SECTION 1: ISLAMIC THEORY OF FINANCE AND ASSET-BASED FINANCING
VALUE PROPOSITION OF ISLAMIC FINANCE

- Direct link to real economy
- Certainty – supported by underlying activities (avoidance of gharar - uncertainty)
- Less leveraging

- Greater transparency & disclosure -
  - additional Shariah governance
  - unique risks
- Greater fiduciary duties & accountability

- Avoidance of unethical activities e.g. hoarding
- Avoidance of maysir (gambling), & riba (interest)

- Different contractual relationship
- Equity-based & risk-sharing transaction
- Clearly defined risk & profit-sharing characteristic served as additional built-in mechanisms
- Increase financial inclusion

... promote just, fair, trustworthy & honest, while ensuring equitable wealth distribution

... inherent features in Islamic financial transaction promote and sustain global financial stability

Islamic Finance...

fastest growing segment in global financial system...

Islamic Banks
US$ 1.076 trillion

Global Sukuk
US$ 178 billion

Takaful
US$ 15.2 billion

Islamic Mutual Funds
US$ 60 billion
An Enormous Potential

Total Assets
US$ 6.5 trillion by 2020*

Islamic theory of finance

- Shariah rules and regulations:
  - Islam establishes a unique system that protects individual investors and financial institutions from potential risks
  - Islamic finance is governed by Shariah rules
  - Forbid:
    - usury (riba)
    - gambling (maisir)
    - ambiguity (gharar)
    - stipulate that income must be an outcome of productive economic activities based on the principles of profit-and-loss-sharing contracts

600 IFIs in the world
680 funds
US$ 10 trillion

600 IFIs
680 funds
US$ 10 trillion

*GIFF 2012 by KFH
Islamic theory of finance

- Based on themes of Community Banking
- Ethical and Socially Responsible Investments
- Socio-economic justice
- Wealth accumulation and wealth distribution that is fair
- Supply of money therefore must be proportionate with the prospects of real growth
- Reinstate value for money and streamline its supply – currency peg

Islamic theory of finance

- Financial approach of Muslims should be governed by major sets of rules:

  Muslims are strictly prohibited from investing in or dealing with economic activities that involve interest, uncertainty, and speculation.

  Muslims are, not only discouraged but also, forbidden from investing in businesses that are engaged in illicit (haram) activities.

  Islam prohibits paying or receiving any predetermined fixed rate of return on borrowed/lent money; Charging interest (riba) tends to drive the poor into more poverty and create more wealth for the wealthy.

  Trade, not banking is the primary function of markets.
Islam And Poverty Eradication

- Islamic principles of poverty alleviation are based on the Islamic views of social justice and the belief in Allah Almighty.

- Islamic approach involves a holistic approach with set of anti-poverty measures:

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<th>Poverty Eradication Scheme of Islam</th>
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<td>Compulsory Transfer: Zakah</td>
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<td>Recommended Transfer: Charity</td>
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<td>State Responsibility</td>
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Islamic Financial Institutions

Profit Oriented
- Business process
- Asset growth
- Good Corporate Governance

Zakat and Islamic Social Institutions

Social Oriented
- Empowerment process
- Beneficiaries coverage
- Good Amil Governance

The Role of the State

Economic Justice and Welfare Oriented
- System Approach
- Economic Growth and Distribution
- Efficient and Accountable Bureaucracy

The Role of the Society

Individual Productivity Oriented
- Careness, Love and Affection
- Support to IFI and ZISI
- Fulfillment of “Sharing Spirit”

- The role of the state
  - Economic justice and welfare oriented
  - System approach
  - Economic growth and distribution
  - Efficient and accountable bureaucracy

- The role of the society
  - Individual productivity oriented
  - Careness, love and affection
  - Fulfillment of “sharing spirit”
  - Support to IFI and ZISI
Islamic Finance – A pro-development financial system?

- Prohibition of Interest
- Promotion of Exchange and Trade
- Information Asymmetry (gharar)
- Economic Institutions
- Property Rights
- Contracts,
  - Trust
  - Rules of Markets
- Business Ethics
- Entrepreneurship
- Redistributive Instruments (Zakaat, Qard-al-Hassan, Waqf, Sadaqat, etc)
- Economic Institutions
- Property Rights
- Contracts,
  - Trust
  - Rules of Markets
- Business Ethics
- Risk Sharing
- Economic Development
- Corporate Governance and Leadership
- Financial Inclusion

What causes the recurring boom-bust cycles and crises?

- Credit creation must be divided into 2 streams:
  - Credit used for the 'real economy', determining GDP ('real circulation credit' = \( C_R \))
  - Credit used for financial (non-GDP) transactions ('financial circulation credit' = \( C_F \))

Source: Werner (2013)
The effect of credit creation depends on the use of money

- Case I: credit creation for ‘real economy transactions’ CR ➔ nominal growth
  
  **Two possibilities**

  - (a) **Inflation without growth:**
    
    Credit creation is used for consumption:
    
    More money, but same amount of goods and services
    
    = **consumptive credit creation**

  - (b) **Growth without inflation:**
    
    Credit creation is used for productive credit creation:
    
    More money, but also more goods and services
    
    = **productive credit creation**

- Case II: Credit creation for financial transactions CF ➔ Asset Markets

**Asset Inflation, Boom-Bust Cycles:**

Credit is used for financial and real estate speculation:

More money circulates in the financial markets

= **speculative credit creation**
Credit for financial transactions explains boom/bust cycles and banking crises

- A significant rise in credit creation for non-GDP transactions (financial credit $C_F$) must lead to:
  - asset bubbles and busts
  - banking and economic crises

- **USA in 1920s**: margin loans rose from 23.8% of all loans in 1919 to over 35%

- **Japan in the 1980s**: $C_F/C$ rose from about 15% at the beginning of the 1980s to almost twice this share

- **UK banks 2001-11**: credit for the UK real economy (incl. mortgages) accounted for only 22% of their total assets

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**Riba prohibited**

- Intuitive description
  - ‘Earning money from money’ or interest, is prohibited. Profit, which is created when ‘money’ is transformed into capital via effort, is allowed. However, some forms of debt are permitted where these are linked to ‘real transactions’, and where this is not used for purely speculative purposes

- Linkage to ‘market failures’?
  - A real return for real effort is emphasised (investments cannot be ‘too safe’), while speculation is discouraged (investments cannot be ‘too risky’). This might have productive efficiency spillover benefits (‘positive externalities’) for the economy through linking returns to real entrepreneurial effort
Fair profit sharing

Intuitive description
Symmetric profit-sharing (eg. Musharakah) is the preferred contract form, providing effort incentives for the manager of the venture, while both the investor and management have a fair share in the venture’s realised profit (or loss)

Linkage to ‘market failures’?
Aligning the management’s incentives with those of the investor may (in contrast to pure debt financing) once again have productive efficiency spillover benefits for the economy, through linking realisable returns to real entrepreneurial effort

No undue ambiguity or uncertainty

Intuitive description
This principle aims to eliminate activities or contracts that are gharar, by eliminating exposure of either party to excessive risk. Thus the investor and manager must be transparent in writing the contract, must take steps to mitigate controllable risk, and avoid speculative activities with high levels of uncontrollable risk

Linkage to ‘market failures’?
This may limit the extent to which there are imperfect and asymmetric information problems as part of a profit-sharing arrangement. Informational problems might, for example, provide the conditions for opportunistic behaviour by the venture (moral hazard), undermining investment in all similar ventures in the first instance.
Halal versus haram sectors

- **Intuitive description**
  - Investing in certain haram sectors is prohibited (e.g., alcohol, armaments, pork, pornography, and tobacco) since they are considered to cause individual and/or collective harm.

- **Linkage to ‘market failures’?**
  - Arguably, in certain sectors, there are negative effects for society that the investor or venture might not otherwise take into account (negative externalities). Prohibiting investment in these sectors might limit these externalities.

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**SECTION II. FINANCIAL DEVELOPMENT, ECONOMIC GROWTH AND FINANCIAL INCLUSION**
Financial Development and Economic Growth and Welfare: What we know?

**Five Views**

- **Finance promotes Growth** - Schumpeter (1911), King and Levine (1993), Beck et al. (2000) and Haiss and Fink (2006)
- **Finance follows growth** - Robinson (1952), Gupta (1984), Demetriades and Hussein (1996)
- **Finance matters because financial crises hurt growth** - IMF/World Bank
- **Finance doesn’t matter in growth** - Lucas (1988)

**Financial Development and Economic Growth and Welfare: What the Theory Says?**

- Impact of Financial Development
  - improves the efficiency with which those savings are used and increasing the amount of capital and productivity.
  - Better screening and monitoring of borrowers can lead to more efficient resource allocation.
  - Share risk associated with high-quality investment. Improvement on risk-sharing can enhance savings rates and promote innovation, which will ultimately promote economic growth.
- Help to accommodate macroeconomic shocks
- Help to reduce poverty and undernourishment
- Better health, education and Gender Equality
- Help to mitigate a variety of risks

Channels of Interrelationships between Financial Development and Economic Growth and Wealth Welfare

- Efficiency of Capital
- Output Growth
- Capital Accumulation
- Innovation
- Financial Health of Customers
- Increased Demand of Financial Services
- Financial Development

First empirical study: Goldsmith (1969) – Found relationship but remained uncertain of the direction of causality.


Criticism of cross-country analysis: neglects some of the more country specific effects.


- Arestis, Demetriades, and Luintel (2001): focus on link between real growth and stock market development, long-run relationships causality may change, the relationship show substantial variation

- Rajan and Zingales (2003): the process is diverse and complex.

Debatable empirical results, but strong consensus for positive role of FD on growth and welfare.

Why Financial Inclusion is important

a. Worldwide, approximately 2.5 billion people do not have a formal account at a financial institution

b. Access to affordable financial services is linked to:
   a. Overcoming poverty
   b. Reducing income disparities
   c. Increasing economic growth

c. For the poor, access to the financial system can:
   a. Smooth consumption
   b. Improve resilience to shock
   c. Expand livelihood opportunities
*WHY ARE PEOPLE UNBANKED?*

The Global Findex shows 3/4 of the world's poor do not have a bank account, not only because of poverty, but also due to costs, travel distance and paperwork involved.

In all regions, with the exception of high income economies, borrowing from friends and family is the most commonly reported source of credit for current loans.

- **59%** of adults in developing economies don't have an account at a financial institution.
- **77%** of adults earning less than $2 a day.
- **11%** in high income economies.

**Access to financial services**

- User of formal financial services
- Non-users of formal financial services

**Involuntary exclusion**

- Cultural/religious reasons not to use/indirect access
- Insufficient Income/high risk
- Discrimination
- Contractual/informational framework
- Price/ Product features

**Voluntary self-exclusion**

- No Need

**Population**

- Access to financial services
- No access to financial services
Financial Inclusion Versus Financial Development: Concepts

- Financial inclusion: drawing unbanked population into the formal financial system.
- How?
  - not by disregarding risks and other costs when deciding to offer services, nor by forcing everybody should make the use of financial services
  - but by policy initiatives that aim to correct market failure and to eliminate nonmarket barriers to accessing a broad range of financial services.
- Benefits of financial inclusion: Financial Stability, equity, growth and poverty elevation
- Financial Inclusion: Current state
  - A global survey of regulators with regards to financial access (CGAP’s Financial Access 2009) = 2.6 billion unbanked adults in the developing world.
  - World Bank’s composite access indicator (2009) = the number of financially excluded adults significantly exceeds the adult population living under the $2-1-day poverty line.

Financial Inclusion Versus Financial Development: Financial inclusion and Poverty alleviation

Figure 3.1 Financial depth and poverty alleviation

Note: This figure is a partial scatter plot of growth of poverty headcount vs. private credit to GDP, controlling for the initial level of poverty headcount, with data averaged over the period 1980–2005.
FI promotes Savings and stability

- It helps to provide a more stable retail base of deposits.
- Including people into the formal financial system and opening accounts will increase the savings-base of the national financial system and thus increase the liquidity ratio, which in turn allow banks for more lending to companies and individuals, thus boosting the national economy.
- Raising small deposits nationally is also a positive factor since it reduces the financial sector reliance on external funding which can contract during financial crises.

Why does Financial Inclusion matter?

- Financial Inclusion is key to stability:
- Financial Inclusion and Financial Stability is not no longer policy option but policy compulsion.
- 1. FI supports financial sector deepening and broadening by:
  a) Using new channels,
  b) Applying new technologies,
  c) Developing new products and services,
  d) Including new financial sector actors and
  e) Widening segments of the population into the formal financial system.
- 2. FI facilitates greater participation by different segments of the economy in the formal financial system.
- 3. FI helps to facilitate implementation of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) guidelines.
What is financial inclusion?

- Delivery of financial services to low-income segments at affordable cost.
  - Traditionally, poor have not considered as viable market.
- Four dimensions:
  - Easy access
  - Regulated and supervised institutions
  - Sustainability
  - Competition
- Nonusers: Cannot access or opt out of system.
  - Unbankable: Households and enterprises, who do not have enough income or present high lending risk.
  - Discrimination: Social, religious or ethnic grounds.
  - Unreached groups: Too costly to be viable.
  - Inappropriate products: Too high cost or feature is not appropriate.

Why is financial inclusion important?

- Developed financial sector promotes growth and reduce poverty.
  - Enables the poor to finance income-enhancing assets.
  - Reduce vulnerability and exposure to adverse events.
- Two tracks of thinking in modern development theories:
  - Redistribution policies: Imbalance in redistribution of wealth and income as an impediment to growth.
  - Financial market frictions: Financial market imperfections is the key obstacles.
- Main problems in delivering credit are linked to risks arising from different sources.
- Financial inclusions holds back investment, persistent with income inequality and reduces poverty rates faster.
Issues with the conventional Approach to Financial Inclusion

- Redistribution aims to equalize outcomes and better financial systems serves to equalize opportunities.
- Two tracks to remove financial market frictions:
  - Developing the overall infrastructure.
  - Expanding credit to MSMEs.
- Key challenges by microfinance industry:
  - High Interest rate: Due to high transaction cost and high risk premium. But this imposes undue stress.
  - Recognizing that not every poor borrower is a micro entrepreneur: Need to promote entrepreneur, but funds constraint.
  - Diversion of funds: Funds used in nonproductive activities, some cases into a circular debt situation.

Issues with the conventional Approach to Financial Inclusion

- Large-scale fund mobilization: MFIs cannot mobilize funds on a large scale. Also have limited coverage.
- Product design: May require different product features with different payment and delivery structures.
- Absence of private sector participation: MFIs are not effective because of limitations. Need to move toward a market-based or private sector based solutions.
- Microloans does not produce dramatic transformations, but have some important outcomes.
  - Evidence of a shift away from nonproductive to productive activities.
Concept of Financial Inclusion in Islam

- Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system.
- From Islam’s concept of Property Rights view, property is not a means of exclusion but inclusion in which the rights of those less able in the income and wealth of the more able are redeemed.

Risk-Sharing or Hybrid Financing Instruments
- Micro-Finance (MF)
- Small-Medium Enterprises (SME)
- Micro-Insurance (Micro-Takaful)

Distributive and Re-Distribution Institutions
- Zakah (Mandatory contribution)
- Sadaqat (Voluntary contribution)
- Qard-al-Hassan (No cost debt)
- Waqf (Endowment)

Challenges of Islamic Microfinance in the OIC countries

- Small industry with limited product offering, serving only a fraction of the potential clientele
- Population of 57 OIC countries: 1.6 billion (733m below poverty line of USD 2 per day)
- 1.28m Islamic microfinance clients, mainly concentrated in 3 countries
- 255 institutions in 16 OIC countries
- Total loan portfolio of all microfinance institutions: USD 628m
- A fraction of loan portfolio most likely invested into housing
OIC Countries - Capital Markets

- Most GCC and MENA countries still are dominated by bank financing. Consistent with the theory that countries at early stages of development would be bank-centered financial systems.

- Capital markets are relatively under-developed. Islamic capital markets are even less developed.

- Outside of Malaysia, level of government engagement in developing Islamic capital markets is below expectations.

- Most governments borrow primarily in conventional form.
- Most sovereign wealth funds invest primarily in conventional form.

The concept of Financial Inclusion in Islam: Concept of Development

- **Concept of development has three dimensions:**
  - Individual self development
  - Physical development of the earth
  - Development of human collectivity

- **Individuals faces two kinds of risk:**
  - Uncertainty and risk due to external and internal economic circumstances and vulnerabilities to shocks.
  - Risk relates to personal lives.

- **According to Islamic perspectives, risk are mitigated in various ways:**
  - Rule based system: Complying with the rules reduces uncertainty.
  - Mitigate uncertainty by sharing risks: Sharing allows risk to be spread and thus lower for individuals.
Risk Sharing Approach of Islam

2. Redistributive risk-sharing instruments.
3. Inheritance rule.
   - Based of the belief that the system facilitates real sector activities through risk sharing.
   - Transactions are conducted via contracts of exchange, not through interest based debt contracts.
     - One reason is that this type of contract transfers all the risks, or at least major portion, to the borrower.
     - By exchange contracts, parties improve welfare, thus allowing division of labor and specialization.

Redistribution Instruments of Islam

- Used to redeem the rights of the less able in the income and wealth of the more able.
- Qur'an ordains that net surplus, after moderate spending, must be returned to the poor.
- Most important economic institution is the distribution-redistribution rule of Islamic economics paradigm.
  - The expenditures are repatriation and redemption of the rights of others in one's income and wealth.
  - The expenditures intended for redeeming these rights are referred as Sadaqat.
- Zakah is considered a component of Sadaqat.
- Qard-al-hasan is a voluntary loan, without any expectation by the creditor of any return on principle.
- Waqf is a trust established for a charitable purpose.
- Institution of inheritance is crucial in the intergenerational justice framework.
Public Policy Implications

- Microfinance do not allow businesses to grow beyond subsistence.
  - High interest rates reduce available resources.
  - Risk pooling allows greater opportunity for informal risk sharing due to repeated interaction among borrowers.
    - Structure can create tension between risk taking and risk pooling.
- Government can promote risk sharing broadly.
  - Have power, capacity and agent.
  - Reduce moral hazard and adverse selection by investigate, monitoring and enforcement.

Government as the Risk Manager
Promoting Risk Sharing

- In most economies, governments play a major role in bearing risk on behalf of their citizens.
- Competitive markets would have a stable equilibrium, provided some stringent conditions were met.
- It was clear, even in the best conditions, markets did not perform well.
  - Justifies government's intervention to protect the public interest.
- Contemporary societies implement social safety nets because individual households face substantial risk over their life span.
- Private insurance market do not provide perfect insurance against all risks.
- Before the recent crisis, it was assumed that government intervention was solely to address market failures.
- But providing a social security nets are also about collective risk sharing.
Need for Developing a Supportive Institutional Framework

Access to finance in many developing countries is constrained by:
- An underdeveloped institutional framework,
- Inadequate regulations and
- Lack of specialized supervisory capacity.
1. **Regulators should make financial inclusion a priority**: Not a priority in most of the 57 OIC countries.
2. **Priority should be given to improving financial infrastructure, especially the current credit information system**: Blocking further SME lending in MENA region.

Contribute to financial exclusions:
- Lack of access to credit information
- Small portion has a credit history.

3. **Infrastructure conducive to products complaints with Shari’ah should be developed**: Growth will depend on attractive and competitive products.
- Integrating Shari’ah compliant products and customer information will help to integrate with conventional finance.
4. **Micro-insurance should be developed and promoted**: Evidence of positive causal relationship at the country level between insurance penetration and economic growth.
- Micro takaful institutions are still significantly underdeveloped in OIC countries.
5. **Engagement by formal sector should be encouraged**: The development community is shifting away from microcredit institutions.
- Widening of financial sectors to the poor and small enterprises by private sector institutions required.
Institutionalization of Islamic Redistributive Instruments

- Islam provides a set of redistributive instruments that could play a critical role in enhancing financial access and reduce poverty.
- But requires institutional structures to being developed.
- Need to formalize or institutionalize redistributive mechanisms.
- Building nation-wide institutions and related legal infrastructures to maximize effectiveness.
- Institutional building can take place in three steps:
  - Development of institutions
  - Integrate them with the rest economic and financial system
  - Transparent mechanism to ensure enforceability of rules
- Objective is to formalize and standardize operations to facilitate each instruments.
- Policy makers need to pay attention to enhance access.
  - Should encourage development of these institutions through development of legal framework and transparent governance.

Financial Engineering

- Financial engineering can be used in financial inclusions and to enhance financial access.
- One way is to securitize assets generated by microfinance and SMEs.
  - *Sukuk* are a successful application of securitization.
  - A marketable instruments could be introduced to provide funding for much-needed microfinance and SME.
- Several researchers have suggested ways to formalize and institutionalize Islamic models of redistributions.
  - Establishing a nonprofit financial intermediary based on *Qard-al-hasan* model or MFIs based on a hybrid of Zakat, awqaf and sadaqat.
  - Securitization could be used to securitize assets in the MSME sector and to mobilize funding from the market.
- Similarly, issuing an equity instruments on the portfolio has an added advantage of improving domestic income distribution.
- Innovative techniques should be explored further by Islamic financial institutions.
- Policy makes should aim to encourage financial innovation.
SECTION III. POLICY ANALYSIS

Financial Inclusion Policies: General

Center for Global Development (Claessens et al. 2009) recommends ten policy principles for expanding financial access:

1. Promoting entry of and competition among financial firms.
2. Building legal and information institutions and hard infrastructure.
3. Stimulating informed demand.
4. Ensuring safety and soundness of financial service providers.
5. Protecting low-income and all customers against abuses by financial service providers.
6. Ensuring that usury laws, if used, are effective.
7. Enhancing cross-regulatory agency coordination.
8. Balancing government’s role with market provision of financial services.
10. Ensuring data collection, monitoring, and evaluation.
Financial Inclusion policies: Central bank Role

1. Agent Banking: policies that enable banks to contract with nonbank retail agents as outlets for financial services
2. Formalize microsavings: licenses for specialized institutions dedicated to taking microdeposits, licenses for nonbank financial institutions, bank licenses for successfully transforming financial NGOs
3. State bank reforms
4. Consumer protection and education
5. Lowering documentation barriers
6. Mobile banking

G20’s Financial Inclusion Experts Group (FIEG)

G20’S FINANCIAL INCLUSION EXPERTS GROUP (FIEG) 9 PRINCIPLES:
1. Leadership: Cultivate a broad-based government commitment to financial inclusion to help alleviate poverty.
2. Diversity: Implement policy approaches that promote competition and provide market-based incentives for delivery of sustainable financial access and usage of a broad range of affordable services (savings, credit, payments and transfers, insurance) as well as a diversity of service providers.
3. Innovation: Promote technological and institutional innovation as a means to expand financial system access and usage, including by addressing infrastructure weaknesses.
4. Protection: Encourage a comprehensive approach to consumer protection that recognises the roles of government, providers and consumers.
G20’s financial inclusion experts group 9 principles:

5. **Empowerment:** Develop financial literacy and financial capability.
6. **Cooperation:** Create an institutional environment with clear lines of accountability and co-ordination within government; and also encourage partnerships and direct consultation across government, business and other stakeholders.
7. **Knowledge:** Utilize improved data to make evidence based policy, measure progress, and consider an incremental “test and learn” approach acceptable to both regulator and service provider.
8. **Proportionality:** Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.
9. **Framework:** Consider the following in the regulatory framework, reflecting international standards, national circumstances and support for a competitive landscape: an appropriate, flexible, risk-based Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime; conditions for the use of agents as a customer interface; a clear regulatory regime for electronically stored value; and market-based incentives to achieve the long-term goal of broad interoperability and interconnection.

What should we focus on?

1. **Improve data collection and measurement:**
   - Understand better the impact of financial services (or lack of it) on the poor
   - Translate what we learn into better products & services
2. **Focus on new technologies & innovation:**
   - Branchless banking
   - Mobile money
3. **Target financial education:**
   - Consumer protection
   - Improve access
4. **Government to lead and prioritize financial inclusion:**
   - Balance between enabling and protective regulatory environment (Proportionality)
   - Payment systems & financial identification
Key products and services

1. Savings
   - basic low cost accounts
   - “Gateway” to other products
   - Facilitate G2P payments

2. Credit
   - Important for micro and small enterprises
   - Significant unmet demand
   - Lesson from the growth in microfinance

3. Insurance
   - Reduce risk
   - Reduce vulnerability of poor

4. Payments
   - Remittance
   - Micro and small enterprises

5. Education
   - Financial literacy
   - Informed choices

SECTION IV. INTEGRATED FINANCIAL INCLUSION POLICY IN ISLAM: NGO VERSUS IBS
Difference between Microfinance and Financial inclusion

- **Microfinance**
  - Initial focus on microcredit then broadened to other products
  - Providing access to financial services to the poor through a new low cost model
  - Providers often through informal or semi-formal
  - Transformation

- **Financial Inclusion**
  - Financial access through a diverse group of regulated or licensed providers
  - Policies to promote financial access are integrated or in harmony with the financial sector and its planning
  - Implicit preference for wider range of products and financial intermediation
  - Part of financial sector development, stresses links to the macro context: growth and stability
  - Demand side

An Integrated Islamic Model of Financial Inclusion

**Sources of Funds**
- ZAKAT FUND
- AWQAF FUND
- DONATION from other sources
- BORROWINGS from other Islamic Institutions
- RETAINED EARNING carried from Previous year
- CAPITAL MARKET Through issuing shares
- PROFIT or LOSS

**Uses of Funds**
- ZAKAT Donations to fulfill Basic Consumption
- ZAKAT Donations to fulfill Capital Investment Need
- CAPITAL Financing (From Awqaf Fund)
- WORKING Capital Financing (From Awqaf Fund)
- INVESTMENT in Islamic Bonds and other Instruments
- INVESTMENT in other Islamic Financial Institutions
- TOTAL REVENUE

**Expenses**
- NON-EARNING Investments
- EARNING Investments
Financing MSEs-Sustainability

- Mitigating **Credit Risk**
  - Ensure repayment in the absence of acceptable physical collateral
- Solving the **Moral Hazard** problem
  - Ensure funds not diverted and used for intended activity
- **Economic viability** — keep costs to a minimum relative to income
  - Operating costs
  - Financing costs

Sustainability-Relative Status

<table>
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<th>Credit Risk</th>
<th>Moral Hazard</th>
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<td><strong>W-MFI</strong></td>
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IBs is the most efficient MF Delivery Model

- There are strong economic reasons for establishing Islamic alternatives to poverty-focused microfinancing.
- Financing should adopt operational mechanisms of MFIs (as they suit these clients).
- Financing MSEs by IBs is most efficient (cost effective)—given the social responsibility and excess liquidity in IBs, financing MSEs should be undertaken.
- Traditional institutions of *waqf*, *zakat*, and *qard hassan* are important means of financing MSEs during contemporary times—should be integrated with microfinancing.

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