

# ENHANCING FINANCIAL INCLUSION THROUGH ISLAMIC FINANCE

Governments around the world are increasingly viewing financial inclusion as an important part of economic development. More than 50 countries have set formal targets and ambitious goals for financial inclusion which is critical in poverty alleviation and in line with the main features of a Shariah-compliant. While various Shariah-compliant programmes in Malaysia, Bangladesh and Indonesia have seen significant success in poverty alleviation in those countries, substantial improvements are needed in terms of financial infrastructure to enable the world's poor to benefit from economic advancement. With proper infrastructure and regulations in place Islamic finance will eventually contribute to a more inclusive economic growth.

**MALAYSIA**  
WORLD'S ISLAMIC FINANCE  
MARKETPLACE

## Financial Inclusion: A Key Component of Economic Growth & Development

Today, Islamic finance has accumulated assets worth more than USD2tn and is expected to surpass USD3tn by 2018.<sup>1</sup> To date, expansion has been concentrated in parts of the Middle East, South Asia and East Asia. Nonetheless with the promising growth it has achieved thus far, poverty is still a pervasive problem among many Muslim-majority nations. In line with the primary goals of Islam, financial inclusion which has been broadly recognized as critical in poverty alleviation and achieving inclusive economic growth<sup>2</sup> is consequently one of the main features of a Shariah-compliant financial system that should be given extra consideration.

Financial inclusion is broadly defined as a measure of the proportion of individuals

and firms that use financial services.<sup>3</sup> The benefits go beyond individuals and firms as greater access to financial services for both individuals and firms may help to reduce income inequality and accelerate economic growth.<sup>4</sup> Through financial inclusion, it enables a wider array of individuals and enterprises access to financial services. Over these types of services offered, it is then able to reach the economically and socially underprivileged group of people who have been excluded from the formal financial sector due to various factors such as socio-economic deficiencies that include, inter alia, financial capability and literacy, geographical inconvenience and a religious concern of prohibited elements such as Riba, Maysir and Gharar.

Importantly, with greater financial inclusion, this will enable all citizens, including the low-income and rural residents to undertake financial transactions, generate income, accumulate assets and protect themselves financially against unexpected adverse events, thereby enabling them to benefit from

economic progress. The successful achievement of the financial inclusion agenda will be characterized by the following outcomes<sup>5</sup>, which will in turn contribute to balance and sustainable economic growth and development:

<sup>1</sup> ISRA

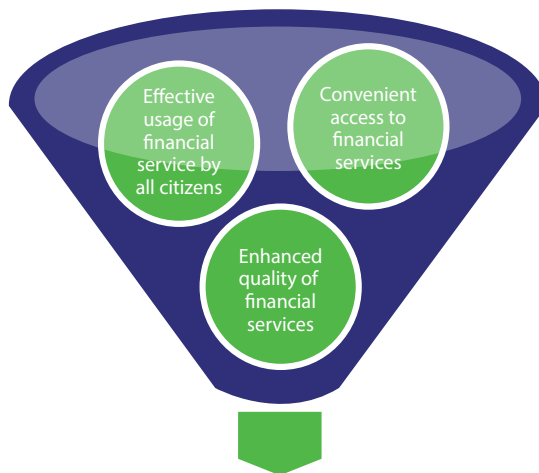
<sup>2</sup> "Measuring Financial Inclusion around the World", The Global Findex Database (2014)

<sup>3</sup> "Financial Inclusion: Reaching the Unbanked", Standard Chartered Global Research Special Report (2014)

<sup>4</sup> Burgess and Pande 2005; Beck, Demirguc-Kunt, and Levine 2007. See also, for example, King and Levine (1993); Beck, Levine, and Loayza (2000); Clarke, Xu, and Zou (2006); Klapper, Laeven, and Rajan (2006); and Demirguc-Kunt and Levine (2009).

<sup>5</sup> Bank Negara Malaysia Financial Sector Blueprint 2011-2020

## Financial Inclusion



Successful Achievement of Financial Inclusion

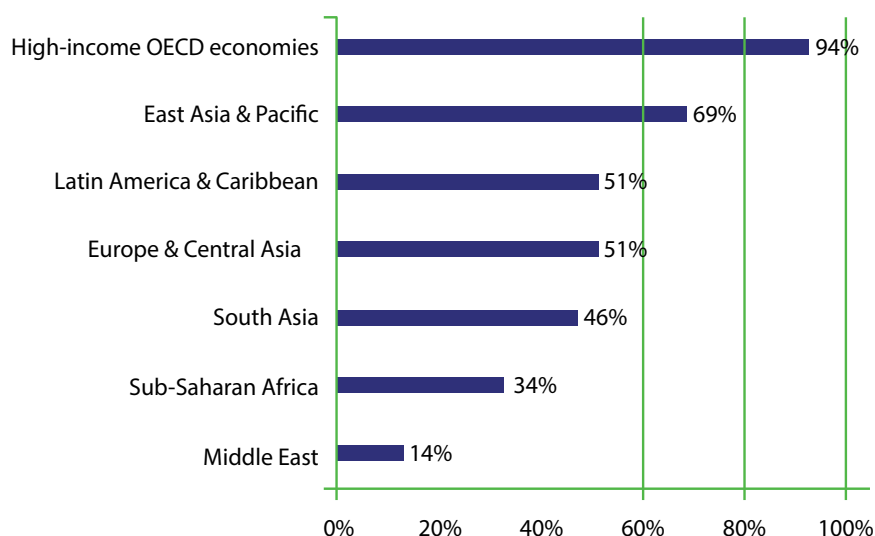
Source: Bank Negara Malaysia Financial Sector Blueprint 2011-2020

### The State of Financial Inclusion across the Globe Today<sup>6</sup>

Between 2011 and 2014, financial inclusion levels across the globe have broadly improved. Nevertheless, several key Islamic finance jurisdictions lag behind global averages of access to financial services. Using the most basic measure of share of adults with an account at a formal financial

institution, the 2014 Global Financial Inclusion (Global Findex) database reveals that 62% of adults worldwide have an account at a bank or another type of financial institution or with a mobile money provider. And between 2011 and 2014, 700 mln adults became account holders while the number of unbanked adults has reduced by 20%.

### Account Penetration by Region (2014)



Source: Global Findex database, World Bank (2014)

<sup>6</sup> "Measuring Financial Inclusion around the World", The Global Findex Database (2014)

Islamic finance clearly has room to grow in supporting financial inclusion, given that account penetration rates in key regions such as the Middle East, Sub-Saharan Africa and South Asia remain fairly low. In the Sub-Saharan African region, amongst the 34% of adults with an account, almost a third of account holders – or 12% of all adults is reported to have a mobile money account only. The mobile money account is increasingly being used in the Sub-Saharan Africa to extend financial services past the limits of bank branches. With the convenience and affordable financial services offered by the mobile money accounts, it promises to reach the unbanked adults traditionally excluded from the formal financial system – such as women, poor people, young people, and those living in the rural areas. An example is the

M-PESA found in Kenya, Tanzania, Afghanistan, South Africa, India and Eastern Europe.<sup>7</sup> Moving to the key Islamic finance jurisdictions, such as the Middle East, some parts of South Asia and East Asia & Pacific, there are wide disparities where account penetration ranges from only 14% in the Middle East, to 46% in South Asia and 69% in the East Asia & Pacific. These jurisdictions may benefit from the more inclusive nature of Islamic finance. Nevertheless, several challenges lie ahead for Islamic finance to truly fulfil its potential as a more inclusive source of financial services. To improve access to financial services, substantial improvements are needed in terms of financial infrastructure, for example credit information systems. In addition, newer Islamic finance jurisdictions are still in the early stages of regulatory development.

## Some Areas of Improvement for Islamic Finance to Achieve Inclusive Source of Financial Services



Source: Policy Research Working Papers - The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries

### Islamic Finance Role in Supporting Financial Inclusion

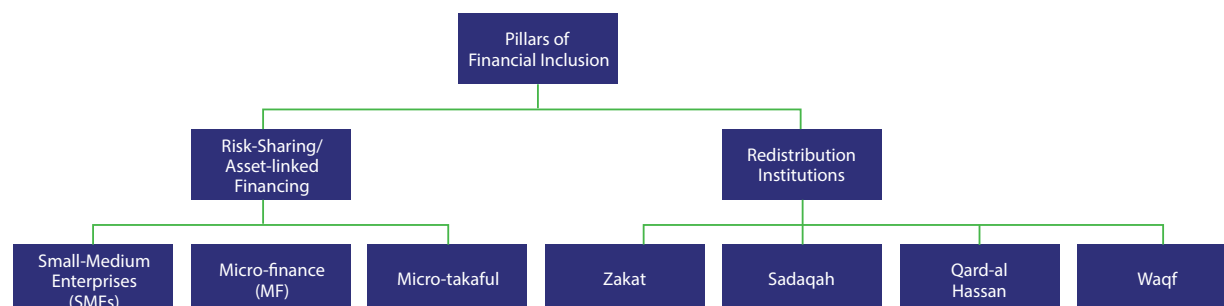
Islamic finance addresses the issue of financial inclusion from two directions – one through promoting risk-sharing contracts that provide a viable alternative to conventional debt-based financing, and the other through specific instruments of wealth redistribution among the society.<sup>8</sup> Recently, hopes for Islamic finance resurfaced through Shariah-compliant microfinance, small and medium enterprises (SMEs) and micro-takaful

which are designed to provide financial assistance to the poor, thus increasing financial inclusion among the Muslim population. The risk-sharing contracts will be used in the above types of financing, whilst the redistributive instruments such as zakat, sadaqah, qard al-hassan and waqf will complement the risk-sharing instruments to target the poor sector of the society so as to offer a comprehensive approach towards reduction in poverty and building a healthy economy.

<sup>7</sup> M-Pesa is a mobile-phone based money transfer and microfinancing service, launched in 2007 by Vodafone for Safaricom and Vodacom, the largest mobile network operators in Kenya and Tanzania. M-Pesa allows users to deposit, withdraw, transfer money and pay for goods and services easily with a mobile device.

<sup>8</sup> "The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", Mohieldin, Iqbal, Rostom and Fu (2012)

## Pillars of Financial Inclusion for Islamic Finance



Source: ISRA

Being the pillars of financial inclusion for Islamic finance, Islamic redistribution institutions such as zakat, sadaqah, qard al-hassan and waqf could support efforts to improve access to financial services. For example, researchers from the World Bank estimated that 20 out of 39 OIC countries have a large enough

zakat collection to alleviate poverty for those living with income below USD1.25 per day.<sup>9</sup> By estimating the share of Zakat to GDP vis-à-vis the resources needed to support poverty reduction, half of the sample countries were found to have enough Zakat funds to make up for the resource shortfall.

## Zakah Estimation to Fill the Poverty Gap

No	Country	Zakat (% of GDP)	Resource shortfall under \$1.25 per annum as % of GDP	Does zakat cover?	No	Country	Zakat (% of GDP)	Resource shortfall under \$1.25 per annum as % of GDP	Does zakat cover?
1	Albania	1.44	0.01	Y	21	Bangladesh	1.62	5.58	N
2	Algeria	1.77	0.14	Y	22	Bemin	0.44	5.78	N
3	Azerbaijan	1.82	0.01	Y	23	Burkina Faso	1.06	9.83	N
4	Cameroon	0.32	0.26	Y	24	Comoros	1.77	8.89	N
5	Djibouti	1.75	1.49	Y	25	Cote d'Ivoire	0.66	2.05	N
6	Egypt	1.9	0.04	Y	26	Gambia	1.72	5.42	N
7	Gabon	0.17	0.03	Y	27	Guinea	1.52	6.71	N
8	Indonesia	0.89	0.39	Y	28	Guinea-Bissau	0.76	8.21	N
9	Iran	1.79	0.02	Y	29	Guyana	0.13	0.88	N
10	Iraq	1.78	0.09	Y	30	Mali	1.67	8.2	N
11	Jordan	1.77	0.01	Y	31	Mozambique	0.41	13.62	N
12	Kazakhstan	1.02	0	Y	32	Niger	1.77	8.31	N
13	Kyrgyz Republic	1.55	0.02	Y	33	Nigeria	0.91	8.26	N
14	Malaysia	1.09	0.06	Y	34	Senegal	1.74	3.05	N
15	Maldives	1.77	0.91	Y	35	Sierra Leone	1.28	16.1	N
16	Morocco	1.81	0.02	Y	36	Suriname	0.29	0.61	N
17	Pakistan	1.55	0.04	Y	37	Tajikistan	1.51	1.7	N
18	Syrian Arab	1.39	0.02	Y	38	Togo	0.22	6.42	N
19	Turkey	1.86	0.04	Y	39	Uganda	0.22	3.1	N
20	Yemen	1.78	0.87	Y					

Source: Mohieldin, Iqbal, Rostom and Fu(2011)

<sup>9</sup> "The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", World Bank (2011)



In regard to Shariah-compliant microfinance and SMEs programmes, there are several Shariah-compliant microfinance and SMEs programmes found in some of

the Muslim countries. These amenities are offered by either the federal government, state government, non-governmental organizations or banking institutions.

### Selected Malaysian Organizations that offer Islamic Microfinance Programmes

Federal Government	State Government	Non-Governmental Organizations	Bank
<ul style="list-style-type: none"> <li>• Yayasan Pembangunan Ekonomi Islam Malaysia</li> <li>• Perbadanan Nasional</li> </ul>	<ul style="list-style-type: none"> <li>• Yayasan Pembangunan Usahawan (Terengganu)</li> <li>• Yayasan Bina Upaya (Perak)</li> <li>• Yayasan Dar Al-Qard Al-Hasan (Selangor)</li> </ul>	<ul style="list-style-type: none"> <li>• Amanah Ikhtiar Malaysia (AIMI)</li> </ul>	<ul style="list-style-type: none"> <li>• Agrobank</li> <li>• Bank Simpanan Nasional</li> <li>• Bank Rakyat</li> <li>• CIMB Islamic</li> </ul>

Source: Abdullah, 2015

In Malaysia, there are several Shariah-compliant microfinance programmes offered utilizing the risk-sharing contracts. Through the Shariah-compliant microfinance programmes offered, AIM has managed to lift 347 thousand people from the poverty-line into becoming entrepreneurs by 2014.<sup>10</sup> AIM has a membership populace of 129 thousand members and investments worth USD21.27 mln as at August 2014; while the total cumulative funds disbursed on the 30th September 2014 was USD3.18 bln.<sup>11</sup> It has exceeded its target in increasing the number of entrepreneurs and by enabling them to earn a constant monthly income. AIM was mandated by the government under the Economic Transformation Program to continuously increase its efforts to raise the living standards of low-income households and the number of entrepreneurs.

Apart from Malaysia, Bangladesh has also established a notable Shariah-based microfinance model – a poverty alleviation programme through Muslim Aid Bangladesh (MAB). The programme is purely a social mission geared to empower the underprivileged and marginalized people in Bangladesh.<sup>12</sup> By end of 2013, it served 53, 832 depositors, with a total deposit

amount of USD3.4 mln and 43, 893 borrowers with USD6.6 mln gross loan portfolio.<sup>13</sup> There is also the Rural Development Scheme (RDS), mainly for the poor women of the rural areas of Bangladesh under the Islamic Bank Bangladesh Limited (IBBL). As of 2012, RDS has disbursed approximately USD577 mln benefitting 624, 591 in 13, 373 villages within 61 districts.<sup>14</sup> IBBL plans to extend the RDS programme to all its 266 branches across the country's 64 districts in the coming years.<sup>15</sup>

Moving to the world's largest Muslim population, there are various Shariah-compliant programmes offered in Indonesia.<sup>16</sup> For example, Amarth Microfinance<sup>17</sup> was founded to serve the low-income people living in Indonesia's rural areas who have limited access to affordable and quality financial services. By end of 2013, the institution has in total 4, 400 members from 51 villages across 9 sub-districts in Bogor regency. The members are 100% women. The institution hopes to become a nationwide MFI that provides affordable financial services to 1 mln low-income families by year 2020.

<sup>10</sup> "Financial Inclusion: The future of a sustainable economy", S. Abdullah (2015)

<sup>11</sup> "Financial Inclusion: The future of a sustainable economy", S. Abdullah (2015)

<sup>12</sup> <http://www.mixmarket.org/mfi/muslim-aid>

<sup>13</sup> <http://www.mixmarket.org/mfi/muslim-aid>

<sup>14</sup> "Poverty Reduction Scaling Up Local Innovations for Transformational Change", United Nations Development Programme (UNDP)

<sup>15</sup> "Poverty Reduction Scaling Up Local Innovations for Transformational Change", United Nations Development Programme (UNDP)

<sup>16</sup> The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", World Bank (2011)

<sup>17</sup> Amarth Microfinance Annual Report, 2013

## Financial Inclusion: An Important Part to Economic Growth and Development of Nations

Governments around the world are increasingly viewing financial inclusion as an important part to economic development as it is important for a sustainable economy. This is evident with over 90 developing countries, representing more than 75% of the world's unbanked population, signing the Maya declaration since 2011.<sup>18</sup> As a key link in achieving desirable socioeconomic outcome, financial inclusion has become an increasingly important concern for a vast number of countries worldwide. For example, the World Bank's 2014 Global Financial Development Report (GFDR) on financial inclusion reported that more than two-thirds of regulatory and supervisory agencies have been tasked with encouraging financial inclusion, and more than 50 countries have set formal targets and ambitious goals for financial inclusion.<sup>19</sup> In addition, among the bank regulators in 143 jurisdictions, a recent survey found that 67% have a mandate to promote financial inclusion.<sup>20</sup> It has also been informed that the World Bank Group and a broad coalition of partners have issued numeric commitments to promote financial inclusion and achieve universal financial access by the year 2020.<sup>21</sup>

In regard to Islamic finance, even though it has

achieved rapid growth over the past years, further progress can be made to support the socioeconomic aspects. Furthermore, the risk-sharing contracts inherent in Islamic finance complemented with the redistributive instruments such as zakat, sadaqah, qard al-hassan and waqf can facilitate access to finance by the Shariah-compliant microfinance and SMEs programmes, thus creating an enabling environment for economic and social development. IMF also highlighted that for Islamic finance sectors to facilitate financial inclusion, access to the banking services to the undeserved Muslims has to increase<sup>22</sup>. However to realize the potential of Islamic finance in achieving financial inclusion, some areas of Islamic finance shall need further enhancements. This include improvising the current operating model of Islamic banks, private and public sector initiatives to strengthen the role of Islamic finance in broadening financial access and necessary reformations made to both the financial infrastructure and regulation.<sup>23</sup> Indeed, Islamic finance is a more equitable and just financial system designed to support growth and betterment of society. Hence with proper infrastructure and regulations in place to support the potential of Islamic finance, this will eventually contribute to a more inclusive economic growth.

<sup>18</sup> The declaration is a set of measurable commitments that aim through financial inclusion to improve social and economic conditions of the poorest in society.

<sup>19</sup> IMF Working Paper - Can Islamic Banking Increase Financial Inclusion?

<sup>20</sup> World Bank 2014

<sup>21</sup> "World Bank Groups and a Coalition of Partners Make Commitments to Accelerate Universal Financial Access", The World Bank IBRD-IDA (17th April 2015)

<sup>22</sup> "Growth of Islamic Finance to Facilitate Financial Inclusion", IslamicFinance.com (27th June 2015)

<sup>23</sup> "Can Islamic Banking Increase Financial Inclusion?", IMF Working Paper (2015)

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