



# ISLAMIC FINANCE: PROMOTING REAL ECONOMIC DEVELOPMENT

During the global financial crisis and its aftermath, Islamic financial institutions were less affected, protected by their fundamental operating principles of risk sharing and the avoidance of leverage and speculative financial products. This has led to a greater appreciation of the role of Islamic finance in supporting economic growth across the globe. With its in-built principles that support financial stability, inclusiveness and economic development, Islamic finance lends itself well to catalysing and promoting real economic.



## Contribution of Islamic Finance to Real Economic Development

While overall economic growth in 2015 remains moderate, with uneven prospects across the main countries and regions<sup>1</sup>, pockets of economic activities continued to expand in key real sectors such as infrastructure (including transportation, power and utilities and telecommunications).<sup>2</sup> Comparative to last year, the prospects for advanced economies are improving, while growth in emerging market and developing economies is projected to be lower, reflecting weaker outlook for some large emerging market economies and key Islamic finance oil-exporting countries.<sup>3</sup> However, important processes which contribute to real economic development such as sovereign funding, financing of business and household transactions remained an important areas for Islamic finance to serve.<sup>4</sup> Key Islamic finance segments such as Islamic banking and capital markets continued to support economic growth across the globe by providing Shariah-compliant modes of funding and financing. It is noteworthy to inform that Islamic finance not only offers an alternative source of financing for real economic development but also has inherent characteristics and principles that lend themselves well to catalyzing and

promoting real economic development.<sup>5</sup>

Some characteristics and principles of Islamic finance include being an equity-based, asset-backed, ethical, sustainable, environmentally and socially-responsible type of financing which promotes risk sharing, connects the financial sector with the real economy, and emphasizes financial inclusion and social welfare in the economy.<sup>6</sup> As the 2008 global financial crisis witnessed a series of unparalleled financial meltdown and disruptions of the international financial system<sup>7</sup>, Islamic financial institutions (IFIs) were less affected, protected by their fundamental operating principles of risk-sharing and the avoidance of leverage and speculative financial products.<sup>8</sup> This has led to a greater appreciation on the distinct nature of Islamic finance in addition to its explicit in-built strengths that supports financial stability.<sup>9</sup>

In summary, the contribution of Islamic finance to real economic development among others include the inherent nature of Islamic finance which promotes real economic development, the availability of socio-economic tools that could help to improve financial access and foster the inclusion of those deprived of financial

<sup>1</sup> International Monetary Fund (IMF) World Economic Outlook (2015)

<sup>2</sup> MIFC

<sup>3</sup> International Monetary Fund (IMF) World Economic Outlook (2015)

<sup>4</sup> MIFC

<sup>5</sup> United Nations ESCAP (Economic and Social Commission for Asia and the Pacific)

<sup>6</sup> [www.worldbank.org](http://www.worldbank.org)

<sup>7</sup> <http://www.albany.edu>

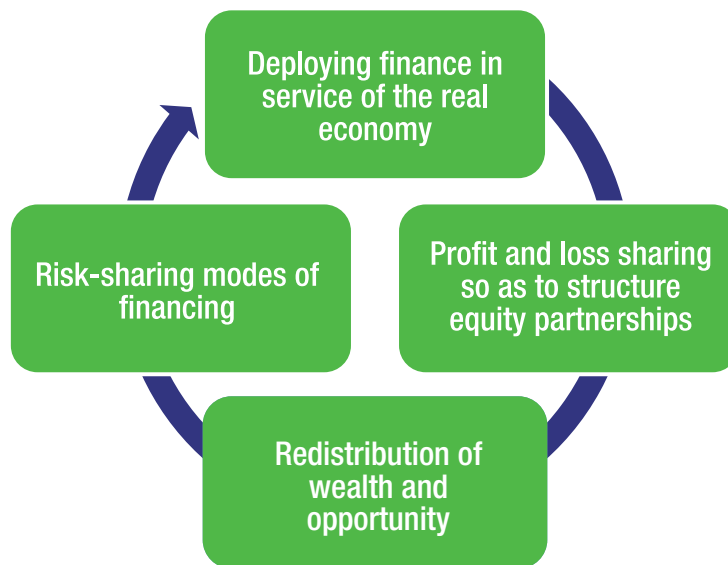
<sup>8</sup> Opening address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Shari'ah Research Academy for Islamic Finance (ISRA) Colloquium 2012 "Islamic finance in a challenging economy – moving forward", Kuala Lumpur, 27 November

<sup>9</sup> Opening address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Shari'ah Research Academy for Islamic Finance (ISRA) Colloquium 2012 "Islamic finance in a challenging economy – moving forward", Kuala Lumpur, 27 November 2012.

services to achieve real economic growth and the availability of formal Islamic financial services in several Muslim-majority markets

which previously, have remained largely undeserved by the financial sector due to religious reasons.

**Key Principles of Islamic Finance which Promote Real Economic Development**



Source: United Nations ESCAP (Economic and Social Commission for Asia and the Pacific)

There are several key principles of Islamic finance which help to promote real economic development. These include among others the deploying of finance in service of the real economy, greater emphasis on profit and loss sharing, facilitate redistribution of wealth and opportunity and utilize risk-sharing modes of financing.<sup>10</sup>

It is important to note that firstly, the sustainable development nature of Islamic finance offers benefits for economic growth, reducing poverty and fostering shared prosperity. In addition, Islamic finance can significantly contribute to economic development, given its direct link to physical assets and the real economy. Secondly, greater emphasis on profit and loss sharing encourages the provision of financial support to productive

enterprises that can increase output and generate jobs. The emphasis on tangible assets ensures that the industry supports only transactions that serve a real purpose, thus discouraging financial speculation. Thirdly, the redistribution of wealth and opportunity in Islamic finance helps to promote financial sector development and broadens financial inclusion. This is because through the redistribution of wealth and opportunity, Islamic finance could help improve financial access and foster the inclusion of those deprived of financial services. Finally, the risk-sharing modes of financing could be useful in improving access to finance for the poor and small businesses. Overall, these key principles of Islamic finance can help to create a better understanding of the positive role that Islamic finance can play in promoting real economic development.

**Shariah-Compliant Socio-Economic Financial Tools: Towards the Attainment of Real Economic Development**

Positive economic growth is linked with the goal of enhancing financial inclusion.<sup>11</sup> Hence, in line with the main aims of Islam, socio-economic tools which

have generally been known as critical in achieving financial inclusion, is one of the main instruments in the Islamic financial system that should be given extra consideration. Various socio-economic financial tools that are designed to provide financial assistance to the poor include the Shariah-compliant

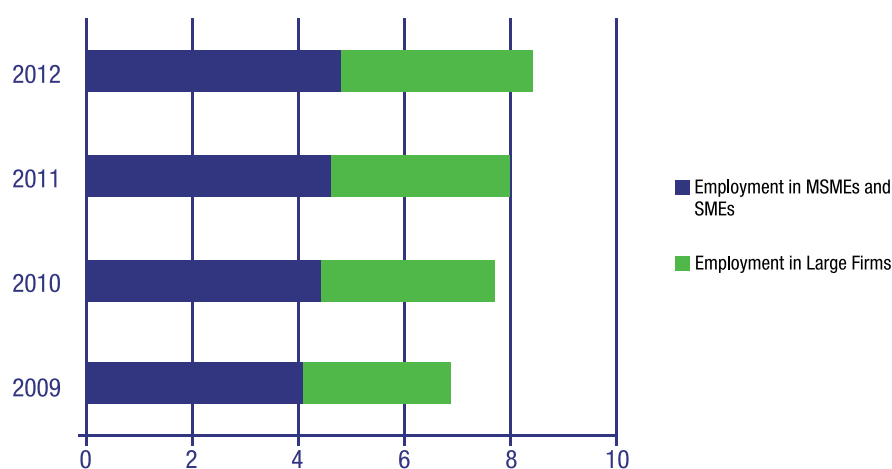
<sup>10</sup> United Nations ESCAP (Economic and Social Commission for Asia and the Pacific)

<sup>11</sup> "A Big Step Forward for Bolstering Financial Inclusion", IMF direct, The International Monetary Fund's global economy forum (28th January 2015)

micro-small medium enterprises (MSMEs), and small and medium enterprises (SMEs). Alongside the socio-economic financial tools, Islamic financial system can also further tap into both the zakat and waqf system as part of serving the real economy. As part of attaining real economic development, the overall Islamic financial system has taken various

steps to promote MSMEs and SMEs. In key Islamic finance jurisdiction such as Malaysia, MSMEs and SMEs play a key role towards the economic growth of the country. In 2012, MSMEs and SMEs absorbed approximately 4.8mln workers, whilst large firms absorbed approximately 3.6mln workers only.<sup>12</sup>

**Employment in MSMEs & SMEs and Large Firms (million)**



Source: Malaysia Islamic Finance Report 2015

Moving to other key Islamic finance jurisdiction such as Indonesia, presence of Shariah-compliant MSMEs and SMEs in Indonesia are also important engine

for economic growth, representing 99.99 percent of market share of all businesses, absorbing 97.2 percent of employments.<sup>13</sup>

**Profile of MSMEs in Indonesia**

	Number		GDP		Labour	
<b>Micro</b>	55,856,176	98,79%	2,951,120.2	35.81%	99,859,517	90,12%
<b>Small</b>	602,195	1.11%	798,122.2	9.68%	4,535,970	4.09%
<b>Medium</b>	44,280	0.09	1,120,325.3	13.59%	3,262,023	2.94%
<b>Total MSMEs</b>	55,206,444	99.99%	4,869,568.1	59.08%	107,657,509	97.16%
<b>Large</b>	4,952	0.01%	3,372,296.1	40.92%	3,150,645	2.84%
<b>Total</b>	56,539,560		8,241,864.3		110,808,154	

Source: Ministry of Cooperative and SMEs, 2012. Yearly revenues for small: <IDR 1 billion; medium IDR 1-5 billion; large >IDR 5 billion

The Financial Services Authority/Otoritas Jasa Keuangan (OJK) issued the regulation which requires commercial banks to allocate a minimum of 20% of their total financing for MSMEs.<sup>14</sup> Evident to this statement, PT Bank Syariah

Mandiri has extended its Shariah-compliant microfinancing services to various rural parts of Indonesia whilst Bank Rakyat Indonesia (BRI) Syariah were also expected to triple its loans to micro, small and medium businesses in 2011.<sup>15</sup>

<sup>12</sup> Malaysia Islamic Finance Report 2015

<sup>13</sup> Ministry of Cooperative and SMEs, 2012

<sup>14</sup> Peraturan Bank Indonesia Nomor 14/22/PBI/2012

<sup>15</sup> "Microfinance Dominates Indonesian Shariah Loans: Islamic Finance", Bloomberg Business (November 2010)

### Key Features of Microfinancing Products



Source: Nawai, N. and Mohd Shariff, M.N. (2011)

Apart from the above, voluntary sector such as zakat and waqf are also essential tools towards achieving economic growth. If properly executed, it can play a major role towards unemployment and poverty elimination, eventually contributing towards the economic growth of the Muslim societies. In the case of zakat, through proper distribution among the recipients of zakat<sup>16</sup>, each and every individual can then be assured of a minimum standard of living.<sup>17</sup> In key Islamic finance jurisdiction such as Malaysia, IFIs have thus far played its role towards the fulfilment of zakat. For example, both Bank Islam Malaysia Berhad (BIMB) and Maybank Islamic offer online zakat services so as to help both the IFIs and the Muslim society to fulfil their obligations and create greater awareness on the importance of zakat towards achieving the community social agenda.<sup>18</sup> The average figures for the distribution of zakat in Malaysia among the recipients also present a stable scenario where around 40% of the total zakat is channelled to the poor and

needy.<sup>19</sup> In addition, the zakat distribution and collection have also grown consistently over the years, where the distribution of zakat as a percentage of collection is 80% on average over time, and has further improved to approximately 85% over the last five years.<sup>20</sup>

Moving to waqf, it is a type of institution that creates a sustainable entity, administered by the essential principles of perpetuity, inalienability and irrevocability. It is widely known that through proper administration of waqf, the existing gap between contemporary Islamic finance and its socioeconomic aspects can therefore be addressed, thus achieving its real economic goals. The institution of waqf has the potential to create robust not-for-profit entities that may address education, healthcare, and other social needs in the Muslim societies, thus unlocking both its economic potentials and philanthropic objectives.

<sup>16</sup> There are 8 recipients of zakat; destitute (masakeen), needy or poor (the fuqaraa), the alms collectors (amil' zakat), in the path of God (fi sabi lillah), people burdened with debt (gharimun), the wayfarers (ibnu assabil), people in bondage or slavery (riqab) and those who have inclined towards Islam (mu'allaf).

<sup>17</sup> www.ikim.gov.my

<sup>18</sup> www.bankislam.com.my and www.maybank.com.my

<sup>19</sup> Malaysia Islamic Finance Report 2015

<sup>20</sup> Malaysia Islamic Finance Report 2015

Key Islamic finance jurisdiction such as GCC has accordingly played its role towards waqf development. For example, the Central Bank of Bahrain and the IFIs together established the waqf fund in 2006, proceeds from which were allocated to finance training, education and research at various levels in the Islamic finance.<sup>21</sup> The Jeddah-based Islamic Development Bank (IDB) established the World Waqf Foundation (WWF) in 2001 in collaboration with waqf organizations, governmental organizations, NGOs and philanthropists from the private sector with an aim to promote waqf so as to contribute to the social and economic development of member countries and Muslim communities and to alleviate poverty.<sup>22</sup> For instance, the recent 304th meeting of the Board of Executive Directors of the Islamic Development Bank (IDB) held in Jeddah, has approved three grants for a total of USD540,000 under the IDB Waqf Fund for educational projects for Muslim communities in Australia, Germany and India.<sup>23</sup> Elsewhere, realizing the solid potential of mobilizing waqf for the development and

progress of the socioeconomic Muslim society has also inspired Islamic Bank Bangladeshi Limited (IBBL) to establish the cash waqf certificate in 1997.<sup>24</sup> More recently in this year, Malaysia's Bank Muamalat Malaysia Berhad (BMMB) has allocated approximately USD24mln (RM100mln) to develop 4.47ha of waqf land via collaborations with UDA Waqf Sdn. Bhd., a wholly-owned unit of UDA Holdings Bhd.<sup>25</sup> The development of waqf land is part of the company's ongoing effort to ensure the growth and diversification of waqf assets, maximise its potentials and increase its value as well as ensuring its continuous benefits."<sup>26</sup>

Taking all the above factors into considerations, waqf is a powerful socio-economic vehicle that, if efficiently managed, has the ability to eradicate poverty, establish socio-economic justice and achieve equitable distribution in a society. Notably, pledged assets in waqf are utilised to fund real economic activities or financial investments and the returns from these are then used to achieve the societal welfare and social benefits.

## Accessibility of Formal Islamic Financial Services in Muslim Countries Facilitate Economic Growth

Islamic finance can also help to meet the needs of those who do not currently use conventional finance due to religious reasons. Of the 1.6 bln Muslims in the world, only 14% use banks.<sup>27</sup> Therefore with the increasing availability of Islamic banks offering basic types of Shariah-compliant financing and savings services in several Muslim-majority markets, this can help to reduce the overall gap in access to finance, somehow supporting the goals of financial inclusion enhancement, eventually attaining real economic growth.<sup>28</sup>

These Muslim-majority markets which have remain largely undeserved by the financial sector due to religious reasons have taken concrete steps to support the development and growth of Islamic finance as a means to encourage the population to engage in formal financial services. For example in a handful of Muslim countries such as Nigeria, Turkey, Turkmenistan and Uzbekistan, approximately 25 percent of adults without an account reported religious reasons as a barrier, hence offering Islamic financial products and services in these countries could become the catalyst for account ownership expansion, simultaneously achieving financial inclusion enhancement.<sup>29</sup>

<sup>21</sup> "Waqf Can Be Financing Source For Wealth Distribution: Perak Regent", Bernama (November 2014)

<sup>22</sup> <http://www.idbgbf.org>

<sup>23</sup> Thomson Reuters Zawya

<sup>24</sup> Banking Model of Corporate Waqf: An Analysis of Wakaf Selangor Muamalat

<sup>25</sup> "Bank Muamalat Allocates RM100mil to develop wakaf land", The Star Online (January 2015)

<sup>26</sup> "Bank Muamalat Allocates RM100mil to develop wakaf land", The Star Online (January 2015)

<sup>27</sup> [www.worldbank.org](http://www.worldbank.org)

<sup>28</sup> A Gallup poll (2011) on the relationship between account penetration and "religiosity" found that Muslims are more likely than non-Muslims to report religion as a barrier to account ownership, including in Djibouti and Afghanistan.

<sup>29</sup> World Bank Global Findex (2014)

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, ISRA

## Conclusion and Way Forward

During the recent global financial crisis and its aftermath, the international financial system has experienced a series of unprecedented financial disturbances. However during this period, the Islamic financial industry has generally weathered these challenging financial and economic conditions.<sup>30</sup> In relation to this, Islamic finance highlights the importance of a close link between financial transactions and real economic activity, thus emphasising on the importance of serving the real economy. Overall Islamic finance not only offers an alternative source of financing for sustainable development activities and projects but more importantly it has inherent characteristics and principles that lend themselves well to catalysing and promoting real economic development.<sup>31</sup>

Moving forward, there are three important areas which are imperative to ensure the continued development of Islamic financial system for the purpose of serving the real economy. First is the need to highlight with greater clarity the value proposition of Islamic finance, ensuring that it remains a form of financial intermediation that serves the real economy and that it will continue

to be beneficial to the society.<sup>32</sup> This requires further in-depth applied research to develop more financial products that create closer links between Islamic finance and real economic activity, in terms of its operating models, risk management and supporting infrastructure. Second is for the outreach of Islamic finance to be inclusive and to be accessible to all, particularly the lower income groups and small businesses.<sup>33</sup> This is because an important agenda in the global economy is to achieve a more balanced growth with reduced income disparities. Third is for the effective dissemination of information to facilitate the standardisation and harmonisation process in Islamic finance.<sup>34</sup> Several developments in this recent decade have facilitated standardisation and harmonisation in Islamic finance. Examples include the extensive engagement related to setting the prudential standards for Islamic finance by the Islamic Financial Services Board (IFSB) and various international dialogues conducted between global Shariah scholars through several platforms and structured forums organized by the International Shariah Research Academy for Islamic Finance (ISRA) and others.

<sup>30</sup> Opening address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Shari'ah Research Academy for Islamic Finance (ISRA) Colloquium 2012 "Islamic finance in a challenging economy – moving forward", Kuala Lumpur, 27 November 2012.

<sup>31</sup> United Nations ESCAP (Economic and Social Commission for Asia and the Pacific)

<sup>32</sup> Opening address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Shari'ah Research Academy for Islamic Finance (ISRA) Colloquium 2012 "Islamic finance in a challenging economy – moving forward", Kuala Lumpur, 27 November 2012.

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### Islamic Financial System Developmental Areas for the Purpose of Serving the Real Economy



Source: ISRA



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