



Economic Brief | Issue No. 1

Series of 2024

January 2024

THE ECONOMICS OF ISLAMIC FINANCE AND ITS REGIONAL IMPACT IN BARMM

Exploring Islamic Finance in the Global Context and Its Potential Impact in the Bangsamoro Autonomous Region in Muslim Mindanao



ACKNOWLEDGEMENT

We extend our heartfelt gratitude to the Honorable Minister Ubaida C. Pacasem. His vision, guidance, and steadfast support have been instrumental in making this briefer not only possible but focused on the most impactful areas of need and opportunity.

We would also like to acknowledge the dedicated team at the Bangsamoro Finance Office, particularly the astute guidance of Atty. Sittie Amirah K. Pendatun and the expertise of Farrell Hazsan E. Usman. Their efforts and dedication to excellence have infused this briefer with valuable insights, shaping it into a resource that stands to significantly benefit the socio-economic landscape of BARMM.

Finally, we are grateful to all who contributed their time, knowledge, and efforts in reviewing this briefer. Together, we hope to foster a better understanding of Islamic Finance in BARMM and its potential to catalyze socio-economic development in a manner that is congruent with the values and traditions of the communities it serves.



ABOUT THIS BRIEFER

This economic brief offers an exploration of the evolving landscape of Islamic finance within the Bangsamoro Autonomous Region in Muslim Mindanao (BARMM). It aims to provide a comprehensive analysis of the regional impact and broader economic implications associated with the principles and practices of Islamic finance, particularly in the context of the recent global transition from the London Interbank Offered Rate (LIBOR) to Risk-Free Rates (RFRs).

This document is crafted to serve as a valuable resource for policymakers, financial professionals, and various stakeholders who are actively engaged or interested in Islamic Finance. By shedding light on the challenges and emerging opportunities, this brief strives to contribute significantly to the discourse on Islamic finance and its vital role in regional and global economic frameworks.



Executive Summary

This briefer presents an analysis of Islamic finance, an increasingly prominent sector in the global financial landscape, particularly focusing on its application and potential impact within the Bangsamoro Autonomous Region in Muslim Mindanao (BARMM). Through a series of distinct sections, the briefer analyzes the principles, shifts, challenges, and impacts of Islamic finance, both globally and regionally. The following are the key points of each section:

Fundamental Principles of Islamic Finance: At its core, Islamic finance is guided by Shariah law, eschewing traditional interest-based models in favor of ethical practices like riba (interest) prohibition, risk-sharing, and ethical investment. This unique approach sets it apart as a ethically grounded alternative to conventional financial systems.

Shift of Financial Systems: In the transition from LIBOR to Risk-Free Rates (RFRs), Islamic financial institutions face a pivotal change in the global financial landscape. This shift requires rigorous analysis and Shariah authority approval to ensure adherence to Islamic principles, notably in avoiding riba and gharar (uncertainty), thereby upholding the ethical and strategic imperatives of Islamic finance.

Global Adaptation to RFRs in Islamic Finance: The adaptation of the Islamic Finance to the global shift from the LIBOR system to RFRs necessitates critical updates in profit calculation and product pricing, with countries like Oman, Saudi Arabia, and Malaysia customizing their approaches to align with Shariah principles.

Status of Islamic Financial Systems Globally: Islamic finance is experiencing robust growth, particularly in Islamic Banking and the Islamic Capital Market, with instruments like Sukuk showing a strong positive correlation with economic growth. The expansion of Shariah-compliant assets is proving beneficial for the economic landscapes of Muslim nations, fostering investment and innovation.

Economic Impacts of Islamic Finance: Islamic finance is positively influencing economic growth in Muslim nations, with its expansion linked to increased capital availability and GDP growth. Shariah-compliant financing methods and products are attracting diverse investors, stimulating investment and entrepreneurship. This can contribute to economic diversification and creation of new industries, underlining Islamic finance's pivotal role in economic development.

Islamic Finance in BARMM: In BARMM, Islamic finance is expected to catalyze economic growth, particularly in sectors like agriculture and trade. The ethical lending principles and profit-sharing models could enhance financial inclusion, spur entrepreneurship, and strengthen community bonds.

Economic Challenges in Islamic Finance Evolution: As the sector evolves, it grapples with balancing rapid financial innovation with strict Shariah compliance. Challenges include the diverse interpretation of Shariah principles across regions, the need for standardized regulatory frameworks, and overcoming misconceptions about Islamic finance.

The briefer culminates with a forward-looking perspective, aspiring to contribute significantly to the enrichment of the financial fabric of BARMM.



Introduction

Islamic finance is increasingly recognized as a significant and emerging sector within the international financial markets. Defined by its adherence to Shariah law, Islamic finance embodies a transformative shift away from conventional interest-based financial paradigms. This shift is rooted in the emphasis on ethical and moral considerations in financial transactions. Islamic finance aligns financial activities with broader ethical mandates, aiming to create a more socially responsible and sustainable financial system.

Central to Islamic finance is the prohibition of Riba (interest), contrasting sharply with conventional banking and investment practices. It promotes equity, social justice, and economic participation through profit and risk-sharing mechanisms. These practices are designed to prevent exploitation and ensure that financial transactions contribute positively to society.

While this brief offers a global perspective on Islamic finance, it also focuses on BARMM. This region presents a unique case study for the application and impact of Islamic financial principles. In BARMM, these principles have the potential to address specific regional economic challenges and contribute to socio-economic development.

The report includes discussions on the fundamental principles of Islamic finance, the shift in financial systems to incorporate these principles, global adaptation to changes like the transition to Risk-Free Rates (RFRs), and the current status of Islamic financial systems globally. Additionally, it examines the economic impacts of Islamic finance and provides a regional perspective from BARMM, discussing the economic challenges in the evolution of Islamic finance.

Transitioning from these detailed explorations, the brief culminates in a holistic understanding of Islamic finance. It underscores the role of Islamic financial principles in contemporary financial landscapes and their specific implications and challenges, both globally and within BARMM. This report emphasizes Islamic finance as a potential catalyst for transformative change in the global financial order, driven by its unique blend of ethical practices and economic functionality. This exploration not only sheds light on the operational aspects of Islamic finance but also illustrates its broader impact on fostering equitable and sustainable economic development.




Fundamental Principles of Islamic Finance

Islamic finance promotes ethical transactions and social equity within its economic framework. Essential to this framework are several fundamental principles, which collectively shape the ethical and moral landscape of Islamic finance. These principles not only dictate financial transactions but also reflect a commitment to broader social and ethical responsibilities. Below, we explore these core principles that form the backbone of Islamic finance [1]:

01


Prohibition of Riba (Interest)



Islamic finance strictly prohibits riba, which encompasses any form of fixed or guaranteed interest on loans or deposits. This prohibition is rooted in the pursuit of fairness and justice, as interest is seen as leading to exploitation and social inequities.

02


Risk and Return Sharing



Income should not be generated through interest but rather through risk and return sharing between parties in a transaction. This principle is believed to foster partnership and shared responsibility, which increases the likelihood of success for ventures.

03


Avoidance of Gharar (Uncertainty)



Transactions involving gharar, which signifies deception or excessive uncertainty, are forbidden. This ensures that all parties engage in contracts with full consent and satisfaction, avoiding deceit and fraud.

04

Prohibition of Maysir (Gambling)



Maysir, or gambling, is prohibited in Islamic finance. This is in line with the principles of reducing uncertainty and ensuring that wealth is generated through legitimate trade and investment, not through chance or speculation.

05

Shariah Approved Activities



Islamic finance does not support activities or products that are harmful to society, such as alcohol, tobacco, and gambling. Islamic banks operate with a Shariah supervisory board to ensure all activities are compliant with Islamic principles.

06


Sanctity of Contract



Contracts in Islamic finance are considered sacred and must include full disclosure to ensure informed consent. They must not violate Islamic religious and moral principles, which govern their legality and enforceability.

07


Usage of Money



Money in Islamic finance is treated purely as a medium for transactions and not as a commodity. The trading of money for profit is prohibited, emphasizing its role as a facilitator of trade.

08

Paying and Collecting of Zakah



Zakah is a mandatory charitable contribution and a key component of Islamic finance, aiming to purify wealth by redistributing it to the poor and needy, thereby contributing to socio-economic development.

Shift of Financial Systems

Financial systems globally encompass the institutions, instruments, and practices that facilitate the flow of money and investments. They play a crucial role in the economy by managing savings, extending credit, and regulating monetary exchanges. Key to this system are benchmark interest rates, which influence the cost of borrowing and lending money. Shifts in these benchmarks, such as the move from LIBOR to Risk-Free Rates (RFRs), can significantly impact the financial landscape, particularly for institutions like Islamic banks that prioritize Shariah compliance in their operations.

LIBOR System

LIBOR, a benchmark interest rate, played a crucial role in determining prices for various conventional financial products, with banks employing it as a reference rate for interbank lending. However, its use within Islamic finance required careful consideration to ensure compliance with Shariah principles, which prohibit Riba (interest). Islamic financial institutions, therefore, adapted the reference point provided by LIBOR to develop Shariah-compliant profit-and-loss sharing mechanisms, avoiding the use of interest-based transactions.

RFRs System

RFRs are founded on actual market transactions. They are considered more transparent and potentially more aligned with the ethical investments valued in Islamic finance. The following table outlines some of the main RFRs [3]:

RFR Name	Region/ Currency	Basis of Calculation	Start Date	Publishing Body
SOFR Secured Overnight Financing Rate	US Dollar	Secured repurchase transactions	April 2018	New York Federal Reserve
SONIA Sterling Overnight Index Average	British Pound	Overnight unsecured transactions	1999 (Bank of England since 2016)	Bank of England
ESTER Euro Short-Term Rate	Euro	Short-term transactions	October 2019	European Central Bank
SARON Swiss Average Rate Overnight	Swiss Franc	Overnight transactions	2009	SIX Swiss Exchange
TONAR Tokyo Overnight Average Rate	Japanese Yen	Overnight transactions	2016	Bank of Japan

Transitioning to RFRs necessitates not only technical adjustments but also strategic considerations. This shift requires Islamic financial institutions to conduct a rigorous analysis and secure approval from Shariah authorities to ensure the new benchmarks conform to Islamic principles. Such thorough scrutiny is vital to avoid Riba and Gharar, maintaining the integrity and compliance of Islamic financial products. Consequently, RFRs' adoption in Islamic finance is a deliberate move to uphold ethical investment and social responsibility principles.

The switch from LIBOR to RFRs underscores the need for Islamic finance to adapt to evolving financial landscapes. This adaptation is multi-faceted, involving regulatory compliance, product restructuring, and the affirmation of Shariah adherence, all of which are imperative to safeguard the ethical foundations of Islamic finance. [2]



Global Adaptation to RFRs in Islamic Finance

The shift from the traditional LIBOR system to RFRs marks a pivotal moment for Islamic financial institutions worldwide. This section of the brief explored how countries are navigating this change, adapting their practices to ensure continued alignment with Islamic principles and the demands of a dynamic global economy. [4]

Switching Financial Benchmarks



Islamic financial institutions are currently updating their systems to adapt to new financial benchmarks called RFRs, moving away from the traditional LIBOR system. This change requires them to revise their methods for calculating profits and product pricing. As a result, the cost and value of financial products might fluctuate more than before.

How Different Countries are Adapting



Different countries are responding to this transition in varied ways. Oman's central bank, for example, directed its banks to phase out LIBOR and prepare for the new RFRs. Saudi Arabia established a group to assist banks during this transition, while Malaysia ensured that the new rates comply with Islamic financial principles.

Choosing New Reference Rates



Countries are considering both local and international options for their new benchmark rates. The choice of these rates is crucial as they need to align with the principles of Islamic finance and accurately reflect market costs. Some popular international options include SOFR and SONIA.

Options for Islamic Finance



In Islamic finance, it is important to choose benchmark rates that are Shariah-compliant. Since some new rates rely on past data, determining future costs can be challenging. To address this, Islamic finance might use fixed profit rates or create new methods for setting prices, like trading commodities.

Guidelines for Islamic Banks



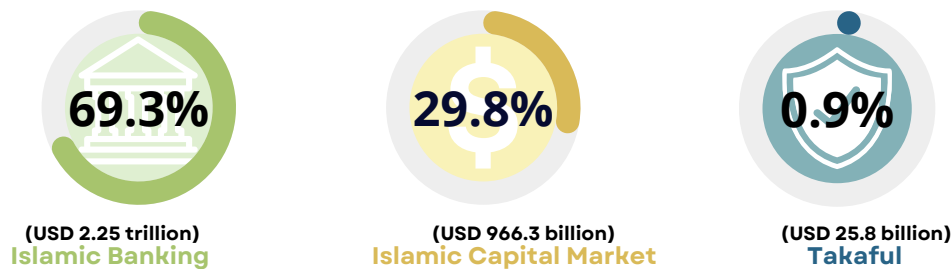
Islamic banks are advised to revise their contracts, enhance their technological infrastructure, and establish robust management systems to handle these changes. Collaborating with Islamic law experts is also crucial to ensure compliance and fairness. Additionally, they need to be mindful of the interactions between Islamic and conventional banking systems to maintain industry stability.



Status of Islamic Financial Systems Globally

The Islamic finance has marked a significant presence in the global financial landscape. This sector is showing a trajectory of growth and diversification across its principal instruments: Islamic Banking, Islamic Capital Market, and Takaful (Islamic Insurance). This overview delves into the current status, trends, and challenges in these segments, reflecting their pivotal role in shaping the global economy.

ISLAMIC FINANCIAL SYSTEM



Islamic Banking

- Islamic banking is the cornerstone of the Islamic financial system, holding about **69.3% (USD 2.25 trillion)** of its total assets in 2022 [2].
- Significant growth is observed in the GCC, South-East Asia, and the Middle East, with the GCC region being particularly dominant.
- The sector grapples with challenges such as limited public awareness of Islamic finance principles, exchange rate impacts on asset values, and the need for more Shariah-compliant liquidity management tools.

Islamic Capital Market

- Demonstrating resilience, the Islamic capital market's value stood at **USD 966.3 billion** in 2022, equivalent to **29.8%** of Islamic financial system's total assets [2]. This growth is buoyed by strong global risk appetite and favorable external conditions.
- Sukuk remains a crucial element, particularly in the GCC region, facilitating funding for various initiatives, including economic diversification and climate-transition projects.
- The market is poised for continued growth, bolstered by rising investor interest and an uptick in sustainability-related issuances.

Takaful (Islamic Insurance)

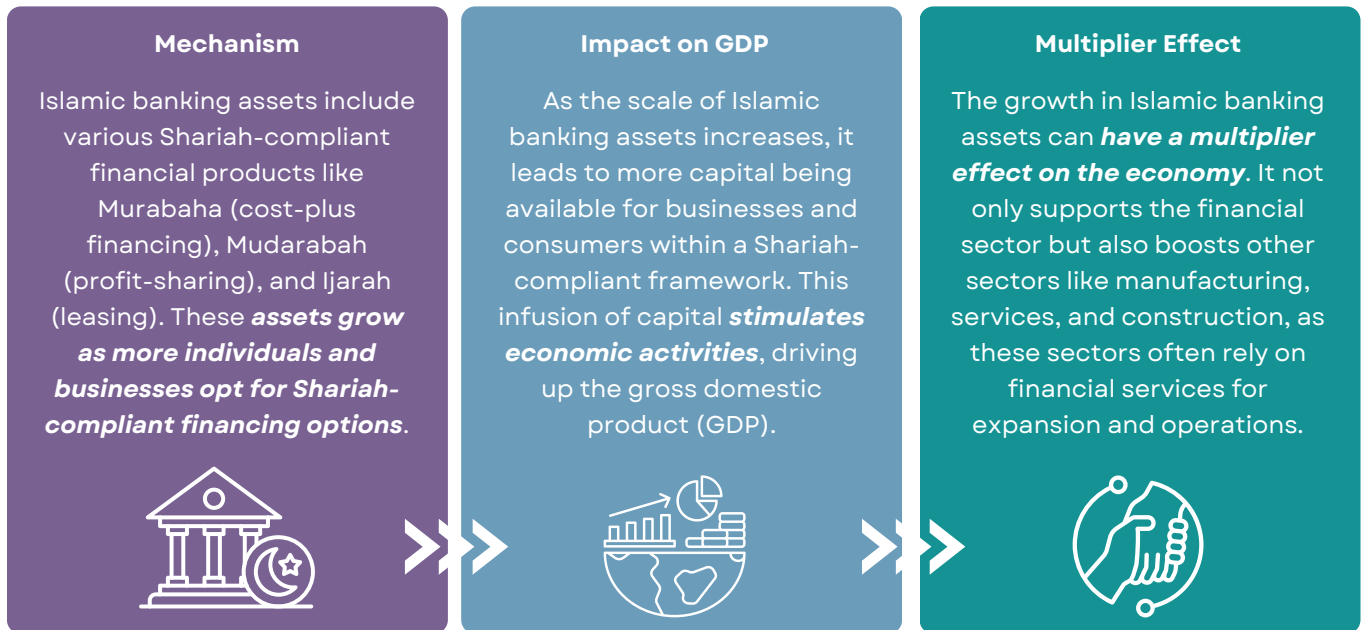
- Takaful is experiencing consistent growth, with a 16.1% year-on-year increase in direct contributions to **USD 25.8 billion (0.9% of Islamic financial system's assets)** in 2022, underscoring its growing significance in Islamic finance [2].
- Regulatory frameworks in various Islamic finance jurisdictions are evolving to support Takaful, enhancing its integration into the global financial system.

The Islamic financial services industry is navigating through global economic challenges with resilience and adaptability. Its distinctive principles, centering around ethical investment and risk-sharing, are garnering global attention. With sustained growth, diversification, and expansion into new markets, Islamic finance is solidifying its position as a crucial component of the global financial ecosystem.

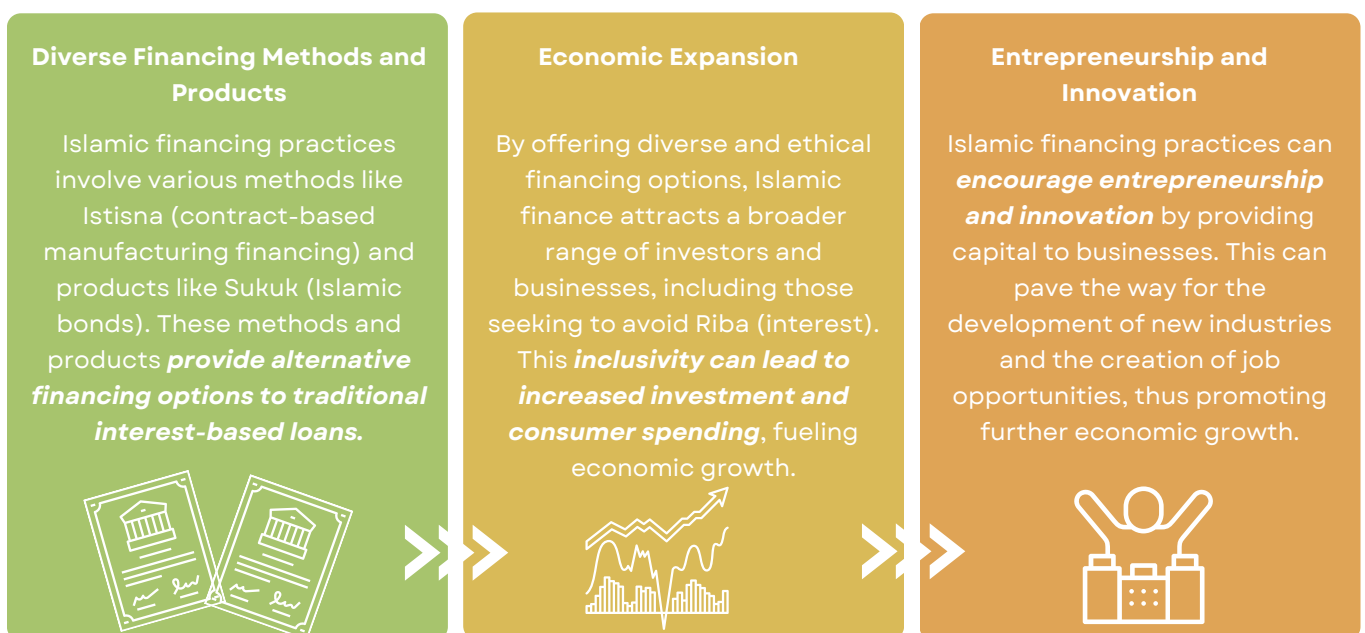
Economic Impacts of Islamic Finance

Both Islamic banking assets and the practice of Islamic financing are closely linked to the economic growth of Muslim nations, suggesting that as these financial practices grow, so does the economy. The issuance of sukuk (Islamic bonds), also shows a strong positive correlation with economic growth, underlining its effectiveness as a financial instrument in Islamic finance. [3]

ISLAMIC BANKING ASSETS AND ECONOMIC GROWTH



ISLAMIC FINANCING PRACTICES AND ECONOMIC GROWTH



Islamic Finance in BARMM: A Regional Perspective

SOCIO-ECONOMIC IMPACTS OF ISLAMIC FINANCE

The majority-Muslim population in BARMM offers a fertile ground for the growth of Islamic finance, as many remain underserved by conventional banking. The alignment with Shariah law positions Islamic finance as a natural fit for the Bangsamoro culture. BARMM's developing economy could leverage Islamic finance to boost investment and entrepreneurial activity, fostering overall economic development.



Financial Inclusion

The introduction of Islamic finance in BARMM could lead to a significant increase in financial inclusion. Traditionally, residents, particularly those in remote areas, have faced barriers to accessing conventional banking services. The ethical lending and investment principles of Islamic finance are likely to align well with the local population's beliefs and values. Consequently, it is expected that Islamic finance could provide previously underserved individuals with new opportunities for banking, loans, and investments that are customized to their needs and congruent with their religious principles. [4]



Economic Boost

The economic landscape of BARMM could potentially experience a significant uplift with the Islamic finance. Businesses, especially within the agricultural and trade sectors, will have the opportunity to benefit from the interest-free loans and profit-sharing models that Islamic finance offers. This could result in a surge in economic activity, fostering entrepreneurship and stimulating innovation throughout the region. [5]



Community Cohesion

Beyond the economic benefits, Islamic finance could foster a sense of community and mutual trust among the residents of BARMM. The shared values and principles underlying Islamic finance could bring people together, creating a sense of unity and shared purpose. This communal bond is essential for the long-term stability and growth of the region.

Broader Halal Ecosystem



The Chief Minister of BARMM has emphasized the importance of the Islamic Finance System (IFS) in the development of a broader Halal ecosystem. [6]. Such an ecosystem is anticipated to extend well beyond finance to include diverse sectors such as food, cosmetics, and pharmaceuticals, all operating under the guidance of Islamic principles. The emphasis on ethical and equitable transactions is expected to resonate with the social evolution sought by the Bangsamoro region. This approach represents a comprehensive pathway to development, aiming to integrate the principles of justice, fairness, and communal well-being into every aspect of life in BARMM, from commerce to daily living.



Economic Challenges in Islamic Finance Evolution

Islamic finance faces unique economic challenges as it evolves, primarily due to its need to comply with Shariah principles while innovating and competing in the global financial market. These challenges impact its development, standardization, and competitiveness.

Financial Innovation vs. Compliance



Balancing the rapid pace of financial innovation with the strict adherence to Shariah principles has always been a challenge in Islamic finance. Financial products and services must be designed to meet the economic needs of the society while ensuring they do not violate any Islamic prohibitions. This balance ensures that the financial system remains resilient and trustworthy. [9]

Diversity in Interpretation



The interpretation of Shariah principles can vary across different countries and cultures. This diversity in interpretation can lead to varied jurisprudential views, impacting the standardization and harmonization of Islamic financial products and services across borders. Such variations can influence the economic decisions of investors and consumers who operate in multiple jurisdictions. [10]

Competing with Conventional Finance



The prohibition of riba (interest) and the requirement for asset-backed transactions limit its flexibility compared to conventional finance. Balancing Sharia compliance with global financial norms and innovating within these constraints is a significant hurdle, impacting its competitiveness and diversity in the global market. [11]

Regulatory Frameworks and Standardization



Developing a comprehensive regulatory framework that accommodates the unique aspects of Islamic finance while ensuring global standardization is a major challenge. This includes creating regulations that address the specific risks and operational models of Islamic finance, as well as harmonizing these standards across different jurisdictions. [9]

Market Perception and Awareness



There is often a lack of awareness and understanding of Islamic finance principles among the broader public. Misconceptions and limited knowledge about the benefits and structures of Islamic financial products can hinder market penetration and acceptance. [10]

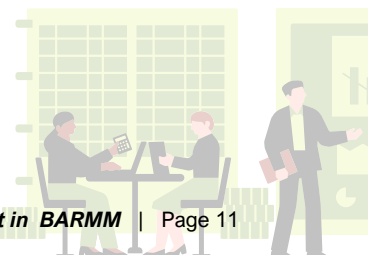
Conclusion

As we conclude this briefer, it is clear that Islamic finance represents a significant and evolving force in the global financial landscape. The transition from traditional finance mechanisms, exemplified by the shift from LIBOR to RFRs, is not merely a procedural change but a fundamental realignment with Islamic finance's inherent principles of fairness, transparency, and risk-sharing. This transition is particularly resonant within the context of the BARMM, where Islamic finance is not just a financial system but a catalyst for socio-economic development and stability.

The exploration of Islamic finance in this briefer has underscored its potential to reshape economic landscapes, aligning profit-making with ethical considerations and social welfare. It has highlighted how Islamic finance can offer innovative and ethically grounded solutions to modern financial challenges. This is especially pertinent in regions like BARMM, where such financial practices can significantly contribute to regional development and social progress.

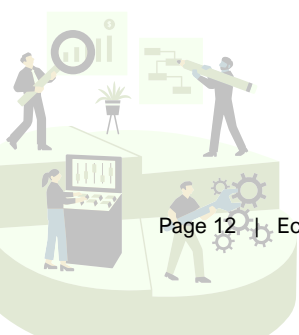
Looking ahead, the ongoing global shift in financial benchmarks and the increasing integration of Islamic finance into mainstream financial markets present both challenges and opportunities. These developments demand adaptive strategies, innovative financial products, and continuous alignment with Shariah principles. The evolution of Islamic finance, as evidenced in this briefer, is not only a testament to its resilience and adaptability but also an indication of its growing influence and relevance in the global financial order.

In summary, this briefer has offered a comprehensive view of Islamic finance, illustrating its distinctive principles, regional impact, and global integration. As the financial world continues to evolve, the unique approach of Islamic finance to combining ethical practices with economic activities will undoubtedly play a pivotal role in shaping a more equitable and sustainable financial future.



References

1. Tabash, Mosab & Dhankar, Raj. (2018). The Relevance of Islamic Finance Principles in Economic Growth. 2278-9359.
2. Islamic Financial Services Board. (2022). Transitioning from London Interbank Offered Rate (LIBOR) to Risk-Free Rates (RFRs): Early Policy Responses in Selected Jurisdictions. IFSB Working Paper Series.
3. IBOR Transition (1/2): Background. Finance Unlocked. Accessed December 20, 2023. <https://financeunlocked.com/videos/ibor-transition-1-2-background>.
4. Islamic Financial Services Board. (2023). Islamic Financial Services Industry Stability Report. Kuala Lumpur, Malaysia.
5. Naz, S.A., & Gulzar, S. (2020). IMPACT OF ISLAMIC FINANCE ON ECONOMIC GROWTH: AN EMPIRICAL ANALYSIS OF MUSLIM COUNTRIES. *The Singapore Economic Review*, 1-21.
6. Department of Finance, Republic of the Philippines. (n.d.). Strong Islamic Bank System to Boost BARMM Development - Dominguez. Retrieved from <https://www.dof.gov.ph/strong-islamic-bank-system-to-boost-barmm-development-dominguez/>
7. Manila Bulletin. (2021, April 21). BSP sees 2 Islamic banks in BARMM. Retrieved from https://mb.com.ph/2021/04/21/bsp-sees-2-islamic-banks-in-barmm/#google_vignette
8. Bangsamoro Autonomous Region in Muslim Mindanao. (2023). BARMM to create Islamic finance system to advance region's socio-economic devt. Retrieved from <https://bangsamoro.gov.ph/news/latest-news/barmm-to-create-islamic-finance-system-to-advance-regions-socio-economic-devt/>
9. Idiab, A., Rahim, M., & Jusoh, M. (2012). *Islamic Banking and Finance: Principles and Practices*. Kuala Lumpur: Darul Fikr Publications.
10. International Shariah Research Academy for Islamic Finance. (2015). *Islamic Financial System: Principles & Operations*. Kuala Lumpur: ISRA Publications.
11. Schoon, N. (2023). The state of Islamic finance: challenges and prospects. The London Institute of Banking & Finance. Retrieved from <https://www.libf.ac.uk/news-and-insights/news/detail/2023/10/24/the-state-of-islamic-finance-challenges-and-prospects>





ABOUT US

The **Economics Division** serves as the support arm to the Office of the Minister, tasked to undertake research, and examine economic data/trends for the continuing formulation of fiscal and other development policies and processes toward efficient and responsive fiscal management and resource utilization in the Bangsamoro region.




The Economics Division Team:

Noraida G. Macapantar
Anisah U. Lingga
Qairah M. Amatonding
Irishassia A. Garuda
Princess Diana G. Salik



ECONOMICS DIVISION
Ministry of Finance, and Budget and Management
Bangsamoro Autonomous Region in Muslim Mindanao

 Ministry of Finance, and Budget and Management Bldg., Governor Gutierrez Ave., Rosary Heights 7, Cotabato City 9600, Philippines

 mfbm.econ@gmail.com

 www.sites.google.com/view/mfbmecon/home



Copyright January 2024 by Economics Division of Ministry of Finance, and Budget and Management

All information from this publication that will be published or quoted in presentations or documents must acknowledge the "The Economics of Islamic Finance and its Regional Impact in BARMM".