Islamic Finance: Innovative Financing for the SDGs

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I- Introduction

With the world leaders adopting the 2030 Agenda for Sustainable Development in 2016, various countries and development organizations (international and regional) have been working to set the course of all development efforts towards promoting prosperity, preserving and protecting our planet and improving the livelihoods of all people. 2030 Agenda defines 17 Sustainable Development Goals (SDGs) that aim to end poverty, fight inequality and injustice and tackle climate change. The implementation of this agenda requires significant financial resources, much more than what has been available. Hence, to help countries deliver the SDGs, there is a need for exploring new approaches of partnerships, and innovative sources of finance to leverage private investments, faith-based and social giving alongside official development assistance.

One vital area where innovative partnerships could better respond to the financing needs of SDGs is Islamic finance (IF) that has emerged as an effective tool for financing development worldwide, including in non-Muslim countries. There is evidence that IF has untapped potential as a substantial and non-traditional source of financing for the SDGs. This is especially true for Africa which is home to roughly 400 million Muslims – about a quarter of the world's total. There are growing signs that Africa is embracing large-scale IF as it seeks to tap cash-rich Middle Eastern investors to finance their large infrastructure programs.

Nonetheless, there is a range of challenges that need to be addressed, to realize the great potential for growth in both the size and scope of IF industry. This potential can only be tapped if there is a strong drive to adopt an appropriate regulatory regime, coupled with market and product innovation and diversification. Considering the scale, strengthening the collective ability of various relevant institutions to better leverage IF will be crucial to offer governments a strong, non-traditional source of financing to advance towards realizing the SDGs and leave no one behind.

The objective of this note is to boost awareness on the major respects in which Islamic Financial Institutions (IFIs) play a fundamental role in the achievement of SDGs, and highlight interest about the potential of IF to help governments in Africa leverage new sources of financing SDGs. Accordingly, the note is divided into 7 sections, including the introduction and the conclusion. Section 2 reviews the potential contributions that IF can make to achieving the SDGs, section 3 discusses the principles and instruments of IF, section 4 highlights the most important growth drivers of IF in Africa, section 5 addresses the most important challenges facing IF in Africa, and finally section 6 provides some recommendations that can overcome the identified challenges.

II- Islamic Finance potential in financing SDGs

On 1 January 2016, the 17 SDGs of the 2030 Agenda for Sustainable Development officially came into force. The SDGs build on the success on several fronts of the Millennium Development Goals (MDGs) that covered the period from 2000 to 2015[1], and aim to go further to end all forms of poverty. Yet, the world today still faces a number of severe crises, from the environmental devastation of climate change, to the upheaval and suffering caused by political and military unrest. At present, for example, 783 million (10.9% of the world population) live in extreme poverty— less than $1.90 a day, another more than 1.2 billion poor living on US$1.90 to less than US$ $3.2 a day (World Bank, 2018). SDGs should continue to pursue the ultimate objective of MDGs, namely to transform the world for sustainable development by 2030. SDGs contain 17 goals and 169 targets. The scale of aspiration embodied in the SDGs is huge, while the current levels of voluntary donations and available investments are simply not sufficient to provide even the most basic of necessities.

Financing SDGs has been estimated at between US$5 and US$7 trillion over the 15 years' horizon of SDGs[2], with an investment gap in developing countries of about US$2.5 trillion[3] every year (at least 50% of the required funding). The largest financing gap in reaching SDGs is projected to be in climate change and power, while the smallest gap to be in health and telecoms (See Figure 1). Official Development Assistance (ODA)[4] flows (US$146.6 billion in 2017) and all financing by Multilateral Development Banks (about US$ 127 billions) (Ahmad, 2017) represent less than 5.5 percent of the estimated total financing needs. To help countries deliver the SDGs, there is a need for exploring new approaches of partnerships, and innovative sources of finance. One essential area where innovative partnerships could better respond to the financing needs of SDGs is IF that has been one of the fastest-growing segments of the global financial industry during the last two decades.

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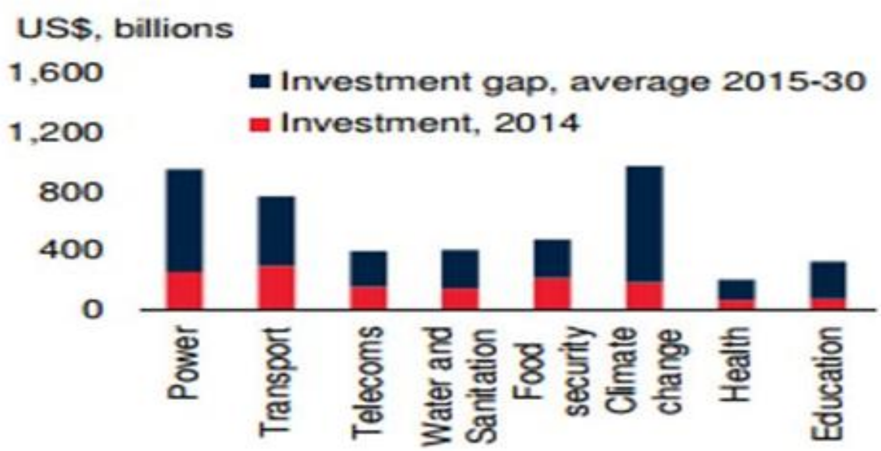
[1] For example, more than one billion people lifted out of extreme poverty; undernourished people in the developing regions declined by almost half (from 23.35% to 12.9%); child mortality rate for those under five declined by over 50%; more girls attended school than ever before; and new HIV infections fell by 40%.

[2] Source http://www.undp.org/content/undp/en/home/blog/2017/7/13/What-kind-of-blender-do-we-need-to-finance-the-SDGs-.html

[3] Source: http://www.worldfinancialreview.com/?p=22037

[4] ODA is provided by the member countries of the OECD Development Assistance Committee (DAC).

Figure 1: Investment Gaps in Reaching SDGs, by sector



Source: World Bank, Global Economic Prospects, January 2017

The worth of worldwide Islamic financial assets leapt from half a million dollars in the 1970s to US$200 billion in 2003, to over one trillion US$ in 2009, and had surpassed US$1.88 trillion by 2015[5]. Should IF keeps this growth momentum, there are promising prospects that the global IF will develop into an industry with a value of US$3.24 trillion by 2020, with a growing number of new market entrants to reach one billion users. This explains the increasing global interest in exploring how various mechanisms of IF can play a critical role in closing the SDGS financing gap in Muslim and non-Muslim countries, as well. It's estimated that there are over 1,500 organizations working in IF across 90 countries – 40 percent of which are non-Muslim-majority countries. In fact, IF has also seen substantial progress breaking ground in new non-Muslim majority countries and growing in already-established markets, including China, Kenya, Nigeria, Tanzania, South Africa, and the U.K.

III- Islamic Finance Principles and Instruments: the link to SDGs

Successful implementation of the 2030 Agenda for sustainable development requires a significant amount of financial resources beyond traditional development financing. While the later has helped to lift the lives of many, some argue that not only it is not enough to meet the basic needs of the ambitious SDGs, but it has also derailed from its intended objectives, resulting in many economic, environmental and social challenges. This is partly because financial entities managing the global financial capital focus on financial risk and return considerations, with little attention, if any, to negative externalities of an investment- like environment pollution.

[5] Source: https://blogs.worldbank.org/eastasiapacific/sustainable-development-goals-and-role-islamic-finance

Therefore, there have been attempts in recent years to make finance more "ethical", and to explore innovative ways and solutions that finance can offer to build a more sustainable future. IF has proved to be one of the prominent innovative solutions in this respect. Furthermore, there is growing evidence that IF resonates with the 2030 Agenda. It provides an important complementary and supplementary means that can go a long way in supporting efforts to overcome the challenge of underfunding the 2030 Agenda (IDB and WB, 2018). IF has ingrained positive values and ethical characteristics and principles and a range of social finance tools that enable it well to catalyze and promote the SDGs. To be considered Sharia-compliant, a financial institution or transaction needs to meet the Quran's rules against usury and uncertainty. The specific principles of IF ethical framework include:

(i) Fostering social solidarity and social welfare schemes via compulsory and voluntary donation modes that facilitate redistribution of wealth and opportunity (*zakat, sadaqah, waqf and qard hassan*);

(ii) Prohibition of *Reba* (interest or excessive interest leading to slavery)[6], limiting debt to the value of assets;

(iii) Encouraging risk/reward-sharing modes of financing, promoting access to assets, goods, markets, finance, etc..;

(iv) Prohibition of *Gharar* (excessive uncertainty of payout, deception, risk and speculation; and gambling), encouraging responsible behavior;

(v) Transactions must be backed by tangible and identifiable assets that anchor the financial sector in the real economy and focus on the long term; and

(vi) Forbidding investment in or dealings with prohibited (*haram*) industries, notably all businesses related to alcohol and brewing, tobacco, drugs, weapons and armaments or pork-based products. The ultimate goal of these principles is to create a sustainable, equitable, and socially responsible financial system.

With respect to IF instruments, the traditional Islamic philanthropy tools and programs such as *zakat* (compulsory almsgiving[7]), *sadaqah* (charitable giving); *wakf* (donation of endowments) are central in the IF model and have the greatest role to play in pursuit of many SDGs. This is, of course, in addition to multiplicity of real asset-based structures that facilitate long-term investment, like *Mudarabah* (Profit sharing and loss bearing), *Wadiah* (safekeeping), *Musharaka* (a cost-plus-mark-up or joint venture), *Murabahah* (cost plus), and *Ijar* (leasing); beside *takaful* (a joint guarantee based on the underlying principle of mutual cooperation and solidarity – an Islamic alternative to conventional insurance -to protect and stabilize institutions in the case of financial

[6] Sharia does not consider money as an asset on its own because it is not tangible; therefore, it may not earn a return from the simple fact of time elapsing.

[7] Almsgiving or zakat is one of the Islam's five pillars. It is an annual obligatory practice for Muslims to give a certain percentage of their income or 2.5% their assets for mustahiq (zakat legitimate recipients). It is not levied from the wealth that relates to consumption or production investment, but it is levied from idle wealth, creating thus disincentive to hoarding wealth and induces economic redistribution from the rich to the poor.

collapse), and *sukuk* bonds (Islamic capital market instruments that can address some of the financing challenges faced by developing countries).

Table 1 shows an array of 17 modalities of IF that lead ultimately to the main objectives of *Shariaa*[8], namely empowerment of beneficiaries and sustainable development and shared prosperity. Nevertheless, some types appear more predominantly than others and financial institutions tend to combine aspects of different instruments to tailor different transactions (Gelbard et al., 2014).

Furthermore, IF's strong potentials to promote financial inclusion, which is seen as the key enabler of other developmental goals, are completely in line with the SDGs. A relatively large population in OIC member states is currently out of available financial services due to their religious ethical concerns. Equally relevant for SDGs is the potential of IF to promote SMEs, agriculture and micro finance. Islamic financial instruments offer viable alternatives to debt issuance, through Sukuk, which is backed by assets, to finance sovereign and infrastructure projects in many developing countries.

Table 1: Islamic Finance Modes of Finance

#	Mode of Financing	Role of the Financial Institutions	Role of the Beneficiaries	Kind of Business	Benefit and Impact
(i) *Sales related Financial products*					
1	Murabaha (Buy-resell),	Sell	Buy	Trade	Access to Goods
2	Bai-Ajal (Instalment Sale),	Sell	Buy	Trade	
3	Salam (Forward selling)	Buy	Sell	Trade	Access to Markets
4	Istisnaa (Manufacturing)	Manufacture	Buy	Industry	Promote Manufacturing
5	Parallel Istisnaa	Buy Manufactured Goods	Manufacture	Manufacturing	
(ii) *Placement related Financial Products: Mudarabah, Muzaraa, Mussakat, Mugharassa (Venture capital in Agriculture production)*					
6	Mudarabah (Profit sharing)	Participate and follow-up	Execute Works	Diversified Works	Promote works
7	Mussakat	Participate and follow-up	Follow-up Agriculture	Agriculture	Development of Agriculture and Agribusiness production
8	Muzaraa	Participate and follow-up	Execute Agriculture Activity	Agriculture	
9	Mugharassa	Participate and follow-up	Plant trees	Orchards	
(iii) *Lease and Leasing financial Products:*					
10	Ijara(Lease)	Lease	Rent	Service	Access to Equipment
11	Ijara Wa-Iqtinaa(Leasing)	Rent and Sell	Rent with possibility of purchase	Lease with possibility of purchase	Access to Equipment
(iv) *Equity related financial Products: Musharaka, Musharaka Mutanakissa*					
12	Musharaka	Participate	Participate	Works	Promote Business
13	Musharaka Mutanakissa	Participate and withdraw	Participate and Own	Business	
14	Muqawalah	Construct & Realize Works	Buy	Public Works	Promote of Public Works
15	Muqawalah Muwazizh	Buy	Construct & Realize Works	Public Works	

[8] *Shariaa* is defined as Islamic law or Law of Allah. *Shariaa* covers not only religious rituals, but also many aspects of day-to-day life, politics, economics, banking, business or contract law, and social issues. The authority of *Shariaa* is drawn from two primary sources (i) the specific guidance in the Holy Quran, and (ii) the *Sunnah*, or the way that Prophet Muhammad (pbuh) lived his life.

Table 2 2/2

#	Mode of Financing	Role of the Financial Institutions	Role of the Beneficiaries	Kind of Business	Benefit and Impact
(iv) *Saving, Micro-insurance (Takaful)*					
14	Saving	Provide Saving Facility and investment opportunities	Save for investment and Micro-insurance	Investment and Takaful	Promote Investment
15	Micro-insurance (Takaful)	Provide Takaful Facility	Construct and Realize Works	Takaful	Mitigation against future risks and promote investment
(v) *Free loans (Qard Hassan) and (vi) Grant (Sadaqah, Zakat, Waqf)*					
16	Qard Hassan	Participate	Get a Loan	Varies	Access to Finance
17	Grant	Participate and withdraw	Get Financed	Varies	

Source: Ahmad, 2017.

Commonalities of principles between IF and sustainable development architecture are striking, as both tend to emphasize ethics, justice, fair treatment, equity, inclusiveness, etc. It is possible to trace the fingerprint of the Quran in each and every one of the SDGs. For example, the Quran expounds the importance of food, water, safety, security, and peace which are all also central to the SDGs.[9] A recent report (S&P, 2016) found IF to be especially relevant in addressing 12 of the 17 SDGs (See Figure 3)[10].

For example, *zakat*, as well as *sadakah* and *waqf*, share in essence with SDGs a huge portion of profound commonalities. The first and foremost of zakat recipients are *al fuqaraa* and *massakin* (poor and needy/vulnerable) which aligns with SDGs 1 and 2 to end poverty in all forms and achieve food security and zero hunger in the world.[11] Moreover, zakat reflects the spirit of SDGs such as reducing inequality (Goal 10) and supporting economic growth by transferring the idle wealth to the less fortunate that empower (Chapra, 2008) them as well as encourage them to have socio-economic opportunity to grow (Goal 8). In general, *Zakat*, *waqf* and *sadaqah* have long been used to help the poor, at-risk and destitute in a variety of ways — for instance, by providing access to affordable housing (Goal 11), by improving quality of living standards, and by implementing better avenues to good healthcare (Goal 3) and education (Goal 4), and

[9] See for example *Surat Al-Anbiyaa*, verse 30, and *Surat Quraysh*, verses 1 to 4. Also, Water, for example, is mentioned over 60 times in the Quran, and its centrality to life is emphasized

[10] IDB, 2015 identified 9 SDGs that are compatible with IF modes (See Annex Fig 1)

[11] These two goals could probably be dealt with through the use of concessional loans from Multilateral Lending Institutions (MLIs) or bilateral loans from developed countries. Yet, IF has its own forms of concessional lending, specifically qard hassan, zakat and waqf.

access to clean water and sanitation (Goal 6) There are several best practices in utilizing zakat as a social intervention.[12]

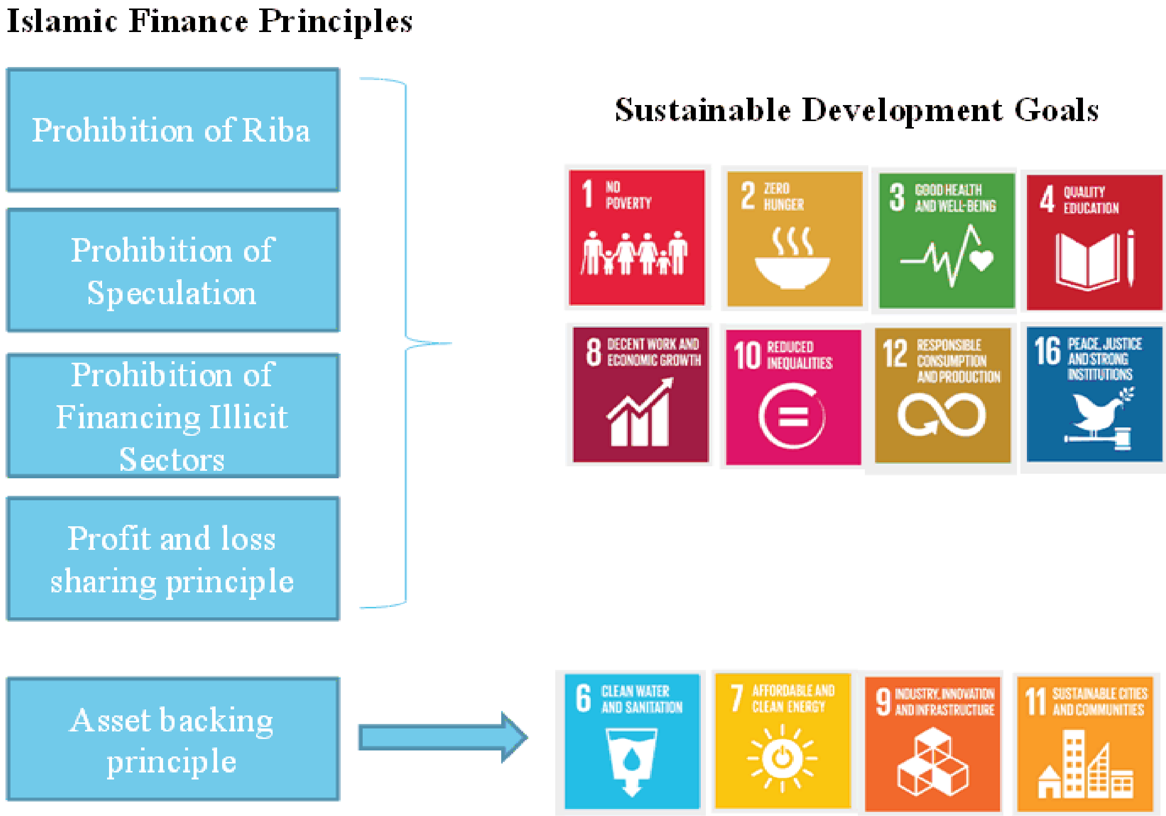
Also, the principle requiring underlying assets in each Islamic financial transaction makes IF a good equivalent for the financing of infrastructure, which is part of SDGs 6, 7, 9, and 11. Another example comes from the analogy between the probation of excessive speculation (*gharar*) and responsible production (Goal 10), and between prohibition of financing certain sectors such, as weapons and armaments, and Goal 6, which aims to promote peaceful and inclusive societies.

IF can thus be used to increase funds and mobilize donations from a diverse range of sources, including the corporate sector, impact investors and social entrepreneurs. These funds can be used to support delivering essential aid in the midst of crises, as well as to provide the more long-term financial support necessary for long-term investments to achieve SDGs (IDB and World Bank, 2016).

IF and sustainable development have the potential to mutually reinforce each other, with IF offering an alternative and innovative source of finance for SDGs, and the latter offering an opportunity to the IF industry to accessing large unreached markets, serving a large unbanked population, consequently gaining additional financial returns while deploying funds for sustainable activities . It is estimated that the SDGs-related sectors can generate up to US$12 trillion in business value (Business and Sustainable Development Commission, 2017). The Islamic financial industry has great potential to secure as much as it can of this sizeable business.

[12] Akhuwat in Pakistan is a prolific example of Islamic microfinance that funded by alms and charity donation with 99.9% of recovery rate IDB. (2016).

Figure 3: Compatibility of IF Principles with SDGs



Source: Standard and Poor's, 2016

The above mentioned advantages provided by IF, as a participatory system of financing, in addition to the acknowledged resilience Islamic financial institutions developed during the financial crisis (Ahmed et al. 2015), made IF accepted globally irrespective of faith or nationality. Indeed, some investors seek less risky investment and Islamic financial institutions have a strong financial performance record in recent years worldwide, partly due to high capitalization rates, and their avoidance of speculative activity. This can explain why international organizations, like the World Bank, IDB among others, are paying significant attention to them. Also, IF is ripe for growth in South America and Europe and has future markets in North America, Central Asia and Australia.

Other factors that can explain the diffusion of Islamic banking include the presence of Muslims in the population[13], a large segment of population that is underserved by conventional markets[14], an enabling legal framework, and economic

[13] Out of the 1.6 billion Muslims in the world, only 14 percent use banks.

[14] More than 2.5 billion people — half the world's adult population— do not have access to a bank account (CIF, 2016).

integration with Middle Eastern countries or proximity to Islamic financial centers (Imam and Kpodar, 2010; Ilias, 2010; Alam, 2012). Other key drivers behind interest in IF today is the possibility of tapping the international *sukuk* market, which does not require a domestic Islamic financial system (e.g., Japan has issued *sukuk*, as well as many other countries); under-exploitation of existing capital markets, and large infrastructure deficits, both physical and social.

However, we must acknowledge that IF is not currently being utilized to its full potential. The growth of IF has been witnessed primarily in more economically-developed nations, improving the lives of the well-off without equally impacting on those who are less privileged and live in poor areas. Some believe that the ideals core principles of socioeconomic empowerment and support of IF have been diverted from, and that IF is not so very different from conventional economic systems. As in conventional interest-based finance, IF still relies on customers' credit ratings and their ability to repay, benefiting thus those with already good credit standings, while leaving the less fortunate in a difficult financial situation. This is observed in the way that *sukuk* bonds have been engineered by *Shariaa* scholars today, where *murabahah*, or debt-based contracts, rather than a true risk-sharing structure, without obligors or guarantors, is still the most prevalent funding mechanism in the present market place.

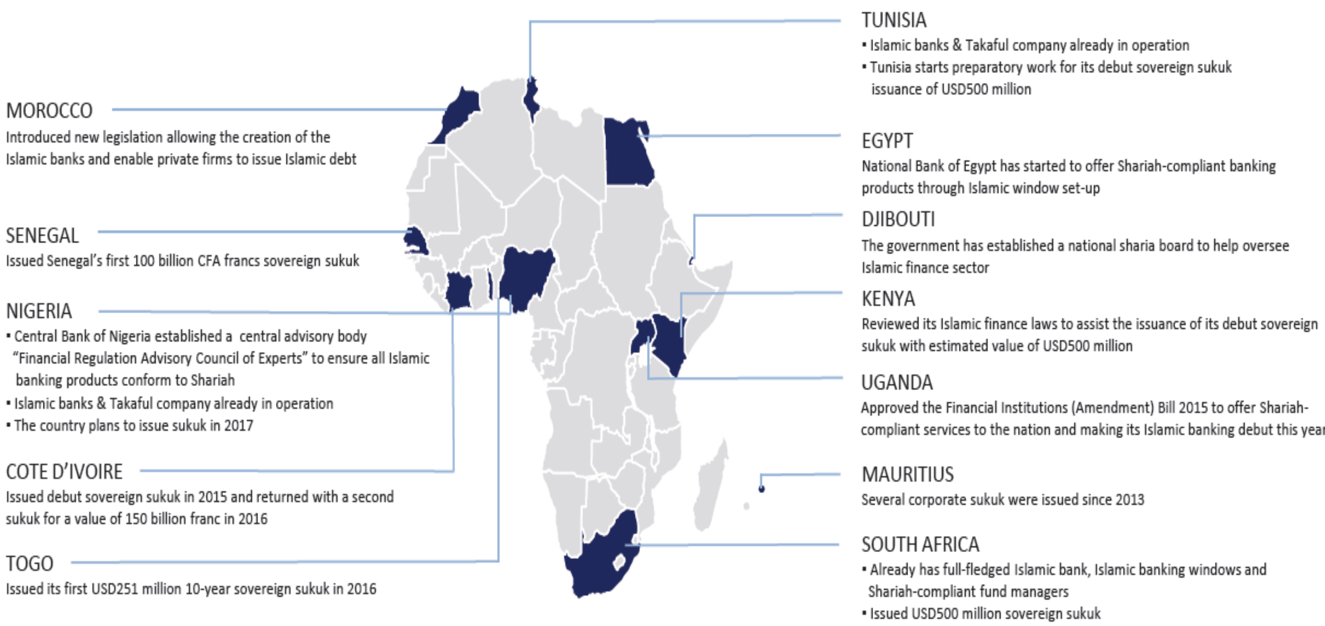
Therefore, all relevant parties must work hard to practically refute this narrative, and inch the industry back to the right direction. They must demonstrate to the world that Islamic spiritual principles and practices do have much to offer when it comes to improving the global socioeconomic outlook, and tackling many of the crises facing our world today.

IV- IF Growth Stimulus in Africa

Finance development in Africa has a crucial role in releasing the region's untapped potentials in various sectors to boost its prosperity. The growth of IF is expected to allow the region to enhance its financial instruments offerings, providing wider diversification of funding sources, and opportunities to greater access to liquidity pools of investors looking for Shariaa-compliant investment opportunities, especially across the Middle East and Asia. Currently, the IF industry comprises three sectors: Islamic banking, Takaful5 and the Islamic capital market. There remains huge potential for growth as the industry remains untapped locally and within Africa, and the challenge lies in exploring new avenues to tackle existing problems.

Fortunately, IF development in Africa is in tandem with the emerging global interest in IF. It has become a centerpiece in many African countries, with a significant number of market developments and regulatory efforts taking place in the region in recent years (See Figure 4). For example, IF has presence in 21 African countries, from well-established systems, like Sudan, to new entrants, like Uganda. Sudan has the most experience in formalized Islamic finance, dating back to the 1970s. South Africa has taken significant measures to advance its IF system since 2011, as have Nigeria, Senegal and Kenya. Other countries are in the exploratory phase, including Ethiopia, Uganda, Zambia and Mozambique (EIU, 2015). Also, more than 50 Islamic financial institutions exist in Africa out of 600 institutions globally (Islamic Corporation for the Development of the Private Sector, 2015). Furthermore, many conventional banks across the continent have also started to offer Shariaa-compliant banking products through Islamic window set-up[15].

Figure 4: Recent IF Developments in Africa



Source: MIFC from Malyaisa, 2017.

Africa is the world's largest untapped growth market for IF. This is the result of both "positive" trends, including a rapidly growing population, increased consumer spending and robust GDP growth, increasing trends in financial inclusion, and economic need for large infrastructure. IF offers various instruments that are poised to support the governments' need for raising capital required to meet all these purposes. Each of this growth driving pillars will be briefly discussed in the following:

1) Economic Growth

Africa has been home to six of the ten fastest growing economies[16]in the world during the last two decades, with an average annual growth rate of almost 5 percent during the last two decades. Yet, according to a recent report (African Development

[15] For example, the National Bank of Egypt, FinBank of Nigeria, Absa Bank of South Africa or First Community Bank of Kenya.

[16] Some argue that the number of these countries is seven, depending on the source of data.

Bank, 2018) the continent's growth rate fell in 2016 and 2017 to 2.2 and 3.6 percent, respectively, and is projected to be 4.1 percent a year in 2018 and 2019.

The report also shows that economic growth varied widely across countries and across Africa's five subregions, with East Africa[17] remaining the fastest-growing subregion in Africa, with estimated growth of 5.6 percent in 2017, and expected growth of 5.9 percent in 2018 and 6.1 percent in 2019. North Africa recorded the second-highest growth rate in Africa, at 5.0 percent in 2017, up from 3.3 percent in 2016, and is projected to accelerate to 5.1 percent in 2018. West Africa comes in the middle of the scale, with growth projected to accelerate to 3.6 percent in 2018 and 3.8 percent in 2019. *Southern Africa and Central Africa* have had moderate growth and are projected to continue at 2.0 and 2.6 percent in 2018, and 2.4 and 3.4 percent in 2019, respectively.

The relatively high growth rates in East and North Africa, and to a less extent in West Africa, should create higher demand on IF. Although the empirical literature in the area of the IF and economic growth nexus is still in early stages and the results are often mixed and inconclusive, the direction of causality runs, in general, from IF development to economic growth (Zarrouk et al. 2017, Jobarteh and Ergec, 2017, Tabash and Dhankar, 2014). This may be achieved through greater contribution to macroeconomic and financial stability (Dridi, 2010; and Hasan, Oliver Agha, Ahmed El-Galfy and Khiyar), or attracting Foreign Direct Investment (FDI) inflow in the long term (Tabash and Dhankar, 2014). Hence, it is recommended that policy makers increase their efforts in promoting Islamic finance (Jobarteh and Ergec, 2017).

On the other hand, some economists believe that economic growth leads to the development of financial sector (Robinson, 1952). Also, there is more recent evidence to support "demand following" hypothesis of GDP and Islamic Banking, where increase in GDP causes Islamic banking to develop (Zarrouk et al. 2017). One can, therefore, argue that IF and economic growth reinforce each other. IF can act as the catalyst in mobilizing funding into Africa, thereby resulting in economic growth and sustainable development, and economic growth can increase the potential demand for IF.

2) Demographics

The demographics of Africa provide immense potential strong demand for IF services and products such as credit, savings and insurance. Africa is currently the second most populous continent on earth and the total population is expected to double by the year 2050 (UN, 2017). This will drive a larger demand for financial products and services, and consequently for IF.

Muslims constitute a large segment of this fast growing population (estimated at 48 percent in 2002[18]. Islam has a large presence in North Africa, the Horn of Africa, the Swahili Coast, and much of West Africa, with minority immigrant populations in South

[17] East Africa region includes Djibouti, Ethiopia, Kenya, Comoros, Rwanda, Tanzania and Uganda

[18] Source: https://en.wikipedia.org/wiki/Islam_in_Africa

Africa. Sub-Saharan Africa is now home to over 250m Muslims, projected to grow to over 385m by 2030 (EIU, 2015). The share of the world's Muslims who live in sub-Saharan was projected to increase from 15.5% in 2010 to 24.3% (Pew Research Center, 2010).

Almost every country will see a significant increase in their Muslim population. For example, Muslim population in West Africa (160million) will rise to 257m Muslims by 2030 (EIU, 2015). By then, the region will account for 67% of Muslims in Sub-Saharan Africa. Furthermore, 40 percent of West Africa's Muslim population is under 25 years old. This youthful population is starting to achieve a certain level of wealth that makes of it a potential vibrant customer base for decades to come that no one can afford to ignore. This will result in a sizeable demand for sharia-compliant products and services (EIU, 2015).

Perhaps counter-intuitively, while Sharia-compliant goods and services appeal to the values of Muslims, majority Muslim populations are not necessary for a vibrant Islamic economy sector, including IF. While countries such as the populous Nigeria stands out as potential markets due to population size and religious makeup, interest in IF is not exclusively reliant on a majority or even large Muslim populations. Even in countries with a low proportion of Muslims, the values and principles of IF—such as investment products that avoid alcohol, gambling and no-interest lending—appeal to investors and consumers seeking ethical schemes and alternative financial products. Governments of some non-Muslim countries have already identified economic potential in *sukuk*, and in halal sector in large, notably South Africa, whose commercial banks have improved product development and marketing, rebranding Islamic-compliant products to attract a broader audience rather than appealing only to Muslims (EIU, 2015). Counting non-Muslims who are interested in IF, the market is absolutely huge.

3) Infrastructure Needs

The second driver of Africa's Islamic economy is the infrastructure needs, whether for industrialization or urbanization purposes. Infrastructure facilities give the fundamental foundations to business and trade, improve competitiveness, and are important determinants of long run growth. During the last decade, many African governments embarked upon mega infrastructure projects. Yet, still, one of the key factors retarding industrialization in, which is needed to end poverty and generate decent jobs in Africa, has been the insufficient stock of productive infrastructure (EIU, 2015). This is true across all sectors: roads, power, water, transport services. Also, an urbanizing population—forecast to grow from 38% of the total population in 2015 to 45% in 2030 and to 55% by 2050 (UN Department of Economic and Social Affairs, 2014.)—will be driving demand for social infrastructures, encompassing housing, healthcare, education, utilities, administrative capacity, and security.

Infrastructure needs are estimated at between US$130 and US$170 billion a year, leaving a financing gap in the range of US$68–US$108 billion (AfDB, 2018).[19] With such a large infrastructure gap, government budgets under pressure due to low commodity prices, and urgent needs in many of these infrastructures, Africa has to explore all possible tools for raising capital to unleash its potential. The contribution of the private sector in infrastructure financing is still little. World Bank56 estimates that 70-75% of total infrastructure financing in creating countries is provided by the public sector, 10% by authority development assistance and the remaining 15 to 20 percent by the private sector. There is a need to consider innovative options in which new players and lenders can fill the gap and contribute to the development of sustainable infrastructure.

IF provides significant opportunities to deepen and broaden the sources of funds required. At the same time, the infrastructure sector gives a perfect business chance to IF, given its reliability with the IF, as investments and social investments tend to benefit large part of society. Africa's infrastructure financing needs come at a time when global interest in IF for such purposes is growing. A special interest is put on *Sukuk*, because of two main reasons: (i) as Islamic bonds, *Sukuk* are structured in such a way to generate returns to investors without infringing upon Islamic law, are of growing interest to governments trying to raise capital for infrastructure projects; and (ii) infrastructure is an ideal form of projects for *Sukuk* due to long timelines to completion, large values, and a clear connection to the real economy in the form of the asset. The *Sukuk* issuances were part of a funding diversification strategy by African governments. Also, entering into the *Shariaa*-compliant financial markets is part of African governments' strategy to attract investments from the Middle East.

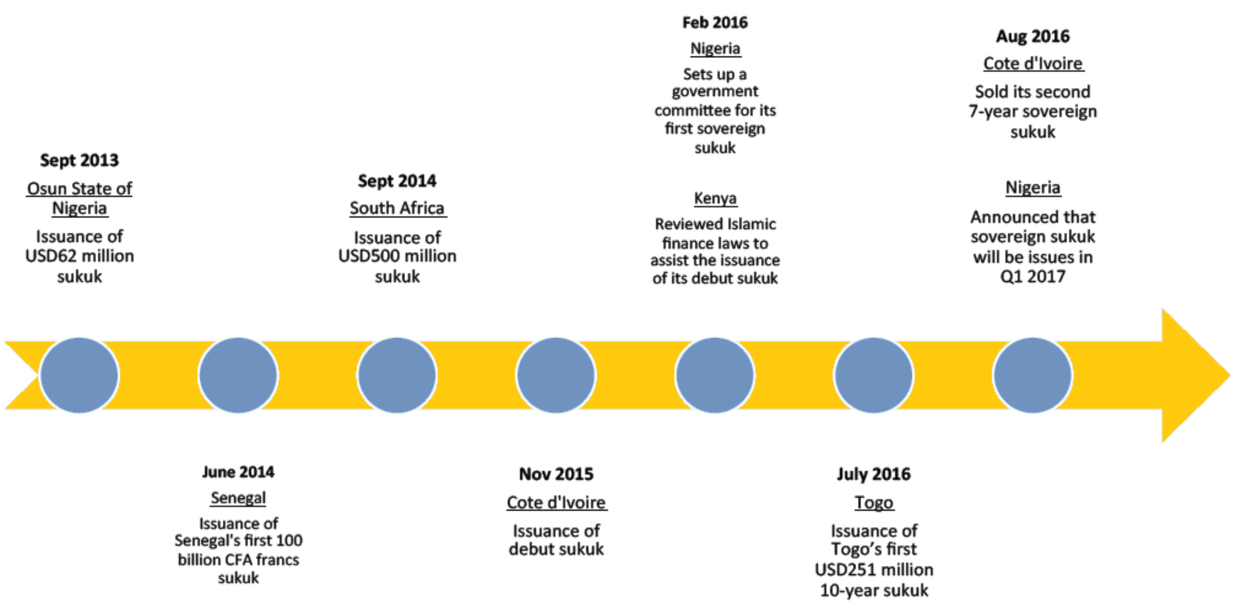
Sharia-compliant bonds, or *Sukuk*, have been used in five countries to raise capital. As a recent report shows (Malaysia, 2017), Gambia and Sudan have been regularly issuing short-term sukuk. In 2016 alone, the sukuk issuance and sukuk outstanding of Africa is US$ 657 million and US$ 1.9 billion respectively out of the global sukuk total amount. Also, Senegal, Nigeria[20], and Mauritius, have issued *Sukuk*, and Morocco is finally firming up plans to issue its first *Sukuk* during 2018, after a lengthy legislative process. A recent milestone in this area is the *Sukuk* issuance by the Africa Finance Corporation, which had an initial target of US$100 million that was upsized to US$150 million to reach a final order book of around US$230 million (Vanguard, 2017). Finally,

[19] Bielenberg et al. (2016) found lower estimates for infrastructure needs and financing gap. To close the financing gap for the SDGs, they estimated investments needed in sustainable infrastructure projects to be of $US 93 trillion during 2015-2030. They projected the bulk to go to the energy sector ($40 trillion or 43 percent), followed by transport ($27 trillion or 29 percent), water and waste ($19 trillion or 20.4 percent) and telecom ($7 trillion or 7.5 percent). The funding gap for the period is estimated to be between $39 trillion (under aggressive investment growth scenario) to $51 trillion (under conservative investment growth assumption).

[20] The Nigerian government, recently announced the sale of a N100 billion ($326 million) debt sovereign sukuk on the local market, meant to fund road infrastructure in the country.

Côte d'Ivoire returned to the market with a second sukuk issuance and there are several sovereign African sukuk in pipeline.

Figure 5: Sukuk Key Milestones in Africa (2013- 2016)



Finally, Nigeria, Sudan, South Africa and Senegal, Kenya, Morocco and Niger developed new legal and regulatory frameworks to enable Islamic banking offerings in their respective jurisdictions. Also, Uganda, Ethiopia and Zambia are currently exploring and developing the system.

The Islamic financial sector, nonetheless, has not been prospective in financing the infrastructure sector. For instance, out of an aggregate US$ 40 billion Shari'ah-perfect financing in the GCC, just US$ 9 billion went into infrastructure financing57. This might be due to (i) long time lags to *Sukuk* issuance because of technical and legal hurdles, (ii) limited knowledge of IF instruments, including *Sukuk*, among end-users and policymakers. Greater support from multilateral development agencies could thus help. (EIU, 2015).

4) Financial Inclusion

Limited access to finance is a developmental challenge for Africa. Economic, social and religious reasons all cater to the low percentage of financial inclusion in African countries. Financial inclusion includes provision of appropriate and quality financing which is accessible and affordable to low-income and other vulnerable households to reduce poverty and inequality and provide enough opportunity for vulnerable groups to improve their living standards (Triki and Issa. 2013).

All ten of the world's poorest countries are in sub-Saharan Africa[21]. An essential requirement of poverty alleviation in association with sustainable development is the availability of financial services for the poor. Also, prohibitive interest rates offered by conventional banks means many individuals, entrepreneurs and SMEs eschew the mainstream banking system. Many remain unregistered to avoid bureaucratic interference and taxes.

Because IF is interest free, it could be an appealing source of capital for small companies and individuals. There is evidence that there is a negative correlation between financial inclusion and the population size of Muslims of the total country's population in Sub-Saharan Africa. Only 24% of Muslims compared to 44% of non-Muslims own a formal bank account. Muslims are more likely than non-Muslims to report religion as a barrier to have an account (Demirguc-Kunt, Klapper, and Randall, 2013). Moreover, it is observed that large percentage of population in many African countries tends to borrow from family and friends rather than from formal financial institutions.

IF will serve in these areas. Considering these reasons as well as the demographics of the regions, IF can be as one of the most reasonable forms of inclusive finance through serving the rising appetite for *Shariaa*-compliant financial products, especially Islamic microfinance. This will lead to an increase in account ownership and facilitation of financing needs for MSMEs and may be also to bring informal SMEs into the formal economy. The opportunity for Islamic finance to flourish is strong, given the fast growth of *Halal* industry (Thomson Reuter, 2016), which is no longer exclusive to Muslims, and where SMEs can thrive. SMEs and microfinance play a key role in fueling country's growth, growing the demand for labor and thereby improving living standards (Malaysia, 2017). Innovative Islamic microfinance instruments may enable SMEs to offer jobs and benefits to the underprivileged. Supporting SMEs to be drivers of growth, through IF, will definitely help realize SDGs.

Numerous microfinance institutions have been set up, but a few banks have introduced Islamic microfinance windows and insurance companies started to develop "micro" products. The government of Sudan has also developed Islamic microfinance over the last decade. The Central Bank of Sudan created a Microfinance Unit and required that banks allocate 12% of their portfolio to microfinance (Malaysia, 2017).

The greatest role of IF institutions lies in the development of the social sector for financial inclusion is through *zakat* and *waqf*. This currently lacks integration with the broader financial structure- if *zakat* and *waqf* are incorporated in the institutional structure/financial sector and regulated appropriately, then outreach and sustainability can be achieved. Given the charitable nature of *zakat* and *waqf*, it can also contribute to support which would result in long run poverty alleviation. *Waqf*-based models have been

[21] https://www.gfmag.com/global-data/economic-data/the-poorest-countries-in-the-world

previously suggested through research and utilized with considerable success34. *Waqf* based micro-finance and interest free loans ensure capital outreach and poverty alleviation.

However, there are many challenges for the IF to reap all the benefits of the existing opportunities. Consideration should be given to the risks; costs and sustainability of using various Islamic instruments and establishing Islamic microfinance institutions that could help eradicate poverty and achieve sustainable development (Sadiq and Mushtaq, 2015).

V- Challenges Facing IF

The recent unmatched growth in IF and its edge in promoting financial stability are noticeable. Also, the various strategic steps taken by some authorities to accelerate the development of IF are well acknowledged. However, IF's size is still very small, representing less than 1 percent of total global finance (IFSB, 2014). This means that IF can only provide a limited contribution to achieving the SDGs (Standard and Poor's, 2016), if the challenges facing IF are not efficiently and effectively addressed by various relevant stakeholders.

Some of the challenges faced by IF are the same and as problematic as for conventional finance. For example, challenges of lending to African SMEs - risks associated with providing loans to the extremely poor: lack of collateral, absence of property titles, thin business plans and inadequate financial documentation. But, there are also challenges that relate only to the IF system. In the following, a brief description of these challenges is provided.

1) Compliance to Shariaa

IF instruments face critics concerning their compliance to Shariaa. Some Islamic banks and microfinance institutions still have rates and fees that are ambiguous, and may simply be interest dressed up as "management fees". For example, *Banque Islamique du Sénégal* had operated as conventional banks, before ICD and Bank Asya bought the majority shares, and started to work on changing it into a true Islamic bank (EIU, 2015).

The IF sector will thrive only if investors and customers fully trust in adherence to sharia. Ensuring sharia compliance among a vast number of often unregulated providers is a far from easy task.

2) Slow pace of Islamic product innovation

Just as the needs of the economy and society change, IF also needs to evolve to keep pace in being part of the solutions innovation can help IF achieve quality growth, by focusing on amplifying the positive value and impact of this industry to the economy and society. Until now, IF lacks product diversity. For example, in spite of the increase in the number of microfinance institutions that have Sharia-compliant offerings, they are largely limited to cost-plus-mark-up (non-interest-bearing) loans called *murabaha.*

While there have been some developments in Environmental, Social and Governance (ESG) related investments in IF, it is necessary to come up with new, innovative products that can finance sustainable infrastructure projects. However, to enable stakeholders to invest in this asset class would require developing more Shariaa-compliant products and instruments for both retail and institutional investors. Green sukuk is one good example of innovation within the Islamic capital market. It is an innovative financing vehicle to combat climate change. The recent issuances of the world's first green sukuk in Malaysia have kicked start the growth of green sukuk market and will significantly boost the "cleantech" movement.

On the other hand, at the global level, donations (from *Zakat*, *waqf* and *sadaqah)* have been collected and disbursed via a mostly un-coordinated and informal structure, and that the benefits have been randomly distributed. The system of IF will need to modernize if it is to help on a more global scale. Innovation has a great role to play in collecting and channeling these donations resources[22] more efficiently and effectively and for long-term investments, and hence in fighting poverty, leading to long-term social improvements and long-term resilience of communities.

3) Catching the FinTech Wave

IF must embrace the technology revolution to power up innovation. Financial Technology (FinTech) is rapidly changing the facets of the global financial industry, reshaping the expectations of consumers and businesses on financial services. IF have large opportunities to develop financial solutions, using FinTech. This can help drive IF to deliver even greater, wider and deeper positive impact - particularly in realizing its promise in risk-sharing and providing support for genuine and productive economic activities.

In fact, the widespread advent of FinTech is also penetrating the IF realm[23]. An example is the Investment Account Platform in Malaysia, which is a multi-bank online platform that connects investors to viable economic ventures, mainly SMEs. Technology can also widen access to and increase outreach of social financing instruments through digitization of collection and disbursement of its proceeds. Fintech startups such as LaunchGood and SkolaFund are already making their names in social impact initiatives, which is a promising start. The reality however is that Islamic FinTech is still in its infancy and growing - and there is plenty of catching up with conventional peers to do.

[22] Collected zakat alone is estimated to be at least US$600 billion per year (SFC, 2017).

[23] See http://www.cgap.org/news/innovation-islamic-microfinance

4) Lack of enabling Legal and Regulatory Framework

International experience (Pakistan and Malayisa) shows that innovative products that can finance sustainable infrastructure projects require a supporting legal and regulatory framework to grow further. A stable and predictable legal and regulatory regime that provides and enforces regulation related to all aspects of infrastructure investment is necessary for creating the right incentives and instilling the confidence among investors to support long-term projects.

Since most countries, where IF operates, have either common law or civil law regimes, it is necessary to provide a supporting legal and regulatory framework that can cater to the needs of Islamic infrastructure financing. Specifically, there is a need to introduce enabling Islamic financial laws that would address the unique issues in Islamic financial contracts and reduce legal uncertainty in disputes. Also, the tax regime should recognize the tax implications of different Islamic financial contracts and change relevant tax laws to level the playing field between Islamic and conventional finance.

Furthermore, there is a need to introduce enabling laws and regulations that encourage use of green and social investments in the infrastructure sector. For example, the introduction of the SRI *sukuk* framework in Malaysia in 2014 facilitated the issuance of green *sukuk* and impact *sukuk* in the country. (Ahmed, 2017)

5) Lack of skilled and expert

Africa has too few IF and *Shariaa* experts in government, financial institutions, central banks and regulatory bodies, and hiring in such expertise is prohibitively expensive. Developing products that are acceptable to investors would require increasing the number of professionals who have the knowledge and skills of both Islamic law and complex infrastructure products.

6) Misleading perceptions

There are three main areas where wrong perceptions lead to wrong decisions:

i. There is almost an exclusive focus on economic considerations in most of due diligence of projects.

ii. There is currently pervasive preference for short-term financing, hindering a greater volume of infrastructure investment.

iii. IF is still widely perceived to be only for Muslims, and is often associated with worries, among non-Muslims and some Muslims as well, about “islamization” of countries (Standard and Poor’s, 2016). . This is particularly acute in African countries that suffer long-standing religious tensions, like Nigeria.

VI- Recommendations

IF can become a catalyst for bridging the funding gap for long-term investments (IDB and WB, 2018), through private sector engagement. This depends on how swiftly IF can overcome the above-mentioned challenges. In the following is a set of recommendations that would lead to expand the IF contribution to achieving the SGDs.

1) Progress from *Shariaa*-compliant products to a *Shariaa*-based system

IF should go beyond mimicking conventional products. There is a need to move from legalistic compliance with Shariaa to fulfilling broader social and ethical objectives and using more participatory forms of financing, i.e. to progress from *Shariaa*-compliant products[24] to a *Shariaa*-based system[25] that innovates and creates new products and solutions. Distinct modifications should be made to the products, services, business practice and operations of IF, to significantly improve the offerings of IF and to build a sustainable business model to meet the unfulfilled 'real' needs of the economy and customers. Considering the overall goals of Shariaa (*maqasid*) in operations of IF will enhance IF contribution to the SDGs in general and to sustainable and social infrastructure in particular.

2) Promote more Islamic product innovation

Tapping into unreachable beneficiaries, requires the innovation of new IF products and instruments. The delivery of products and services to SMEs for example, can be remodeled to reflect deep understanding of their needs and circumstances. This paves the way for tailor-made financial services solutions that can better assist aspiring entrepreneurs. The financing model of Islamic banks for SMEs can be more holistic - to include provision of entrepreneurship training and consulting services, as well as infrastructure support. This model not only leads to greater sustainability, but also provides more meaningful customer experience.

For example, Islamic banks can play a greater role and participate more actively in the area of collecting and channeling Waqf, sadaqah and zakat, particularly in developing innovative ways to enhance access to and outreach of zakat. Positive partnerships between Islamic banks and zakat institutions is a means to explore in this regard, to provide greater convenience to customers, while strengthening public trust and confidence in the system.

[24] Shariaa-compliant products are conventional financing products that are "Islamized". This means removing those elements or components which contradict with Shariaa and replace them with a Shariaa acceptable concept, with inevitably some form of legal trickery. An example of a Shariaa compliant product is an Ijarah transaction where only the beneficial ownership is transferred and not the legal ownership.

[25] A Shariaa-based product is a financial instrument that is derived from the laws of Shariaa. It may share some similarities with existing conventional products but it is not originated from any conventional products. A Mudharabah venture capital model is an example of a Shariaa based product.

3) Embrace the possibilities of new technology

To modernize the IF system, there is a need to embrace the possibilities of "Fintech" new technology, which is the current buzzword in the financial world, and to envisage how "Fintech" might be harnessed to revolutionize IF modalities. This includes *zakat* and *waqf* collection as well as distribution; and financial inclusion solutions that can help bridge the "digital divide". IF industry can certainly take inspiration from the vibrancy of the non-financial services industry to adopt, adapt and collaborate with FinTech players – a strategy proven to be far successful. A good example is the partnerships formed between over 11,000 post offices in the U.K with a couple of FinTech startups that have enabled these challengers to extend their simple, transparent online services to in-branch facilities.

4) Strengthen the regulatory and tax frameworks

There is a need for regulatory framework to support authenticity and compliance of IF instruments and products, while enabling a level playing field between conventional and IF. Therefore, legal and regulatory frameworks and guidelines for structuring Islamic financial products, which currently vary across markets and financial institutions should be standardized. This would enable Islamic financial markets to work together.

This also applies to niche legislation such as taxation. Currently, tax codes are often biased against IF. For instance, tax incentives are offered to debt over equity financing, and profits are taxed, while interest payments are tax deductible. South Africa's regulators have evened the playing field over the last five years, with tax amendment laws recognizing arrangements such as *musharaka, murabaha and mudaraba* as credible alternatives to conventional financing agreements. In Senegal, on the contrary, *sukuk* is exempt from tax. However, there is debate about whether countries need to build unique legislation to issue IF instruments such as *sukuk*, or base them on existing financial legislation.

5) Promote an enabling environment

Countries serious about building their Islamic financial system must prioritize capacity building (skills and technical capacities) to overcome the constraint of having too few professionals with knowledge and skills needed for this industry. The journey ahead is one that is long and complex, but it is worthy, since it would foster the foundations for long term sustainable IF value creation. This calls for attracting quality talent with a passion to build a more sustainable business model, while preparing skilled IF staff to effectively provide and implement solutions to real world problems. A much broader set of competencies, which go beyond knowledge in the application of IF principles, provide a stronger foundation to achieve this aim. This includes skills and knowledge ranging from green financing to conducting holistic assessments of credit linked to value-based intermediation. Knowledge of behavioral finance can also be used to "nudge" customers into making good financial decisions.

Given that the 2030 Agenda for Sustainable Development is a global initiative, it would be good to build closer realtion with Multilateral development banks (MDBs) and agencies that may have an interest in, and experience with, supporting IF regulations. Such agencies include the Islamic Development Bank (IDB), the African development bank (AfDB), the Arab Fund for Economic and Social development, and the World Bank Group. Along with being key sources of investment for sustainable infrastructure development, they can contribute to the sector by building the country's institutional capacity.

MDBs can also provide a collaborative working space that supports the development of Sharia-compliant impact investing tools; serves as a forum for knowledge-sharing, policy dialogue and advocacy; and functions as a marketplace for deal sourcing and matchmaking. AfDB and IDB are arguably the best-positioned institutions to currently act as a research and development hub for Islamic microfinance in Africa, shaping and testing new products and services, optimal legal environments, and basic computing requirements. The scope for the collaboration is high and the capacity for innovation in this still-nascent industry, where supply has not met demand, should encourage impatient optimism of industry observers, providers, and clients alike.

Also, closer relations with international standard-setting institutions, such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can help. These bodies are responsible for international standards and guidelines for Islamic finance. These allow for greater transparency and standardization in the way that products are structured, increasing harmonization across regions.

6) Adjust misperceptions about IF

Part of the various misperceptions about IF in Africa can be dealt with through effective marketing campaigns that create awareness within each country, to educate the public and the industry about the principles, benefits and risks of IF and how it can be used by Muslims and non-Muslims as an alternative ethical source of funding to finance the SDGs. There is also a need to promote IF to make the provision of long-term financing more efficient, and also to encourage a global paradigm shift away from overreliance on short-term instruments toward making investments that add economic value. This would, however, require a supportive legal and regulatory environment that mitigates risks and creates the incentives for long-term investments.

Also, sustainability should be integrated into the decision-making process of a project, by moving from an exclusive focus on economic considerations to inclusion of social and environmental dimensions. MDBs, among others, can provide a framework for use at the operational level.

VII- Conclusion

We are on the brink of a new era in IF, driven by a global appetite for socially responsible and ethical investment, and a collective awareness that we must act now to safeguard the future of our planet. Many African countries with sizable Muslim populations have high levels of poverty and score low in terms of progress towards achieving the SDGs. While the financial sector can play a vital role in the promotion of the SDGs, Muslim countries can face some limitations in mobilizing resources due to economic, cultural and religious factors. Since interest-bearing transactions are prohibited under Islamic teachings, many Muslims do not engage with the conventional financial sector because of their religious convictions.

Providing Islamic financial services in Muslim countries thus becomes an issue of financial inclusion at the micro level and economic development at the macro level. More generally, IF can also be used as an alternative source of funds to cater to the high demands for infrastructure financing in non-Muslim countries, as well.

In this endeavor, steadfast commitment from the IF industry to progress from *Shariaa*-compliant products to Shariaa-based system, to innovate and diversify its products; to embrace FinTech; to invest in talent and skills; to strengthen the regulation frameworks, and to adjust misperceptions is crucial. IF must be a force for global benefit, proving that 2030 Agenda for Sustainable Development is not just good for the world, but it is also good for business. To conclude, we should continue to acknowledged the merits of this industry and promote it as an integral part of resource mobilization and intermediation mechanisms.

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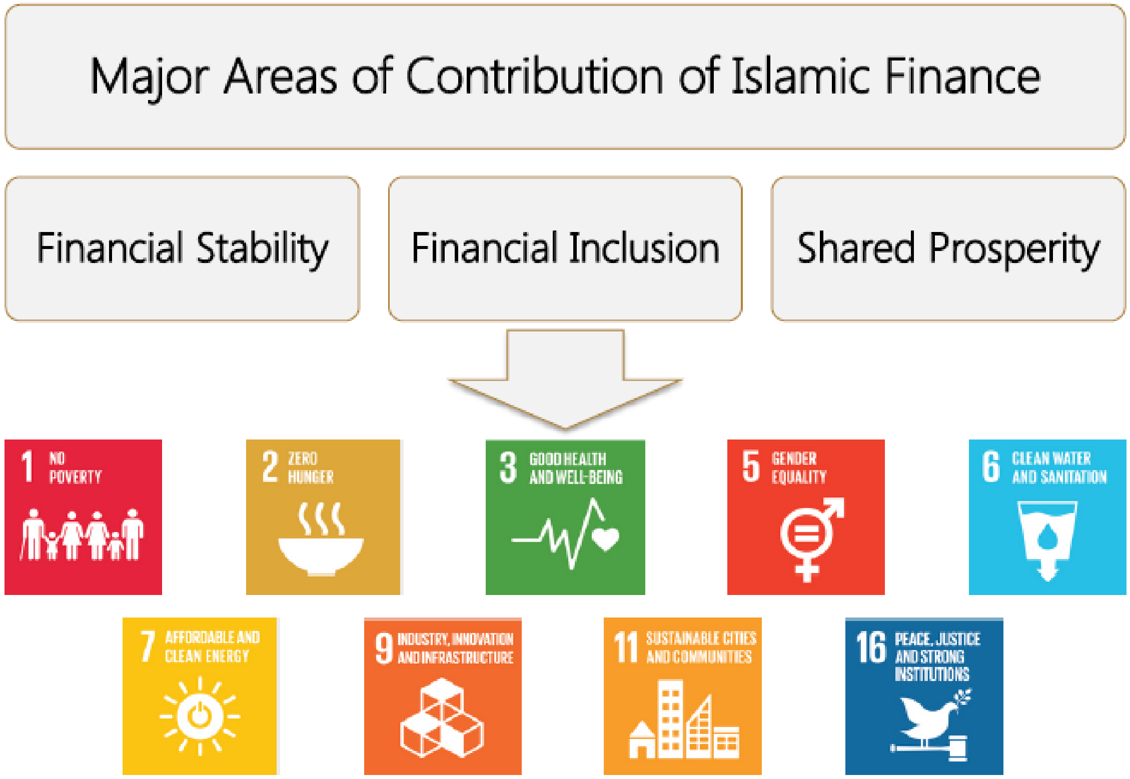
Annex

Figure A-1: Major Areas of Contribution of IF



Source: Islamic Development Bank (2015)