SHARIA COMPLIANT CONSUMER FINANCING

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Africa Clean Energy
Catalysing Africa's Solar Markets

TETRA TECH
International Development

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Foreign, Commonwealth and Development Office (FCDO)
Africa Clean Energy Technical Assistance Facility

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ABBREVIATIONS

Acronym	Definition
ACE TAF	Africa Clean Energy Technical Assistance Facility
ADELE	Access to Distributed Electricity and Lighting in Ethiopia
CSA	Central Statistics Agency
CBE	Commercial Bank of Ethiopia
CBO	Cooperative Bank of Oromia
DBE	Development Bank of Ethiopia
ETB	Ethiopian Birr
IFB	Interest-Free Banking
IFW	Interest-Free Window
MFI	Microfinance Institution
MoWE	Ministry of Water and Energy
NBE	National Bank of Ethiopia
PUE	Productive Use of Energy
PV	Photovoltaic
SHS	Solar Home System

1. Introduction to Financing of Off-grid Solar PV Products

Financing to Off-grid solar PV products has been available for consumers through selected Micro Finance Institutions (MFIs) in many of the regions in Ethiopia. These MFIs have had access to finance from the Development Bank of Ethiopia (DBE) which is specifically allocated for rural consumers to adopt off-grid solar products. DBE financing has two streams. The first one is to provide access to foreign currency to solar companies for the importation of solar PV products. The second one is the revolving fund which DBE allocates for consumer financing. This revolving fund is channeled to rural consumers through the MFIs. The revolving fund is obtained from the repayment of loans by the solar companies that import solar products using the foreign currency from the DBE. The repayment of this loan by the solar companies is in local currency. DBE currently has over Ethiopian Birr (ETB) 500 million as a revolving fund that the MFIs can still access for onward lending to their rural customers for adoption of off-grid solar products.

The DBE financing has actually helped the adoption of off-grid solar lighting products by rural consumers. Rural consumers benefited from this financing scheme as it has made the products affordable to them through extended payments which are subject to a certain amount of interest rate. Additionally, since the DBE financing is available only for quality approved products, consumers who adopted these technologies have also benefited from high-quality services and longer uses of the products.

The DBE financing scheme, however, has been challenged as it has made a significant portion of the rural communities, particularly those that are in predominantly Muslim areas, financially excluded. In Ethiopia, over 30% of the population is Muslim. Many of them are strict observers of Islamic rules and practices of which accessing interest-based financing such as “riba” or usery is considered ‘haram’ or a moral wrong by the observers of the religion. This guide gathers information about the legal framework and existing practices of Sharia-compliant lending and identifies Sharia-compliant lending options for off-grid solar PV products and the expansion of the DBE finance facility to potential end-users of off-grid solar PV products.

2. Common Islamic financing modalities

Sharia-compliant financing saving service is an easier transaction and requires only a legal permit. The most commonly known banking facility for saving that comply with Islamic rule is referred to as al Wadia. It is a contract where a depositor places property with another party such as a bank for safekeeping which provides a payment guarantee. On the other hand, lending is sophisticated and a high risk business in the Islamic financing system.

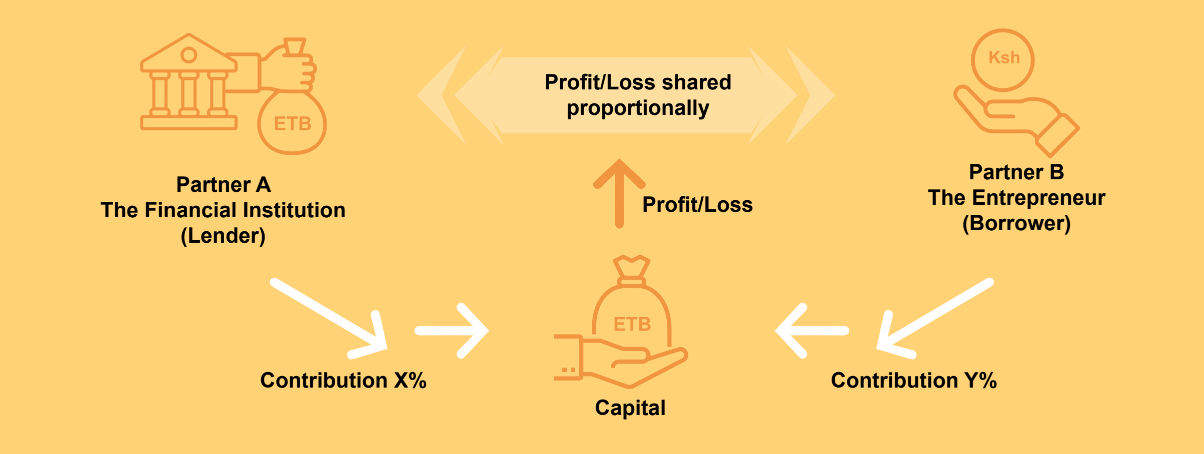
Islamic or Sharia-compliant financing schemes provide products and services through two types of financing models which are non-profit models and profit-based models. In non-profit models, finance institutions may collect and pay Zaka (donation by Muslims as a religious obligation), manage awqaf (endowment, donation of assets), and collect Qard Hasan (benevolent loan). This transaction does not involve interest, profit or markup. On profit-based financing, finance institutions still provide interest-free products and services such as saving and lending which may involve additional fees such as the cost of lending and profit.

1. *Sharia-Compliant Microfinance: 5 Takeaways from CGAP’s Research, By Mayada El-Zoghbi, Samer Badawi, 24 February 2015 (Source: https://www.cgap.org/blog/sharia-compliant-microfinance-5-takeaways-cgaps-research)*

The most common Sharia-compliant lending financing modalities that are widely operational in the countries that practice them are the following:

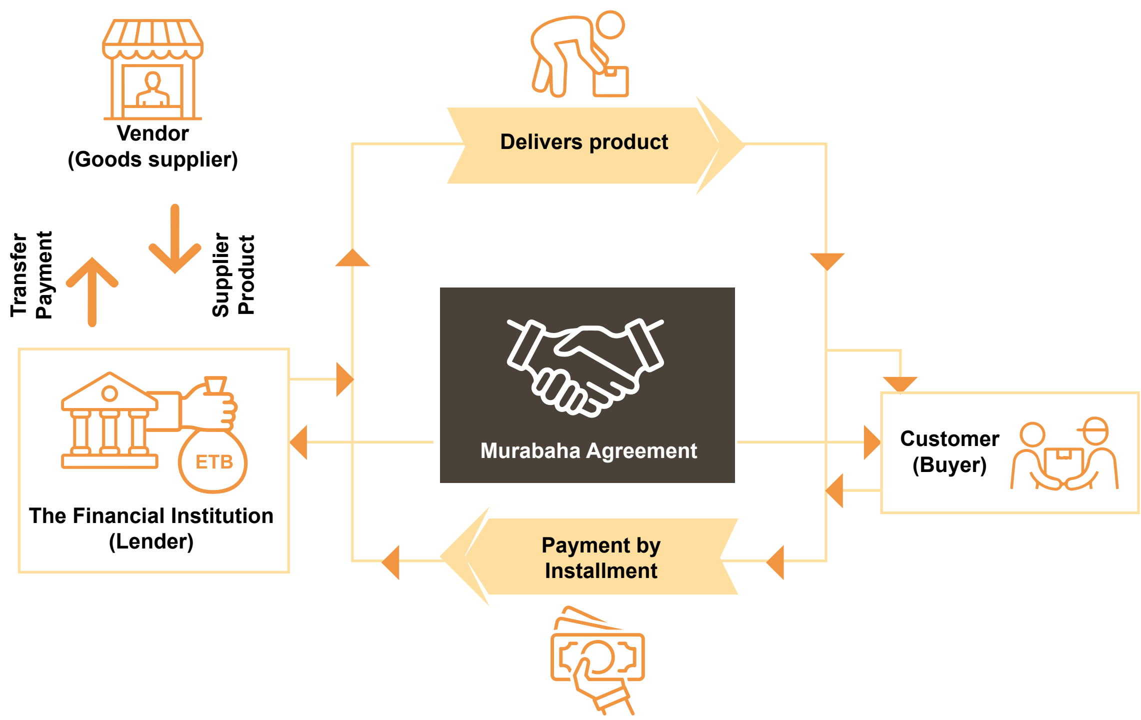
Musharaka

Primarily is a profit-and-loss sharing contract between the client and the finance institutions. It is a partnership structure in Islamic finance in which partners share in the profits and losses of an enterprise in proportion to their contribution.



Murabaha

It is commonly referred to as a cost-plus financing modality. Murabaha is the most widely practiced sharia-compliant contract used to finance products. The transaction requires three distinct steps. First, the client needs to request for a specific product. Second, the financier procures the product directly from the market and owns it. It is not allowed for one to sell a product that one does not own. Thirdly, the financier resells the product to the client after adding the cost of lending and a profit. Murabaha is also a basis for most other variations of similar financing modalities.

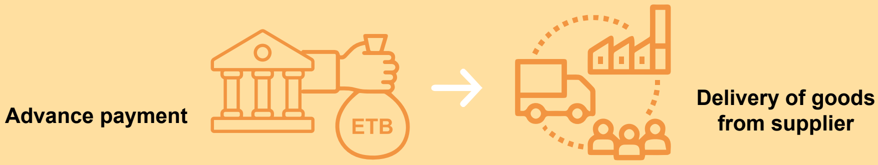


Ijarah

It is a variation of Murabaha financing. The customer and the lender get into agreement which is similar to a hire-purchase system where the customer pays for the product in a regular installment while having the use of it. It is a kind of leasing contract of a product that is leased to a customer for a series of rental and purchase payments. With the completion of the payment, the ownership of the property will be transferred to the lessee.

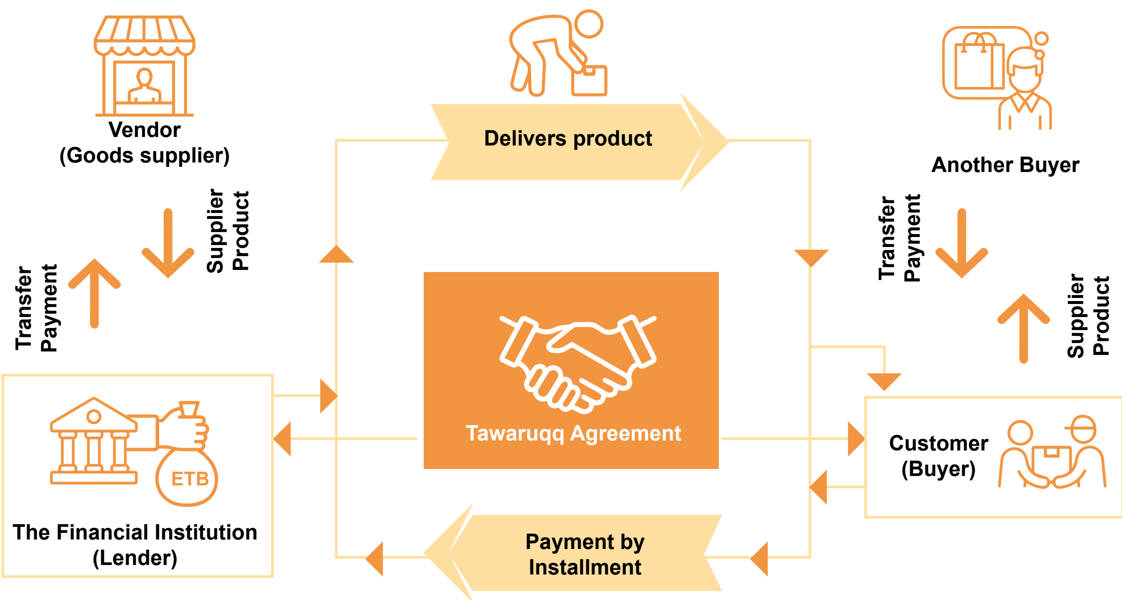
Salama

It is a financing modality to a product supplier. The transaction involves the purchase of a commodity for a deferred delivery in exchange for immediate payment. In Salama financing the lender provides an advance payment to the seller of the product to deliver or produce the goods. It is required of the lender to advance the full amount of the price of the good to the supplier at the time of effecting the sale.



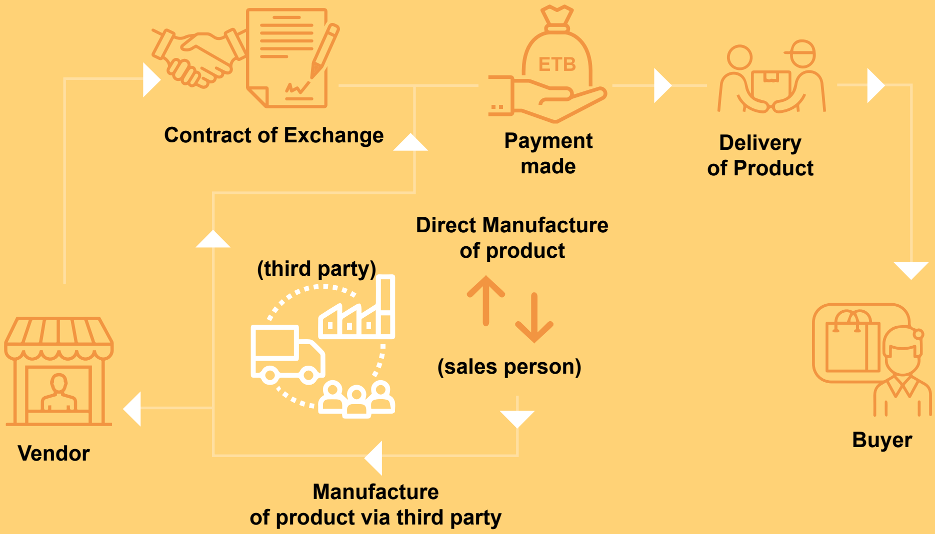
Tawarruq

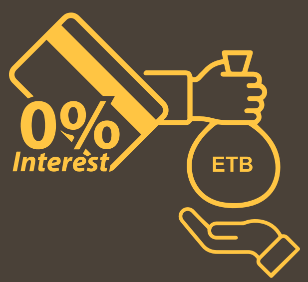
It is an arrangement that involves a purchase of a commodity or asset based on deferred payment basis by way of Murabaha. In this case, the Customer is purchasing the commodity as the underlying asset from the Bank. The commodity or asset is then sold for cash to a party other than the original seller. Tawarruq is practiced by one who wants to meet ones immediate cash need. Usually the product is sold to a third party at a lesser price.



Istisanaa

A contract of exchange between a vendor and a buyer for the sale of an asset. Salespersons can either manufacture the products themselves or purchase them from a third party. End clients can pay the sale price either as a lump sum upon signature of the contract or later at different stages of the manufacturing process.





Qard al Hassan

It refers to an interest-free lending mainly for meeting a short-term financial gap. In a Qard al-Hasan financial transaction, it is only the principal amount of the loan that the borrower is expected to pay. The borrower may repay in differed payments but without interest, mark-up, or a share in the business for which the loan was used. Qard al-Hasan is primarily designed for people in need.

The most common financing modality under the Sharia law is Murabaha. It is a cost-plus financing mechanism which charges the cost of providing the loan with some additional profits. In Murabaha financing, if the borrower defaults to repay the loan on the planned payment schedule, the lender cannot make additional charges for the delayed payment. This has been one of the main challenges for Murabaha financing. It is important to note that in Sharia Compliant Financing method interest-bearing loans are prohibited under the Sharia law. This implies, as remarked by the MFIs, that the DBE financing facility should be sharia-compliant from end-to-end. This means, it is not only the finance that the DBE provides but also the finance that it receives should be interest-free.

3 The legal framework for sharia-compliant financing

One of the main challenges in the finance sector in Ethiopia was the absence of a legal framework for Sharia-compliant financing which has made a significant percentage of the population financially excluded.

Proclamation 592/2008 (Article 22.2) marked the beginning of Sharia-compliant financing in Ethiopia. This Proclamation was enacted in 2008 and allowed the National Bank of Ethiopia (NBE) to regulate banking businesses in relation to non-interest bearing deposit mobilization and fund utilization. Following Proc. 592/2008, the Directive No. NBE SBB/51/2011, Article 2.2 and 2.3, permitted conventional banks to provide interest-free banking services in an exclusive interest-free banking window. Since 2011 conventional commercial banks were allowed to start to provide interest-free banking services for saving. The legal framework for Sharia-compliant financing progressed to allow the establishment of a full-fledged interest-free financial institution with the enactment of Proclamation No. 1159/2019 (Article 59.1) in September 2019. Following this proclamation, a few full-fledged interest-free banks such as Zam Zam Bank and others were established.

Even though Proclamations were enacted and Directives passed allowing interest-free banking services, the practice of interest free financing still has challenges . Interviews with the MFIs also confirmed that these challenges are still major limitations to bring financial inclusion to the Muslim communities in Ethiopia.

- **Regulatory challenge** – lack of clarity on Directive No. SBB/60/2015 and SBB/65/2017 (Article 4.4) as it limits banks hold up to 10% equity shares in a single non-banking business other than insurance, and that article 4 (6) also indicated that “A bank’s aggregate equity investment in all non-bank business, including insurance companies, shall not exceed 10% of its net worth. This regulation does not allow implementation of Musharekah and Mudareba financing since these financing modalities depend on equity investment based on co-investment principles where the lender and the borrower get into a contract in co-ownership of the investment where they would share both losses and benefits. If these Directives are applicable to Interest-free banking, then it would be difficult for Interest-free banks to expand.
- **Double taxation** - Another potential challenge for Murabaha (Cost-plus-Profit Sale) transaction which is rendered by Interest free banks is double taxation. The purpose of Murabaha is providing goods with mark-up profit instead of giving loan with interest to customers. Accordingly, the Murabaha transaction is taxed two times when the bank first buys the product from the suppliers and when the customer buys it from the bank. If direct taxes like income tax from business (trade) activities and indirect taxes like Value Added Tax (VAT) and Turnover Tax (TOT) are enforced for Murabaha transaction, Sharia-compliant services would not be competitive as the products would be more expensive to the consumers.

Additional challenges that were highlighted by MFI’s during consultation included the following.

- The significantly high administrative cost of the transaction system on lending which requires the banks to purchase the products and own them before selling it to the client under the Murabaha financing modality.
- Shortage of trained and knowledgeable workforce related to interest-free microfinance services
- Clients’ nonconformity with some Sharia principles. These are default cases where borrowers fail to repay their loans on time or not at all, and failure to deliver the item to the lender after they acquired it from the market on behalf of the MFIs according to the principle of Murabaha lending.

4 Recommended Sharia-compliant financing models for off-grid solar products

As described in the sections above, the optimal Sharia-compliant lending service is Murabaha. Murabaha might take several forms with variations as per the specific purpose of financing required. It applies to both processes that the lender needs to do for purchasing and owning the product before it passes to the borrower. Hence, the recommended financing modality at the initial stage of extending Sharia-compliant financing for off-grid solar products is the Murabaha financing model.

2. *Islamic Finance in Ethiopia: Current Status, Prospects and Challenges, International Journal of Islamic Banking and Finance Research Vol. 6, No. 1; 2021)*

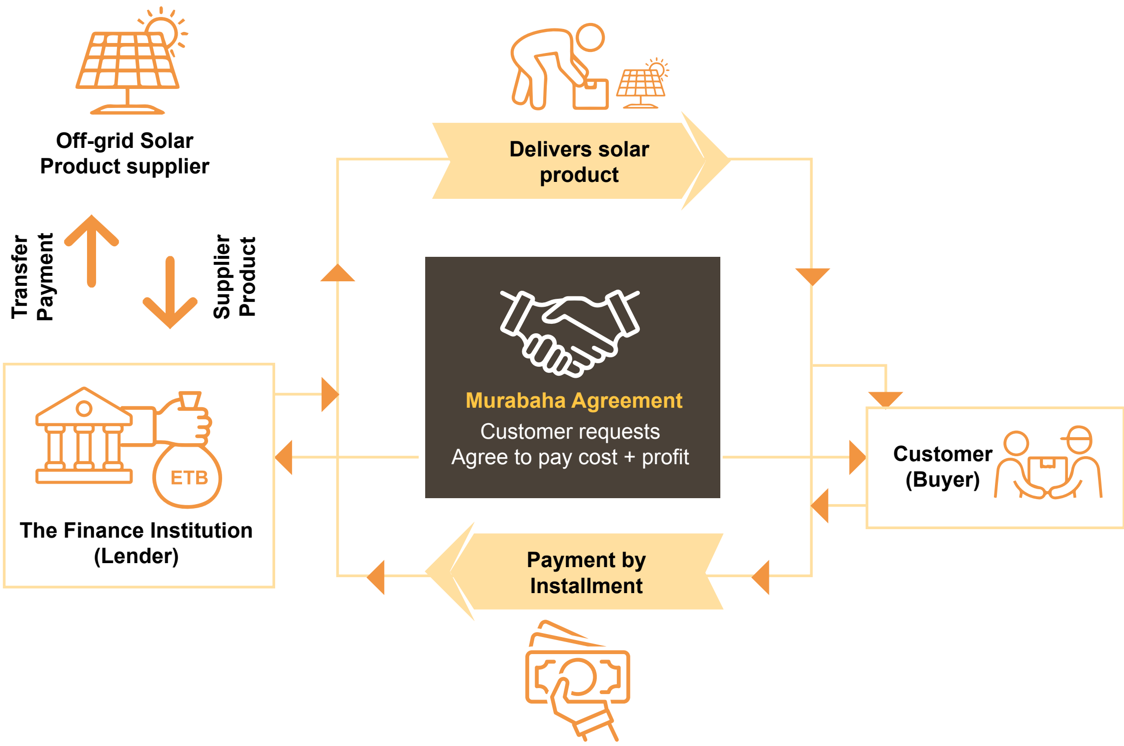
Murabaha financing is the modality that has been widely experienced by interest free banking services and hence, a wider experience has been built up over the years. Extending this financing modality to off-grid rural consumers for adoption of off-grid solar products would be relatively easier for MFIs as there is an already built up experience by many of the conventional banks and some of the MFIs. Lessons learned can be shared to new MFIs that choose to extend interest free banking services.

Steps for extending interest-free financing for Off-grid solar products through Murabaha financing:

i. Customers approach MFIs requesting financing for the adoption of specific types of off-grid solar products
ii. MFIs identify suppliers for the requested products .
iii. MFIs purchase and own the products .
iv. MFIs sell the product to consumers adding the cost of transaction and some profit
v. Consumers repay for the product on differed payment basis

In step ii, if the MFIs have interest in supporting rural solar enterprises to get into the business of supplying off-grid solar products, they can extend financing to the enterprises through Salama financing modality. In Salama financing, the MFI pay the full amount in advance to the solar enterprise to acquire the solar product and deliver to the MFI. The solar enterprise provides the solar product to the MFI on the basis of differed delivery. This means, the MFI would receive the solar products that it wants to sell to the client who requested for it after the payment is fully made to the solar enterprise. Such transaction takes time and requires more resources from MFIs, however, there is benefit to the supplier as they are included in the transaction.

In order for MFIs to reduce the transaction costs in step iii, lenders may request clients to first purchase the product under the name of the lender (i.e., MFI) and the lender would resell the product to the client. However, this would require more paperwork, and the clients usually fail to deliver the product to the MFI before it is sold back to them.



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