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# Islamic Banking opportunities Across small and Medium Enterprises in Africa

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**Abstract:** After a first part dedicated to the presentation of the Islamic financial landscape, through its history, the different products offered and its mode of operation, the present work addresses the financing issues of small and medium enterprises in Africa.

Our study focuses more specifically on identifying the financing of small and medium-sized companies in Africa, what contribution can alternative finance play in terms of diversification of funding sources.

The motive of this research is that the reader will find the elements likely to nurture and enrich a very relevant debate in these times of turbulence where the system that made the heyday of the financial world lacks solutions.

**Keywords:** SMEs, Islamic finance, Africa, financing.

## 1. Introduction

Islamic finance is going global. It seems to fascinate the West and excite the curiosity of financiers who see it as a crucible of financial innovations. The financial engineering that underlies certain Islamic bond financing products such as Sukuk is becoming more sophisticated. But this nascent financial industry still faces challenges before it can assert itself in the contemporary circuits of global finance.

Thanks to its considerable development, the Islamic Financial Institution is undeniably part of today's global financial landscape. A surge in the price of hydrocarbons has generated an excess of liquidity in the producing countries, particularly the Persian Gulf, thus contributing, if not to the appearance, at least to the growth of IFIs. These countries, whose Islamic current is considered the most literalist, have not hesitated to adopt this mode of wealth management, prohibiting any loan with interest and promoting the concept of Profit and Loss Sharing, also called PLS.

Islamic finance is not a novelty because Islamic financial institutions' products already existed before in the conventional banking market. In the same way, the principle of the PLS stated previously, and defining the relations between the institutions and their clients as being of partnership, even of association, does not constitute a revolution of the financial professions. Is the *Musharaka* contract not simply an unoriginal variant of the venture capital or LBO operations that made the classic economic system successful before the crisis?

The originality of the Islamic financial system lies on the one hand in the formal prohibition of any interest-bearing loan operation, or usury more exactly, according to the Muslim legislator, the value of money altering through time is simply not recognized. On the other hand, the prohibition of certain illicit activities according to the *Sharia* constitutes the legislative referent of the Muslim world, for example, all the cycles of alcoholic drinks (from production to marketing), pork production, games of chance and Gambling.

After a first part dedicated to the presentation of the Islamic financial landscape, through its history, the various products offered, and its mode of operation, the present work focuses on the problem of financing SMEs and Islamic finance.

It will attempt to answer the following questions:

- The principles, the functioning, and the development of Islamic finance?
- What are the main limitations of Islamic finance?
- What are the Islamic financing opportunities for SMEs?

## 2. The rise of Islamic finance

### 2.1. Globalized finance open to non-Muslims

Islamic finance has been expanding considerably over the last twenty years. The Arthuis report notes that the figures concerning Islamic finance are still very partial and subject to caution. Nevertheless, all the experts agree that the global Islamic finance market would exceed 500 billion dollars today, ten times more than twenty years ago. A recent study by Moody's even indicates that it would have already reached an amount of 2000 billion dollars.

According to Standard & Poor's, the Islamic banking market is below its true potential, 4200 billion.

The geographical distribution of this market is as follows: approximately 70% of assets are held in the Persian Gulf region, 20% in Asia -Malaysia and Indonesia-, and the remaining 10% are held in Europe, notably in London and in the United States. Over the past twenty years, its assets have grown by an average of 8 to 11% per year. Their growth would be of the order of 15% per year. Today, Islamic finance operates in over 60 countries through more than 300 financial institutions.

"We will adapt our legal environment so that the stability and innovation of our financial center can benefit Islamic finance" these words of Mrs. Christine Lagard , Industry and Employment, reflect the interest of the West for Islamic finance . Should we also see it as a response to Mr. Gordon Brown, who wants to make London "the western gateway and the world center of Islamic finance "?

With the economic and financial globalization and the craze for ethical and sustainable finance, non-Muslims are interested in Islamic finance and even contribute to its development outside its natural borders, those of the Islamic countries. What has helped this finance develop is the Muslim oil-producing countries, they have committed large amounts of money in Islamic financial institutions.

This halal finance appears like an excellent opportunity for conventional banks. It is an alternative way to invest and an additional way to raise vital funds. It is finance that allows gaining new market shares. The interest in Islamic finance goes beyond the Muslim world. It is becoming a global issue, with experts from Standard & Poor's and Moody's expecting it to continue its global geographic expansion. The strong demand for Sharia-compliant financial products and services around the world will encourage the development of increasingly sophisticated but tangible and stable non-interest-based Islamic banking products. These products are no longer the prerogative of the Gulf monarchies or Muslim Asia.

And yet, thanks to globalization, Islamic finance is experiencing a revival, with, in particular, the launch in 2002 by Malaysia of the first Islamic government loan, the Sukuk (Islamic bond).

Will this finance nevertheless be exported throughout the world to become a financial system in its own right?

In March, a Moody's Investors Service report noted that non-Muslim countries "as economically necessary as Japan, the United Kingdom, and China are seriously considering strengthening the role of Islamic finance in their domestic markets, adding to the credibility of this phenomenon. These countries want to improve the attractiveness of their financial centers for capital-seeking Sharia-compliant management.

#### 2.1.1. Profitable market

Islamic banks benefit in principle from risk reduction related to moral hazard and adverse selection. By participating in companies' boards of directors through profit and loss sharing instruments (Musharaka), Islamic banks can improve their performance level. Indeed, several comparative studies show that Islamic banks are more efficient than conventional banks.

We compare the return on equity (ROE) often large conventional banks and ten large Islamic banks. Their total assets measure the size of the banks.

The conventional banks selected are Bank of America, Barclays, BNP Mellat, Citigroup, Crédit Agricole, Deutsche Bank, HSBC Holding, ING, Royal Bank of Scotland, UBS.

The selected Islamic banks are Al Rajhi Bank, Bank Saderat Iran, Bank Mellat, Bank Tejarat, Kuwait Finance House, Dubai Islamic Bank, Bank Sepah, Agricultural Bank of Iran- Bank, Keshavarzi, Bank Maskan, Abu Dhabi Islamic Bank.

As we have already seen, Iranian banks dominate the ranking of Islamic banks in the world. However, these banks must be studied with caution because their Islamization results from a different historical process than in other countries; the evolution of banking in Iran, according to some experts, resulted from a public initiative after the 1979 revolution that transformed the system with a forced manner.
Islamic banks have a lot of liquidity on their liabilities, and their refinancing cost is low. As a result, margins are high, and risks are low on some business lines.
These data show that the Islamic banking system has a better overall performance and could explain the enthusiasm for opening Islamic branches by conventional banks.
The Islamic banking market is divided into two categories: the historical Islamic banks by creation or by change of status and the conventional banks with "sharia-compliant" windows.
The transition from conventional to sharia-compliant banking has generally been successful. Banks with adopted Islamic status have set higher rates without changing their investments, especially in quality services. Being "sharia-compliant" is a label longed for by clients.
Islamic finance has its advantages but also its constraints. It could usefully contribute to an ethical reorganization of capital flows on a global scale. It can also play a role in the financing of emerging economies and Western countries with significant Muslim minorities; it has potential compatibility with microfinance and can reinforce the experiences of microcredit like the Grameen Bank for agricultural projects and micro-enterprises. The waqf or habous technique can be used to finance social activities both in emerging and developed economies.

### 2.2. Islamic finance in Africa

The penetration of Islamic banks took place in the early 1980s with the creation of banks (Massraf Faysal Al Islami) and investment companies in three West African countries with a Muslim majority: Senegal, Niger, and Guinea. Today, the active establishments are mainly spin-offs of the most influential groups: Dar Al-Mal Al Islami Trust and Al-Baraka Group.
**In** Sunni **Sudan,** the successful establishment of the Faysal Islamic Bank in 1977 encouraged the authorities to promote other Islamic banks. In 1984, the entire banking system was deemed Islamicized, but conventional banks continued to operate in practice. It was not until 1994 that the government decided to Islamize the system and make it more organized and structured.
**As far as the Maghreb is concerned**, this region could become one of the future development centers of Islamic finance. More and more Islamic institutions are operating there.
Only one Islamic bank currently offers its services in Tunisia: BEST Bank (Beit Ettamouil Essaoudi Bank). However, in February 2007, this type adopted a bill authorizing the creation, in collaboration with the IDB, of the first Islamic bank to develop inter-Arab trading, which will be responsible for

financing and promoting trade between Arab countries and, more particularly, between the countries of the Maghreb and the East.

**In Algeria**, Islamic finance shows a certain dynamism compared to its neighbors. Established in 1991 through the Al Baraka bank of Algeria, it has been redeployed, since 2002, to other market segments (professionals, individuals). For a long time in a monopoly situation, the Al Baraka bank attracts, because of its performances, other establishments (Al Salam Bank of the United Arab Emirates, Kuwait Finance House). However, although the government has authorized the marketing of Islamic products, it refuses to grant favors to Islamic banks in terms of specific conditions of exercise.

The rise of Islamic finance in this part of the world is explained by the changes that the North African banking sector is currently undergoing (privatization). In this environment, Islamic banks, which are very successful in the retail banking segment, want to play a role in the new banking landscape (as far as corporate and investment banking is concerned, they still seek the expertise of their foreign counterparts). However, it does not seem that Islamic finance can, in the short term, develop as a dominant financing technique, especially since financial institutions are fully aware that the determining criterion, beyond the rules of compliance with the Sharia, will remain economic profitability.

**Appendix 1**: islamic financial institutions by region

| Region | Number of financial institutions | Percentage shares |
|---|---|---|
| South and Southeast Asia | 36 | 42,4 |
| Golf Country | 19 | 22,4 |
| Others from the Middle East | 13 | 15,3 |
| Africa | 9 | 10,6 |
| Europe and America | 8 | 9,4 |
| Total | 85 | 100 |

Source: SOULEIMANI R , La finance islamique: évolution, licence fondamentale en sciences économiques et gestion,

## 3. SMEs in Africa and Islamic finance:

SMEs represent an essential part of the African economic fabric and participate in production and employment. However, the major obstacle of these enterprises is the insufficiency of sources of financing, the traditional bank credit does not allow to cover all the needs and remains very weak; indeed the financial institutions work with vigilance and consider the sector of SMEs too risky, while the establishments of microcredit do not have enough funds to answer the increasing needs of the SMEs.

The problem of SME financing in Africa is due to the following reasons:

- Insufficient equity ;
- Lack of guarantees;
- Very high applied rates;
- Management issues;
- Credit risks;

The evaluation and rating procedure for SMEs must be adapted to the particularities of SMEs, especially concerning the guarantees required and the rates applied (excessive). Thus, the loan repayment terms should be designed so that repayment is synchronized with revenue flows. This is especially true for seasonal businesses with high but unstable revenue streams. African policymakers should pay special attention to SMEs by increasing access to finance and should reduce the tax burden to encourage the competitiveness of these firms in the domestic and international markets.

## 4. Prospects for SME financing in Africa by Islamic banks

The global Islamic finance market is worth more than $2,000 billion at the end of 2015, which has motivated African countries to seek to position themselves and take advantage of this young industry. But statistics show that the continent still lags on the global map.

The governments of African countries have launched several projects in recent years. For example, the first Sukuk project in Senegal in 2018 (fundraising of 200 billion CFA francs), the Ivory Coast, and Togo have also launched similar projects, and these countries have raised nearly 1.2 billion euros in the last two years. As a result, several Islamic banks have been created.

Islamic finance, known as alternative finance, attracts new entrants every day, but the regulatory and fiscal framework remains weak; there is not enough regulation to reassure investors. The start and growth of this activity necessarily require the establishment of a good legislative framework, whether the tax framework or even the regulatory framework framing this branch of conventional finance.

African central banks need to adopt specific rules for Islamic finance, as their authorities do not master the workings of this industry due to insufficient training.

In addition, traditional banks could launch new products following the principles laid down by the religion of Islam to better meet clients' expectations, minimal and medium-sized enterprises. The practice of leasing corresponding to the Ijara Wa Iktina could also be encouraged. Conversely, the Islamic bank could find a way to use operations used in conventional banks such as discounting or bank overdraft following the Sharia.

The PLS (Profit and Loss Sharing) principle allows to spread the risks well between the bank and the investor; the entrepreneur will work in better conditions because this financing approach will enable him to reduce the risks. For example, in the mucharaka contract, the client brings his skills and, at the same time, the bank puts the requested funds at his disposal. This association encourages the bank to share its know-how and its assistance. It is an opportunity for the bank to control the projects permanently.

This mode of financing is ideally suited to SMEs, and more particularly, to companies with ill-defined projects. Islamic banking always keeps a human vocation, "Islamic finance integrates [...] moral and ethical values. A parallel is often made between Islamic finance and responsible investment [...]. The accountable investment seeks to optimize both the financial return and socially responsible or ethical behavior.

The formulas proposed by Islamic banks (alternatives) can make the relationship "bank-SME" more equitable because the bank will be a real partner (principle of the PLS) and not a simple intermediary. In addition, Islamic banks will provide their expertise to accompany SMEs; we can also add that the diversity of Islamic financial products will encourage young project holders, whose primary concern remains the presentation of sureties and solid guarantees when applying for conventional credit banks. It should also be noted that the principle of the PLS (profit and loss sharing) will upset in some ways the working methods pursued by conventional banks that should change their behavior and practices of doing by offering other complementary solutions.

## 5. Conclusion

Today, the subject is of greater interest. The accumulation of oil revenues, the weakening of conventional finance, and financial traceability requirements make the debate around "interest-free" Islamic finance more precise. Some actors see it as a valuable complement to international banking expansion, serving to channel part of the oil revenues. Others see it to increase the number of people seeking "sustainable financial products" in line with Muslim ethics.

Despite its young age, contemporary Islamic finance has excellent potential for success in Africa.

But the increase in complexity through the innovation of "Sharia-compliant" products must be controlled. It is, therefore, hoped that a future Sharia financial council, preferably of public origin, will preserve the natural character of this interest-free loan so that it remains finance at the service of the real economy. Any "speculative" slippage based on unconsidered "leverage effects" will give reason to its detractors.

The line that should not be crossed regarding Islamic financial innovation remains to be defined, especially in light of the current global crisis. It is one of the main challenges for the emergence of an actual African-style Islamic finance in the years to come.

The arrival of alternative banks in Africa could boost the economy, thanks to the multiplicity of financing offers intended for companies and households. The SME can accelerate its growth; it is necessary to adapt to the new financial landscape thanks to better reactivity and good governance at the management level and strategic choices to take up the challenges.

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