Insights

GLOBAL FINANCIAL INCLUSION

ISLAMIC FINANCE MEETS THE CHALLENGE

As access to financial services remains a major challenge in some parts of the world, financial inclusion has become a key policy objective for many governments and central banks across the globe. In their efforts to improve financial inclusion, policymakers may consider Islamic finance as a potential catalyst for improving access to finance, in particular for the alleviation of poverty and the promotion of entrepreneurialism. The essential objectives of Islamic finance are to promote justice, inclusion and equality, so financial inclusion is a familiar concept that is already being put into practice in several ways.

16 July 2014

Enhancing financial inclusion through Shariah compliant finance

The global financial industry is worth more than USD200tln and continues to expand further[1]. Despite its size, half of the world's adult population remains unbanked, especially in low-income economies and in rural areas. This suggests that access to financial services remains a major challenge in some parts of the world and policymakers must address this issue, in the interest of ensuring a more sustainable growth path. Indeed, financial inclusion is recognised by some experts as a key determinant of sustainable, inclusive economic growth. In September 2013, the leaders at the G20 (Group of 20) summit defined it as a core priority of development. Meanwhile, the World Bank has set a goal of universal financial inclusion by 2020 and continues to be at the forefront of research, consultative work and policy solutions, towards this goal. Following this lead, policymakers are increasingly making financial inclusion a priority, especially in emerging economies, where access to financial services tends to lag behind that of advanced economies. Financial inclusion is now a key policy objective for many governments and central banks across the globe. Broad recommendations include improving financial literacy, creating a supportive regulatory ecosystem, ensuring that products cater to customers' requirements and increasing access points to financial services.

From an Islamic economic perspective, the concept of financial inclusion and income equality are not new. In fact, these ideas form the basis of risk-sharing contracts and are the main reason behind the prohibition of riba' and speculative activities. Essential objectives of Islamic finance are to promote justice, inclusion and equality. Moreover, the existence of poverty attributed to the inefficient allocation of resources between the rich and the poor, and not as a result of scarcity. In the context of financial inclusion, Islamic finance addresses the issue in several ways. The first is by promoting risk-sharing contracts, in lieu of debt- and interest-based contracts by the conventional system. In Islamic finance, a financial transaction must be supported by an underlying economic activity as money cannot be treated as commodity to generate interest. The second is related to unique redistributive instruments such as Zakat, Sadaqah, and Waqf. Broadly, these instruments are based on voluntary contributions from wealthier members of society, and are channelled to low-income or needy households. In addition,

[1] Estimates by McKinsey, PWC

Islamic finance provides an alternative to tap voluntarily unbankable individuals who have refrained from using formal financial services due to religious or ethical considerations.

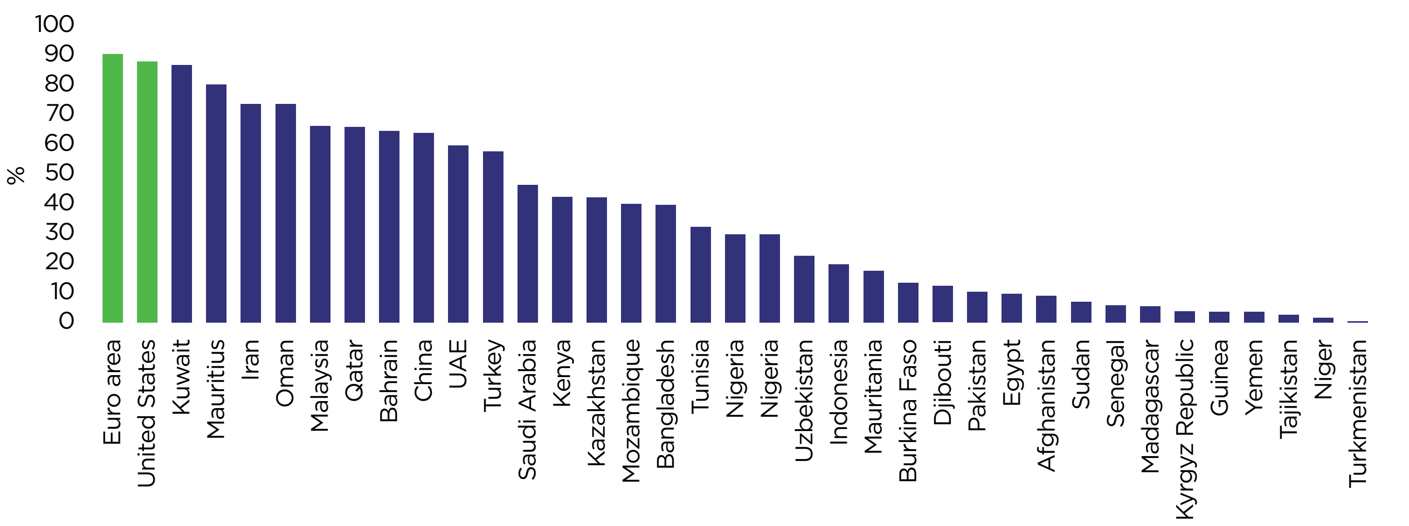
Prospects for Islamic finance, as a mechanism to support financial inclusion, remain bright. Going forward, the world's Muslim population will grow twice as quickly as non-Muslims. By 2030, Muslims will make up more than a quarter of the global population[2]. Notably, Muslims are expected to be more geographically-dispersed, reflecting migration and globalisation patterns. As evidenced in the rapid growth of Islamic finance, a large Muslim population provides natural support for Islamic banking retail and takaful services. In the context of Islamic microfinance, policymakers in countries with substantial low-income Muslim populations may consider encouraging the expansion of the Islamic microfinance and microtakaful sector as part of the national financial inclusion agenda. Importantly, Islamic finance is not limited to Muslims only, non-Muslims too, stand to benefit from Shariah compliant microfinance services that do not impose riba' or encourage speculative activity, as the absence of these practices would minimise the wealth gap between the rich and the poor.

Financial inclusion in selected countries

Quite recently, the concept of financial inclusion evolved into several dimensions, encompassing easy access to finance, sound and financially-sustainable institutions, and healthy competition between service providers for the benefit of consumers. There are several measures of financial inclusion, and the most common one is banking penetration, measured by the share of population aged above 15 years old with an account at a formal financial institution[3]. At present, banking penetration is relatively low in some countries with large Muslim populations. Another common measure is the share of adults with loans from financial institutions, for which a few Muslim countries fare slightly better (compared to the banking penetration measure). Islamic finance jurisdictions are broadly characterized by low financial inclusion, as measured by bank account penetration and the prevalence of individuals taking loans from financial institutions.

Percentage (%) of individuals >15 years old with bank accounts at formal financial institutions

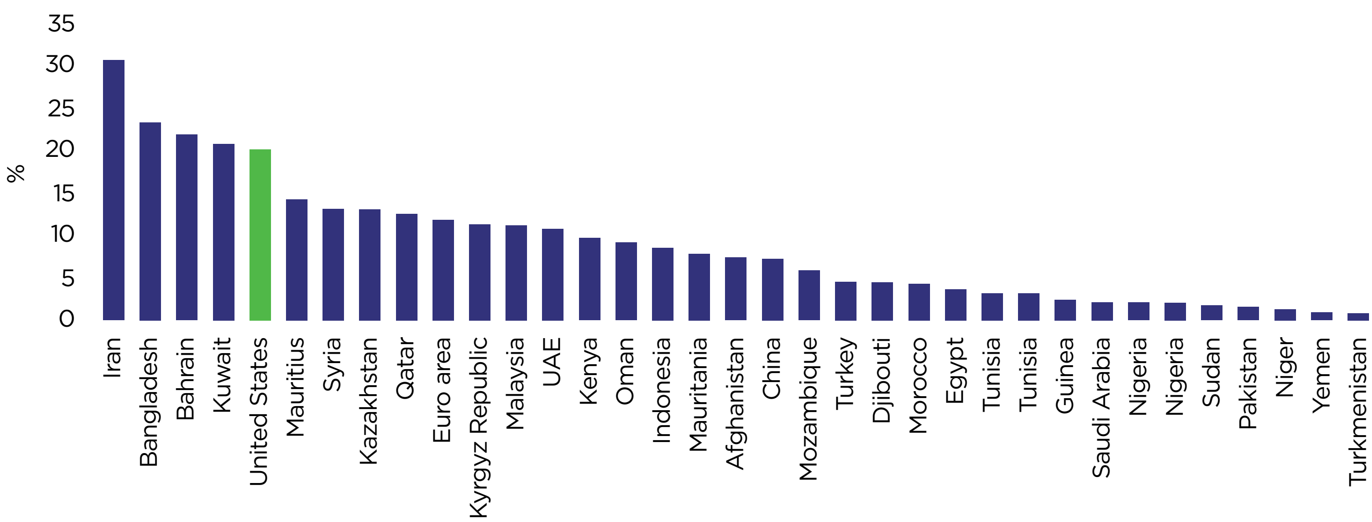
Source: World Bank Global Findex (2011), KFH Research Ltd



[2] Pew Research
[3] World Bank

Percentage (%) of individuals >15 years old with loans from formal financial institutions

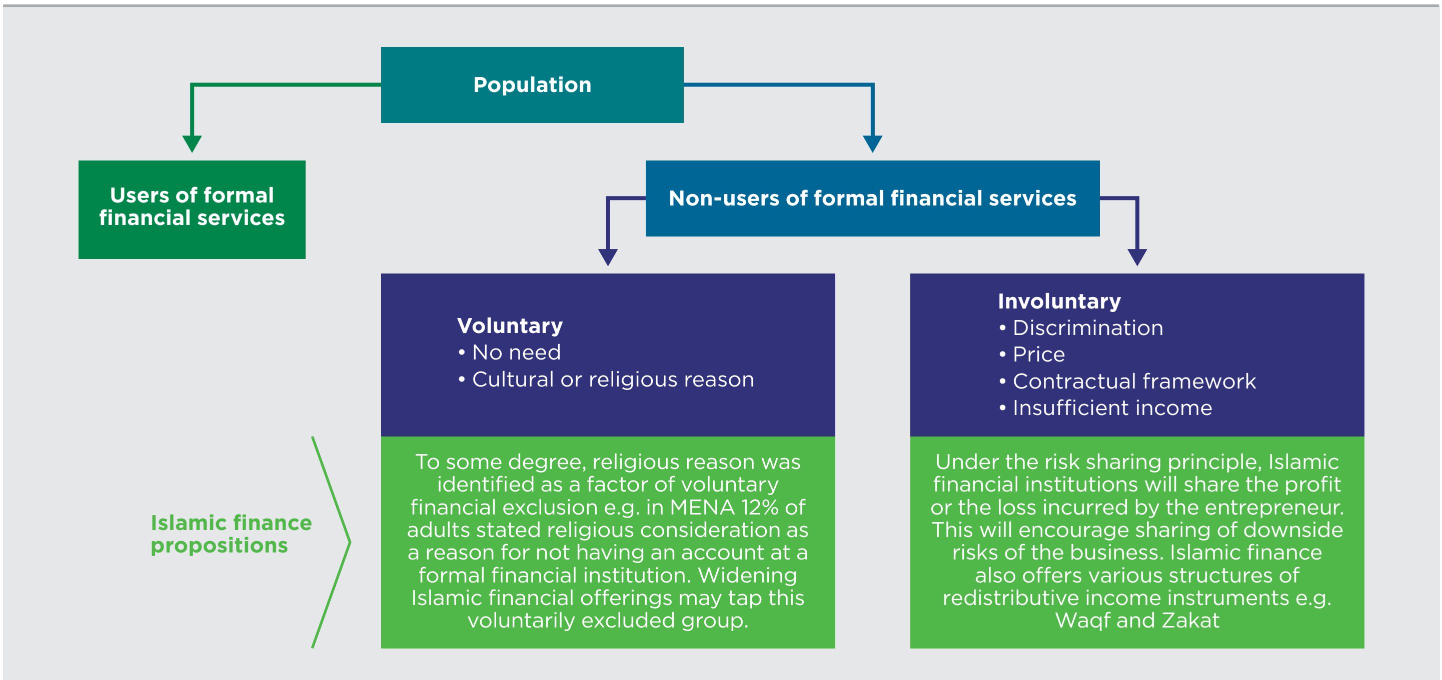
Source: World Bank Global Findex (2011), KFH Research Ltd



In efforts to improve financial inclusion, policymakers may consider Islamic finance as a potential catalyst for improving access to finance. For those who have voluntarily excluded themselves from the formal financial system, Islamic finance provides a Shariah compliant and ethical alternative. Meanwhile, the variety of risk-sharing contracts in Islamic finance means that borrowers and investors do not have to bear all risks associated with engaging financial services. Implicitly, this would lower the cost of financing and doing business.

Potential Barriers to Financial Inclusion and Islamic Finance Solutions

Source: World Bank, KFH Research Ltd



A snapshot of banking penetration and religious considerations in Islamic finance jurisdictions reveals two policy insights. In the context of overall financial inclusion policies, countries that have reasonably high banking penetration tend to be wealthier and thus, the challenge is to improve outreach in poorer countries. A secondary challenge, is for the Islamic finance industry to expand to countries where adults have cited religious reasons as a barrier. Notably, these countries happen to be ones where the Islamic finance industry is smaller or just starting to grow, where there is a lack of Shariah-compliant options in the banking and microfinance systems. For example, adults in Afghanistan and Tunisia are more likely to cite religious barriers to finance, compared to those in established Islamic finance industries. Comparatively, in countries where Islamic finance has significant presence, such as Kuwait, Malaysia and Bahrain, less than 2% of Muslims surveyed had cited religious reasons as a barrier to opening an account.

Islamic finance and financial inclusion: Developments and opportunities

Overall, Islamic banking accounts for 80% of total Islamic finance assets and is a USD1.4tln industry. The expansion of the global Islamic banking industry has culminated in a strong presence in the Gulf Cooperation Council (GCC), Middle East and North Africa (MENA) and Asia. Several European countries also have a budding Islamic banking sector, to cater to a growing Muslim population.

Across the globe, key drivers for the industry include a large share of Muslim population, complemented by a supportive regulatory environment. From its nascent growth in the 1960s, Islamic finance gained traction globally since the early 2000s, and continues to expand rapidly today.

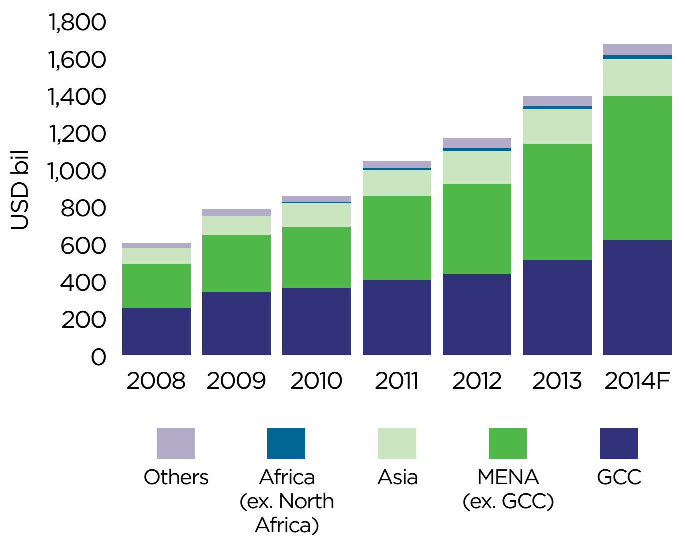
Banking Account Penetration and Religious Reason for Not Having an Account

Country	Adults with account at formal financial institutions (%)	Adults with no accounts due to religious reasons (%)
Afghanistan	9.0	33.6
Bahrain	64.5	0.0
Bangladesh	39.6	4.5
Djibouti	12.3	22.8
Egypt	9.7	2.9
Indonesia	19.6	1.5
Kuwait	86.8	2.6
Malaysia	66.2	0.1
Nigeria	29.7	3.9
Pakistan	10.3	7.2
Qatar	65.9	11.6
Saudi Arabia	46.4	24.1
Tunisia	32.2	26.8
Turkey	57.3	7.9
UAE	59.7	2.3

Source: World Bank Global Findex (2011), Gallup Poll, KFH Research Ltd

Islamic Banking Assets (2008-2014F)

Source: Central banks, annual reports, KFH Research Limited

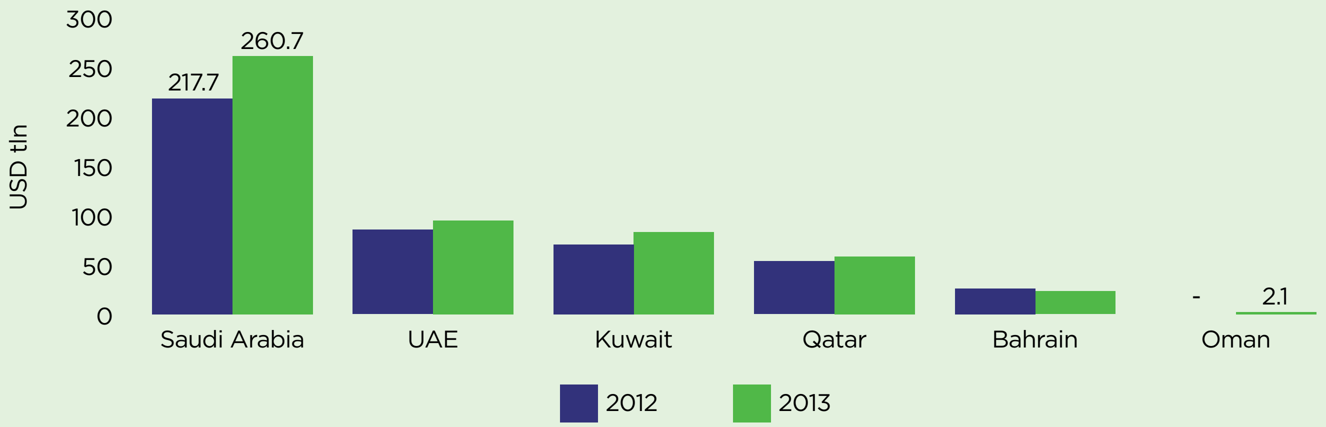


Snapshot of Islamic Banking by Region

Islamic banking assets in Asia of USD192.3bln accounted for approximately 14% of global Islamic banking assets of USD1.4tln as at end-2013. By country, about 70% of Shari'a compliant banking assets in Asia are held by Islamic banking institutions in Malaysia. Indonesia (11%), Bangladesh (9%) and Pakistan (5%) are also considered to be major jurisdictions in the Islamic banking sector in Asia. Countries with large Muslim populations, such as India, China and most of the Commonwealth of Independent States (CIS), also hold strong potential for growth. A wide range of products and services are on offer – from basic deposit and financing to Shari'a compliant trade finance, treasury and investment banking solutions.

Islamic Banking Assets in GCC by Country (2012-2013)

Source: Central banks, annual reports, KFH Research Ltd



The GCC is home to some of the world's largest players and markets in Islamic finance. Islamic banking assets in the GCC recorded a solid y-o-y growth rate of 17.1%, having reached USD521.7bln as at end-2013 from USD445.7bln in 2012. In the aggregate, Islamic banking institutions in the GCC presently hold 37% of the total global Islamic banking portfolio and, along with their Asian counterparts, lead the sector in terms of scale, activity and product development. Within the GCC, Saudi Arabia accounts for the biggest share of Islamic banking assets (50%), followed by the UAE (18%), Kuwait (16%) and Qatar (11%).

Meanwhile, African countries such as Kenya and Nigeria have made important strides in Islamic finance, by setting up several full-fledged Islamic banks. South Africa, a predominantly non-Muslim country, is home to three Islamic banking institutions – one full-fledged Islamic bank and two Islamic banking windows. Total Islamic banking assets currently account for 1-2% of total banking assets in South Africa. North Africa, however, remains an untapped market of 190 million people (91% of the population is Muslim).

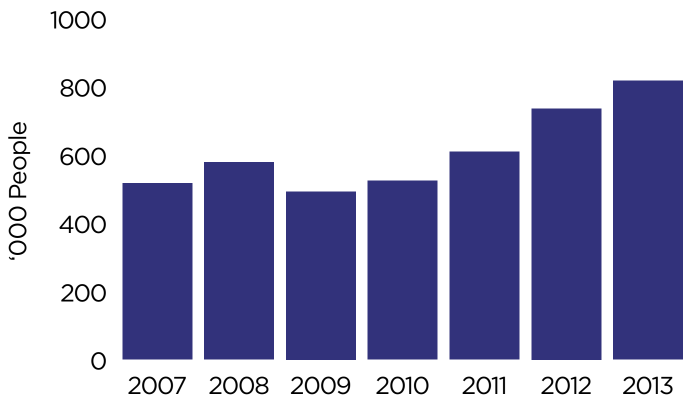
In Europe, Islamic finance has a presence in major economies such as Germany, France and the UK, with 40 institutions that offer Islamic finance products to varying degrees. In the UK, there are six are fully-fledged Shari'a compliant institutions. In addition, a variety of retail and corporate Shari'a compliant banking products and services are offered through Islamic window operations in France and Germany. A number of European banks in France offer Shari'a compliant products such as deposits, mortgages, trade finance, and corporate banking.

By segment, Islamic finance generally offers Shariah compliant solutions for households and SMEs, while Islamic microfinance is targeted for low-income households. Basic financial services for households and SMEs include savings, investment, financing and protection against unforeseen events. Savings products in Islamic finance typically take the form of Murabahah or Wadiah, based on concepts of cost plus and fees charged for safekeeping, respectively. Another common structure is Mudharabah, where the Islamic bank and the customer agree on a profit-sharing ratio.

Zooming into Islamic microfinance in selected countries, jursidictions with notable Islamic microfinance presence include Bangladesh, Pakistan, Indonesia and Malaysia. Bangladesh, in particular, has made tremendous progress over several decades. Of significance, the microfinance sector in Bangladesh has been widely credited with playing a key role in alleviating poverty, amid broader efforts to assist the low-income population. As a result, the share of population living below the national poverty line declined significantly within less than 20 years, from 56.6% in 1992 to 31.5% in 2010. An important success story in Bangladesh is the Rural Development Scheme (RDS), developed by the Islami Bank of Bangladesh (IBB) in 1995. The RDS is an innovative Islamic microfinance program which was designed to support Muslims in the rural areas of Bangladesh, who were left out from conventional microfinancing due primarily to religious considerations. Starting off as a small pilot project spanning four villages in 1995, the RDS expanded and became a widely recognized model in poverty alleviation. As at end-2013, the RDS had benefitted more than 800,000 people. Broadly, the underlying concept of the RDS mirrors that of Grameen Bank, in providing micro loans and using a group-based credit approach. However, the scheme uses Islamic modes of investment based on the profit and loss sharing methodology.

Islamic Bank Bangladesh: Uptake of Rural Development Scheme

Source: Bank's website, KFH Research Ltd



Meanwhile, Pakistan has an established and growing Islamic microfinance industry. Prominent Islamic MFIs include Akhuwat and the Wasil Foundation. As of 31 May 2014, Akhuwat has 225,824 active loans on its portfolio, and has a commendable loan recovery rate of 99.8%. Akhuwat operates 272 branches in 186 towns, and has lowered its costs by operating mainly from community centres such as mosques. The business model is based primarily on channelling donor funds to borrowers via Qard al-Hassan loans. On the other hand, the Wasil Foundation offers mainly commecial–based Shariah compliant products, including Salam (advance against future delivery), Istisna and Murabaha (cost plus mark-up), Musharakah, and Ijarah (leasing).

In Malaysia, Islamic banking is part of a well-regulated overall banking system. The nation's financial inclusion targets are ambitious, and current statistics show that significant strides have been made to improve accress to financial services. Overall, 92% of the population has a deposit account and 36% have financing accounts[4]. These figures encompass the total

[4] "Developing a Financial Inclusion Index" (2013), Zarina Abd Rahman, Bank Negara Malaysia

banking system, including both conventional and Islamic accounts. As part of the broad nationwide strategy, a comprehensive microfinance institutional framework was launched in 2006 to promote the development of a sustainable microfinance industry in Malaysia. The development plan for financial inclusion is a holistic one, with emphasis on improving access to financial services via agent banking and improving financial education. These measures have facilitated the growth of the banking industry, including Islamic banking. The country operates a dual banking system, where Islamic banking holds a 25.7% share[5] of total domestic banking system assets, and competes on an equal basis with conventional finance. Notably, Islamic finance has gained acceptance amongst the population, irrespective of race or religion. Industry estimates that non-Muslims make up more than 50%[6] of the customer base of Islamic banks in Malaysia. In the microfinance industry, microfinance services are usually integrated into major banks' services via the Skim Pembiayaan Mikro (microfinancing scheme). Presently, seven out of ten participating financial institutions offer Islamic microfinance. Shariah compliant microfinancing as a share of total microfinancing outstanding stands at 47.6% or RM407.5mln (USD128.6mln). For example, Bank Rakyat, one of the participating banks, provides financing to small businesses through its Ar Rahnu or pawnbroking programme, since 1993. The goal of the programme is to support microbusinesses via small capital injections or as a source of funds for daily expenses.

Notably, Islamic SME financing has also made inroads in countries such as Kenya and Mauritius. Particularly given that SMEs are an engine of growth, and the main source of employment growth, access to finance for SMEs is a priority in most countries. In March 2013, the International Finance Corporation, the private investment arm of the World Bank Group, announced a USD5mln equity investment in Gulf African Bank (GAB) in Kenya to increase Shariah compliant banking products and services for SMEs. The GAB is a fully Shariah compliant bank in Kenya, offering products that address the needs of not just Muslims, but are marketed to everyone in the country as fair, safe and ethical.

In 2011, the Mauritian government established the Mauritius Business Growth Scheme (MBGS), to support and provide access to Islamic financing for SMEs. Basically, the Mauritian government and the SMEs enter a contract of profit-sharing. After the 2-3 years, the SMEs a portion on company's incremental revenue growth based on its revenue level before it participated in the MBGS. The repayment period is limited to five years so that if the business is notable to provide the funds back to the MBGS, it will not become forever burdened with repayment, as it would if it received a loan instead. As of May 2014, about 300 firms received financing under the program.

Djibouti, a small country of less than 900,000 people, is another instructive example on the promotion of Islamic banking to increase overall banking penetration. Policymakers recognised early on that a sizeable share of the population had abstained from conventional financial services due to religious reasons. By promoting Islamic banking services, banking penetration improved from 10% in 2007 to about 17-18% in 2013. Currently, Islamic banks have grown to 15% of the banking sector in the country, and are likely to expand further given strong government support amid an increasing customer base.

[5] Including DFIs. Data from Bank Negara Malaysia (2013).
[6] Source: Speech by Bank Negara Malaysia Deputy Governor Dato' Muhammad bin Ibrahim at 11th Islamic Financial Services Board (IFSB) Summit on 22 May 2014

Appealing features to support financial inclusion objectives

The essence of Islamic finance is in risk-sharing contracts, which are very supportive of entrepreneurship and wealth creation. Importantly, the use of risk-sharing contracts eliminates the need to charge riba' and excessive penalties in case of default. Consequently, Islamic banks then have a vested interest in supporting the success of business, which is especially important for SMEs. In other words, access to finance can be improved by utilising Shariah compliant contracts. Both households and business can use Islamic financing to fund asset purchases or as working capital. SMEs which need working capital financing may utilise various contracts such as Mudharabah and Musharakah.

Examples of Islamic Financing Facilities for an SME

Source: IBFIM, Global Islamic Finance Forum (2012), KFH Research Ltd

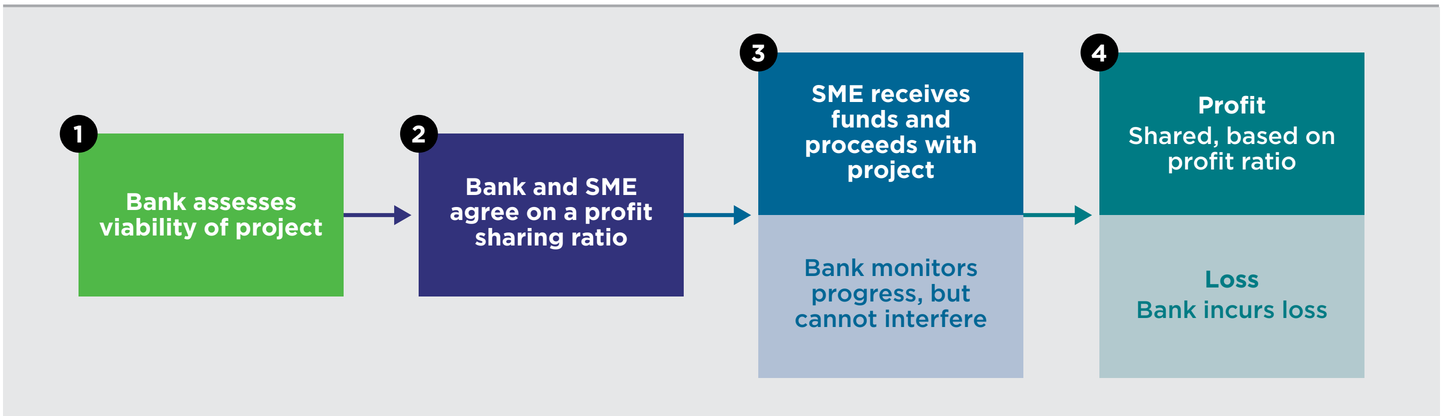
SME in Manufacturing Sector

Project and contract financing	Working capital	Cash line facility	Plant & machinery financing
• Mudharabah • Musyarakah	• Murabahah contract	• Tawarruq	• Istisna' • Murabahah • Ijarah • Bai Bithaman Ajil

To provide financing for projects, an SME may choose a Mudharabah or Musharakah financing structure. Before agreeing to provide capital, the bank may assess the project, its potential profits and risks. In Mudharabah, the SME manages the project and will be monitored by the bank. Any profits made from the project will be shared between the bank and the SME on a pre-agreed profit-sharing ratio. However, losses would be borne only by the bank.

Mudharabah for SMEs

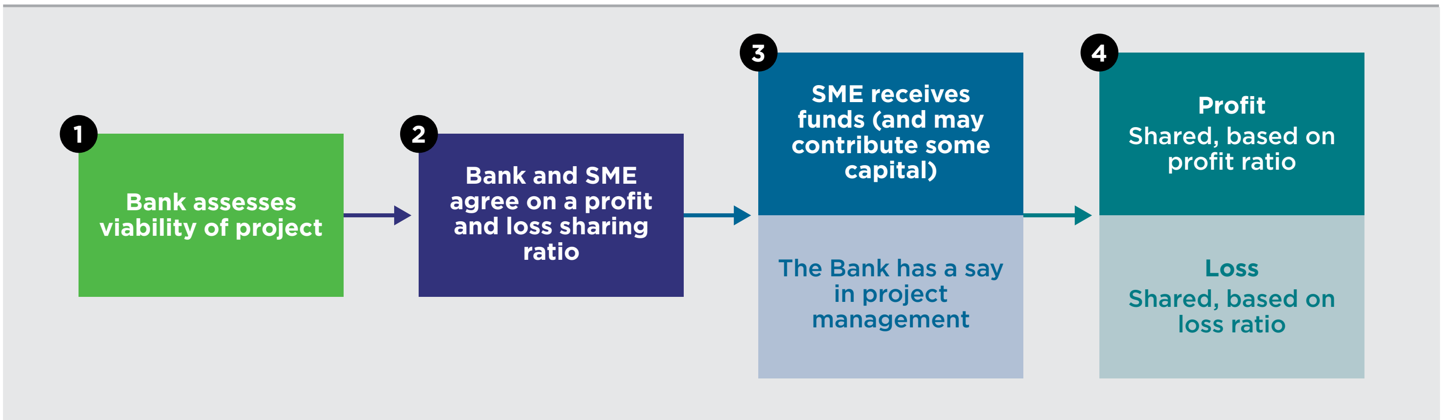
Source: KFH Research Ltd



A somewhat similar option for project financing is Musharakah, where the bank also has a say in the management of the project. Both profits and losses would be shared by both the bank and the SME. In both contracts, the bank has a strong interest in supporting the SME and ensuring the project is successful. If the SME suffers losses at the end of the contract, the bank may extend the contract if it assesses that business prospects remain bright, which provides further support for the SME.

Musharakah for SMEs

Source: KFH Research Ltd



While the complementarities between Islamic finance and financial inclusion are extensive, an area which shows great promise is Islamic microfinance. In many ways, the challenge of financial inclusion is most profound in poorer populations – a sole proprietor in a remote area, a farmer with few assets except his agriculture produce, and many others. To improve financial inclusion, the growth of Islamic microfinance should be encouraged, as the industry supports low-income households and microenterprises by providing soft financing terms, usually for working capital and asset purchase. Broadly, low-income households have many of the same financial needs as wealthier households, and thus, gain similar benefits from having access to quality, affordable financial services.

An important success story in Bangladesh is the Rural Development Scheme (RDS), developed by the Islami Bank of Bangladesh (IBB) in 1995. The RDS is an innovative Islamic microfinance program which was designed to support Muslims in the rural areas of Bangladesh, who were left out from conventional microfinancing due primarily to religious considerations. Starting off as a small pilot project spanning four villages in 1995, the RDS expanded and became a widely recognized model in poverty alleviation. As at end-2013, the RDS had benefitted more than 800,000 people. Broadly, the underlying concept of the RDS mirrors that of Grameen Bank, in providing micro loans and using a group-based credit approach. However, the scheme uses Islamic modes of investment based on the profit and loss sharing methodology.

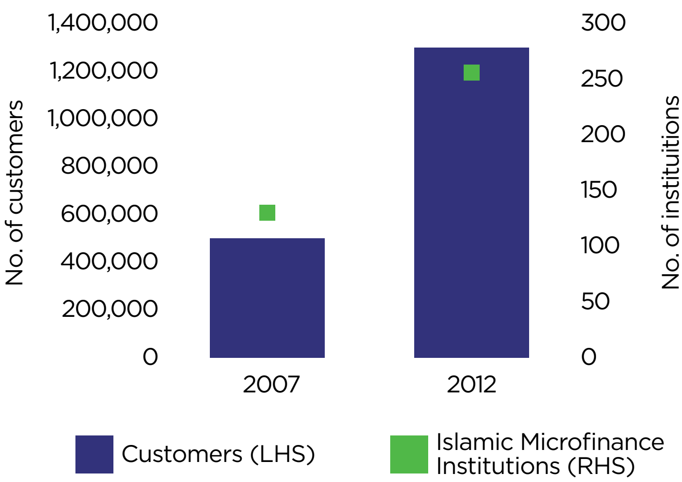
Another salient feature of the scheme is that it is conducted by a private sector Islamic bank, and thus, its success is testament to the viability of Islamic microfinance, including for private institutions. An often cited reason for the slower-than-anticipated growth of microfinance in general, is the sustainability of microfinance institutions, given the risky profile of customers amid reliance on donor funds. To enhance the sustainability of the fund, members of the RDS have to open a Mudharabah savings account and are required to deposit a small amount on a weekly basis. These savings may be withdrawn once these members have fulfilled their liabilities toward the bank. In addition, to encourage the act of Zakat (welfare giving to the poor), members are encouraged to deposit a small weekly amount to a Qard al-Hassan fund, which is an interest-free fund given to the extremely poor, for members who are not able to make their timely payments or toward the rural development of the community.

The way forward

There is significant potential in Islamic microfinance to support financial inclusion, especially in countries with a sizeable low-income population. Generally, financial inclusion is weaker in countries with lower-income and even within countries, there are urban-rural disparities. Globally, Islamic microfinance has recorded a robust expansion, from serving just 500,000 customers in 2007 to 1.3mln clients in 2013.

Islamic Microfinance Institutions and Customers

Source: Consultative Group to Assist the Poor (CGAP), KFH Research Ltd



These Islamic MFIs are quite concentrated in Bangladesh, Afghanistan and Indonesia. Nevertheless, there is strong potential in the Middle East and North Africa (MENA) region, as 20-40% of respondents in Jordan, Algeria, and Syria, cited religious reasons for not accessing conventional microloans. Similarly, Islamic microfinance is expected to expand in Asia, where Islamic finance already has a substantial presence in some countries. The development of Islamic microfinance in Asia will be underpinned by a large population and rising demand for modes of financing that are Shariah compliant.

Looking ahead, the formulation of policies to enhance financial inclusion should include Islamic finance and address some of the challenges in the industry. As seen in several countries, the promotion of Islamic finance served to complement the conventional system and likely played a role in improving the outreach of financial services. Notably, many key Islamic finance countries have recorded an increase in the share of Islamic finance as part of the total banking system, implying that when given the option, consumers may prefer Islamic finance to conventional finance, and; populations without initial access to formal financial services have opted for Islamic finance as an alternative to the riba'-based finance. Using risk-sharing contracts, Islamic finance is able to avoid the use of riba' as a means to gain profit, thus narrowing the gap between the wealthy and the poor. In addition, the availability of benevolent loans (Qard al-Hassan) and voluntary contributions such as Zakat and Waqf, further support financial inclusion, especially for the low-income segment.

In light of the untapped demand for Islamic finance, measures to support financial inclusion should encompass the promotion of Shariah compliant financial services, amid efforts to improve supporting financial infrastructure.