Can Islamic Banking Increase Financial Inclusion in the Muslim World?

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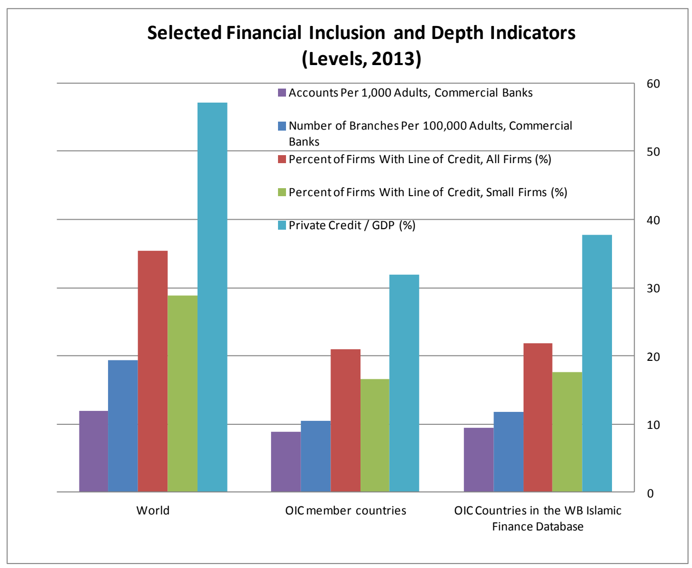
Can Islamic Banking increase financial inclusion in the Muslim world? This is the main question of a recent IMF paper on Islamic Banking, attempting to establish a clear link between Islamic Banking and financial inclusion.

Less Financial Access and Use

Using a comprehensive set of financial inclusion indicators from IMF and World Bank databases, the paper finds that Islamic banking has so far had a limited impact on financial inclusion. Despite the rapid growth of Islamic Banking in recent years—total assets worldwide more than doubled since 2006—its expansion is still in its early stages (2 percent of global banking assets). In addition, the data suggests that countries from the Organization of Islamic Cooperation (OIC) have less access to financial services and make less use of them than the rest of the world (see Chart).



Sources: IMF, Financial Access Survey; World Bank Enterprise Survey; World Bank Finstats database.

A number of factors can help explain the low access and use of Islamic Banking: i) a less developed financial infrastructure—including legal rights—that limit the capacity of Islamic Banks to select, monitor, and fund households and SMEs; ii) a regulatory framework adapted to conventional finance institutions rather than Islamic ones; and iii) lack of trained bank personnel in Shari'ah-compliant instruments that impedes a more rapid outreach of services.

Vast Need and Potential

Despite existing constraints, there is an important role for Islamic Banking in facilitating access to financial services and in promoting inclusion and growth [in the Muslim world]. Financial inclusion is closely linked to economic development and growth, with access to credit in particular playing a crucial role for entrepreneurship and poverty reduction. Yet, a bank survey in the Middle East and North Africa region reveals that only 8 percent of bank lending is directed to small- and medium-sized firms (SMEs), the main engines of job creation in the developing world.

The impact of Islamic Banking could be particularly relevant among the poor, where micro finance combined with Shar'iah type institutions could help boost credit for a segment of the population with limited access to conventional banking, or who may otherwise be reluctant to seek access to traditional banking for religious reasons. (Indeed, self-exclusion for religious beliefs has been cited by 25 to 35 percent of surveyed adults in countries such as Afghanistan, Tunisia and Saudi Arabia, as one of the main reasons for not having banking account.)

Policies to Foster Financial Inclusion

So how can Islamic banking promote financial depth and more inclusive economic growth? The outright answer is that Islamic banking needs to enhance its current operating model to attract depositors and expand credit services by tailoring its instruments to the specific needs of the market. For instance, Islamic banks could create separate SME business units, strengthen credit risk evaluation, further develop private equity and venture capital which are well-suited to Islamic finance, and improve the training of bank personnel in Sharia'ah-compliant instruments.

The set up of Islamic equity funds for SMEs could play a key role in diversifying financing sources, reducing the cost of funding and administrative costs, and ultimately strengthening access to finance. For instance, *Qard-al-Hassan* resources (interest-free loan encouraged for the needy in the Qur'an) can be made available to Islamic microfinance institutions to reduce the burden of high interest rates on their borrowers.

In sum, revamping the current model of Islamic banking, by improving and expanding the use of Sharia'ah-compliant instruments, could play a key role in strengthening financial inclusion, and improving higher and more inclusive growth in the Muslim world.

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