

# Islamic finance: financial inclusion or migration?

Islamic finance

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## Abstract

**Purpose** – This paper aims to define a methodology to assess the impact of introducing Islamic finance on financial inclusion.

**Design/methodology/approach** – The paper is based on a literature review to understand the link between Islamic finance and financial inclusion. The second part of the paper presents a conceptual framework to assess the impact of introducing Islamic finance on financial inclusion in a defined context based on the profiling of people interested in Islamic finance.

**Findings** – The paper brings an insight on the impact of introducing Islamic finance. Indeed, it could cause a financial migration to Islamic banks that can take many forms and depends on many factors that call for deep analysis.

**Research limitations/implications** – The paper would help financial authorities and financial institutions to measure the impact of introducing Islamic finance on their businesses and the stability of the whole system.

**Practical implications** – Islamic finance can not only enhance financial inclusion but also create financial migration. The two implications can vary from one context to another.

**Social implications** – Islamic finance can contribute in the effort of including “self-excluded” people with religious concerns as well as people without access to financial services.

**Originality/value** – This paper promotes the idea that Islamic finance is not exclusively a way to enhance financial inclusion.

**Keywords** Islamic finance, Financial inclusion, Financial migration, Unbanked people, Self-exclusion, Lack of access

**Paper type** Research paper

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## Introduction

Islamic finance covers a wide range of mechanisms and institutions delivering high added-value services to clients in accordance with Sharī‘ah (Islamic law) principles. It covers banking and microfinance, capital markets, insurance and all the recent financial innovations such as crowdfunding, cryptocurrencies and others. Indeed, Islamic finance continues evolving to compete with conventional finance in attracting customers from different faiths (Abdullah *et al.*, 2012), and this is in itself an achievement for this young industry.

From a theoretical perspective, Islamic finance can play a significant role in enhancing financial inclusion in countries with dominant Muslim populations (The World Bank, 2013).



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Nevertheless, the Global Financial Inclusion Database (Global Findex) shows that religious beliefs seem to be the least relevant reason for not having a bank account. Globally, only 6 per cent of the unbanked people, as per [The World Bank \(2018\)](#), cited religious concerns as their main reason for not having a bank account.

Some authors ([Demirguc-Kunt and Klapper, 2012](#)) would find such results very encouraging for Islamic financial institutions (IFIs) to launch their offer. However, it is necessary to check whether unbanked people with religious concerns are all interested in Islamic finance. Indeed, being aware of the Shari'ah dimension in the financial sphere and endorsing anti-usury practices do not automatically imply acceptance and adherence to Islamic financial services. Thus, it is important to make sure that Shari'ah compliance is the main factor that matters for unbanked people with religious concerns and that the Islamic financial model adopted is credible enough in their eyes. Otherwise, people who are supposed to become customers could be the main detractors of the model.

Moreover, investors need to understand whether the unbanked people with religious concerns are interesting from the IFIs' perspective. In practice, the financial performance of any institution is based on the size of assets not on the number of customers. Therefore, it is important to ensure that unbanked people with religious concerns who accept the Islamic financial model are eligible for financing and the other services.

Finally, investors have to measure the potential demand for Islamic financial services and make sure that it justifies the launch of IFIs. Therefore, the launch of an IFI needs to be justified by the potential demand of unbanked people. If it is not sufficient, it goes without saying that the project would have to be aborted. Otherwise, the business model does not have to rely only on unbanked people with religious concerns but also on other segments of customers.

For other people, the results could seem daunting and do not justify the introduction of full-fledged IFIs. However, the Global Findex survey ([The World Bank, 2018](#)) focused only on people who do not have a bank account. In practice, having a bank account does not mean that the customer would necessarily have access to all the other financial services. Moreover, having a bank account in many countries is obligatory to be able to receive a wage and to create and run a business. Thus, among those who are obliged to have a bank account and deal with conventional financial institutions, there are those who are self-excluded in terms of financing, savings and insurance for religious concerns. Such persons may be very interesting from the perspective of IFIs.

Assessing the impact of introducing Islamic finance is a real issue in terms of financial inclusion and competition with incumbents. Strategies and approaches to be adopted will depend strongly on the expected impact of such an introduction.

This paper aims at drafting a methodology to assess the impact of introducing Islamic finance. To do so, it first starts with providing a definition of the concept of financial inclusion and describes its different levels from the conventional finance perspective. Then, it presents the different profiles of customers interested in Shari'ah-compliant financial products and defines the levels of financial inclusion from the Islamic finance perspective. Based on the elements above, the paper presents a methodology to define the impact of introducing Islamic finance on incumbents and on financial inclusion and the strategies that both financial authorities and incumbents can adopt.

### **Financial inclusion: main concepts and levels**

Financial inclusion is globally defined as the proportion of individuals and firms that use financial services ([The World Bank, 2018](#)). This concept covers both lack of access to

financial services and the self-exclusion phenomenon. Lack of access means that people are not able to use financial services because of the following reasons:

- people do not own enough money to use financial services;
- people find the maintenance of bank accounts expensive; and
- financial institutions are not available in their regions or zones.

To tackle the issue of lack of access, much effort has been expended to lower the cost of financial services and to digitalize them. Daniel Schulman, the CEO of PayPal (Schulman, 2016) related that he has experienced the life of those who are unbanked (paying bills and moving cash through methods available) on a voluntary basis. He came away with a newfound appreciation for how costly it is to be poor, which helped drive the work at American Express to create new payment systems for people without access to traditional banks. Other initiatives led to real solutions to tackle the issue of lack of access such as M-PESA[1], WeChat Pay[2], AliPay[3] and others.

The self-exclusion phenomenon refers to people who have access to financial services but choose not to use them for the following reasons:

- one of the family members already has an account;
- people do not trust financial institutions; and
- religious beliefs, especially within the Muslim community that the usurious practices of conventional financial institutions are prohibited.

Figure 1 depicts the analysis of unbanked people with religious concerns from the perspectives of Islamic finance (i.e. whether they are interested in Islamic finance) and IFIs (e.g. whether IFIs find them interesting).

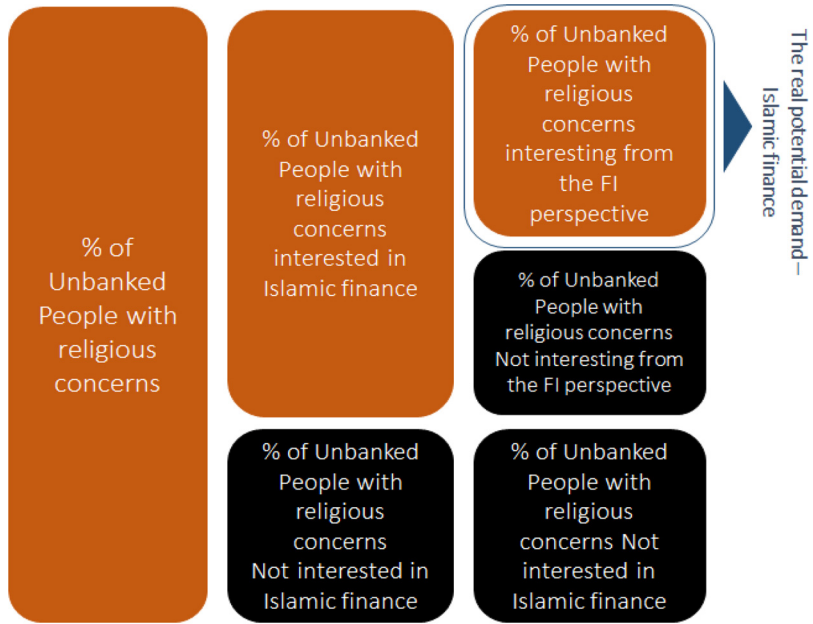
For the self-exclusion issue, Islamic finance and financial literacy seem to be the main solutions to bring more people to the financial system (Ramakrishnan, 2012). Nevertheless, self-exclusion can take a different form, which is informal finance (Mauri, 2000). In some contexts, businesses try to use cash rather than their bank accounts to escape tax control. People are underusing banking services because they are looking for more privacy and less control. Figure 2 describes the mapping of the unbanked people and the associated reasons for financial exclusion.

#### *Financial inclusion levels from a conventional finance perspective*

When talking about financial inclusion, the main focus is on account ownership data, including key aspects such as savings, accessing credit and managing financial risk. Nevertheless, in conventional banking, the first step to access other financial services is to have a bank account; otherwise, the customer is excluded from the whole system.

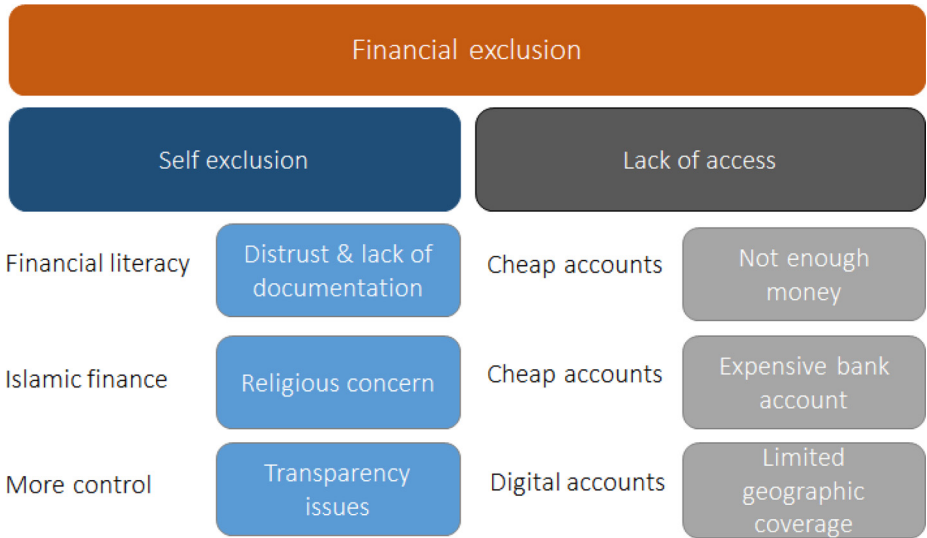
From this perspective, financial inclusion consists of three different levels:

- (1) *Account ownership*: Holding an account means access to payment systems and other financial services. For financial institutions, if someone does not have a bank account, the person will not have a track record and will not even exist. Therefore, from this perspective, everything starts with a bank account and the rule here is “I have a bank account; I do exist.”
- (2) *Access to credit and savings*: If someone does not have an account, the person will not have a credit record and the bank will not grant him/her a loan easily. Thus, borrowing is a second layer of financial inclusion. Otherwise, people have to deal with informal borrowing systems such as rotating savings and credit associations,



**Figure 1.**  
Unbanked people  
with religious  
concerns

Source: Author's own



**Figure 2.**  
Mapping the  
unbanked people

Source: The World Bank (2018)

commonly known as ROSCAs (Fang *et al.*, 2015). Similarly, to save money in the formal system, a person needs to have a bank account. However, owning a bank account does not necessarily mean that people will use the formal system for their saving. From the financial institutions' perspective, if saving is done through non-formal practices, it will limit the size of financing through the formal system.

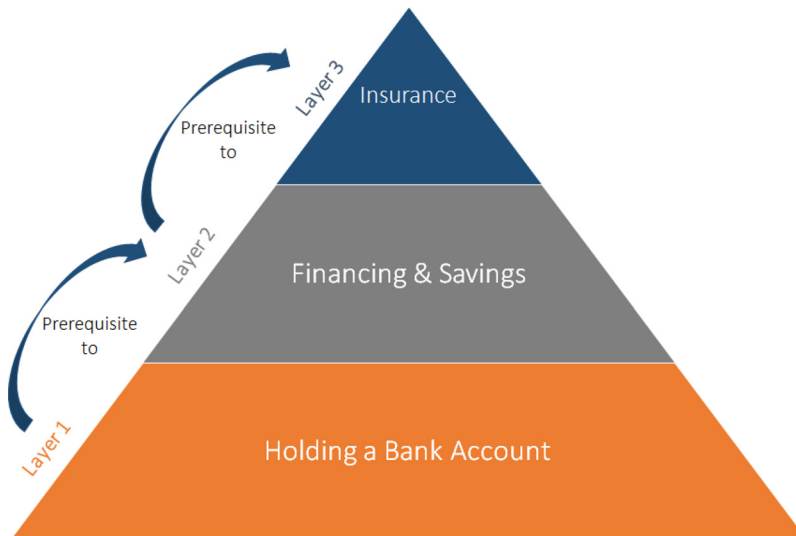
- (3) *Access to insurance services*: In developing countries, people subscribe to insurance products only when they are obliged. Indeed, the lack of compulsory insurance slows the pace of the insurance sector development (Lester, 2011). When granting a loan, banks usually require insurance coverage for death, incapacity and risks related to the underlying assets. Thus, if someone does not take a loan, the person will not be subscribing to an insurance product.

Therefore, the main challenge in conventional finance in terms of inclusion is account ownership. If the proportion of people that have a bank account is increased, the financial inclusion indicators are automatically increased. Figure 3 briefly describes the three layers of financial inclusion from the conventional finance perspective, starting from the need to hold a bank account as the basis for having access to financing and savings facilities, and ultimately to having access to insurance services.

#### *Financial inclusion is a driver of development*

Having no access to financial services is a costly matter. Indeed, a person with no access to a bank account would have to go to every retail establishment and stand in line to pay his/her bills and may even have to pay extra fees for paying in cash.

In some countries, if a person gets his/her wage in cash, it would mean probably that his/her employer pays him under the table and that he/she is not declared to the social services. Therefore, having a bank account where a person receives his/her wage is a sign that he/she



**Source:** Author's own

**Figure 3.**  
Layers of financial inclusion from the conventional finance

gets access to his/her rights as an employee. The following describes how financial inclusion can have an impact on development.

*Account ownership and its impact on development.* The best example to cite is the mobile money account experience in East African countries ([The Economist, 2018](#)). According to a study conducted in Kenya ([Suri and Jack, 2017](#)), access to M-PESA increased consumption levels and lifted 194,000 Kenyan households out of poverty. This positive impact is due to the possibility that mobile money accounts offer to unbanked people to send money back to their home villages faster, more cheaply and more securely. This increases consumption and the stability of their revenues, especially when times get tough.

*Access to loans and its impact on development.* Having an account means having a credit record, which makes it possible to get micro- or nano-loans when needed. Having access to micro- or nano-loans can inspire companies to find solutions for daily problems.

One example is how a mobile payments system inspired other firms to sell their commodities on credit and get paid through daily payments from mobile money accounts. The best case to highlight is that of M-Kopa[4], which brought electricity to hundreds of thousands of homes in Kenya, Tanzania and Uganda. If the customer misses a payment, the panel is automatically locked.

*Access to insurance services and its impact on development.* The mobile money account gives the opportunity to unbanked people to get access to insurance services. In Zimbabwe, based on its Econet experience, farmers were offered Index insurance for their crops that would pay out automatically to a mobile phone account without the need to put in a claim if the rainfall index drops below a certain level ([The Economist, 2018](#)). Such innovations can help farmers in periods of drought and avoid deep crisis effects.

### **Role of Islamic finance in financial inclusion**

Islam encourages all the means that enable a balanced distribution of wealth. Indeed, it is a Qur'anic principle that is established as follows:

Whatever God restored to His Messenger from the inhabitants of the villages belongs to God, and to the Messenger, and to the relatives, and to the orphans, and to the poor, and to the wayfarer; so that it may not circulate solely between the wealthy among you (Qur'an, 59:7).

Islamic finance is a way to enhance financial inclusion by bringing those who are self-excluded on the basis of religious concerns to the financial system, and it can use the same mechanisms and techniques of the conventional finance sphere to target different segments of people that are unbanked, such as microfinance, micro-insurance and mobile money accounts.

#### *Financial inclusion levels from Islamic finance perspective*

Most analysts and researchers adopt the approach of conventional finance regarding financial inclusion and consider Islamic finance as a complementary tool to attract self-excluded people with religious concerns ([The World Bank, 2018](#)). Nevertheless, the levels of financial inclusion in Islamic finance are not organized in the same way. Four profiles of people exist:

- (1) *Profile 1:* People who do not have a bank account out of religious concerns and thus reject all conventional financial instruments and services. According to the Global Findex Database 2017 ([The World Bank, 2018](#)), the proportion of unbanked people per country for religious reasons is as detailed in [Table I](#).

Country	Have an account (% age 15+)	No account because of religious reasons (% age 15+)
Algeria	43	5
Bahrain	83	1
Egypt, Arab Rep	33	3
Iraq	23	12
Jordan	42	11
Kuwait	80	1
Libya	66	6
Morocco	29	3
Saudi Arabia	72	2
Tunisia	37	10
UAE	88	1
West Bank and Gaza	25	12

**Table I.**  
Financial inclusion in  
12 Islamic Congress  
Organization (ICO)  
member countries

Source: The World Bank (2018)

Based on the data provided by Findex, when the proportion of banked people is high, the proportion of unbanked people having religious concerns is low and vice versa.

- (2) *Profile 2:* People who have a bank account but are limited to basic services and reject all the financing and savings products as well as insurance. They merely accept to have a bank account because it is compulsory as an employee or when running a business. Therefore, focusing on the account ownership indicator to assess the level of financial inclusion is misleading.
- (3) *Profile 3:* People who use all the conventional financial services but, in terms of Sharī'ah compliance, they will prefer to subscribe to Islamic financial products once available for their new needs and projects.
- (4) *Profile 4:* People who use all the conventional financial services but, if there is a Sharī'ah-compliant offer, they will prefer to convert all their conventional financial commitments to Sharī'ah-compliant ones.

When dealing with profile 1, Islamic finance can give total access to financial services including account ownership, financing, savings and insurance. It is a case of *pure financial inclusion*.

When dealing with Profile 2, Islamic finance focuses on Layer 2 of financial inclusion (financing and savings). As a result, it causes account migration from conventional to Islamic finance. It is a case of *partial financial inclusion*.

For Profile 3, Islamic finance represents a suitable alternative to conventional finance. Indeed, people are already using conventional financial instruments but would prefer moving to Islamic financial instruments for their future needs (Ahmad *et al.*, 2011). This case happens in the absence of financial mechanisms to immediately convert financing commitments to Islamic ones. It depicts the case of *gradual financial migration*.

In the presence of financial mechanisms to immediately convert financing commitments to Islamic ones, dealing with Profile 4 causes immediate financial migration. It reflects the case of *pure financial migration*.

Figure 4 summarizes the different profiles of customers and the impact of dealing with each of them.

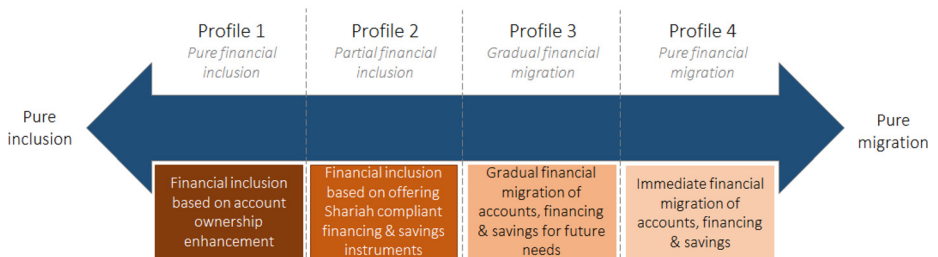
**How to assess the impact of introducing Islamic finance on financial inclusion?**

In countries willing to introduce Islamic finance, the main argument is that it will enhance financial inclusion, bringing more funds to the banking system, which will constitute a real opportunity for investors and the whole economy. Nevertheless, the impact can be different. Indeed, instead of financial inclusion, introducing Islamic finance can create financial migration. Each impact (migration or inclusion) has a suitable strategy to be adopted by investors and financial authorities.

It is worth noting that although Sharī‘ah compliance is an important factor for moving to an IFI, research (Aminou and Aboulaich, 2017) showed that pricing and proximity of branches and quality of services are also critical to the decision function. Thus, the proportion of people who are migrating to IFIs would depend on factors other than Sharī‘ah compliance.

To assess the impact of Islamic finance on financial inclusion, a series of questions need to be answered, as follows. Figure 5 further summarizes the assessment main points.

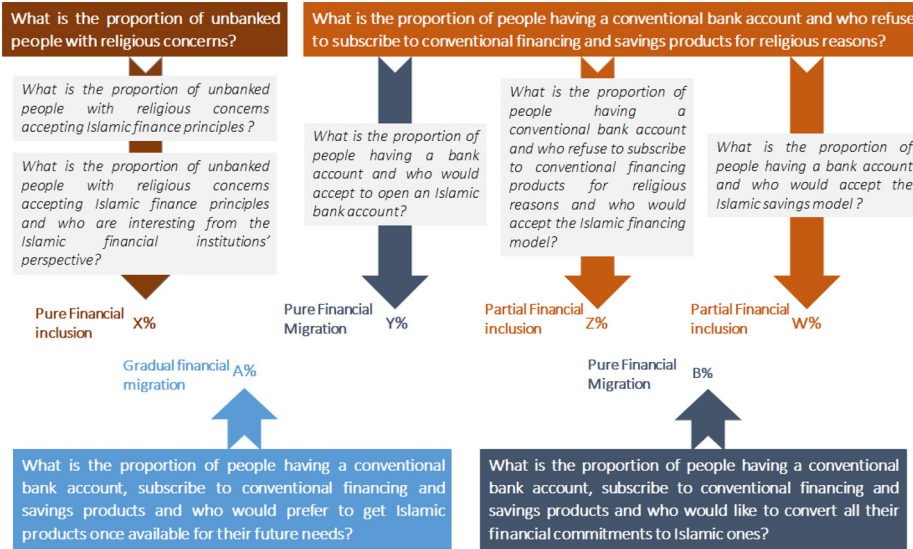
- (1) What is the proportion of unbanked people with religious concerns?
  - What is the proportion of unbanked people with religious concerns who accept Islamic finance principles?
  - What is the proportion of unbanked people with religious concerns who accept Islamic finance principles and who are interesting from the IFIs’ perspectives?
- (2) What is the proportion of people having a conventional bank account and who refuse to subscribe to conventional financing and saving products on the basis of religious concerns?
  - What is the proportion of people having a bank account who would accept to open an Islamic bank account?
  - What is the proportion of people having a conventional bank account who would refuse to subscribe to conventional financing products for religious reasons and would accept the Islamic financing model?
  - What is the proportion of people having a conventional bank account who would accept the Islamic saving model?
- (3) What is the proportion of people having a conventional bank account who subscribe to financing and saving products and would prefer to get Islamic products once they are available in the future?
- (4) What is the proportion of people having a conventional bank account who subscribe to conventional financing and products and would like to convert all their financial commitments to Islamic ones?



**Figure 4.** Profiles of customers – inclusion or migration

Source: Author’s own





**Figure 5.** Assessment methodology of introducing Islamic finance

**Source:** Author’s own

By combining the different proportions estimated, we can find four main scenarios.

*Context 1*

$$\frac{X\%}{X\% + Y\% + Z\% + W\% + A\% + B\%} > \frac{2}{3}$$

In this context, introducing Islamic finance will bring more people to the financial system to open bank accounts and start to subscribe to financial services. For such a context, introducing Islamic finance seems to present a real opportunity to include more people and to attract more customers. The appropriate strategy would be to recommend the introduction of Islamic finance to financial authorities and investors.

In practice, this scenario is not realistic and the situation has to be analysed carefully. If we analyze the results of the survey in the Findex report, we find that countries with high proportions of people that are self-excluded for religious reasons already have Islamic banks. Examples include Tunisia (3 Islamic banks, 10 per cent of people unbanked), Jordan (3 Islamic banks, 11 per cent of people unbanked) and Iraq (18 Islamic banks, 12 per cent of people unbanked). Thus, having Islamic banks does not ensure financial inclusion of all the people that are self-excluded for religious concerns.

*Context 2*

$$\frac{X\% + Z\% + W\%}{X\% + Y\% + Z\% + W\% + A\% + B\%} > \frac{2}{3}$$

Introducing Islamic finance will bring more people to the financial system. Some will open bank accounts, while others will convert their conventional bank accounts to Islamic ones to subscribe to financing and saving products.

For such a context, introducing Islamic finance would represent an opportunity for banks which would invest to grant Shari'ah-compliant financing to people who are not interested in conventional loans. The appropriate strategy in this context would be for financial authorities and existing banks to target underserved people in terms of financing and saving products.

#### *Context 3*

$$\frac{Z\% + W\% + A\%}{X\% + Y\% + Z\% + W\% + A\% + B\%} > \frac{2}{3}$$

Introducing Islamic finance would cause a soft financial migration. Indeed, those who do not have conventional loans would subscribe to Islamic financing instruments and would convert their deposit and saving accounts to Islamic ones. Generally, those who are not interested in financing or saving products would not move their accounts to IFIs because they may not consider their existing conventional accounts as being Shari'ah non-compliant and do not have a real incentive to migrate.

Moreover, in this context, people who are already using conventional financial services would prefer to deal with Islamic banks once available.

In this context, introducing Islamic finance would represent a threat and an opportunity at the same time. It would represent a threat for conventional banks since an important proportion of their customers would move to Islamic finance and concurrently an opportunity because they can attract underserved customers.

#### *Context 4*

$$\frac{Y\% + B\%}{X\% + Y\% + Z\% + W\% + A\% + B\%} > \frac{2}{3}$$

Introducing Islamic finance would cause a hard financial migration. Even people who have financial commitments would ask to convert them to Islamic ones.

For incumbents, introducing Islamic finance in this context becomes a necessity rather than a choice because conventional banks are exposed to a significant migration threat.

### **Conclusion**

Most of the time, researchers and analysts link the introduction of Islamic finance to financial inclusion. Nevertheless, from the perspective of Islamic finance, the issue of financial inclusion needs to be tackled in a different manner. Customers dealing with IFIs can be categorized into different profiles, starting with people that are self-excluded for religious reasons and thus do not use conventional finance products, and ending with people who use all conventional instruments but would prefer to convert their commitments to Shari'ah-compliant ones once available.

In practice, introducing Islamic finance is not limited to financial inclusion. It could cause a financial migration from conventional to Islamic banks, but even this migration can take many forms and depends on many factors that need to be analysed deeply and carefully. In real experiences, people interested in Islamic financial products can have different profiles,

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and the proportion of each profile can define whether Islamic finance enhances inclusion or creates migration. Islamic finance

Finally, Islamic finance has to contribute to the efforts of financial inclusion. Indeed, it has to adopt the same mechanisms of conventional finance and adapt them to Shari'ah principles. Moreover, Islamic finance can use Islamic institutions such as *waqf* (Islamic endowments) or *zakāh* (Islamic almsgiving) to have a wider impact on financial inclusion.

## Notes

1. M-Pesa is a mobile phone-based money transfer, financing and microfinancing service, launched in 2007 by Vodafone for Safaricom and Vodacom, the largest mobile network operators in Kenya and Tanzania.
2. We Chat Pay is a Chinese multi-purpose messaging, social media and mobile payment application developed by Tencent.
3. AliPay is a third-party mobile and online payment platform, established in Hangzhou, China in February 2004 by Alibaba Group and its founder, Jack Ma.
4. M-Kopa is a Kenyan solar energy company that was founded in 2011 by Nick Hughes, Chad Larson and Jesse Moore. Headquartered in Nairobi, the company sells home solar systems in Kenya, Tanzania, and Uganda.

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