

Islamic Finance and SMEs: Macroeconomic and Regulatory Perspective



ABAC Malaysia - SME Finance Forum Workshop on Innovative Financing for SMMEs

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Islamic Finance and the IMF

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- Policy advice and technical assistance to members
 - Regulation and supervision of Islamic banks and Sukuk market development
- Interdepartmental working group
 - Develop institutional view on Islamic finance industry, build in-house expertise, and coordinate better with various stakeholders
- External Advisory Group
 - Composed of leaders of relevant institutions, as well as highly regarded international experts in the field
- Current analytical work
 - **Islamic banking regulation and supervision**, macro-prudential policy, safety nets, resolution, **financial inclusion**, consumer protection, monetary policy, **Sukuk markets**, public financial management and tax policy

Islamic Banking and Financial Inclusion*

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- **Based on country-level information on financial inclusion and Islamic banking**
 - IMF's Financial Access Survey, World Bank Global Financial Inclusion Index and Enterprise Survey
 - Distinguish between supplier side (depositors and investors) and user side (recipients of Islamic financing)
- **Organization for Islamic Cooperation (OIC) members have lower levels of financial inclusion**
- **Religious self-exclusion slightly in OIC members with Islamic banking (10¼%) than in those without (9½%)**

*Ben Naceur et al.(2015)

Stylized Facts on Financial Inclusion

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- “ OIC Countries have lower FI on both demand and supply side
- “ Islamic banking countries do better
- “ Weak correlation between user and supplier side FI

- “ Firm use of bank credit lower in OIC countries
- “ Performance of Islamic banking countries mixed

Figure II.4. Selected Financial Inclusion and Depth Indicators (Levels, 2013)

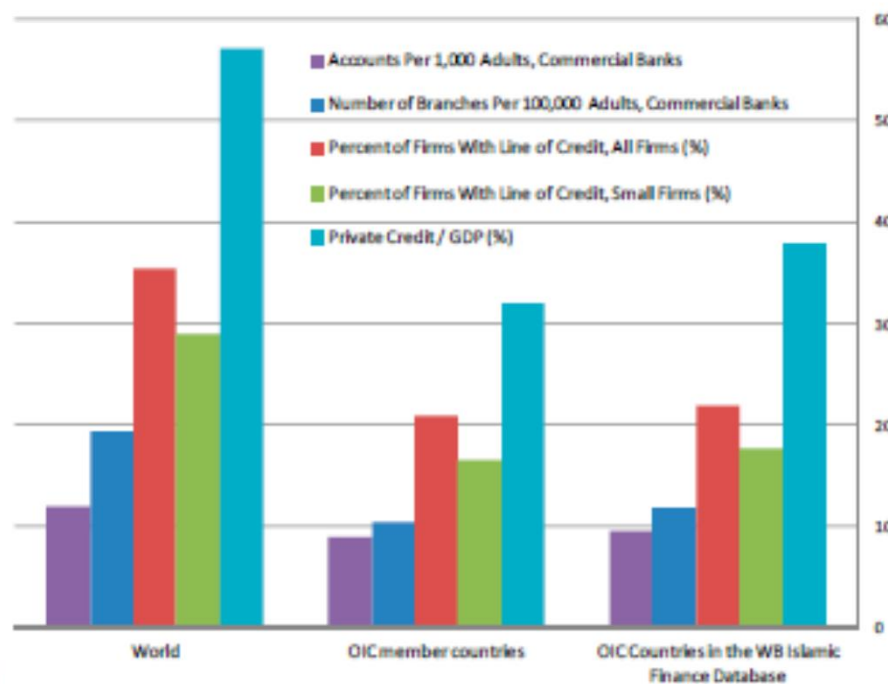
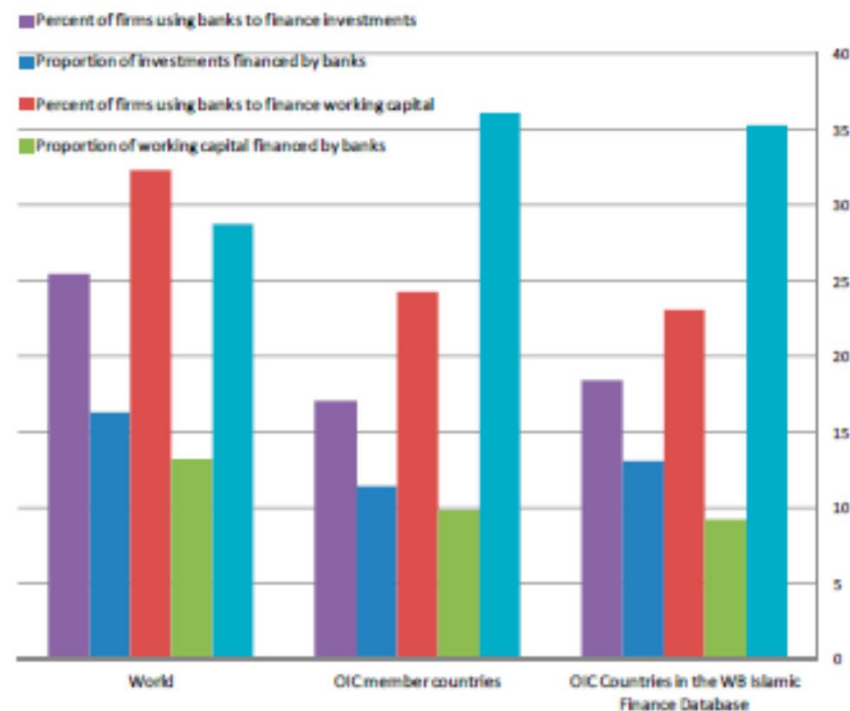


Figure II.6. Selected Indicators of Firm Use of Financial Services, 2013



Source: World Bank Enterprise Survey

Key Findings

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- Tentative and weak relationship between Islamic banking and financial inclusion
 - May be due to data issues
- Supplier-side and user-side financial inclusion highly correlated
 - Reforms needed on both sides
 - Self exclusion a key issue even in Islamic banking

Other issues for Islamic SME Financing

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- **Financial stability and regulation**
 - SME credit, especially if diversified across sectors, should reduce overall risk of IB asset portfolios
 - Risk weights on PLS may be excessive in some jurisdictions
- **Taxation "debt bias"**
 - Deductibility of interest costs for corporate tax purposes
 - Need cross-border consistency, especially as SMEs internationalize
- **Collateralized Sukuk (e.g. CIMB)**
 - Need to avoid CDO pitfalls, disclosure at both asset and transaction levels
 - Allows mobilization of additional funding
 - But doesn't solve liquidity management issues for Islamic Banks

Policy recommendations – User Side

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- Separate SME business units in Islamic banks.
- Development of PC and VC business lines needs domestic capital markets to allow exit/graduation
- Improved credit evaluation techniques
- Improve training of staff on Sharia'ah compliant instruments
- Ensure risk weights do not unduly discriminate against PLS financing
- Remove tax distortions on equity-like financing
- Improvement of credit information

Recommendations – Supplier side

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- Consumer protection and education
 - Deposit insurance
- Islamic equity funds – targeted at SMEs, VC.
- Islamic partial credit guarantee
- Institutionalization of Islamic redistributive schemes
 - Could be directed to microfinance
- Encourage development of collateralized sukuk
 - Disclosure, high asset quality

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