Islamic Finance: An Alternative Approach to Financial Inclusion

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ABSTRACT

Financial inclusions now a day buzz word and have attracted the attention of policy maker's researchers and academia. However the cross country data reveals the gap between Muslims and non-Muslims with regard to financial inclusion is very wide. The Islamic economic system with the policy of inclusion has the scope to play its role. The study will make an attempt to take away the fact that Islamic microfinance has the potential to not only respond the unmet demand but also to cater and care for less fortunate with microfinance power to provide financial access to the poor.

1. Introduction

The linkage between the development of countries financial sector and level and rate of economic growth has been proved by voluminous literature. Two hypotheses have been developed in this background and the studies so. The first is supply leading hypothesis suggests that financial development spurs growth, boosts overall economic efficiency, liquidity, savings, capital accumulation and entrepreneurship. The second hypothesis is demand leading, suggests a lagged response to economic growth implying growth creates demand for financial services leading to higher financial development and thus financial inclusion. Gurley, Shah 1955 and Patrick 1966 has found the functions of financial sector provide spatial design of economic growth. Goldsmith, 1969 study establishes a significant theoretical framework that indicates average rate of economic growth tend to be accompanied by faster financial development. North, 1990 and Neal, 1990 concluded from their studies that regions that developed more sophisticated and well functional financial system were the one that were the leaders of economic development of their times. Odedokun, 1998 also found the positive impact of real financial aggregates on development pace of the countries. Levine, 2005 based the

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cross sectional data sets argued the robust linkage between financial developments to economic growth. Hassen, Sachez and Yu 2011 validated the point of view of positive relationship between financial developments an economic development. The major conclusion of the empirical literature is the more developed the financial system and more prosperous the economic growth and vice versa.

However the major problem with this development and with the financial sector development is neither this development is inclusive, nor the financing services are accessible to the masses of the people. The exclusion may be both voluntary as well as involuntary. Keeping aside the involuntary as they are uncontrolled but the voluntary exclusion (due to faith reasons) creates yet another hindrance in the way of financial inclusion. According to the world value survey sixth wave (2011-2014) 75.4% respondents in 21 OIC member countries regard religions as very important as compared 36% holding the same in non-OIC countries. Most of the countries of OIC with significant Muslim population have high and raising poverty levels. Just 5 of them Indonesia, Bangladesh, Pakistan, Nigera and Egypt accounted over half a billion (528 millions) of world population with incomes below $2 a day. Interestingly these countries are also characterized with high degree of financial exclusion among there population. 31 out of 44 countries (for which estimates are available) over two-third were excluded from the formal system. Alarmingly, in 17 Muslim countries four-fifth of 80% of adult population had no access to financial services. This naturally raised questions, did the Islamic faith with its prohibition on interest based transaction play a role? Were the poor Muslims in these countries self-excluding themselves from formal financial system because of its incompatibility of their belief and culture with modern financial system? A survey of 6500 adults from 64 economies reveals that Muslims are significantly less likely than non-Muslims to own formal accounts or save at formal interest based financial institutions, after controlling for other individuals and country level characteristics (Demiurgic Kunt et.al 2013). Lone, N, Sumaiya, H, (2017) in their study revealed that Muslims financially at back step as compared to non-Muslims because of trust deficit (they do not have the trust on contemporary financial system despite the affirmative actions taken by the government) and financial illiteracy.

Muslims are more likely than non-Muslims to represent religion as a barrier to account ownership; however this result appears to be mainly driven by the respondents in Sub Saharan Africa (World Bank survey in 2013 Islamic finance and financial inclusion…..) Surveys in Jordan, Algeria and Syria for example revealed that 20-40 percent of respondents cite religion for not accessing conventional microfinance (Karim, Tarazi, 2008).

In this backdrop the study will make an attempt to take away the fact that Islamic microfinance has the potential to not only respond the unmet demand but also to cater and care for less fortunate with microfinance power to provide financial access to the poor. As Islamic financial principles are on the general principle of providing for welfare of the population by prohibiting practices considered unfair or exploitive.

2. Economic Development an Islamic Perspective

Islam is considered a rule-based system which specifies rules for social and economic activities of the society. In this respect, economic principles of Islam deal with (a) the rules of behavior (similar to the concept of economic institutions) as they relate to resource allocation, production, exchange, distribution and redistribution; (b) economic implications of the operations of these rules; and (c) incentive structure and policy recommendations for achieving rules compliance that would allow convergence of the actual economy to the ideal economic system envisioned by Islam. (Iqbal, Mirakhor, 2007)

The concept of development in Islam has three dimensions: individual self-development, the physical development of the earth, and the development of the human collectivity, which includes both (Mirakhor and Askari, 2010). The first specifies a dynamic process of the growth of the human person toward perfection. The second addresses the utilization of natural resources to develop the earth to provide for the material needs of the individual and all of humanity. The third dimension of development refers to the progress of the human collectivity toward full integration and unity. Happiness and fulfillment in a person's life is not achieved by a mere increase in income, but with a full development of a person along all three dimensions. At the same time, economic progress and prosperity is encouraged in Islam since this provides the means by which humans can satisfy their material needs and thus remove the economic barriers on the path to their spiritual progress. Economic transactions are based on freedom of choice and freedom of contract, which, in turn, require property rights over possessions to be exchanged.

It is widely recognized that the central economic tenant of Islam is to develop a prosperous, just and egalitarian economic and social structure in which all members of society can maximize their intellectual capacity, preserve and promote their health, and actively contribute to the economic and social development of society. Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of an Islamic society must be given the same opportunities to advance themselves; in other words, a level playing field, including access to the natural resources provided by God. For those for whom there is no work and for those that cannot work (such as the handicapped), society must afford the minimum requirements for a dignified life: shelter, food, healthcare and education.

3. Financing Economic Development

Financing of economic development is likely to represent some fresh challenges, especially at government level, in view of prohibition of *riba* in Islam. Absence of *riba* would imply an end to the all-too familiar dichotomy between the mobilization of funds by financial intermediaries from the savers on one hand and profitable applications of the funds by investors, on other. Practically the funds will flow:

(i) parallel to sale/purchase transactions on credit
(ii) under participatory financing arrangements
(iii) in leasing context

The doors will be closed on the financing of exciting debt with newly floated debt. On the positive side trying of funds directly to economic transactions will put an end to speculative investments and lead to greater financial and fiscal health of economy. As argued by Tahir (1994, 1995) the Islamic financial system will have enough flexibility to meet any existing or conceivable need. There may be some transaction costs due to new approach to project management, especially in case of large projects with long gestation period. However those costs pale in comparison with the social costs of periodic financial scandals in interest-based economies. In this regard the Islamic finance even though it has achieved rapid growth over the past years. Further progress can be made to support the socio-economic aspects furthermore. Risk-sharing contracts inherent in Islamic finance complement with redistribution institutions can have access to financing by Sharia compliant micro-finance and SME,s progress. Thus creating an established environment for economic and social development.

4. Principles of Islamic Finance

Islamic finance refers to a system of finance based on Islamic law (commonly referred to as Sharia) (Karim, Tarazi, 2008). Islamic financial principles are premised on the general principle of providing for the welfare of the population by prohibiting practices considered unfair or exploitative. The most widely known characteristic of the Islamic financial system is the strict prohibition on giving or receiving any fixed, predetermined rate of return on financial transactions. This ban on interest, agreed upon by a majority of Islamic scholars, is derived from two fundamental Sharia precepts:

Money has no intrinsic worth. Money is not an asset by itself and can increase in value only if it joins other resources to undertake productive activity. For this reason, money cannot be bought and sold as a commodity, and money not backed by assets cannot increase in value over time.

Fund providers must share the business risk. Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors (who share the rewards as well as risks associated with their investment). Islamic finance, however, extends beyond the ban of interest-based transactions. Additional key financial principles include the following:

- **Material finality.** All financial transactions must be linked, either directly or indirectly, to a real economic activity. In other words, transactions must be backed by assets, and investments may be made only in real, durable assets. This precludes the permissibility of financial speculation, and therefore, activities such as short selling are considered violations of Sharia.
- **Investment activity.** Activities deemed inconsistent with Sharia, such as those relating to the consumption of alcohol or pork and those relating to gambling and the development of weapons of mass destruction, cannot be financed. In broader terms, Sharia prohibits the financing of any activity that is considered harmful to society as a whole.
- **No contractual exploitation.** Contracts are required to be by mutual agreement and must stipulate exact terms and conditions. Additionally, all involved parties must have precise knowledge of the product or service that is being bought or sold.

5. Islamic Finance and Financial inclusion

Financial inclusion, a concept that gained its importance since the early 2000s, has been a common objective for many governments and central banks in developing nations. The concept initially referred to the delivery of financial services to low-income segments of society at affordable cost. During the past decade, the concept of financial inclusion has evolved into four dimensions: easy access to finance for all households and enterprises, sound institutions guided by prudential regulation and supervision, financial and institutional sustainability of financial institutions, and competition between service providers to bring alternatives to customers. Traditionally, the financial inclusion of an economy is measured by the proportion of population covered by commercial bank branches and ATMs, sizes of deposits and loans made by low-income households and SMEs. However, availability of financial services may not equal financial inclusion, because people may voluntarily exclude themselves from the financial services for religious or cultural reasons, even though they do have access and can afford the services (Beck,Demirguc-Kunt 2008

6. 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 (The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", Mohieldin, Iqbal, Rostom and Fu (2012) 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. Risk sharing and redistribution institutions being the pillars of financial inclusion for Islamic finance. Islamic redistribution institutions such as Zakat, sadqadah, qardal-hassan and waqf 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 (The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", World Bank (2011) 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. 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, nongovernmental organizations or banking institutions (Iqbal, Z, (2014).

7. Conclusion

Access of the public to financial services enables it to participate in the development process and benefit from it. Islamic finance makes financial services relevant for a large segment of the world population. However, despite progress in different segments of the Islamic financial services industry, Islamic microfinance institutions have an extremely limited presence and outreach. In order to enhance the reach and richness of Islamic microfinance it is imperative to examine the major challenges confronting this sector in a holistic manner and find in partnership with the various stakeholder's strategic solutions to redress the challenges. It is recommended that Islamic banks should give equal priority to agriculture finance, SME finance and in ensuring their presence in less privileged areas of the country. Finally, cost competitiveness is also needed for faster growth and adoption of Islamic banking.

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