamic finance promotes the use of additional financial products amongst consumers and companies. This accelerates the mobilisation of domestic savings, which can be used for investments in infrastructure like roads, water systems, and electrification for poor households. Furthermore, it also promotes an entrepreneurial culture. The availability of regulated Islamic financial products also enhances inclusive capital markets for the communities.

- **Encouraging alternative sources of long-term finance** – Islamic finance offers a wealth of opportunity for the Eastern African countries that are undertaking huge strides to develop their national infrastructure. However, raising long-term finance is often a key challenge to the success of these projects. Islamic financial instruments, such as Sukuk, offer an attractive solution: they provide a source of long-term funds for projects that are tied to tangible assets (like roads). Improving economic infrastructures in the region constitutes one of the necessary conditions for the industrialisation of Eastern Africa.

- **Attracting investment flows through FDI** and developing overseas partnerships – A regulated Islamic financial framework could not only support investment flows to Eastern African countries from overseas (mainly Arab countries and investors from the Middle East) through FDI but also bolsters investor protection and confidence. It will further strengthen the ongoing partnerships with foreign governments and allow for more, similar, partnerships to be developed.

The Case of Kenya

Islamic banking emerged in Kenya with Barclays launching Islamic banking products in December 2005. The sector later expanded with the introduction of two Islamic banks, First Community Bank in 2007 and Gulf African Bank (GAB) in 2008 (Gelbard et al., 2014). Other conventional banks such as Kenya Commercial Bank now offer Sharia-compliant products through special Islamic windows. In 2010, through the Finance Act, the Kenyan authorities amended section 45 of the Central Bank of Kenya Act to allow the Central Bank, as the fiscal agent of the government, to recognise the payment of a return rather than interest on government securities, thus opening up the specter of Sharia- compliant investments in the country (Ndung'u, 2011). In 2017, the Kenyan government established new measures allowing it to issue Sukuk. The then Finance Minister, Henry Rotich, outlined the state's ambitions for Islamic finance in the 2017-2018 budget, aiming to revamp the laws governing Islamic finance to issue a first Sukuk in the fiscal year 2017. The country has set up an organisation: the Islamic Finance Project Management Office (IFPMO) to coordinate and monitor its efforts in developing the appropriate regulations. In 2015, the Kenyan government introduced new regulations, allowing conventional insurers to enter the takaful domain. However, the law requires companies to set up separate takaful units whose operational management is ensured by a committee approved by a board of religious studies.

The country is positioning itself as the hub of Islamic finance to lead Eastern Africa. It can leverage its 11% Muslim population. As of 2022, approximately 19 Islamic finance institutions operated in the country. Since 2014, Kenya had developed some initiatives to boost the sector. These include industry framework, Islamic financial education, and sovereign Sukuk issuance. For instance, Kenya is among the few African countries that have already issued a legal framework for Sukuk issuance in the country. Although the share of Islamic banks' assets remains relatively marginal in the country (1%), Kenya and Djibouti lead Islamic banking in the region in terms of the sector's asset share within the banking industry. In 2019, Takaful contribution in Kenya was only US$ 11.5 million. However, the country was the third African country after Egypt and Tunisia in terms of takaful contribution[26].

The development of Islamic finance in Eastern Africa can lead to the mobilisation of significant financial resources that can be used to support the region's industrialisation and economic development and growth. Moreover, through the profit and loss sharing approach, most of Islamic banking's financings are invested in the real economy with productive assets. Based on this, the impact of Islamic finance on the regions' industrialisation could be more important compared to the impact of financings from the conventional banking system.

[26] *IFSB. (2021). Islamic financial services industry stability report (2021): https://www.ifsb.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2021_En.pdf*

4.3 Islamic finance and innovative finance in Eastern Africa

Innovative finance refers to a range of non-traditional mechanisms to raise additional funds to finance development through "innovative" projects[27]. The innovative investment approaches that try to address climate change and social responsibility are part of innovative finance. Broadly speaking, these types of investment refer to any investment strategies that combine financial return objectives, social/environmental concerns, and sustainability objectives. Within this type of investment process, not only financial returns matter but also Environmental, Social and Governance (ESG) factors are considered for the selection of projects.

The realisation of the ambitious 2030 Agenda for Sustainable Development requires the mobilisation of resources from multiple sources with the right scale and mix of financing. In 2018, worldwide, the United Nations estimated a gap of US$2.5 trillion between the annual investment needs of US$3.9 trillion and current annual investments of US$1.4 trillion on Sustainable Developments Goals (SDGs)[28]. As discussed in section 2 of this report, Islamic finance offers a new range of financing products that differ from those offered by conventional finance. Islamic finance with its equity participation and risk-sharing principles can be one of the important sources of innovative financing solutions for the SDGs. Unlike conventional finance in which investments focus on risk and return, Islamic financing has a strong social and sustainable development value component. The vision of Islamic finance is to be a source of stability against the dangers of over-leverage and short-termism in the current global financial system. Together, these principles can potentially promote entrepreneurship and responsible risk-sharing in global financial systems. Furthermore, Islamic finance principles and funds can be applied beyond the Islamic community.

With increased awareness and an appropriate enabling environment, Islamic finance could generate a significant contribution from capital markets and the Islamic banking industry toward financing SDGs for Eastern African countries. In that sense, the potential Islamic finance has in Eastern Africa could be leveraged to fill the financing gaps for social and sustainable development in the region.

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[27] Wikipedia. (2024). Innovative financing. Accessed from https://en.wikipedia.org/wiki/Innovative_financing

[28] United Nations Department of Economic and Social Affairs. (2018). Innovative Financing for the SGDs: The Role of Islamic Finance. Accessed from https://www.un.org/esa/ffd/ffdforum/events/event/innovative-financing-for-the-sdgs-the-role-of-islamic-finance.html

Business owner working in his store.
Photo Credit: Shutterstock/ FG Trade

4.4 Role of Islamic finance in promoting intra-regional trade in goods and services in the context of the AfCFTA

The African Continental Free Trade Area (AfCFTA) is a free trade area established with an agreement signed on 21 March 2018 in Rwanda between African countries. The main objective of the AfCFTA is to achieve a deeper integration of African economies. As a project of 'deep integration', AfCFTA involves the free movement of goods, capital, and people. Under the agreement, AfCFTA members are committed to eliminating tariffs on most goods and services over a certain period depending on the country's level of development or the nature of the products. In detail, the long-term objectives include creating a single, liberalised market; reducing barriers to capital and labour to facilitate investment; developing regional infrastructure; and, establishing a continental customs union. The overall aims of AfCFTA are to increase socioeconomic development, reduce poverty, and make Africa more competitive in the global economy.

As AfCFTA should, over the long term, eliminate or reduce tariff barriers across African countries, this should increase intra-regional trade of goods and services. Islamic finance as an alternative source of financing could help the successful implementation of the agreement, which could definitively lead to the promotion of intra-regional trade in goods and services. This can be achieved through several channels with the main ones listed as follows:

- **Financing of economic infrastructures** (for example, roads, bridges, railways, telecommunication) to connect African countries to facilitate the movement of goods and people. For the success of AfCFTA, people and merchandise need to move from one country to another. This is a key and necessary condition to have the trade agreement work better. Currently, African countries are less connected as there are not sufficient roads, railways, and telecommunication infrastructures to easily move from one place on the continent to another. This means that African countries need to develop new and significant economic infrastructures to increase connectivity among countries. Islamic finance, particularly the issuance of Sukuk can be used to finance such economic infrastructures.

- **Financing of the development and growth of local enterprises** to boost their production to target a larger market. By accessing a larger market, domestic enterprises need to invest to increase their production (quality and quantity). This will require long-term investments and financings. Part of these financings can come from Islamic finance institutions. It has already been demonstrated above that financings from Islamic finance based on profit and loss sharing mechanisms have a positive impact on industrial production. By providing financing to support industrial production, Islamic finance can definitively play a key role in promoting intra-regional trade in goods and services.

- **Financing of trades through Islamic trade finance products** Islamic finance has trade finance (short-term) products that can be used to support the development of trade on the continent. There are some Islamic financial institutions such as the International Islamic Trade Finance Corporation (ITFC), a member of the Islamic Development Bank (IsDB) specialised in the development of trade. With a larger African market, traders will need to have the support of the banking sector to finance their activities. Islamic finance through its trade finance vehicles and products can play an important role in promoting trade.

Islamic finance can support the development and growth of Eastern African economies by providing them with alternative resources to fill the financial gaps. This contribution can also have a positive impact on the industrialisation of the region and can play a key role in promoting intra-regional trade in goods and services in the context of AfCFTA. However, these positive impacts on the region's economies will be significant only if Islamic finance develops and reaches a certain size and share of the region's financial market.

5 SKILLS, COMPETENCIES GAPS, LEGAL AND REGULATORY ISSUES, AND OTHER CONSTRAINTS IN ISLAMIC FINANCE IN EASTERN AFRICA

5. SKILLS, COMPETENCIES GAPS, LEGAL AND REGULATORY ISSUES, AND OTHER CONSTRAINTS IN ISLAMIC FINANCE IN EASTERN AFRICA

This part of the report discusses Islamic finance skills and competencies requirements with their gaps in the Eastern Africa region. The legal and regulatory requirements are also discussed.

5.1 Skills and competencies requirements in Islamic finance

Competency is a characteristic of an individual that is correlated to job performance (Hodges and Burcell, 2003). It refers to the capability of someone to perform certain skills. Mitchell (2003) defines competencies as skills, abilities, and attributes that complement the field of specialisation of employees for work performance. Under normal circumstances, those who possess competency should result in acceptable or even superior job performance. Kanungo and Misra (1992), however, differentiate skills and competency. According to them, skills are the ability to engage in specific behaviours to accomplish specific routine tasks and they can be learnt from training and experience. Competency on the other hand is the ability to engage in non-routine cognitive and intellectual activities which would enable someone to cope with uncertainty in the environment.

Islamic finance is not designed and does not work like a conventional financial system. It has its own business model and rules based on a profit and loss sharing approach in line with Islamic laws. Hence, all the products are designed to be Sharia-compliant. This means that Islamic finance's products are not structured in the same way as the conventional financial system's products. These products are more challenging to be structured and implemented than conventional finance ones. Therefore, Islamic finance professionals will need to have specific skills and knowledge on top of the general finance skills and competencies. These specific skills and competencies requirements are linked to the specificities of Islamic finance and are summarised as follows:

- **Sharia law knowledge**: The starting point in terms of competencies and knowledge in the Islamic finance industry is to have a better understanding of the Islamic law aspects/provision related to the practice of ribã. The key objective is to know what is accepted and what is forbidden and why and how to deal with these.

- **Profit and loss sharing mechanism:** The practicalities of the profit and loss sharing mechanism applied in the Islamic finance industry within its business model should be well understood. How to define the sharing mechanism (distribution rate of the loss or profit) for each specific transaction, and how to monitor each transaction during its lifecycle to follow up on the performance of the investment are key aspects to be understood.

- **Understanding of Islamic finance products**: As discussed above, Islamic finance products are designed to be Sharia-compliant and are in line with the profit and loss sharing mechanism. This means that Islamic finance products are specific to this industry, and they should be well understood by professionals, investors, and customers of the system. This is key for the professionals to be able to sell these products and explain them to their clients. This is also important for the investors and the clients to be able to choose the right products that meet their investment and financing needs.

- **Other basic and usual skills/competencies**: These include basic finance skills and competencies as well as soft skills such as people skills, which cover a range of skills and competencies (emotional skills, collaboration/teamwork, problem-solving ability, ability to build relationships - inter-personal skills, selling skills, capacity to influence, conflict management, communication, adaptability, flexibility). These skills and competencies are key to growth and success in all organisations, including Islamic finance institutions.

5.2 Skills and competencies gap in the region

According to Salh and Mohammed (2019), the Islamic financial industry has a problem with talent and there is a huge shortage of suitably skilled employees working within the industry. Such a lack of Islamic finance skills and competencies is not a specific issue for Eastern African countries. It is a worldwide industry issue mainly explained by the fact that Islamic finance is relatively new and so far, there is an insufficient number of education and


Muslim woman shopping at public market.
Photo Credit: Shutterstock/ martinedoucet

training centres for it. Salh and Mohammed (2019) also conclude that this situation harms the performance of Islamic finance institutions slowing the development and the growth of the industry. If not addressed, the Islamic finance industry could lose instead of gaining market share.

Islamic finance remains poorly understood across many markets, including Eastern African markets. Conventional aspects of modern commercial banking and capital markets practices have existed and have been taught in all universities and schools for many decades. Hence, the principles and concepts in the conventional finance system are well understood and mastered by all (professionals, investors, and clients). But modern Islamic finance is relatively new as discussed in the second part of this report. It is not surprising that Islamic finance actors, particularly in Eastern African countries, do not have the full knowledge of the industry. As discussed, this situation is mostly explained by the shortage in education and training centres dedicated to Islamic finance. In Eastern Africa, not all universities and schools offer courses and diplomas in Islamic finance. For instance, in Kenya, it seems that only four (4) universities and colleges (Umma University in Kajiado, Greenwich College in Garissa, Kenya Institute of Foreign Languages and Professional Studies in Nairobi, and The East African University in Kajiado)[29] offer courses and diplomas in Islamic finance. This means that Islamic finance concepts, products, and practices are not known or mastered by most graduate students nor by financial professionals in the region who have never worked in an Islamic bank or a conventional bank with an Islamic banking window. The skill and competency gaps in the sub-region cover those specific to Islamic finance.

To promote Islamic finance in the region and fill the competencies gaps in the industry, universities and schools will need to start teaching this type of finance. They should design and offer specific courses in Islamic finance to students in finance programmes. These courses should cover all the specificities of Islamic finance. In addition, establishing training centres for creating talents in Islamic finance by Islamic financial institutions would also help to develop industry knowledge, skills, and competencies. This is key to provide students in finance and professionals with the required knowledge in Islamic finance.

[29]Kenyaplex. (2024). Colleges and Universities Offering Diploma in Islamic Banking and Finance (Islamic Banking and Finance) in Kenya. Accessed from https://www.kenyaplex.com/courses/3601-diploma-in-islamic-banking-and-finance-islamic-banking-and-finance.aspx

5.3 Legal and regulatory requirements of Islamic finance within the financial sector ecosystem

The development of Islamic finance in a specific jurisdiction is fully linked to the legal and regulatory framework in place. A lack of, or a gap, in the legal and regulatory framework for Islamic finance is a key driver of the less developed Islamic finance industry in a country. Hence, the introduction of the relevant regulations in Eastern African countries is the starting point and necessary condition for the successful development of Islamic finance. This should come with the standardisation of products, documentation, and business practices. Also, the question of what is and is not Sharia-compliant will inevitably improve awareness of Sharia-compliant products and increase the efficiency with which they can be deployed to meet public and private sector funding needs. This type of standardisation already exists in other regions where Islamic finance is more widely used, such as the Gulf Cooperation Council states and Malaysia (Dey and Jin, 2018).

A legal and regulatory framework for Islamic finance should address the rules and laws around the practice and the system's specificities such as the practice of interest-free financing products and profit-and-loss sharing approach as well as other types of consideration. For instance, general considerations for unsecured Sukuk financing, which do not arise in conventional unsecured bond issuances, include[30]:

How the laws of the relevant jurisdiction (including any foreign ownership restrictions) treat asset transfers, especially where onshore assets are to be contractually sold to foreign special-purpose vehicles;

Whether the tax code (and any exemptions and reliefs laid out therein) of the relevant jurisdiction applies to Sukuk issuances, in the same way, it does to bonds;

If the tax code does not apply to Sukuk issuances in the same way it does to bonds, how the regulatory treatment of Sukuk (or other Islamic finance products for that matter) can be afforded equivalence to its conventional/non-Islamic counterparts under the applicable laws.

[30] Lexology. (2018). Islamic finance in Africa: Opportunities and challenges. Accessed from https://www.lexology.com/library/detail.aspx?g=a894d8a4-f5e7-45bc-9b6a-05ac657e8984

Without amendments to existing tax codes, the asset-based nature of Islamic finance may trigger various tax payment obligations from country to country that are not involved in conventional finance. These could include registration tax/stamp duty land tax, VAT (Value Added Tax), capital gains tax, and withholding tax. Regulatory consideration is required to harmonise these issues.

In Eastern Africa, the existing laws for the financial system of most of the countries were not designed to cater to interest-free financing based on the sharing of economic risks and rewards, and achieving returns by reference to the performance of Sharia-compliant assets. To allow the implementation of Islamic finance, some countries in the region have already amended their conventional financial system laws to include Sharia-compliant aspects. These have established a limited legal framework in which Islamic financial institutions can operate. However, not all the countries in the region have done such a move. The table below summarizes the current state of Islamic finance's legal and regulatory framework in the region.

Table 6: Current state of Islamic finance's legal and regulatory framework in Eastern African countries

Countries	Current state
Kenya	No legal and regulatory framework is fully dedicated to Islamic finance. However, Finance Act section 45 has been amended to allow Islamic finance institutions to operate
Djibouti	In 2011, a regulatory and institutional framework specific to Islamic finance was adopted
Tanzania	No legal and regulatory framework for Islamic finance
Burundi	No legal and regulatory framework for Islamic finance
Uganda	Financial Institutions Act 2004 was amended in 2016 to allow companies and banks to offer Islamic finance banking services
Rwanda	No legal and regulatory framework for Islamic finance
Eritrea	No legal and regulatory framework for Islamic finance

Madagascar	No legal and regulatory framework for Islamic finance
Seychelles	Legal and regulatory framework to allow Islamic finance institutions to operate adopted in 2014
Comoros	No legal and regulatory framework for Islamic finance. However, the country hired DM consulting firm to assist in developing a legal and regulatory framework for Islamic finance
DRC	No legal and regulatory framework for Islamic finance
South Sudan	The country inherited Sudan's fully Islamic financial system and is pushing to convert it into a conventional banking system
Ethiopia	No legal and regulatory framework for Islamic finance. All guidelines issued to regulate "conventional" banks are applied to Islamic banks
Somalia	The country is fully ruled by Islamic laws, which means that existing financial system laws are Sharia-compliant

Source: Author's compilation from various sources

Regulatory gaps in Eastern Africa will take time to be addressed, but positive trends are already evident. Sharia-compliant regulatory frameworks are emerging in more and more Eastern African countries. Eastern African policymakers and end-users have also engaged with more developed Islamic finance markets, and are on a learning curve. To accelerate that learning process, Eastern Africa will need to explore opportunities to learn from best practices in established Islamic financial markets in the GCC and Europe and specialised Islamic financial organisations. There are several specialised international Islamic financial institutions established to support the development of Islamic finance. These institutions can support country members to improve their legal and regulatory frameworks. They include the Islamic Financial Services Board (IFSB); the Islamic Development Bank (IsDB); the International Islamic Financial Market (IIFM); the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI); the International Islamic Rating Agency (IIRA); the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA); and the General Council of Islamic Banks and Financial Institutions

Muslim woman paying with card in restaurant.
Photo Credit: Shutterstock/ MilosStankovic

(GCIBFI). Eastern African countries can join these institutions to benefit from their support in establishing the right legal and regulatory framework consistent with Islamic laws for the development of Islamic finance in the region.

It is clear that without the required legal and regulatory framework that caters to Islamic finance products and specificities, including the profit and loss sharing approach, it will likely prove difficult to reach the critical mass necessary for Islamic finance to flourish and have a positive impact on economic development and growth of these countries.

Overcoming this regulatory challenge requires that Eastern African governments continue to promote changes in their regulatory frameworks to facilitate the penetration of Islamic financial products and services, and enhance their attractiveness to domestic and international stakeholders alike.

6 CONCLUSION AND RECOMMENDATIONS

6. CONCLUSION AND RECOMMENDATIONS

Islamic finance is a financial system that provides Sharia-compliant (Islamic laws) financial products and services. The system is based on interest-free financing with a profit and loss sharing mechanism to reward financial institutions for providing financial services. In other words, Islamic finance provides ethical financial services.

Over the past decades, Islamic finance had a significant expansion across the world. The total assets of institutions offering Islamic financial products and services have grown by almost 25% a year over the past decade to reach US$2.7 trillion in 2020. The total asset of Islamic banks, which are the main component of Islamic finance, reached US$1.7 trillion as of the end of 2021. Although Islamic finance's assets are mostly concentrated in the Golf Cooperation Council countries, the development of Islamic finance over the last decade is not limited to only Muslim countries. It has expanded in the USA and Europe where conventional banks offer more and more Sharia-compliant products and services to address the needs of the increasing number of Muslims in these countries.

In Eastern Africa, Islamic finance is at its early stage of development with approximately 84 financial institutions in 2022, a sharp increase from 16 institutions in 2012. 23 Islamic financial institutions are located in Ethiopia and 19 entities in Somalia and Kenya. However, Djibouti and Kenya, in this order, are the leading countries in terms of the share of Islamic banking assets in total banking assets within the country with, respectively, 25% and 1% in quarter three 2020.

Islamic finance represents an alternative financing opportunity for Eastern African countries to partly fill their financing gap. In addition, this could increase financial inclusion, support the development and the growth of SMEs and contribute to fostering industrialisation in the region. However, despite the growth potentiality of Islamic finance in the region, with an important share of the Muslim population, the development of this financial system is currently limited in Eastern Africa. This is mainly explained by lack of knowledge, shortage of education and training centres, as well as absence in many countries of a formal and dedicated legal and regulatory framework for Islamic finance as the existing laws, were designed for conventional finance and not for Sharia-compliant financing.

To support the development of Islamic finance in the region that will, in turn, have a positive impact on Eastern Africa's economic development and growth, the main challenges faced by the system will need to be addressed. The following recommendations are intended to help policymakers to address these challenges:

- Design specific and dedicated legal and regulatory framework for countries that do not have such a framework;
- Join international Islamic financial organisations to leverage their assistance on standardisation of Islamic finance products, documentation, and business practices;
- Include Islamic finance in the curriculum of universities and schools;
- Create Islamic finance training centres for financial professionals.


Muslim woman customer paying using mobile payment.
Photo Credit: Shutterstock/ Zuraisham Salleh

Appendices

Annex 1: List of Islamic Finance Institutions in Selected Eastern African Countries

Countries	Islamic bank windows	Full-fledged Islamic banks	Microfinance	Takaful (Insurance)
Kenya	Gulf African Bank, Sharjah Islamic Bank, DIB Bank Kenya Limited, First Community Bank, Absa Bank Kenya, Salaam Africa Bank	Chase Bank, SBM, NIC Bank, Standard Chartered Bank, Barclays Bank, Diamond Trust Bank, KCB, Imperial Bank, National Bank of Kenya	Uwezo Microfinance Bank Limited, Asante Finance Group	Takaful Insurance of Africa, Kenya Reinsurance Corporation
Djibouti	Salaam African Bank, Saba Islamic Bank, East Africa Bank	International Investment Bank, Banque pour le Commerce et l'Industrie Mer Rouge, Commercial Bank of Ethiopia, Djibouti	Unité Pilote de Microfinance Islamique	Tamini Insurance
Tanzania	Amana Bank Limited	CRDB Bank, Azania bank, KCB Sahl Bank, National Bank of Commerce, PBZ Ikhlas, Stanbic Bank		
Burundi		KCB Bank Burundi Ltd, CRDB Bank		
Uganda	National Islamic Bank of Uganda	Afrixembank	Asante Finance Group, Microfinance Support Centre Ltd	AL-Takaful Islamic Uganda Insurance Company
Rwanda			Asante Finance Group	

Seychelles	Al Salam Bank			
Ethiopia	Hijra Bank S.C, ZamZam Bank, Salaam African Bank, Zad Bank, Shabelle Bank,	Coop Bank of Oromia, Enat Bank, Awash Bank, Bank of Abyssinia, Dashen Bank, Commercial Bank of Ethiopia (CBE), Dashen Bank, Commercial Bank of Ethiopia (CBE), Oromia International Bank, Nib International Bank, Hibret Bank, Bunna Bank, Debub Global Bank, Wegagen Bank		Global Insurance, Ethiopia Reinsurance, Awash Insurance Company, Oromia Insurance Company
Somalia	Amal Bank, Amana bank, Bushra Business bank, Dara-Salaam Bank, Dahabshil Bank International, Daryeel Bank, First Somali Bank, Galaxy International Bank, IBS Bank, Idman Community Bank, Premier Bank, Sombank	My Bank Limited		Takaful Insurance of Africa, Baraka Takaful Insurance, Amanah Insurance, First Somali Takaful and Retakaful Insurance, Horn of Africa Insurance Company,

Source: Author's compilation from various sources

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