

FAQs on TN-3

Technical Note on Financial Inclusion and Islamic Finance

Q1. What are the main objectives the Financial inclusion Technical Note?

Answer: The technical note (TN-3) provides guidance on good practices in regulating the financial sector to enhance financial inclusion through Islamic finance by considering proportionality in balancing the benefits of regulation and supervision against the risks and costs. TN-3 highlights the importance of financial inclusion, due to its significant connection with economic growth, shared prosperity, and poverty reduction. Furthermore, it enables us to understand how financial inclusion policies and regulatory initiatives can support Islamic microfinance/savings/investment activities. The TN-3 also covers recent developments in enhancing financial inclusion through digital finance and financial technology (FinTech) platforms, while further identifying the current main challenges and emerging issues, as experienced by the market players and regulators, in microfinance and financial inclusion related to Islamic financial services. Finally, the TN-3 explores practical modalities for the integration of social finance modes in Islamic finance (e.g. Sadaqah, Waqf – each based on their Sharī'ah parameters) with the commercial IFSI to promote financial inclusion.

Intuitively, the Technical Note embarks on the following objectives:

- to provide international benchmark guidelines on regulatory and supervisory policies to support financial inclusion initiatives in the IFSI;
- to propose guidance to RSAs on the application of the proportionality principle so that the benefits of regulation and supervision can be balanced against the risks and costs; the survey exercise was conducted from October to December 2017. Therefore, the scope of this Technical Note excludes discussion of crypto-assets and blockchain technology;
- to factor in recent developments in enhancing financial inclusion through Sharī'ah compliant mechanisms by digital finance and FinTech platforms;
- to consider a modality for the integration of modes of Islamic social finance (e.g. Sadaqah, Waqf – each based on their Sharī'ah parameters) with the commercial IFSI;
- to highlight challenges in, and propose solutions to, emerging regulatory issues in microfinance and financial inclusion activities in the IFSI.

Q2. What is the conventional definition of financial Inclusion?

Answer: The conventional definition of Financial Inclusion refers to a state where individuals and businesses in a society have access to, and usage of, a range of affordable and quality

financial products and services that appropriately and justly meet their needs; and that are delivered by formal financial services providers in a transparent and simple manner, enabling informed understanding and decision making by the customer. In fact, several different definitions are used globally by various organisations, referring to a set of activities with relatively identical objectives. These objectives include enhancing access to formal financial services for the segments of society that are currently either unserved or underserved by formal financial institutions. This objective is usually achieved by addressing those constraints that make it difficult for people to access financial services and products offered by the formal financial institutions that are appropriate to their needs. These financial services and products are not limited to accessing credit, but also include savings, payments, insurance and investments.

Q3. What is the working definition of Financial Inclusion in Islamic Finance?

Answer: Financial inclusion is defined as a state where individuals and businesses in a society have access to, and usage of, a range of affordable and quality Shari'ah-compliant financial products and services that appropriately and justly meet their needs; and that are delivered by formal financial services providers in a transparent and simple manner while duly complying with the rules of Shari'ah, thus enabling informed understanding and decision making by the customer.

Admitting that the main goal of financial inclusion is enhancing the livelihood of beneficiaries while contributing to the overall well-being of the society, this definition therefore encompasses all the following key components of financial inclusiveness:

- Shari'ah compliant financial products and services are available and accessible by both individuals and businesses, reflecting that micro-, small and medium-size enterprises (MSMEs), particularly in emerging and less-developed economies, often find it difficult to access finance at an affordable price;
- The definition stresses both access to and usage of the Shari'ah compliant financial products and services, since access might be available, but a lack of awareness by consumers may limit their usage of these products;
- It reinforces the achievement of a balance between affordable products that do not compromise on a certain level of quality in terms of efficiency, safety and reliability;
- It highlights aspects of consumer protection and caveat emptor by way of ensuring the appropriateness/justness of financial products that are understood by the customer and offered by the service providers in a transparent and simple manner;
- Finally, it clarifies an intention to support financial inclusion activities by the formal financial services providers to ensure regulatory coverage and protection of the participants/stakeholders involved.

Q4. What are the specificities of Financial Inclusion in Islamic Finance?

Answer: The concept of financial inclusion is well grounded in the Islamic economic and financial system. **Justice, transparency, and equality** constitute the foundation of an Islamic economic system with the objective of developing a prosperous economic and social system. Islamic economics gives same weight to both individual and societal interests to encourage **social harmony**. The principle of **Social solidarity** is also supported by the subsystems of the Islamic economic system, including Islamic finance, which is anchored in a number of fundamental principles such as **sanctity of contracts, links to the real economic sector and risk sharing**.

The Islamic financial system's endorsement of **justice and risk sharing** provides for the establishment of a clear link between the Islamic concept of development and the notion of financial inclusion, in view of their holding a common goal of enabling the development of marginalised individuals and communities. Islamic financial contracts, particularly **risk-sharing financing instruments** and social **solidarity instruments** such as **Sadaqah, Waqf** and **Qard** can be adopted for financial inclusion.

The social solidarity instruments in an Islamic economic system are intended specifically to safeguard the rights of the less able through the income and wealth of the more able, thus ensuring social protection and poverty alleviation, leading to wider social and financial inclusion.

Q5. What are the factors that financial inclusion needs to comply with, beyond the traditional regulatory and supervisory measures?

Answer: Islamic financial inclusion organizations must comply with the following requirements:

- **Permissible and impermissible activities:** operators in Islamic financial inclusion activities must ensure that their operations comply with rules of halal (permitted) and haram (prohibited), and that they only finance activities (of counterparties) that are permissible in Sharī'ah.
- **Sharī'ah advisers/board and Sharī'ah reporting:** Islamic finance activities need to be under ongoing supervision by qualified experts who are well versed in the principles of Islamic finance and Sharī'ah. The activities/institutions may be supervised either by a Sharī'ah advisor or by a team of three or more experts forming a Sharī'ah board. The regulatory and supervisory guidelines on Islamic financial inclusion and microfinance activities need to be clear in terms of who or what constitutes a Sharī'ah advisor/board and spell out in detail the "fit and proper" criterion in relation to it.

- **Products – mechanism and operations:** the Islamic jurisprudence of transactions also has provisions regarding the way products function and contracts of exchange are executed. The regulatory and supervisory guidelines need to be elaborated based on the Islamic jurisprudence of transactions that would govern the execution of Islamic financial inclusion and microfinance contracts.
- **Sources of funds – social solidarity instruments:** NGO-type microfinance institutions are typically non-deposit-taking institutions. In Islamic finance, there are contracts that enable donations/grants, such as Sadaqah and Waqf. These social solidarity instruments, in turn, have their own specific concepts and contractual obligations that need to be duly considered by the institution collecting these funds and utilising them for financial inclusion activities. Although these non-commercial contracts are considerably easier to manage in non-deposit-taking institutions, there is a need for further regulatory thinking in terms of integration when they are utilised to raise deposits in commercial deposit-taking institutions.
- **Commensurate prudential and non-prudential regulations:** from a regulatory and supervisory perspective, the various specificities highlighted above create the need for commensurate prudential regulations on matters such as solvency requirements, liquidity buffers, Sharī'ah compliance issues, etc. Policymakers will have to carefully balance the costs of regulatory compliance against those of facilitating financial inclusion and microfinance activities. Both deposit-taking and non-deposit-taking institutions will also need regulations – in particular for non-prudential issues – in terms of consumer protection, financial literacy, financial reporting and transparency, as well as know-your-customer (KYC) rules and financial crime risk management. Given specifics from Sharī'ah law, these institutions require appropriate adjustments in business processes in the form of Sharī'ah governance requirements to ensure that non-prudential regulatory issues are soundly addressed.
- **Creditor rights and dispute resolution:** the specificities of Sharī'ah contracts utilised in transactions, combined with prohibition of interest (Ribā), usually require a different restructuring process in Islamic finance. The specific restructuring process would depend on the type of contract used. Hence, for instance, microfinancing done on a Murābahah sale basis of underlying assets creates a debt obligation on the client; a default event then creates complications, as the financing party is prohibited by Sharī'ah from simply rolling over the outstanding obligation for additional time in return for higher compensation from the client. As such, regulations must provide clarity on how defaults and non-performance of obligations should be approached.

- **Other considerations:** a further consideration arising from Islamic financial inclusion and microfinance activities is the segregation of funds in mixed operators; that is, when institutions operate both conventional and Islamic finance activities, funds mobilised through Sharī'ah contracts should only be used to finance Sharī'ah-compliant activities. Hence, this calls for regulations preventing a spillover of funds mobilised through Sharī'ah contracts into the conventional business. A common policy initiative by the national RSAs is to provide credit guarantees to enhance the eligibility of MSMEs and other clients. This initiative also calls for due consideration of Sharī'ah rules in the provision of guarantees for consumers that wish to avail themselves of Islamic financial inclusion and microfinance services. A related concern will be ensuring the availability of skilled human capital who understand the due rights and responsibilities arising from the various Sharī'ah-compliant activities to run and manage the operations of the Islamic financial inclusion and microfinance businesses.

Q6. How efficient Digital financial inclusion is?

Answer: Digital financial inclusion involves the adoption of digital means to reach financially excluded and underserved populations with a range of formal financial services. The concept is particularly noteworthy, and is rapidly gaining traction, since it enables formal financial institutions to reach previously unserved areas (e.g. rural areas, suburbs, villages) in an efficient and cost-effective manner. Reduced operational expenditure (e.g. by avoiding setting up physical branches) also enables service providers to potentially lower transaction costs for the customer, thus increasing affordability and usage.

Q7. What are the challenges related to the adoption of Fintech towards financial inclusion?

Answer: Digital financial inclusion presents a potential new set of operational, settlement, liquidity, credit, consumer protection and money laundering and financing of terrorism (ML/FT) risks, requiring a specific regulatory and supervisory approach by the RSAs. Overall, regulation and supervision of digital financial inclusion activities is a developing area and the TN, in its various guidelines, duly highlights specific considerations and/or treatments that may be essential for FinTechs and that differ from the typically non-digital financial inclusion activities.