Available online at www.sciencedirect.com
ScienceDirect
Review of Development Finance 3 (2013) 136–151
Review of DEVELOPMENT FINANCE
www.elsevier.com/locate/rdf

The Islamic finance promises: Evidence from Africa☆

Issa Faye, Thouraya Triki, Thierry Kangoye *

Development Research Department, The African Development Bank, Tunisia

Received 13 August 2013; accepted 13 August 2013

Abstract

The objective of this paper is to improve understanding of the market for Islamic finance in Africa. Specifically the paper provides a mapping of Africa-based Islamic finance providers, quantifies the amount of foreign Islamic funding received by Africa and compares performance of African Islamic and conventional banks. We find that there are significant cross country variations in the way Islamic banking has been developed in Africa and in the type of services offered. Our empirical findings also support the superior efficiency of Islamic banks and suggest that Islamic banking could be beneficial for Africa.

Keywords: Islamic finance; Islamic banking; Bank performance; Efficiency; Stability; Africa

JEL classification: F30; G20; O16

1. Introduction

Islamic financial institutions achieved annual growth rates in excess of 20% over the last decade, leading to an estimated market size of about USD 1.25 trillion in 2010 (The CityUK, 2011).[1] This growth was mainly fostered by the innovative aspect of Islamic finance, reforms in regulatory and taxation frameworks aimed at accommodating Islamic financial activities, and efforts made to beef-up Islamic financial infrastructure geared towards ensuring better risk management and corporate governance.

The origin of Islamic finance in Africa can be traced back to the 1960s with Egypt being the first African country offering Islamic banking under a low profile for political reasons (Aburime and Alo, 2009; Mouawad, 2009). Several African countries followed suit which helped give raise to an African market for Islamic finance estimated at USD 37.5 billion as of 2008 (The CityUK, 2011). While this figure looks high at first sight, it remains negligible compared to the potential for Islamic finance in Africa estimated at USD 235 billion (Moody's, 2008). What's more, the market for Islamic finance in Africa is not only small in absolute terms but also in relative terms with African Islamic financial institutions holding less than 3% of global Islamic financial assets. The disparity between the current state of Islamic finance in Africa and its potential raises questions about constraints to the development of this type of finance. Lack of detailed information about Islamic finance providers in Africa and on the performance of African Islamic financial institutions further prevents a good understanding of this market. Indeed, research about the state and structure of the Islamic finance market in Africa is rather scant.

The objective of this paper is to fill this gap in the literature by answering 3 questions. First, what does the market for Islamic Finance in Africa look like? The paper provides what we believe is the first comprehensive mapping of Africa-based Islamic finance providers. Second, to what extent does Africa benefit from international Islamic funding? Third, how do African Islamic banks perform compared to their conventional

☆ The views expressed in this paper are those of the authors' only They should not be interpreted as those of the African Development Bank, its management or those of its member countries The authors would like to thank Mouna Ben Dhaou for excellent research assistance and Soumendra Dash for useful comments.
* Corresponding author. Tel.: +216 71101609.
E-mail address: t.kangoye@afdb.org (T. Kangoye).

[1] Throughout the paper Islamic finance refers to all financial assets and institutions that are compliant with *Shariah* principles, namely the prohibition of interest and speculation (*Riba* and *Gharar*). The paper does not discuss the distinguishing characteristics of *Shariah*-compliant institutions and instruments. For such a detailed description, please refer to Iqbal et al. (1998), Aburime and Alo (2009), Mouawad (2009), Gait and Worthington (2008) and Islamic Finance and Global Financial Stability Report (2010).

Peer review under responsibility of Africagrowth Institute.

Production and hosting by Elsevier

1879-9337 © 2013 Africagrowth Institute. Production and hosting by Elsevier B.V. Open access under CC BY-NC-ND license.
http://dx.doi.org/10.1016/j.rdf.2013.08.003

peers? The rationale for focusing on Islamic banks is twofold. First, banks represent the dominant players both in African financial systems and the global Islamic market.[2] Hence, it is important to identify differences in performance related to the "Islamic" characteristic of banks as this could have policy implications to further develop financial sectors in Africa. Second, the market for Islamic non-bank financial institutions in Africa remains embryonic which makes any robust statistical analysis impossible.

Our results show that the market for Islamic finance in Africa remains severely underdeveloped and counts only 116 providers from 21 countries. This number falls to 67 when Sudan, which carries a financial system that is *Shariah*-compliant, is excluded. Islamic banking is by far the most commonly offered Islamic finance service with 74 providers. This is consistent with patterns observed in the conventional African financial system and the global Islamic financial market. Yet, Islamic banking providers in Africa remain scarce and represent less than 10% of commercial banks operating in the 21 African countries offering Islamic financial services. Interestingly, Islamic banking has been developed using 2 different models in Africa. The first model consists in setting up fully fledged Islamic banks while the second model consists in setting up windows dedicated to Islamic finance within conventional banks. So far the first model prevails.

We find that North Africa counts the largest number of Islamic finance providers but that East Africa is home to the largest number of Islamic banking providers. We attribute this trend to the flexible approach that regulators have been adopting in East Africa and which is conducive to innovation. We also document strong variations in the type of Islamic financial services available in African countries. While South Africa has been successful in developing Islamic investment funds, West African countries have been more successful in developing Islamic microfinance.

Our research reveals also that Africa received at least USD 14 billion in Islamic project finance and USD 1.6 billion from *Sukuk* issuances on international markets over the period 2005–2012. While these amounts may look impressive at first sight, they remain negligible compared to the continent's needs. For instance, the annual funding gap for infrastructure alone is estimated at USD 93 billion. International Islamic funding is not only limited but is also concentrated on few countries. Project finance remains concentrated in North Africa which captured 82% of resources provided while Sukuk issuances remains limited to 3 African countries.

Finally, our results suggest that Islamic banks in Africa are more stable as they report lower insolvency risk and higher returns on average assets. They also have lower non-performing loan (NPL) ratios but higher loan loss provisions. This result likely reflects the fact that Islamic banking transactions are backed by real assets giving very small room for speculation and lower NPLs. Our results suggest that Islamic banks adopt a prudent approach to provisioning to circumvent taking avoidable risks. These provisions are expected to help them to tide over the difficult times without affecting their normal banking operations in case of any large scale defaults. Our results also suggest that Islamic banks are more efficient. Our findings are robust to controls for country fixed effects and the share of assets held by the government in the banking sector. They also have strong policy implications for financial sector development in Africa as they tend to indicate a superior performance of Islamic banks which gives support to the development of such institutions in Africa.

The remainder of the paper is organised as follows. Section 2 provides a mapping of the Islamic finance market in Africa while explaining the main identified trends. Section 3 describes Islamic funding flows that Africa was able to attract. In Section 4 we empirically investigate differences in performance between African Islamic and conventional banks while Section 5 concludes the paper.

2. Africa as a home for Islamic finance: a mapping exercise

Our data show that the number of African countries offering *Shariah*-compliant products remains limited to 21 out of 54 African countries (Table 1). We also find a wide diversity in the type of Islamic finance services available in Africa.[3] We were able to identify 116 institutions offering 4 different Islamic financial services: 74 providers of Islamic banking, 33 institutions offering Islamic insurance "*Takaful*", 4 offering *Shariah*-compliant investment services through investment funds and 5 offering Islamic microfinance. Table 1 shows that East Africa counts the largest number of Islamic finance providers (65) followed by North and West Africa which count respectively 25 and 14 providers.[4] Interestingly, East Africa is downgraded to the second position with 16 providers once we exclude the Republic of Sudan (hereafter referred to as "Sudan"), which has a fully *Shariah*-compliant financial system.[5]

While North Africa counts the largest number of Islamic finance providers if one excludes Sudan, their number remains low compared to what one would expect from a region that is home to about 38% of Muslims living in Africa. For instance GCC which counts a large Muslim population account for over

[2] According to The CityUK (2011) 80% of global Islamic financial assets were controlled by Islamic banks in 2010.

[3] Figures discussed in this section are computed by the authors using different data sources that are listed in Table 1. Note that institutions offering multiple services were counted only once under their main area of focus to avoid double counting. For instance, an Islamic bank that offers banking and microfinance services is counted only once as an Islamic bank. Hence, figures discussed in this section constitute lower bounds for Islamic finance providers in Africa.

[4] The following country classification is used throughout the paper: North Africa: (Egypt, Mauritania, Morocco, Tunisia, Libya); Eastern Africa: (Sudan, Uganda, Djibouti, Somalia, Sudan); West Africa: (Mali, Gambia, Burkina Faso, Senegal, Sierra Leone, Guinea, Togo, Niger, Benin); Central Africa: (Chad, Cameroon, Gabon); Southern Africa: (Mozambique). These countries were identified as those offering Islamic finance in their respective regions.

[5] Under the 2005 Comprehensive Peace Agreement, it was agreed that the Republic of South Sudan will have a conventional financial system while the Republic of Sudan will maintain a financial system that is *Shariah*-compliant.