Islamic Finance & Financial Inclusion

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Islamic Finance in a Nutshell
It is an alternative system of financial services, compliant with the principles of Shari’ah and Divine Ethical Standards, aiming at a fair commercial gain with a simultaneous humanitarian concern.

“At the core of Islamic finance are the religious principles governing what is good and permitted, or halal, and what is harmful and forbidden, or haram...The logic of Islamic teaching on the subject is that when people earn their living in a wholesome and lawful manner, everyone will benefit...The aim of Islamic investing is to ensure that one’s earnings are halal”

(DeLorenzo 2002, p.12)
It is an asset-backed system. Money has no intrinsic value. The prohibition of the receipt and payment of *riba*, is of particular importance in the Islamic financial system. *Riba* is thought to be a threat to society as a fixed rate of return discourages entrepreneurship and productivity. Business owners and investors could be less motivated and careful about performance, as guaranteed returns involve no direct risk.

Speculative behavior based on uncertainty – *gharar* - is also discouraged.

Activities (investment /financing) can only be performed within *Shari’ah* approved activities.

Islamic Finance promotes financing of trade and exchange of goods and services to ensure a close link between the real economy and the financial sector. Because all financial contracts should be backed by assets or activities of the real economy.
Nevertheless, opponents argue that, the differences between the theoretically envisaged Islamic financial model and what is observed in reality are substantial, and that Islamic finance is simply conventional finance with Arabic names (Khan, 2010).

To their defence they posit that the cornerstone of Islamic finance i.e. equity participation constitutes a small percentage of a typical Islamic financial institution’s asset portfolio (Khan, 2010). Instead, fee-based financial products are the norm, where an “implicit” interest rate is charged that is often highly correlated with the “explicit” interest rate observed in the conventional banking sector (Hussan and Masih, 2014).
Whatever the case, **Islamic Finance is gaining a growing interest** in the international financial arena.

- As per recent Deloitte’s report: By the end of 2018, it is estimated that Islamic banking assets could reach up to US$3.4 trillion.

Besides, Islamic finance also represents:

- More than 300 Islamic banks & windows that are present in at least 60 countries
- More than 750 Islamic funds worldwide with assets under management of more than US$60 billion.


The estimated growth of the industry is based on the assumption that the potential size of the industry grows steadily with a satisfactory growth rate. This assumption is based on a number of factors:

- **Global Muslim population continues to grow;**
- **Awareness about Islamic banking and finance (IBF) continues to rise; and**
- **The per capita income and wealth held by Muslims are also rising, in line with the trends in other faith-based groups.**
Financial Inclusion ?
• It is the process of ensuring access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream Institutional players.

• The Findex (World Bank) data for 2004 shows that 2 billion adults were unbanked. This number fell to 1.7 billion in 2017 - still 40% of the adults in the world. Also, a big number of the population is under banked.
Different studies on financial inclusion, in particular cross-country studies, tend to use a wide variety of indicators to measure financial inclusion:

- the number of ATMs,
- bank branches per 1,000 adults,
- geographical and demographic penetration of financial services,
- the volume of deposits and lending to SMEs and households, etc. cost of usage).
Among the main markers of **market-driven barriers** to financial inclusion identified in the literature are:

- relatively high maintenance costs of small deposits and loans;
- high costs of providing financial services in small towns and rural areas (e.g. transport-related problems);
- information asymmetry on the market (lack of credit data about the clients and/or lack of usable collateral);
- lack of convenient access points to financial services.
BARRIERS

Among the markers for **regulatory barriers** are:
- strict requirements for opening branches and day to day access facility with ATMs;
- strict identification requirements, which can limit access of poor households;

The **infrastructure barriers** could be inferred from:
- lack of reliable payments and settlements system;
- limited availability of direct communication / access (either by phone, fax, email or mobile);
- lack of convenient transport to ATMs;
- lack of reliable internet connection.
Demand side barriers to financial inclusion consist of all the factors that can limit the demand of households for financial services. The major factors include but not limited to the following aspects:

- low income levels of the population;
- lack of knowledge (low levels of financial literacy);
- lack of trust towards financial institutions;
POSSITIVE RESULTS OF FINANCIAL INCLUSION

High level of financial inclusion in a country assists the positive improvements such as:

- the increase in the activities of small enterprises,
- the faster and healthier growth of the country’s economy,
- the control of inflation,
- the increase of employment,
- the increase of the welfare level of the people,
- the increase of the living standards of the poor,
- the decrease of income inequality,
- the obtainment of financial development and financial stability and improving resistant of the financial system to shocks.

Because of its importance, financial inclusion has created a global awareness and gained a growing reputation as a policy objective in the sight of policy makers and governments.

At the G20 Summit in Seoul (2010), the Leaders of the G20 endorsed a Financial Inclusion Action Plan and announced the establishment of the Global Partnership for Financial Inclusion, and so financial inclusion has become one of the most important matters in the universal reform agenda. More than 50 countries have set financial inclusion policies as a priority in their reform agenda, developed financial inclusion strategies and committed to targets for increasing financial inclusion. (Worldbank, 2014).
Financial inclusion is also highly regarded by scholars. A glance at the existing literature indicates that researchers have focused heavily on:

(i) how financial inclusion is measured (refer to, e.g. Sarma, 2008; Chattopadhyay, 2011; Gupte, Venkataramani, & Gupta, 2012; Arora, 2014; Chakravarty & Pal, 2013; Wang & Guan, 2017) and

(ii) what factors are associated with financial inclusion (refer to, e.g. Beck & De la Torre, 2006; Chithra & Selvam, 2013; Martinez, Hidalgo, & Tuesta, 2013; Leeladhar, 2006; Rao, 2007; Chakravarty & Pal, 2013; Fungáčová & Weill, 2015; Swamy, 2014; Corrado & Corrado, 2015; Honohan, 2008; Sahoo, Pradhan, & Sahu, 2017; Wang & Guan, 2017; Burgess & Pande, 2005; Levine, 2005).
Financial inclusion is a positive thing benefiting individuals and society. Thus, policies supporting financial inclusion should be designed and implemented.

The support of financial inclusion by governments is a clear task. Nevertheless, the Islamic Finance and Banking industry can play a role in this. It is estimated that given the demography of the Muslim population, financial inclusion is key to further growth of Islamic Banking and Finance. It is estimated that by doubling the pool of Muslim customers for Islamic banks, the size of the industry will increase by 2.5 times.

**Algeria** is in the top 10 countries with the highest increase in FI score were: Kyrgyz Republic, Algeria, Iraq, Congo Dem. Rep., Bahrain, Indonesia, Uruguay, Russian Federation, Venezuela and Moldova.
Nevertheless, financial inclusion comes with potential dangers.

Recent experiences in the microfinance arena have shown that poor people take loans that they have no capacity to service. Farmers have also taken loans that they have not been able to repay. Many have been driven to suicide because of debt problems. Unless financial literacy goes hand in hand with financial inclusion, instead of helping the poor, they will be put into more trouble.
Financial Inclusion and Financial Literacy are twin pillars:

**Financial Literacy** stimulates the demand side – making people aware of what they can demand.

**Financial Inclusion** acts from supply side providing the financial market/services what people demand.
Financial Literacy
Financial inclusion is typically addressed by improving financial structure but a high level of financial literacy has a beneficial effect.

Financial Literacy is a problem of non Muslim countries as well.

People in western societies were asked:

Suppose you need to borrow 100 money units today. Which is the lowest amount to pay back after a year?

A) 105 money units
B) 100 money units plus 3 percent interest rate per year
C) do not know
D) refuse.

50% of all respondents across the world give the right answer B while the remaining 50% say either A C or D.
Hot topics in financial literacy globally are:
• risk diversification,
• inflation, and
• compounded interest.

Financial Literacy has three components:
• Personal financial management.
• Information about various financial services, products to choose from.
• Operational knowledge.
Financial Literacy is the possession of the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources.

Some of the topics covered in these workshops and talks include: making sense of your money, financial planning begins now, implementing your financial plan, basics of money management, understanding loans and credit, understanding life insurance, types of life insurance, understanding basic health insurance, types of health insurance, assessing your retirement income needs, options to build your retirement income, introduction to estate planning, steps in estate planning, introduction to personal investing, major financial products, starting a family, buying your first home, baby and child support schemes, buying a home within your means, money management for youth, give your child money sense, financial planning for families with special needs, financial planning for employees in transition.
There is need for financial literacy in both the developed and the developing countries alike.

The increasing number and complexity of financial products, the continuing shift in responsibility for providing social security from governments and financial institutions to individuals, and the growing importance of individual retirement planning make it imperative that financial literacy be provided to all in the developed countries.

In the developing countries financial literacy can be seen as the first step toward alleviation of poverty and development.
Policies for Financial Inclusion
The International Monetary Fund (2018), acknowledged that “the growth of Islamic finance presents important opportunities to strengthen financial inclusion, deepen financial markets, and mobilize funding for development by offering new modes of finance and attracting unbanked populations that have not participated in the financial system.”

Islamic finance could contribute to the financial inclusion agenda through two main mechanisms: profit and loss sharing (PLS) or risk-sharing instruments, like musharakah and mudharabah, as an alternative to conventional debt-based financing and risk transfer; and Islamic social finance instruments, such as zakat, waqf (endowment fund), shadaqah, and qard hasan (benevolent loan), which complement PLS instruments.

PLS promotes the financial inclusion agenda because the concept can offer access to finance to low-income segments at an affordable and fair rate: the imposition of cost and the distribution of profit are based on the actual performance of the business. As a result, the optimum application of PLS will create an equitable distribution of income and wealth among partners or between wealth owners and entrepreneurs, presenting the concept of justice and fairness in financial dealings.
Furthermore, social finance is an integral part of the Islamic financial system to offer equal opportunity to financial access to the low-income segments, that is, the underserved and poor, “so that it may not (merely) make a circuit between the wealthy among you” (al-Qur’an 59:7).

Financial technology (fintech) is a perfect device to reinforce the role of Islamic finance in promoting the financial inclusion agenda. The use of digital finance, such as blockchain and crowdfunding, can lower transactional costs and minimise asymmetric information.

Bank Negara Malaysia Assistant Governor, Datuk Ahmad Hizzad Baharuddin, at the Association of Shariah Advisers’ Shariah Fintech Forum 2017, affirmed that fintech promises to revolutionize finance and bring a broader range of benefits to financial institutions and the public.
Santander FinTech issued a report in 2015 estimating that blockchain could reduce transactional costs attributable to cross-border payment, securities trading and regulatory compliance between US$15 billion (RM62 billion) and US$20 billion per annum by 2022. Furthermore, the ability of blockchain to transmit and to record the ownership of the digital assets and immutably store information — where all blockchain participants have access to the same information — might significantly reduce information asymmetries.

According to World Bank estimate, there are approximately 240 million to 334 million people in developing economies that could participate in crowdfunding. Islamic crowdfunding platforms can be deemed as an integral component of the present Islamic financial industry. For example, in Malaysia, a successful education-based crowdfunding platform named Skolafund is established as an online web platform for students, especially the ones in need, to crowdfund their scholarships for higher education. The platform was very successful as it has helped to sponsor the education of many poor Malaysians.
G20 New High Level Principles on Digital Financial Inclusion (HLPs)
The new 2016 Principles are intended to catalyze country-level actions by G20 governments to drive financial inclusion using digital technologies.

**PRINCIPLE 1:** PROMOTE A DIGITAL APPROACH TO FINANCIAL INCLUSION

**PRINCIPLE 2:** BALANCE INNOVATION AND RISK TO ACHIEVE DIGITAL FINANCIAL INCLUSION

**PRINCIPLE 3:** PROVIDE AN ENABLING AND PROPORTIONATE LEGAL AND REGULATORY FRAMEWORK FOR DIGITAL FINANCIAL INCLUSION

**PRINCIPLE 4:** EXPAND THE DIGITAL FINANCIAL SERVICES INFRASTRUCTURE ECOSYSTEM

**PRINCIPLE 5:** ESTABLISH RESPONSIBLE DIGITAL FINANCIAL PRACTICES TO PROTECT CONSUMERS

**PRINCIPLE 6:** STRENGTHEN DIGITAL AND FINANCIAL LITERACY AND AWARENESS

**PRINCIPLE 7:** FACILITATE CUSTOMER IDENTIFICATION FOR DIGITAL FINANCIAL SERVICES

**PRINCIPLE 8:** TRACK DIGITAL FINANCIAL INCLUSION PROGRESS
Encourage Financial participation with media e.g. TV soap operas.

In Niger, the state television station and UNICEF have joined forces to produce a serial drama entitled “Soueba” which focuses on the lives of young people in Niamey, Niger’s capital. Following their journey into adulthood, the program explores the realities of love and sex and the dangers posed by the HIV/AIDS epidemic. “‘Soueba’ is more than entertainment. Our aim with ‘Soueba’ is to stop the taboo around HIV/AIDS, decrease the stigma of people living with the disease, encourage positive attitudes and improve prevention behaviors,” declared the director of the program, Mahaman Souleymane.

In Ethiopia, the characters in the soap opera “Yeken Kignit” (“Looking over one’s daily life”) have kept millions of Ethiopians glued to their radios for two and a half years. In the process, they may also have changed their lives. Men who followed “Yeken Kignit” and a similar program called “Dhimbibba” (“Getting the best out of life”) sought to be tested for HIV at four times the rate of non-listeners, while the demand for contraceptives rose 52 percent among married women who listened to the programs.

In Nicaragua, PATH, an international nonprofit organization based in Seattle, working with a Nicaraguan non-profit group called Puntos de Encuentro (Meeting Points), has inserted health-related messages into one of the country’s most popular soap operas. The aim of those messages is to change some cultural assumptions that lead to domestic violence and sexual abuse among adolescent girls and young women.

“Why not put basic lessons of financial behavior in soap operas?”
Governments in countries with low level of financial inclusion should:

(i) include women in the financial system more than up to now;
(ii) develop Islamic finance to more include both Muslims & Non-muslim in financial system;
(iii) reduce inequality in income distribution and tax rates;
(iv) establish confidence of the society to the politics and policy making process by preventing corruption and bribery;
(v) ensure trade freedom and
(vi) improve quality in public services and alleviate political instability.
Another policy implication is the presence of significant spillovers and that decisions of policy makers influence not only their own country but also neighboring countries.

A positive (negative) change in financial inclusion of a country may negatively (positively) influence the change in financial inclusion level of the contiguous country. Therefore, improving well-balanced collaboration between the border countries is important for providing maximum benefit to them.
Banking profitability may be increased by previously unbanked population. So banks should consider policies that will provide more products and services to the previously excluded population.

Islamic banks may need to improve their current operating model so as to attract depositors and serve SMEs, which have so far been excluded from the formal financial sector for religious considerations. One option is to create separate SME business units within Islamic financial institutions, to understand the market dynamics of these firms, and to tailor Islamic financial instruments to their specific needs.

Use of Fintech, telecommunication and banking institutions are working hand-in-hand to create mobile payment and micro lending facilities for financially under banked users. Examples of popular apps that have been created to foster financial inclusiveness include China’s AliPay and India’s Paytm Wallet, serving 450 million and 122 million users in 2016, respectively. Robo-advisers that openly disclose and offer low fees for customers who have limited access to traditional financial advisers due to high costs; and peer-to-peer (P2P) lending sites that promote financial transactions where individuals lend and borrow from each other.
There is also a need to **better train bank personnel in Shari’ah-compliant instruments** and to streamline the execution of Islamic transactions, especially those related to loan applications for SMEs. Islamic banks need to introduce credit evaluation techniques such as behavioral scoring and an early warning system to better price and reduce risk exposure to SMEs, which will help develop equity related instruments (*musharaka* and *mudaraba*) and *Murabaha* & *ijara* for SMEs. Islamic banks can also explore the potential of private equity (PE) and venture capital (VC), both of which seem well suited to Islamic models of finance. In this regard, Bahrain provides an example of the successful introduction of an Islamic VC bank focused on financing SMEs. The most appropriate way to encourage the development of PE/VC is to **develop the domestic capital market for easing the exit of VC banks from the capital of funded firms**, to promote business incubators, and to review the legal framework related to intellectual property protection and the security of financial transactions.
• People – individuals are the demand side of financial inclusion and financial literacy.
• **Knowledge** is the key point.
• So responsible citizens must seek and understand financial information.
• They have to **follow** financial news and developments.
• They must **read and learn**.

• **Read** is the first word of the Holly Qur’an.

• People must put knowledge in to practice.
Thank You!

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