Role of Islamic Banking in Financial Inclusion: Prospects & Performance

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Introduction

- Empirical literature supports a positive association between financial development and economic growth. (North, 1990; Neal, 1990; Odedokun, 1998).

- Levine (2002) using cross country data argues that financial development is robustly linked with economic growth.

- Even for Organization of Islamic Cooperation (OIC) member countries, Hassan et al. (2011) find positive relationship between financial development and economic growth.

Introduction

- However, financial services are not accessible to the masses of poor people.

- Voluntary exclusion due to faith reasons creates yet another hindrance in the way of financial inclusion in OIC countries.

- According to World Values Survey sixth wave (2010-2014), 75.4% respondents in 21 OIC member countries regard religion as ‘very important’ as compared to 36% holding the same view in non-OIC countries.

- Most Muslims believe that modern day interest is Riba, which is prohibited in Islam (Verse 275: Al-Baqarah).

Introduction

- Voluntary exclusion from interest based banking products and services in Muslim societies could be significant.

- For instance, in countries like Afghanistan, Morocco, Iraq, Niger and Djibouti, the percentage of adult population with no bank accounts for religious reasons stands at 33.6%, 26.8%, 25.6%, 23.6% and 22.8%, respectively (Naceur et al., 2015).

- Thus, Muslims, in particular, need financial solutions which are Shari'ah compliant.

- In response, Islamic banking institutions were established in various parts of the world.

Introduction

- Global Islamic banking assets exceeded $925 billion in 2015.

- Among individual countries, market share of Islamic banking in national banking remains at 51.2% in Saudi Arabia, 45.2% in Kuwait, 29.3% in Bahrain, 25.8% in Qatar, 21.6% in UAE, 21.3% in Malaysia and 10.4% in Pakistan.

- In countries like Indonesia, Pakistan, Turkey, Qatar and Saudi Arabia, the CAGR has exceeded 20% during 2010-14.

Growth Comparison in Islamic & Conventional Banking

Compound Annual Growth Rate (2010-14) (%)		
Country	**Islamic Banking**	**Conventional**
Indonesia	29	11
Pakistan	27	13
Turkey	25	16
Qatar	22	7
Saudi Arabia	20	7
Malaysia	17	9
UAE	13	19
Kuwait	10	4
Bahrain	4	-1

Source: E&Y Islamic Banking Competitiveness Report 2015-16

Financial Inclusion in OIC Countries

- On average, 28% adults in OIC countries hold a bank account at a formal financial institution. This is lower than the 30.26% average for the middle income countries and 93.05% average for the high income countries.

- OIC countries with higher per capita incomes have half of their adults holding a bank account. These include countries like Kuwait, Iran, Oman, Malaysia, Qatar, Bahrain, United Arab Emirates and Turkey.

- OIC countries with less than 10% adults holding bank accounts mostly include members from Africa. Countries like Egypt, Chad, Sudan, Senegal, Guinea and Niger have lower than 10% adults with bank accounts at a formal financial institution.

Account Penetration in OIC Countries

Account at a Formal Financial Institution (% age 15+)			
Country Name	**2011**	**Country Name**	**2011**
Kuwait	86.77	Indonesia	19.58
Iran	73.68	Mauritania	17.46
Oman	73.60	Azerbaijan	14.90
Malaysia	66.17	Burkina Faso	13.35
Qatar	65.88	Djibouti	12.27
Bahrain	64.51	Iraq	10.55
UAE	59.73	Benin	10.46
Turkey	57.60	Pakistan	10.31
Saudi Arabia	46.42	Togo	10.19
Kazakhstan	42.11	Egypt	9.72
Bangladesh	39.55	Afghanistan	9.01
Morocco	39.07	Chad	8.96
Lebanon	37.03	Sudan	6.90
Algeria	33.29	Senegal	5.82
Tunisia	32.19	Kyrgyz Republic	3.76
Somalia	31.01	Guinea	3.69
Nigeria	29.67	Yemen	3.66
Jordan	25.47	Tajikistan	2.53
Syria	23.25	Niger	1.52
Uzbekistan	22.50	Turkmenistan	0.40

Financial Inclusion in OIC Countries

- In Nigeria, Pakistan, Uganda, Sierra Leone, Guinea, Afghanistan and Chad, less than 30 persons per 1,000 adults obtain loans from banks.

- In almost half of the countries (16 out of 33), less than 10% adults are bank borrowers. It could be said that low bank borrowing could be voluntary rather than involuntary.

- However, income poverty rate is less than 30% only in 3 countries out of 16 countries where bank borrowing adult population is less than 10% of total adult population.

- Thus, much of the OIC member states with less bank borrowing population are largely poor and hence, they may face binding liquidity constraints due to involuntary financial exclusion.

Financial Inclusion in OIC Countries

- One-third of the poorest 40% respondents from low and middle income countries opine that it is impossible to obtain emergency funds. Even in high income countries, about one-fourth respondents share the same view.

- On average, the poorest 40% respondents are less optimistic than the richest 60% on ease in sourcing emergency funds.

- On average, the respondents in OIC countries show relatively higher pessimism in obtaining emergency funds (26%) as compared to low income (24%), middle income (23%) and high income countries (15%). This observation holds true for overall, the poorest 40% and the richest 60% segments of the respondents.

Financial Inclusion in OIC Countries

- Thus, we see that OIC countries have low levels of financial inclusion.

- Islamic banking has a challenge as well as an opportunity to offer inclusive financial services to the voluntary and involuntary excluded population.

- So far, Islamic banking products offer Shari'ah compliance, but their credit criteria in debt based products include and exclude similar kinds of clients.

- Thus, they remain an alternative means of doing banking for those people who voluntarily excluded themselves from conventional finance even though they are 'bankable' clients for both conventional and Islamic banks.

Financial Inclusion in OIC Countries

- Purchase of durable goods like house and automobiles require substantial resources which most people are not able to generate solely through their periodic incomes and savings.

- Hence, they could either postpone their purchase or obtain financing from a financial institution.

- Shirazi et al. (2012) suggest that the IDB member countries need around 8.2 million houses per year to accommodate poor and low income urban people. This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth.

Social Institutions for Moderating Liquidity Constraints

- With regards to flexibility in accessing funds across time, it will be interesting to explore the usual source of borrowed funds.

- It is interesting to note the lower reliance or accessibility to financial institutions in OIC countries.

- Households in relatively high per capita income countries, such as Malaysia, UAE, Bahrain and Turkey have greater access to financial institutions and hence the source of borrowing from financial institutions is generally higher in these countries.

Social Institutions for Moderating Liquidity Constraints

- On average, 7.7% of the poorest 40% people in OIC countries borrow from financial institutions. This is even lower than the average for poorest 40% countries in the low income countries.

- However, 32.5% of the poorest 40% people in OIC countries borrow from family or friends. It suggests that the strength of social institutions compensates the financial sector underdevelopment to an extent for OIC countries.

Source of Borrowing in OIC Countries

	Financial Institution			Private Informal Lender			Family or Friends		
Country	Total	P40	R60	Total	P40	R60	Total	P40	R60
Afghanistan	3.6	2.2	4.5	7.6	7.7	7.6	22.3	22.6	22.1
Algeria	2.2	1.1	3.0	1.5	0.3	2.4	13.2	14.2	12.4
Azerbaijan	18.9	18.0	19.5	6.1	5.3	6.6	33.3	37.3	30.5
Bahrain	21.3	20.2	22.1	13.3	12.8	13.6	36.4	39.5	34.3
Bangladesh	9.9	11.1	9.0	4.5	5.3	4.0	25.2	26.3	24.4
Benin	7.6	7.1	8.0	2.7	2.0	3.2	24.2	26.5	22.6
Bosnia	14.0	12.1	15.3	0.1	-	0.2	6.6	8.0	5.6
Burkina Faso	5.0	3.5	6.1	2.4	3.1	2.0	30.5	33.7	28.2
Chad	2.4	2.7	2.1	3.1	5.0	1.8	24.5	29.0	21.5
Egypt	6.3	5.8	6.6	2.5	2.9	2.3	21.5	22.8	20.6
Guinea	2.0	1.3	2.4	3.6	1.8	4.9	37.1	40.3	35.0
Indonesia	13.1	11.3	14.3	2.9	3.2	2.8	41.5	43.8	40.0
Iran	31.6	24.4	36.4	9.1	7.7	10.0	48.7	48.0	49.1
Iraq	4.2	2.6	5.1	19.8	21.1	19.0	48.2	56.4	43.3
Jordan	13.6	10.8	15.4	1.1	1.4	0.9	17.4	19.6	15.8
Kazakhstan	16.5	11.5	19.6	2.1	1.2	2.7	23.9	19.1	26.9
Kuwait	14.1	12.8	14.9	12.0	14.7	10.1	30.2	35.9	26.4
Lebanon	15.6	12.5	17.5	4.4	6.5	3.1	12.9	16.5	10.5
Malaysia	19.5	15.2	22.4	0.8	1.8	0.1	39.0	45.6	34.5
Mauritania	7.7	5.1	9.4	5.1	5.0	5.2	29.8	30.1	29.6
Niger	1.4	1.3	1.4	1.5	1.7	1.3	56.0	50.3	59.9
Nigeria	5.3	6.5	4.4	1.7	3.6	0.4	37.5	35.8	38.8
Pakistan	1.5	2.0	1.1	5.3	4.6	5.8	34.0	32.7	34.9
Saudi Arabia	12.2	9.0	14.5	18.3	22.2	15.4	37.3	41.8	33.9
Senegal	3.5	1.4	5.0	2.5	2.3	2.7	41.4	33.9	46.8
Sudan	4.2	3.3	4.8	1.6	1.5	1.7	38.0	39.2	37.2
Tajikistan	3.8	2.5	4.6	1.9	1.8	2.0	12.2	16.1	9.7
Togo	3.7	2.2	4.7	2.2	1.9	2.4	17.1	13.9	19.2
Tunisia	8.0	4.9	10.1	3.3	4.2	2.7	16.1	21.9	12.3
Turkey	20.0	17.1	22.1	2.4	4.1	1.2	29.0	37.7	22.6
Turkmenistan	2.2	0.9	3.0	2.4	2.0	2.6	32.7	33.9	31.8
Uganda	15.7	11.3	18.7	6.3	5.5	6.8	69.4	65.6	72.0
UAE	15.4	13.6	16.7	5.9	5.7	6.1	28.5	32.5	25.8
Uzbekistan	1.3	1.3	1.2	1.5	2.2	1.0	11.1	13.8	9.3
Yemen	0.4	0.2	0.6	15.0	19.1	12.1	51.7	52.6	51.0

Source: Global Financial Inclusion Database, World Bank

Social Institutions for Moderating Liquidity Constraints

- In low income countries, the reliance on family and friends is much greater for emergency funds.
- In low income countries, the least reliance is on financial institutions.
- It shows significant involuntary financial exclusion in low income countries.
- In high income countries, there is relatively less reliance on family and most reliance on savings.
- In 17 out of 35 OIC countries for which data is available, the reliance on family and friends network for emergency funds is more than 50%.

Social Institutions for Moderating Liquidity Constraints

- In 30 out of 35 OIC countries, the most reliable and readily used source for emergency funds is family and friends network.

- In other 5 countries where another source is more relied upon, it is either private precautionary savings as in Malaysia, Togo and Benin or additional work and loan obtained from the employer as in United Arab Emirates and Iraq.

- In 8 OIC countries, more than 30% respondents use private precautionary savings for emergency funding. These include Malaysia at the top with 46% respondents using private precautionary savings, followed by Benin (38%), Algeria (36%), Togo (36%), Pakistan (34%), Turkmenistan (34%), Nigeria (32%) and Senegal (30%).

Social Institutions for Moderating Liquidity Constraints

- In 6 OIC countries, more than 30% respondents use additional work for the employer to gain emergency funds or take loan from the employer. These countries include Iraq at the top with 50% respondents, followed by Uzbekistan (35%), Saudi Arabia (34%), United Arab Emirates (33%), Kuwait (30%) and Bahrain (30%).

- In 4 of these countries from Middle East (Saudi Arabia, UAE, Kuwait and Bahrain), a lot of South Asian immigrants from India, Bangladesh and Pakistan work in informal jobs and hence, they fund their emergency need of funds through additional labor supply or loan from their employers.

Microfinance Outreach Gap in OIC Countries

- Muslim countries represent quarter of global population, but they are generally poorer than non-Muslims as their share in global poverty pool is twice as much as their share in global population.

- In OIC countries like Guinea-Bissau, Gabon, Chad, Sudan, Syria, Mozambique, Gambia and Iraq, microfinance outreach is not even catering to 1% of the poor people in these countries.

- In 26 out of 36 countries where sufficient data is available, we find that not even 10% of the poor people are under the microfinance radar.

- In 5 OIC countries, the poverty headcount ratio at national poverty line exceeds half of the population. In these OIC countries where the poverty headcount ratio is more than 50%, not even 10% of the poor people are reached by microfinance.

Microfinance Outreach Gap in OIC Countries

- Most poor people are in Nigeria, followed by Bangladesh, Pakistan, Indonesia and Egypt. In all these 5 OIC member states, the poor population exceeds 20 million in numbers.

- Bangladesh has the highest outreach in microfinance. Along with Bangladesh, Pakistan, Nigeria and Indonesia are the other OIC countries where microfinance client base exceeds 1 million.

- Nevertheless, apart from Bangladesh, the outreach gap is more than 90% in Pakistan, Nigeria and Indonesia.

Microfinance Outreach Gap in OIC Countries

Country Name	PHCR-National (%)	Total Borrowers	Total Population	Total Poor	Outreach Gap (no.)	Outreach Gap (%)
Guinea-Bissau	69.3	1,662	1,663,558	1,152,846	1,151,184	99.9
Togo	58.7	297,093	6,642,928	3,899,399	3,602,306	92.4
Guinea	55.2	117,037	11,451,273	6,321,103	6,204,066	98.1
Mozambique	54.7	68,299	25,203,395	13,786,257	13,717,958	99.5
Sierra Leone	52.9	110,713	5,978,727	3,162,747	3,052,034	96.5
Niger	48.9	218,109	17,157,042	8,389,794	8,171,685	97.4
Gambia, The	48.4	4,389	1,791,225	866,953	862,564	99.5
Burkina Faso	46.7	201,537	16,460,141	7,686,886	7,485,349	97.4
Senegal	46.7	282,745	13,726,021	6,410,052	6,127,307	95.6
Chad	46.7	21,430	12,448,175	5,813,298	5,791,868	99.6
Sudan	46.5	67,435	37,195,349	17,295,837	17,228,402	99.6
Nigeria	46.0	2,600,000	168,833,776	77,663,537	75,063,537	96.7
Mali	43.6	271,619	14,853,572	6,476,157	6,204,538	95.8
Cameroon	39.9	292,146	21,699,631	8,658,153	8,366,007	96.6
Benin	36.2	305,470	10,050,702	3,638,354	3,332,884	91.6
Afghanistan	35.8	148,033	29,824,536	10,677,184	10,529,151	98.6
Syrian Arab Republic	35.2	32,518	22,399,254	7,884,537	7,852,019	99.6
Yemen, Rep.	34.8	112,494	23,852,409	8,300,638	8,188,144	98.6
Gabon	32.7	907	1,632,572	533,851	532,944	99.8
Tajikistan	32.0	339,039	8,008,990	2,562,877	2,223,838	86.8
Bangladesh	31.5	18,600,000	154,695,368	48,729,041	30,129,041	61.8
Kyrgyz Republic	30.6	432,980	5,607,200	1,715,803	1,282,823	74.8
Lebanon	28.6	79,017	4,424,888	1,265,518	1,186,501	93.8
Egypt, Arab Rep.	25.2	905,888	80,721,874	20,341,912	19,436,024	95.5
Pakistan	22.3	3,600,000	179,160,111	39,952,705	36,352,705	91.0
Uganda	19.5	731,393	36,345,860	7,087,443	6,356,050	89.7
Iraq	18.9	56,008	32,578,209	6,157,282	6,101,274	99.1
Bosnia and Herzegovina	17.9	257,037	3,833,916	686,271	429,234	62.5
Uzbekistan	16.0	176,029	29,774,500	4,763,920	4,587,891	96.3
Tunisia	15.5	263,268	10,777,500	1,670,513	1,407,245	84.2
Jordan	14.4	333,723	6,318,000	909,792	576,069	63.3
Albania	14.3	63,280	2,900,489	414,770	351,490	84.7
Indonesia	11.3	1,200,000	246,864,191	27,895,654	26,695,654	95.7
Morocco	8.9	883,852	32,521,143	2,894,382	2,010,530	69.5
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Microfinance Outreach Gap in OIC Countries

- In terms of realizing the theoretical and structural potential, we do not find an impressive progress on Islamic microfinance.

- Islamic microfinance is still just 1% of the total global Islamic banking assets.

- This is despite the impressive growth and stable profits of the Islamic commercial banks all over the world.

Conclusion

- We explored the state of financial inclusion in OIC countries. The proportion of adult population holding bank accounts in 25 out of 48 OIC countries stands below 20%.

- We also investigated the relative significance of social institutions and the other coping mechanisms to deal with financial exclusion in low income OIC countries.

- We also estimated the microfinance outreach gap in OIC countries. In 26 out of 36 countries where sufficient data is available, we find that not even 10% of the poor people are under the microfinance radar.

- Finally, we highlighted the need for broad based product and market outreach extension in Islamic consumer finance segment.

Thank You

For Questions, Feedback & Comments

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