ISLAMIC BANKING AND FINANCE IN DJIBOUTI

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MASTER THESIS
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ISLAMIC BANKING AND FINANCE IN DJIBOUTI

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THESIS APPROVAL PAGE

I certify that in my opinion the thesis submitted by Roda Mohamed Omar titled "ISLAMIC BANKING AND FINANCE IN DJIBOUTI " is fully adequate in scope and in quality as a thesis for the degree of master of finance.

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This thesis is accepted by the examining committee with a unanimous vote in the Department of Finance and Participation Banking as a Master of Finance thesis . june 24/20201

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The degree of Master of Science by the thesis submitted is approved by the Administrative Board of the Institute of Graduate Programs, Karabuk University.

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DECLARATION

I hereby declare that this thesis is the result of my own work and all information included has been obtained and expounded in accordance with the academic rules and ethical policy specified by the institute. Besides, I declare that all the statements, results, materials, not original to this thesis have been cited and referenced literally.

Without being bound by a particular time, I accept all moral and legal consequences of any detection contrary to the aforementioned statement.

Name Surname: Roda Mohamed Omar

Signature :

FOREWORD

With the name of Allah Almighty the most merciful, the most beneficent, I am very thankful to Him for His blessings and pray for complete success in this life and life hereafter.

I salute and pay my heartiest tribute to the Holy Prophet Muhammad (peace be upojn him) being an ideal personality to follow his practices.

I would like to express my deep sense of gratitude to my thesis supervisor Dr. Muhammet BELEN, for the kindness, guidance and supervision.

I pleased to thank my Father Mohamed Omar and my mother Mako Moumin who have been responsible for raising and educating me since my life began

I really appreciate the efforts and support provided by my brothers A/rahman and Yacin med and my soulmate Amina and my freind Farha who always there for me.

Finally, I give thanks the university for the good provision and facilitation of services to students and their assistance in all matters that would give them a comfortable space to study and seek knowledge in safety and order.

May Allah Almighty give us courage and taufeeq to follow the instructions of the Holy, Quran and the practices of the Holy prophet Muhammad (Peace be upon him).

DEDICATION

I dedicated This thesis to my parents without them, I would not have existed in this life, and from them, I learned to be steadfast, regardless of the difficulties. I hope that they will find in this work all my gratitude and all my love. to my brothers who encouraged me to face any challenge.

ABSTRACT

This study aims to identify Islamic finance and banking in the Republic of Djibouti and the obstacles that delay its spread and is the birth of Islamic banking in the Republic of Djibouti has changed the economic dynamics of the country?

The Djiboutian economy has registered robust growth in recent years, averaging at the rate of 6.5 percent annually. Islamic banking assets grow at an average rate of 20 percent annually. Islamic finance represents 17 percent of Djibouti's banking market. Domestic prices are relatively stable with an annual inflation rate of 3 percent in 2017. Djibouti has a currency board which has served the country well. It has a fixed exchange rate to the US dollar. The external international reserves are at a comfortable level with above three months of imports cover.

The Islamic banking sector has been growing steadily. As of end 2017, three of the 11 banks operating in the country were Islamic banks and their market share accounts for 21% of the total banking assets.

Overall, financial services account for 13% of GDP. Banking accounts for the vast majority of Djibouti's financial services industry, with 97% of assets. The insurance sector accounts for an additional 2.5% of assets, while microfinance is responsible for the remaining 0.5%.

In light of the study a set of recommendations had been deduced: to achieve continuous growth in Islamic banking going forward, the commitment from the leadership and positive attitude of the public on Islamic finance need to be accompanied with the necessary regulatory framework and guidelines in support of Islamic banking instruments, products and Islamic financing. Djibouti's Islamic banking system will greatly benefit from cross-synchronization of Islamic standards, procedures and practices.

Keywords: Financial System, Islamic Banking, Djibouti, finance.

ÖZ

Bu çalışma, Cibuti Cumhuriyeti'ndeki İslami finans ve bankacılığı ve yayılmasını geciktiren engelleri tespit etmeyi amaçlamaktadır ve Cibuti Cumhuriyeti'nde İslami bankacılığın doğuşu ülkenin ekonomik dinamiklerini değiştirdi mi?

Cibuti ekonomisi, son yıllarda yıllık ortalama yüzde 6,5 oranında güçlü bir büyüme kaydetti. İslami bankacılık varlıkları yıllık ortalama yüzde 20 oranında büyüyor. İslami finans, Cibuti'nin bankacılık pazarının yüzde 17'sini temsil ediyor. Yurt içi fiyatlar, 2017'de yıllık yüzde 3'lük enflasyon oranıyla nispeten istikrarlı. Cibuti'nin ülkeye iyi hizmet eden bir para kurulu var. ABD doları için sabit bir döviz kuru vardır. Dış uluslararası rezervler, üç ayın üzerindeki ithalatı karşılamasıyla rahat bir seviyede.

İslami bankacılık sektörü istikrarlı bir şekilde büyüyor. 2017 sonu itibarıyla ülkede faaliyet gösteren 11 bankadan üçü İslami bankalardır ve pazar payları toplam bankacılık varlıklarının% 21'ini oluşturmaktadır.

Genel olarak, finansal hizmetler GSYİH'nın% 13'ünü oluşturmaktadır. Bankacılık, varlıkların% 97'si ile Cibuti'nin finansal hizmetler endüstrisinin büyük çoğunluğunu oluşturmaktadır. Sigorta sektörü, varlıkların ilave% 2,5'ini oluştururken, mikrofinans kalan% 0,5'lik kısımdan sorumludur.

Çalışmanın ışığında, bir dizi öneri çıkarıldı: İslami bankacılıkta ileriye dönük sürekli büyümeyi sağlamak için, İslami finans konusunda liderliğin taahhüdü ve halkın olumlu tutumu, gerekli düzenleyici çerçeve ve destekleyici kılavuzlar ile desteklenmelidir. İslami bankacılık araçları, ürünleri ve İslami finansman. Cibuti’nin İslami bankacılık sistemi, İslami standartların, prosedürlerin ve uygulamaların çapraz senkronizasyonundan büyük ölçüde faydalanacaktır.

Anahtar Kelimeler: Finansal Sistem, İslami Bankacılık, Cibuti, finans.

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ABBREVIATIONS

AAOIFI	**:** Accounting and Auditing Organization for Islamic Financial Institutions
ADDS	**:** Agency Djiboutian Social Development
ATMs	**:** Automated teller machines
CAR	**:** Capital-to-risk weighted assets ratio
CBD	**:** Central Bank of Djibouti
CPEC	**:** Caisses Popular Savings and Credits
CSR	**:** Corporate Social Responsibility
DJF	**:** Djiboutian Franc
EAB	**:** East African bank
FSIs	**:** Financial soundness indicators
IMF	**:** International Management Financial
ISDB	**:** Islamic Development Bank
LFR	**:** Long - term failure rate
NPLs	**:** Non-Performing Loans
PCA	**:** Principal components analysis
ROA	**:** Return on assets
ROE	**:** Return on equity
SAB	**:** Salaam African Bank
SIB	**:** Saba Islamic Bank
SMEs	**:** Small and medium-scale enterprises

THE RESEARCH OBJECTIVES

The aim of this study was general to know the Islamic banks in Djibouti, do they work in Islamic law sharia and also knowing the financial situation in Islamic banks and how they developed and knowing the performance of Islamic banks in Djibouti.

The importance of this research ambush in the peoples need to deal with banks of an Islamic orientation in order to increase their reassurance especially since the number of Islamic banks in Djibouti does not exceed three from this it was necessary to increase the number of banks that implement Islamic law in their dealings with the aim of partially or maybe holistically in the future in addition to the duty of Djiboutian society leave forbidden transactions since they are a Muslim society.

RESEARCH QUESTION

What are the challenges for the development of Islamic finance in Djibouti?

RESEARCH PROBLEM

In the light of the above justification that indicated the focus of Islamic banks in Djibouti on financing through the most murabaha instrument then musharakah and mudarabah with need to find more effective financing alternatives to mobilize savings, in the case Islamic banks in Djibouti encouraging development, they will need to expand their range of financial services, including through the larger-scale development of Al Istisna'a ʿ, Al- Ijarah , Al-Salam. Instruments of non-banking institutions are not yet developed such as Islamic insurance (Takaful), project financing / infrastructure (Sukuk Bonds).

RESEARCH METHODOLOGY

This research is based on qualitative research method and the data collection is done of primary and secondary data.

The study is based on qualitative research, and I also used already available information or pre-existing data provided by other researchers, including financial reports and annual publications. With this method, part of my analysis is based on quantitative data. This method provided me with sufficient resources that gave me the opportunity to learn about Islamic banking and finance. These secondary data were obtained from several reliable sources, official websites, books, research articles, reports, and magazines where all sources of information were properly recognized in the references and in accordance with the rules. Academic and Ethics Politics.

RELEVANT LITERATURE REVIEW

There have been many recent studies on Islamic finance especially with regard to it is philosophy, objects and the different financing formulas that it can undertake through a review it was found that most of these studies are based on theoretical presentation of the work of Islamic finance in generally. Below are some studies that dealt with Islamic banks.

Shaheen (2002) aimed to research the mechanisms necessary to develop the traditional banking supervision system, from the perspective of Islamic thought, to match the functional characteristics of Islamic banks. In the areas of receiving funds and their uses, methods of dealing with the financial elements that make up accounts, and the new elements associated with them, related to the rules and foundations of control over profit distribution between shareholders and depositors, in accordance with the principles of Islamic banking (Abdullah, 2002).

The results of the study showed the urgent need to prepare, qualify and develop the technical supervisory capabilities and skills of the supervisors of the Palestinian Monetary Authority, and the importance of reviewing some of the existing supervisory standards.

Ashour (1998) aimed to test the importance of murabaha as a financing policy in the field of long-term financing in comparison with financing policies such as: Participation, speculation and cultivation in Islamic banks.

Among the most important findings of the research is the evidence that musharakah and mudarabah are no less important than murabaha, while sharecropping is the least common formulation in the field of long-term financing in Islamic banks (Mahmoud, 1998).

Abu muammar (1997) aimed to know the Islamic banking dependence on audited reports and bulletins and effect of that on the banks investment policies.

The study concluded that about a third of the clients of the bank depend on the sharia supervisory authority as primary source for obtaining information clients (92% of the banks clients welcome the increase in Islamic banks) (Faris ,1997).

AL-ghanemy (1990) aimed to devise a set of indicators through which to judge the adequacy of Islamic banks at the national level, in order to ensure the extent to which they achieve the goals for which they were established, whether those goals are economic or social.

The study reached a set of suggested indicators for evaluating the performance of Islamic banks, and it applied these indicators to one of the Islamic banks operating in Egypt and job creation index (Al-Salam., 1990).

AL-khalidi (2002) aimed at discussing and evaluating the foundations of accounting measurement and organization, highlighting its role in evaluating investment in Islamic banks, and examining the extent of the relationship between the work of Islamic banks operating in both Sudan and Palestine during the period 1997-2000.

The study concluded that the accounting principles and methods applied in Islamic banks operating in Sudan and Palestine to evaluate investments are inadequate, and that there are fundamental differences in the application of some of the principles of measurement and accounting organization for investment operations between Islamic banks in Sudan and Palestine (Nahid 2002).

INRODUCTION

ISLAMIC BANKING AND FINANCE IN DJIBOUTI

The Islamic banking system is based on the Islamic faith and derives from it and it components; it depends on its legislative and ethical foundations on the economics method. Islamic law is part of comprehensive legislation with a view to achieving a balance6 between individual interest and the interest of society.

The Islamic bank does not trade in cash but considers it a means of directing and mobilizing human and material energy in society, just as an investment as the focus of activity.

Islamic finance, despite its name, is not a religious product. It is however a growing series of financial products developed to meet the requirements of a specific group of people (CIMA , 2015).

An Islamic bank is a financial facility that operates in Islamic framework and aims to achieve profit by managing halal money and in the manner of actions under economic management, it also contributes to achieving social solidarity in society and adhere to principles and requirements of Islamic law, with aim of achieving positive economic and social development for individual and institutions, taking into account the conditions of society and the economic-financial and banking organization, it seeks to generate resources from individual and institution and works to use them for better use with the performance of multiple banking services and works to achieve the appropriate for owners of capital.

Although Islamic banking still makes up only a fraction of the banking system of Muslims, it has been growing faster than banking assets as a whole, growing at an annual rate of 17,6% between 2009 and 2013, and is projected to grow by an average of 19,7% a year to 2018 (Muatuz , 2017).

The Islamic banking sector is the dominant component of the Islamic finance industry. It has grown exponentially in the last two decades, accumulating nearly $1.9 trillion in assets and spreading across 50 Muslim and non-Muslim countries around the world (Mohamed , 2017).

Islamic finance is growing rapidly across Africa, where around 40% of the population are Muslims. It is now offered across 21 African countries, with one country leading the pack: Djibouti. Djibouti can be referred to as the logistical and financial hub for East Africa due to its fast-growing port access and availability, progressive banking regulations, and strong intraregional connectivity with Ethiopia and other landlocked countries which have no or poor port access. Besides logistics, other sectors that continue to show significant growth in Djibouti are financial services, tourism, and hospitality, education, and telecommunications (Pasha , 2019).

The financial system in Djibouti provides for Sharia-based financial products offered by its Islamic financial institutions.

Djibouti is strategically located, and is poised to be the Center of Islamic Finance in the world. There is strong potential for Islamic finance to grow further in the country, given the strong and positive reception from the population and support from the political leadership towards Islamic finance.

The Djiboutian financial sector, with total assets of 265 billion FD or 102 per cent of GDP, has not been affected by the international financial crisis. The insurance sector, regulated by the Ministry of Finance, consists of only two large corporations.

The official currency is the Djiboutian Franc (DJF). Djibouti is one of the smallest nations in Africa, and currently have eleven banks operating in the country.

Djibouti is a trade free zone with its economy mostly reliant on the services industry - primarily through its ports. With one of the most sophisticated ports in the world.

The world bank cites its “rapid, sustained growth” a result of public debt-financed investments in infrastructure. Moreover, the world bank predicts Djibouti’s GDP growth to reach 7.5% in 2020, with 2021-2023 having the potential to accelerate to rates of 8% GDP growth. Its geographical location means that through taxes and harbour fees related to the Port of Djibouti inputs into the government's revenue. Moreover, for nearby landlocked countries Djibouti is used to re-export goods. Djibouti relies on foreign markets, mainly trading with the neighbouring country Ethiopia (https://www.worldbank , 2020).

Supervising credit institutions is one of the tasks of the Central Bank of Djibouti (CBD). In addition to the type of supervision to which conventional banks are subject, Islamic banks are subject to supervision of compliance with the provisions of Islamic law. There is no body dedicated exclusively to supervising Islamic banks but it is rather two persons from the department in charge of the supervision who control the Islamic banks. Supervision at the CBD takes the form of off-site and on-site controls.

Djibouti's financial system is primarily dominated by the banking sector with 94% of the nation's total assets and 80% of total loans to the economy. The central bank of Djibouti (CBD) is in charge of regulating and supervising banks. The growth of the banking sector has undergone rapid expansion in recent years. The main contact for international financial institutions (e.g. the IMF or World Bank) is the Central Bank. Additionally, the banks are divided into Retail Banks and Islamic Banks, with all banks are supervised by the BCD.

This thesis consists of three main chapters. In the first chapter which is introductory chapter that gives us a brief preview of the history and background of Islamic finance generally.

In the second chapter, we discussed the Djibouti economy, the banking sector in Djibouti, and currency credit also the external sector.

And the last chapter discussed the Islamic banks in Djibouti and the challenges that faced also Islamic finance performance over the last years.

CHAPTER 1

HISTORY OF ISLAMIC BANKING AND FINANCE SYSTEM

The chapter discusses the literature on the Islamic banking and financial system. This part of research will present the principles and methods of Islamic banking as stated early, an Islamic bank follows principle, which is based on profit and loss sharing principle.

The origin of the modern Islamic bank can be traced back to the very birth of Islam when the Prophet himself acted as an agent for his wife's trading operations. Islamic partnerships (mudarabah) dominated the business world for centuries and the concept of interest found very little application in day-to-day transactions (Toutouchain , 2021).

The first experience of opening an Islamic bank dates back to 1963 in the Egyptian city of Mit Ghamr, when Dr. Ahmed Al-Najjar suggested establishing a local Islamic savings bank (Orhan, 2018) .

After the Egyptian experience, the Islamic Development Bank was established in Jeddah in 1975 according to a decision issued by the meeting of the finance ministers of Islamic Countries. In 1973 and the Dubai Islamic Bank, which was established according to a government decree issued by the Emirate of Dubai.

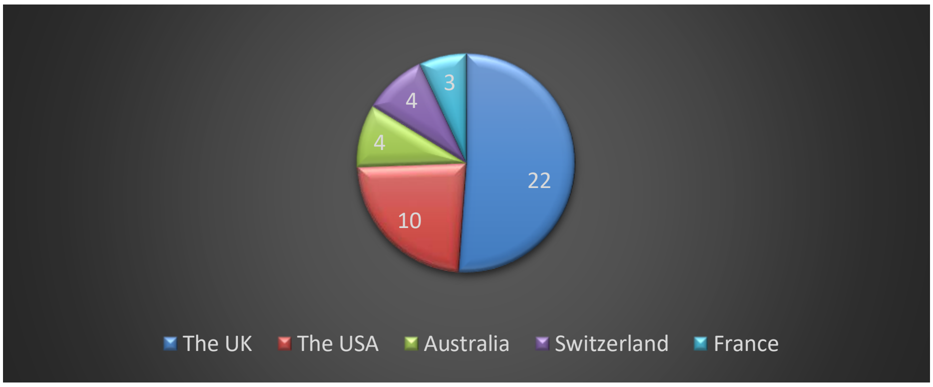
Over the following years, countries established their own Islamic banks, establishing Bahrain in 1979 the Bahrain Islamic Bank, and in 1982, Qatar knew the first Islamic bank and Islamized Al-Rajhi Bank in Saudi Arabia in 1988. These banks provide alternative credit services to the interest-bearing credit services in banks. Ordinary, includes murabaha, leasing, sale of salam, Istisna'a, Musharakah and Qard Hassan. In addition to non-credit services, such as current accounts, transfers, securities and time deposits. However, the spread of Islamic banking was not limited to the Islamic world. (https://www.arabnak.com, 2019)

After 1980, the spread of Islamic banks expanded into non-Muslim countries. In order to attract Muslim customers around the world, Western and Asian banks did not just establish Islamic portfolios and branches, in 2004 Islamic Bank of Britton open its doors for potential customers.

In 2010 Kuwait Turk, a subsidiary of Kuwait Finance House, opened its first western branch in Germany.

At the beginning of 2017 the numbers of Islamic banks in top Islamic banking dominated Western countries are as follow: (Global Finance Magazine , 2017)

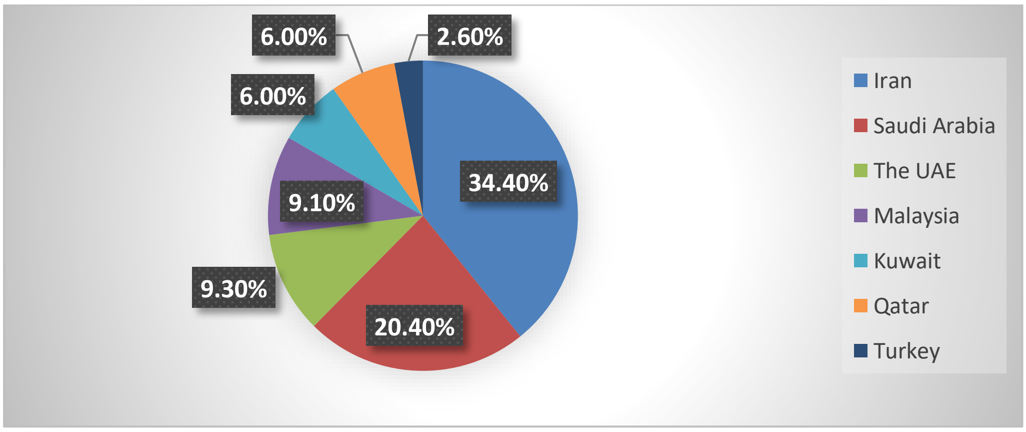
Figure 1**.** Number of Islamic banks in the top



There are more than 500 banking and financial institutions in 80 countries offering interest free Islamic banking.

Over .5 trillion USA dollar Islamic banking asset were shared by the following top countries in 2018.

Figure 2.Islamic banking asset.



Source: Share of Global Islamic Banking Assets 2017

Islamic finance has witnessed a rapid expansion in the financial system. (Karaahmetoğlu , 2014)

1.1. Six Key Islamic Banking Principles

The principles of Islamic finance are established in the Quran; which Muslims believe are the exact. Words of God as revealed to the Prophet Mohammed. These are Islamic principles of finance can be narrowed down to six individual concepts (Kettell, 2011).

- Predetermined loan repayments as interest (riba) is prohibited
- Profit and loss sharing is at the heart of the Islamic system.
- Making money out of money is unacceptable, all financial transactions must be asset-backed.
- Speculative behaviour is prohibited.
- Only Sharia ’a-approved contracts are acceptable.
- Contracts are sacred.

1.1.1 Predetermined Payments Are Prohibited

Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is Qard al Hassan (literally meaning good loan), whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim Jurists have construed this principle so strictly that, according to one Islamic scholar

The prohibition applies to any advantage or benefits that the lender might secure out of the qard (loan) such as riding the borrower’s mule, eating at his table or even taking advantage of the shade of his wall.

The principle, derived from this quotation, emphasises that any associated or indirect benefits that could potentially accrue to the lender, from lending money, are also prohibited (Kettel , 2011).

1.1.2. Profit and Loss Sharing

The principle here is that the lender must share in the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in a business instead of becoming creditors. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, service companies or simple trade deals. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower who must pay back the loan, with the agreed interest, regardless of the success or failure of his venture. The objective of all this is to encourage investments, thereby provide a stimulus to the economy, and encourage entrepreneurs to maximise their efforts to make them succeed.

Therefore, Islamic financial institutions are invited to create partnerships or joint ventures with entrepreneurs seeking funding instead of merely becoming creditors. The partnership agreements should clearly state the rights and obligations of the parties, roles, profit ratio as well as the extent of each party's liability. In this case, the partners will have a common objective of creating a successful enterprise that would eventually result in earning big profits for them. And unlike a conventional loan agreement, the entrepreneur does not take on the burden of repayment of the loan by himself. Also, the lending entity (i.e. bank or any other financial institution) gets the opportunity of achieving big returns that could reach multiples of the interest payments (Maddah, 2017).

1.1.3. Making Money Out of Money is Not Acceptable

Making money from money is not islamically acceptable. Money, in Islam, is only a medium of exchange, a way of defining the value of a thing. It has no value in itself, and therefore should not be allowed to generate more money, via fixed interest payments, simply by being deposited in a bank or lent to someone else. Muslims are encouraged to spend and/or invest in productive investments and are discouraged from keeping money idle. Hoarding money is regarded as being Islamically unacceptable. In Islam, money represents purchasing power, which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the creation of goods and services.

1.1.4. Uncertainty is prohibited

Gharar literally means uncertainty, danger, opportunity, or risk and It is a negative element in transactions (the jurisprudence of Islamic transactions) Like usury and gambling.

Gharar is related to the uncertainty that may result from a contract and which may lead to deception, fraud, dispute or injustice because this contract was not clear enough regarding its results and what it might lead to.

Among contemporary Islamic scholars, Zarqa (1990) wrote that "gharar is the sale of potential things that do not exist or whose properties are uncertain, due to the dangerous nature that makes commerce akin to gambling."

Types of gharar

a) Gharar yasira is a small amount of gharar (also gharar qalil or gharar yaseer) that cannot be avoided due to the nature of the subject matter of the contract (aqd). Tolerated and will not invalidate a contract.
b) Gharar fahish an excessive degree of gharar that rendehnrs a contract or transaction void from a sharia point of view**.** Gharar represents some form of asymmetric or incomplete information and/or deception, in addition to risk and uncertainty as to the subject matter of a commutative contract (exchange-based contract)

Examples:

In finance, gharar is observed within derivative transactions, such as forwards, futures and options, as well as in short selling and other forms of speculation. In Islamic finance, most derivative contracts are forbidden and considered invalid because of the uncertainty involved in the future delivery of the underlying asset. (https://www.investopedia.com/, 2020).

1.1.5. Only Sharia Approved Contracts Are Acceptable

Generally, Islam permits trade and commerce and the contracts that are applied thereto are termed muamalat in the Sharia. Muamalat are civil contracts and all civil contracts can be used in Islamic banking and finance.

Conventional banking is secular in its orientation. In contrast, in the Islamic system, all economic agents have to work within the ethical system of Islam. Islamic banks are no exception. As such, they cannot finance any project that conflicts with the Islamic moral value system. For example, Islamic banks are not allowed to finance a wine factory, a casino, a night club or any other activity prohibited by Islam or known to be harmful to society.

1.1.6. Sanctity of Contract

Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest and legitimate trade and business. It is a duty for Muslims to earn a living, support their families and give charity to those less fortunate. Just as Islam regulates and influences all other spheres of life, so it also governs the conduct of business and commerce. Muslims have a moral obligation to conduct their business activities in accordance with the requirements of their religion. They should be fair, honest and just towards others. A special obligation exists upon vendors because there is no doctrine of caveat emptor in Islam. Monopolies and price-fixing are prohibited. The basic principles of the law are laid down in the four root transactions of:

- Sales (buy): transfer of the ownership or corpus of property for a consideration;
- Hire (Ijara): transfer of the usufruct (right to use) of property for a consideration;
- Gift (hiba): gratuitous transfer of the corpus of property;
- Loan (ariyah): gratuitous transfer of the usufruct of property.

These basic principles are then applied to the various specific transactions of, for example, pledge, deposit, guarantee, agency, assignment, land tenancy, waqf foundations (religious or charitable bodies) and partnerships. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard, defined in the next section, which are potentially major problems for Islamic banks.

1.2. Financial Products offered By Islamic Banking

An Islamic bank provides the same services that a regular bank provides, with the exception of services that contain interest, which is considered usury, which is forbidden in Islamic law. The services provided by Islamic banks can be divided as follows:

1.2.1. Murabaha

Murabaha is derived from the Arabic root word (rabiha), which means to grow in business and succeed. Making profit is the measurement of that success, Therefore the generic term Murabaha is often linked to the declaration of profit as a way of measuring the success of a sale transaction and the return on the exchange of money with commodity. In the classical Arabic dictionaries, Murabaha is often used to describe the sale transaction, where the profit amount is known and declared, for example, when a trader says: I will sell you this commodity with a profit of one dirham for every ten dirhams (Ebrahim , 2011)

Murabaha is one of the fiduciary sales contracts that are based on the statement of the capital of the commodity (the cost) and the seller defines the price in terms of capital, more or less.

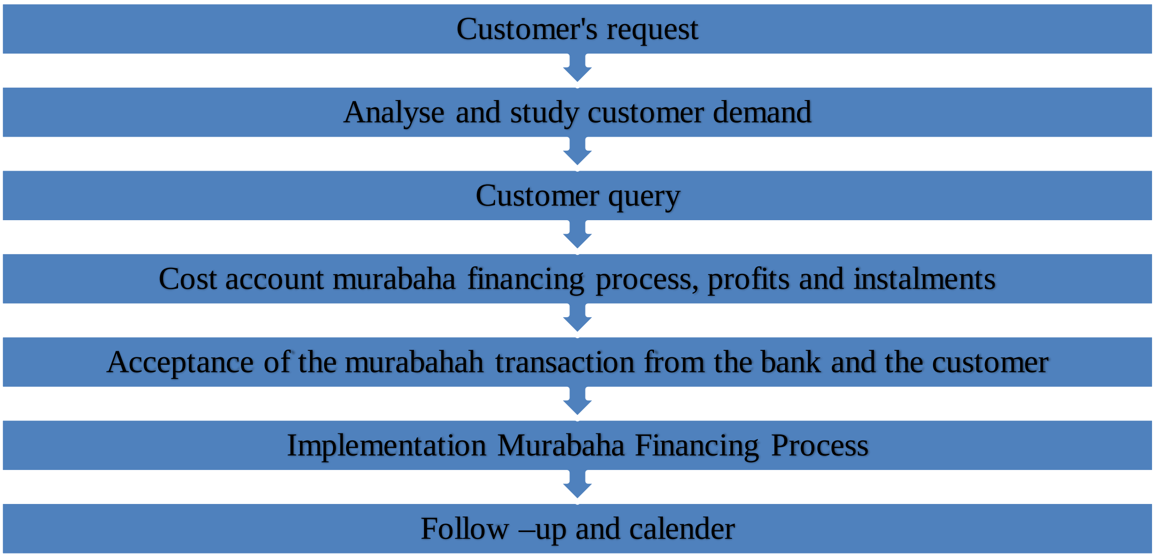
1.2.1.1. Conditions of Murabaha Sale

For a murabaha transaction to comply with sharia rules and principles, the following set of conditions must be strictly observed:

- ❖ Murabaha as one of the types of commercial sales that is legally permissible, requires full knowledge of market conditions and circumstances, types of products subject to dealings, location of product distribution and business ethics.

- The Murabaha is on something owned by the seller that he has the right of ownership which is arranged as soon as the contract is concluded, and it is valid even if the sale is not seized or possessed and received.
- The necessity of identifying the price paid by the seller, and what is added to it from all the necessary costs of the products and what is applied to the commercial custom so that all of this is known to the buyer upon contracting.
- The necessity to define the profit, whether it is a specific amount or a percentage, in order for the buyer to know it and accept it.
- The clarity of the data related to the murabaha and its understanding by the buyer, in order for it to stand on all its characteristics, there will be no ignorance or deceit.
- Every lie or betrayal in the placement sale process corrupts it and this entails that the buyer has the choice whether or not to proceed with the contract.

Figure 3**.** Steps of murabaha financing.



1.2.1.2. Steps to finance murabaha in an Islamic bank

The process of financing through murabahah in an Islamic bank took place according to several steps that can be explained as shown in the Figure 3. It can shed light on the previous steps in some detail as follows:

1. Customer's request for Murabaha Financing:

   The customer submits a request to the Islamic bank that includes his desire for the bank to purchase materials, machines, commodities, etc.

2. Analyse and study customer demand:

   The Murabaha Department studies the murabahah process and makes sure of its legitimacy and the absence of Sharia barriers.

3. Customer query:

   It includes the bank’s competent departments studying and analysing the submitted documents and examining them and conducting the inquiry process about the customer to find out his reputation commercial activity, size of business and his properties.

4. Cost account murabaha financing process, profits and instalments:

   After it is complete Previous analysis and examination process, then the bank calculates the price of the goods according to the results of the bank’s studies of sales offers presented by suppliers, either from the inside or outside then the determine the bank's profit from this process.

5. Acceptance of the Murabahah transaction from the bank and the customer:

   After making the previous calculation for a process in terms of costs and profits, the deadline for providing the products, the down payment, and payment method agreed upon by the customer and the bank murabahah financing process can be adopted.

6. Implementation Murabahah Financing Process:

   After the process is approved, the customer supplies the amount agreed upon as a down payment to prove the seriousness of the contract then the Islamic bank starts in agreed upon product provision procedures.

7. Follow –up and calendar:

   If the murabahah transaction is executed and the customer receives the agreed products, whether they are one or several batches so the bank must follow up on the customer. (Al-maghribi, 2014).

1.2.2. Mudarabah

Mudarabah is a type of partnership between the owner of the money and the owner of the experience in which the first provides his money and the second his experience and they share the results of the project in an agreed upon ratio and it is the legitimate Islamic means of introducing cash assets into economic activity and converting them into an element of production throught the common factor that the money owner and employer.

Mudarabah contract is a profit-sharing contract employed by modern Islamic banks. Although representing a growing market segment, currently, mudarabah along with musharakah cover less than ten percent of all dealings of Islamic banking and finance world-wide. Despite numerous efforts have been made to encourage the practice of mudarabah in Islamic banking and finance, the usage of mudarabah is still considered to be enormously risky (Rahman, 2018).

1.2.2.1. Condition of mudarabah

For a mudabahah transaction to comply with sharia rules and principles, the following set of conditions must be strictly observed:

A. Conditions related to capital:

i. The capital must be a cash not the price of asset: It is the value and is not affected by changing markets who plagued offers and goods Therefore, it is not permissible to offer a real estate among the majority of scholars.
ii. The speculative capital must be known in the amount and character when entering into contract because it is ignorant Lead to ignorance of profit.
iii. the speculative capital must be in kind, present and there is no debt owned to a speculator and if one the parties says to other “work with debt that you owe, speculating in half” then that spoil the speculation.
iv. Handing over capital to the mudarib and that’s to be enable to move the money and invest it.

B. Conditions related distribute profits:

i. Determine the share of the profit for the owner of the money and the speculator and the amount must be a known profit in the ratio specified for both the speculator and the owner of money because profit is contracted and the ignorance of the contractor necessitates the corruption of the contract.

ii. The profit is shared between the owner of the money and the speculator If all profit was restricted to one of them, the contract would be spoiled Likewise, it is not permissible for one of the contracting parties to stipulate for himself known amounts of profit.
iii. The share of the owner of the money or the speculator shall not be a specified amount of the profit: It is not permissible to specify a specific amount, such as ten thousand liras, for example If that does not violate the requirements of the contract, it spoils the speculator because it leads to ignorance of profit.
iv. That the stipulated ratio for both the money owner and the speculator a common share from profit, not from capital, unless profit is defined as the amount of capital.
v. The loss is on the owner of the money unless there is a default on the part of the speculator.

C. Conditions related to implementation:

i. For the owner of the money to provide what was agreed upon from the speculative capital to be enable to work.
ii. The nature of the speculative range the owner of the money may stipulate that the speculator should work in a specific country, or to carry out its activity in certain products, or other conditions in which it is the interest of both of two sides.
iii. Limits of speculation: the mudarib is not entitled to do some business like speculative money loan manumission and the gift.

1.2.2.2. Steps to Speculate in an Islamic Bank

1. Funding request: The customer goes to the Islamic bank, asking him to finance a specific speculative operation. The bank officials hold some discussions and questions with him about the nature of the speculation process, its characteristics, the amounts required to finance it, and the period
2. Research and study: The department or section concerned with financial multiplication audit works on analysing the information and data provided by the customer.

3. Make decision: The previous report or the memorandum prepared for the delegated authority shall be submitted the nature of the speculation process, the amount of financing required, and the period covered by the operation mudarabah, which is decided upon with the justified approval or rejection.
4. Decision implementation: If the financing request is approved, the customer will be notified to prepare the required documents and preparation of the contract for signature by the two parties (the client and the person responsible for Islamic Bank)
5. Follow-up and evaluation of the speculation process: The follow-up and evaluation process begins after approval and taking executive procedures to ensure the proper conduct of operations,
6. Measuring results and distributing returns: At the end of the agreed upon mudarabah period, a preparation is made final accounts and financial positions to make the distribution of profits or take into account losses.

1.2.2.3. Types of Mudarabah

There are four types of Mudarabah

- ❖ Restricted Mudarabah (Mudarabah Muqayyadah): restricted mudaraba refers to the financing process in which the owner of the speculative money is restricted to a specific type of business, or that he required to practice the activity in a specific place or time.
- ❖ Unrestricted Mudarabah (Mudarabah Mutlaqah): However, The Rab-ul-maal gives full freedom to Mudarib to undertake whatever business he deems fit, this is called Al Mudarabah Al Mutlaqah (unrestricted Mudarabah). However, Mudarib cannot, without the consent of Rab-ul-Maal, lend money to anyone. Mudarib is authorized to do anything, which is normally done in the course of business.
- ❖ Individual mudarabah: it is well known that legitimate speculation was practice mostly on an individual basis between a person who works in money speculator and the owner of money who provides a money to a speculator.
- ❖ Collective mudarabah: It is permissible for speculation to be between one owner of the money and several speculators with work .it also permissible for

one to speculate with multiple money for several people as a joint factor in speculation.

1.2.3. Musharakah

Participation is one of the old financing methods, but it is a new banking method. It is based on the Islamic bank's provision of the financing requested by the client and participant a percentage of this funding, along with his work, experience and trust, and without charging fixed interest.

As is the case in conventional bank financing, but the Islamic bank participates in the potential results whether they are profit or loss.

Musharakah is an Arabic word which means "sharing" Participation can be defined as participation of two or more persons in a certain business with defined amount of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportions.

1.2.3.1. Types of Musharakah

There are two types of musharakah:

- Money companies : are the company in which the principal money is shared between the parties to the contract and its correct according to the agreement of all jurists and the money company is held on two terms , namely the negotiation company and al-anan. the negotiation company is based on full equality with partners in everything, especially in the capital, in a profit and management then each partner is authorized over the other work with his opinion without referring to him, and for this, of course, each of them were to be a guarantor of the other. As the al-anan company shall be established if the condition of the negotiation company is not met, and in general it is established based on the following points
  - unequal shares of partner's capital
  - the profit is distributed among the partners based on the conditions they put it.

- each partner must obtain permission from each other in order to be free to act.

❖ Business companies: are contracts according to which two or more are required to do something such as trade, consulting, etc., and profit among them.

1.2.3.2. Conditions of Musharakah

i. That the share capital be of specified and known money and circulated currencies.
   If the share of some partners is in kind, then it must be carefully evaluated in the observance of fairness in assessing and evaluating the shares of the partners It will be used as the basis for the distribution profits and losses after that.
ii. The share of partners in the share capital may not be equal.
iii. That the profit is a common and known percentage and not limited to a specific amount of money everything that leads to ignorance in the profit or to sever the company from it corrupts the participation.
iv. That the loss is equal to the share of each partner or the capital. Whatever the loss is borne is based on the share of every partner in the capital in all cases and not according to what they stipulated.
v. That each partner is eligible for the power of attorney it means being enjoyable with the capacity that enables him to be original in his work for the company and as an agent at the same time. he is authentic as he works with his money, and as an agent, as he does not work with his money only, but is mixed with someone else's money.

1.2.4. Ijarah

Literally, it means “To give something on rent” (Usmani, 1998) .

A financing tool that allows the acquisition of equipment and machinery through leasing instead of immediate purchase, thus reducing the burden and costs on capital. It is also defined as the sale of a known benefit in exchange for a known consideration for a specified period. The lessee has the right to purchase the leased assets at the end of the lease period.

Ijarah is considered one of the Islamic financing methods of great importance, as it is an effective form in Islamic banks as it enables the bank and its clients to achieve advantages and benefits commensurate with the objectives of each of them, especially with the rapid developments that the world is currently witnessing (Rizvi , 2017).

According to AAOIFI standard, it is also supported by the saying of the Prophet Muhammad (Peace be upon Him) that, “whoever hired a worker must inform him of his wages; And his saying: “give a worker his wages before his sweat (body odour) is dried”.

1.2.4.1. Rules of Ijarah

I. that the eye is permissible for the benefit according to sharia.

II. That the leased property is owned by the lessor or he has the power to dispose of it.

III. Enabling the lessee from the leased property so that he can benefit from it

IV. A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.

V. The leased property must be useable, such as: houses, cars, and capital assets

VI. The rental must be determined at the time of contract for the whole period of lease.

VII. The Lease period will start when the asset has been delivered to the Lessee (https://islamicmarkets.com/education/category/ijarah, 2019).

1.2.4.2. Types of Ijarah

In ijarah can be classified as operatingijarah and financialijarah:

1. Operating ijarah (ijarah tashgheeliah):

It is a lease that is based on the tenant owning the benefit of a specific asset during a specific period of time provided that the asset is returned to its leased owner (Islamic Bank)

The owner operates, maintains, and markets, machinery, and other capital assets by purchasing them for the purpose of leasing them for a certain period, with lease payments and attractive condition, and the lessor bears the consequences of ownership of the asset in terms of insurance, registration, and maintenance. After the expiry of the lease period and re-renting it again until the capital asset is acquired or sold scrap.

2. Financial ijarah (ijarah muntahia bittamleek):

It is a lease in which the bank (the lessor) takes over the lease of the asset again and again so every time the lease term ends, the lessor (the bank) seeks to lease to another party, the lessor bears the risks of market stagnation and decrease in the demand for these assets and not exploit them optimally. According to the method of ownership transfer, this particular type of ijarah can be classified into four different types:

- ❖ Ijarah muntahia bittamleek through hibah (gift)
- ❖ Ijarah muntahia bittamleek through ba'i (sale)
- ❖ Spot ijarah
- ❖ Forward Ijarah (ijarah mawsufah fi al-dhimmah):

1.2.4.3. Termination of Ijarah

- ❖ Dismissal: that one of the parties requests the other to dismiss him.
- ❖ If the Lessee stops paying the rent or delays it.
- ❖ The loss of specific rental property such as a house, a car, etc.
- ❖ By the expiration of its term.

1.2.5. Istisna’a

Istisna'a sale is a contract by which the bank buys something that does not exist and still needs to be manufactured, and the manufacturer (seller) is obligated to manufacture and supply it with materials from his own, with specific descriptions and a specific price, and it is not required that the buyer pay the value immediately, such as selling salam, but he may pay part of the value. nothing is paid except at the time of receiving the item.

The Istisna'a sale formula covers the financing of all industrial goods and the manufacturing and extractive industries, and in general all commodities that enter the industry in their production at any stage of production, starting from the manufacture of doors and windows to cars, airplanes and ships.

1.2.5.1. Steps to Istisna'a in an Islamic bank:

1. The customer submits to the bank a request from him to construct a building for him or to manufacture equipment or a production line for a specific factory, and attach with his request a complete statement supported by drawings and maps from the consultant engineer about the shape and specifications of the building (or production line) that he wants to construct, copies of ownership, plan the land area and location, a blueprint for the building, and a brief report from the engineer who designed the building. This report includes the construction cost.
2. The customer also presents with his request the down payment that can be paid to the Islamic bank, the guarantees he offers, and the method of payment (one payment or in multiple monthly or quarterly instalments), accompanied by a financial study in which the expected revenue is estimated and the extent of his ability to fulfil the instalments.
3. The bank conducts a specialized technical feasibility study for the project with the knowledge of finance experts in the bank, with the help of an engineering consultancy office affiliated with the bank, in order to identify the feasibility of financing the project.
4. In the event that the bank approves the offer submitted by the customer, it is required to submit the final documents for financing and to provide the necessary guarantees.
5. After the final agreement, the bank signs an Istisna'a sale contract with the customer in which it specifies all the rights and obligations of each party to the contract, namely (the bank and the customer) and the most important thing in the contract is the following: the price of selling the building to the customer by the bank, the delivery date according to the specifications, the period Payment, instalment value, and down payment value.
6. After signing the Istisna'a sale contract between the bank and the customer, the bank signs an implementation contract with the contractor to whom the bid was awarded through a tender called "parallel Istisna'a contract".

The client has the right to appoint a consultant engineer to follow up the progress of the project, but the cost is borne by the customer (Imad , 2016).

1.3. Risks of Islamic Banking and Finance

There is no doubt that Islamic banks are exposed to great and many risks, in terms of quantity and quality, through the activities that they undertake that's means the aspect of investing money, which is what differentiates its work from conventional banks in a clear way. Islamic finance is practiced in Islamic banking through several formats: Such as murabahah for the one who ordered the purchase, leasing ending with ownership, diminishing musharakah or ending with ownership, Salam and Istisna'a and others, and these in turn lead to the creation of a real economy. Because it is based on the contract or participations.

The risks faced by Islamic banks can identified in the following points

1.3.1. Credit Risk

credit risks are the risks associated with the other party in the contract i.e. the extent of his ability to fulfil contractual obligations in full and on time as stipulated in the contract.

In conventional banks, the credit risk appears in the loan when the other party is unable to full fill the terms of the loan in full and on time.

In Islamic banks credit risk differ from financing in known margin formulas in which credit risk arises through the failure of the other party's performance in its trade or industry and financing in profit and loss sharing formula in which the credit risk comes in the form of the partner not paying the bank's share when due and this is the results of insufficient information with the bank about the real profits of business establishments (Helmy , 2012).

1.3.2. Market Risk

The instruments and assets that are traded in the market are considered a source of this type of risk that comes for reasons related to macroeconomic variables.

General market risks are the result of a general change in prices and policies at the level of the economy as a whole as for private market risks, they arise when there is a change in the prices of assets and traded instruments as a result of special circumstances.

1.3.3. Reference Price Risk

İt may appear that Islamic banks are not exposed to the risk of a change in the interest rate as long as they do not deal with the interest rate, however changes in the interest rate cause some risks in the revenues of Islamic financial institutions that use a reference rate to determine the price of their various financial instruments, and it is usually an indicator.

Also, the nature of fixed income assets requires that the profit margin be determined once throughout the contract period.

Accordingly, when the reference price changes, it will not be possible to change the profit margin in these fixed income contracts that are predetermined and for this term.

Islamic banks face risks arising from interest rate movements in the banking market

1.3.4. Operational Risk

This risk is generally the result of human or technical errors or accidents and is the possibility of loss resulting from internal or external factors.

The internal factors are either the inefficiency of the equipment or the technologies used, and the risk of humanity is due to incapacity as for the technical risks they may result from faults affecting communication equipment and office equipment.

As for the external factors they represented in the natural disasters that lead to the destruction of the physical assets of expenses.

1.4. Islamic Microfinance

Microfinance refers to the sustainable provision of financial services to the poor and small business activities, including not only loans but also savings and money transfer services (including a very important money transfer service and insurance).

Usually, the interest in small business activities is primarily focused on credit, and at that time the poor also need access to credit, but they need saving and money transfer services.

Loans are often short-term, less than 12 months and in general, they are to finance working capital and are on weekly or monthly payments and they are disbursed quickly after approval, epically those who do not receive these loans repeatedly.

1.4.1. Challenges to Islamic Microfinance

Muhammad Khaled (2009) a "microfinance expert" and a member of the Consultative Group to Assist the Poor, mentions that none of the Islamic microfinance institutions has been able to access Islamic microfinance on a large scale "tens of thousands of active clients" and to achieve financial sustainability (to achieve profitability). Khaled believes that the reason is this may be due to the fact that Islamic finance has succeeded with small and medium businesses, but it has not been properly adopted at the level of microfinance and its clients.

In a study by the Research and Studies Institute of the Islamic Development Bank (2008) the challenges facing Islamic microfinance were addressed, and among these challenges that the study dealt with were the following: (IRTI , 2007).

Non-Compliance with the Provisions of Islamic law:

The commitment to the provisions of Sharia is a major difference between traditional and Islamic microfinance institutions, and the Islamic microfinance institution must work to adhere to Sharia in all its transactions and products, and to clearly demonstrate this and clarify it to its clients and not only apply.

Absence of Sharia Supervision

Most Islamic financial institutions have a Sharia supervisory body that monitors their work from the Sharia point of view, and this gives confidence to shareholders and dealers about the legitimacy of these institutions ’transactions and their compliance with Islamic law. If we look at microfinance institutions, we will find that none of them has a Sharia supervisory body, so the challenge is in front of that. Institutions in finding a practical alternative to the Sharia Supervisory Board.

Different Perception of the Concept

Where clients 'perception of the concepts of mudarabah, murabahah, and Qard al Hasan , which are among the prevailing forms of Islamic microfinance, varies greatly, which may pose a serious challenge to the Islamic microfinance sector, and in some cases, this misconception is inherent due to clients' ignorance of the jurisprudential rules that govern the various mechanisms devoid of Suspicion of usury.

Lack of Variety of Products

Despite the abundance of jurisprudential literature, Islamic microfinance is still based on the Murabaha formula. And although musharakah profit and loss sharing formulas are considered by many to be ideal, they are rarely used (with a few exceptions in countries such as Indonesia). In general, compulsory savings, deposit services, insurance, transfers, and other fee-based services are not being used as required by Islamic microfinance institutions.

Lack of Education and Training

The absence of education and training among clients and organization staff poses a major challenge to the Islamic microfinance sector. The shortage of trained workers is a major obstacle to growth, expansion, and integration. Currently, only a limited number of resource centres are available, in addition to fewer training programs available in the local language. There is an urgent need to provide resource centres and training materials in local languages (Ghanem, 2010).

1.4.2. Formulas of Islamic Finance in Microfinance with Example

There are various forms and financing methods that compatible with Islamic sharia and this formula are murabahah, mudarabah, musharakah and Istisna'a and each of these formulas has a nature differs from the other, as in the following with example.

1.4.2.1. Murabaha Contract of Sale in Microfinance

Murabaha is defined for the one who ordered the purchase as: "Selling the commodity according to the specifications specified by the one who ordered the purchase at the same price as the first price that the Islamic bank bought with an agreed-upon knew profit increase on the basis of a binding promise" (Shuwaidah, 2007)

An illustrative example of using the murabaha formula for buy-in in microfinance. assuming that the dealer of a microfinance institution who works as the owner of a business that sells calculator machines (calculator) has asked the institution to buy him a specific commodity, the cash price of which is $ 100, provided that he is committed to buying this commodity from the institution at a profit of 8% and to pay the total price. In monthly instalments starting from the month following the implementation of the transaction, after approval of the request and signing of the promise to buy and the necessary documents, the organization purchases these goods and possesses them and then sell them to the dealer (who ordered the purchase) so that the customer can pay the monthly instalments based on the following method of calculation:

- ❖ The value of the goods (net financing) = 100$
- ❖ Murabaha profits 100 X 8% = 8$
- ❖ Total financing value including profits =108$
- ❖ Monthly Instalment 108/12 $Month =9$

Advantages and disadvantages of using the "Murabaha" In microfinance institutions.

Advantages

- ❖ Low risk

- ❖ Easy to apply
- ❖ Fits a lot of small projects

Disadvantages

- ❖ It is similar to a traditional loan, so it is suspected by some people and considered a detour to obtain an interest-based loan.
- ❖ Some dealers abuse murabaha by deceiving the microfinance institution in order to obtain cash in a way that is not legally permissible (for example, an agreement with the seller to return the goods to him after the institution buys it and sells it to the one ordering the purchase).

1.4.2.2. Mudarabah Financing in Microfinance

Speculation is for the owner to pay the worker money to trade in, and the profit is shared between them according to what conditions. As for the loss, it is upon the owner of the money alone, and the speculative worker does not bear anything from the loss, but rather he loses his work and effort. (Al-Zuhaili, 1997).

Under it, the microfinance institution pays money to the dealer, and profits are shared at rates to be agreed upon, while the loss is borne by the institution that paid the money to the speculator who loses his effort and works only unless the loss due to negligence.

An illustrative example of using the mudarabah formula in microfinance:

For to give a customer a cow to produce milk or give him money to buy a dairy cow for a value 2000 $USD He signed a speculative contract with him providing for a profit sharing 30% For speculators and 70% of the institution. Assuming that a monthly profit of 500 $ USD has been generated, it is distributed according to the agreed rates and be 150 $ from the share of the speculator a microfinance institution 350 $ from the share of the institution that funded the project.

In the event of a loss, the corporation bears the loss in the capital and the speculator (the dealer) loses his effort and work (unless the loss is a result of his negligence).

Advantages and disadvantages of using the speculative financing formula in microfinance institutions:

Advantages

- ❖ Achieve high profits
- ❖ It contributes directly to economic development
- ❖ It is preferred by many dealers and considers free from legitimate suspicions

Disadvantages

- ❖ The riskiest form of Islamic finance, as it relies on the honesty and ethics of the dealer
- ❖ The seriousness is lower because the speculator does not contribute any part of the money

1.4.2.3. Musharakah Financing in Microfinance

According to the partnership formula, a partnership is established between the microfinance agency and the client of this agency, whereby the institution provides the necessary funding to implement a specific project, while the client covers the remaining part of the financing, and in the event that profits are achieved, they are distributed between the two parties in rates to be agreed upon in advance between the two parties, and upon loss, they are charged. For the two parties according to the percentage of each other's contribution to the capital.

An illustrative example of using the end-of-ownership partnership formula in microfinance:

Assuming that microfinance institution bought a taxi and owned it for an amount of 10,000$ then the customer pays 2,500$ (of the car’s capital) and then receives the car from the institution to work on it according to the following conditions:

- The customer must have 30% of the net profits.
- the microfinance institution will have 20% of the net profits.

- 50% of the net profits are set aside in a special account to amortize the capital until it reaches 7,500 $, at which point the Corporation assigns its ownership of the car in favor of the participating dealer.

Suppose that the monthly profits were 500 $, it is distributed as follows:

Profits of 150 $ are from the share of the customer, 100 $share of the institution, 250 $ are set aside in a special account to amortize the capital of the institution, and accordingly, to the account, the customer owns that car after 30 months.

But if the result is a loss, it is distributed according to the contribution of each party to the capital.

Advantages

- ❖ Contribute directly to achieving economic development
- ❖ Achieving a high return for the enterprise
- ❖ It is preferred by many dealers and considers closer to Islamic law
- ❖ There is seriousness due to the partner's participation in a part of the capital.

Disadvantage

- ❖ High risk on microfinance Institution
- ❖ It depends on the honesty of the partner
- ❖ You need accounting experience and special accounting guidance in a microfinance Institution.

1.4.2.4. Istisna'a Financing in Microfinance

Istisna'a is a contract whereby one of its parties undertakes to produce something specific according to specific specifications to be agreed upon and at a specific price and delivery date. (Sawan 2001).

According to the Istisna'a formula, the MFI manufactures what the customer wants in terms of production or real estate units through the manufacturers, then divides the amount in instalments that include the institution's profit from Istisna'a.

An illustrative example of using the Istisna'a financing formula in microfinance:

i. The client submits to the microfinance institution asking him to complete the construction of a house and attaches with his request a complete statement supported by drawings and maps of the required specifications indicating the expected costs.
ii. The application, maps, and attached documents are studied.
iii. In the event of approval, the Corporation asks the customer to sign an Istisna'a contract in which he specifies the rights and obligations of each party. The contract includes the agreed price and delivery dates according to the required specifications, the payment period, the value of the instalments, and the amount of the deposit that the customer will pay to ensure the seriousness.
iv. After signing the Istisna'a contract between the corporation and the client, the corporation signs another Istisna'a contract with a contractor to carry out the work and it is called a parallel Istisna'a contract, and the client does not have any relationship with the contractor, rather the relationship is between the corporation and the contractor and between the corporation and the client.
v. The contractor who carried out the work delivers the foundation according to the agreement and gets paid.
vi. The Corporation delivers the house to the customer ready according to the agreement, and the customer starts paying the instalments agreed upon according to the Istisna'a contract.

Advantages

- Fits in financing goods and housing units that need to be manufactured.
- Confirms disbursement of funding in the target set for it.
- Istisna'a payments and installments can be obtained prior to final handover
- Istisna'a has a major role in revitalizing the industry and advancing the economy.

Disadvantage

- Needs contracting with manufacturers and contractors and requires them to provide guarantees for proper implementation.
- It needs supervision and follow-up from the institution to ensure the progress of work according to the agreement (Muhammad, 2005).

CHAPTER 2

CONVENTIONAL FINANCE AND BANKING IN DJIBOUTI

In this part ıs discussed about economy of Djibouti, finance and banking in Djibouti also currency credit.

2.1. Economy of Djibouti

The economy of Djibouti has shown robust growth in recent years, recording an average of over 6.5 percent year-on-year from 2014 to 2017, with the real GDP forecast to grow at 7 percent in 2018 and 2019. The strong growth is due to several factors: public sector investments namely railroad to Ethiopia, construction of new ports and water pipeline from Ethiopia, foreign direct investment inflows largely from China, the rent from foreign military bases, and its strategic geographic location.

There are prospects for the economy to grow stronger due to major reforms under the vision Djibouti 2035. The aim of the vision is to "transform the country into a logistics and commercial hub for the whole of East Africa and turn the country into a middle-income economy". The vision targets annual GDP growth rates of 7.5 - 10 percent, increased per capita income in three folds, and increased employment opportunities. The vision comprises of five main pillars:

- Peace and national unity.
- Good governance.
- Economic diversification.
- Human capital development.
- Regional integration.

To implement this reform, the country has launched several infrastructure investment projects, many of which are externally financed. However, external financing could pose a greater risk on the country's public external debt position.

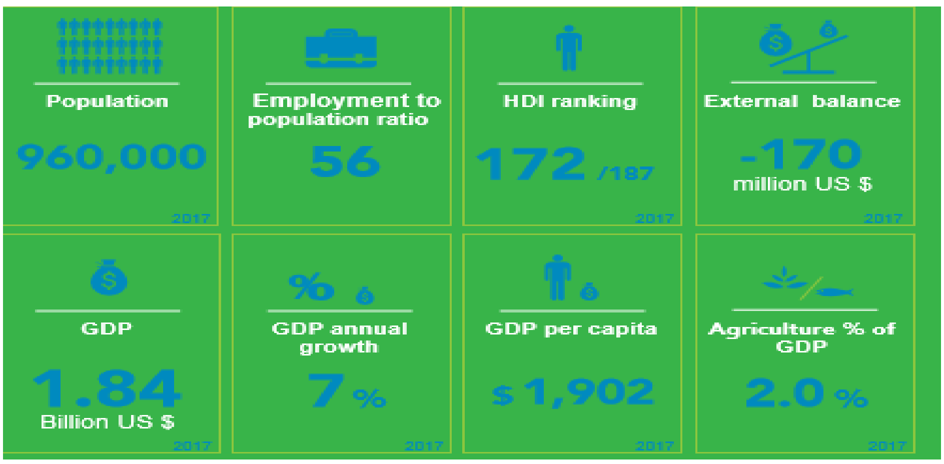
Even with the high economic growth rate, however, the country is subject to a high risk of debt distress. Going forward, the economic growth may be impacted by lower productivity investment than expected from investment in ports and railway projects, a slowdown in

International trade, an economic slowdown in China and Ethiopia, and the continuous tension in the region which could result in mass inflows of migrants from Yemen.

Despite the high economic growth and a relatively small population size of less than a million inhabitants, poverty and unemployment remain high. The unemployment rate is about 40 percent, while 41 percent of the population live below the poverty line. The debt situation continues to be of great concern with the country having a large portfolio of external debts. Over the past years, a number of large investment projects were mostly financed by external borrowing, notwithstanding the large foreign direct investment inflows (FDIs), mainly from China and rents from the military base.

Djibouti’s economy is driven by the service sector. The financial sector also plays a pivotal role in the economy. The banking industry, comprising conventional and Islamic banks, dominates the financial sector. There are 11 banks, of which eight are conventional and three Islamic. Islamic banking started in 2006 and is now growing rapidly. As of today, the asset size of Islamic banks has reached 50 billion Djiboutian franc. Islamic banks assets have grown by 20 percent. The assets, deposits and loans of Islamic banks have grown by 20, 15 and 14 percent respectively. The financial sector indicators for Islamic banks remained stable. The average Non-Performing Loans (NPLs) for the Islamic banks is 3 percent Islamic banks are also highly liquid.

Figure 4. Djibouti at glance.



Source: World Data Bank - Latest reported data.

2.1.1. State Budget of Djıbouti

The state budget amounted to 133.9 billion FDJ at the end of 2019, against 134.2 billion FDJ at the end of 2018, thus showing a slight contraction of 0.2% from year to year. The increase in receipts and grants on the one hand, and the reduction in expenditure on the other hand, made it possible, however, to improve the budget balance with a public deficit (on a commitment basis) which was reduced to 0.9 % of GDP in 2019, while it reached 2.5% of GDP in 2018. The budget deficit is estimated at 16 percent of GDP in 2016 representing a decline compared to 22 percent of GDP in 2015. The major infrastructure investment projects, namely the ports, railways and water pipelines exert pressure on public finance.

Table 1. State budgetary operations, 2016-2019.

Table of State budgetary operations, 2016-2019 **In millions FDJ**					
	2016	**2017**	**2018**	**2019**	**2019/18 variance**
Recipes and Donations	**112810**	**116138**	**123930**	**128931**	**+4,0%**
Internal recipes	105231	107212	106311	109283	+2,8%
Official donations	7579	8927	17619	19648	+11,5%
Expenses	**119781**	**117172**	**134200**	**133968**	**-0,2%**
Current expenses	83 013	87 024	91 841	91934	+0,1%
Investments	36 768	30 147	42 359	42 034	-0,8%
Overall balance (payment order basis, donations included)	-6972	-1033	-10270	-5037	-50,9%
Overall balance (in% of GDP)	-2,1%	-0,3%	-2,5%	-0,9%	+1,6%
Changes in arrears (positive minus sign)	-1650	-363	1993	2871	+44,0%
Overall balance, (cash basis)	-8622	-1396	-8277	-2166	-73,8%
Overall balance on a cash basis (in% of GDP)	-2,6%	-0,4%	-2%	-0,4%	-1,6%
Funding	4648	1467	9147	3326	-63,6%
Interior	-1885	-2602	511	-4947	-868,1%
Outside	6533	4069	8636	8273	-4,2%
Residual deficit	-3974	71	870	1160	+33,3%

Source: Ministry of Budget

2.1.1.1. Recipes and Donations

The total resources mobilized in 2019 stood at FDJ 128.9 billion, against FDJ 137.6 billion provided for by the Amending Finance Law (LFR), which represents an achievement level of 93.7% and a poorer performance. than the rate of 97.7% achieved in 2018. The mobilization of domestic revenue and Donations which did not reach the objectives expected in the 2019 LFR explains this drop in performance, in terms of mobilizing public resources. Overall, the total public resources, having increased from 123.9 billion FDJ in 2018 to 128.9 billion FDJ, however, increased by 4% between 2018 and 2019.

Internal Recipe

Having reached 71.4 billion FDJ at the end of 2019, against 69 billion FDJ at the end of 2018, tax revenue increased by 3.5% annually. However, the level of mobilization of these revenues remained lower than the amount programmed in the 2019 LFR which was 75 billion FDJ. Direct taxes, amounting to 30.5 billion FDJ in 2019, recorded an increase of 5.9% compared to 28.8 billion FDJ collected in 2018. Indirect taxes, for their part, increased by 3.5%, from 36.6 billion FDJ in 2018 to 37.9 billion FDJ at the end of 2019. Indirect taxes also exceeded by 197 million FDJ the target set in the 2019 LFR.

Other tax revenue, reaching 3 billion FDJ in 2019, compared to 3.6 billion FDJ in 2018, fell by 16.7% over the period and, moreover, remained below the forecasts of the 2019 LFR, with a lack of to earn 3 billion FDJ. At the end of the 2019 fiscal year, mobilized tax revenues represented 65.3% of domestic revenues, a better level than in 2018 when these revenues represented 64.9% of domestic resources.

Non-tax revenue, with a total of 37.86 billion FDJ in 2019 have increased slightly compared to the 37.3 billion FDJ of revenue achieved at the end of 2018. The non-fiscal resources mobilized in 2019 did not, however, reach the amount projected (39.2 billion FDJ) in the framework of the LFR 2019.

State revenues collected to the tune of 8.3 billion FDJ in 2019, against 7.9 billion FDJ in 2018, increased by 5.1%, with an achievement rate of 86% compared to the amount provided for in the 2019 LFR. Other revenues, such as royalties on petroleum and mining products, as well as miscellaneous products, from 7.8 to 8.2 billion FDJ, between 2018 and 2019, increased by 5.1% year on the other.

The rents received for foreign military bases, having amounted to 21.3 billion FDJ in 2019, against 21.6 billion FDJ in 2018, decreased slightly and show an achievement rate of 95.9% of the amounts expected in the LFR 2019.

According to IMF Article IV report, in 2016, revenue collection remained relatively strong. However, non-tax revenue and grants fell below expectations. On the one hand, tax revenues exceeded projections; on the other hand, non-tax revenues fell below projections by 1.5 percent of GDP due to lower dividend transfers by the port operator because of an ongoing dispute with the government. Further delays in disbursements led to a significant revenue shortfall in grants by 1.8 percent of GDP. In 2016, Djibouti central government's tax to GDP ratio was 31.3 percent of GDP, and this far exceeded the average for other comparator countries at similar levels of development

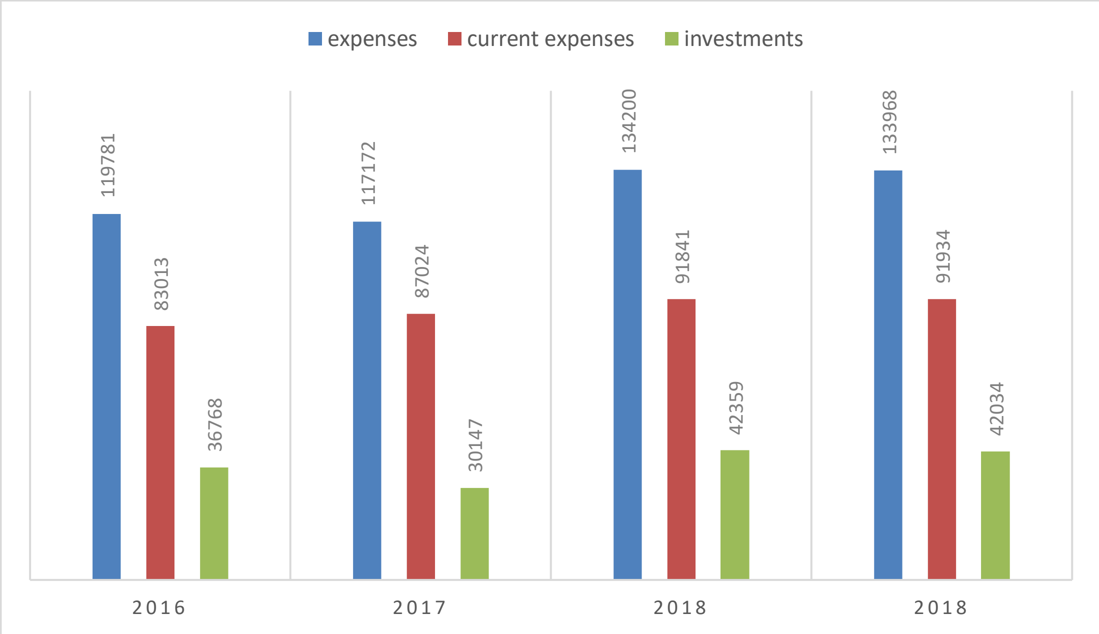
The Donations

Official donations received by the Republic of Djibouti, amounting to 19.6 billion FDJ at the end of 2019, against a total of 17.6 billion FDJ mobilized in 2018 thus increased by 11.4%, but show an achievement rate of 84.1% lower than the 166% achieved in 2018. Donations earmarked for social projects (380 million FDJ) and public investments (7.5 billion FDJ), reaching a total of FDJ 7.9 billion at the end of 2019, recorded a contraction of around 41% compared to the FDJ 13.4 billion received in 2018. Donations not allocated to projects have, for their part, achieved a jump of 181%, from 4.2 billion FDJ in 2018 to 11.8 billion FDJ in 2019.

2.1.1.2. Total Expenses

At the end of the 2019 financial year, State spending was stopped at 133.9 billion FDJ, against 134.2 billion at the end of 2018, an annual decline of 0.2%. However, these expenditures remained below the programmed amount (139.2 billion FDJ) in the 2019 LFR.

Figure 5. Evolution of expenses 2016-2019 in millions FDJ.



Source: Ministry of Budget

Current Expenses

Current expenditure, which rose from 91.8 billion FDJ to 91.9 billion FDJ, between 2018 and 2019, remained practically at the same level over the period under review, with a slight exceeding of the planned amount (91.5 billion FDJ) in the 2019.

The expenditure for salaries, reaching 35.6 billion FDJ in 2019, against 35.5 billion FDJ in 2018, recorded an annual increase of 0.3% and an excess of the same order compared to the planned amount (35.5 billion FDJ) in the 2019.

Equipment expenses, established at 29.4 FDJ billion at the end of 2019 and also Maintenance expenditure increased from 1.6 to 1.3 billion FDJ.

The current account deficit of the Djibouti economy widened due to large investment related to imports. According to IMF 2016 Article report, the external current account deficit increased to 32 percent of GDP in 2015 before going down to 29 percent of GDP in 2016. Although, there was high exports growth, the increase in imports of investment goods resulted in the large deficit. This deficit is mainly financed through public sector borrowing related to infrastructure projects and foreign direct investment (FDI) inflow. The currency board coverage remains at a comfortable level. In 2014 and 2015, the ratio of reserves to base money is estimated to have reached 110 and 107 percent respectively. From 2016 to date, the currency board coverage remains at 109 percent.

Investments

Djibouti has engaged in many large-investment projects to reinforce its port capacities and to catch-up with some of its infrastructure gaps in capital-scarce countries such as Djibouti, public investments are expected to have high returns, but the impact on growth depends crucially on the quality of public management.

Investment expenditure, with a total of 42 billion FDJ in 2019, against 42.3 billion FDJ at the end of 2018, have remained roughly the same from year to year. The investment objectives targeted by the LFR 2019 (an amount of FDJ 47.7 billion) was not reached. The jump in investments on domestic financing, which went from 17.2 billion FDJ to 22.7 billion FDJ, between 2018 and 2019, not only offset the decline (-23.2%) in investments on external financing, but also allowed to exceed to the tune of 745 million FDJ the amount of investments on domestic financing provided for in the LFR. In 2019, investments from domestic resources represented 54% of total investment expenditure, while they represented 40.7% in 2018. Investment expenditure on external financing fell from 25.1 to 19.3 billion FDJ between 2018 and 2019. Among these expenditures, investments financed in the form of grants and in the form of external loans both fell, respectively, by 41% and 4.8% in twelve months.

2.1.2. The External Sector

The external sector is the part of a country's economy that react with the economies of other countries. In the commodities market, the external sector includes exports and imports. In the financial market, it involves capital flows.

The external sector consists of these components. the current account, financial account. capital account, exchange rate, and balance of revenue.

Current Account

The current account represents the calculation of the value of a country's exports of goods and services in exchange for its imports, which is also known as the trade balance but the current account is a broader measure than the trade balance as it also takes into account some income and payments such as interest on debt or dividends on shares. In the event that the value of a country's imports exceeds its exports, this country suffers from a current account deficit. In the event that the value of exports exceeds imports, the state runs a surplus in the current account.

At the end of 2019, the current account balance of the Republic of Djibouti, with a surplus of 77.3 billion FDJ, improved compared to 2018 (76 billion FDJ). This performance is mainly linked to the improvement in the balance of the balance of services (+ 16%) between December 2018 and December 2019.

These transactions consist of imports and exports that take place between the state and other countries, including goods, services and capital, as well as foreign aid and remittances.

Financial Account

The financial account is calculated by the difference between the change in foreign ownership and local assets.

The financial account traces the transactions of transfers of financial assets between residents of the Republic of Djibouti and non-residents. These are trade credits, direct and portfolio investments and, in general, the creation or liquidation of debts between residents of Djibouti and non-residents.

Capital movements between residents and non-residents recorded net inflows of FDJ 73.852 million in 2019, compared to FDJ 73.922 million the previous year, a virtually stable level from one year to the next.

Flows under other investments were characterized by a net inflow of capital of 49,974 million FDJ in 2019, after 23,807 million FDJ in 2018. In terms of cash and deposits, there is an increase in the assets of the Djiboutian economy to the foreigner of 30,061 million FDJ, after a decrease of 5 million FDJ noted in 2018.

Regarding loans, there was a net inflow of capital of FDJ 19,913 million in 2019, compared to FDJ 28,950 million in 2018. This balance corresponds to the repayment of public administration loans amounting to FDJ 19,437 million.

Capital Account

The capital account - or capital and financial as it is called in some countries - includes all transactions that result from the movement of capital, whether from within the country to outside it or vice versa, and whether these capitals are in the form of financial assets (which means intangible assets that cannot be seen such as Stocks, bonds, bank deposits) or in the form of real assets such as real estate.

The capital account includes the acquisition of non-productive assets and transfer of capital

The balance of capital transfers stood at FDJ 7,142 million, after FDJ 12,361 million in 2018, a decline of FDJ 5,219 million, due to the decrease in project grants received by the public administration. Indeed, capital transfers for the benefit of the Public Administration have fallen, from 12,711 million FDJ in 2018 to 7,492 million FDJ in 2019.

The Balance of Transfers

Transfers from the public administration showed a positive balance of 25,430 FDJ million in 2019, down by 9,524 FDJ million compared to the previous year. This development is mainly due to the decline in program grants received by the Public Administration from international institutions.

The Balance of Revenues

The structure determines who pays for public goods and services. By distributing income among different instruments, countries can share the burden among specific groups of citizens and or sectors of the economy Income includes income from work on the one hand and income from capital on the other. These include income from direct investment, portfolio investment and other investment. The surplus generated by labor income that comes from salaries paid to local residents by international organizations and diplomatic representations increased by 36.6%, from 10,336 million in 2018 to 14,122 FDJ million in 2019.

The primary income deficit reached 16,678 FDJ million in 2019, after 25,267 FDJ million a year earlier, a decrease of 34%. It is mainly driven by the fall in interest payments on the external debt of public establishments and the central administration to their respective creditors (C. B. Djibouti , 2019).

And this table will summarize the above points.

Table 2**.** Balance of payments.

Balance of payments In millions FDJ				
	2017	**2018**	**2019**	**Var. 2019/18**
Current account	**-23.543**	**76.176**	**77.353**	**1,5%**
Goods	**-73.514**	**-14.363**	**-25.229**	**75,6%**
Exports	561.954	625.926	710.204	13,5%
Imports	-	-640.289	-735.433	14,9%
Services and Income	635.468	**55.585**	**77.151**	**38,8%**
Credit	**22.668**	195.665	219.122	12,0%
Debit	182.326	-140.080	-141.971	1,3%
Current transfers	-	**34.954**	**25.430**	**-27,2%**
Public administrations	159.658	4.879	3.353	-31,3%
Other sectors	**27.303**	30.075	22.077	-26,6%
Other	1.145 26.158 0	0	0	0
Capital account	**4.643**	**12.361**	**7.142**	**-42,2%**
Capital transfers	4.643	12.361	7.142	-42,2%
Public administration	4.63	12.361	7.142	-42,2%
Migrant transfers	0	0	0	0
Acquisitions & disposals of non-financial, non-produced assets	0	0	0	0
Financial transactions account	**60.846**	**73.922**	**73.851**	**-0,1%**
Direct investments	29.312	30.213	31.101	2,9%
Portfolio investments	0	0	0	0
Other investments	59.805	23.807	49.974	109,9%
Reserve assets	-28.271	19.903	-7.223	-136,3%
Errors and omissions	**-41.946**	**-164.484**	**-158.343**	**-2,5%**

Source: BCD

2.1.3. Exchange rate regime in Djibouti

The official currency is the Djiboutian franc (DJF).

Despite the advantages of the full convertibility of the Djiboutian franc, other factors (including real effective exchange rate imbalances, an unfavorable business environment, and a rigidity in the labor market) have impeded foreign investment and economic growth. Looking at the period from 1990 to 2002, foreign investment remained less than 1% of GDP. Real GDP has decreased by about half a percent on average annually and unemployment has risen with more than half of the labor force unemployed, resulting in lower per capita income and increased poverty. Meanwhile, the real effective exchange rate rose by nearly 60 percent and interest rates remained at high levels.

2.2. The Banking Sector in Djibouti

The liberalization of Djibouti's banking sector in 2006 led to an increase in the number of banks, as well as to an improvement in the indicators reflecting access to financial services. The level of financial inclusion, however, remains low, as most of the adult population and small and medium-scale enterprises do not have access to financial services. The financial sector is largely dominated by banks, whose business is concentrated with a few economic players. To broaden financial inclusion, in order to promote inclusive growth with a view to reducing poverty, it will be necessary to strengthen financial infrastructure, develop the microfinance sector, and improve economic formalization (Victor Davies, 2015) .

The financial sector landscape includes a large network of branches of foreign exchange and money transfer agencies, with 17 agencies approved by the Central Bank of Djibouti. Djibouti features no active capital markets or fixed income markets. The country received no sovereign rating from any of the three major credit rating agencies. The national pension system, based on a pay-as-you-go system, is comprised of three pension funds: one for civil servants, one for retired military personnel, and one covering employees from the private sector and public enterprises.

Notwithstanding the quick extension of the banking system as of late, access to financial services stays inadequate in Djibouti. The level of banking penetration remains unobtrusive. Under 20 percent of Djibouti grown-ups hold a deposit account with a bank and less than 8 percent have access to a loan account in 2014. Outstanding deposit came to 82 percent of GDP though outstanding loans from commercial banks, albeit expanded as of late, just reached 32 percent. Only 4 percent of adults could obtain a loan from a formal-sector financial institution in 2011, while 18 percent of adults had obtained credit from their circles of family or friends. Access to credit is one of the main constraints for formal sector enterprises. Only 5 percent of formal-sector enterprises have access to bank financing. Djibouti lags behind many other countries in the region in terms of number of bank accounts, bank branches and ATMs.

The financial sector of Djibouti has developed significantly since mid-2000s and that was largely bolstered by the large amount of trade. Growth in the banking sector began in the last decade. Djibouti's banking sector, which features both Islamic and conventional banks, has grown sizably with the arrival of new banks bringing the number of institutions to 11, compared with only two in 2006. The banking sector accounts for 97 percent of financial assets and 10 per cent of GDP. Authorities are also working closely with banks to address the issues of access to finance and further expand their range of financial products and services, such as automated teller machines (ATMs), Islamic products, and products for small and medium-size enterprises.

The financial sector is characterized by a substantial prevalence of banks and insufficient diversification among institutions and financial instruments. The banking sector is by far the main component of the financial sector, accounting for more than 95 percent of the sector's total assets and 106 percent of GDP. While the sector is dominated by the two largest banks, representing nearly 67 percent of its total assets, the share of these banks is decreasing as a result of competition from new banks.

Banking is entirely under the supervision of the Central Bank of Djibouti, while the capital of local banks is majority owned by foreign groups. Djibouti today can thus boast of having a healthy and reliable banking Center fully connected to the international banking sphere, and able to provide all banking services, both locally and internationally via a large network of foreign correspondents. The Djiboutian financial sector, with total assets of 265 billion FD or 102 per cent of GDP, has not been affected by the international financial crisis. The insurance sector, regulated by the Ministry of Finance, consists of only two large corporations.

Table 3. Djibouti: Financial Soundness Indicators (All Banks, Periods Average in Percentage).

Indicator	**2013**	**2014**	**2015**	**2016**
Capital adequacy				
Regulatory capital to risk-weighted assets	9.6	10.7	11.0	13.1
PCA Rating	1	1	1	1
Tier 1 capital to risk-weighted assets	9.6	10.7	11.0	13.1
Asset quality				
Nonperforming loans to gross loans	14.5	18	21.8	22.8
PCA Rating	5	5	5	5
Earning and profitability				
Return on assets (ROA)	1.2	0.7	0.4	0.4
PCA Rating	3	4	4	4
Return on equity (ROE)	28.5	15.7	9.8	6.8
Interest margin to gross income	67.4	61.2	64.7	66.4
Non-Interest expenditures to gross income	59.1	56.3	65.8	79.5
Liquidity				
Liquid assets to total assets	64.6	60.4	60.5	63.8
PCA Rating	1	1	1	1
Liquid assets to short-term liabilities	110.8	94.5	91.5	92.8
Liquid assets to demand and saving deposits	251.6	266.9	273.7	348.2
Liquid assets to total deposits	82.3	79.9	77.5	81.8

Source: CBD data, IMF, and IRTI staff calculations

Djibouti financial soundness indicators (FSIs) show mixed results (see Table 3). The period averages show a significant deterioration in earnings and asset quality, greater than capital adequacy and liquidity end-of-period figures. According to the prompt corrective action (PCA) framework, supervision should be enhanced for higher PCA ratings, with banks that report a rating above three for any of the PCA components to be subjected to intensive supervision. Given the level of deterioration in some FSIs, the aggregate PCA ratings for the banking sector have worsened in 2015 and early 2016 for asset quality, earnings and profitability.

Assessing the banking system as whole, the industry's PCA rating over time confirms that asset quality and profitability deteriorated significantly in the past year. Moreover, it supports the view that credit risk is the key risk facing the Djibouti banking system today. The PCA rating for asset quality of 5 remained unchanged since 2013. Furthermore, the number of banks exceeding maximum single borrower limit have been trending upward. Nearly, all banks in the industry have exceeded the maximum single borrower limit in 2014. The upward trend in the number of banks exceeding the maximum single borrower limit implies that defaulting of a single borrower on its debt could pose risk in the banks concerned.

The level of financial inclusion in Djibouti remains low, as most of the adult population and small and medium-scale enterprises do not have access to financial services. The financial sector is largely dominated by banks, whose business is concentrated with a few economic players. To broaden financial inclusion, in order to promote inclusive growth with a view to reducing poverty, it will be necessary to strengthen financial infrastructure, develop the microfinance sector, and improve economic formalization (Tamsir Cham, 2018).

2.3. Credit and Deposit in the Banking System in Djibouti

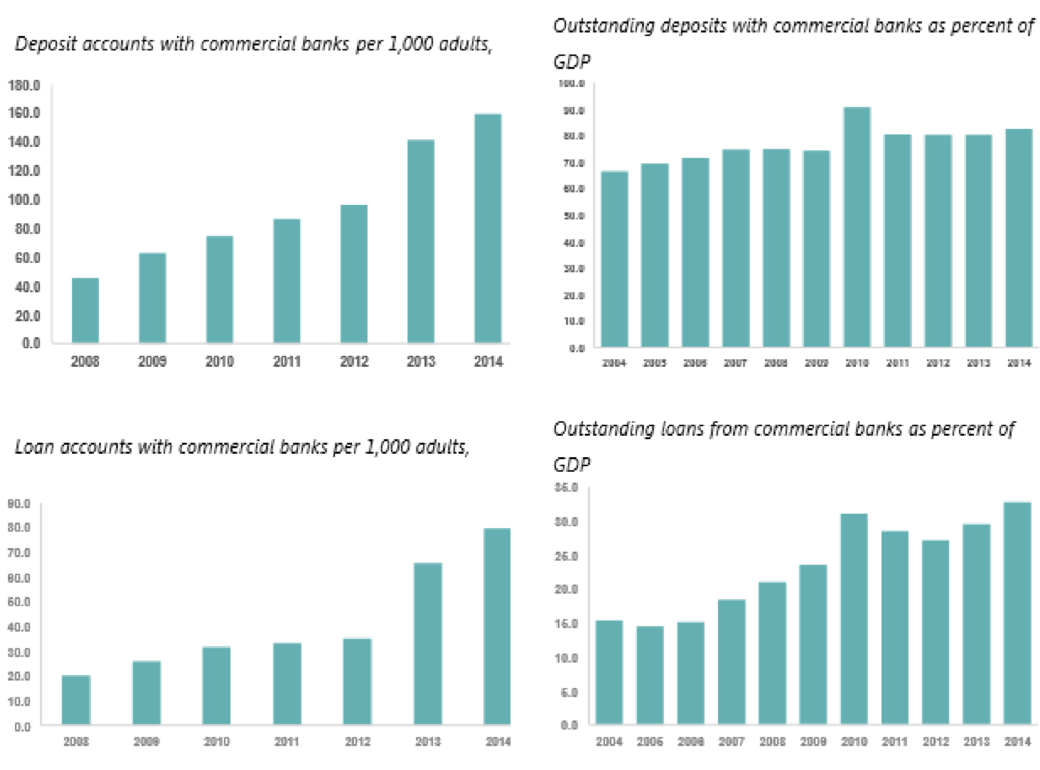
Despite a high level of liquidity in the banking system, increased competition between banks, and growing demand for credit, access to financial services, and particularly to bank financing, is still limited for most of individuals and small and medium-scale enterprises (SMEs).

The level of bank financing for small and medium-sized enterprises remains extremely low, accounting for only 12 percent of total corporate credit.

Most SMEs are located in the informal sector and are excluded, the facto, from accessing bank credit because they cannot provide banks with the required documents (administrative, tax, and financial records) or required guarantees. Nearly two-thirds of the population of an estimated 10,000 companies in 2010 worked in the informal sector.

Djibouti ranked 180th out of 189 in the World Bank's 2015 Doing Business Report for access to credit. (Victor Davies, International Monetary Fund of Djibouti, 2015).

Figure 6 : Djibouti Evolution of Deposit and Credit in the Banking System

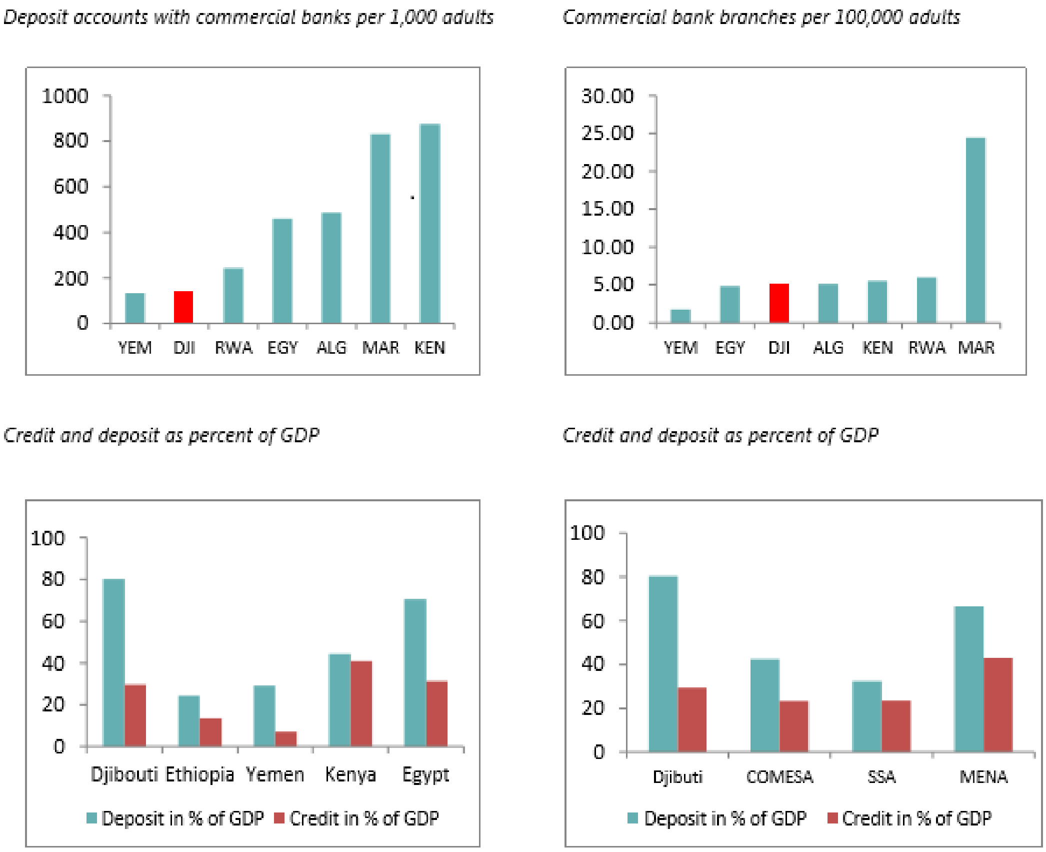


Sources: Financial Access Survey, International Monetary Fund, 2014.

2.3.1. Credit and Deposit in Djibouti and Other Countries

In terms of financial depth, Djibouti compares favorably with the countries of the region. Credit to GDP and deposits to GDP - which stood at 32 percent and 82 percent, respectively in 2014 - are rough indicators of financial depth. However, the high levels of credit and deposits relative to GDP contrast with the low level of financial inclusion, indicating a high level of concentration among a few individuals and institutions. In fact, as a result of the liberalization of the banking system, credit to the private sector has increased significantly from DF 33.9 billion in 2007 to DF 90.3 billion in 2014. The high level of concentration among a small number of clients leads to exceeding the limit of individual borrowing by all banks.

Figure 7 : Credit and Deposit in Djibouti and Other Countries.

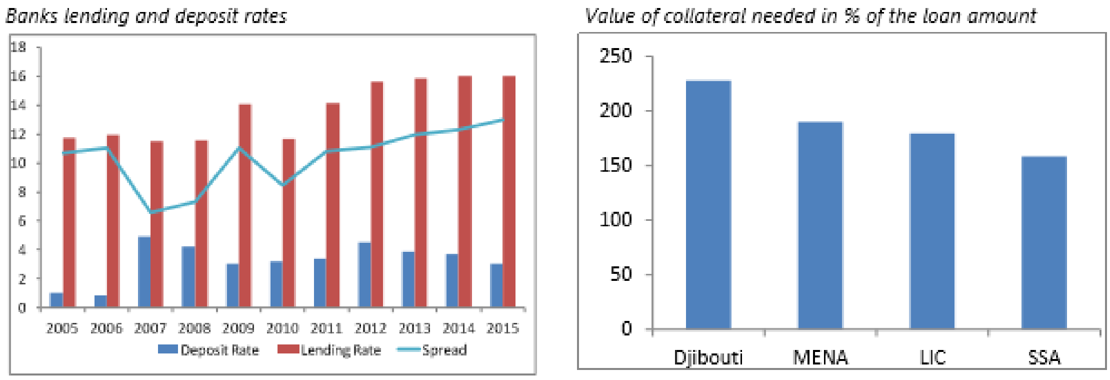


Sources: Financial Access Survey, International Monetary Fund, 2014.

2.3.2 Banks lending in Djibouti

On the supply side, while liberalizing the banking system has improved financial intermediation, the latter remains somewhat limited. The gap remains large between average lending and deposit rates, which are respectively 13 percent and 3 percent. In light of relatively low levels of inflation and low cost of funds, the cost of credit largely reflects the banks' risk premium. Banks have high lending rates and / or require large collateral (see figure 8) due to default risk associated with small and medium-sized enterprises due to inconsistent information, deficiencies in the credit reporting system, lack of credit history, and lack of reliable financial data. Djiboutian banks require, on average, 228 percent of the loan application amount as collateral, compared to 190 percent for the MENA region and 179 percent for Sub-Saharan Africa.

Figure 8. Djibouti: Banks Lending



Source: CBD

Source: Enterprise Surveys, World Bank

Unlike in 2018, the expansion of the money supply in 2019 is driven by the increase in domestic credit, whose annual growth stood at 12.4%, representing 38.6% of the total monetary counterpart. For their part, net foreign assets saw a slight increase of 0.7% compared to their level in 2018 and represented 72.4% of the total increase in money supply in 2019. Year-on-year, official reserves increased by 11% and covered 3 months of importation of goods and services.

In this below table 4 wıll defıne the evolution of the conterpatarts of the currency.

Table 4. The evolution of the conterpatarts of the currency.

Evolution of the counterparts of the money supply,2015-2019 In millions FDJ						
Components	**2015**	**2016**	**2017**	**2018**	**2019**	**2019/18 Var**
A- Net foreign assets	**213.292**	**236.231**	**297.956**	**273.800**	**275.834**	**0,7%**
B. Domestic credit	**109.629**	**110.128**	**122.487**	**130.800**	**147.052**	**12,4%**
Net claims on the state	6.652	8.713	8.994	3.572	7.016	96,4%
Receivables from public institutions	9.364	9.925	9.541	15.215	17.337	13,9%
Credit to the private sector	93.613	91.490	103.952	112.013	112.013	9,5%
Total A+B	**322.921**	**346.359**	**420.443**	**404.600**	**422.886**	**4,5%**
Balance of non-monetary items	-38.559	-38.559	-49.879	-54.722	-42.286	22.7%
Total money supply counterparts	**284.362**	**308.805**	**370.564**	**349.878**	**380.600**	**8,8%**

Source: BCD

A. Net Foreign Assets

In 2019, the net foreign assets of the banking system recorded an increase of 0.7%, reaching 275,834 million FDJ, against 273,800 million FDJ the previous year. In terms of structure, 31% of net foreign assets are held by the monetary authorities and the remainder is held by commercial banks. Also, the relative share of net foreign assets in the money supply continued to shrink by 5.8% year over year.

Table 5. Net foreign assets and liabilities of the banking system, 2017-2019.

Net foreign assets and liabilities of the banking system, 2017-2019				
Components	2017	2018	2019	2019/18 var
Ext. gross of monetary authorities	98.686	79.022	87.608	10,9%
External commitments of monetary authorities	-4.665	-3.805	-2.655	-30,2%
Net foreign assets of monetary authorities	94.021	75.217	84.953	12,9%

Gross foreign assets of banks External liabilities of banks	253.283 -49.348	237.864 -39.281	250.343 -59.462	5,2% 51,4%
Net foreign assets of banks	203.935	198.583	190.881	-3,9%
Total net foreign assets	297.956	273.800	275.834	0,7%

Source: BCD

B. Domestic Credits

Domestic credit got importance in the global markets and it is essential to the stability of the economic system at the same time it constitutes a risk factor that may afflict the country with economic crises that affect the entire economy.

In Djibouti Domestic credit increased by 12.4%, from 130,800 to 147,052 million FDJ, following the expansion of both net claims on the State (+ 96%) and claims on the economy (+ 10%)

Domestic revenue mobilization: Tax revenues in percent of GDP are relatively high in Djibouti. They averaged 21 percent of GDP over 2000–14 compared with 11 percent in Ethiopia, and 7 percent in Yemen. This could be explained by the existence in those countries of a large subsistence agricultural sector, with limited scope for taxation, while agriculture in Djibouti accounts for about 3 percent of GDP.

C. Net External Assets of Banks

Despite an accumulation of customer accounts payable with credit institutions, the banks' net foreign assets continued their downward trend during 2019, i.e. a volume deceleration of FDJ 7,702 million from one year to the next. the other. This decrease was the result of a strong increase in the external commitments of commercial banks which amounted to 59,461 million FDJ against 39,287 million FDJ in 2018, which represents an improvement of more than 51%. The external commitments of commercial banks consist of investments by correspondents of foreign banks and term or sight resources of non-resident customers.

Table 6. External liabilities of commercial banks, 2017-2019.

External liabilities of commercial banks, 2017-2019 In millions FDJ				
Components	2017	2018	2019	2019/18 var
Passive correspondents	24.741	14.555	30.222	107,6%
Demand deposits of non-residents	20.520	19.777	24.533	24,0%
Term deposits from non-residents	2.635	3.624	3.744	3,3%
Loans & Equity securities	500	500	500	0,0%
Miscellaneous liabilities	952	831	462	-44,4%
Total	49.348	39.287	59.461	51,4%

Source : BCD

According to IMF 2016 Article IV reports that the 12-month percentage change in credit to private sector grew in 2014 and 2015 by 8.6 and 7 percent, respectively, with a declining trend since then. However, credit to the private sector as a percentage of GDP is projected to grow in the double digits from 5.5 percent in 2017 to 16 percent by the end of 2018. This could be because of the investment boom and greater confidence in the economy, driven by external investments.

The low credit to private sector can be attributed to unfavorable business environment, smaller size of the private sector, fewer registered private enterprises and the predominance of informal activities.

According to the World Bank's 2018 Doing Business report, Djibouti is ranked 154 out of 190 countries with very low scores in terms of getting credit, enforcing contracts, and access to electricity. Therefore, until there is considerable improvement in the business environment, credit to private sector will remain a challenge. Furthermore, government and non-government enterprises compete for credit with the private sector resulting in the "crowding-out" of the private sector. Notwithstanding these developments, the increasing trend of Non- Performing Loans (NPLs), from 21.8

percent in 2016 to 22.8 percent in 2017, present a challenge for the financial sector. (Report, 2018)

CHAPTER 3

ISLAMIC FINANCE AND BANKING IN DJIBOUTI

3.1. Overview Islamic finance in Djibouti

Djibouti is one of the smallest countries in Africa, and it currently has eleven banks operating in the country. There is a strong potential for Islamic finance to grow further in the country, given the strong and positive reception from the population and the political leadership's support for Islamic finance. Islamic finance also offers attractive financing methods without putting financial stability at risk. In addition, the risk-sharing principle in which Islamic banks work to enhance financial stability, which in itself is a necessary condition for the stability of the economic system, which ultimately promotes economic growth. Furthermore, the World Bank predict Djibouti’s GDP growth to increase 7.5% in 2020, with 2021-2023 having the Possibility to speed up to rates of 8% GDP growth.

In terms of assets, Islamic banks now account for about 25% of the market, according to the BCD. It also accounts for 14% of deposits. The weight of Islamic finance is set to increase in the coming years.

3.2. History of Islamic finance in Djibouti

The Republic of Djibouti has witnessed, for years, a significant increase in the number of Islamic banks due to the Djiboutian government's tendency to attract foreign investments.

There are currently eleven banks in Djibouti, of which three are Islamic banks, which are the Saba Islamic Bank (SIB), Salaam African Bank (SAB) and East African bank (EAB).

Islamic banks are well received by the Djiboutian community as part of the Islamic economic system. This comes after three decades or more since the national independence in 1977, during which the banking arena remained under the control of two gigantic traditional banks, namely the Bank of African Red Sea and the Andosuis Bank.

These two banks continued to monopolize the banking arena in Djibouti due to the absence of other competitors.

In Islamic Banks the first successful experience was when the management of Saba Islamic Bank in Yemen made the decision to open a branch in Djibouti on 06/26/2006. And after obtaining assurances and pledges from the Djiboutian government that it will provide him with all the necessary facilities and support if they enter the country, Indeed, the government fulfilled its pledge to the bank and carried out its role in transferring its expertise and financial and material capabilities to Djibouti. It provided many banking services to the public, and put an end to the severe monopoly that was practiced by the two traditional banks. It also provided a way out for a large segment of society that used to take loans from interest-based banks because they did not obtain someone who would meet their financing needs in an Islamic form, as well as those who refrained from dealing with banks for fear of falling into usury.

Saba Islamic Bank has achieved great successes, as it was able during the period that it worked in Djibouti to maintain its leadership in the banks operating in Djibouti in achieving the highest rates of profits, it also contributed greatly to financing many investment and commercial projects that would contribute to supporting the Djiboutian economy.

It was followed by the Salam African Bank, which opened its headquarters in Djibouti in 2008 and then he opened a banking network in the main cities in the Republic of Somalia, and representative offices in some countries, such as the UAE, Bahrain and Ethiopia, and the bank is owned by Somali and Djiboutian merchants, headed by Sheikh Ahmed Jamaal, then came the Islamic Shure Bank, which did not last long. It was followed by the International Dahab Shell Bank, which later became an East African Bank in 2009.

The three banks provided distinguished banking services and established Islamic economic theory until it gained the confidence of the public, and the Djiboutian citizens became acquainted with the difference between an interest-based and an Islamic bank in practice Consequently, new regulations for Islamic banking were adopted in 2011.

The field of Islamic finance in Djibouti remains limited. The industry mainly includes the Islamic banking sector and there is a small Islamic microfinance sector that represents less than 1% of the industry's total assets. Despite the existence of the Takaful (Islamic Insurance) Law, there is still no Takaful company. There is still no market or legal framework for the sukuk.

Among the services provided by Islamic banks in Djibouti are the following:

i. Regular banking services (accepting various deposits - withdrawing cash)
ii. Individuals and corporate finances in Islamic formats (murabahah, mudaraba, musharakah, istisna, and Qard Hassan.)
iii. Foreign remittances, credits and commercial guarantees.
iv. Internet cards and ATM network.
v. Social projects such as sponsoring orphans and helping the needy and the poor in the areas of providing housing and other in-kind assistance.

Everyone also notices that Islamic banks in Djibouti have become a reality, and have formed a tangible reality that contributes to solving many economic and social problems that the Muslim community of Djibouti was suffering from, as it presented a real and non-imaginary economic formula and theory based on a base (no harm no foul) which takes into account the interest of both parties (the owner of the money and the need for Islamic money.) Islamic banks in Djibouti are like those Islamic banks that abide by the Islamic Sharia in all their transactions. (sabafrican bank 2020)

3.3. The Role of Islamic Banks in Advancing Development in Djibouti

There is no doubt that the coming of Islamic banks to Djibouti covered many gaps and met many of the economic needs of society, and among these things are the following:

3.3.1. Filling the Void

The Islamic banks came to fill the void and meet the urgent need to find this type of banks that operate in accordance with Islamic Sharia in all their transactions, it practices investment financing according to Islamic formulas in the areas of financing foreign trade and financing domestic trade, in addition to financing industrial, agricultural and other projects, it provides the Muslim community of Djibouti with banking services far from usurious transactions. An official of Islamic banks confirms that these banks are currently receiving large numbers of clients, especially after they have proven their worth in front of traditional banks.

3.3.2. Reviving the Islamic Approach in Financial and Banking Transactions

Islamic banks generally seek to revive the Islamic approach in financial and banking transactions by adhering to Islamic rules and principles in banking transactions, and understanding and applying the economic and social function of money.

3.3.3. Modern Services

In addition to the investment methods that Islamic banks follow, such as murabaha and musharakah of various kinds, Sharia speculation and leasing, it is distinguished from the traditional banks in Djibouti by its predecessor in using modern technology in the banking field in an effort to satisfy customers' desires and meet their increasing demands.

3.3.4. National Economic Development

Banks play an important role in economic life. They are the basis of the modern economic system, and international trade cannot be imagined now in isolation from it. The majority of the peoples of the Islamic world believe in the prohibition of usury, and therefore they fall into great embarrassment in dealing with banks due to their reliance on the usurious system. They have developmental purposes that commercial banks cannot do, as they are abler to collect savings from middle and lower income groups, as well as from religious believers, the poor and the rich. Moreover, Islamic banks, in their role in the direct investment that they undertake, play an important role in the development process, making them of great importance for developing countries.

Table 7 shows the role that Islamic banks play in Djibouti in developing the national economy and their market share:

A. Deposits			
Banks	Deposits for 2011	Deposits for 2015	Bank share
Saba African bank	9,252.20	14,542.58	%5.46
Salaam African bank	3,992.00	12,728.79	%4.78
East Africa bank	4,762.18	9,660.86	%3.76
Total deposits for the Islamic banking sector	18,006.38	36932.23	%14
Banking sector deposits total	177,438.99	266341.14	
B. Funding			
Banks	Funding for 2011	Funding for 2015	The share of each bank of each bank separately
Saba African bank	1,787	3,091.96	%3.51
Salaam African bank	1,586	3,569.65	%4.05
East Africa bank	851.03	4,658,10	%5.29
Total Financing for Islamic Banking Sector	4,224	11,319.66	%13
Total financing to the banking sector	62,709.06	88,060.86	87%for 8 non-Islamic banks

Source: Central Bank of Djibouti, Economic Situation, 2011-2015

Through this report, it is evident that Islamic banks with little capital contribute to economic development in attracting customer deposits, and then finance the individuals and commercial institutions sector. (CBD , 2016)

3.4. Islamic Banking Services Resources and Financing Formulas in Djibouti

Islamic banks offer services to their customers and here types of services offered by Islamic Bank in Djibouti:

3.4.1. Banking Services in Islamic Banks

The Islamic bank performs most of the banking services rendered by commercial banks and specialized development banks, without using interest as a compensation factor for customers and deposits of all kind represent the most important resources of both conventional and Islamic banks.

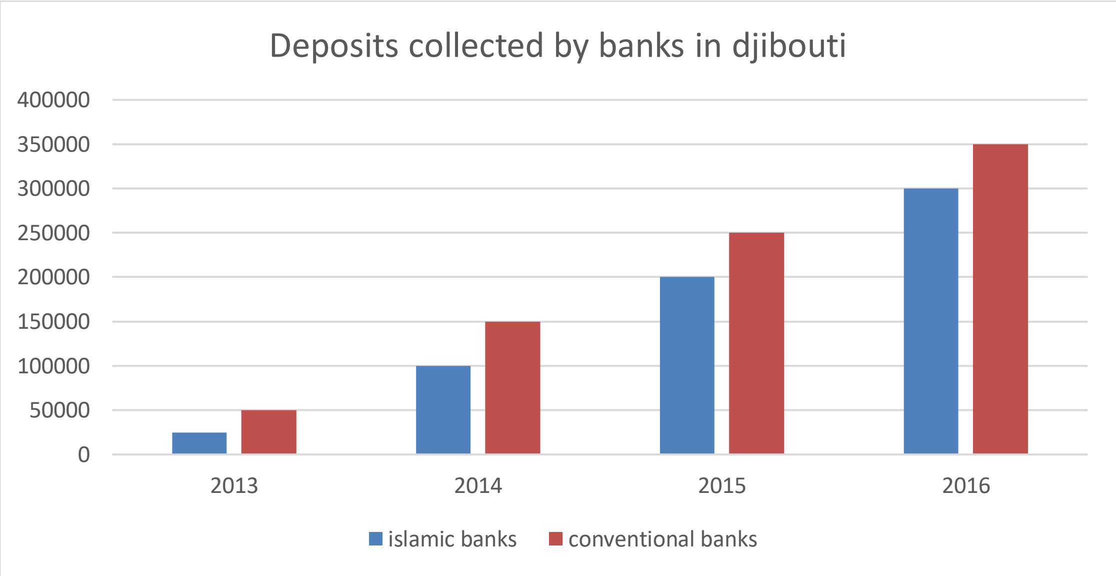
The bank deposit is money as loan from the customer to bank, it is permissible for him to benefit from it and mix it with his money, because the bank does not take it as safeguard for it to return to its owners.

Deposits in Islamic banks consist of: current account, demand deposits, saving deposits, investment deposits, Islamic investment certificates and custom investment deposits.

Islamic banks provide many of the services offered by traditional banks, with some legal adaptations to each other, and they are like: Bank guarantees of all kinds, documentary credits, bills of collection, service of commercial papers, securities, financial, safe keeping in the iron treasury, and internal and external bank transfers, buying and selling foreign currencies along with providing them other banking services.

Here is figure 9 deposits collected by banks in Djibouti both Islamic and conventional banks.

Figure 9. Deposits collected by banks in Djibouti (in million DFJ).



Source: CBD data

3.4.2. Financial Resources in Islamic Banking

The financial resources in Islamic banks are identical to their counterparts and these are the traditional economy that feed expenses with money from different sources. these financial resources are divided in to two main parts.

The first is the internal source it consists in paid up capital for these expenses, the retained earnings and the various needs that they deduct from their profits and collectively called ‘’shareholders right’’

The second is the external sources represented in the various deposits through which clients keep their money with the bank and it is divided into two main parts credit deposit’s and investment deposits. both internal and external sources are called the total resource are explained in the following:

3.4.2.1. Internal Sources of Financing in Islamic Banks

❖ Paid up capital: it is the first source on which the bank relies and which is formed through the first founder’s contribution and then the shareholders and it represents the basic building block in establishing the bank and processing in building devices, equipment, supplies, publication etc. in order to be ready to conduct its business, in addition to providing the necessary financing to customer's at the beginning of the bank work period and providing various banking services.

- ❖ Precautions: They are sums deducted from profits for a specific purpose, such as strengthening the financial position, supporting the bank's capital or settling distributed profits, and is usually charged to the profit distribution account, It is included in the balance sheet as a liability, and is considered a source of internal financing in the bank, It is a protective shield for the bank's capital, and it is one of the property rights of shareholders in banks and public joint-stock companies, the most important of which are legal reserves and voluntary reserves.
- ❖ Retained earnings(Rotator): They are the surplus profits after making annual dividends in the bank, where the bank withholds a portion of the surplus profits and is carried over to the following years, that is why it is called retained earnings, as they are recycled and transferred from year to year. These profits are considered shareholders' and its presence strengthens the bank's financial position, the bank has the right to distribute them at any time, and the previous three elements, represented in the capital, reserves, and retained earnings, are the property rights in the bank.

3.4.2.2 External Sources of Financing in Islamic Banks

Deposits are generally considered the most prominent sources of external financing for banks. Deposits are of two parts, credit deposits and investment deposits.

❖ Credit deposit and it represented in

Accounts payable: They are the ones that banks offer to their customers where they deposit cash, checks, discounted bills, or transfers from other accounts, and then they can withdraw from them in cash or by checks. There are no restrictions on depositing or withdrawing within the allowed balance, and these accounts do not participate in any percentage in investment earnings

- ❖ Investment deposits: They are accounts that the bank offers to its clients who want to invest their money in it, check books are not issued to these accounts and are managed by the bank. Investments deposits are main source on which banks rely to provide their financing to various economic sectors which the three types are shown as follow's:

a) Savings deposits: They are investment accounts with simple amounts that banks provide to encourage small depositors. These accounts participate in the results of the annual profits of the bank in all its branches, whether through profit or loss, Typically, owners of these deposits receive a lower profit rate than investment account holders.
b) Term deposits maturing on a specific date: They are accounts that the bank provides to those of its clients wishing to participate in investing in Islamic banks, and with which the bank participates in the results of its business, and these accounts are monthly, quarterly, semi-annual or annual deposits.
c) Special Investment Deposits: They are accounts that banks offer to those wishing to invest in projects or deals predetermined, or for a specific purpose, and the bank receives a specific commission as a speculator, and the bank operates these investment deposits according to the agreement and on the guarantee of their owners who bear the investment risks that may occur during the investment period of the project. (Bank, http://www.sabafrican.com/ 2020).

3.4.3. Forms of Financing in Islamic Banks

The investment and financing policy is considered one of the most important banking policies in an Islamic bank as it is the only outlet for employing the bank's resources, where it's forbidden to deal in credit as is the case in traditional banks Among the most important features that characterize investment in Islamic banks, For its supposed commitment to the intuitive concept of the function of money in these banks, as a means of investment and not a commodity for it with the need to link the investments and investment projects carried out by these banks with the real needs of society, with the necessity for Islamic banks to adhere to the provisions and objectives of the Sharia from their investments, to begin with, a path and a goal, so Islamic banks biased in choice to what Allah has permitted, and avoids what Allah forbade, and refrains from what is suspicious. Islamic banks have a distinct set of different investment methods and formulas that enable them to have an effective impact on achieving economic development, namely:

- ❖ Contract sale:
- ❖ Participations of all kinds.
- ❖ Speculation.
- ❖ Leasing financing.
- ❖ Other financing business. (Bank, http://www.sabafrican.com 2020)

3.5. Islamic Microfinance in Djibouti

Microfinance means providing microcredits to families who are extremely poor, with the aim of helping these families to start productive activities or develop their enterprises. The microfinance cycle has expanded over time to include more services like (lending, saving, insurance…. etc.). The financial system in Djibouti provides Sharia-based financial products provided by its Islamic financial institutions. However, these institutions like their traditional counterparts tend to exclude large sections of the population from the poor and the economically inactive in order to effectively address the problem of financial exclusion, and consequently of poverty, the Djiboutian Government set up, through the Agency Djiboutian Social Development (ADDS), the Cuisses Popular Savings and Credits (CPEC), which grants conventional financing to the poor.

Moreover, Islamic microfinance was seen as catering to the needs of many clients who were unwilling to use traditional microfinance, due to its non-compliance with Sharia principles. In order to test the situation, a pilot project of Islamic microfinance was implemented by the government in Balbala with the support of the Islamic Development Bank. The Balbala project started in 2011 targets five neighborhoods from Balbala - Old Balbala, Ward 5, Quarawill, Bahache, and Cheick Moussa – with 20 percent of funding going to other neighborhoods in the city of Djibouti. The program aims to create integrated financial support for the poor of the Balbala community, especially for women at home and youth who do not have job skills.

About 199 units were funded with 66 million FDJ (US $ 372,000) that included 78 women, 67 male individuals, 42 feminist solidarity groups, 9 men's groups, and 3 mixed solidarity groups. A total of 221 women and 103 men have benefited from this funding.

The portfolio is dominated by short-term financing of 53.94 million acres. Medium and long term financing represents 8.80 million FDJ and 3.25 million FDJ respective.

The project includes a set of Islamic financial products, such as murabaha, musharakah, mudarabah, Istisna'a, and Qard Hassan. Funded projects are in nature projects stay for a period of 6-8 months and with financing up to 300,000 FDJ. Agricultural projects with a duration of one year and their financing between 300,000 to 1,000,000 FDJ, and small enterprises for a period of two years, with financing amounting to 1,500,000 FDJ.

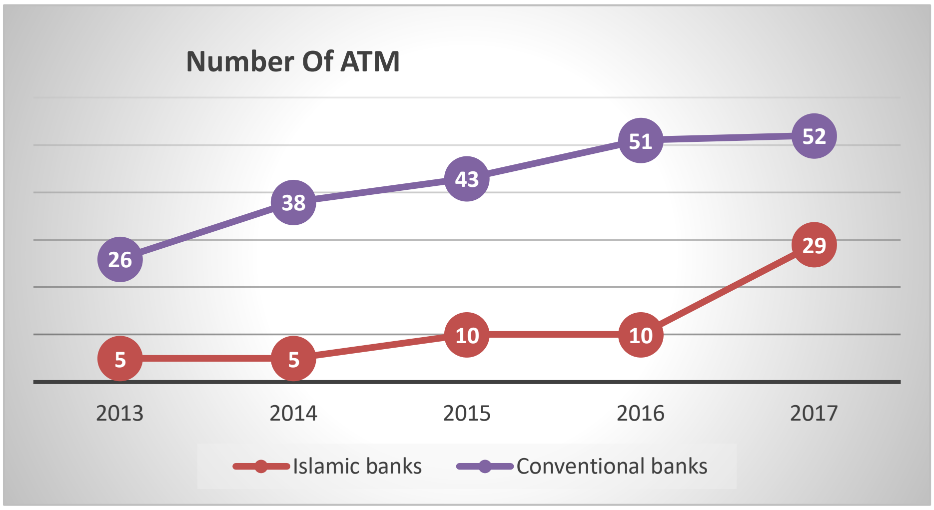
Islamic microfinance in Djibouti faces some major challenges. These include, among others, the lack of an enabling legal, financial and social framework, the lack of local microfinance experts and Sharia experts, the scarcity of long-term resources for microfinance institution, and the lack of interest of Islamic banks in moving into the microfinance sector. Some of these challenges can be addressed through the strategy of mainstreaming the Islamic social finance sector and integrating zakat and endowment resources for micro-finance and economic empowerment projects. Moreover, the importance of developing expertise in microfinance as well as Sharia matters cannot be overemphasized. (ali , 2019)

3.6. Performance of Islamic Banks

Comparative analysis of the performance of Islamic and conventional banks in Djiboutian Islamic banks in Djibouti has only been around for a decade while conventional banks have had a century-long presence in the country. Therefore, any comparison between the two must be dealt with in this context.

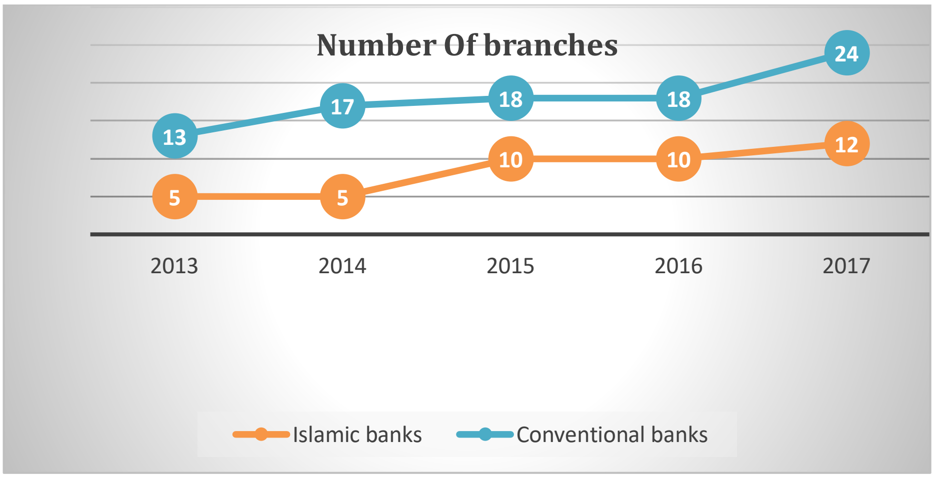
Access to Banking Services

Figure 10. Number of ATM.



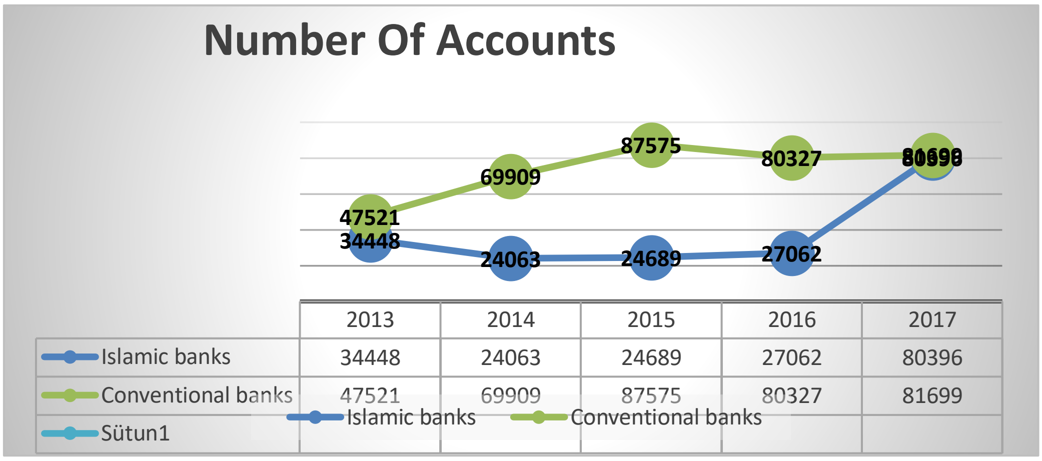
Thus, from 2013 to 2017 the market share of Islamic banks increased from 16% to 36% ATMs ownership.

Figure 11. Number of branches.



from 2013 to 2017 the market share of Islamic banks increased from from 28% to 33% branches.

Figure 12. Number of accounts



Source: CBD data

from 2013 to 2017 the market share of Islamic banks increased 42% to 50% for the number of bank accounts.

In this Figures show that Islamic banks (which are only 3 out of the 11 banks in the country) have made great progress in terms of scope and access to financial services. Thus, from 2013 to 2017 the market shares of Islamic banks increased from 16% to 36% ATMs ownership, from 28% to 33% branches, 42% to 50% for the number of bank accounts.

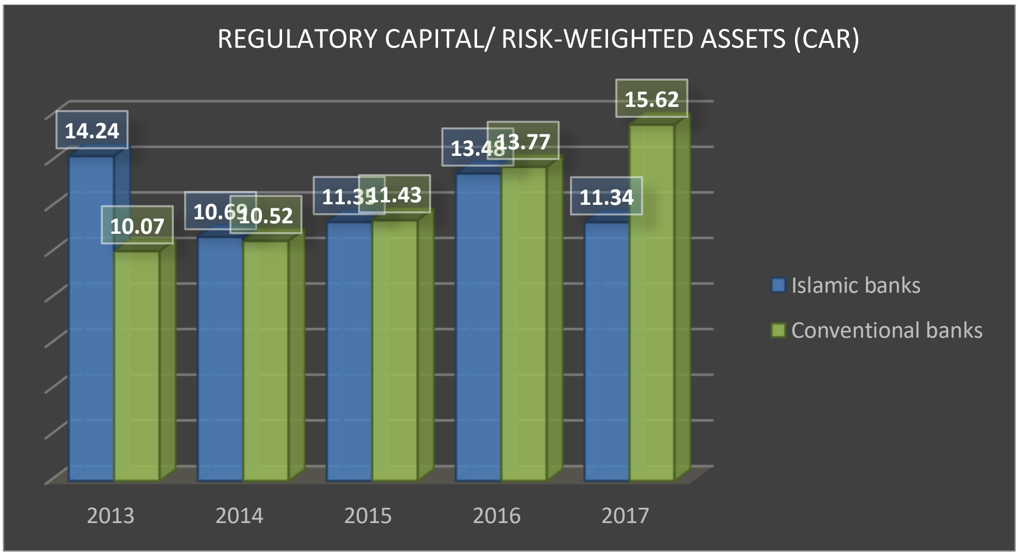
This reflects the significant contribution of Islamic banks to improving financial inclusion in Djibouti as evidenced by the average banking population, which increased from 10% in 2006 to 25% in 2017. Islamic banks have also managed to increase their market share both in terms of total assets and in terms of deposits mobilization. In 2013, the total assets of Islamic banks were 34,448 million DJF, or 17.7% of the total banking assets. In 2017, their assets are estimated at 91,543 million DJF, representing a market share of 20.9%. A similar development is observed with regard to deposit mobilization and financing. Deposits collected by Islamic banks increased from 30.087 million in 2013 (14.4%) to 59.340 million in 2017 (16.6%). Financing granted by Islamic banks increased from 7,799 million in 2013 to 16,874 million in 2017, representing a change in their market share from 10.2% to 16.5% respectively. However, it should be noted that despite its good performance in terms of accessing financial services, collecting deposits and granting financing, Islamic banks in Djibouti are outperformed by conventional banks in most of other financial performance indicators, over the period considered (2013 - 2017).

In fact, Islamic banks outperformed conventional banks only in the non-performing loan indicator, maintaining a rate of less than 4% during the studied period, while the rate in conventional banks was about 20%. However, for all other indicators, Islamic banks generally underperform their traditional counterparts.

The average profitability of Islamic banks during the mentioned period is 0.58% and 6.53% return on assets (ROA) and return on equity (ROE) respectively, while for conventional banks, return on assets and return on equity are 0.74% and 12.14% respectively. This is a relatively low profitability of Islamic banks can be explained by the low loan - deposit ratio that has never exceeded 32.35% during the last 5 years. Compared to the performance of Islamic banks globally, the conclusion remains the same: Djiboutian Islamic banks need to better manage their assets to be on par as their traditional counterparts. (T. A. Tamsir Cham , 2018)

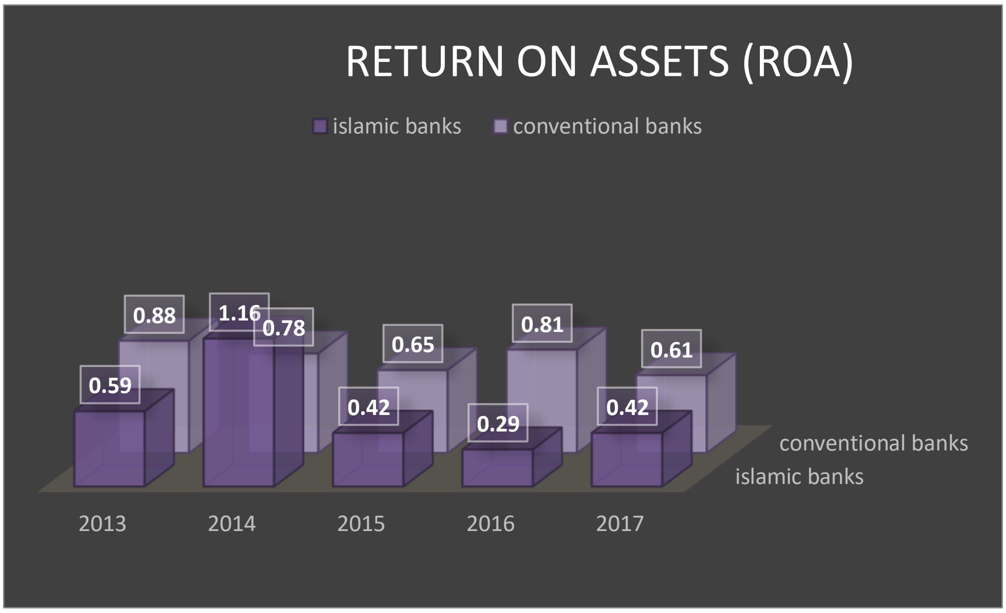
Some Financial Performance Indicators %

Figure 13**.** Regulatory capital/ Risk-weighted assets (CAR).



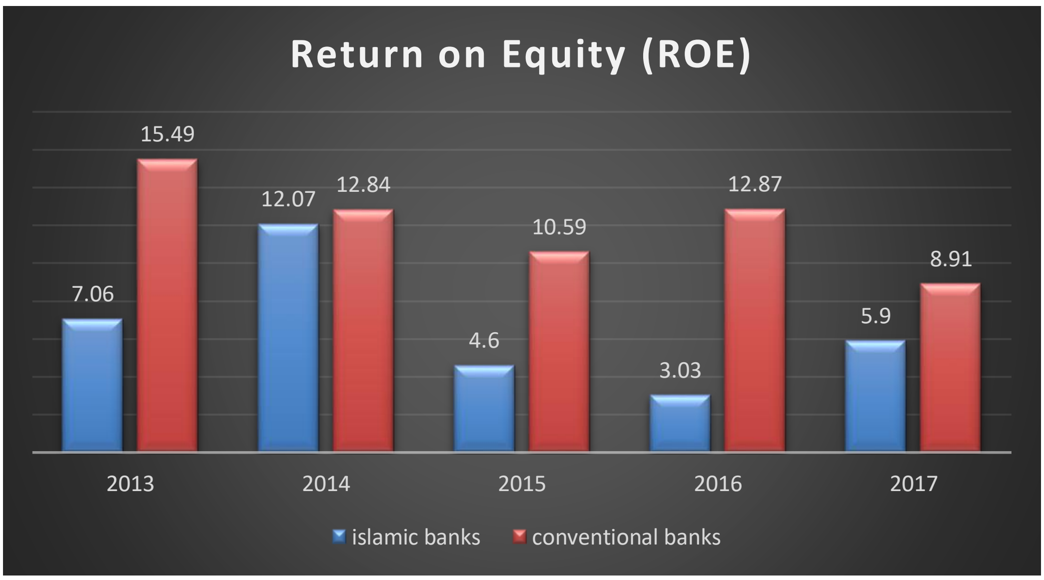
Bank regulatory capital to risk-weighted assets in Djibouti was reported at 11.34 % in Islamic banks while conventional banks 15.62 % in 2017, according to the World Bank collection of development indicators.

Figure 14. Return on assets (ROA).



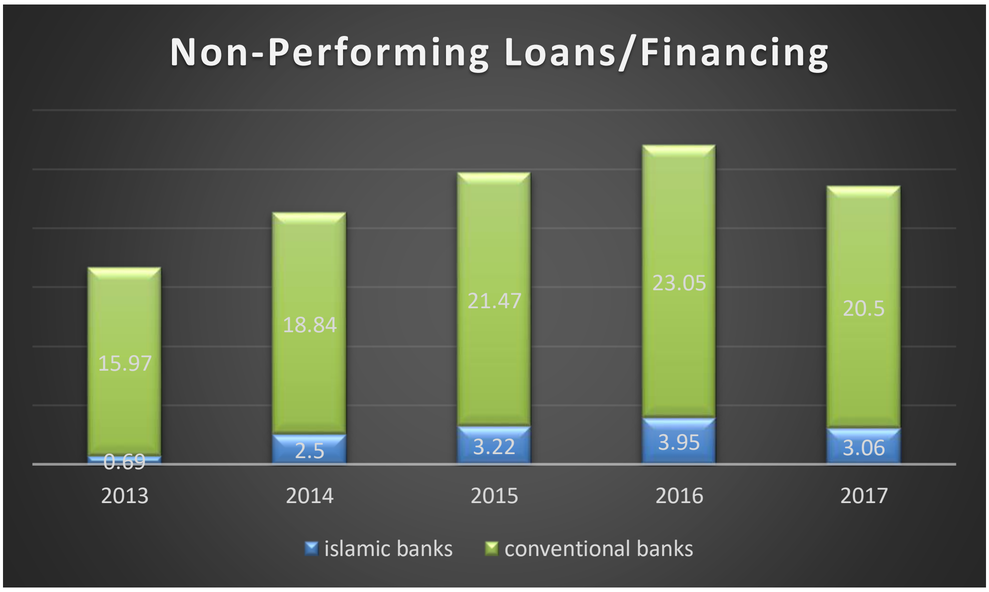
The average profitability of the Islamic banks in ROA over the period considered is 0.58% while for conventional bank is 0.74%.

Figure 15. Return on assets (R0E).



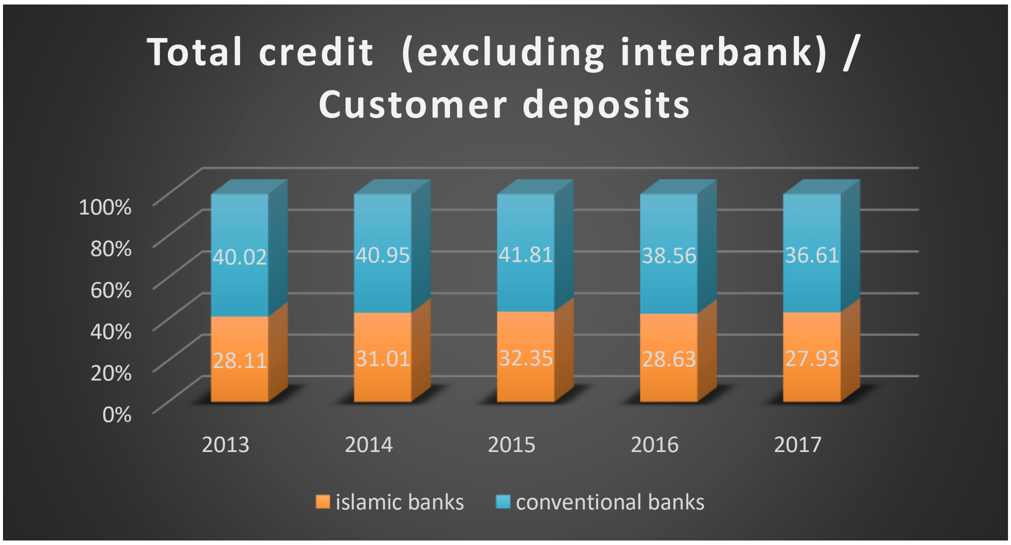
The average profitability of the Islamic banks in ROE over the period considered is 6.53% while for conventional bank ROE is 12.14%.

Figure 16. Non-Performing Loans/Financing.



This relative low profitability of Islamic banks can be explained by the low loan–deposit ratio that has never exceeded 32.35% during the last 5 years.

Figure 17. Total credit (excluding interbank) / Customer deposits.



Source: CBD data

The average transformation ratio for the global Islamic banking industry for 2017 stands at 85%.

3.7. Financial Profile of Islamic Banks in Djibouti

The major part of the assets of Islamic banks consists of Murabaha and Mudarabah

Financing types. Other products, such as Salam, Istisna'a, Ijarah, and Musharakah not adequately developed.

According to the central bank, Islamic banks use a number of liquidity management tools, including interbank musharakah and interbank speculation, in addition to commodity murabahah Islamic banks mainly use international financing, rather than the interbank market, in case liquidity is needed.

The share of interbank operations increased by 95% from 21,432 million DJF in 2016 to 41,840 million DJF in 2017. Islamic banks financing are directed more towards the private sector (7044 million FDJ in 2017). No public institution has benefited from Islamic banks.

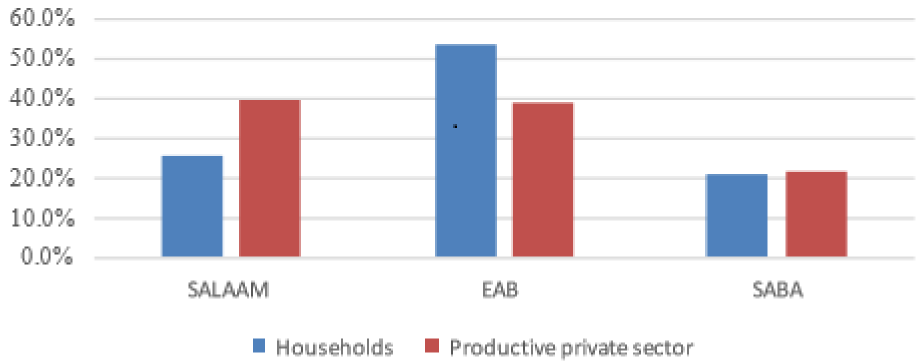
Table 8. Uses of funds by Islamic banks, 2015-2017 (in million DJF.

Components	2015	2016	2017
Interbank operations	19,082	21,432	41,840
Receivables on Treasury & CBD	7,044	7,575	10,918
Customer financing	11,329	12,219	16,871
Fixed assets	5,095	5,389	5,479
Others	15,018	14,459	16,435
Total	**57,568**	**61,074**	**91,543**

Source: Central Bank of Djibouti (CBD)

The following chart shows the distribution of Djiboutian Islamic banks' financing by category of clients. It shows that East African Bank holds the largest portfolios in terms of customer financing, while Saba African Bank holds the smallest share.

Figure 18. Distribution of the Djiboutian Islamic banks financing by category of clients, in 2017.



Source: Central Bank of Djibouti (CBD)

On the breakdown by sectoral financing activities, Islamic banks seem to gear towards buildings and public works (5,518 million DJF), transport (3,500.2 million DJF) and trade (5,109 million DJF).

Only EAB (East African Bank) is present in all sectors identified in Table 9, while the other 2 banks did not finance.

Islamic banks reveal that Murabaha is the most used for concept customer financing. This is especially true for Saba African bank. For the East African Bank, murabaha financing represents 85% of the portfolio, followed by Ijarah financing (10%) and Mudarabah financing (5%). Salaam African Bank seems to stand out with a portfolio comprising 30% Mudarabah and Musharakah financing, as part of its Corporate Social Responsibility. As part of its Corporate Social Responsibility (CSR) policy, Salaam African Bank has allocated $ 5 million for interest-free loans (Qard Hassan).

Table 9. Islamic banks financing by sectors in 2017 (in million DJ F).

Components	Total	Proportion in %
Mining, petroleum, gas & other extractive industries	593,4	4
Manufacturing industries	483,04	3
Buildings and public works	5518,72	32
Transport	3500,28	20
Trade	5108,8	29
Others	**2132,52**	**12**
Total	**17336,7**	**100%**

Source: Central Bank of Djibouti (CBD)

The consolidated balance sheet liabilities of Islamic banks mainly include customer deposits that are largely made up of streams, while investment accounts are very limited.

The absence of long-term borrowing is due to a lack of capital markets and can also be an obstacle to banks' ability to finance long-term projects. At the end of the 2017 fiscal year, Islamic banks raised 59.34 billion DJF. It comprises of 65% of its total assets which recorded an increase of 40% compared to 2016. Investments from other financial institutions registered a significant growth of 92% to reach 16.064 million DJ F. Islamic banks continued to enhance their level of equity, increasing from 6,789 million DJF in 2016 to 9,731 million DJF in 2017 representing an increase of 43%.

3.8. Regularly Challenge Facing Islamic Banks in Djibouti

Despite the great achievements Djibouti has made in the field of Islamic finance, there are some challenges.

i. Islamic finance is not well diversified at the geographic, sectoral and commercial levels. About 80 percent of branches of Islamic banks that provide Islamic financial services are located in Djibouti City with very little presence in rural areas. Given the importance of the Islamic faith for Islamic finance, the rural population should have been the main target of Islamic banks.
ii. Another limitation for Islamic finance is lack of adequate regulations, although notable work has been done.
iii. There is also a need to enhance communication to sensitize the population on the benefits and the characteristics of Islamic finance.
iv. Islamic finance in Djibouti is facing a widespread perception that banking operations in the country do not conform to Sharia.
v. There is also a lack of standardization of Islamic finance practices. Due to differences in rulings of different schools of Islamic thought, Islamic finance risks operating in a heterogeneous manner.
vi. Moreover, Islamic banks in Djibouti tend to emulate traditional banking intermediation. In Djibouti, two products, Musharakah and Murabahah, account for two-thirds of an Islamic bank's financing.

For Islamic banks to realize their full potential, they need to expand and diversify their financial services by providing Istisna'a, Ijarah and Salam products. There is also a need to develop non-banking tools, such as Islamic insurance (Takaful) and project financing through sukuk to reap the benefits that come from these tools. However, for these tools to take effect, the necessary legal framework is needed. In developing the Islamic finance industry in Djibouti, the Islamic Development Bank (ISDB) has played a role in assisting the Government of Djibouti to establish a regulatory framework by providing technical assistance.

The main obstacle to the development of Islamic finance remains regulation, but Djibouti has already made remarkable progress in this area.

The Islamic financial industry also faces many risks. Some of them are special to it.

The main risks are banks' perceptions of non-compliance with Sharia in their operations. The fierce competition among Islamic banks may lead to opening the doors to temptations for complacency in applying Sharia principles.

The second risk is the lack of standardization in Islamic finance. There will not be a single Islamic finance, but there are many "Islamic finance" that runs the risk of a heterogeneous system due to normative competition between the four Islamic schools. However, in Djibouti like any other African country, the Islamic finance sector faces the same problem, which is that most activities tend to reproduce traditional banking intermediation. Thus, murabahah is the most used tool while musharakah and mudarabah (products based on sharing losses and profits) as well as sukuk are less used. As a result, Islamic financial institutions do not sufficiently benefit from these attractive advantages that Islamic finance can bring through its innovative tools. To fully reap the benefits of this innovative financing, the regulation and diffusion of Islamic products is essential to allow healthy market liquidity and thus enhance the interest of consumers and investors.

3.9. Problems and Recommendations

We discussed the problems and recommendation through this study and the period that I trained through Saba African bank in Djibouti.

Problems

The main problem of the bank comes down to the way it operates in its internal organization. More precisely on staff motivation. From the analysis results, we realize the main weaknesses or problems of the bank. It is based on how to interact and communicate with its employees. Employee motivation is low; the company is somewhat lacking in its responsibilities to lead its staff here is:

- Fairly busy working conditions. The staff must stay and finalize their tasks throughout the day, even if this greatly exceeds their ability to work.
- In addition to being in busy conditions, employees benefit from sufficient rest.
- Most of them receive a low salary, one more reason for not having motivated them, and most important is the style of the superior, which is none other than authoritarian style, no sense of sharing, nor consultative.
- Despite the existence of the Takaful (Islamic Insurance) Law, there is still no Takaful company. There is still no market or legal framework for the sukuk in Djibouti.
- In Djibouti, two products, Musharakah and Murabaha, account for two-thirds of Islamic bank financing.

These aspects are critical for the proper functioning and success of the business; this clearly represents a great weakness of the business. Because, not having motivated employees or having the necessary desire to work for the company, generate an economic or commercial failure for the latter.

Recommendations

As we have seen previously, the main problems of the company, I would like to recommend solutions necessary for the good of this one.

At first glance, the company must change the way it does business with its organization, and opt for a participatory style.

The manager must:

- Seek to create a favorable climate between its employees, avoiding conflicts that could lead to a tense atmosphere and poorly done work. He must unite the team, encourage the exchange of information and ideas, in order to improve actions and results, because the atmosphere is a unifying element.
- Motivate its employees: those involved in the choices and culture of the company, so that in the end, they project a better image to customers, give them more rest if necessary.
- Communicate, try to listen to them, take their concerns into account, understand them;
- To congratulate them in different ways as a reward, will then allow them to be boosted and to work with more motivation.
- Djibouti plans to enter into a relationship with a specialized institution to issue sovereign Ṣukuk but as a first step, they need to put a legal and regulatory framework. And then to contacted the IsDB to put in place a general strategy to develop Islamic finance.
- they need to expand and diversify their financial services by providing Istisna'a, Ijarah and Salam products. There is also a need to develop non-banking tools, such as Islamic insurance (Takaful) and project financing through your right, to reap the benefits that come from these tools

CONCULUSION

Islamic finance began in Djibouti in 2006 with the launch of the first Islamic bank. Today Islamic financial institutions are growing, becoming more assorted and striking new investors. In addition, Djibouti outperforms the economic side by achieving impressive real GDP growth of 6% in 2016 and 2017 and forecasts of over 7% growth over the coming years. In the last ten years, the number of banks has grown from two institutions to eleven, three of which are Islamic. The latter are now an integral part of the country›s economic and financial landscape: their cultural proximity andwillingness to support the productive sectors have enabled them to capture 16% of banking sector assets in a few years of activity. To date, three banks are active in the niche of Islamic finance (SABA Islamic Bank, East Africa Bank and Salaam African Bank), and are fully dedicated with their 10 branches. Since the launch of the first bank dedicated entirely to Islamic finance activities in 2006, the assets, deposits and loans of this part of the banking sector (expressed in local currency) have grown at average annual rates of 18%, 15% and 14%, respectively.

The main aim of this thesis is to study of the development Islamic banks in Djibouti, Convinced that the Islamic finance system can make important contributions to savings mobilization and financial inclusion, the Government of Djibouti has established a robust legal framework to facilitate a healthy and sound expansion of Islamic finance in the country. The advent of Islamic finance has been designed to respond to a real need of the local market by integrating in the financial circuit customers who want to have services in accordance with their religious ethics, the Djiboutian banking market while their assets are growing at an average annual rate of around 20%. While the Islamic finance industry still has great development potential.

It is concluded that Islamic finance industry in Djibouti still has limited scope. The industry mainly includes the Islamic banking sector and there is a small Islamic microfinance sector that accounts for less than 1% of total industry assets. Even though there is a Takaful (Islamic Insurance) Law, there is still no Takaful company. There is still no market or legal framework for the Sukuk.

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CURRICULUM VITAE

Roda Mohamed Omar she finished her primary education from shafia High school. Later on, for pursing of his higher education, he got merit based full funded scholarship among one hundrant Djibouti students from University of Djibouti (UD).in 2016, she was honored with dual degree from Djibouti University in accountant department. In addition, she has worked with the largest islamic bank in djibouti (sabafrican bank) for five months as trainer. she has also done diploma in administrarive and financial sciences at imam muhammad bin sauad islamic University of Djibouti. In addition, she is fluent in Arabic, English, Turkish, Somali and little french.

Beside focusing on her academic and professional goals, she has also been involved in many voluntary community activities in Djibouti. for the purpose of doing her Master degree she got admission in Karabuk University of Turkey. Finally, she has successfully finished her Banking and Finance from Graduate Business School of Karabuk University in 2021.