

# On the Sustainable Development Goals and the Role of Islamic Finance

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## Abstract

The Sustainable Development Goals, the global development agenda for 2015 through 2030, will require unprecedented mobilization of resources to support their implementation. Their predecessor, the Millennium Development Goals, focused on a limited number of concrete, global human development targets that can be monitored by statistically robust indicators. The Millennium Development Goals set the stage for global support of ambitious development goals behind which the world must rally. The Sustainable Development Goals bring forward the unfinished business of the Millennium Development Goals and go even further. Because of the transformative and sustainable nature of the new development agenda, all possible resources must be

mobilized if the world is to succeed in meeting its targets. Thus, the potential for Islamic finance to play a role in supporting the Sustainable Development Goals is explored in this paper. Given the principles of Islamic finance that support socially inclusive and development promoting activities, the Islamic financial sector has the potential to contribute to the achievement of the Sustainable Development Goals. The paper examines the role of Islamic financial institutions, capital markets, and the social sector in promoting strong growth, enhanced financial inclusion, and intermediation, reducing risks and vulnerability of the poor and more broadly contributing to financial stability and development.

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# ON THE SUSTAINABLE DEVELOPMENT GOALS AND THE ROLE OF ISLAMIC FINANCE

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## I. INTRODUCTION

With the Millennium Development Goals (MDGs) expiring at the end of 2015, the world is preparing for the global development agenda to succeed them post-2015. The proposed 17 Sustainable Development Goals (SDGs) are more ambitious and holistic than their predecessor, and countries will require commensurately ambitious financing to implement them. Thus a traditional approach to financing is insufficient and a paradigm shift in development finance is needed. Islamic Finance has the potential to play a transformative role in supporting the implementation of the post-2015 agenda.

The Millennium Declaration, signed by 189 countries in September 2000, gave birth to the MDGs. The eight goals with their 21 targets set outcomes for ending poverty (MDG 1), eradicating human deprivation in education, gender, and health (MDG 2-6), and promoting sustainable development (MDG 7); all to be supported by a global partnership for development (MDG 8) and to be achieved by the end of 2015. After their adoption, the MDGs were discussed at various international fora, but none was as important for their implementation as the United Nations Conference on Financing for Development in Monterrey, Mexico, in 2002.

The outcome of the Monterrey Conference resulted in a grand bargain among developing and developed countries that led to the so-called Monterrey Consensus. Developing countries were expected to speed up reforms to spur growth and improve MDG-related service delivery, while donors would provide larger financial resources and international trade access. The OECD-DAC countries were expected to reach their commitment of providing Official Development Assistance equal to 0.7% of Gross National Income (GNI).

Although it is too early to undertake a full retrospective analysis of the successes and failures of the MDGs, one thing is clear: when policies improve, it quickly becomes apparent that financing is a major bottleneck to accelerating progress toward the MDGs at the country level. One can realistically expect the same to happen with the SDGs. Hence, there is an urgent need to explore all options available to countries to see how they can finance their development.

One important potential source of development finance that is often overlooked is Islamic finance. Though Islamic finance is a relatively new industry, it is growing rapidly and has become a significant financial sector in many countries.<sup>1</sup> Islamic finance assets grew at an annual rate of 17% during 2009-2013 and are estimated to exceed USD 2 trillion in 2014 (IFSB 2014). Given the

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<sup>1</sup> The World Bank Group in 2013 opened the Global Center for Islamic Finance in Istanbul, envisaged to be a “knowledge hub for developing Islamic finance globally, conducting research and training, and providing technical assistance and advisory services to World Bank Group client countries interested in developing Islamic financial institutions and markets.”

huge gaps in financing the SDGs, it is important to explore the role that Islamic finance can play in promoting wider social and environmental issues.

This paper begins by discussing the evolution of the concept of sustainable development, in order to provide context for an assessment of the potential role of Islamic finance. The principles underlying Islamic finance are then considered, and the recent contribution of Islamic finance to development is explored. The prospect of using two key Islamic social institutions, alms (zakat) and endowment (waqf), in achieving some of these development goals is also examined.

## **II. THE DEVELOPMENT FRAMEWORK**

The second half of the 20<sup>th</sup> century has been labeled the ‘era of development’ (Allen, Thomas 2000). The approach to development by donors has changed over the years. In the immediate post-war period, the Western powers focused on the reconstruction of Europe and the reduction of barriers to international trade and associated capital flows (Steil 2013). European recovery was followed by a refocusing of developmental efforts on infrastructure investments in the developing world. With decolonization, however, a more comprehensive approach to development was adopted, eventually leading to international agreement on the Millennium Development Goals. The challenge now is to define the development agenda post-2015, which is the target year for achieving the goals.

### **1. The Post-War International System**

Based on fears that poverty, unemployment, and dislocation would reinforce the appeal of communism to Western Europe, the United States sought to create stable conditions where democratic institutions could survive (Encyclopædia Britannica 2014). Beginning in 1948, the United States gave \$13 billion (approximately \$148 billion in current dollars) under the Marshall Plan to help rebuild European economies after WWII. The World Bank was initially established to assist European reconstruction, but then its efforts shifted to the development of Europe’s remaining and former colonies (Goldman 2005). During its first twenty years, the Bank financed only the most direct investments in productive capital (i.e. roads, power plants, ports, etc.) (ibid). However, decolonization—at least 17 former colonies achieved independence in Africa in 1960—ushered in a period of increased demand for financial and technical assistance in the context of maintaining independence. That year marked a turning point in international development. The countries of the developing world, having gained independence and freed themselves of colonial rule, now also needed to free themselves of poverty. These new governments would need financial and technical assistance to speed up development, while maintaining independence; thus leading to the push for development in its more contemporary sense – a notion which, in combination with more conventional ideas of economic investment, embraced moral and humanitarian ideals. The year 1960 also marked the World Bank’s establishment of a subsidiary

body with an initial subscription of approximately \$900 million, the International Development Association (IDA), to provide concessional lending to the world's poorest countries.<sup>2</sup> 1960 also marked the creation of the OECD's Development Assistance Committee (DAC), a forum for discussion among the developed countries of aid, development, and poverty reduction. The DAC established the official definition of Official Development Assistance (ODA) and set international standards on the financial terms of aid. The United Nations then came to adopt the DAC-recommended 0.7% of Gross National Income (GNI) as the official target for ODA for developed countries. Beginning in 1961, donor countries also began to establish aid agencies.

## **2. The Millennium Development Goals**

The 1990s saw a series of efforts to define goals for improvements in welfare in developing countries. OECD-DAC proposed seven International Development Goals (IDGs) in 1996, drawn from agreements and resolutions of UN conferences in the first half of the 1990s. While a lack of engagement by many large donors limited the immediate impact of the IDGs, negotiations in the context of the UN General Assembly resulted in its adoption of the Millennium Declaration on September 8, 2000. The Millennium Development Goals (MDGs) were then established as a set of 8 goals and 21 targets, monitored through 60 indicators, to achieve progress towards the Declaration, with a target date of December 31, 2015.

The official launch of the MDGs represented a fundamental shift in development policy: it was the first time that a holistic framework to meet the world's (human) development needs had been established. A major strength of the framework derives from its focus on a limited selection of concrete, common human development targets and goals that can be monitored by statistically robust indicators. Its simplicity, transparency, and multi-dimensionality helped rally broad support for the goals, as well as a concentration of policy attention on a joint mission. The eight goals are: Eradicate Extreme Poverty and Hunger; Achieve Universal Primary Education; Promote Gender Equality and Empower Women; Reduce Child Mortality; Improve Maternal

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<sup>2</sup> World Bank investments in the 1950s and 1960s were dominated by industry and infrastructure. Later in that period, the Bank began investing in capacity and institution building as well. In the 1970s, under President Robert McNamara, the Bank became involved in more direct approaches to poverty reduction – pioneering strategies like 'basic human needs' and 'integrated rural development' (Goldman, 2005). McNamara argued that most World Bank loans completely ignored the 'poorest 40 percent', and pushed for a more comprehensive approach to poverty alleviation and lending to the poorest countries. He thus began to use the language and political ideology of 'development' rather than 'investment banking'. Whereas the World Bank made no loans for primary school education prior to his Presidency, by the end of McNamara's tenure in 1981 lending for education had increased significantly, as had lending for nutrition, population control, and health, which represented a major shift for the World Bank. He standardized these types of poverty alleviation investments not only for the World Bank, but for the transnational development agency network, as well as borrowing-states (Goldman, 2005).

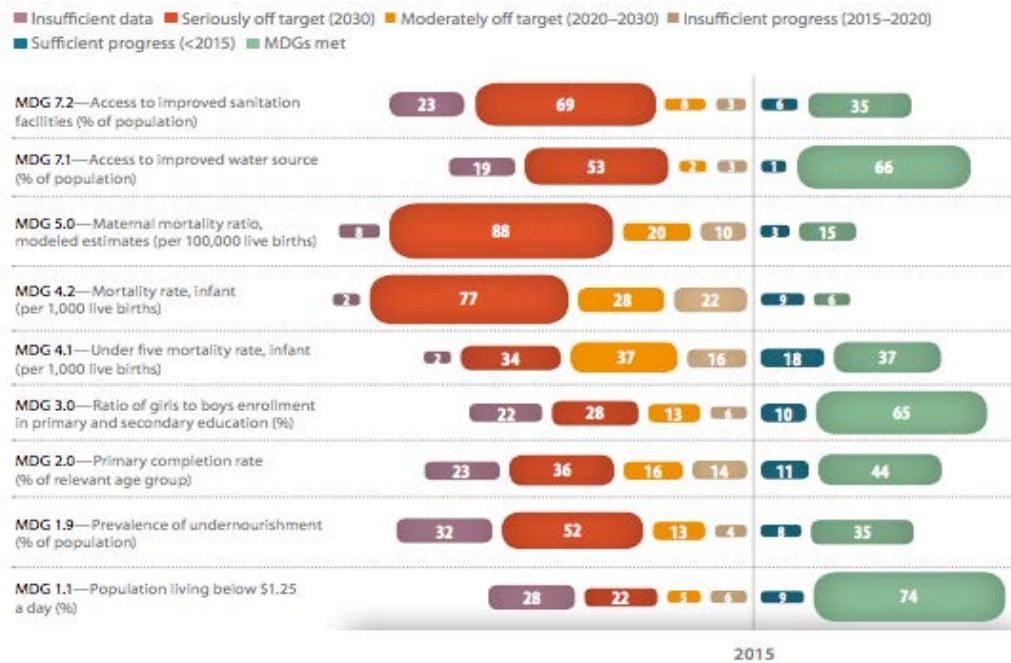
Health; Combat HIV/AIDS, malaria, and other diseases; Ensure Environmental Sustainability; and Develop a Global Partnership for Development.

The world has made significant progress in meeting the goals. The goal of halving extreme poverty has been met; 700 million fewer people lived in poverty in 2010 than in 1990. Access to primary education has made significant progress, with a 91% enrollment rate in developing countries in 2012, up from 77% in 1990. The number of people lacking access to safe drinking water has been halved, with 2 billion people gaining access from 1990 to 2010, improving the lives of over 100 million slum dwellers. Gender equality in education has improved. Women's political participation has continued to increase. And health care has become more accessible for millions of people (World Bank Development Indicators 2015).

But there is still much to be done. Many countries are lagging behind, and there is considerable discrepancy within countries. Approximately 1 billion people are still living in extreme poverty today. Hunger and malnutrition rose from 2007 through 2009, partially reversing prior gains. There has been slow progress in reaching full and productive employment and decent work for all, in achieving environmental sustainability, and in providing basic sanitation. New HIV infections still outpace the number of people starting antiretroviral treatment. The slow progress being made in reducing maternal mortality and improving maternal and reproductive health has been particularly worrisome. Sub-Saharan Africa's maternal mortality ratio currently stands at a staggering 500/100,000 – more than double the developing world average of 240/100,000 (ibid). Progress on many other targets is fragile and vulnerable to reversal. Monitoring and data, as well as financing and implementation, to be further discussed later in the paper, have proven to be major obstacles.



**Table 1: Extent of Progress toward Achieving the MDGs, by number of countries**



Source: WDI and GMR team estimates.

Note: Progress is based on extrapolation of latest five-year annual growth rates for each country, except for MDG5, which uses the last three years. Sufficient progress indicates that an extrapolation of the last observed data point with the growth rate over the last observable five-year period shows that the MDG can be attained. Insufficient progress is defined as being able to meet the MDG between 2016 and 2020. Moderately off target indicates that the MDG can be met between 2020 and 2030. Seriously off target indicates that the MDG will not even be met by 2030. Insufficient data points to the fact that not enough data points are available to estimate progress or that the MDG's starting value is missing (except for MDG2 and MDG3).

In the poverty target, 11 out of the 66 countries that have met the target have less than 2 percent of people living below \$1.25 a day.

### 3. Shaping the Post-2015 Development Agenda

One of the main outcomes of Rio+20 in 2012 was the agreement to launch intergovernmental processes to prepare the Sustainable Development Goals (SDGs), led by the United Nations. Two reports outline a vision for development post-2015. In July 2012, the UN Secretary General announced his High-Level Panel of Eminent Persons (HLP) to provide recommendations and guidance on the next development framework. The HLP report of May 2013 recommended 12 universal goals,<sup>3</sup> to be measured by national targets, which would only be considered 'achieved' if they are met for all income and social groups. Such goals and targets are supported by five transformative shifts to create the conditions and build the momentum to meet such ambitious

<sup>3</sup> End poverty; empower girls and women and achieve gender equality; provide quality education and lifelong learning; ensure healthy lives; ensure food security and good nutrition; achieve universal access to water and sanitation; secure sustainable energy; create jobs, sustainable livelihoods, and equitable growth; manage natural resource assets sustainably; ensure good governance and effective institutions; ensure stable and peaceful societies; create a global enabling environment and catalyse long-term finance (A New Global Partnership: Eradicate Poverty And Transform Economies Through Sustainable Development, The Report of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda, 2014)

goals: Leave no one behind; put sustainable development at the core; transform economies for jobs and inclusive growth; build peace and effective, open, and accountable institutions for all; and forge a new global partnership. In January 2013, the UN Open Working Group on Sustainable Development Goals was established and tasked with preparing a proposal for the Sustainable Development Goals. The proposal, submitted in July 2014, outlined 17 goals and 169 targets. As an intergovernmentally negotiated document, it represents a delicate political balance. The proposal forms the basis of the official SDG framework, to be presented during the UN summit for the adoption of the post-2015 development agenda.

One issue which impeded early efforts to achieve the MDGs was that the financing framework was not agreed upon until two years after the goals were adopted. To avoid a reoccurrence of this problem, the international community has agreed to establish an intergovernmentally-negotiated and agreed financing and implementation framework to support the SDGs prior to their adoption.<sup>4</sup>

Reports by the UN Intergovernmental Committee of Experts on Sustainable Development Finance and the World Bank both highlight four key pillars of financing for development: domestic resources (public and private) and international/external resources (public and private), as well as blended finance. Key issues in financing development include: improving the ability of poor countries to generate tax revenues and improve resource management; focusing aid on sectors unlikely to be served by private finance; using aid to leverage and attract more private sector financing to projects that support development (for example, infrastructure) through public-private partnerships and investment risk mitigation, coupled with innovative mechanisms such as carbon markets and other mechanisms to attract investors and sovereign wealth; directing resources through global funds to address some global public goods; efforts to mobilize diaspora financing for development (remittances exceeded \$400 billion in 2013); and building a more robust private sector by improving access to finance for micro, small, and medium-enterprises (MSMEs—the International Finance Corporation estimates the global financing gap for MSMEs to be at over \$3.5 trillion), as well as households. The most effective use of finance for development depends on the circumstances and state of development of each country. Islamic finance has the potential to play a role in supporting development, particularly as found in the SDGs, as it can allow for more robust growth, support outcomes with positive social impact, improve financial inclusion, and enhance resilience of the financial sector.

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<sup>4</sup> The Third International Conference on Financing for Development, scheduled to take place July 13-16, 2015 in Addis Ababa, Ethiopia

#### 4. Sustainable Development: Role of the Financial Sector

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' (UN undated: 3) and require engagement of different stakeholders including governments, businesses, financial institutions, civil society and nonprofits. The extent to which the private sector in general, and the financial industry in particular, can contribute to sustainable development will depend on both the economic returns on these projects and their orientation towards social and environmental issues. While there is an increasing global awareness that private firms should consider environmental, social and governance (ESG) issues in the decision making process (Caplan et. al. 2013),<sup>5</sup> contribution to ESG goals would depend on whether steps are taken to assimilate these in their operations.

At the international level, the International Finance Corporation (IFC) uses ESG criteria to assess projects for financing by assessing environmental and social risks and requiring clients to apply Performance Standards to mitigate these risks (IFC 2012).<sup>6</sup> Similarly, the UN has taken initiatives to encourage responsible investing under its UN Environment Programme (UNEP) Finance Initiative (UNEP 2011). Other than coming up with principles of integrating ESG goals in different businesses, the UNEP has issued guidelines showing how these can be implemented by different segments of the financial sector. These guidelines recommend that financial institutions should incorporate environmental and social risks in their risk assessment and management processes (ibid).

A financial institution's involvement in meeting social and environmental objectives will depend on its nature, orientation and culture. Organizational culture can be defined as 'the set of values, norms, and standards that control how employees work to achieve an organization's mission and goals' (Hills and Jones 2008: 30). Thus, an organization's mission and goals, along with its values and norms, would determine the importance given to social and environmental issues compared to the rate of return and risk. Maon *et al.* (2010) identify three cultural phases that firms experience concerning the incorporation of corporate social responsibility (CSR) in their operations. First, in the *CSR cultural reluctance* phase the firm ignores the social and environmental impact of its operations, and opposes any pressure from stakeholders to undertake CSR initiatives. In the second phase of *CSR cultural grasp*, the firm becomes aware

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<sup>5</sup> The initiatives have been termed variously as corporate social responsibility (CSR), socially responsible investment or social impact investments, corporate citizenship, corporate social performance, etc. (Caplan et. al 2013, Silberborn and Warren 2007).

<sup>6</sup> The performance standards of IFC include environmental and social risks, labor and working conditions, resource efficiency and pollution prevention, community health, safety and security, land acquisition and involuntary settlement, biodiversity conservation and sustainable management of natural resources, indigenous peoples and cultural heritage (IFC 2012).

that reduction of environmental and social burdens can protect its value in the long run, but takes a cautious approach. Finally, in the *CSR cultural embedment* phase, the firm integrates CSR within the organization, its decision making process and all its stakeholders. Essentially, the firm moves from viewing CSR as value-protection concept to one that is value-creating.

There are different investment strategies that the financial sector can take to achieve ESG goals. GSIA (2013) identifies four approaches. First is the *screening of investments* strategy, which can be negative, positive/best-in-class and norm-based. Whereas negative screening excludes some companies and sectors due to ESG criteria, under positive screening investments are made in firms for their contribution to ESG goals. Norm-based screening uses international standards on best practices to make decisions on investment.

The second investment strategy is *integration of ESG goals*, in which ESG considerations are integrated in traditional financial analysis. Capital markets and businesses move from a two-dimensional focus on risk and return in investment decisions, to add a third dimension of impact in terms of the building a better society (SIIT 2014). A related strategy is *sustainability themed investments*, which refers to financing sustainable industries such as clean energy, green technology, etc.

The third strategy is *impact/community investing*, whereby investments are made to solve social and environmental problems. Under this strategy, capital is invested in communities that are underserved or in businesses that have a social and environmental purpose.

The final strategy involves *corporate engagement and shareholder action*, whereby shareholders influence of companies to engage in ESG-related investments by explicitly expressing their views and preferences towards these issues.

The increase in awareness and measures taken on ESG issues is manifested in the significant growth in global sustainable investments during recent times. ESG-related investments were estimated at USD 13.6 trillion by the end of 2011, representing 21.8% of total assets managed in the key regions of the world (GSIA 2013). The bulk of sustainable investments were concentrated in Europe (USD 8.7 trillion; 64.5% of the total) followed by the United States (USD 3.7 trillion; 27.6% of the total). The Global Sustainable Investment Alliance (2013) reports that most of the global ESG investments were allocated to negative screening strategies (USD 8.2 trillion). Investments made based on a positive screening strategy totaled USD 1.01 trillion, while sustainability and impact/community based screening amounted to USD 83 billion and USD 89

billion, respectively.<sup>7</sup> While these figures represent considerable commitment to ESG goals, more can be done to channel sustainable investments to developing countries.

### III. ISLAMIC FINANCE AND SOCIAL SECTORS

Islamic finance seeks to ensure that financial practices and their accompanying legal instruments comply with Islamic law (*Shari'ah*). This section describes the basic principles of Islamic finance, how these principles are reflected in the instruments used and the policies of institutions that seek to be *Shari'ah* compliant, and the extent to which Islamic finance has contributed to social and environmental goals.

#### 1. Rules Governing Islamic Finance

Islamic law (Shariah) provides a comprehensive approach to various aspects of life, including economic dealings. In addition to legal rules, Shariah also provides moral principles relating to economic activities and transactions. It defines the founding concepts of an economic system, such as property rights, contracts, the objectives of economic activities, and principles that govern economic behavior and activities of individuals, markets, and the economy.

The basic notion that emanates from Islamic economic principles is 'freedom of action and collective responsibility' (Nasr 1989). Thus, the motivations of economic activity should be to meet one's own needs and also contribute to the good of the society (Siddiqi 1968). An inference of equality is the concept of justice, which forms one of the hallmarks of Islamic teachings. As establishing justice is one of the primary goals of Islam, an Islamic economic system would endeavor to eradicate "all forms of inequity, injustice, exploitation, oppression and wrong doing" (Chapra 1992).

Property rights in Islam are deemed sacred and gainful exchange and trade by mutual consent are encouraged. Kahf (1998) identifies some rules related to using one's property. These include balance in use, avoiding waste, using property without harming others (negative externalities) and conforming to the principles of Shari'ah when exchanging property. Ownership of wealth beyond a threshold level entails responsibilities towards others and obligates payment of alms (zakat). While commercial transactions are sanctified and encouraged as they preserve and support wealth and posterity (Hallaq 2004), transactions also must support the overall goal of Islamic law (maqasid), to promote welfare (maslahah) and prevent harm (mafsadah). From the perspective of society (macro maqasid), this implies that an economy should ensure growth and stability with equitable distribution of income, where every household earns a respectable income to satisfy basic needs (Chapra 1992). For example, achieving the objectives of optimal

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<sup>7</sup>Some investments are unallocated across strategies

growth and social justice in an Islamic economy would require universal education and employment generation (Naqvi 1981: 85). Laldin and Furqani (2012) identify the specific goal of Islamic finance as preservation of wealth, which can be done by acquiring and developing assets, by circulating wealth and protecting its value, and by protecting ownership and preserving wealth from damage.

From the perspective of an individual firm (*micro maqasid*), commercial transactions are subject to rules that prohibit engaging in harmful activities such as selling products that harm consumers, dumping toxic waste harmful to the environment or residential areas, engaging in overly speculative ventures, etc. *Shari'ah* compliance also implies fulfillment of the objectives of contracts (Kahf 2006), including upholding property rights, respecting the consistency of entitlements with the rights of ownership, linking transactions to real life activity, the transfer of property rights in sales, prohibiting debt sales, etc.

These principles have several implications for the financial transactions that are permissible under Islamic law. The two broad categories of prohibitions related to economic transactions recognized in *Shari'ah* are excess in loan contracts (*riba*) and excessive uncertainty and ambiguity in contracts (*gharar*).<sup>8</sup> *Riba*, which means usury, is prohibited by Islamic law. Although it is common to associate *riba* with interest, it has much wider implications and can take different forms. The common premise in the prohibition of *riba* lies in the unequal trade of values in exchange (Siddiqi 2014). One of the implications of *riba* is that debt cannot be sold at a discount and can be transferred at its par value only. Debt in Islamic finance would entail interest-free loans (*qard hassan*) or those created through real transactions. For example, Islamic financial institutions use debt instruments, such as a credit sale whereby the price of an asset/commodity is paid at a later date.

*Gharar* can exist in the terms of a contract because the consequences of a transaction are not clear or there is uncertainty about whether a transaction will take place. *Gharar* can also arise in the object of the contract arises when there is uncertainty about the subject matter of the sale and its delivery. *Gharar* is present when either the object of sale does not exist or the seller and/or buyer has no knowledge of the object being exchanged. One of the implications of *gharar* during contemporary times is the prohibition of derivative products such as forwards, swaps and options.

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<sup>8</sup>For different meanings of *gharar* see ElGamal, M. (2001) An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence. *Islamic Economic Studies* 8 at p. 32. For a detailed discussion on *gharar* see Kamali<sup>10</sup> and Al-Dhareer, SMA (1997) *Al-Gharar in Contracts and its Effect on Contemporary Transactions*. Jeddah: Islamic Research and Training Institute, Islamic Development Bank.

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' (*al-ghurm bi al-ghunm*) which associates 'entitlement of gain' to the 'responsibility of loss' (Kahf and Khan 1988: 30). This maxim implies a preference for using profit-loss sharing instruments (these instruments include *mudarabah*, an investment partnership whereby profits are shared per a pre-agreed ratio and the loss of investment is borne by the investor only and *musharakah*, an investment whereby profits are shared on a pre-agreed ratio and losses are shared in proportion to the investment of each partner). The second principle arises from the Prophetic saying which 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 ownership (Vogel, Hayes 1998). Associating profit and return with risks arising in business ventures or possession of assets changes the nature of the risks in *Shari'ah*-compliant financial transactions.

## 2. Voluntary and Charitable Sectors (*Zakat* and *Waqf*)

Obligatory alms (hereafter referred to as *zakat*) is one of the fundamental pillars of Islam that has direct economic bearing on the distribution of income and emancipation of the poor. Considered among one of the essential forms of worship, it requires Muslims whose wealth exceeds a certain threshold level (*nisab*) to distribute a percentage of their wealth and income among specified heads annually.<sup>9</sup> The percentage of *zakat* varies from 2.5% paid on assets such as cash, gold, silver, goods for trade, etc. to 5% on agricultural products if the crops are irrigated or 10% if they use water from natural sources such as rain, rivers or springs. Early Islamic history demonstrates that *zakat* was used as an effective distributive scheme in taking care of the poorer sections of the population in Muslim societies.<sup>10</sup>

Governments of a few countries, such as Saudi Arabia, Pakistan and Sudan, currently take the responsibility for collecting and distributing *zakat*. While *zakat* is collected on a mandatory basis in these countries, there are differences in the coverage of kinds of assets/properties on which *zakat* is levied. Several other countries, such as Jordan, Kuwait, Qatar, Bahrain, Bangladesh, Indonesia and Oman, have established governmental agencies to receive *zakat* paid on a voluntary basis (Kahf 1989 and 1997). The total *zakat* collection in most countries, however, is small. Kahf (1997) reports that *zakat* collected in Saudi Arabia, Yemen and Pakistan varies between 0.3-0.4 percent of GDP. Shirazi and Amin (2009), who studied the potential for

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<sup>9</sup> The Qur'an (9: 60) determines eight categories of recipients for *zakat* as the poor, the needy, people burdened with debt, people in bondage and slavery, the wayfarer/traveller, those in the path of God, those whose hearts have been reconciled and the administrators of *zakat*.

<sup>10</sup> Narrations from the time of Umar bin al Khattab (13-22H) and the period of Umar bin Abdul Aziz (99-101H) indicate that poverty was eliminated during the time of these two rulers, as *zakat* collected in some regions could not be disbursed due to lack of poor recipients (Kahf 2004).

institutionalized zakat to reduce the rate of poverty in Organization of the Islamic Conference (OIC) countries, estimate that the maximum that can be collected through zakat ranges between an average of 1.8 percent to 4.3 percent of GDP annually.<sup>11</sup>

*Waqf* is a charitable endowment that has wide economic implications and can play an important role in increasing social welfare.<sup>12</sup> Whereas the corpus of this endowment is usually immovable assets such as land and real estate, moveable assets such as cash, books, grain to use as seeds, etc. are also included. In addition to providing support for religious matters, which was its original purpose, *waqf* can be established for provision of economic relief to the poor and the needy, and to provide social services such as education, health care, public utilities, research, service animals and environmental protection. Examples of the latter types of *waqf* include those created to preserve forests, feed birds and maintain animals such as horses and cats (Kahf 2000 and 2004). One form of *waqf* is cash to be used either for providing interest-free loans or investing, with its return assigned to designated beneficiaries.

The *waqf* sector grew significantly in Muslim societies and became one of the most important institutions for poverty alleviation (Cizacka 2002). The historical significance of *waqf* in Muslim societies is evident from information available on its size. In the 19<sup>th</sup> century, the share of arable land devoted to *waqf* was three-quarters in some regions of the Ottoman empire, half in Algiers, and one-third in Tunis (Schoenblum 1999). Large investments in the social sector empowered the poor and succeeded in transforming society.

The status of *waqf*, however, has deteriorated in many Muslim countries during contemporary times. Not only have the existing *waqf* become dormant and unproductive, fewer new *waqf* are being established to serve social functions (Ahmed 2004). The large pool of *waqf* assets in most Muslim countries are dormant and not being used for socio-economic development purposes. For example, IRTI & TR (2013) report that Indonesia has 1400 sq. km of *waqf* land valued at US\$ 60 billion. If these assets yield a return of 5% per annum, then US\$ 3 billion could be used for various socio-economic purposes. Considering that there are other forms of *waqf* assets, the potential of utilizing *waqf* for effective social development schemes is huge but remains untapped.

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<sup>11</sup> Kahf (1989) estimates the potential range of *zakat* revenue in different countries to be from 0.9 percent to a high of 7.5 percent of GDP based on various assumptions. The average of the lower and higher ranges equals 1.8 and 4.3 percent of GDP. See also Ahmed (2004) for a discussion.

<sup>12</sup> For detailed discussions see El Asker and Haq (1995) for *zakat* and Basar (1987) and Cizaka (1996, 1998) for *waqf*.



#### IV. ISLAMIC FINANCE AND SUSTAINABLE DEVELOPMENT: PRACTICE AND EVIDENCE

Islamic financial assets increased at an annual rate of 17 percent from 2009-13, and are estimated to have exceeded USD 2 trillion in 2014 (The Economist 2014). Despite rapid growth, there is a view that Islamic finance has failed to fulfill social goals (Siddiqi 2004). Moving forward, the impact of Islamic finance on SDGs can be enhanced if the broader goals of *Shari'ah* are integrated into its operations. This section focuses on the role of Islamic finance in promoting resilience, increasing social sustainability (financial inclusion and reducing vulnerability), achieving environmental and social goals, and facilitating sustainable infrastructure development. The role of these factors in affecting different SDGs is considered in Annex table 2. For each of these factors, the current and potential roles that Islamic financial institutions, the capital market and the social sector can play are discussed.

##### 1. Enhancing Stability and Resilience of the Financial Sector

Islamic finance can play a role in improving the stability of the financial sector. The estimated USD 15 trillion in losses from the global financial crisis (GFC) highlights the vulnerability of the financial sector and the potential for reducing output and welfare (Yoon 2012).<sup>13</sup> Though various factors contributed to the GFC, one key cause was excessive debt (Buiter and Rahbari 2015, Mian and Sufi 2014 and Taleb and Spitzagel 2009). There is also some evidence that high levels of debt are generally associated with lower growth. Arcand et. al (2012) find that the financial sector increases economic growth when private sector credit is less than 100% of GDP, but reduces growth when credit expands beyond this level. Similarly, Cecchetti et. al (2011) find that levels of corporate debt exceeding 90% of GDP, and of household debt exceeding 85% of GDP, tend to slow down economic growth. Thus, financial sector stability may be increased by raising the proportion of equity modes of financing relative to debt (Buiter; Rahbari 2015 and Taleb; Spitzagel 2009).

The extensive use of instruments such as mortgage backed securities (MBS), collateralized debt obligations (CDO) and credit default swaps (CDS) also contributed to the crisis. The value of the overall notional amounts of over-the-counter (OTC) derivatives contracts reached \$596 trillion by the end of 2007, with CDS increasing by 36% during the second half of the year to reach \$58 trillion (BIS 2008). While some of these instruments are used for hedging purposes, the fact that the notional amounts of derivative contracts were more than 10 times the size of global GDP (\$54.3 trillion) indicates that most of them were used for speculation. Some of the derivatives do not have links to any real transactions or assets, creating risks that are complex and difficult to understand (LiPuma; Lee 2005). Furthermore, certain types of derivatives such as futures,

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<sup>13</sup> Researchers from the Federal Reserve Bank of Dallas estimate the losses from GFC in the US to be in the range of US\$ 6 to US\$ 14 trillion. See Atkinson et. al. (2013).

forwards and options can introduce risks of loss that go beyond the original investment (Swiss Banking 2001). These features can make the financial sector vulnerable to instability in the face of negative shocks.

Greater reliance on the principles underlying Islamic finance could improve financial sector stability. The principles of risk-sharing and linking finance to the real economy would limit the amount of debt that can be created. Furthermore, the prohibition of using derivative instruments for speculation would produce a relatively resilient and stable financial system. This is confirmed by some of the studies comparing the performance of the Islamic banking sector with its conventional counterpart. Hasan and Dridi (2010) show that during the years immediately after the crisis, Islamic banks were more resilient and achieved higher credit and asset growth than conventional banks. As a result, Islamic banks were assessed more favorably by rating agencies in the post-crisis era. Beck, Demirguc-Kunt and Merrouche (2010) find that in the period prior to the crisis (1995-2007), Islamic banks had higher capitalization and liquidity reserves compared to conventional banks, indicating more stability.

Although the evidence shows that the Islamic banking sector was more stable than conventional banks, there are concerns that the Islamic financial sector is closely mimicking its conventional counterpart and can potentially have similar problems. In particular, Islamic financial institutions appear to be using predominantly debt-based contracts, while the use of equity based modes is minimal (Khan 2010 and Mansour et. al 2015). Furthermore, some Islamic finance institutions use products that resemble derivatives that were partly blamed for exacerbating the crises (Ahmed 2009). For example, the features of tradable *sukuk* created through securitization of assets have features similar to those of CDO and MBS. Similarly, products similar to CDS exist in the form of return-swaps through which returns on the *Shari'ah* compliant asset can be swapped with returns on any type of asset, even ones that are not permissible by *Shari'ah*.<sup>14</sup>

### *Financial institutions*

A move from debt- to equity-based financing can decrease the likelihood of insolvencies in institutions and reduce systemic risks in the economy (Buiter; Rahbari 2015 and Taleb; Spitzagel 2009). As the nature of risks in equity financing is qualitatively different from that of debt financing, appropriate organizational and operational structures are needed that can manage the former risks. Islamic banks are typically based on conventional debt-based banking models, and thus lack the skills to manage equity risks effectively. The appropriate institutions to provide equity modes of financing include venture capital firms, private equity firms, investment banks, etc. These institutions manage risks of equity financing by playing an active role in advising and

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<sup>14</sup> For a critical discussion on return-swaps see Delorenzo (2007)

participating in the activities of firms to ensure that value is added before exiting. There are only a relatively small number of Islamic equity based organizations.

Other innovative organizational forms can also be used to introduce risk-sharing modes of financing. A unique equity based NBFIs is the *modaraba* companies in Pakistan that are established under the Modaraba Companies and Modaraba Floatation and Control Ordinance 1980 (Khan 1995). These financing institutions raise funds by issuing *Modaraba* certificates and use these in various income generating activities. The resulting profit is shared with investors at an agreed upon ratio. Another novel option is crowd funding that promotes investments in projects that can reap both economic and social benefits. While crowd funding is relatively new in most developing countries, Shari'ah compliant platforms are even rarer. Shekra, the first Shari'ah compliant crowd-funding platform launched in Egypt in 2013, provides opportunities to people to invest in enterprises (CCA and FCA 2013). This model could be expanded to other countries, although crowd funding requires a supporting ecosystem in terms of regulations, technology and active social media penetration.

The growth of equity-based Islamic financial institutions is constrained by a scarcity of professionals with an understanding of both the financial and business risks involved in equity finance, in particular the ability to manage counter-party risks by judicious structuring, coupled with strong monitoring and control of projects.

### *Capital Markets*

Expanding the role of Islamic finance in equity-based capital markets would require increasing its share in both stock and *sukuk* (bond) markets. Stock markets in most Muslim countries are still small and relatively underdeveloped. For example, the MENA region accounted for only 2% of global equity market wealth, compared to 13% for the BRIC (Brazil, Russia, India and China) countries (Saidi 2013). The share of stock market assets that satisfy Shari'ah requirements is even smaller. Increasing the size of stock markets in Muslim countries, and the role of Islamic equity in particular, would require setting up appropriate institutions and enabling legal and regulatory regimes that can promote listing of not only larger companies, but also medium and smaller size companies.

Whereas the bond markets in conventional finance are traditionally debt-based, *sukuk* can take various forms. *Sukuk* can be partnership-based (such as *musharakah* and *mudarabah*) and the risk-sharing features of these instruments can potentially enhance the stability of the financial markets. However, the use of equity-based *sukuk*, and in particular international transactions, has declined recently (Table 2).

**Table 2: Trends in Equity-Based *Sukuk* Issuances**

<b>Equity based <i>sukuk</i> (<i>Musharakah &amp; Mudarabah</i>)</b>	<b>2001-2008</b>	<b>2009-2012</b>
Domestic: Value (US\$ billions)	37	39.5
Percentage of Total	47%	14%
International: Value (US\$ billions)	13.5	2.6
Percentage of Total	36%	6%

Source: IIFM (2013)

The smaller size of equity-based securities is not a problem for the Islamic financial industry alone, but is indicative of a larger trend. McKinsey Global Institute projects that the share of the publicly-traded equities in global financial assets will fall from 28% to 22%, creating a equity gap of \$12.3 trillion by 2020 (Roxburgh et. al 2011). In the MENA region, the household sector (which holds close to 43% of total assets) invests 65% of their US\$ 2.7 trillion wealth in cash and deposits and only 18% in equities (Roxburgh et. al. 2011). Increasing the role of equity-based capital markets would, therefore, require providing appropriate products and instruments that satisfy the risk-return preferences of households. Although the number of Islamic funds has increased significantly, to 1,065, with a total valuation of US\$ 56 billion at the end of September 2013 (TR 2014), only 34% of the fund assets are equity based (IFSB 2014). As the funds industry is still a small fraction (4.7%) of global Islamic assets, there is a potential for further growth in this sector in general and for increasing the equity component of Shari'ah compliant mutual funds in particular.

The public sector can also play a part in increasing the equity capital markets by moving away from traditional debt based financing, for example by using risk-sharing capital market instruments, such as GDP-linked securities, to finance developmental projects. Though there have been some attempts to issue GDP-linked bonds, the risks arising from slow growth periods and accuracy in reporting of growth figures need to be managed to attract investors (Geddie 2014). Diaw et. al. (2104) propose a GDP-linked *sukuk* that can be used to raise funds in a Shari'ah compliant way to finance government expenditure. They suggest using a forward lease (*ijarah*) contract to structure the *sukuk* and link the rent paid to the investors to the GDP growth rate.

## **2. Inclusive Finance**

With the exception of a few countries in the Middle East and Southeast Asia, Muslim countries have some of the highest poverty rates in the world (Obaidullah and Khan 2008). Ensuring that the poor have access to a variety of financial services is critical to poverty reduction (ADB 2000: 1, United Nations 2006: 4). A large segment of the poor population, however, do not benefit from

formal financial services, either voluntarily due to cultural or religious reasons or involuntarily due to economic or social reasons (Mohieldin et. al. 2011).

The religious prohibition against charging interest is an important reason why many poor people in Muslim countries do not take advantage of financial services. Karim et al (2008) estimate that 72% of people living in the Muslim world do not use formal financial services, and that from 20% to more than 40% would not use conventional microfinance because it involves paying interest. Thus, increasing access to financial services in all segments of the population in these countries would require *Shari'ah* compliant financing.

In addition, the poor are often excluded from lending by formal financial institutions because they are high risk, because they cannot afford the cost involved in servicing loans, or because lenders find it too costly to collect sufficient information on their creditworthiness (World Bank 2008). Since delivering micro-financial services entails high risks and costs, sustainability becomes an important concern in providing microfinance. Organizations providing microfinance to the poor thus potentially face a tradeoff between depth of outreach and sustainability.<sup>15</sup> To cite one study, Hermes et.al (2011) find a tradeoff between outreach and sustainability among 435 microfinance institutions over 11 years.

Given the tension between sustainability and outreach, two broad approaches to microfinance can be identified. The first is the poverty approach, in which the financial institutions operate as nonprofits with the objective of providing finance to the poor and core-poor (Schreiner 2002). Under this approach, financial services are provided by NGOs, government agencies, cooperatives and development finance institutions (Bennett 1998). The second approach is commercial, wherein the goal of providing services is profit maximization (Schreiner 2002). The operations of financial institutions are self-sufficient and sustained by providing larger loans to the relatively less poor at higher interest rates. Though the commercial approach can help the growth of micro and small enterprises, it may fail as a tool to eliminate core poverty (Weiss and Montgomery 2005).

Islamic microfinance is provided by a small number of providers, covering less than 1% of total microfinance outreach (El-Zoghbi and Tarazi 2013). In a survey of 255 institutions globally, El-Zoghbi and Tarazi (2013) find that a large percentage of *Shari'ah* compliant microfinance institutions appear to be commercial (in terms of the two kinds of institutions described above) and include banks, non-bank financial institutions (NBFIs), and village/rural banks, though some

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<sup>15</sup> Navajas et al (2000) and Schreiner (2002) identify six dimensions of outreach. Of these, only two are relevant here. Whereas *breadth* of outreach is the number of clients served or the scale of operations, *depth* relates number of poor covered by any microfinance program.

of the latter are nonprofits. Nonprofits (NGOs and cooperatives) constitute only 14% of the institutions surveyed (Table 3).

**Table 3: Types of Institutions Offering Shari’ah Compliant Microfinance and Clients Reach**

Type of Institution	Numbers Percentage*	Clients Reach*	Scale Effectiveness
Village/Rural Banks	77%	16%	0.21
NGOs	10%	17%	1.70
NBFIs	5%	3%	0.60
Cooperatives	4%	1%	0.25
Commercial Banks	3%	60%	20
Others	1%	2%	2

Source: El-Zoghbi and Tarazi (2013)

Scale effectiveness<sup>16</sup> is highest for commercial banks, where 3% of the institutions serve 60% of the total clientele. Village/rural banks make up 77% of the institutions in the sample, but they serve only 16% of the clients. Their scale effectiveness is lowest, at 0.21. Similarly, the scale effectiveness of cooperatives and NBFIs is also low (at 0.25 and 0.60 respectively), with NGOs performing relatively better with a score of 1.70. Note that while commercial organizations do well in terms of scale (breadth) of outreach, Ahmed (2013) contends that they do not perform well in the depth of outreach compared to nonprofits. Furthermore, as nonprofits are not deposit taking institutions, they also face problems of scale due to lack of funds to expand operations (Ahmed 2002).

As Muslim countries have high levels of poverty and provision of microfinancial services by the Islamic financial sector is still very small, representing only 1% of the total (El-Zoghbi and Tarazi 2013), there is potential for Islamic finance to positively contribute to financial inclusion. Given the large gap that needs to be filled, the ways in which the Islamic financial institutions, capital markets and the social sector can promote financial inclusion are presented below.

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<sup>16</sup> Scale-effectiveness of different types of institutions is calculated by dividing the percentage of the clients reached by the percentage of the number of institutions. It indicates the average percentage of clients served by one percent of each institutional type.

## *Financial Institutions*

Karim et al (2008) assert that building sustainable business models is a key challenge for Islamic microfinance institutions. As the financing needs are significant, microfinance services have to be provided by both commercial and nonprofit institutions to cover different market segments. Though most Islamic banks are shying away from microfinance, provision of finance to the poor can be one way of manifesting their social role. Ahmed (2004) shows that Islamic banks are predisposed to providing microfinance. Using the example of the Rural Development Scheme (the microfinance program of Islami Bank Bangladesh Limited), he argues that Islamic banks can provide microfinance more efficiently than many existing microfinance institutions. Banks already have the skilled employees with the requisite know-how to expand their microfinance operations. Furthermore, as banks use their existing infrastructure and network of branches to provide microfinance, they can serve a large number of clients at relatively lower costs compared to other microfinance institutions.

Whereas Islamic banks can succeed in expanding the scale of operations and breadth of outreach, they may not be able to serve the poorer sections of the population (Ahmed 2013). The depth of outreach can be enhanced by expanding the provisions of financial services by diverse types of nonprofit organizations. In Indonesia, smaller institutions, such as village/rural banks, can complement the efforts of commercial banks by providing microfinance to poorer sections on a commercial basis. These institutions, both conventional (BPR) and Islamic (BPRS), are owned by individuals, nonprofits or companies. Seibel (2005: 24) notes that while conventional BPR have a commercial orientation, the owners of BPRS tend also to have social missions. The goal of BPRS includes assisting the enterprising poor while covering the costs of operations. In a sample of four BPRS, he finds that 6% of the clients had income levels below the official poverty line (Seibel 2005).

Elgamal (2006 and 2007b) asserts that an organizational format based on mutuality may reflect Islamic values in financing and suggests establishing non-profit financial institutions such as cooperatives, credit unions, mutual insurance companies as alternatives to Islamic banks. Though various Islamic financial cooperatives exist in different parts of the world, one of the more successful is Bank Kerjasama Rakyat Malaysia (Bank Rakyat) in Malaysia. This cooperative bank offers a variety of services, including savings and investments, consumer financing, commercial financing, financing small, medium and cooperative entrepreneurs, financial planning and electronic banking. The bank offers microfinance in the form of Islamic pawning services under the *ArRahnu* programme through all of its branches and specialized ArRahnu centers (Ahmed 2013).

Ahmed (2002) shows that nonprofit microfinance institutions in Bangladesh were successful in reaching the poorer clients and performed satisfactorily in terms of profitability. In Indonesia, Peramu Foundation (Yayasan Pengembangan Masyarakat Mustadh'afiin) operates three microfinance programs, two structured as cooperatives (Baitul Maal Tamwil and Koperasi Baytul Ikhtiar) and a rural bank (Bank Perkerditan Rakyat Syari'ah--BPRS). These programs provide financing to different types of clients, including the poor. Peramu is one of the few organizations that has integrated *zakat* funds in its microfinance programs (Ahmed 2013).

One way to expand financial inclusion by both conventional and Islamic financial institutions is to use information and communication technology (ICT) to lower the costs of operation and improve the sustainability of microfinance institutions. Several countries in Africa have been successful in introducing mobile technology to provide certain financial services (Demirguc-Kunt and Klapper 2013 and Fengler 2012). The financial services using mobile technology, however, are relatively simple, such as exchanging money, storing money for safe-keeping and money transfer (Dittus and Klein 2011). Although using ICT to provide more sophisticated financial transactions, such as deposits and loans, could increase access to many consumers, appropriate regulations may be needed to protect consumers and minimize the likelihood of creating financial instability (Mlachila et. al. 2013).

### *Capital Markets*

Islamic microfinance institutions face funding constraints due to, among other issues, regulatory restrictions on accepting deposits that limit their scale of operations. One way to overcome this constraint is to raise funds from capital markets in the form of microfinance and social impact funds. For example, the Bangladesh Rural Advancement Committee (BRAC) issued a zero coupon tax bond to raise USD 90 million in 2007 to finance its microfinance operations. The bond, issued in local currency *taka*, raised funds domestically from local investors to provide credit to small and tenant farmers (Rennison 2007 and Davis 2008). The Islamic financial sector has not yet tapped into capital market to raise funds for inclusive finance.

As financial inclusion also involves providing services such as savings, retail *sukuk* can provide opportunities to the household sector to invest in capital market products. Retail *sukuk* not only taps into newer market segments to raise funds, but also is an instrument of financial inclusion as it enables investors to participate in alternative investment products. The government of Indonesia issued a retail *sukuk* in 2014, to raise funds to finance development projects such as building roads and ports. The IDR 19.3 trillion (USD 1.7 billion) *sukuk* paying a return of 8.75% per annum is the largest-ever Islamic instrument issued in Indonesia. The *sukuk* was oversubscribed and bought by a variety of investors, including self-employed (32%), private sector employees (27%), housewives (17%), civil servants (4%) and army and police personnel (1%) (Ho 2014).



## *Social Sector*

An effective way in which *zakat* and *waqf* can be used to enhance productive capacities of the poor is to integrate these institutions with the financial sector. Given the charitable nature of *zakat* and *waqf*, these instruments can partially resolve the problem of tradeoff between outreach and sustainability. *Zakat* and *waqf* can be sources of subsidies to lower the costs of financial services provided to the core poor (Ahmed 2002, Ahmed 2011, Kahf 2004). Specifically, charitable funds can provide support and subsidies to sustain the activities of both non-profit organizations and commercial enterprises to expand their outreach to the poor.

Various suggestions of establishing *waqf*-based microfinance institutions have been put forward. Cizakca (2004) suggests a model in which cash *waqf* would be used to provide microfinance to the poor. Similarly, Elgari (2004) proposes establishing a nonprofit financial intermediary that provides interest-free loans (*qard hassan*) to the poor. The bank's capital would come from monetary (cash) *waqf* donated by wealthy Muslims. Ahmed (2011) and Kahf (2004) suggest a model of a *waqf*-based Islamic microfinance institution to serve the poor, which would be capitalized by cash *waqf*.

### **3. Reducing Vulnerability of the Poor and Mitigating Risk**

The way in which risks are managed in any society plays an important role not only in providing security to the poor, but also in determining innovation and growth (Greif et. al. 2011 and 2012). Poverty and vulnerability reinforce each other, as risk events can move households into poverty traps (Carter and Barrett 2006, Dercon 2004, Morduch 1994 and Wheeler and Haddad 2005).<sup>17</sup> Since negative shocks contribute to the persistence of poverty, WEF (2014) considers resilience against risks as one of the crucial features of social sustainability. A resilient social system is one that can 'absorb temporary or permanent shocks and adapt to quickly changing conditions without compromising on stability' (WEF 2014: 61). Resilience against negative shocks can be enhanced by formal and informal means by stakeholders at different levels (Holzmann and Jorgensen 2000).

Going forward, households and societies will face new and diverse risks that will require novel mitigating strategies. Shiller (2003) identifies some key risk management areas that may be relevant in the 21<sup>st</sup> century, including insurance for livelihood and home values, reducing the risks of hardship and bankruptcy, inequality insurance to protect the distribution of income and

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<sup>17</sup> The relationship between risks and poverty is confirmed by Suryahadi and Sumarto (2003) who find that in Indonesia the number of poor and vulnerable increased from one fifth of the population before the financial crisis of 1997 to one third after the crisis.

intergenerational social security. While these risks would require mitigation approaches at different levels, the financial sector would play an important role in addressing them.

The financial sector can reduce vulnerability by providing risk-mitigating services such as insurance to different segments of the population, including the poor.<sup>18</sup> As selling unbundled risk is prohibited by Shari'ah, risk mitigation from an Islamic perspective focuses on risk-sharing rather than risk-transferring mechanisms (Siddiqi 2009). As conventional insurance is deemed not to be *Shari'ah* compliant, various models of mutual guarantee (*takaful*) are developed as *Shari'ah* compliant insurance schemes.<sup>19</sup> *Takaful* is based on charitable donations (*tabarru'*) and cooperation or mutual help (*ta'awun*). The key organizational feature of the *takaful* is that of mutual insurance, whereby the policy holder takes up the role of ownership and risk-bearing, while the managerial function is performed by a *takaful* operator.

Although *takaful* can play an important role to enhance resilience, the current size of the industry is relatively small. IFSB (2014) reports that the global *takaful* contributions were \$18.3 billion during the first half of 2013, constituting only 1.1% of global Islamic financial assets. In 2012, 38.7% of the 200 total *takaful* operators were operating in the GCC region, followed by 20.1% in South East Asia. The small size of *takaful* operations reflects the low penetration of overall insurance in most of the countries in the region.<sup>20</sup> However, *takaful* increased at an average annual rate of 18% globally during 2007-2012, demonstrating potential to provide some of these services in the future (IFSB 2014).

### *Financial Institutions*

Low penetration of insurance in developing countries is indicative of the high growth potential of *takaful* in the future. As in the case of microfinance, both commercial and nonprofit approaches can be employed to provide micro*takaful* by using direct and indirect delivery channels. The direct delivery channel is one in which a *takaful* company provides services directly to participants, while in indirect channels the services are provided through agents and intermediaries.

Examples of commercial *takaful* services include Prime Islami Life Insurance (Ltd.) based in Bangladesh and Bank Rakyat, the largest cooperative bank in Malaysia, which offers micro*takaful*

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<sup>18</sup> Dercon (2004) shows that the impact of weather-related covariate shocks in Ethiopia increased poverty from 33% to 47% of the rural population. If all the shocks are insured, poverty goes down to 29%.

<sup>19</sup> Islamic Fiqh Academy declared conventional insurance as prohibited in Resolution No, 9 (9/2) and proposes using cooperative insurance (IRTI an IFA 2000: 13).

<sup>20</sup> Insurance penetration rates as a percentage of GDP for selected countries are 0.5% for Kuwait, 0.7% for Pakistan, 0.9% for Bangladesh, 1.3% for Turkey, 1.5% for Indonesia, 2.0% for UAE and 5.1% for Malaysia (IFSB 2014: 35).

products as an agent of other *takaful* operators. The scale of operation of these services is large, but they have not been successful in reaching the poor (Ahmed 2013).

Takaful T&T Friendly Society (TTTFS) is a nonprofit, multipurpose cooperative in Trinidad and Tobago that provides *microtakaful* services directly to the poor. TTTFS has sustained moderate surpluses over the years that have consistently resulted in an increase in reserves and the distribution of rebates. While the scheme provides *takaful* services to the poorer sections of the population, it covers only a limited number of members. Another example of a nonprofit organization serving the needs of the poor is Peramu Foundation in Indonesia, which provides *microtakaful* to its microfinance clients and non-clients. Using the indirect approach, it sells the *microtakaful* services to the poorer sections of population as an agent of other established *takaful* operators (Ahmed 2013).

### *Social Sector*

*Zakat* and *waqf* can be used to reduce the vulnerability and enhance the resilience of the poor. While traditionally *zakat* and *waqf* have acted as safety nets, their application can be expanded to protect the non-poor who are vulnerable to becoming poor due to adverse shocks. One approach is to provide interest free loans (*qard hassan*) to the vulnerable. Kahf (2004) indicates that in Sudan, *Diwan al Zakat* has initiated lending to farmers at the beginning of the agricultural season to enable them to buy necessary inputs; the loans are repaid after the harvest. This policy has increased the productivity of farms and increased *zakat* collection from farmers, equivalent to 74.4 percent of the loans. In case of negative shocks, *zakat* can be used for debt relief of the poor. Another effective way to reduce vulnerability is to use *zakat* and *waqf* funds to pay the monthly *takaful contributions* (premiums) to hedge against some defined risks. This scheme can increase the penetration of *takaful* services among the poor.

## **4. Contribution to Environmental and Social Issues**

Several studies find that the Islamic financial sector's role in addressing environmental and social goals is either small or non-existent. In a survey of the social reporting of 19 Islamic banks, Kamla and Rammal (2013) did not find any evidence of Islamic banks contributing to social development or having any 'serious schemes targeting poverty elimination or enhancing equitable redistribution of wealth in society' (Kamla and Rammal 2013: 933). They conclude that the 'failure to make social justice the core value of their operations has contributed to the failure of Islamic banks to fulfill their ideological claims' (Kamla and Rammal 2013: 933). Whereas Haniffa and Hudaib (2007) find high scores for commitment of Islamic banks towards stakeholders such as debtors and employees, the commitment towards society scored the lowest.

In a study of social reporting of 29 Islamic banks, Maali et al. (2006) find their charitable activities and employee-related issues to be moderately good. However, none of the Islamic banks report any activities related to environment. Similarly, interviews of 18 senior executives of Islamic financial institutions in the Gulf Cooperation Council (GCC) showed that corporate social responsibility is not a major concern for Islamic banks (Aribi and Arun 2012). The focus of their operations is on Shari'ah compliance, and none reported anything on environmental issues. In a study of 48 Islamic financial institutions from 19 countries, Sairally (2007) finds that though they did some corporate philanthropy, social responsibility was not an integral part of their business policy.

Evidence from Islamic capital markets also reveals similar patterns. The bulk of the Islamic investment screening used for the stock markets applies negative and exclusionary criteria. The focus of the screening is on legal prohibitions such as interest-based income and on prohibited sectors such as gambling, pornography, alcohol, etc. The current practice does not apply positive screening criteria, and commitment to socially-responsible business practices to support ESG goals seems to be negligible (BinMahfouz and Ahmed 2013). For example, issues such as employee rights, human rights, and environmentally-friendly production are not included in the contemporary Islamic investment decision-making processes (Wilson, 2004 and Forte and Miglietta, 2007).

The contribution of Islamic financial institutions to environmental and social goals would partly depend on how the broader goals (*maqasid*) of Islamic law are conceptualized and implemented. One reason of the poor performance of Islamic banks in this regard is that the contemporary notions of social and environmental sustainability have not been incorporated in *maqasid* and concepts related to Shari'ah compliance. Promoting *maqasid* to include the broader environmental and social perspectives at the operational level would, therefore, require modifying the concept of Shari'ah based financing and endorsing the environmental and social goals as essential components of macro-*maqasid*.

Some academic writings link the broader *maqasid* to environmental and social goals. However, an authoritative Shari'ah body, for example the OIC-affiliated Islamic *Fiqh* Academy, would have to recognize environmental, social and cultural issues as important elements of *maqasid al Shari'ah* to have the industry recognize these issues as integral to Islamic banking operations.

### *Financial Institutions*

Integrating environmental and social goals into the operations of Islamic financial institutions would require moving from the current ESG *cultural reluctance* phase (as defined above) prevalent in Islamic financial institutions to ESG *cultural grasp* and then to ESG *cultural embedment* phases. This would require, among other steps, actions by Boards of Directors to

ensure that ESG issues are integrated into the mission and goals of Islamic financial institutions and changes in values and norms to ones that embed the notion of *maqasid* in the broader sense.

Islamic financial institutions can also promote social and environmental goals indirectly by investing in the social sector to increase the capacity to produce social goods. Given that many *waqf* properties lie in prime areas of commercial importance, investments to develop these assets could greatly increase their return. Islamic Development Bank (IDB) established the *Awqaf* Properties Investment Fund (APIF) in 2001 to mobilize funds to promote and develop the *awqaf* properties worldwide. APIF invests in *waqf* properties that are socially, economically, and financially viable using Shariah-compliant modes of financing. At the national level, Bank Islamic Malaysia Berhad has been involved with investments of several *waqf* properties in Malaysia (Yusoh undated).

### *Capital Markets*

Responding to the high demand for responsible investing, various funds dealing with social issues (such as social impact and venture philanthropy) and the environment (such as climate change, carbon and environmental funds) have been launched in developed economies (KPMG and ALFI 2013). Due to a lack of awareness, the growth of Islamic-responsible investment funds has been scant. The practice of ethical financing in Islamic capital markets has been primarily focused on negative screening to avoid companies in certain sectors such as alcohol, tobacco, etc. and those not fulfilling specified financial ratios related to debt levels and impermissible income. Positive screening of companies related to ESG issues is new to the industry and has yet to take hold in the Islamic capital markets.

The Dow Jones (DJ) Islamic Market Sustainability Index, initiated in 2006, includes companies that are included in both the DJ Islamic index and the DJ Sustainability World Index. The companies in the DJ Islamic Market Sustainability index thus meet the negative screening criteria resulting from *Shari'ah* prohibitions and undertake the positive screening related to social and environmental issues. Information on the extent of use of this index is, however, not available. One of the first *Shari'ah*-compliant initiatives that uses ESG criteria was launched by SEDCO Capital, a Saudi Arabian asset management group, in 2013 (SEDCO 2014). SEDCO initiated three pioneering *Shari'ah*-compliant funds, representing more than US\$ 300 million of assets that use ESG filters.

A first of its kind, socially responsible and ethical US\$ 500 million *sukuk* was issued in 2014 by International Financial Facility for Immunization (IFFIm) to raise money for a vaccine fund (Chew 2014, Vizcaino 2014). With the World Bank acting as the treasury manager, IFFIm's revenue consists of legally-binding grant payments of approximately US\$ 6.3 billion from nine sovereign donors (IFFIM 2014). The three-year debt-based *sukuk* raised funds from institutional investors for Gavi, the Vaccine Alliance, to help protect millions of children from preventable diseases in

the world's poorest countries such as Afghanistan, Indonesia, Mali and Yemen. The *sukuk* was oversubscribed, with banks taking up 74% and central banks and official institutions taking 26% of the offering. The investors were mainly from the Middle East and Africa (68%), followed by Asia (21%) and Europe (11%).

As in the case of financial institutions, the capital markets can also contribute to the development of the social sector in general and *waqf* assets in particular. One example of an innovative *sukuk* used to develop *waqf* properties is that of King Abdul Aziz *Waqf* in Makkah, Saudi Arabia. Using a timeshare bond structure (*sukuk al intifa*), USD 390 million was raised for a tenure of for 24 years to construct the Zam Zam Tower Complex on land adjacent to the Holy Mosque in Makkah (Ahmed 2004). In Singapore, Islamic Religious Council of Singapore (MUIS) issued a *musharakah sukuk* to raise SGD 60 million to fund development of two *waqf* properties. Investments in one of the *waqf* properties increased the revenue from SGD 19,000 per annum in 1995 to an income of SGD 5.3 million in 2006 (Karim undated).

### *Social Sector*

Enhancing the role of *zakat* and *waqf* in social development would require a revival of these institutions, involving the resolution of two issues. First, there is a need to expand the assets on which *zakat* can be levied by revising the definitions of wealth to reflect contemporary times. One reason for the poor collection of *zakat* proceeds is the use of traditional interpretations that exclude many present day assets/properties on which *zakat* should be paid. Many traditional assets such as livestock are not owned by most individuals, while many modern-day assets such as stocks are not included under the definition of wealth (Kahf 1989 and 1997). Second, the efficiency and effectiveness of *zakat* institutions in terms of collection and disbursement need to be improved. This would require various measures at the legal, institutional and operational levels.<sup>21</sup>

Similarly, there is a need for a multifaceted approach to revive the *waqf* sector so that it can play an important role in social development. A few countries have taken steps to revitalize the *waqf* sector. For example, the Sudanese Awqaf Authority has sought donations to create new *waqf* and established an investment/construction department to develop the existing *waqf* properties to make them more productive and increase revenue (Kahf 2002: 295-98). Similarly, an autonomous General Secretariat of Awqaf was established in Kuwait that was responsible to manage the country's *waqf* assets. The secretariat created specialized investment funds for different objectives and invited donations to promote these objectives. Furthermore, a

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<sup>21</sup> For a discussion, see Ahmed (2004).

construction/development department is responsible for revitalizing the existing *waqf* properties (Kahf 2000: 299-304).

A large percentage of *waqf* assets have huge potential for revenue generation but remain undeveloped. For example, a study on a sample of 32 *waqf* properties from four states in India done by Islamic Research and Training Institute showed that only two *waqf* properties were developed, and the remaining 30 were either undeveloped or underdeveloped (IRTI 2000). With an average investment of USD 660,896, the expected income from each *waqf* property could be increased by USD 126,547 annually, giving an average rate of return of more than 19%.

## 5. Infrastructure Development

Infrastructure facilities provide the basic foundations for commerce and trade, enhance competitiveness, and are important determinants of long-term growth. While the total required global investments in infrastructure is estimated to be US\$ 100 trillion over the next two decades, only US\$ 24 trillion is expected to be spent before 2030, resulting in a shortage of around US\$ 60 trillion (WEF 2013: 12-13). Sustainable infrastructure development would require using approaches that are friendly towards the environment and society. Factoring in the need to slow climate change adds an extra cost of US\$ 0.7 trillion per year related to green investments (WEF 2013: 7).

While traditionally governments have been responsible for providing infrastructure facilities, in most countries they are burdened with large deficits and debt and find it difficult to generate resources. The huge demand for infrastructure investments calls for partnerships between private and public sectors, with the latter playing a facilitating role. The contribution of the private sector in providing infrastructure financing, however, is still small. World Bank (2008) estimates that 70-75% of total infrastructure financing in developing countries is provided by the public sector, 10% came from official development assistance and the remaining 15-20% from the private sector. There is a need to come up with innovative ways in which new players and financiers can fill the gap and contribute to the development of sustainable infrastructure.

Given the focus on the real economy and preferences for risk-sharing financing and social investments, the infrastructure sector provides an ideal business opportunity for Islamic finance. Moreover, financing infrastructure projects would be consistent with the ideology of Islamic financing, as these projects benefit the community at large (Miller and Morris 2008). The Islamic financial industry, however, has not been forthcoming in financing the infrastructure sector. For example, out of a total USD 40 billion *Shari'ah*-compatible financing in the GCC, only USD 9 billion went into infrastructure financing (Ernst and Young 2008).

Another potential source of funds for infrastructure financing by both the public and private sectors is through Islamic capital markets. After a slowdown of *sukuk* (Islamic investment certificates) issuance after the global financial crisis, the *sukuk* market has picked up again with the outstanding amount reaching \$245.3 billion during the first half of 2013 (IFSB 2014). The bulk of the *sukuk* (65.9%) was issued by governments. Funds raised by using *sukuk* for infrastructure projects are relatively small. For example, out of a total of USD 14.9 billion in *sukuk* issues during 2008, only USD 1.6 billion was used for infrastructure (S&P 2009). Recent figures show that the share of private sector *sukuk* used to finance infrastructure sectors is modest, with 9.1% being used for power and utilities and 7.4% for transport (IFSB 2104: 24).

### *Financial Institutions*

Syndicated financing is usually used to diversity the sources and risks of financing large infrastructure investments. Being a relatively new industry, Shari'ah-compliant syndicated financing is small and underdeveloped (Khaleq et al. 2012), reaching a peak of USD 26.7 billion in 2012 before declining to USD 21 billion in 2013. About 72% of this financing was used by the corporate sector, followed by sovereigns (18%) and quasi sovereigns (10%) (Khalifa undated). Since most of the Shari'ah-compliant syndicated financing was raised by the corporate sector, its use for infrastructure projects is likely small.

One of the first syndicated Islamic project finance deals was financing a tranche of the USD 1.8 billion Hub River Power Project in Pakistan in 1994. In this first private infrastructure project with limited recourse in Pakistan, Al Rajhi Bank and Investment Corporation and IICG Islamic Investment Bank financed a USD 92 million bridge financing facility to procure and install power turbines for the project (Clifford Chance 2009 and Hamwi and Aylward 1999). The potential of using Shari'ah compliant syndicated financing for infrastructure projects in the future can be expected to improve with the expansion of the industry.

### *Capital markets*

The successful experience of public and private *sukuk* issues signifies the potential of raising funds from private sector players and markets to finance infrastructure projects. Some countries have had success in using *sukuk* to raise funds for developmental purposes in general and financing infrastructure in particular. In Sudan, the government has introduced Government Investment Certificates (GIC) to finance procurement, trade, and development projects (Ali 2005). Bank Milli (the Central Bank of Iran) has issued participation bonds for, among others things, construction of infrastructure projects (Siddiqi 1999).

Retail *sukuk* can also be used to finance infrastructure projects. For example, DanaInfra Nasional Berhad, a company owned by the Malaysian Ministry of Finance, issued the DanaInfra Retail



Sukuk to finance the extension of the capital city's Mass Rapid Transit (MRT) rail network, the country's most extensive infrastructure project. The company has raised a total of RM2.5 billion (US\$789.14 million) by selling three tranches of *sukuk* of RM1.6 billion, RM300 million and RM400 million with tenors of 7 to 20 years. Priced at MYR 100 per unit and requiring a minimum subscription of MYR 1000, the 7 year *sukuk* will pay a return of 4.23% per annum. Investors can buy the *sukuk* by using, among other modes, internet banking or automated teller machines (ATMs) of participating banks and financial institutions (Star 2014 and DNB 2014).

## V. CONCLUDING REMARKS

The role of the Islamic financial industry in supporting the SDGs will depend on the extent to which stakeholders can influence its direction. The industry has been driven predominantly by supply-side factors and considerations and demand for it dominated by the household sector, with other sectors, such as institutional investors, corporations and governments, showing varying degrees of interest. There are important factors on the demand side that are likely to change the dynamics of Islamic finance and could link it more profoundly to the SDGs, especially if one of the most distinctive characteristics of Islamic finance – backing financial transactions by real economic activities – is fully operationalized. Some important demand-side factors include the recent rise in demand for Islamic finance products by enterprises across sectors and sizes, as well as the growing demand by sovereign and quasi-sovereign entities for long-term finance based on Islamic principles.

It is worth mentioning that a more effective role for Islamic finance in the implementation of the SDGs would require the supply of an innovative mix of products, adequate governance of Islamic finance intermediaries, and a supportive legal and regulatory framework. Based on the experience with the MDGs, and given the requirements of Islamic finance instruments for better ex-ante and ex-post understanding and scrutiny of transactions, the need for high quality data cannot be overemphasized.

Islamic finance principles support socially-inclusive, environmentally-friendly and development-promoting activities. However in practice, the industry's contribution to these objectives has been below its potential. And despite the fact that it has been growing, its share globally remains small, even in Muslim countries. Practical measures are required to enhance the contribution of the Islamic financial sector to achieve the SDGs. We have identified five tracks through which Islamic Finance could support efforts to achieve the SDGs: financial stability, financial inclusion, reducing vulnerability, social and environmental activities, and infrastructure finance, as summarized in annex 1.

As mentioned earlier, financing for development focuses on four foundational pillars: domestic resource mobilization, better and smarter aid, domestic private finance, and external private

finance. In this context, Islamic finance has the potential to play a major role in supporting all four of these pillars. Given the magnitude of the SDGs and the important role that can be played by Islamic finance in supporting their implementation and ensuring more robust and inclusive growth, the opportunity to more closely link Islamic finance with sustainable development cannot be missed.

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Annex table 1

	<b>Financial Institutions</b>	<b>Capital Markets</b>	<b>Social Sector-Zakat and Waqf (Z&amp;W)</b>
<b>Financial Stability</b>	<ul style="list-style-type: none"> <li>Organizational diversity (VC private equity firms, <i>modarabah</i> companies, etc.)</li> <li>Equity based financing</li> <li>New equity-based financial firms</li> </ul>	<ul style="list-style-type: none"> <li>Expansion of equity based capital markets</li> <li>Listing opportunities for medium and smaller firms</li> <li>Public and private risk-sharing <i>sukuk</i></li> </ul>	
<b>Financial Inclusion</b>	<ul style="list-style-type: none"> <li>Special units to serve microfinance in Islamic banks</li> <li>Organizational diversity (cooperatives, NPOs, etc.)</li> <li>Use of ICT to expand provision of services</li> </ul>	<ul style="list-style-type: none"> <li>Social Sukuk to raise funds (BRAC)</li> <li>Retail <i>sukuk</i></li> </ul>	<ul style="list-style-type: none"> <li>Integration with microfinance</li> <li>Waqf /zakat based MFIs</li> <li>Subsidize MFIs</li> </ul>
<b>Reducing Vulnerability</b>	<ul style="list-style-type: none"> <li>Savings opportunities for the poor</li> <li>Expansion of micro-<i>takaful</i></li> </ul>		<ul style="list-style-type: none"> <li>Using zakat and waqf as safety nets</li> <li>Use waqf/zakat to pay contributions for <i>takaful</i></li> </ul>
<b>Social and Environmental Factors</b>	<ul style="list-style-type: none"> <li>Incorporation of macro-<i>maqasid</i> perspective in operations</li> <li>Financing development of social sector</li> </ul>	<ul style="list-style-type: none"> <li>Positive screening (along with negative screening)</li> <li>Social <i>sukuk</i></li> <li>Sukuk to develop waqf</li> </ul>	<ul style="list-style-type: none"> <li>Expand zakat and waqf base</li> <li>Increase the efficiency and effectiveness of Z&amp;W</li> </ul>
<b>Infrastructure Development</b>	<ul style="list-style-type: none"> <li>Syndicated finance</li> </ul>	<ul style="list-style-type: none"> <li>Private/public sector sukuk for infrastructures</li> <li>Retail sukuk</li> </ul>	<ul style="list-style-type: none"> <li></li> </ul>

**Annex table 2: Contribution of the financial and social sectors to SDGs**

SDGs	Financial Inclusion	Reduce Vulnerability	Social and Environmental Impact	Infrastructure Development
1. End poverty everywhere	x	X		
2. End hunger, achieve food security and improved nutrition and promote sustainable agriculture	x	X	X	
3. Ensure healthy lives and promote well-being for all at all ages	x	X	X	
4. Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all			X	
5. Achieve gender equality and empower all women and girls	X		X	
6. Ensure availability and sustainable management of water and sanitation for all			X	x
7. Ensure access to affordable, reliable, sustainable and modern energy for all				x
8. Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all	x	X		
9. Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation				X
10. Reduce inequality within and among countries				
11. Make cities and human settlements inclusive, safe, resilient and sustainable			X	X
12. Ensure sustainable consumption and production patterns				
13. Take urgent action to combat climate change and its impacts			X	
14. Conserve and sustainably use the oceans, seas and marine resources for sustainable development			X	
15. Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss			X	
16. Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels	X		X	
17. Strengthen the means of implementation and revitalize the global partnership for sustainable development			X	X