Role of Islamic Finance in Promoting Inclusive Economic Development

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Outline

1. Finance and inclusiveness
2. Is the current economic system inclusive?
3. Islamic Finance: Principles, trends and challenges
4. Role of Islamic Finance in promoting inclusive development
5. Way forward
1. Introduction

- Many studies find positive relationship between financial sector development and economic growth.
- The relationship between finance and economic growth has been identified by Ibn Khaldun (1332-1406) in the *Muqaddimah* (1377)
Functions of the Financial System

- Easing the exchange of goods and services
- Monitoring of investments - Corporate governance
- Mobilization and pooling of savings
- Production of ex-ante information about the investment opportunities
- Trading, diversification - Management of risk
- Quality of institutions, Government policies, Geographic conditions, Income level, Cultural characteristics

Source: Levine (2005)
• **Economic Inclusiveness**: “the degree to which economic opportunities are shaped by individual skill, ideas, and initiative rather than by familial wealth, political influence, and social connections” (R. Levine, 2011)

• Finance has an impact on the degree of inclusiveness of economic development.

• “Financial system influences who can start a business and who cannot, who can pay for education and who cannot, who can attempt to realize one's economic aspirations and who cannot. Thus, finance can shape the gap between the rich and the poor and the degree to which that gap persists across generations.” (Demirgüç-Kunt and Levine, 2009)
• Financial development comprises “factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services” (WEF, Financial Development Report, 2012)
2. Is the current economic system inclusive?

Number of Undernourished People in the World, 1969-2010

Source: Earth Policy Institute (www.earth-policy.org) from FAO

World Hunger (2010) argues that the economic system in place is the principal cause of poverty and hunger since it resources and wealth are controlled by a minority of people who live well, while those at the bottom just survive.
B. Milanovic (2011) “Income inequality has risen over the past quarter-century instead of falling as expected”
Increasing income inequality

Source: Gasparini et al. (2010)

Joseph Stiglitz: “There has been no improvement in well-being for the typical American family for 20 years. On the other side, the top one percent of the population gets 40 percent more in one week than the bottom fifth receive in a full year”.
Unemployment in Q1 of 2012

Source: Clements et al (2012)
Global housing crisis

- 100 million are homeless,
- 1.6 billion people living in substandard housing,
- Estimated 3 billion persons will be living in slums in 2050 (UN-Habitat, 2007).
• Need to design the right economic policies to enhance inclusiveness specially in the developing countries.

UNDP works with developing countries to improve the way inclusive development policies and programmes are designed and implemented, based on a human development approach that integrates the standards and principles of human rights ensure that the most vulnerable and marginalized people:

1. benefit from that policies and programmes
2. be involved in deciding on policy options
3. control the implementation of the policy decisions

• Freeman (2010): “…Restoring finance to its role as a productive force in the economy will require new institutions and modes of compensation, as part of a general overhaul of the relation between finance and the real economy”. 

Source: "It’s financialization!", International Labour Review, Vol. 149, No. 2.
3. Islamic Finance

a- Origin and Principles

- Purposes of the Islamic Doctrine (Shari’ah) according to Ghazali are preserving and enriching:

  - Faith
  - Life
  - Intellect

  Posterity
  Wealth

  Socially-agreed moral filter ensuring cooperation and well-being of all
  It is not an end in itself – it is a mean for realizing human well-being

- Forget (2009): “Islam proposes a model of social responsibility more extensive than the models suggested by the classical economic theories”

Source: Chapra (1992, p.7)
• “.. The goals of socio-economic justice and equitable distribution of income and wealth are an integral part of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood.”

• “.. Pursuit of self-interest demands that one should be conscious of the interest of others and should avoid hurting them. The requirement invokes mutual respect and calls for cooperation - not conflict - for promoting the interest of each other.”
• Fundamental precept: *Money has no intrinsic utility.* It is a potential capital which materialize only if it joins other resources (effort and labor) to undertake a productive activity →

1) The remuneration of capital should be the counterpart of risk inherent to trade and investment activities. No guaranteed predetermined rate of return.

2) Profit and Loss Sharing.

3) All financial transactions must be backed by real assets
Principles of Islamic Finance

- Prohibition of Riba
- Profit and Loss Sharing
- Prohibition of Gambling
- Linkage with real economy
- Lawful activities
- Ethical and moral values

Islamic Finance
• Chapra (2008): In order for the financial system to promote justice, it should satisfy at least two conditions, in addition to being strong and stable:

1. Financier must also share in the risk so as not to shift the entire burden of losses on the entrepreneur.

2. An equitable share of bank lending should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

3. Islamic Finance

**b- Categories of Islamic financial products**

### Exchange-based Trading contracts
- **Leasing**
  - Lease (Ijarah)
  - Lease-purchase (Ijara wa iqtina)
- **Sale**
  - Cost-plus sale (Murabahah)
  - Deferred-payment sale (bay‘ bi-thaman ‘ajil)
- **Forewards**
  - Salam: payment at t=0 and delivery at t = T
  - Istisna (Manufacture) payment at t=0,1,2.. and delivery at t = T.

### Equity-based– Partnership contracts
- **Profit sharing & loss bearing** (Mudharabah)
- **Profit and loss sharing** (Musharakah)

### Cooperative–Insurance Takaful contracts
- Mutual insurance where each participant contributes to fund which is used to support the group. Premiums are invested in Islamic financial products. Surpluses are shared.

### Social well-being Gratuitous contracts
- **Loan without charge** (Qard Al-Hasn)
- **Donation** (Hiba)
- **Endowment** (waqf)

### Islamic Investment Certificates - Sukuks
- Certificates of ownership of underlying assets, issued with the aim of using the mobilized funds for establishing a new project, developing an existing project, or financing a business activity.
3. Islamic Finance

c- Recent trends

- The Islamic financial services industry (IFSI) has grown in size and geographic coverage. More than 600 Islamic Financial Institutions operating in more than 75 jurisdictions.

Islamic Finance Asset Growth

- Reached USD150.0 billion
- Expected to reach USD1.6 trillion
- Estimated to surpass the USD6.5 trillion mark

Source: KFH Research (2012)
3. Islamic Finance  c- Recent trends

• **Islamic banks and Islamic banking windows** are the central pillar of the IFSI with a CAGR of 40.3% between 2004 and 2011 and total assets estimated to USD 1.1 tln.

• **Sukuk** segment: sukuk issuances growing at CAGR of 42.3% over the period 2004-2011 passing from USD 7.2 bln to USD 85.1 bln. From Jan. 1996 to Sept. 2012 the value of the global aggregate sukuk is USD 396.4 bln.

• **Takaful** segment is a small segment but its total gross contributions have grown by a CAGR of 23.1% over 2004-2011 with an estimate of USD 15.2 bln in 2012.

• **Islamic funds**: assets under the management of passed from USD 29.2 bln in 2004 to USD 64 bln in Oct. 2012.

• **Islamic Microfinance**: emerging market niche. ~ 255 providers around the world. 92% of providers in East Asia and Pacific (164 providers) and MENA (72) providers. Poor clients using Sharia-compliant products estimated at 1.28 million

Islamic banking Industry - High potential of growth

Banking asset penetration (% of Nominal GDP) and Islamic banking market share of total assets (%) in 2011

Source: Central Bank Reports, Ernst & Young Analysis

Size of circles denote the relative size of Islamic banking assets in 2011
Islamic banks - Adjusting the business model

• “...Although IBs have illustrated a degree of resilience and stability, they have been impacted by the crisis because of their higher exposure to real estate and their limited reliance on risk sharing or equity based transactions...” (Shamshad Akhtar (2009), Speech during the “Symposium on Islamic Finance in Roma: Developments in MENA region”, Bank Italia, Rome, Italy, November, 11th, 2009)

Source: Bourkhis and Nabi (2013)
Islamic banks - Adjusting the business model

Source: Islamic Banking and Finance Information System (IBFIS) - IRTI
Islamic Microfinance – A promising segment for financial inclusion

- CGAP (2008): “Islamic microfinance represents the confluence of the two rapidly growing industries: Microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance’s power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law.”
Islamic Microfinance – A promising segment for financial inclusion

NUMBER OF ACTIVE CLIENTS, BY TYPE OF PRODUCT

<table>
<thead>
<tr>
<th>Product Type</th>
<th>Number of Active Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Murabaha</td>
<td>800,000</td>
</tr>
<tr>
<td>Qard-Hassan</td>
<td>400,000</td>
</tr>
<tr>
<td>Musharaka/Mudaraba</td>
<td>50,000</td>
</tr>
<tr>
<td>Salam</td>
<td>30,000</td>
</tr>
<tr>
<td>Other</td>
<td>20,000</td>
</tr>
</tbody>
</table>

TYPES OF IMFIs

<table>
<thead>
<tr>
<th>Institution Type</th>
<th>Percent of Institutions Covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Village/rural banks</td>
<td>77%</td>
</tr>
<tr>
<td>NGOs</td>
<td>10%</td>
</tr>
<tr>
<td>NBFIs</td>
<td>5%</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>4%</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>3%</td>
</tr>
<tr>
<td>Other</td>
<td>1%</td>
</tr>
</tbody>
</table>

Note: NGOs = nongovernment organizations; NBFIs = nonbank financial institutions

Profit-and-Loss Sharing Products, by Number of Active Clients

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Active Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan</td>
<td>5</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>5</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>50</td>
</tr>
<tr>
<td>Sudan</td>
<td>529</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5,688</td>
</tr>
</tbody>
</table>

4. Role of Islamic Finance in promoting inclusive development

- Innovation, entrepreneurship and SMEs financing
- Risk sharing - Equity based contracts
- Connection to the real economy
- Solidarity (obligatory alms, endowments solidarity)
- Moral Filter – Social Responsibility - Sustainability
- Transport, Housing
- Health, Education, Transport, Housing
- Financial inclusion, Social cohesion
- Insulation from excessive leverage and speculative financial activities
- Food security, Renewable energy, Green economy,
4. Role of Islamic Finance in promoting inclusive development

b- Example of the benefit of using obligatory alms (Zaqat)

• Mohieldin et al (2011) : “we find evidence that 20 out of 39 OIC countries can actually alleviate the poorest living with income under $1.25 per day of the poverty line simply with domestic and remittances Zaqah collection”
4. Role of Islamic Finance in promoting inclusive development

b- Example - The Microfinance Development Program (MDP) of the Islamic Development Bank

The MDP aims to increase outreach of microfinance to reduce poverty through the development of Islamic Microfinance industry:

• Several modes of intervention, both Financial and Technical, designed to address the wide ranging microfinance needs in member countries, thus avoiding the one-size-fits-all approach.

• Leverages resources and partners with established Microfinance organizations – such as Grameen, BRAC, AGFUND and agencies such as DFID (UK), and now GIZ
Examples of Latest Islamic Model of Partnership with the poor

**Indonesia**
Rice growing, harvesting and local marketing

**Pakistan**
Cotton and rice growing, harvesting and marketing support to farmers.
Livestock (Cows and goats)

**Sudan**
Herbal tea growing, harvesting, packaging and marketing, local marketing and export.
Exotic vegetables and fruits growing in greenhouses, harvesting, local marketing and export

**Palestine:** Olive orchards to oil mill
5. Way forward

1. Fortifying the Infrastructure for **growth of Equity Financing**
   → Leverage on the productive potential of SMEs
   → Creating jobs specially for youth

2. Enhancing **financial inclusion through microfinance** and integrate it with other Islamic financial products (Micro-Takaful, Endowments, Zaqat)

3. Enhance Public and Private Sector Partnership through the issuance of sukuks for financing education, health and transport
   → **inclusiveness through the enhancing of the public services**

4. Developing dedicated regulatory, risk management and corporate governance frameworks for the different segments of the Islamic financial services industry to guarantee its sustainability
References

Thank you

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THE ISLAMIC DEVELOPMENT BANK

Snapshot

• Head Quarter: Jeddah, Kingdom of Saudi Arabia
• Regional Offices: Kazakhstan, Malaysia, Morocco and Senegal
• Field Representatives in several Member Countries
• AAA Rating by Moody’s, Fitch, and S&P. Zero-Risk Rating by the European Commission

Mission Statement

“To promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.”

Priority Areas

• Human Development
• Agricultural Development & Food Security
• Infrastructure Development
• Private Sector Development
• Intra-Trade among Member Countries
• R&D in Islamic Banking & Finance
THE ISLAMIC RESEARCH AND TRAINING INSTITUTE

- Islamic Research and Training Institute (IRTI) was established in 1981.
- The purpose of the organization is to develop and advance the Islamic Financial Industry through Research, Training, Advisory and Information.
- The name IRTI is now synonym with Islamic Finance, Islamic Economics and Islamic Banking.

**Functions**

- Undertake research for enabling the economic, financial and banking activities in Member countries to conform to Islamic Shariah.
- Provide advice, consultancy and technical assistance in Islamic Banking and Finance to IDB Group Members, to the Bank’s Member Countries and to third parties.
- Develop curricula and course material to disseminate research and policy findings in different fields, and organize seminars, workshops and training programmes for IDB member countries.
- Develop, update and maintain information systems and databases in Islamic Banking and Finance, and disseminate them through all modern media.
Profile of the Speaker

Mahmoud Sami Nabi, Senior Researcher Economist – IRTI

Mahmoud Sami NABI (Tunisian) is a Senior Research Economist at the Research Division of IRTI. Before joining IRTI in 2011 he occupied the position of Associate Professor of economics at the Sousse Institute of Higher Commercial Studies (Tunisia) and was a vice-director of the same institution for three years. He holds an Engineering Diploma from Tunisia Polytechnic School, and a PhD in economics from the University of Paris I Panthéon-Sorbonne. While pursuing his PhD studies he enrolled in the distance-learning program of the Institute of Islamic Banking and Insurance (London) and obtained the diploma in Islamic Banking and Finance in 2002.

He has published several papers in refereed international journals focusing on different subjects under the finance-development theme. He has recently focused his research on Islamic Economics and Finance and produced the following working papers:

- Have Islamic banks been more resistant than conventional banks to the 2007-2008 financial crisis?
- A Theory of Profit Sharing, Income Inequality and Capital Accumulation
- Islamic Banks and Bankruptcy among their Conventional Peers
- Access to finance and investment: does profit sharing dominate debt?

In addition to his research activities he is the Editor of the French Journal of IRTI “Etudes en Economie Islamique” and responsible of monitoring the administrative processes of the IDB Prize lecture series and the IDB Prize in Islamic Economics & Islamic Banking and Finance.
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