
IS ISLAMIC FINANCE THE FUTURE OR THE PAST?

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Abstract

Today, Islamic financing occupies leading positions in the world of Finance and economics. This article highlights the development, perspective and practice of Islamic finance. As well as this short analysis for 2019-2025, the strategy and future expectation of implementing Islamic financing in Indonesia and Malaysia have been studied.

Keywords: Islamic finance, Islamic social finance, ESG, CAGR.

Introduction

The Islamic financing market represents a dynamic and rapidly growing segment within the global financial landscape. Rooted in Islamic principles of ethical and socially responsible investing, Islamic finance offers an alternative to conventional banking that adheres to Sharia law, prohibiting interest (riba), uncertainty (gharar), and investments in businesses considered haram (forbidden). Characterized by risk-sharing, asset-backed transactions, and ethical investment practices, Islamic finance provides a diverse range of products and services, including Islamic banking, Islamic bonds (Sukuk), Islamic insurance (Takaful), and Islamic investment funds. With a growing Muslim population worldwide and increasing demand for Sharia-compliant financial solutions, the Islamic finance market has expanded beyond traditional Muslim-majority countries to become a global phenomenon, attracting interest from both Muslim and non-Muslim investors seeking ethical and sustainable investment opportunities. As the industry continues to innovate and evolve, Islamic finance is poised to play an increasingly significant role in shaping the future of finance, promoting financial inclusion, and fostering economic development while adhering to the principles of fairness, transparency, and social justice.

Islamic finance (IF) and Islamic social finance (ISF) are two broad frameworks within the innovative financing landscape that have proven to offer great potential for supporting sustainable development given their fundamental emphasis on environmental, social, and corporate governance criteria to generate positive societal impact.

IF refers to the provision of financial services based on moral principles and backed by a set of values based on legal framework of Islam (Shari'ah Islamic law). While focus on IF has been largely on what it prohibits, many overlook the development potential that it allows or advocates for:

- filling in the financial gap in addressing humanitarian crises in conflict-stricken or climate disaster locations, whereas developing countries annually need USD5-7 trillion to keep their SDG ambitions on track.

- ensuring a close link between the real economy and financial sector, where investments are made into real economic activities.
- emphasizing principles of morality and ethics in business conduct, in a larger legal and ideological context than the ESGs;
- advocating the sharing of risk and reward between investors and investees, or creditors and borrowers without any elements of riba' or usury.
- upholding the economic principle of freedom of action and collective responsibility, where motivations for economic activity should meet not only one's own needs but also contribute to the good of the society.

IF has the potential to contribute to sustainable development in at least three dimensions. Firstly, it aims to foster greater financial inclusion, especially of large, underserved Muslim populations who may avoid conventional interest-based financial institutions because of the prohibition of riba (interest) by the Islamic law. Secondly, its emphasis on asset-backed financing and risk-sharing means that it could provide support for small and medium-sized enterprises in developing OIC countries, as well as investment in public infrastructure. Finally, its risk-sharing features and prohibition of speculation suggest that IF may, in principle, pose less systemic risk than conventional finance. The principles of risk-sharing and the strong link of credit to collateral means that Islamic bank is well-suited to the financing of SME and start-ups, thereby potentially contributing to more inclusive growth. These features make Islamic financial instruments a potentially transformative new source to finance the SDGs, through its ability to stimulate economic activity and entrepreneurship, increase financial inclusion and social stability - all of which are consistent with the 2030 Goals. Islamic financial services such as Islamic microfinance, sukuk and takaful are equally entrenched in socio-economic justice principles.

According to the State of the Islamic Economy Report 2022, despite the continued uncertainty related to the pandemic COVID-19, the global Muslim spending in 2022 is forecasted to grow by 9.1% for the Islamic economy sectors. All related Islamic economy sectors, except travel, have returned to pre-pandemic spend levels by the end of 2021. Muslim spending is forecasted to reach USD2.8 trillion by 2025 at a four-year Cumulative Annual Growth Rate (CAGR) of 7.5%. Specifically, Islamic finance assets are estimated to have grown to USD3.6 trillion in 2021, up 7.8%, from USD3.4 trillion in 2020 (DinarStandard, 2022). A summary of the global Islamic economy for 2019-2024 is shown in Figure 1.1.

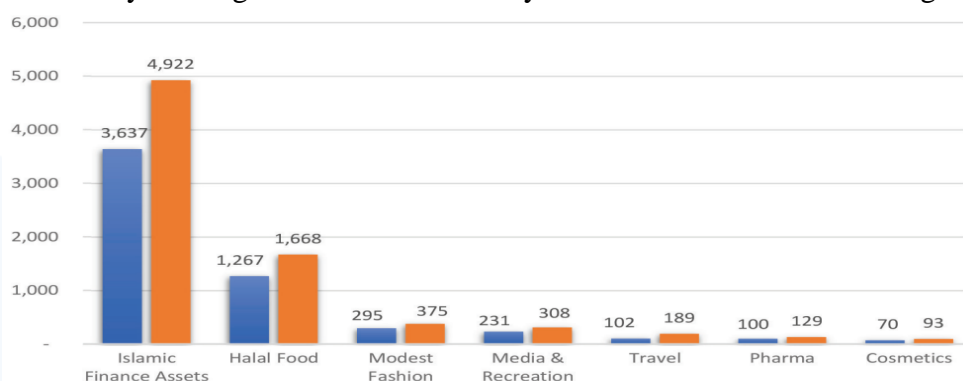


Figure 1.1: Global Islamic Economy 2021-2025

Source: State of the Islamic Economy Report 2022 (DinarStandard, 2022)

Meanwhile, the Islamic Financial Development Report 2021 highlights the growth of Islamic finance assets with a significant, continuous rise from USD1.975 trillion in 2014 to USD3.374 trillion in 2020, and a projected reach of almost USD5 trillion in 2025 (see Figure 1.2).

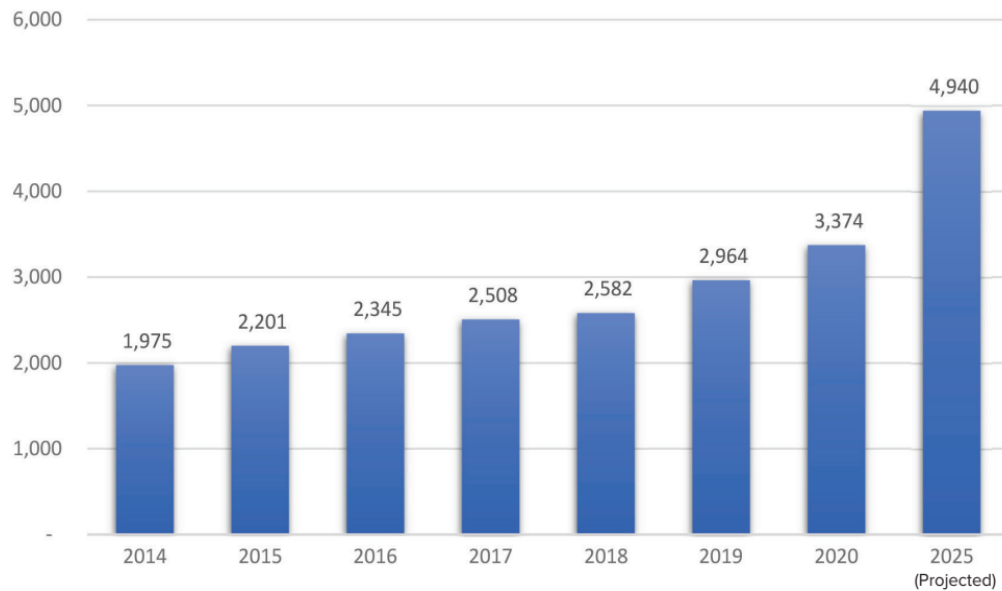


Figure 1.2: Islamic Finance Assets Growth

Source: Islamic Financial Development Report 2021 (ICD-REFINITIV, 2021)

Islamic finance in Malaysia has undergone three broad phases of development over the last four decades – foundation-building, mainstreaming, as well as driving diversification and innovation. Development phases and strategic intents:

1. Building foundation: promote financial inclusion for Muslims, providing alternative solutions;
2. Mainstreaming (2001-2010): broaden range of solutions beyond Muslim community, achievescale, enhance capacity and widen solutions;
3. Driving diversification and innovations: addressing ecosystem gaps and global expansion, drive innovative solutions.

Malaysia’s global leadership in Islamic finance is the result of concerted efforts by the government, financial regulators, and industry players. Over the years, a wide range of initiatives have been advanced – to set up the overall enabling legal and regulatory environment, rolling out structural reforms to align strategies, addressing market frictions and incentives, as well as building long-term capacity of the financial industry players. Malaysia has also contributed to the development of global infrastructures to promote Islamic finance development, such as the setting up of the Islamic Financial Services Board (IFSB) and the International Islamic Liquidity Management Corporation (IILM), which are both headquartered in Malaysia.

Similar to Malaysia, Islamic Finance industry began to flourish in Indonesia in the 1990s and has since grown in leaps and bounds. The first Islamic Bank was established in 1991, Bank Muamalat Indonesia, the first Islamic insurance company, PT Syarikat Takaful Indonesia in

1994, and the first Shari'ah mutual fund product was rolled out by PT Danareksa Investment Management in 1997. Through these and other milestones, Indonesian Islamic Finance ecosystem has progressed into a comprehensive one as seen today. Milestone of the Indonesian Islamic Finance Industry:

1. In 2015 : Indonesian Islamic banking roadmap 2015-2019, Islamic capital market roadmap 2015-2019, Islamic non-bank financial industry roadmap 2015-2019;
2. In 2016: Establishment of National Islamic finance committee;
3. In 2018: Launching Islamic initial Public Offerings;
4. In 2019: Inauguration of National Islamic finance committee executive management;
5. In 2020: Indonesian Islamic banking roadmap 2020-2025.

The Indonesian Islamic finance business has grown significantly, even though it is still relatively modest on a national basis. In terms of development, Indonesia's Islamic finance industry differs from that of other nations such as Malaysia and the Gulf Cooperation Council (GCC) countries, which place a greater emphasis on investment banking and Islamic financial products. Its industry is primarily focused on the retail banking segment. Today Indonesia has the largest Islamic financial service institutions and Islamic finance customers in a single jurisdiction, as well as Shari'ah People's Financing Banks (BPRS) and informal Islamic microfinance institutions.

According to Cognitive Market Research, the global Islamic Financing market was estimated at USD 2514.2 Million, out of which Asia Pacific held around 23% of the global revenue, with a market size of USD 578.27 million in 2024. The market will grow at a compound annual growth rate (CAGR) of 12.5% from 2024 to 2031. The Asia Pacific region is experiencing growth in Islamic Financial Institutions (OIFIs). According to Cognitive Market Research, the global Islamic Financing market size was estimated at USD 2514.2 Million, out of which the Latin America market of more than 5% of the global revenue with a market size of USD 125.71 million in 2024. It will grow at a compound annual growth rate (CAGR) of 9.9% from 2024 to 2031. Commercial entities have emerged as the fastest-growing category over the forecast period within the Islamic finance industry. This trend reflects the increasing adoption of Sharia-compliant financial solutions by businesses, including corporations, SMEs, and multinational enterprises. Commercial entities are drawn to Islamic finance due to its adherence to ethical principles, risk-sharing mechanisms, and diverse product offerings tailored to meet their financing needs. As businesses seek to align their operations with socially responsible practices, the demand for Islamic finance continues to surge, driving the rapid growth of commercial entities within the industry and shaping the future of ethical banking and finance.

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