ISLAMIC FINANCE IN THE AGE OF DIGITAL TRANSFORMATION

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It is in our collective interest to reduce the dependence of so many households and businesses on so few institutions that engage in so many risky activities.

Mervyn King

Since its modern inception in the 1970s, Islamic finance has emerged as one of the fastest-growing segments of the global financial system. That almost four-decades period for the industry to establish its indelible footprint in the international financial scene with assets of more than USD 2 trillion held by hundreds of financial institutions in approximately 50 economies across the globe. Albeit the fact that the size of the industry remains miniscule and dwarf by its conventional counterparts, the narratives of Islamic finance remain intriguing and relevance. In particular, to address global issues such as inequality, financial exclusion, climate change and even intergenerational equity. The need for a better and sustainable system is becoming even more imperative as the complexity of these challenges are profound and require innovative solutions.

In the past, resources have been channelled to enrich Islamic financial products that would complement, if not compete with its conventional counterparts. As such Islamic finance particularly Islamic banking and Islamic capital market have grown significantly over the years. With its more significant global presence today, the focus of Islamic finance is now—or should be—shifting to proliferate its roles and contributions in addressing the aforementioned challenges and enhancing the economic welfare and the well-being of the society, especially in the Muslim countries.

It is a common fallacy to envision that Islamic finance is a panacea to all malaise of the humanity. Nonetheless taking into consideration several facts that are paradoxical to human achievements, it is not wrong to think that an alternative system is required. For instance, despite years of peace and economic prosperity, extreme poverty and inequality remains profound. No doubt, the weakness or shortcomings of the current practices could have contributed to many astounding facts. Just to name a few, since 1990, CEO compensation has increased by 300% and corporate profits have doubled but the average worker’s salary has increased only by 4% (Economic Policy Institute, 2015). In fact, if the salary increment is adjusted for inflation, the minimum wage has actually decreased. Also, in the recent past, on average 26 rich people owned the same as the 3.8 billion people who make up the poorest half of humanity (Oxfam International, 2019). The aphorism “a rising tide lifts all boats” sounds more like a myth than a solid economic argument. It is also unsettling—perhaps shocking— to observe that despite the proliferation of financial sectors globally, about 1.7 billion adults remain unbanked— without an account at a financial institution or through a mobile money provider (World Bank, 2017). One would wonder, what prevents the banking sector to include a sizable global community and why financial inclusion remains a challenge in many parts of the world. The fact that an inclusive society is a necessary condition to end human misery from extreme poverty pose a serious question on the efficacy of the current banking system.

Distressingly, these problems seems to be more pertinent in the Muslims countries and indicate an obvious gap in Islamic finance that needs to be urgently addressed by improving the ability to intermediate the Muslim world’s resources to meet their own needs more effectively. The following figures depict that the share of the population that live below the international and national poverty lines. Although in general the statistics have improved over a long period of time, it is still worrying for certain Muslim countries, especially the ones in Middle East and North Africa (MENA) and Sub-Sahara.
Critics of Islamic finance are of the view that the less prevalence of Islamic finance in the worldwide act of combatting these economic issues could be due to its tendency to replicate the economics and risk profile of conventional products. While others argue that replicating conventional products is perhaps a more pragmatic approach in the early days to ensure the survival of Islamic finance, heavy reliance on such approach in a long run would create a path for Islamic finance to nowhere but convergence and the likelihood to appear trivial. The questions that remain are why Islamic banking is not evolving and why the convergence is taking place. Is it the failure of policy makers or the current ecosystem does not favour the practice of true Islamic banking. No doubt, in the world where asymmetry information is a common feature, risk sharing contracts are anathema to the role of banking as financial intermediaries, in particular guaranteeing deposits with positive return.

Figure 1: Proportion of population below the international poverty line (%)  
This figure depicts the percentage of the population living below the international poverty line. The ‘international poverty line’ is currently set at $1.90 a day at 2011 international prices. Data are from United Nations Global Sustainable Development Goals (SDGs) Database.
Will Islamic finance be any different in the future? I strongly believe cultivating innovation is what it takes for Islamic finance to step out of the shadow and resolve its own ‘crisis of identity’. Creative thought should be encouraged to accentuate the true value-added proposition of Islamic finance, including risk-sharing, fairness, social justice and inclusiveness. Social based institutions such Zakat and Waqf are often repeated in the various conferences and seminars as tools to ascend the status of Islamic Finance. Nonetheless, these institutions seems to be weak in governance and not able to build trust as much as the banking institutions. In fact, the isolated success of several institutions invariably depend on strong support from government or leadership of charismatic individuals. Unlike banking system that has evolved of the years and becoming more inclusive, social based institutions are still primitive and operate at a very small scale. The inept of these institutions to scale-up and replicated globally impede their acceptance and growth.

Having said that, I believe the solutions are still within our reach. As much as we need banking system to continue plays its role in promoting growth, there is a greater need for non-financial institutions such as Zakat and Waqf to scale up their operation and address some of the outlined challenges. It is important that these institutions are well accepted not only because they adhere to Islamic principles but also due to a better and fairer business models. Nonetheless, one would argue how smaller institutions can replicate the success of gigantic banking system.
One possible way to do so is by making use of digital technology to promote its services to a greater outreach to previously unserved and/or underserved. In the age of technological disruption, we have seen business models in most industries have been transmuted into platform-based services. A reliable technology not just enhance reachability but build trust and change the precept of the users. Technology ease scaling and replication, thus make it easier for a successful model to be implemented elsewhere.

In a much broader set-up, venturing into digital transformation is imperative as Islamic finance set to become disintermediated, it will help the industry’s key players to employ different types of classical Shariah contracts including profit-sharing, leasing and many more in designing their products and services that suit specific customers’ financial needs best, apart from a traditional loan. As a result, Islamic finance is able to refrain itself from being trapped in the maze of debt creation and money lending, just like in conventional finance.

My arguments are not simply build on rhetoric as in the recent past we have seem many cases where digital revolution have enable proliferation of new business models. For instance, as at December 2017, there were 116 fintech companies offering shariah-compliant products in which 21 are in Malaysia, 18 (Britain), 15 (Indonesia) and 14 are in the United State (IFN Fintech, 2017). The flexibility of Fintech allows these firms to circumvent rigid regulatory requirements in banking system and offers various products that cater the needs to the Islamic finance industry. In addition, the same flexibility allows strategic collaboration between Islamic financial institutions and technology companies in the effort to create a fertile environment to nurture innovation in Islamic finance. In Tunisia, for example, the Islamic Corporation for the Development of Private Sector (ICD), the private sector arm of Islamic Development Bank Group (IsDB) in December 2018 had partnered with a local bespoke advisory firm called I-FinTech Solutions (IFTS) to develop financial technology (fintech) solutions that facilitate transaction of real commodities by Islamic banks. It is anticipated that this innovative platform will benefit the end users through reduction of cost of financial transactions with faster execution and greater level of transparency and increase access to finance in poor communities.

Last but not least, Islamic finance with the help of digital technology can also capitalize on the rise of small and medium enterprises (SMEs) and start-ups, which look to tap the 1.8 billion Muslims worldwide to sell their goods. The International Finance Corporation (IFC) of the World Bank Group has estimated a potential gap of USD8.63bn to USD13.20bn for Islamic SME financing across the nine surveyed countries in MENA, while only 36% of more than 160 surveyed banks in that region had an SME offering (IFC, 2016). To fill this gap, a new digital exchange, known as Huulk, aims at attracting listings from Shariah-compliant financial technology start-ups. Meanwhile, in Malaysia, the Islamic Digital Economy Framework (Mi’yar) was released by the Malaysian Digital Economy Corporation (MDEC) that serves
as a guidance for start-ups and venture capitalists who wish to understand digital economy and available financing facilities from a Shariah point of view. The digital economy has been identified as a key growth driver for Malaysia, contributing 18.2% to the country’s gross domestic product in 2016 (MDEC, 2018). Moreover, Digital technology can also be a conduit for revitalizing the roles of Islamic wealth management in modern days. For instance, Wahed Invest, a New York-based Islamic digital wealth management company, managed to raise USD 8 million from MENA investors through its halal and ethical online investment platform in 2018. In addition, its robo-advisors are available to assist the investors to make investment decisions in diversified portfolios comprising of socially responsible stocks, sukuk, gold and other commodities in compliance with Shariah tenets.

Moving forward, Islamic finance should put an end to the imitation game and drive innovation within itself instead. Being a follower, but not a leader, has witnessed Islamic finance to have not had peculiar solutions to many economic problems and social illnesses in the Muslim countries as many of us wish to see. It is now the time that academician and policy makers to see solutions from a different lenses and not just through the existing system.

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References


