Global Report on Islamic Finance

Islamic Finance: A Catalyst for Shared Prosperity?

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Foreword

Under a joint initiative by the Islamic Development Bank Group and the World Bank Group, the inaugural Global Report on Islamic Finance has been prepared with a focus on widening disparity of global wealth, and how Islamic finance can help in enhancing shared prosperity. This Report is timely as world leaders have adopted the 2030 Agenda for Sustainable Development, which includes a set of Sustainable Development Goals (SDGs) to end poverty, fight inequality and injustice, and tackle climate change by 2030. The Islamic Development Bank Group in its 2016-2025 strategic plan gives priority to inclusive and sustainable socio-economic development among Member Countries within its role in advancing Islamic finance globally.

Besides social and environmental costs, severe inequality adversely affects economic growth and wealth creation. The question that needs to be addressed is how to minimize wealth disparity and enhance shared prosperity? Given its potential role, Islamic finance can contribute towards achieving these objectives. Accordingly, the joint initiative of the Islamic Development Bank Group and the World Bank Group provides detailed research under the general theme 'Islamic Finance: A Catalyst for Shared Prosperity'.

The Global Report provides a comprehensive overview of the existing status of various Islamic finance sectors and identifies major challenges hindering the growth of Islamic finance. It also identifies policy interventions and tools for policymakers to leverage the principles of Islamic finance in an effort to eradicate extreme poverty and work towards a more equitable distribution of wealth. The main message of the Report is that Islamic finance, built on social and economic justice, can contribute to shared prosperity through the principles of inclusive participation and risk sharing.

The experts from both institutions who helped creating this Report come with vast experience and technical knowledge and provide dual perspectives on finance, enabling readers to connect with the Islamic perspective of finance. The joint initiative highlights that there is a lot that we can learn from each other. We hope that this Report would be the beginning of a fruitful and productive collaboration among international and multilateral institutions to serve our global community.

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Abbreviations and Acronyms

10YF	Ten-Year Framework and Strategies document for the development of the Islamic financial sector
10-YS	10-Year Stategy (Islamic Development Bank Group)
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AUM	assets under management
BNM	Bank Negara Malaysia (central bank, Malaysia)
CAR	capital adequacy ratio
CDD	community-driven development
CIBAFI	General Council for Islamic Banks and Financial Institutions
CSR	corporate social responsibility
GCC	Gulf Cooperation Council
IDB	Islamic Development Bank
IFIs	Islamic financial institutions
IFSB	Islamic Financial Services Board
IFSIs	Islamic financial services institutions
IICRA	International Islamic Center for Reconciliation and Arbitration
IIFM	International Islamic Financial Markets
IIRA	International Islamic Rating Agency
IMF	International Monetary Fund
IRTI	Islamic Research and Training Institute (Islamic Development Bank)
KPIs	Key Performance Indicators
MDGs	Millennium Development Goals
MFI	microfinance institution
MSE	micro and small enterprises
MTR	Mid-Term Review of the Ten-Year Framework and Strategies document
NBFIs	nonbank financial institutions
OECD	Organisation of Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
OJK	Otoritas Jasa Keuangan (Financial Services Authority, Indonesia)
PCA	Prompt Corrective Action
PLS	profit-and-loss–sharing
PPP	purchasing power parity
RBC	risk-based capital approach
SDGs	Sustainable Development Goals
SMEs	small and medium enterprises
SRI	socially responsible investment

Islamic Finance: A Catalyst for Shared Prosperity?: Executive Summary

There is growing realization that despite good intentions, development policies have led to an undesireable imbalance in income and wealth distribution. Given the significant evidence of growing inequality, its adverse effects on economic growth, and its social costs, among other wide-ranging negative impacts, there is an ongoing debate as how to minimize extreme inequality and enhance shared prosperity. Much has been said about the damages of high inequality of income and wealth to society. It erodes trust, creates barriers to social mobility for current and future generations, increases social resentment, undermines effective governance, creates a "winner-take-all" society, and breaks down social solidarity. While income and wealth inequality undermine economic performance, shared prosperity and economic performance support each other; there is no trade-off.

The development community's concern about growing inequality and the imbalance in distribution of wealth has led to a realization that equitable sharing of prosperity is essential. However, there is difference of opinion as to the approaches to achieve this goal. Islamic economics and finance provide an alternative perspective and solution to the development challenges mentioned above. Given the potential role of Islamic finance in economic development, the World Bank Group and Islamic Development Bank Group decided to focus on the topic of "Islamic Finance and Shared Prosperity" as the general theme for the inaugural edition of the *Global Islamic Finance Report* (GIFR). This report aims to improve the understanding of the theoretical foundation of Islamic finance's approach to economic development. It focuses on enhancing shared prosperity and identifying policy interventions and tools for policy makers to leverage Islamic finance to eradicate extreme poverty and ensure equitable distribution of wealth.

The report develops a theoretical framework to analyze the progress of Islamic economics and finance based on four fundamental pillars: an institutional framework and public policy oriented to the objectives of sustainable development and shared prosperity in line with the broader objectives of Islam; (ii) prudent governance and accountable leadership; (iii) promotion of the economy and entrepreneurship based on risk sharing; and (iv) financial and social inclusion for all, promoting development, growth, and shared prosperity.

The risk-sharing and asset-based financing nature of Islamic finance and its potential contribution to growth and inclusive prosperity have considerable merit, particularly in light of the mounting evidence of the negative effects of debt and leverage on the economy. For example, two recent seminal works by Mian and Sufi (2014) and Turner (2016) document the strong relationship of household leverage to financial crisis and instability, and their adverse effect on economic growth.

Islamic finance, through its core principles, advocates for the just, fair, and equitable distribution of income and wealth during the production cycle and provides mechanisms for redistribution to address any imbalances that may occur. Islamic finance's approach to redistribution is based on a balanced blend of income-based redistribution through redistributive instruments; and asset-based redistribution through the notion of risk-sharing. The income-based redistribution approach offers only a partial solution, as it takes the current income distribution as given and aims at fairer distribution of future GDP. By contrast, asset-based redistribution is

basically a risk-sharing approach; it empowers equity participation by the lower-income groups in the society. By making the poor direct holders of real assets in the real sector of the economy, it reduces their aversion to risk. It also creates positive incentives for behavioral factors that enhance productivity (such as trust, truth telling, and hard work,) through the design of contracts that reduce or eliminate the difference between principles and agents and are conducive to the advancement of the interests of all parties to a contract (Mirakhor 2015).

The report first presents the theoretical foundations of Islamic finance to enhance prosperity. It then reviews and analyzes recent developments and policy challenges in different sectors. The theoretical foundation is rich in content and is promising in offering an alternative and viable approach to address poverty and income/wealth distribution challenges. However, to overcome challenges and to realize the full potential of Islamic finance, a serious and consorted efforts by stakeholders is required. A summary of issues follows.

Going beyond Banking

The Islamic banking sector is the dominant component of the Islamic finance industry. It has grown exponentially in the last two decades, accumulating nearly $1.9 trillion in assets and spreading across 50 Muslim and non-Muslim countries around the world.

Financial intermediation through risk-sharing contracts, as well as financial inclusion by Islamic banks, could contribute to shared prosperity—provided that Islamic banks pursue risk-sharing intermediation and increase the allocation of credit to the micro, small, and medium enterprises (MSME) sector. Islamic banking is not typical conventional banking; rather, it is mode of financial intermediation offering banking and asset-management services. Current practices are restraining its full potential because of attempts to replicate conventional banking.

To live up to the ideals of Islamic finance, Islamic banks face many challenges, ranging from the gap between the prevalence of debt-based instruments and the aspirations of financing predominantly through equity and risk sharing, to the need for increased social capital, and the challenges of creating an enabling regulatory framework. To contribute to shared prosperity, the Islamic banking sector should focus on six key areas of improvement, and adopt best practices. These include:

(i) Creating an enabling regulatory environment by supporting consistent regulations; ensuring consistent implementation of the Basel III and Islamic Financial Services Board (IFSB) frameworks; ensuring that systemic risks in dual banking systems (conventional and Islamic) are addressed; and implementing cross-border supervision

(ii) Introducing innovative risk-sharing products and services, rather than replicating conventional risk-transfer products

(iii) Harmonizing *sharī'ah* governance through efforts to unify cross-country *sharī'ah* rulings about Islamic finance, which would help accelerate the growth of the industry

(iv) Enhancing the scale and access to Islamic finance to include low-income earners

(v) Improving liquidity and ensuring stability

(vi) Bolstering human capital and literacy in Islamic finance.

Developing Vibrant Capital Markets

Capital markets through equity- and asset-based finance could play a critical role in reducing poverty by providing opportunities for poor to build assets. Islamic capital markets are relatively young, but are second largest segment of the Islamic finance sector, after banking. The *ṣukūk* (Islamic bond) market has grown considerably over the last decade. *Şukūk* offer great potential for promoting shared prosperity due to their suitability for financing infrastructure, raising funds for new businesses, encouraging entrepreneurship, and supporting economic development. Unlike other asset classes, they offer a hybrid profile between pure equity and debt, and are thus attractive to a wide range of investors and finance seekers, again with a positive potential for shared prosperity.

Development of vibrant capital markets is the essential ingrediant for Islamic finance. There is the need for incentives to encourage risk sharing: in particular, through the development of markets for equity trading. This is hindered by the perverse tax treatment that classifies interest as a tax-deductible expense. In order to create a level playing field for debt and equity, there is a need to eliminate the tax shelter on interest payments. Tax neutrality for *ṣukūk* issuers and investors could further boost the market. The use of *ṣukūk* by governments and governmental agencies' to mobilize financing is essential to develop a long-term yield curve and to develop a corporate *ṣukūk* market, as well as to promote transparency and efficiency of the asset pricing.

Promoting the Nonbank Financial Institutions Sector

International financial systems are realizing the growing importance of nonbank financial institutions (NBFIs) such as housing finance, leasing, and asset management,_especially their potential contribution to economic development. The risk-sharing and asset-backed nature of Islamic finance products are more suitable for providing financial services through NBFIs. This sector is currently under-developed and under-utilized in Islamic finance, and therefore should be given priority by policy makers.

A good place to start is with Islamic insurance. Besides providing protection against risk and uncertainty, *takāful* could play a critical role in enhancing financial inclusion, reducing poverty, achieving inclusive economic growth, and boosting shared prosperity. *Takāful* can provide important benefits to households and firms. Greater access to financial services for both households and firms may help reduce income inequality and accelerate economic growth. Protection against unexpected shocks to income and enhanced productivity through better health for the poor and the vulnerable segment of the society through micro*takāful* could become an

effective tool for combating poverty. With the growth of Islamic microfinance, especially in member-countries of the Organisation for Islamic Cooperation (OIC) , there is need to develop the micro*takāful* industry to provide protection against uncertain events and loss of income.

Takāful, as an infant industry, faces many challenges. Sound public policy is needed to balance protection for participants' rights with the requisite for effective pricing, greater solvency, operators' financial sustainability, good business conduct, and relevant disclosures. One of the major challenges for *takāful* operators is that *sharī'ah*-compliant investment opportunities are lacking in many jurisdictions; thus the operators do not have adequate venues for long-term and stable investments that offer desirable risk and return profiles. As a result, *takāful* operators lack access to adequate portfolio and risk-management instruments to adequately match and hedge their liabilities. Development of Islamic capital markets, particularly *sukūk*, is essential for further development of the *takāful* industry.

To attain a robust Islamic financial NBFI sector that will promote inclusive economic development and shared prosperity, certain requirements must be met, including supportive institutions and public policy; responsible governance and leadership; promotion of risk sharing and entrepreneurship; and a sound regulatory and supervisory framework. Serious supply- and demand-side and legal challenges must be overcome. Increasing the number and diversity of Islamic NBFIs, together with increasing the range of products offered to various segments, are two major challenges on the supply side. On the demand side, low levels of financial literacy about the products and services offered by Islamic NBFIs; cultural, social, and physical barriers; insufficient consumer protection practices; and reputation- and credibility-related challenges are the biggest obstacles hindering further improvement of Islamic NBFIs. Another main challenge is the need for a balanced and enabling regulatory and taxation framework that also fosters cross-border investments in the Islamic NBFI sector.

Alleviating Poverty and Sharing Prosperity through Islamic Social Finance

Islamic social finance advocating a sharing economy and promoting redistribution could play a significant role in helping achieve the twin development objectives of ending extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population. The institutions and instruments of Islamic social finance are rooted in redistribution and philanthropy. Such interventions, involving *qard-al-hasan*, *zakat,* and *ṣadaqāt* (charity), can potentially address the basic needs of the extremely poor and the destitute and create a social safety net. The instrument of *awqāf* (Islamic endowment) is ideal for the creation and preservation of assets that can ensure a flow of resources to support the provision of education, health care, and other social goods. These Islamic institutions can play a critical role in the realization of the global vision of generating sufficient income-earning opportunities; investing in people's development prospects by improving the coverage and quality of education, health, and sanitation; and protecting the poor and vulnerable against sudden risks of unemployment,

hunger, illness, drought, and other calamities. These measures would greatly boost shared prosperity, improving the welfare of the least well-off.

The role of Islamic social finance has great significance in countries with high levels of exclusion and deprivation. This report estimates that for most countries in South and Southeast Asia and Sub-Saharan Africa, the resource needs to alleviate deprivation could be met adequately if the potential of institutions of *zakāt* and *waqf* were realized, even if only in part.

Public Policy Interventions

In an environment of constrained sources of development financing, timely public policy interventions are the need of the hour. Islamic finance, with its rich theoretical promise to fight poverty and enhance prosperity, could play the role of a catalyst. Despite recent encouraging developments and the growth of Islamic finance, there are a number of areas in which policy interventions or improvements in policy effectiveness are needed to further develop Islamic finance and boost shared prosperity. Lower-income countries are lagging behind higher-income countries in terms of developing Islamic finance to enhance shared prosperity. The significance of timely and effective policy can not be overemphasized.

This report identifies areas in different sectors that could guide policy makers in formulating policy interventions to meet the objective of leveraging Islamic finance to alleviate poverty and enhance shared prosperity. These include enhancing implementation and enforcement of regulations; creating institutions that provide credit and information that in turn support the provision of equity-based finance, particularly to small and medium enterprises (SMEs) and microenterprises; developing capital markets and *ṣukūk* products to help finance large infrastructure projects; harmonizing regulations; and regulatory recognition of products from other jurisdictions to expand the markets through cross-border transactions.

The process of identifying policy interventions and areas to focus has been going on for more than a decade. Notably, the Islamic Development Bank Group and Islamic Financial Services Board (IFSB) jointly prepared a Ten-Year Framework Document and Mid-Term Review. These and other initiatives emphasize incorporating the use of Islamic finance in national development plans , as well as building master plans to develolp the Islamic finance sector domestically. Recently, the G20 has made similar recommendations to better integrate Islamic finance with global financial systems. This report identifies additional areas for policy recommendations.

Table ES.1 reflects essential recommendations and policy measures by each sector with respect to each pillar of development framework of Islamic finance presentated in this report. Without the right enabling environment, Islamic finance may not be able to attain the potential expected from it. However, with adequate policy interventions and an enabling financial infrastructure, Islamic finance could become a catalyst for alleviating poverty and promoting inclusive prosperity.

Table ES.1 Recommendations and Policy Interventions by Sector

	Institutional framework and public policy	Governance and leadership	Risk sharing and entrepreneurship	Financial and social inclusion
Banking	• Create an enabling regulatory environment by supporting consistent regulations, and ensuring consistent implementation of the Basel III and Islamic Financial Services Board (IFSB) framework • Ensure that systemic risks in dual banking systems (conventional and Islamic) are addressed • Implement cross-border supervision • Improve liquidity • Ensure stability	• Harmonize *sharīʻah* governance through efforts to unify cross-country *sharīʻah* rulings about Islamic finance	• Introduce innovative risk-sharing products and services, rather than replicating conventional risk-transfer products	• Enhance the scale and access to Islamic finance to include low-income earners • Bolster human capital • Increase Islamic finance literacy
Capital markets	• Create a level playing field for debt and equity instruments by: ○ Eliminating the tax shelter on interest expense; ○ Allowing tax-free transfer of assets in asset-backed *sukūk* or at least treat the transfer fee as a tax-deductible expense	• Incorporate higher ethical standards through transparent governance mechanism and robust regulatory framework • Improve *shari'ah* governance: ○ Align *shari'ah* screening standards for equities across jurisdictions ○ Publish *shari'ah* screening	• Encourage investment in equities, which is the purest form of risk-sharing that not only distributes wealth more equitably but also creates more jobs and enhances shared prosperity • Improve the scalability and liquidity of *sukūk* by providing an enabling environment for trading *sukūk* in secondary markets	• Introduce retail *sukūk* for smaller investors • Relax the condition for listing of companies in order to provide a larger universe of equities for investment

	Institutional framework and public policy	Governance and leadership	Risk sharing and entrepreneurship	Financial and social inclusion
		standards, and list compliant equities for the convenience of investors on a periodic basis. • Provide disclosures relevant to *shari'ah* compliance, especially events that may trigger noncompliance in the regular reporting of firms • Strengthen resolution frameworks and investor protection mechanisms	• Provide incentives for issuing long-term *sukūk* based on more equity-like structures such as *muḍārabah* and *mushārakah*	
Takāful	• Adopt an holistic approach while formulating the policy guidelines for the industry that takes into consideration both the industry and consumer in a *shari'ah*-compliant manner • Design policies that balance the protections for participants' rights with the need for effective pricing, greater solvency, operators' financial sustainability, good	• Establish clear and transparent corporate governance and regulatory framework for the formal as well as informal takaful operations • Regulate the *takāful* industry based on its risk characteristics. A risk-based approach may be desirable however, this should take into consideration the	• Introduce *takāful* and *microtakāful* as a mode for pooling of risk and assets; • The long-term *shari'ah* -compliant investment from the savings and investments in *takāful* funds can be a critical source for economic development; • Encourage investment in capital market instruments	• Allow participants to use *microtakāful* for savings and investment • Allow *microtakāful* for family, health, crop, livestock and property based on cooperative (*Wakālah*-partner) model.

	Institutional framework and public policy	Governance and leadership	Risk sharing and entrepreneurship	Financial and social inclusion
	business conduct, and relevant disclosures • To avoid confusion among Muslims, a board consisting of *shari'ah* scholars at the national level may provide guidance as to how to implement *takāful* • Expand investment through Islamic capital market to provide flexibility in the implementation of the risk-based capital regime	difference between conventional insurance and *takāful* • Set requirements for solvency purposes on the investment activities of *takāful* in order to address the risks faced by the operators		
Nonbank financial institutions (NBFIs)	• Develop policies that requires strong investor protection and stringent disclosure requirements as far as the investment is concerned • Ensure that the products and activities of NBFIs comply with *shari'ah*	• Develop legal infrastructure to support contract enforcement: a prerequisite for the development of the financial sector, as it not only reduces transactions costs but also enhance investor confidence • Clearly define regulatory requirements such as licensing, disclosure, and corporate governance	• Enhance diversification by directing more financing to small and medium enterprises relative to larger firms • Develop skills and alternative approaches to mitigate risks (moral hazard) through proper monitoring and evaluation	• Increasing the number and diversity of Islamic NBFIs • Encourage Islamic NBFIs to provide Islamic financial services in countries where establishing Islamic banks is not possible due to legal and regulatory restrictions
Islamic social finance	• Recognize the diversity in *zakāt* management	• Create a network of supporting	• Mitigate and absorb high risks with financing to the	• Recognize self-exclusion as a key

	Institutional framework and public policy	Governance and leadership	Risk sharing and entrepreneurship	Financial and social inclusion
	practices across globe and create a adequately flexible and enabling regulatory environment; • Introduce/ Reform the *waqf* regulatory framework in order to establish waqf as institution in the voluntary sector; • Recognize Islamic social finance as sustainable means of absorbing operational cost and provide "affordable" financing to the poor.	infrastructure institutions, including research, training, and advocacy for the sound and orderly function of Islamic social finance institutions • Develop a sound governance system that recognizes the significance of trust and credibility as key drivers underlying Islamic social finance • Harmonize the financial reporting of Islamic social finance institution to enhance transparency	poor through mechanisms rooted in philanthropy and benevolence • Make innovative use of *zakāt* and *waqf* to create risk management tools (e.g credit enhancement/ guarantees and micro*takāful*)	problem due to religious, cultural, and ethical beliefs of the poor • Enhance social and human capital through community empowerment initiatives funded through the sustainable Islamic social funding instrument

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Overview

There is broad consensus that the objective of economic development is not only to boost economic growth but also to share prosperity with all segments of society through equitable distribution of income and wealth. The "trickle-down" approach asserts that higher productivity and industrial advancement lead to higher GDP growth, which in turn will improve the well-being of all segments of the society, including the poorest and most marginalized in a country. However, recent experience has shown that the immediate impact of such a growth-led policy can be an undesirable concentration of wealth in the hands of a few, while the growth benefits trickle down to the extremely poor only over a relatively long period of time. Inequality increased considerably in the aftermath of financial crisis of 2007–08. The seriousness of the problem is highlighted by a few striking facts:

- Almost half the world's wealth is now owned by just 1 percent of the population (Working for the Few 2014).

- The richest 10 percent of the world's population hold 86 percent of the world's wealth, and the top 1 percent alone account for 46 percent of global assets (*Global Wealth Report 2013;* Credit Suisse 2013).

- In the United States, the wealthiest 1 percent has captured 95 percent of growth since 2009, while the bottom 90 percent has become poorer (Working for the Few 2014).

Given the significant evidence of inequality, its adverse effects on economic growth, and its social costs, among other wide-ranging negative impacts, there is an ongoing debate as how to minimize the extreme inequality and enhance shared prosperity. In this regard several global agencies including United Natiions emphasize on inclusive and sustainable development rather than mere economic development. The World Bank Group has revised its mission for the first time in 30 years and included promotion of share prosperity one of the two goals besides reducing the number of people living in extreme poverty.[1] Similarly, the new 10-Year Strategy of the Islamic Developmet Bank Group (IDBG) (2016–25) also aims at promoting inclusive and sustainable socioeconomic development among member countiries by providing a leadership role in promoting Islamic finance globally.

Against the backdrop of growing inequality and more refined understanding of its harmful effects, the Islamic Development Bank Group (IDBG)—the leading multilateral development institution providing development solutions through Islamic finance since its inception in 1975— has partnered with the World Bank Group to undertake research exploring how Islamic finance can be mobilized to achieve common development goals. Given the lack of research that analyzes the potential role of Islamic finance, we have chosen the topic of "Islamic Finance and Shared

[1] Specifically, the goals are to end extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population. See "Ending Poverty and Sharing Prosperity," http://www.worldbank.org/content/dam/Worldbank/gmr/gmr2014/GMR_2014_Full_Report.pdf.

Prosperity” as the general theme for the inaugural edition of the *Global Report on Islamic Finance* (GRIF). This report has the following key objectives:

- Develop understanding of the theoretical foundation of Islamic finance and shared prosperity
- Review recent development and trends in various sectors of Islamic finance, such as banking, capital markets, and social finance
- Identify policy interventions and tools for policy makers to leverage Islamic finance to eradicate extreme poverty and ensure equitable distribution of wealth.

Chapter 1 lays the theoretical framework of Islamic economics and finance promoting development, growth, and shared prosperity. This framework is based on four fundamental pillars: an institutional framework and public policy oriented to the objectives of sustainable development and shared prosperity in line with the broader objectives of Islam; prudent governance and accountable leadership; promotion of the economy and entrepreneurship based on risk sharing; and financial and social inclusion for all.

The first pillar is crucial because having a sound institutional framework and appropriate public policies are the foundation upon which the other pillars must rest and can function optimally. Institutions play a critical role in this framework, as they implement the rules prescribed by the tenets of Islam. The institutions also adhere to the core objectives of Islam (commonly known as *maqāṣid al-sharīʻah*, or Objectives of *Sharīʻah*) that lay the foundation to formulate the policies promoting economic and social justice, preservation of human rights, dignity, health, and the intergenerational wealth of the society.

The second pillar focuses on developing a governance mechanism and accompanying compliance system based on the objectives and institutions prescribed by the first pillar. The ethically based governance, leadership, and compliance system helps increase the transparency and accountability in the public, private, and social sector institutions of the overall economic system, and hence strengthens trust in the system. Trustworthy and capable leadership can ensure protection of rights of the vulnerable or those who could be vulnerable (as in future generations). Increased trust and better governance in turn strengthen the institutional framework, which enables better implementation of better public policies.

The third pillar is the distribution channel; it works at both the individual and organizational level. One of the central features is the advocacy of risk sharing and promotion of entrepreneurship. This is one of the most important aspects of Islamic finance, which differentiates it from the conventional approach of over-reliance on debt-dominated instruments that shift or transfer risk. Sharing the risks of economic and financial transactions also ensures the stability of the financial system. In addition, risk sharing with equitable sharing mechanisms encourages

entrepreneurship and innovation, since counterparties receive their fair share in the investment. This in turn will increase the allocation of resources to the real sector, rather than channeling excessive financial flows to the financial sector, leading to over-financialization of economy.

An important component of risk sharing in Islamic economics is risk sharing through Islamic instruments of redistribution. Without this channel, certain segments of the society could easily be left out of the system, which would marginalize them and decrease the full productive potential and social harmony of society. This redistribution of income and wealth is not charity; rather, it is an endowment that would enable them to conduct their lives honorably and have an equal opportunity to contribute productively to society.

The fourth pillar aims to ensure that the fruits of higher growth are distributed to every segment of the society inclusively, either through participation in the economic growth or through Islam's instruments of redistribution. Since member-countries of the Organisation of Islamic Cooperation (OIC) have predominantly Muslim populations—for whom certain methods of conventional finance could contradict their faith and thus exclude them from the financial system—using a new framework of economic development and finance could help increase financial and social inclusion, which could facilitate equal opportunity.

The main goal of the *Chapter 2* is to take a snapshot of the current state of the extreme poverty and income disparity globally and compare it with the OIC countries. A brief analysis of the historical trend in several metrics with respect to select benchmarks against the framework of economic development developed in chapter 1 is provided as well. Finding and discussing the root causes of the disparities between OIC and non-OIC countries is beyond the scope of this report and is left for future research.

Extreme poverty has been reduced considerably around the world in the past two decades —although at a slower pace within the group of OIC countries than globally. OIC countries are very diverse in terms of income group, geography, and culture, and are tied only by religion. The rate of poverty alleviation among the extreme lower-middle-income and lower-income countries is higher for OIC member-countries than for the non-OIC group. Among the regional differences, in Sub-Saharan Africa, OIC countries have exhibited higher poverty reduction than the non-OIC countries in the same region. However, OIC countries have lagged behind non-OIC countries in terms of poverty reduction in East Asia and South Asia. In terms of the income disparity, there is no significant difference between OIC and non-OIC countries. In both groups of countries, the top ten percentiles receive the major share of the income.

To assess the state of shared prosperity, various indexes are used as a proxy for each pillar of shared prosperity, as discussed in chapter 1. In terms of the institutional framework and public policy, the rule of law index score was negative for all groups of countries except for the high-income group, clearly highlighting the need to strengthen the legal system in order to break out of the poverty cycle. The Government Effectiveness Index indicates a similar trend for governance

and leadership; on average, countries from the lower and lower-middle income groups trail behind the high-income group, highlighting the importance of governance and leadership in enhancing shared prosperity.

Although not perfect, this report uses the inverse of the correlation between consumption and income as a proxy for risk sharing. OIC countries on average have a better risk-sharing environment than non-OIC countries. The capital market could be a better proxy for entrepreneurship. However, stock markets are not established in most of the lower-middle and lower-income groups of countries. The development of capital markets with wider access to the public under a strong legal and governance framework is desirable to promote shared prosperity in countries where poverty is still prevelant. In terms of social and financial inclusion, OIC countries exhibit tend to borrow less from formal financial institutions which may indicate self-exclusion due to religious reasons. Developing the Islamic finance sector may enhance financial inclusion.

In summary, chapter 2 provides the fair state of affairs with respect to trends in poverty alleviation and income distribution which can be used by the policy makers to formulate policy interventions and to identify areas to strengthen keeping in mind the objective of leveraging Islamic finance for alleviating poverty and enhancing shared prosperity.

Chapter 3 provides a roadmap for supportive public policy, a sound enabling environment, and conducive financial infrastructure to support the development of Islamic finance and its effectiveness in delivering the socioeconomic benefits expected from it. As Islamic finance caters to the needs of real economic activities and provides financing by taking on the risk of the business or the economic activities it finances, policies to develop that Islamic financial sector cannot be pursued in isolation from broader public policy concerning economic development, business promotion, and social advancement.

Islamic finance at present is working within a system that is heavily biased in favor of debt-based financing. The financial infrastructure, peripheral support institutions, and legal environment are more conducive to debt than other modes of financing. Thus creating an enabling environment to support the proper growth and socially beneficial development of risk-sharing Islamic finance is important. This entails cross-sectoral, well-coordinated, and timely reforms in financial sector regulations; in legal provisions for new types of institutions; in contract enforcement; and in tax treatment. Such changes lie beyond the capacities of individual financial institutions; hence the role of government and financial sector regulators and stakeholders is particularly important.

Efforts are underway at the national and supra-national levels to develop and enhance the impact of Islamic finance. At the international level, various financial infrastructure institutions are developing standards for accounting, auditing, governance, *sharīʻah*-compliance, regulation, and supervision for the Islamic financial sector. Multilateral cooperation at the international level

helped create a Ten-Year Framework and Strategies Document for the development of Islamic financial sector, which underwent a Mid-Term Review (MTR) in 2013. The MTR emphasizes Enablement, Performance, and Reach as three pillars of strategic importance, and proposed 20 initiatives within these three pillars that can be pursued by individual countries and their respective regulatory authorities. It is hoped that this undertaking will help coordinate policies and consolidate efforts to develop Islamic finance across countries. Some countries have used these recommendations as guides to come up with their own national plans to foster the development of Islamic finance.

The issue of development of the Islamic financial sector to increase shared prosperity was also a part of the agenda of the Group of Twenty (G-20) in 2015; the World Bank and IMF offered suggestions to better integrate the Islamic finance with the global financial system by classifying them by national level and international level stakeholders recommended actions. At the national level it recommends (i) Adapting regulatory and supervisory frameworks to take into account the industry's specific features such as risk-sharing where deemed appropriate. (ii) Exploring means for enhancing liquidity management of Islamic banks. (iii) Adapting tax systems to avoid Islamic finance instruments being at a disadvantage, and (iv) Providing the right incentives to ease access to asset-based and equity-like financing, particularly for SMEs. At the global level the G20 calls for (v) Systematically incorporating the industry's features in global standards and guidance, and developing accounting and statistics standards especially for *Sukuk*. (vi) Granting membership to Islamic finance standard-setters in the consultative groups of global standard-setters with the view to strengthen the emerging cooperation between these institutions, and (vii) Stepping up the engagement of International financial institutions and multilateral development banks (MDBs) in Islamic finance through analytical work, policy advice, and capacity development.

Chapter 3 further provides an overview of recent policy initiative taken by Indonesia, Malaysia, and Pakistan as case studies to highlight recent developments in, and the enactment and implementation of, policies to promote shared prosperity. In the case of Indonesia, Malaysia and Pakistan, Islamic financial sector development and financial inclusion are integrated within the national development or financial development plans of these countries. Strengthening *sharī'ah* governance, improving the alignment of the national-level banking regulations with the principles issued by international Islamic financial infrastructure institutions, and establishing diversified financial institutions has become an explicit part of their agenda. Similarly, financial inclusion, its promotion by integrating *zakāt* and *awqāf*, and fostering the financing of a wider set of economic sectors, are gaining policy importance.[2]

In an effort to align Islamic financial sector development with its long-term economic development plan, Indonesia has issued a road map for Islamic banking development, a road map for Islamic capital market development, and a road map for sustainable finance. These are targets

[2] *Zakāt* are obligatory contributions to the poor and marginalized payable by all Muslims having wealth above a certain threshold. *Awqāf* (plural of *waqf*) are Islamic endowments or trusts.

for improving the resilience and competitiveness of the Islamic financial sector, promoting economic growth and well-being, and supporting the national commitment to environmental protection. Indonesia is also working toward integrating the collection and distribution of *zakat* into its financial system.

Islamic finance has been a priority area in Malaysia for three decades. In 2013, it enacted a comprehensive Financial Services Act to consolidate Islamic financial sector regulations, improving *sharī'ah* governance, properly differentiate Islamic deposit taking from investment activities, and provide relevant regulations for both. These efforts foster proper risk sharing between the financial institutions and their clients.

Pakistan has a strategic plan in place to develop Islamic finance. It also developed a National Financial Inclusion Strategy that encompasses many of the areas needed to develop Islamic finance. It is one of the few countries with well-developed regulatory framework for microfinance and has a microfinance credit information bureau. Pakistan has a system of *zakāt* collection and distribution at both the private and public levels.

Despite these encouraging developments, there are a number of aspects where policy interventions or improvements in policy effectiveness are needed to develop Islamic finance and boost shared prosperity. These include enhancing implementation and enforcement of the regulations; creation of institutions that provide credit and other information, that in turn support the provisioning of equity-based finance, particularly to small and medium enterprises (SMEs) and microenterprises; development of capital markets and *ṣukūk* (Islamic bond) products to help finance large infrastructure projects; harmonizing regulations; and regulatory recognition of products from other jurisdictions to expand the markets through cross-border transactions.

The importance of regulatory policies and enabling public policies cannot be overemphasized. Without the right environment, Islamic finance may not be able to attain the high results expected from it.

Chapter 4 focuses on the Islamic banking sector, which is the dominant component of the Islamic finance industry, accounting for more than three-quarters of the industry's assets. The sector has grown dramatically since the first known experiment in the Arab Republic of Egypt in 1963. Today, more than 300 Islamic finance institutions, with assets close to $1.9 trillion, are spread across 50 economies around the world in both Muslim and non-Muslim countries. Its major hubs are the Middle East and Southeast Asia**,** with the Islamic Republic of Iran the biggest market in terms of total banking assets, followed by Malaysia, Saudi Arabia, and the United Arab Emirates. These four countries account for 60 percent of the industry's global assets.

Islamic banking is based on key Islamic principles of prohibiting exploitation, emphasizing ethical standards, promoting moral and social values, and rewarding enterprise (linking risk and reward). The aspiration of Islamic banking is the creation of equitable distribution, and circulation of wealth in order to promote economic and social justice and to satisfy customers' needs for

sharīʻah-compliant investments and financing opportunities. This wealth creation and its fair distribution ensure shared prosperity. Islamic banking contributes to shared prosperity through its impact on economic growth, as a provider of capital for economic activities, and through the risk-sharing characteristics of its products.

The key features of risk-sharing contracts, and financial inclusion through increased banking options, contribute to shared prosperity. Islamic banking can have a positive impact on financial intermediation by the poor, which ultimately should boost the mobilization of savings and prosperity. In addition, Islamic banks have a social responsibility that transcends the maximization of profits.

To live up to the ideals of Islamic finance, Islamic banks face many challenges, ranging from the gap between the aspirations of financing predominantly through equity and risk sharing and the reality of the prevalence of debt-based instruments, the need for increased social capital, and the challenges of creating an enabling regulatory framework. To contribute to shared prosperity, the Islamic banking sector should focus on six key areas of improvement, and adopt best practices:

- Shift toward *sharīʻah*-based banking and practices, away from mere *sharīʻah* compliance
- Harmonize *sharīʻah* standards through efforts to unify cross-country *sharīʻah* rulings about Islamic finance, which would help accelerate the growth of the industry
- Create an enabling regulatory environment by supporting consistent regulations; ensuring consistent implementation of the Basel III and Islamic Financial Services Board (IFSB) framework; ensuring that systemic risks in dual banking systems (conventional and Islamic) are addressed; and implementing cross-border supervision
- Enhance the scale and access to Islamic finance to include low-income earners
- Improve liquidity and ensuring stability
- Bolster human capital and the Islamic finance literacy.

Chapter 5 addresses how capital markets can contribute to enhancing shared prosperity by facilitating long-term financing through tradable instruments that enable easy market entry and exit. In a pure equity-based and risk-sharing framework, Islamic capital markets can serve the real sector of economy more effectively in an equitable and sustainable manner than conventional capital markets. The main requirements to facilitate the development of Islamic capital markets are similar to those for conventional capital markets: notably, protecting property rights, controlling market manipulation and fraudulent practices, maintaining fair pricing, and supporting the rule of law. However, there are additional requirements for the sound development of Islamic capital markets: particularly the promotion of risk-sharing and asset-based finance in light of the prohibition of debt-based finance.

At present, there is no organized stock exchange that is operating in full compliance with *sharīʻah* principles. Any investor in the Islamic equity market invests in the shares of *sharīʻah*-

compliant companies or in a publicly offered portfolio consisting of these equities offered through unit trusts, mutual funds, or exchange traded funds (ETFs). There are several prevailing standards for screening equities, including screens offered by major index provider companies such as the Financial Times Stock Exchange (FTSE), Standard and Poor's (S&P), Dow Jones, and Morgan Stanley Capital International (MSCI). The empirical evidence provided in the report suggests that Islamic equity indexes based on the S&P's *sharīʻah* screening standard perform at least as well on average as their conventional counterparts—despite lower diversification, due to the exclusion of financial products and stocks backing activities prohibited by *sharīʻah*.

The *ṣukūk* (Islamic bond) market has grown considerably over the last decade. *Sukūk* are now used for financing by corporate and sovereign entities. The *ṣukūk* market recovered quickly after the global financial crisis and peaked in 2012. Issuance declined somewhat in 2014 and 2015, but it is still considerably higher than its precrisis level. *Ṣukūk* offer great potential for promoting shared prosperity due to their suitability for financing infrastructure, raising funds for business, and supporting economic development. Unlike other asset classes, they offer a hybrid profile between pure equity and debt, and are thus attractive to a wide range of investors and finance seekers, again with a positive potential for shared prosperity.

A Mid-Term Review of the Islamic financial services industry jointly prepared by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and the Islamic Financial Services Board highlights some of the major challenges hindering the development of Islamic capital markets. First is the need for incentives to encourage risk sharing: in particular, through the development of markets for equity trading. This is hindered by the perverse tax treatment that classifies interest as a tax-deductible expense. In order to create a level playing field for debt and equity, there is a need to eliminate the tax shelter on interest payments. Second, because asset-backed *ṣukūk* could be more costly to structure than conventional securities, there is a case for allowing these expenses to be tax deductible. In addition, provision should be made for tax exemption on the asset transferred in sale-based structures, as such transfers are a precondition for *sharīʻah* compliance. The authorities may wish to extend the favorable treatment of *ṣukūk* further by exempting investors from income and capital gains tax. This could apply where *ṣukūk* are used to fund specific development projects, rather than for nonspecified government or corporate expenditures.

The Mid-Term Review highlights the lack of a uniform approach to Islamic capital market regulation and governance. It is important for Islamic capital markets to be seen as incorporating higher ethical standards through transparent governance mechanisms and robust regulatory frameworks. It would also be helpful for market confidence and perceptions of financial product integrity if *sharīʻah* governance standards were harmonized. This would facilitate cross-border activities in both primary and secondary markets, and the acceptance of contracts across regions and across schools of thought and markets. The Mid-Term Review urges the adoption of the *sharīʻah* standards proposed by the Accounting and Auditing Organization for Islamic Financial

Institutions (AAOIFI) and the IFSB, with *sharīʻah* boards taking full responsibility for the capital market products they approve.

The report also cites liquidity constrains as an impediment: notably the lack of depth in the secondary market in *ṣukūk* reflecting limited issuance, and the preference of investors to hold *ṣukūk* to maturity rather than trade. Greater pricing transparency and faster settlement procedures are recommended to encourage *ṣukūk* trading. Revaluation of the underlying assets may also be justified for the resolution of disputes and investor protection. A high level of financial literacy is needed by those investing and trading in Islamic financial markets, especially with respect to legal and *sharīʻah* safeguards and the nature of the risks shared rather than transferred.

Chapter 6 deals with important topic of *takāful,* the Islamic counterpart of conventional insurance. The scheme is similar to a mutual insurance concept, but complies with Islamic Law, and is based on concepts of mutual solidarity and risk sharing. A group of participants agree to support one another jointly for the losses arising from specified risks. The scheme is managed on the participants' behalf by a *takāful* operator. The *takāful* industry has two unique characteristics: mutual risk sharing and *sharīʻah* compliance. In order to make it feasible, viable, and accessible to all segments of the society, there should be a globally acceptable *takāful* business model.

Besides providing protection against risk and uncertainty, *takāful* could play a critical role in enhancing financial inclusion, reducing poverty, achieving inclusive economic growth, and boosting shared prosperity. *Takāful* can provide important benefits to households and firms. Greater access to financial services for both households and firms may help reduce income inequality and accelerate economic growth. Protection against unexpected shocks to income and enhanced productivity through better health for the poor and the vulnerable segment of the society through micro*takāful* could become an effective tool for combating poverty. With the growth of Islamic microfinance, especially in OIC countries there is need to develop micro*takāful* industry to provide protection against uncertain events and loss of income.

Takāful, as an infant industry, faces many challenges. Sound public policy is needed to balance protection for participants' rights with the requisite for effective pricing, greater solvency, operators' financial sustainability, good business conduct, and relevant disclosures. One of the major challenges for *takāful* operators is that *sharīʻah*-compliant investment opportunities are lacking in many jurisdictions; thus the operators do not have adequate venues for long-term and stable investments offering desirable risk and return profiles. As a result, *takāful* operators lack access to adequate portfolio and risk management instruments to adequately match and hedge their liabilities. Development of Islamic capital markets, particularly s*ukūk*, is essential for further development of the *takāful* industry.

Chapter 7 discusses the growing importance of nonbank financial institutions (NBFIs) and highlights the important linkages of the products and services offered by NBFIs to shared prosperity. The chapter covers Islamic asset management, housing finance, and some specialized

NBFIs, such as *muḍārabah* (risk-sharing partnerships) and *ijārah* (leasing) financing companies. The chapter argues that NBFIs in an economy add to the development of a diverse financial sector that expands the menu of products to better serve dynamic needs of the society.

A diverse financial sector also increases the stability of the financial system. NBFIs can serve as back-up institutions that may help stabilize the financial sector when negative shocks adversely affect the dominant financial institutions, notably banks. Moreover, a well-developed NBFI sector can provide services to those segments of the society that are not adequately served by the formal banking sector. In this way, NBFIs have great potential to promote shared prosperity more effectively.

Despite the low levels of development in most of countries with a high Muslim population, Islamic NBFIs have gained momentum since the global financial crisis, especially on the asset management side. Assets under management of Islamic funds exceeded $60 billion as of 2014, with an average annual growth of 13.5 percent between 2008 and 2014. A case can be made to exploit the synergies between socially responsible investments and s*ukūk* as an alternative tool for mobilizing financing that could attract Islamic and SRI investors to make a visible contribution to sustainable development. Advocating for the potential of Islamic NBFIs for SMEs, chapter 7 presents a case study of novel *sharī'ah*-compliant crowdfunding, to demonstrate how Islamic finance can be deployed to enhance SMEs' access to finance. The chapter also includes some highlights and cases on Islamic house financing, *muḍārabah,* and *ijārah* companies, that when properly implemented have the potential to improve financial inclusion in most OIC developing markets.

To attain a robust Islamic financial NBFIs sector that will promote inclusive economic development and shared prosperity, certain requirements must be met, including supportive institutions and public policy, responsible governance and leadership, promotion of risk sharing and entrepreneurship, and a sound regulatory and supervisory framework. There are serious supply- and demand-side and legal challenges to be overcome. Increasing the number and diversity of Islamic NBFIs, together with increasing the range of products offered to various segments, are two major challenges on the supply side. On the demand side, low levels of financial literacy about the products and services offered by Islamic NBFIs; cultural, social, and physical barriers; insufficient consumer protection practices; and reputation- and credibility-related challenges are the biggest obstacles hindering further improvement of Islamic NBFIs. Another main challenge is the need for a balanced and enabling regulatory and taxation framework that also fosters cross-border investments in the Islamic NBFIs sector.

Chapter 8 provides an overview of alternative asset classes in Islamic finance and explores how this sector could enhance shared prosperity. As alternative investments are a diverse asset class, there are no all-embracing regulations or guidelines that can be applied. Usually alternative investments are under the remit of securities or capital market regulators, rather than being the responsibility of central banks. Among OIC countries, the Malaysian Securities Commission and the Capital Markets Authority of Saudi Arabia have played leading roles in identifying the issues

that arise with alternative investments. The Kuala Lumpur-based IFSB has not yet issued any standards specifically on alternative investments, as it focuses more on Islamic banking, capital markets, and *takāful*, although it has published Guiding Principles for Islamic Collective Investment Schemes. There is clearly a case for more comprehensive guidance on alternative investments by the IFSB, as it is the institution that includes regulatory authorities from the OIC states as its members.

Regulators should at least try to ensure that their policies do not inhibit risk-sharing and asset-based financing. These are core principles of Islamic finance that are particularly applicable to investment in alternative assets. There is a case for encouraging the establishment of nonbank Islamic financial institutions that can serve investors seeking alternative assets. The IFSB and national regulators should take the initiative in providing an enabling environment, specifically by drafting guidelines that could be applied to *sharīʻah*-compliant alternative investment. They need to consider the incentive structures for new entrants and the governance framework that can best promote the use of risk-sharing partnerships such as *muḍārabah* and *mushārakah*for alternative investments.

At the same time, it must be recognized that those involved in alternative investments are typically sophisticated investors who do not need protection in the same way as retail investors. Many analysts urge so-called "light touch" regulation for alternative investments, as this reduces transaction costs, which ultimately get passed on to the investors. The European Union and the United Kingdom have relatively liberal directives on alternative investments. Nevertheless, in the case of Islamic investment, the *sharīʻah* oversight should not be "light touch": otherwise this might undermine the credibility of the investments for the pious. There would be reputational risks to the financial institutions offering such investments, and potential reputational damage to the scholars involved in approving the investments.

Sharīʻah scholars working on Islamic finance need to address the issue of the permissibly of alternative asset classes more comprehensively. At the international level, this includes the OIC Fiqh Academy, which has issued *fatāwá* (religious opinions) on many Islamic financing contracts, but not specifically on alternative investments. The *sharīʻah* scholars advising securities regulators also have a role to play, although at present only the Securities Commission in Kuala Lumpur has a formal s*hariʻah* board. It has produced a joint report on Islamic capital markets in collaboration with another Kuala Lumpur-based institution, the International Sharīʻah Research Academy (ISRA). A similar joint initiative in the field of Islamic alternative asset classes would be welcomed by the world-wide Islamic finance community.

Chapter 9 advocates that Islamic social finance could play a significant role in helping achieve the twin development objectives of ending extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of populations. The institutions and instruments of Islamic social finance are rooted in redistribution and philanthropy. Such intervention, involving *zakāt* and *ṣadaqāt* (charity), can potentially address the basic needs of the extremely poor and the destitute and create a social safety net. The instrument of *awqāf* (Islamic endowment) is ideal for the creation and preservation of assets that can ensure flow of

resources to support the provision of education, health care, and other social goods. These Islamic institutions can play a critical role in the realization of the global vision of generating sufficient income-earning opportunities; investing in people's development prospects by improving the coverage and quality of education, health, and sanitation; and protecting the poor and vulnerable against sudden risks of unemployment, hunger, illness, drought, and other calamities. These measures would greatly boost shared prosperity, improving the welfare of the least well-off.

While poverty and deprivation are global phenomena, the plight of Muslim societies is particularly dire. The role of Islamic social finance has great significance in countries with high levels of exclusion and deprivation. The chapter estimates that for most countries in South and Southeast Asia and Sub-Saharan Africa, the resource needs to alleviate deprivation could be met adequately if the potential of institutions of *zakāt* and *waqf* were realized, even if partially.

The chapter reports several creative experiments using *zakāt* and *waqf,* including creating an interest-free credit pool funded with *zakāt* and *ṣadaqāt;* supporting community-driven development using *zakāt* and *ṣadaqāt* funds; creating a guarantee fund with *zakat;* providing affordable health care through corporate *waqf;* and engineering a *waqf* to provide relief and rehabilitation.

Policies are needed to support the efficient mobilization of Islamic social finance, efficient utilization and management of such resources, and their integration with microfinance to make it more inclusive and affordable. At the macro and meso levels, these include policies to create enabling legal, regulatory, and fiscal frameworks and to provide a supportive infrastructure. At a micro level, these include policies to enhance the accountability and transparency of the institutions, improve their governance structures, and diversity their product offerings, while transforming the poor into financially literate and more responsible clients.

Chapter 10 is based on an academic paper that provides empirical evidence of the links between Islamic finance and economic growth. A well-established body of literature has shown that financial development is broadly conducive to economic growth. A developed financial sector helps mobilize savings, facilitates the efficient allocation of capital to where returns are expected to be highest, monitors the use of capital once invested, and allows for diversification of risk. It does not matter much for economic growth whether the financial system is more bank-based or market-based; what matters is the level of overall financial development.

However, the empirical literature has looked only at conventional banking, not Islamic banking. Do these findings that financial sector deepening fosters growth also apply to systems where Islamic banking plays a significant role? Chapter 10 investigates the relationship between Islamic banking development and economic growth in a sample of low- and middle-income countries, using data from 1990 to 2010. The results show that, notwithstanding its relatively small size compared to the economy and the overall size of the financial system, Islamic banking is positively associated with economic growth, after controlling for various determinants, including

the level of financial depth. The results are robust across different measures of Islamic banking development, econometric estimators (pooling, fixed effects, and System GMM), and to the sample composition and time periods.

These findings are encouraging, as Islamic banking still represents a relatively small share of the economy and of the overall size of the financial system, and it has yet to reap the benefits from economies of scale. This means that many countries that currently suffer from low growth—a feature often present in OIC countries—should aim to further develop this segment of finance. As an initial step, it is essential to develop and update legislation and regulation to encourage Islamic finance, as well as the supporting infrastructure, including the necessary human skill sets.

Finally, *chapter 11*, based on an academic paper, discusses how Islamic finance may contribute to the achievement of the Sustainable Development Goals (SDGs) launched in 2015 by the United Nations. The chapter highlights important linkages between an effective financial system and the enhancement of shared prosperity. By mobilizing savings and managing assets, a financial system can promote growth by mobilizing financial resources for investment; reduce inequality by providing asset management services for the poorest 40 percent of the population; and reduce vulnerabilities by providing saving products for emergencies. By allocating capital for production in an efficient and effective manner, a financial system would promote growth, while reducing inequality by providing financing to low-income households and micro and small enterprises (MSEs). In addition, by properly allocating capital and financing for short-term needs and emergencies, a financial system can reduce vulnerabilities. Finally, the management of risks is another function of a financial system through which the growth can be promoted and inequalities and vulnerabilities can be reduced.

Conventional finance practices face several challenges in contributing to shared prosperity with respect to both households and MSEs. On the household side, the financial system provides three main kinds of products: survival products, such as deposits and mortgage funding; security products, such as insurance and pension schemes; and growth products, such and mutual funds and real estate. However, because information about low-income households and MSEs is scarce, conventional financial institutions tend to consider them too risky as clients. As the income level increases, so does the supply of information, and thus the risk perception improves. This pattern works against financial inclusion and shared prosperity.

The chapter establishes the link between the main objectives of the Islamic economic and financial system and the aim of shared prosperity by describing how the ideas of social justice and benevolence underlying the Islamic economic and financial system are in compliance with SDGs. Different risk-sharing and asset-based modes of Islamic finance are analyzed to show how they can be used to serve to the needs of the poorest 40 percent of the societies as survival, security, and growth products. The chapter also investigates the ways Islamic finance can provide innovative tools to fill the gap for medium- and long-term financing needs of MSEs. The chapter concludes that in order to reflect the foundational principles and values and positively contribute

to shared prosperity, however, Islamic financial sector must reorient itself. The industry should strive to develop institutions that can fulfil the broader goals, or *maqāṣid al-sharīʿah,* that can come up with more risk-sharing financial products and services.

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Chapter 1

Islamic Finance and Shared Prosperity

There is broad consensus that the objective of economic development is not only to boost economic growth but also to share prosperity with all segments of society through equitable distribution of income and wealth. In recent decades, policy makers, including multilateral development organizations such as the World Bank Group, have often applied a "trickle-down" approach to reduce levels of absolute poverty. This approach asserts that higher productivity and industrial advancement lead to higher GDP growth in a country. However, the immediate impact of such a growth-led policy could be an undesirable concentration of wealth in the hands of a few, while the growth benefits trickle down to the extremely poor only over a relatively long period of time. This approach has resulted in only partial success at the cost of social disequilibrium.

Rising inequality and ways to cope with this growing problem top the agenda of multilateral development institutions and the policy makers in both developed and developing countries. International organizations such as Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) and multilateral development institutions including the World Bank Group have repeatedly warned about the dire consequences of the increasing gap between the incomes of the very rich and the very poor. Professor Thomas Pikety's influential 2013 book, *Capital in the Twenty-First Century,* highlighted the inequality in 20 countries during the last three centuries. The drastic deterioration in the distribution of wealth and income between the very rich and the very poor in the world is highlighted by a few striking facts:

- Almost half the world's wealth is now owned by just 1 percent of the population (Working for the Few 2014).

- The richest 10 percent of the population hold 86 percent of the world's wealth, and the top 1 percent alone account for 46 percent of global assets (Credit Suisse 2013).

- In the United States, the wealthiest 1 percent has captured 95 percent of growth since 2009, following the financial crisis, while the bottom 90 percent became poorer (Working for the Few 2014).

Income distribution is worsening around the world, leading to widening inequality.[3] Recent research on inequality and growth has provided strong evidence that inequality has damaging

[3] Various theories have been proposed to explain the deterioration in income and wealth distribution. One strand of academic literature considers the globalization of finance and trade to be the main culprit of rising inequality around the world (Krugman and Venables 1995). Another strand focuses on recent technological advances, and identifies a "skill bias" that tends to benefit skilled workers more in comparison to unskilled workers (Acemoglu 2002).

effects not only on economic development and growth but also on social mobility and the social contract.[4]

- An extensive literature review in a 2012 report by the European Commission (EC) finds that high inequality has adverse effects on household well-being, criminality, health, social capital, education, political participation, and female labour market participation
- The same report (EC 2012) notes that according to human capital accumulation theory, in imperfect financial markets, an agent's ability to invest is determined by his or her own wealth. Hence a highly unequal income distribution would block agents with insufficient funds from contributing to economic growth.
- Considering all the negative externalities of income distribution, a 2014 report for the OECD (Cingano 2014) concludes that unequal distribution of income slows economic growth. Enhancing the income of the lowest 10 percent of the population is especially needed to increase economic growth.[5]
- A 2010 study for the IMF (Kumhof and Rancière 2010) shows that the precrisis periods of 1920–29 and 1983–2008 were both characterized by a large increase in the income share of the rich and a large increase in leverage.[6]
- The influential 2010 book *Fault Lines* (Rajan 2010) argues that rising income inequality in the United States was one of the main reasons behind the 2007–08 global financial crisis. Rajan's thesis is that the declining share of low-income households was compensated by ever-expanding credit facilities, which in turn increased fragilities in the economic system through high leverage ratios, creating systemic risk.
- A 2013 study of Asia (Egawa 2013) finds that middle-income trap problem can be alleviated by creating a more equal distribution of income.

The economists' perception that there is always a tradeoff between growth and inequality and their notion that redistributive policies are necessarily non-conducive to growth are both gradually changing (Ostry et al. 2014). In the context of finance, too the recent literature emphasizes how inequality intensifies leverage, produces financial cycle, and precipitates a crisis (Rajan 2012). A host of political-economic factors also contributes through power of the richer few (Stiglitz 2012). Against the backdrop of growing inequality and more refined understanding of its harmful effects, this chapter focuses on alternative perspective that could assist countries to reach the goals of reducing poverty and promoting shared prosperity. We should emphasize that the perspective presented in this chapter is not intended to substitute for but to augment the World Bank Group perspective.

Reducing Extreme Poverty

[4] Earlier views on inequality thought that it might help spur growth. For example, Lazear and Rosen (1981) argue that high inequality might strengthen the incentives for workers to work harder and take on risk and pursue innovative ideas. Okun (1975) argues that there is a negative relationship between policies addressed to reducing inequality and productivity, and coined the term "equity-efficiency trade-off." Kaldor (1955) argues that since rich people have a higher saving rate than poor people, higher inequality results in higher savings and capital accumulation, which spur economic growth.

[5] From a different perspective, and drawing on extensive empirical data and theory, Kuznets (1955) argues that at the early stages of economic development, equality declines, but as the development process proceeds, there will be a turning point as equality begins to improve. He postulates that the relationship between economic development and inequality is in the form of an equality U-curve or inequality inverse U-curve.

[6] Kumhof and Rancière (2010) present a dynamic general equilibrium model that produces these stylized facts.

In 2000, member-countries of United Nations unanimously agreed on achieving eight development goals, commonly known as Millennium Development Goals (MDGs), by 2015.[7] Several international and multi-lateral development organizations, including the World Bank, IMF, and Islamic Development Bank (IDB) have pledged to help achieve these eight development goals. Progress has been made in several MDG goals, such as reducing extreme poverty, narrowing disparities of primary school participation between girls and boys, and decreasing tuberculosis and malaria (UN 2014).

New goal under Sustainable Development Goals (SDGs) initiative to reduce the number of people living on less than $1.25 a day to 3 percent globally by 2030 follows the success of the MDG, set in 2000 to be achieved by 2015, of reducing the percentage of people living on less than $1.25 a day by half, which was reached ahead of its target in 2010. By 2011, the share of the worldwide population living on less than $1.25 a day had decreased from 43 percent in 1990 to 17 percent (figure 1.1). The share has declined in every region.

Figure 1.1 Percentage of Population Living below $1.25 a Day, 1981–2011

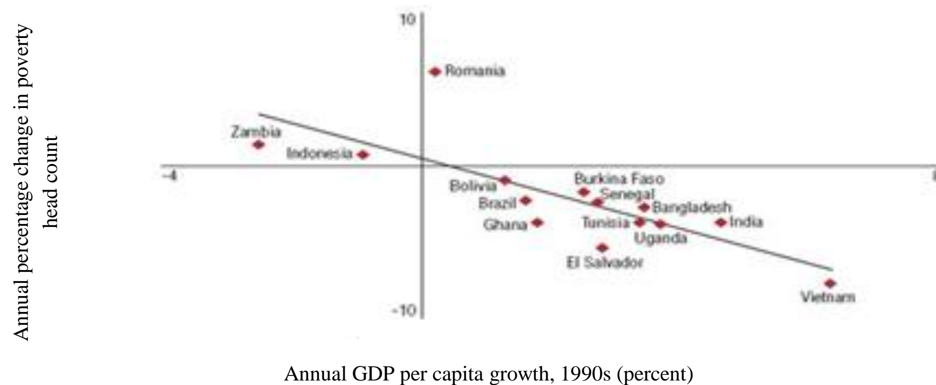
Region	1981	1984	1987	1990	1993	1996	1999	2002	2005	2008	2011
East Asia and Pacific	77.95	65.63	54.27	57.01	51.66	38.27	35.89	27.34	16.56	13.72	7.93
East Europe and Central Asia	2.92	2.31	1.88	1.54	2.87	4.28	3.83	2.13	1.26	0.49	0.49
Latin America and the Caribbean	11.66	13.38	12.47	12.63	11.14	10.57	10.95	10.22	7.35	5.37	4.63
Middle East and North Africa	8.85	6.62	7.24	5.77	5.33	4.78	4.79	3.83	2.99	2.05	1.69
South Asia	61.35	57.73	56.85	54.09	52.07	48.55	44.96	44.1	39.28	34.05	24.5
Sub-Saharan Africa	52.81	56.29	55.81	56.78	60.84	59.75	59.4	57.18	52.86	49.65	46.85
World total	52.71	47.53	42.98	43.44	41.56	35.87	34.24	30.62	24.77	21.85	16.99

Source: http://iresearch.worldbank.org/PovcalNet/index.htm?4.
Note: Data are in 2005 U.S. dollars in purchasing power parity terms (PPP).

Reaching the target of reducing the extreme poverty level to 3 percent by 2030 is not impossible, but is certainly very ambitious. It requires developing countries to maintain the growth rates they have achieved since the late 1990s (figure 1.2).

Figure 1.2 GDP Growth Reduces Poverty

[7] The eight main MDGs seek to: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.



Source: AFD and others 2005.
Note: The downward sloping line (the decrease in poverty relative to the increase in growth) represents the best fit of the data of countries in the sample.

The recent decrease in global poverty was mainly the result of rapid growth of China. As China's growth rate starts to slow down, reducing poverty will be more complex (Narayan and others 2013). Even if developing countries achieve the high growth rates of the past decade, the benefits of high growth may not be evenly distributed to different income groups in the society. In addition to maintaining high growth rates, low-income countries urgently need to implement institutional and governance reforms that enhance the accountability of the State, raise the quality of service delivery, and improve the overall economic and social environment.

Complementing Poverty Reduction with Shared Prosperity

There are various approaches designed to deal with inequality. Those approaches fall into two main categories: those dealing with income-based distribution, and those dealing with asset-based distribution.

Income-based distribution approaches take the current income distribution as given and aim at fairer distribution of future GDP. Within this approach, there are "soft" and "hard" redistribution proposals. The World Bank Group's proposal is considered a "soft" solution, as it requires no immediate redistribution. It does recommend that member-countries consider a new social contract, labor and gender empowerment, and institutional reforms, and redirect public expenditures.

Almost all income-based redistribution proposals require a new social contract. Nobel Prize winner and former World Bank Chief Economist Joseph Stiglitz (2104) argues that without a new social contract, the problem of inequality will remain intractable. He proposes rewriting the rules of the game (40 different rules) in economic and financial areas. This approach presents a serious challenge in terms of political acceptability and viability since existing rules, Stiglitz argues, are put in place for the benefit of the "haves" who control the legislative and enforcement power of State. His proposals, like those of Thomas Piketty—high income taxes, property taxes, and inheritance taxes—are considered "hard" redistribution precisely because they entail such difficult political, economic, and social challenges.

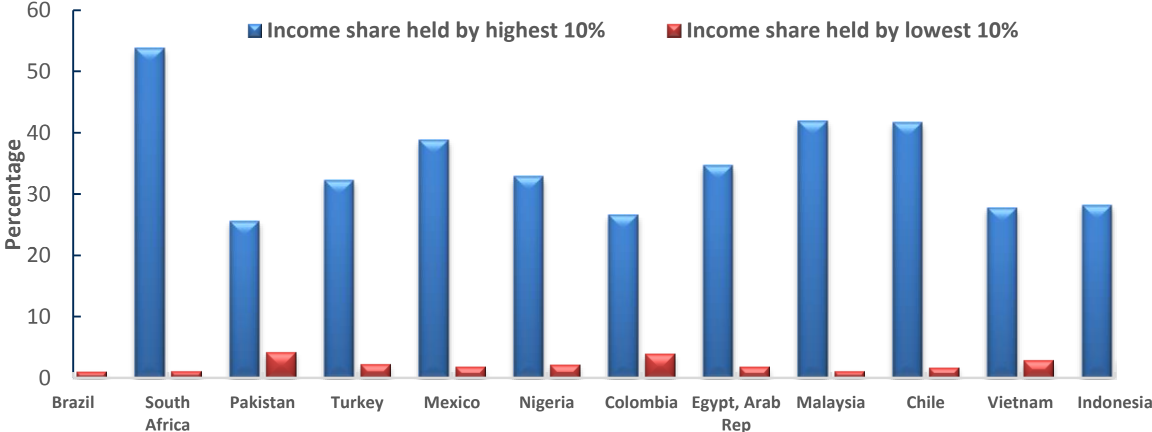
The second approach is asset-based redistribution. The approach is explained best in Samuel Bowles' 2012 book, *The New Economics of Inequality and Distribution*. This approach

does not require an explicit new social contract, does not propose explicit changes in the rules of the game, and does not pose a political challenge. It relies principally on the methods of contracting, financing, and ownership through the market. Its major objective is changing financial and labour contracts to create an incentive structure that improves productivity by better aligning the interests of principles and agents in such a way that avoids moral hazard and other informational problems.[8] The intention is not only to include the excluded in the financial system, but to empower them to become asset-and-wealth builders, thus effectively addressing the dual problems of poverty and inequality simultaneously.

Given the strong evidence of the negative impact of inequality on economic growth, the social and economic costs associated with inequality, and the risks high inequality poses to any economic system, it is difficult to argue that inequality in a society can be ignored. Inequality in a society not only damages the growth prospects of a country but also creates social unrest and has negative effects on mobility between different income groups. No country has managed to escape from the middle-income trap while maintaining high levels of inequality. Hence shared prosperity could be instrumental both in decreasing extreme poverty and increasing average growth rates of countries (Ostry, Berg, and Tsangarides 2014).

The shared prosperity indicator (figure 1.3) focuses directly on the income of the less well-off, rather than focusing only on growth rates of GDP per capita. Shared prosperity is not a simple redistributive policy where wealth is taken from the rich and given to the poor. Instead, shared prosperity aims not only to increase the economic resources of the countries, but also to maximize the share of those continuously increasing resources going to the bottom 40 percent of the income distribution. Hence shared prosperity mainly relies on enforcing a social contract where all agents in society have a fair opportunity to realize their full potential, contribute to economic growth, and receive their fair share of income/wealth.

Figure 1.3 Percentage of Income Held by Top and Bottom 10 Percent in Select Countries



Source: World Bank, World Development Indicators, 2014.

[8] Moral hazard is a situation in which one party gets involved in a risky event knowing that it is protected against the risk, and the other party will incur the cost.

Boxes 1.1 and 1.2 briefly present the development strategies from two multi-laterals—the World Bank and the Islamic Development Bank. Both strategies have common goal but different approaches. The key difference in two approaches is use of Islamic finance by Islamic Development Bank but the end goal is the same—reducing poverty and enhancing shared prosperity.

Box 1.1 The World Bank Group Approach to Enhance Shared Prosperity

For the first time in 30 years, development community led by the World Bank Group has revised its objectives to give priority to inequality. The new mission of the World Bank Group, introduced in 2013, has two pillars: reducing the number of people living in extreme poverty, and promoting shared prosperity.[1] The World Bank Group defines promoting shared prosperity as boosting the incomes of the bottom 40 percent of the population in every country (figure 1.3). By focusing on the advancement of the poor and vulnerable segment of the society, the World Bank Group aims to achieve a more equitable distribution of growth revenues.

The World Bank Group's approach in promoting shared prosperity relies on five sets of policies focusing on:

Raising growth potential

Increasing economic growth is the most efficient method of reducing poverty levels and promoting shared prosperity of the poorest 40 percent of the population. Dani Rodrik (2008) has stated that "historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom." These groups are mostly excluded from the economic developments benefiting the other segments of their society. Without access to proper health care, education, credit, and land usage, they are trapped in a spiral of extreme poverty. In order to tackle these problems, the needs of those people should be carefully analyzed, and specific micro policies reflecting the realities of each different geographic location should be considered.

Financial and social inclusion

To improve the prospects and well-being of the marginalized extreme poor, the World Bank Group is also focusing on enhancing social and financial inclusion of the society, in addition to increasing growth rates. These two priorities are connected. Increasing financial and social inclusion would also help boost overall economic growth by promoting countercyclical economic policy and helping poor people maintain their human capital for the future and assist in the recovery of the economy. In addition to increase financial access, increasing the financial literacy of low-income groups is important.

Fiscal sustainability

Fiscal sustainability became an important focus after public debt/ GDP ratios rose rapidly in the aftermath of the global financial crisis. The high level of public indebtedness not only limits the functionality of welfare states but also makes using Keynesian types of growth policies less plausible. Throughout the history, the prevailing financial system has created a growth path that many experts describe as a boom-bust cycle. During the boom period, high growth rates have been accompanied by high levels of leverage. When the level of leverage reaches a certain inflection point, the system collapses and a rebound follows. Smoothing out this cycle through fiscal sustainability is an important task for the economy and society, as recognized by the World Bank Group strategy.

Environmental sustainability

In addition to fiscal responsibility, creating environmentally friendly economic growth strengthens the sustainability of economic growth. The World Bank Group has committed to develop

new metrics to measure the true positive effects of economic growth that takes into account not only the economic growth but also negative effects of pollution and depletion of natural resources.

Institutional and governance reforms

In order to create a well-functioning social contract where all income groups—not just the very few privileged ones—are included in the prospects of economic growth, trust in government and institutions should be established and strengthened. Measures to increase accountability of institutions will reduce corruption and make institutions more efficient in fulfilling their responsibilities.

Box 1.2 The Islamic Development Bank Group Strategy for Development

In 2015, the Islamic Development Bank (IDB) Group adopted its 10-Year Strategy (10-YS) to be implemented during the period 2016-2025. The new 10-YS is based on the IDBG Vision as a guiding Compass, and is in line with the 10-Year Program of Action (10-PoA) of the Organization of Islamic Cooperation (OIC), and the Sustainable Development Goals (SDGs) adopted by the UN General Assembly in September 2015. The new 10-YS aims at promoting inclusive and sustainable socio-economic development and enhance cooperation between IDB Member Countries (MCs). It enables the IDB Group to serve varying development needs of its 56 MCs. It also aspires the IDB Group to take leadership role in promoting Islamic Finance Globally.

The 10-YS is founded on a framework which revolves around three strategic objectives, five priority areas and seven guiding principles for effective and efficient implementation. These strategic objectives translate the vision aspirations in the MCs into IDBG goals for the next 10 years. The five strategic pillars have been chosen reflecting three main considerations: (i) the uniqueness, by mandate, of IDBG; (ii) the strengths and capabilities accumulated over decades of experience; and (iii) the relative position and potential of IDBG in the context of the evolving development landscape.

Infrastructure development and private sector support are critical areas because of their role in fostering growth and because they offer potential for building on capabilities already in place. Social development (including Agriculture and Rural Development, Education and Health) as a priority area would provide solutions to problems of the neediest and underserved populations, build on widespread experience and fulfill the inclusive mandate. Islamic Finance and Cooperation are unique areas of activities and core mandates for IBDG. On top of that, capacity development will play a very important role in each of the pillars.

In order to translate the strategic pillars into action, given the existing constraints, the strategy includes a set of guiding principles to improve operational effectiveness and organizational efficiency. These guiding principles will help IDBG to: (i) continue growing – with higher emphasis on mobilization of external resources and implementation through gradual decentralization; (ii) be more selective to maximize the impact in development given the available resources; (iii) build capabilities in strategic areas cost efficiently; and (iv) have better integration and coordination of activities across the group to maximize synergies.

Islamic Perspective on Development and Shared Prosperity

The Islamic perspective of income distribution shares many similarities with the asset-based approach to redistribution.[9] The asset-based approach is basically a risk-sharing approach. It converges with Islamic finance's contractual framework in terms of empowering equity participation by the lower-income groups in a society. Making the poor direct holders in real assets in the real sector of the economy reduces their high risk aversion. It also creates positive incentives for behavior to enhance productivity (such as trust, truth telling, and hard work) through the design of contracts that reduce or eliminate the difference between principles and agents and are conducive to achievement of interests of all parties to a contract.

[9] For an in-depth discussion on development issues in Islam, see Chapra (2007); Mirakhor and Askari (2010); and Askari, Iqbal, and Krichene (2010).

The foundations of human and economic development in Islam are well defined. Islamic system of economics can be regarded as a rule-based system with well-defined principles, rules, and institutions. Compliance to this rule-based system leads to material and nonmaterial progress of the society as a whole. The conventional perspective on economic development during 1950s equated economic development with economic progress without taking into consideration the well-being of individuals. This paradigm evolved and has shifted considerably during the last 50 years. Today, development economists acknowledge the importance of individuals as well as the state of institutions. The Islamic perspective on economic development encompasses this revised view. It has three dimensions: the development of the material world; self-development; and development of the society as a whole (Iqbal and Mirakhor 2013).

The central economic tenet of Islam is to develop a prosperous and egalitarian economic and social system wherein all members of society can maximize their intellectual capacity; preserve and promote their faith, health, and wealth among generations; and actively contribute to the economic and social development of society. From this perspective, Islamic economics and finance offers an alternative and viable framework that can play an important role in achieving sustainable development and boosting shared prosperity. This framework is based on four fundamental pillars, depicted in figure 1.4:

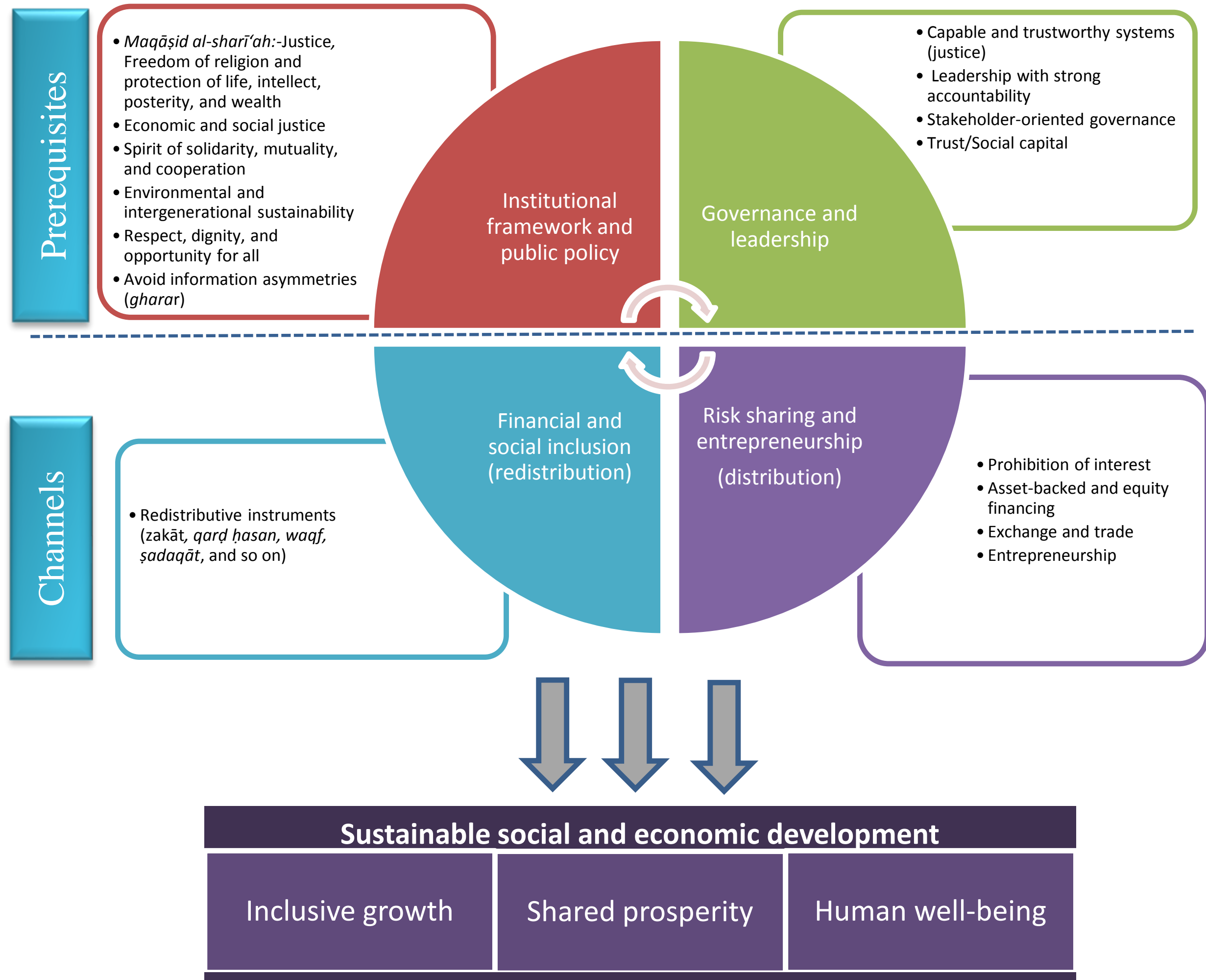
1. An institutional framework and public policy in line with the objectives of Islam
2. Prudent governance and accountable leadership
3. Promotion of economy and entrepreneurship based on risk sharing
4. Financial and social inclusion for all.

The first two pillars are prerequisites, while the last two are the channels to achieve sustainable development with equitable distribution of both opportunities and wealth, which are the main objectives of the concept of economic development in Islam. The proposed framework, which is constructed by interpreting central tenets of Islamic principles, could be utilized in creating a universal strategy and policy in line with the principles of Islamic finance in achieving the goal of sustainable development and increasing the welfare of all members of the society.

The first pillar is crucial because having a sound institutional framework and appropriate public policies are the foundation upon which the other pillars must rest and can function optimally. Institutions play a critical role in this framework, as they implement the rules prescribed by the tenets of Islam. The institutions also to adhere to the core objectives of Islam (commonly known as *maqāṣid al-sharī'ah,* or Objectives of Islamic Law)[10] that lay the foundation to formulate the policies promoting economic and social justice, preservation of human rights, dignity, health, and the intergenerational wealth of the society.

[10] For purposes of this book, and as an oversimplification, the *sharī'ah* is Islamic Law derived from two divinely revealed sources: the *Qur'ān* and the Tradition of the Prophet Mohammed. There are other means of ascertaining the *sharī'ah* from nonrevealed sources such as *ijma* (the contemporary consensus of scholars of the *shari'ah)* and *qiyās* (reasoning): however, there are many others.

Figure 1.4 Islamic Framework to Achieve Sustainable Development and Shared Prosperity



Note: For definitions of the terms of Islamic finance, see the glossary.

The second pillar focuses on developing a governance mechanism and accompanying compliance system based on the objectives and institutions briefly outlined in the first step. The ethically based governance, leadership, and compliance system helps increase the transparency and accountability in the public, private, and social sector institutions of the overall economic system and hence strengthens trust in the system. Trustworthy and capable leadership can ensure protection of rights of the vulnerable or those who could be vulnerable (as in future generations). Increased trust and better governance in turn strengthen the institutional framework that enables better implementation of better public policies. The desired institutional and governance structure must be able to:

1. Design policies to foster inclusive growth and development by promoting entrepreneurship, risk-sharing financial transactions, and equity participation, and discouraging financial leverage and speculation.

2. Encourage all members of society to contribute to the creation of economic, social, human, and moral capital.

3. Enhance the equitable distribution of wealth by promoting sharing of both risk and rewards.

4. Alleviate poverty by redistributing wealth, with special focus on the poorest.

5. Achieve economic and social justice by the correct use of material growth and development that enhances the overall well-being of the society.

The third pillar is the distribution channel; it works at both the individual and organizational level. One of the main features is the advocacy of risk sharing and promotion of entrepreneurship. This is one of the most important aspects of Islamic finance, which differentiates it from the conventional approach of over-reliance on debt-dominated risk-shifting or risk-transfer mechanisms.[11] Sharing the risks of economic and financial transactions also ensures the stability of the financial system (Askari and others 2010). In addition, risk sharing with equitable sharing mechanisms encourages entrepreneurship and innovation, since counterparties receive their fair share in the investment. This in turn will increase the allocation of resources to the real sector, rather channelling excessive financial flows to the financial sector (over-financialization).[12]

The fourth pillar aims to ensure that the fruits of the higher growth are distributed to every segment of the society inclusively, either through participation in the economic growth or through Islam's instruments of redistribution.

Pillar I. Institutional Framework

Establishing efficient institutions and institutional framework in line with the principles of Islam that emphasize universal values such as protection of life; preservation of property rights and sanctity of contracts; building a more just society; protecting the rights of future generations; mutuality and solidarity; and being sensitive to environmental issues is essential in creating an enabling environment for the Islamic economic and financial systems to flourish.

The institutional framework of the ideal economy consists of a collection of institutions: rules of conduct and their associated means of enforcement to deal with the allocation of resources, production, and exchange of goods and services and the distribution and redistribution of the resulting income and wealth. The objective of these institutions is to achieve social justice. Each economic system has an "institutional matrix" that "defines the opportunity set…that makes the highest pay offs in an economy's income distribution or …that provides the highest payoffs to productive activity" (North 2005, 61). Douglass North, in his book, *Understanding the Process of Economic Change*, contends that in all economic systems, institutions (rules of behavior) are designed by humans to impose constraints on human interaction. These institutions "structure human interaction by providing an incentive structure to guide human behaviour. But an incentive structure requires a theory of the way the mind perceives the world and its functioning so that

[11] Islamic finance is comprised of four areas of activity that are conducted in accordance with *sharī'ah* principles: banking; financing; investing; and *takāful* (*sharī'ah* -compliant cooperative insurance).
[12] Financialization is a term sometimes used to describe the form of financial capitalism that developed between 1980 and 2010, in which financial leverage tended to override capital (equity), and financial markets tended to dominate over the traditional real sector economy.

institutions can provide those incentives" (North 2005, 66). At this point, paradigms become relevant because paradigms in economics include conceptions of humankind and society and their interrelationships.

An important function of the institutional framework is reducing uncertainty caused by lack of information, which can hinder decision making. Rules specify what kind of conduct is most appropriate in achieving just results, especially when individuals face alternative choices and must take action. Rules impose restrictions on what society's members can do, without upsetting the social order upon which all members depend in choosing their own actions and forming their expectations of how others will respond and act. Compliance with the rules makes people more certain in forming those expectations, prevents conflict, reconciles differences, coordinates actions, facilitates cooperation, promotes social integration and social solidarity, and strengthens the social order. In an ideal society, the degree of effectiveness in enforcing rules is determined by the degree to which the objective of achieving social justice becomes integral to members of the society.

Key Institutions of Islamic finance

Islamic economic paradigm is a Creator-centred conceptualization of reality (box 1.3). Its view of the institutional framework is based on:

- Clear and secure property rights
- Contract enforcement
- Trust among people and between government and people, and other institutions. Such abiding trust can reduce risk, uncertainty, and ambiguity; strengthen social solidarity; bring private and public interests into closer harmony; and ensure coordination so risk can be shared better.

Box 1.3 Key Institutions in an Ideal Islamic Economy

The institutional structure of the ideal Islamic economy rests on rules governing property, production, exchange, trust, markets, and distribution and redistribution, among others.

Property Rights

All property ultimately belongs to the Creator, who has made all created resources available for humans, to empower them to perform what their Creator expects of them. Individuals are free to acquire and accumulate property as long as it does not violates the rights and the interests of the society and individuals. Islam prohibits the concentration of wealth and imposes limits on consumption through its rules prohibiting overspending (isrāf), waste (itlāf), and ostentatious and opulent spending (itrāf).

Contracts

Islam places great significance on the sanctity and commitment to contracts. Islam's strong emphasis on the strictly binding nature of contracts covers private and public contracts, as well as international treaties. Moreover, every public office in Islam is regarded as a contract: an agreement that defines the rights and obligations of the parties. Every contract entered into by

the believer must include a forthright intention to remain loyal to performing the obligations specified by the terms of the contract.

Trust
Trust is considered the most important element of social capital in Islam, which considers being trustworthy an obligatory personality trait. In the sharī'ah, the concepts of justice, faithfulness, reward, and punishment are linked with the fulfillment of obligations incurred under the stipulations of the contract. Trustworthiness and remaining faithful to promises and contracts are absolute requirements, regardless of the costs involved or whether the other party is a friend or a foe.

Markets
The market's institutional structure is built around five pillars: (a) property rights; (b) the free flow of information; (c) trust; (d) contracts; and (e) the right not to be harmed by others, and the obligation not to harm anyone. Together, they serve to reduce uncertainty and transaction costs and enable cooperation and collective action to proceed unhindered.

Distribution and redistribution
The most important economic institution of the Islamic economic paradigm to achieve social justice are its rules regarding distribution and redistribution. Distribution takes place after production and sale, when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution occurs after the distribution phase, when the charges due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in one's income and wealth.

Source: Iqbal and Mirakhor 2011.

One of the main advantages of having a well-established institutional framework is that it improves the flow of information and can reduce information asymmetries. The Islamic institutional framework has well-defined rules and guidance on everyday life and economic transactions. Rules governing transactions—such as trustworthiness, truthfulness, faithfulness to the terms and conditions of contracts, transparency, and noninterference with the workings of the markets and the price mechanism so long as market participants are complying with the rules—provide a reasonably strong economy where information flows unhindered. Participants can engage in transactions confidently, with minimal concern for uncertainty regarding the actions and reactions of other participants. Because of the high level of trust, transaction costs can be minimal. Due to the level of depth and clarity in these rules, if agents in an economy comply with them, the problem of information asymmetry would be minimized, which in turn would encourage Islamic financial instruments to function.

The role of public policy

In all economic systems, the State plays a role in the economy. Only the extent of the State's involvement differs, depending on the common values and belief system shared by the individuals that make up the particular society and the political structure that is in power during a

particular period. Islamic economy is to ensure that everyone has equal access to resources and means of livelihood, that markets are supervised so that justice is attained, that transfers take place from the more able to the less able, and that distributive justice is ensured for the next generation (Al-Hasani and Mirakhor 2003).

The role of the government is only that of a trustee to society, and it is to act according to the rules prescribed in the *Qur'ān* and *sunnah*.[13] The role of the government is broadly divided into two functions: a policy function that ensures that private interest does not diverge too far from public interest; and a function to design and implement an incentive structure to encourage rule-compliance, coordination, and cooperation.

Islam uses the market as a mechanism to solve part of the coordination problem within the economy. The State enters the market as the supervisor/regulator of economic activity. It is the combination of State supervision/regulation and free enterprise that will be used to maximize social welfare. The State must actively complement market forces to ensure that individual initiative does not degenerate into a private greed for gains, especially when the gains are nonproductive.

The symbiotic relationship between humankind, the Creator, and the environment can off an alternative in achieving sustained and civilized development that could augment the proposed framework proposed by the World Bank Group. Macroeconomic policies are taking cognizance of social and environmental elements as integral parts of the decision process (Mirakhor and Askari 2010). Hence there is a clear link between public policy based on Islamic principles and the emphasis on inclusive and environmentally friendly and fiscally sustainable development policies.

Islamic finance clearly states that the sole owner of all the property, including natural resources, is the Creator. Hence any abuse of natural resources wasteful or inefficient use or disregard or negligence in creating externalities such as pollution is forbidden (Majah 1952).The Islamic perspective places a strong emphasis on intergenerational sustainability in both environmental and fiscal issues.

In addition, Islamic public policies are required to pay a great deal of attention to inclusiveness and efficiency. *Maqasid al-sharī'ah* principles direct the State to implement socially optimal and effective public policies that encourage cooperation rather than competition and support basic freedoms under which a market-oriented and socially inclusive economic system can flourish. Public policy to support financial integration with real economy and mobilize savings in developing countries could help promote risk mitigation and risk sharing, thus building resilience in the face of shocks.

Pillar II. Responsible Governance and Leadership

Governance can be regarded as the set of rules and norms that deals with the process and structures with which entities are managed, and that define the distribution of responsibilities between the management and related parties that are to gain or lose from the actions of the entity. The main objective of governance is to maximize the gains of the related parties and stakeholders

[13] The *Qur'ān* is the holy book of Islam. The *sunnah* are *e*stablished practices that Muslims are required to follow, embodied in *ḥādīth*, or verified reports of the utterances, actions, and tacit approvals of the Prophet Mohammed.

within the social, legal, and market environment. The governance model in Islamic economic system is a stakeholder-oriented model where governance structure and process at the system and firm level protect the rights of stakeholders that are exposed to any risk as a result of firm's activities. Whereas the conventional financial system is struggling to find convincing arguments to justify stakeholders' participation in governance, a stakeholder model is built into Islam's principles of property rights, commitment to explicit and implicit contractual agreements, and implementation of an effective incentive system.

The design of the governance system in Islam can be best understood in light of principles governing the rights of the individual, society, and the State; the laws governing property ownership; and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings but encompasses all forms of life as well as the environment. Each element of Allah (swt)'s creation has been endowed with certain rights, and each is obligated to respect and honour the rights of others (Iqbal and Mirakhor 2004).

Iqbal and Mirakhor (2004) argue that the principles of property rights and contracts in Islam offer theoretical foundations to acknowledge the rights of all stakeholders. Islam's principles of property rights, contracts, and just social order define the business environment where economic agents are morally conscious of protecting property rights and contractual obligations to one another, whether acting as public servants, managers, employees, suppliers, customers, or in any other capacity. All participants in economic activities, whether individuals, firms, corporations, nonprofit organization, or public institutions, are subject to the same degree of commitment. The notion of the sanctity of contractual obligations is not limited to explicit contracts, which are well defined, stipulated, and documented, but is equally applicable to implicit contracts, which are incomplete in nature. Property rights of all contractual parties—whether individuals, local communities, intangible legal entities, or the society—are preserved and protected.

A financial sector with weak governance and lack of transparency is bound to lead to debt financing, market frictions, inefficiencies, and financial exclusion. Strong corporate governance values would increase the accountability and transparency of the financial system.

In Islam, the expected behavior of a firm would not be any different from the expected behavior of any other member of the society. Although the entity itself does not have a conscious, the behavior of its managers becomes the behavior of the firm, and their actions are subject to the same high standards of moral and ethical commitment as expected from any member of society. A firm's economic and moral behavior is shaped by its managers acting on behalf of the owners, and it is their fiduciary duty to manage the firm for the benefit of all the stakeholders and not for the owners alone. Consequently, it will be incumbent upon managers and owners to ensure that the behavior of the firm conforms to the principles and the rules of Islamic law.

Notions of responsibility and accountability play an important role in shaping the behavior of the leaders in public and private sector. Business leaders are expected to act prudently as opposed to recklessly and to act with the best ethical behavior. For example, taking excessive risks is a form of acting without prudence and probably in one's own self-interest rather than the larger interest of the shareholders and stakeholders. Similarly, attempts to circumvent regulatory

constraints,[14] find loopholes in the law, and misrepresent matters, and acts of wilful negligence that were common practice among top business leaders during the global financial crisis, would not be the traits of a leader compliant with the rules of Islam.

Pillar III. Risk-Sharing Finance

The core principle of Islamic finance[15] is risk sharing among the investors and the users of funds that stipulates that both share the outcome of the business or asset being financed —whether positive or negative.[16] Unconditional prohibition of interest in any form by Islamic Law eliminates unsecured debt from the financial system. Instead, preference is given to asset-backed and equity or participatory finance, as well as financing of trading and exchange activities.

Encouraging financial instruments that promote risk sharing and asset-backed financing could help deleverage financial systems (box 1.4) and make them more stable and resilient to economic shocks. The development of equity-based capital markets could play an important role in mobilizing resources without creating leverage in the economy. A financial system based on asset-backed financing would encourage real transactions and growth in real sector. A financial system based on risk-sharing principles would smooth out the boom-bust cycles in the economy, creating a more just and equitable society, since such system the distribution of profit and loss would be determined according to the risks each agent bear.

Since counterparties would receive their fair share of proceeds in investments according to the risk they bear, the entrepreneurial spirit in a society would be invigorated. Agents would be willing to take judicious risk in developing innovative ideas and actually bringing these ideas to life if they were rewarded according to the risk they would bear. A growing body of evidence demonstrates the significance of developing entrepreneurship in the economy through micro, small, or medium enterprises, which could serve as the engine for growth. Entrepreneurship encourages socially optimum risk sharing and promotes innovation.

An economic system based fully on the principle of risk-sharing mitigates the negative effects of recessions on certain investors, while enabling the returns during high-growth episodes to be distributed in a more equitable manner. Hence the risk-sharing principle not only can help create smoother business cycles but can also enhance a more sound and equitable pattern of income distribution in a society.

Islamic finance through its core principles advocates for just and fair distribution of income and wealth during the production cycle and provides mechanisms for redistribution to address any imbalances which may occur. Islamic finance’s approach to redistribution is based on a balanced blend of (a) income-based redistribution through redistributive instruments; and (b) asset-based redistribution through notion of risk-sharing. Whereas income-based redistribution approach offers partial solution as it takes the current income distribution as given and aims at fairer distribution of future GDP, the asset-based redistribution is basically a risk-sharing approach and converges to Islamic finance's contractual framework in terms of empowering equity participation by the lower income

[14] The financial sector and its lobbyists are often accused of resisting any substantial regulation that attempts to restrict the sector’s risky behavior. If one believes the accusation of Nobel Laureate Joseph Stiglitz that the financial sector in the United States prefers to return to the golden (unregulated) days before the crisis (Stiglitz 2014), the world is in for another financial and humanitarian catastrophe (Graafland and van de Ven 2011).

[15] See Askari and others (2010).

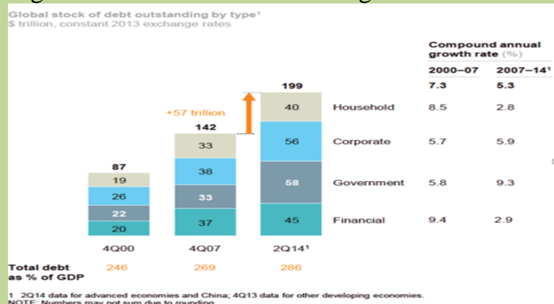
[16] Arrow (1971, 121–33, 143, 239–66) demonstrated that in a competitive market economy, in which markets are complete and Arrow securities whose pay offs are State-contingent are available, it would be Pareto optimal for the economy if its members were to share risk according to each participant’s ability to bear risk (Askari and Mirakhor 2014).

groups in the society. Analytically, by making the poor direct real-asset holders in the real sector of the economy, the approach reduces their empirically observed high risk aversion, it creates positive incentives for actualizations of behavioral factors that are productivity enhancing (such as trust, truth telling, hard work, etc.) through design of contracts that reduce or eliminate the difference between principles and agents and are conducive to achievement of interests of all parties to a contract.

Box 1.4 Why Is Debt Finance So Prevalent?

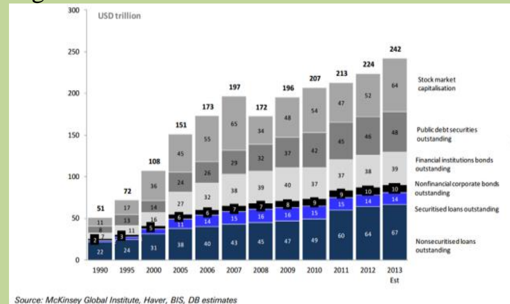
In 2013, outstanding global debt reached $199 trillion (Dobbs and others 2015)—almost triple the capitalization of the equity market, at $64 trillion (Deutsche Bank Research 2014) (figures B1.4.1 and B1.4.2).

Figure B1.4.1 Global Outstanding Debt



Source: Dobbs and others 2015.

Figure B1.4.2 Stock Markets versus Debt Securities



Source: Roxburgh, Lund, and Piotrowski 2011.

One of the major reasons why debt finance is so prevalent is because the interest payments are tax deductible. Tax breaks for debt occur in two principal forms. Interest payments on mortgages are tax deductible for personal income tax purposes in many countries. Meanwhile, firms can deduct interest payments to debtholders from their taxable earnings. By contrast, the dividend payments and retained profits that flow to shareholders are taxable (*The Economist* 2015). It could be argued that debt finance is being subsidized by sovereigns, and this subsidy makes it more favorable than equity finance.

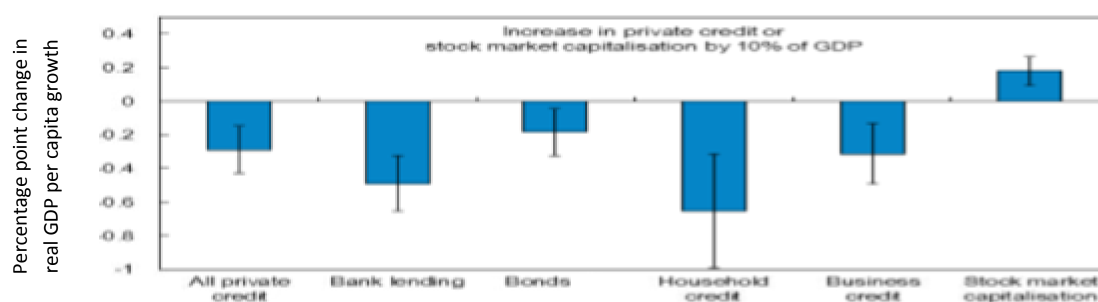
Another reason is information asymmetry. Investors have insufficient information regarding the state of investment projects. Townsend (1979) argues that debt contracts are optimal when only the entrepreneur can observe the state of the world and his or her project; investors must pay a fixed cost (in terms of time, money, and/or effort) to verify the prospects of the project. However, if the probability of monitoring the environment in which the future stream of investment are to be realized is somehow endogonized through some sort of screening process, then a debt contract is no longer efficient even after the debt contract has matured. Furthermore, considering the systemic risks posed by debt-fuelled growth that this strategy poses, the optimality of contracts would change drastically, favoring instruments based on risk sharing.

Another reason why debt financing is much more prevalent is because investors might prefer the relative safety of bonds to equities. Moreover, the entrepreneur retains the entire marginal return through a debt contract**;** the entrepreneur does not have to share the future stream of profits with other investors. This creates incentives for debt financing rather than equity financing (Jensen and Meckling 1976).

Researchers suggest that good public policy and strengthened institutional frameworks in developing countries can go a long way toward reducing aggregate risk in an economy. Policy improvements include strengthening governance to reduce damage to households due to excessive risk taking; achieving and sustaining economic and political stability; and promoting financial sector development. In terms of the institutional framework, clear and secure property rights, contract enforcement, and trust among people and between government and people and other institutions can reduce risk, uncertainty, and ambiguity; strengthen social solidarity; bring private and public interests into closer harmony; and ensure coordination to encourage risk sharing (North 2005; Mirakhor 2009; Mirakhor and Askari 2010).

A system based on risk sharing has the potential of not only creating a smoother business cycle and a more equitable distribution of wealth but also speeding up the deleveraging of the financial system while encouraging the entrepreneurial spirit. Figure 1.5 illustrates how equity finance is more conducive to economic growth than other forms of financing.[17]

Figure 1.5 The Contrasting Effects on Growth of Different Forms of Financial Expansion



Source: http://www.oecd.org/eco/How-to-restore-a-healthy-financial-sector-that-supports-long-lasting-inclusive-growth.pdf.

Pillar IV. Financial and Social Inclusion

The main problems in enhancing financial inclusion is linked to risks arising from information asymmetries and the high transaction costs of processing, monitoring, and enforcing small loans. Information asymmetries can result from adverse selection (the inability of the lender to distinguish between high- and low-risk borrowers) or from moral hazard (the tendency for some borrowers to divert resources to projects that reduce their likelihood of being able to repay the loan, and the inability of the lender to detect and prevent such behavior).

From an Islamic perspective, property is not a means of exclusion but of inclusion, in which to redeem the rights of those less able in the income and wealth of the more able. Islam emphasizes financial inclusion more explicitly than conventional finance, as inclusion is embedded in core economic and social institutions of Islam. Two distinct features of Islamic finance—the notions of risk-sharing and redistribution of wealth—differentiate its path of development significantly from conventional financial model.

The main drivers of financial inclusion are:

- Contracts of exchange and risk-sharing instruments in the financial sector
- Redistributive risk-sharing instruments that the economically more able segment of the society utilize in order to share the risks the less able segment of the population face.[18]
- Inheritance rules specified in the Qur'ān through which the wealth of a person at the time of death is distributed among current and future generations of inheritors (Mirakhor and Iqbal 2012).

Instruments of redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Rules of redistribution ensure that those unable to benefit by participating directly in production and consumption in the market, through a combination of their labor and their

[18] See Askari, Iqbal, and Mirakhor (2015) and Iqbal and Mirakhor (2011).

right of access to resources provided by the Supreme Creator for all humans, are redeemed their rights through various redistributive mechanisms (see box 1.5). Once these rights have been redeemed out of the income and wealth of the more economically able, the latter's property rights on the remaining income and wealth are held inviolable. Contrary to common belief, these are not instruments of charity, altruism, or beneficence, but instruments of redemption of rights and repayment of obligations. (Iqbal and Mirakhor 2013).

Box 1.5 Key Instruments of Redistribution in Islamic Finance

Sadaqah **(recommended contributions)**

The *sadaqah* is intended to redeem the rights of the less privileged in society. *Sadaqāt* is the plural of the term *ṣadaqah*, a derivative of the root meaning truthfulness and sincerity.

Zakāt **(mandatory levy)**

Zakāt is one of the key pillars of Islam and is ordained to mobilize funds for the welfare of the poor. Its collection was enforced by the governments in early Muslim history.

Qarḍ ḥasan **(benevolent loan free of any charge)**

Qarḍ ḥasan, a loan mentioned in the *Qur'ān* as "beautiful" (*hasan*), is a voluntary loan, without any expectation by the creditor of any return on the principal.

Waqf **(endowment)**

A *waqf* is a trust established when the contributor endows the stream of income accruing to a property for a charitable purpose in perpetuity.

Source: Iqbal and Mirakhor 2013.

The *Qur'ān* considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able in the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism for redeeming the right of the less able in the income and wealth of the more able are the network of mandatory and voluntary payments such as *zakāt* (a 2.5 percent levy on asset-based wealth), *khums* (a 20 percent levy on income), and payments referred to as s*adaqāt* (recommended contributions). Finally, individuals who for some reason were left marginalized in the system without having the necessary resources to meet their basic needs are provided with the necessary social safety net through redistributive instruments.

For centuries, Islamic redistributive instruments such as *zakāt, qarḍ ḥasan*, *waqf,* and *sadaqāt* have played vital role of social protection and alleviating poverty in a dignified manner that has led to wider social and financial inclusion. These instruments need to be revived and institutionalized to gain optimal benefits.[19] Through these redistributive instruments, the rich share the risk by helping the poor, which creates a more equitable society where everyone would have equal opportunity and contribute to economic development of the society.

While periodic income redistribution can reduce inequality in the dimension of income, yet the change may not persist over the longer-run. For example, incomes through re-distribution could be

[19] For example, a World Bank study estimates the resource shortfall to close the poverty gap in countries using *zakāt* collection and finds that 20 out of 39 OIC countries could lift the poorest living on less than $1.25 per day above the poverty line simply with adequate *zakāt* collection (Mohieldin and others 2011). See also chapter 9.

subject to misused by the recipient or allocated to consumption which could bring the system back to the same state of inequality. As compared to income redistribution, asset redistribution is potentially more durable as it affects the potential future stream of earnings not one time income. For these reasons, Islam not only puts in place a method of redistribution of wealth, e.g. at the time of inheritance distribution, but also a method of periodic redistribution of income and wealth in the form of zakat, waqf, and more frequent, sadaqat and other charities. This not only directly helps the poorer segment of the population but also brings idle wealth into circulation and productive use. Islam also puts in place overall system of fairness, unambiguity in transactions, risk-sharing, and equitable dealings. This is important to avoid nullification of any redistributive effect and to ensure proper incentives to work, take risks, and share in the outcomes. Together these elements of distribution and redistribution of income and wealth ensure circulation of wealth and avoidance of its concentration among the rich.

The Role of the Financial Sector in Achieving Shared Prosperity

On a macroeconomic level, academic research has shown that not all types of growth contribute to the reduction in poverty rates in the same manner. Even though over-financialization poses dangers to economic stability, in order to achieve sustainable growth a well-functioning financial system that would channel the funds to the most productive resources is essential. Growth fuelled by the financial sector generates less employment for the lower income segment of the society than growth driven by labor-intensive sectors. For example, growth favoring the agricultural sector helps improve the conditions of the very poor. Hence, the importance of focusing resources of financial sector into the real sector development cannot be underemphasized in realizing the World Bank Group goals. Several studies have shown that financial sector development can make positive contribution to economic development (Levine 1997). There are several areas where development of financial sector can make significant contribution to achieving shared prosperity such as those described in box 1.6.

Box 1.6 How Development of the Financial Sector Could Promote Shared Prosperity

Institutions and Public Policy
• **Institutional framework:** Establish efficient, well-run institutions in line with the principles of *maqāṣid al-sharīʿah* that emphasize universal values such as protection of life, preservation of property rights and sanctity of contracts, building a more just society, protection of rights of future generations, mutuality and solidarity, and being sensitive to environmental issues.
• **Fiscal prudence and environmentally sustainable development:** Develop risk-sharing instruments to finance fiscal deficits. Ensure that prudent fiscal policies are in place to protect the rights and wealth of future generations. Pay special attention to the negative externalities higher economic growth might create, such as pollution and depletion of resources. Not taking these effects would shift the burden from the current generation to future generations.
• **Socially optimal and inclusive public policy:** Use *maqāṣid al-sharīʿah* principles to implement socially optimal and effective public policies encouraging cooperation rather than competition, and basic freedoms under which a market-oriented and socially inclusive economic system could flourish.
Responsible Governance and Leadership

- **Enhance governance:** A financial sector with weak governance and lack of transparency is bound to lead to debt financing, market frictions, inefficiencies, and financial exclusion.
- **Enhance accountability:** Greater accountability would induce policy makers and agents within an economy to act according to the predefined set of rules that would enhance property rights, contracts, and trust in the entire economic system. This, in turn, would lead to more efficient resource allocation and a more vibrant economy. An increase in trust would reduce the cost of screening and monitoring and encourage investments in the real economy.
- **Strong leadership to implement policies:** Strong political will and leadership is of utmost importance to implement the theoretical goals of responsible governance.

Promotion of Risk Sharing and Entrepreneurship

- **Deleveraging the financial system and promoting risk sharing**: Financial instruments promoting risk sharing and asset-based financing can help deleverage financial systems to make them more stable and robust, thus promoting sustainable growth. Similarly, the development of equity-based capital markets can play an important role in mobilizing resources without creating leverage in the economy. A financial system based on asset-based financing would encourage transactions and growth in the real sector. A financial system based on risk-sharing principles would smooth out the boom-bust cycles in the economy. This would create a more just and equitable society, since in such system, the distribution of profit and loss would be determined according to the risks agents bear.
- **Reducing information asymmetries (*gharar*):** Since agents are rewarded according to the risk they bear, counterparties have incentives to act in a responsible manner without taking unnecessary risk. This mutuality increases the trust in counterparties, which decreases *gharar* and results in a more efficient allocation of resources. Since Islamic principles strictly prohibit the existence of vagueness in contracts, this also reduces information asymmetries.
- **Entrepreneurship:** Promoting entrepreneurship through micro, small, and medium enterprises can serve as an engine for growth. Entrepreneurship encourages socially optimum risk sharing and promotes innovation. However, every micro or SME owner is not an entrepreneur. A key consideration is how to develop such skills and encourage calculated risk-taking to promote development and making opportunities available to share in the prosperity.

Financial and Social Inclusion

- **Revitalizing and insitutionalizing redistributive instruments.** For centuries, redistributive instruments such as *zakāt, qarḍ ḥasan, waqf, and ṣadaqāt* have played a vital role of social protection and alleviating poverty in a dignified manner that has led to wider social and financial inclusion. These instruments need to be revived and institutionalized to yield optimal benefits.
- **Innovative social finance.** Both social and financial inclusion are critical tools in boosting shared prosperity. However, the conventional means of financial inclusion through microfinance and SME financing face serious challenges, including the high cost of borrowing and lack of affordable funding. This problem is even more serious for countries with massive poverty, including the majority of OIC countries. There is a need to develop financial mechanisms that make affordable financing available to the poor. Market-based solutions, public-private partnerships, and social finance instruments can help.
- **Unconventional means of social protection.** Conventional finance's answer to increasing social inclusion mainly relies on the activities of the welfare state. However, the spike in government indebtedness after the financial crisis, especially in developed countries, has limited the availability of sovereign financial resources and thus the role welfare states might play in terms of reducing income inequality. Countries that have high levels of poverty also often have very weak institutions that make it difficult to support a welfare state. Hence a different framework is needed to reach the poor and marginalized.

Conclusion

This chapter presents a perspective based on Islamic economics and finance that offers an alternative approach to achieving two key development objectives: reducing extreme poverty to 3 percent globally by 2030, while promoting shared prosperity. Given the severity of these problems

in OIC countries, where policy makers are challenged with high levels of inequality and high indebted households, firms, and sovereigns, a solution provided by Islamic finance could lead to sustainable development and enhanced shared prosperity.

The main core principles of Islamic finance are its asset-based and risk-sharing principles. The asset-backed nature of Islamic finance prevents an economy from becoming over-financialized and leveraged. Risk-sharing not only offers the foundation for a more stable financial system but also more equitable growth, since the proceeds of returns to growth are shared by agents in line with the risk they bear.

For those core principles to be realized, certain preconditions must be met. The starting point is establishing a sound institutional framework that has well-defined rules and reduces information asymmetries in economic transactions. The institutional framework should be strengthened by governance structures that take into account all the stakeholders, as well as the broader society. Finally, adherence to redistributive principles could enhance financial inclusion and would enable the proceeds of growth to be redistributed to the marginalized groups who for some reason did not have the necessary resources to participate in the growth strategies.

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Chapter 2

The State of Development and Shared Prosperity in OIC Countries

This chapter provides a brief overview of economic development in the 57 countries belonging to the Organization of Islamic Cooperation (OIC) in relation to the goals of the World Bank Group, Islamic Development Bank, and other development multilateral institutions.[20] The aim is to provide an overview of the state of development and shared prosperity in those countries, and identify the gaps in meeting the goals set by global development community. Such an analysis is vital for formulating effective policy responses in OIC countries, some of which are facing serious development and income distribution issues.

The Millennium Development Goals

At the turn of the new millennium, all member-states of United Nations and more than 20 international organizations identified eight development goals, known as the Millennium Development Goals, and pledged to achieve them by 2015. The eight goals aimed to:

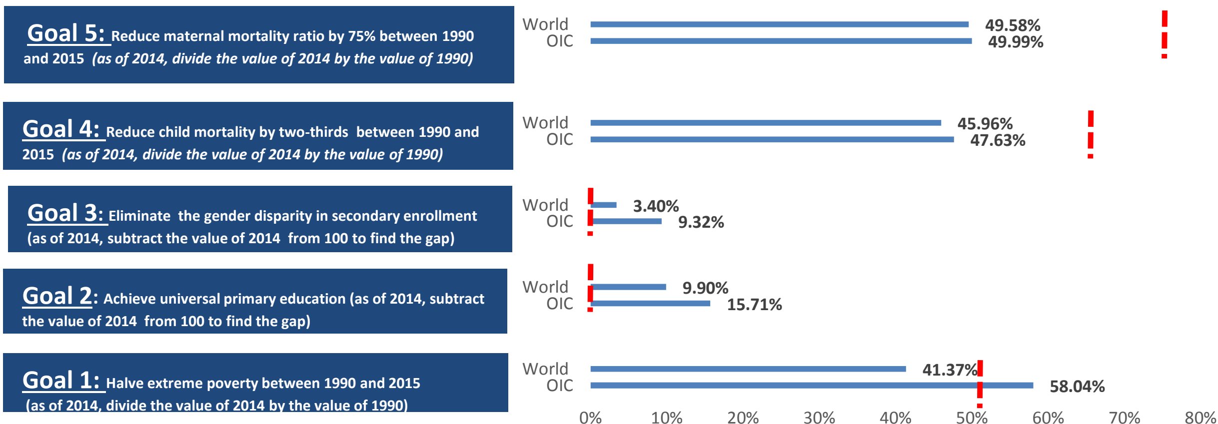
1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria, and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development.

Good progress has been made and some of the development goals have been met ahead of the target deadline. Figure 2.1 presents progress in the first five MDGs as of 2014. The red dotted line represents the MDG target for every metric. For the sake of brevity, the comparison is reported at the World versus the OIC countries as a group.[21] Except for the Goal 1 of reducing the extreme poverty by 50 percent, no other MDGs were attained by either the World or the OIC countries. In terms of compararive performance, OIC countries as a group, on average, did not deviate significantly from the World as a group.

[20] The Organisation of Islamic Cooperation (OIC) (formerly the Organisation of the Islamic Conference) has a membership of 57 States spread over four continents, covering around 1.7 billion people. It is the collective voice of the Muslim world, dedicated to ensuring and safeguarding the interests of the Muslim world in the spirit of promoting international peace and harmony among various people of the world. http://www.oicun.org/.

[21] We are thankful to Dr. Ishrat Husain to caution for interpretation based on aggregates data for a group as heteregenous as OIC. Furthermore data on various variables used in this chapter is not consistent as highlighted by Bello and Suleman (2011). Hence, the interpretation should be used cauticoiuly.

Figure 2.1 Progress in Meeting Millennium Development Goals 1–5



Source: http://mdgs.un.org/unsd/mdg/Data.aspx.
Note: The red dotted line indicates the MDG targets for each subcategory.

The world has witnessed a reduction in the share of people living under extreme poverty by half; however, this success has not been distributed evenly across different income groups or regions. Figure 2.2 shows the state of poverty according to two different benchmarks: the poverty headcount ratio at $1.25 a day and $2 a day, grouped by different income levels.[22] Overall, the headcount ratio of people living under extreme poverty (less than $1.25 a day) has declined considerably among OIC countries and worldwide. However, there is a great variation between the distributions of the ratio of people living on less than $1.25 a day. The trendlines clearly indicate that the reduction of the poverty among the OIC member countries were much faster than their non-OIC counterpart in almost all income groups as highlighted with solid lines in Figure 2.2.

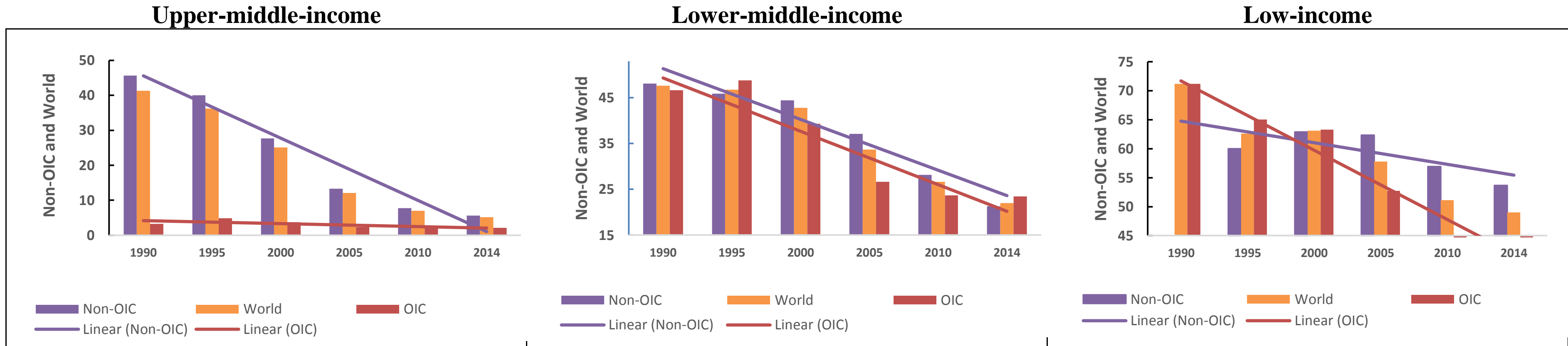
Figure 2.3 provides the regional distribution of poverty ratios by both measures. As expected, the region that is worst off in terms of people living in extreme poverty is Sub-Saharan Africa., By contrast, East Asian nations succeeded in reducing the extreme poverty ratios significantly between 1990 and 2014, thanks to their high growth rates.

[22] For each five-year period, the latest available data for every country were used. High-income OIC countries were excluded from the analysis because no data were available. The income and regional classifications are adopted from World Bank Group's classifications. Aggregate values were computed with a weighted average, using the overall population of a given country. Data are in purchasing power parity (PPP) terms.

Figure 2.2 Poverty Headcount Ratios, Income Level Classification
Percent of population

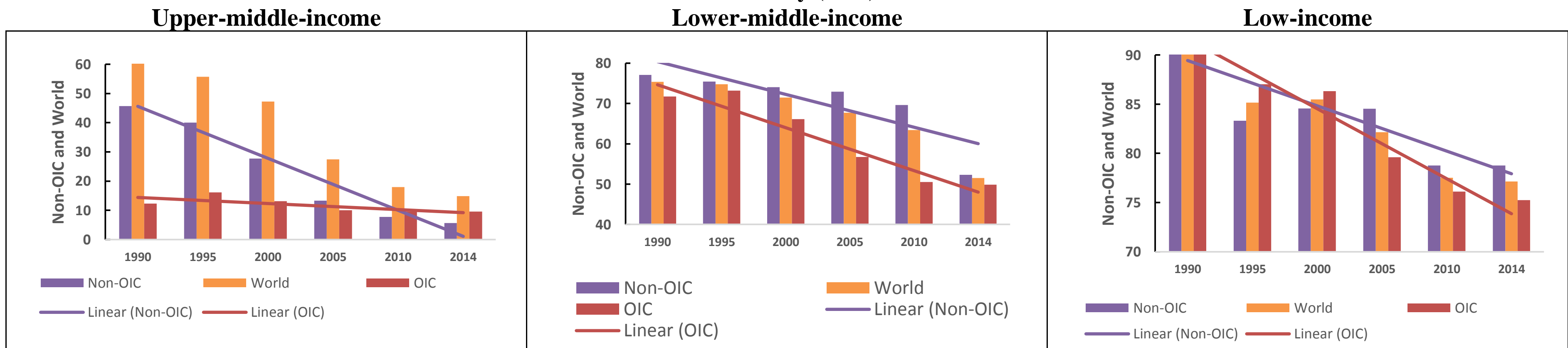
a. $1.25 a day (PPP)

Upper-middle-income	Lower-middle-income	Low-income



b. $2 a day (PPP)

Upper-middle-income	Lower-middle-income	Low-income



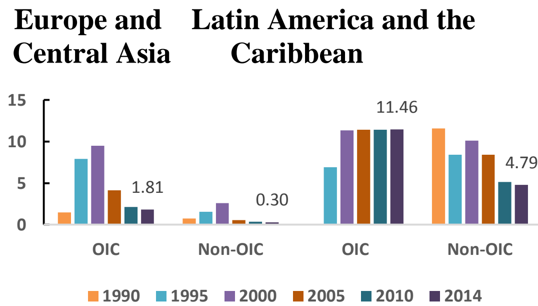
In upper-middle-income group, OIC countries are better off compared to Non-OIC countries for both poverty metrics. However, the pace of reduction of extreme poverty has stalled, especially after 2005.	In lower-middle-income group, the pace of poverty reduction in the OIC group is steeper than the non-OIC group. Furthermore the rate of poverty eradication is more steeper for the $2 a day metric.	In low-income group, OIC countries reduce extreme poverty more effectively than the Non-OIC countries, especially between 1990 and 2014 on both metrics.

Source: Compiled using data from World Bank World Development Indicators (WDI) database.

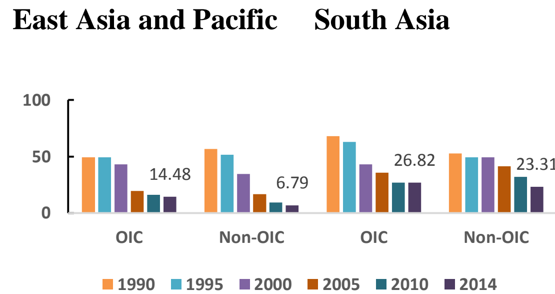
Figure 2.3 Poverty Headcount Ratios, Regional Classification
Percent of population

a. $1.25 a day (PPP)

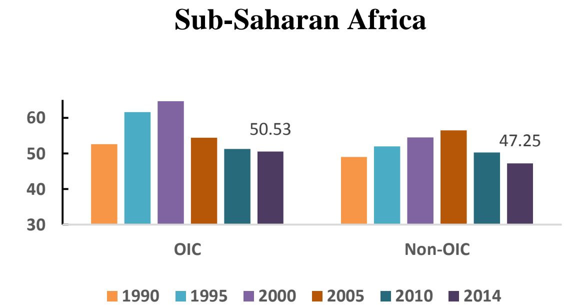
Europe and Central Asia **Latin America and the Caribbean**



East Asia and Pacific **South Asia**

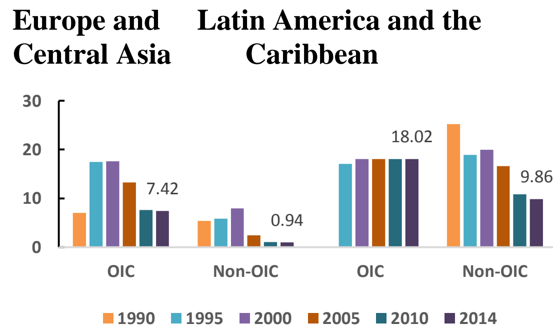


Sub-Saharan Africa

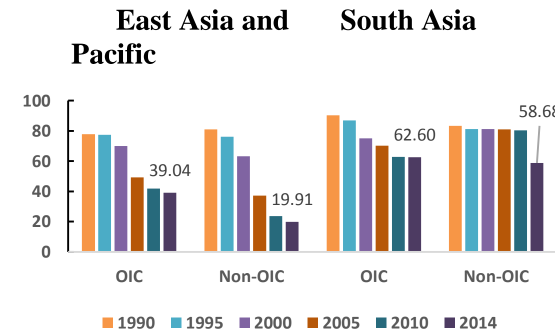


b. $2 a day (PPP)

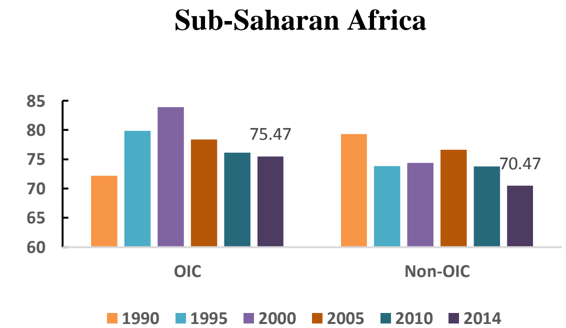
Europe and Central Asia **Latin America and the Caribbean**



East Asia and Pacific **South Asia**



Sub-Saharan Africa



Poverty declined for OIC and non-OIC countries in both regions according to both metrics. However, the poverty ratios in OIC countries remained flat or even increased in the same period.

Poverty declined considerably in the East Asia and South Asia for both OIC and Non-OIC countries. However, the pace of decline seems to have slowed down in OIC countries for the $2 a day metric.

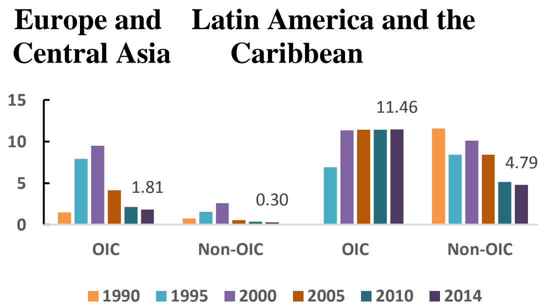
Between 1990 and 2000, the ratio of people living in extreme poverty increased in Sub-Saharan Africa, but started declining in the 2000s. The net reduction in poverty among OIC countries since 2000 was better in OIC countries as compared to Non-OIC countries. Overall, OIC countries marginally lagged behind non-OIC countries.

Source: Compiled using data from World Bank World Development Indicators (WDI) database.

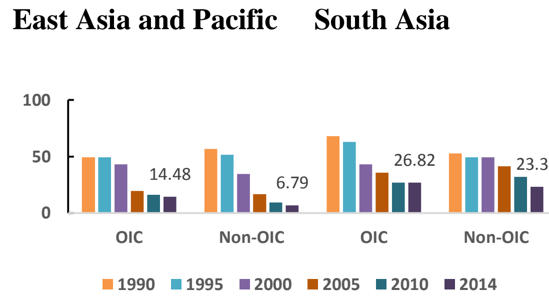
Figure 2.3 Poverty Headcount Ratios, Regional Classification
Percent of population

c. $1.25 a day (PPP)

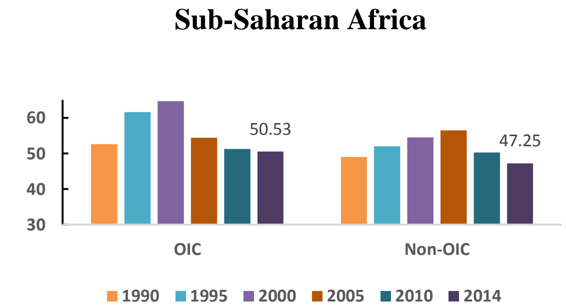
Europe and Central Asia **Latin America and the Caribbean**



East Asia and Pacific **South Asia**

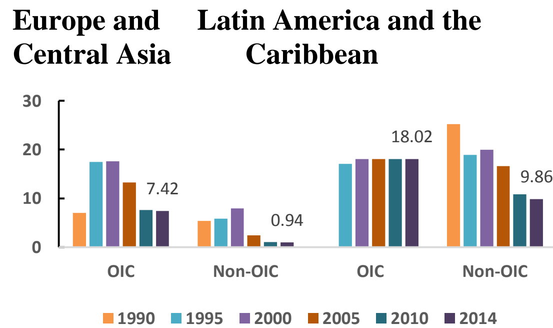


Sub-Saharan Africa

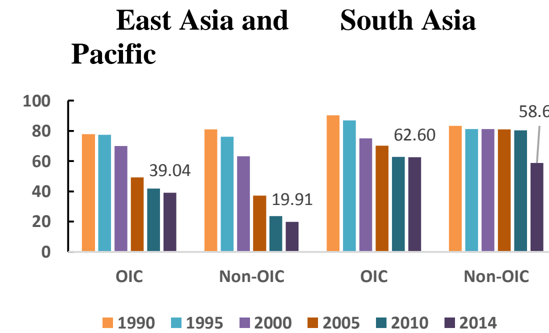


d. $2 a day (PPP)

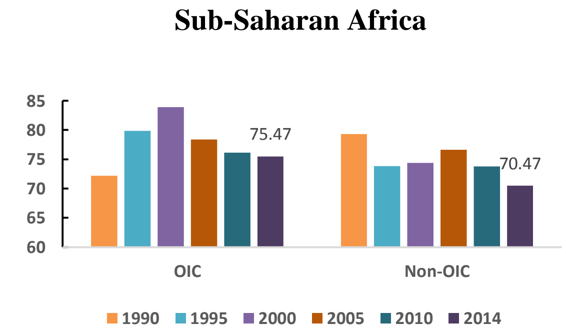
Europe and Central Asia **Latin America and the Caribbean**



East Asia and Pacific **South Asia**



Sub-Saharan Africa



Poverty declined for OIC and non-OIC countries in both regions according to both metrics. However, the poverty ratios in OIC countries remained flat or even increased in the same period.

Poverty declined considerably in the East Asia and South Asia for both OIC and Non-OIC countries. However, the pace of decline seems to have slowed down in OIC countries for the $2 a day metric.

Between 1990 and 2000, the ratio of people living in extreme poverty increased in Sub-Saharan Africa, but started declining in the 2000s. The net reduction in poverty among OIC countries since 2000 was better in OIC countries as compared to Non-OIC countries. Overall, OIC countries marginally lagged behind non-OIC countries.

Source: Compiled using data from World Bank World Development Indicators (WDI) database.

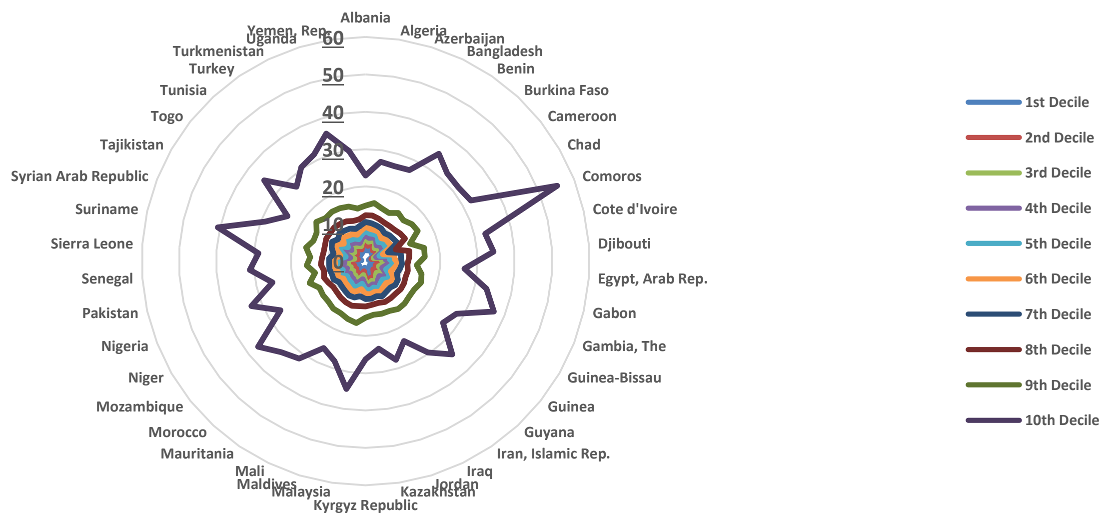
The State of Shared Prosperity

Despite progress made towards the reduction in extreme povery ahead of the target deadline, the gap between the rich and poor has widened especially after the global financial crsis. The proceeds of the economic growth seemed to be concentrated in the very top layer of economies, creating social unrest.

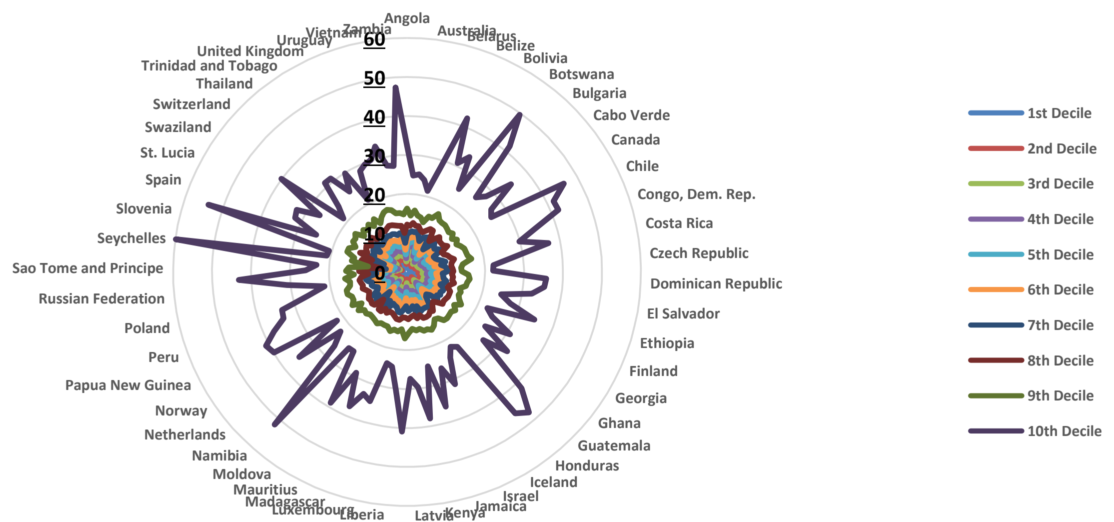
Figure 2.4 makes it clear that the share of the income going to the top 10 percent is significantly higher than the income of the rest the deciles throughout the world. This is the case for both OIC countries and Non-OIC countries.

Figure 2.4 Income Distribution by Decile

a. Selected OIC countries



b. Selected Non-OIC Countries



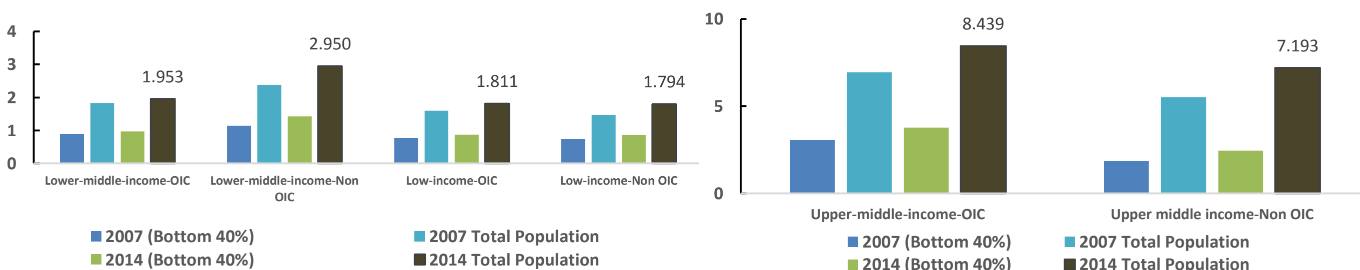
Source: Compiled using data from World Bank World Development Indicators (WDI) database.

Figure 2.5 presents survey data on consumption or income (depending on the type of survey) of the bottom 40 percent and the total population. Unfortunately, the lack of continuous survey data hampers analysis. However, based on the available data, the figure depicts the state of OIC and Non-OIC countries with respect to regional and income classifications.

Figure 2.5 Per Capita Income (Consumption) of the Bottom 40 Percent and the Total Population

2005 PPP $ per day

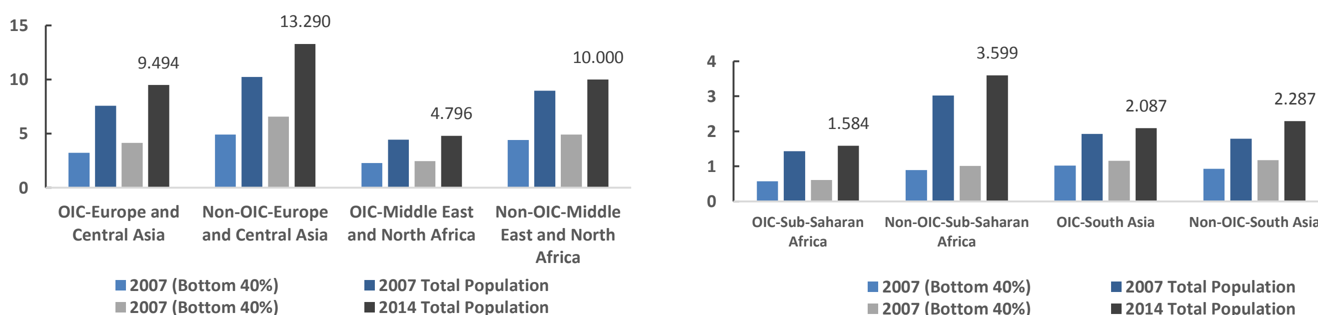
a. Income level classification



For the lower-middle-income group, the OIC countries follow the same trend as non-OIC countries while have similar figures for low-income group.

The upper-middle-income OIC countries fared better than the Non-OIC countries on both measures in 2007 and 2014. The two segments of the population had similar growth rates.

b. Regional classification



Share of bottom 40% as well as total population increased for both OIC and non-OIC countries in Europe and Central Asia as well as Middle East and North African countries.

Whereas distribution at total populations increased in both OIC and non-OIC countries, the growth in distribution to bottom 40% for OIC countries took place at a slower pace.

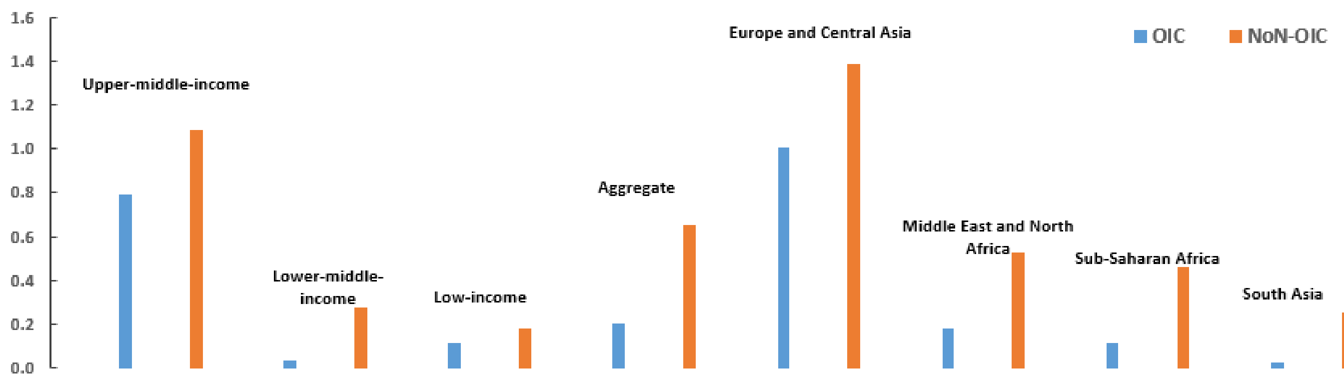
Source: Calculations using data from World Bank World Development Indicators (WDI) database.

Panel a of the Figure 2.5 exhibits the comparison among the Non-OIC and OIC member countries. The OIC countries in the lower middle income group increased the income for the bottom 40% by 10% while the income of the total population increased by 6% only. The gap is reducing for OIC-Lower Income group however, for the Non-OIC lower income group, the per capita income for the bottom 40% increased at almost the same rate as the total population between the period from 2007 to 2014. We also note that growth rate in per capita income for Non-OIC group is much higher than that of the OIC group. While in case of upper-middle income group, the growth rate of per capita income for total population and bottom 40% within the group for OIC and non-OIC is not very different however, the growth rate for non-OIC group is higher than that

of the OIC group. The slower growth rates for the OIC group clearly indicates the need for a policy response to boost the distribution of economic growth overall as well as for the bottom 40%.

Figure 2.6 analyzes whether the gap between per capita consumption (income) of the bottom 40 percent and overall population increased or decreased between 2007 and 2014. To be more specific, the gap between bottom 40 percent and the overall population (Δ) was calculated as the difference between the gaps in 2007 and 2014 to observe whether that gap between bottom 40 percent and overall population in terms of income per capita has been increasing or decreasing. A positive value for Δ implies that the relative position of bottom 40 percent has worsened. Overall, the gap was positive in all countries, but more so in Non-OIC countries. This indicates that bottom 40 percent were worse off in all regions, but the disparity in OIC countries was lower compared to other countries in the region. In other words, the relative gap between the bottom 40 percent and overall population diverged less in OIC countries that in Non-OIC countries. It is difficult to attribute this trend to any specific factor; it could be result of various factors requiring further research.

Figure 2.6 Change in the Gap between Per Capita Consumption (Income) of the Bottom 40 Percent and the Overall Population between 2007 and 2014



Source: Calculations using data from World Bank World Development Indicators (WDI) database.

The State of the Pillars of Economic Development Framework of Islamic Finance

Chapter 1 presented a theoretical framework of how inclusive growth and shared prosperity could be achieved through Islamic economics and finance principles. Islamic perspective on economic development was presented as based on four pillars:

1. Objective-oriented institutional framework and public policy

2. Governance and leadership
3. Risk-sharing and entrepreneurship
4. Financial and social inclusion

This section takes this general framework as the starting point and examines the state of each pillar to enhance our understanding to suggest adequate policy response. Since each component is a composite of various variables, some of which are not directly observable, proxies are used to analyze the state of each component. Given the complexities of the framework and the broad nature of the components, developing a comprehensive analytical tool would require extensive effort and resources. This section includes a very broad analysis to get a feel of the state of affairs without delving too deeply into subcomponents. Several studies have been undertaken to determine the observation and implementation of Islamic principles in Islamic countries.[23]

Table 2.1 presents these proxies, which are used to quantify the relative status of OIC countries with respect to other countries in several classifications. Additional measures are included to understand the dynamics of financial sector with respect to poverty and shared prosperity.

Table 2.1 Factors to Measure Core Development Components

Dimension	Proxy
Institutional framework and public policy	Rule of Law Index
Governance and leadership	Government Effectiveness Index
Risk-sharing and entrepreneurship	Correlation between real GDP and consumption
	Relative value of market capitalization of listed companies
Financial and social inclusion	Alternative sources of funding (percent of population, age 15+)
	CPIA (Country Policy and Institutional Assessment) policies for social inclusion/equity cluster average
Financial sector depth and interaction with shared prosperity and poverty reduction	Domestic credit to private sector (percent of GDP) Gross portfolio debt assets to GDP (percent) Gross portfolio equity assets to GDP (percent)

Institutional Framework and Public Policy

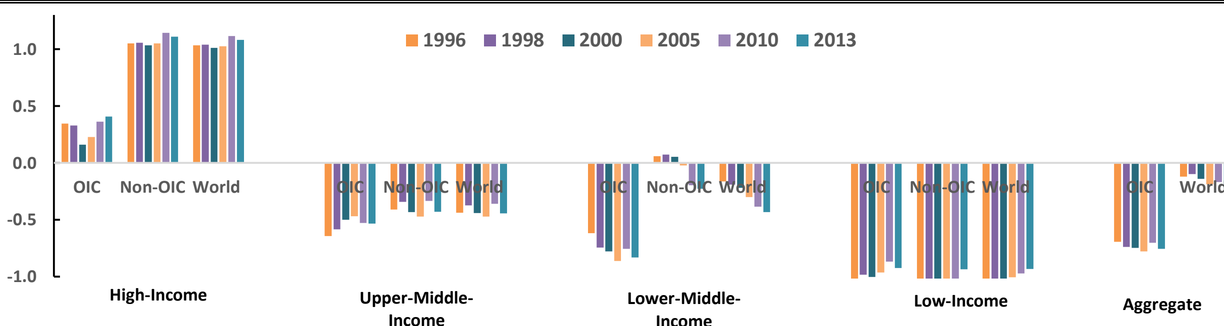
A well-established institutional framework is one of the major requirements for Islamic finance to flourish and to achieve fairness in a society. In a panel of around 100 countries from 1960 to 1990, Barro (1996) finds that among other factors, better maintenance of the rule of law enables countries to grow faster. He argues that a country where rule of law principles are strongly adhered to would grow faster because the environment for investment would be sound.

The core foundation of a sound institutional framework is the strength of the legal structure. To assess the quality of the institutional framework in OIC countries, the World Bank's Rule of

[23] For example, see Askari and Rehman (2010) who construct an Islamicity index of various countries. Also, see Askari and Rehman (2013).

Law Index, is used as a proxy. The Rule of Law Index, shown in figure 2.7, captures the essential elements that should be present in a well-functioning judicial system. The values of this index range between 2.5 (weak) and 2.5 (strong). On aggregate, both the World and the OIC group showed the value of the index in the sub-zero category with the low income group at the bottom. Since, as mentioned, economic growth is the main force that reduces economic poverty, strengthening the legal system should be a priority in supporting development in OIC countries. In particular, the largest discrepancy between OIC and Non OIC countries is in the lower-middle-income group, which constitutes roughly 54 percent of the overall OIC population. Hence policy makers from these countries should especially focus more on strengthening the legal system.

Figure 2.7 Rule of Law, Income Level Classification



Source: http://info.worldbank.org/governance/wgi/index.aspx#home.
Note: The Rule of Law index captures perceptions of the extent to which agents have confidence in and abide by the rules of society, particularly the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, ranging from approximately -2.5 to 2.5.

Governance and Leadership

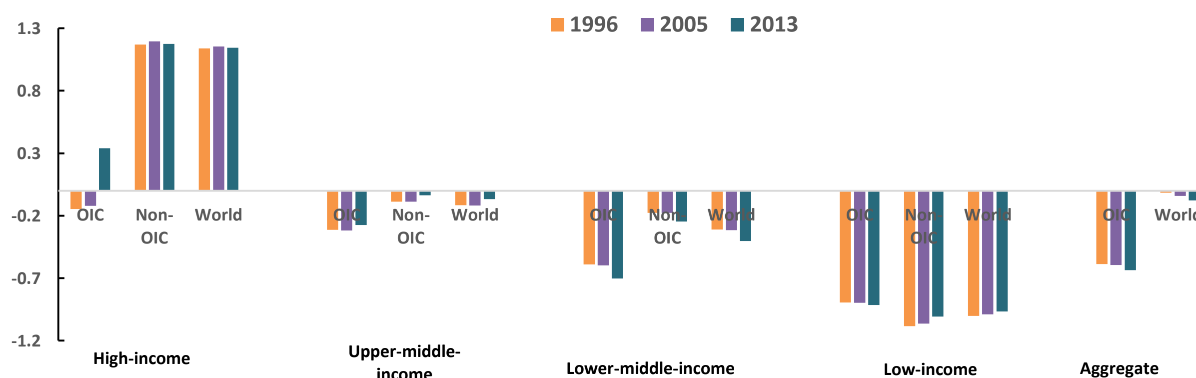
Sound public policy is essential to providing services in an efficient manner and addressing the needs of the public. Strong leadership is needed to implement the necessary reforms. Conversely, the lack of a well-functioning and effective government could result in an environment that is chaotic and unfriendly toward market practices and economic growth. For example, Middle East and North African countries with better measures in political stability, government effectiveness, and corruption control metrics grow by as much as 2.5 percentage points a year faster in terms of GDP than those that score lower these indicators, Han, Khan, and Zhuang (2014) find.

Good governance also ensures that the rights of shareholders and all stakeholders will be protected. This will promote investment, since investors will feel secure in making investments. Good governance will also strengthen the soundness and effectiveness of institutions. Rodrik, Subramanian, and Trebbi (2004) analyze the relative contributions of institutions, geography, and

trade in determining income levels around the world and conclude that the quality of institutions "trumps" everything else.[24]

To capture the state of the quality of governance, the World Bank's Government Effectiveness Index (GEI) is used as a proxy. Figure 2.8 shows that on average, the countries from the lower and lower-middle income group are low on the GEI with the trailing OIC countries from the same group in terms of the effectiveness of government.

Figure 2.8 Government Effectiveness Index, Income Level Classification



Source: http://info.worldbank.org/governance/wgi/index.aspx#home.
Note: The government effectiveness index captures perceptions of the quality of public services, the quality of the civil service, and the degree of its independence from political pressures; the quality of policy formulation and implementation; and the credibility of the government's commitment to such policies. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, ranging from approximately -2.5 to 2.

Risk Sharing and Entrepreneurship

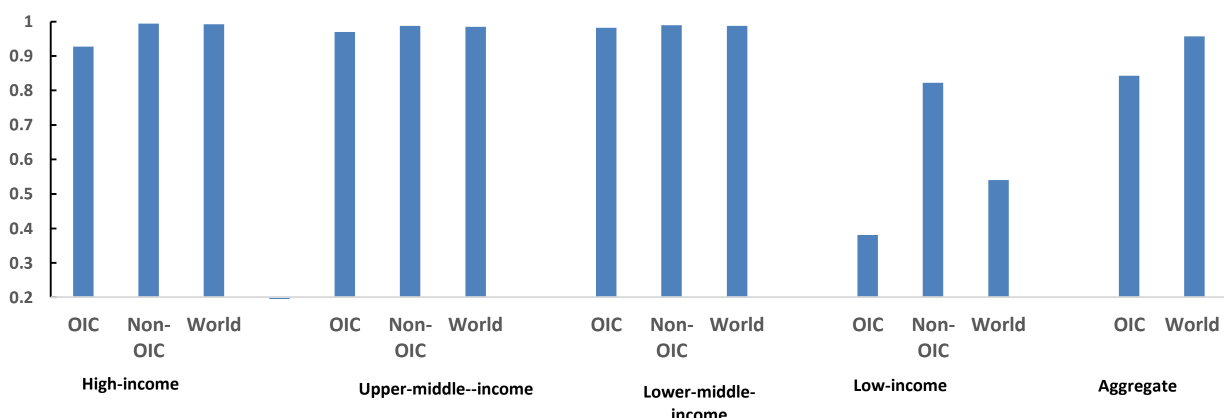
A core concept of Islamic finance, which clearly distinguishes it from conventional financing, is risk sharing. Quantifying the extent of risk sharing in an economy is very difficult because risk sharing is an abstract term that encompasses many channels, including the welfare state, financial globalization, and revenues from the export of natural resources. Despite these difficulties, a proxy for risk sharing—the inverse of the correlation between domestic aggregate consumption and GDP—can be used. If there is perfect risk sharing in a given economy, then the evolution of consumption should not be determined solely by movements of income; other factors would smooth the negative and positive effects on the consumption (Kalemi-Ozcan, Sørensen, and Yosha 2003).

As figure 2.9 shows, the correlation between consumption and income is very high, but on an aggregate level OIC countries seem to be faring better in terms of risk sharing than he world as

[24] Adam Smith, in *The Wealth of Nations* (1776), long ago recognized the thee significance of the first two pillars as the prerequisites for the development model described in chapter 1: "Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government" (cited in Rodrik, Subramanian, and Trebbi 2004).

a whole (that is, the correlation of OIC countries is lower). It is important to keep this result in regional context, however. The slightly lower correlation between income and consumption in OIC countries might not necessarily indicate better risk sharing, but might reflect the high level of oil revenues that have been accumulated in sovereign wealth funds, which could offset the negative effect of recessions on consumption, hence weakening the correlation between income and consumption.

Figure 2.9 Correlation between Consumption and Real GDP, Income Level Classification

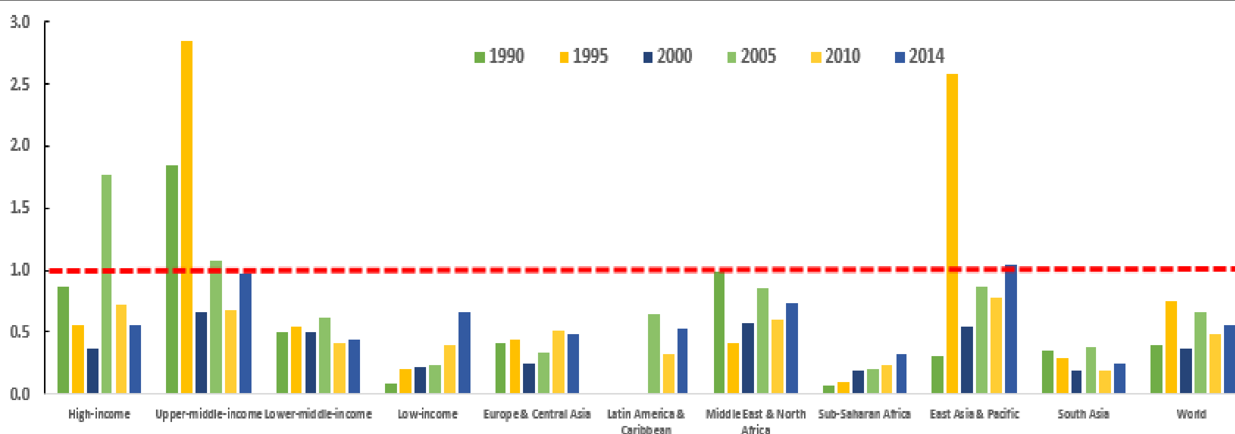


Source: http://www.rug.nl/research/ggdc/data/pwt/pwt-8.1.
Note: Consumption includes both private and government consumption. The Penn World Table (PWT), upon which this figure is based, is a set of national accounts data developed and maintained by scholars at the University of California, Davis and the Groningen Growth Development Centre of the University of Groningen to measure real GDP across countries and over time. Successive updates have added countries (currently 167), years (1950–2011), and data on capital, productivity, employment, and population.

In all income levels, OIC countries perform better than Non-OIC countries. A value of 1 indicates that OIC and Non-OIC countries are on a par. In all income groups and regions, the relative ratio is less than 1. The relative spikes in 1995 could partially be explained by the booms and busts in commodity markets, which might be important for OIC countries.

Stock market development is positively and robustly associated with long-run economic growth, Levine and Zervos (1996) find, using cross-country growth regressions. Figure 2.10 presents the relative value of market capitalization to GDP between OIC and Non-OIC countries. Since Islamic finance is based on risk sharing and has an asset-backed nature, one would expect to see a higher ratio of this metric among OIC countries compared to the others. However, due to the less developed capital markets for equities and asset-based securities, the OIC group does not reflect a strong presence. Without developed capital markets, the full potential of a risk-sharing financial system such as Islamic finance cannot be envisioned. Hence in order for OIC countries to grow faster in a development model based on risk sharing, stock markets must play an essential role and to materialize, OIC countries need to reform legal and governance structures and strengthen their institutions.

Figure 2.10 Relative Value of Market Capitalization of Listed Companies, Ratio of OIC to Non-OIC Countries
Percent of GDP



Source: Calculated using data from http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS.
Note: A value of 1 indicates that OIC and Non-OIC countries are on a par. Market capitalization (also known as market value) is the share price times the number of shares outstanding. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year. Listed companies do not include investment companies, mutual funds, or other collective investment vehicles.

Financial and Social Inclusion

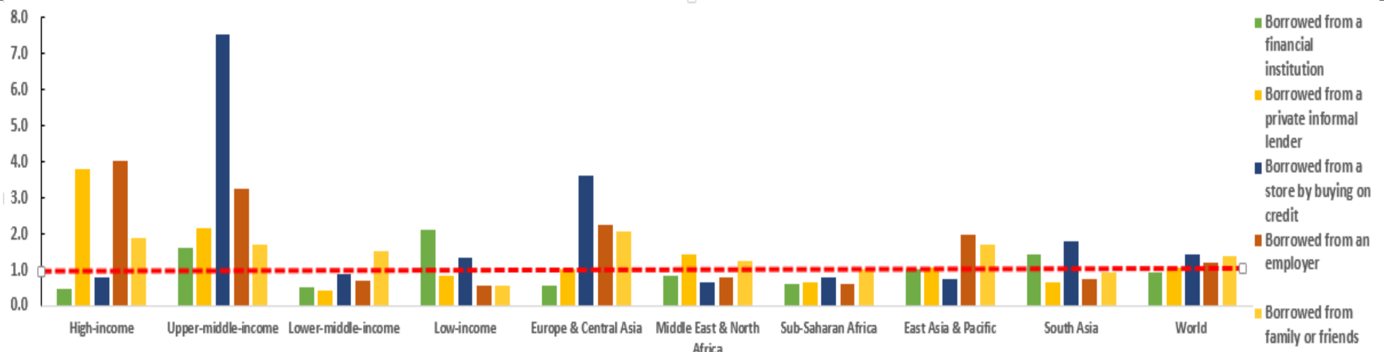
While Islamic principles stress the importance of hard work and free market enterprise where everyone is expected contribute according to his or her ability, they also emphasize that individuals who are left behind should be protected and provided with the basic needs that would enable them to live their life in a humane way.

To analyze the extent of financial inclusion in the world and in OIC countries, two metrics were used. Figure 2.11 depicts the various sources people use in obtaining funds. A value of 1 indicates that OIC and Non-OIC countries are on a par. A value greater than 1 indicates that for that OIC countries use a particular type of funding more extensively that Non-OIC countries. In almost all income groups and regions, the relative ratio is less than 1. The use of formal financial institutions is limited in OIC countries compared to Non-OIC countries. Other sources, such as private informal lenders, buying on credit, or borrowing from family or friends, are more common.

Several factors could affect the level of access of citizens in a country to financial services. For example, countries where population is condensed rather than dispersed, countries where citizens have higher income per capita, and/or where the banking system is more competitive may find it easier to provide financial services to their citizens. In addition, some individuals may stay away from financial services due to religious principles. Demigüç-Kunt, Klapper, and Randall (2013) find that Muslim are less likely to have an account at official financial institutions. This could be one factor explain the patterns for OIC countries depicted in figure 2.11.

Figure 2.11 Sources People Use to Obtain Funds, Ratio of OIC to Non-OIC Countries, Regional and Income Level Classification

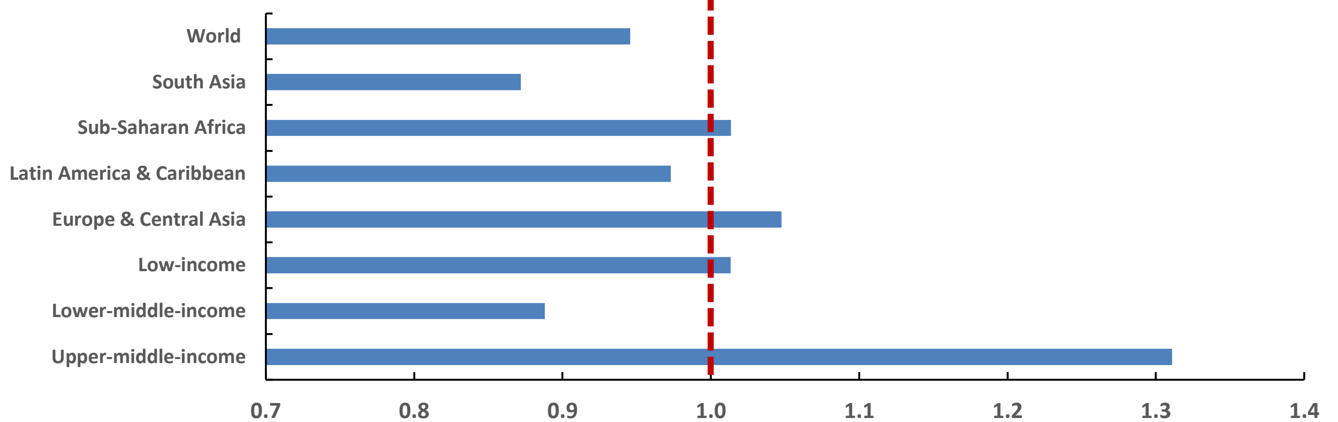
Percent of population, age 15+



Source: Calculated using data from http://datatopics.worldbank.org/financialinclusion/ (Findex) 2011.
Note: A value of 1 indicates that OIC and Non-OIC countries are on a par.

Figure 2.12 is intended to capture the degree of social inclusion in the world and in OIC countries. In terms of social inclusion, OIC countries lag behind the world on aggregate basis.

Figure 2.12 Social Inclusion, Ratio of OIC to Non-OIC Countries



Source: Calculated using data from http://data.worldbank.org/indicator/IQ.CPA.SOCI.XQ/countries.
Note: A value of 1 indicates that OIC and Non-OIC countries are on a par. The figure presents the CPIA (Country Policy and Institutional Assessment) policies for social inclusion/equity cluster average The policies for social inclusion and equity cluster includes gender equality, equity of public resource use, building human resources, social protection and labor, and policies and institutions for environmental sustainability. Scores range from a low of 1 to a high of 6.

The figure depicts the World Bank's social inclusion metric as a ratio of OIC to Non-OIC countries. OIC countries in the upper-middle- income and Europe and Central Asia region have greater social inclusion than their counterparts in the same classification.

Variations across countries in social inclusion metric could have various sociological, economic, political, and other dimensions. Minorities and different ethnic and religious groups could be marginalized, depending on the historical and cultural situation of a country. Income level

could be another factor that could make it difficult for certain individuals to participate in the society productively and utilize the resources in education, health care and employment sectors. Hence, when trying to pinpoint the root causes of the social exclusion in their countries, policy makers in OIC countries should take a broad perspective and design policies to effectively deal with these causes.

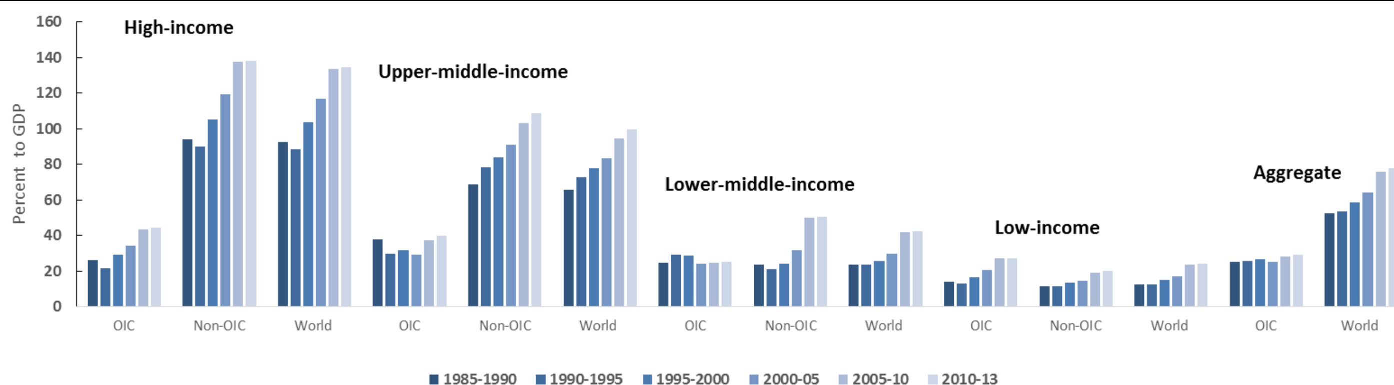
Financial Sector Depth and Interaction with Shared Prosperity and Poverty Reduction

The positive relationship between financial sector development and economic development has been well established; various studies have shown the contribution of a developed financial sector to overall economic growth.[25] In this respect, it is important to understand the degree of financial sector development in any country. It is particularly important for a risk-sharing financial system such as Islamic finance, which requires well-developed financial sector with reduced information asymmetry.

The next three figures examine the financial depth of countries with respect to certain metrics. Figure 2.13 examines domestic credit to the private sector as a ratio of GDP and compare the OIC and the Non-OIC countries belonging to the same income level groups. The OIC group in all income level group lags behind the non-OIC group implying that financial sector in select OIC countries is in early stages of development and with further development, could contribute to economic growth. In addition, business do not usually borrow from the financial institutions which could be due to lack of access to financial services or due to voluntary religious constrains on borrowing from conventional modes of financing. This underscores the importance and potential of the provision of Islamic finance in the OIC member countries.

Figure 2.13 Domestic Credit to the Private Sector

Percent of GDP



Source: Calculated using data from http://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS

[25] In a seminal paper, Levine (1997) finds evidence suggesting a positive, first-order relationship between financial development and economic growth. Enhancing financial services could ease the firms to obtain funds to make additional investments and for individual to smooth their consumption and weather the negative income shocks to their income stream. Furthermore a well-functioning financial system not only channels funds to the most efficient sectors, but also enables the pricing of risk and assets which are essential for reducing uncertainty about future investments. All these factors contribute to economic growth.

Note: Domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of no equity securities, and trade credits and other accounts receivable that establish a claim for repayment.

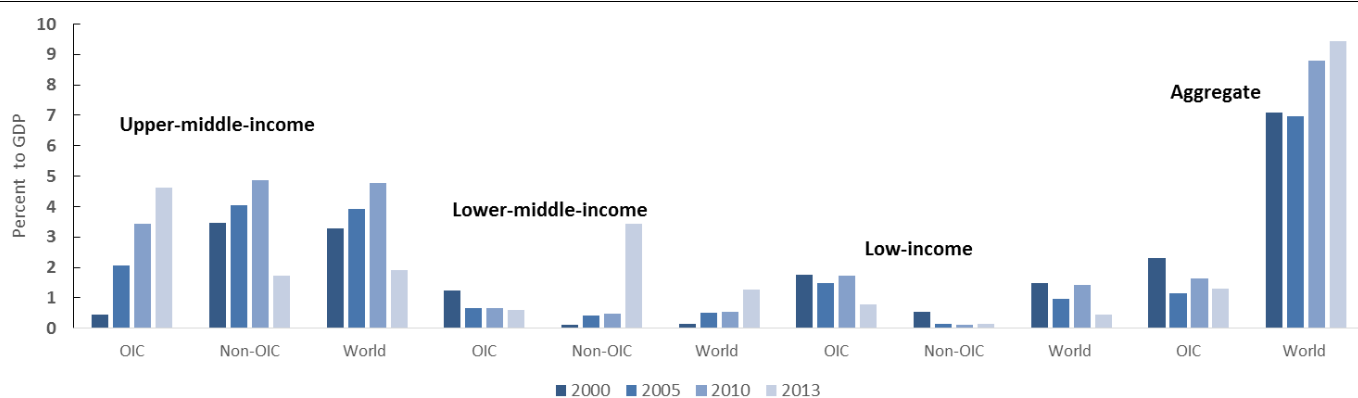
Using enterprise World Bank's Business Enterprise surveys, Bhattacharya and Wolde (2012) quantify the impact of the various constraints faced by local businesses in the Middle East and North Africa (MENA) region and conclude that the main difficulties are access to finance, labor skill mismatches and shortages, and electric power constraints. Hence easing the financial access to firms and individuals in MENA region would promote growth and speed up their convergence to better-off nations.

Figures 2.14 and 2.15 analyze the forms of financing (equity versus debt financing) relative to GDP, and contrast OIC countries to Non-OIC countries belonging to the same income level groups. The objective is to determine how conducive a country is to developing risk-sharing finance as advocated by Islamic finance. Given the prohibition of interest-based-debt by Islamic finance, equities market and asset-based securities market becomes a preferred capital market. Figure 2.15 shows the gross portfolio debt assets to GDP ratio, while figure **2.16** depicts the gross portfolio equity assets to GDP (percent) metric and contrasts OIC countries to Non-OIC countries belonging to the same income level groups.

In the aggregate, OIC countries have reduced the amount of debt assets in their portfolios, while that ratio has been increasing in the world. Similarly, in the aggregate, OIC have reduced the amount of equity assets in their portfolios in recent years, while the same ratio has been increasing in the world. This could indicate a shift toward alternative asset classes, but further analysis and research is required to understand these trends.

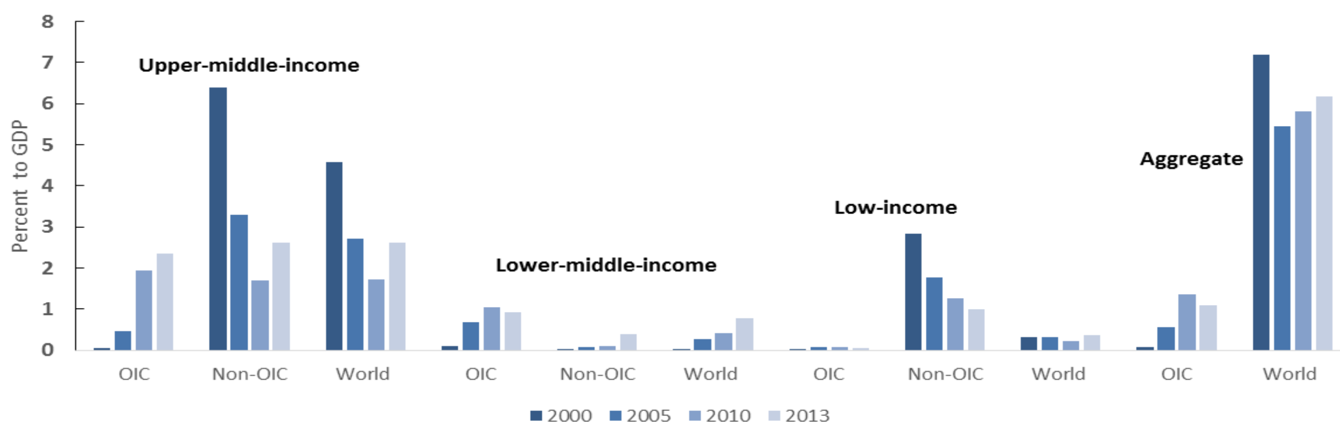
Figure 2.14 Gross Portfolio Debt Assets to GDP

Percent



Source: Compiled using data from the World Bank Global Financial Development Database (GFDD).
Note: Ratio of gross portfolio debt assets to GDP.

Figure 2.15 Gross Portfolio Equity Assets to GDP
Percent



Source: Compiled using data from the World Bank Global Financial Development Database (GFDD).
Note: Ratio of gross portfolio equity assets to GDP. Equity assets include shares, stocks, participation, and similar documents (such as American depository receipts) that usually denote ownership of equity.

Policy Response

While there is strong theoretical support for Islamic economics and finance to lead to sustainable growth and enhance shared prosperity, however, the enabling environment is lacking to reap the benefits. Public policy measures are needed to develop and strengthen institutions in key areas of governance, the legal system, and government effectiveness. In addition, strengthening the financial sector in ways that are conducive to risk-sharing finance based on the core principles of Islam should be the main objective of policy makers wishing to exploit the full potential of Islamic finance. Until these reforms are undertaken, it would be unrealistic to expect Islamic finance to fulfill the promise of a developing a more stable, sustainable, and inclusive economic system.

Analysis in this chapter provides fair state of affairs with respect to trends in poverty alleviation and income distribution which can be used by the policy makers to formulate policy interventions and to identify areas to strengthen keeping in mind the objective of leveraging Islamic finance for alleviating poverty and enhancing shared prosperity. Next chapter provides a roadmap for such policy measures.

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Chapter 3

Public Policy Measures to Increase Shared Prosperity

The Islamic financial sector cannot reach its full potential in terms of the expected socioeconomic benefits without supportive public policy, conducive financial regulations and strong institutions. While this assertion is true for any financial system, the significance of the proper public policy initiatives, legal and business environment, and the need for strong political will to overcome the obstacles, are much higher for Islamic finance. The policies needed to spur economic activity are also important to the growth of Islamic financial sector. Similarly, the obstacles that constrain the business environment and create legal uncertainties not only hamper the economic growth but also detrimental to the Islamic finance.

It is imperative to note that the existing legal and regulatory environment is not attuned to the requirements of Islamic finance. There is a need for reforms not only in the financial sector regulations to comply with the Islamic financial principles but also require a supportive legal system that provide necessary protection for new types of institutions, help in contract enforcements, and provide favorable tax treatmen. Implementing these changes is not within the power of individual Islamic financial institutions or in the hands of the users of finance, who are the source of the demand for Islamic finance. Here the role of regulatory bodies, development agencies, taxation authorities, legislatures, and governments becomes crucial to move Islamic finance forward. Coordination among various stakeholders and strong political will is needed to bring about the change.

The recommendations contained in the chapters that follow underscore the point that interlinked and coordinated policy responses across various dimensions will be required. Some key recommendations for the development of Islamic financial sector aligned with shared prosperity include: strengthening the enabling regulatory environment; enhancing the scale of and access to Islamic finance; improving liquidity management and ensuring stability of financial sector; bolstering human capital; increasing Islamic finance literacy; promoting risk sharing; promoting project-specific *ṣukūk;*[26] broadening the investor base by introducing retail *ṣukūk;* developing capital markets; and enhancing the small and medium enterprise (SME) sector. These and other recommendations require coordination among various stakeholders and organizations nationally as well as internationally.

At present, the Islamic financial infrastructure at the international level consists of various support institutions that are responsible for setting standards concerning regulatory, *sharīʿah*, (Islamic Law), and accounting aspects, as well as institutions that are facilitating market development, credit rating, and arbitration of commercial and financing disputes. These support institutions offer services to all Islamic financial institutions and to the country-level regulators.

[26] Project-specific *sukūk* are the *ṣukūk* that are issued for financing a specific project (or a well-defined set of projects) and generate returns for *ṣukūk* holders from the same project(s). For a general definition of *sukūk,* see the glossary.

Each of these Islamic financial infrastructure institutions has a different and well-defined scope for its work. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) sets accounting, auditing, and the related *sharīʿah* standards for Islamic Financial Services Institutions (IFSIs). The Islamic Financial Services Board (IFSB) is tasked with designing regulatory and supervisory standards for Islamic banks; it has also started issuing standards or guidance notes for other nonbanking institutions, as well. The International Islamic Financial Markets (IIFM) promotes development of Islamic capital markets. It has focused on developing standardized documents for various Islamic capital market products, including *ṣukūk*. The International Islamic Rating Agency (IIRA) provides credit rating services, taking into consideration the *sharīʿah* compliance of the financial institutions and their products and services. The International Islamic Center for Reconciliation and Arbitration (IICRA) handles resolution of financial and commercial disputes among the Islamic financial institutions, their customers, or other third parties through arbitration and reconciliation. It thus addresses the uncertainty and ambiguity faced by Islamic financial institutions regarding *sharīʿah* compliance of the decisions issued by conventional law courts.

These infrastructure organizations not only help avoid multiplicity of efforts and costs, but also significantly contribute to better regulation, convergence/harmonization of rules, and improved *sharīʿah* compliance—the factors that enhance shared prosperity through financial sector stability and its compliance with *sharīʿah*.

At the country level, central banks, security market commissions, and the respective regulatory bodies contribute to the regulation and development of the Islamic financial sector. The contribution of taxation authorities, legal and judicial institutions, and other support organizations is also important.

This section surveys recent initiatives to develop the Islamic financial sector and related regulatory policies and evaluates them in terms of their alignment toward meeting the goal of promoting shared prosperity. This evaluation is done in relation to the Ten-Year Framework and Strategies Document (10YF) for the development of the Islamic financial sector. Many other regulatory measures and financial sector policies that only indirectly impact shared prosperity are not discussed.

The Status of the Ten-Year Framewordk and Mid-Term Review

The Ten-Year Framework document was jointly produced by the Islamic Research and Training Institute (IRTI), the Islamic Development Bank (IDB), and the Islamic Financial Services Board (IFSB) in 2007 in consultation with a large number of Islamic Financial Services Institutions and central banks. The document was created to have a strategic framework to systematically study, discuss, and propose policy measures to promote the orderly development of the Islamic financial services industry. It aimed to provide a general blueprint for new and existing Islamic finance jurisdictions in designing and developing their national plans and major initiatives as part of their financial sector development policies.

The 13 framework recommendations proposed have stood the test of time. Nonetheless, in order to reflect the current status of the Islamic finance industry more accurately, three recommendations have been added. The updated set of recommendations is based on three pillars:

1. Enablement: Fostering conditions for the industry to thrive
2. Performance: Enhancing the effectiveness of institutions active in the industry
3. Reach: Expanding the set of potential beneficiaries of the industry.

The Mid-Term Review (MTR) was launched in 2014 in conjunction with the 11th IFSB Summit, hosted by the Bank of Mauritius. It discussed proposed measures to address the gaps or challenges in meeting the objectives of the Ten-Year Framework, as well as the roles of the public and private sectors and other stakeholders of the Islamic Financial Services Institutions in carrying out the 16 recommendations, taking into account the state of development of the IFSIs in the respective jurisdictions.

How Did the 10-Year Framework Document Come About?

The idea of preparing such a strategic framework document was first considered during the Seminar on Challenges Facing the Islamic Financial Industry, held on April 1, 2004 in Bali, Indonesia. The seminar, which was jointly organized by IRTI and IFSB, was held in conjunction with the meeting of the IFSB Council hosted by Bank Indonesia. To follow up on the issues discussed in the seminar, IRTI and IFSB undertook a joint initiative to address the challenges in a systematic manner and began preparing the 10-Year Framework document.

As a first step, a number of leading specialists and practitioners were asked to prepare technical papers on various themes. These were presented in a technical workshop jointly organized by IRTI and IFSB, held from May 31 to June 1, 2005 in Dubai, and hosted by the Dubai Financial Services Authority. IRTI and IFSB jointly held a policy dialogue on the same theme on June 22, 2005 in Putrajaya, Malaysia, which was facilitated by Bank Negara Malaysia. A drafting committee was formed as a result, which held three meetings and finalized a draft document. The draft document was distributed by IFSB to solicit feedback from its members and other interested parties. It was also discussed at the Islamic Bankers' Forum on May 28, 2006 in Kuwait, jointly organized by IRTI, IFSB, and the General Council for Islamic Banks and Financial Institutions (CIBAFI). At its final meeting on August 17, 2006 in Kuala Lumpur, Malaysia, the drafting committee reviewed all the comments, received feedback, and reached a consensus on the revised document.

Why Was a Mid-Term Review Conducted?

In 2013, IRTI and IFSB initiated a Mid-Term Review of the Ten-Year Framework, as more than half the period has passed since its publication in 2007. The Mid-Term Review was aimed at assessing the impact of macroeconomic events, monitoring progress in implementing the recommendations, and proposing additions or modifications to the recommendations to guide the industry. The effort was considered crucial due to the increasingly challenging economic and financial environments, as well as the significant developments taking place in the international financial landscape, particularly after the 2008 global financial crisis. Even more important was to ensure that the 10Y Framework document remained relevant as a platform for various Islamic

finance jurisdictions to assist them in orchestrating the future direction of the industry. The Mid-Term Review was guided by the following objectives:

- To assess the impact of developments in the global financial system following the global financial crisis on various segments of the Islamic finance industry
- To examine the progress and current status of the priorities and initiatives suggested in the Ten-Year Framework and Strategies
- To identify gaps in implementing the priorities and initiatives
- To assess the need for a reorientation of such priorities and initiatives.

The Mid-Term Review thus sought to assess progress made by the industry in implementing the 2007 recommendations, and amend the recommended Ten-Year Framework in light of developments since its publication.

In conducting the Mid-Term Review, IRTI and IFSB were supported by a number of prominent research institutions and have engaged with leading regulators, market players, academicians and s*harīʿah* scholars. Intensive discussions took place in roundtables held in Qatar, Malaysia, and Turkey, where IRTI and IFSB had an opportunity to obtain further insights from key stakeholders and the entire Review Committee.

What Were the MTR's Key Findings?

Following in-depth research and engagement with key stakeholders in the industry, the MTR document generated three main findings:

1. The industry has shown growth and resilience. Market share and profitability are growing, the number of institutions has expanded, and numerous industry-level initiatives are underway, reflecting customer confidence in the sector, whose concept has been proven in many markets.

2. Macroeconomic events and external factors have brought both challenges and opportunities to the sector, which has been affected by the global financial crisis directly and indirectly, via the economic impact, the approach to financial regulation, the strength of partners and counter-parties, and the value of assets and investments. As the global economy has stumbled, some member countries of the Islamic Development Banks (IDB) have acted as important centers of growth. Political developments in recent years have also made several countries more open to Islamic financial services. Technological innovations such as branchless financial services are now available, and can allow the industry to broaden its reach.

3. The development of the industry has varied by sector. Islamic banking remains the most developed subsector of the industry. Estimates of its total asset size and growth rate vary significantly (from nearly $1 trillion to well above that level). To cite a notable example, Islamic microfinance has made the transition from a concept with isolated case studies to a fledgling sector in multiple markets. Moreover, the breadth and sophistication of *sharīʿah*-compliant instruments (shares and *ṣukūk*) in capital markets has improved. However the performance of certain instruments in terms of market value has been mixed due to overall capital market challenges. Challenges related to the *sharīʿah* compliance remain.

What are the Distinct Features of the MTR?

Three additional recommendations were made (in addition to the 13 recommendations in the original document):

- Recommendation no. 14. Develop an understanding of the linkages and dependencies between different components of Islamic financial services to enable more informed strategic planning to be undertaken.
- Recommendation no. 15. Foster and embrace innovative business models, including new technologies and delivery channels, in offering Islamic financial services.
- Recommendation no. 16. Strengthen contributions to the global dialogue on financial services, offering principles and perspectives to enhance the global financial system.

The three-pillar framework was introduced. While the original document categorized the recommendations into two groups (institutional and infrastructural), the new categorization (enablement, performance, and reach) places greater emphasis on the outcome desired from the framework. The first pillar (enablement) centers on fostering conditions for the industry to thrive. The second pillar (performance) supports efforts to enhance the effectiveness of institutions active in the industry. The third pillar (reach) seeks to substantially increase the commitment to expand the set of potential beneficiaries in the industry.

Key Performance Indicators (KPIs) were developed to help address weaknesses and monitor progress in a more focused manner. As noted, the progress made on the original recommendations has been mixed. While many countries have adopted international standards specific to Islamic financial services, these have not gone far enough and more work is needed.

Metrics for tracking progress, which initially were not specified, are now considered crucial for assessing progress. Thus the MTR proposes a set of Key Performance Indicators (KPIs), and countries are urged to set national targets to meet them.

A stronger Implementation Plan was established for a range of stakeholders. The role of central banks and governments will be especially important in driving implementation.

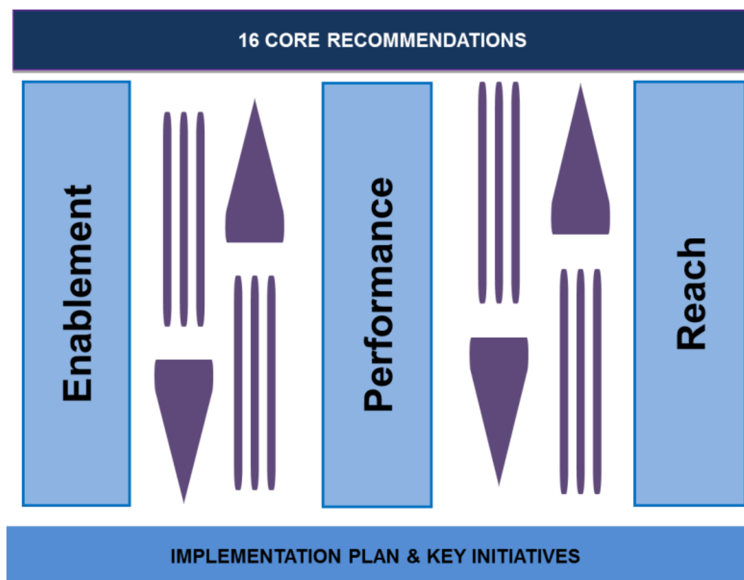
Twenty Key Initiatives were identified and prioritized, based on their potential impact and the feasibility of implementation (see table 3.1).

Distinctive features of the MTR are illustrated in figure 3.1. As the figure shows, the framework is dynamic. The three main pillars (enablement, performance, and reach) support the 16 core recommendations, implementation plans, and key initiatives, but all those elements strengthen one another and strengthen the entire system.

Table 3.1 Twenty Key Initiatives under the Mid-Term Review

Pillar	Initiative
Enablement	Integrate Islamic finance in national development plans
	Introduce national Islamic financial services master plans
	Enhance regulatory implementation and enforcement
	Harmonise, where possible, regulation and regulatory frameworks across borders
	Adopt and strengthen national *Sharī`ah* governance frameworks
	Where mandates overlap, align the positions of industry bodies
	Link Islamic financial markets across borders
	Form a "Technical Assistance and Linkage Network"
	Form regional working groups
	Foster information-providing institutions that support the provision of Islamic finance
	Incorporate Islamic finance data in statistical and official reporting
Performance	Institute centralised R&D for Islamic financial products in addition to the decentralised R&D
	Establish diversified financial institutions
	Demonstrate the industry's distinctive value proposition
	Fund public infrastructure projects to build Islamic capital markets
Reach	Revitalise *zakah* and *awqāf* for greater financial inclusion and make them an integrated part of Islamic financial system
	Ensure that regulations allow for the use of new technology to provide affordable services
	Engage with newly-opened markets
	Foster the financing of a wider set of economic sectors
	Brand Islamic financial services for wider markets

Figure 3.1 Distinctive Features of the Mid-Term Review



Why Does the MTR Matter?

The recommendations of the MTR must be implemented in a diverse group of nations that vary in terms of region, culture, stages of economic development, and types of law (Islamic Law, common law, and civil law). Thus the MTR recognizes that diverse views are particularly salient with respect to whether:

- Countries should have specific laws for Islamic financial services or fit Islamic structures into a single set of financial services laws
- Countries should adopt national-level *sharī`ah* boards or retain *sharī`ah* governance solely at the institutional level
- Central banks should allow conventional institutions to offer Islamic financial services
- Adopting international standards specific to Islamic finance is essential or not
- Product standardization should be a policy objective or not.

Against this diverse backdrop, an underlying theme is that a supportive public policy stance is essential to enable the industry to reach its full potential. Different countries have been successful under various models; each choice has benefits and drawbacks. In all models, a strong and supportive public policy stance can help contribute to greater confidence that energizes the private sector.

The MTR therefore does not seek to prescribe specific approaches to the choices above. It does, however, urge various jurisdictions to deliberate carefully on these matters and form well-considered strategies. The MTR also encourages Islamic financial services to offer benefits to the wider economy and the public at large, and advocates thoughtful strategies on how best to bring about these benefits.

As a result, the framework recognizes the need to uplift the underprivileged in society so they can also benefit from the economic growth. The framework also recognizes that the "financialization" of economies has considerably worsened the linkage between the real sector and the financial sector and has failed to ensure that the least privileged benefit from economic growth.[27]

The third pillar of the MTR addresses such issues. It shares this focus with the World Bank Group, which has recently revised its mission to make "shared prosperity" the second of its twin goals (see chapter 1). While the MTR and the World Bank Group are committed to this goal, the mechanisms of attaining a society based on shared prosperity under each approach might differ, however.

As discussed in chapter 1, achieving shared prosperity from the perspective of Islamic economics and finance is based on four fundamental pillars: objective-oriented institutional framework and public policy; prudent governance and accountable leadership; promotion of an economy based on risk sharing and entrepreneurship; and financial and social inclusion for all.

[27] See Palley (2007), who notes that the principal impacts of financialization are to elevate the significance of the financial sector relative to the real sector; transfer income from the real sector to the financial sector; and increase income inequality and contribute to wage stagnation.

Enacting and Implementing Policies to Promote Shared Prosperity: A Three-Nation Case Study

This section examines whether policy objectives in selected jurisdictions are in line with the notion of shared prosperity by seeing how they have adopted the MTR's Key Initiatives. The analysis compares the strategic plan or road map established in selected jurisdictions, and related efforts, with the Key Initiatives. Indonesia, Malaysia, and Pakistan were selected because these countries have comprehensive road maps or strategic plans.

The objective of the comparison is to figure out whether the MTR and the selected strategic plans and road maps are moving in the same or similar direction. In addition to content analysis, feedback was also gathered from regulators in Indonesia (Financial Services Authority, Otoritas Jasa Keuangan, OJK) and Malaysia (Bank Negara Malaysia, BNM).

Over the course of the Mid-Term Review process, over 70 initiatives were suggested to help implement the recommendations. These initiatives included ideas from sector specialists, input from expert reviewers, and guidance from various review committees. An analysis of how Indonesia, Malaysia, and Pakistan are adopted these initiatives follows.

Integrate Islamic finance in national development plans and introduce national Islamic financial services master plans.

This initiative is of the utmost importance since it is the basis for the institutional building and policy formulation to bring about shared prosperity. Some recent developments in selected jurisdictions have been promising. The fact that a strategic plan or a road map on a national level is in place in jurisdictions such as Indonesia, Malaysia, and Pakistan shows that the governments in those countries are no longer taking Islamic finance lightly.

The Indonesian government committed to taking the initiative to the next level by establishing the National Committee in Islamic Finance, chaired directly by the President of Republic Indonesia, Mr. Joko Widodo (box 3.1). Indonesia recently introduced a revised version of its 2002 road map. In addition, the Financial Services Authority (OJK), has come up with a road map for Islamic capital market development and a road map for sustainable finance in Indonesia for 2015 to 2019 (OJK 2015a, 2015b, 2015c). Although the road map for sustainable finance does not address Islamic finance directly, the objectives of promoting economic sectors such as agriculture, manufacturing, infrastructure, small and medium enterprises (SMEs), and energy that contribute to sustainable development and have a high multiplier effect for the Indonesian economy are aligned with the norms of Islamic finance. A key step forward would be if the country could promote Islamic modes of financing to mobilize funds and investment for these sectors.

The Malaysian government amended its Islamic Financial Services Act in 2013. Among the major changes:

- It consolidated various pieces of legislation, acts, and regulations issued at different points in time for various financial subsectors. The consolidated act helps remove ambiguities across subsectors.

- It provided legal recognition and standing for *sharīʿah* governance and the s*harīʿah* governance framework. Such governance had been in practice previously, had not had legal cover.
- Most significantly, it required financial institutions to properly differentiate between Islamic deposits (which are principal-guaranteed s*harīʿah* contracts) and investment accounts (which are principal-nonguaranteed s*harīʿah* contracts) in their business processes and clearly communicate the differences to stakeholders. This implies putting into place appropriate processes to utilize such funds, calculate their profits, maintain transparency, and communicate this information.

Pakistan's central bank has set out its strategic plan for 2014-18 regarding the Islamic banking industry (SBP 2014). This is an effort to reach an industry-wide consensus on the future direction of the industry in the country. The four key elements of this strategy are well aligned with the recommendations of the MTR:

1. *Enabling policy environment*. Enabling the legal, regulatory, supervisory, and liquidity management frameworks, the taxation regime, and the financial accounting and reporting framework
2. *Sharīʿah governance and compliance*. Standardization and harmonization of *sharīʿah* practices, as well as creation of distinct Islamic banking products and services
3. *Awareness and capacity building*. Increasing coordination and collaboration among internal and external stakeholders to enhance awareness of Islamic finance, and build stakeholders' capacity
4. *Market development*. Initiatives for product diversification and financial inclusion, with the collaboration of stakeholders.

Box 3.1 Indonesia's Initiative to Take Islamic Finance to the Next Level of Development

Indonesia has become one of the main engines for growth in the world of Islamic finance. However, compared to the country's huge potential and its large Muslim population, the development of Islamic finance in Indonesia remains modest. Penetration of Islamic finance has been surprisingly low: only 3.7 percent of total Muslim population, according to the latest data in the World Islamic Banking Competitiveness Report 2016 (EY 2015).

It has become evident that the traditional "bottom-up" approach in Indonesia can no longer be relied upon. Thus the Financial Services Authority (Otoritas Jasa Keuangan, OJK) felt the need to provide further clarity on how the Islamic finance industry should move forward. Hence it undertook a revision of the first blueprint for the development of Islamic banking development, first published in 2002. A revision is vital to align future steps with the long-term development plan for the Indonesian economy and to anticipate the commencement of South East Asia Economic Society in early 2016. In early 2015, OJK published the road map for the development of Islamic banking development (OJK 2015a), followed by the road map for the development of Islamic capital market (OJK 2015b) and a road map for sustainable finance (OJK 2015c) in Indonesia.

Sustainable finance, from OJK's viewpoint, is defined as comprehensive support from the financial service industry to achieve sustainable development resulting from a harmonious relationship between economic, social, institutional-governance, and environmental interests.

The road map for sustainable finance sets forth a detailed work plan on the sustainable finance program for the banking, capital market, and nonbank financial services industry sectors as governed by OJK. The road map is also aligned with the Master Plan for Indonesia's Financial Services Sector, which will serve as a reference for other stakeholders in the sustainable finance program.

The goals of the sustainable finance program in Indonesia include:

1. Improving the resilience and competitiveness of the financial services industry so it can grow and develop in a sustainable manner. Resilience, in this respect, is associated with improved risk management, while competitiveness is associated with the ability to innovate and produce environmentally friendly products/services.
2. Providing financing resources required by the public by using the pro-growth, pro-job, pro-poor, and pro-environment approach.
3. Contributing to the national commitment to address the challenge of global warming by support businesses' efforts to mitigate and adapt to climate change, in a move toward a competitive low-carbon economy.

Sources: OJK 2015a, 2015b, 2015c.

Harmonize, where possible, regulation and regulatory frameworks across borders.

Harmonization of regulations is necessary to increase cross-border market activity and to encourage more collaboration between market players. In the context of Islamic finance, the importance of harmonization of *sharīʿah* through *fiqh*[28] interpretations cannot be understated. *Sharīʿah* scholars in Indonesia and Malaysia regularly conduct symposiums on these matters. Although both countries follow the same school of thought, in practice there are differences that cannot be overlooked. A similar effort to resolve differences in understanding may be considered in the Indian subcontinent.

Adopt and strengthen the national sharīʿah *governance framework.*

Prudent governance and accountable leadership are required to bring about shared prosperity and are needed to support the development of Islamic finance. The *sharīʿah* governance framework is advanced in all three countries, particularly Malaysia. All three countries have introduced a comprehensive two-tiered *sharīʿah* governance framework whereby *sharīʿah* boards are not only in place at the national level but also at the institutional level. In all three countries, no *sharīʿah* scholar may serve in more than two Islamic financial institutions. This limitation is in place is to ensure the credibility and accountability of not only the products and the institutions, but more importantly the industry as a whole.

[28] *Fiqh* means understanding. It comprises rules derived from the understanding of *sharīʿah*.

Where mandates overlap, align the position of industry bodies.

A strong commitment to create synergies among regulators across sectors is needed. The banking sector has been the dominant sector in the Islamic financial services industry. Harmonization of regulations is needed to enable other sectors to flourish, as well. The governments of Indonesia and Pakistan have clearly stated that effective coordination and collaboration among key stakeholders are vital for sustaining the momentum for growth of Islamic finance.

The principles set out by standard-setting bodies in the Islamic financial services industry such as the IFSB and AAOIFI also need to be synchronized with one another. All three countries have made a strong commitment to continuously align their regulations with the principles of these bodies.

Establish diversified financial institutions.

Achieving an economy based on shared prosperity cannot be attained by depending solely on the banking sector, given its risk tolerance, costs, and business model. It is thus very important to support the development of other segments of the sector to achieve a balanced growth of a stable and inclusive industry that covers the full spectrum of financial services. Indonesia and Pakistan are excellent examples; their respective road maps explicitly state the need for diversification at the level of both products and institutions. More importantly, the road maps also address the need to move away from products that create debt toward greater use of products based on risk sharing.

Diversified financial services increase financial inclusion. Further improvement is possible through policies that target the adoption of new technologies to lower the cost of delivery of finance, incorporate regulatory changes to increase the use of the new delivery channels, and enhance financial literacy to increase its acceptance by the population. This route has been followed in the National Financial Inclusion Policy recently embraced by Pakistan (box 3.2).

Box 3.2 Diversified Institutions and Efforts toward Financial Inclusion: Highlights of Some Policy Initiatives of the State Bank of Pakistan

- The State Bank of Pakistan (SBP) has developed a National Financial Inclusion Strategy (NFIS) that encompasses many of the areas needed to develop the Islamic financial sector (SBP 2015a). The Strategy covers Islamic finance, along with other areas such as branchless banking, SME finance, infrastructure finance, microfinance, rural and agricultural finance, housing finance, digital payment systems, consumer protection and financial literacy, insurance, and pensions.
- Pakistan has a well-recognized legal and regulatory framework for microfinance. In 2015, ten microfinance banks (MFBs) were operating in Pakistan. All are privately owned and have a diversity of ownership and approaches.
- Three leading microfinance institutions (MFIs) have been transformed into MFBs; they are now among the top five MFBs in the country.
- Pakistan is one of the few countries in the world that has a national microfinance credit information bureau.

- A microfinance credit guarantee facility provides MFBs and MFIs with the access to commercial funding sources such as banks and the domestic capital market.
- Branchless banking has become a promising way to deliver financial services at low cost. Pakistan has built up the retail capacity of financial institutions through agent network that reduces service delivery costs. The use of such services is growing quickly. For example, during the last quarter of 2014, around 72 million transactions worth Rs372 billion ($3.55 billion) were processed, with an average size of Rs5,181 (about $50).[a] A Secured Transaction Law will facilitate establishment of a Registry Office in the country to use moveable assets as collateral.
- SBP has issued a separate regulatory framework for housing finance.[b]
- SBP is encouraging the development of agricultural financing based on warehouse receipts and *salam* concepts.[c] It has issued a consultative paper on the "Framework for Warehouse Receipt Financing in Pakistan" (SBP 2015b).

Source: Compiled from various sources available at the SBP website, http://www.sbp.org.pk/,

a. Speech by Mr. Riaz Riazudding, Deputy Governor State Bank of Pakistan, July 06, 2015. http://www.sbp.org.pk/DG-Speeches/DGSpeech-06-Jul-2015.pdf.
b. Speech by Mr. Ashraf Mahmood Wathra, Governor State Bank of Pakistan, May 28, 2015, delivered at the International Conference on Affordable Housing Finance. http://www.sbp.org.pk/about/speech/Governors/Mr.Ashraf.Mahmood.Wathra/2015/Affordable-Housing-28-May-15.pdf.
c. *Salam* is the short form of *Bai'-Salam,* a forward sale in which the price of a good is paid in advance for its delivery at a specified time in the future.

Revitalize zakāt and awqāf for greater financial inclusion and make them an integrated part of Islamic financial system.

The potential of *zakāt* and *awqāf* in alleviating poverty and improving financial inclusion is high.[29] However, utilization of this potential requires not only initiatives from the mass but also a concrete support from the authority at national level, as it involves working with *zakāt* organizations, financial institutions and the *zakāt* beneficiaries. In Indonesia, for instance, *zakāt* is a tax-deductible instrument; such a policy is expected to attract more people to pay for the annual *zakāt* obligation. This practice has a legal standing based on Indonesian National Act No. 38/1999.[30] The way it works is that following a registration at the *Zakāt* National Authority (BAZNAS), the *muzakki* (*zakāt* payer) will receive a *Zakāt* ID card along with its *Zakāt* ID number (NPWZ).[31] Once he/she completes his/her *zakāt* payment through a counter at the bank or even via an automatic teller machine (ATM), he/she will automatically receive a notification from BAZNAS stating that his/her zakāt payment has been received as a proof of *zakāt* payment. The proof is then factored in when paying the tax. The initiative indicates the government's commitment to make this sector part of the Islamic financial system. Indonesia and Pakistan are perhaps the strongest proponents of incorporating financial inclusion as a policy objective.

Foster the financing of a wider set of economic sectors.

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[29] *Zakāt* is the amount payable by a Muslim on his or her net worth (when the net worth exceeds a given threshold) as a part of his or her religious obligations, mainly for the benefit of the poor and the needy. *Awqāf* is plural for *waqf* an Islamic trust. It is aappropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf.* For more discussion of both instruments, see chapter 9 on social finance.

[30] http://kemenag.go.id/file/dokumen/UU3899.pdf.

[31] NPWZ stands for Nomor Pokok Wajib Zakāt, or Zakāt ID Number.

Islamic finance is often known for serving the "haves" rather than the "have nots," which may be contrary to the fundamental principles of ideal Islamic finance and the rationale for institutionalizing Islamic finance. Current evidence may reinforce such a contention. However, some recent efforts may be widening the economic base for Islamic finance somewhat. For instance, the introduction of retail *ṣukūk*[32] in Indonesia is an indication that Islamic finance can also be designed to cater to segments of society with lower net worth. It will facilitate greater retail participation in the *ṣukūk* market by making *ṣukūk* available in smaller denominations that can be bought directly by retail investors. This not only meets the retail investors' demand for access to a wider range of investment products, but increases the diversity of the investor base to the issuers and makes the market more liquid. Access for retail investors to *ṣukūk* was previously available only through *ṣukūk* unit trust funds (mutual funds) and exchange traded funds. Retail investors buy for their own investment; they are the direct opposite of institutional investors that buy on behalf of their clients and have the capacity to hold until maturity.

Pakistan clearly makes financial inclusion a goal in its road map of Islamic banking development and Islamic capital market development for the years 2014-2018. Pakistan also places greater importance on channeling financing to the agriculture sector and to small and medium enterprises (SMEs).

Incorporate Islamic finance data in statistical and official reporting.

Some jurisdictions have started to compile Islamic finance data as an official reporting requirement for their regulatory purposes. About 16 jurisdictions are now collecting and reporting aggregated prudential indicators data proposed by the IFSB. Indonesia, Malaysia and Pakistan are among these countries that are collecting and compiling such data and regularly contributing to IFSB database on prudential indicators for Islamic banking. Data for 2013 and all quarters of 2014 are available now on the IFSB website.[33]

Develop the required pool of specialized, competent, and high-calibre human capital.

The development of a pool of competent, skilled, and high-calibre human capital is also important for developing Islamic finance and using it to enhance shared prosperity. Pakistan has been developing education and research infrastructure to promote Islamic finance in partnership with leading higher education institutions. It aims to develop the industry's human capital base in the form of Islamic finance professionals, specialists including s*harīʿah* scholars, economists, and researchers to meet the growing demands for compliant products and services in Pakistan. Through a nation-wide competition, three universities have been selected to establish Centers of Excellence in Islamic Finance in three provinces. The impact of these Centers will be felt in a few years.

Malaysia has established International Centre for Education in Islamic Finance (INCEIF), International Shariah Research Academy (ISRA) at the national level and several other smaller institutions affiliated with educational institutions or professional bodies to meet the human capital

[32] Retail *sukūk* in Indonesia are available to individual investors, as opposed to institutional investors only. The minimum investment requirement is Rp5 million (about $350).
[33] For the Prudential and Structural Islamic Financial Indicators (PSIFIs) data, see http://ifsb.org/psifi_01.php.

needs of this growing sector. Along similar lines, Indonesia has also created centers of learning and training at the national and regional levels.

Islamic Finance has been a priority area in Malaysia for more than three decades and because of strong policy commitment legal, institutional, regulatory, frameworks and infrastructure have evolved and are in place. However, despite such support and commitment, Islamic finance's share of the market is still below potential. The answer to this question lies in the fact that every system develops its own culture, and the culture it develops help perpetuate the system. The financial institutions, supporting rules, and methods that were created for Islamic finance were not radical departure from the incumbent debt based institutions. However, with the introduction of FSA in 2013, it is expected that public can distinguish between an Islamic and conventional financial institution in terms of product offering and hopefully, this will lead to higher penetration of Islamic finance in Malaysia.

Table 3.2 depicts the key initiatives set out by MTR's three pillars against the progress of Islamic finance development in Pakistan, Indonesia and Malaysia.

Table 3.2 Progress in Developing Islamic Finance in Indonesia, Malaysia, and Pakistan

Fully implemented

Work is underway

Work has started

Needs to be initiated or developedand further

MTR's three pillars	Twenty Key Initiatives	Country Analysis			Remarks
		Indonesia	Malaysia	Pakistan	
Enablement	Integrate Islamic finance in national development plans				Well established in all three countries.
	Introduce national Islamic financial services master plans				Well formulated in all three countries.
	Enhance regulatory implementation and enforcement				May require further development.
	Harmonize, where possible, regulation and regulatory frameworks across borders				Harmonization does not take place across jurisdictions. Furthermore, although Indonesia and Malaysia shre the same *fiqh* school of thought, in practice there are variations of financial products offered in the market
	Adopt and strengthen national *sharī`ah* governance frameworks				Malaysia may be most advanced

	Where mandates overlap, align the positions of industry bodies				Adaptation and adoption are promising.
	Link Islamic financial markets across borders				Needs a boost.
	Form a Technical Assistance and Linkage Network				Further synergy needed.
	Form regional working groups				
	Foster information-providing institutions that support the provision of Islamic finance				
	Incorporate Islamic finance data in statistical and official reporting				Efforts established by central banks in each country.
Performance	Institute centralized R&D for Islamic financial products in addition to the decentralized R&D				This is a vital initiative which remains a scarcity
	Establish diversified financial institutions				
	Demonstrate the industry's distinctive value proposition				Indonesia stands out, as it has introduced the concept of sustainable finance that also fosters a harmonious relationship with economic, social, and environmental interests.[a]
	Fund public infrastructure projects to build Islamic capital markets				
Reach	Revitalizse *zakah* and *awqāf* for greater financial inclusion and make them an integrated part of Islamic financial system				
	Ensure that regulations allow for the use of new technology to provide affordable services				The act and regulations are rather silent on this matter. Pakistan has issued a National Financial Inclusion Strategy and made some progress in exploiting new technology in delivering of financial services to a wider population at lower cost.
	Engage with newly opened markets				

	Foster the financing of a wider set of economic sectors				
	Brand Islamic financial services for wider markets				

a. Roadmap for Sustainable Finance in Indonesia 2015–2019, 16.

Challenges and Policy Recommendations

Long-term sustainability of Islamic finance can be achieved if Islamic financial services have a positive impact on the lives of a broader spectrum of people. Islamic finance holds the promise of sharing risk; sharing prosperity; promoting social and economic justice and ethical finance; strengthening linkages with real economic activity; increasing the stability of financial system; and supporting the pursuit of mutual gains with social responsibility. To realize these benefits, policy makers need to address the challenges and issues that are constraining the proper development of Islamic finance. The policy stance has to be clear, firm and openly made in coordination with various stakeholders.

Development of sustainable legal and economic institutions—as envisioned by the principles of Islamic economics and articulated in chapter 1—should be the first priority. Development of institutions cannot be done overnight; it takes time and requires strong commitment and efforts by policy makers. A long-term view and vision is required to achieve the full potential of such institutions. Issues can be prioritized as part of the strategy by the national and supra-national authorities, instead of avoiding them because they are difficult. Some of the recent developments are highlighted in box 3.3.

Many of the problems in the current direction being taken by the Islamic finance industry and its deficiencies in achieving the goals of risk sharing and shared prosperity can be traced to the tendency to avoid addressing these systemic challenges. When faced with bottlenecks, which the individual financial institutions cannot correct by themselves, the players in the industry tend to seek out suboptimal short-term solutions. These devices or strategies provide them a way out from the difficulty, but do not necessarily generate long-term solutions or foster institutional development. This short-term, self-interested approach also dilutes the spirit and objectives of Islamic finance. Hence the importance of intervention by the authorities and coordination of efforts by all stakeholders to create an enabling environment for Islamic financial sector.

As discussed in this report, Islamic finance emphasizes financing economic transactions through trade finance, leasing, partnership, and securitization through asset-backed *ṣukūk*. Hence it can directly contribute to economic growth and shared prosperity. This approach entails commercial and economic risk taking and managing those risks. However, the financial sector supervisory frameworks that exist in many countries focus only on financial risk management and thus hinder the growth of Islamic finance. For Islamic finance to flourish, key reforms are needed in the areas of financial sector regulations, liquidity management, taxation, bankruptcy resolution, and infrastructure to support asset-backed financing. Sector-specific policy recommendations are discussed in the chapters that follow.

Box 3.3 Regulatory Developments at the International Level Supporting Shared Prosperity

A recent development in the regulatory arena is the issuance of core principles of Islamic finance regulation by the Islamic Financial Services Board (Standard No. IFSB-17). One of the stated objectives of IFSB-17 is to link the financial sector with the real economic sector (see Para 8 of IFSB-17). Such a linkage is one of the key features of Islamic finance to promote the sharing of economic and enterprise risks among investors and financiers.
In the area of Islamic capital markets, the IIFM has come up with two initiatives. The first is standardization of documents for various hedging and capital market products. The second is its work toward creation of bankruptcy resolution regimes for ṣukūk. This second initiative is conducive to promotion of shared prosperity by streamlining sharīʿah compliance and quick resolution in case of default and bankruptcy.

Sources: Standard No. IFSB 17 is available at: http://www.ifsb.org/standard/
Note: More information about IIFM activities can be found at http://www.iifm.net/.

One of positive development recently is the attention that the Group of Twenty (G-20) under the Presidency of Turkey, has given to Islamic finance. Recognition is growing among the financial sector policy makers that with its emphasis on risk sharing and asset-based financing, Islamic finance has the potential to foster investment and infrastructure, and thus to support the G-20 strategy to raise global economic growth. The final communique of the G-20 meeting in 2015 made explicit reference to alternative financing, such as asset-based finance, which needs to be developed through capital markets.[34] Such encouraging developments offer significant opportunities to the stakeholders of Islamic finance to take core principles of Islamic finance to the next level and to have Islamic finance compete at global level through its value proposition of risk-sharing, asset-based, and ethical finance.

A joint G-20 draft note prepared by the International Monetary Fund and World Bank, in consultation with the Islamic Development Bank and other stakeholders, highlights the need for integrating Islamic finance in the global financial system (see box 3.4). The note calls for the full adoption of IFSB and AAOIFI standards to manage the risks arising from exposure to equity, complexity of products, and uncertainties over resolution of insolvency.

In addition to these efforts, creating supportive infrastructure in the form of business information bureaus that can collect and share information about business worthiness (as opposed to credit worthiness) of firms seeking finance will greatly help Islamic banks as well as other nonbank institutions scale up financing to SMEs and microenterprises.

Finally, in its developmental stage, the Islamic financial services industry needs strong public policy support from the governments and stakeholders to realize the full potential of Islamic finance in achieving sustainable development and becoming a beacon of shared prosperity.

Box 3.4 Integrating Islamic Finance into Global Finance IMF-World Bank Joint G-20 Note

[34] http://www.g20.org/English/Documents/PastPresidency/201512/t20151201_1661.html.

For countries that wish to further develop Islamic Finance, **national policies** should aim to build an enabling environment and level the playing field with conventional finance. Actions could include:

- Further opening up to Islamic financial services, including by considering grant of licenses to new Islamic financial institutions, and adapting regulatory and supervisory frameworks to take into account the industry's specific features (national regulators) where deemed appropriate;
- Exploring means for enhancing liquidity management of Islamic banks (central banks);
- Adapting tax systems to avoid Islamic finance instruments being at a disadvantage (ministries of finance);
- Tapping into Sukuk markets to finance investment through asset-pooling schemes that could allow for regular issuance of tradable instruments while strengthening public investment frameworks (ministries of finance);
- Providing the right incentives to ease access to asset-based and equity-like financing, particularly for SMEs (ministries of finance and regulators).

At the **global level**, actions could include:

- Increasing the G20 membership in the Islamic finance standard setters;
- Leveraging these institutions to further cooperation and experience-sharing among the G20 members, and advance standardization, notably of Sukuk;
- Granting membership to Islamic finance standard-setters in the consultative groups of global standard-setters with the view to strengthen the emerging cooperation between these institutions;
- Systematically incorporating the industry's features in global standards and guidance, and developing accounting and statistics standards for Sukuk;
- Stepping up the engagement of International financial institutions and multilateral development banks (MDBs) in Islamic finance through analytical work, policy advice, and capacity development;
- Expanding MDBs' operations to include Islamic finance instruments.

Sources: http://www.g20.org.tr/wp-content/uploads/2015/09/IMF-WBG-Note-on-Integrating-Islamic-Finance-into-Global-Finance.docx. Also see: http://g20.org.tr/resources/current-presidency/?stream%5B%5D&wpv_column_sort_id=post_date&wpv_column_sort_dir=desc&wpv_post_id=4472&wpv_view_count=4475-CPID4472&wpv_paged=1.

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Chapter 4

The Islamic Banking Sector

The Islamic banking sector, which is the dominant component of the Islamic finance industry, has grown dramatically since the first known experiment started in the Egyptian village of Mit Ghamr in 1963. Today, more than 300 Islamic finance institutions, with assets close to $1.9 trillion,[35] are spread across 50 economies around the world in both Muslim and non-Muslim countries.

This chapter discusses the theoretical channels through which Islamic banking contributes to shared prosperity, presents an overview of Islamic banking, examines the key challenges facing Islamic banks, and offers policy recommendations.

Islamic Banking and Shared Prosperity

The aspiration of Islamic banks is the creation, equitable distribution, and circulation of wealth in order to promote social justice and to satisfy customers' needs for *shari'ah*-compliant investment opportunities. This wealth creation and its fair distribution ensure shared prosperity. Islamic banking contributes to shared prosperity through its impact on economic growth, as a provider of capital for economic activities, and through the characteristics of its products. Islamic economics is normative in nature, with the objective of complying with *shari'ah* (*maqāṣid al-sharīʻah*). The Islamic economy is built upon a set of objectives, or *maqāṣid,* that are the underlying principles that promote the well-being of all humanity[36]. The existence of Islamic finance and banking is supported by these key Islamic principles, which can be summarized as preference of risk-sharing over risk-transfer through debt, prohibiting social and economic exploitation, emphasizing ethical standards, promoting moral and social values, and rewarding enterprise (linking risk and reward) which would boost shared-prosperity as argued in Chapter 1.

The Abu Halima projects in Sudan are a good illustration of the potential for Islamic banking to take advantage of business opportunities and enhance living conditions in low-income settings (see box 4.1). Justice demands that resources be employed in a manner that benefits the whole of society and is accompanied by an underlying productive economic activity that generates real wealth.

[36] For more on this, see the *maqāṣid al-sharīʻah* as developed by al-Ghazali and al-Shatibi, in Zarqa (1980).

Box 4.1 Abu-Halima *Muḍārabah* Greenhouse Project in Sudan

This small project, located in Abu Alima, a rural community in north Khartoum, is an example of how Islamic banking products have the potential to contribute to shared prosperity. This initiative by the Islamic Development Bank, the Bank of Khartoum (Sudan), and the Central Bank of Sudan aims to empower low-income households by financing 125 graduates of college agriculture who work with their families to set up and operate greenhouses through the profit-sharing contract of *muḍārabah* (see details below). The project supports shared prosperity through two modalities.

First, by targeting low-income households, it ensures an efficient way of reducing poverty and income inequality. One of the qualifying criteria is that the young graduate's income must not exceed twice the Sudanese minimum wage.

Second, by adopting profit sharing, the project helps low-income households build equity, acquire productive capacities, and develop human capital. The adopted mode of financing is restricted *muḍārabah*, a joint venture in which the financier attaches some conditions to the use of funds.

The project has the following characteristics:

- Beneficiaries: 125 families headed by college agriculture graduates, forming one cooperative.
- Business type: Greenhouses for production of 1,400 tons of vegetables annually.
- Mode of financing: *Muḍārabah* (capital management). Profits are shared on a ratio of 40 percent for the project managers and 60 percent for the bank. Losses are absorbed by the bank. However, each family receives a living allowance throughout the production process, whether there is a loss or not.
- Finance amount: $4 million for the cooperative, which works out to $30,000 for each family
- Partners: One technical consultant and two private supermarkets for commercialization.

Today, these units are among the most important providers of vegetables near Khartoum.

Source: Bank of Khartoum, Sudan.

How Risk Sharing through Islamic Banking Promotes Shared Prosperity

Islamic banking is built on principle of risk-sharing in the financial system. Islamic financing instruments ensure that the sharing of the rewards from economic activity is not skewed by individuals' initial endowment of financial resources. Furthermore, the prohibition of interest and usury is intended to create more favorable conditions for shared prosperity by removing guaranteed returns and safeguarding the fair transfer of property and value among all economic actors. Islam banking adheres to certain conditions for financing real economic activities that help prevent the excessive expansion of debt (Chapra 2011) and moving economy from debt-based risk-shifting economy to a risk-sharing economy (Askari, Iqbal, Krichene, and Mirakhor 2012).

Islamic banking, in its theoretical form, should help mobilize resources from a large spectrum of the population, substantially increase the share of equity-financing in business, and advance risk-sharing in entrepreneurial activities.A close examination of Islamic modes of finance reveals that they keep finance tied to real economic activity. Islamic modes of profit-and-loss-sharing through partnership (*sharikah*), or agency (*muḍārabah*), trade-based contracts such as deferred payment mark-up sales (*murābaḥah*), the sale of goods to be manufactured (*istiṣnā'*), and forward sales (*salam*) share this characteristic. This concept of financing helps promote growth of the financial sector in tandem with that of the real sector.

Risk sharing ensures that banks thoroughly evaluate business proposals, as it creates an incentive for financial institutions to internalize costs related to bankruptcy. In addition, risk sharing is implemented through equity-based financing. Equity-based financing helps foster cooperation, interdependence, and above all universal brotherhood by involving everyone in both production and investment. Advocates of shifting the reliance from debt-based to equity-based financing are growing in mainstream economics. Greater reliance on equity also opens the door to greater demands by investors for shareholder values. The International Monetary Fund, in a *World Economic Outlook* on the causes and indicators of financial crises, acknowledges the advantage of equity financing in sustaining financial stability, noting that foreign direct investment, in contrast to inflows that create debt, is often regarded as providing a safer and more stable way to finance development (IMF 1998).

Although Islamic banking may not be the ultimate answer to improving socioeconomic justice and shared prosperity, the ethical aspects ingrained in the principles of Islamic banking can lead to increased transparency and social accountability, which in turn can help societies achieve economic growth and prosperity.

How Islamic Banking Promotes Shared Prosperity through Financial Stability

Pass through nature of Islamic banking eliminates classical asset-liability mismatch inherit in classical conventional banking which promotes a stable financial system. In case of a financial crisis, portfolios are balanced automatically and there is less need for any bail-outs by the governments (Askari, Iqbal, Krichene, and Mirakhor 2010). The stability feature of Islamic banking could protect poor segments of the society from the financing of bail outs through additional taxes and higher costs. In this respect, shared-prosperity will be protected as bottom 40% of segment will be less burdened.

How Islamic Banking Promotes Shared Prosperity through Financial Inclusion

The concept of financial and social inclusiveness and income equality are central to Islamic economic teaching. Islamic finance can be effectively used to address the issue of financial inclusion (see box 4.2), as it can provide a viable alternative to conventional debt-based financing by promoting risk-sharing contracts. It also can utilize specific wealth redistribution instruments to aid access to finance for the poorest in society. In the case of redistribution, this refers to the distribution of income from the wealthy and privileged to those defined as poor and needy, through voluntary or involuntary levies (Mirakhor and Iqbal 2012). This redistribution, not only ensures social justice, but also mobilizes resources making finance available to the poor, improving the productive capacity of the community.

Table 4.1 shows the state of Islamic banking and financial inclusion in selected Muslim-majority countries. The degree of religiosity[37] is on average about 85 percent in these countries, highlighting the important role of religion in daily life and society. About 9 percent of the population of these countries are financially excluded due to religious reasons (World Bank 2014). Hence Islamic finance can play a role in bringing more than 40 million financially excluded individuals into the formal financial system.

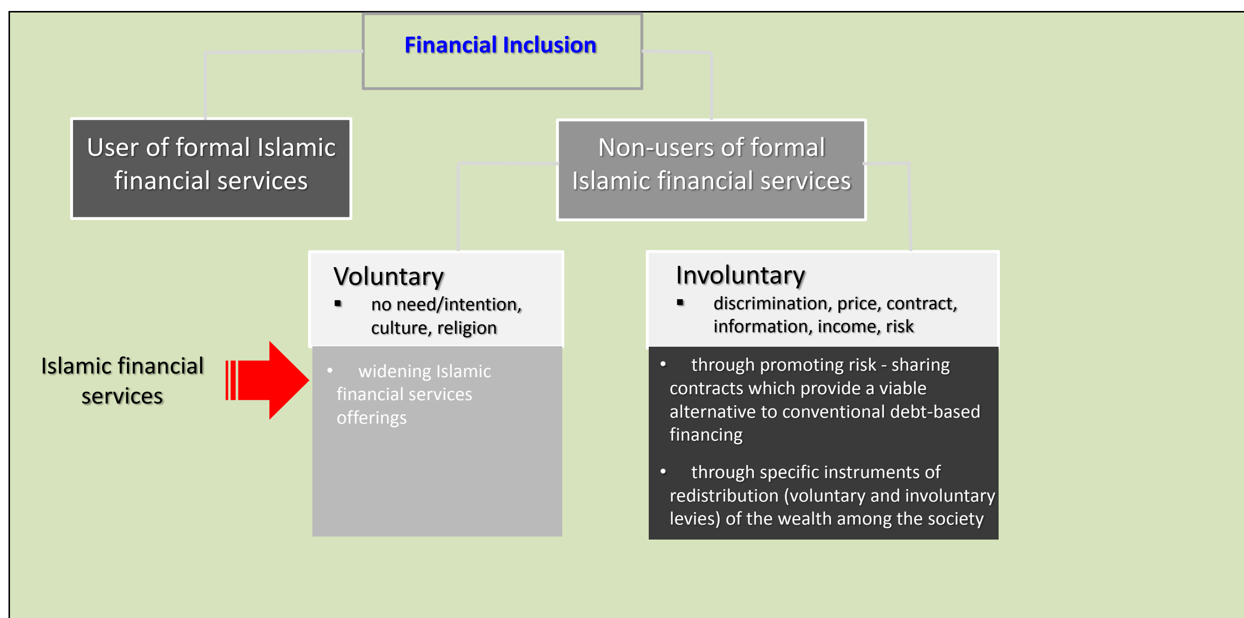
Box 4.2 Channels of Financial Inclusion from Islamic Finance Perspective

The Islamic financial services can addresses the issue of financial inclusion from two approaches: by promoting risk-sharing contracts, which provide a viable alternative to conventional debt-based financing; and by using specific wealth redistribution instruments (Mirakhor and Iqbal 2012).

The users of formal Islamic financial services can be categorized into user and non-user groups. Non-users may not be able to access the financial system (involuntary exclusion) or opt out from the financial system (voluntary exclusion) (figure B4.2.1). The financially excluded segments do not have access to the financial system because these segments of the population do not have enough income or present too high a lending risk; certain segments of population or groups are subject to social, religious, ethnic, gender, or other discrimination; and/or the informational and contractual framework might prevent financial institutions from reaching out to certain segments of population groups because the outreach is too costly to be commercially viable.

Figure B4.2.1 Channels of Financial Inclusion

[37] The percentage of adults in a given country who responded affirmatively to the question, “Is religion an important part of your daily life?” in a 2010 Gallup poll.



At present, however, the number of banks that offer *shari'ah*-compliant financial services per 10 million adults is low except in a few countries such as Bahrain, Kuwait, Malaysia, and Qatar (Zulkhibri 2016). Geographical reach is also limited for banks offering *shari'ah*-compliant financial services (as measured by such banks per 10,000 square kilometers). Efforts to increase financial inclusion in countries with Muslim populations thus require sustainable mechanisms to be able to offer *shari'ah*-compliant financial services to all residents, especially the Muslim poor and near poor, estimated at around 700 million people who are living on less than $2 a day.

Table 4.1 Islamic Financial Institutions and Financial Inclusion by Country

	Religiosity and financial inclusion				Islamic financial institutions (IFIs)			
Economy	Religiosity (%)[a]	Account at a formal financial institution (%, age 15+)	Adults with no account due to religious reasons (%, age 15+)[b]	Adults with no account due to religious reasons (thousands, age 15+)[b]	Number of IFIs	Islamic assets per adult ($)[c]	Number of IFIs per 10 million adults	Number of IFIs per 10,000 km^2
Afghanistan	97	9.0	33.6	5,830	2	--	1.1	0.03
Albania	39	28.3	8.3	150	1	--	4.0	0.36
Algeria	95	33.3	7.6	1,330	2	--	0.8	0.01
Azerbaijan	50	14.9	5.8	355	1	--	1.4	0.12
Bahrain	94	64.5	0	0	32	29,194	301.6	421.05
Bangladesh	99	39.6	4.5	2,840	12	14	1.2	0.92
Benin	--	10.5	1.7	77	0	0	0	0
Burkina Faso	--	13.4	1.2	98	1	--	1.1	0.04
Cameroon	96	14.8	1.1	114	2	--	1.7	0.04
Chad	95	9	10.0	573	0	0	0	0
Comoros	97	21.7	5.8	20	0	0	0	0
Djibouti	98	12.3	22.8	117	0	0	0	0
Egypt, Arab Rep.	97	9.7	2.9	1,480	11	146	1.9	0.11
Gabon	--	18.9	1.5	12	0	0	0	0
Guinea	--	3.7	5.0	279	0	0	0	0

Indonesia	99	19.6	1.5	2,110	23	30	1.3	0.13
Iraq	84	10.6	25.6	4,310	14	98	7.4	0.32
Jordan	--	25.5	11.3	329	6	1,583	15.4	0.68
Kazakhstan	43	42.1	1.7	126	0	0	0	0
Kuwait	91	86.8	2.6	7	18	28,102	87.2	10.10
Kyrgyz Republic	72	3.8	7.3	272	0	0	0	0
Lebanon	87	37.0	7.6	155	4	--	12.4	3.91
Malaysia	96	66.2	0.1	8	34	4,949	16.8	1.03
Mali	95	8.2	2.8	218	0	0	0	0
Mauritania	98	17.5	17.7	312	1	76	4.7	0.01
Morocco	97	39.1	26.8	3,810	0	0	0	0
Mozambique	--	39.9	2.3	189	0	0	0	0
Niger	99	1.5	23.6	1,910	0	0	0	0
Nigeria	96	29.7	3.9	2,520	0	0	0	0
Oman	--	73.6	14.2	78	3	--	14.4	0.10
Pakistan	92	10.3	7.2	7,400	29	40	2.5	0.38
Qatar	95	65.9	11.6	64	14	13,851	86.5	12.08
Saudi Arabia	93	46.4	24.1	2,540	18	1,685	9.2	0.08
Senegal	96	5.8	6.0	411	0	0	0	0
Sierra Leone	--	15.3	9.9	287	0	0	0	0

Source: Bankscope; Global Findex; World Development Indicators; World Bank *Global Financial Development Report* 2014.
Note: -- = not available.
a. Percentage of adults in a given country who responded affirmatively to the question, "Is religion an important part of your daily life?" in a 2010 Gallup poll.
b. Number of adults and percentage of adults that point to a religious reason for not having an account at a formal financial institution.
c. Islamic assets per adult ($)/Size of the Islamic assets in the banking sector of an economy per its adult population.

A substantial number of Muslims have voluntary shunned formal banking activities because of their religious beliefs (Zulkhibri 2016). At the same time, as the Islamic financial sector has deepened, many previously excluded individuals have started to undertake Islamic banking transactions. This suggests that Islamic banking can have a positive impact on financial intermediation by the poor, which ultimately should boost the mobilization of savings and prosperity. The opportunities for Islamic banking to offer financial products and services to the poor, especially in Muslim-dominated populations, is expected to grow. Islamic banking may also be more likely to finance projects that can be beneficial for low-income people, given the religious nature of its business and the ethical objectives enshrined in Islamic financing principles.

Despite the apparent difficulties in applying principles in practice, Islamic banking may increasingly play an important and positive role in improving financial inclusion. Structured approaches can be applied to enhance financial inclusion for individuals and households experiencing extreme poverty (via *zakāt, ṣadaqāt, waqf*, and collective risk sharing); poverty (via *qarḍ ḥasan, zakāt, waqf*, microfinance, micro-*takāful*); and low income (via market-based solutions and support to micro, small, and medium enterprises) (see chapter 9, on social finance). The uniqueness of the risk-sharing principle should be promoted more in rural areas in Muslim-

majority countries. The availability of profit-and-loss-sharing instruments helps individuals mitigate their market risks, as it contributes to portfolio diversification.

A World Bank (2014) study shows that the greater the number of Islamic banks per 100,000 adults, the lower the proportion of firms identifying access to finance as a major constraint. This finding suggests that increasing the number of *shari'ah*-compliant financial institutions can make a positive difference in the operations of small firms (0–20 employees) in countries with Muslim populations by reducing barriers to accessing formal financial services.

Recent Developments in Islamic Banking and Current Status

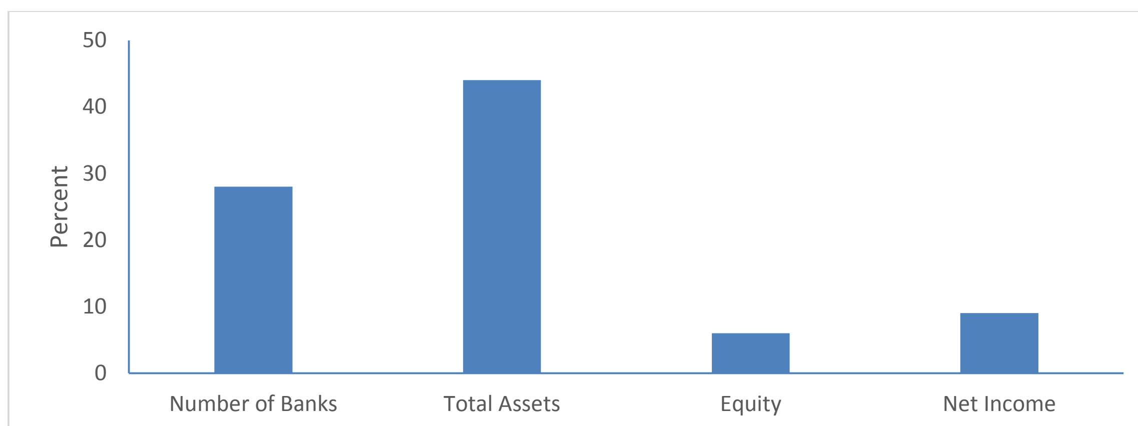
Recently, the Islamic Financial Services Board (IFSB 2015) estimated the size of the industry in terms of assets at $1.87 trillion and the size of the banking sector at $1.4762 trillion as of mid-2014.[38]

Size and Structure

Islamic banking has been growing not only in Muslim countries, but also in the non-Muslim world. The global spread of Islamic banks has transformed the financial systems of growing number of Muslim countries. According to Bureau van Dijk Bankscope data, there were 161 deposit-taking Islamic banks globally as of the end of 2014, a 28 percent increase from 2010. Net income, total assets, and total equity have also grown (figure 4.1). Globally, the Islamic Republic of Iran accounts for one-third of the assets of Islamic banks (table 4.2). Together with Sudan, these are the only two countries with a financial system based solely on Islamic finance. The rapid increase in Islamic banking and the importance of the sector for the economies of various other countries, particularly the member-countries of the Gulf Cooperation Council (GCC), Indonesia, Malaysia, and Pakistan, make it important to increase the understanding of recent developments, current trends, and industry drivers.

Figure 4.1 Average Percentage Increase in Various Elements of Islamic Banking, 2010–13

[38] There are many reports on the state of Islamic banking, but they adopt different approaches, leading to a wide range of estimates of the size of the industry. Data on Islamic banks often cover commercial as well as investment banks, and sometimes they even include multilateral institutions such as the Islamic Development Bank. Such differences in the choice of institutions to include explain the wide range of estimates of the size of the Islamic banking industry.



Source: Figures calculated from data extracted from Bankscope 2015.

Table 4.2 Islamic Banking Asset by Region, 2013

Region/Country	Total assets ($billion)
Middle East, including the Islamic Republic of Iran	
Iran, Islamic Rep.	482.4
Saudi Arabia	121.7
United Arab Emirates	100.3
Kuwait	78.7
Qatar	59.0
Bahrain	46.2
South and Southeast Asia	
Malaysia	156.7
Bangladesh	17
Indonesia	13
Pakistan	6.2
Africa	
Sudan	6.5
Egypt, Arab Rep.	5.0
Tunisia	0.76
Gambia, The	0.02
Other	
Turkey	44.8
United Kingdom	3.3

Source: Figures calculated from data extracted from Bankscope 2015.

Recent increases in Islamic banking activity have been driven by a number of factors. First, increased oil prices prior to 2015, particularly in GCC states, have bolstered liquidity in these economies, increasing demand for financial services. Given the substantially lower oil prices in 2014 and 2015 and projected for 2016, however, this raises issues related to sustainability. Second and more positively, Islamic banks were not as adversely affected by the 2008–09 global financial crisis as were conventional banks. Finally, Islamic banking has gained momentum as a credible competitor to conventional banking. Its products and services continue to evolve, as has the legal and regulatory frameworks under which it operates.

Together, the GCC countries and the Islamic Republic of Iran constitute the dominant players with the majority of the assets in the banking industry. As a consequence, the Middle East dominates the growth of Islamic banking globally. The South and Southeast Asian region rank as

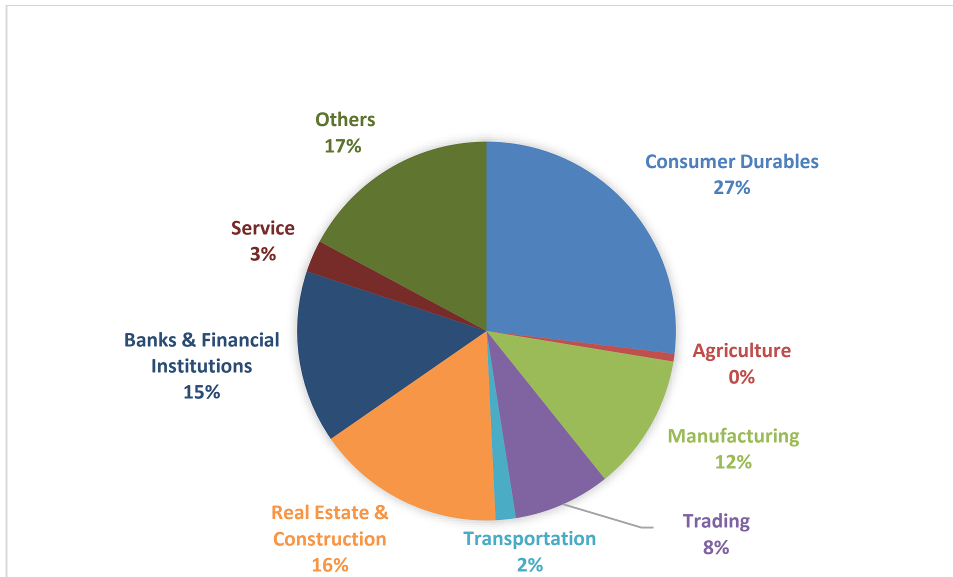
second globally for Islamic banking, with 15 percent of the market share. The region includes Malaysia, the second largest economy in terms of total *shari'ah*-compliant financial assets, and Indonesia, the country with the world's largest Muslim population. Pakistan and Bangladesh are two other emerging countries in the region, with combined assets of almost 2 percent of the global market. Overall, there is a large potential for Islamic banking to continue growing, taking into account income growth rates in these countries, in addition to the large and growing population of Muslims. Turkey and the United Kingdom complete the current picture, respectively accounting for 4 percent and a symbolic fraction of 1 percent of bank assets, respectively.

In addition, there are a relatively larger number of countries that that have less developed Islamic banking sectors but that host substantial Muslim populations. Thus there are two clear potential areas for expansion: entry of new Islamic banks, as well as the expansion of existing banks, in countries where Islamic banking already exists; and the introduction of new Islamic banks, and expansion of existing institutions, where Islamic banking is underdeveloped despite a substantial Muslim population. Countries such as Nigeria and Senegal in West Africa are good candidates for an expansion of Islamic banking in the near future. Other candidates include Afghanistan, Algeria, Azerbaijan, Cameroon, Libya, Mali, Kazakhstan, Morocco, Mozambique, and Uzbekistan.

Although data availability is an issue in most of the 57 member-countries of the Organisation of Islamic Cooperation (OIC), there is some evidence that Islamic banks are contributing to shared prosperity through the modes of financing they are offering, as well as the sectors they are supporting (see chapter 11 of this report).

Figure 4.2 shows the distribution by sector of financing provided by Islamic banks, reported as percentage of the total, and aggregated by country. One-quarter of financing facilitates the acquisition of consumer durables, while financing for real estate and construction, manufacturing, and trading accounts for 13.7 percent, 10 percent, and 7 percent, respectively. All these sectors are drivers of economic development, a necessary condition for shared prosperity.

Figure 4.2 Financing by Sector, Islamic Banks, 2012



Source: Ibisonline.net /IRTI.

Performance of Islamic Banks: Indicators of Financial Soundness

The Islamic banking system as a whole is well capitalized and liquid, although the degree of liquidity varies by region and according to the market share of Islamic banks. The capital adequacy ratio for Islamic banks is generally well above the regulatory requirement (see table 4.3). Major portion of the risk weighted capital ratio consists of Tier 1 capital.

In 2014, Islamic banks in the United Kingdom, Turkey, Africa, the GCC, and the Islamic Republic of Iran had the strongest capital positions, followed by countries where Islamic banks were relatively important in terms of market share. For instance, in 2014 the Capital Adequacy Ratios (CAR) for Islamic banks in the United Kingdom, Turkey, the GCC, and the Islamic Republic of Iran were all satisfactory, averaging 33, 32, 26, and 19 percent, respectively, well above the minimum 8 percent requirement for total capital under Basel III.

In terms of profitability, return on assets of Islamic banks is merely positive with banks operating in Africa, the GCC, the Islamic Republic of Iran, the Middle East, and Asia score better than their counterparts elsewhere with return on assets above 0.5 percent. One possible reason is that some of banks in these regions are state-owned banks and for the most part finance state-owned enterprises and government projects at concessionary rates.

In terms of credit risk, nonperforming loans (NPLs) have declined across the regions, although they have remained relatively high in the GCC, the Islamic Republic of Iran, and Africa, averaging double digits from 2010 to 2013. The GCC and the Islamic Republic of Iran made significant progress in reducing the ratio of nonperforming loans to total loans from double digits in 2010–13 to a single digit in 2014. Islamic banks in Indonesia, Malaysia, Pakistan, and Sudan have relatively lower levels of credit risk, averaging 6 percent in the period under review. In 2014,

the level of NPLs for the United Kingdom, Turkey, the GCC, and the Islamic Republic of Iran averaged 9 percent, 8 percent, 7 percent, and 6 percent, respectively.

Table 4.3 Financial Soundness Indicators, All Islamic Banks

GCC, including the Islamic Republic of Iran	2010	2011	2012	2013	2014
Capital Adequacy Ratio (CAR)	27.7	36.7	29.5	30.8	26.3
Tier 1 ratio	27.0	33.0	29.6	30.0	25.4
Nonperforming Loans to Total Loans	10.1	12.3	10.1	9.2	6.0
Return on assets	-2.5	0.5	0.3	1.5	0.5
Return on equity	-2.0	4.9	5.2	6.4	5.8
Liquid assets/Deposits and Short-term Funding	50.7	85.6	60.1	63.6	45.1
Liquid assets/Total Deposits and Borrowing	47.6	50.2	47.5	46.6	51.4
Middle East and Asia (excluding GCC/Iran)					
Capital Adequacy Ratio	45.6	27.4	24.9	19.0	19.1
Tier 1 ratio	25.0	24.1	20.4	15.3	14.4
Nonperforming Loans to Total Loans	6.6	7.9	7.0	9.2	9.2
Return on assets	0.3	1.1	0.9	1.3	0.7
Return on equity	6.5	7.5	4.3	-2.4	7.4
Liquid Assets/Deposits and Short-term Funding	110.5	85.4	52.2	44.2	35.1
Liquid Assets/Total Deposits and Borrowing	23.6	26.2	19.5	17.9	18.9
Africa					
Capital Adequacy Ratio (CAR)	35.2	102.8	26.7	30.2	32.2
Tier 1 ratio	22.9	163.1	22.2	25.3	27.9
Nonperforming Loans to Total Loans	6.5	11.5	10.8	10.8	7.8
Return on assets	3.7	2.4	2.7	1.6	2.7
Return on equity	17.1	9.6	10.3	12.3	18.4
Liquid Assets/Deposits and Short-term Funding	83.8	97.6	74.9	81.7	48.8
Liquid Assets/Total Deposits and Borrowing	93.3	112.0	77.1	115.7	29.7
United Kingdom and Turkey					
Capital Adequacy Ratio	36.2	30.4	30.1	28.4	32.8
Tier 1 ratio	14.3	13.0	12.9	11.6	12.5
Nonperforming Loans to Total Loans	3.5	3.0	2.9	3.1	7.2
Return on asset	8.1	6.3	4.9	1.1	-0.1
Return on equity	21.1	18.5	16.3	11.2	-0.9
Liquid Assets/Deposits and Short-term Funding	161.1	216.2	86.0	176.9	22.5
Liquid Assets/Total Deposits and Borrowing	158.2	265.7	101.6	176.2	21.1

Source: Figures calculated using data extracted from Bankscope 2014.

The high level of NPLs in the Middle East and Asia highlights the relatively high level of credit risk in the region, and calls for greater regulatory oversight. Regulatory frameworks for banking supervision need to be scaled up. Banks with double-digit NPLs need more intensive credit risk supervision from their central banks so as mitigate such risks. In particular, central banks in these countries need to pay greater attention to Islamic banks and also more closely

monitor their largest clients. In addition, both central credit registries and credit reference bureaus could be established to check borrowers' credit histories. There is also the need in these jurisdictions to establish Asset Management Recovery Corporations in order to recover some of the bad loans.

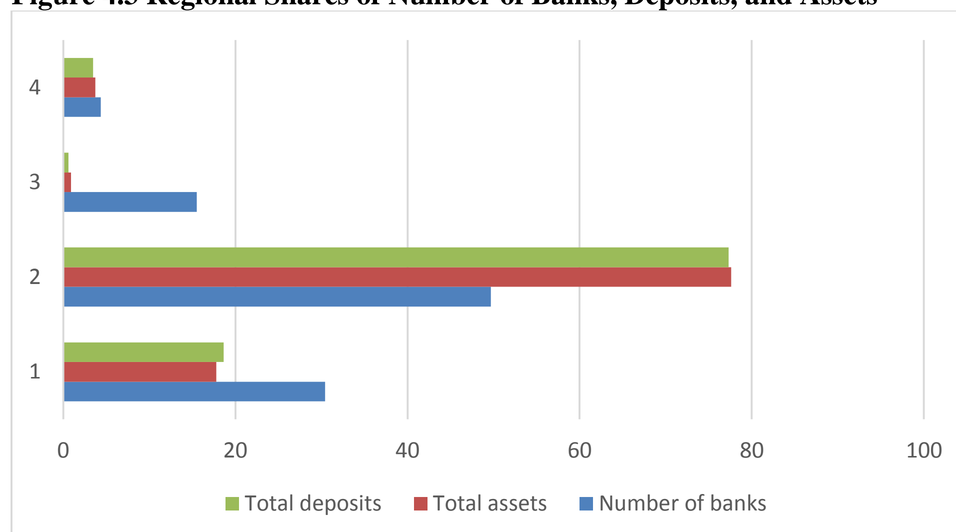
Islamic banks in the GCC and the Islamic Republic of Iran are more liquid than their counterparts elsewhere, followed by banks in Africa. The reason for this pattern is that the lion share of Islamic banks in Africa are in located in Sudan—one of the two countries, with the Islamic Republic of Iran, where the whole banking system is *shari'ah*-compliant, and Islamic banks are not in competition with conventional banks. Compliant Islamic banks in the Middle East, Asia, the United Kingdom, and Turkey appear to only have moderate liquidity positions.

Regional Perspectives

Assets and deposits in the global Islamic banking industry are highly concentrated, yet the majority of Islamic banks are small. Eleven percent of the 161 banks identified as Islamic banks with Bankscope data have assets above $20 billion; 11 percent have assets between $10 billion and $20 billion; 12 percent have assets between $5 and $10 billion; 27 percent have assets between $1 billion and $5 billion; and 40 percent have less than $1 billion in assets.

The bulk of the world's assets (77 percent) in Islamic banking are in the Middle East and North Africa (MENA) region, followed by Asia (18 percent), Europe (3.73 percent), and Sub-Saharan Africa (less than 1 percent) (see figure 4.3). The pattern for the number of Islamic banks is similar, with 50 percent of Islamic banks located in the MENA region, 30 percent in Asia, and 15 percent in Sub-Saharan Africa, despite having less than 1 percent of total assets. In the MENA region, which has the lion's share of Islamic bank assets, more than half the assets belong to Iranian banks ($451 billion) as well as the largest seven banks accounting for 80 percent of the Iranian market. These banks individually have assets valued at more than $20 billion.

Figure 4.3 Regional Shares of Number of Banks, Deposits, and Assets



Source: Figures calculated using data extracted from Bankscope 2014.

Challenges Facing the Islamic Banking Sector

Over half a decade since the establishment of modern Islamic banking, the evidence from Muslim-majority countries remains mixed concerning the sector's contribution to socioeconomic development. A few studies have found that Islamic banking has yet to make a significant contribution to financial inclusion and economic development (Abedifar and others 2015), while others find a positive link (Imam and Kpodar 2015; see also chapter 10 in this report). Some studies have found that gains from Islamic banking have been limited to only a small segment of the general population.

The main reason is that the benefits of Islamic banking can be achieved only if it is practiced in its true spirit and form. Its misuse, like the misuse of any system, can preclude the attainment of its benefits. Another reason has to do with how the business and industry of Islamic banking evolved and how it has been preoccupied with high-net worth individuals, making it difficult to develop a healthy socioeconomic environment that would be close to the ideal of Islam. *Shari'ah*-compliant practices may have created additional burdens, inefficiencies, and operational constraints, undermining the original *shari'ah* objectives of fairness, inclusiveness, equity, and economic justice (Sufian, Noor, and Zulkhibri 2008).While the current contribution of Islamic banks to growth is unclear, the literature argues that there is a large potential for *shari'ah* financial products to play a role in growth.This suggests that the litmus test of the usefulness of Islamic banking would be its ability to induce growth and reduce poverty through its chief characteristic, risk sharing (Askari and others 2012). Islamic banks have social responsibilities that transcend the goal of profit maximization. In reaching these goals, many challenges exist that need to be addressed by all stakeholders.

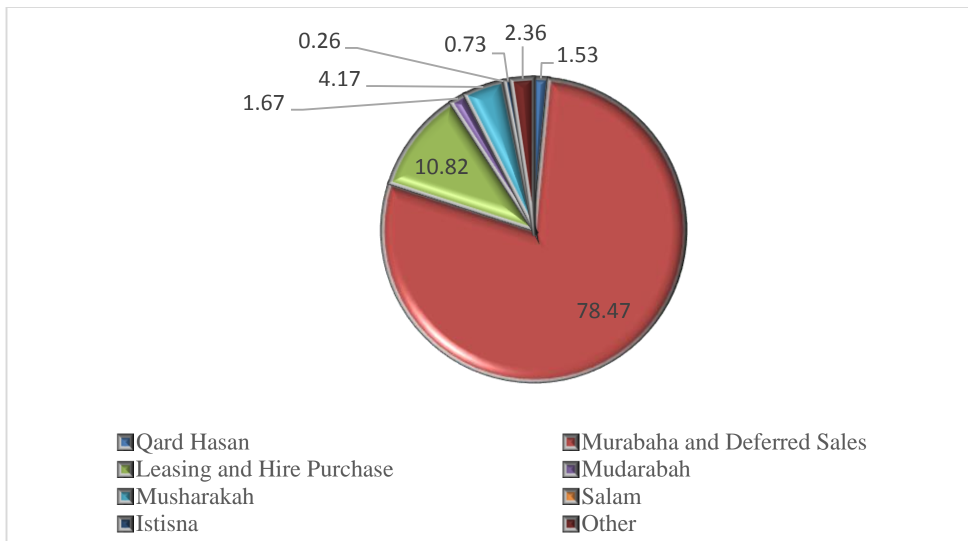
Divergence between Theory and Practice of Islamic Banking

The most important issue is the perception of the gap between what the Islamic banking identity is in theory, and the reality in practice. To date, Islamic banks have tended to position themselves close to conventional banks through product innovations, such as *tawarruq*, commodity *murābaḥah*, Islamic repos, and asset-based securities, which some argue are detached from the real economy and move too far away from the theoretical underpinnings of Islamic economics. There is a need to develop such policies that could narrow the gap between the aspirations of Islamic banking to be based essentially on risk-sharing instruments such as *muḍārabah* and *mushārakah*, and the reality of Islamic banks relying heavily on debt-based instruments such as *murābaḥah*[39].

Nowhere is such a gap between aspiration and reality more apparent than on the asset side of their balance sheets. Islamic banking is still largely based on mark-up or profit margin techniques—a pattern identified over a decade ago (Iqbal and Molyneux 2005). This shift from equity-based financing or profit and loss-sharing contracts to debt-based financing poses the risk of negating their advantages in terms of financial stability, and the systemic benefits in terms of promoting sustainable development. Figure 4.4 clearly illustrate this challenge: more than 75 percent of the financing offered by Islamic banks globally is in the form of *murābaḥah* and deferred sales contracts. Leasing and hire purchase contracts come second, with about 11 percent. The shares of profit-sharing instruments (*mushārakah* and *muḍārabah*) remain at a lowly 4.17 percent and 1.67 percent, respectively. To put another way, it appears that less than 6 percent of global Islamic financing is on a profit-sharing basis. The benevolent *qarḍ ḥasan* contract stands at 1.53 percent. Overall, the "star" Islamic banking products represent less than 8 percent of the total of Islamic financing globally.

Figure 4.4 Islamic Modes of Finance by Islamic Banks, 2012

[39] Dar and Presley (2000) suggest several explanations for the tendency of Islamic banks to prefer to use modes of financing other than profit and loss-sharing (overwhelmingly *murābaḥah*)



Source: Ibisonline.net /IRTI.

Governments and the relevant authorities should look to remove barriers in order to boost the attractiveness of risk-sharing contracts in Islamic banking. The issues of clearly defining property rights and improving tax rate treatment will be a starting point to provide a level playing field. Internalizing the social dimension and social justice aspects into Islamic bank's own operational functions also may help close the gap between theory and practice. Extending financial inclusion via profit and loss-sharing Islamic modes of finance will extend this economic dynamic to a larger section of society.

Scale, Access, and Outreach of Islamic Banking

Underdevelopment of risk-sharing instruments discourages investors from investing in sectors that are perceived as high risk, such as micro, small, and medium enterprises (MSMEs). The MSME market is largely untapped in emerging markets and has huge potential (World Bank-IDB-IRTI 2015). With the proper enabling environment, investors with a matching risk appetite are likely to be attracted to providing capital for these sectors. Increasing the access of poor and low-income groups to wider Islamic financial services and products could be a way forward to achieving the goal of ending poverty, particularly in Muslim countries.

To create the real impact, Islamic finance needs to reach a critical mass by exploring untapped markets, or consolidating existing platforms to build an entity with the required expertise and capital that can influence multiple areas of the market. A large-scale Islamic financial institution, with a large amount of capital, is needed to generate change. The fragmentation in domestic markets has led to the erosion of banks' profit margins and difficulties for banks that want to scale up their business operations. However, a large-scale Islamic financial institution would be able scale up through its presence in key financial markets. This, in turn, would make vital funding sources available to wider consumers, generating new product profiles to penetrate new markets, influencing global markets, and increasing investor awareness.

Soundness, Stability, and Efficiency of Islamic Banking

Islamic banks pose several regulatory, market behavioral, and legal challenges. One of the challenges is the designing and implementing effective financial regulation and supervisory framework for Islamic banking that takes into account the unique features of the Islamic banking business, without increasing the regulatory burden and restricting their growth potential. The soundness of Islamic banking is important for the overall stability of the domestic and global financial system. One way to ensure stability is to reduce asset-liability risks and to adopt policies that minimize moral hazard and adverse selection, excessive debt creation, and leverage.[40]

An appropriate and robust legal, regulatory, and tax framework is a basic requirement for establishing sound Islamic financial institutions and markets. It is also important to ensure a more integrated Islamic financial services industry globally so it can withstand shocks and adverse market developments. Putting in place these building blocks and applying mutually acceptable rules and standards will strengthen the resilience of the Islamic financial system. Innovation and knowledge sharing between various market players at the global level can facilitate the standardization and globalization of Islamic financial products. Accelerating the development of these critical building blocks of the Islamic financial system is vitally needed to respond to the changing economic and financial landscape.

Leveling the playing field with respect to the tax treatment of financial instruments is urgently needed. Conventional debt often receives advantageous tax treatment, while some Islamic finance products face double taxation. Treatment of such products requires uniform regulation, as well as a supportive legal framework. Similarly, existing legal and supervisory frameworks that are based on the conventional banking model may also create difficulties in the longer term for the efficient running of Islamic banks. An accounting procedure based solely on conventional banking practice is inadequate because of the different nature and treatment of financial instruments.

Liquidity and Basel III Compliance

Issues of liquidity and compliance with the Basel III capital requirements also present challenges. Banks in general, and Islamic banks in particular, are inherently subject to liquidity risk, relying mostly on relatively short-term demand deposits to finance illiquid investments. For example, in 2012, 77 percent of Islamic bank liabilities consisted of demand deposits, while 76 percent of their assets were in the form of investments (see table 4.4). Issues of maturity mismatch are therefore unavoidable. It is critical for Islamic financial institutions to innovate and revolutionize *shari'ah*-compliant products to enhance and manage liquidity.

[40] Askari and Krichene (2014) provide a review of the arguments in support of risk-sharing being the essence of Islamic banking and the major reason for its stability. Hasan and Dridi (2010) also argue that risk-sharing characteristics of Islamic banking should increase stability, thereby stimulating growth.

Table 4.4 Demand Deposits and Investments of Islamic Banks, 2012

Region	Total deposits over total liabilities, percent	Total investments over total assets, percent
Europe	30.47	69.85
Middle East	83.15	76.23
Asia	73.67	75.41
Africa	87.04	73.38
Global	76.95	75.60

Source: Ibisonline.net /IRTI.

By relying on equity-based finance, Islamic banks incur a higher charge of regulatory capital, since by definition Islamic banks are required to hold more equity than conventional banks. This places Islamic financial institutions at a disadvantage under Basel III's new capital requirements. A further complication concerns the calculation of risk-weighted assets, given variation across jurisdictions in the treatment of profit-sharing investment accounts (PSIAs). It is important to ensure proper regulatory treatment of the PSIA of Islamic banks. It is also essential to identify instruments eligible for treatment as additional Tier-1 and Tier-2 capital, bearing in mind revised IFSB standards on capital adequacy (IFSB-15).[41]

Shari'ah Governance Credibility in Islamic Banking

Improvement in the *shari'ah* governance framework is needed to enhance *shari'ah* compliance, credibility, and integrity. A strong *shari'ah* governance framework helps increase consumer confidence and provides greater flexibility for Islamic financial institutions to be innovative within the boundaries of *shari'ah*. The *shari'ah* board contributes to public awareness about the philosophical basis and concepts of Islamic banking and finance. *Shari'ah* governance adds value to the existing corporate governance framework in Islamic financial institutions. Furthermore, *shari'ah* compliance is not just restrictive with respect to investment in companies with unacceptable business; it also promotes investment in businesses that contribute to the ethical values of Islam and purification of dubious profits by distributing them to charity for the welfare of the community as a whole.

On the other hand, standardized *fatāwá* (religious opinions) and centralized *shari'ah* boards help unify operations between Islamic banks and also increase public awareness and confidence. Differences in *Shari'ah* interpretations can lead to a lack of harmonization both within and across borders, which can affect trust in the industry. The IFSB and AAOIFI recommend establishing, at the bank-level, an independent *Shari'ah* Supervisory Board (SSB), a well-resourced internal *shari'ah* review process, and periodic external *shari'ah* reviews (Kammer and others, 2015). However, a centralized *shari'ah* board, in addition to bank-level *shari'ah* boards,

[41] IFSB-15 provides guidelines for the components of regulatory capital (Tier 1 and Tier 2). IFSB-15 also defines common equity as the Tier-1 core capital, and preferred stock as the additional Tier-1 capital. Currently, the IFSB standard is the only international guideline to integrate Islamic contracting principles into the global financial system. A unified adoption of this standard would ensure that institutions offering Islamic financial products and services assign sufficient capital to cover the risk of the institution's Islamic operations.

can be advantageous in ensuring consistent *shari'ah*-compliance approaches. Malaysia is a leader in terms of *shari'ah* regulatory and governance framework for its Islamic financial services industry. An increasing number of countries (including Bahrain, Indonesia, Morocco, Nigeria, Oman, Pakistan, and Sudan) are moving in the same direction in putting in place their own *shari'ah* regulatory and governance framework. For Islamic finance to move to the mainstream and extend into a broader range of jurisdictions, it must resolve inefficiencies associated with the *shari'ah* compliance process.

Adequately Trained and Skilled Human Capital

The institutional, technical, and human resource requirements of Islamic banks are unique. The Islamic banking industry requires human capital with combination of accounting, finance and *shari'ah* competencies. Without appropriate training and skilled human resources, even if demand for Islamic banking services increases, the supply of such services cannot be met unless the industry has suitably qualified staff at all levels of management. Even so, if skilled human capital are not of the highest standard, the credibility, competitiveness, and stability of the Islamic banking industry will be at stake. Hence the most important unique challenge of Islamic banking institutions is to address the shortfall of trained and skilled human capital for the industry to adequately meet its operational requirements and *shari'ah* governance standards.

Many banks still have limited capabilities and expertise to consistently originate and structure large Islamic finance deals, which often include pioneering arrangements and features. The need for highly skilled staff will increase with the development of innovative Islamic financial products and services. *shari'ah* experts need to have an adequate knowledge of banking and finance, while Islamic bankers, finance specialists, and regulators need an adequate knowledge of the applicable *shari'ah* rules and principles. Specialized training and educational institutions to provide Islamic financial knowledge to the mass are also needed, along with collaboration and exchange of knowledge across jurisdictions, and supplementary research into and development of key specialized and human resource areas. To meet this human capital requirement, large financial institutions can act as knowledge centers to attract foreign talent from the existing international financial hubs, as well as retain local talent.

Policy Recommendations

The rapid development of Islamic banking is adding considerable variety and choice for both Muslims and non-Muslims who wish to engage in financial activities. However, the absence of a truly global Islamic financial system based on *shari'ah* principles, as well as the varying ways in which Islamic banking business is conducted in different jurisdictions, has led to somewhat haphazard growth and development of Islamic banking and finance. In terms of policy reponse, the Islamic banking sector should focus on six key priorities to improve and adopt best practices for the Islamic banking sector to contribute to shared prosperity. In this respect, joint IMF-World

Bank G20 note on integrating Islamic finance with global financial systems could serve as a good roadmap as mentioned in Chapter 3.

1. Shift toward *shari'ah*-based banking and practices. Currently, Islamic banking based on *shari'ah*-compliance is primarily serving established corporate entities and relatively high net-worth individuals. The operating model of Islamic financial institutions needs to be revisited to promote *shari'ah*-based banking models. This will ensure that a greater portion of finance is available for microenterprises and SMEs through the use of risk-sharing instruments.

2. Harmonize *shari'ah* standards. Efforts must be made to develop global *shari'ah* reference bodies that can assist in harmonizing cross-country *fatāwá* relating to Islamic finance and help in accelerating the growth of the industry. Facilitating regional harmonization may be the first step toward greater harmonization of the Islamic banking system. It would be desirable to have clear and consistent rulings by scholars on *shari'ah* issues so that no ambiguity remains.

3. Create an enabling regulatory environment. Given the evolving global financial landscape, critical regulatory challenges include ensuring a level playing field for both conventional and Islamic banks through consistent regulations; ensuring consistent implementation of the Basel III framework; ensuring that systematic risks in dual banking systems are addressed; and implementing cross-border supervision.

4. Enhance the scale of and access to Islamic finance. For Islamic banking to live up to the promise of delivering equitable growth, it is vital that the scale, access, and outreach of Islamic banking be increased to include low-income earners. There is a need to enhance risk management practices; reduce costs; make best use of available technology; and use a range of channels, such as branchless banks, e-money, and mobile banking, to deliver financial services.

5. Improve liquidity and ensuring stability. The problem of liquidity management needs to be addressed by developing new instruments through research and innovation. Developing a credible liquidity management framework will help accelerate the growth of the industry. Sustainable growth and stability in Islamic banks require the development of a comprehensive risk management framework geared to their specific situation and requirements.

6. Bolster human capital and Islamic finance literacy. The human capital of the industry could be strengthened by creating credible Islamic finance knowledge platforms through regular training, seminars, and workshops, as well as developing frontier knowledge in Islamic finance for the industry, with the support of the industry and academia. Trust and

confidence in using Islamic financial services needs to be increased. Public awareness can be increased by promoting Islamic financial literacy, including knowledge of which financial products are best suited for particular purposes.

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Chapter 5

Islamic Capital Markets

The purpose of capital markets is to facilitate long-term investment. The principles of Islamic finance promote risk sharing in lieu of risk transfer in conventional markets. The risk-sharing and equity participation principles of Islamic finance promote the long-term value of investments in real assets rather than the maximization of short-term profits. The ethical dimension of Islamic finance ensures the long-term sustainability of society. The main components of Islamic capital markets are equity markets and *sukūk* (asset-backed securitized Islamic products). This chapter evaluates the current state of the equity and *ṣukūk* markets and analyzes their role in fostering economic development with shared prosperity.

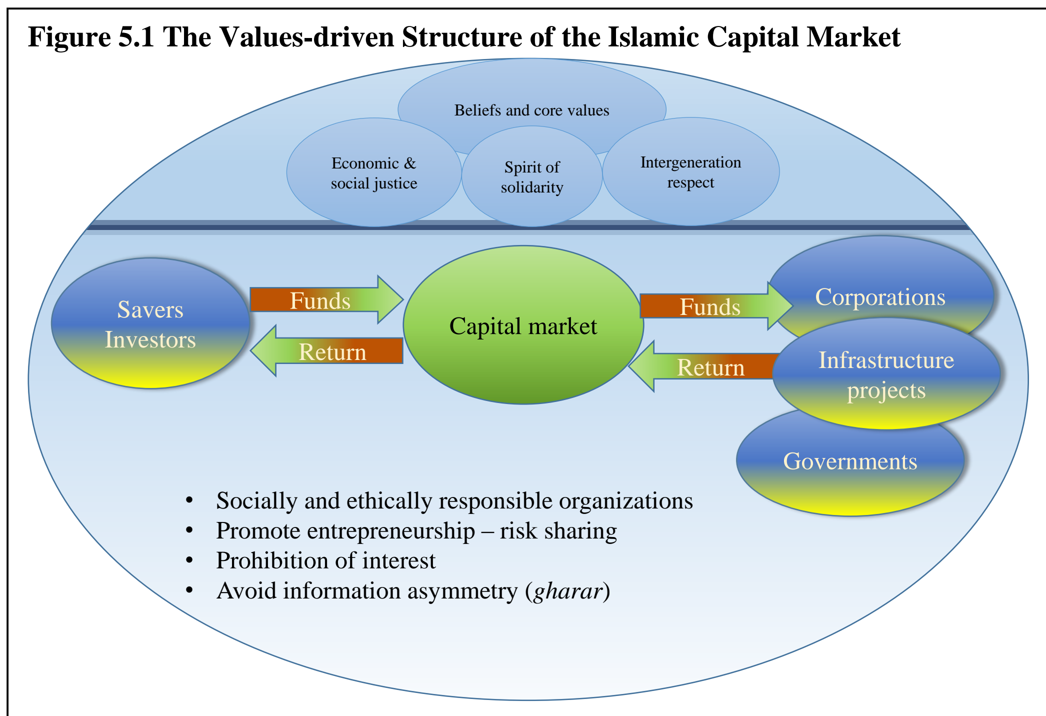
The Role of Capital Markets in Enhancing Shared Prosperity

A well-functioning capital market not only improves the capital allocation in the economy but also enhances productive growth. Islamic capital markets can make a significant contribution to achieving economic development and enhancing shared prosperity using the principles of risk sharing and equity participation. There is ample research supporting the contribution of the financial sector to economic development and its impact on income distribution. Levine (1997, 2005) clearly demonstrates that financial development produces faster average growth. Pagano (1993), King and Levine (1993), Bekaert and Harvey (1997), and Beck, Demirgüç-Kunt, and Levine (2007) emphasize the importance of capital markets development on the path of economic growth. Similarly, Agarwal and Mohtadi (2004) find that stock market development is positively associated with economic growth. Pradhan and others (2014) investigate the linkages between stock market development, bank development, and economic growth and find that stock market development is an important ingredient of growth.

It is well documented that when risk is spread among a large number of participants through an efficient capital market, closer coordination between the financial and real sector is promoted, as well as better sharing of the benefits of economic growth and greater stability for the financial system. By contrast, risk transfers through debt instruments, along with higher leverage, weaken the link between the financial and real sector, thus posing a threat to financial stability. The growth of pure financial assets can outpace the growth of real sector, a phenomenon known as decoupling (Menkoff and Tolksdorf 2001) or financialization (Epstein 2006: Palley 2007), whereby economic growth is no longer anchored with growth of the real sector. Excessive financialization of assets may result in bubbles (Parenteau 2005). All too often, financial sector crises have required large government interventions and massive bailouts. Thus while private financiers enjoy the gains of robust pure financial innovations, which ultimately lead to decoupling, the society at large suffers the pain of saving the real sector from the vagaries of financial sector crises.

Efficient risk sharing requires that economic risks are allocated among participants in accordance with their respective degree of risk tolerance (Mirakhor 2010).[42] Efficient capital markets allow risky investments to be matched with those investors who have the appetite for risk taking in the expectation of better returns. The alignment of risk taking with the expected returns of investment enhances risk-sharing opportunities, improves the dissemination of information, lowers the cost of mobilizing funds, facilitates investments in the most productive technologies, and enhances the efficient allocation of capital (Levine and Zervos 1998; Agarwal and Mohtadi 2004). Furthermore, liquidity in capital markets encourages firms to invest in long-term and more productive projects. This higher productivity raises the return on the investment, and encourages

Figure 5.1 The Values-driven Structure of the Islamic Capital Market



more saving and investment in physical capital, which leads to faster economic growth.

What makes the Islamic capital market different from the conventional capital market is the ethical dimension, which focuses on the long-term sustainability of society, and its principles of risk sharing (ownership dispersion) and avoidance of excessive leverage and speculation. Figure 5.1 depicts the mechanism of an Islamic stock market based on respect for core values. Economic and social justice, the spirit of solidarity, and intergenerational respect supersede the market structure. Organizations that are socially and ethically responsible can raise funds in this market on the basis of sharing both risk and reward. In the absence of interest and speculation, the possible return is based purely on the underlying economic activity. The Islamic principles of finance thus help in the allocation of more resources to the real sector of the economy, create more job opportunities, and ultimately distribute wealth more equitably.

Equity-based investment is well established in the world of Islamic finance. Investment in instruments such as common stocks and *ṣukūk* is permissible in those companies that are not engaged in businesses such as gambling or production/trading in prohibited items like alcohol or

[42] This process is explored in the Arrow and Debreu (1954) model of competitive equilibrium.

pork (*harām*), and those that are engaged in socially irresponsible activities (usually referred to as sin stocks). Although investment in stocks is permitted, many of the practices associated with stock trading are not. Speculation through derivative positions and short-selling are some of the practices not allowed under *shari'ah* principles (Naughton and Naughton 2000). The main distinction between the conventional and Islamic capital market is the lower leverage and the absence of speculative behavior promoted by short selling and derivative trading.

Ṣukūk are one of the two pillars of Islamic capital markets. Instead of conventional bonds that are based on a debt contract, *ṣukūk* are based on risk-sharing contracts backed by real underlying assets, such as asset-backed securitization. The aim for *ṣukūk* is to develop innovative assets and distribute income from entrepreneurial activities funded by the *ṣukūk* (Jobst 2007).

In summary, equity-based financing and asset-backed securitization have a positive impact on economic growth. The absence of leverage in a risk-sharing framework will lower riskiness and risk premiums on financial assets such as stocks and *ṣukūk*. This will support shared prosperity. The risk-sharing framework links the financial sector to the real sector. Thus the risk premium on financial assets directly reflects the riskiness of the real sector. The stock market will have low correlation with the rest of the world, which makes it a good alternative for foreign investors in order to diversify their portfolio. It facilitates capital inflows, which lower the cost of capital and support economic growth. It does all this in a way that does not increase risk—unlike debt-based speculative capital.

The Current Status of Islamic Capital Markets

Despite the extraordinary growth of the Islamic banking industry, there is a great need for vibrant and efficient capital markets in the area of Islamic finance. The Islamic capital market is underdeveloped—which is not surprising, since Islamic finance is a relatively new industry.

There is no organized stock exchange dedicated to trading in equities that are compliant with the Islamic investment principles. Organized markets for conventional stocks exist in a number of member-countries of the Organisation of Islamic Cooperation (OIC), and some are quite mature, as in Indonesia, Malaysia, Pakistan, and Saudi Arabia. However, growth in market capitalization does not necessarily contribute to economic development or the more equitable distribution of wealth (Ali 2005, 2013). Figure 5.2 shows the relationship between capital formation (gross domestic investment) and market capitalization.

As the figure shows, market capitalization does not translate into capital formation in any income group, including the high-income countries. However, there is a stark difference between the low-income and higher-income groups of countries. For low-income countries, no relationship between market capitalization and capital formation seems to exist, which suggests either the nonexistence or lower depth of the stock market. Other factors may also be at play. Investors may voluntarily exclude themselves due to their conservative nature (their risk-aversion to the speculative nature of market). Or they may stay out of the market because of their faith, especially in countries where a majority of the population is Muslim. This factor is evident in the figures depicting the OIC member-countries. The only exception is the OIC-high income group—and even here, capital formation remains well below the market capitalization ratio. Interestingly, peaks in the market capitalization ratio for the Non-OIC member country groups coincide with the

formation of bubbles in those markets, especially before the onset of the global financial crisis in 2008.

In summary, stock markets in their current form contribute relatively less to economic development than their potential and expectations because of the speculative nature of these markets. The rise in speculation in recent years has been the result of easy access to leverage in a very low-interest-rate environment, and has led to the formation of asset bubbles. If the capital markets are to play any role in economic development, there is a need for a comprehensive policy initiative covering both regulatory and governance mechanisms to curb the speculative behavior in those markets. Al-Masri (2007) highlights the difference between speculation and investment in stock markets and suggests that although speculators in the market provide liquidity and depth to the market, by trading stocks or futures without actually possessing those assets at any point of time, they ultimately increase speculation in those markets.

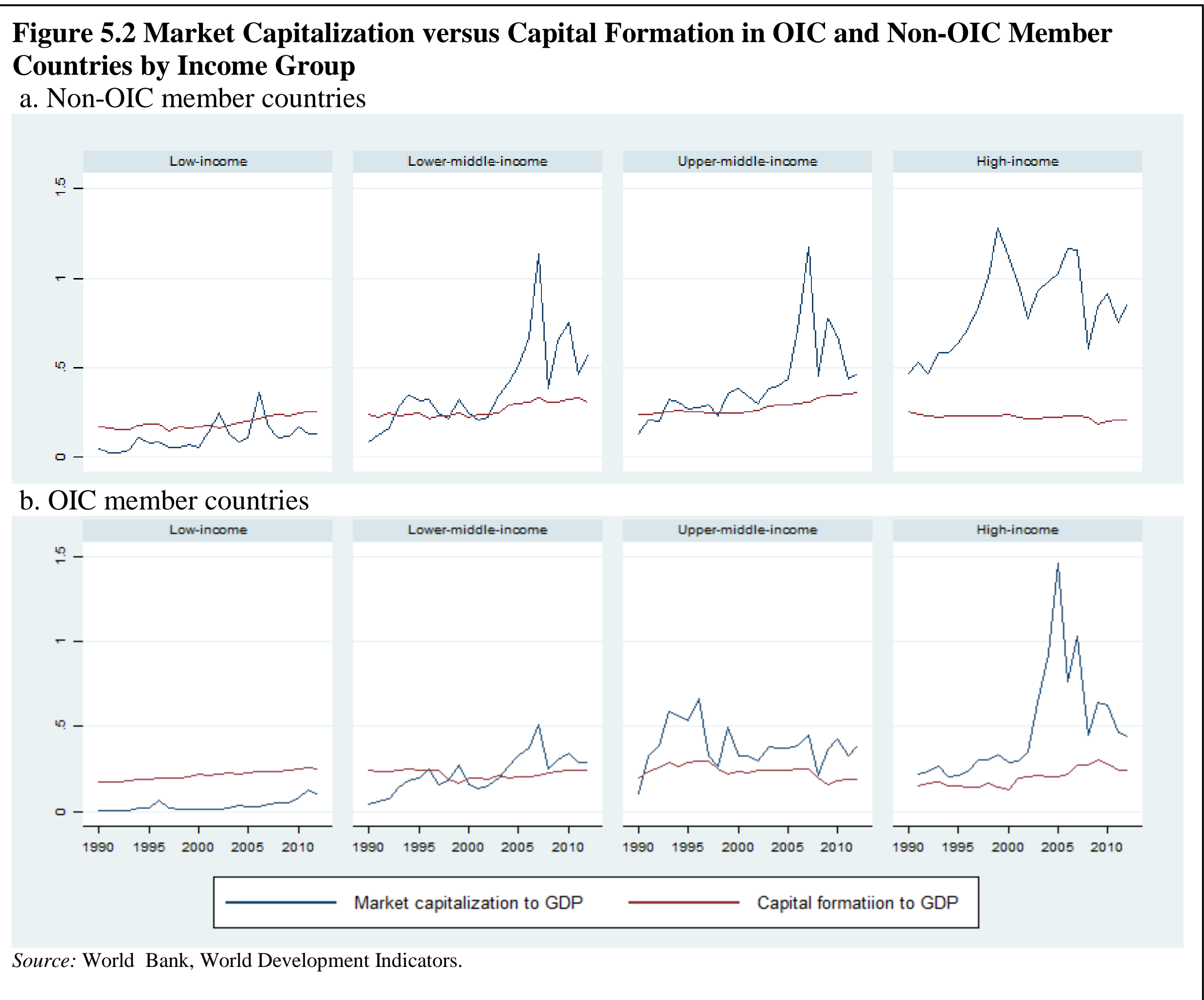


Figure 5.2 Market Capitalization versus Capital Formation in OIC and Non-OIC Member Countries by Income Group

Source: World Bank, World Development Indicators.

Risk-Return Analysis of Main Shari'ah Indexes

Whether to invest in equity stocks through stock markets is a matter of heated debate among Muslim scholars. Some believe that investment in the stock market encourages speculation among market participants, which is not a permissible activity, since the outcome of speculation is similar to the gambling (Taj El-Din 2009). On the other hand, most scholars consider investment through stock markets to be permissible, based on the view that shareholders are similar to the partners in a partnership firm (Naughton and Naughton 2000). However, these scholars endorse only long-term investment, in which an investor seeks dividend income or long-term gains by investing in shares of those companies with sound management, good business model, positive future growth potentials, and *shari'ah* -compliant business activities.

Any investor in the Islamic equity market invests in the shares of *shari'ah* -compliant companies[43] or in a publicly offered portfolio consisting of these equities offered through unit trusts, mutual funds, or exchange traded funds (ETFs). Measuring the performance of fund managers is one of the major challenges for investors in Islamic capital markets. To meet this need, all the major index providers—the Financial Times Stock Exchange (FTSE), Standard and Poor's (S&P), Dow Jones, and Morgan Stanley Capital International (MSCI)—now build and provide Islamic equity index (IEIs) data based on independent *shari'ah* screening criteria at the global, regional, and country level. Each of these index providers follows slightly different screening criteria for including equities in IEIs, based on the interpretation of the *shari'ah* board.[44]

To avoid unnecessary confusion, this report uses *shari'ah* screening standards for performance comparison only as proposed by S&P.[45] Since the scope of this report is global, this chapter provides a detailed analysis of the global and regional index performance. Figure 5.3 compares the performance of S&P *shari'ah*-compliant indexes with that of the conventional indexes. Panel a compares the performance of the S&P Global 1200 with that of the *shari'ah*-compliant version of the same index, entitled S&P Global 1200 *shari'ah*. The performance of the *shari'ah*-compliant index was superior over the entire period. However, a similar comparison of the S&P/OIC COMEC 50 *shari'ah* index,[46] as shown panel b, reveals that the performance of the *shari'ah*-compliant index was quite similar to the index for the 50 biggest listed companies in OIC member-states, as measured by the S&P Frontier Broader Market Index (BMI).

Figure 5.4 provides a similar analysis on the regional level for the S&P indexes. The *shari'ah*-compliant indexes usually outperform the conventional indexes for developed markets in the United States, Europe, and Asia. However, for the Pan-Arab region with a majority Muslim

[43] *Shari'ah*-compliant companies include companies whose major source of revenue comes from permissible (*halāl)* activities. Companies that are excluded are predominantly engaged in any of the following nonpermissible *(harām)* activities: trading of alcohol or pork, pornography, gambling, or from profit associated with the charging of interest on loans.

[44] The general criteria for including any security in an Islamic index depends on two levels of screening: business and financial. Business screening excludes shares of all companies engaged in activities strictly prohibited (*harām*) in Islam. Financial screening further screens those companies that passes the business screen but have a portion of revenue from *harām* activities, such as borrowing or lending money with interest (*ribā*) and/or have a major proportion of assets in liquid form. These screens are based on arbitrary financial ratios and are quite controversial within the Muslim community (Ashraf 2014; Obaidullah 2005). For a detailed discussion of the different screening criteria and their impact on portfolio performance, see Ashraf (2014).

[45] There is no specific reason for the choice of S&P *shari'ah* screening.

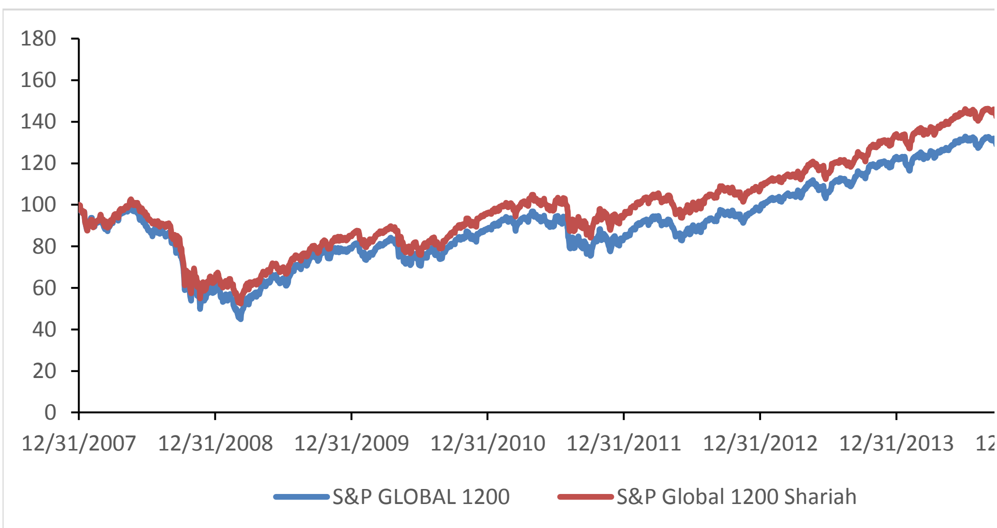
[46] COMCEC is the Standing Committee for Economic and Commercial Cooperation of the Organisation of the Islamic Cooperation.

population, the *shari'ah*-compliant index lags behind the conventional index. This can be attributed to the fact that in developed markets, *shari'ah* screening filters out financial sector companies, resulting in a lean portfolio with lower financial risk. Since most of the listed Islamic banks are in the Pan-Arab region, the performance of the *shari'ah*-compliant index is not very different from that of the conventional index.

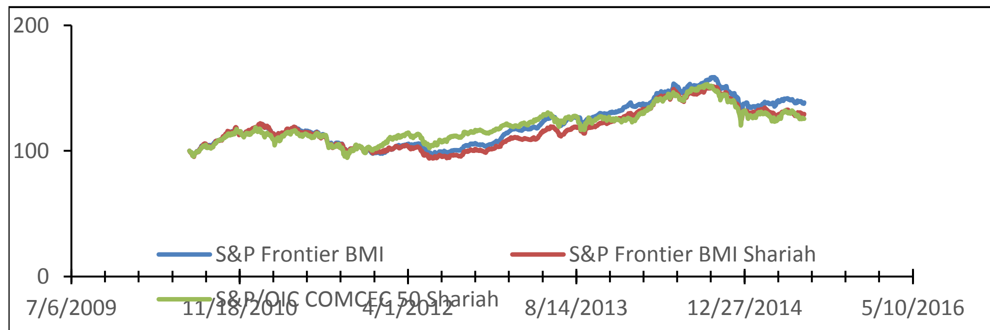
Figure 5.5 provides the sectoral breakdown of conventional indexes versus *shari'ah*-compliant S&P indexes**.** One of the important differences between the indexes is the absence of the financial sector from the Islamic equity indexes. The information technology (IT) sector dominates the Islamic equity indexes globally and in the developed markets of the United States and Japan. The proportion of financial sector firms is similar in the Islamic index and the conventional index for the Pan-Arab region, suggesting the presence of a strong Islamic banking sector. The sectorial breakdown further confirms the assertion that the diversification of the

Figure 5.3 Relative Performance of Conventional versus *Shari'ah*-compliant Stocks, Global Indexes

a. S&P Global 1200 versus S&P Global 1200 *Shari'ah*

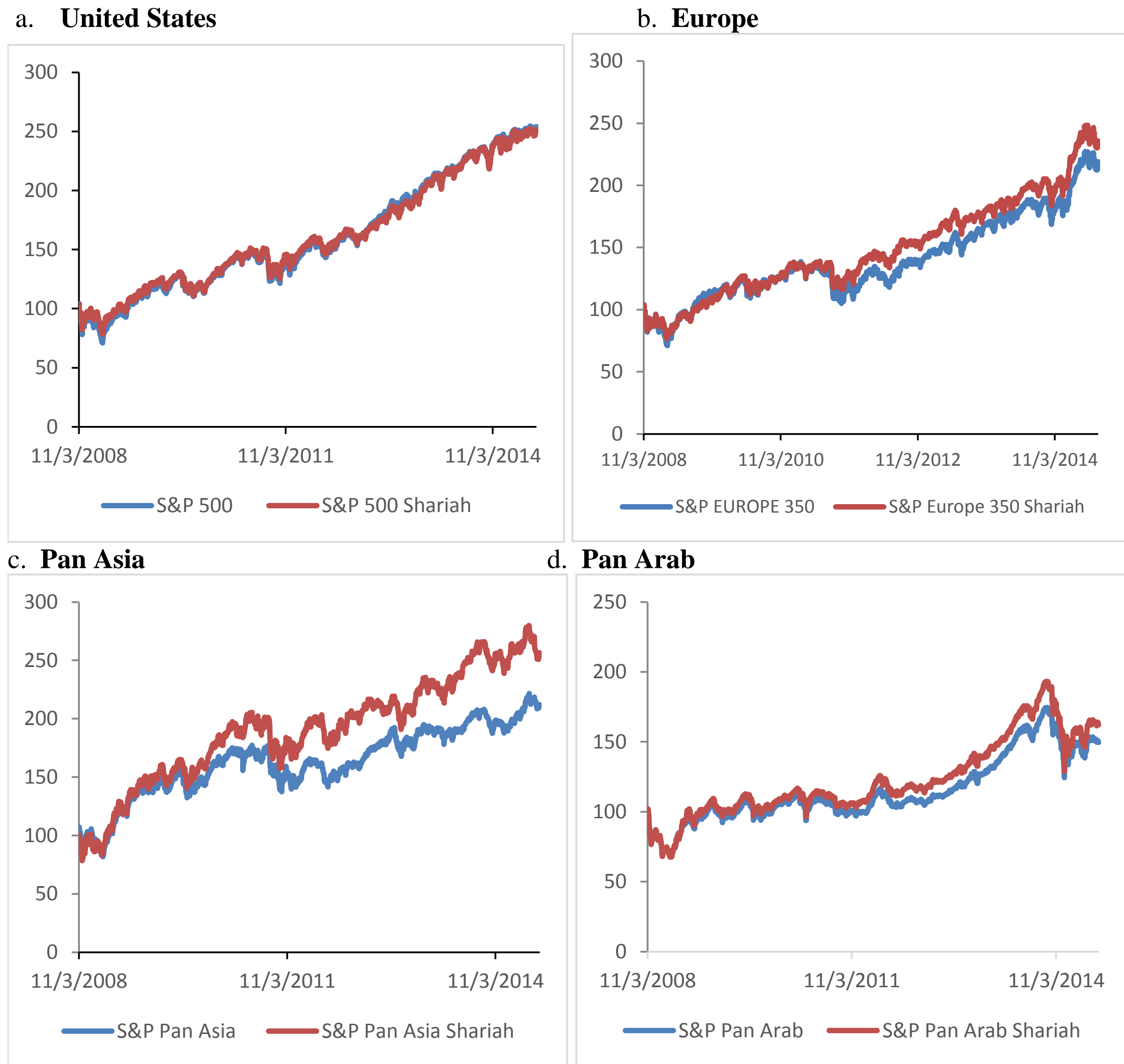


b. **S&P Frontier BMI versus S&P Frontier BMI *Shari'ah* and S&P OIC COMEC 50**



Source: S&P Dow Jones Indexes (http://eu.spindices.com/).

Figure 5.4 Relative Performance of Conventional versus *Shari'ah*-complaint Stocks, Regional Indexes

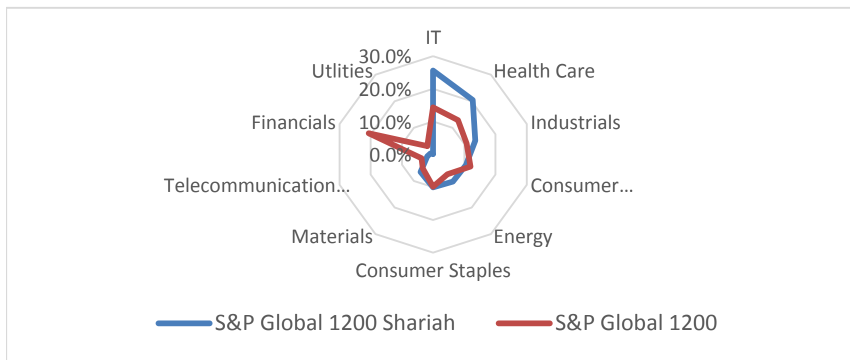


Source: S&P Dow Jones Indexes (http://eu.spindices.com/).

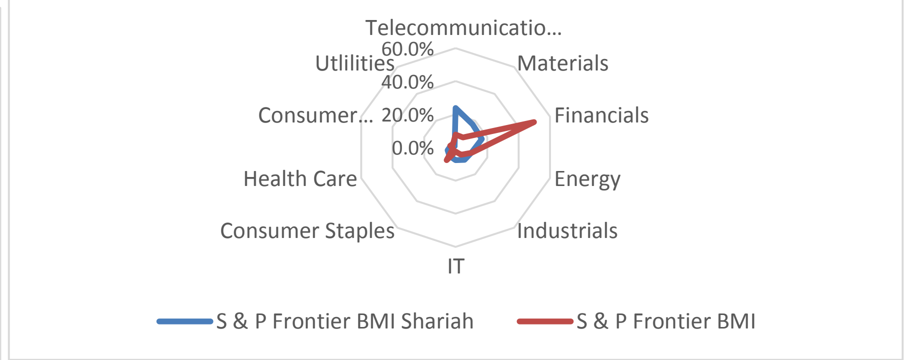
Islamic equity indexes and the conventional indexes are similar, even though a major portion of equities have been screened from the Islamic index.

Figure 5.5 Breakdown by Sector of Major Conventional and *Shari'ah*-Compliant Indexes

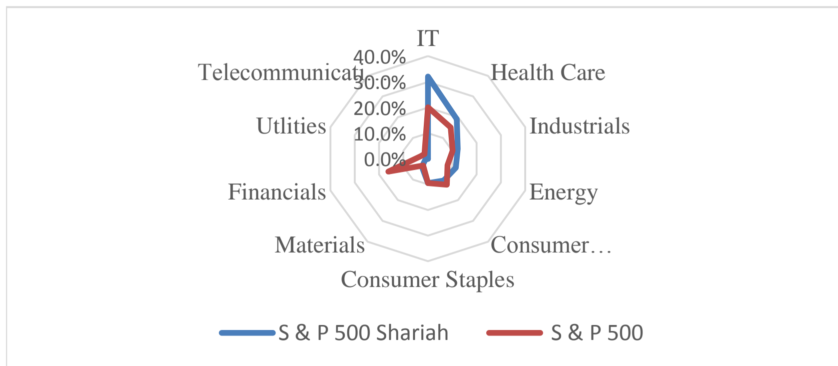
a. Sectoral distribution S&P Global 1200 versus S&P Global 1200 *Shari'ah*



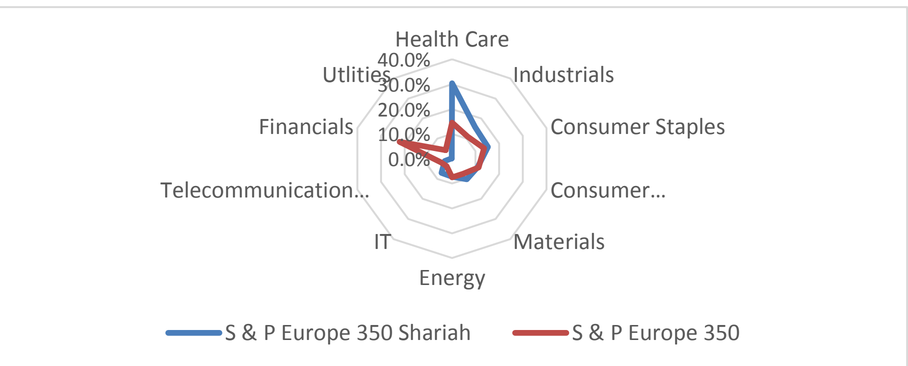
b. Sectoral distribution S&P Frontier BMI versus S&P Frontier BMI *Shari'ah*



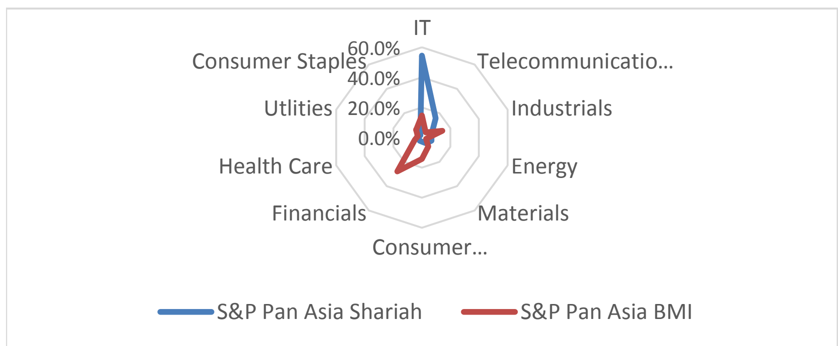
c. Sectoral distribution S&P 500 versus S&P 500 *Shari'ah* (United States)



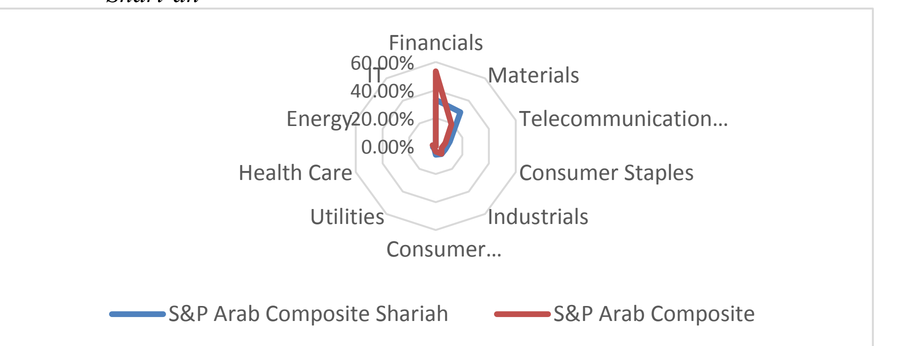
d. Sectoral distribution S&P Europe 350 versus S&P Europe 350 *Shari'ah*



e. Sectoral distribution S&P Pan Asia BMI versus S&P Pan Asia *Shari'ah*



f. Sectoral distribution S&P Arab Composite versus S&P Arab Composite *Shari'ah*



Source: S&P Dow Jones Index Website, various fact sheets as on May 31, 2015.

Table 5.1 reports the return on risk of S&P conventional and *shari'ah* indexes. In terms of excess return, it is evident that *shari'ah* -compliant indexes outperform their benchmark, with the exception of the indexes for the OIC countries and the United States. For the other indicators, the higher correlation, lower tracking error, and positive information ratios clearly indicate that investors in Islamic equities do not have to sacrifice return to reap the benefits of adhering to their faith**.** Although not reported here, a comparison of performance based on the MSCI standard was made following a book value of equity approach. No significant difference was found between

Table 5.1 Measures of Selected *Shari'ah*-compliant Indexes and Benchmark Indexes for Various Holding Periods

Indexes	Variables	5 years	4 years	3 years	2 years	1 year
S&P Global 1200	Excess Return	0.44%	0.58%	-0.30%	0.52%	0.61%
	Tracking Error	2.23%	2.18%	1.87%	1.83%	1.64%
	Information Ratio	0.2	0.27	-0.16	0.28	0.37
	Correlation	0.99	0.99	0.99	0.99	0.99
S&P 500	Excess Return	-0.65%	-0.36%	-0.94%	0.37%	-0.47%
	Tracking Error	2.07%	1.91%	1.68%	1.64%	1.63%
	Information Ratio	-0.31	-0.19	-0.56	0.23	-0.29
	Correlation	0.99	0.99	0.99	0.99	0.99
S&P Europe 350	Excess Return	1.15%	1.99%	-0.28%	-1.00%	2.33%
	Tracking Error	4.99%	4.74%	3.91%	3.60%	3.23%
	Information Ratio	0.23	0.42	-0.07	-0.28	0.72
	Correlation	0.96	0.96	0.96	0.97	0.98
S&P/OIC COMCEC 50 Shariah	Excess Return	-1.63%	-0.99%	-4.49%	-4.51%	-2.97%
	Tracking Error	8.22%	8.43%	8.63%	9.68%	9.14%
	Information Ratio	-0.20	-0.12	-0.52	-0.47	-0.32
	Correlation	0.70	0.69	0.63	0.61	0.70
S&P Pan Asia	Excess Return	4.17%	3.91%	2.14%	2.39%	2.24%
	Tracking Error	8.15%	8.76%	8.68%	9.14%	7.06%
	Information Ratio	0.51	0.45	0.25	0.26	0.32
	Correlation	0.88	0.85	0.77	0.73	0.83
S&P Pan Arab	Excess Return	0.62%	0.97%	-0.01%	-1.05%	-0.76%
	Tracking Error	2.90%	3.00%	3.13%	3.37%	4.02%
	Information Ratio	0.21	0.32	0.00	-0.31	-0.19
	Correlation	0.98	0.98	0.98	0.99	0.99

Source: S&P Dow Jones Indexes (http://eu.spindices.com/).

a. Excess return reflects the excess return of *shari'ah* index over the conventional index.
b. Tracking error is the standard deviation of the excess return.
c. Information ratio is the ratio of excess return to the tracking error.
d. Correlation measures the correlation between the s*hari'ah*- compliant index and its conventional benchmark index.

shari'ah-compliant S&P indexes and the conventional S&P indexes on the global scale or in the developed markets of the United States and the Europe. The similar performance pattern suggests that different *shari'ah* screening standards only add confusion for investors. This further suggests that policy makers and *shari'ah* scholars need to closely work and align these standards to provide a single benchmark to measure performance, to avoid confusing the investing public. A good example is the revision of *shari'ah* screening standards the Malaysia Securities Commission released in November 2013.

In summary, the investors in a passive *shari'ah*-compliant portfolio do not lose in terms of diversification or returns, whether on a nominal or risk-adjusted basis. The performance of *shari'ah*-compliant portfolios is at least as good as the performance of more diversified portfolios with higher financial and lower operating leverage. Since the Islamic portfolio represents shares of those companies in the real sector, it thus helps create more jobs and distribute wealth more equitably.

The Status and Contribution of the Asset-based Securities (Ṣukūk) Market to Economic Development with Shared Prosperity

Global Trends in Ṣukūk

Ṣukūk products have been used to raise funds for businesses, support economic development, provide government financing, and manage liquidity in financial institutions. Because they are different from stocks and can be adjusted to various contractual forms and structures, they suit the needs of both the investors and seekers of funds. *Ṣukūk* have been growing globally since the debut of first global *ṣukūk* in 2001. In 2014 alone, *ṣukūk* issuance totaled $133.26 billion from 22 domicile countries. Of the 826 issues, 54 were international and 772 were domestic. The total *ṣukūk* outstanding was $310.95 billion as of year-end 2014. Table 5.2 presents summary statistics, while figure 5.6 provides a breakdown of *ṣukūk* issuance by currency from 2001 to 2014. The U.S. dollar-denominated *ṣukūk* have been growing, but *ṣukūk* denominated in Malaysian Ringgit (MYR) are growing even faster and dominate the market. In the first half of 2015, 302 *ṣukūk* were issued, amounting to $36.845 billion.[47]

Table 5.2 Status of *Ṣukūk* as of December 31, 2014

Status	Amount ($ billion)
Announced	71.16
Defaulted	1.71
Redeemed early	13.83
Outstanding	310.95
Redeemed	451.57
Restructured	103.97
Total	953.11

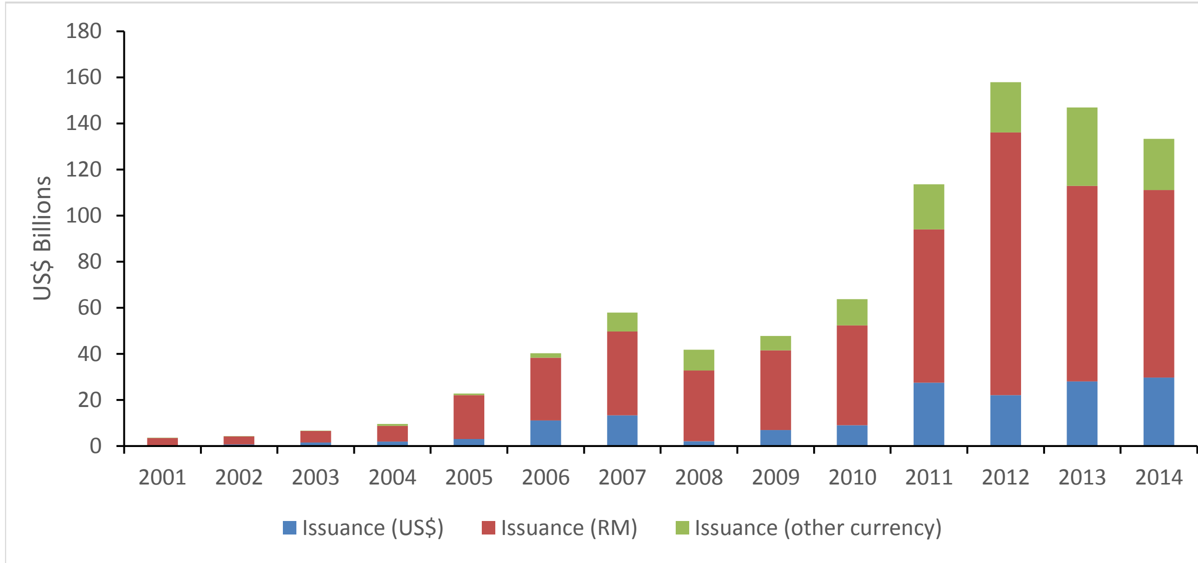
Source: Islamic Research and Training Institute (IRTI) calculations based on IFIS (Islamic Finance Information Service) data.

After dipping slightly in 2008 in the aftermath of the global financial crisis, *ṣukūk* issuance has risen and has surpassed the pre-crisis amounts. *Sukūk* issuance peaked in 2012 at $218.3 billion. In 2013 and 2014, issuance declined (see figure 5.6). However, the market is gaining strength and getting established; during the same period, some very large size *ṣukūk* were issued. The total issuance per year for the last four years has been well above $100 billion—a level that was not anticipated after the global financial crisis.

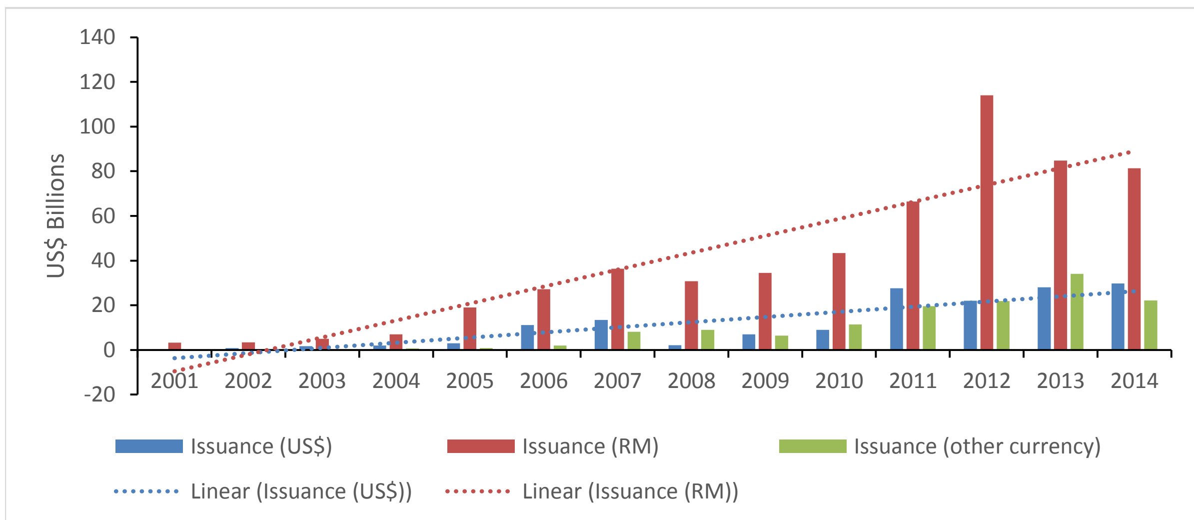
[I] IRTI calculations based on data from Zawya.

Figure 5.6 *Ṣukūk* Issuance, 2001–14

a. Total *ṣukūk* issuance



b. *Ṣukūk* issuance by currency



Source: IRTI calculations based on IFIS data.
Note: RM = Malaysian ringgit.

Regional Analysis

A regional analysis using four major regions—Asia, the Middle East and North Africa (MENA), Africa,[48] and Europe and North America (Europe/NA)—shows that the bulk of the market is dominated by Asia, followed by MENA region (table 5.3). Within Asia, Malaysia has been dominating the *ṣukūk* issuance market. The cumulative amount and percent of *ṣukūk* issued from 2001 to 2014 was $639.9 billion (75 percent) in Asia, compared to $108 billion (13 percent) in MENA, $91 billion (11 percent) in the Europe/North America (ENA) region, and about $10.75 billion (1 percent) in Africa (see figure 5.7, panels a and b). The pattern of *ṣukūk* amounts outstanding is similar across the regions (see panel c).

Table 5.3 Status of *Ṣukūk* by Region, 2001–14

a. Amount ($ billion)

Status	Asia	MENA	Europe/NA	Africa	Others
Announced	34.56	22.68	7.37	6.05	0.50
Defaulted	0.70	0.65	0.37		
Redeemed early	6.08	4.29	3.46		
Outstanding	207.89	42.60	57.31	3.14	
Redeemed	390.65	37.76	21.57	1.59	
Restructured	0.02	0.1	0.92		
Total (regional)	639.90	108.09	91.00	10.78	0.50

b. Number of issuances

Status	Asia	MENA	Europe	Africa	Others	Total
Announced	39	25	16	7	1	88
Defaulted	46	1	2	0	0	49
Redeemed early	135	4	5	0	0	144
Outstanding	2,030	70	108	62	0	2,270
Redeemed	5,396	264	54	378	0	6,092
Restructured	1	1	1	0	0	3
Total	7,647	365	186	447	1	8,646

Source: IRTI calculations based on IFIS data.
Note: Europe/NA = Europe and North America.

In 2014 and 2015, several new jurisdictions progressed toward issuing *ṣukūk*, particularly in Africa. Some huge *ṣukūk* at the sovereign and quasi-sovereign levels were launched in MENA and Asia. These include:

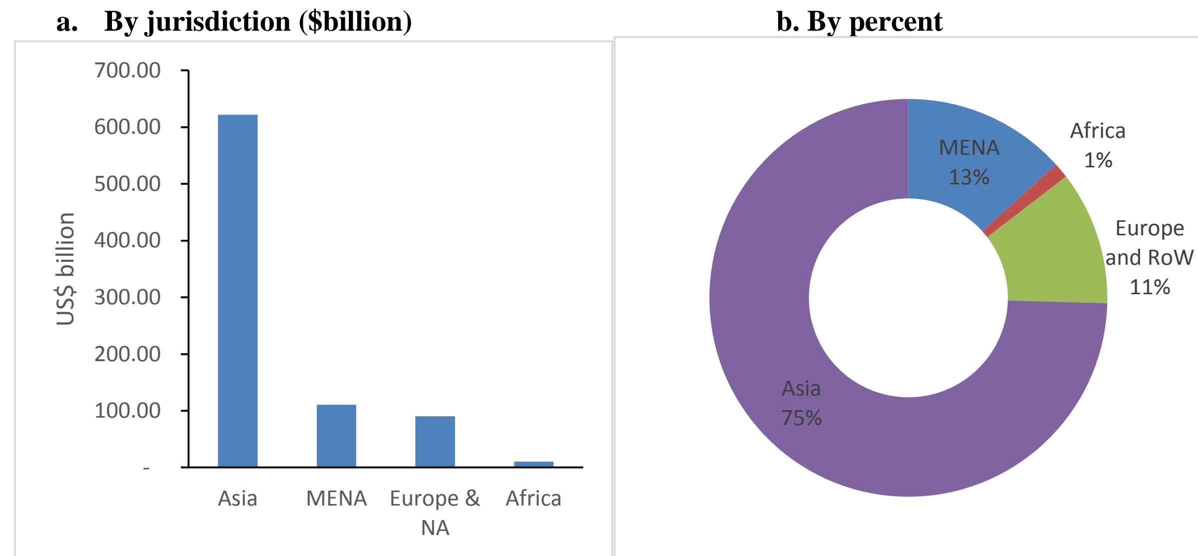
- Saudi Aviation *ṣukūk* of $7.7 billion to purchase 50 Airbus aircraft.
- Saudi Aramco SADARA Basic Service Company *ṣukūk* to fund construction of a chemicals and plastics complex (Saudi Arabian Riyal-denominated, totaling $2 billion).

[48] For purposes of this chapter, Africa refers to Sub-Saharan Africa, excluding North Africa.

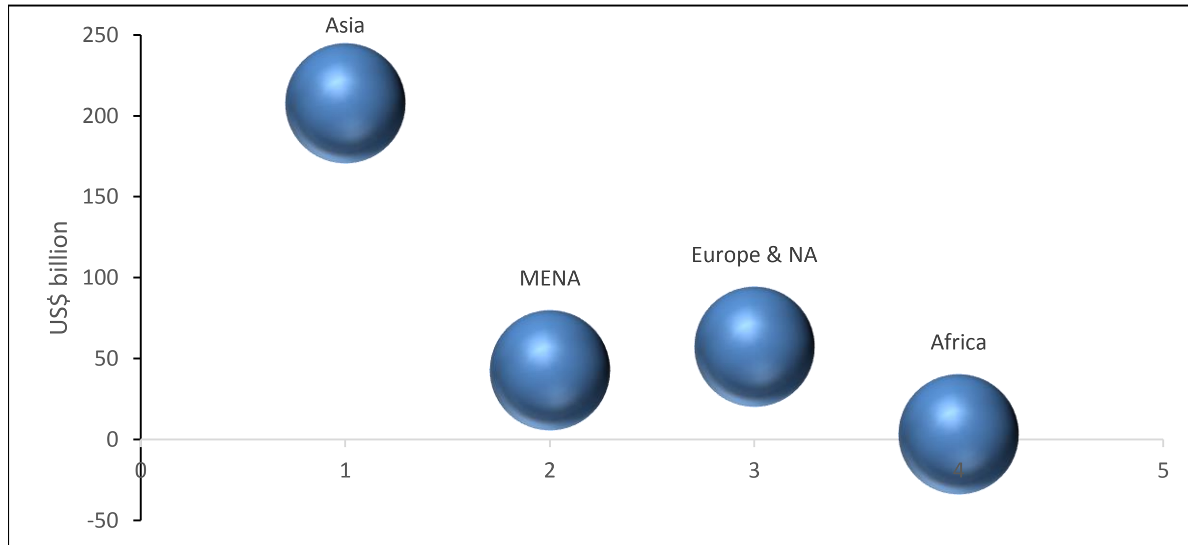
- Malaysia Trust Certificates (*ṣukūk*) of $1 billion with a 10-year maturity and $500 million

Figure 5.7 Cumulative Issuance of *Ṣukūk*, 2001–14

a. By jurisdiction ($billion) **b. By percent**



c. Outstanding amount at end-2014



Source: IRTI calculations based on IFIS data.
Note: NA=North America; RoW=rest of world.

with a 30-year maturity. These were long-term *ṣukūk,* and all of them were oversubscribed.

- The Islamic Development Bank (IDB) has announced expansion of its Medium-Term *Sukūk* Program from $10 billion to $25 billion, and plans to issue at least one *sukuk* publically each year with minimum size of $1 billion.

- Several Islamic financial institutions (IFIs) have issued perpetual *ṣukūk* to create a risk-absorbing capital buffer and to use as High Quality Liquid Assets (HQLA) to meet the capital requirement of the Basel III Accord. While this does not promote shared prosperity directly, it does so indirectly by strengthening IFIs, helping them manage their risks, and supporting a continuity of their own business operations that ultimately support the operations of the businesses they invest in.
- Despite these developments, more innovation on the *fiqh* and *shari'ah* regulatory side is needed to expand the horizon of *ṣukūk* and provide refinements to the structuring and operational practices. Nonetheless, every new *ṣukūk* structure and issuance must undergo evaluation and be endorsed for *shari'ah* compliance. Thus some degree of innovation and changes in practices is taking place.

A Framework for and Analysis of the Contribution of Ṣukūk to Shared Prosperity

Knowing whether *ṣukūk* are actually contributing to the socioeconomic development and shared prosperity, and if so, by how much, are difficult tasks. However, some informed assessment of *ṣukūk*'s contribution can be made at the macro level by analyzing various dimensions and compositions of *ṣukūk*. That is the focus of this section. The section that follows presents a micro-level analysis in the form of case studies.

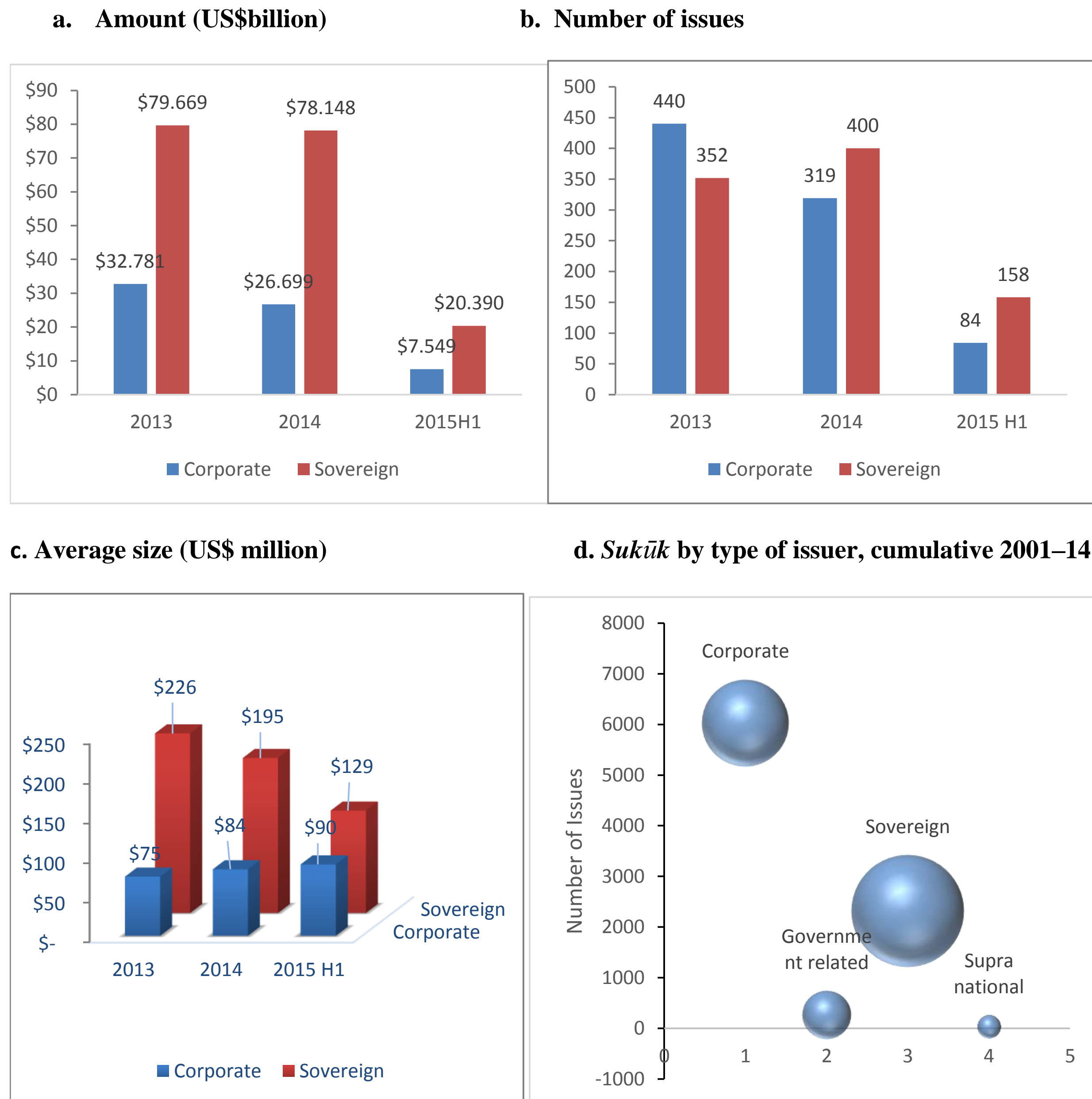
The proportion of sovereign *ṣukūk* in the total issuance compared to the proportion of corporate *ṣukūk* issuance can reflect the extent of public versus private benefits generated in the economy. However, assuming that private sector is more efficient than the public sector, the break-down of sovereign versus corporate issuances can represent different levels of effectiveness in their economic impact. In this regard, both the size and the number of issuances can be analyzed. The average size of the *ṣukūk* and the long-term versus short-term maturity can also shed light on the possible economic impact over time. The intended use of the funds and the nature of projects and economic subsectors they will support also matter for their impact on the economic development of a country or a region. Since various economic sectors differ in terms of factor intensity, the choice of sector can also have varying implications for job creation and employment generation. *Ṣukūk* that support the development of infrastructure projects can have long-term and economy-wide impact, compared to general-purpose *ṣukūk*. Similarly, the accessibility of diversified kinds of investors, including the general public, to *ṣukūk* purchases has implications for generating savings and channeling them for productive use. The retail-denominated *ṣukūk* units can diffuse the benefits of *ṣukūk* more quickly, compared to the large unit value *ṣukūk* targeting only institutional investors. Moreover, diversifying the investor base by also attracting the retail investors can help in creating an active secondary market in *ṣukūk*. The more diverse the investor base, the more likely their investment holding horizon will be asynchronous and hence the more likely the *ṣukūk* will change hands during the maturity period, creating a liquid market. All these comparisons and judgments mentioned are only heuristic because many other factors at the implementation stage, as well as the finer details of the *ṣukūk* structure, matter for the attainment of economic impact and the sharing of prosperity. Nonetheless, the various ratios and proportions-based criteria can help gauge the direction of the development of the *ṣukūk* market.

Sovereign versus Corporate Issuance

Sovereign issuers dominate the market in terms of the amounts, number, and average size of *ṣukūk*. In 2013, 2014, and the first half of 2015, the total amount of sovereign issuance was

much higher than the total corporate issuance (see figure 5.8, panel a). The number of sovereign issues was lower than corporate issues in 2013, but the situation reversed with higher proportion of sovereign issues in 2014. The trend continued in the first half of 2015 (panel b). Despite this,

Figure 5.8 Characteristics of the *Sukūk* Market



Source: IRTI own calculation based on data from Zawya data and IFIS.

Note: 2015H1 = first half of 2015.

the average size per issue of sovereign *ṣukūk* had been higher than the average size of corporate *ṣukūk* (panel c). Overall, corporate *ṣukūk* issuance remained higher from 2001 to 2014 however, sovereign issues dominated the market in terms of size during the same time period (panel d).

Since the motivations of the government as an economic agent are more social as compared to the motivations and decision-making criteria of other economic agents such as private sector businesses, sovereign *ṣukūk* are expected to generate wider socioeconomic impacts through the provision of public goods and services, as well as infrastructure development. Sovereign issuance also has positive implications for the development of the *ṣukūk* market by providing confidence and assurances of the continuity of the market development policies. However, if the *ṣukūk* mechanism is used by governments simply to finance their current expenditures, then sovereign issuance can contribute to financial repression and crowding out of private investment.

Maturity Structure

The maturity structure of the *ṣukūk* instruments is presented in figure 5.9. Short-term *ṣukūk* with tenor of one year or less are the dominant kind, both in the number and in the total amount per year (panel a). These are mostly based on commodity *murābaḥah* or *ʿīnah* sale or *tawarruq* transactions,[49] and commonly used either for liquidity management by financial institutions or for providing short-term finance. The trend to issue very short-term *ṣukūk* of three months or less is increasing. Long-term *ṣukūk* with a maturity of 10 or more years have been declining and are relatively rare. Medium-term *ṣukūk* with maturities between 3 to 5 years and 5 to 7 years occupy a middle ground but are increasing.

Sukūk by Type of Contractual Structure

Murābaḥah-based *ṣukūk* account for 38 percent of the cumulative amount of *ṣukūk* issued from 2001 to 2014, followed by *ijarah* (15 percent) and *Bai Bi-Thaman Ajil* (BBA) (12 percent) (figure 5.10). A disadvantage of *murābaḥah ṣukūk* is that they are not tradable in the secondary market;[50] this reduces their potential to change and diversify ownership through secondary trades and lowers the potential for shared prosperity. Moreover, a large proportion of these *murābaḥah ṣukūk* are issued only to manage liquidity. Hence they do not directly contribute to economic development; they contribute only indirectly, by strengthening Islamic financial institutions.

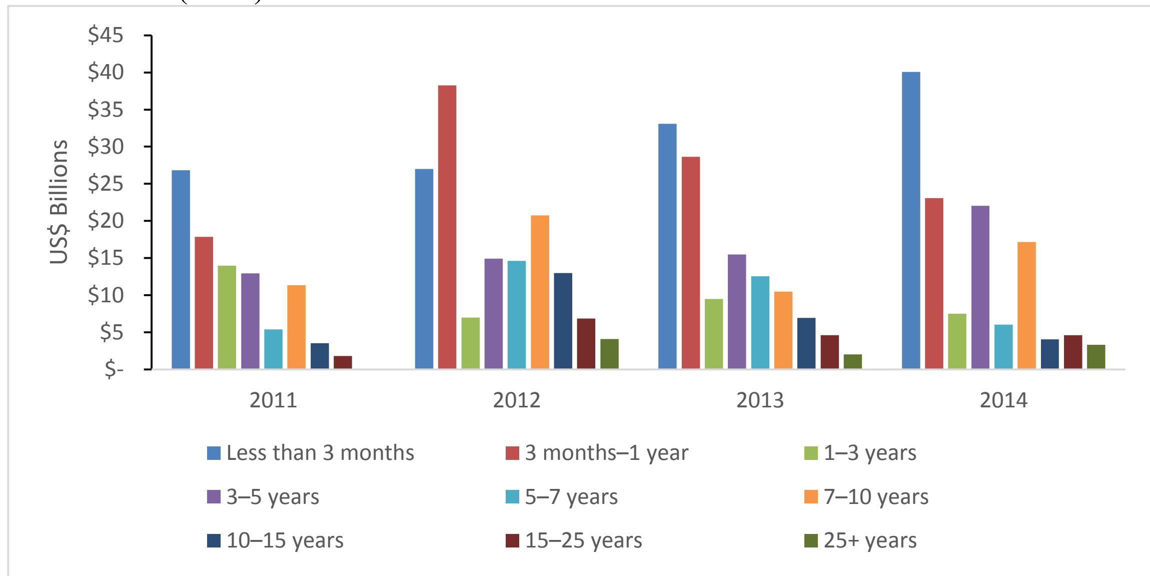
The composition of the types of contractual structure used in *ṣukūk* has kept changing since 2001. In recent years, the most commonly used structure has been *ijarāh* (43 percent). This has been followed by *wakalah* (34 percent), which are becoming more prominent (see table 5.4). *Murābaḥah* constituted a smaller proportion (13 percent) in 2013−14. Factors for these changes include *shari'ah* rulings and revisions in the standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). However, the main drivers of change have been issuers' quest to issue *ṣukūk* without the requirement of qualifying assets, and investors' demand for secured returns

[49] See glossary for definitions of *murābaḥah, ʿīnah* sale, *tawarruq,* and other Arabic terms.

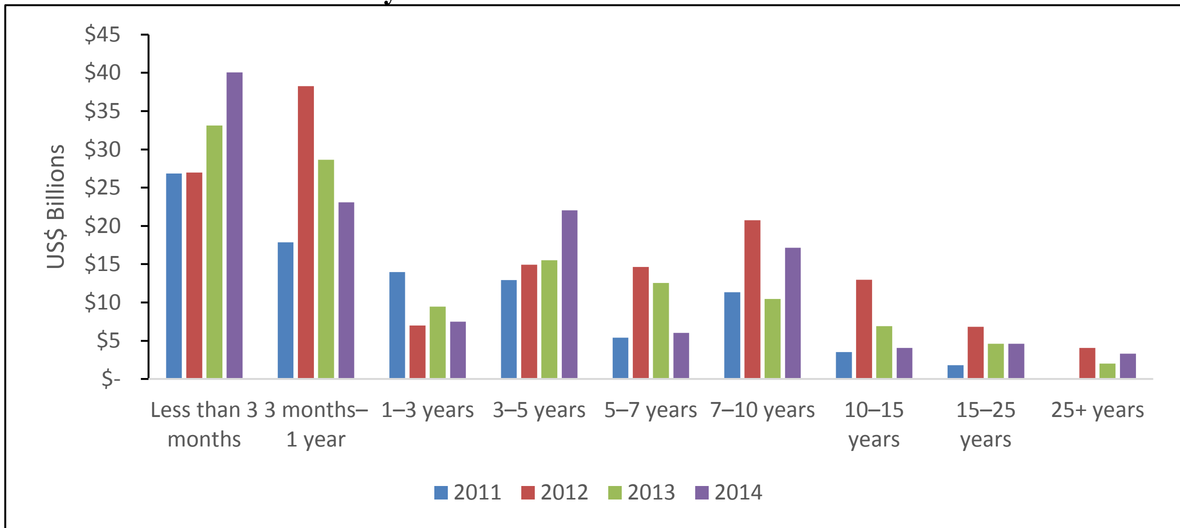
[50] The *Murābaḥah* sales contract creates a cash receivable as the asset of the seller. This type of asset cannot be traded at a premium or discount. However, this *Shari'ah* restriction is not operational in Malaysia, which differentiates between a loan (pure debt) and debt resulting from a sale of commodity on a deferred price (trade-generated debt). The trade-generated debt is tradable in the secondary markets in Malaysia.

Figure 5.9 Maturity Structure of *Şukūk* Instruments

a. Duration (tenor)



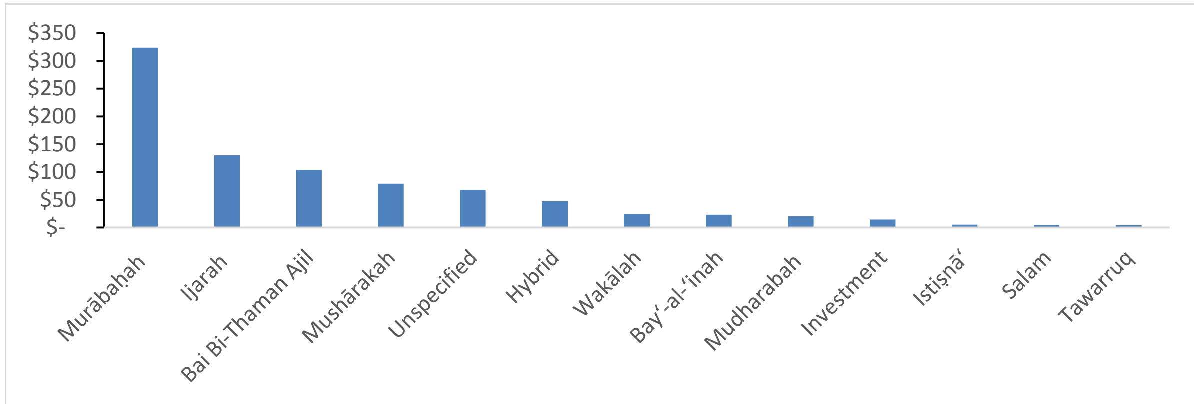
b. Trends in each maturity bucket



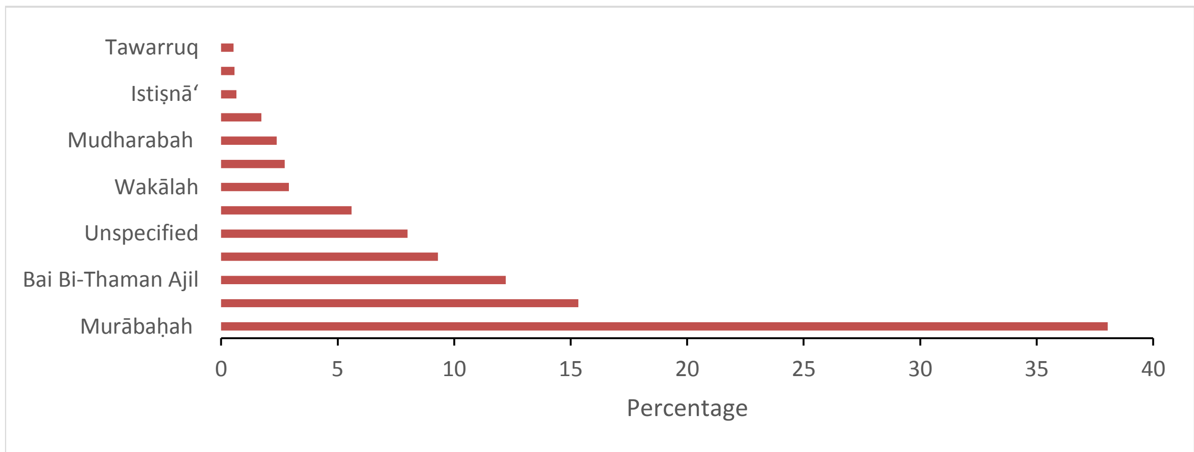
Source: IRTI based on IFIS data.

Figure 5.10 *Ṣukūk* by Structure, 2001–14

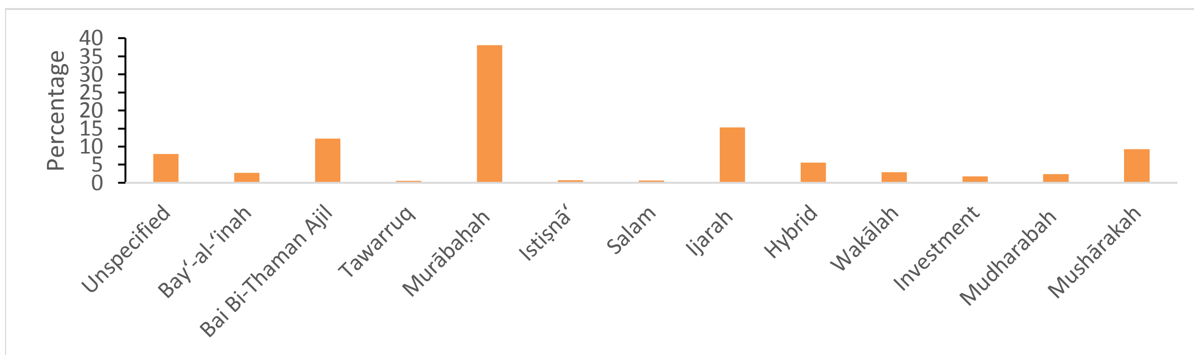
a. **Amount ($billion)**



b. **Percentage share of each structure, 2001–14**



c. **From pure debt to pure equity *ṣukūk* (left to right)**



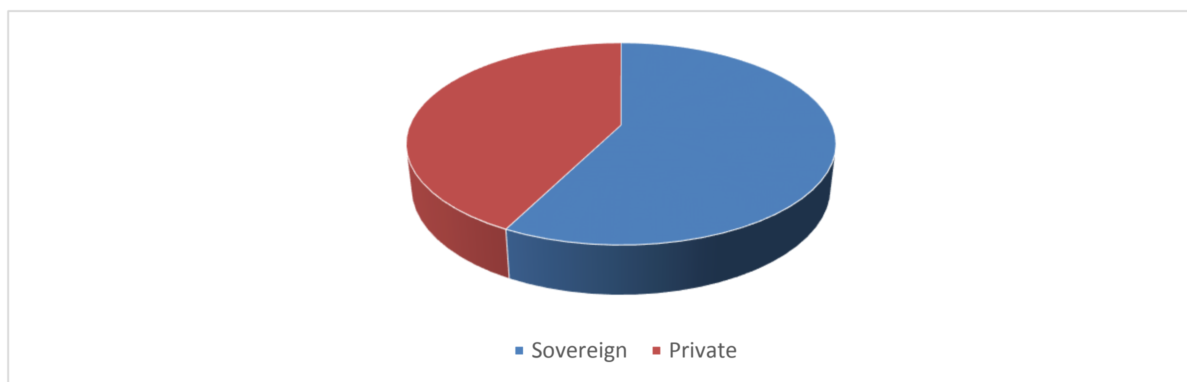
Source: IRTI based on IFIS data.

Ṣukūk Issuance by Sector

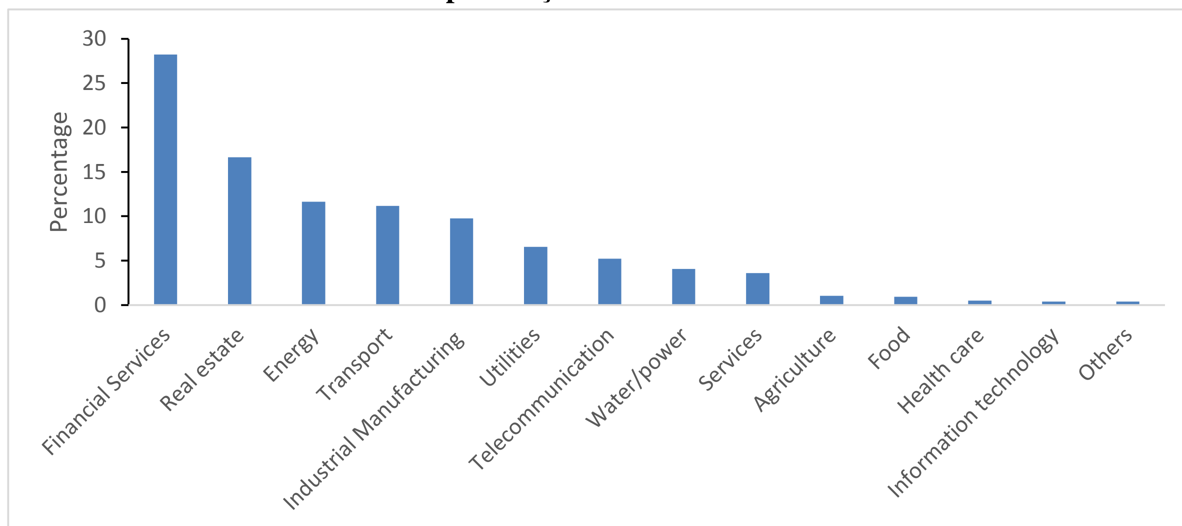
Sovereign *ṣukūk* had a larger share of the market (58 percent) than private *ṣukūk* (42 percent) from 2001 to 2014 (figure 5.11, panel a). For private *ṣukūk*, the largest share of the total cumulative *ṣukūk* issuance has been for the financial sector (12 percent), followed by real estate (7 percent), energy (5 percent), transport (5 percent), industrial manufacturing (4 percent), utilities (3 percent), telecommunication (3 percent), water and power (2 percent), and services (2 percent) (panel b). Issues for agriculture, food, health care, education, and other sectors has been very small. This has been the case from 2001 to 2014. In recent years, there has been increase in the share of sovereign issuance and in the share of issuance for financial sector, while issuance for other private nonfinancial sectors has declined. In 2013–14, the share of sovereign issuance and financial sector

Figure 5.11 *Ṣukūk* Issuance by Sector, 2001–14

a. **Sovereign or private Issuance (percentage)**



b. **Percent of cumulative issuance for private *ṣukūk***



Source: IRTI, based on IFIS data.

issuance reached 61.4 percent and 21.5 percent, respectively, while the issuance for private nonfinancial sector declined to 17 percent.[51]

Table 5.4 *Ṣukūk* by their Underlying Contracts

Underlying contract structure	2013–14		2009–12	
	($ million)	**Percent**	**($ million)**	**Percent**
Ijarāh	17,295	43	19,085	48
Wakālah	13,628	34	10,670	27
Murābaḥah	5,047	13	1,942	5
Hybrid	1,964	5	5,408	14
Mudharabah	1,599	4	1	0.002
Mushārakah	391	1	2,605	6

Source: International Islamic Financial Markets (IIFM) *Ṣukūk* Report 2014.

Economic Development and Shared Prosperity through Ṣukūk Markets

Potential for Infrastructure Financing

Physical infrastructure plays an important role in the socioeconomic development of countries and regions in many ways both during its construction phase and for a long period after its construction. It helps long-term development by lowering the costs of economic activity and by facilitating connections and networks. Its benefits reach a wide range of the population, thus contributing to shared prosperity. Often the investments required for such infrastructure projects are quite large and long term. A common problem encountered is the mismatch in maturities between the underlying assets and funding.

Some projects can generate revenues, while others may be in the nature of a public good. In such cases, some kind of public-private partnership may be needed. Yet another issue is scalability: Some projects may offer sufficient incentives for the private sector to step-in, but the size of the individual projects may be small and thus have little or no economy-wide impact. Scaling up and coordination would be required to have a wider development impact. An example could be renewable energy projects, such as those promoting wind power. Each windmill is a small investment, but thousands of windmill generators are required to create an economy-wide impact.

Harmonization and connectedness of one infrastructure project with another are also important. For example, the usefulness and impact of some infrastructure projects in one country can depend on the development of coordinated infrastructure projects in neighboring countries. The impact of a cross-country highway built in country A will be enhanced if a highway is also constructed in country B and linked to it. The impact of the infrastructure will be amplified both nationally and regionally. This implies the need for regional initiatives for large infrastructure projects and coordinated issuance of *ṣukūk*.

In short, infrastructure investment requires more than a financial instrument. On the financial instruments side, it requires scalability and liquidity so that all types of investors are able to participate. On the institutional side, it requires supportive laws, adequate enforcement, and good governance to create an environment where just and fair treatment of all parties is ensured.

[51] Percentages for 2013–14 are based on the IFSB, 2015 *Islamic Financial Services Stability Report*.

On the political side, it requires coordination and public will. On the financial sector side, it requires domestic banking and nonbanking financial institutions, along with capital markets.

Given these complexities, less developed countries tend to rely more on external debt and foreign aid for infrastructure projects. This adds to their debt burden, particularly when projects get delayed or remain incomplete or are even abandoned because of the institutional development difficulties mentioned. Even for better performing developing countries, only 2.5 to 3 percent of infrastructure investment comes from international donors (World Bank 2013). Private sector financing from the big private international banks is also drying up, as these banks are also facing deleveraging and will not be funding large infrastructure projects.

In this environment, *ṣukūk* have the opportunity to play a role in increasing shared prosperity (see Ali 2014). Given that the size of Islamic capital market is small, a strategic use of sovereign and quasi-sovereign *ṣukūk* can be made to finance crucial enabling infrastructure projects that can facilitate further inflows of private funding for infrastructure. Project-specific *ṣukūk*, instead of general purpose *ṣukūk*, would be ideal to overcome some of the problems encountered in infrastructure financing. *Sukūk* can facilitate risk sharing between the investors, the project company, government, and the operators. These risk-sharing arrangements can vary in different parts of a large project. Financing infrastructure would also require longer-term *ṣukūk*.

Possibilities for Social Inclusion and Poverty Alleviation through Awqaf

The nonprofit, voluntary sector is a privately initiated sector the provides social goods and works in parallel to the government public sector. *Awqāf* (singular, *waqf*) a kind of trust institution; see glossary) can be used to support the voluntary sector. *Awqāf* can be used not only to provide immediate necessities to the poor, but also to create or strengthen business support institutions that can lower the cost of doing business for the poor. *Awqāf* can also be used to support and build infrastructure institutions that can improve corporate governance and reduce the cost of doing business. For example, information bureaus, market regulatory bodies, the provision of accountancy services, and other such shared services for a group or for the entire society can be funded through *waqf*.

Many of the properties of *awqāf* are amenable to securitization through the issuance of *ṣukūk* on the usufruct of those properties. The proceeds can be used to expand operations and build new social projects. These *ṣukūk*, like government *ṣukūk*, have multiple benefits. They help expand the provision of social goods and services. The issuance and performance of these ṣukūk require appropriate monitoring, reporting, and payments mechanisms. Thus, as a byproduct, these ṣukūk foster institutionalization of reporting and monitoring practices that can also become useful for the entities in the for-profit sector. By fostering shared institutions, *awqāf* can help reduce the cost of doing business. Equally important, the public provision of social goods through the voluntary sector such as *awqaf* builds mutual trust in society, which is a requirement for exponential growth and economic development.

Ṣukūk for Socioeconomic Development: Experiences and Lessons

***Case 1. The Islamic Development Bank's Use of Ṣukūk for Development Financing*[52]**

The Islamic Development Bank (IDB) promotes economic development in its 56 member-countries, as well as in Muslim communities in non-member countries. It has traditionally relied on capital contributions from its members to fund its operations. As the demands for development assistance has been rising faster than the Bank's equity capital, the IDB has been resorting to the capital market. Its debut issue in 2003 of a stand-alone, five-year, $400 million *ṣukūk* was done as an experiment with the market and to convey the IDB's intentions of using market resources in the coming years.

In 2005, IDB established its $1 billion Medium-Term Note (MTN) Program, which allowed issuance of *ṣukūk* in multiple currencies as and when needed (box 5.1). The program was initially listed on the Luxemburg Stock Exchange, but was later shifted to the London Stock Exchange and Bursa Malaysia. The MTN program was updated and expanded several times in tandem with the Bank's growing operational funding needs. It was increased to $10 billion in 2013. By 2014, it was listed in multiple markets, including Nasdaq Dubai, to further enhance IDB's *ṣukūk* profile and improve its liquidity for investors. In June 2015, IDB increased the ceiling of its *ṣukūk* program from $10 billion to $25 billion, in keeping with its aim to expand its financing across member-countries. The expanded program will take advantage of IDB's AAA-rating. It seeks to issue one *ṣukūk* publicly every year, with a minimum size of $1 billion, while keeping pace with growing investor requests for private placements.

The proceeds from the *ṣukūk* are mainly used to complement IDB's equity resources for its development funding. The funding needs are expected to grow 10 percent a year in the years to come. So far, using proceeds from the *ṣukūk,* the Bank has been able to expand its development assistance in energy, infrastructure, agriculture, health, and other sectors to its member-countries. This has been achieved at a much lower cost than what the beneficiary countries would have paid if they had raised the funds themselves from the international markets.

IDB *ṣukūk* can be termed as hybrid balance sheet assets *ṣukūk,* as these *ṣukūk* are issued against a specified pool composed of *ijārah* (leasing) and non-*ijārah* (non-lease) assets segregated from the balance sheet of IDB. The asset pool contains a significant proportion of *ijārah* compared to receivables (or nontangible assets) so that the composite pool itself can be considered as a tangible asset class for all practical purpose and in the legal classification. Hence the laws pertaining to tangible asset class are applicable to it, and the *ṣukūk* issued against this pool become eligible to receive a return and also eligible for sale in the secondary market, making them liquid. Each issuance of *ṣukūk* represents a different pool. *Ṣukūk* cannot be issued against the same assets until those assets come back into the ownership of IDB.

Using this type of *ṣukūk* structure for development funding poses challenges. In order to be continually able to issue *ṣukūk* backed by assets, the Bank must be able to increase the creation of tangible assets or tradable contracts in the IDB balance sheet more quickly before it can issue further *ṣukūk.* Moreover, most of the assets held by IDB on its balance sheet are development

[52] This case is based on Ali (2014).

projects or development financing contracts that are not rated; because they are development-oriented, they do not generate commercial rates of return. How to induce investors to accept low-return *ṣukūk* in the market is a challenge.

Box 5.1 Issuances in IDB's Medium-Term Note Program

Under the Medium-Term Note (MTN) Program, IDB had issued 17 series of *ṣukūk* as of April 2014. In 2015, IDB announced that it intends to issue up to $25 billion in *ṣukūk* cumulatively over the next several years under the MTN program, with at least $1 billion issued each year.

In addition to the above, IDB also issued three tranches of Malaysian Ringgit (RM) *ṣukūk* in 2008, 2009 and 2013, with a cumulative total of RM 700 million, under a different MTN Program of RM billion, with maturity dates of August 2013, March 2014, and August 2018 respectively.

Series	Currency	Amount (million)	Type of Issuance	Issue date	Maturity date
1	US$	500	-	2005	June 2010
2	SRls	200	Private placement	2009	September 2012
3	US$	850		2009	September 2014
4	SRls	1875	Private placement	2010	September 2020
5	SRls	1875	Private placement	2010	September 2020
6	US$	500		2011	October 2015
7	£	60	Private placement	2011	February 2016
8	US$	750		2011	May 2016
9	£	100	Private placement	2012	January 2017
10	US$	800		2012	June 2017
11	£	100	Private placement	2012	August 2015
12	US$	300	Private placement	2012	October 2015
13	US$	500	Private placement	2012	October 2017
14	US$	700	Private placement	2013	March 2018
15	US$	1000	Public issuance	2013	June 2018
16	US$	1500	Public issuance	2014	March 2019
17	US$	100	Private placement	2014	April 2017

Source: Omar and others 2014

Therefore, IDB *ṣukūk* are asset-based rather than asset-backed. This essentially means that the ultimate recourse in case of default on the *ṣukūk* would be to IDB as the obligor and originator of the *ṣukūk* through a Special Purpose Vehicle (SPV), rather than the *ṣukūk* assets itself. This does not meet AAOIFI *ṣukūk* standards or conform to the views of majority of *Sharīʿah* scholars, who hold that *ṣukūk* should represent undivided ownership in the specified assets (or pool of assets) that are sold to the SPV and held in trust with it. This would justify the periodic payments (rents) to the *ṣukūk* holders as the de facto owners of the underlying assets. In case of default, they would have recourse to those assets in some form. However, this defect exists and the reasons for this anomaly in IDB *ṣukūk* are economic and legalistic in nature. Thus, to give comfort or rather to enhance the credit profile of its *ṣukūk*, IDB has to link the performance of the *ṣukūk* to the Bank's credit strength, which is AAA-rated, based on the strength of its capital and the commitment by its member-countries to provide support. In this way, IDB has been able to mobilize resources at

a cost much lower than that of the beneficiary countries if they had raised the funds themselves from the international markets.

In addition to its high credit rating, the Basel Committee on Banking Supervision has designated IDB as a "Zero-Risk Weighted" multilateral development bank since 2004. The European Commission has accorded the same treatment to IDB since 2007. All these factors have made it possible for the Islamic financial services industry to use IDB *ṣukūk* in various ways, including as an acceptable asset class to satisfy Basel III requirements of High Quality Liquid Assets. It is yet another way in which IDB *ṣukūk* are contributing to the economic progress through the development of the Islamic financial sector globally.

***Case 2. Vaccination and Immunization Ṣukūk*53**

The *ṣukūk* issued by the International Financial Facility for Immunization (IFFIm) is another example of *ṣukūk* used for social and developmental purposes. The proceeds will be used to fund vaccination development and immunization programs by the Global Alliance for Vaccination and Immunization (Gavi).[54] The $700 million *ṣukūk* were issued in 2014 and mature in December 2017. They are based on commodity *murābaḥah* structure.[55] Because the *ṣukūk* are *murābaḥah*-based, they are not tradable in the secondary market. Although there is nothing innovative in the structure of the *ṣukūk,* the fact that they are dedicated to an important social and health purpose is laudable and demonstrates the usefulness of a *Shari'ah* -compliant structure in attracting the funding. It is noteworthy that 85 percent of the bids for the *ṣukūk* came from new investors, mainly from the Middle East (68 percent) and Asia (21 percent). Seventy-four percent of the *ṣukūk* were taken by Islamic banks, while central banks and other official institutions took 26 percent.[56]

Before it issued the immunization *ṣukūk*, IFFIm pioneered the issuance of (conventional) vaccination bonds to overcome the problem of slow delivery of money (donations) pledged by sovereigns. Such pledges pass through various channels of approvals until they are delivered, or sometimes they are promised to be delivered several years in the future. IFFIm was created in 2006 to securitize the donation pledges made by certain developed countries for the development of vaccines and immunization programs. IFFIm essentially securitizes and sells these pledged cash receivables at a discount to the investors to get cash-in-hand to finance its immunization projects. Selling of future cash for the present at a discount would not be permissible in Islam. However, by purchasing a commodity on the basis of a deferred payment and selling it on a spot price, the cash-

[53] This case is based on Ali (2014).

[54] Gavi is an international organization created in 2000 to improve access to new and underused vaccines for children living in the world's poorest countries.

[55] In a commodity *murābaḥah* structure, the party seeking finance buys a commodity today from the party providing finance for a marked-up price to be paid on a future date. It then sells that commodity in the spot market (or to the same seller) at a discount to get upfront cash. The price-payable in the future with a mark-up becomes a debt obligation for the buyer.

[56] http://www.iffim.org/Library/News/Press-releases/2014/International-Finance-Facility-for-Immunisation-issues-first-Sukuk,-raising-US$-500-million/ and http://www.reuters.com/article/2014/12/07/iffim-sukuk-idUSL6N0TI04J20141207.

in-hand is generated without explicitly resorting to a sale of pledges.[57] In this process, the AA credit rating of the IFFIm, along with the *shari'ah* -compliant structure of the *ṣukūk,* also helped. However, greater compliance to *shari'ah* structuring would have been possible without the use of commodity *murābaḥah* structure as follows.

The donations from sovereign are essentially a purchase order for vaccines from the donorcountries for distribution to less-developed countries. The IFFIm needs to purchase the available vaccines from Gavi (the vaccine alliance) on spot payment to sell to the purchase-orderer at a higher deferred price. IFFIm could have issued *muḍārabah* certificates to investors for this particular deal and shared with them the *murābaḥah* markup profit. In this way, the risk of vaccine purchase and sale would have been shared by the investors along with the IFFIm. The deal would have directly linked financing with the actual business and the actual intended commodity (the vaccine) rather than creating a secondary layer of transaction on a second commodity that was not intended for final use by any of the transacting parties. The *mudharabah* certificates so issued would have been tradable in the secondary market, which would have been good for their liquidity and an added attraction for the investors.

There is another important lesson to be learned in the structuring of this *ṣukūk*. Although the second *mudārabah*-based structure was possible, the issuers chose the first structure because it was easier to administer. Thus the transaction shifted from the market for the vaccine to the market for the other commodity (such as metals), which was not intended by any party but used for the commodity *murābaḥah* only. A policy recommendation for the development of Islamic financial sector, and specifically for the development of Islamic capital market products, is that the government and the regulators should take steps to make it easy to do the transaction on the intended commodity and make the use of *ribā* and its alternate stratagems more difficult and costly.

Recommended Policies to Enhance Shared Prosperity through Islamic Capital Markets

The main requirements of Islamic capital market framework are not any different from the requirements of the conventional capital market. These include protecting property rights, minimizing corruption and fraudulent practices, and supporting the rule of law. However, there are some differences in the requirements for the sound development of Islamic capital markets. These differences stem from the needs to attain *shari'ah* compliance and the overarching objectives of Islamic teachings. These include the prohibition of interest, and the execution of transactions in ways that neither circumvent nor covertly help in circumventing any *shari'ah* prohibition. The needs arising from meeting the moral and overarching Islamic objectives include facilitating the circulation of wealth instead of its concentration, wider sharing of risks and rewards instead of risk shifting, and serving the real economy instead of commandeering it.

The growth of the Islamic capital market has been hindered by several challenges. A Mid-term Review of the Islamic Financial Services Industry jointly prepared by Islamic Research and

[57] "Under the sukuk Al-Murabaha structure, IFFImSC issued US$500 million in sukuk certificates to investors in November 2014. The proceeds of these sukuk certificates were used by IFFImSC to purchase eligible commodities, which were then sold to IFFIm at a pre-specified deferred price. This deferred price included the US$500 million principal cost component and a profit component. Simultaneous to its purchase of the commodities, IFFIm on-sold the commodities to a third party commodity purchaser, through a commodity agent, generating US$ 500 million in proceeds for use in funding vaccine programmes and refinancing IFFIm's existing debt" (Gavi 2014, 17).

Training Institute (IRTI) and the Islamic Financial Services Board (IFSB) highlights some of the major challenges and the policy response needed by the Islamic finance industry. Some policy recommendations emerging from the above discussion, including those from the MTR, specifically addressing the Islamic capital markets in enhancing shared prosperity follow, along with some context.[58]

Create More Incentives for Risk Sharing

One of the biggest challenge that may hinder the promotion of equity markets in general and Islamic capital markets in particular is the preferential tax treatment of interest expenses paid by corporations. This provides an incentive to corporations to issue more debt than equity. In order to level the playing field for debt and equity, the tax shelter on interest payments needs to be eliminated. Abolishing the tax shelter on interest payments would help reduce reliance on debt markets and increase investment in the equity markets.

Another challenge that Islamic capital markets face is discrimination in the use of financial innovations such as asset-backed securitization. Securitization facilitates risk sharing and thus enhances shared prosperity. In the case of conventional finance, there is no requirement for the assets (title) to be transferred. Moreover, the lack of transfer of the asset does not create a tax liability for the investor. However, in the case of Islamic securitization (*ṣukūk*), transfer of assets is a *shari'ah* requirement. It incurs additional expenses at the origination and termination of the transaction. There is a need to develop regulations that allows the transfer of ownership without any additional cost for the issuance of *ṣukūk*.

Sukūk are also failing to meet their goal of sharing prosperity when they are structured to refinance an existing loan as opposed to creating a new economic activity, are general purpose rather than project-specific, or used to finance government budget deficits rather than development financing. The refinancing *ṣukūk* do not directly contribute to the projects, but only provide continuity to the existing *ṣukūk*. If the original *ṣukūk* were not funding economic development projects, extending such *ṣukūk* would be detrimental to sharing prosperity. Use of such *ṣukūk* can simply increase public expenditures and adversely affect sustainability.

Short-termism dominates the *ṣukūk* markets globally as well as regionally, as can be seen from higher proportion of short-term *ṣukūk* issuance to total issuance and a trend toward very short maturities. An entire spectrum of maturities would be needed to benefit from the development and orientation of *ṣukūk* market. Many of the short-term *ṣukūk* are based on *murābaḥah* or other such arrangements that are not suitable for developing a secondary market for *ṣukūk*. Hence the risk sharing that is possible through trade is curtailed by reliance on nontradable *ṣukūk*. Developing short- and longer-term sovereign and corporate *ṣukūk* is critical for developing *ṣukūk* markets. So is addressing legal and fiscal impediments to *ṣukūk* issuance by corporates.

Standardize and Harmonize the Approach to Islamic Capital Market Regulation

The need for better corporate governance mechanisms and regulatory frameworks cannot to be overemphasized for the Islamic capital markets. Since Islamic capital market products are based on higher ethical standards than the conventional market due to the requirement to be

[58] The list of general recommendations is well documented in IRTI and IFSB (2014).

shari'ah-compliant, a well-designed regulatory framework is the basic requirement. However, there is a lack of consensus among regulator in terms of devising uniform rules across jurisdictions.

Improve Shari'ah Governance

Islamic finance is not a local phenomenon anymore. The Islamic financial services industry exists in one form or the other in at least 50 countries. The need to harmonize *shari'ah* rulings and standardize practices or products in Islamic finance industry is obvious. To stimulate cross-border activities in both primary and secondary markets, the acceptance of contracts across regions and across schools of thought and markets will also be helpful. Conformity or similarity among the *shari'ah* supervisory boards of Islamic financial institutions is urgently required to extend the possibilities of the concept and application in the industry. A global approach is required for dealing with governance issues, especially issues related to *shari'ah* governance. Developing and adopting universal standards such as those proposed by AAOIFI and IFSB, among others, is highly recommended.

In the absence of a stock market for the Islamic equities, it may be difficult for investors to identify the investible universe of *shari'ah* -compliant capital market products, especially equities. Policy makers may consider a two-step approach disclosure by the firm and attestation by the regulator

- *Disclosures:* Firms are required to report their *shari'ah* compliance status based on a minimum compliance criterion, with the encouragement to provide better disclosures, especially all those events that may result in possible noncompliance in the future.
- *Attestation:* A *shari'ah* board at the apex level validates/attests that the disclosures by the reporting firm are to their satisfaction in terms of meeting the *shari'ah* requirements, and publishes the list of such firms and products on a regular basis.

There is no limit on financial innovation in Islamic finance, provided that it complies with the *shari'ah*. However, several recent financial innovations have attempted to replicate a conventional product, especially leveraged or derivative products. This has led to criticism of Islamic finance practices in general. A clearance requirement from an apex *Shari'ah* committee to attest the *shari'ah* compliance of all financial products offered in any jurisdiction is recommended.

Improve Market Liquidity by Addressing the Constraints

There is evidence that the secondary market in *ṣukūk* is very thin, due to the limited supply of *ṣukūk,* as well as the strategy of the *ṣukūk* buyers to hold their *ṣukūk* to maturity. *Sukūk* certificates are traded only about 40 percent of the time (Safari 2013), which works out to trading once every 12 trading days. A market infrastructure that facilitates trading, price transparency, and efficient clearing and settlement of transactions is required. According to an IMF report (2014), limited secondary market activity results in lack of adequate pricing and severely hinders effective marking-to-market. Main factors that hinder the secondary market trading of *ṣukūk* instruments are lack of supply, incorrect valuations, and the *shari'ah* limitation on tradability. Investors tend to hold their *ṣukūk* to maturity. Some *ṣukūk* types are eligible for secondary market trading, such

as equity-based *ṣukūk* (as in *mushārakah* and *muḍārabah*) or those based on the value of an underlying asset (as in *ṣukūk ijāra*). Others are not, such as debt-based *ṣukūk* (*murābaḥah ṣukūk*). The pricing of *ṣukūk* instruments in the secondary market would require a valuation of the underlying assets pool or business venture. Policies are required to promote correct valuation of the underlying asset pool, enhance standardization of products and the design of structures that can be traded with wide acceptance as compliant with *shari'ah* , and ensure transparency and discourage ambiguities. In addition, targeting a diverse set of investors to buy *ṣukūk* can also improve liquidity of the secondary markets. A diversity of investor types would mean that different investors would have different investment horizons and their liquidity needs would not be correlated. Thus sale and purchase in the secondary market would remain active.

Strengthen Resolution Frameworks and Investor Protection

Weak or nonexistent default resolution and insolvency regimes to handle *ṣukūk* defaults pose a challenge. Legal uncertainty about the resolution framework is mitigated in sovereign *ṣukūk*, which are often issued under international law (IMF 2014). However, there is a need for further clarification of the resolution framework regarding corporate and quasi-sovereign *ṣukūk*. Most corporate *ṣukūk* are issued under domestic law in jurisdictions with underdeveloped legal and regulatory infrastructures. Default cases have illustrated that legal uncertainty is high when the performance of the underlying asset falls below expectations and the *ṣukūk* effectively defaults. Due to the lack of a clear legal framework for restructuring, *ṣukūk* holders must seek resolution in case-by-case negotiations.

In addition, the necessary infrastructure to quickly identify current *ṣukūk* holders—which would help speed negotiation—is not in place in many jurisdictions. The problem is compounded when the Special Purpose Vehicle (SPV) that is normally created to issue the *ṣukūk* and hold the assets in trust does not have any executive power to negotiate with any party or do any transaction except with the permission of the originator (IIIFIM 2013). To alleviate these problems, building robust bankruptcy and insolvency frameworks and scenarios of how *ṣukūk* instruments might unwind in the event of default could be helpful. In the same vein, it would be helpful to have a mechanism for defined executive powers of the SPV in case of default by the obligor.

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Chapter 6

Takāful (Islamic Insurance)*,* Re*takāful,* and Micro*takāful*

Takāful, or mutual assistance, is the Islamic counterpart of conventional insurance. The word *takāful* is derived from an Arabic word *kafālah,* which means to guarantee. A group of participants agree to support one another jointly for the losses arising from specified risks. They contribute to a fund, and are compensated or reimbursed from that fund in the event of certain risks. The scheme is managed on the participants' behalf by a *takāful* operator. It is similar to a mutual insurance concept, but complies with *sharī'ah*, and is based on concepts of mutual solidarity and risk sharing.

Although *takāful* and conventional insurance share the same function of handling pure risks, they differ in a number of ways. From the perspective of insurance policyholders, risk management entails transferring a risk held solely by the policyholder wholly to the insurance company. The underlying contract between the insurance companies and the policyholders is an exchange contract, where the insurance company promises to indemnify any losses in consideration of premiums, and the insurance company's only hope of making a profit would be for the risk covered not to occur, and for the premiums collected to exceed the payouts for claims. However, in *takāful*, the risk is usually borne by the individual participant, but is shared and transferred to the group of participants.

Potential Role of *Takāful* in Promoting the Shared Prosperity

Besides being *shari'ah* compliant, *takāful* promotes shared prosperity by helping individuals and businesses reduce their exposure to risks, increase their savings and promote long term capital investment.

Since *takāful* is based on the concept of mutualization (resource pooling and risk sharing), the understanding and acceptance of the *takāful* mechanism is enhanced when traditions of mutual aid exist within the target population. This spirit of mutual aid may arise from a number of situations, such as being members of a community or a cooperative, residents of the same neighborhood, or members of a social or Islamic movement. Such common ties can increase social trust, which underpins micro*takāful*—supporting the growth in Islamic micro-finance.

Generally, savings in *takāful* as opposed to a commercial bank is regarded as a better means to accumulate an estate and distribute such wealth to heirs. There may also be other advantages, as risk management practices are a natural discipline of a *takāful* operator, which reduces the possibility of failure. Furthermore, *takāful* operators' businesses focus on investments, while the bank focus on financing. As low yield environment is likely to continue, *takāful* investors will tend to earn higher yields than account holders in a typical conventional or Islamic bank. There is evidence that micro*takāful* has encouraging savings, and thus alleviated poverty, in the Arab Republic of Egypt, as microfinance institutions and microleasing companies are not allowed to accept deposits. Thus while being socially responsible, micro*takāful* helps support poor microfinance consumers by boosting their savings.

Funds from pensions and insurance companies have deepened and widened financial systems in the developed world. In the United States, institutional investors have contributed not only to the deepening of equity markets but also to the development of the corporate bond market, which in 2012 ranked largest in the world, at 140 per cent of GDP. The greater involvement of insurance companies and pension funds has also helped reduce the volatility of the equity and bond market. Institutional investors bring stable pools of capital with an interest in long-term positions instead of speculative trades. *Takāful* operators can similarly contribute to the growth of the *sukūk* market] (see chapter 5).

Likewise, savings or investments made in *takāful* funds can provide a critical source of funding for a variety of economic activities for the community and even for the country. There is an immense need for infrastructure investments worldwide, especially in developing countries. As traditional sources of public and private financing face greater constraints, institutional investors are increasingly being considered as sources of financing for infrastructure project development and maintenance in developing countries. Together, these institutional investors would benefit from the better return on investment and diversification. Furthermore, infrastructure investments can provide a predictable cash slow that can often keep pace with inflation. While *takāful* and micro*takāful* funds are still small in size, the rapid growth of the industry in such countries is encouraging.

Micro*takāful* has a great role to play to promote financial inclusion. Besides being *shari'ah* compliant, *takāful* promotes social and economic values by helping individuals and businesses reduce their exposure to risks. Though micro*takāful* is still limited in comparison to microinsurance, it has great potential in the light of the growing demand for *shari'ah*-compliant microfinance. Financial institutions are now promoting the use of insurance or *takāful* as a guarantee for credit. This is very important in developing countries, where the poor have low liquidity in general and low capacity to pledge other type of guarantees that might be acceptable to formal banking standards.

Micro*takāful* is a socially responsible tool that aims to reduce poverty, help the vulnerable, and assist the underserved population through financial inclusion and practices such as pooling risks and assets within villages or communities. Micro*takāful* covering family and health benefits and crop, livestock, and property damages can be implemented through a community-based model, cooperative-based model, *Wakālah* partner model, or even a provider-driven model. People who participate in a micro-health insurance scheme will be able to reduce their out-of-pocket expenditures and increase their ulitization of health care services (Panda and others 2015).

Micro*takāful* also has several comparative advantages as a means to extend traditional social security schemes. Micro*takāful* has the capacity to reach groups excluded from statutory social insurance, especially where the workers are in the rural and informal economy. The transaction costs necessary to reach these populations can be reduced, since micro*takāful* schemes can be operated by local governmental/society/organizations or nongovernment organizations that are usually in the vicinity of their target population; their staffs include social workers who are used to working with and are closer to targeted group. Micro*takāful* benefits package can be designed in close partnership with the target population to assure a higher participation rate.

An area of concern for micro*takāful* is that the poor are more likely to prefer informal *takāful* schemes rather than formal ones, as they are easier to join and more affordable. In addition, while options like subsidies and coupons increase enrollment, complete inclusion will not be possible for all, given the cost.

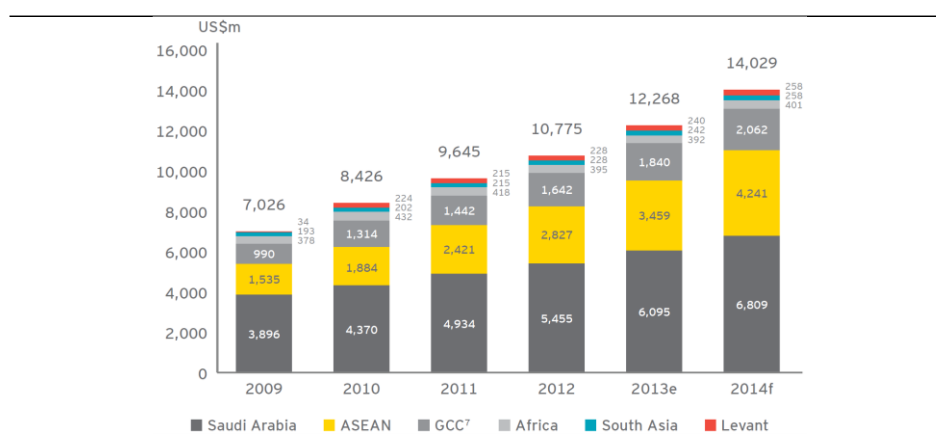
Awareness programs linked with microinsurance schemes have also increased financial literacy, which in turn can increase participation in the financial system and adoption of financial products and services. This pattern is supported by studies in Burkina Faso (Cofie and others 2013), Cameroon (Noubiap and others 2013), and India (Panda, Chakraborty, and Dror 2015). A study of a farmers' literacy training program in Gujarat, India, (Gaurav, Cole, and Tombacman 2011) showed that training through a financial module increased the take-up rate of microinsurance from 8 percent to 16 percent.

The Current State of the Takāful Industry

The market for *takāful* is potentially huge. The world's 1.5 billion Muslims represent a potential customer base that no insurer can afford to ignore. Moreover, the majority of the world's Muslim population is young (under 25 years of age). The underinsured status of most Muslims is also a significant enticement to potential *takāful* operators.

The *takāful* market has been growing strongly. It is currently concentrated in Malaysia and the Middle East (primarily Saudi Arabia). The growth rate of the *takāful* market in those areas is well ahead of the conventional insurance market.

Figure 6.1 Total Amounts of Global Gross *Takāful* Contributions by Region, 2009–14f



Source: Ernst &Young 2014.
Note: ASEAN = Association of Southeast Asian Nations; GCC=Gulf Cooperation Council; 2014f = forecast.

Global gross *takāful* contributions amounted to an estimated $14 billion in 2014, up from $12.3 billion in 2013 (figure 6.1). Year-on-year growth has moderated from a high compound annual growth rate (CAGR) of 22 percent in 2007–11 to a still healthy growth rate of 14 percent in 2012–14 (Ernst & Young 2014).The market in ASEAN countries (Brunei Darussalam, Indonesia, Malaysia, Singapore, and Thailand), driven by strong economic dynamics and young

demographics, continues to grow at 22 percent. The countries of the Gulf Cooperation Council (GCC), including Saudi Arabia, have registered a growth rate of about 12 percent (figure 6.2).

Saudi Arabia accounts for nearly half (48 percent) of the share of global gross *takāful* contributions (excluding the Islamic Republic of Iran, which has a unique domestic industry).[59] Malaysia and Indonesia account for nearly one-third (30 percent), followed by other GCC countries account (15 percent), and Africa, South Asia and Levant (the remaining 7 percent).

Box 6.1 Similarities and Differences between Conventional Mutuals/Cooperatives and *Takāful*

The majority of modern insurance companies in the developed countries (classified as stock insurance companies) are owned by investors who have purchased the company's shares. Any profits generated by this form of insurance company are distributed to the investors in the form of dividend payments. Profits are typically generated if claim experiences are lower than those expected in the pricing assumption. Policyholders are customers who have purchased a policy from the company for protection in the event of unforeseen events. Policyholders usually do not benefit directly when claims are low because the insurance company takes the underwriting surpluses as profits.

By contrast, a mutual insurance company is owned entirely by its policyholders. Any profits may be distributed back to policyholders. They have a stronger influence on the company management practices; they may elect or terminate the company's management at annual meetings. The major disadvantage of mutual insurance companies is the difficulty in raising capital needed to remain solvent or fund expansion. The independence of management can also be limited, as policyholders are the owners.

In both kinds of companies, the contract of insurance is still a bilateral contract of exchange (*mu'āwaḍāt*) involving a seller and buyer. This differs from the *takāful* contract, which is a unilateral contract (*tabarru'āt*). By contributing a sum of money to a common *takāful* risk fund in the form of a donation (*tabarru*'), an individual will become one of the participants and agree to mutually help other participants, should they suffer from a mishap. *Takāful* participants are not owners of any company, though they have a collective interest in the *takāful* risk fund.

The relationship of the *takāful* operator to the participants is that of a manager (*muḍārib*) or agent (*wakil*). The operator administers the schemes and manages the risks and investment aspects of the *takāful* funds for a fee or share of the investment profits. The operator does not cover the risk the participants face, as the participants have already agreed to mutually help one another. *Takāful* operators are required by regulation to lend funds to support any deficiency in the *takāful* risk funds to protect the interests of the participants, but are restricted to using only to a temporary interest-free loan (*qarḍ ḥasan*). The operators have the right of recovery once the fund is solvent.

Takāful based on a cooperative model may resemble a mutual insurance setup; however, mutual insurance does not have any restriction as to the type of activities and investments that it can enter into. By contrast, *takāful* contributions from participants must be invested in a *halāl* (permissible) or *shari'ah*-compliant type of investments, which are free from *ribā*'. If the investments generate a surplus, all the participants will share the benefits. *Takāful* operators are also required to have a *Shari'ah* Advisory Board to monitor the processes and activities of the operations, including their product offerings and investments, so that they are *shari'ah*-compliant. In certain jurisdictions, such as in Malaysia, *takāful*

[59] For more on the Iranian market, see the *World Islamic Banking Competitiveness Report 2014-15* (EY 2015).

companies must undertake a *shari'ah* audit in addition to the customary accounting audit, in each accounting period.

Although the end results for both insurance and *takāful* are the same—which is to provide compensation against possible losses—the central difference lies in the way that each achieves this objective. The notion "the ends will justify the means" does not hold when it comes to *shari'ah,* where both the ends and the means must be compliant.

Takāful Practices in Selected Countries

The two *takāful* models most widely adopted are *Wakālah* (agency) and *muḍārabah* (profit sharing) (see table 6.1). In each case, the operator is responsible for developing the products, underwriting the risk, collecting the contributions, investing the contributions, and dealing with claims. There has also been a significant growth in the use of a mixed or hybrid model, which combines aspects of *Wakālah* and *muḍārabah*. Another model, known as the *waqf* model, has also evolved as an enhancement to the governance structure of *takāful,* though it is not widely practiced.

Table 6.1 *Takāful* Models

Properties	*Muḍārabah*	Pure *Wakālah*	Mixed	*Wakala- Waqf*
Creation of fund	Participants' contributions			Donations to create initial *waqf*
Fees	None	Upfront fees as agreed		
Underwriting surplus	As per agreed ratio	None (following strict AAOIFI interpretation)		
Underwriting losses	*Qard hasan* from *takāful* operator			*Waqf* to solicit funds
Investment profits	None	None	Profit-sharing ratio as agreed	
Investment losses	Borne by participants			
Operational expenses	Borne by *takāful* operator (except under Mixed Model)	Borne by *takāful* operator		
Liquidation	Proceeds accrue only to participants			
Jurisdiction	Some GCC members, Malaysia, Saudi Arabia	United Kingdom	Bahrain, Malaysia, Sudan	Pakistan, South Africa

The Wakālah Model

In the *Wakālah* model, mutual risk sharing occurs among participants who contribute to a *takāful* fund. These contributions include the payment of fees and charges due to the operator, together with a donation to the *takāful* fund. The operator acts as the agent (or *wakil*) of the participants, and is therefore entitled to a fee for the services provided. The fee is deducted upfront when participants make contributions, and the balance is channeled into the *takāful* fund. In the strictest sense, the *takāful* operator should not share directly in either the investment or underwriting risks borne by the *takāful* fund nor in any surplus/deficit of the fund. Under the generic *Wakālah* model, the operator faces the challenge of ensuring that the operational and management expenses are less than the fees collected; only then can the operator make a profit.

Depending on the terms of the contract, the operator's remuneration may include a performance fee, charged against any surplus, as an incentive to effectively manage the *takāful* fund.

This model is gaining popularity across the world due to its transparency and the fixed nature of charges, irrespective of the amount of *takāful* contribution received, as it provides an incentive for the company to act in the best interests of participants and enhance their returns. Moreover, there are fewer issues associated with this model that might create disagreements among *shari'ah* scholars of different schools of thoughts (Akhter 2010).

The Muḍārabah Model

In the *muḍārabah* model, the operator is usually entitled to a fixed pre-agreed percentage of any underwriting surplus or/and investment profits of the *takāful* fund. *Takāful* participants are similar to investors who provide capital and contributions in a business venture. Under this arrangement, the operator is allowed to share in the underwriting results from operations, as well as the favorable performance returns on invested premiums. However, the operator's earning is not guaranteed, as there may be no investment return or underwriting surplus at year's end.

The Mixed Model

The mixed model is widely practiced by *takāful* companies around the globe and is currently the dominant model in the Middle East. The Central Bank of Bahrain has also taken the initiative to make it compulsory for *takāful* and re*takāful* companies to adopt this mixed model in their business (Al Sadah 2006).

The mixed model combines elements of the *Wakālah* and *muḍārabah* models. It is structured so that the *takāful* operator retains two funds: one for the shareholders, and the other for participants. The underwriting activities are conducted according to the *Wakālah* model; the shareholders manage the funds as an agent on behalf of the participants. In exchange, each participant is charged a *Wakālah* fee, which is normally a percentage of their contribution. As an incentive for effective management, the operator is also entitled to earn a fee if there is a surplus in the participants' fund. With regard to investment activities, the operator invests the surplus contributions in different *shari'ah*-compliant instruments based on the *muḍārabah* contract. The operator acts as the investment manager or *muḍārib* on behalf of the participants. The ratio of profit is fixed and agreed between the parties at the time the contract begins. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recommends that the mixed model be adopted (Yusof 2001).

The Waqf Model

After several objections were raised regarding the *shari'ah* issue that a "profit sharing" contract should not be applied (as donations cannot simultaneously be capital), the issue of sharing any surplus in the *muḍārabah* model, and the legal status of the *takāful* fund, the *waqf* (Islamic trust) model emerged. The model is a modified form of the *Wakālah* model, where a *waqf* fund is created by the initial donations of shareholders. Participants' contributions then go directly to the *waqf* fund. A *waqf* has no owner; however, the operator have the right to devise and administer

the fund's rules and regulations. The general idea is that the *takāful* fund should be perpetual communal property devoted to public and community use. *Waqf*-like trusts are legal institutions in their own right and can be governed by the trustees under a civil legal structure. *Waqf* can be expanded beyond the scope of religious activities to cover education, public utilities, social work, and other areas of social services.The *takāful* operator are usually paid its fees from the *waqf* fund as the administrator.

The contributions or donations in the *waqf* fund are invested in *shari'ah*-compliant instruments. The *takāful* operator and participants share the profits from investments according to pre-agreed ratios. The *waqf* fund will pay claims, re*takāful* expenses, and underwriting costs as usual; the net surplus will vested to the participants. Participants who have no prior claims can be paid the surplus according to their proportion of contribution. The *waqf* model has been adopted by *takāful* operators in South Africa.

Re*takāful*

Re*takāful*[60] allows operators to share risks that they cannot or do not wish to absorb themselves. The main purpose of re*takāful* is similar to that of reinsurance: to spread risk and add capacity, so that larger or more risks can be included. By spreading risk within the industry, *takāful* operators can function more efficiently. Re*takāful* plays a vital role in the general *takāful* sector, especially for large and specialized risks, as compared to family *takāful*.

This arrangement seems very much like reinsurance, but the fundamental difference is that conventional underwriting is about transferring risk, but re*takāful* is about sharing the risk. The operator also becomes a risk manager instead of a risk taker. This is a mirror of the relationship between a *takāful* operator as agent and the *takāful* participants as owners of the *takāful* fund (hence the name, re*takāful*). The risk remains with the participants. By extension to re*takāful,* this implies that the risk remains with the ceding *takāful* operator (Frenz and Soualhi 2010).

Currently, there are a limited number of re*takāful* operators in the industry. Commercial market *takāful* operations have not yet grown to scale in many jurisdictions, except for the GCC countries and Malaysia. On the other hand, *takāful* operators have claimed that their expansion has been limited: particularly their inability to take on large commercial risks, partly due to a lack of scale and re*takāful*. Whatever the situation may be, the wealth from oil-driven growth is encouraging society and businesses to seek protection using *shari'ah*-compliant products and hence will raise the demand for *takāful*, and thus for re*takāful*.

The existing re*takāful* operators are located mainly in GCC States and Malaysia, where the *takāful* businesses are concentrated. Bahrain and Dubai each have two registered re*takāful* operators, Malaysia has four, and Singapore has one. Several renowned companies are also operating from a low tax haven in Malaysia, Labuan Business International Financial Center, mainly as branches of their worldwide entities serving the regional markets in Asia.

[60] *Retakāful* is a transaction whereby one company (typically, the *retakāful* operator) agrees to indemnify another *takāful* company (the ceding company, or cedant) against all or part of the loss. For this service, the ceding company transfers or shares part of the contribution it receives with the *retakāful* operator.

One of the main problems worldwide is the lack of re*takāful* companies that are capitalized to the levels required by insurers, and more particularly the lack of A-rated re*takāful* companies. This has resulted in *takāful* companies having to reinsure on a conventional basis, contrary to the preferred option of seeking cover consistent with Islamic principles. About 80 percent of ceded premiums are placed with traditional reinsurers.[61] This practice is allowed under the concept of *ḍarūrah,* or extreme necessity. *Shari'ah* scholars have granted dispensation to *takāful* companies to reinsure on a conventional basis so long as there are no re*takāful* alternatives available, but they may do so for a limited period only. At the same time, industry traditionalists are increasingly challenging whether the necessity (*ḍarūrah*) concept is still applicable in today's market, and are encouraging alternatives.

One alternative that some *takāful* operators may embark on is the practice of co*takāful*. In this arrangement, a common *takāful* certificate is issued, and the risk will be shared based on certain agreed percentages between several *takāful* operators. Often, one operator will take the lead. The leading *takāful* operator will be responsible for administering various aspects of the coverage, such as collecting contributions, making claims, and the preparing documents. In this situation, the lead operator may levy a charge (termed leader fees).

In another practice, a number of large conventional reinsurance companies from Muslim countries take on the risks and retrocede a large proportion of risk with international reinsurance companies that operate on conventional basis. The cession from *takāful* companies ranges from some 10 percent in Southeast Asia, where *takāful* companies have relatively smaller commercial risks (so far), to the Middle East, where up to 80 percent of risk is reinsured on a conventional basis.

Even though a typical reinsurance transaction is generally based on the principles of contract (*al-'aqd*), the nature of this transaction is quite different from other forms of commercial contracts in conventional reinsurance. It must also comply with *shari'ah* principles. Reinsurance contracts must essentially be financial transactions that bind both the reinsurance company and the insurance company on the general principles of contract.

All the same, there have been several moves for Islamic reinsurance to displace use of conventional reinsurance. One of the world's largest reinsurer/re*takāful* operators is in talks with Malaysian market players and the Malaysian *takāful* Association to set up a market re*takāful* pool. This initiative is supported by Bank Negara Malaysia. Given stricter regulation that is likely, especially in GCC countries, *takāful* operators' demand for re*takāful* arrangements should increase. Lloyd's of London is also building its capacity in the *takāful* sector. It has opened an office in Dubai and is in talks with regulators to access the Malaysian market.

Takāful/Retakāful Windows

Where the market and its regulation are still in their infancy, as in Indonesia and many countries in Africa, window operations within an insurance company are prevalent. A window is

[61] Estimated by Vasilis Katsipis, Dubai-based general manager for market development at insurance rating agency A.M. Best, quoted in "Islamic Reinsurance Moves to Displace Use of Conventional Finance, " http://uk.reuters.com/article/2015/04/26/islam-reinsurance-idUKL5N0XJ11Z20150426.

attractive from the standpoint of shareholders, since setting up a separate *takāful* entity requires additional capital. While shareholders see the potential of *takāful,* they also perceive many uncertainties. Usually, companies have segregated the *takāful* funds from other insurance funds, but these companies tend to market *takāful* merely as just another insurance product. Generally, the public lacks awareness of *takāful* and what is *shari'ah* compliant and what is not.

Conflict among brands is also an issue when a company is providing both conventional insurance and *takāful*. Another cause of concern for a window operation is the high likelihood of its Muslim *takāful* intermediaries marketing *takāful* and selling insurance at the same time.

When *shari'ah* compliance is left totally to the producer (in this case, the insurance company), there is a danger as to whether the operator will eventually achieve its status as an Islamic organization. The concept of "permissible in times of necessity" (*ḍarūrah*) may be invoked but sparsely, such as fulfilling the reinsurance needs of the *takāful* operator in the absence of sophisticated re*takāful* arrangements for large and specialized risks. Achieving consistency and standardization in *shari'ah* review may take several years; however, it is a strategy that should be undertaken with full enthusiasm. Similarly, *shari'ah* compliance risk should be minimized by installing a mandatory *Shari'ah* Board. A definite timeline should be formulated and followed to separate the *takāful* business so that it can be a stand-alone entity. In Indonesia, all windows were given three years to dismantle before the OJK (Otoritas Jasa Keuangan) (Indonesia's equivalent of the Financial Services Authority) was inaugurated.

Micro*takāful*

Micro*takāful* can be defined as "*takāful* accessed by the low-income market." As such, micro*takāful* is not just a scaled down version of regular *takāful;* the product and processes need to be completely reengineered to meet the characteristics and preferences of the low-income market, such as farmers, blue collar workers, and small traders. This means that micro*takāful* must have unique product features in line with the income and other realities of the target market. It also requires innovative and cost-effective approaches to reach masses of people who may not be formally employed or have a bank account.

The first micro*takāful* scheme was established in 1997 in Lebanon by the Lebanon Agricultural Mutual Fund. It provides health insurance coverage and meets costs not covered by the Government Social Security Fund, which usually covers 85 percent of hospital fees. The fund covers more than 5,000 families (23,000 beneficiaries). Each family pays a premium of $10 per month. Those who cannot afford the premiums are sponsored by local villagers or other policyholders (Brugnoni 2013).

As with conventional microinsurance, micro*takāful* is delivered with the help of agents and financial institutions. However, to reach the poor, additional innovative distribution channels are organized, including the following:

- *Full-service model:* Regulated *takāful* operators downsize their insurance services and charge a premium affordable by the poor. Islamic microfinance institutions (IMFIs) can

assume the role of insurers by offering basic credit life insurance to protect their loan portfolios.

- *Partnership model: Takāful* operators with products pair with IMFIs and others to provide microinsurance in low-income markets.
- *Community-based model:* Local communities form groups that capitalize and manage a risk pool for their members.
- *Provider model:* Providers, such as hospitals, clinics, or dairy cooperatives, create prepaid or risk pooling coverage for people who use their facilities or services.
- *Social protection models:* National governments underwrite cover for certain risks through social insurance programs, such as for health care, crops, and livestock, as well as covariant risks.[62]

General characteristics of micro*takāful* are presented in table 6.2.

Table 6.2 General Characteristics of Micro*takāful*

Consideration	Micro*takāful*
Extension of social insurance	Yes
Benefits and coverage	Basic assistance, funeral benefits, income during hospital stays, small term life cover benefits
Risks	General, catastrophic
Customer segmentation	Informal economy, affinity groups, cooperatives
Affordability	Salary deductions, benevolent sponsorships, affordable contributions by low-income participants
Underwriting	Group basis, link with microfinance
Distribution	Home service agents, micro Islamic financial institutions (MIFIs), cooperatives, affinity groups, *Masjid*

Challenges for the *Takāful* Industry

With regard to regulations, the same regulatory regime cannot be applied to both micro*takāful* and conventional insurance, even for operator-provided schemes. For example, any risk-based requirements will drive up capital costs. The capital requirements for micro*takāful* operators should also be much reduced and regulations must encourage schemes through cooperatives with additional tax incentives.

1. *Corporate governance and regulatory framework*

Although the application of *takāful* products has grown considerably in recent years, only a few countries have distinct *takāful* regulations, and some countries favor the use of one *takāful*

[62] http://www.microinsurancenetwork.org

model over another.Regulators need to understand the implications of regulations and accounting standards for how assets are valued and how surplus and profits are computed and distributed. In *takāful*, just like insurance, premiums are due upfront before service is rendered. This means that premiums must be invested in suitable *shari'ah*-compliant assets. For contingent benefits where claims can happen at any time, investing solely in volatile assets like equities is not advisable.

Malaysia has one of the most advanced sets of *takāful* regulation. The growth of *takāful* is only one part of the general growth of Islamic finance in the country. Malaysia has a vibrant Islamic banking and capital market, with by far the largest *sukūk* market anywhere in the world (see chapter 5). It also has a large (but not large enough) base of human capital trained in Islamic finance, including *takāful*. Thus using Malaysia as a standard as to how *takāful* should be regulated may not be appropriate for a country only now venturing into *takāful*.

In contrast to Malaysia, Bahrain's conventional and *takāful* industry remains rules-based. Regulations are set out in rulebooks that provide guidance as to how insurance and *takāful* liabilities should be valued.[63] There is built-in flexibility, though, as other methodologies can be acceptable, if justified. As in Malaysia, *takāful* windows are not allowed. However, the regulation says that only the *Wakālah* (agency) contract can be used in *takāful*, with a subsidiary *mudārabah* contract for assets being invested.

There is no explicit guidance as to how *takāful* products should be priced. Thus operators are free to set their fee under the *Wakālah* contract. This arrangement has been exploited by some *takāful* companies, with little consideration for whether the premium net of *Wakālah* fees is sufficient to pay claims.

Regulating *takāful* is different from regulating insurance. This stems from the hybrid nature of its setup. A risk-based approach to regulating *takāful* is desirable, but well-thought-out, rules-based regulation may suffice initially. An important early decision for the regulators is whether to allow *takāful* windows. *Shari'ah* is flexible on this matter only if regulations preclude the setup of stand-alone *takāful* companies.

2. *Shari'ah-compliance risk*

Having a holistic approach that keeps in mind the viewpoint of both the industry and consumers is a critical factor to nurture industry best practices and market development. Policies need to balance protections for participants' rights with the need for effective pricing, greater solvency, operators' financial sustainability, good business conduct, and relevant disclosures. On the consumer side, there is demand for greater transparency of *takāful* operators and better financial education to unlock various opportunities for industry's growth. To avoid confusion among Muslims, there should be a consensus among *shari'ah* scholars in the country as to how *takāful* is implemented. While in Malaysia, the majority of Muslims are happy for the government to decide what *shari'ah* compliance means, this may not be possible in other jurisdictions. An early consensus among local scholars on how *takāful* is structured is important.

[63] See the *Central Bank of Bahrain Rulebook*, Volume 3–Insurance, 2011.

Looking at substance over form is important, as ultimately if risks are similar, the capital solvency requirements should be the same, no matter how the risk fund is branded. Regulators should look for arbitrage opportunities between *takāful* and the insurance industry. For example, a similar product could require lower solvency capital if it were sold as a *takāful* product than if it were sold as a conventional product. Such arbitrage may harm the *takāful* industry over the long term if such lower solvency capital is not justified.

3. *Lack of investment opportunities*

The investment environment remains challenging for *takāful* operators. Not only are *shari'ah*-compliant investments lacking in many jurisdictions, but *takāful* operators do not have many options for long-term and stable investments. In addition, as many of the players in the industry are relatively young, the *takāful* industry has generated higher expense ratios in comparison to insurers operating in the same market, reducing operators' profitability. Stricter solvency and capital requirements also make it harder for smaller players to achieve profitability. Young *takāful* players will need to either quickly build scale or consider mergers to meet the regulatory demands. Hence governments wanting higher growth in *takāful* should also look into development of an Islamic capital market and provide flexibility in the implementation of the risk-based capital regime.

Policy Response

Takāful, like Islamic finance, has two sides: financial efficiency and *shari'ah* compliance. There is a need to develop a globally accepted business model based on risk sharing that promotes share prosperity. Governments have always played a pivotal role in creating a conducive legal and regulatory framework. They must recognize that *takāful* is markedly different than insurance. Unlike insurance, *takāful* is a unilateral agreement that is based on the principles of mutual cooperation (*ta'awu*n) of the participants and donation (*tabarru*').

Bahrain, Malaysia, and Pakistan have comprehensive *takāful* regulations in place that take into account the unique requirements of the industry. The Saudi Arabian Monetary Authority (SAMA) now requires all *takāful* business be aligned with the cooperative insurance model rather than *Wakālah* and *qard* concepts. Several regulatory changes have been introduced recently in many countries; while they are positive in nature, there is concern about the increased inconsistencies across jurisdictions, such as differences in accounting standards. Inconsistencies in *takāful* regulations make it difficult for multinational *takāful* operators to function across regions and also lead to confusion for customers (Ernst & Young 2012).

The global *takāful* industry is small in comparison with the conventional insurance industry. Thus the market needs to gain worldwide brand recognition and exceed performance. *Takāful* can build up public confidence. Once it has, the public can be expected to voluntarily opt for the various *takāful* options in their individual and collective interests. Financing for small and medium enterprises (SMEs) and microfinancing is high on the agenda of the Group of Twenty (G-20). This will have a positive influence on *takāful,* especially in Muslims start-ups and small and

medium enterprises. Micro*takāful* can be a mechanism to mitigate financial risk for the poor by safeguarding and ensuring the productive use of their savings and credit facilities, and can also be effective in reducing their vulnerability to the impact of disease, theft, disability, and other perils.

Regulators need to be cohesive in their approach to regulation of the industry these should not hamper the growth and stability of the *takāful* market. Industry practitioners and regulators must attempt to discover an approach to implement *takāful*'s conceptual requirements as defined by *shari'ah* scholars in a way that is commercially viable for shareholders and considerate of participants' interests. In the marketplace, the attraction of *takāful* business should be not just for the fact that it is based on *shari'ah* law, but because it is better, rational, and equitable. This aspect should be attractive to everyone, irrespective of any religious foundation upon which the system stands initially.

The dual *takāful*/insurance regulatory system, as in Malaysia, may be a good alternative to adopt and can stand as a worldwide benchmark for *takāful* services in terms of customer satisfaction, quality of services, and transparency of its operations. However, regulators need to watch for any operators taking advantage of the situation and working to converge its operations along the lines of conventional insurance. *Takāful* operators have tended to choose this as their preferred form and have modelled a *takāful* operation around them or have feigned a *shari'ah* wrap over these contract(s), just to be compliant. New operators, especially, have taken a totally business perspective of *takāful.* While this is correct, there is a risk that the spirit of *takāful* may be lost or severely diluted in the process.

Developing a Best Practice Charter as a benchmark for *takāful* operations worldwide is valuable, but has proven to be challenging, mainly because of diverse legal frameworks, the varying kind of markets and their level of maturity, and also the differences in interpretations on matters related to *shari'ah*. Table 6.3 is an attempt to provide elements of such a charter.

Box 6.2 Country Case: Regulation and Challenges in Nigeria

With a population of 177.2 million people, Nigeria has about one-sixth of the population of Africa and is the eighth most populous country in the world. Fifty percent of the population is Muslim (CIA 2015). Nigeria currently has no social security system, and only 1 percent of the total adult population is insured, according to the Nigerian Insurance Regulator (NAICOM). The reasons for the low rate of penetration includes low income levels and limited awareness of insurance products and their benefits, as well as a lack of transparency regarding the operating practices of some companies.

To increase the penetration of insurance among the Muslim population, NAICOM has issued landmark guidelines to support the *takāful* operations in Nigeria.[64] The Guidelines provides the framework for *takāful* operations. The approved models include *Muḍārabah* (profit sharing), *Wakālah* (agency) and Hybrid *Wakālah-muḍārabah* (agency-profit sharing) for *takāful* set-ups.

The Guidelines recommend that each *takāful* operation have in place an Advisory Council of Experts (ACE) to ensure that the operations are in line with best practice. The ACE is responsible and accountable for all *shari'ah* decisions, opinions, and views provided by them. As having their own *shari'ah* advisers and experts can be challenging in the initial stages, operators can refer *shari'ah* matters to a *takāful* Advisory Council, which resides with NAICOM.

NAICOM had two main objectives in introducing the Guidelines. The first was to make *takāful* a better platform for financial inclusion, especially for Muslims, but also for Christians and others with ethical inclinations/beliefs. The second was to make *takāful* a better means to intensify the penetration rate of insurance in Nigeria. As Muslims are a big majority, intensifying insurance penetration in the Muslim population can contribute to the nation's GDP.

The main challenge for both insurance and the *takāful* industry is poverty. Micro*takāful* can play a role in overcoming this challenge. As noted, is not social welfare or social assistance, but a complementary market solution. For the low-income market to access micro*takāful*, it needs to be affordable and appropriate to the target market's needs and convenient.

Another major challenge is customer's awareness of *takāful*. For a long time, many Nigerian Muslims believed that insurance is contrary to Islamic principles, particularly with regard to life insurance (Fadun 2014). *Takāful* intermediaries such as the *takāful* agents must be properly trained and committed, as they are usually the operators' first point of contact and primary source of information about *takāful*.

Another important pillar for successful *takāful* operation is the presence of sustainable investment portfolios that comply with *shari'ah* requirements. The lack of Islamic financial instruments poses enormous challenges to *takāful* operators in Nigeria, as *takāful* funds cannot be invested in conventional bonds and interest-based financial assets. It is also essential that the regulatory regime does not treat *takāful* less favorably than conventional insurance in Nigeria. This is necessary to promote prudent *takāful* practices.

[64] Operational Guidelines 2013, *Takāful* Insurance Operators Guidelines, http://naicom.gov.ng/payload?id=964fc42e-4025-43f3-8b34-97e82b2c50f7.

Table 6.3 Best Practice Charter for *Takāful* Operations Worldwide

Takāful core principles	Description	Best practice
Regulations	Clear and transparent regulation and supervisory procedures that are appropriate for *takāful* are needed.	A separate *takāful* law is recommended, but supplementary regulation is needed, at minimum. Micro*takāful* should be regulated differently from *takāful*.
Licensing requirements	A legal entity that intends to engage in *takāful* activities must be licensed before it can operate. The *takāful* legislation must set out the procedure and form of establishment under which companies will be allowed to conduct *takāful* activities within a jurisdiction.	A full-fledged operation with some minimum initial capital for a single license. A "window" operation may be permissible under special conditions and provided it is only a temporary arrangement.
Takāful model	*Takāful* operators should establish an operational model that outlines the key policies, procedures, and management responsibilities in carrying out the *takāful* operations. The operational model should be based on fair and equitable agreements and approved by the *Shari'ah* Committee.	*Wakālah* model is preferred, with sharing of investment returns. *Wakālah* fees should be limited to 40 percent of *tabarru'*. The profit-sharing ratio to the company should be restricted to 30 percent. Surplus-sharing to operator is not allowed. Where the law permits, *takāful* funds should be ringfenced as a *waqf*.
Shari'ah compliance and corporate governance	Regulations must ensure that the *takāful* entity demonstrates the essential features of *takāful* and that they are consistent with *shari'ah* principles Operators must also establish and implement a corporate governance framework that provides for sound and prudent management and oversight of the business and adequately recognizes and protects the interests of participants.	• A proper *shari'ah* governance framework should be followed. • A *Shari'ah* Board should be established, and consist of no fewer than three fit and proper members. • Members should serve on no more than three committees. • The Board and *Shari'ah* Committee will be liable for non-*shari'ah* compliance. • A *shari'ah* audit should be conducted annually. • A report by the chairman of the *Shari'ah* Committee should be included in its annual report. Various committees of the Board, such as Risk Management, Audit, and Investment, must be established.

Risk management and internal control	As part of its overall corporate governance framework, the operator must have effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters, and internal audit.	As *takāful* operators derived their income mainly from fees and performance incentives, they must establish effective policies and procedures to manage operating costs. Guidelines on controlling operational cost can be introduced. All operators must acquire their own actuarial expertise.
Conduct of business	Requirements should be established for the conduct of the business of *takāful* to ensure that customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied. These requirements are expected to enhance market discipline in the area of marketing and business development.	To strengthen public trust and consumer confidence in the *takāful* sector, staff must be properly and adequately trained, particularly with respect to operational and *shari'ah* aspects of the business. A minimum levy (for example, 5 percent of total salaries) should be imposed if staff training is deficient. Customers must be treated fairly. • Products should be developed and marketed with due regard for customers. • Customers should be provided with clear information before, during, and after the point of sale. Any advice given should be high quality. • The privacy of information obtained from customers should be protections. • The reasonable expectations of customers should be met.
Capital adequacy and solvency	Capital adequacy requirements (CAR) should be established for solvency purposes so that operators can absorb significant unforeseen losses.	Establish a risk-based capital (RBC) framework. The supervisory CAR should be set at appropriate levels to recognize the different level of maturity of the market.
Investments	Requirements should be set for solvency purposes on the investment activities of *takāful* in order to address the risks faced by the operators.	The concept of "admitted assets" should no longer apply. Risk charges applicable for different asset classes under the RBC framework will ensure the right investment discipline. *Shari'ah*-compliant assets that are back by real assets should have lower risk charges.
Consumer protection	The interest of the participants must be given priority by the operator, especially if there is a conflict of interest.	• The law must require the separation of the *takāful* funds from the shareholder's fund and explicitly stipulate that *takāful* funds do not belong to the operators.

		• *Takāful* contracts and certificates must be written in a language that is easily understood by the participants and other stakeholders. • The law must stipulate that *takāful* intermediaries have ostensible authority and will bind the operator. • A cooling-off period must be provided to the participants.
Public disclosure	Operators should disclose relevant, comprehensive, and adequate information on a timely basis to enable participants, stakeholders, and the public to better understand the underlying *takāful* operations and to give participants and the public a clear view of their business activities, performance, and financial position.	In addition to their annual reports, *takāful* operators should publish a special report on the fund's investment performance. To further promote transparency, *takāful* operators should publish on their website details of its operational model, together with its underlying *shari'ah* principles, and details of products, fees, and charges.

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Chapter 7

Nonbank Financial Institutions

While banks are the dominant form of financial intermediaries in most economies, nonbank financial institutions (NBFIs) complement the activities of banks by providing various services that banks typically do not provide. NBFIs provide diversity in the financial sector and perform various functions essential for growth and development of the economy (Carmichael and Pomerleano 2002). A diversified financial sector that includes banks and NBFIs provide a basis for a sound and stable financial system (Bakker and Gross 2004). NBFIs can also act as backup institutions that may help stabilize the financial sector when negative shocks adversely affect the dominant financial institutions, notably banks.

A comprehensive Islamic financial system reflect the broader goals Islam, which aim not only to achieve economic goals but also to address social needs. The eradication of poverty, socioeconomic justice, and the equitable distribution of income are core features of an Islamic economic system (Chapra 1985). The Islamic financial system should be able to fulfill these general economic goals and include institutions that aim to meet these objectives. Accordingly, Islamic financial institutions would give prominence to risk-sharing modes of financing that promote growth and would cater to the social needs of all segments of the society. While Islamic banks modeled as commercial banks do not reflect these features completely (see chapter 4), NBFIs may be able to provide services that fulfill the the broader goals of Islam and promote shared prosperity more effectively. Similar to banking and capital markets, for a robust Islamic NBFI sector that enhances shared prosperity the requirements include a supportive institutions and public policy, responsible governance and leadership, and robust regulatory framework that promotes risks sharing and entrepreneurship.

Recent Developments and Current Status

Broadly speaking, NBFIs cover all financial institutions other than commercial banks. However, for the purpose of this report, NBFIs include all those institutions that are not subject to the supervision of the central bank but can act like banking institutions: that is, accepting funds and investing those funds, whether in the capital market or through direct placement. Specifically, this chapter focuses on Islamic asset management, housing finance, and some specialised NBFIs such as *muḍārabah* and *ijārah* (Islamic leasing) financing companies.

The NBFIs operating in the field of Islamic finance can be classified according the nature of the service provided to clients and the segment of their clients. From this perspective, Islamic NBFIs provide four basic financial services for their clients from five different segments (table 7.1).

- Islamic asset management, venture capital, and private equity companies provide investment-related services for their institutional and corporate clients.

- Corporate foundations provide philanthropic services such as *awqaf (Islamic foundations, endowments and trusts)*
- Asset financing and and *mudārabah* companies[65] provide financing and investment services to either their private customers or to customers from various segments of the mass market.
- Microfinance and microsavings institutions provide funding to usually under-banked.
- Through *hajj* funds, Muslims from different income groups can save to finance pilgrimage travel and accomodation at various stages of their lives.

Table 7.1 Classification of Nonbank Islamic Finance Institutions

Type of Client	Financing	Investment	Pilgrimage	Philanthropy
Institutional	Investment banks and funds	Asset management (fund managers, venture capital, private equity)		
Corporate				Corporate foundations
Affluent	Financing companies	Brokerage, fund managers, *muḍārabah* companies		
Mass market	Financing companies, leasing companies, credit unions, and cooperatives		*Hajj* funds	
Underbanked	Microfinance pawn shops, microfinance institutions	Microsavings		

Source: Adapted from IDB, IRTI, and IFSB 2014.
Note: The underbanked are those not served by formal financial institutions, such as banks.

The composition of the NBFI sector differs from country to country, depending on the legal environment and the organizations that exist. With the exception of a few countries, the nonbank financial sector is relatively underdeveloped in most emerging economies in general and in member-countries of the Islamic Development Bank (IDB) in particular. For example, whereas the banking systems in the Middle East and North Africa (MENA) are generally large relative to other regions, the NBFIs are mostly undeveloped (Rocha, Arvai, and Farazi 2011). The average development index for the nonbank financial sector in the MENA region (3.3) is much lower than the index for the banking sector (5.5) (Creane and others 2006). Indonesia, however, has a vibrant nonbank financial sector, with a wide array of financial institutions providing a diversity of financial products. In a survey of 3,360 households in Indonesia, 51 percent of the respondents disclosed that they saved in a nonbank financial institution, compared to 41 percent who had bank

[65] A partnership whereby one party (the capital owner) provides capital to an entrepreneur to undertake a business activity. Profit are shared between them as agreed, but any financial loss is borne only by the capital owner, as his loss is his unrewarded effort put into the business activity.

accounts. Moreover, 52 percent took loans from informal sources, compared to 25 percent who had formal loans (Cole, Sampson, and Zia 2011).

Not only is the NBFI sector small in most IDB member countries, but the bulk of the NBFIs are still conventional. For example, in Pakistan, the total asset size of the NBFI sector was PRe 747.07 billion ($7.34 billion) in April 2015, and only 21 percent of the total assets were *shari'ah*-compliant (SECP 2015). However, the sector has been moving toward greater *shari'ah* compliance over time. In Pakistan, the Islamic NBFI sectors grew around 224 percent from June 2010 to April 2015, while the convention sector grew 74 percent; as a result, the share of *shari'ah* compliant NBFI assets grew from 12.3 percent to 21 percent (SECP 2015).

The discussion that follows describes the status and development of different types of NBFIs in IDB members. Unfortunately, the data and information on NBFIs in general and Islamic NBFIs in particular are scattered and are not available in an organized manner. Given these constraints the following part of the chapter summarizes recent developments in Islamic asset management, SME finance, housing finance, and other NBFIs such as muḍārabah and ijārah companies.

Asset Management

The overall size of the mutual funds industry is relatively small in most IDB member countries. As table 7.2 shows, the stock market in the MENA region is relatively large, (amounting to 23.37 percent of GDP); however, there are no comparative data available on mutual fund assets for the region (Ocha and others 2011).

Table 7.2 Size of Capital Markets and Mutual Funds Assets in Selected World Regions, 2012

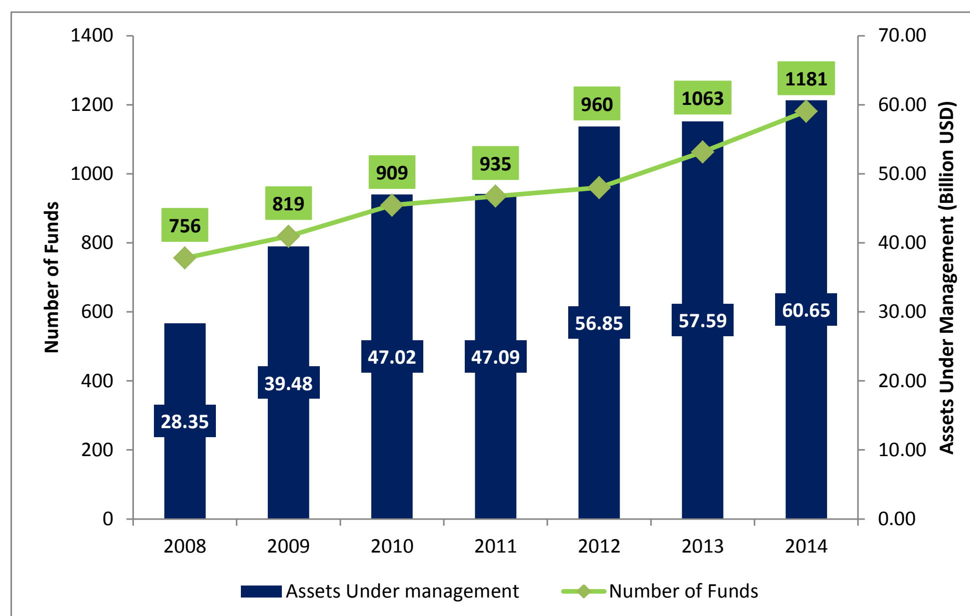
Regions	Mutual fund assets to GDP (%)	Stock market capitalization to GDP (%)
Income group		
World	10.91	30.76
High-income	18.75	53.01
Middle-income	2.01	20.14
Low-income	..	19.37
Developing countries only		
Sub-Saharan Africa	19.01	22.19
East Asia and Pacific	4.04	44.07
Europe and Central Asia	1.37	11.66
Latin America and Caribbean	3.35	24.58
Middle East and North Africa	..	23.37
South Asia	3.76	20.09

Source: World Bank Global Financial Development Database.

Islamic mutual funds grew rapidly in the 1990s, following the ruling by the Islamic *Fiqh* Academy (IFA) on the legitimacy of investments in stocks. The recent growth trends in numbers

and assets under management (AUM) of global Islamic funds and mutual funds are shown in figure 7.1. The Islamic asset management industry has gained remarkable momentum since the global financial crisis. The total amount of assets under management has more than doubled from $28.35 billion in 2008 to $60.65 billion as of 2014, with a cumulative average growth rate around 13.5 percent. Despite the dramatic growth, the sector still has a market share that is below 1 percent of the total global asset management industry and around 3 percent of all Islamic financial assets worldwide. Nevertheless, during the same period, the number of funds has increased from 756 to 1,181, corresponding to a cumulative average growth rate around 8 percent per year.

Figure 7.1 Global Islamic Asset Management Industry, 2008–14



Source: Thomson-Reuters 2015.

The traditional assets classes include *shari'ah* -compliant stocks, *sukūk* and money market instruments. Alternative Islamic investment assets comprise real estate/infrastructure, commodities, private equity funds, and some newly established hedge funds. Table 7.3 shows the asset type of the Islamic funds that were launched over the last five years from 2009 to 2013. The bulk of the funds (41.8 percent) were equity-based, followed by *sukūk* (24.1 percent). Mixed funds were 14.3 percent of the new funds during the period, followed money-market funds (12.8 percent) and real estate funds (4.57 percent).

Table 7.3 Funds Launched and Asset Type, 2009–13

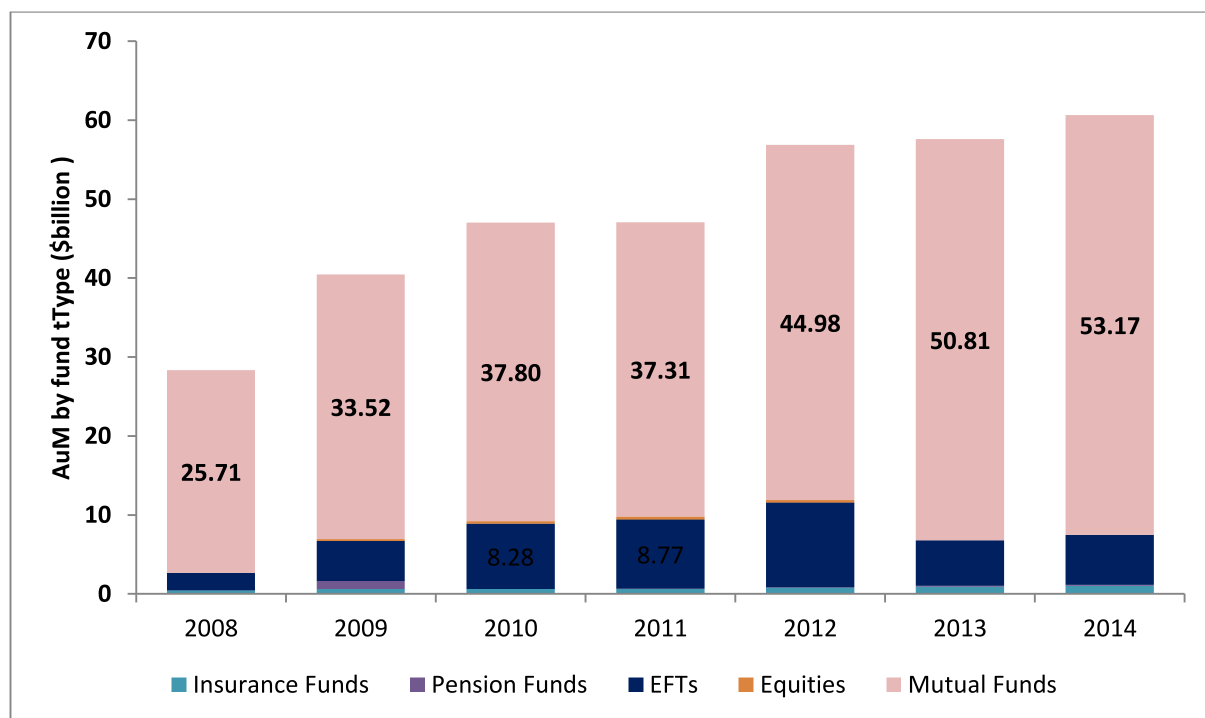
Year	Total number of funds launched	Bonds (*şukuk*)	Equity	Mixed	Money market	Real estate	Other
2013 (through September)	82	24	30	19	8	1	
2012	54	9	23	9	6	3	4
2011	62	9	32	4	10	6	1
2010	77	19	34	12	7	4	1

2009	53	18	18	3	11	1	2
Total	328	79	137	47	42	15	8
Percentage	100	24.09	41.77	14.33	12.80	4.57	2.44

Source: Thomson Reuters 2014.

The global Islamic asset management industry is dominated by mutual funds. As of 2014, mutual funds accounted for almost 88 percent of all assets managed by the global Islamic asset management industry and 80 percent of the total number of Islamic funds. The assets under management of Islamic mutual funds rose from $25.71 billion to $53.17 between 2008 and 2014 (figure 7.2), while the number increased from 568 to 953. With a cumulative average annual growth of around 13 percent in terms of assets under management and 9 percent in terms of number of funds, the mutual fund segment is the flagship of global Islamic asset management industry.

Figure 7.2 Assets under Management by Fund Type, 2008–14



Source: Thomson-Reuters 2015. Note: AuM=assets under management; ETF=exchange traded funds.

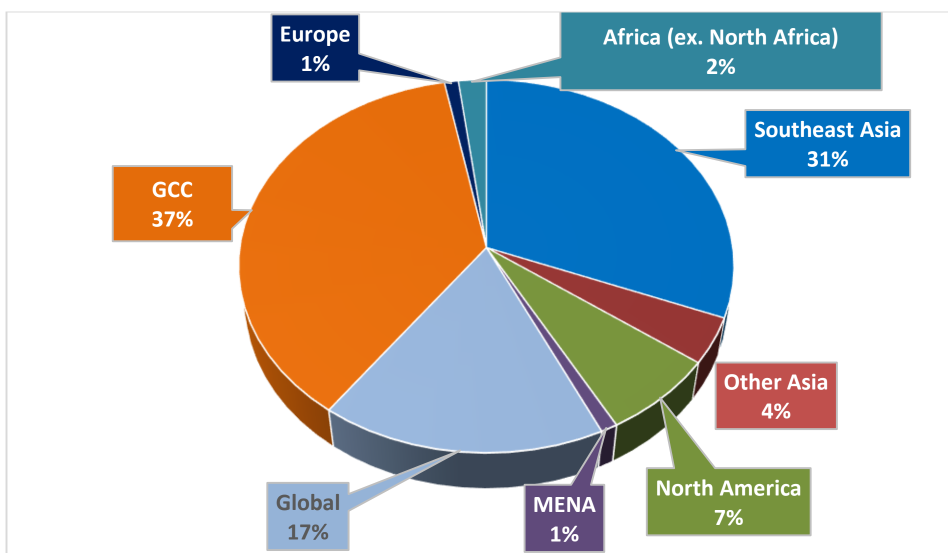
A promising segment of the Islamic asset management sector is exchange traded funds (ETFs). From 2008 to 2014, the segment experienced a remarkable rate of growth of around 20 percent on a cumulative average basis. Total assets under management by Islamic ETFs grew from $2.17 billion in 2008 to $10.75 billion in 2012. After a sharp decline in 2013 to $5.77 billion, the Islamic ETF sector recovered in 2014, with assets under management rising by around 10 percent to $6.33 billion, which accounted for more than 10 percent of total assets managed by the Islamic funds industry.

The share of pension, insurance, and equity funds is around 2 percent of the total assets under management (figure 7.2). The share of these three categories of funds did not change

significantly from 2008 to 2013, reflecting the general trends within the industry. This indicates that there is scope of diversification and expanding these types of funds in the future.

Figure 7.3 shows the distribution of outstanding Islamic funds by geographic area. Islamic funds are concentrated in the Gulf Cooperation Council (GCC) region (37 percent), followed by Southeast Asia (31 percent). Globally focused Islamic funds make up 17 percent of the total, while 7 percent target North America, and 4 percent are directed toward other Asian countries, notably Japan and China.

Figure 7.3 Global Islamic Funds Outstanding by Geographic Area, End-2014 (percent of assets under management)



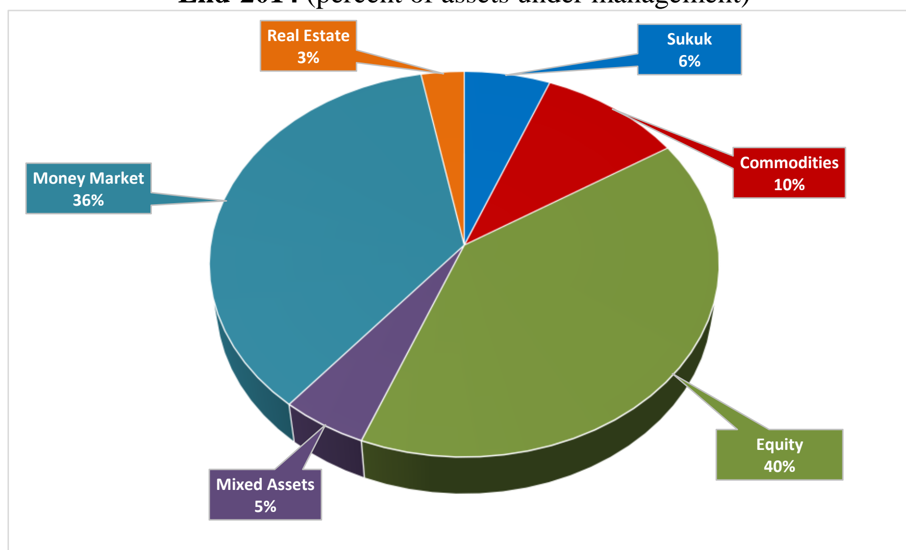
Source: Thomson Reuters 2015.
Note: GCC = Gulf Cooperation Council; MENA = Middle East and North Africa

As of end-2014, funds invested in equities dominated the Islamic asset management sector, with around 40 percent of the total assets under management (see figure 7.4). Money market funds were also popular, accounting for 36 percent of the total. While there has been a move away from commodity funds from 2009 to 2014 because of commodity price volatility, these funds still accounted for 10 percent of the total at the end of 2014. *Sukūk* funds constituted 6 percent of the total assets, mixed assets funds made up 5 percent of Islamic funds, and real estate funds accounted for around 3 percent.

While most the OIC member countries have public pension schemes for government employees, the number of private pension schemes is very small. Nevertheless, several *shari'ah*-compliant pension schemes are being established by Islamic financial institutions, which will enhance provision in the private sector. For example, in Pakistan, Meezan Bank has established a voluntary pension scheme called the Meezan Tahafuzz Pension Fund, and MCB-Arif Habib Savings, an asset management firm, launched the Pakistan Islamic Pension Fund. In some countries such as Turkey, the government has initiated regulatory reforms that promote expansion of pension schemes under public-private partnerships. Under the new regime that became effective

January in 2013 in Turkey, the government matches 25 percent of the contributions of participants (KPMG Turkey 2013). The reform has boosted the fund management industry in general and the private pension market in particular in the country (Sezer 2013).

Figure 7.4 Global Islamic Asset Management Funds by Asset Class, End-2014 (percent of assets under management)



Source: Thomson Reuters 2015.

The majority of the asset management products are targeted toward people who are well-off. For example, in the MENA region, while public pension funds target government employees, private pension funds are targeted toward a small number of privileged professionals (Rocha, Arvai, and Farzi 2011). As a result, people with lower income levels are unable to benefit.

However, achieving the goal of shared prosperity would require coming up with products that serve the needs of the poor and the low-income groups. One way for asset management products to be more accessible to the masses is to make them more affordable by, for example, lowering the minimum subscription rates. The Meezan Islamic Fund is an example of a fund that has a low minimum subscription of only PRs5,000 (aprox US$ 50)mto open an account, with subsequent investments of PRs1,000 (aprox US$ 10), which are very affordable amounts for small investors. Similarly, the Amana Mutual Funds in the United States has a minimum subscription of only $250.[66]

Although still being at the idea stage, a recent opportunity in Islamic finance realm that can contribute to the well-being of a sociey is the sustainable and responsible investment (SRI) *sukūk* which provides the investors opportunities to invest to assets and projects that are targeted

[66] See http://www.almeezangroup.com/MutualFunds/OpenEndFunds/MeezanIslamicFund/tabid/75/Default.aspx for the Meezan Islamic Fund, and http://www.saturna.com/pdf/amana/Amana-application.pdf for the Amana Mutual Funds.

to produce environmentally sustainable and socially responsible outcomes. Box 7.1 describes a promising new market for sustainable and responsible investment *sukūk*.

Box 7.1 Case 1. Green *Şukūk* and the Rising Trend in Responsible Investment

The area of sustainable and responsible investment (SRI) has remarkable implications for Islamic asset management industry to increase its contribution to shared prosperity. This is due to fact that the notions underlying SRI concept have a lot in common with the broad goals of Islamic finance. The strong emphasis on adhering to the values related to social and environmental development inherent in Islamic theology and jurisprudence has important implications for the investment behavior of Islamic finance investors. Therefore, relating the Islamc finance prodcuts such as *sukūk* to the concept of SRI and building such product structure in compliance with the fundamentals of SRI concept, will not only increase the number of products in which bot Muslim and non-Muslim investors may invest but also increase the contribution of Islamic asset management to shared prosperity.

As one of the recent examples of relating Islamic finance to SRI, the Securities Commission of Malaysia has launched of a new framework for SRI *sukūk* in August 2014 to facilitate the financing of sustainable and responsible investment initiatives (Securities Commission Malaysia 2014). As an extension of existing *sukūk* regulations, the new framework has refined the conditions for the issuance of SRI *sukūk,* defining the utilization of the proceeds; eligible SRI projects in areas such as education, health, and renewable energy that will contribute to the quality of life within society; disclosure requirements; and the appointment of independent auditors to provide detailed financial reporting.

Following this new legislation, Malaysia's sovereign wealth fund, Khazanah Nasional, is set to issue Malaysia's first social impact *sukūk* under the *Sukūk* Ihsan Programme (Reuters. 2015). The aim is to raise RM1 billion ($282 million) in 2015 and use the proceeds on educational projects.. The issue received a rating of AAA by a local rating agency. The Ihsan *sukūk* has several unique features, including a reduction in the principle amount invested whenever the projects to be financed meet specified performance indicators. Given this feature, the main driver for the demand for the *sukūk* is expected to be the annual distributions investors may collect and the buy-back guarantee provided by Khazanah for a nominal consideration. In addition to local investors, the *sukūk* is expected to attract a wide range of corporate investors with social responsibility agendas.

Along with the Malaysia's efforts in terms of SRI *sukūk*, the Gulf counties are working to develop green *sukūk* that will finance renewable and clean energy projects. The Dubai Supreme Council of Energy has announced a partnership with the World Bank to develop a green energy strategy, which also includes *sukūk* financing tool. The United Arab Emirates Securities and Commodities Authority has recently developed reforms to incorporate green *sukūk* into its *sukūk* regulation framework. The Saudi Arabia government also has ambitious intentions in the area of green energy. Given the fact that the GCC is one of the fastest growing regions in the world, with a population expected to exceed 53 million by 2020, the need for sustainable and responsible investments in energy, water, transport, and urban development is also predicted to grow. This need increases the potential for the development of SRI *sukūk* investments within the region.

Sources: *Islamic Finance News* 2015a, 2015b.

SME Finance

Small and medium enterprises (SMEs) contribute significantly to employment in developing countries. SMEs employing 5 to 250 workers contribute two-thirds (66.4 percent) of the average total permanent full-time employment in 99 countries, Ayyagari, Demirgüç-Kunt, and Maksimovic (2011) estimate. While they find that SMEs contribute greatly to employment and GDP, they do not find a robust relationship between the SME sector and productivity growth.

Despite this remarkable contribution of SMEs to GDP, in a survey of micro and small enterprises from 13 countries, the World Bank (2014, 107) found that limited access to finance was the key obstacle to operations identified most frequently (by 36 percent of the firms). SMEs worldwide face huge financing gaps. Table 7.4 shows the number of formal and informal SMEs that are unserved and underserved and the estimated amounts of the financing gap in different regions.

Table 7.4 Gaps in Enterprise Financing

Region	Total number of SMEs (million)	Unserved or underserved SMEs (million)	Total formal SMEs (million)	Unserved or underserved formal SMEs (million)	Formal SME credit gap ($billion)
East Asia and Pacific	188	92	12	8	$150–$180
Europe and Central Asia	20	10	3	2	$150–$190
Latin America and the Caribbean	52	27	3	2	$210–$250
Middle East and North Africa	21	10	2	1	$260–$320
South Asia	78	36	2	1	$10–$20
Sub-Saharan Africa	40	22	4	3	$70–$90

Source: Stein, Pinar Ardic, and Hommes (2013).

Although the financing gap for the SME sector is huge in developing countries, traditional banks do not have incentives or appetite to provide financing to these enterprises, as they are considered risky and costly (World Bank 2008). Specifically, banks are not willing to finance SMEs due to the various obstacles they face, including not only high risk but also limited specialization, high operating costs, and poorly developed legal systems. (IFC 2014b).

This is also reflected in the financing practices of Islamic banks as displayed on Table 7.5. In a survey of 160 conventional banks from nine countries, IFC (2014b) found that although 47 percent had adequate SME product offerings, the overall SME portfolio penetration rate was only 37 percent. The corresponding figures were much lower for Islamic banks: 16 percent had SME product offerings, but the portfolio penetration rate was only 11 percent (IFC 2014a).

In the same study on nine countries, IFC (2014b) estimates that about one-third (32.2 percent) of the SMEs would prefer *shari'ah*-compliant financing. That suggests a potential gap of $8.63 billion to $13.29 billion for Islamic SME financing in these countries. While there is a large demand for Islamic finance from SMEs (as table 7.5 indicates), Islamic banks have been unable or unwilling to meet this demand.

Table 7.5 Financing Penetration for SME Financing and Preference for *Shari'ah*-compliant Products

Countries	SME penetration (percent of lending)	Preference for *shari'ah*-compliant products (percent of SMEs)
Egypt, Arab Rep.	8.0	20
Iraq	5.0	35
Jordan	12.5	25
Lebanon	16.1	4
Morocco	24.0	54
Pakistan	7.3	25
Saudi Arabia	2.0	90
Tunisia	15.0	18
Yemen	20.3	37

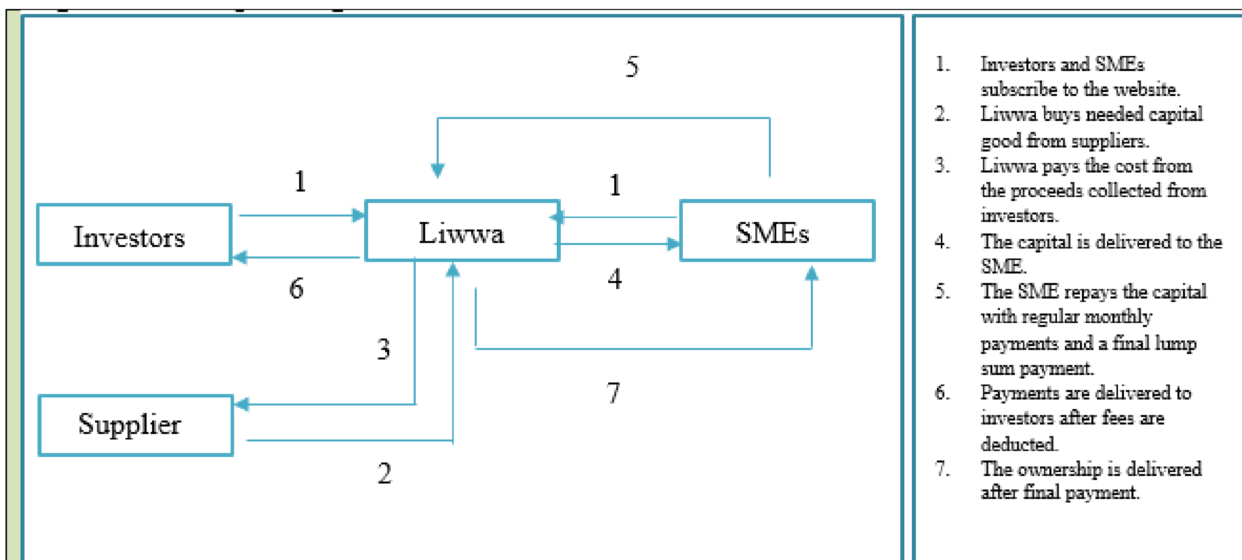
Source: IFC 2014b.

An alternative to provide financing to SMEs would be NBFIs. A survey of 36 Islamic micro SME financing providers revealed that only 15 percent of the institutions were banks (Sanabel 2012). Nearly half of the providers (49 percent) were nongovernmental organizations (NGOs), followed by NBFIs (24 percent). While 6 percent of the providers were microfinance banks, government organizations and cooperatives constituted 3 percent each. The substantial demand for SME financing and the low penetration by banks indicate that there is a role that NBFIs can play to fill the gap. The gap can be filled by various types of NBFIs, such as private equity funds, rural cooperatives, and leasing companies. An example of an innovative NBFI using crowd-funding is given in box 7.2.

Box 7.2 Case 2. Liwwa: A *Shari'ah*-Compliant Peer-to-Peer Lending Platform

Liwwa is an electronic platform that aims to tackle the chronic unemployment and underdevelopment problems of the Middle East. Developed in 2012 by two Palestinian entrepreneurs at Harvard University, it was launched in September 2013. Specifically, the new company's mission is to deliver job and income growth in the markets it serves. Liwwa is operating in Amman, Jordan for borrowers and across the MENA region for those who seek to lend to SMEs. The platform provides investors a return on a regular basis through a *shari'ah*-compliant mechanism with no equity or interest in the equation (figure B7.2.1).

Figure B7.2.1 Operating Framework of Liwwa



The platform focuses particularly on the finance of small businesses in compliance with *shari'ah* . Using the crowd-funding model offered by Liwwa, SMEs that need working capital and physical capital can raise funds from crowds of investors, who pool their assets through the internet platform in return for the principle amount raised and part of the profit in the form of monthly payments. After the full payment, borrower becomes the whole owner of the assets acquired through raised funds. Working along the lines of an *ijārah* (Islamic leasing)-*like* lease-to-own basis, the transactions taking place through the platform are recognized as *shari'ah*-compliant. Since investors know what they are going to get in returns and at which date, the model offered is more like a bond rather than an equity investment. The platform takes services fees from the monthly repayments made by the borrowers to cover administrative expenses, and the funding of a reserve to underwrite the payments to the investors.

The services are available to the small businesses in Jordan, and to investors from countries such as the Algeria, the Arab Republic of Egypt, Jordan, Lebanon, Saudi Arabia, Sudan, Tunisia, United Arab Emirates, and the United Kingdom. As of March 2015, the target loan of the company was 10,000 to 15,000 Jordanian dinars (around $14,100 to $21,100). Up to that time, Liwwa had provided 34 loans, some of which were still at the funding stage, for a total of $260,000.

Although these amounts are rather small, the company has grown by 400 percent since March 2015, when the initial $500,000 of seed capital was paid up. Moreover, the model presents a good example of how Islamic finance tools can be utilized to share prosperity by people who have excess funds with SMEs so that added value is created. The crowdfunding model of Liwwa, which is based on a lease-to-own structure, has attracted not only investors with an Islamic orientation, but also a diversified set of investors from various parts of the world. This is promising in light of the momentum in the peer-to-peer finance sector worldwide.

Source: https://www.liwwa.com/ .

Housing Finance

The use of Islamic finance has significant implications as respect with enhancing shared prosperity and risk sharing in housing finance. Indeed, the deployment of Islamic finance tools for home financing has the potential to prevent from some of the problems that led to the recent global financial crisis. One of the main reasons underlying the global financial crisis was the housing

market bubble in the US that was fuelled by excessive household debt (Mian and Sufi 2014; Turner 2015). Turner (2015) contends that the financial sector has tendencies to create excessive debt and proposes introducing regulations that restricts the growth of credit to the household sector. Mian and Sufi (2014) assert that debt-based contracts used to purchase houses leaves the household sector vulnerable when the bubble eventually bursts. For example, equity of a household putting 10 percent down payment on a mortgage can become negative with a drop of price of house of more than 10 percent in a housing market downturn. While this decreases household wealth and reduces consumption and aggregate demand that can further aggravate the recession, it leaves the debt owed to the bank intact. They suggest that one way of solving this problem is to use risk-sharing contracts that not only protect households but also can prevent housing bubbles to emerge. In this regards, implementing Islamic finance solutions,i.e. diminishing musharakah structure, properly in home financing can serve as a stabilizing factor for both the financial and housing sectors and protect households during recessions.

Housing finance in most IDB member-countries is at a nascent stage. Considerable housing financing is needed to meet the housing finance requirements. While the bulk of housing finance is provided by banks, governments in some countries have established specialized home financing institutions. Some 8.2 million units are needed each year in the urban areas of IDB member countries, according to estimates based on the growth rates of population and urbanization (Shirazi, Zulkhibri, and Ali 2012). Providing for these units is estimated to cost $15.6 billion a year. The distribution of the housing units and the corresponding financing costs for different regions are shown in table 7.6.

Table 7.6 Demand for Housing Units by Region, 2010–20

Regions (number of countries)	No. of units/year (million)	Amount of financing/year ($billion)
MENA (19)	3.2	6.0
Asia (8)	2.7	5.2
Sub-Saharan Africa (22)	1.9	3.7
Countries in transition (7)	0.4	0.7
Total (56)	8.2	15.5

Source: Shirazi, Zulkhibri, and Ali 2012.

As an illustration, table 7.7 presents the features of the housing finance market in Pakistan, which has a mortgage to GDP ratio of 0.46 percent. The total size of gross outstanding housing financing in the country on December 31, 2014 was PRs53.7 billion ($5.35 million), advanced to 74,147 clients.[67] Thirty-six percent of the financing was supplied by private banks, 24 percent by the House Building Finance Corporation Limited (HBFCL), 28 percent by Islamic banks, and 11 percent by public sector banks (SBP 2015).

[67] The U.S. dollar figure was calculated at the exchange rate of $1.00 to PRs00.30 as of December 31, 2014.

Table 7.7 Housing Finance in Pakistan, End-2014

Financial institutions	Gross outstanding (PRs billion)	Outstanding disbursed (percent of total)	Number of borrowers	Average financing size (PRs million)
Public banks	6.0	11	4,991	3.0
Private banks	19.2	36	10,613	5.8
Foreign banks	0.3	1	129	5.0
Islamic banks	15.3	28	3,277	5.1
DFIs	0.1	0	53	--
HBFCL	12.7	24	55,084	2.5
Total	53.7	100	74,147	3.8

Source: SBP 2015.
Note: -- = not available; DFIs=development financial institutions; HBFCL = House Building Finance Corporation Limited.

Outreach to the poorer sections of the population can be gauged by examining the average size of financing. Private financial institutions averaged at PRs5 million or more, compared to PRs3 million for the public financial institutions, with HBFCL extending the smallest amount, PRs2.5 million. Microfinance banks provided PRs 216.07 million to 2,154 borrowers as of December 2014, according to SBP (2015). With an average of PRsR 0.1003 million outstanding per borrower, the number of persons served appears to be very small compared to the poor and low-income population in the country.

The case of Pakistan shows that most of the housing finance comes from banks and specialized financial institutions that serve the relatively well-off. Some financing for houses to the bottom 40 percent of the population is provided by specialized banks such as HBFCL and by microfinance banks. Other NBFIs have a role to play in providing house financing to the unserved. An example of NBFI that provides home financing is given in box 7.3.

Box 7.3 Case 3. NBFI *Shari'ah*-compliant Home Financing in Canada

Ansar & Islamic Cooperative Housing Corporation Ltd. (ACHC) was established in Toronto in 1981 to provide *shari'ah*-compliant home financing for Canadian Muslims using the deminshing *musharākah* model. ACHC has two kinds of shares. Common shares are shares in the equity of the cooperative. Preferred shares are attached to the individual members' own houses. The price of both common and preferred shares is fixed at Can$100 each. Initially, every member is an investor or common shareholder providing equity to the cooperative. Everyone who wishes to participate in the cooperative must become a member by paying a one-time membership fee of Can$75 and must invest a minimum of Can$600 by buying six common shares. Those members who wish to buy a house through the cooperative must buy and accumulate a certain minimum number of common shares, depending on the cost of the house. This minimum investment must remain in the cooperative for at least six months before the member can qualify to apply for housing finance.

Once a member becomes eligible to buy a house, he/she submits an application to the cooperative. If approved, the member is authorized to locate a suitable house anywhere in Canada, negotiate the price, and obtain a closing date from the cooperative for the full payment and possession of the house. At the time of the purchase of the house, members surrender their common shares and are issued preferred shares to reflect their total contribution, including any deposits they gave to the vendor

when they signed the contract to buy the house. The concept of decreasing *musharākah* (partnership) is used to finance the housing. The decreasing partnership model was chosen because of its practical features and flexibility. There is no fixed term in the contract. A rental value for the house is determined, and the members pay a proportionate rent to the cooperative every month. The members are free to buy any number of preferred shares at any time. When they do, their proportionate rent is adjusted for the following month.When members complete 100 percent purchase of the required preferred shares, they surrender those shares to the cooperative and the legal title of their houses is transferred to them after sharing any gain or loss in the value of the house. The members are entitled to share 90 percent of any gain or loss, and the cooperative shares 10 percent. At this point, the partnership in that house between the member and the cooperative is terminated. The membership in the cooperative, however, continues and members are expected to continue to invest their savings in the cooperative so that the other members can be helped the same way. The cooperative pays dividends annually to all common shareholders from the rental income according to the ratio of their quarterly ownership of the shares

Sources: Nasim 2003; http://www.ansarhousing.com/.

Other NBFIs (*Muḍārabah* and *Ijārah* Companies)

A unique example of Islamic NBFIs are the *muḍārabah* companies. *Muḍārabah* companies operate on the principle of 'profit-sharing and loss-bearing' wherein enterprenure share the profit with the financier but lossess are fully born by financiers. *Muḍārabah* companies started their operations after the enactment of the *Muḍārabah* Companies and *Muḍārabah* Floatation and Control Ordinance in 1980. After the launch of the first *muḍārabah* company in 1980, the number has increased to 56 in the mid-1990s and then declined to 24 as of December 2014 (NMAP 2013; SECP 2014). The value of total assets held by the *muḍārabah* companies was PRs30.19 billion ($296.8 million) as of December 2014.[68] While the bulk of the funds of *muḍārabah* companies are in the form of equity, some of them also raise funds by issuing *mushārakah* Certificates of Investment and Terms Finance Certificates (NMAP 2013).[69] The total amount of funds raised from different categories of clients is shown in table 7.8. More than two-thirds of the funds raised by *muḍārabah* companies come from individuals, followed by corporations and trusts.

Table 7.8 Deposit Raising by *Muḍārabah* Companies, End-2104

Categories	Amount (million PRs)	Percentage of total
Individuals	4,226.84	67.4
Corporates	970.27	15.5
Trusts	840.34	13.4
Financial institutions	229.45	3.7
Total	6266.90	100

Source: SECP 2014.
Note: PR = Pakistan rupees.

[68] Calculated with an exchange rate of $1 = PRs 101.7 (on June 24, 2015)
[69] *Mushārakah* is a partnership whereby all the partners contribute capital for a business venture. The partners share profits on a pre-agreed ratios while losses are shared according to each partner's capital contribution.

The scope of operations of *muḍārabah* companies is wide ranging. In addition to providing financing using a variety of methods, *muḍārabah* companies are also involved in trading, manufacturing, investment in equities, portfolio management, financing private equity/venture capital, housing finance, and providing investment finance services (NMAP 2013). Given the range of activities that *muḍārabah* companies can engage in, they can potentially make a positive contribution to economic growth. However they account for only a very small part of the financial sector, representing only 0.12 percent of Pakistan's GDP as of December 2014.

Another important type of NBFIs are *Ijārah* companies. *Ijārah* is similar to the concept of leasing in conventional finance. One of the important feature of leasing is the financing of assets without any collateral. Leasing companies are better able to assess credit risk due to their ability to understand the cash flows associated with the assets. Thus leasing can be a better financing mode for SMEs that do not have a sound credit history (Rocha, Arvai, and Farazi 2011). The leasing sector in most the IDB member-countries, however, is relatively small. Box 7.4 illustrates an example in Tajikistan.

Box 7.4 Case 4. ASR Leasing in Tajikistan

The leasing industry in Tajikistan is relatively small. Before the establishment of ASR Leasing as the first *Ijārah* company in 2013, the country had seven other conventional leasing companies. ASR was established by Ansar Leasing of Azerbaijan along with two local partners with initial paid-in capital of only $200,000. The paid-in capital was later increased to $4 million with additional shareholders' funds that include Islamic Corporation for the Development of the Private Sector (ICD) of the Islamic Development Bank Group.

ASR Leasing typically leases fixed assets to SMEs and corporations up to a maximum of $200,000 per contract, for a tenure that can range from 1 to 4 years. The conditions of the leasing contract include a 20 percent minimum security deposit/advance payment and insuring the leased asset for the duration of the tenure. The lease contract can be structured in either the local currency or in U.S. dollars. Repayments must be made using the prevailing exchange rate announced by the National Bank of Tajikistan. The expected rate of return on leasing is in the range of 20–23 percent, depending on the length of the tenure. Given that 90 percent of the country's population is Muslim and that SMEs account for more than 80 percent of the trading sector, the demand for Islamic leasing is expected to increase in the future.

Source: Presentation by the Managing Director of the ASR Leasing, http://idbgbf.org/assets/2013/7/9/pdf/23edbe7c-6b56-49a6-9e80-237804c5b058.pdf.

Islamic NBFIs and Shared Prosperity: Key Challenges and Policy Recommendations

Sectoral Challenges: Supply-side Issues

The achievement of shared prosperity requires expansion of the NBFI sector to facilitate the provision of financial services to more segments of the population. Specific challenges in expanding the NBFIs sector are discussed next.

Increasing the Number and Diversity of Islamic NBFIs

The key constraint on the supply side is the limited number of NBFIs in most of the Muslim countries. The development of the range of Islamic NBFIs can take place in two ways. The first approach is to create new institutions that do not have counterparts in the conventional financial world. Examples of these are *Tabung Haji* in Malaysia and the *muḍārabah* companies developed in Pakistan. These institutions have unique institutional features serving different purposes in the economy. The second approach is to adopt and adapt conventional financial institutions to encourage them to provide Islamic finance services. Adaptations involves eliminating undesirable elements (like *ribā* and *gharar*) from transactions. In this process, the functions performed by the Islamic NBFIs will be similar to their conventional counterparts, but the operations would be within the bounds prescribed by *shari'ah*. In response to demand, some conventional NBFIs are offering Islamic financial alternatives to their clients. Examples include the ORIX Leasing Company in Pakistan and the Peoples Leasing and Finance Company in Sri Lanka.[70]

Another key role of Islamic NBFIs is to provide Islamic financial services in countries where establishing Islamic banks is not possible due to legal and regulatory restrictions. As laws related to NBFIs are less stringent than those governing Islamic banks, Islamic NBFIs can provide Islamic financial services under existing laws and regulations. For example, finance companies in the United States and cooperatives in Canada are offering Islamic housing products to Muslims residing in these countries. An indigenous institution providing funds to small-scale enterprises and businesses is the pawning institution in Malaysia (Ahmed 2011). By combining contracts of *wadī'ah* (deposit) and *rahn* (pledge or mortgage), the pawning services provide short-term cash advances, including working capital for businesses.

The financial sector requires specific knowledge and skill sets that analysts, bankers, accountants, and lawyers often lack in developing countries. The growth of the financial sector in general and the NBFI sector in particular can be constrained by the availability of adequate and relevant human capital (Carmichael and Pomerleano 2002, 199). The risks arising in providing financial services to the bottom 40 percent of the population are considerable and need to be dealt with prudently. For example, information asymmetry is more acute in the case of financing SMEs relative to larger firms and would require different types of skills and approaches for mitigation.

Sector-specific Supply-side Issues

The limited number of services providers is constraining the asset management industry (Rocha, Arvai, and Farazi 2011). Many countries lack the critical mass of fund managers to serve different segments of the population. Furthermore, there is a lack of suitable instruments and products. Thus there is a need to expand the products geared toward lower income groups.

SMEs financing has relatively high risks, as is evident from the proportion of nonperforming loans (NPLs) (IFC 2014a, 33). NBFIs may have limited specialization in SME financing. Their capabilities to serve the SME sector must be improved to deal with the specific risks involved in SME financing (IFC 2014b). Enhancing the skills to manage the risks arising in SME financing is thus important. In coming up with a strategy, a distinction should be made

[70]See http://www.orixpakistan.com/islamic-financing.aspx for ORIX Leasing Company and http://www.plc.lk/inpages/products_and_services/islamic_finance.php for the Peoples Leasing and Finance Company .

between the different market segments: well-served, unserved, and underserved enterprises. While the former are being funded adequately, the latter two segments are not. In this regard, a classification of SMEs according to sectors would be useful.

The bulk of SME financing is short term and is used to finance working capital. There appears to be a gap in the provision of long-term financing for SMEs. Furthermore, the product offerings for SMEs are very limited. There is a need to come up with new product offerings that meet the needs of SMEs (IFC 2014a). Currently, debt-based products dominate the assets side of the balance sheet. Other modes of financing such as *istiṣnāʿ, muḍārabah,* and *mushārakah* also need to be used. However, the risks associated with these products need to be mitigated.

Since most leasing companies use financial leases in most of developing markets, there is a need to expand the number of leasing companies that also use operating leases to fulfill the *shariʿah* requirements. An enabling environment that can provide support to these kinds of companies is needed.

Demand and Investor Side Issues

Consumers demand determines the financial services that are provided. In case of NBFIs, individuals and entities use the sector to obtain capital, and also supply the funds as investors. The expansion of Islamic NBFIs will largely be driven by demand for their services, which in turn depend on several factors, discussed next.

Low Levels of Financial Literacy

Research shows a positive relationship between financial literacy and financial inclusion (Atkinson and Messy 2013). A survey of 301 microfinance institutions revealed limited financial literacy to be the main obstacle in providing financing (Gardeva and Rhyne 2011). This is particularly true for Islamic financial products, which are not only new for many people, but also may be more complex. There is a need to come up with schemes to educate people and raise awareness of Islamic financial products.

Cultural, Social, and Physical Barriers

Many Muslims would not engage with the conventional interest-based financial institutions due to religious convictions. Furthermore, the lack of language and technological skills may prevent people from using modern technology such as the internet to access financial services. A large percentage of the population living in rural areas in developing countries faces physical barriers due to poor physical infrastructure (Atkinson and Messy 2013). One way to overcome the physical barrier is to have local NBFIs that can provide financial services to the poor. Another option is to use modern information and communications technology to deliver basic financial services at a very low cost.

Consumer Protection

One of the key determinants of the growth of the financial sector is the protection of the rights of the investors. Expanding the investor base requires not only products and instruments that are appropriate, but systems to ensure the protection of clients and investors. As the NBFIs sector is relatively less stringently regulated, cases might emerge where institutions have been mismanaged that have resulted in loss of assets of investors. After the financial crisis of 2008,

some NBFIs, including a few that were Islamic, became insolvent or declared bankruptcy[71]. These failures highlighted the need for sound disclosure of relevant information related to the terms and conditions of the contracts, with the relation to returns and risks. This needs detailed disclosure. In countries that have weak investors rights, funds with longer-term investment horizons will not be forthcoming. Thus leasing companies that depend on long-term funding will face funding constraints that will hamper their growth (Nasr 2004, 9).

Reputation and Credibility

Provision of funds to financial institutions by investors also depends on their perceptions of risks and rights. As significant percentage of the customers use Islamic financial institutions for religious reasons, there is a need to ensure that the products and activities of NBFIs comply with *shari'ah*. Furthermore, perception and trust about the integrity and efficient management of the operations are important determinants of growth of the Islamic financial industry. There have been a few cases of mismanagement and fraud that have hurt the reputation and credibility of the industry. For example, UM Financial, an Islamic NBFI in Canada, filed for bankruptcy in December 2011 due to mismanagement (Pasha and French 2011).

Legal and Regulatory Challenges

An enabling environment to promote Islamic finance in general would imply the presence of a favorable political, economic, and regulatory environment (IFC 2014b). The legal and regulatory framework not only determines the specific NBFIs that can be established in a country, but also the activities they can engage in. There is a need to not only have laws that support Islamic NBFIs, but also a legal infrastructure to support contract enforcement. Sound contract enforcement regime is essential for the development of the financial sector, as it not only reduces the transactions costs (Nasr 2004) but also instills trust among investors and financial institutions.

A balanced regulatory framework can play an important role in the healthy growth of the NBFI sector. The key objectives of regulations are to deal with anticompetitive behavior, market misconduct, asymmetric information, and systemic instability (Carmichael and Pomerleano 2002, 33). The nature of an NBFI in terms of its association with these areas of concern and the risks involved will determine the regulatory perameters that would govern the specific institution.

Sector-specific Legal and Regulatory Issues

In addition to general laws that support economic and financial activities such as property rights and contractual enforcement, the legal framework is a key determinant of the strength and soundness of the NBFI sector (Carmichael and Pomerleano (2002). Given the diversity of the NBFIs, there is a need to come up with laws that can deal with the specific issues arising from the different areas and the ways in which NBFIs operate. While the existing laws on NBFIs can be extended with minor adjustments for Islamic NBFIs such as Islamic leasing companies and mutual funds, there may be a need to enact new laws to accommodate unique Islamic NBFIs. Such as the *Mudārabah* Companies and *Mudārabah* Floatation and Control Ordinance in Pakistan.

The specific issues related to the establishment and operations of Islamic NBFIs, such as licensing, minimum capital requirements, and disclosure requirements, can be covered under regulations for the supervision of specific NBFIs. The nature of regulatory measures applied to

[71] The failures in the GCC, in particular, caused reputational damage to the industry. The institutions affected included Aayan Leasing and Investment Company (2011), Investment Dar (2010), Noor Financial Investment Company (2011), and Arcapita Bank (2012) (Raghu, Pattherwala, and Tulysan 2013).

different NBFIs will depend on the extent to which they are exposed to and cause anticompetitive behavior, market misconduct, asymmetric information, and systemic instability (Carmichael and Pomerleano 2002, 33). The regulatory measures to deal with these problems can be broadly categorized as competition regulation, market conduct regulation, prudential regulation, and systemic stability regulation.

Since mutual funds are less exposed to systemic risks, the investor protection regulations would be required such as licensing, disclosure, and good governance (Carmichael and Pomerleano 2002, 111). The regulation of pension funds, however, would depend on their type and the risks involved. For example, whereas a defined contribution scheme managed by competitive private sector entities would have the same regulatory requirements as mutual funds, the regulation of a defined benefits scheme would require more regulatory oversight, which may include periodic actuarial reviews.

A sound legal and regulatory framework for leasing companies is necessary for the growth of leasing industry in general and for Islamic leasing companies in particular. For leasing companies, the World Bank (2008) asserts that the leasing law should clarify the lessor's effective ownership and repossession rights and acknowledge the lessee's responsibility as the custodian of the asset. For leasing to succeed, it requires a sound legal framework that defines the rights and obligations of the lessor and lessee in general, and in case of bankruptcy in particular. The law needs to recognize that some features of Islamic leasing are different from financial leases. Most countries lack registries for leased assets, which limits the lease financing.

One of the key financial infrastructure institutions that reduces asymmetric information are credit bureaus (Nasr, 2004). Financing to SMEs could be expanded by different NBFIs if credit registries exist that enable financiers to reduce adverse selection problems.

Housing sector financing for construction or acquisition would also require a facilitating legal environment. The lack of efficient laws related to land registration, land division, mortgage laws, laws related to collateral, and precise legal titles can be challenging (Shirazi, Zulkhibri, and Ali 2012).

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Chapter 8

Alternative Asset Classes

Islamic financial institutions have endeavored to provide as wide a range of facilities for their clients as their conventional counterparts. This includes not only banking services and mainstream capital market products, but also alternative investments. Asset diversification is not just desirable for investors seeking *shari'ah*-compliant assets, but also opens up wider possibilities for those seeking financing. The pricing of alternative assets is often uncorrelated with equity prices and those of fixed income instruments, including *sukūk* (Islamic certificates of investment). Hence such assets provide a degree of hedging for investors from the inevitable business cycles.

Overview of Alternative Asset Classes

There is a very wide variety of Islamic alternative assets, which in essence comprise all financial investments apart from listed equity and fixed income securities (Schneeweis, Kazemi, and Martin 2003). The major categories include private equity, hedge funds, real estate investment trusts, the *ḥalāl* food industry, trade financing instruments, and infrastructure investments through project finance (Terhaar, Staub, and Singer 2003). All of these serve very different purposes and share few common characteristics apart from being usually less liquid than mainstream investments. Most are relative new from an Islamic finance perspective, as the industry has been focused mainly on banking and capital market instruments for most of the half century since its development. It is only in the last decade, and especially since the global financial crisis of 2007–08, that interest in Islamic alternative investments has increased, partly reflecting disillusionment with returns on *shari'ah-* compliant equities and *sukūk* securities.

When considering the merits of alternative asset classes from an Islamic perspective, the principles of risk sharing and participatory finance should be taken into account. How far do alternative asset classes adhere to these principles, which justify the returns earned by investors? Islamic finance is not about earning windfall gains, but rather implies an active involvement in what is being funded, usually by sharing in risk rather than playing a managerial role in a project (Archer and Karim 2006).

The wide variety of alternative asset classes means that *shari'ah* concerns vary according to the particular asset being considered as an investment vehicle; it is difficult to generalize across alternative assets as a whole. Some of the assets, such as private equity holdings, are inherently more *shari'ah*-compliant than others, such as hedge funds. The detail matters from a *shari'ah* perspective, and it is important to understand the workings of the financial arrangements and how returns are generated for the investors. *Shari'ah*-compliant capital is often deployed alongside conventional finance in alternative asset categories. Although such combinations may be quite legitimate, it is necessary to understand the nature of the interactions.

Islamic alternative asset classes are managed by a wide range of financial institutions, including Islamic and conventional banks, Islamic funds, *takāful* providers, pension funds, and other institutional investors. As a consequence, there are no aggregate data enabling comparisons to be made of the size of different asset categories, such as private equity or hedge funds. It is likely that real estate dominates, given the preference of many Muslim investors for visible assets. This is especially the case with individuals of high net worth in many Muslim countries, including family offices in the Gulf Cooperation Council (GCC) States, that value investment in commercial and residential real estate more than investing in financial instruments.

Investors in alternative assets, especially those seeking superior returns, typically have a greater appetite for risk than those investing in bonds and traded equities. One motivation for investment in alternative investments is to seek higher returns, especially for investors in private equity and hedge funds. Often investments in alternative assets are less liquid than bonds and listed equities that can be sold at any time (Siegel 2008). Once funds are locked in, there is little that investors can do if there are market downturns as the economic outlook deteriorates. As alternative assets are so diverse, however, that price movements are not necessarily correlated with those of listed equity or bonds. Some, such as hedge funds, can be regarded as countercyclical. Real estate valuations are subject to different business cycles than those for equity markets. In short, alternative assets may be more risky, but they also serve to diversify risk.

Alternative investments are usually less transparent than those in stock markets, as private equity purchase and sales prices are subject to negotiation, and in the case of real estate, valuations may differ widely. Hedge funds are often opaque, with limited information provided on their investments or the contracts used to generate profits (Agarwal and Naik 2004). This lack of transparency adds to risk, with most investors in alternative asset classes largely relying for information about them on their previous performance, rather than the fundamentals regarding the underlying assets and the disaggregated sources of income and capital gains.

Islamic Private Equity

Shari'ah-compliant private equity investment is subject to the same screens as investment in listed companies, which exclude companies that are heavily leveraged or are engaged in *ḥarām* activities, such as alcohol and pork production or distribution (Chatti and Yous 2010). Companies that derive a significant proportion of their income from *ribā'* (interest) are also excluded, including conventional banks and many other financial institutions. In practice, as the dominant financial institutions are large listed companies, private equity plays no role in their financing. Rather it is usually small to medium enterprises (SMEs) that seek private equity, especially in fields such as pharmaceuticals, alternative energy, or information technology, which are inherently *shari'ah*-compliant. Injections of private equity into such companies can reduce their debt burdens, resulting in them being more suitable for Islamic investment.

Venture capital represents a subset of private equity finance, as it is sought by recently established companies that are insufficiently mature to be listed on the market, but which can use private equity not only to fund development directly but also to gain additional debt finance. In the case of *shari'ah*-compliant venture capital, this can include trade and project financing from Islamic banks, often under *murābaḥah* (trade finance) and *istiṣnā'* (project finance) contracts. *Mushārakah* (joint ventures) and *muḍārabah* partnership finance can also be used for private equity. *Mushārakah* is more suitable for proactive investors who wish to be more involved in the management of the venture that is seeking capital (Alam Choudjury 2001). *Shari'ah*-compliant

private equity and venture capital finance should not be seen as an alternative to debt finance, but rather as a facilitator of such financing, while keeping leverage within limits that are acceptable from an Islamic perspective.

Islamic private equity finance has emerged only since the 1990s, with most of the activity confined to Malaysia and the GCC States (Karake-Shalhoub 2008). While much of the financing in Malaysia has been in domestic enterprises, in the GCC the financing has largely been directed toward European and U.S. companies. This is starting to change, however, as opportunities for private equity increase, especially in Saudi Arabia and the United Arab Emirates. Family businesses are becoming more interested in raising private equity finance to fund expansion. In the case of pious owners, Islamic private equity seems the obvious choice, especially as their businesses are already *shari'ah*-compliant (Wilson 2006). The institutions providing Islamic private equity finance are mostly investment companies rather than Islamic banks, which are much more constrained as regulated deposit takers.

Case Study: Alkhabeer

Typical of these companies is Alkhabeer Capital, an investment company based in Jeddah, which is playing a major role in the provision of private equity finance in Saudi Arabia.[72] The company was established in 2004 as an investment advisory business focused on the development of *shari'ah*-compliant products, but has since increased its own proprietary capital base, as well as managing investments on behalf of its clients. It employs a staff of 80 professionals, including investment analysts. As table 8.1 shows, its assets under management have grown rapidly. As it has gained more experience with the businesses financed, the return on assets has increased impressively.

Table 8.1 Alkhabeer Financial Highlights

	2010	2011	2012	2013	2014
Assets under management (SRl million)	535.84	1,442.87	1,641.87	2,498.18	3,335.07
Total revenue (SRl million)	54.81	64.63	107.35	125.70	158.18
Operating expenses (SRl million)	43.81	45.49	76.31	83.19	100.88
Net income (SRl million)	11.00	19.15	31.04	43.32	57.30
Return on assets (percent)	2.74	3.23	3.89	5.25	6.32

Source: Alkhabeer Annual Report, 2014.

Two initiatives sponsored by Alkhabeer in 2014 illustrate its business priorities. The first aims to assist the SME sector in playing an increasing role in the economy of Saudi Arabia. SMEs, while considered to be the engine of growth and stability in developed economies, often suffer from a lack of access to capital in emerging markets. As a result, Alkhabeer decided to support this subsector by providing SMEs with growth capital.

Second, Alkhabeer decided to invest further in the small but expanding venture capital sector in Saudi Arabia. While the Kingdom is the largest economy in the region, it has lagged behind regional centres such as Dubai in terms of providing the ecosystem required for the venture capital companies to succeed. Despite significant amounts of resources invested in this sector, the

[72] http://www.alkhabeer.com/.

landscape is still mostly void of serious participants. No Authorized Person[73] has yet moved into this arena. Alkhabeer has therefore launched a venture capital initiative to plug the gap in the marketplace, by preparing for the launch of a Saudi venture capital.

Alkhabeer Private Equity is closely involved with the senior management of its portfolio companies to realize both operational and financial value for all parties, including co-investors. It invests in potential targets through opportunity-specific funds. Target companies are primarily selected with on the basis of the following investment strategies:

- Acquisition of majority stakes in noncore operating companies owned by family groups
- Acquisition of significant minority stakes in blue chip companies with prospects for initial public offerings (IPO)
- Involvement in partnerships with international companies
- Investments in small and medium enterprises.

In 2014, Alkhabeer launched two *shari'ah*-compliant close-ended private placement health care funds. The first, Alkhabeer Health Care Private Equity Fund I (AHPEF I closed fund), acquired a majority stake in Eed Group, a Saudi-based health care company based in Jeddah. Established in 2001, Eed Group is one of the leading vertically integrated health care groups in Saudi Arabia. The Group initially operated as an independent health care provider focusing on cosmetic surgery and outpatient specialty primary care services, but in 2013 expanded into additional services such as a pharmacy business, medical equipment supply, and third-party management and operations.

The second initiative, the Alkhabeer SME Fund I, is a private placement close-ended fund launched in December 2014 to manage the acquisition of the majority stake in the Ajaji Medical Group, based in Riyadh. Established in 1995, the Group owns and operates four polyclinics and five pharmacies in Riyadh, providing health care services primarily to resident expatriates in the Kingdom. This new Fund heralds the implementation of Alkhabeer's private equity SME strategy, which targets *shari'ah*-compliant small and medium enterprises in Saudi Arabia and the United Arab Emirates.

Hedge Funds

The term "hedge" implies an investment strategy that seeks to minimize risk, often by transferring it to another party. Islamic finance involves risk sharing, rather than risk transfers. As sharing is what justifies the returns to investors, hedging activity would appear at first glance to be off limits to investors seeking *shari'ah*-compliance. In reality, however, hedge funds represent a very heterogeneous class of assets, and the distinction between risk sharing and risk transfers often becomes somewhat blurred. Hedge funds are relatively safe investments most of the time, but when they fail, the results for the investors can be catastrophic, wiping out all their capital. Some investors are willing to be exposed to hedge funds with such a risk profile, either because they expect vastly superior returns when markets are rising or positive returns in falling markets.

Managers of hedge fund usually have a less restrictive mandate than those managing equity or bond portfolios, as they can invest in derivative instruments such as futures and option contracts

[73] A registered and regulated fund, regulated by the Capital Markets Authority of Saudi Arabia.

to hedge their positions (Ackermann, McEnally, and Ravenscraft 1999). Instead of diversifying by holding a wide range of investments in equities and bonds to reduce risk, they often concentrate on acquiring major holdings in a few companies, while limiting the risks through derivatives trading. The aim is not to attain market returns as with tracker funds or exchange traded funds, but to obtain high absolute returns.

While direct investing in equities is seen as socially useful, as it contributes to business expansion and job creation, the link between derivatives and the real economy is much less clear. Derivatives trading can either destabilize or stabilize financial markets. Although it may be justified in commodity markets, where hedging can be helpful for companies and their clients,[74] its merits in equity or bond markets are more questionable. In particular, short selling, which is widely used by hedge funds, can be viewed as exploitative of counterparties, whose losses accrue to the hedge fund gains in what amounts to a zero sum game.

One type of short selling to profit from falling markets is where an investor lends stock to a hedge fund manager under a repurchase contract. The hedge fund manager then proceeds to sell the stock at the prevailing spot price, while simultaneously purchasing a future contract to buy back the stock at a lower price, given some market participants' anticipation of price falls. The hedge fund manager gains from the price difference, while ensuring that the transaction can be closed with the return of the stock to the original investor (Agarwal and Naik 2004).

From a *shari'ah* perspective, short selling activity is highly dubious, as it is regarded as speculative and involves *gharar* (contractual uncertainty or legal ambiguity), which is explicitly condemned in Islamic teaching (Dusuki 2008). Moreover, disposing of stock that is not owned by the seller is viewed as potentially deceptive. Although there is a future contract to buy back the stock, the trades are always in danger of unwinding before the stock is returned to the original supplier. There is also concern that the pricing of the contracts is potentially unfair, especially if the hedge fund manager is in a monopoly position and the transactions are not conducted in an open market. The lack of transparency with hedge fund transactions is often criticized by financial commentators, no matter their religious beliefs (if any).

More fundamentally, simply making money by trading financial instruments that have little connection with real business is not viewed as productive, as it amounts to a zero sum game similar to gambling, which is designated as *maysir*, a practice also condemned in Islamic teaching. *Maysir* is derived from *yusr,* in Arabic, meaning "ease." Gambling both fails to qualify as work and provides an opportunity to gain a pecuniary advantage at the expense of others. On the same basis, an investment entered into for purely speculative reasons would be deemed unacceptable (Mohamad and Tavatabaei 2008).

Existing Islamic hedge funds claim to use contracts that were accepted in traditional *fiqh* (Islamic jurisprudence), notably *arboun*, which is a type of option contract, and *salam*, a contract under which a financier pays in full, up front, for a commodity to be delivered at a future date. *Arboun* involves paying a deposit for a commodity for delivery at a future date, rather than the price in full. There is a revocation option akin to a call option in the conventional sense. However, the contract is about a sale of a good for which the deposit is part of the price, while the option is about the right to purchase, and the price for this right is lost if the contract is allowed to lapse

[74] Many airlines, for example, hedge their fuel purchases so that they can control their costs.

without being exercised. In classical *fiqh, arboun* is controversial, but it is accepted by the Hanbali School of Islamic jurisprudence (Dali and Ahmad 2005).

Case Study: Shari'ah Capital

New York-based *Shari'ah* Capital has a long-short Islamic commodities hedge fund that has been operating since 2007.[75] Sheikh Yusuf Talal DeLorenzo, the firm's chief *shari'ah* advisor, is well known and respected in the Islamic finance industry. The chief executive officer is Eric Meyer, who has long been involved in hedge funds and Islamic finance. Although the fund mainly generates income from commodity trading, transportation and manufacturing have been identified as sectors that can accommodate Islamic hedge funds. Just over $250 million is invested in the *Shari'ah* Capital's fund, with institutional investors from Saudi Arabia, the GCC, and Malaysia among the participants. *Shari'ah* Capital's hedge fund trades in commodities such as oil, as well as in energy, mining, and natural resource stock.

Investors in the fund buy securities instead of borrowing them, using *arboun* contracts to short the market to comply with the *shari'ah* rule that one must own an asset to sell it. Using *arboun,* the fund manager pays a deposit, which forms part of the purchase price, to buy assets at a later date. In the unlikely event that the sale does not proceed, the seller keeps the deposit and gets back the assets.

Shari'ah Capital's Commodity Fund gained 41 percent in its first year, compared with the Lipper Global Hedge/Long/Short equity index, which had a one-year return that same year of 31 percent. Since then, returns have been more modest, reflecting the poor performance of hedge funds generally, rather than *shari'ah* constraints on trading activity. As the U.S. economy rebounded after the global financial crisis, mutual funds often outperformed hedge funds. However, the low level of investment in *Shari'ah* Capital also reflected the uncertainty over the legitimacy of *arboun* by many *shari'ah* scholars. Islamic institutional investors tend to be conservative and concerned with their reputations and client perceptions. Given this context, it is not surprising that there was a reluctance to invest in structures as controversial as Islamic hedge funds. Nevertheless, major shareholders include the Dubai Multi Commodities Centre Authority (DMCCA), an agency of the Dubai government, which has a 5 percent stake in the fund.

In 2007, *Shari'ah* Capital jointly announced with Barclays Capital the development of the Al Safi Trust, a comprehensive *shari'ah*-compliant platform for alternative investments. Designed as a "one-stop" platform primarily for single strategy hedge funds, Al Safi provides *shari'ah* screening and *arboun* sale solutions, along with prime brokerage, administration, and trustee oversight within a pre-established Cayman trust framework. The Al Safi Trust was named Best Islamic Alternative Product at the Hedge Funds World Middle East Conference in 2009.

In 2008, *Shari'ah* Capital formed a joint venture, Dubai *Shari'ah* Asset Management (DSAM), with Dubai Commodity Asset Management (DCAM), a wholly owned division of DMCCA. DCAM, an investment company licensed by the United Arab Emirates central bank, develops and distributes *shari'ah*-compliant, commodity-linked investment products in the United Arab Emirates. The first four hedge funds were funded by DMCCA in 2008 and registered on the

[75] http://www.shariahcap.com/.

Al Safi Trust platform. Two funds are marketed under the DSAM Kauthar brand name as the DSAM Kauthar Gold Fund and the DSAM Kauthar Global Resources & Mining Fund.

The DSAM Kauthar funds have received numerous performance awards:

- Barclay Hedge, an independent hedge fund research organization with a database of over 5,800 hedge funds, consistently ranked the DSAM Kauthar Gold Fund, Ltd. in its Top Ten Metals and Mining hedge funds, based on its monthly performance results throughout 2009, 2010, and 2011. In both 2010 and 2011, the DSAM Kauthar Gold Fund received the MENA Fund Manager Award for outstanding performance and innovation.
- The DSAM Kauthar Energy Fund was ranked among the Barclay Hedge Top Ten Energy Funds for its performance in February 2011.

Real Estate Investments

Exposure to real estate markets is correctly viewed as a real alternative to equities and bonds, but it should be seen as a very long-term investment with a payback over decades rather than months or even years (Faishal and Eng 2008). Such investments are well suited to the time horizon of pension funds, insurance companies, and other institutional investors seeking rental yields, as well as long-term capital gains, or at least inflation proofing. In the case of Muslim majority countries, most pensions are paid by the state rather than private providers, and are often financed from current revenues rather than long-term funding. Family *takāful*, the *shari'ah*-compliant alternative to life insurance, remains in its infancy (see chapter 6). Hence institutional investors are much less important than in developed markets. The main potential institutional sources for Islamic real estate investment are the semi-autonomous sovereign wealth funds, none of which is managed on a *shari'ah*-compliant basis (Jen 2009).

The means of obtaining exposure to real estate markets are also diverse, with direct investment into commercial and residential property and indirect exposure through investment in construction and real estate development companies. Real Estate Investment Trusts (REITs) are an increasingly popular asset class, including Islamic REITs, which have been pioneered in Malaysia (Newell and Osmadi 2009). Malaysia has 14 REITs, of which 3 are *shari'ah* compliant. Each specializes in a different asset subclass. For example, Al Hadharah specializes in oil palm plantations. Another, specializing in office buildings and industrial properties, was formed by the conversion of a conventional REIT. Real estate investments are inherently illiquid, but the attraction of REITs is that the funds can be redeemed at any time, as they are listed in a market. Therefore, they represent financial vehicles rather than investments in buildings. The disadvantage is that the prices are more correlated with other market instruments, especially equities, than direct investments in commercial and residential property, because when stock markets are performing well investors have more spare cash to invest in REITs.

In Malaysia, guidelines for Islamic REITs were issued by the *Shari'ah* Advisory Council of the Securities Commission in November 2005.[76] To ensure *shari'ah* compliance, there are restrictions on the purposes for which investment properties can be used. The rentals cannot be derived from *ḥarām* activities. Prohibited tenancies include *ribā*-based banks; conventional insurance offices; betting shops and casinos; manufacture or sale of non-*ḥalāl* beverages and

[76] http://www.sc.com.my/guidelines-for-islamic-real-estate-investment-trusts/.

foodstuffs, such as alcohol or pork products; tobacconists; and entertainment venues of a morally dubious nature.

Where real estate with existing tenants is acquired by the Islamic REIT manager, it is recognized that some of the activities of the tenants may be *ḥarām*. Such activities do not preclude the acquisition of the property, provided they do not account for more than 20 percent of the rental income. However, as tenancies are renewed, only *shari'ah*-compliant activities are permissible, with tenancies such as betting shops or alcohol retailers obliged to close or move elsewhere. The properties should be insured with a *takāful* operator; existing conventional building insurance contracts should not be renewed when they expire. Cash holdings of Islamic REITs should be deposited in an Islamic bank.

Case Study: Al Salam REIT

Malaysia's Johor Corporation, a state investment firm, launched the Al-Salam REIT in June 2015. It has subsequently been listed on the Kuala Lumpur stock exchange.[77] Its mandate is to focus on *shari'ah*-compliant diversified assets, including, but not limited to, commercial retail, office, and industrial assets. It raised RM900 million ($253.24 million), which is funding real estate projects in Johor, the port city and development zone on the Malay Peninsula across the straights from Singapore. The REIT already owns 31 assets, including a chain of Kentucky Fried Chicken and Pizza Hut restaurants, as well as industrial assets. The REIT manager, Damansara Sdn. Berhad (DRMSB), a Malaysian-based company, was founded in 2005 and has considerable experience, including management of the Al-'Aqar Healthcare REIT, which was listed on the Main Board of Bursa Malaysia on August 10, 2006. By 2014, the Al-`Aqar Healthcare REIT had total assets under management amounting to RM1.5 billion ($339 million).

Demand for Malaysian Islamic real estate investment trusts has withstood a sluggish property market, as their steady rental income is popular with pension funds amidst a shortage of *shari'ah*-compliant assets. Returns for 2016 are projected to be 6.3 percent, an attractive rental yield. Islamic lenders in Malaysia are facing a shortage of investing options, with worldwide *sukūk* issuance down 28 percent in 2015. The Southeast Asian nation's $1.5 billion global Islamic bond sale in August 2015 drew more than $9 billion of bids and was priced below the initial target, reflecting demand for *shari'ah*-compliant instruments.

There are only 3 listed Islamic REITs in Asia, compared with 128 non-Islamic vehicles, according to data compiled by Bloomberg. Al-Salam REIT is targeted at investors or fund managers with long-term investment objectives who seek regular stable income distribution and long-term capital appreciation. Malaysia's two *shari'ah* REITs outperformed *sukūk* in 2014. The Al-'Aqar Healthcare REIT, majority owned by Johor Corp., returned 11.7 sen a unit to shareholders, equivalent to a dividend yield of 8.4 percent based on its year-end closing price. Axis REIT paid out a quarterly average dividend of 4.94 sen a unit last year, or an annual yield of 5.5 percent. The third Islamic REIT in Asia, Singapore's Sabana *Shari'ah*-compliant Industrial REIT, was less successful. It declined 10 percent in 2015, while the city-state's benchmark stock index rose 2.2 percent.

[77] http://www.jcorp.com.my/reit-sector-107.aspx; http://www.bloomberg.com/profiles/companies/SALAM:MK-al-salam-real-estate-investment-trust.

The falling prices are unlikely to dent the popularity of Islamic REITs due to the amount of funds that need to be invested in a *shari'ah*-compliant manner. Malaysian Islamic banking assets climbed 12 percent to RM625.2 billion ($141.4 billion) in 2014, central bank data show. That represents almost half of the $300 billion of outstanding *sukūk* worldwide, according to figures from the Malaysia International Islamic Financial Centre.[78]

Investment in *Ḥalāl* Foodstuff

An obvious destination for *Shari'ah*-compliant alternative investment is the *ḥalāl* foodstuff industry. This industry has grown worldwide as the global Muslim population has increased and become more prosperous. Although *ḥalāl* foodstuff is traditionally associated with meat production, it extends to other sectors, including pharmaceuticals, and niche areas such as alcohol-free mouthwash. In the past, most *ḥalāl* foodstuff production was undertaken by small family businesses, which did not seek external funding. This is changing as major multinational corporations get involved and *ḥalāl* products are increasingly marketed and sold by supermarket groups, including those based in North America, Europe, and Japan. This brings new investment opportunities, although there is debate over whether mixed businesses are legitimate destinations for *shari'ah*-compliant investment, or such investment should be channelled solely to enterprises that are exclusively *ḥalāl.*

Until recently, *ḥalāl* production was very fragmented; there was no industry associations and no attempt to use the term *ḥalāl* as a trademark or brand. The United Kingdom-based Muslim Food Board, which was established in 1992, was a pioneer in *ḥalāl* certification.[79] Approved producers can use their registered logo for advertising purposes. The organization provides ongoing monitoring after certification to reassure Muslim consumers, as well as training for those employed in the industry. Similar organizations providing certification are found in Australia and North America, but their absence in most Muslim-majority countries largely reflects the inadequate legal environment for trademark protection. Such protection is as important for investors as for consumers.

Malaysia has had more initiatives in *ḥalāl* activities than most Muslim majority countries. In 2014, the SME Bank announced it was allocating another RM200 million ($45.4 million) under its *Ḥalāl* Industry Fund, which is available for SMEs to add value or improve their *ḥalāl* products.[80] The initiative was made in collaboration with strategic partners, including the Islamic Development Bank (IDB), the Malaysia External Trade Development Corporation, and the *Ḥalāl* Industry Development Corporation, as well as the Young Entrepreneur Fund (YEF), which helps youths aged 18–30 years venture into entrepreneurship. The SME Bank is open for investment from GCC countries and the involvement of the Jeddah-based Islamic Development Bank gives assurance to these investors. Most of the SMEs are involved in the distribution and sale of *ḥalāl* produce rather than production, apart from fields such as poultry production, where there is a local industry. Much of the cattle and mutton originates in Australia and New Zealand, where *ḥalāl* producers welcome investment from consuming nations.

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[78] http://www.mifc.com/.

[79] http://www.tmfb.net/about.

[80] http://www.freemalaysiatoday.com/category/business/2013/03/22/halal-industry-fund-for-smes-to-improve-halal-products/.

Case Study: Ḥalāl Cluster in Dubai Industrial City

To cater to the growing demand for *ḥalāl* produce, the United Arab Emirates government has established a *Ḥalāl* Cluster on a site comprising 6.7 million square feet in Dubai Industrial City.[81] The Cluster is designated for firms dealing in *ḥalāl* food, cosmetics, and personal care items. An emerging industry of *ḥalāl* certification has been created to attempt to verify any issues that may arise when considering the true definition of "*ḥalāl*" products. The methods for discovering *ḥarām* impurities in products are rapidly improving. These days, the type of animals that the raw materials are derived from can be identified using polymerase chain reaction (PCR), which greatly improves the potential for *ḥalāl* integrity, allowing the development of *ḥalāl* supply chains and product tracking.

The *Ḥalāl* Cluster has been promoted at the annual *Ḥalāl* Expo held in Dubai, now a well-established business-to-business event.[82] The seventh Expo was held in Dubai in September 2015, with the promoters stressing the huge potential that the global $2.3 trillion *ḥalāl* market has to offer. The Expo has proved to be a high-impact business platform to canvass the lucrative business opportunities that the global *ḥalāl* market presents and cater to the needs of the *ḥalāl* producers, traders, and business leaders looking to expand their business in the Middle East. The value of *ḥalāl* food sector is almost $700 billion annually. The non-food sector is even bigger, and includes chemicals, health care, cosmetics, personal care, and pharmaceuticals. The Expo also stressed the *shari'ah*-compliant services available in the *Ḥalāl* Cluster, which include banking and finance, logistics, warehousing, and distribution.

Investment in Traded Commodities

Despite the dramatic fall in commodity prices in 2014 and 2015 with the slowing in China's economic growth, commodities are still regarded as a potentially worthwhile alternative investment asset (Tang and Xiong 2012). From an Islamic finance perspective, commodities are regarded as tangible assets rather than simply financial instruments. The buying, holding, and selling of commodities are viewed as useful service activities that justifies the earning of profits. Historically, many of the great capitals of the Islamic world thrived as trading centers, with the buying and selling of metals and agricultural commodities handled by specialist brokers on behalf of wealthy investors (Kathirithamby-Wells 1986).

As modern Islamic banking emerged in the 1970s, *murābahah* transactions took off, with the Islamic financial institution purchasing commodities on behalf of clients who agree to repay the institution with a deferred lump sum or through installments (Dusuki 2007). The Islamic bank charges a mark-up for this service, which clients are willing to pay, as they have insufficient funds to buy the commodity until they arrange their financial affairs or receive payments from business partners. Islamic banks can also arrange commodity financing through *salam* and *arboun* contracts. With *salam,* the bank pays in advance the full amount for a commodity to be delivered at a future date. The bank will not be speculating on the future price, as it will usually have a client or clients lined up who have already agreed to purchase the commodity from the bank at a slightly higher price, to cover the bank's financing costs. These clients prefer to purchase from the bank

[81] http://www.gulfood.com/Content/Dubai-gears-up-for-67million-sqft-Halal-Cluster.
[82] http://www.worldhalalexpos.com/.

for a known fixed price, rather than purchasing through a commodity market at a future unknown spot price.

Similar considerations arise with *arboun*, but under these contracts the Islamic financial institutions pay only a deposit for a commodity to be delivered at a future date for a fixed price, rather than paying the full amount in advance. As discussed, an *arboun* agreement resembles an option contract, but it is usually exercised, rather than left simply to expire as with derivatives contracts, which are used for gambles on spot and futures prices.

Case Study: Jadwa Saudi Riyal Murabaha Fund

Riyadh-based Jadwa was incorporated on August 21, 2006 with a paid-up capital of SRl500 million ($133 million), when the Capital Markets Authority (CMA) of Saudi Arabia granted the company all five licenses to operate as a full service *shari'ah*-compliant investment bank in the Kingdom under the license number 37-6034. Jadwa offers wide-ranging investment services that support both individual and institutional clients. Jadwa is a comprehensive financial services firm with a proven track record in asset management, financial advisory, and mergers and acquisitions, as well as researched brokerage.[83]

Designed for low-risk investment in local currency, the Jadwa Saudi Riyal *Murābahah* Fund mirrors certificates of deposits in terms of investment strategy and easy liquidity, but in compliance with *shari'ah* guidelines. Jadwa places the trades with banks in a *shari'ah-* compliant manner in short-term *murābahah* contracts, usually for 30 or 90 days. The fund aims to attract retail investors with a minimum initial subscription of SRl50,000 ($13,332) and a minimum additional subscription or redemption of SR125,000. The fund is valued on a daily basis and charges a management fee of 0.50 percent annually. The fund was first established on June 30, 2007, and has a track record of yielding modest returns while maintaining the value of investors' capital.[84]

Project Finance

Alternative financing can contribute to project finance. Although such financing used to be largely undertaken by governments, there have been many initiatives to encourage private sector involvement since the 1980s (Brealy, Cooper, and Habaib 1996). Most of these initiatives were aimed at diversifying the sources for long-term project finance rather than changing the methods, as the financing largely involved syndicating debt rather than alternative financing such as private equity (Kleimeier and Megginson 2000). Islamic financial institutions can also participate in syndicated funding with the money raised by issuing *sukūk,* rather than bonds paying interest. The Islamic Development Bank (IDB), for example, has regular *sukūk* issuances to fund its project financing, and given its Aaa rating by Moody's, the cost of its capital is very low (Moody's Investors Services 2014).

Istiṣnā''a s regarded as a particularly useful method for providing project finance, as it is widely favored by Islamic scholars as suitable for paying for manufacturing supplies (Zarqa 1997). Most Islamic finance is used to pay for assets that already exist, but with projects, it often takes several years for facilities to be constructed. For investors, *istiṣnā''a* provides a steady long-term

[83] http://www.jadwa.com/en/article/about-jadwa/who-we-are.html.
[84] http://www.jadwa.com/en/fund/asset-management-products-and-services/mutual-funds/jadwa-saudi-riyal-murabaha-fund-1.html.

income stream once the project is completed, but they may have to wait two years or longer until the first income is received. Such assets are attractive for managers of pension funds and *takāful* providers, especially for family *takāful*, the *shari'ah*-compliant alternative to conventional life insurance. There is an element of risk sharing in *istiṣnā''a* contracts, as the completion of projects is often delayed; hence it is important to spell out clearly the protection for investors, while allowing some flexibility for contingencies.

Case Study: The Islamic Development Bank's Funding for Electricity in Rural Mozambique

The Cahora Bassa dam generates most of Mozambique's electricity, but the northern province of Cabo Delgardo had no distribution network. The construction of the network was a long-term project scheduled as three phases from 1999 to 2013. The IDB has been involved since the start. The third phase, implemented from 2009 to 2013, is an especially successful example of syndicated funding involving IDB and other international agencies, as table 8.2 shows.

Table 8.2 Funding of Phase III Electricity Project in Rural Mozambique

Agency	Finance ($ million)	Percent of total funding	Purpose
IDB	9.49	32	248 km subtransmission lines
Arab Bank for Economic Development in Africa (BADEA)	9.00	31	95 km transmission line
European Union	5.99	20	194 km subtransmission line
Government of Mozambique	4.85	17	Joint financing with each donor

Source: IDB Success Story Series, No. 22, June 2015.

The benefits from the Cabo Delgado electrification were not only to households but also to businesses and the wider economy. The former diesel generators were unreliable and expensive to maintain. With reliable electricity supplies, businesses can stay open longer and use modern equipment, including air conditioners, computers, photocopiers, refrigerators, and freezers. Employment opportunities have been enhanced, as businesses have flourished and the local inhabitants have been more willing to stay in the region than move. Many regard being able to recharge mobile phones cheaply and easily as a significant benefit.

Alternative Assets and Economic Development

Although project finance directly contributes to economic development, the link with other alternative investments is less robust. For example, the link between hedge fund investments involving financial speculation and wider development is doubtful. Such investments often benefit the rich and contribute to income inequalities, with so-called trickle-down effects to the less affluent arguably weak—if they exist at all. Private equity finance is more positive from a developmental perspective, but it tends to be concentrated in higher-income countries, as opportunities in low-income economies are less easy to identify and support. The World Bank vision of shared prosperity is commendable, but the challenge of building the physical infrastructure and developing human resources to achieve this goal is enormous (Badré 2015).

There is a question of causation: What comes first? Does the accumulation of alternative assets facilitate economic development, or vice versa?

When alternative investment is undertaken using *shari'ah*-compliant contracts, this helps ensure that there are outcomes that contribute to shared prosperity. From an Islamic perspective, economic development should be socially inclusive, which all too often is not the case in practice. Islamic alternative investment contracts should be transparent. It is the responsibility of the religious scholars vetting the contracts to ensure there is no element of *gharar*, defined in classical Islamic jurisprudence as contractual uncertainty or ambiguity that favors one party at the expense of the other (El-Gamal 2001). The prohibition of *gharar* is more important today than ever, especially given the complexity of the contracts for alternative investments. There is considerable potential for fund managers to exploit investors who are locked in (Al-Suwailem 1999).

Regulatory Implications and Policy Responses for Alternative Investments

As alternative investments are a diverse asset class, there are no all-embracing regulations or guidelines that can be simply applied. Usually alternative investments are under the remit of securities or capital market regulators where such institutions exist, rather than being the responsibility of central banks. Within the Islamic world, the Malaysian Securities Commission and the Capital Markets Authority of Saudi Arabia have played leading roles in identifying the issues that arise with alternative investments. The Kuala Lumpur-based Islamic Financial Services Board (IFSB) has not yet issued any standards specifically on alternative investments, as it focuses more on Islamic banking and *takāful*, although it has published Guiding Principles for Islamic Collective Investment Schemes.[85] There is clearly a case for more comprehensive guidance on alternative investments by the IFSB, as it is the institution that includes regulatory authorities from the Organisation for Islamic Cooperation (OIC) States as its members.

At the same time, it must be recognized that those involved in alternative investments are normally sophisticated investors who do not need protection in the same way as retail investors. Many analysts urge so-called "light touch" regulation for alternative investments, as this reduces transactions costs, which ultimately get passed on to the investors. The European Union and the United Kingdom have relatively liberal directives on alternative investments.[86] Nevertheless, in the case of Islamic investment, the *shari'ah* oversight should not be light touch; otherwise this might undermine the credibility of the investments for the pious. There would be reputational risks to the financial institutions offering such investments, and potential reputational damage to the scholars involved in approving the investments.

Shari'ah scholars working on Islamic finance need to address the issue of the permissibly of alternative asset classes more comprehensively. At the international level, this includes the OIC *Fiqh* Academy, which has issued *fatāwá* on many Islamic financing contracts, but not specifically on alternative investments.[87] The *shari'ah* scholars advising securities regulators also have a role to play—although at present only the Securities Commission in Kuala Lumpur has a formal

[85] http://www.ifsb.org/standard/ifsb6.pdf.
[86] http://ec.europa.eu/finance/investment/alternative_investments/index_en.htm#maincontentSec2; http://www.fca.org.uk/firms/markets/international-markets/aifmd.
[87] http://www.fiqhacademy.org.sa/.

shari'ah board. It has produced a joint report on Islamic capital markets in collaboration with another institution based in Kuala Lumpur, the International *Shari'ah* Research Academy (ISRA).[88] A similar joint initiative in the field of Islamic alternative asset classes would be welcomed by the Islamic finance community around the world.

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[88] http://www.sc.com.my/highlight/isra-and-sc-launch-joint-publication-on-islamic-capital-markets-principles-and-practices-2/.

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Chapter 9

Islamic Social Finance

Poverty and financial exclusion go hand in hand. Any attempt to enhance shared prosperity and curb poverty must therefore address the issue of financial exclusion. The task may be more daunting in Muslim societies, where the poor may be excluding themselves from the financial system because of their faith and beliefs. As a 2007 survey for the Consultative Group to Assist the Poor (CGAP) concluded, “Islamic microfinance has the potential to combine the Islamic social principle of caring for the less fortunate with microfinance’s power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law” (Nimrah, Tarazi, and Reille 2008, 1). Islamic social finance that includes the provision of microfinance along with safety nets and social goods could be a powerful tool to fight financial exclusion and poverty and enhance shared prosperity.

Philanthropy and benevolence occupy a central position in the Islamic scheme of poverty alleviation and redistributive justice. Islamic social finance comprises instruments and institutional structures that are rooted in philanthropy. Their integration with for-profit risk-sharing instruments may provide some key success factors, while addressing some critical challenges. The broad instrument of Islamic philanthropy is *ṣadaqāt*. When made compulsory on well-to-do Muslims, *ṣadaqāt* is called *zakāt*. When *ṣadaqāt* results in flows of benefits that are expected to be stable and permanent (such as through endowment of a physical property), it is called *ṣadaqāt jāriyah* or *waqf*. Contemporary Islamic economists emphasize that a philanthropy-based intervention inherent in the institutions of *zakāt* and *ṣadaqāt* could potentially take care of the basic needs of the extremely poor and the destitute and create a social safety net (Chapra 2008). A recent study that estimates the potential *zakāt* collection in member-countries of the Organisation of Islamic Cooperation (OIC) finds supporting evidence that 20 out of 39 OIC countries could actually lift the extreme poor (those living on less than $1.25 per day) above the poverty line simply with collection of *zakāt* through domestic sources and remittances (Moheildin and others 2012).

The other institution of philanthropy—*waqf,* or Islamic endowment—is ideal for the creation and preservation of assets that can ensure flows of resources to provide education, health care, and other social goods. *Waqf* may also direct resources toward improving skills and developing human resources through technical assistance and capacity building. The social safety net, technical assistance, and capacity building may then be linked to financial assistance by helping to develop microenterprises. Thus these Islamic financial institutions, by improving access to and quality of education, health, and other social goods, can play a critical role in achieving the global goals of generating sufficient income-earning opportunities and investing in people’s development. These Islamic institutions can also serve to protect the poor and vulnerable against sudden risks of unemployment, hunger, illness, drought, and other calamities. These measures would greatly boost shared prosperity, improving the welfare of the least well-off.

The Islamic approach to poverty alleviation is more inclusive than the conventional interventions based on microcredit. It provides for the basic conditions of sustainable and

successful microfinance, blending wealth creation with empathy for the poorest of the poor. It favors models based on equity and cooperation, in contrast to mechanisms that tend to perpetuate debt (Obaidullah and Khan 2007). The discussion that follows briefly describes *zakāt* and *waqf* as the key instruments of Islamic social finance that help reduce extreme poverty and boost shared prosperity. It presents brief case studies to highlight alternative models of intervention that utilize Islamic social finance.

The Redistributive Role of *Zakāt*

Zakāt is a compulsory annual levy on the wealth of the rich that is directed by the *shari'ah*, to flow to the poor and the needy. By definition, it is a tool of redistribution of wealth, transferring wealth from the rich to the poor. Every Muslim individual who possesses wealth beyond a prescribed minimum threshold is liable to contribute from his or her wealth. *Zakāt* is levied on savings that account for part of the wealth of an individual. It is also levied on forms of wealth that are characterized as stocks, such as gold, silver, trade inventory, and livestock. *Zakāt* is not levied on income that is used for consumption, and items of wealth that are for personal and family use, such as a house or a car. It is also not levied on wealth that is categorized as the means of production, or capital goods. Thus the levy of *zakāt* results in the transfer of wealth from the rich without adversely affecting their consumption or productive investments.[89]

Islam stipulates conditions on the use of *zakāt* funds and requires that funds must clearly flow only to specified categories of beneficiaries.[90] *Zakāt* is primarily targeted to the underprivileged and the excluded sections in the society, such as the poorest of the poor, the needy, the destitute, and those in bondage or overburdened with debt. These include individuals with no means of livelihood or inadequate income to meet basic necessities, such as orphans, the sick, the disabled, and the homeless. *Zakāt* is thus rightly seen as a safety net to take care of the basic necessities of life of those who cannot afford them.

Zakāt funds must be clearly distinguished from funds in an Islamic treasury that are pooled through taxes and State revenues. *Zakāt* cannot be used to finance infrastructure projects, public utilities, and services beneficial to all Muslims—the poor and the rich—or to meet the administrative expenditures of the State. *Zakāt* funds may, however, be used to defray the operational costs of managing a *zakāt* organization, in the form of wages and salaries of *zakāt* personnel. This provision aims to maintain the integrity and independence of collection and disbursement of *zakāt* funds (Obaidullah 2012).

The primary objective of *zakāt* is to provide a safety net for all Muslims by providing for basic needs. Basic needs by definition are recurring in nature. Some Islamic scholars thus argue

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[89] Islamic Law provides elaborate rules relating to estimation of the *zakāt* base (the amount of wealth on which *zakāt* is levied) and the rates of levy that vary with forms of wealth. With most forms of financial assets, the rate is 2.5 percent.

[90] The eight eligible categories of beneficiaries of *zakāt*, according to *shari'ah*, include: *fuqara* (the poorest of the poor); *masakeen* (the needy and the destitute); *ameleen-a-alaiha* (*zakāt* personnel); *muallafat-ul-quloob* (people whose hearts are inclined toward Islam); *fir-riqaab* (those in bondage); *ghārimīn* (the indebted); *ibn al-sabīl* (travellers); and *fi-sabilillah* (in the path of Allah).

that *zakāt* proceeds should be used for economic empowerment and not simply to meet immediate consumption needs—which could encourage dependence and make the poor permanently dependent on *zakāt*. In their zeal to bring about economic empowerment, proponents often tend to undertake large investments in education, health care, and other social welfare projects (which benefit the poor, the not-so-poor, and even the well-to-do) or engage in financing of microenterprises. Although worthy, such expenditures may result in a drying up of funds to meet the immediate consumption needs of the poorest of the poor.

Economic empowerment and meeting basic consumption needs should not be mutually exclusive. In any program of economic empowerment through *zakāt,* satisfying the immediate basic needs of the poorest of the poor must always be accorded top priority. In a subsequent phase, *zakāt* funds can finance education and training so the poor can gain the skills and human capital to be more self-sufficient. *Zakāt* funds may also be provided as start-up capital for the poor for their business activities, accepted either in the form of outright grants or loans (*qarḍ al-ḥasan*) or micro-equity without expectation of returns, depending upon the degree of their vulnerability. This would enable the poor to generate a sustainable means of livelihood and transform them from *zakāt* recipients into *zakāt* payers. Such ambitious poverty alleviation and economic empowerment projects through efficient collection and distribution of *zakāt* can be undertaken by the State or a not-for-profit organization funded with *zakāt*. At the same time, the use of *zakāt* funds for the provision of microfinance raises several important issues.

Low-cost Microcredit with Ṣadaqāt and Zakāt

A critical issue for conventional microcredit and its Islamic equivalent relates to the pricing of the finance. In general, microcredit—whether *shari'ah*-compliant or otherwise—remains unaffordable to the poorest of the poor. The cost of microcredit remains high because of the high operational costs involved. Even where the Islamic microfinance provider seeks to recover only the actual cost of financing from the borrower without any profit element, in conformity with *shari'ah*, the very poor are likely to find it unaffordable. The extreme vulnerability of this segment of society makes them reluctant to opt for such loans. As a solution, a model combining *zakāt* and *ṣadaqāt* funds may be used to cover part of the operational costs in a sustainable manner and make the credit affordable to the poor.

The model envisages provision of revolving credit through *qarḍ ḥasan* loans out of pooled *ṣadaqāt* and *zakāt* proceeds. It is a departure from the traditional approach of making grants out of *zakāt* funds to the poor. Creating a credit pool ensures that the fund is automatically replenished every time loans are repaid. The outcome is a sustainable *shari'ah*-compliant financial service provider for the poor.

An excellent example of this model is the Akhuwat scheme, based in Pakistan (box 9.1). The key elements of the Akhuwat strategy are as follows. The first is to bring down the operational cost of providing microcredit to the poor by drawing on volunteers and other means (such as use of places of worship for credit delivery). The second is to mobilize charitable funds on a sustained basis to absorb the operational costs—which are now much lower. As a result, the costs of loans have not just been brought down—they have been brought down to zero.

Box 9.1 Case 1. Revolving Credit out of Pooled *Sadaqāt* and *Zakāt* Proceeds: Akhuwat, Pakistan

From modest beginnings in 2001 (with an initial transaction of PRs10,000 funded through a single donation), Akhuwat has steadily expanded and now has 350 branches in 250 cities and towns in Pakistan. It serves 953,933 beneficiaries with a staff of 2007. It had about PRs4.8 billion in outstanding loans as of June 30, 2015, with total disbursements of about PRs16.3 billion to date**,** and an impressive recovery rate of 99.9 percent in the same period.

Drawing on a credit pool established through philanthropic donations, Akhuwat makes small loans (*qarḍ ḥasan*) to the poor. The credit pool is in the nature of a revolving fund that is continuously depleted with the disbursal of loans, and replenished and enhanced as they are repaid and new donations are received. Akhuwat uses a simple loan product that is free from any element of profit. Loans are made to start or expand businesses or to meet social needs that are ultimately aimed at increasing the income of poor and improving the quality of their lives. The loan size is small, and is based on the borrower's need and repayment performance. The loan amount may be increased in subsequent cycles, but only up to a predetermined maximum. Akhuwat actively discourages the perpetuation of debt, unlike conventional microcredit. More than 90 percent of Akhuwat borrowers have incomes of less than $70 a month, thus belonging to the poorest of the poor. Akhuwat also provides a small percentage of loans to the moderately poor who are economically active as microentrepreneurs. Akhuwat provides family loans targeting entire households instead of individuals.

Initially, Akhuwat worked on cost recovery basis, with 5 percent of the loan amount termed as the administrative fee, without charging any markup or fee to microenterprises. The sustained growth in charitable contributions and special donations from borrowers has enabled Akhuwat to absorb all costs and make all loans entirely costless. Akhuwat has also consistently worked to minimize its operational costs so that these could be easily absorbed by charitable contributions from its donors. To cut costs, Akhuwat delivers credit delivery and manages the process at places of worship, and draws on volunteers, including its top staff. The CEO and the top management and about one-third of Akhuwat staff work voluntarily without any remuneration. Akhuwat also seeks to minimize its personnel costs by recruiting staff from the same communities as their borrowers, and not hiring highly qualified professionals. The organization has made minimal investments in office assets. It owns no vehicles. Its staff sits on the floor, as do its clients. It has found a way to do business with the poor that keeps costs to bare minimum. As a result, its operating costs as a percentage of loan amount disbursed have consistently been in the range of 8–12 percent of amount disbursed, and fell to 5 percent in 2015**.**

Akhuwat seeks to mitigate credit risk using an innovative combination of credit delivery at places of worship and personal guarantees. Using places of worship for loan disbursement significantly reduces the probability that borrowers will break their commitment to repay their loans on time. In addition, borrowers need to bring two other guarantors to co-sign their loans. The guarantors may not be from the borrower's household, and may not have high net worth, but should have high moral character, displaying piety and trustworthiness and willingness to assist the borrower in times of adversity. This mechanism effectively replaces the group guarantee. Extending the loan to the entire family, rather than the individual, also ensures that the entire family is the guarantor and the beneficiary.

The transformation of borrowers into donors has become an important component of Akhuwat's strategy for the future. Past borrowers have increasingly sought to donate to Akhuwat. Such donations now are a significant pool and cover over one-third of Akhuwat's total operating costs.

Source: Personal interviews and information collected from the organization by the authors.

The model is not without its critics, who feel that the poor should be provided grants and not loans. The provision of microcredit may violate the very essence of *zakāt*: of pulling an individual out of indebtedness. Proponents defend the Akhuwat model on the grounds that the amount of *zakāt* funds mobilized in contemporary Muslim societies may be grossly inadequate if given as grants. As loans from a revolving pool, a given amount of zakāt can serve much larger number of beneficiaries.

Community-driven Development with Ṣadaqāt and Zakāt

An alternative approach to poverty alleviation that is of more recent origin than the mainstream microfinance models is the community-driven development (CDD) approach. CDD is a grant-based intervention. It approaches the poor as partners in the development process, rather than as mere recipients, and builds on their institutions and resources. Its key elements include:

- Focus on communities and/or community groups
- Inclusive and participatory decision-making processes
- Direct transfer of resources to the community
- Community involvement in implementing subprojects
- Community involvement in monitoring and oversight.

While CDD has been quite effective as an intervention, its fundamental weakness has been the absence of a sustained grant-funding mechanism. Even in the most effective of CDD programs, participating poor communities may expect to receive from one to three grants in support of community-identified activities over the course of a CDD program—yet the full development of the community will require much more than these few grants. To sustain local initiatives, an ongoing grant funding mechanism is needed. A *zakāt*-funded CDD program can meet this need, since *zakāt*, by definition, involves recurring annual flows.

However, any arrangement that pools *zakāt* funds to be utilized for a common good or collective benefit must resolve ownership issues. A key principle of *shari'ah* relating to disbursement of *zakāt* is *tamleek,* which translates as the "transfer of ownership" of *zakāt*. The norm requires the poor and the needy (eligible beneficiaries) to be made owners of *zakāt* or *zakāt*-funded assets. As such, *zakāt*-funded collective enterprises are allowed only when these are fully owned only by the poor. *Shari'ah* scholars rule out the possibility of financing broad development projects with *zakāt* funds that may benefit both the well-to-do and the poor. While this restriction on development projects in the nature of social goods, such as schools and hospitals, appears to be severe, a novel experiment by the Indonesian nongovernmental organization (NGO) Dompet Duafa Republica seems to be providing a solution that is both sustainable and practical (box 9.2).

Box 9.2 Case 2. Community-driven Development: Dompet Dhuafa Republika, Indonesia

Dompet Dhuafa Republika (DDR) is a philanthropic institution that helps the poor using donated assets, including *zakāt*, *ṣadaqāt* , and *waqf,* from individuals, groups, companies, or institutions. The funds dedicated to economic empowerment programs average around 10 percent of total *zakāt* resources available. The low dedication is attributable to apparent *shari'ah* objections by some scholars, who emphasize the utilization of *zakāt* for consumption alone in the short term. In the face of a growing realization that an emphasis on meeting short-term needs may lead to a dependency syndrome among the poor, and that the long-term need of the poor is economic and social self-reliance, DDR seeks to enhance the utilization of *zakāt* for community empowerment programs.

These programs focus on promoting self-reliant communities, enhancing health, and encouraging organic farming and livestock development. Like Akhuwat in Pakistan (box 9.1), DDR extends interest-free loan financing to groups from a pool created out of *zakāt* funds. The distinguishing feature of this model is the phased building of self-reliant communities and the creation of a community organization that will continue to provide financing to the members.

To ensure full *shari'ah* compliance as well as the efficiency and effectiveness of the intervention, the model follows clearly defined criteria to identify its target region and beneficiaries. A rural region targeted for the program should have comparative advantages in specific commodities or produce; natural resources that can be accessed by the poor; and available human resources in terms of both quality and quantity; and should not be experiencing or exposed to conflicts or have a high potential for conflict.

The program has the following key components:

- *Building awareness.* It helps the community identify its problems and its potential under the assumption that the community itself has the ability to solve its problems.
- *Organization.* It generates self-help groups as the way to give voice and authority to those groups and helps form a local organization through community initiative.
- *Building local support.* It prepares a local cadre that will develop local self-help and that will take over the "hand-holding" role once the program ends.
- *Technical support.* It provides technical training based on locally available and appropriate technology.
- *Partnership.* The local community figures out what can be implemented and what support will be needed from the program. The community establishes cooperation based on specific roles for each stakeholder, based on mutual trust and transparency.

The program provides the following services to its beneficiaries:

- Developing human resources through training programs, workshops, and meetings among members.
- Developing institutions with proper documentation of standard operating procedures, so each organization or group can be commonly monitored.
- Providing capital to local businesses through group-based credit and self-help savings.
- Providing business development services to improve production methods.
- Developing markets by sharing information about business opportunities, and building networks and synergies.

The program has a clear termination and exit strategy. It withdraws from the region and the program comes to an end as soon as the community cadres are ready to take part in maintaining the program's financial and institutional sustainability. It ensures that a community-based organization is a legal entity with adequate capacity to sustain cooperation among all stakeholders. From a *shari'ah* perspective, this ensures that the *tamleek* condition of *zakāt* is complied with, since the poor beneficiaries ultimately become the owners of the local organization in a collective sense, with the transfer of assets from the program to the local organization. Thus the fact that they are borrowers in the first instance does not appear to violate the *tamleek* requirement.

Source: Personal interviews and information collected from the organization by the authors.

Guaranteed Fund with Zakāt

As some scholars point out, there is a large gap between the potential and actual realization of *zakāt*—for many reasons. Thus there is a need to leverage the use of such funds. A *Zakāt* fund can be used to provide a guarantee for microfinance, while other for-profit Islamic financial institutions can undertake the direct financing. The guarantee can encourage institutions that have been reluctant to finance microenterprises because of the high perceived default risk to extend financing, backed by the guarantee. Given that the observed default rate in many microfinance operations is 3–5 percent, the fund may back 20–30 times more microentrepreneurs. The 3–5 percent of microentrepreneurs facing default will be able to avoid insolvency with the help of *zakāt* funds. A guarantee fund could cover all those who are indebted, both poor and not-so-poor. A pioneer of this model of intervention is the Al-Aman Microfinance Fund in Sudan (box 9.3).

Box 9.3. Case 3. A *Zakāt* Fund: Al-Aman Microfinance Fund, Sudan

The Bank of Khartoum (BoK)'s microfinance program (IRADA) was established in 2009 with the support and assistance from the Jeddah-based Islamic Development Bank. IRADA was given the mandate to implement the SD200 million Al-Aman Fund for Microfinance. The fund was formed in a strategic partnership between the apex body of *zakāt* management in Sudan, Diwan *Zakāt,* and 32 Sudanese commercial banks.

In perhaps the first documented example of utilization of *zakāt* for *al-ghārimīn* (the indebted) in an organized manner, a security portfolio of SD200 million was created. Diwan *Zakāt* contributed 25 percent, and the banks contributed the rest. The portfolio covers all productive sectors (commercial, agricultural, and vocational) across Sudan. It provides insurance to the program against genuine defaults by clients at the second level. At the first level, the default is covered by individual personal guarantor(s) brought in by the client.

Source: Personal interviews and information collected from the organization by the authors.

Sustainable Provision of Social Goods through *Waqf*

Waqf is an important institution in the Islamic economy. It is a perpetual endowment. Certain physical assets are held or set aside by the donor and preserved so that benefits flow continuously to a specified group of beneficiaries or community.[91] By providing a flow of benefits on a sustained basis, *waqf* can thus serve as a mechanism to create and support robust charitable institutions. It has a legal identity separate from its manager and therefore is most suitable for creation of a sustainable entity, governed by the fundamental principles of perpetuity, inalienability, and irrevocability. By creating community assets, it has the potential address the education, health care, and other social needs in Muslim societies.

Yet the potential of *waqf* remains largely untapped. Thus there is an urgent need to revise the existing inefficient laws to create an enabling legal and regulatory framework. The welcome developments in knowledge pertaining to *waqf* (including reinterpretations of *fiqh* rules based on

[91] The nature of the expected benefit or purpose of the *waqf* is clearly stated in the *waqf* deed or articles of association created for this purpose by the donor. The donor also specifies the trustee-manager(s), who ensure that the intended benefits materialize and flow to the community. The trustee-manager is variously described as *mutawallī* or *nazir*. The *waqf* deed provides for the method of compensation of the trustee-manager, usually a part of the earnings or benefits from the assets under *waqf*.

contemporary conditions) can yield very positive results in developing the *waqf* sector if national laws change to convert the possibilities into realities. Contemporary developments in the Islamic financial sector have also opened up many possibilities in terms of new structures for financing the development of *waqf* assets.

Role of Waqf in Establishing Fair and Affordable Prices

The integration of *waqf* with the market has yielded positive results in terms of providing microfinance, education, and health care at affordable prices to the poor and excluded. A case in point is provision of health care by the *Waqf* al-Noor, an innovative corporate *waqf* that was structured by the Johor Corporation of Malaysia (box 9.4).

Box 9.4 Case 4. Corporate *Waqf:* Johor Corporation's *Waqaf* al-Noor, Malaysia

Johor Corporation (JCorp) was established as a State investment corporation in 1968 in the state of Johor, Malaysia. It is one of the country's largest conglomerates, with core business sectors encompassing palm oils, foods and quick service restaurants, specialist health care services, hospitality, property, and logistic services.

As part of its corporate social responsibility (CSR) initiatives, JCorp has created nonprofit entities under its umbrella, called Amal Business Organizations (ABOs). ABOs function as a medium for JCorp to contribute to the development of the society through various aspects of charity, well-being, and recreation, as well as entrepreneurship. In 2011, 27 ABOs were operating in four areas: social and public welfare development, entrepreneurship development, sports and recreation development, and staff welfare.

The innovative element of these initiatives is the establishment of a corporate *waqf* in the form of *Waqaf*An-Nur Corporation Berhad (WANCorp), a limited liability company set up to guarantee proper management of Johor Corporation and the *Waqf* and the stocks and assets in the endowment. WANCorp has entered into a Memorandum of Agreement with the Johor Islamic Council, recognizing its role in making a success of JCorp's corporate *waqf*. WANCorp has consequently been endowed with powers of trusteeship and with the duty and obligation to manage JCorp's corporate *waqf*.

JCorp's corporate *Waqf* took off in 2006 when JCorp transferred RM200 million (on a net asset value basis) in public listed shares to WANCorp. WANCorp's main income is derived from the annual dividend payout by the Public Listed Companies (PLCs), part of whose equity is now endowed and transferred to its ownership. These payouts are allocated for reinvestment, as well as to fund Islamic corporate social responsibility programs that are not restricted to Muslims as beneficiaries. For instance, in 2009, WANCorp received RM4.9 million as dividends; of this, it allocated 70 percent for reinvestment. It spent another 25 percent of the dividends on various Islamic CSR initiatives, including the nationwide chain of charity *Waqaf* An-Nur clinics and hospitals to serve the health care needs of the poor of all ethnic groups. Johor Islamic Religious Council is the beneficiary of the remaining 5 percent.

A flagship initiative of WanCorp is to provide health care and dialysis services to the less fortunate segments of the society through a full-fledged hospital, *Waqaf* An-Noor Hospital, and 16 *Waqaf* An-Noor Clinics that it owns and manages. The clinics provide health services not only in Johor, but also in nearby states, including Negeri Sembilan, Selangor, Perak, and Sarawak, in cooperation with the respective State Islamic Councils. The number of beneficiaries from these services has steadily increased from 0.56 million in 2009 to 0.77 million in 2011. About 6 percent of the treatments are provided to non-Muslim patients. Patients of *Waqaf* An-Nur clinics pay only RM5 for treatment by a qualified doctor, plus the cost of medicine prescribed.

Another program with high impact is the provision of treatment for kidney ailments through dialysis centers that operate alongside these clinics. These centers offer subsidized dialysis treatments. For many

patients the cost is reduced to almost zero with further financial support from other charities (such as the Bayt al-māl Funds of state religious councils) that are part of the support network.

Source: Personal interviews and information collected from the organization by the authors.

Waqf may also directly contribute to the success of Islamic microfinance experiments to improve the economic lot of the poor. Islamic economists have often sought to make microfinance more affordable by suggesting an integration of *zakāt* and/or *waqf* with microfinance. A cash *waqf* with returns dedicated to fully or partly absorb the cost of financial and nonfinancial services may be able to ensure that loans are offered at zero or low cost, making them interest-free as well as affordable for the poorest of the poor. Nowhere is this phenomenon better documented than in Bangladesh, which is often referred to as the "university of microfinance." Fa'el Khair *Waqf* offers a real-life example of this exciting solution to poverty and destitution.

Box 9.5 Case 5. Using *Waqf* to Fund Microfinance: The Fael Khair Program, Bangladesh

The Fa'el Khair Program of the Islamic Development Bank was motivated by the urgent need to help the victims of the Sidr cyclone, which devastated the southwestern coast of Bangladesh in November 2007, resulting in loss of life and considerable damage in 30 of the 64 districts of the country. Since cyclones are a recurring phenomenon in the country, long-term rehabilitation solutions were needed, as well as an immediate emergency response. The Program has two main components:

- The Fa'el Khair project, initially funded at $110 million, supports the construction of several hundred schools that also serve as cyclone shelters in the coastal belt of Bangladesh.
- The Fa'el Khair microfinance program, initially funded at $20 million, provides urgent relief and support steps to restore the livelihoods of affected farmers, fishermen, and small businesses. It was registered as the Fa'el Khair *Waqf* under the provisions of *Waqf* Ordinance 1962.

The second component initially aimed at providing urgent relief to the victims of the Sidr cyclone in the form of agricultural inputs and support for small businesses. To implement the program, the Islamic Development Bank signed three-year (extendable) agreements with several NGOs. The microfinance intervention provides interest-free (*qard*) microloans as well as training to the cyclone victims in order to help them recover their losses and regain their livelihoods. When the agreement period of three years is over, NGOs are to return the funds by depositing them into the Fa'el Khair *Waqf* account. The Committee of Mutawallīs will then decide whether to renew agreements with the partner NGOs.

The NGOs together recruited and trained some 774 staff and are operating through 80 field offices in the areas most impacted by the cyclone. As of January 2014, *qard* amounting to Tk8 billion (roughly $105 million) has been disbursed to 192,821 beneficiaries. This implies that the original funding (amounting to $20 million) has been leveraged more than five times. The *qard* repayment rate was as high as 99.75 percent. In addition, 196,710 beneficiaries were trained through 6,338 training courses on agriculture, cattle rearing, and fishing and fish farming.

In 2012, the NGOs were instructed to start implementing their exit plan by returning one-third of the Program funds to the Fa'el Khair *Waqf*. It was then up to the Committee of Mutawallīs to decide how to use the funds that were returned. They have been placed in Islamic investments that have generated returns in the range of 10 percent a year. These proceeds are being used to cover the administrative costs of the Fa'el Khair Program.

The Fa'el Khair project provides an excellent example of how a benevolent cash donation can be used to engineer a *waqf*. It is also a rare example of how the high administrative costs of a poverty alleviation program (with finance as well as skill enhancement inputs) may be absorbed by returns generated by a *waqf* dedicated to poverty alleviation.

Source: Personal interviews and information collected from the organization by the authors.

Hybrid Models of Islamic Microfinance

Both *zakāt* and *waqf* funds may be used to support microfinance. While the *zakāt* funds can be used immediately and on a one-to-one basis,[92] the establishment of a portfolio with *waqf* funds requires a larger initial amount of resources, as only the returns from investing such resources may be used for microfinance.

Zakāt and *waqf* funds should be an integral part of any poverty alleviation initiative. First, they provide for the immediate basic consumption needs of the poorest of the poor, such as food, clothing, and shelter. As discussed, such safety nets can be funded only through charity. Second, they support ways to impart or strengthen appropriate skills so that the poor are able to generate income on a sustained basis without being dependent on charity. *Zakāt* and charity funds can also fund initiatives to impart these technical and entrepreneurial skills.

So that the same individuals may move through several stages, from poverty to self-sufficiency, it is important to link safety nets with microfinance programs. While for-profit microfinance institutions are reluctant to invest in start-up equity, *zakāt* and *waqf* could fill the gap by providing micro-equity to enterprises set up by the poor.

Often, individuals borrow funds from microfinance institutions (MFIs) to meet emergency needs relating to health, education, and social obligations such as weddings and funerals. Further, the gains people may achieve through a growing business could easily be set back by a catastrophe such as a tsunami or even smaller risks at a household or personal level. What is needed is a way to finance productive activities, as well as to meet contingencies and emergencies. While a revolving *qarḍ al-ḥasan* fund based on *zakāt* may not be an ideal solution for developing microenterprises, it may be ideal to provide emergency credit. Since individuals burdened with debt constitute eligible recipients of *zakāt*, it may also be used to create guarantee funds that leverage its use for provision of finance to greater numbers of people who suddenly must take on debt. Finally, *zakāt* along with *ṣadaqāt* and *waqf* may be used to establish micro*takāful* projects for the poor and the vulnerable (see chapter 6).

Given these considerations, a hybrid model of Islamic microfinance is presented that can lead to economic empowerment in a comprehensive manner. *Zakāt* plays an important role in the model and is integrated with *ṣadaqāt, waqf,* and various nonprofit and for-profit modes of Islamic finance. The model encompasses 11 activities:

1. A *Zakāt* fund is created with contributions from the zakāt payer (*muzakkī)*.
2. A program is established to facilitate *waqf* of physical as well as monetary assets. The physical assets are used to support education and skills training. The monetary assets may be in the form of a cash *waqf* or simply as ordinary *ṣadaqāt.*
3. The program carefully identifies the poorest of the poor and the destitute who are economically inactive and directs a part of the zakāt funds as a safety net to meeting their basic needs. A revolving *qard* fund is created to provide emergency credit.

[92] That is, a dollar (or its equivalent, in local currency) in the fund can support a dollar (or its equivalent) in microfinance lending.

4. Skills training is provided to the economically inactive, utilizing the revenue from community-held physical assets under *waqf.*
5. Beneficiaries graduate with improved skills and managerial acumen. The recurring costs of the training programs are borne by the *Zakāt* Fund.
6. Beneficiaries are formed into groups with mutual guarantees under the concept of *kafālah.*[93]
7. Financing is provided using a combination of for-profit debt-based modes, such as *bay' mu'ajjal , ijārah, salam, istiṣnā',* and *istijrār ,* or equity-based modes, such as *muḍārabah, mushārakah,* or diminishing *mushārakah* (see Glossary for definitions) .
8. Group members pay back their debt and/or meet the expectations of equity providers and, in turn, are provided with greater amounts of financing.
9. Guarantee against default by the group is provided by the *Zakāt* fund, and actual defaulting accounts are paid off with *zakāt* funds; this is the distinct feature of this model.
10. Group members are encouraged to save under appropriate microsavings schemes.
11. Groups members are encouraged to form a *Takāful* fund to provide microinsurance against unforeseen risks and uncertainties resulting from loss of livelihood or illness (see chapter 6).

A few recent experiments in Islamic microfinance in Sudan use hybrid models of intervention with components that are rooted in benevolence, which may easily be replaced with *zakāt* and/or *waqf*. A good example is the Abu Halima Project in Sudan, discussed in chapter 4 (box 4.1).

The various case studies clearly demonstrate that the institutions of *zakāt* and *waqf* can be used to provide finances to the deprived and underprivileged, provide for their education and health care, and create livelihood opportunities by enhancing skills, and extending financial services. These have been made possible despite the many challenges and constraints, notably the absence of an enabling environment and supportive infrastructure. The sections that follow highlight some good practices at the macro, meso, and micro levels in several countries across the globe. If replicated, these will go a long way toward strengthening the institutions of *zakāt* and *waqf*, enabling them to address the key problems they are meant to tackle, such as poverty, exclusion, and denial of opportunities, in a sustainable manner.

Meeting the Resources Gap for Poverty Alleviation

While poverty and deprivation is a global phenomenon, the plight of Muslim societies is particularly bad. The role of Islamic philanthropy-driven funds, or what are called Islamic social funds, assumes great significance in countries with high levels of exclusion and deprivation. This section seeks to estimate to what extent Islamic social funds may meet the resource requirements to alleviate deprivation for a sample of countries in South and Southeast Asia and Sub-Saharan Africa.[94] It proceeds first by estimating the resource gap and then discusses the potential Islamic social funds that could be tapped to meet the resource gap.

Estimating the Resource Gap

The resource gap has been estimated by using the poverty gap index, which is defined as the mean shortfall below the poverty line, expressed as a percentage of the poverty line. The World

[93] *Kafālah* and other *fiqhi* terms used for various modes of Islamic finance are explained in the glossary.
[94] The data are drawn from Obaidullah and others (2014) and Obaidullah and Sirazi (2015).

Bank has used the recently updated poverty lines of $1.25 a day in 2005 purchasing power parity (PPP) terms for the extreme poor and $2.00 a day for the relatively poor, which represents the mean of poverty lines found in the poorest 10 to 20 countries ranked by per capita consumption.[95] This reflects the depth of poverty, as well as its incidence. The poverty gap index does not explicitly provide the total income (consumption) shortfall. For this purpose, the estimated poverty gap indexes based on international poverty lines of $1.25 a day and $2.00 a day, respectively, have been converted into percentages of GDP for selected countries. Table 9.1 shows the resource gap for sampled countries. The resource gap is highest in countries like Bangladesh, Tanzania, India, and Pakistan, and lowest in countries such as Malaysia and South Africa.

Table 9.1 Gap in Resources Needed to Alleviate Poverty

Country	Resource gap at $1.25 a day (percent of GDP)	Resource gap at $2.00 a day (percent of GDP)
Bangladesh	7.570	33.36
India, total population	2.390	12.59
India, (Muslim)	0.344	1.813
Indonesia	0.350	2.74
Malaysia	None	0.02
Pakistan	1.620	13.35
Kenya	0.320	0.96
Nigeria	1.470	3.50
South Africa	0.001	0.01
Sudan	0.490	2.20
Tanzania	3.020	8.17

Sources: Global Islamic Finance Development Center calculations, based on Obaidullah and others 2014; Obaidullah and Sirazi 2015.

Estimating the Potential Resources from Zakāt

The estimates for *zakāt* potential of the countries under study are based on three different opinions of jurists regarding *zakāt* the method of calculating *zakāt* liability, which are denoted as Z1, Z2, and Z3. Z1 is estimated in accordance with the majority traditional view according to which *zakāt* is levied on agriculture, livestock, and stock-in-trade, gold, silver and money. Z2 is based on the view of some contemporary Muslim scholars that *zakāt* is payable on net returns of manufacturing concerns, rentals of building, and net savings out of salaries. Z3 is based on views of the Malaki School, in which the *zakāt* base includes buildings and other fixed assets, except those assigned for personal and family use.

Zakāt is collected from the rich Muslims only, and non-Muslims citizens are exempt from the payment of *zakāt*. Thus the GDP of each country under study has been adjusted by taking into account per capita income and the proportion of Muslim population in each country. The average score of Zs has been applied as a proxy to estimate potential *zakāt* collection for the countries.

Table 9.2 shows that *zakāt* potential under Z1 varies from about 1 percent of GDP to 1.74 percent of GDP in the five predominantly Muslim countries. Under Z2, potential *zakāt* ranges from 2 percent of GDP to 3.71 percent of GDP, while under Z3 it ranges from 2.25 to 4.18 percent of

[95] For more precise estimates, national poverty lines and micro data of each country are required, which are not available. Therefore, international poverty lines and the corresponding poverty gap indexes are used for estimation.

GDP. Potential *zakāt* is much lower for the Muslim minorities in India (0.26 percent) and Singapore (0.65 percent of GDP). The potential is low for South Africa, as well, reflecting its small Muslim population.

Table 9.2 Estimates of the Potential of *Zakāt* (percent of GDP)

Country	Z1	Z2	Z3
Bangladesh	1.63	3.48	3.92
India	0.26	0.55	0.63
Indonesia	1.59	3.39	3.82
Malaysia	1.11	2.36	2.66
Pakistan	1.74	3.71	4.18
Kenya	0.13	0.27	0.30
Nigeria	0.86	1.84	2.08
South Africa	0.03	0.06	0.07
Sudan	1.44	3.08	3.47
Tanzania	0.54	1.15	1.30

Sources: Global Islamic Finance Development Center calculations, based on Obaidullah and others 2014; Obaidullah and Sirazi 2015.
Note: Z1 is estimated in accordance with the majority traditional view. Z2 is based on the view of some contemporary Muslim scholars that *zakāt* is payable on net returns of manufacturing concerns, rentals of building, and net savings out of salaries. Z3 is based on views of the Malaki School. See text.

Juxtaposing tables 9.1 and 9.2 provides a comprehensive picture of whether and to what extent the resource shortfall required for poverty alleviation may be met by potential *zakāt* collection. The resource shortfall in Bangladesh is much higher than its potential *zakāt* collection. However, in some other countries, resources needed for poverty alleviation can easily be provided by the potential *zakāt* collection. Indian Muslims can generate enough resources (0.63 percent of GDP) to provide for the resource shortfall (0.344 percent of GDP) for lifting their extreme poor out of poverty. Countries like Nigeria, South Africa, and Sudan can easily generate resources for poverty alleviation. In some countries with Muslim minorities, the gap between resource required and potential *zakāt* collection is minimal. In Kenya, for instance, the resource gap for extreme poverty is 0.32 percent of GDP, whereas corresponding potential *zakāt* collection is 0.30 percent of GDP, using the Z3 measure. However, Tanzania would be unable to bridge the resource gap with potential *zakāt* collection.

Based on the evidence from sampled countries, it appears that the potential resources from *zakāt* collection alone can meet the shortfall in resources required for poverty alleviation in most countries in the sample.

Estimation of Potential Resources from Waqf

The process of estimating potential resources from *waqf* is more challenging due to the absence of data in most countries. However, based on limited data available for two countries, India and Indonesia,[96] the potential resources that may flow from the *waqf* assets can be estimated.

[96] See chapter 2 of Obaidullah and others (2014).

Estimates of the economic potential of *waqf* assets in India indicate that there are about 490,000-registered *waqf* assets*,* in India, with a total area of about 600,000 acres and with a book value of about Rs60 billion. Many of the *waqf* properties are located in city centers, and the current market value is many times more than the book value. The authors of the *Islamic Social Finance Report* 2014 argue, "as the book values of the properties are about half a century old, the current value can safely be estimated to be several times more and the market value of the properties can be put at Rs1,200 billion (about US$24 billion). If these properties are put to efficient and marketable use they can generate at least a minimum return of 10 per cent, which is about Rs120 billion (about US$2.4 billion) per annum. Wherever the *waqf* land have been put to efficient use, they have generated an average return of about 20 per cent" (Obaidullah and others 2014, 75). At Rs120 billion, the annual return is about 0.3 percent of India's GDP as of 2005. The resource shortfall of the Muslims poor is 0.344 percent, as indicated in table 9.1. By combining *zakāt* and *waqf*, a surplus could be generated, which would be enough to lift the poor Muslims in India out of grinding poverty.

Zakāt and *waqf* could also wipe out extreme poverty in Indonesia. According to data obtained from the Ministry of Religious Affairs, the market value of registered *waqf* land is about Rp590 trillion ($60 billion). At a similar minimum rate of return of 10 per cent, these assets may generate an annual cash flow of $6 billion, which is 0.849 percent of Indonesia's GDP. This compares favorably against a resource shortfall of 0.350 percent needed to lift Indonesia's poor above the $1.25 a day poverty level.

Estimation of Potential Resources from a Social Tax (Equivalent to Zakāt)

A recent study extended the analysis of *zakāt* and *waqf* to a scenario where a social tax equivalent to *zakāt* potential is levied and collected.[97] This study found the expected impact of social tax collection to be at least 2.93 percent of GDP (equivalent to the median for *zakāt* collection under three different definitions of *zakāt*, Z1, Z2, and Z3). This includes transfers to reduce the poverty gap and headcount ratio and improve the income distribution of the lowest 40 percent of population for a sample of 104 low-income and middle-income countries. It finds that if countries choose to levy 2.93 percent of the GDP as social tax, then as many as 66 countries could entirely cover the resource gap measured at the $1.25 a day level, and the rest of the countries would be able to bridge the poverty gap partially.

Toward the Optimal Mobilization of *Zakāt* and *Waqf* Resources

The previous sections clearly demonstrate how *zakāt* can potentially meet the resource gap for poverty alleviation in all the countries under study. However, the potential remains unrealized, as actual *zakāt* mobilized falls far short of its potential in most countries. For instance, in Indonesia, the actual *zakāt* collected according to the latest figures available is just 0.025 percent of GDP against a potential of 1.59 percent, while the estimated resource shortfall is 0.41 percent of GDP. In Pakistan, actual *zakāt* collected is just 0.06 percent of GDP, against a potential of 1.74 percent, while the estimated resource shortfall is 0.709 percent of GDP. In Sudan, the situation is better; the actual *zakāt* collected is 0.33 percent of GDP against a potential of 1.44 percent and an

[97] This section is based on Shirazi and Zarka (2015).

estimated resource shortfall of 0.49 percent. In Malaysia, the actual *zakāt* collected is 0.24 percent of GDP, against the potential of 1.11 percent with an estimated resource shortfall of 0.012 percent of GDP.

Similarly, while potential returns from existing *waqf* could meet the resource gap to eradicate extreme poverty, the actual returns are dismal. Studies show widespread usurpation of *waqf* assets by both State and non-State actors**,** as well as leasing of *waqf* assets at grossly below-market rates.[98]

Trends in Mobilizing Zakāt and Waqf Resources

Mobilization of *zakāt* has generally been increasing in the countries under study. For instance, according to the latest data available

- Brunei Darussalam. Increased by 55 percent over 10 years ($13.8 million in 2010)
- Indonesia. Increased by over 32 times over 10 years (**$**231.6 million in 2012)
- Malaysia. Increased by 7 times over last 12 years and 37 times over 22 years ($628.6 milllion in 2013)
- Nigeria. Total *zakāt* collected was $3 million in 2013, but it has fluctuated greatly.
- Pakistan. Increased by 40 percent[99] over 3 years ($105 million in 2011)
- Singapore. Increased by 20.2 percent over 3 years ($20.4 million in 2012)
- Sudan. Increased by 4.8 times over last 9 years ($220 million in 2013)

In Indonesia and Pakistan, where private institutional *zakāt* collection is permitted, several nongovernment actors perform exceedingly well. In Indonesia, private institutional collectors together mobilize about 38 percent of total national collection, according to official figures. Interestingly, just 3 institutions account for 17 percent, or one-sixth, of the total national collection. Similarly, in Pakistan, just one NGO—the Edhi Foundation—collects about 16 percent of all *zakāt* mobilized, according to unofficial estimates.

With respect to mobilization of *waqf* resources, data indicate a near-freeze in the creation of new social *waqf*, though religious *waqf* continue to be created. Places of worship (*masjids)* and seminaries (*madrasas)* have increased in numbers, especially where new Muslim communities have emerged. There has been some rejuvenation of social *waqf* in the form of cash *waqf* in Indonesia, Malaysia, and Singapore. Some development of *waqf* assets and their prudent investment to generate returns has also occurred in these countries, as well as in Sudan, which is also known for its successful family *waqf*.

What factors have contributed most to success in mobilization of *zakāt* and *waqf*? What factors constitute major obstacles and challenges? What should be the strategic response of policy makers? Some policy recommendations follow.

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[98] See, for example, chapter 11 of Government of India (2006).

[99] Based on figures available for *zakāt* collected by the government of Pakistan; excludes *zakāt* collected by private institutions and individuals.

Evidence and Policy Recommendations to Better Mobilize Zakāt Resources

1. Contrary to commonly held perceptions regarding the lack of dependability in flow of donations, *zakāt* is dependable and sustainable, and could be a growing source of funds for institutions that acquire the necessary professionalism in fundraising and seek continued improvement in their social credibility through actions to promote integrity, transparency, and good governance. This is the evidence in Southeast Asian countries. The evidence is more mixed in the agrarian economies of Sub-Saharan Africa, where there is greater volatility in *zakāt* collections because of the changing fortunes in the farming sector.

2. There is a clear upward trend in the mobilization of *zakāt* in South Asia and Southeast Asia. *Zakāt* mobilization has grown steadily in Indonesia and Malaysia, under two distinct *zakāt* management systems. While *zakāt* collection is mandatory in Malaysia, it is voluntary in Indonesia. The pattern of growth is more varied in other countries in those regions, such as Bangladesh, India, and Pakistan, as well as in Sub-Saharan Africa. While *zakāt* is mandatory in Sudan and four states in Nigeria, it is voluntary in other states of Nigeria, as well as in the other countries under study. In Sudan, *zakāt* has been steadily increasing at an annual average growth rate of 19 percent. In absolute terms, *zakāt* collected in Sudan is impressive. At around $200 million per year, it ranks lower than Saudi Arabia, Malaysia, and Indonesia. However, in term of per capita *zakāt* collected, it fares better than Indonesia. Annual *zakāt* collection in all Nigerian states together is much smaller—around $3 million, particularly considering the much larger size of the Muslim community. This is perhaps explainable because these bodies are relatively new, and the per capita income of the Nigerian people has fallen greatly since the country became independent.

3. Malaysia and Sudan provide supporting evidence for compulsory *zakāt*. The Nigerian states that have both compulsory and voluntary *zakāt* provide modest supporting evidence in favor of compulsory *zakāt*, with relatively better performance in states like Zamfara and Jigawa. However, the policy in these states may not have paid off well in view of lack of enforcement mechanisms, unlike in Sudan. The voluntary nature of *zakāt* may not itself have contributed to the poor performance of other states. A more important factor may be the absence of a vibrant network of organizations at different levels. In Indonesia, Pakistan, and South Africa, the performance of voluntary *zakāt* organizations has been excellent. Irrespective of whether *zakāt* is compulsory or voluntary, a policy of decentralization seems to work. The presence of a network of healthy institutions at multiple levels—in the public, not-for-profit, and private domains—seems to lead to increased public awareness and greater participation in the process of poverty alleviation through *zakāt.*

4. The issue of incentivizing *zakāt* payment is crucial. Where *zakāt* payment is made compulsory and noncompliance leads to penalties and punishment, weak enforcement can lead to low *zakāt* collection, as in case of some Nigerian states. With reasonably strong enforcement mechanisms, as in Sudan, incentives in the form of benefits for compliance (such as tax incentives for levies of *zakāt* on salaries), as well as costs for noncompliance (such as making *zakāt* payment a precondition to other commercial transactions) work well. At the same time, where *zakāt* payment is voluntary, its mobilization has not been any less impressive.

5. Where *zakāt* collection and distribution is entrusted entirely to the State, *zakāt* may be seen as a component to the aggregate resources available to the State. In this sense, *zakāt* payment may function as a perfect substitute of the direct taxes to the State and may be allowed as deductions

to taxes payable. However, there must be absolute clarity on the issue, as well as coordination between *zakāt* and tax authorities. The absence of clarity seems to have affected *zakāt* collection in Sudan adversely in the initial stages of operation of the Diwan, but was sorted out later with a tax incentive that was made available only on *zakāt* paid on salaries. In the Nigerian states, on the other hand, the incentive was withdrawn because of difficulties in coordination among agencies, creating further confusion. Where private agencies are permitted to collect *zakāt*, there seems to be merit in allowing *zakāt* payment as a deduction to taxable income only, at par with various kinds of charity flows. Treating *zakāt* payment at par with taxes to the State when the payment is made to private collecting bodies might seriously erode state revenues.

6. There does not seem to be a strong case for having standardized and globally acceptable definitions of assets liable to *zakāt* and methods of estimating *zakāt* liability. Since Islamic societies are typically characterized by a multitude of *madhabs* and schools of thought, the *zakāt* laws must retain enough flexibility to accommodate alternative views. The diversity in legal opinions should be respected. However, in societies like Sudan, where there is great homogeneity in *shari'ah* legal positions, and where *zakāt* is compulsory, the clarity provided by law in the definitions and methods seems to have imparted greater stability and added to enforceability. Where *zakāt* is voluntary, it is more practical to ensure that *zakāt* estimation is an outcome of a consultative process between the *muzakki* and the institutions that collect *zakāt*.

7. The success or failure of an institution as *zakāt* collector and distributor depends not so much on whether it is in government or private hands, but on the credibility and trust it enjoys among the *muzakki* population—which in turn depends on the integrity, transparency, and good governance reflected in its practices and as perceived by the stakeholders. For example, the national *zakāt* body in Indonesia is highly regarded while the national body in Pakistan seems to suffer from a severe deficit in trust.

8. The coexistence of public and private players as *zakāt* collectors raises certain issues. Competition among a multitude of *zakāt* institutions brings efficiency and gives more choice to the *muzakki*. However, competition also presupposes a level playing field for the players. Where the public agency also assumes the role of the regulator of the *zakāt* sector, it should restrict itself only to regulation, leaving *zakāt* collection to private agencies. Alternatively, the entire process of *zakāt* management could be undertaken by the public agency, through its own decentralized network. Such a scenario does not preclude the involvement of private players as agents of the public body, as is the case with Malaysian states.

9. Using a large network of private institutional collectors to mobilize *zakāt* is far more efficient than having a large number of unconnected private individual collectors. How to remunerate the private collector, however, is a tricky issue under *shari'ah* and calls for putting in place adequate and transparent mechanisms to ensure that a minimal percentage of *zakāt* collected is utilized in this manner. Use of private entities should not be pushed too far. For example, private agencies should not be allowed to offer *zakāt* investment services, as this might involve a misalignment of objectives of such private agencies with those of other stakeholders.

10. In the context of in-kind *zakāt* involving crops and livestock, some specific policy recommendations may be made. Due to the vast expanse of agricultural areas and given the hugeness of the monitoring task, the *zakāt* collection efforts may be timed to allow for the seasonality of crops. *Zakāt* mobilization should actively involve local committees as a way to

build social capital and enhance community solidarity. Local participation should be sought in the collection of *zakāt* on agricultural products of smallholdings, inventory merchandise, and leased property in the locality.

Policy Recommendations to Better Mobilize Waqf Resources

1. The legal framework must not put undue restriction on creation of new *waqf*. A case in point is the restriction on the creation of new *waqf* in Zanzibar. Legal requirements that make the process more difficult, such as the approval of the head of State, are both unnecessary and undesirable. A simple process of registration with the regulatory body is both desirable and adequate. The legal framework should actually encourage creation of new *waqf* by minimizing financial and nonfinancial costs of creating and managing *waqf*. Sudan, for instance encourages the creation of *waqf*; by law, the major objectives of the Diwan are to conduct scientific studies and research on *waqf*, carry out training and capacity building and institutional development in the field of *waqf,* and encourage citizens to establish *waqf*. The case of Zamfara state in Nigeria is quite interesting: government agencies and contractors are encouraged to endow a certain percentage of their total revenues as *waqf,* thereby ensuring the continuous enhancement of *waqf*.
2. *Waqf,* in general, have fallen behind common trusts and other forms organizing charitable and nonprofit activities in responding to evolving social needs. Creation and management of *waqf* is a relatively more complex and demanding process and involves additional financial and nonfinancial costs. Incentivizing *waqf* in a manner similar to secular trusts and other forms of nonprofit organizations, such as through tax rebates on contributions for the donor/endower, would make the system both efficient and fair.
3. The legal framework should make it possible for all segments of the society to establish *waqf*. Currently, some laws restrict making a *waqf* only to Muslim individuals. Laws should permit both non-Muslims and institutions to establish *waqf* as long as the purpose of *waqf* is religious or charitable.
4. The legal framework should not restrict the definition of the endowed asset to immovable tangible assets, such as real estate, but should also explicitly recognize movable, financial, and intangible assets, such as cash, equities, bonds and financial securities, transportation vehicles, rights on land and buildings, leasing rights, and intellectual property rights.
5. Most observers and scholars of *waqf* believe that the institution of family *waqf* must be revived. Sudan and Mauritius provide some excellent examples of family *waqf*. The law in Mauritius explicitly provides for family *waqf.* Interesting features include the possibility of restricting the benefits to one or two generations; the need for concurrence of a wife before a husband may make a *waqf;* list of relatives who may benefit from *waqf* and the order of priority among them; the definition of a child and a descendant; how *waqf* benefits should be apportioned between children and descendants and other possible beneficiaries across generations and between males and females; and the conditions under which the benefits will lapse.

Toward Better Management of *Zakāt* and *Waqf* Resources

Zakāt management essentially involves its safe deposit and its timely distribution among the *asnaf,* or the eligible categories of beneficiaries within the annual cycle. Related considerations include prioritizing among the categories of beneficiaries and among regions. Prudent *zakāt*

management requires the complete and effective transfer of resources to beneficiaries and meeting their pressing needs as soon as possible.

Prudent *waqf* management, on the other hand, requires preservation and development of the *waqf* assets, investment and generation of returns, and ensuring that the returns/benefits flow to the beneficiaries as intended by the *waqif*.

Trends in Utilization of Zakāt and Waqf

Distribution of *zakāt* has kept pace with its mobilization and is growing in almost all sampled countries, which have a zakāt management system in place. The trends in *zakāt* distribution in the sampled countries reveal the following:

The poor receive:

- More than 90 percent of *zakāt* distributed in Bangladesh, Indonesia, India, and Pakistan
- More than 80 percent of *zakāt* distributed in Brunei Darussalam
- About two-thirds of *zakāt* distributed in Sudan
- 35-40 percent of *zakāt* distributed in Malaysia and Singapore.

As a percentage of total *zakāt* distributed, distributions *to fi-sabilillah* (those in the path of Allah) amount to:

- Less than 5 percent in Indonesia and Sudan
- About 40 percent in Singapore and Malaysia.

Within the poor category, education, health, and social safety nets receive priority; around 10 percent is allocated for economic empowerment programs in Indonesia.

As much zakāt is collected as is distributed in Malaysia and Singapore, over time. In Brunei Darussalam, the relative proportion varies widely, from 50 percent to 500 percent, indicating symptoms of *zakāt* “holding” or accumulation of surplus.

The proportion of administrative costs to *zakāt* collected varies from zero to 10 percent for most countries. The exception is India, where anecdotal evidence suggests that the percentage could be more than 30 percent. In countries with in-kind *zakāt* such as crops and livestock, such as Nigeria and Sudan, the costs are higher due to costs of storage and transportation. Sudan considers 20 percent as the cap for the proportion of administrative costs.

Some policy recommendations are discussed next, in the light of findings pertaining to the countries under study.

Policy Recommendations to Improve the Utilization of Zakāt

1. In the light of various legal opinions relating to distribution of *zakāt* among eligible beneficiaries, there is a case in favor of a scheme of prioritization among different types of beneficiaries, with highest priority being given to the needs of the extreme poor.
2. Basic consumption needs are, by definition, more urgent than needs that may be deferred to a future date. In this sense, *zakāt* is traditionally viewed as a solution to the consumption needs

of the poor. However, there is also merit in using *zakāt* to enhance the wealth-creating capacity of the poor so that they are able to get out of the vicious circle of poverty and find lasting solutions to their needs. Complete neglect of the empowerment dimension is likely to perpetuate the dependency syndrome among the poor.

3. The term *tamleek* implies a process of imparting ownership. In the context of *zakāt*, *tamleek* is seen as a requirement that essentially entails making the *mustahiq* the owner of the donated funds. This clearly rules out the possibility of giving *zakāt* as a loan to be repaid later. The question of ownership, however, opens up two further issues. Should the poor beneficiary have absolute right to decide how he/she is going to use the funds? Where there is a genuine possibility that the poor may not use the donated cash in an optimal way, can the institution distributing *zakāt* insist on conditionality for the possible use of *zakāt*, such as *zakāt* payment in the form of scholarships to poor students to cover tuition fees? Given the recent evidence in the development literature in favor of unconditional cash transfers (UCTs) over alternative methods of financial assistance to beneficiaries (Haushofery and Shapiro 2013), the case in favor of interpreting *tamleek* as unconditional cash transfers appears to be a sound one. However, it is perhaps a good idea to treat the issue more as related to efficiency than as a matter of *shari'ah* compliance.

4. Traditionally, scholars have frowned upon the prospect of giving *zakāt* as loans, since *zakāt* is supposed to make the *mustahiq* the owner of donated funds and not a borrower of funds. The objections seem to lose weight in light of the leveraging possibility that loans offer. Arguably, a professionally managed *zakāt*-financed microfinance program can potentially serve a much larger population of the poor as compared to the prospect of grant-making to a small number of beneficiaries. Further, a scenario where the poor are also made the sole owner of the revolving fund is on far stronger grounds. The first scenario (an independent *zakāt*-funded microfinance institution) appears to involve efficiency-related gains while raising concerns about *shari'ah* compliance. The second scenario (the microfinance institution being owned by the poor) is clearly superior, as it simultaneously takes care of the *tamleek* requirement.

5. *Zakāt* payment is an act of worship (*ibada*) for the *zakāt* payer or *muzakki*. It is a matter of grave concern for the *muzakki* to ensure that *zakāt* is not only paid, but also distributed in compliance with the norms of the *shari'ah*. A *zakāt* institution essentially acts as an agent of the *zakāt* payer or *muzakki*. As the principal, the *zakāt* payer or *muzakki* would like its agent to ensure that the *zakāt* funds flow to eligible beneficiaries according to *shari'ah*. Therefore, fulfillment of the conditions relating to collection and distribution of *zakāt* is the most fundamental requirement for a *zakāt* institution to earn the trust of the *zakāt* payers and enhance its credibility.

6. Separation of *zakāt* funds from other forms of donations is a primary concern for a *zakāt* institution acting as an agent of the *zakāt* payer or *muzakki* for distribution of *zakāt*. Since the conditions relating to eligibility apply only to *zakāt* and not to other forms of donor funds, it becomes extremely important to ensure separation between *zakāt* and other types of funds. To ensure this is the case, *zakāt* institutions must put in place appropriate standard operating procedures and accounting and governance practices.

7. The *shari'ah* identifies *zakāt* officials as one of the eight eligible categories of beneficiaries. Therefore, part of the *zakāt* mobilized by the institution may be utilized to cover the administrative and operational costs of the *zakāt* institution. While some would like to place

of legal cap of one-eighth on the percentage of *zakāt* that may be utilized for this purpose, others would like to treat the matter as one of good governance. As good practice, a *zakāt* institution that typically collects other forms of donations should cover its administrative and operational costs from such “free” funds as much as possible.

8. Within the overall eligibility framework stipulated by s*hari'ah*, a *zakāt* payer or *muzakki* may have a unique preference or priority scheme in favor of specific regions, beneficiaries, or projects. In the interest of good governance, a *zakāt* institution should ensure compliance with such “revealed preferences.” While there may be practical hurdles that impede such compliance for some *zakāt* institutions, an increasing use of information technology in *zakāt* management may make a payer*-to-beneficiary (muzakki-to-mustahiq,* or M2M) flow a reality as well as a good practice to replicate.
9. There is a case in favor of using *zakāt* to cover genuine credit defaults by the poor, since such borrowers qualify as eligible beneficiaries in the teachings of *shari'ah*. There is, however, need for caution while designing an institutional mechanism for this purpose. It is not easy for any microfinance institution operating with inadequate and imperfect information to differentiate between genuine and willful defaulters. The simultaneous functioning of a microcredit initiative and a *zakāt*-based initiative to cover credit defaults by poor borrowers under the same organizational umbrella may involve serious conflicts of culture and moral hazard issues. The Sudanese experiment of using *zakāt* only as a third-level institutional guarantee to microfinance providers (after post-dated checks and personal guarantors) is a step in the right direction for a *zakāt*-based credit default mechanism to evolve.
10. There is a need to revisit the *fiqh* of Muslim minorities, as it relates to *zakāt*. The interpretations of “eligible” beneficiaries (*asnaf*), the definition of assets liable to *zakāt*, and the legal and institutional infrastructure for *zakāt* are largely influenced by whether Muslims are a majority or minority in the population.
11. *Zakāt* management in Sub-Saharan Africa in general seems to have suffered a great deal due to absence of mid-level organizations, such as networks, training and education providers, consultancy and standard-setting bodies, and advocacy organizations. As a result, public awareness about *zakāt* obligations is extremely low in many parts of this region. Data are very scarce. Capacity building is extremely important, but neglected. Arguably, a large percent of *zakāt* should go to this. A major change in the mindsets of all stakeholders is needed. There is a lot to be done in the matter of improving the administration and governance and disclosures. Transparency and accountability are preconditions for credibility and successful fund raising.
12. In the context of in-kind *zakāt* such as crops and livestock, some specific policy recommendations may be made. *Zakāt* should be distributed in the neighborhood in order to enhance community solidarity. A large proportion of cattle collected as *zakāt* should be distributed at the collection area itself to save on costs of transportation and storage. The workers engaged in the collection of *zakāt* for cattle may be given a special in-kind incentive to devise livelihood projects for rural poor owners of livestock. *Zakāt* bodies should set up their own storage facilities and warehouses to save the crops and livestock.
13. Since management of in-kind *zakāt* entails huge collection costs, a more flexible approach is called for in relation to the cap on operational costs, which is traditionally one-eighth of *zakāt* funds collected. Further, once *zakāt* are collected, the transportation and storage of in-kind *zakāt* involves substantial costs. This justifies the strategy of on-the-spot distribution.

Policy Recommendations to Improve the Management of Waqf

1. Preservation of *waqf* is the most important concern in *waqf* management. The legal framework must clearly articulate the permanent nature of *waqf* arising from the principle of "Once a *waqf*, always a *waqf*." In case old laws fail to ensure protection, they must be replaced with new provisions that enable recovery of lost *waqf* assets. A good example is the Sudanese law that empowers the Diwan to recover all the endowed money that is possessed by other individuals, institutions, companies, or governmental authorities or to receive just and equitable compensation from them.[100]
2. While preservation is important, the law must clearly recognize the importance of sustaining and enhancing the benefits that result from the *waqf*—this being the ultimate purpose of the act of *waqf*. This is possible only when the importance of development of *waqf* is clearly recognized. An undue emphasis on preservation (such as constraints on leasing) would lead to neglect of developmental possibilities with private participation. Similarly, an undue emphasis on development, to the extent that it results in loss of full or partial ownership of assets to private developers, would dilute and vitiate the concept of *waqf*. The regulatory framework must seek to strike a balance between concerns about preservation and development. A good example is the Sudanese law that seeks to strike a balance between preservation and development aspects of investment by requiring the Diwan to undertake the maintenance and improvement of endowed funds and the evaluation, construction, and reconstruction of endowed assets. Further, the issue of sale and replacement (*istabdal)* of endowed assets is explicitly dealt with by the law. The Diwan is empowered to sell an endowed asset to replace it with better ones "only to the extent deemed absolutely necessary."
3. *Waqf* is an institution originally and always meant to be in the voluntary sector, with management of *waqf* entrusted to private parties. However, the State has often sought to play a role in the ownership and management of *waqf* assets, at times governed by motives to expropriate, and at other times, by need to curb the corrupt practices of private trustee-managers. There is no clear answer to the question of whether ownership and management of *waqf* assets should be in private hands or with the State. There seems to some be positive evidence that the State can play the role of an efficient manager of *waqf* assets. Contrary to general belief, State control may not necessarily hamper creativity and innovation in *waqf* development. Positive examples include corporate *waqf* as well as cash *waqf* in Malaysia, and large-scale development of existing *waqf* assets in the public-private mode in Malaysia, Singapore, and Sudan.
4. Where *waqf* management is in private hands, the State agency as regulator should clearly stipulate elaborate and clear eligibility criteria for a *mutawallī* or *nazir* or trustee-manager, not only covering aspects of integrity and trustworthiness but also professional competence. If the individual or institution so nominated meets the criteria, the regulator must respect the expressed intention of the *waqif* or endower. Laws must clearly articulate the responsibility of *waqf* management to emphasize not only preservation and protection of *waqf* assets, but also their development. The responsibility should also include transparent and honest reporting of financial assets and transactions. Laws must clearly stipulate the method of

[100] The law excludes endowments from application of any superseding law, and the law also applies the provisions of the Evacuation of Public Buildings Act concerning expropriation to endowments.

determining remuneration of managers, sufficiently incentivizing sound and professional management of *waqf* assets. The laws in Indonesia and Mauritius provide good examples related to these matters. The law stipulates that the remuneration to which a *mutawallī* is entitled shall not exceed one-tenth of the income of the *waqf*.

5. There is every reason for the State to take punitive action against *mutawallīs* who are negligent or lack integrity and transparency. The measures must act as effective deterrent against further acts of carelessness, neglect, and misappropriation. At the same time, the State should not be allowed to wield absolute power to engage in irrational or whimsical action against the *mutawallī*. Instances of unfair and unlawful action by the State are numerous, as are cases of corrupt *mutawallīs*. There is need for effective checks and balances in the law against wrongful acts by both the State and private *mutawallīs*. Power has a tendency to corrupt, and the possibility of such action can significantly increase the nonfinancial cost of creating new *waqf*. Endowers are likely to seek alternative forms of organizing their charitable activities if there is a possibility of undue State interference in the management of the endowed assets or outright usurpation of the endowed assets by the State.
6. The law must explicitly prohibit the *waqf* asset from being used as a mortgage, confiscated, given away, sold, inherited, exchanged, or being alienated into any form of right. The *waqf* asset, however, may be exchanged as an exception to the above general rule, when this is deemed to be in public interest. Such exchange requires prior permission from the regulator, with additional conditions that the exchange is necessary or beneficial to the *waqf*; consistent with the objects of the *waqf*; made against another asset of equal or higher value; and made with due respect to the inalienability of religious *waqf*. Laws are quite explicit in preventing the *waqif/mutawallī* from selling, exchanging, or using the *waqf* assets as collateral for mortgages. They can, however, permit leasing for varying periods. Caps on leases range from one year in Zanzibar to three years in Mauritius to ninety-nine years in Singapore. In India, they were three years, subsequently increased to thirty years. However, the rules could be less explicit in preventing similar actions by State agencies. Laws often permit sale and replacement (*istibdal)* by State agencies to the extent considered necessary and even in some cases to sell the property where the intentions of the endower cannot be reasonably carried out.
7. *Waqf* development must be a mandatory obligation of the *waqf* management. Innovative financing methods may be employed that bring in new *waqf* capital to develop existing *waqf*. Innovative methods may also be employed that facilitate private-public partnerships that involve the transfer of rights to lease, as distinct from ownership rights to private financing entities for a finite, yet sufficiently long period to provide a fair return on investment capital. Legal constraints motivated by preservation concerns, such as on long-term leasing of *waqf* assets, should be removed. The Singaporean and Sudanese cases of partnership between the State *waqf* body and private Islamic financial institutions are worth replicating in other countries.
8. Financial penalties, especially when these are expressed in absolute amounts, tend to lose their effectiveness as deterrents over time. These should either be subjected to continuous revision or be linked to the extent of misappropriation.
9. It is compulsory to invest *waqf* assets, whether they are real estate or moveable assets like cash. Investment can generate returns, which may then be applied to the purpose for which the *waqf* has been created. The assets purchased using the *waqf* investment returns do not

form part of the *waqf,* and therefore may be resold, unlike the original assets that have been given as *waqf*. Further, the conditions given by the endower or *wāqif* with regard to the investment of the *waqf* and/or conditions that the returns from investment are to be spent on specific areas are also binding. It would be rational to try to minimize risks through diversification or avoidance of high-risk investment activities. Risk minimization, however, may not be sought if the purpose of the *waqf* itself is to engage in specific risky ventures.

Policy Recommendations to Integrate Zakat and Waqf with Microfinace

1. There are sound economic reasons why conventional microfinance and especially microcredit may not be appropriate for the chronically poor and the destitute. Loans to the destitute may make the poor poorer if they lack opportunities to earn the cash flow necessary to repay the loans. A destitute person may or may not be reluctant to incur debt and start a microenterprise because of risk and uncertainty about cash flows. Profit-maximizing and risk-minimizing behavior on the part of the microfinance institution would lead to exclusion of such clients. Usually, such clients do not possess the entrepreneurial and technical skills needed to create wealth. Such an economically inactive individual would find it difficult to obtain financing from for-profit microfinance institutions. Indeed, more than financial services, these individuals must be provided for their basic needs, such as food, shelter, or guaranteed employment. Such safety nets may be funded through charity. Such individuals also need training to develop skills before they can make good use of microfinance. Thus safety nets may be linked with microfinance programs, so that the same individuals may move through several stages: from extreme poverty to a stage where they are able to meet their consumption needs, then to a stage where they acquire the necessary technical and entrepreneurial skills to set up microenterprises, and then to a stage where they are able to obtain required funds from microfinance institutions and get the microenterprises up and running. Fighting poverty in this way requires an integrated finance-plus approach, or the provision of financial services along with business development services that are linked to social safety nets. This is possible only by bringing philanthropy and cooperation into the model of microfinance. With the institutionalization of philanthropy and its integration with for-profit microfinance, Islamic microfinance institutions (MFIs) would perhaps be better placed to address the needs of the extreme poor.
2. There are also sound economic reasons why high-cost microfinance may push beneficiaries into a spiral of debt. Microfinance entails high administrative charges, monitoring costs, and of course, high portfolio risk. Thus it is invariably costlier than the traditional sources of finance. At the same time, both the microfinance institution and its clients may find this an attractive option if they believe that the expected return on the microenterprise is higher than the cost of debt. Such expectations may indeed materialize for the successful projects during "good times." However, the same may not be true for all projects at all times. Debt-related liability can compound and accentuate the financial problems of a project experiencing bad times and hasten its failure. The pace, frequency, and intensity of such failure is directly related to the levels of cost of debt. In contrast to debt, profit- and risk-sharing mechanisms provide a clear alignment between profitability of the project and cost of capital. The latter rises and falls in line with the realized profits of the venture. Islamic MFIs, as compared to

conventional MFIs, are more inclined to use profit- and risk-sharing modes. Even when they use financing methods creating debt such as *murābaḥah* , the amount of debt once created cannot be increased through restructuring if the client fails to repay the debt on time. Further, given the Islamic emphasis on avoidance of debt, an Islamic MFI should refrain from seeking to entrap a client in ever-rising levels of debt.

3. Charity and philanthropy occupy a central position in the Islamic scheme of poverty alleviation. The *shari'ah* clearly identifies eight categories of beneficiaries who may benefit from *zakāt*. Out of these, the potential beneficiaries relevant from the standpoint of poverty alleviation programs are the poor (*fuqara*), the destitute (*masakeen*), the indebted (*ghārimīn)* and the *zakāt* administrators (*amileen*). Scholars generally agree that *zakāt* may be disbursed in the form of a grant or be used to form a revolving credit pool from which microloans may be provided. *Zakāt* could thus form the basis of designing a range of programs for the poor, including safety net programs to meet basic consumption needs, and improve health and education; economic empowerment programs involving skill enhancement and business development services; programs to provide emergency grants or credit; programs to provide micro*takāful*; and programs to provide guarantee against credit default. The administrative costs related to *zakāt* management may partially be recovered from the *zakāt* collected, thus paving the way for a self-sustained *zakāt* management institutional infrastructure.

   There is total flexibility with respect to beneficiaries of voluntary *ṣadaqāt* . In the case of *ṣadaqāt jāriyah* or *waqf*, perpetuity of endowed assets is an essential condition that ensures that benefits from the assets flow to the beneficiaries on a sustainable basis. *Waqf* similar to *zakāt* may form the basis of various poverty alleviation initiatives, as stated above. While the major requirement in the case of *zakāt* is that benefits flow to the poor, in the case of *waqf,* benefits must flow to beneficiaries as intended by the donor. However, if the intention of the donor is not explicit, the proceeds may be used for general-purpose community welfare projects, including poverty alleviation initiatives. *Waqf* therefore provides a definitive mechanism with added elements of sustainability and flexibility. The issue of high-cost microfinance can be addressed by creating *waqf*s whose benefits can be dedicated to absorbing specific cost elements so as to make microfinance affordable to the extreme poor.

   In an Islamic system, far greater priority is given to the needs of the chronically poor than those of the poor or the moderately poor or the not-so-poor. Therefore, an Islamic microfinance institution, unlike its conventional counterpart, is expected to aggressively integrate the various forms of Islamic philanthropy with for-profit microfinance to address the multiple issues related to poverty alleviation programs.

4. *Murābaḥah* remains overwhelmingly popular among Islamic MFIs for two main reasons. First, *murābaḥah* is simple. The straightforward calculation of the installments for repayment is easier for the beneficiary to comprehend. In contrast, the payments under a partnership-based mode are uncertain, and therefore are less favored. Second, *murābaḥah* is familiar. For conventional MFIs venturing into Islamic microfinance and using *murābaḥah*, the transition is less demanding. Among all Islamic products, *murābaḥah* comes closest to interest-bearing microloans.

   For Islamic modes of finance involving multiple contracts such as *murābaḥah*, *shari'ah*-compliance often requires careful sequencing of contracts to ensure that profits are associated with risk bearing. However, in the context of microfinance involving a large

number of repetitive contracts for small amounts, adherence to desired sequencing becomes practically impossible. Creative *fiqhi* solutions such as *istijrār* may have significant advantages over *murābaḥah,* as *istijrār* is tailor-made for repetitive transactions.

Partnership-based modes place demands on beneficiaries in terms of the need for proper bookkeeping and the reporting of the financial results of the business. Financial illiteracy acts as a constraint. Further, the beneficiaries may be justifiably reluctant to share information relating to all aspects of their business with the MFI. Output-sharing modes or revenue-sharing modes[101] may work better in such situations due to the "revealed" nature of the benefits to be shared between the parties and the difficulties and uncertainties associated with cost calculation.

5. For-profit *shari'ah*-compliant methods of financing offer no built-in protection against exploitation and abuse through overpricing. Enhancing the financial literacy of poor clients is perhaps the only effective bulwark against such exploitation. The following examples clearly highlight the possibility of exploitation, and therefore, the need for financial literacy.

a. Returns on micro-*murābaḥah* and micro-*ijārah* financing are deemed *shari'ah*-compliant, while interest rates are not. However, both can be and often are high to the point of exploitation.

b. In case of participatory modes of finance such as *muḍārabah, mushārakah,* and *mudharaa,* the sharing ratio could be unfairly biased against the poor beneficiary because of their low bargaining power. Similarly, in case of fee-based financing through *wakālah* and *ḥawālah*, the agent-microfinance institution may charge an exorbitant fee for the same reasons.

c. The permissibility of *salam* (sale of nonexistent produce) is linked to the economic benefits it confers on poor farmers who need financing before they can cultivate their crops or produce their agricultural goods. However, *salam* can involve exploitation when the advance price paid to the poor farmer is artificially pegged at low levels due to his or her weak bargaining power.

An Islamic economy promotes free pricing and allows intervention by the regulator only when natural forces of demand and supply are manipulated to result in an artificial price. By implication, price ceilings or administered prices are frowned upon in a market where there is free and fair play of competitive forces in the determination of prices. However, in case of financing methods where the regulator is in a position to determine a fair estimate of the costs for the MFI, it may seek to regulate the profit margin so that prices charges by MFIs ensure full cost recovery and a fair amount of returns in the interest of sustainability.

At times, identifying an appropriate organizational structure may offer a bulwark against possible exploitation. For example, in the case of *salam*, a farmer's cooperative may replace the vendor and thus prevent exploitation of individual farmers by the latter.

6. There is no consensus on how to estimate the actual cost of operations chargeable to the beneficiary under not-for-profit modes, such as *qard* and *kafālah*. There is a need to develop accounting standards to estimate the actual cost of operations and clear guidelines on what should ideally be passed on to the beneficiary. Vigilance by *shari'ah* scholars to prevent

[101] Unlike profit and loss-sharing modes known in mainstream Islamic finance, output or revenue sharing is simpler. A landowner and a landless farmer can come together and jointly undertake farming; the post-harvest output is shared between them as per a pre-agreed ratio.

disguised *ribā* may also ensure that actual administrative costs recoverable from the beneficiary in *qard* or *kafālah* are not overstated.

7. A conventional MFI seeking to transform into an Islamic MFI is confronted with a range of issues at various levels. An enabling environment and a regulatory and policy framework are needed that permit the MFI to engage in trade, leasing, and investment in real projects. This is usually not permitted for a conventional MFI, which is viewed as a financial intermediary. The law must recognize the special status of Islamic MFIs, which are financial intermediaries as well as players in the real economy at the same time. Fiscal constraints in the form of taxes on real transactions must be removed.

8. Islam gives utmost importance to the family as the core social institution that plays a major role in shaping the future of humankind. It also sees a balanced role for men and women in ensuring the economic and social well-being of the family. Islam promotes the concept of "family empowerment" by exhorting men and women to play their respective roles in seeking economic and social well-being of all members of the family. Indeed, the "women only" approach to conventional microenterprise development and poverty alleviation is alien to the Islamic religion and culture. Further, there is the possibility that women may be doubly exploited instead of being empowered where they are made to take the loan-related liability, while the male member in the family manages to "pocket" the cash. Therefore, there is merit in the argument that Islamic MFIs should aim to empower families and not women alone.

9. The institutionalization of charity as well as voluntarism is a creative strategy that has the effect of drastically cutting down operational costs. Under this arrangement, microfinance can be provided at low or zero costs, making it affordable to the poorest of the poor

10. Combining Islamic charity, especially *zakāt* collection and application, with for-profit financing involves serious transparency and governance issues concerning the commingling of funds. A major condition in raising *zakāt* funds requires such funds to be directly channeled into the hands of the eligible beneficiaries or the poor; they cannot simply be credited to the organization capital. In the absence of relevant and adequate accounting standards and regulatory norms, *shari'ah* scholars have generally discouraged the use of *zakāt* funds in economic empowerment initiatives, preferring the direct channels of distribution for consumption purposes, instead. Therefore, better accounting standards and regulatory norms are needed. Further, the law relating to charities must clearly address governance issues related to the commingling of funds.

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Chapter 10

Islamic Banking: Is It Good for Growth?

Since the modern birth of Islamic banking in the 1960s in the Arab Republic of Egypt, it has expanded rapidly across the globe.[102] The expansion has taken place, in particular—though not exclusively—in countries with larger Muslim populations (Imam and Kpodar 2013). From an insignificant beginning, the industry has grown to over $1.6 trillion in assets in 2012, and is expected to reach $6.1 trillion by 2020 (Gewal 2013). Not only have local banks in Muslim countries adopted Islamic banking principles, but large multinational banks have established Islamic windows. Islamic finance has spread beyond commercial banks, and now spans investment banks and insurance companies, as well as investment (such as asset management) and financial companies (including leasing). The development of new products, such as *sukūk* (equity-based certificates of investment), has also broadened the range of products available.

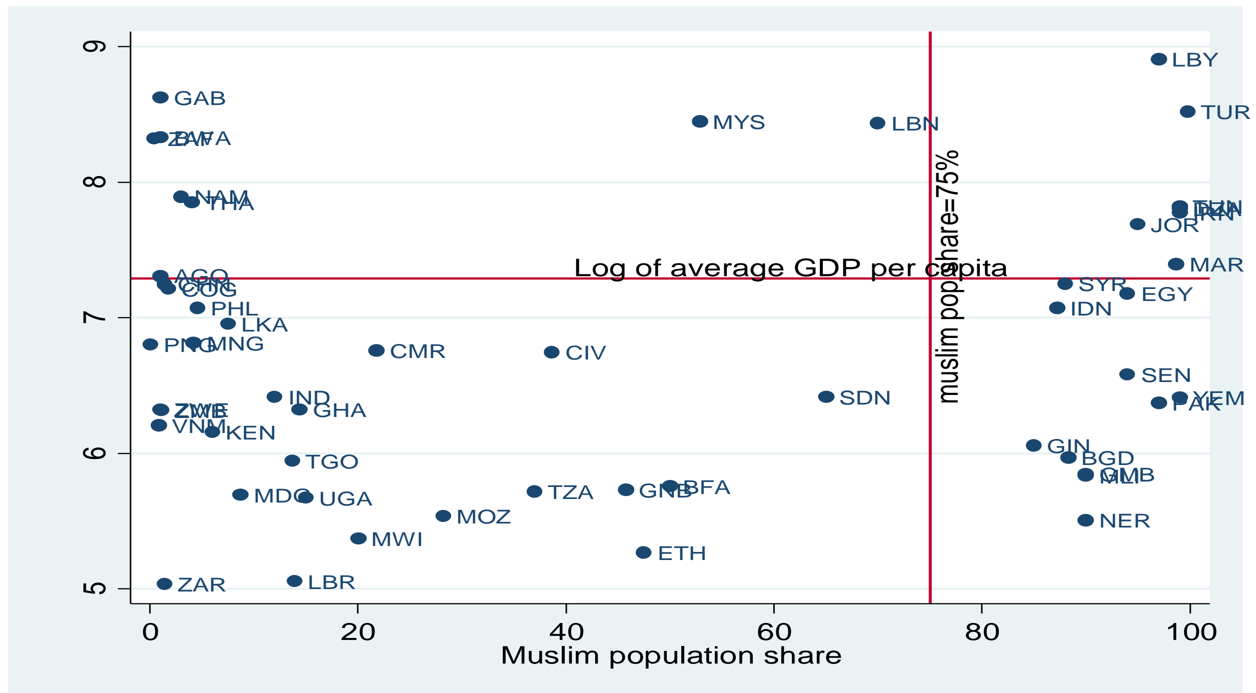
There is mounting evidence—at least for lower- and middle-income countries—that financial sector development is good for growth (see the seminal paper by Levine, Loayza, and Beck 2000). A developed financial sector helps mobilize savings, facilitates the allocation of capital to where returns are expected to be highest, monitors the use of capital once invested, and allows for diversification of risk. Moreover, there is a growing consensus among economists that it does not matter much for economic growth whether the financial system is more bank-based or market-based (Allen and Gale 2000; Levine 2002). The particular institutional arrangements that provide financial services to the economy are not so important; what matters is the level of overall financial development.

However, do these findings that financial sector deepening impacts growth also apply to systems where Islamic banking plays a significant role? Is the development of Islamic banking good for growth? This is an important question to answer, as Islamic banking has unique characteristics that differ from conventional banking; they appear better adapted to characteristics prevailing in poorer countries of the Middle East and North Africa, Sub-Saharan Africa, and parts of South Asia and Southeast Asia. In addition, with a few exceptions, countries with large Islamic populations are typically not highly developed (see figure 10.1), and have often not performed well in economic terms; one of the reasons has been an underdeveloped financial system. This study is not attempting to answer the question of whether the development of Islamic banking would contribute more to financial sector development than conventional banks—an altogether different question. It is simply asking the question of whether Islamic banking is good for growth. There are parallels to the Information Technology Revolution. As information and communication technology was becoming ubiquitous in the 1980s, Robert Solow famously quipped: "You can see the computer age everywhere but in the productivity statistics" (Solow 1987). A whole niche within the economics profession emerged to help explain this apparent paradox. Similarly, Islamic banking has made inroads into many countries, reaching a critical threshold. It is therefore valid

[102] This study is based on a paper by Patrick Imam, Senior Economist in the African Department, IMF and Kangni Kpodar, Senior Economist in the Fiscal Affairs Department, IMF presented at the Inaugural Annual Symposium on Islamic Finance held in Istanbul, Turkey from September 8–9, 2015.

to ask whether Islamic banking is becoming visible in the statistics, or whether explanations need to be found to explain why it is not visible (yet).

Figure 10.1 Average GDP per Capita in Islamic and Other Countries, 1990–2010



Sources: IMF for data ; Alesina and others 2003, N*ote:* See annex 10A for country names.

Growth in Islamic countries, while not spectacular, has not been dismal compared to other countries with a similar level of development. The widely held perception is that Islamic countries have performed poorly in economic terms since the 1950s, but this does not hold. After an initial strong growth spurt following independence—in sync with other low-income countries—growth rates were subpar following the lost decades of the 1980s and 1990s. While it is true that Islamic countries and subnational regions with large Muslim populations are characterized by low incomes and a low level of social development, with the exception of oil-producing countries of the Gulf Cooperation Council (GCC), they are in fact not much different from other emerging markets and low-income countries (figure 10.2). Once adjustments for low education levels, poor institutions, commodity prices, and the like are made, evidence is mounting that Islam per se is not holding back these countries (Nolan 2003).

Similarly, Islamic countries do not currently stand out in terms of private sector credit to GDP (figure 10.3). However, as Islamic banking becomes more acceptable to a large swath of the population, it could expand faster, as it would not necessarily be a substitute for conventional banking, but it would provide financial products to a part of the population that otherwise would not use the financial system, potentially leading to higher financial inclusion and an acceleration of economic growth in these countries. Currently, while many Muslims use conventional banking services, a large swath of the population—pious individuals who want to adhere to the principles of Islam—are significantly less likely than non-Muslims to own a formal account or save at a

formal financial institution after controlling for other individual- and country-level characteristics (Demirgüç-Kunt, Klapper, and Randall 2013).

Figure 10.2 Average Real GDP Growth: How Islamic Countries Compare to Others, 1990–2010

Sources: IMF for data ; Alesina and others 2003. *Note:* See annex 10A for country names.

Figure 10.3 Average Private Sector Credit Ratio to GDP in Islamic and Other Countries, 1990–2010

Sources: IMF for data ; Alesina and others 2003. *Note:* See annex 10A for country names.

Thus the rapid diffusion of Islamic banking represents a growth opportunity for Islamic countries, as much of the empirical evidence suggests a strong link between financial sector development and growth (see Levine 2005 for a summary). However, the empirical literature has only looked at conventional banking, not Islamic banking. This study aims to rectify this lacuna by considering whether Islamic banking is also potent in raising growth. This study aims to establish the positive relationship between Islamic banking and economic growth, and not to answer the question of whether the growth-enhancing effect of Islamic banking goes beyond that of conventional banking. Using a sample of low- and middle-income countries with data over the period 1990–2010, it investigates the impact of Islamic banking on growth and discusses the policy implications. The results show that, notwithstanding its relatively small size compared to the economy or the overall size of the financial system, Islamic banking is positively associated with economic growth, even after controlling for various determinants, including the level of financial depth. The results are robust across different measures of Islamic banking development, econometric estimators (pooling, fixed effects, and System GMM), and to the sample composition and time periods.

Literature Review

Although the finance–growth nexus continues to be heavily debated in the literature, the main thrust is that financial development has, by and large, a favorable impact on economic growth. Financial intermediaries carry out five basic functions that serve growth: they facilitate the trading, hedging, diversifying, and pooling of risk; allocate resources; monitor managers and exert corporate control; mobilize savings; and facilitate the exchange of goods and services (Levine 1997). In performing their functions, financial intermediaries mitigate the effects of information and transaction costs, and improve the allocation of resources, thus influencing saving rates, investment decisions, technical innovation, and ultimately long-run growth rates. In turn, economic activity can also influence financial development. It is worth noting that this whole literature implicitly refers to conventional banking. An interesting question is: Does this also apply to Islamic banks?

The literature has evolved over time, and alternated between periods of optimism and scepticism about the benefits of finance for growth. It began with the pioneering work of Schumpeter (1912), who highlights the essential role of banks in financing innovative businesses and increasing productivity. Robinson (1952) challenges this view, arguing that financial development simply follows economic growth. Although Gurley and Shaw (1960) share Schumpeter's view on the importance of finance for growth, they stress instead the role of financial innovation for economic development, as it facilitates better risk management and a reduction in intermediation costs.

However, following the work of McKinnon (1973) and Shaw (1973), mixed country experiences from the wave of financial liberalization policies in the 1970s and 1980s raised uncertainties about the potential benefits of finance for growth. The studies of King and Levine (1993a, 1993b, 1993c) and Levine (1997) gave a new impetus to the finance–growth literature. The authors thoroughly documented the channels through which financial development positively impacts economic growth and undertook convincing theoretical and empirical investigation to support their hypothesis. Subsequent studies confirmed their findings (including Rajan and Zingales 1998; Levine, Loayza, and Beck 2000), although some more recent studies—especially since the global financial crisis—cast doubt on the strength of the positive relationship between

financial development and growth (see, for instance, Andersen and Tarp 2003; Arcand, Berkes, and Panizza 2012; Panizza 2014). There is also evidence that by increasing the likelihood of banking crises, the positive relationship between financial sector development and growth may be conditional (Guillaumont Jeanneney and Kpodar 2006).

The work of Modigliani and Miller (1958)—who found that capital structure was irrelevant to finance investment projects—suggests that it is likely that Islamic banking and conventional banking will not have different impacts on growth per se if they finance the same projects. Although the benefits/risks of the project are distributed differently for conventional banks than for Islamic banks, the overall return on the project is the same. On the other hand, while Islamic banks perform similar functions to conventional banks, they have distinct features. While some view Islamic banking as being indistinguishable in practice from conventional banking (see, for example, Khan 2010), most scholars think that there are differences, even in practice (see Iqbal and Mirakhor 2013). Islamic banking has many advantages, not only in Islamic countries, but also in low- and middle-income countries in general, that could make it better adapted to the local environment and could be better at stimulating growth compared conventional banking, under certain circumstances. As this study will show, while Islamic banking could, at the macroeconomic level, contain features that may stimulate growth, at the microeconomic level, given that it is still a nascent industry, it still faces hurdles that may make it difficult to fully maximize this advantage. Therefore, this study only looks at whether the development of Islamic banking has a positive impact on growth, not whether it is more "efficient" than conventional banks in increasing growth. What are these distinct attributes of Islamic banking?

It encourages lending (to individuals without assets) and shares risks and rewards. Conventional banks in most countries lend based on some form of guarantee/collateral. The risk-sharing characteristic of Islamic banking means that the borrower and the bank share the risk of any investment on agreed terms, and divide any profits or losses between them, without recourse to guarantees. Risk sharing leads providers of financial capital and entrepreneurs to share business risks in return for a share of profits, suggesting that borrower liabilities are state-contingent, in contrast to conventional banks. This should in principle encourage more investment—notably by individuals who could not otherwise borrow because of a lack of assets that could act as a guarantee—and thereby encourage growth.[103]

Through the prohibition of *ribā* (interest), the incentives of lenders and borrowers are aligned, thus reducing moral hazard.[104] At the same time, it helps to spur investment that would

[103] Most Islamic financial instruments can be thought of as falling into one of two general families. First, contracts can be classified as venture financing, where the provider of funds to a venture expects a return conditional on the success of the venture (profit and loss sharing). Contracts that are most common include equitable participation (*mushārakah*) in a venture such as an import consignment, and a sleeping partnership, where one party brings capital and the other personal efforts (*muḍārabah*) in a defined venture. Second, and rising in importance are arrangements that smooth out payments, where an intermediary's client needs a large lump sum of cash in order to accomplish some project (such as housing or a productive investment). The intermediary enters into an arrangement that, while profitable to it, enables the client to smooth its cash outlay. For example, the provider of funds may acquire a productive asset and make it available to the user of funds for a fee, as in installment sale (*murābaḥah*), leasing (*ijārah*), or hire-purchase arrangements (see Honohan 2001). These innovations should help economic development in Islamic countries by providing access to financing that is acceptable to the (pious) population.

[104] Moral hazard occurs when one person takes more risks because someone else bears the burden of those risks. Moral hazard occurs, for instance, under information asymmetry where the risk-taking party to a transaction knows more about its intentions than the party paying the consequences of the risk.

otherwise not take place, and thereby growth, and also acts as a shock absorber for countries subject to large economic shocks.

It raises savings (promotes capital accumulation). In Islamic countries, large segments of the Muslim population do not have access to adequate banking services—often because devout Muslims are unwilling to put their savings into a traditional financial system that runs counter to their religious principles. Therefore, Islamic banking can raise the savings of pious individuals who refrain from using conventional banks. This could thereby increase financial intermediation. Demirgüç-Kunt, Klapper, and Randall (2013) explore the difference between Muslims and non-Muslims within the same country, and find that in the 64 countries they cover, 24 percent of Muslim adults report having a bank account, in contrast to 44 percent of non-Muslims who have one. This under-banking of an important segment of the population prevents savings from being channeled to the formal sector, and therefore not being used efficiently, leading to suboptimal financial intermediation.[105] Bringing Muslims into the formal sector, by providing them with suitable products, would increase access to finance, and would commensurately increase savings.

It enhances financial stability. Most boom-bust cycles that have occurred around the world in recent decades have exposed several underlying factors that highlight the vulnerability of conventional banking: namely, high leveraging, wholesale financing, and utilization of complex instruments.[106] In Islamic finance, balance sheet mismatches are absent, as banks do not have asset-liability mismatches, given that short-term deposits finance short-term trading, while for longer-term investments, longer-term deposits are used (Mirakhor 2010). There is also consistent evidence that Islamic banks have higher capitalization than conventional banks. This capital cushion, combined with higher liquidity reserves, explains the relatively better performance of Islamic banks during the recent crisis. Derivatives and other nontransparent products are also not allowed.[107] This, combined with the sharing of profits and losses, creates a system that is less prone to crisis (Cihak and Hesse 2010; Hassan and Dridi 2010). It is probably fair to say that banking systems that are diversified, through including Islamic banks as a complement to conventional banks, are likely to contribute to financial stability (Imam and Kpodar 2013).[108]

The quality of "modern institutions" is less relevant in Islamic banking. It has long been established that the quality of modern institutions—such as legal systems—is a major determinant of financial sector development, which is a key input into growth (Levine 2005). Islamic countries often do not have strong legal systems; but as Imam and Kpodar (2013) have shown, the spread of Islamic banking is not dependent on the quality of these formal institutions. This does not mean that legal, regulatory and other institutional reforms are not crucial for the success of Islamic finance; it simply means that Islam has often its own "traditional" institutions that can resolve conflicts among parties.

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[105] A growing body of evidence suggests that better functioning financial systems exerts a disproportionately positive impact on the relatively poor; see Levine (2008) and Demirgüç-Kunt and Levine (2009).

[106] Islamic banking prohibits speculative products, which are deemed *gharar* (contracts and transactions that contain excessive uncertainty). This reduces the probability of fraud, for instance. Derivative products are generally viewed as unacceptable under s*hari'ah* (Islamic Law), as they involve speculation.

[107] While some financial innovations may add to the risk of financial instability, it may not necessarily be a first-best response to abstain from such financial innovations altogether, but this consideration goes beyond this study.

[108] Minsky moments, whereby periods of calm create the seeds for financial instability (endogenous financial instability) are absent in Islamic banking (Minsky 1988).

*It finances morally acceptable projects***.** Islamic banking is based on a moral system of Islam, which allows for the financing of only those assets that are not harmful to society. Islamic banks are not allowed to finance casinos and other activities that are deemed harmful to society, and to the poor in particular. While the standard of "morally" acceptable projects might seem subjective in many cases, there are few gray areas, and in case of doubt, an Islamic scholar will be able to provide an answer. This aspect is difficult to quantify, but could be growth-enhancing by reducing negative externalities imposed on society by undesirable projects. If conventional banking and Islamic banking coexist, this aspect is unlikely to matter much, as *ḥarām* (prohibited) activities can be financed by conventional banking.

All these factors are, in principle, conducive to higher growth and the alleviation of poverty. Moreover, if Islamic banking is more likely to develop in Islamic countries because it is more acceptable to pious Muslims, growth is likely to accelerate more rapidly in these countries than it would if only conventional banking were available.[109] However, Islamic banks have certain structural weaknesses that counterbalance the positive aspects. These weaknesses are likely to lessen as the industry matures.

Difficulty managing financial risk/operational risk. As Islamic banks are not allowed to use derivatives, it is simply harder for them to mitigate and diversify risk. In addition, given their size, most Islamic banks are highly concentrated by geographical area and sector, accentuating the lack of diversification. Lack of proper accounting standards and clearing and settlement processes, coupled with the lack of stakeholder participation in governance of financial institutions offering Islamic products, lead to lack of transparency, rendering Islamic banks more risky (see Abedifar, Molyneux, and Tarazi 2013; Beck, Demirgüç-Kunt, and Merrouche 2013). Again, all these hurdles should gradually become less constraining as the industry matures and grows in size.

Lack of economies of scale. Islamic banks are often newer, and therefore smaller, than conventional banks. This means that they are often still below optimal scales and thus have higher cost structures (Hassan and Dridi 2010).[110] As the industry grows, it can be expected that the disadvantage of scale will disappear over time. Comparing conventional and Islamic banks and controlling for other bank and country characteristics, Beck, Demirgüç-Kunt, and Merrouche (2013) find few significant differences in business orientation, efficiency, asset quality, or stability. While Islamic banks seem more cost-effective than conventional banks in a broad cross-country sample, this finding reverses in a sample of countries with both Islamic and conventional banks. However, conventional banks that operate in countries with a higher market share of Islamic banks are more cost-effective but less stable.

[109] There is sometimes a distorted view that Islamic banks are not profit-maximizing institutions; this is not true. Like conventional banks, they try to be as profitable as possible, but in seeking profits, they are subject to different constraints than conventional banks.

[110] Smallness of the financial system has obvious, though not necessarily visible, costs to the macroeconomy. A small financial system implies a *lack of economies of scale*, as there are significant fixed costs in setting up operations. As more individuals and firms use financial intermediaries, the *information flow* on customers improves, but a small financial system reduces the information flow function of financial intermediaries (Greenwood and Jovanovic 1990). Smallness of the financial system also limits *risk-diversification* options for savers and investors alike. In addition, a small financial system implies that profitable investment opportunities will be forgone, thereby limiting *growth below potential*. The lack of easily available financing reduces the resilience of the economy to shocks, smoothing consumption over time—a feature particularly important for many low-income countries and emerging markets that lack flexibility.

Lack of liquid instruments. There is no secondary market for Islamic fixed-income products, forcing Islamic banks to have large liquidity buffers, putting them at a disadvantage relative to conventional banks (Moody's 2009). This is because Islamic banks are prohibited from engaging in activities that include interest, but the way central banks function traditionally in their operation is by purchasing or selling interest-bearing assets. The establishment in 2010 of the International Islamic Liquidity Management Corporation (IILM) should help address this problem. Its objective is to issue s*hari'ah*-compliant financial instruments that facilitate more efficient and effective liquidity management solutions for institutions offering Islamic financial services.[111] However, this is still a work in progress.

Thus Islamic banks have features that can promote growth, but at the same time are disadvantaged by the lack of economies of scale and liquid instruments—though work is ongoing to address these shortcomings. These varying factors suggest that the answer to the question as to whether Islamic banking promotes growth lies in the empirical evidence. While there is a plethora of empirical studies on the impact of financial development on growth,[112] studies on how Islamic banking development affects growth are nonexistent—a void this study attempts to fill in the next section.

Econometric Estimation

The Data and Model

This section attempt to assess the impact of Islamic banking on growth empirically. It is based on a panel of 52 developing economies, of which 29 belong to the Organisation of Islamic Cooperation (OIC) (See Annex 10A for country names). Data span the period 1990–2010, and are averaged over three-year intervals. The sample size is constrained by data availability, in particular on variables capturing Islamic banking expansion and the quality of the institutional environment. In addition, the sample is restricted to low- and middle-income countries, as the macroeconomic variables included in the growth model are more relevant to them, and also because this helps reduce sample heterogeneity. The three-year average represents a good balance between the need to smooth business cycle fluctuations and the need to ensure an adequate number of observations for the regressions.

The analysis relies on a standard growth model, with a set of variables of interest measuring broad financial development and Islamic banking development, and control variables conventionally utilized in the growth literature. The data sources for the variables are found in the Annex 10B. The variables of interest consist of:

Development of Islamic banking. As discussed, there are theoretical grounds for expecting a positive impact of the development of Islamic banking on growth. This makes Islamic banking indicators good candidates for explaining cross-country growth. The analysis measures Islamic banking development by the amount of loans extended by these banks to the private sector divided by nominal GDP. While this indicator gives an idea about the size of the Islamic banking sector, it may not accurately measure the indirect channels through which Islamic banks could ignite growth (facilitating risk sharing, enhancing financial stability, and mobilizing savings). However,

[111] http://www.ifsb.org/preess_full.php?id=149&submit=more.
[112] Levine (2005) offers an overview of empirical studies on financial development and growth. For a more recent survey, see Panizza (2014).

it is reasonable to assume that the larger the Islamic banking sector, the better it can perform its functions, a common hypothesis also made for conventional banking in past studies. Two alternative indicators of Islamic banking development are used: the ratio of Islamic banking assets to GDP, and the ratio of deposits in Islamic banks to GDP. The latter is a useful indicator to gauge the ability of Islamic banks to mobilize savings.[113] As a robustness check, an indicator of capitalization (the capital-to-asset ratio) was also used. The standard ratios of return on equity (ROE) and return on assets (ROA) was used to measure the financial strength and profitability of Islamic banks.

Development of the overall banking system. There is a general acceptance in the economic literature that financial deepening stimulates growth (for a literature review, see Levine 2005). As a result, the model includes the ratio of private sector credit by commercial banks as a percent of GDP as a measure of the development of the banking sector. Since both conventional and Islamic banking coexist in many countries and evolve together, it is important to control growth for the overall size of the banking system in order to properly isolate the growth impact of Islamic banking. Alternative measures of financial development considered include the ratio of private sector credit by bank and NBFIs as a percent of GDP, the total assets of financial institutions as a ratio of GDP, and the total financial system deposits as a ratio to GDP.

The control variables include:

Initial real GDP per capita. This variable is intended to control for growth convergence, as the neoclassical model points out that lower-income countries, with lower initial levels of technology and capital, will tend to grow faster than more advanced countries.

Inflation. It has long been argued that uncertainty about inflation lowers real output growth. Inflation uncertainty increases the variability of prices, which distorts the price signal and thereby harms economic efficiency and productivity. In addition, high inflation is likely to be associated with weaker growth, as it is often a reflection of weak quality and unsustainable macroeconomic policies.

Government consumption. The issue of government spending and its effect on economic growth is still widely debated in the economic literature. While government spending is necessary, and has a growth-enhancing impact when it finances public goods such as infrastructure, it can deter growth when excessively dominated by current spending. The hypothesis is that rising government consumption (as a percent of GDP) encourages poor quality spending, leads to an oversized government and often results in a waste of public resources, which crowd out private investment when the government relies on domestic resources to finance growing deficits.

Education. Human capital accumulation, as proxied by the primary school enrollment rate, is expected to have a positive impact on growth through improved labor productivity.

Trade openness. It can be expected that countries that are more open will experience higher economic growth, as they can take better advantage of economies of scale in production, benefit from technological transfer, promote efficient allocation of resources, and encourage competition in domestic markets. At the same time, trade openness can make countries more vulnerable to

[113] The lack of data availability prevents the analysis from considering the development of the Islamic bond (*sukūk*) market. The market is still in its infancy and has low volumes.

exogenous shocks when export concentration is high, making growth more volatile, which ultimately can result in lower long-term growth.

Terms of trade. Improvements in terms of trade are often associated with economic growth. Conversely, deteriorating terms of trade would hamper growth, especially in developing countries where financial markets are shallow.

Quality of institutions. Institutional quality matters for long-term growth, as it determines the incentives of and the constraints on economic actors, fosters better policy choices, and shapes economic outcomes (Acemoglu, Johnson, and Robinson 2004). However, accurately measuring institutional development remains a challenge. While, no perfect or comprehensive indicator exists, the model uses the indicator of rule of law as a proxy for the quality of institutions, as compiled by the *International Risk Country Guide* (ICRG), which is widely used in the literature.[114] The baseline regression looks as follows:

$$G_{it} = \alpha + \beta IslBank_{it} + \delta FD_{it} + \varphi X_{it} + u_{it} + \varepsilon_{it} + \upsilon_t \,, \qquad (10.1)$$

where G is the growth rate of real GDP per capita; *IslBank* is the indicator of Islamic banking development (ratio of loans, assets, or deposits in Islamic banks to GDP); *FD* is the measure of overall financial development (ratio of private sector credit by commercial banks to GDP); X is the set of control variables described above; u is the country-specific effect; ε the error term; and v is the time-specific effect (see annex 10.B for the source and description of data). Annex 10C provides the summary statistics.

The Methodology

Estimating the growth impact of Islamic banking poses several econometric challenges. First, while Islamic banking is growing rapidly, the size of Islamic banking development in relation to GDP or banking assets is often zero or very small in the majority of countries, including Islamic ones. This makes it challenging to identify any statistically significant impact. Second, similar to conventional banking, there may be a reverse causality from growth to Islamic finance, raising an endogeneity issue that needs to be addressed in the regressions. Third, the indicators of Islamic bank development are subject to measurement errors, as only pure Islamic banks are covered by statistics, while Islamic windows (of conventional banks) are not included, due to lack of data. This is because conventional banks often do not separate activities related to Islamic finance from those of conventional banking in their balance sheets and financial reports. The underestimation of Islamic banking development would lead to a downward bias of the estimated coefficient.

In light of these challenges, the analysis uses a range of econometric techniques, which include pooling and a fixed effects estimator to control for country-specific effects, and the System GMM estimator to control for endogeneity bias. The section that follows provides the rationale behind each econometric estimator, and describes what issues they do and do not address.

[114] http://www.prsgroup.com/about-us/our-two-methodologies/icrg.

Main Results

Pooling and Fixed Effects

Table 10.1 presents the results from the estimations using a pooling and fixed effect estimator. The pooling estimator runs ordinary least squares (OLS) with the panel data, without regard to which countries they belong. Unlike the pooling estimator, a fixed effect estimator allows to control for unobservable country-specific effects that are invariant over time, and that affect a country's economic growth. The results from the pooling estimation are presented in columns 1 to 6, while those of the fixed effect estimator are shown in columns 7 to 12. For each series of regressions, the first specification runs the baseline model only with the control variables (columns 1 and 7), while the second specification controls for overall financial development (columns 2 and 8) measured as the ratio of private sector credit by commercial banks in percent of GDP. Subsequent specifications (column 3 to 6, 9 to 12) add in turn the three indicators of Islamic banking development, as well as a composite indicator constructed as the first principal component of the above three indicators of Islamic banking development, using principal component analysis (PCA).

Table 10.1 Islamic Banking and Growth: Pooling and Fixed Effect Regressions

	Pooling						Fixed effects					
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Initial GDP per capita	-0.001	-0.012	-0.013	-0.014	-0.014	-0.014	-0.034	-0.102	-0.110	-0.102	-0.101	-0.102
	[0.005]	[0.006]*	[0.006]**	[0.006]**	[0.006]**	[0.006]**	[0.034]	[0.037]***	[0.039]***	[0.037]***	[0.037]***	[0.037]***
Education	0.062	0.059	0.060	0.062	0.062	0.061	0.153	0.165	0.171	0.167	0.166	0.167
	[0.020]***	[0.019]***	[0.019]***	[0.019]***	[0.019]***	[0.019]***	[0.049]***	[0.048]***	[0.048]***	[0.048]***	[0.048]***	[0.048]***
Inflation (log)	-0.084	-0.078	-0.078	-0.080	-0.080	-0.079	-0.085	-0.080	-0.077	-0.080	-0.081	-0.080
	[0.007]***	[0.011]***	[0.011]***	[0.010]***	[0.009]***	[0.010]***	[0.008]***	[0.009]***	[0.008]***	[0.008]***	[0.008]***	[0.008]***
Government consumption/GDP	-0.252	-0.330	-0.328	-0.319	-0.318	-0.321	-0.517	-0.685	-0.670	-0.673	-0.673	-0.671
	[0.101]**	[0.117]***	[0.118]***	[0.118]***	[0.118]***	[0.118]***	[0.218]**	[0.242]***	[0.242]***	[0.241]***	[0.242]***	[0.241]***
Trade openness	-0.026	-0.033	-0.032	-0.030	-0.031	-0.031	0.011	0.007	0.009	0.004	0.004	0.005
	[0.014]*	[0.015]**	[0.015]**	[0.015]**	[0.015]**	[0.015]**	[0.043]	[0.041]	[0.040]	[0.041]	[0.041]	[0.041]
Terms of trade growth	0.119	0.185	0.182	0.180	0.181	0.180	0.111	0.107	0.106	0.107	0.107	0.107
	[0.068]*	[0.067]***	[0.067]***	[0.067]***	[0.067]***	[0.067]***	[0.057]*	[0.056]*	[0.058]*	[0.057]*	[0.057]*	[0.057]*
Quality of Institutions	0.027	0.022	0.022	0.021	0.021	0.021	0.010	0.008	0.008	0.008	0.008	0.008
	[0.004]***	[0.004]***	[0.004]***	[0.004]***	[0.004]***	[0.004]***	[0.006]*	[0.005]	[0.006]	[0.005]	[0.005]	[0.005]
Overall financial development		0.001	0.001	0.001	0.001	0.001		0.002	0.001	0.002	0.002	0.002
		[0.000]***	[0.000]***	[0.000]***	[0.000]***	[0.000]***		[0.001]**	[0.001]**	[0.001]**	[0.001]**	[0.001]**
Loans by Islamic banks/GDP			0.857						5.254			
			[0.475]*						[2.748]*			
Assets of Islamic banks/GDP				0.673						0.711		
				[0.202]***						[0.269]**		
Deposits of Islamic banks/GDP					1.001						0.801	
					[0.233]***						[0.279]***	
Composite indicator of Islamic						0.006						0.008
						[0.002]***						[0.003]**
Constant	-0.024	0.051	0.054	0.059	0.060	0.060	0.172	0.587	0.628	0.584	0.580	0.588
	[0.030]	[0.037]	[0.038]	[0.038]	[0.038]	[0.038]	[0.201]	[0.222]**	[0.232]***	[0.218]**	[0.219]**	[0.219]**
Observations	286	252	252	252	252	252	286	252	252	252	252	252
Number of countries	52	45	45	45	45	45	52	45	45	45	45	45
R-squared	0.34	0.33	0.33	0.34	0.34	0.34	0.32	0.37	0.38	0.37	0.37	0.38

Note: Robust standard errors in brackets.

Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

deepening matters for growth. The coefficient is positive and significant in all specifications, at least at the 5 percent significance level. More interestingly, for a given level of financial development, Islamic banking is found to stimulate growth. The coefficients for all the indicators of Islamic banking development, including the composite index, are positive and enter the regressions in a statistically significant way, confirming the theoretical predictions, despite the fact that Islamic banking has been small relative to GDP.[115] This result suggests that Islamic banking responds to the specific needs of households and firms, which would have been otherwise unmet and the associated incremental growth would have been forgone. This result also provides evidence that Islamic banking does not appear to crowd out traditional finance—it complements, rather than substitutes for conventional banking—as for a given level of financial development, more Islamic banking raises economic growth.

Regarding the control variables, as expected, accumulation of human capital stimulates economic growth, with the coefficient for the primary school enrollment rate highly significant in all regressions. Testing the secondary school enrollment rate gives similar results, but missing values on this variable reduce the sample size. Countries with sound macroeconomic policies, characterized by low inflation and subdued government current spending, tend to grow faster. This also seems to be the case for countries with positive terms of trade changes and good institutional quality. Further, the hypothesis of economic convergence is supported by the negative and significant sign of the variable initial GDP per capita. In contrast, trade openness seems to have an ambiguous effect on growth, often with a counterintuitive sign, which is not surprising given the contrasting results in previous studies focusing on the growth dividend of trade openness (for an overview, see Winters 2004). Overall, the model helps explain 33 to 38 percent of the variability in economic growth rates

Although the pooling and fixed effect estimators provide interesting results, the coefficients may be biased in the presence of the endogeneity of the right-hand side variables, in particular with regard to the financial sector indicators. This is particularly relevant for Islamic banking indicators, as their potential endogeneity results not only from the reverse causality to growth, but also from measurement errors when the full size of Islamic banking development is not captured in the data.[116]

System-GMM

To address the endogeneity issue, not only for the banking indicators but also for some other explanatory variables, the analysis relies on the System-GMM estimator (dynamic panel Generalized Method-of-Moment) developed by Blundell and Bond (1998). They show that the System-GMM estimator, which simultaneously uses both the *difference* in the panel data and the data from the original *levels* specification, produces dramatic increases in both consistency and efficiency relative to the first-differenced GMM developed by Arellano and Bond (1991).[117] The one-step System GMM estimator is used, while controlling for sample

[115] A cross-country regression averaging the dependent and explanatory variables over the entire period also shows that Islamic banking is positively and significantly correlated with economic growth.
[116] Indeed, measurement errors on Islamic banking indicators would be captured by the error term, which will then be correlated with the Islamic banking variable. This violates the assumption of the fixed-effect estimator, whereby the error term is orthogonal to right-hand side variables.
[117] For a useful guide on the application of the System GMM estimator to growth models, see Bond, Hoeffler, and Temple (2001).

heterogeneity.[118] Further, to minimize over-fitting of the model, careful attention is paid to the selection of the instruments. For variables considered as predetermined or endogenous, only the first relevant lag is used.[119] To test the validity of the lagged variables as instruments, the standard Hansen test of over-identifying restrictions is used, where the null hypothesis is that the instrumental variables are not correlated with the residual; and the serial correlation test, where the null hypothesis is that the errors exhibit no second-order serial correlation.

The results from the System GMM estimator presented in table 10.2 are comparable to those from the fixed effect estimator.[120] Once again, both overall financial system development and Islamic banking development appear to have a meaningful positive impact on economic growth. The coefficients on financial variables should be interpreted with caution, however, given the relatively small size of Islamic banking compared to the overall financial development, which makes them not directly comparable. One way to make the coefficients more informative by taking into account the scale effect is to estimate the coefficients for the standardized financial variables.[121]

The results (in annex 10D) suggest that a one standard deviation increase in the overall financial development of the Islamic banking sector would lead to about 3.4 percent increase in real GDP per capita growth. For a one standard deviation increase in the ratio of loans by Islamic banks to GDP, the impact on growth would be of 0.5 percent, compared to about 0.8 percent for the ratios of assets and deposits of Islamic banks to GDP. However, even with the standardized variables, the regressions do not allow for reliable inference on the magnitude of the growth impact of Islamic banking, although they provide strong evidence on the positive effect of Islamic banking on growth. From that perspective, the fixed effects and GMM System results are quite encouraging, especially given the concern that a significant number of countries in the sample are reported as not having Islamic banking activities (although they might have banks with Islamic finance windows), while in countries where Islamic banks are present, their relative importance in the economy or the banking system is still far from significant.

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[118] The two-step method with the Windmeijer's correction produces comparable results.

[119] As commonly done in the literature, it is assumed that the initial GDP per capita is predetermined, which rules out contemporaneous correlation with the error term, but not feedbacks from past shocks. The variables of inflation, government spending, and more importantly financial sector development and Islamic banking development, are treated as endogenous. This allows the analysis to address reverse causality issues, measurement errors, and omitted variable bias. Given the small size of the sample, not all the variables can be assumed to be endogenous, as the number of instruments grows very quickly to the point that they can weaken the Hansen test. For practical and theoretical reasons, the variables of primary school enrollment, quality of institutions, terms of trade, and trade openness are considered exogenous. Since the first two variables vary little over time, the high persistence makes lagged values poor instruments for the equations in first differences. Although the System GMM is meant to reduce this bias, the use of these instruments leads to a noticeable increase in the Hansen test probability toward the maximum value of 1. For the other two variables, terms of trade and trade openness, it is assumed that these are likely to be exogenous, considering that the sample consists of relatively small and developing countries. All that said, it is worth noting that the quality of the results from the regressions are not affected when all the right-hand side variables are assumed endogenous, except for the Hansen test probability, which suffers from the high ratio of the number of instruments over the number of observations.

[120] In addition, neither the Hansen test nor the serial correlation test rejects the null hypothesis of the validity of the instruments.

[121] The regressions are rerun with the financial variables rescaled to have a mean of zero and a standard deviation of one.

Table 10.2 Islamic Banking and Growth: Dynamic Panel System GMM Estimations

	(1)	(2)	(3)	(4)	(5)	(6)
Initial GDP per capita	0.014	-0.020	-0.025	-0.017	-0.012	-0.014
	[0.019]***	[0.011]***	[0.011]***	[0.011]***	[0.011]***	[0.011]***
Education	0.038	0.072	0.080	0.070	0.063	0.064
	[0.038]	[0.029]**	[0.028]***	[0.029]**	[0.030]**	[0.030]**
Inflation (log)	-0.235	-0.213	-0.219	-0.208	-0.203	-0.203
	[0.104]**	[0.114]*	[0.118]*	[0.107]*	[0.102]**	[0.103]**
Government consumption/GDP	-0.718	-0.713	-0.633	-0.561	-0.666	-0.657
	[0.468]	[0.360]**	[0.353]*	[0.312]*	[0.331]**	[0.337]*
Trade openness	-0.040	-0.048	-0.043	-0.047	-0.048	-0.046
	[0.024]*	[0.023]**	[0.024]*	[0.024]*	[0.025]*	[0.024]*
Terms of trade growth	0.108	0.167	0.175	0.162	0.158	0.159
	[0.082]	[0.078]**	[0.079]**	[0.078]**	[0.079]**	[0.077]**
Quality of Institutions	0.017	0.016	0.015	0.015	0.015	0.015
	[0.007]***	[0.006]***	[0.006]**	[0.006]***	[0.005]***	[0.005]***
Overall financial development		0.002	0.002	0.002	0.002	0.002
		[0.000]***	[0.000]***	[0.000]***	[0.000]***	[0.000]***
Loans by Islamic banks/GDP			1.395			
			[0.518]***			
Assets of Islamic banks/GDP				0.900		
				[0.336]***		
Deposits of Islamic banks/GDP					1.300	
					[0.522]**	
Composite indicator of Islamic banking						0.007
						[0.003]**
Constant	0.027	0.169	0.188	0.140	0.127	0.134
	[0.070]	[0.062]***	[0.063]***	[0.059]**	[0.057]**	[0.056]**
Observations	286	252	252	252	252	252
Number of countries	52	45	45	45	45	45
AR(2) test prob.	0.35	0.70	0.70	0.67	0.75	0.73
Hansen test prob.	0.07	0.36	0.64	0.67	0.67	0.76

Note: Robust standard errors in brackets. AR(2) = Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

Robustness Analysis and Alternative Specifications

Table 10.3 presents additional regressions to test the robustness of the relationship between Islamic banking development and economic growth using alternative indicators of Islamic banking. Column 1 uses a step dummy, taking 1 for strictly positive values of the composite indicator if Islamic banking, and zero otherwise to measure the presence of Islamic banking in a given country. The associated coefficient is positive and significant, confirming

the above results that for countries with similar level of financial development, those with Islamic banking would experience faster economic growth.

Table 10.3 Dynamic Panel System GMM Estimations with Alternative Indicators of Islamic Banking Development

	(1)	(2)	(3)	(4)	(5)
Initial GDP per capita	-0.027	-0.026	-0.030	-0.028	-0.028
	[0.012]***	[0.011]***	[0.012]***	[0.012]***	[0.011]***
Education	0.087	0.088	0.089	0.085	0.089
	[0.029]***	[0.027]***	[0.028]***	[0.028]***	[0.027]***
Inflation (log)	-0.219	-0.221	-0.217	-0.218	-0.221
	[0.117]*	[0.119]*	[0.118]*	[0.116]*	[0.117]*
Government consumption/GDP	-0.683	-0.610	-0.298	-0.667	-0.615
	[0.350]*	[0.327]*	[0.277]	[0.326]**	[0.316]*
Trade openness	-0.043	-0.043	-0.036	-0.042	-0.041
	[0.023]*	[0.022]**	[0.025]	[0.024]*	[0.023]*
Terms of trade growth	0.163	0.180	0.195	0.143	0.161
	[0.078]**	[0.077]**	[0.074]***	[0.080]*	[0.078]**
Quality of Institutions	0.015	0.016	0.014	0.014	0.015
	[0.006]**	[0.006]***	[0.006]**	[0.006]**	[0.006]**
Overall financial development	0.002	0.001	0.001	0.002	0.001
	[0.000]***	[0.000]***	[0.000]***	[0.000]***	[0.000]***
Dummy variable for strictly positive values of Islamic banking					
Composite indicator of Islamic banking	0.036				
	[0.017]**				
Soundness and profitability of Islamic banks					
Total capital ratio		0.002			0.001
		[0.001]***			[0.001]*
Return on equity			0.004		
			[0.001]***		
Return on assets				0.026	0.016
				[0.012]**	[0.007]**
Constant	0.200	0.186	0.167	0.207	0.200
	[0.069]***	[0.063]***	[0.063]***	[0.072]***	[0.067]***
Observations	252	252	252	252	252
Number of countries	45	45	45	45	45
AR(2) test prob.	0.77	0.77	0.77	0.96	0.91
Hansen test prob.	0.42	0.71	0.68	0.55	0.82

Note: Robust standard errors in brackets. AR(2) = Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

The subsequent regressions test the impact of variables related to the soundness and profitability of Islamic banks on economic growth (columns 2 to 5). It emerges that well-capitalized Islamic banks may have a favorable impact on economic growth, probably because healthy banks are less prone to crisis. With profitability measured by the standard ratios of return on equity (ROE) and return on assets (ROA), the analysis finds that Islamic banks' profitability also benefit economic growth.

Using alternative measures of overall financial development does not change the conclusion that Islamic banking matters for growth. The coefficient for Islamic banking

indicators retains its sign and statistical significance when bank and nonbank private credit ratio, a broader measure of financial development, is controlled for (table 10.4, columns 1 to 3).

Table 10.4 Use of Different Indicators of Overall Financial Development

(System GMM Estimations)

	(1)	(2)	(3)	(4)	(5)
Initial GDP per capita	-0.019	-0.009	-0.007	-0.010	-0.014
	[0.010]***	[0.011]***	[0.011]***	[0.011]***	[0.013]***
Education	0.076	0.065	0.062	0.062	0.069
	[0.029]***	[0.030]**	[0.031]**	[0.030]**	[0.029]**
Inflation (log)	-0.238	-0.221	-0.220	-0.222	-0.227
	[0.134]*	[0.118]*	[0.116]*	[0.098]**	[0.122]*
Government consumption/GDP	-0.574	-0.588	-0.558	-0.538	-0.321
	[0.267]**	[0.245]**	[0.242]**	[0.263]**	[0.267]
Trade openness	-0.028	-0.031	-0.033	-0.031	-0.058
	[0.021]	[0.020]	[0.022]	[0.020]	[0.024]**
Terms of trade growth	0.169	0.159	0.157	0.158	0.166
	[0.079]**	[0.079]**	[0.078]**	[0.074]**	[0.074]**
Quality of Institutions	0.017	0.018	0.017	0.016	0.010
	[0.006]***	[0.006]***	[0.005]***	[0.005]***	[0.006]*
Overall financial development (banks and nonbanks)	0.001	0.001	0.001		
	[0.000]**	[0.000]*	[0.000]*		
Assets of banks and other financial institutions/GDP				0.050	
				[0.029]*	
Financial system deposits/GDP					0.134
					[0.037]***
Loans by Islamic banks/GDP	1.593				
	[0.683]**				
Assets of Islamic banks/GDP		0.873		1.067	
		[0.373]**		[0.401]***	
Deposits of Islamic banks/GDP			1.385		1.507
			[0.616]**		[0.538]***
Constant	0.152	0.103	0.089	0.102	0.111
	[0.062]**	[0.058]*	[0.055]	[0.061]*	[0.065]*
Observations	258	258	258	258	258
Number of countries	45	45	45	45	45
AR(2) test prob.	0.38	0.43	0.42	0.39	0.20
Hansen test prob.	0.67	0.65	0.65	0.58	0.60

Note: Robust standard errors in brackets. AR(2) = Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

In addition, a measure of overall financial development is introduced: the ratio of total financial sector assets to GDP and the ratio of total financial sector deposit to GDP, respectively in the specification using the corresponding measure for Islamic banking (table 10.4, columns 4 and 5). Both the indicators of overall financial development and Islamic banking continue to be positively and significantly correlated with economic growth.

To test the robustness of the results, it is worthwhile to assess their sensitivity to sample composition and the time period. As Islamic banks are likely to emerge and expand in countries with large Muslim population, the sample was restricted to countries with more than 50 percent

Muslim population share (columns 1 to 3, table 10.5). In subsequent regressions, this threshold is increased to 75 percent (columns 4 to 6, table 10.5). The results are broadly in line with those obtained for the whole sample and the magnitudes of the coefficients are also comparable,[122] suggesting that countries with smaller share of Muslim population can potentially benefit from Islamic banking. The regressions are rerun with a sample restricted to net oil importer countries (columns 7 to 9, table 10.5) in order to exclude potential outlier countries where Islamic banking development might have been fuelled by oil money. While the three indicators of Islamic banking remain positively correlated with economic growth, the asset and deposit ratios are significant, but not the loan ratio. This probably is a reflection that Islamic banks in net oil importer countries may not enjoy the benefits of large oil money deposits that could be used to scale up loans, compared to net oil exporting countries.

The regressions were also run over different time periods to see if the results hold. First, the period 1996–2010 was considered, leaving out the first half of the 1990s, where Islamic banks were at the nascent stage. Second, the regressions were run over 1990–2007, excluding the 2008–10 period which might be affected by structural breaks associated with the 2008 global financial crisis. The conclusion that Islamic banking is favorable to economic growth holds, regardless of the period considered (table 10.6). The regressions over the period 1996–2007 yield similar results.

Conclusion

The objective of this study is to assess whether the development of Islamic banking is good for economic growth. This is the first study, to our knowledge, that comprehensively assesses this question using robust empirical techniques. It finds that, holding constant the level of financial development and other growth determinants, countries where Islamic banking is developing—and hence its impact on growth is measurable—experience faster economic growth than others. This is a powerful result, and robust to various specifications: different measures of Islamic banking development and econometric estimators (pooling, fixed effects and System GMM) were used, and controls were put in place for country and time-specific dummies.

This finding is also encouraging as, despite its rapid growth, Islamic banking still represents a relatively small share of the economy and of the overall size of the financial system, and it has yet to reap the benefits from economies of scale. Although the study does not suggest that Islamic banking provides more "bang for the buck" compared to conventional banks, it does, however, establish the positive impact on growth. As indicated, there are uncertainties about the magnitude of the growth effect of Islamic banking, which calls for further research as Islamic banks spread and become larger. Should future studies confirm this finding, the policy implications would be significant. One further avenue of research going forward will be to look at the development of Islamic banking at the local level—comparing localities where Islamic banks are present to those where they are lacking—to confirm more robustly the findings of this study.

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[122] The difference is not statistically significant. This was cross-checked by introducing the interaction between Islamic banking development indicators and the share of Muslims in the population in the baseline model; there were no conclusive results.

As the global crisis has illustrated, conventional banking has many weaknesses; one of them is its excessive dependence on leverage. However, Islamic banking, which is one of the fastest growing segments of global finance, has unique features that are highly appropriate for developing countries. In particular, it is based on risk sharing, making its activities more closely related to the real economy than conventional finance; it is also more flexible in the face of shocks, and more inclusive with regard to growth. Not only does Islamic finance help stimulate growth, but it also appears less prone to risks such as bubbles (Hassan and Dridi 2011).

This means that many countries that currently suffer from low growth—a feature often present in Muslim countries—may want to further develop this segment of finance. As an initial step, it is essential to develop proper legislation and regulation, as well as the supporting infrastructure, including the necessary skill set. Future areas of research include better measuring Islamic banking development and assessing the impact of Islamic banking on inequality and social development.

Table 10.5 Sensitivity to Sample Composition (System GMM Estimations)

	Muslim population share > 50 percent			Muslim population share > 75 percent			Net oil importer countries		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Initial GDP per capita	-0.001	-0.001	0.011	0.001	0.003	0.010	-0.014	-0.010	-0.008
	[0.010]***	[0.009]***	[0.010]***	[0.012]***	[0.008]***	[0.009]***	[0.013]***	[0.011]***	[0.012]***
Education	0.051	0.059	0.027	0.071	0.074	0.055	0.090	0.087	0.085
	[0.042]	[0.034]*	[0.037]	[0.049]	[0.036]**	[0.042]	[0.029]***	[0.029]***	[0.029]***
Inflation (log)	-0.143	-0.136	-0.129	-0.131	-0.142	-0.151	-0.179	-0.174	-0.173
	[0.104]	[0.048]***	[0.055]**	[0.109]	[0.049]***	[0.051]***	[0.080]**	[0.076]**	[0.075]**
Government	-0.760	-0.728	-0.675	-0.710	-0.736	-0.669	-0.561	-0.535	-0.556
	[0.240]***	[0.253]***	[0.206]***	[0.303]**	[0.347]**	[0.282]**	[0.261]**	[0.225]**	[0.243]**
Trade openness	-0.033	-0.028	-0.039	-0.038	-0.030	-0.039	-0.048	-0.046	-0.047
	[0.042]	[0.035]	[0.040]	[0.050]	[0.046]	[0.046]	[0.023]**	[0.024]*	[0.024]*
Terms of trade growth	0.207	0.188	0.204	0.079	0.061	0.062	0.144	0.140	0.140
	[0.107]*	[0.098]*	[0.102]**	[0.077]	[0.065]	[0.071]	[0.099]	[0.096]	[0.096]
Quality of Institutions	0.008	0.008	0.007	0.007	0.007	0.006	0.019	0.019	0.019
	[0.008]	[0.008]	[0.007]	[0.006]	[0.006]	[0.005]	[0.006]***	[0.006]***	[0.006]***
Overall financial	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001
	[0.001]**	[0.000]**	[0.001]**	[0.001]**	[0.000]**	[0.001]*	[0.001]**	[0.001]**	[0.001]**
Loans by Islamic banks/GDP	1.196			1.307			2.286		
	[0.440]***			[0.352]***			[4.091]		
Assets of Islamic banks/GDP		0.650			0.733			1.110	
		[0.302]**			[0.320]**			[0.606]*	
Deposits of Islamic			0.921			1.252			1.310
			[0.637]			[0.583]**			[0.758]*
Constant	0.091	0.083	0.032	0.058	0.047	0.012	0.097	0.074	0.067
	[0.065]	[0.063]	[0.065]	[0.061]	[0.056]	[0.058]	[0.073]	[0.066]	[0.067]
Observations	101	101	101	92	92	92	213	213	213
Number of countries	19	19	19	17	17	17	36	36	36
AR(2) test prob.	0.12	0.13	0.11	0.13	0.14	0.12	0.38	0.40	0.41
Hansen test prob.	0.99	0.94	0.94	0.98	0.98	0.98	0.90	0.91	0.90

Note: Robust standard errors in brackets. AR(2) = Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

Table 10.6 Sensitivity to Time Periods (System GMM Estimations)

	1996-2010			1990-2007		
	(1)	(2)	(3)	(4)	(5)	(6)
Initial GDP per capita	-0.018	-0.015	-0.010	-0.021	-0.008	-0.008
	[0.011]***	[0.010]***	[0.010]***	[0.013]***	[0.013]***	[0.013]***
Education	0.079	0.078	0.071	0.071	0.052	0.052
	[0.031]**	[0.028]***	[0.030]**	[0.025]***	[0.029]*	[0.029]*
Inflation (log)	-0.218	-0.191	-0.191	-0.221	-0.207	-0.207
	[0.098]**	[0.081]**	[0.076]**	[0.121]*	[0.107]*	[0.107]*
Government consumption/GDP	-0.771	-0.626	-0.744	-0.395	-0.417	-0.387
	[0.369]**	[0.328]*	[0.351]**	[0.332]	[0.305]	[0.304]
Trade openness	-0.046	-0.049	-0.052	-0.040	-0.043	-0.044
	[0.025]*	[0.024]**	[0.026]**	[0.027]	[0.027]	[0.027]
Terms of trade growth	0.255	0.239	0.235	0.172	0.155	0.155
	[0.072]***	[0.070]***	[0.071]***	[0.079]**	[0.080]*	[0.079]*
Quality of Institutions	0.023	0.021	0.021	0.014	0.014	0.014
	[0.007]***	[0.007]***	[0.007]***	[0.007]**	[0.006]**	[0.006]**
Overall financial development	0.002	0.002	0.002	0.001	0.001	0.001
	[0.000]***	[0.000]***	[0.000]***	[0.001]***	[0.000]**	[0.000]**
Loans by Islamic banks/GDP	1.065			1.504		
	[0.523]**			[0.544]***		
Assets of Islamic banks/GDP		0.868			0.923	
		[0.371]**			[0.349]***	
Deposits of Islamic banks/GDP			1.308			1.482
			[0.570]**			[0.573]***
Constant	0.133	0.103	0.093	0.146	0.085	0.079
	[0.062]**	[0.062]*	[0.061]	[0.070]**	[0.067]	[0.065]
Observations	182	182	182	224	224	224
Number of countries	45	45	45	45	45	45
AR(2) test prob.	0.60	0.51	0.57	0.70	0.80	0.82
Hansen test prob.	0.62	0.63	0.61	0.28	0.27	0.26

Note: Robust standard errors in brackets. AR(2): Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

Annex 10A Country Sample

OIC members				Non-OIC members			
DZA	Algeria	MYS	Malaysia	AGO	Angola	PNG	Papua New Guinea
BGD	Bangladesh	MLI	Mali	BWA	Botswana	PHL	Philippines
BFA	Burkina Faso	MAR	Morocco	CHN	China	ZAF	South Africa
CMR	Cameroon	MOZ	Mozambique	ZAR	Congo, Dem. Rep.	LKA	Sri Lanka
CIV	Côte d'Ivoire	NER	Niger	COG	Congo, Rep.	TZA	Tanzania
EGY	Egypt, Arab Rep.	PAK	Pakistan	ETH	Ethiopia	THA	Thailand
GAB	Gabon	SEN	Senegal	GHA	Ghana	VNM	Vietnam
GMB	Gambia, The	SDN	Sudan	IND	India	ZMB	Zambia
GIN	Guinea	SYR	Syrian Arab Republic	KEN	Kenya	ZWE	Zimbabwe
GNB	Guinea-Bissau	TGO	Togo	LBR	Liberia		
IDN	Indonesia	TUN	Tunisia	MDG	Madagascar		
IRN	Iran, Islamic Rep.	TUR	Turkey	MWI	Malawi		
JOR	Jordan	UGA	Uganda	MNG	Mongolia		
LBN	Lebanon	YEM	Yemen, Rep.	NAM	Namibia		
LBY	Libya						

Annex 10B Variable Definition and Sources

Variables	Definitions	Sources
GDP per capita growth	Change in the ratio of real Gross Domestic Product (GDP) divided by the size of the population.	International Monetary Fund (International Financial Statistics)
Growth volatility	Standard deviation of real GDP growth	
Inflation (log)	Change in consumer price index (CPI).	
Government consumption/GDP	General government current expenditure divided by GDP.	
Terms of trade growth	Change in terms of trade index calculated as the percentage ratio of the export unit value indexes to the import unit value indexes, measured relative to the base year 2000.	
Education (primary)	The ratio of total enrollment in primary education, regardless of age, to the population of the age group that officially corresponds to the primary education level.	World Bank (Word Development Indicators)
Trade Openness	The sum of exports and imports of goods and services measured as a share of GDP.	
Investment to GDP ratio	Total investment as a share of nominal GDP	
Rule of law	The confidence of citizens in law, and the extent that they abide by the rules of the society, such as contract enforcement, property rights, police, and court	World Bank Governance Indicators
Number of loan accounts/population	Number of loan accounts in commercial banks, MFIs, credit unions and financial cooperatives divided by total population	International Monetary Fund (Financial Access Survey)
Number of deposit account/population	Number of deposit accounts in commercial banks, MFIs, credit unions and financial cooperatives divided by total population	
Banking crisis	A dummy variable taking 1 in the year a banking crisis occurred and zero otherwise	Laeven and Valencia (2012)
Overall financial development (Bank private credit ratio)	Credit by deposit money banks to the private sector divided by GDP.	Beck, Demirgüç-Kunt and Levine (2000); 2013 Financial Development and Structure Dataset
Private credit by banks and other financial institutions/GDP	Demand, time and saving deposits in deposit money banks and other financial institutions as a share of GDP	
Assets of banks and other financial institutions/GDP	Credit by deposit money banks and other financial institutions to the private sector as a percentage of GDP	
Financial system deposits/GDP	Claims on domestic real nonfinancial sector by deposit money banks and other financial institutions as a share of GDP	
Share of Muslims in the population	Numbers of Muslims divided by the size of the population	Alesina and others (2003)
Loans by Islamic banks/GDP	Total loans by Islamic Banks divided by GDP	Bankscope database
Assets of Islamic banks/GDP	Total assets of Islamic Banks divided by GDP	
Deposits in Islamic banks/GDP	Total deposits in Islamic Banks divided by GDP	
Islamic bank liquidity ratio	Total liquid assets of Islamic banks divided by their total deposits	
Distance from Malaysia	Minimum distance between Malaysia and a given country (in kms)	Gleditsch and Ward (2001)

Annex 10C Summary Statistics

Variables	Observations	Mean	Std. Dev.	Min	Max
GDP per capita growth	286	0.05	0.09	-0.39	0.33
Education (primary)	286	0.93	0.24	0.26	1.56
Inflation (log)	286	0.13	0.35	-0.05	4.48
Government consumption/GDP	286	0.14	0.05	0.04	0.41
Trade openness	286	0.71	0.35	0.14	2.14
Terms of trade growth	286	0.00	0.07	-0.37	0.28
Rule of law	286	3.23	1.13	0.14	6.00
Overall financial development (Bank private credit ratio)	252	23.1	21.5	0.4	103.8
Loans by Islamic banks/GDP	286	0.001	0.005	0.000	0.051
Assets of Islamic banks/GDP	286	0.002	0.011	0.000	0.125
Deposits in Islamic banks/GDP	286	0.001	0.008	0.000	0.106
Private credit by banks and other financial institutions/GDP	286	28.1	30.7	0.4	168.2
Assets of banks and other financial institutions/GDP	286	0.34	0.35	0.00	2.08
Financial system deposits/GDP	286	0.32	0.25	0.01	1.15

Annex 10D Islamic Banking and Growth: Dynamic Panel System GMM Estimations with Standardized Coefficients for the Financial Variables

	(1)	(2)	(3)	(4)
Initial GDP per capita	-0.025	-0.016	-0.011	-0.018
	[0.011]***	[0.011]***	[0.011]***	[0.011]***
Education	0.079	0.068	0.061	0.070
	[0.029]***	[0.029]**	[0.031]**	[0.028]**
Inflation (log)	-0.218	-0.204	-0.199	-0.189
	[0.118]*	[0.105]*	[0.100]**	[0.090]**
Government consumption/GDP	-0.641	-0.581	-0.681	-0.491
	[0.354]*	[0.318]*	[0.339]**	[0.286]*
Trade openness	-0.043	-0.046	-0.048	-0.051
	[0.024]*	[0.024]**	[0.024]**	[0.025]**
Terms of trade growth	0.174	0.159	0.155	0.172
	[0.077]**	[0.077]**	[0.078]**	[0.075]**
Quality of Institutions	0.016	0.015	0.015	0.015
	[0.006]**	[0.006]***	[0.005]***	[0.006]***
Standardized coefficients				
Overall financial development	0.034	0.032	0.032	0.034
	[0.009]***	[0.008]***	[0.009]***	[0.008]***
Loans by Islamic banks/GDP	0.005			
	[0.002]***			
Assets of Islamic banks/GDP		0.008		
		[0.003]***		
Deposits of Islamic banks/GDP			0.008	
			[0.003]**	
Composite indicator of Islamic banking				0.007
				[0.003]***
Constant	0.223	0.171	0.160	0.171
	[0.067]***	[0.062]***	[0.059]***	[0.067]**
Observations	252	252	252	252
Number of countries	45	45	45	45
AR(2) test prob.	0.70	0.69	0.75	0.63
Hansen test prob.	0.73	0.74	0.76	0.63

Note: Robust standard errors in brackets. AR(2) = Arellano and Bond test of second order autocorrelation. Significance level: * = 10 percent; ** = 5 percent; *** = 1 percent.

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Chapter 11

Islamic Finance, the Sustainable Development Goals, and Shared Prosperity

With the expiry of the Millennium Development Goals (MDGs), the United Nations launched the bold initiative of the Sustainable Development Goals (SDGs) in September 2015 to eradicate poverty by 2030.[123] The SDGs correspond to the World Bank's vision of ending extreme poverty by encouraging growth that promotes shared prosperity. The World Bank defines shared prosperity as "fostering the well-being of the bottom 40 percent of the population" and measures it by "the extent to which the bottom 40 percent of the population takes part in and benefits from the process of economic development" (World Bank 2015a, 9). Along with enhancing growth and reducing income inequality, the World Bank envisions shared prosperity to be achieved by enhancing environmental, social, and fiscal sustainability (World Bank 2013a, 7), which coincides with some of the goals identified in the SDGs.

The SDGs are more ambitious than the MDGs, and it will be challenging for many countries to achieve them. In particular, the challenge will be more daunting for countries that did not fare well in achieving the MDGs. Many Muslim countries fall in this category; poverty is pervasive, and 700 million people in those countries live on less than $2 a day (World Bank 2014, 38). While member countries of the Islamic Development Bank (IDB) will be on track to meeting 16 specific indicators of MDGs, they will be off tack to meeting 29 key MDG indicators, such as poverty, income distribution, job creation, hunger, and nutrition, Bello and Suleman (2011, ix) report. They identify slow growth, the dearth of institutional reforms, lack of inclusive growth, uneven income distribution, and resource constraints as some of the factors inhibiting the achievement of MDGs by IDB member countries.

One of the key constraints in achieving the SDGs will be funding the huge investments that will be necessary to achieve the goals. At current levels of investment, the developing countries will face an annual gap of $2.5 trillion to achieve the SDGs, the United Nations Conference on Trade and Development (UNCTAD 2014) estimates. Given the scale of funding requirements, promotion of sustainable development will need "significant mobilization of resources from a variety of sources and the effective use of financing," the United Nations concludes (UN undated, 3). It will also require the engagement of different stakeholders, including government, businesses, civil society, and the financial sector.

While the financial sector can play an important role in mobilizing resources, its contribution to achieving the SDGs and shared prosperity will depend not only on the quantity of financing but on its quality. On the supply side, the financial sector needs to be inclusive and provide various financial services to the poorest 40 percent of the population so that they can

[123] This study is based on a paper by Habib Ahmed, Sharjah Chair in Islamic Law & Finance, Durham University Business School presented at the Inaugural Annual Symposium on Islamic Finance held in Istanbul, Turkey from September 8–9, 2015.

improve their economic conditions and contribute to growth. On the demand side, an issue in Muslim countries relates to voluntary exclusion; a large segment of the population does not deal with the interest-based financial sector because of their religious convictions. Including this group in the financial system and development process will require providing them with financial services that comply with *shari'ah* (Islamic Law). This study examines the ways in which the Islamic financial sector can contribute to achieving economic aspects of SDGs and enhancing shared prosperity.[124]

The Financial Sector and Shared Prosperity: Concepts and Framework

To understand the ways and extent to which the financial sector can promote shared prosperity, it is necessary to understand its nature and functions. A financial system performs certain core functions that are common to different financial structures and stable across time and place (Merton 1992).[125] The key functions of financial institutions that are relevant to achieving shared prosperity can be summarized as mobilizing savings/managing assets, allocating capital/financing, and managing risks. These are discussed below.

Mobilizing savings/Managing assets. Mobilizing savings from the resource surplus of households and firms, and allocating these savings to productive activities not only promotes growth but also provides important services that meet various financial needs of households and firms.

The short-term and long-term financial needs of households include emergency planning, money management, investment for goals, and inheritance and estate planning (Chieffe and Rakes 1999). The former two needs are dealt with mainly through savings, while the latter two rely mainly on asset management. Similarly, banks provide various financial services to businesses, including different types of accounts that meet their needs. Achieving these needs requires an appropriate and affordable range of products and services.

Allocating capital/financing. In performing its role of financial intermediation, the financial sector allocates capital and funds to both the household and business sectors. The financial sector fills the gap between consumption and income by catering to the short-term and long-term financing needs of the household sector.[126] In the business sector, one of the key functions of a financial system that enhances growth is promoting capital accumulation and technological innovation (Levine 1997). Firms need lump sums and long-term investments to start and sustain their businesses. They also need short-term working capital to fill the mismatch between cash inflows

[124] Throughout this chapter, the term "shared prosperity" is used to mean both shared prosperity and the economic aspects of the SDGs.
[125] Merton and Bodie (1995) identify six functions of financial system as managing risks; transferring economic resources; dealing with incentive problems; pooling resources; clearing and settling payments (to facilitate trade); and providing price information. Similarly, Levine (1997, 689) identifies the functions of a financial system as "the trading of risk, allocating capital, monitoring managers, mobilizing savings, and easing the trading of goods." The functions that a financial system performs can enhance growth by increasing saving and promoting capital accumulation and technological innovation (Levine 1997). The Bank for International Settlements recognizes that financial innovations perform the functions of "transferring risks, enhancing liquidity and generation of debt and equity" to meet the evolving financial requirements (BIS 1986, 8).
[126] Pressman and Scott (2009, 2010) group the main types of consumer loans into five categories: loans to buy motor vehicles, education loans, instalment loans, credit cards, and other debt that can be both instalment and non-instalment loans.

and outflows, as well as financing to buy inputs, and liquid funds to cover operational costs such as paying rent, utilities, salaries, travel expenses, and marketing.

Managing risks. One of the main functions of the financial system is "facilitating the trading, hedging, diversifying and pooling of risk" (Levine 1997). Risks can be classified in different ways. The World Bank (2001) distinguishes between risks arising from shocks at the micro, meso and macro levels. While micro risks are idiosyncratic, arising at the individual household or firm level (death, health problems, unemployment, default, bankruptcy, and the like), meso and macro risks are covariant risks that affect communities and national economies. Micro risks involve good and bad states that randomly occur for individual households/firms over a period of time. With covariant risks, group of individual households/firms face the same type of risks. Another way to view risks is those that arise exogenously or endogenously. Households and firms face certain external (exogenous) risks such as floods or drought. They protect themselves through insurance, among other defensive schemes such as building up savings and emergency funds. Households also proactively engage in various degrees of risky savings/investment activities, depending on their income levels and risk appetite (endogenous risks). Similarly, firms engage in business ventures that entail various types of risks such as market risk, operational risk, and liquidity risks.

The insurance industry protects individuals against external (exogenous) risks. The financial sector acts as the agent to manage their savings and provide appropriate risk/return profiles for investments. It also mitigates risks directly by providing risk management instruments and insurance services to the business sector, and reduces risks indirectly when allocating capital to firms by carrying out due diligence and monitoring.

The Financial Sector's Contribution to Shared Prosperity

The financial sector can promote shared prosperity in three ways: by facilitating economic growth, decreasing income inequality, and reducing vulnerability.

Facilitating economic growth. While the positive impact of finance on growth at the aggregate level has been demonstrated empirically, the evidence at the disaggregated and sector levels is mixed.[127] The link between finance and growth is the strongest in middle-income countries, while the impact tends to decline for higher-income countries (Beck 2012). Recent work shows that for high-income countries, finance has a negative impact on growth beyond a threshold level (Arcand, Berkes, and Panizza 2015).[128] Whereas in most members of the Organization for Economic Cooperation and Development (OECD), higher equity financing boosts growth, higher levels of credit to the private sector slows growth (OECD 2015). Higher credit in the economy impedes growth more when it is channeled to the household sector than to the business sector (Beck 2012; OECD 2015). Thus financing appears to have a greater impact on growth when it is channeled to enterprises rather than the households.

Decreasing income inequality. Though some aggregate-level studies show that the growth in the financial sector lessens inequality, recent work indicates that expansion of the financial sector increases income inquality (Denk and Cournede 2015). This is partly explained by the distribution of credit, whereby households with higher incomes benefit more than their poorer counterparts from credit-financed investments that increase their income (OECD 2015). Similarly, in the

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[127] For a review of the link between the financial sector and growth, see Beck (2012) and Levine (2005),

[128] The threshold level for private credit to GDP is around 100 percent, beyond which the relationship becomes negative (Arcand, Berkes, and Panizza 2015).

business sector, smaller and medium firms face more financial constraints than larger, better-off firms (Beck and Demirgüç-Kunt 2006). Thus while finance to the business sector promotes growth, the distribution of the financing among different sized firms determines the impact on inequality.

Reducing vulnerability. Reducing insecurity about the future is a key determinant of enhancing welfare (Cafiero and Vakis 2006). Risk and uncertainty increase insecurity; thus one way to increase sustainability is to reduce the vulnerability of households and firms. Vulnerability of a household or firm depends on the characteristics of the risk event and their ability to manage these. Households and firms subsisting at the margin are vulnerable; negative shocks can drive households back to poverty and make firms insolvent. The effects of risk events and shocks can be persistent and move households into poverty traps (Wheeler and Haddad 2005; Carter and Barrett 2006).[129]

How risks are shared in an economy has a great impact on growth and inequality. Greif, Iyigun, and Sassan (2011, 2012) examine the role of risk-sharing institutions in determining how societies evolve and grow. They assert that risk-sharing social institutions,[130] along with legal, political, and economic institutions, determine levels of technological development and growth. They found, in particular, social institutions that provide support to the poor in the society reduce social disorder and threats of appropriation, thereby creating incentives to invest in new technologies that produce growth. Risk-sharing institutions can thus promote new knowledge and risk taking that enhances productivity.

One of the keys functions of financial intermediaries is to manage risks when allocating capital. The insurance industry is vital in directly mitigating different risks that the household and business sectors face by reducing their risks and vulnerability during economic shocks. For the financial sector to contribute to growth, help distribute wealth more equitably, and reduce vulnerability, however, the industry itself must be resilient and must be able to reduce its own risks. The financial sector can be more stable and resilient to shocks if it uses instruments that are less opaque, engages more with the real economy rather than in excessive financialization, and reduces its excessive levels of leverage and debt. Table 11.1 show the relationships of the functions that the financial sector performs and factors that can contribute to shared prosperity.

Table 11.1 Functions of the Financial Sector and Factors Affecting Shared Prosperity

	Mobilizing savings/ Managing assets	Allocating capital/Financing	Managing risks
Facilitating growth	Mobilizing financial resources for investments	Allocating capital for production	Avoid economic crisis and promotion of innovation
Decreasing income inequality	Asset management for poorest 40 percent of the population	Provide financing to the poor and micro and small enterprises	Protect the poor against downturns and negative shocks

[129] Using an empirical model, Dercon (2008) simulates the impact of weather-related covariate shocks in Ethiopia, and finds that it causes poverty to increase from 33 percent to 47 percent of the rural population. If all the shocks were insured, poverty would decrease to 29 percent.

[130] For a discussion on the role of social systems such as households and communities in reducing risks, see chapters 3 and 4 in World Bank (2013b).

Reducing vulnerability	Savings for emergencies	Reduce risk by monitoring and provide financing for short-term needs and emergencies	Provide insurance and protection against risks and uncertain events

The Role of the Financial Sector in Promoting Shared Prosperity for Households and Businesses

To examine the role of the financial sector on shared prosperity, the household and business sectors are divided into two groups. The household sector is further divided into poor (the bottom 40 percent of the population) and non-poor (the better-off 60 percent of the population). The business sector is divided into micro and small enterprises (MSEs) and medium and large firms. MSEs predominate in lower-income economies, they are an important source of employment, and the people who work in them tend to have lower incomes. Thus the financial sector needs to better serve these enterprises to promote shared prosperity. The financial needs of poor households and MSEs, and how the financial sector serves these needs, are discussed next.

The Household Sector: Finance and Shared Prosperity

Using the notion of Maslow's hierarchy of needs, Xiao and Anderson (1997) identify three levels of financial products and services from a consumers' perspective. The first are *survival products* that satisfy basic needs. These include different kinds of deposits (checking and savings), mortgages, and financing required for emergencies, essential activities/items, and the like. Second, *security products* satisfy additional needs beyond the necessity level. These products meet cash reserve and risk management needs, and include insurance, pension plans, endowments, and time deposits. Finally, *growth products* offset inflation and protect against risk and taxes. These products include investment in equities, mutual funds, tax-protected bonds, and real estate.

The household sector's demand for these different types of products depends on income levels and risk preferences. To better understand the demand for these different types of financial services, the household sector can be classified into low-income, middle-income, and high-income groups. As the income level increases, the household sector's risk appetite tends to increase. Many low- and middle-income households are risk averse and prefer predictable income and expenditures. While all income groups need survival financial products, low-income groups will have less demand for security financial products compared to other two groups. The demand for growth financial products will mainly come from the high-income groups. Low-income and middle-income will have lower demand for high-return/high-risk savings and investment products.

Available data on financial services for different regions of the world show that the poorest 40 percent of population is underserved compared to their better-off counterparts. Furthermore, there is wide disparity in different regions of the world in financial services that people can access. Table 11.2 shows the percentage of the population that has an account with a financial institution—which is defined broadly to include not only banks but other NBFIs such as credit unions and cooperatives. The Middle East has the lowest percentages of people who have accounts, followed by Sub-Saharan Africa. The disparity of the financial engagement of the poorest 40 percent and the richest 60 percent of the population in the Middle East is apparent, as in the former group only

6.92 percent of the people have an account with a financial institution, compared to 18.63 percent for the latter group.

Table 11.3 shows the percentage of people who borrowed money during the past year and Tables 11.4 and 11.5 show the sources of borrowing. Table 11.3 demonstrates that on average, a high percentage of people have borrowed money globally (42.37 percent); the figure is higher for low-income countries (52.45 percent). A higher percentage of the poorest 40 percent of the population tend to borrow than the richer 60 percent of the population. The percentage of poorest 40 percent of the people who borrow funds is highest for Sub-Saharan Africa (53.49 percent), followed by the Middle East (47.79 percent) and South Asia (46.99 percent). Comparing these figures with those who have accounts in table 11.2 indicates that although people may not have account with a financial institution, they still borrow money—but they do so from other sources.

Table 11.2 Accounts at a Financial Institution, 2014 *(Percent of population, age 15+)*

Region	All	Poorest 40%	Richest 60%
World	60.70	53.30	65.70
High-income	90.63	86.88	93.19
Middle-income	57.10	48.67	62.79
Low-income	22.30	14.81	27.42
Developing countries only			
East Asia and Pacific	68.76	60.73	74.22
Europe and Central Asia	51.38	44.16	56.32
Latin America and the Caribbean	51.14	40.92	58.05
Middle East	13.97	6.92	18.63
Sub-Saharan Africa	28.90	19.80	35.13
South Asia	45.49	37.35	50.89

Source: Global Findex (Global Financial Inclusion Database).

Table 11.3 Borrowed Any Money in the Past Year, 2014 (*Percent of population, age 15+)*

Region	All	Poorest 40%	Richest 60%
World	42.37	42.64	42.19
High-income	38.34	39.64	37.44
Middle-income	42.23	42.04	42.35
Low-income	52.45	53.88	51.48
Developing countries only			
East Asia and Pacific	41.21	41.92	40.73
Europe and Central Asia	39.50	41.90	37.86
Latin America and the Caribbean	32.74	28.43	35.65
Middle East	45.73	47.79	44.36
Sub-Saharan Africa	54.49	53.49	55.17
South Asia	46.66	46.99	46.45

Source: Global Findex (Global Financial Inclusion Database).

Table 11.4 indicates that the percentage of borrowing from a financial institution is relatively small in low-income countries, particularly those in the Middle East, Sub-Saharan Africa, and South Asia. Worldwide, access to loans for the bottom 40 percent of the income groups from financial institutions is smaller compared to their better-off counterparts. Table 11.5 shows

that the bulk of the borrowing in low- and middle-income countries comes from friends and families. In most regions, including the Middle East, the percentage of the people in the poorest 40 percent population borrowing from friends and families is higher than the better-off 60 percent of the population. These data indicate that lower-income people are meeting their borrowing needs from friends and families and other non-formal sources because of limitations to access to finance from the formal financial sector.

Table 11.4 Borrowed from a Financial Institution, 2014 (*Percent of population, age 15+)*

Region	All	Poorest 40%	Richest 60%
World	10.69	8.69	12.04
High-income	17.27	16.25	17.97
Middle-income	9.08	6.63	10.74
Low-income	8.57	7.86	9.06
Developing countries only			
East Asia and Pacific	10.98	7.95	13.05
Europe and Central Asia	12.44	10.43	13.82
Latin America and the Caribbean	11.31	6.87	14.30
Middle East	5.62	4.76	6.19
Sub-Saharan Africa	6.29	4.83	7.29
South Asia	6.39	5.50	6.98

Source: Global Findex (Global Financial Inclusion Database).

Table 11.5 Borrowed from Family or Friends, 2014 (*Percent of population, age 15+)*

Region	All	Poorest 40%	Richest 60%
World	26.18	28.25	24.78
High-income	15.00	19.73	11.79
Middle-income	28.25	29.79	27.21
Low-income	34.91	35.20	34.71
Developing countries only			
East Asia and Pacific	28.27	30.89	26.48
Europe and Central Asia	23.58	27.24	21.08
Latin America and the Caribbean	13.49	13.03	13.79
Middle East	30.74	33.30	29.04
Sub-Saharan Africa (developing only)	41.92	41.31	42.34
South Asia	31.39	32.01	30.98

Source: Global Findex (Global Financial Inclusion Database).

Table 11.6 shows the percentage of the people who are not able to come up with emergency funds. The response to the question is a good indicator of vulnerability, as it shows whether a household has access to funds in case of emergencies. Not surprisingly, the numbers in table 11.6 demonstrate that a higher percentage of the poorest 40 percent are unable to come up with the funds compared to the better-off 60 percent of the population. The figures for the Middle East are the highest, with close to 60 percent of the poorest 40 percent in the region indicating that they do not have access to emergency funds.

Table 11.6 Not Able to Come Up with Emergency Funds, 2014 (*Percent of population, age 15+)*

Region	All	Poorest 40%	Richest 60%
World	21.72	31.46	15.12
High-income	15.71	24.78	9.54
Middle-income	23.09	33.26	16.23

Low-income	24.36	32.36	18.88
Developing countries only			
East Asia and Pacific	15.76	25.06	9.44
Europe and Central Asia	24.97	33.49	19.13
Latin America and the Caribbean	31.98	44.87	23.27
Middle East	43.12	59.24	32.46
Sub-Saharan Africa	25.27	33.54	19.61
South Asia	28.14	38.47	21.28

Source: Global Findex (Global Financial Inclusion Database).

The Business Sector: Finance and Shared Prosperity

Definitions of what constitutes micro, small, and medium firms differ from country to country. For example, in the Middle East and North Africa (MENA) region, the cut-off point between small and medium varies from 5 to 50 workers, and between medium and large firms from 15 to 100 employees (IFC 2010, 9). Micro and small enterprises (MSEs) constitute a large percentage of enterprises and contribute to both growth and employment in most countries. In a study covering 99 countries, Ayyagari, Demirgüç-Kunt, and Maksimovic (2011) find that the mean employment share of small and medium enterprises (employing less than 99 employees) is 47.94 percent, and that small firms (with less than 20 employees) generate 45.34 percent of the new jobs.

Firms have specific financing needs that evolve with the growth of their businesses. The International Finance Corporation (IFC 2014, 37) identifies these as liability products (current accounts and payments, cash management, and payroll services); working capital (overdraft and factoring); trade finance (letters of credit, letters of guarantee and documentation); and asset finance (securitized loans and lease financing). The sources of funds can be broadly categorized as internal and external. While the initial capital of firms is in the form of equity that comes from household itself or funds from friends and relatives, additional investments can take the form of debt or equity. As capital invested is positively related to returns of a project, a firm that does not have adequate capital may become unprofitable (Kerr and Nanda 2009, 7). One way to categorize financial needs is according to period of use, in terms of short-, medium-, and long-term financing. Long-term finance allows firms to address their life-cycle challenges and can contribute to faster growth, stability, and shared prosperity by reducing rollover risks and improving performance (World Bank 2015b, 1).

In a recent survey of micro and small enterprises from 13 countries, the World Bank (2014, 107) finds that the key obstacle to operations identified most frequently (in 36 percent of the firms) is limited access to finance. Table 11.7, adapted from IFC (2010), shows the types of financing available to meet financial needs of firms with different sizes. The key gaps that that micro and small enterprises face are medium- and long-term finance. This is confirmed by the 2014 *World Financial Development Report* (World Bank 2015b, 3), which reports that in developing countries only 66 percent of small firms report having any liabilities longer than one year, compared to 80 percent in high-income countries. Within developing countries, the ratio of long-term debt to total debt for small and medium firms stands at 12.7 percent, compared to 20.4 percent for large firms (World Bank 2015b, 28).

Table 11.7 Financing Needs and Financing Types for Different Firm Sizes

Horizon of financing need	Micro	Small	Medium	Large

Short-term	MF	BF, TF	BF, TF	BF, TF
Medium-term		BF, LF	BF, LF	BF, CM, LF
Long-term			BF, PE	BF,CM, PE

Source: Adopted from IFC 2010.

Note: BF = bank financing; CM = capital markets; LF = lease financing; MF = microfinance; PE = private equity; TF = trade financing.

Islamic Finance: Scope and Principles

The preceding overview of access to financial services shows that the financial needs of a large percentage of the poorest 40 percent of the people are not being met by the financial sector. In particular, while a large percentage of the population borrows funds, they do so not from the financial sector but from friends and families. Furthermore, a large percentage of population cannot come up with emergency funds in case of emergencies, indicating their vulnerabilities to negative shocks. The disengagement with the financial sector is the highest for the Middle East region. While there are supply side–related issues for the low numbers for the region, one possible reason on the demand side is voluntary exclusion; a significant segment of the population does not engage with the conventional financial sector due to religious convictions.

The preference for Islamic finance and its implications for financial exclusion in Muslim countries are confirmed by various surveys. Karim, Tarazi, and Reille (2008) find that 72 percent of the people living in the Muslim countries do not use formal financial services, and a large percentage of the population (ranging from 20 percent to more than 40 percent) would not avail themselves of conventional microfinance to avoid interest. In a survey of 66,484 adults from 64 countries carried out in 2011, Demirgüç-Kunt, Klapper, and Randall (2013, 4) report that Muslims are less likely than non-Muslims to have an account and save at a formal financial institution, and more likely to identify religion as a reason for not having an account. In a smaller survey of 5,071 respondents in five Arab countries (Algeria, the Arab Republic of Egypt, Morocco, Tunisia, and the Republic of Yemen), they find that 45 percent of the respondents would prefer a loan from an Islamic bank than a conventional bank, even if they had to pay 5 percent annually more on the former. By contrast, 27 percent of respondents would prefer a loan from a conventional bank under the same cost structure. In another survey of nine countries in the Middle East and North Africa (MENA) region, IFC (2014, 39) finds that on average, 32.19 percent of the small and medium enterprises (SMEs) in these countries prefer to have a *shari'ah*-compliant product.

Even though the demand for Islamic financial products appears to be huge, the penetration of Islamic finance in most Muslim countries is small. For example, the five-country survey by Demirgüç-Kunt, Klapper, and Randall (2013, 40) reveals that only 2 percent of the 5,071 respondents use Islamic banking. IFC (2014) reports that even though 90 percent of the SMEs in Saudi Arabia prefer *shari'ah*-compliant products, only 2 percent of Islamic banks funding goes to them. Similarly, El-Zoghbi and Tarazi (2013) report that Islamic microfinance is provided by a small number of providers covering less than 1 percent of the total microfinance outreach in some selected Muslim countries. Given that Islamic finance can potentially play an important role in providing services to the poor and MSEs, the goals and principles of the sector are presented next.

Goals of* Shari'ah *and Islamic Finance in Terms of Shared Prosperity

The essential goals of *shari'ah* (*maqāṣid al-sharī'ah*) are safeguarding the faith, self (life), intellect, posterity, and wealth (Chapra 2008). The objectives of Islamic commercial law and an ideal Islamic economy are to strive to protect and enhance one or several of the *maqāṣid*. Specifically, commercial transactions are sanctified and encouraged, as they preserve and support property and posterity (Hallaq 2004). Laldin and Furqani (2012) identify the specific *maqāṣid* related to Islamic finance as preservation of wealth, which can be done through its acquisition, development, and circulation, by protecting its value, by protecting ownership, and by preserving it from damage.

Maqāṣid can be classified into the micro (specific) level (*maqāṣid khassah*) and macro (general) level (*maqāṣid ammah*) (Abozaid 2010; Dusuki 2009; Dusuki and Bouheraoua 2011). Micro (specific) *maqāṣid* deal with issues related to individual transactions. Macro (general) *maqāṣid* relate to the benefits and well-being of the overall society. The micro*maqāṣid* relate to specific issues arising in the operations and transactions of the Islamic businesses and the financial sector. Using various legal maxims, Dusuki and Abdullah (2007) and Dusuki and Bouheraoua (2011) conclude that preventing and minimizing harm should be a key objective of an Islamic firm. This includes not engaging in harmful activities such as selling products that harm consumers, dumping toxic waste harmful to the environment or residential areas, or engaging in speculative ventures. *Maqāṣid* at the micro or product level also require *shari'ah* compliance and fulfilling the objectives of contracts. These include upholding property rights, respecting consistency of entitlements with the rights of ownership, linking transaction to real life activity, transferring property rights in sales, and prohibiting the sale of debt (Kahf 2006). Scholars view the macro implications of *maqāṣid* in a variety of ways. At the broadest level, Abozaid (2010, 67) views it as a vision that would protect and preserve public interests in all aspects and segments of life. Fulfilling the *maqāṣid* at the macro level implies that an economy should ensure growth and stability with equitable distribution of income, where all households earn respectable income to satisfy basic needs (Chapra 1992). For example, achieving the objectives of optimal growth and social justice in an Islamic economy would specifically require universal education and employment generation (Naqvi 1981, 85). The macro implication of the *maqāṣid* for the financial sector is that it should contribute to growth and equitable distribution of income, which coincides with the goals of shared prosperity.

Islamic Finance: Principles and Modes of Financing

The basic norm for commercial transactions in an Islamic economy is *permissibility,* which signifies that all acts/contracts are permissible unless they contain elements that are prohibited by Islamic law (Kamali 2000, 66). The two broad categories of prohibitions related to economic transactions recognized in *shari'ah* are *ribā* (excess in loan contracts) and *gharar* (excessive uncertainty). As interest is considered prohibited Islamic financial institutions use different modes of financing.[131] The key forms used by the Islamic financial sector are described next.

Debt. Debt is created in sale contracts through deferred-trading transaction whereby one component of the transaction (paying price or the delivery of good) is postponed to a future date. In a price deferred sale (*bay' mu'ajjal*), the object of sale is delivered at the time of the contract,

[131] Detailed expositions of the different principles of Islamic financing can be found in Kahf and Khan (1992) and Ahmad (1993).

but the price is paid later. One type of financial transaction under this format is mark-up sale (*murābaḥah*), in which a good or asset is sold to the client at a mark up. The client pays for the good or asset at a future date or in installments. In a *salam* contract, the delivery of the good is postponed. In an *istiṣnā'* contract, both payment and delivery can be postponed.

Leasing. *Ijārah* is a leasing contract in which the client uses an asset by paying rent. One form of this asset-based financing is the hire-purchase scheme or lease-purchase scheme (*ijārah wa-iqtina'*), in which the installment includes rent and part of the capital. When the installments are fully paid, the ownership of the asset is transferred to the client.

Equity. Profit-sharing modes can take two forms: *mushārakah* and *muḍārabah*. In *mushārakah,* more than one party finances and manages a project and distributes the profit at an agreed ratio. A *muḍārabah* is a silent partnership, whereby one party supplies the funds and the other party manages the project and shares the profit at an agreed-upon ratio. In both cases, the loss is borne by the capital provider on a pro rata basis.

Agency (Wakālah). In an agency contract, a person represents other person(s) to perform certain duties. The agent can do the work for the principal for free or be compensated; the compensation can be structured in different ways.

Loan. In a loan (*qarḍ*) contract, the ownership of the asset is transferred without consideration. If money is loaned, repayment should be in exact quantities, as excesses charged would constitute *ribā*, which is prohibited. Actual administrative costs incurred, however, can be charged to the loanee in *qarḍ* transactions.

Two key Islamic principles governing economic and financial transactions link return to risks. The first is the legal maxim of "the detriment is as a return for the benefit" (a*l-ghurm bi al-ghunm),* which associates "entitlement of gain" to the "responsibility of loss" (Kahf and Khan 1988, 30). This maxim is usually used to propose the preference for using profit-loss sharing instruments. The second principle arises from the Prophetic saying that developed into a legal maxim: "The benefit of a thing is a return for the liability for loss from that thing" (*al-kharaj bi al-daman*). The maxim implies that the party enjoying the full benefit of an asset or object should also bear the associated risks of the ownership (Vogel and Hayes 1998). The implications of the maxims are that profit and returns must be associated with risks arising either in business ventures or possession of assets. In this regard, Siddiqi (2009), among others, maintains that while the tendency in conventional finance is to transfer risks, the approach in Islamic finance should be risk sharing.

Debt in Islamic finance is not a result of monetary transactions, but is linked to the real economy, as debts are created through sale contracts. Whereas Islamic financing can be debt-based or equity-based, proponents of Islamic banking prefer equity modes of financing. They point to the advantages of profit-sharing modes of financing over the debt-based financing such as increase in investment, allocative efficiency, stability, equity, and reduction of poverty.[132] Specifically, they argue that as the reward for a financier would be a share of profit, financial resources will be allocated to projects with the highest productivities and there will be more monitoring of investments, thereby reducing moral hazard. Furthermore, equity-based financing tends to be for longer terms, which contributes positively to growth.

[132] The advantages of Islamic banking are discussed in Chapra (1985); Khan (1995); and Siddiqi (1981, 1983).

Islamic Finance and Shared Prosperity

The foundation principles and values of *shari'ah* imply that socioeconomic justice and equitable distribution of income are among the primary goals of Islam and are expected to be unyielding features of an Islamic economic system (Chapra 1985). The Islamic financial system, as part of the Islamic economic system, should also reflect and promote these objectives of Islam. The philosophical basis of the Islamic financial system lies in *'adl* (social justice) and *ihsan* (benevolence) (Siddiqi 2004). The implication of these concepts is "taking care of those who cannot be taken care of by the market, who cannot play with economic forces or do not have access to economic means to enable them to exploit the economic opportunities around them" (Khan 1997, 12–13). As such, it is imperative for the Islamic financial sector to include social dimensions in its operations, along with regular commercial financing practices.

Given its orientation and foundational basis, Islamic finance is expected to contribute to inclusive and equitable economic development, which coincides with the goal of shared prosperity. Specifically, Islamic finance can play an important role in contributing to shared prosperity by providing the financial services to the poorest 40 percent of the population in the household sector and micro and small enterprises in the business sector. The discussion that follows first identifies Islamic financial sector products needed for these segments and then explores how the financial institutions and capital markets can provide these services.

Financial Products for the Household and Business Sectors to Promote Shared Prosperity

As discussed, financial products can be classified as survival, security, and growth products, and the demand for these will vary by income level. While all products may be provided for the poorest 40 percent of the population, the most relevant products will be survival and security products. The specific products that fall in these categories are listed in table 11.8. Survival products include demand and savings deposits, financing at different terms, education financing, and access to emergency funds. In addition to demand accounts to facilitate payments and savings accounts for safekeeping, households also need short-term and long-term financing to fill the gap between income and expenditure and to purchase fixed assets such as housing. They also require emergency funds in certain cases of unexpected negative shocks.

Table 11.8 Financial Product Needs of the Poorest 40 Percent of the Household Sector

Financial functions	Financial institutions	Capital markets
Mobilizing savings/ Asset management	• Demand and savings deposits (SUR) • Investment accounts (SEC)	• Retail *sukūk* (GRO) • Mutual funds (GRO)
Allocating capital/financing	• Short-term financing (SUR) • Medium- to long-term financing (house, fixed assets, etc.) (SUR) • Education financing (SUR)	
Managing risks	• Emergency funds (including *qarḍ hasan*) (SUR) • Micro*takāful* products (SEC)	• Retirement plans (SEC)

Note: GRO = growth financial product; SEC = security financial product; SUR = survival financial product.

Security products include investment accounts, *takāful* products, retirement plans, and opportunities for investment in capital market instruments such as *sukūk* and mutual funds. The

risks that households face in the short term can be mitigated by different types of *takāful* products. There are two main types of *takāful:* general and family (see chapter 6). While the former provides short-term protection against accidents and losses of property, the latter provides saving opportunities and long-term protection arising from death or disability. The types of products under family *takāful* have become diverse, providing a variety of products that can be used for wealth and lifestyle protection. The management of longevity/livelihood risks and old-age care are also important products for an aging population. The growth products for the poor household include opportunities to invest in mutual funds and *sukūk* products.

Whereas some of these products may be relatively easier to provide, others will be more challenging. For example, while offering different types of deposits to the poorest 40 percent of the population may be straightforward, providing financing for poor and low-income households can be challenging for financial institutions for the economic reasons discussed. In some cases, inclusive finance may involve changing a small feature in the product. For example, if the minimum investment requirements of mutual funds are reduced from $5,000 to $100, many people with lower incomes can invest in them. However, coming up with some products such as *shari'ah*-compliant education financing for the poor can be challenging. While all types of financial products are important, the survival and security products should have priority over the growth products.

The different types of products that the financial sector can provide to the MSEs are shown in table 11.9. The survival products include demand and savings accounts and financing of different maturity terms. In addition to long-term financing to purchase fixed assets, they also need short-term financing to cover working capital and operational costs. Appropriate *shari'ah*-compliant products are needed to fulfill the different needs of MSEs. For example, whereas working capital can be financed by trade-financing instruments such as *murābaḥah*, long-term assets can be financed by asset-based financing such as *ijārah*.

The security products include *takāful* products and access to funding from capital markets. Firms can mitigate risks by using *takāful* to protect specific assets. Another way in which risks in MSEs can be shared with others is by using risk-sharing modes of financing, both from financial institutions and from capital markets. While financial institutions are likely to provide the bulk of the financing to MSEs, firms can also tap into capital markets to raise funds. This is a growth financial product; it will not be feasible for microenterprises. Enabling smaller firms to raise funds from capital market would require making listing of securities easier and less costly.

Table 11. 9 Financial Product Needs of Micro and Small Businesses

Financial functions	Financial institutions	Capital markets
Mobilizing savings/Asset management	• Demand and savings accounts (SUR)	
Allocating capital/financing	• Short-, medium-, long-term financing (SUR) • Working capital (SUR) • Trade credit (SUR) • Leasing (SUR)	• Listing opportunities of smaller firms (GRO) • Social and short-term *sukūk* (SEC)
Managing risks	• *Takāful* (SEC) • Risk-sharing instruments (SEC)	• Risk-sharing *sukūk* (SEC)

Note: GRO = growth financial product; SEC = security financial product; SUR = survival financial product.

The financial sector is reluctant to finance the poor households and MSEs due to a variety of economic factors, in addition to their relatively low income and the uncertainty of that income (World Bank 2008). Private information about the poor households is scarce, which can lead to moral hazard and adverse selection problems, among others. In the face of extreme information problems, markets tend to either break down or function poorly as verification of the credit status becomes very costly (Holzmann and Jorgensen 2000). Other key constraints to providing financial services to the poor include higher costs arising from the small size of financial service and scale of production. Some of the risks of financing can be mitigated if the entrepreneur has good collateral; however, if the potential borrowers have limited collateral (which is often the case for low-income households and MSEs), then good projects may go unfunded.

While equity-based modes of financing can contribute to growth and also increase stability in firms, the Islamic financial sector has not used them extensively. Various factors determine the modes of financing used by the business sector. First, the costs of the different modes of financing affect the choice of modes. Equity is considered to be more costly than debt; thus there is a preference to use more debt. Second, there are considerations about maximizing profit. Specifically, if the goal of a firm is maximizing the return on equity (as opposed to the return on assets), firms will prefer higher levels of leveraging. Finally, most tax regimes favor debt-based financing, as interest payments can be deducted from costs, whereas dividends are taxed. Thus the overall incentive structures lead the business sector to use more debt than equity.

Tax regimes need to be reformed to level the playing field for equity with respect to debt. There is also need to strengthen investors' rights in general and equity-holders' rights in particular to mitigate the risks arising in agency relationships such as *muḍārabah* contracts (Ahmed 2012). Stronger rights and better provision of information of prospective business ventures would reduce the possibilities of misappropriation and create incentives to use more equity-based modes.

Addressing these challenges will require coming up with new innovative ways to provide financing to the MSEs. For example, the problem of collateral can be mitigated by providing group-based financing, whereby physical collateral is substituted with social capital collateral. An example is Grameen Bank in Bangladesh, which has successfully used group-based lending for providing microfinance to the poorer sections of the population.[133] Another option is to use asset-based financing such as leasing and use the leased asset as collateral. The social orientation, preference for risk-sharing features, and link between financing and the real sector provide a sound foundation for Islamic finance to provide financial services to MSEs. However, there is a huge and urgent need to develop a variety of products and services based on these principles at different tenures (short-term, medium-term- and long-term) and yielding different returns, to cover different kinds or risks, financing needs, and risk profiles. This will require investments in research and development. It will also require a reorientation of Islamic financial institutions from their current type of product development, which tends to replicate conventional products, to the development of new products and services based on *shari'ah* foundations and values.

A functional approach to product development will facilitate the development of *shari'ah*-based alternatives, Ahmed (2006) and Al-Suwailem (2006) argue. The functional approach would examine the needs that banks satisfy and then come up with Islamic alternatives that can meet these needs. For example, in hedging, the function that financial institutions perform is minimizing

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[133] For information on Grameen Bank, see http://www.grameen-info.org/.

risks. In conventional finance, derivatives are widely used as hedging instruments. As conventional derivatives do not comply with *shari'ah* principles, financial engineering and stratagems or ruses are being used to circumvent the prohibitions. Under the functional approach, however, the need to minimize risks can be done through other means. For example, a cooperative technique of hedging currency risks that does not employ any derivatives can be used (Al-Suwailem 2006).

Diversifying Organization Formats and Approaches to Align Financial Institutions with Islamic Law

The dominant financial institution in Islamic finance is the commercial bank, which is modelled after conventional counterparts. As a debt-based corporate financial organization, the format of conventional banks may not appropriately reflect the transaction needs of Islamic finance, with their social orientation and emphasis on risk-sharing modes of financing. There is a need to diversity the organizational formats and approaches to align the financial institutions with the principles and spirit of Islamic Law (see chapter 4).

Achieving the goals of shared prosperity requires having a variety of NBFIs that can serve the poor and MSEs. Financial intermediaries that are local are better equipped to monitor and overcome the costs of screening and monitoring smaller enterprises (Kerr and Nanda 2009, 3). Furthermore, as many nonbank financial institutions (NBFI) have less stringent regulations, they can be used to circumvent the legal and regulatory constraints limiting the use *shari'ah*-compliant products and serving social needs (see chapter 7).

The social goals of Islamic finance can be achieved by establishing not-for-profit financial institutions such as cooperatives, credit unions, and mutual insurance companies as alternatives to Islamic banks (El Gamal 2006). Some Islamic cooperatives exist in countries such as Canada (see chapter 7) and Thailand. An example of a successful cooperative that serves the needs of all segments to the population is Bank Kerjasama Rakyat Malaysia (Bank Rakyat) in Malaysia. In addition to providing savings and investments opportunities along with financial planning services, the cooperative bank offers a variety of services, including consumer financing, commercial financing, and financing for small, medium, and cooperative entrepreneurs. The bank also offers microfinance in the form of Islamic pawning services under the *ArRahnu* program through all of its branches and specialized *ArRahnu* centers, mainly to meet emergency funding needs (Ahmed 2013).

Similarly, nonbank financial institutions can provide micro*takāful* services directly to the poor (see chapter 6). Examples of micro*takāful* provided by NBFIs include *Takāful* T&T Friendly Society (TTTFS), a multipurpose cooperative in Trinidad and Tobago that provides funeral *takāful* and investment opportunities to its members. A nonprofit organization in Indonesia, Peramu Foundation, *Takāful* provides micro*takāful* to clients of its microfinance program and also to others (Ahmed 2013).

Increasing equity-based financing will also require organizational forms that are different from debt-based banks, including Islamic versions of venture capital and private equity firms. Other organizational models can also be used that satisfy the social and legal *shari'ah* requirements. In Pakistan, for instance, *muḍārabah* companies have been established under the *Muḍārabah* Companies and *Muḍārabah* Floatation and Control Ordinance 1980 (Khan 1995). These equity-based NBFIs raise funds by issuing *muḍārabah* certificates and use these in various income-generating activities. The resulting profit is shared with investors at an agreed upon ratio.

Another novel contemporary option is crowdfunding that promotes investments in projects that can reap both economic and social benefits. While crowdfunding is relatively new in most

developing countries, *shari'ah*-compliant platforms are even rarer. Shekra, launched in the Arab Republic of Egypt in 2013, is the world's first *shari'ah*-compliant crowdfunding platform that provides opportunities to people to invest in enterprises (CCA and FCA 2013). Crowdfunding requires a supporting ecosystem in terms of regulations, technology, and active social media penetration. There is need to understand this model and expand it in other countries.

Opening Up Capital Markets to the Bottom 40 Percent and MSEs

Because Islamic capital markets are relatively young and evolving, there are very few products that are catering to the needs of the poor and MSEs. However, with the expansion of the Islamic financial industry, there is a potential for financial markets to contribute to shared prosperity.

One way in which the poorest 40 percent of the population can benefit from the capital markets is to have savings and investment opportunities in Islamic securities. One option is to provide mutual funds that are accessible to lower-income groups. Another option is to issue retail *sukūk.* This not only taps into newer market segments to raise funds, but also serves as an instrument of financial inclusion, as it enables investors with meagre means to participate in alternative investment products. An example of a retail *sukūk* is one issued in 2014 by the government of Indonesia to raise funds to finance development projects such as building roads and ports. The Rp19.3 trillion ($ 1.7 billion) *sukūk,* paying a return of 8.75 percent per year, is the largest Islamic instrument issued in Indonesia. It was oversubscribed and bought by a variety of investors that included the self-employed (32 percent), private sector employees (27 percent), housewives (17 percent), civil servants (4 percent), and army and police personnel (1 percent) (Ho 2014).

Lack of funding remains a major obstacle in financing MSEs for Islamic financial institutions in general and NBFIs in particular. One way to overcome this constraint is to raise funds from capital markets in the form of microfinance and social impact funds. For example, Bangladesh Rural Advancement Committee (BRAC) issued a zero coupon tax bond to raise $90 million in 2007 to finance its microfinance operations. The bond was issued in the local currency (taka) and raised funds domestically from local investors to provide credit to small and tenant farmers in the country (Rennison 2007; Davis and Dubitsky 2008). Unfortunately, this type of arrangement is rare. Islamic financial sector has not yet tapped into capital market to raise funds for inclusive finance.

Conclusion

The household and business sectors need financial services so that they can save, invest, get financing, and protect themselves from uncertainties. A developed and robust financial sector would provide a mix of products with different risk/return/maturity profiles to satisfy these needs. At the aggregate level, the financial sector can positively contribute to shared prosperity by promoting growth and reducing inequality and vulnerablity. At the disaggregated level, it can provide financing to all market segments, including poor households and micro and small enterprises. The impact of the financial sector on shared prosperity will, therefore, depend not only on the quantity of finance but also its quality in terms of the clientele being served. Moving forward, the financial sector is expected to play an important role in meeting the funding needs of achieving the SDGs and shared prosperity.

The principles and values of Islamic finance provide a sound foundation for the industry to contribute to shared prosperity. Inclusive finance in Muslim countries will require that the Islamic financial sector play an important role in providing financial services to the poorest 40 percent of the population and MSEs. Not only is there a need to come up with products and services that

satisfy the needs of the poor and MSEs, but there is also a need to come up with new organizational formats. In order to reflect the foundational principles and values and positively contribute to shared prosperity, however, Islamic financial sector must reorient itself. The industry should strive to develop institutions that can come up with more risk-sharing financial products and services that can fulfill the broader goals of *maqāṣid al-sharīʿah*.

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Glossary and Index to come

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