Lingnan Journal of Banking, Finance and Economics

Volume 6 2015/2016 Academic Year Issue Article 6

December 2016

The role of Islamic finance in economic development

Nora KHAN

The Role of Islamic Finance in Economic Development

Nora KHAN

Introduction

Islamic financial institutions have been growing rapidly in the past few years. Islamic finance refers to investments that are permissible in accordance with Sharia, the Islamic law. Sharia law views money as a measuring tool for value and not an "asset" itself. "It does not permit receipt and payment of *riba* (interest), *gharar* (excessive uncertainty), *maysir* (gambling), short sales or financing activities that it considers harmful to society" (IMF website). Interest, a form of income from money, is therefore prohibited. For example, the income obtained from banks must come from the gain or loss of the enterprises they underwrite and not from interest obtained from loans granted. Sharia-compliant finance is thus often viewed as a unique form of socially responsible investment. Islamic finance exists to further the socio-economic goals of Islam. The question is: How can Islamic finance contribute to economic development? This essay explores its contribution to economic development through microfinance and the use of sukuk (Islamic bond). It will also explore the main opportunities and challenges for Islamic finance today. In order to facilitate the following reading, all Islamic terms used in this essay will be defined in the glossary (Appendix I).

Islamic Microfinance in Developing Countries

Islamic Microfinance Versus Conventional Microfinance in Developing Countries

One of the ways it contributes to the economic development of a country is through Islamic microfinance. Before exploring how Islamic microfinance contributes to this development, it is important to understand microfinance and the distinction between conventional microfinance and Islamic microfinance. Conventional microfinance began as a means of offering loans to small businesses in the form of micro-credit. However, the term "microfinance" expanded to not only offer micro-credit, but also offer micro-savings and micro-insurance. A micro-credit product involves an interest-bearing microloan and the repayment of the loan regardless of the success of the business venture. In addition to the loans, microfinance has expanded to offer deposit products that would allow clients to build their asset base as a means of security for their loans. Essentially, microfinance offers financial services to low-income individuals who do not have access to typical banking services. In Islamic microfinance, micro-credit is offered through four main methods: *murabaha*, *ijara*, *mudaraba/musharaka* and *qard al-hasan*. In the case of *murabaha*, the client requests the bank to purchase an asset and resell it to the client at a higher price. In other words, the bank purchases an asset from client A to sell to client B with a mark-up as per requested by client B. The payment will usually take the form of equal installments over a time period.

The second method involves leasing using *ijara*. In the case of this financing option, the bank leases the asset for a fixed period of time for the client and transfers the ownership of the asset to the client through a sale for a nominal price. The difference from a conventional lease is that the costs with maintaining and insuring the asset through *takaful* (insurance) must be covered by the bank. The method of *mudaraba* and *musharaka* are similar to that of venture capital and joint ventures. Under *Mudaraba*, both parties agree to a profit-sharing process. However solely the provider of the capital will bear the losses. The client will also purchase one share of the investment of the bank on the microbusiness, thus reducing the profit-sharing payments across time. This is the major difference to conventional microfinance involving venture capital and joint ventures. The *musharaka* differs in that since both parties (the client and the bank) provide capital for the investment, both parties will be liable for losses. Finally, the fourth method, the *qard al-hasan*, can be defined as a benevolent loan. This method is most difficult to sustain due to the prohibition from accepting any amount in excess of the loan. This method also allows the borrower to be forgiven if he or she cannot repay the loan (Hunt-Ahmed, 2013).

Case Study in Bangladesh (Islami Bank Bangladesh Ltd. And the Rural Development Scheme)

The Rural Development Scheme (RDS) program by Islami Bank Bangladesh (IBBL) started as a pilot-program in the villages of Bangladesh. The need for an effective microfinance scheme was great in an agrarian country where 43.3 percent (in 2010) of the population lives below the poverty line. With the RDS, each branch surveys an area of a 10 km radius, allowing service to four to six villages per center. The criteria set to select the area targeted are the proximity to an existing IBBL branch and the presence of sufficient off-farm business opportunities. Off-farm business activities include off-farm labor wages and migration earnings. According to a World Bank study (Jannat, 2009), the loans granted usually span on an average of one year, but may be extended depending on the specific area of business. The financing through the RDS is mainly done through *bai-muajjal*, a financing product similar to that of *mudaraba*. The main difference lies in the disclosure of the cost-plus-profit results of the company. In other words, both financial products involve a profit-sharing process, but there is no disclosure of exact results in *bai-muajjal*. Many other forms of financing offered through the RDS include *ijara*, *murabaha*, *mudaraba* and *musharaka*. The program focuses on financing industries such as crop production, livestock, rural transportation, and rural housing. By 2005, the RDS expanded to cover a larger clientele base by providing financing through a Micro Enterprise Investment Scheme (MEIS), providing financing of between 50,000 BDT to 300,000 BDT (between $659 and $3,955). Between 2005 and 2010, 3.6 billion BDT (around $48 million) was disbursed in the RDS scheme.

The study below gathers surveys from more than 1,200 beneficiaries from more than 34 branches of IBBL that extended to RDS program. According to the results, households earned an average of 29.3% to 30.1% (depending on the source of income) more after joining RDS for a period of three years or more.

Table 1:Annual Income Generation of Households by Source After Joining RDS for a Period of Three Years or More

	Household income per year (in Taka)		Change in income	
Source of income	**Before joining**	**After joining**	**Amount (in Taka)**	**Percent (%) change**
Agriculture	17,470	22,595	5,125	29.3
Business	46,513	60,505	13,992	30.1
Total	63,983	83,100	19,117	29.9

Source: *Rahman, M. M., Islamic micro-finance programme and its impact on rural poverty alleviation, International Journal and Finance, 2010.*

In an another field study done by Tasnimum Jinan in 2008, the change in asset possessions after joining the RDS for a period of three years or more increased around three-folds for both the agriculture and business sectors.

Table 2: Change in House Income and in Assets for a Period of Three Years or More

	Change in asset possessions (in Taka)	
Broad Category of Activities	Before	After
Agriculture	35,112	101,785
Business	25,957	87,762
All	30,932	94,773

Source: *Field study by Tasnimum Jinan (2008).*

Case Study in Syria (Sanduq in Syria)

The case study in Syria involves one of the poorest areas of the country, Jabal al-Hoss. The Islamic microfinance present in that area has existed merely for 15 years and began under the Rural Community Development Project from the UN Development Program (UNDP). The concept of *sanduq* involves the contribution of capital from the members and the borrowing from the fund to finance income-generating activities or short-term needs. The income-generating activities are usually financed using *murabaha* with a 1% per month fee as a fixed markup in the cost of the goods, instead of accruing interest. Since the short-term funding is not necessarily income generating, the loans are usually in the form of *qard al-hasan*, with repayment having principal only and no profit margins. The success of this project is remarkable with loan repayment rates of 100 per cent (as of December 2008) and a zero failure rate for ongoing enterprises. This scheme has been crucial for the development of the local economies of the area. This project is particularly helpful for women, who are becoming the majority population in many of these poor villages. These women are increasingly participating in the *sanadiq* as owners, managers and users.

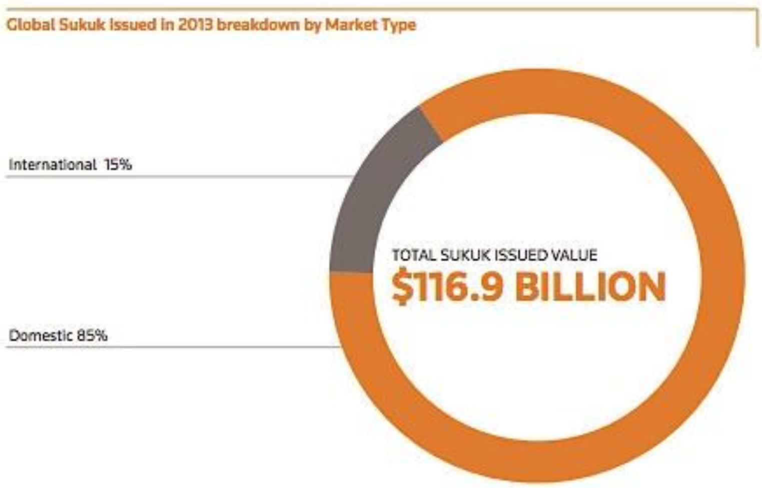
The Role of Sukuk in Economic Development

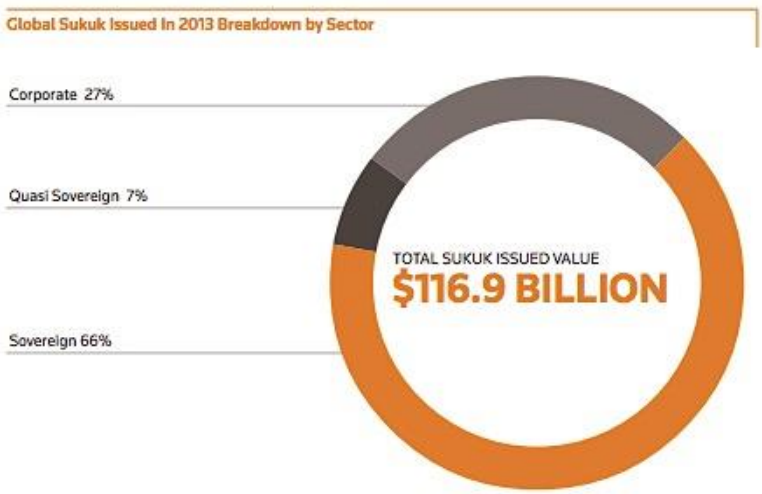
Characteristics and Investor Base

Another way that Islamic finance contributes to economic development is through the issuance of sukuk, commonly referred to as an Islamic bond. This instrument represents pro-rata ownership rights to the underlying asset and/or the income generated from this underlying asset. Sukuk are commonly referenced as bonds since they have very similar risk and return characteristics. Sukuk often mimic the cash flow structure of bonds by offering a final payment similar to the principal payment as well as fixed amounts of profit regularly through profit distribution. Any excess will be distributed to the entrepreneur as an incentive to maximize profit of the business. As of 2014, sukuk represented approximately 15 percent of the total $1.8 trillion Sharia-compliant assets in the world. The market size has been growing at an annual compounded growth rate of 20 percent between 2009 and 2014 (Kusuma and Silva, 2014). Many policy makers regard sukuk markets as sources of long-term financing. Being one of the only Sharia-compliant tools for financing, sukuk attracts a segment that would not otherwise invest in any other type of vehicle for investment due to religious reasons.

The Use of Sukuk in Infrastructure

Sukuk provides an alternative type of long-term financing for key sectors such as infrastructure. This Sharia-compliant instrument has recently emerged as an important element in funding government projects. The infrastructure needs for Islamic economies are in many cases nearing their historical and functional peak. Infrastructure needs not only include new projects, but also maintenance of existing infrastructure. According to data collected by Thomson Reuters in their 2014 annual report "Islamic Finance Development", the total value of Sukuk issued in 2013 was $116.9 billion, in which 85% was to the domestic market of the issuer. Countries issued 66% of the total issuance of sukuk in 2013, the remaining 34% was issued by corporate and quasi-sovereign issuers.





Source: ICD Thomson Reuters' Islamic Finance Development Report 2014