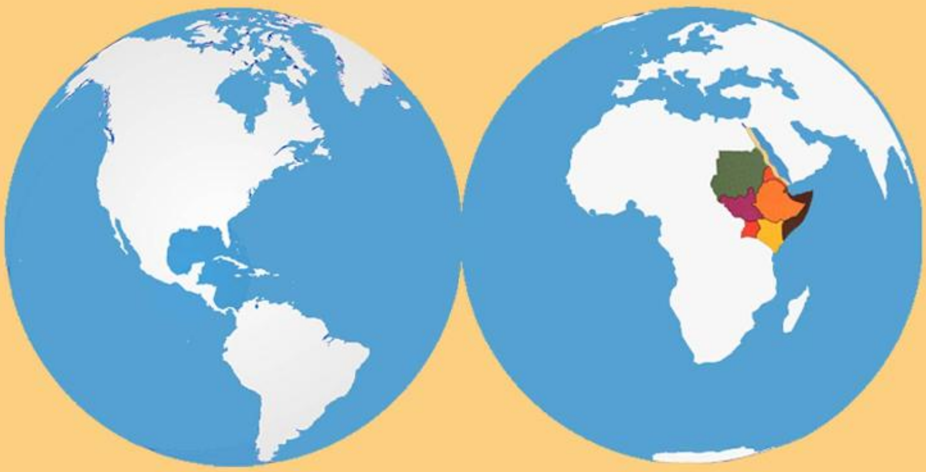
The Horn Economic and Social Policy Institute

The Prospects and Challenges of Islamic Microfinance in the IGAD Region

by Ms. Rahma Hersi, in Association with HESPI Staff



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List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BBK	Barclays Bank Kenya
CBOS	Central Bank of Sudan
CFA	Chartered Financial Analyst
CMA	Capital Markets Authority
FCB	First Community Bank
FSA	Financial Services Authority
GAB	Gulf African Bank
GCC	Gulf Cooperation Council
HRMC	Her Majesty's Revenue and Customs
IBS	International Bank of Somalia
ICD	International Cooperation Development
ICCIA	Islamic Chamber of Commerce, Industry and Agriculture
IF	Islamic finance
IFSB	Islamic Finance Service Board
IGAD	Intergovernmental Authority for Development
IMFI	Islamic Micro-Finance Industry
KCB	Kenya Commercial Bank
MAISA	Mit-Ghamr Islamic Saving Association
MIX	Microfinance Information Exchange Market
NBE	National Bank of Ethiopia
NBK	National Bank of Kenya
OIC	Organization of Islamic countries
PASED	Port of Sudan Association for Small Enterprise Development
PFC	Pilgrim Fund Corporation
PFMA	Public Finance Management Act
SACCO	Savings, Credit and Cooperative Organizations
SME	Small and Medium Enterprise
SRD	Strategic Roundtable Discussion
UNCCI	Uganda Chamber of Commerce and Industry

Preface

This report commissioned by the Horn Economic and Social Policy Institute (HESPI) is a review of the challenges and prospects of Islamic Microfinance in the IGAD sub region. The study is based on a desk review that relied mainly on secondary sources of information.

The report has benefited from various reports in the public domain on Islamic Microfinance prospects and challenges with particular focus on the IGAD region. It also tried to bring in experiences on the subject from other regions. The targeted beneficiaries of the report are policy makers and other interested stakeholders in the promotion Islamic of Micro-Finance and Financial Inclusion for economic equality and development.

The views expressed in the report are those of the author and do not necessarily reflect the opinions of the Board of Directors or the management of the Institute that cleared the dissemination of the report.

Executive Summary

There is wide range of evidence-based research support that Islamic Microfinance (IsMF) or interest-free microfinance is found to be instrumental to reach the marginalized and religiously observant Islamic poor. The scheme prohibits paying pre-determined interest. It intends to meet the financial needs of interested Muslim borrowers with microloan models and products that comply with the sharia law (not making interest) and addressing their quest for accessing finance in the fight against poverty. The scheme is meant to provide microfinance services in compliance and coherence with Islamic rules, moral values of social solidarity as it promotes the fact that money has no intrinsic value.

Many countries in the world such as Singapore, Hong Kong, even Europe and some other non-Muslim countries are now paying attention to IsMF. Islamic Finance (IF) and IsMF are found to be an alternative option to the global financial system because of their stability, pro-poverty alleviation orientation and reduction of income inequality. The 2007 survey for the Consultative Group to Assist the Poor (CGAP) concluded that "IsMF has the potential to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor and marginalized groups."

Though there are documentations on IsMF in many regions of the world, little is written about it in the IGAD region and the Sub Saharan Africa at large. Therefore, assessing its state and legal/regulatory framework in the region is difficult due to data limitations. Nevertheless, some observations from the International Monetary Fund (IMF) and the World Bank (WB) reports as well as a few research work in the member countries indicated that there are large unmet demand for IsMF products given the large number of religiously observant Muslims, low financial inclusion and limited providers of the service (Ibrahim, 2017).

Demographically, there are significant proportions of Muslim population in the IGAD region who avoid microloans from conventional financial institutions for reasons of sharia compliance. The concentration of such community groups is higher in Islam majority countries of the region such as Somalia, Sudan and Djibouti with growing numbers of such groups in Eritrea and Ethiopia. The Muslim poor in the region exclude themselves from the conventional financial system because of their faith and beliefs.

Studies show that poverty and financial exclusion go hand in hand. For example, the WB and the Islamic Development Bank (IDB) joint studies (2016) indicated that promises of fostering financial inclusion for poverty alleviation and tackling widening economic inequality can be realized by factoring access to finance into other pro-poor measures. Attempt to enhance shared prosperity and curb the abject poverty must therefore address the issue of financial exclusion in regions like IGAD with large number of underserved Muslim Population. Such community groups should enjoy feasible and religiously sound microfinance alternatives for creation and development of household livelihoods and run various forms of micro-enterprises.

There has been growing literature support to the fact that IsMF can be instrumental in the fight against poverty as it has the potential to render on its intents and is considered as key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic Laws (Karim *et al* (2008). Multilateral organizations such as the IMF and the WB have also tapped into the industry to solve problems facing some of the poorest people. The scheme is fueled by increased attention from governments, central banks, donors, and commercial Islamic banking and finance institutions (IBFIs).

On top of its steady growth, the scheme is also said to be resilient to shocks compared to its conventional counterparts owing partly to the differentiating principles that govern the IsMF such as equity, active participation, ownership, and risk sharing feature and strong links to real activities.

This study conducted by the Horn Economic and Social Policy Institute (HESPI) therefore bids to understand the growth trends of IsMF globally and in the IGAD region followed by analysis of available enabling legal and regulatory environment to promote the scheme in the member countries. The report also tried to unearth key challenges hindering the thriving of the scheme and provides policy recommendations helpful to promote it in the IGAD context to support the regionalized fight against poverty and realization of the Sustainable Development Goals (SDGs) by way of creating more access to finance or microloans.

Historical accounts witness that the IsMF started and had its anchor in liquidity-rich Gulf States and gradually expanded to other countries in Asia and Africa. The IsMF has shown growth trend under the umbrella of the IF industry. According to Ernst and Young (2016) estimate, the IF has been growing at about 14% annually and the worth of worldwide IF assets leapt from half a million dollars in the 1970s to over one trillion USD by 2009. The same sources also estimated that global Islamic asset will top 3.4 trillion USD by 2018.

While Islamic banking and finance have long been dominated by the liquidity-rich, advanced economies in the Persian Gulf, the fastest growing markets are now more evenly spreading across the world. According to some seminal reports on IF such as Zourai (2014), Qatar, Indonesia, Malaysia, Saudi Arabia, Turkey and the United Arab Emirates are estimated to currently hold 80% of IBF assets, with a five-year compound annual growth rate (CAGR) of 18% from 2009 to 2013, and an expected CAGR of 19% from 2014 to 2019.

Though the IGAD member countries are evaluated to be at various stages in engulfing IsMF scheme into their conventional financial system as a financial access and inclusion tool, there are overall indications of growth trend of the scheme. Success case stories with IsMF in helping the poor Muslim communities in building their livelihoods have been reported from Djibouti and Sudan (Ali, 2015). Yet, though the scheme is sought to be Potential Avenue for financial inclusion in the IGAD, it is still a tiny share of the microfinance industry even in the Muslim majority Countries of the region (IMF, 2017).

This study has shown that though IsMF, as an extension of the Islamic Banking and IF, have been long introduced in the IGAD member countries such as Sudan and Djibouti, most of them are at their early stages in practicing it and creating enabling legal and regulatory environment. Islamic windows with the commercial banks have been the starting point and move to wider operational arrangements.

Countries like Ethiopia and Eritrea are at their exploring stages and shown recognition to the scheme. Uganda and Kenya tried to make systematic amendments in the existing financial directives to accommodate the scheme. Though Somalia has been identified as Islam majority country, the prolonged civil conflicts have devastated FIs and hence the legal framework has to be rebuilt. Similarly, South Sudan lacks the Financial Institutional basis to promote the IsMF.

IsMF has been struggling to get adequate policy support and find sustainable business models with a broad array of microloan products that can meet the diverse financial needs of religiously observant poor Muslims in the IGAD. The scheme also suffered lack of public awareness and financial and faith-based advisory institutional capacities. Therefore, the countries are required to ensure political will, include the scheme in financial inclusion plans, and develop enabling legal and regulatory environments.

This report is structured in such a way that in its introductory sections, it assessed IF and its historical growth trends globally and in the IGAD region with particular focus on member countries.[1] It also looked into the available enabling environments and policy frameworks. The historical accounts summarize that the scheme is a useful and growing financial access tool that was initiated to comply with the Islamic Law, helpful to solve some of our modern-day challenges to combating poverty.

The section on country-by-country assessment outlined the growth status and analysis of enabling legal and policy environment; the potential challenges and constraints that would hamper its growth; the available opportunities therein. The various available feasible IsMF models have also been assessed. In this vein, the report addresses mechanisms how the challenges can be tackled by countries or regions with more advanced and mature IF markets.

To streamline the various views and empirical conclusions, the report also included a section on literature review where it outlined the state of the play of the scheme worldwide and in the region, its growth and expansion trends, its utility in fighting poverty and promoting financial inclusion. Though most of the empirical conclusions take a mixed stands on these saying that the debates and evidences are not yet complete, sizeable number of descriptive writers fully support the notions and the positive claims. Literature or data in the IGAD region (addressing the region as a single entity) remains to be scanty-hence the reviews largely focused on country-by-country observations.

The assessment indicated that IF (and therefore IsMF) in the region are at their infancy except for a few window services in some commercial banks. Sudan has the oldest IF experience in the region followed by Djibouti, Kenya, Uganda and Ethiopia which have included the aspects of Islamic Banking services in their banking sector directives. Enforcement of the legal provisions is difficult due to negative perception of the people and government toward IF, standardizing of the models, financial illiteracy, war/conflicts, shortage of competent human resources, lack of technical and advisory institutions, etc.

It is important to closely and deeply see the challenges and draw lessons from advanced IsMF markets. As the scheme provides useful social and economic values, principles and goals of poverty reduction, the IGAD member states should provide adequate inputs as well as create enabling secular legal and policy environment. By so doing, they are ought to prove to be consistent with and support the achievement of the common goals enshrined in the SDGs by way of promoting financial inclusion. Also, the policy actions should pave the way for more people that were heretofore not part of the traditional financial industry for various reasons including financial literacy, faith based reasons, under developed banking systems and conflict and war to name a few.

In a nutshell, the policy and operational measures the IGAD member states take in favor of the IsMF scheme will contribute to financial inclusivity and sustainable development. At a regional scope, this would also lend to building bridges between different peoples and different countries that may not necessarily have carried out business together because of religious tension or civil war. Financial inclusivity can also be seen to be a powerful tool to eradicate violent extremism as young people who engage in these acts are sometimes in it only for financial gain and not because they support any ideology that seeks to harm people. Productive youth and communities will lead to more positive and impactful growth for the economy of the IGAD region.

[1] *The assessment included Eritrea to have full regional view*

1. Background

1.1 Introduction to the Islamic Finance Industry: A historical account

Islamic Finance which is the fulcrum for Islamic Microfinance (IsMF) is an emerging financial system which is a confluence of a faith into ethically sound business practices to support humanity. It is a venture where economics and religion blend to provide people holistic life support and is based on religious moral code and values being introduced to people's economic lives in the form of livelihoods building, poverty reduction, etc. IsMF is therefore a branch of the Islamic financial system that seeks to implement financial inclusion with the purpose of contributing to the efforts of poverty alleviation amongst the lower income populous of the Islam communities.

Historically, the IF has existed since the onset of Islam and since the beginnings of Judaism and Christianity. Its evolution incrementally continued until the beginning of the 20th Century when most of the Muslim world was impacted by challenges like colonialism and secularism that were not in tandem with the religion's principles (Zouari, 2014). This trend continued into the 1960's when what is now considered as IF in its modern form was seen to be pioneering in Egypt with the Mit-Ghamr Islamic Saving Association (MAISA) by El-Naggar, which mobilized the savings of Muslim investors, providing them with returns that did not transgress the Islamic (sharia) Laws. Subsequently, the Pilgrims Fund Corporation (PFC) established in Malaysia as early as 1963 enabled Malaysian Muslims to save gradually and invest in Sharia compliant instruments with the purpose of supporting their pilgrimage expenditures.

Other major developments in the evolution of modern day IsMF emerged when the Dubai Islamic Bank was established in 1970 in the United Arab Emirates (UAE) which paved the way for the establishment of the Islamic Development Bank (IsDB) in 1975, the Faisal Islamic Bank in Sudan and the Kuwait Finance House (Kuwait) back in 1977. Though there are ongoing debates among idealistic and realistic schools of thoughts on ideological and economic grounds of IF, the role of the scheme is believed to have been eminent on dealing with financial exclusion in Muslim majority countries. The scheme also has high potential for growth.

Tangentially with the growth of the IF industries, there are some steps taken to make the financial system conform with the sharia principles. In Pakistan, the legal framework was amended in 1980 to allow for the operation of *Sharia compliant profit-sharing financing* companies, and to initiate bank finance through Islamic instruments. Similarly, Iran enacted a new banking law in 1983 to replace conventional banking with interest-free banking. The law gave banks a window for their operations to become compliant with Islamic principles. Within the IGAD region, Sudan's efforts to align its entire banking system with *Sharia* principles began in 1980's.

The fundamental principle of the emergence of the IF was abolishing interest on lending, which has been historically known as *usury*, and was considered common to the three Abrahamic faiths. It exists within the ambit of Islamic Law where Muslim jurists extracted principles of law from the Primary Source of the Quran (the Holy Book of Islamic faith) and the traditions of the Prophet, (which included His sayings and acts). These principles in summary included:

1. Prohibition of Interest
2. Application of Commerce (sharing of profits and loss)

3. Avoidance of ambiguity in contractual agreements
4. Prohibition of high speculative transactions
5. Prohibition from conducting business involving prohibited commodities such as pork, alcohol, gambling and pornography

Anchored on these fundamental principles, the IF is addressing the issues of providing financial services for the poor and low-income people whose low economic standing excludes them from formal financial systems. As the IF is conforming to Sharia; mainly prohibition of the payment and the receipt of Riba (interest) in a financial transaction, it has the potential to provide opportunity.

Its utility to fighting poverty and promoting growth is also being recognized and gaining the support of policy persons, academicians and leaders of financial institutions. For example, Christina Lagarde, the IMF's Managing Director, said during the IF conference held in Kuwait in 2015 that *"Islamic Finance has two major things to offer and that is Inclusivity and Stability"* and both are needed in our modern day economy. Multilateral institutions such as the IMF and the WB using IF facilities such as an Islamic Bond amounting US$ 500 million Islamic bond to finance and strengthen some of the poorest countries health systems (Michael Bennet, 2013).

1.2 Current Islamic Finance wealth status, reach and growth trajectory

The establishment and strengthening of the aforementioned institutions provided the leverage for the growth of the industry and has led to the modern-day IsMF advancing reach, which includes over 450 financial institutions globally and close to 2.1 Trillion US dollars in assets that continues to grow at a rate of 15.2% annually in 2014 (IMF, 2015).

Gates foundation in 2015 reported that the worth of worldwide Islamic financial assets leapt from half a million dollars in the 1970s to over one trillion USD by 2009. With an annual growth rate of around 14 percent, assets have doubled over the past five years, and now exceed two trillion USD.1 Ernst & Young estimates that global Islamic assets will top 3.4 trillion USD by 2018.

The industry is rapidly growing globally and in the different regions of the world. Its wealth has shown steady growth and its geographic stretch pattern correlates with the concentration of the Muslim Population. The IF growth trend has also shown resilience to financial shocks due to its better risk sharing arrangements[2] compared to its conventional counterparts. According to the IMF reports, the aftermath of the global crisis in 2008-2009 where the traditional banking segment indicated to have experienced losses of close to US$ 3 trillion and no IF industry suffered the same repercussions and thus no bail outs were given to the IF institutions (IMF, 2016).

However, undeniably, the same reports ascertained that due to sharply declining trends in oil prices, slow economic pace and the Arab spring, the trend of Islamic banking, IF and IsMF were slow-paced in 2016 in the Middle East and Arab region, while a sufficient development was recorded in Africa, Central Asia and the Far East.

By 2017, the total volume of the industry is expected to be USD 2.7 trillion (Mughal, 2017) with a steady growth of approximately 13% to 15% in the IF market during 2017 and the total volume crossing the USD 3 trillion figure by 2020. Back in 2006, the banker and KMG reported that the industry witnessed development of over

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[2] *In IsMF risk is shared among the lending company and the borrower*

500 Sharia-compliant institutions, whose reach spanned in 75 countries (KPMG, 2006; The Banker, 2007). In 2007, the Banker reported that its geographic coverage was limited to 36 percent of the industry located in the GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and UAE), 35 percent in non-GCC Southwest Asia and North Africa, and 23 percent in Asia (primarily Malaysia, Brunei, and Pakistan) (The Banker 2007). Indonesia, Malaysia, Turkey, Pakistan, U.A.E, Qatar, Saudi Arabia, Kuwait and Bahrain are prominent with their total assets of Islamic Banking contributing 82% to the global Islamic banking market.

Over time, IF services geographically expanded well beyond the Muslim dominated world and today are offered not only by Islamic banks, but also by Islamic subsidiaries of international financial institutions. The services are currently provided in countries such as India, China, Japan, Germany, Switzerland, Luxembourg, the United Kingdom, the United States, and Canada. Alam et al (2015) reported that the global assets exceed $925 billion in2015 with some individual country shares of Islamic Banking in National Banking with 51.2% in Saudi Arabia, 45.2% in Kuwait, 29.3% in Bahrain, 25.8% in Qatar, 21.6% in UAE, 21.3% in Malaysia and 10.4% in Pakistan. Morocco, Uganda, China and Russia are expected to have a good start in Islamic banking by 2017 (Mughal, 2017). Despite its origins in the Persian Gulf, Sharia-compliant banking has proved popular across North Africa and Asia.

The sector is still largely dominated by a few providers in a few countries that rely only a few products (CGAP, 2008). The largest Islamic banking markets are still in the Middle East and North Africa (MENA) region spearheaded by Iran with MENA excluding the GCC accounting for 27.4% of the total banking assets worldwide (Ismail, 2017). There are notable exceptions, however, such as in Indonesia where the average Islamic product loan size is 45 percent higher than the average conventional microloan.

Despite the marked growth, the ISMF still accounts for a very small portion of most countries' total microfinance outreach. The supply of IsMF is very concentrated in a few countries. Indonesia, Bangladesh, and Afghanistan account for 80 percent of the global outreach of IsMF. In all other countries, microfinance is still in its infancy, with limited scalable institutions reaching clients on a regional and national level. For most countries, the average Islamic microloan amount (with respect to primarily the Murabaha product)[3] (is similar to conventional microloans.

1.3 Motivation of the Study

A disproportionately high rate of global poverty is concentrated in Muslim communities with over half a billion individuals live on under 2 USD per day in Indonesia, India, Pakistan, Bangladesh, Egypt, and Nigeria alone, many of whom struggle to access sufficient liquidity, manage savings, and transfer and receive money (Kustin, 2015). On the contrary, it is estimated that 72% of the population living in predominantly Muslim countries do not use financial services, because they do not follow the precepts of Islam. That is, the financial tenets enshrined in Sharia such as prohibition of interest challenge the microfinance sector's ability to sustainably provide Sharia-compliant financial products at scale. Also, the differing perception of sharia observant Muslim community towards the conventional financial schemes affect the access.

For instance in countries like Afghanistan, Morocco, Iraq, Djibouti, the percentage of adult population with no bank accounts for religious reasons stands at 33.6%, 25.6%, 23.6% and 22.8%, respectively (Kustin, 2015). The same report indicated that poor Muslims in particular "[show] significant rates of rejection of traditional microloans," and that Sharia compliant financing can promote the financial inclusion of populations who

[3] *Product-definition of selected Islamic finance product definitions is provided in Annex 2 of this report).*

are self-excluding from conventional financing options. Perhaps the most frequently cited statistics regarding demand-side market potential for IsMF come from a 2008 CGAP paper suggesting that up to 40% of potential microfinance clients reject non-Sharia compliant loans (CGAP, 2008). There is already high demand for IsMF- and it has high potential of growth as Islamic Financing options become more visible and available.

To cater to this need, Islamic Banking Institutions were established. Muslims use conventional financial products, but various surveys show that if they had the choice they would use sharia-compliance financial products (Kustin, 2015; Ismail, 2017). It is dubbed that the IsMF is a sector with a great potential to expand. However, in Muslim majority countries, IsMF is still a tiny share of microfinance. Why? Others also argue that there are no adequate feasible models developed under the IF systems to promote IsMF (Mughal, 2017; Bennet, 2017).

As a regional Think Tank that exists to address policy and cross-country strategic issues that hinder poverty reduction and growth, HESPI explores all possibilities of creating enabling policy environment for fighting poverty (including access to finance), realization of the SDGs, enhancing the transition from fragility to sustainability and maintaining sustainable growth in the region.

Hence, HESPI has initiated this study to:

- Explore the status of IsMF in the IGAD region as new investment frontier to provide capital/subsidized lending for the less fortunate rural and urban as well as pastoralist segments of the region's communities to help them in the fight against poverty which Bigger Financial Institutions (Including the Islamic Banks) failed to address. The study aims to explore the potentiality of IsMF to provide opportunity of financial access to religiously observant Muslim Poor which otherwise stay out of it.

- Understand the available policy provisions and regulatory framework in the region's member states; and analyze how the policies enhance or hinder the thriving of IsMF in the region.
- Assess availability and expansion of feasible and sustainable IsMF models in the region[4]. This is because the nascent sector continues to struggle to find sustainable business models and policy support with a broad array of products that can meet the diverse financial needs of the religiously observant poor Muslims in the IGAD region.
- Come up with evidence-based policy advise or recommendations to the IGAD member states, policy makers and researchers in furthering IsMF pro-poor poverty alleviation measure
- As there are no systematic studies conducted addressing the IGAD region as a single entity in the existing body of knowledge, this study will make account of and provide recommendations on the subject at a regional scope.

[4] With an estimated 650 million Muslims living on less than $2 a day (Obaidullah and Tariqullay 2008), finding sustainable Islamic models could be the key to providing financial access to millions of Muslim poor who strive to avoid financial products that do not comply with Sharia. The IsMFIs display wide variations in the models, instruments and operational mechanisms. While, in terms of reach, penetration and financial prowess, IsMFIs lag far behind their conventional counterparts they certainly score better in terms of richness and variety. IsMFIs similar to conventional MFIs, use group financing as a substitute to collateral, have a high concentration of women beneficiaries and aim at alleviation of poverty in all its forms.

2. Literature Review

There is broad scholarly support for expanding and developing IsMF and there is bold claim by various Islamic institutions and prominent individuals that IsMF has become a useful alternative tool for financial inclusivity and sustainability as it can address the capital needs of the less favored religiously observant Muslim Poor which have difficulty to access resources from the bigger financial institutions.[5] The scholarly support for IsMF is mirrored in the expansion of organizations providing resources on the topic and other symptomatic indicators for its growth. The literature review part of this report, however, will focus on the objective scholarly and empirical research observations and reports on the subject.

The objective research findings on the topic come under FIVE camps; those that:

- indicate IsMF is a helpful new frontier for poverty alleviation among the needy and poor Islamic community and new financial market niche;
- explain the key differentiating features of the IsMF from the conventional ones and the available products and models for the people to access
- witness the rapidly growing trend and expansion of the industry;
- counter argue that the sharia-complaint financial inclusion is at its infancy with limited reach and market share vis-à-vis other traditional microfinance models; and
- discuss about its policy and other challenges to thrive and broaden its reach

The most important works delivered as proponent to **the usefulness and the characteristic** of the scheme is the work done by Obaidullah (2008) and the case study of Pakistan by Akhter *et al* (2011). In his seminal book on the topic, Obaidullah indicated that microfinance implies provision of financial services to poor and low-income people whose low economic standing *excludes* them from formal financial systems. He also asserted that the services such as, credit, venture capital, savings, insurance, remittance are provided on a micro-scale enabling participation of those with severely limited financial means to fight poverty and excludes the poor from participating in the development process. Hence in a typical developing economy, the formal financial system serves no more than 20-30 percent of the population leaving the excluded poor households fined it difficult to take advantage of economic opportunities and build assets. Financial exclusion, thus, binds them into a vicious circle of poverty.

The Pakistan case indicated that combining the Islamic Social Principles of caring for the less fortunate with Microfinance's power to provide financial services assess to poor has potential to reach out millions. In support of expanding Islamic MFIs, this report noted that microfinance as a poverty alleviation tool is well aligned with the principles of Islam. "Islam views poverty to be a curse to be eradicated through productive efforts…there is therefore a convergence between the objectives of Islam and the avowed aims of 'best practices' microfinance." (Obidallah, 2007). Specifically, the concept of helping the poor is directly supported under the third of the five pillars of Islam[6]; zakat, meaning giving support to the needy.

The CGAP report by *Zeinab Zouari et al* (2014) and Karim et al (2008) *indicated that* IsMF is an emerging market niche and has the potential to expand access to finance to unprecedented levels throughout the

[5] *Such institutions include Center of Excellence in IsMF, AKHUWAT, Islamic Cooperation for the development of the Private sector, for IsMF, CGAP Microfinance Gateway, Islamic Banker, Institute of Islamic Banking and Insurance, etc.).*

[6] *The Five Pillars of Islam: Testimony of faith (shahada), Prayer (salat), Giving support for the needy (zakat), Fasting (saum) the month of Ramadan and The pilgrimage (hajj) to Mecca*

Muslim world. The reports also added that it is a new frontier that many observers, academic and practitioner alike, are keen to explore. Cull et al. (2013), with empirical evidence highlighted that the IsMF would be able to convert the number of unbanked population, currently about half of the world population, by at least 50% over the next 20 years though it seems difficult as most of the MFIs may adopt commercial objectives rather than meeting the more difficult social objective of poverty alleviation.

Back in 2007, Honohon reported that an estimated 72 percent of people living in Muslim-majority countries do not use formal financial services (Honohon 2007) even when financial services are available. They view conventional products as incompatible with the financial principles set forth in Islamic law. They demanded products consistent with Islamic financial principles which led to the emergence of IsMF as a new market niche. Honohon's study indicated that in the IDB's 56 member countries, only 28 percent of the adult population uses formal (or Semi-formal) financial intermediaries, whether through deposit accounts or borrowing. Riwajanti (2013) and Chapra (1983) on their parts argued that IF is a scheme that can respond to the Islamic perspective of poverty; which is not just material shortage but also moral/spiritual aspect of destitution which applies Islamic values to promote social justice and poverty alleviation.

There are ranges of literature which explain the differentiating characteristics of IsMF from the conventional ones. Zeinab Zouari et al (2014) explained that IMFs differs from conventional microfinance in that it must adhere to the same principles as IF, which is structured to provide products for Muslim customers that are in compliance with the code of ethics and conduct laid out under sharia law. It utilizes a range of models to avoid elements forbidden under sharia, namely interest (riba) and uncertainty and deceit (gharar). They further explained that financial instruments are therefore designed to provide funds in a manner that avoids both interest payments while still taking into consideration the need to cover overhead and the cost of financing if the MFI is to be sustainable, and shares the risk of the investment between the financier and recipient or places it on the MFI alone.

The IsMF's interest could alleviate a major criticism of conventional microfinance–namely the high interest rates charged on loans. Commonly available types of IsMF contracts that work in lieu of conventional loan agreements include: cost plus markup (murabaha model) that needs to cover overhead and the cost of financing if the MFI is to be sustainable, and shares the risk of the investment between the financier and recipient or places it on the MFI alone.

On another camp, there are reports that assert the **steady growth** of the scheme from get go. Interesting work by Gates Foundation reported on the growth trends, the expansion and the current wealth. The report indicated that the scheme is growing, expanding and the wealth is increasing (Gates, 2015). The reported narrated that though the scheme has long been dominated by the liquidity-reach Gulf of Persia; growing markets are now more evenly spread across the world. Qatar, Indonesia, Malaysia, Saudi Arabia, Turkey and the United Arab Emirates are estimated to currently hold 80% of IBF assets, with a five-year compound annual growth rate (CAGR) of 18% from 2009 to 2013, and an expected CAGR of 19% from 2014 to 2019. Mughal (2017) reported on the growth trajectory of the scheme. It indicated that the wealth of IsMF is growing and its geographic coverage is expanding (KPMG, 2006; The Banker, 2007) with steadily increasing number of IF intuitions. These reports underscore that the growth trend and trajectory has to increase more to enable it reach out more poor Muslim customers.

The IsMF Network was formed in 2011 to provide a common platform for the scheme around the world by coordinating the efforts of its members in jointly addressing poverty alleviation, establishing best practices in IsMF, and developing guidelines for adopting practices that comply with sharia law.10

Other groups argue that despite the positive acceptance and positive growth pattern, the scheme is still ***at its infancy***. Ismail (2017) reported that despite the marked growth, the IsMF still accounts for a very small portion of most countries' total microfinance outreach. The supply of IsMF is very concentrated in a few countries. Indonesia, Bangladesh, and Afghanistan account for 80 percent of the global outreach of IsMF. In all other countries, microfinance is still in its infancy, with limited scalable institutions reaching clients on a regional and national level. For most countries, the average Islamic microloan amount (with respect to primarily the Murabaha product)[7] is similar to conventional microloans. The report associated the slow growth pace of the scheme to shortage of appropriate model, negative perceptions, unfavorable or lack of policy and legal frameworks, etc. These reports further argued that many Islamic banks failed to reach out to over 650 million poor Muslims that parallel the inability of commercial banks to provide necessary capital to the less fortunate segments of society.

In the IGAD region, report from Sudan by Musa and Ammar (2015) indicated that as conventional microfinance paying interests (riba) are forbidden for the most part, IsMF is good alternative to bring the poor Muslim customers to the formal financial mainstream. However, the authors also indicated that while conventional MFIs have expanded their operations in the last two decades, IsMF products are still quite small. The country requires full compliance with Sharia principles for the entire financial system. The IMF (2014) report indicated the IF industry in Djibouti has limited breadth. The industry comprises mainly of the Islamic Banking sector and a small IsMF sector, which accounts for less than 1 percent of the total industry assets. The Islamic insurance companies (Takaful) have not yet started operating in Djibouti and there are no Islamic equity or Sukuk markets and no Islamic private pension operators.

Zeinab Zouari et al (2014) indicated that failure of banks to address the financial needs of poor segments that IsMF is quietly evolving from an experiment into a niche industry in some Muslim dominant countries. This idea was also supported by Armendariz and Morduch (2005) under their market failure theory, which suggests that the poor have been left out from economic growth and development due to the failure of commercial banks to provide them with capital.

Among the challenges, socio-economic conditions which promote free economy and foreign loans which underpin the concept of an Economy cannot be run without interest base banking; the high income disparity brings about competition and wide spread corruption which masks Islamic values of benevolence, truth, trust, etc. The product developers of the IsMF seem to have ignored the concept of trust and materialized things only in context of tangible guaranties and mortgages. Islamic banks should offer real profit and loss accounts along with the concept of *Muzarbah* and *Musharka*. The papers argued that it should be a share in profit and loss for lending and borrowings rather than giving fixed amount or fixed ratio on equity.

In sum, the literature is scanty on IGAD region on the pertinence of the scheme; growth trends, nature and complexity of the challenges and possible ways of creating thriving environment for the scheme are not

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[7] *Product-definition of selected Islamic finance product definitions are provided in section _____________ of this report).*

adequately researched and reported for IGAD. This report, therefore, aims to contribute its part in filling this information gap and make sound recommendations for the member countries.

3. Islamic Microfinance Industry in the IGAD region8

The IF and the IsMF schemes have been expanding from its source of origin and is now encroaching other regions in Africa and Asia although ratio remains minimal compared to the conventional counterparts. The OIC outlook series 2012 report showed that the Sharia compliant asset distribution in Sub-Saharan Africa (SSA) is only 1% (compared with 40% GCC) in 2011.

The IGAD region, as subset of the SSA is one of the economic blocs in Africa comprised of states transiting through post-conflict fragility and instability. The region also harbors significant number and proportion of Islamic Population as well as Islam majority countries like Somalia, Djibouti and Sudan. Although there has been marked economic development in recent years, many of the region's population (including the sharia observant poor Muslims) are undergoing through abject poverty. The strategizing the approaches of fighting is therefore one of the national and regional priorities through financial inclusion and other means which are also central to realize most of the SDGs in the region.

One of the key challenges in the region in fighting poverty is low access of the poor to finance. Creating access to finance or ensuring financial inclusion for especially of the disadvantaged poor segments of the region's community is pertinent to the realization of the national and regional ambitions and one of the important facets of fighting poverty.

In the IGAD region, information on IF Industries and the IsMF is scanty. However, there is a universal claim that the IF and the IsMF have grown at a slower but steady pace throughout. The available little information is compiled country by country as data is not sufficiently available at regional level. Therefore, specific look at the status of IF/IsMF industry[9] in each of the IGAD member country[10] is presented below. The policy and regulatory framework related issues preceded this assessment and summarized in section 4 below.

As discussed above, empirical data and literature on IsMF are scanty on IGAD as a region. The following country specific analysis shows the practices, growth trends and expansion of the scheme.

3.1 Djibouti

Djibouti, which serves as the headquarters for the Inter-Governmental Authority (IGAD), has a predominant Muslim population (94%) showing high potential for IF. Islamic banks are currently operating in the country with assets of over US$ 280 million. However, the IMF (2017) reported that the sector is inclined to Islamic Banking (IBs) than to IsMF as there are 4 fully fledged IBs out of the 10 banks operating in the country by end of 2015 with a market share of 16.4 percent of the total banking system assets. Hence, the analysis is more of the IBs than IsMF institutions.

Conventional banks in Djibouti have not yet started to offer IB products, although the law in the country permits Islamic windows. The first Islamic bank to enter the Djiboutian market was Saba Islamic Bank Branch in 2008. This was followed by Salaam Africa Bank in 2008 and Dahabshill Bank International (Africa's

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[8] This part of the analysis only describes the status of the scheme in the respective countries but the policy and regulatory framework analysis in each of the countries is provided in section 4 below.

[9] In most countries where the IF industry is at its nascent stage, the IF and the IsMF are discussed jointly

[10] Current IGAD member countries include: Djibouti, Ethiopia, Kenya, Somalia, Sudan, South Sudan and Uganda

largest money transfer business) and later rebranded to East African Bank and established its presence in 2009. Egypt's Shoura bank was established as fourth bank in 2010 but has since 2016 shut down its operations. The biggest of these banks is Dahabshill/East African Bank with a total capital of US$ 17.7 Million, followed by Salaam African Bank with US$ 5.6 Million and finally Saba Islamic Bank with US$ 1.7 Million. The IB's have registered steady growth since the licensing of the first Islamic bank, though it has slowed in 2015.

The Banks are located in Djibouti with branches in the regions such as the Marche Rayad Branch. The banks in Djibouti offer products and services like Personal banking, Corporate banking, online Banking and Business Banking. The EA Bank offers Microfiche products in Djibouti.

In terms of standardization, 2 IBs are publishing their financial statements according to Auditing Organization for Islamic Finance Institutions (AAOIFI), while one is publishing according to Islamic Finance Service Board (IFSB) but there are no fit and proper requirements for Sharia advisors. The supervisory framework and capacity are not yet aligned to cater to the specifics of Islamic modes of banking. Therefore, besides the standard banking risks, such as credit, liquidity, cross border and contagion risks, the IBs are exposed to equity investment and displaced commercial risks (DCR). The absence of developed capital markets also suggests that assessment of equity risk could be challenging.

Hence, given the rapid growth of IB, prudential and supervisory frameworks that are adapted to the specificities of Islamic modes of banking will be critical in ensuring financial stability. This requires adopting IFSB and Accounting and AAOIFI standards, enhancing supervisory capacity in risk assessment, monitoring and management in domestic IBs and their cross-border operations, developing a consumer protection framework that includes disclosure requirements, and further strengthening of the Sharia governance framework.

In terms of Islamic Products, development of a Sukuk market, notably through regular issuance of tradable sovereign Sukuk, and the adaptation of monetary operations to facilitate liquidity management by IBs is feasible. A legal framework authorizing leasing in Djibouti and infrastructure to support it could facilitate use of Ijarah by the IBs. An SCDIS and a special resolution framework for banks that take into account the specific needs of IBs are needed to ensure sustained financial stability.

The Agence Djiboutienne de Développement Social (ADDS) aims to establish a widespread network for IsMF. The country has stated the annual IF conference held under the patronage of the Central Bank of Djibouti and the ministry of finance which is held every December is indicative of the positive support from the regulators and the policy makers on their vision for IF. This forum can serve as a plat form to discuss challenges and forward policy reforms in favor of the Islamic Micro financing.

Moreover, the country expects to see more new entrants in its IF sector and the government plans to work on a framework to allow the use of Sukuk, or Islamic bonds, to fund infrastructure projects. The government is in discussions with the Saudi-based IDB to secure a technical mission to help establish a framework to issue Sukuk. However, the cash culture, which has limited the growth of conventional banking, also presents challenges for the growth of IB.

In sum, the industry in that country is poised for further growth and the policy and legal environment is required to be improved.

3.2 Ethiopia

Ethiopia has (one) of the largest Muslim population in Africa and this makes it an ideal destination for the IF industry. Around a third of Ethiopians identify as Muslim, making the country's Muslim population larger than that in Saudi Arabia, Syria or Yemen. Ethiopia started Islamic banking, which is also referred to as ***interest-free banking***[11] which is at its infancy.

Access to finance is generally very low in Ethiopia with only 14 % of the adult population having access to formal credit and savings products but this rate drops to 1% in remote rural areas. And, until recently, there were no financial institutions catering to the large population requiring Islamic-compliant products. Thus far, the country has no fully fledged IF institutions but rather 3 Islamic windows of universal commercial Banks.

The following three MFIs in Ethiopia own the lions share in the market:

- Amhara Credit and Savings Union(ACSI) leading with 33% of the market share
- Dedebit Credit and Savings Institution (DECSI) with 22% of the market share
- Oromia Credit and Savings Share Company (OCSSCO) with 16% of the market share

Currently there are 32 MFIs registered with the NBE and serving a population of about 2.7 Million borrowers with a portfolio of Birr 9.2 Billion. The MFI's assets in Ethiopia are mainly loan portfolios, fixed asset in the form of building, machinery, furniture etc. The MFIS in Ethiopia are in their upward trend showing significant growth with an increased 36% growth in 2017 compared to the 2011 rate.

The MFIs in Ethiopia are well spread out in the regional states to reach out the rural population in this big country with estimated total population of 106 million residing in 9 regional states and two city administrations. The following list shows their geographic reach of the MFIs.

Table 1: Geographic or regional reach of MFIs in Ethiopia

	Region	Names of MFIs
1	Oromia (the biggest region with a population of estimated 35 million (47.5% are Muslim)	Africa Village Financial Services, Bussa Gonofa MFI, Eshet , Gasha, Harbu, Letta, Wisdom, Wassa, Oromiya Credit and Savings MFI, Metemamen MFI, Peace and Poverty Reduction and Community Empowerment (PEACE) MFI, Specialized Financial Promotional Institution and Tesfa MFI
2	Somali region (98.4% Muslim	Somali MFI and Rays MFI
3	Tigray region	Dedebit Credit and Saving Institute (DECSI)
4	Amhara region	Amhara Credit and Saving Institute (ACSI), Meket and Wisdom MFIs
5	Harari region	Harari MFI
6	Gambella region	Gambella MFI
7	Benishangul Gumuz region	Benishangul Gumuz region MFI
8	Southern Nationals, Nationalities and Peoples (SNNP Regions)	Letta, Metemamen, Omo, PEACE, Sidano MFI, Wisdom, Aggar, Tesfa and Shashimene Eddin Yelimat Agar (SEYA) MFIs.
9	Dire Dawa City Administration	Dire Dawa MFI
10	Addis Ababa City Administration	ADCSI, Afar, Africa Village Financial Services, Digaf, Gasha, Meket, Specialized Financial and Promotional Institutions, Wisdom& Dynamic

[11] *Deliberately named as though by the Ethiopian government to instigate financial service secularity & neutrality*

The products currently on offer by the MFI include:

- Profit Loss Sharing (PLS) mode- which includes general partnership contracts and agricultural partnership contracts where by one party owns the land but partners up with another party that has the requisite skill and expertise, and the third kind is the partnership in fruit trees where again you have one partner who owns the fruit trees and requires a partner who will tend and manage the fruit trees in exchange for the party tending the trees to be entitled to an agreed quantity of the fruits and finally working capital.
- Conventional or Interest Bearing Loans
- Group Guaranteed Loan- not based on IF where the model is a group comes together (solidarity group) and takes financing and the collateral is provided by the group or alternatively a loan guarantee can be used through a group repayment pledge. Incentive to pay is based on peer pressure.
- Medium and Small Enterprises(MSE) loan is another type of loan offered targeting individuals who can access individual guarantees by providing a co-signatory, immovable assets or vehicle as collateral. Organized MSE such as cooperatives are the target customers
- Savings

Apart from the special windows for the interest free-banking with the universal/commercial banks, Ethiopia is also moving into licensing and promoting Interest-Free banking. Following the provision of the legal framework, recently, there are some attempts to establish and cultivate IsMF.

In sum, the conventional MFI's are well spread out across the regions and have penetrated different areas in the last two decades. The better developed conventional MFI provide only conventional products and the research carried out thus far does not indicate there is any evidence to support otherwise, whereas the recently established Islamic MFIs such as RAYs in Somali region offers both Islamic and conventional services and is thus more diverse in their product offering. The country is required to provide wider legal space for IsMF and make aggressive move towards promoting it.

3.3 Kenya

Kenya's progress in the IF industry has seen a rapid growth in the past decade with the number of banks offering IF products reaching 13 by end 2015 and growing to 14 with the addition of Dubai Islamic Bank new entrant to the market as of 2017. The Islamic banking assets grew at 14 percent per annum between 2013 and 2015, the market share has remained below two percent of the banking industry assets (IMF Multi country report, 2015).

In Kenya, there are windows and fully fledged entities for the Islamic/Interest free services that the MFIs are offering. Among the fully fledged Islamic Banks is the First Community Bank (FCB). FCB bank was opened in January 2008 for operations. The Bank was licensed under the Banking Act Cap 499 under exemption from article 12(a) and (c) that prohibits banks from engaging in trading and owning property to accommodate IF. The bank went onto quickly open 25 branches across the country with nearly 10 of these branches in areas in Northern Kenya and the Coastal Region which are areas with high population of Muslims.

The remaining 15 were spread across the country which is indicative that although FCB appears to only target the Muslim market and thus restricting itself to a niche market, it can be argued that with the 15 branches spread across the country they are aiming to cater to all people's and thus embracing the diversity within the land.

Regarding Microfinance Banking, FCB has two products within its portfolio of products that cater to IsMF and these are Ufanisi Chama and Ufanisi Binafsi which is small and have short repayment periods. Gulf African Bank (GAB) is such a bank. GAB opened its doors in Nairobi in 2008 with 19 branches across the country. It partnered up with the International Finance Corporation (IFC) through their Africa Small and Medium Enterprise Finance program to work in developing the IF and SME in Kenya with the aim of developing economic opportunity for women. Another bank with similar role is the Dubai Islamic Bank (DIB). DIB Kenya is the latest entrant and was granted its license in April 2017. The bank is yet to begin fully operating in the market and share the products which will be on offer.

Islamic window is the other service that the banks offer. The National Bank of Kenya has the National Amanah service. Is an IF window that was first launched in 2009 and was later rebranded in 2013. It has now 70 branches across the country with some of these branches located in the predominant Muslim areas like Coast and Northern Kenya regions. There is no indication of any specific product geared towards IsMFI. Moreover, the Kenya Commercial Bank has Sahel Banking service which was launched in April 2015 as the Islamic window. It is the largest in terms of assets and branch network. The window is located in 6 sites including KCB Kimathi, Hurlingham Nairobi, Mwembe Tayari in Mombasa, Garissa, Wajir and Lamu. The areas have a mix of both Muslim and Non-Muslim population.

Standard Chartered Saadiq is another window which was launched in March 2014 as indicated in a press release published on 19th March 2014 stating that Kenya was the first African market to offer Islamic banking. The window is generally located in Nairobi, Coast and Rift Valley regions of Kenya. The products offered include Current accounts, home financing and working capital, saving and term account. There are no indications of IsMFI products being offered by the bank and the main clientele appear to be corporates and individuals.

Barclays Bank-La Riba is the oldest window which opened the way back in 2005 to accommodate the 8 Million Muslims of the time who may have been interested in IF products. In 2010 the bank introduced products that would cater for personal and motor financing. Barclays looks to have been set up to address corporate issues and thus there is no indication of SME or MFI products on offer.

On top of the Islamic Windows within the Banks, Kenya also has IsMFIs. One of such MFIs is the Crescent SACCO which is the 1st Sharia complaint SACCO to be licensed by the Commissioner of Cooperatives Department of the Cooperative Developments. The SACCO is currently seeking a deposit taking license from the SACCO regulator the Society Regulatory Authority (SASRA) to operate front office financial services commonly known as FOSA's. That products that this SACCO offers include:

- Ayutta Range of Products- which involves a rotating or a table banking model predominantly used by Muslim women in the Kenyan Somali Community. These products are intended for partners with a common bond e.g. similar sector or staff with a common employer.

- Mifugo Kash Kash- is a pastoralist livestock value chain trade based financing marketing and supply management in collaboration Neema slaughter house and other development actors.

Taqwa is another SACCO in Kenya. The Kenyan Union of Savings and Credit Cooperatives (KUSCCO) expressed that Taqwa SACCO was licensed to take deposits and offer banking services almost 19 years ago.

Kenya has also been assisted to develop and support the growth of the Islamic Capital markets industry. These efforts paved the way for raising the first Islamic Bond to facilitate infrastructure development. At the 1st International IF Conference in Africa (IIFCA) the Cabinet Secretary of Finance announced that Kenya planned to raise its first Islamic Bond from the Islamic financial hubs globally, as an alternative source for financial mobilization. The Capital Markets Authority of Kenya (CMA) set up the Project Management Office (PMO) to coordinate and guide the changes needed in the industry to further spur growth and development. Kenya has to show more commitment to promote IsMF.

3.4 Somalia

Following the distraction of financial and economic institutions in the prolonged insecurity of more than two decades, Somalia is on a slow recovery path. In regards to revitalizing the economy and tackling financial exclusion however, IF has played a big role in the country (Warsame, 2016).

Like in other countries, the Islamic Banking preceded the IsMF in Somalia. The introduction of the Islamic banking itself is long overdue given the country's strong Islamic identity and the fact that the only functioning institutions currently operating are Hawala companies which only provide money remittance services. The business community in Somalia is in dire need for a well-functioning banking and Microfinance sector. There is high demand for the revival of the Islamic banking services consistent with the belief of the local population who are nearly 100% Muslim. This indicates that there is high potential for IF in the country if rule of law can be ensured. It is also learnt that the severe institutional shortcomings including the absence of the rule of law that could severely impede the process unless properly addressed to introduce the banking service.

But as of mid-2017, there are 5 banks which have been licensed with all fully fledged Islamic banks which include the Premier Bank, International Bank of Somalia (IBS), Dahabshill Bank, and Trust Bank and Salam African Bank. These banks operate within the limited IF regulatory system, currently provided by the Central bank of Somalia. To a large extent limitations to the capacity of the supervision and regulatory system have led the industry to be purely market driven and the potential once a framework is in place could be big.

As the best ways for enhancing the chances of Islamic Banks succeeding in Somalia, the IsMF industry is still at its most rudimentary and there are no specialized MFIs that have licensed as such. The existing banks provide IsMF and small enterprises funding with most banks offering similar products. The lack of commercial transactions owing to absence of correspondent relations with other countries has a great impact on how much further the industry can develop at present.

Several studies suggested that identifying the most suitable marketing tools, joint venturing with International banks is the best banking model in this country due to lack of local expertise and promoting online marketing tools and mobile systems can play a greater role in marketing Islamic banking products and services in Somalia (Warsame, 2016). The supremacy of law and order and enactment of Pro-business laws should precede the promotion of IF in Somalia.

Regarding IsMFIs, Harper and Ajaze (2017) reported that there are some sharia compliant microfinance services in Somalia. MicroDahab was set up in Somaliland in 2014 by Dahabshiil Bank International, a subsidiary of Africa's largest remittance company, in order to enable unbanked people throughout Somalia to access financial services. MicroDahab offers a full range of *Sharia*-compliant financial products, and the majority of it's around 3,000 clients are using *murabaha* finance. MicroDahab has seven branches in all parts of Somalia, and is expanding rapidly.

The same report also indicated that Kaah Islamic Microfinance Services (KIMS) was started in 2014 by Kaah Express, a large international funds remittance company based in Mogadishu. KIMS offers *murabaha* and *ijarah* financial products, and it has a particular focus on serving young men and women who want to start or to develop small businesses. By 2016, KIMS had extended its savings and loan services to over 4,000 people, to a total value of over US$3 m.

Moreover, there is an Ebdaa Microfinance Bank which is a not-for-profit MFI, which was promoted by the Arab Gulf Program for Development. It is a joint stock company, but its shareholders are committed to reinvesting any profits in the business in order to extend its services to more people. Ebdaa was started in 2013, and has a portfolio of about US$1.7 m and some 6,000 active borrowers with an average loan of US$500, and approximately 9,000 savers. The vast majority of its clients, 90 per cent, are women, and they are organized into groups and served by 49 field staff, operating from seven branches. Most of the bank's clients use *murabaha* finance, but Ebdaa also offers *bai salam* or advance purchase and profit- and loss-sharing partnership finance to smallholder farmers.

3.5 South Sudan

Most of the estimated 10.6 million population of South Sudan live in rural areas as pastoralists and farmers. Bank and microfinance penetration is negligible and mobile phone penetration stands at about 15 percent making banking and micro financing so difficult.

The banking sector is led by two Kenyan banks, Equity Bank and Kenya Commercial Bank, both of which are keen on partnering with mobile network operators to launch mobile banking services, based on their experiences in Kenya. There are 16 commercial banks which include Liberty Commercial Bank (LCB), Buffalo Commercial Bank, South Sudan Commercial Bank, International Commercial Bank (ICB), Kenya Commercial Bank (KCB), Commercial Bank of Ethiopia, Equity Bank, Cooperative Bank of South Sudan, First Bank South Sudan, Nile Commercial Bank, Ivory Bank, Mountain Trade and Development Bank (MTDB), Cfc Stanbic Bank Limited, Sudan Microfinance Institution (SUMI) , 7 insurance business companies which include Jamus International Insurance, National Insurance Corporation Ltd (NICL), New Sudan Insurance Company Limited, Renaissance Insurance Company South Sudan Ltd, Savannah Insurance Company, Speed Insurance (SS) Limited, UAP Insurance Sudan Ltd and Central Bank of the Republic of South Sudan

The banking system and microfinance service in South Sudan are rudimentary; but has the potential for growth. Islamic finance and IsMF are unavailable in South Sudan at the present.

3.6 The Sudan

IsMFI in Sudan is one of the most developed in Africa. With nearly 97% Muslim Population, including numerous Arab and non-Arab groups, the Sudan has long history of the IF facility. IF has been in existence in Sudan since 1977 when Feisal Islamic Bank, the first Islamic bank established with the help of Saudi funders which eventually transitioned its entre finance and banking infrastructure into Sharia compliance latter in 1989. In 1979 the world's first Islamic insurance firm was established and in early 1990's the Sudan had the first successful conversion of the entire financial system into an Islamic one.

In 1992, the High Sharia Supervisory Board was established, in 1994 the Khartoum Stock Exchange was set up, and in 2003 a special committee to discuss Islamic bonds was created. In 2006, an Amendment by the

Central Bank of Sudan Act 2002 changed the banking system to a dual banking system. In 2007 an IsMF was established and launched the microfinance fund; and in 2011 after the secession of the South Sudan, there was a reinstatement of a fully Islamic financial system again.

Though Sudan had only a few institutions in 2006 serving the microfinance market and had only a limited penetration of 9,500 clients, it became the 2nd largest market in 2013 in terms of outreach next to Bangladesh with 426,694 active clients. The rapid expansion is attributed to an active Central Bank that prioritized microfinance through a dedicated unit and priority sector lending requirements obligating banks to lend to micro, small and medium enterprises development sector.

The entire financial sector in Sudan is required to be sharia-complaint by law. The growth of the IsMF sector reflects the government's push to provide financial services to the underserved. Currently, the Sudan microfinance industry provides services all over the country amounting to 501 windows. Of these 466 are financial service windows and 35 are non-financial services.

Being the majority are Muslims and more than 35 IBs in addition to others non- banks Islamic financing providers, the country has become a suitable host for Islamic microfinance (Elsadig Musa Ahmed, 2015). Microfinance was officially formalized by Bank of Sudan when it recognized Micro-entrepreneurs and micro-enterprises in 1990 and included Artisan and skilled workers among the priority sectors to receive finance from commercial banks, especially for projects in rural areas.

Micro-enterprises and low-income productive families are entitled to agriculture, manufacturing, exports, mining, power generation, low cost housing, transport, and warehousing as priority sectors to receive finance from commercial banks. Islamic financial infrastructure has witnessed tremendous growth and improvement following the initiative the government that transformed the existing dual economic system into Islamic financial system, to some extent created enabling environment for IsMF.

Geographically, the IMFI's in Sudan are divided into Federal and State. Seven of them are federal namely Al –Amal, Al-Shabab, Al-Ebdaa, Al-Mashier, Al-Watania, Al-Usra and Al-Iradaa. Whearese the other 10 are located in the states with 6 in Khartoum, 2 in Red Sea State and 2 in South Kordofan.

There are also External Partners to Support the Development of IMFI in Sudan. For example, the IDB partnered up with the CBOS to offer US$ 59.5 Million support facility with which, RADA, a newly formed subsidiary of BOK was created. The IDB also brought in capacity building of Bank Al-Usrah (converted into a fully- fledged MFI bank). The IDB facility supported IT training programs, whole sale finance and exposure visits. It also helped to create 4 business development centers at a cost of US$ 160,000 and 5 business incubators at US$ 500,000.

3.7 Uganda

Uganda is the only country in East Africa to be a member of the OIC and the IDB. The membership could have made Uganda's entry into the industry much easier and gave it a pioneering role in the IF industry in the IGAD region. But on the contrary, Uganda began to make explorations in the industry less than 5 years under the patronage of the Uganda National Chamber of Commerce, Industry and Agriculture (UNCCI), which hosted the 1st IF Seminar in 2014 which highlighted the importance of the industry and brought together various stakeholders to discuss the way forward in regards to how IF should develop in Uganda.

Since that conference, Uganda continued to engage various players in the IF market and the public to seek out different opinions on what the industry meant to the population and how it is received by the public.

The advancing awareness on the IF industry in Uganda underpinned the recent passing of legislation to allow for commercial banks to operate Islamic windows. The Bank of Uganda is finalizing regulations to have Islamic Banking roll out throughout the country with commercial banks creating windows for Islamic banking according to the July 2017 *East Africa Business Week.*

4. Islamic Microfinance Policy Analysis in the IGAD region[12]

The IsMFIs policy analysis in the IGAD region is the core purpose of this study. The growing presence of IF and IsMF needs to be accompanied by enactment of effective regulation and supervision by way of developing sound legal and prudential frameworks governing the schemes. In terms of developing enabling secular legal and regulatory environment for the Islamic financial Services and IsMF in particular, there are substantial dispersion among the IGAD member countries.

In jurisdictions that do not have Sharia Law as the basis of its legal system (like in Ethiopia), the supervisory authority typically addresses Sharia compliance from a secular perspective. Typically, these authorities do not consider that they need to have or build any capabilities that will enable them to make any determination relating to Sharia Law compliance. On the other hand, in jurisdictions where Sharia Law is the default source of all legislation (like in Sudan), the supervisory authorities have a responsibility to ensure compliance with Sharia Law. Effective legal and regulatory framework and supervisory oversight is needed to strengthen early detection of risks.

For an IsMF to operate as per the Shariah law it should follow certain principles; which provide the guides to how IsMF is different from other traditional financing and this has to be put in countries financial, legal and regulatory policy context. It also reduces risks to the stability in the financial system.

The legal and regulatory framework provides the legitimacy, operational framework and opportunity for quality control of the scheme. However, most of the IF policy reforms in the region are made recently and are annexed to the existing conventional MFI policies. Given its significance in the financial industry and utility to fight poverty, the IsMF scheme requires distinct legal and regulatory framework within the overall umbrella of the financial policies.

The IGAD member countries are at varying stages regarding the availability and enforcement of legal and regulatory (policy) framework for IsMF. Countries like the Sudan, Djibouti and Kenya have relatively advanced legal and regulatory frameworks; Ethiopia and Uganda at their exploratory stage with legal provisions for financial windows for Islamic Banking with commercial banks. In these countries, the governments recognize the interest-free financial services. Other groups like South Sudan and Eritrea have nearly no IsMF legal and regulatory framework. Though long identified as Islamic majority country, Somalia has very preliminary IF legal provisions due to the devastation of the legal and policy tools and financial institutions over more than two decades of internal conflict.

As there are no legal, and policy and regulatory framework for the IGAD region as one entity (the eight countries in one), the following outline shows country-by-country assessment of the policy framework.

[12] *This section looks into the policy and regulatory frameworks. The IF/IsMF status account is separately documented in annex 3 of this report*

4.1 Djibouti

Djibouti is relatively a newcomer to IF, having introduced sector-specific legislation in 2011, but authorities hope it can increase Micro-financing penetration in rural areas while also attracting foreign investment. The central bank of Djibouti has developed a regulation for IsMF in 2013 and the government has established a national Sharia board to help oversee the sector, appointing 5 members to the independent body.

Following the establishment of the IsMF framework, the country granted microcredit for 32 promoters of the municipality of Balbala in 2017. The promoters are engaged in agricultural sectors like cattle rearing which is now improving the consumer perception of the industry and providing greater clarity on contracts which follow religious principles such as bans on interest and gambling. The Sharia governance framework is anyhow in place in Djibouti.

The IMF, however, evaluated in its recent assessments that Djibouti's legal, regulatory and supervisory frameworks have not yet been adequately tailored to mitigate financial stability risks inherent in Islamic modes of financing (IMF, 2017). Prudential regulations from the central bank currently do not distinguish between conventional and IBs, IFSB rules for computation of capital adequacy requirements and consumer protection. Therefore, more prudential IsMF policies are required to be instigated its predominant Muslim population (94%) which makes the country high potential ground for the proliferation of IsMF.

4.2 Ethiopia

Islamic Finance (IF) is considered as one of the financial services in Ethiopia. The service is understood as an "interest free" financial/banking service instead of IF. Ethiopia has opted to refer to IF as Interest Free banking with neutral naming to avoid its association with the Islamic identity. The authorities do not wish to associate religion directly with financing distinctions. It seems deliberate naming to avoid taking preference of one faith over others and for maintaining a secular identity. IsMF is not adequately recognized as useful financial scheme.

The National Bank of Ethiopia (NBE) recognizes the interest-free banking as banking that is consistent with IF principles and mode of operation that avoids receiving or paying interest and it was introduced in 2008 under proclamation 592/2008, Banking Business Proclamation. In October 2011, the NBE issued formal directives under the Licensing and Supervision and Banking Business Directives to authorize the business of Interest Free Banking – Directive No SBB/5/2011. The legal framework provided the space for separate windows for Islamic Banking with commercial banks. However, individual banks should provide their independent request and get full approval from NBE before the start of service.

Notwithstanding efforts to seek licenses for stand-alone and full-fledged IsMF institutions, the NBE has not seen fit to issue authorization. IsMFI organizations thus have not started operations immediately and this has constrained banking access to certain segment of the population that does not favor borrowing from conventional products. IF is understood as an industry much more than avoidance of interest, but has other critical principles that must be implemented. The choice of staying to a more neutral term was found to be more attractive.

Within the framework of this directive, the following three banks have special window for the interest free banking to offer the services in Muslim majority cities and communities:

- Commercial Bank of Ethiopia (CBE) which began its operations as a window on 28th October 2013

- Oromia International Bank (OIB) began its operations on 23rd September 2013
- United Bank (UB) - began its services on May 1st 2014.

The government also enacted a proclamation No 40/1996 which paved the way for establishment MFI in the country as indicated in the Association of Ethiopia Microfinance Institution (AEMFI) as reported in the Ethiopian Microfinance Institution Performance Analysis Report, 2014. However, it is also required to provide sound legal and regulatory framework to promote IsMF.

4.3 Eritrea

About 50% of Eritrea's 5.1 million populations are estimated to be Muslim. Data is scant on the status of IsMF and its policy framework in Eritrea. Only a few have indicated that microfinance has strong capacity to drive growth and poverty reduction in Eritrea (Rena and Tesfay, 2006). Therefore, the existence, growth and expansion status of the IsMF and the policy framework on the issue cannot be discussed.

Eretria's formal financial sector is very small and is mainly state owned and thus only provides the most basic of services. The Central Bank coordinates monetary and exchange rate policies only in close consultation with the government With the Central Bank regulating financial activities there are two commercial banks, an Eritrean Development Investment Bank (EDIB), the National Insurance Corporation of Eritrea (NICE), and the Himbol Exchange and financial service which acts as an auxiliary providing money transfer and foreign exchange services. Also, there are informal financial agents such as the "hawalas" or money transfer entities that mainly operate through agents. Eritrea has no formal Islamic banking and/or IsMFIs yet.

Given the high concentration of poor Islamic population that needs to access loans to build their livelihoods, developing sound IsMF is believed to reduce the recent day emigration through risky routes and high youth unemployment rate in that country.

4.4 Kenya

The IMF assessment (2017) indicated that Kenya has in place laws and regulations that explicitly recognize IB practices, products and institutions. The Banking Act in Kenya was amended in 2008 to include provisions for banks to provide non-interest financial products and to allow banks to offer IB products, either through full-fledged IBs or windows. The amendment entailed the inclusion of a clause to recognize 'returns' as consideration for money lent/borrowed, as opposed to 'interest'. The Central Bank of Kenya (CBK) has also accommodated IBs by exempting them from provisions of the Act that prohibit trading or investment in consideration of the nature of their business. The law or regulations, however, do not provide adequate guidance on the Islamic contracts acceptable in Kenya. The Capital Markets Authority (CMA) also has powers to supervise and regulate IB investment activities.

The same report indicated that for Islamic Financial Services, the licensing procedures are the same as for conventional banks. A bank, irrespective of whether it is an Islamic bank or a conventional bank, will be issued a standard bank license. There is also no difference between IBs and conventional banks in terms of the fit and proper framework that applies to management and shareholders.

In Kenya, IBs are subject to the same prudential framework as conventional banks. The regulations relating to minimum capital requirements, fit and proper, internal controls, CAR, liquidity, asset classification, provisioning, and related party apply equally to conventional and IBs. Kenya has not adopted IFSB guidelines on capital calculation. IBs have to hold capital on all risk weighted assets (RWA), irrespective of whether they are financed by investment accounts. The PER or IRR are not considered eligible capital for regulatory capital adequacy requirements. IBs and conventional banks with Islamic windows are also not required to segregate funds raised by way of Islamic deposits (demand deposits, URIAs, etc.) separately from other funds under the control of the bank.

The IMF 2017 assessment also indicated that corporate governance structures for *Shari'ah* compliance are in place, but important gaps remain. The legal and regulatory framework does not require the setting up of an NSB (with specified tasks pertaining to IF activities and institutions nor is the Central bank required to do so). IBs are however required to set up SSBs as a subsidiary organ of the board of directors of the IBs. The SSB reports to shareholders through the main Board of Directors, they have powers to rule on the compliance of products and contracts with *Shari'ah* and are by law required to evaluate and determine the *Shari'ah* compliance of the IBs. *Shari'ah* Scholars are full-time employees of banks offering IB services. There is no governing body that oversees *Shari'ah* Scholars discharge of their professional obligations. There are no provisions specific to IBs relating to audit requirements.

The consumer protection framework is yet to be adapted to cater to consumers of IB products. There is currently no difference between IBs and conventional banks in the disclosure requirements, with the exception of the fact that IBs are required to publish a statement by their *Shari'ah* board regarding the bank's state of *Shari'ah* compliance. IBs are not required to appoint independent board directors, explicitly or implicitly, to represent the interests of IAHs. There is neither a *Shari'ah* Court nor an Islamic Affairs Ministry. Nevertheless, the consumer protection framework covers misrepresentation to the general public by someone or an entity holding itself out as conducting its banking business on a *Shari'ah* compliant basis. Consequences range from cautionary warnings, fines and other administrative penalties. Customers may also seek arbitration under the ADR initiative run by the Kenya Bankers Association although the decisions issued by the Forum are not binding in a court of law.

There is no separate supervisory framework for IB or IsMF. All banks are also required to comply with IFRS whereas AAOIFI standards are not mandatory for IBs and have not been adopted. The onsite examination manual and guidelines do not distinguish between Islamic and conventional banks as does the supervisory process. The CBK does not supervise the banks on a consolidated basis nor does it have cross border supervisory arrangements in place. There are no macro-prudential policies tailored to IBs. The IBs, as with their conventional counterparts, are required to apply a risk management approach to the management of risks. Examination of *Shari'ah* compliance is not among the supervisory responsibilities. There is no difference between Islamic and conventional banks in the corrective and enforcement actions or in the processes.

In general, the country operates with a general Micro finance policy for all. The Cabinet Secretary of finance announced making legal and regulatory amendments to existing law to allow for the development of IF. The specific amendments have been made and the concerted effort by the government to make these changes will begin to see clarity in the regulation of this industry. This is inclusive of MFI as amendments have been made to the SAACO and Cooperative Acts.

For example, in its 2012 Public Finance Management (PFM) Act, it redefined "national government security" by inserting the word "Sukuk" immediately after the words "Treasury Bond". "Sukuk" means certificates of equal value, representing undivided shares in ownership of tangible or intangible assets, usufruct of assets; services or an investment activity, structured in conformity with Islamic law. Moreover, in the same act, it was included that "the cabinet secretary may make regulations for raising money by issuing Sukuk bond which shall specific the purpose for which money may be raised. Money raised through Sukuk bond may be raised within or without Kenya. This has enabled the government to issue Sukuk for raising funds from domestic and international markets, diversification of financial instruments and investor pools. As the result, Sukuk is now included in the list of authorized national government securities having a definition as an instrument, in accordance with AAOIFI standards. There is now observed equality between interest and profit, creating level playing field between conventional and Islamic instruments and the taxation applied to them.

Apart from the PFM Act, amendments were also made in the Income Tax Act. New definitions such as the following were inserted.

- "Islamic Finance arrangement" means all financial arrangements, including transactions, instruments, products or related activities that are structured in accordance with Islamic law;
- "IF return" means any amount received or paid in relation to Sukuk or an IF arrangement;
- "Sukuk" has the meaning assigned to it in the PFM Act, 2012; by adding the words "or an IF returns" at the end of the definition of the word "interest".

It also amended the Stamp Duty Act where terms like IF arrangement, IF return, Islamic property finance (property or land leased or sold to a financial institution and then leased or resold to a person for a return in accordance with Islamic law) were included.

The implications of these amendments clarity on what constitutes as Islamic property financing and Islamic mortgage arrangement to ensure legal protection and avoid any misinterpretation or abuse. Some also dub the implications saying that more level playing field created between conventional and Islamic mortgages/property financing arrangements by removing double stamp duty previously applied to the latter and making it more expensive, now the cost of stamp duty will be identical for any type of property financing whether conventional or Islamic. Moreover, tax neutrality provided for the transfer of ownership of any underlying assets in a Sukuk structure from the originator to the SPV and back. The amendments were also made in cooperatives laws.

These amendments in the various Public Acts are enabling now the government and the financial institutions in Kenya to:

- equally treat interest and IF return, providing a level playing field for conventional and IF assets and liabilities products:
- Create possibility of deduction of the cost of Islamic financing in tax returns as for the cost of interest paid on conventional loans putting them on equal footing
- Treat IF return received on Islamic deposits as interest received on conventional deposits, instead of tax treatment as dividend done previously
- Exempt VAT on the profit margin charged by a financial institution in an IF arrangement as in case of interest charged on a conventional loan, putting both types of arrangements on equal footing from VAT perspective

- Providing ground for licensing and supervision of SACCOS operating in compliance with Islamic principles

4.5 Somalia

Depositor's loss of their saving in Somalia during the conflict in 1991 eroded public confidence in the financial systems and banks. From 1991 to 2009 there were nearly no formal financial institutions in Somalia, outside of the Semi-autonomous regions of Somaliland and Punt land. The informal sector had been filling the gaps mainly with trust-based loans and money transfer services (hawalas). The hawalas played key role in facilitating international remittances and domestic financial transactions.

In December 2009, the Central Bank of Somalia (CBS) restarted operations from offices in Mogadishu and Baidoa. It carried out the traditional central bank functions such as licensing, regulating and supervising all banks and other financial institutions. The bank also involved in ensuring the public access general banking services including receiving deposits and providing lending for private or commercial purposes until commercial and development banks can fully takeover these functions. However, this service become potential conflict of interest because of its involvement in both commercial banking and bank supervisory role.

In 2012, Somalia developed its Financial Institutions Act and now (in 2017); the country has the CBS, six licensed banks and nine licensed Money Remittances Providers (Hawalas). There are also about 12 banks applied for licensing and other large number of Hawalas which are not yet registered but already provide international remittance services. Before engaging in legalized IsMF, Somalia has many strategic issues to address in the financial sector such as formalizing the sector and building a strong banking operations foundation.

Nonetheless, due to its Islamic identity, the country has high potential for IsMF. That is because, an estimated 72% of people living in Muslim-majority countries, such as Somalia, can be defined as "unbanked" because they do not have access to traditional financial services offering lending and savings components (Nimrah et al, 2008). Other reports also confirm that the world's approximately 1.7 billion people who live below the poverty line, 44% reside in Muslim countries (The nation, 2011). In Somalia, the majority of its ten million citizens fall into this category. These figures indicate that there are millions of people who could benefit from IsMF should the scheme has enabling and effective legal and regulatory framework. The supremacy of law and order and enactment of Pro-business laws should precede the promotion of IF in Somalia.

4.6 The Sudan

According to Elsadig Musa Ahmed, (2015), the Central Bank of Sudan (CBOS) in 2006 took the initiative of formulating a vision for developing and expanding microfinance sector in Sudan. The vision detailed the creation of a conducive legal environment by: reviewing current law and policies of the CBOS to encourage banks to provide micro financing through i) monetary and flexible pricing policy, ii) restructuring and of some specialized bank like the Savings and Social Development Bank, and the Agriculture Bank of Sudan, iii) improving outreach of financial institutions though more bank branches and downscaling, iv) licensing of MFIs. The vision specified the requirements for a regulatory framework such as minimum capital requirements, capital adequacy, loan provisioning etc. in order to expand the financial resources. It also called for wholesale lending by banks to MFIs. Diversification of products and services including making use of traditional modes of finance and setting conducive modes of investments was emphasized in the vision.

Institutionally; the vision called for the establishment of a Microfinance Unit (MFU) in 2007 at the CBOS for regulating, supervising and promoting the industry and establishing an Apex institution outside CBOS to help in coordination among all stakeholders. Since then, the policies issued annually by the CBOS incorporated specific section on microfinance.

Latter in 2013, Sudan issued policy allowing funds for Micro finance and social dimension finance. The policy ensured the financial inclusion via e-transfers and mobile banking which latter encouraged the establishment of Business Development Centers (PDC's) and made its priority to finance productive projects for graduate women and youth.

Again in 2015, policies were introduced to encourage MFIs to increase their capital and consolidate their governance relationships with banks. They also encouraged MFIs, to engage a mediator, enhance the Comprehensive Insurance Documents as a guarantee and ensure the client protection through the issuance of the Clients Protection Manual. A regulation related to licensing of MFIs and banks was put in place in 2006-2007 to encourage investors to establish MFIs specialized banks. Also, a modified regulatory framework to establish deposit taking, non- deposit taking or credit only in MFIs in Sudan was put in place in 2011. Depositor Protection regulations were introduced. The regulations also prescribe and specify the eligibility criteria for Directors of MFIs.

The general banking system in Sudan is regulated and supervised by the Central Bank of Sudan (CBOS) under section 6C of the Bank of Sudan Act 2002. (*Sudan country Islamic Finance Report 2016, page 32*). The CBOS increased the minimum capital requirement of an Islamic bank to USD 12 Million [when] and the reason for this was to encourage consolidation and the realization of economies of scale. The regulation also showed that there were restrictions when dealing with Directors and Shareholders when it comes to lending to individuals and there was a need to introduce aggregate financing of such connected parties. Also, in order to improve corporate governance the authorities ended the practice of CBOS staff being appointed to sit on bank boards as this was an example of clear conflict of interest.

Reporting standards in Sudan are relatively weak. None of the MFIs, except two, those being Family Bank and Port Sudan Association for Small Enterprise Development (PASED) report data to the Microfinance Information Exchange Market (MIX Market).

There are prohibited areas that apply to MFIs including restrictions to dealing in foreign exchange, accepting deposits from the government or public without prior approval from CBOS. Other prohibitions include engaging in real estate ownership or trading and investing reserve money in the financial market without the approval of the CBOS. The Microfinance industry in Sudan is well developed and is one of strongest in the IF industry and this is mainly attributed to the minimum legal and regulatory framework in place and support from policy makers and the political leadership of the country who see this as a viable and impactful industry.

Ali (2015) investigated that the Sudanese IsMF regulatory and supervisory framework. Despite of the exerted efforts by Sudanese government, Sudanese microfinance regulatory framework is not providing best outreach. Despite the continuous increasing of the ceiling portfolio by the regulatory authority until reached 12% from 4% since the first issued rules in 2006, the actually utilization is insignificant at the end of the year 2013. This might be due to several reasons such as bad basic infrastructures, ineffective follow up by the regulator of the microfinance providers, IsMF deliberately ignoring the rural areas clients' because of the high risk, the framework lack of the building capacity tools for clients as well as for the microfinance providers staff. The policy should be revised and evaluated for efficiency and effectiveness of the current operated microfinance framework in Sudan.

The aggressive microfinance development in Sudan has been driven by state governments and state banks. There has also been collaboration with development organizations in the Middle East to establish new Islamic MFIs (IRADA and El-Ebda being two examples). The lack of microfinance legislation presents problems not found in the neighboring CEMAC region. Because financial laws are not specific to microfinance, Sudan has relatively onerous collateral requirements. Independently operating NGOs and MFIs from foreign countries are generally viewed with suspicion. This is not to say that entering Sudan would be impossible; this study found a surprisingly vibrant microfinance culture in the country. However, it would be difficult without domestic backing, and stability concerns still make any activity outside Khartoum very dangerous.

Regarding the legal and regulatory framework, Microfinance policy was issued in 2011 and stated that MF units would be established at each CBOs branch. Subsequently, funds were allocated to MF and social dimension finance including infrastructure, women's empowerment, electricity and water in 2013.

The policy triggered the establishment of Business Development Centers (BDC's) and made it priority to finance productive projects for graduate's women and youth. In 2014 policies maintained by the continuity of regulations where directing finance to productive sectors and to finance graduates in rural areas such as women, artisans, youth and vocational graduates.

This policy also stipulated that the Cost-Plus Mark Up product (Murabaha) should not exceed 70% of the sales based lending as the nature of this contract is a fixed type of a contract and the bank would receive fixed profits unlike other products that allow for a higher rate of profit. In 2015, policies encouraged MFI to increase capital and consolidate their governance relationships with banks.

There are regulatory frameworks for the MFIs in Sudan.

i. Licensing Regulation -2006-2007

This encouraged the establishment of MF specialized banks and MFI in state capitals.

a) Federal, State and local may seek licensing
b) Documents required include, 5-year Business plans, market study, administrative structure, audit and accounting and names and cv's for directors and board members
c) Applicants should be either a public organization, private or public company registered under law, NGO registered and credit association etc.
d) Minimum required capital for Federal- SDG 20 Million, 10 for state and 4 for local.
e) Depositor Protection must have at least 5% of annual profits in reserve. Must place a minimum of 10% and a maximum of 40% of all deposits in liquid assets

   Reporting standards in Sudan are found to be weak except for 2 MFI Family Bank and Port Sudan Association for Small Enterprises (PASED) report to Microfinance Information Exchange (MIX market).

4.7 South Sudan

The South Sudan's financial sector is in its very early stages of development and access to finance is limited. The environment for microfinance in South Sudan is challenging with high operating expenses and rudimentary infrastructure. Although the Rural Finance Initiative (RUFI) is relatively well performing, it still needs a lot of capacity building. For example, human resources are still very limited in South Sudan and RUFI's capacities to manage a growing and more complex MFI are low.

Nonetheless, there are a few MFIs operating in South Sudan with some small cooperatives/ rotating savings and credit associations (ROSCA's). The Microfinance sector, while expanding, remains limited with 6 MFIs operated 76 branches across the country by 2010 and reached only 5 percent of potential clients in the capital (Juba), and less than 1 percent in the entire regions. The three main MFIs consist of BRAC SS (a subsidiary of the Bangladeshi INGO), SUMI (the result of Greenfield investment by USAID), and FSL (funded by ARC International and Micro Africa Limited).

There is also a functioning microfinance association (MASS), although further support is needed for it to fulfill its potential. MASS is run by the CEOs of two of the leading MFIs but it lacks a secretariat and adequate funding. Also, a credit reference bureau (Credit info) is in place within the Bank of South Sudan (BSS) and functional since January 2015, but not yet accessible by MFIs.

Murphy (2015) reported that there are four major MFIs operating within Juba's state, Central Equatoria, and two others operating in other states in 2015. They serve approximately 20,000 clients in Juba, estimate they have reached about 5% of the Juba area market, and intend to expand outreach to the rest of the target market. The post-conflict environment has contributed to huge needs in terms of capacity building (MFI Boards, management and staff), education and awareness raising for clients, weak infrastructure, ***and weak legal environment for lending*** (Saaid Ali, 2015).

On the legal and regulatory front, the Bank of South Sudan (BOSS) has Act, 2011 which serves as the core banking Act for the country. Although there are 610,000 estimated Muslims population (6.2% of the total population) according to Saaid Ali (2015), South Sudan has not devised Sound legal and regulatory frameworks for Islamic Micro- financing.

4.8 Uganda

The Uganda Parliament made several regulatory changes to the governing law, the Financial Institutions Act 2004 (the "FIA"), by passing the Financial Institutions (Amendment) Act 2016 (the "FIA Amendment Act"). The FIA Amendment Act was passed by Parliament on 6 January 2016 and received Presidential assent on 19th January 2016.

To be able to conduct Islamic banking, the FIA Amendment Act states that the already licensed financial institution which is permitted to carry out Islamic banking can only do such business through an "Islamic window[13]".

This means that where existing financial institutions acquire a license to carry on Islamic banking business, it will be distinct from the mainstream financial institutions business. Islamic banking services/ products will benefit from the experience and systems that the conventional banking business has. The Islamic

[13] *Islamic window is that part of the financial Institution, other than an Islamic financial institution, which conducts Islamic financial business.*

window will make possible liquidity management because of the easy access to liquidity support from the conventional banking division of the financial institutions. With anticipated limited market and demand for Islamic banking services in the initial stages, the Islamic window could be the only feasible way of providing Islamic banking services, thus enhancing financial inclusion.

Uganda has currently no existing IsMF industry, but with the above developments both on the legal framework and the regulations being prepared by the policy makers that all areas of the Islamic finance industry will be introduced in due time.

5. Constraints and challenges facing the Industry in the IGAD region

Despite its prudent contribution to poverty alleviation, the Islamic Finance industry in itself suffers many challenges such as shortage of finance, educated human resources, high interest rates, participation, issues of collaterals, etc. Due to the IsMF's peculiar nature (mainly interest-free nature), it faces even more and complex challenges that hinder it from thriving. Some of the challenges transcend regional frontiers and some are context specific. Some of such challenges the industry is facing in the IGAD regional context are listed and elaborated below:

5.1 Lack of enabling Sharia and secular legal and regulatory framework

The IsMF is unique in that it requires additional layer of oversight which is given by Shariah advisor who are stakeholders and can determine the validity of the transaction. These groups could be the National Sharia Advisory Board that advises and manages all activities at the highest level or the Stand-alone Shariah Boards- which are financial institution which set up its own Shariah board and follows its own policies. These sharia overseeing bodies are commonly found in the Gulf countries and followed by many countries in Africa practicing IF. However, such bodies are not created in most of the IGAD member countries.

As discussed in all of the IGAD member countries in section 3 above, there is no adequate and enabling legal and regulatory frameworks for IsMF even in Muslim majority countries such as Djibouti, Somalia and Sudan. This negatively affects the legitimacy and operations of the scheme and its transparency. Development of enabling legal, policy and regulatory framework can emanate from political will at the governance helm and evidence based policy recommendation from research institutions on the utility and significance of the industry in poverty alleviation and meeting the SDGs.

Therefore, more research work is needed that disclose the practical utility of the scheme in fighting poverty and how lack of enabling legal framework affects its proliferation in the IGAD region. For example, success history cases can be developed and shared for policy influence from among Muslim majority pastoral communities and women groups accessing interest-free loans from the IsMF schemes and their livelihoods advancement.

5.2 Lack of diverse and fitting business models and products for the IsMF

There are a number of Islamic Finance products which are proved to be in compliance with the Sharia law and the fundamental microfinance principles and which can be adapted to promote entrepreneurial development (Hamid, 2016). These include Murabah (Mark-up sale), Musharakah (Partnership), Mudharaba (capital-labor partnership), Muzara'ah (Mudarabah contract in farming), Wadiah (deposits), Qard Hassan (benevolent loan), Musaqah (Musharaka contracts for orchards). Others are Ijarah Muntahiya Bittmalik (lease to purchase), Wakala (procurement), Sarf (Money exchange), and

Hiwala (Money Transfer, among others. Similarly, different models have been developed over the years to serve as modus operandi for the delivery of IsMF products and services.

The models and the products cover range of products such as credit products, financing products and insurances. However, most commonly used products tend to have short or medium-duration maturities. When such a business model, specially the Profit/Loss sharing instruments, is implemented on a wide scale, it is expected to have social benefits/impact such as targeting more poor people, less likely to have over-indebtedness problems, more focus on productive economic activities, more job creation, etc.

The Islamic financial Products should consider the Market segmentation from day one, IsMF should think as an investor and not only as a creditor, Takaful/Micro-insurance and Savings: Wherever regulation allows, savings should be a core element of an IsMF business model. The lack of innovative products has caused the slow growth and development of the industry.

Some of the models and products are being adopted in African countries through Banks and Microfinance Institutions. However, the experience in the IGAD region is limited to Islamic Windows in commercial banks. Therefore, the various players in the region are required to design more diverse models and products for IsMFIs and Islamic Banks to serve different groups of beneficiaries.

5.3 Lack of standard procedures, taxation rules and facilities

At the core of Islamic law are the different juristic interpretations and schools of legal thought. This has led to the development of not only IF but also other sectors of Islamic law to have difference of opinion and different interpretation. Thus, this is reflected in the rulings given by the judges as well as the product development and management of IF services.

Lack of standardized regulatory, accounting, auditing, external ratings, and Shari'a compliance procedures makes operations so difficult. The Islamic Financial Services Board (IFSB, established in 2003 in Kuala Lumpur, Malasia), and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, established in 1991 in Bahrain), were created to provide standard Accounting and Auditing procedures, setting up infrastructure that will help with harmonization and ensure transparency. However, membership and adherence to their standards remains optional. Moreover, the regulatory structures do not have specific provisions for IsMF, making its structures and practices highly variable. The institutions do not have real powers to enforce or require organizations to join and follow the rules rather they are voluntary and you follow the rules based on good faith.

Other opposing views have argued that IF does not require standardization or harmonization as this goes contrary to the traditional understanding of Islamic law and will stifle the vibrant nature of the legal tradition. The standardization organizations have been making particular focus on Sukuk, takaful, and ijara as they are the most theologically contentious and dynamic growth areas. However, recently they announced that there are plans to revise standards concerning murabaha, the most common product in IsMF.

To further enhance IsMF, there is a need for strengthening the supervisory and regulatory frameworks, including with a set of comprehensive prudential standards. Specific standards have been developed by specialized standard-setting bodies, but regulatory and supervisory frameworks in many jurisdictions do not yet cater to the unique risks of the industry. Achieving full compliance with regulatory, and supervisory standards offered by AAOIF and IFSB is important which provide multiple guidelines and standards, but much work is still needed to ensure compliance, including a transparent and credible assessment process for evaluating compliance with standards.

IGAD member countries, except Sudan and Uganda are not members of these standards setting organizations. In the IGAD, there are also no standardized or accredited sharia compliance certification or education programs. An important regulatory challenge is to ensure that profit-sharing investment accounts (PSIA) at Islamic banks are treated in a manner that is consistent with financial stability. The countries are required to be either members or develop sound standards of their own to facilitate the operations of the sharia compliant microfinance products and schemes. These offers have to be promulgated in the financial directives of the IGAD member countries.

5.4 Prevailing misconceptions and political developments about IF and IsMF

There are some times observed political upheavals in the IGAD region that grossly demonizes Muslims and vilification of Islam by linking it to global terrorism chains which resulted in over-protective governments in some countries in the region that treats charity flows in Muslim communities with some degree of suspicion. These have been indirectly reflected in some of "the anti-terrorism laws" of the member countries.

People question that "why is the IF setting such roots to manage assets of Trillions?" The industry is seen to be masquerading as ethical but in reality as perceived it is interchanging terminologies and definitions but the essence is still conventional. The prevalent misconceptions of the industry being geared towards a niche market which looks to serve only Muslims should bet tackled. Instead, those of the faith vis-à-vis an industry with a value proposition that looks to serve all people of all faiths, all backgrounds regardless of their faith-affiliation should be promoted.

The IGAD member states should consider the cross-faith orientation of the services of the IsMF scheme and its poverty alleviation intent and raise the awareness of the broad mass accordingly and the political authorities and financial professionals should develop similar positive perception towards the industry.

5.5 Emerging Risk Management and moral hazards

The IsMF is dubbed for its prudent risk sharing feature. However, in profit-loss sharing contracts (e.g. in models of *mudaraba and musharaka*), the lack of repercussions for defaulting borrowers can incentivize risky behavior, but scholars remain inconclusive about enforcement mechanisms. Requiring borrowers to provide collateral is not necessarily Sharia compliant. Profit-loss sharing also creates a moral hazard for entrepreneurs to report lower profits and exaggerate losses.

Regarding taxation, Islamic mortgages, cross-border payments, the treatment of non-interest mark-up fees, and the applicability of value-added tax or goods and services tax to the assets anchoring transactions all require tax structures and provisions that differ from the conventional equivalents. Without a tax regime specifically suited to IBF, IBFIs can face some degree of double taxation and/or indirect tax. Tax systems should base treatment on economic substance and move away from distortionary transaction taxes toward more neutral profit-based taxes.

More innovations are required in Shari'a compliant accounting software and management information systems. There should be an effort to develop institutional or geographic hub for IT innovation for IsMF in IGAD, for example. The IsMF accountancy, auditing, and risk management professionals also lack a set of common certifications or credentials, and there is no accreditation body for the array of non-profit and for profit educational institutions and programs.

5.6 Levels of public awareness

An acute problem that precludes the mainstreaming of institutions of IF – commercial and social – relates to low levels of public awareness in the region. Not every Muslim avoids transactions with riba (interest) and nor does s/he understand the meaning of zakah, sadaqa, waqf and/or seek opportunities to invest and finance in a Shariah-compliant manner. The low consumer education on IsMF products makes the market not ready. The low penetration rate of IsMF in certain jurisdictions is mainly due to lack of public awareness and perception toward Islamic financial products and services.

5.7 Lack of capable institutions (poor human and physical capacities)

The lack of institutional and human capacity at all levels has proven a great encumbrance for the industry in the IGAD region. Industry growth has primarily been individual based, i. e the industry develops mainly because of certain leaders/personalities who are authorities in the field and have captured the loyalty and respect of the masses as opposed to the industry developing around institutions which are long lasting and outlive the founders of the famous persons and thus the knowledge is not institutionalized and becomes problematic in future.

There is a lack of IF professionals. Many of those who could be interested have low understanding of the industry being open for all peoples of all backgrounds if they have the expertise. And this is primarily because the industry has only been formally existent in the past 40 years and thus most bankers or professionals are conventionally trained and are yet to receive IF training. On the other hand, those interested in the industry because it appeals to their faith might not necessarily work to gaining the technical skills required but rather believe they understand by default of their faith and background. It's a double -edged problem which needs serious attention as the lack of expertise makes for an industry that will suffer in the long run. IF requires very specific skills and these are lacking in the industry. For example, Takaful or Islamic Insurance experts are few and far in between and yet this is an important aspect to the industry.

There is lack of institutions to promote alternative financial products and services to the Muslim population. Regulators do not always have the capacity (or willingness) to ensure Shariia compliance, which undermines consistency of approaches within and across border.

6. Prospects of Islamic Microfinance in the IGAD region

Despite all the challenges clouding the sector, the following positive factors are identified from the assessment which can serve as springing board for future growth of IsMF in the region:

- Significant number of Islamic population avoiding non-sharia complaint financial product lines
- The member countries' overall orientation to fight poverty and work towards financial inclusion and meeting the SDGs is promising
- Support of the International Financial Institutions including IMF and positive research findings endorsing the utility of the scheme for financial inclusion and fighting poverty provides the confidence for promoting IsMF and future research on the subject
- The preliminary legal and regulatory frameworks in the member countries and the start-up service provision practices primarily through the Islamic Window approach can serve as basis for future building up of the scheme in the region

In terms of their move towards adopting IsMF, the IGAD member countries can be classified into three:

i) **Relatively advanced member countries**

Djibouti, Kenya and Sudan have relatively advanced legal and regulatory considerations and have shown that they are well on their way to leading in this regard within the region. However, there are still prevailing challenges. The following table shows summary of some of the success factors and still existing challenges in these countries.

Table: 2 Success measures and challenges of adapting IsMF in advanced group countries

Success measures	**Standing challenges**
Sudan has proven that it is the 4^{th} leading country globally to implement Islamic MFI	Lack of sufficient human capital to develop the industry and limited number of service providers
Regulations and policies in place for both Sudan and Kenya (recent amendments), which are critical factors to developing the industry	Key regulations on reporting and accounting are yet to be developed, standardized and to be followed
Investing in Capacity Building and Awareness creation in the case of Djibouti hosting the annual Islamic Finance Banking Summit as a platform to share knowledge	Capacity building and awareness creation are still not unto par for where the industry needs to be thus leading to continued misconceptions which hamper growth of the scheme
The governments of the three countries have shown good level of political goodwill to developing this industry	Lack of harmonization and standardization of the operational procedures within the industry

ii) Middle group member countries

These are countries which are still exploring. Ethiopia and Somalia are in this group which can learn from the Kenya experience without reinventing the wheel. In Ethiopia, the industry was primarily started as market-driven portfolio and was not based on regulations and policies and thus took longer to develop losing out on opportunities to further the market and support poverty alleviation programs at every level. With the new legal and regulatory amendments and moves from the governments and the financial institutions, there looks to be increased vigor in the industry and the market will open to further competition which will lead to more innovative products and services.

In Somalia, a formal regulatory system is in order first although the ingredients to make the Islamic MFI a success are already there including a predominant poor Muslim community who would see the products as addressing their faith convictions, and developing mobile money network to name a few.

Ethiopia with its large Muslim population and already established partial legal framework in the form of Directives given by the NBE could easily move to the advanced group level. The country can reconsider the restrictions on the opening of only Islamic windows and not fully fledged entities towards realization of full potential for the industry. Islamic windows bring along their own challenges with some Muslims arguing that they cannot be sure its fully Shariah compliant and in the case of Non-Muslims the windows have been seen to a clever way of providing interest based products just by the mere fact of setting up shop in the same premise and no guarantee can be given to no commingling of funds or even separation. Thus, it becomes a case of a calling a mule a horse but looks like a mule, talks like a mule and behaves like a mule and thus is a mule.

iii) Bottom group member countries

The Countries at the bottom with little experience of in terms of practicing the IF and IsMF are Eritrea, South Sudan and Uganda. These countries will be required to initialize the practice nearly from non-existence.

Eritrea can purpose to avoid travelling the long- winded route of developing the industry via the market but rather develop the regulations and policies. The government can put in efforts to understand the benefits of the industry as through their positive support can the industry grow. Developing the legal and policy framework and awareness creation campaigns for the populous and capacity building will be important first steps to promote the scheme.

South Sudan, as the latest entrant to the group can look to see what are the pitfalls the other member countries have made and seek to avoid those and develop the industry. We have the case of Oman which was the last Gulf Country to implement IF and they chose to take the route of developing their Islamic banking laws and developing a strong foundation including capacity building campaigns and marketing for the industry before the actual industry develops and this has seen them catch up and surpass some of their neighbors in the region.

Uganda has opened its markets to IF after decades of being part of the OIC and IDB member countries. The Islamic banking law that was passed early this year will need regulations and policies to support this. As a country, it does not need to reinvent the wheel but rather look to the detailed policies developed by Sudan and the government's active role in developing the industry. This would lead to no wasted opportunity as Uganda can have direct reverse linkage programs with Sudan and exposure trips under the IDB reverse linkage programs and technical support for IDB member countries.

In general, in order to promote positive prospects of the scheme in the region, IGAD can learn from other countries promoting the IsMF scheme and from Mature Markets. The region can consider the following, among others, to improve the prospects:

- At initial steps, assess the market potential for sharia compliant microloans, based on sharia observant Muslim population size, growth rate and prospects of developing regulatory and technically assisting institutions
- Appreciate the IsMF's utility for fighting poverty and ensuring financial inclusion
- Consider developing robust and enabling legal and regulatory framework for IsMF
- Engage in rebranding the scheme to reduce the prejudice against the scheme and do aggressive but targeted awareness creation on poor Muslim communities using the mass media, Mosques, mosque committees and other sharia committees (bodies) available
- Identify and build the human and institutional capacities of the sharia complaint service providers for sustainable development and progression of the industry
- Consider providing strategic and fundamental support to the industry by including it in national financial inclusion and poverty eradication plans
- Consider becoming members and collaborators with relevant global bodies such as the IFSB and AAOIFI which are standard setting bodies and have best practice in the industry

7. Conclusions, Recommendations and the Way Forward

7.1 Conclusions

The Koran and Islamic law prohibit the *riba* (interest) on conventional microfinance. On the contrary, there is a standing and increasing liquidity demand from Millions of poor Muslims in the IGAD region to finance their small to medium livelihood creation and development initiatives to help them extricate from poverty. There are evidence-based claims in this existing body of knowledge on the instrumentality of IsMF in helping in the fight against poverty and ensuring financial inclusion which makes the scheme a compelling choice for impoverished and unbanked/unreached Muslims. Responsible national and regional bodies are required in IGAD to create Islamic financial models and products that comply with the sharia law and at the same time respond to sustainable microfinance principles.

This study has indicated that although there are signs that the scheme is gaining some level of political support and there is growing demand for it in the region, there are still no sound legal and regulatory frameworks. The scheme is also entangled in many forms of challenges hindering its expansion. Some of such challenges include: limited service providers (not often full-fledged) and there are no legitimate operational confidences, low understanding of the nature of the client demand (the need for more authentic product lines that are designed to meet the diverse customers' needs), lack of diverse but fitting business models and IsMF products, lack of standard procedures, misconceptions and negative political developments, risk management problems, low public awareness and lack of institutional and human capacities.

On the contrary, the steady growth trend in the region, significant number of Muslim population, high demand for sharia compliant microfinance service, some registered success histories like from Sudan, etc. indicate that there is potential for growth of IsMF in the region.

7.2 Recommendations

The assessment indicated that there are various policy level reforms and feasible technical adjustments in the financial sector that member states and other involved stakeholders can do to promote IsMF in the IGAD region. The following are recommendations made for concerned bodies based on this study.

a) **Political will:** Significant number of people is being excluded from the fight against poverty because of low access to sound microloans. The IGAD member governments should develop political will that translates into creating suitable policy and operational environment as well as work towards clearing unjustified stereotyping against the scheme and IF at large. Most of these unbanked communities have been through conflicts and marginalization, pastoral communities, etc. and therefore should gain a priority national agenda.

b) **More empirical research:** This assessment report has indicated that data is scanty in the IGAD region on IsMF. Objective and empirical research is required to be conducted in member countries to produce authentic data base on number of Muslim population that demand microfinance loans to run their livelihood initiatives but avoid it for religious reasons. The research should also take account of the capable service providers and nature of IsMF product lines that comply with the Sharia law and can meet microloan requirements. The demand-side equation of the scheme should be deeply understood. The research can be conducted by government entities or non-state actors in the region like Think Tanks and Financial Research Institutions. The evidenced-based research findings can also be used to influence the policy process and to yield the political will.

c) **Creation of Awareness**- The prevailing misconceptions and ignorance surrounding the industry is rampant in the region. Thus, this calls for an aggressive but effective marketing and awareness campaign towards disclosing the ethical values that are inherent in every culture and the scheme. The diversity within the community could be promoted to bring different thoughts and backgrounds to consider the industry and the intrinsic values embedded in it.

d) **Legal and regulatory frameworks**- the industry in IGAD member countries has grown primarily driven from a market perspective. A more concerted effort needs to be made to consider vivid inclusion of IsMF in the financial directives and develop the industry. This would help legitimately navigate any future issues that may arise as the industry develops. The central banks can play useful role on this.

e) **Standardized procedures:** The financial Institutions and the sharia body in countries work together to standardize all operational procedures based on the AAOIFI and IFSB benchmarks. The countries can also customize the standards to their contexts. The standards should ensure the authenticity of the sharia compliant product lines and work in harmony with microfinance principles such as risk management, sustainability, etc. The scheme can exhibit more transparent features and can benefit from the reporting standards as it can utilize the accounting principles, pricing methodologies, financial audits, and eventually, rating services, etc. from the AAOIFI and IFSB guidelines.

f) **Human Capital and institutional capacity** – the industry requires trained professionals at every level on sharia compliant product lines. Initially the industry was developed by bankers and professional service providers. With time, a deeper understanding of the industry is needed and a strong foundation and grasp of the principles is required. A professional model is needed to allow for the industry to grow with best practices in the region.

g) **Financial Inclusion:** The perceptions of the policy makers, bankers and financial professionals on IsMF should be geared towards financial inclusion than any other prejudicial mindsets. The scheme has the potential to bring marginalized, under-banked communities often times ravaged by war and conflict into the development finance accessing community groups. This would go on to address poverty alleviation and play its part in pushing member countries to middle level.

h) **Piloting:** At the micro and institutional levels, international donor agencies can play a major role in expanding access to finance among poor Muslims by funding pilot projects which provide the opportunity to test various Islamic microfinance business models.

i) **Create more service providers:** There are no adequate service providers in countries like

Somalia and South Sudan. The IGAD member countries should address such problems to provide space for the IsMF to thrive.

j) **Develop diverse and more feasible models:** Developing more feasible models where risk is shared between the MFI and the client is important as it gives people more opportunity. Such models sometimes tends to reduce supply and voidance of interest means that there is not a reliable cash flow with which to earn income that can be used to extend loans to additional clients-challenge for sustainability and growth of IsMF. Strive to develop a more diverse market where more providers offer a broader array of products based on customer needs and behaviors.

k) **Beyond Microfinance-Trade and Investments**- majority of the countries except for Kenya, Ethiopia and South Sudan are already part of the OIC and trading through multilateral and bilateral agreements. The relationship has to be strengthened through mutual understanding and cooperation. Trade opportunities must be created to cater to the growing halal economy. The State of the Global Islamic Economy Report 2016/2017 highlighted the Key Islamic Market Based Growth Drivers which are as follows:

- Large, young and fast growing global Muslim demographic
- Large and fast growing Global Islamic economies
- Islamic ethos/values increasingly driving lifestyle and business practices
- OIC economies growing Islamic /Halal(Ethical) market development
- Participation of global multinationals
- Developed economies seeking growth markets
- Growing significance of ethical food, finance, fair trade, education and environment
- Technology and connectedness

The IGAD member countries can position themselves to serve this market through building stronger relationships and marketing strategies which is in turn dependent on strong political will. The policy makers must see that the idea that IF in general is bringing a value proposition to the table to help development program and the fight against poverty.

Annex 1: Defining Measures of a Financial Product to be a Sharia-Compliant

There are various IF products compliant with the sharia law that obtained sharia compliance certification (process by which a product is deemed Sharia-compliant). The certification differs greatly among institutions as they tend to use more than one method.

Zoghbi and Trazi (2013) summarized the characteristic features of sharia-complaint financial products in the sense that Islamic financial principles are premised on the general principle of providing for the welfare of the population by prohibiting practices considered unfair or exploitative. The most widely known characteristic of the Islamic financial system is the strict prohibition on giving or receiving any fixed, predetermined rate of return on financial transactions. This ban on interest, agreed upon by a majority of Islamic scholars, is derived from the following two fundamental Sharia precepts:

i. **Money has no intrinsic worth**. Money can increase in value only if it joins other resources to undertake productive activity. For this reason, money cannot be bought and sold as a commodity, and money not backed by assets cannot increase in value over time. All financial transactions must be linked, either directly or indirectly, to a real economic activity; they must be backed by assets, and investments may be made only in real, durable assets.

ii. **Fund providers must share the business risk**. Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors (who share the rewards as well as risks associated with their investment).

Islamic (Micro) Finance, however, extends beyond the ban of interest-based transactions. Additional key financial principles include the following:

iii. **Investment activity**. Activities that are deemed inconsistent with Sharia, such as those relating to the consumption of alcohol or pork and those relating to gambling and the development of weapons of mass destruction, cannot be financed.

iv. **No contractual exploitation**. To protect both parties, contracts are required to be by mutual agreement and must stipulate exact terms and conditions. Additionally, all involved parties must have precise knowledge of the product or service that is being bought or sold.

Annex 2: Glossary of Commonly Known if Products and Models

Murabaha is a *"cost plus mark-up"* sale contract often used to finance goods needed as working capital. Typically, the client requests a specific commodity for purchase, which the financier procures directly from the market and subsequently resells to the client, after adding a fixed "mark-up" for the service provided. Ownership of the commodity (and the risk inherent thereto) strictly lies with the financier until the client has fully paid the financier. The mark-up is distinct from interest because it remains fixed at the initial amount, even if the client repays past the due date.

Qard-Hassan is an interest free loan, often disbursed for welfare or charitable purposes, mentioned specifically in the Qur'an (57:11). A Qard-Hassan loan is relatively easy to administer, and perhaps more importantly, it is the Islamic financial product that can most easily be applied to consumption smoothing as opposed to enterprise financing or asset building. Its suitable use depends on the institution: some restrict it to education and health care.

Salam is an advance payment against future delivery of goods and services. It is often used in agricultural contexts to buy agricultural inputs to ensure that shortages of cash will not derail production latter on.). It allows the farmers to finance production in exchange for a future delivery of the crop. For the transaction to be considered Islamic, the amount and quality of the future goods and the actual delivery date must be explicitly stipulated.

***Musharaka*:** It is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. The profit-and-loss sharing schemes of musharaka are not widely offered by IsMF providers—though they are the Islamic financial contracts most encouraged by Sharia scholars as best reflecting Sharia principles. It can be used for assets or for working capital. It is an equity investment similar to mudaraba except for differences in the sharing of profits and losses and responsibility for the initial capital**.** It is difficult to implement at the microfinance and even SME level because the transparent and standardized client accounting practices necessary to monitor profits and losses are often rare or unevenly developed skill sets. For regular consumer and commercial financing, the risk of corruption, deliberate overstating of losses and/or underreporting of profits dissuades its widespread use. The information asymmetries and amount of monitoring and evaluation needed is too labor intensive for many institutions. As a result, despite the risk-sharing ethos of musharaka embodying central ideas of Islamic economics, this contract remains underdeveloped and underused.

Mudaraba: An equity investment between a financier (*mudarib*) and an entrepreneur who share profits according to a predetermined ratio. Losses are borne by the financier who supplied the capital; the entrepreneur bears the loss of his or her time and labor. It denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project (or provides some other form of nonfinancial contribution). In this product, profits are shared according to a predetermined ratio but any financial losses are borne entirely by the financier while the manager loses time and effort (or other nonfinancial contribution). It require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed fairly. Consequently, though promoted strongly by Sharia, they result in substantial operating costs, particularly for micro and small enterprises that are not accustomed to formal accounting.

Murabaha: A "mark-up" or "cost-plus" sales contract in which the bank's fee/profit is added to the purchase price of a good and the client pays in installments toward the single, non-disaggregated price. An industry-wide overreliance on murabaha is widely acknowledged, fueling criticism of the IBF industry as only nominally Islamic, as the mark-up fee is seen as analogous to interest. For taxation purposes however, the distinct between fees versus interest can become critical. The bank's offer of murabaha and the client's acceptance of it must be two distinct contracts signed by both parties, rather than one general agreement, with the offer contract being signed before the good is purchased. This document must also include a detailed description of the good, and all dated invoices must be supplied.

Muajjal: A credit sale utilizing a contract to establish deferred payment terms between a buyer and a seller. The contract sets both a fixed price and singular payment date or installment payment dates. Fees are not disclosed separately, but are rolled into the price quoted to customers. Even if there is a purchase of a good at some point in time, if the good is not bought and delivered to the client per the original terms of the contract, then the transaction will not be Shari'a-compliant. Monitoring & evaluation is required to ensure Shari'a compliance, but is often prohibitively expensive.

Ijarah: A leasing contract whereby a financier buys a productive asset on behalf of a client, and then leases it out to the client in exchange for regular repayments. The financier maintains liability for the asset throughout.

Istisna: A payment contract for a made-to-order asset with all materials/inputs provided by the manufacturer. A delivery date does not have to be set in advance, nor does full payment necessarily need to precede manufacture. This tends to be a longer-term contract suitable for infrastructure projects, power development, or other types of construction, whereby installment payments can be tied to construction progress.

Takaful: Takaful encompasses several forms of Islamic insurance, referring broadly to a group of participants who agree to support one another jointly for losses arising from specified risks, motivated by the principle of *ta`awun*, or mutual assistance. A "takaful operator" (the company or institution) organizes this group. A participant contributes a sum of money (akin to a premium) into a common fund as insurance against specified loss or damage. Takaful underwriting is thus undertaken on a mutual basis. Money in the common pool held in reserve is invested (according to Shari'a); profits and losses are distributed between participants and the takaful operator according to the type of takaful model.

Ju'ala* (*Service charge*)*: A party pays another a specified amount of money as a fee for rendering a specific service in accordance with the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.

Kifala: It is a pledge given to a creditor that the debtor will pay the debt, fine or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.

Zakat, Waqf, sadaqat Jariyah: Zakat is Islamic philanthropic tool (2.5% alms giving of your wealth every year and is to be distributed to those who are less fortunate by those who can afford. This is a compulsory charity that is incumbent on all those who can afford. The second tool is that of endowment through a physical asset e.g. a property and is known as Waqf or Sadaqat Jariyah. Zakat collection in member countries of the OIC where 20 out of the 39 OIC member countries can lift those in poverty simply through collection of Zakat and distribution of Zakat through domestic sources and remittances. Half of the IGAD member countries such as Somalia, Sudan, Djibouti and Uganda are OIC member countries and could potentially benefit from this model.

The Pakistan's Akhuwat Model: A model that helps to bring down the operational cost of providing microcredit to the poor by drawing on volunteers and other means (such as use of places of worship for credit delivery). It also mobilizes charitable funds on a sustained basis to absorb the operational costs, which are now much lower. As a result, the costs of loans have not just been brought down—they have been brought down to zero. Some argue that the poor should be provided grants and not loans. The provision of microcredit may violate the very essence of zakat but the proponents defend the Akhuwat model because the amount of zakat funds mobilized in contemporary Muslim societies may be grossly inadequate if given as grants. As loans from a revolving pool, a given amount of zakat can serve a much larger number of beneficiaries.

Johor Corporation (JCorp)-Malaysia: A form of corporate waqf that intends provision of social services such as health care and daily services for those who are less fortunate. The fact that the innovation has been done by a corporate company can lead us to encourage companies in the IGAD region to develop CSR programs of this nature that can offer sustainable solutions of the community.

Using Waqf to Fund Microfinance- Fael Kheir Program in Bangladesh: started by supporting the construction of several hundred schools that also serve as cyclone shelters in the coastal belt of Bangladesh. The initial investment grew exponentially showing us that how a benevolent cash donation can be used to engineer a waqf. It is also a rare example of how the high administrative costs of a poverty alleviation program (with finance as well as skill enhancement inputs) may be absorbed by returns generated by a waqf dedicated to poverty alleviation.

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