



# Economic Premise

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## Realizing the Potential of Islamic Finance

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*Islamic finance has been growing rapidly in recent years. Motivated by a heightened interest in financial instruments that emphasize risk sharing, it has been attracting greater attention in the wake of the recent financial crisis. This class of instruments appears to have avoided many of the most severe consequences of the crisis. Several features underpin the expansion and performance of Islamic finance. Addressing key regulatory and governance issues will be essential for Islamic finance to achieve its full potential. Several multilateral development institutions, including the World Bank, have longstanding programs to support the development of the industry and have used Islamic instruments, to varying extents, to tap capital markets. In the coming years, Islamic finance could account for a substantial share of financial services in several countries, meeting the preferences of significant numbers of people, enhancing financial inclusion and intermediation, and contributing more broadly to financial stability and development.*

### Islamic Finance: What Is Different?

The concept of Islamic or Shariah-compliant finance is based on core tenets of Islam concerning property rights, social and economic justice, wealth distribution, and governance. One of the key features of the system is prohibition of *riba* (interest) and *gharar* (ambiguous contracts or deals) (Kabir and Mahlkrecht 2011, 74; El-Gamal 2009, 58–60). There is consensus among scholars that the prohibition of interest is not limited to usury but refers to interest on debt in any form (Iqbal and Mirakhor 2011, 10). The prohibition of *gharar*<sup>1</sup> is to discourage excessive uncertainty in contracts, enhance disclosure, and proscribe all forms of deception. In addition to the prohibition of *riba* and *gharar*, Islamic finance has seven key precepts. Implemented fully, Islamic finance:

1. Eliminates pure debt securities from the financial system, replacing interest by the rate of return earned ex post on contracts of exchange or risk sharing.
2. Calls for bank deposits to be collected on a profit/loss-(PLS) sharing basis rather than fixed predetermined liabilities. All profits and/or losses on the asset side are to be passed through to the investors (depositors) on the liabilities side (Dar and Presley 2000, 1; Ayub 2007).
3. Promotes financing of trade and exchange of goods and services to ensure a close link between the real economy and the financial sector, because all financial contracts should be backed by assets or transactions/activities in the real economic sector.
4. Upholds property rights for the individual and society, and clarifies the sources of individual ownership.<sup>2</sup>
5. Mandates fulfillment and sanctity of contracts that deal with trade in goods and services, as well as transfer of ownership and honoring of debt obligations (Ayub 2007, chapter 5).

6. Emphasizes principles of morality and ethics in business conduct, proscribing illicit activities according to Shariah (El-Ghazali 2002), and mandating that all economic activities be governed by rules of fair dealing and justice.<sup>3</sup>
7. Advocates the sharing of risk and reward between the rich and the poor through specific instruments of re-distribution.

These elements constitute an alternative approach to conventional finance. Since their development in the mid-1970s,<sup>4</sup> Islamic financial institutions have increasingly provided attractive channels for financial intermediation and have grown rapidly, especially in the last decade (Hassan and Dridi 2010, 8).

### Islamic Finance and Financial Stability

Proponents claim that Islamic finance contributes to the stability of the financial system. During the recent financial crisis, Islamic financial institutions were affected by the adverse second-round effects of the crisis: when the real economy contracted, real estate prices got depressed, and in some cases, issues of Islamic bonds (*Sukuk* or certificate of ownership) defaulted. However, Islamic banks generally escaped the worst effects of the 2008 financial crisis, because they were not exposed to subprime and toxic assets, and had maintained their close connection to the real sector. Hence, some observers have suggested that conventional banking can learn from the alternative systems offered by Islamic finance, which is less skewed toward debt instruments, uses equity for greater risk sharing, and limits the mismatch of short-term demand deposits with long-term loan contracts (Rogoff 2011, 1).

The performance and relative stability of Islamic financial institutions during the crisis stems from the distinctive features of the instruments they offer. As mentioned above, Islamic finance emphasizes asset backing and the principle of risk sharing, ensuring a direct link between financial transactions and real sector activities. The return on savings and investment is closely linked (determined by the real sector, not the financial sector), giving Islamic finance instruments a flexible adjustment mechanism in the case of unanticipated shocks. The adjustment mechanism ensures that the real values of assets and liabilities will be equal at all points in time, and prohibits excessive risk taking, thereby avoiding several forms of complicated securitization. Ex post, Islamic finance is also more equitable, because investors or partners share in the outcome of the partnership, be it profit or loss (Chapra 2008, 16).

Whether both partners provide capital and have the right to manage the project (*musharakah*), or one partner provides the capital and the other works with it (*mudarabah*), there is an emphasis on equitable risk allocation among partners. The same principals are extended in the mutual insurance contracts (*takaful*), which also have a mechanism for fair risk sharing among participants.

Reliance on equity-type financing arrangements helps restrain excessive leveraging. The close link between the amount

of financing and an underlying asset also helps limit leverage. The sharing of risk and reward (*al ghonm bel ghorm*) implies that long-term targets become more important and excessive short-term risk taking is discouraged (El-Ghazali 1986, 65). Financial institutions are more like business partners with their clients, and have stronger incentives to evaluate funding requests carefully and exercise prudence in extending such financing. As business partners, financial institutions are more likely to assist borrowers in working through bad times, thus lowering the pressure to sell assets at “fire-sale” prices. This protects the system against a general fall in asset prices and reduces the probability of cascading defaults. The sharing of losses reduces the probability of contagion to the rest of the financial system. Moreover, Islamic finance protects the exchange/transaction role of a banking system by limiting the risk on deposit balances (Mohieldin 1995, 4).

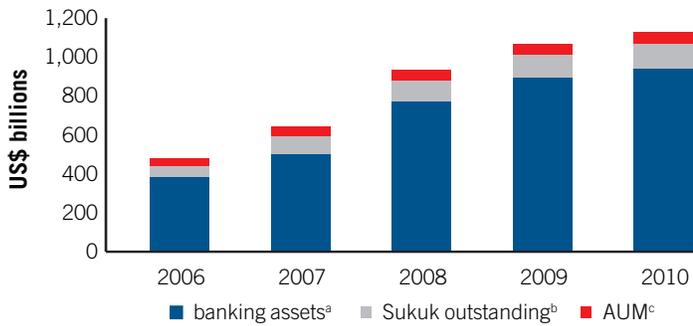
### Shariah-Compliant Financial Assets Have Been Growing Strongly

Global Shariah-compliant financial assets have increased significantly over the past three decades, reaching about US\$1 trillion in 2010 (figure 1), up from about US\$5 billion in the late 1980s. Banking assets account for the bulk of this increase, complemented by *Sukuk* and assets under management (AUM). Banking assets have been growing rapidly for several decades and rose from about US\$386 billion in 2006 to US\$939 billion in 2010 (figure 1). Preliminary estimates suggest that they climbed further to about US\$1.1 trillion in 2011 (Deutsche Bank 2011, 5). In recent years, growth in Islamic financial assets has generally outperformed conventional financial instruments, particularly following the onset of the financial crisis that has been gripping the world since 2008.

The global market in *Sukuk* has expanded rapidly during this period. *Sukuk*, or Islamic bonds, are certificates of ownership that are based on the concept of joint ownership of an asset by several financiers, giving it features more like securitized equity-type financing. After dipping with the start of the global financial crisis in 2008, the total volume of issuances more than doubled to reach roughly the equivalent of US\$48 billion in 2010 (figure 2). Markets absorbed an average of 800 new issuances a year during 2009 and 2010, driven by a heightened demand for asset-backed instruments. In the first 10 months of 2011, the total volume of *Sukuk* issuances rose further to about US\$50 billion. Although the *Sukuk* market is small compared to conventional fixed-income or securitized products, the weaker performance of conventional instruments during the crisis is combining with a greater recognition by issuers that *Sukuk* are a feasible alternative to boost market appetite.

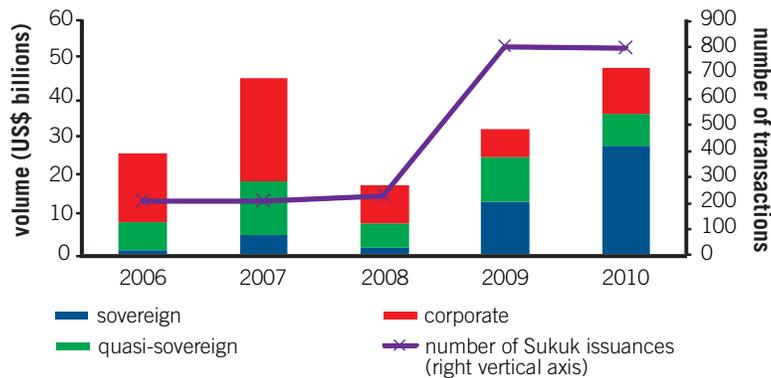
Malaysia is the global market leader for *Sukuk* issuance, accounting for 63 percent of cumulative *Sukuk* issuances between 1996 and 2010 (figure 3). Malaysia issues long-term, local currency *Sukuk* to fund infrastructure projects and

**Figure 1. Global Shariah-Compliant Financial Assets**



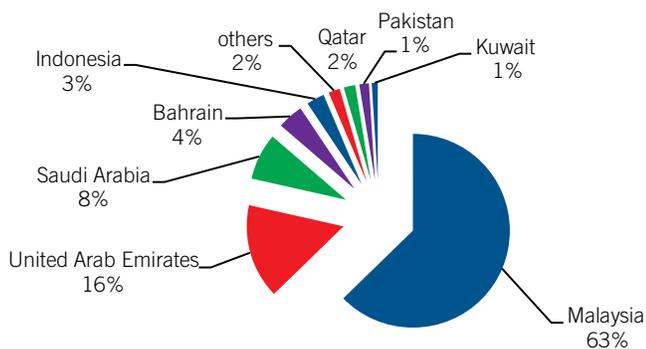
Sources: (a) Deutsche Bank 2011; (b) International Islamic Financial Markets database, March 2012; and (c) Ernest & Young 2011a.

**Figure 2. Global Sukuk Issuances**



Source: Islamic Finance Information Services Database, October 2011.

**Figure 3. Cumulative Sukuk Issuances (1996–2010)**



Source: Islamic Finance Information Services Database, October 2011.

contribute to financial stability. The countries of the Gulf Cooperation Council (GCC) hold almost 31 percent of global market share in Sukuk, and several large transactions, like Dubai's issuance of a US\$3.5 billion Sukuk in 2006 and Qatar's issuance of a US\$9.1 billion Sukuk in 2011, are demonstrating the large potential of Sukuk as a viable way to finance large projects. Saudi Arabia is also considering expanding Sukuk as a vehicle to fund its future infrastructure investments.

Islamic financial instruments are currently available in at least 70 countries, with widely varying shares of banking services compared to conventional equivalents. The recent financial crisis affected the asset quality of conventional banks adversely. In contrast, as shown in recent research, Islamic banks had higher asset quality, were better capitalized, and more likely to continue their financial intermediation role during the crisis than their conventional counterparts (Beck, Demirgüç-Kunt, and Merrouche 2012, 20).

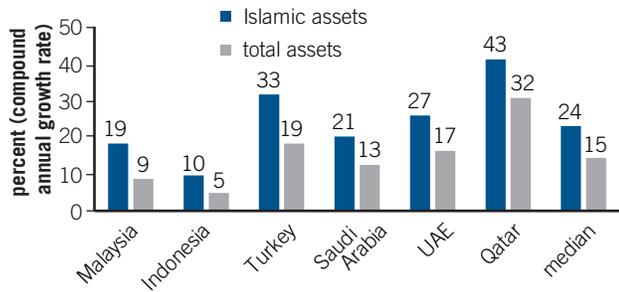
The growth of Islamic banks has been significant during the past five years. For example in Qatar, the assets of Islamic banks expanded by 43 percent during 2006–10, substantially faster than the growth in assets of conventional banks, and constituted around 23 percent of the country's total banking assets in 2010. Turkey's Islamic banking sector also grew rapidly compared to conventional counterparts (figure 4).

Islamic mutual funds come in different flavors, dominated by equity, leasing, and commodity funds. The growth of such AUM has slowed since 2008, after expanding by more than 20 percent a year in the first half of the decade. The sector remains dynamic, however, with the number of Islamic funds reaching 699 in mid-2011, compared with 608 in 2009 (Ernest & Young 2011a, 2).

In addition to banking, AUM, and capital markets, there is a very vibrant industry of Shariah-compliant financing in other asset classes such as venture capital, private equity, and project finance. Several major infrastructure projects are being financed through Shariah-compliant modes of financing.

It is worth noting that the World Bank Group has sought to support Islamic finance through a variety of initiatives, ranging from academic research to execution of transactions. Engagement on technical assistance, advice, and outreach has centered on collaboration with standard-setting institutions like the Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI) and the Islamic Financial Services Board (IFSB), as well as work at the country level. The World Bank Group has also tapped Islamic financial markets. The Multilateral Investment Guarantee Agency completed a transaction in Indonesia in FY11, using a *murabaha* instrument involving exposure of some US\$450 million to improve the quality of the mobile network and increase population coverage. The International Bank for Reconstruction and Development launched a five-year RM760 million Islamic bond in 2005, using the well-tested format of *bai bithaman ajil*, which had previously been used successfully by the International Finance Corporation (IFC), also in the Malaysian market. Recently, IFC also issued Sukuk against a portfolio of leases, which was well received in the market.

**Figure 4. Growth of Islamic Banking and Conventional Banking Assets in Selected Countries (2006–10)**



Source: Deutsche Bank 2011, 10.

## Challenges and Prospects

Several challenges need to be addressed in order to realize the full potential of Islamic finance, including: improving regulatory oversight, rebalancing tax treatment, strengthening insolvency frameworks, promoting standardization, ensuring adequate liquidity, and establishing sound risk-management practices. Knowledge sharing can play an important role in underpinning initiatives in all of these areas.

Sound regulation is essential for a well-functioning financial sector. More effort is needed in order to ensure effective regulation of Islamic financial institutions. Initiatives to improve the regulatory framework have varied from minimal alterations in the United Kingdom, to a dual approach in Bahrain and Oman. Under the dual approach, conventional banks and Islamic banks are chartered and supervised separately, giving Islamic banks greater autonomy and banning conventional banks from offering Shariah-compliant services. Issues of compliance and standardization in Islamic finance are being remedied through internationally recognized standard-setting bodies for Islamic accounting and auditing (AAIOFI) and supervision (IFSB). The mandate of these organizations is to promote common risk-management, accounting, and governance standards. Addressing these factors is helping to lower entry barriers and facilitating product development and innovation, essentially by allowing conventional banks to use their existing networks to provide Shariah-compliant financial services.

The rapid expansion in the use of Shariah-compliant instruments has increased the urgency to improve exit rules in the event of Islamic financial institution insolvency. There is also a need to establish reliable mechanisms for dealing with Sukuk defaults, as well as transparent frameworks to address adverse outcomes, with special adaptations for risk sharing. Setting up these mechanisms requires the specification of parties' rights under Shariah-compliant finance, especially in the case of cross-border transactions. More work is needed to ensure convergence between best insolvency practices on the conventional and Shariah-compliant sides.

In many countries, leveling the playing field with respect to the tax treatment of financial instruments is an urgent need.

At present, conventional debt often receives advantageous tax treatment (encouraging leverage), while some Islamic finance products face double taxation, especially investment income generated from Sukuk. Malaysia and Thailand took fundamental steps to ensure that Islamic financial transactions operate on a level playing field and are treated equally for tax purposes. In Malaysia, this principle has extended to ensuring that profits, asset transfers, and expatriation of profits by foreigners are treated equally, whether occurring under conventional or Islamic financial contracts. In Thailand, a package of proposed tax changes for Sukuk issuances has been introduced to address the main hurdles faced by Sukuk issuers: (i) exempting the originator from income tax, value-added tax, special business tax and stamp duty, and (ii) treating investment income from Sukuk, or capital gains from selling Sukuk, the same as conventional counterparts for the purpose of computing annual income tax (Kuwait Finance House 2011, 11).

Lack of standardization and cohesion, especially in Sukuk products, hinders the growth potential of Islamic finance and deprives the market of an organized structure to facilitate secondary trading and liquidity. For example, the industry would benefit from more widely accepted benchmarks and indices. Innovation and knowledge sharing between various market players are essential to facilitate the standardization and unification of global markets for Islamic financial products.

A challenging area in generating adequate liquidity is the divergence between fully guaranteed Sukuk by sponsors (for example, corporate bonds), partially guaranteed Sukuk, and those that are not covered by any guarantee. Infrastructure companies that are looking to raise funds to finance projects are more likely to adopt Sukuk structures with full guarantees. In the case of stand-alone infrastructure projects, asset-backed Sukuk with no guarantees from the sponsors may be more attractive. The challenge is that these structures are uncommon and poorly understood. Although investors seem keen to invest in Sukuk that will give creditors control of the underlying assets in the event of a default, the market is underdeveloped, partly because Sukuk transactions without guarantees tend to be lengthier, costlier, and more complex. This is an area that needs innovative solutions based on sharing knowledge of what can work on the ground.

While the theoretical framework of Islamic finance and the main principles provide an alternative paradigm and guidance to practical solutions for funding requirements of economic activities, many aspects of the practice of Islamic finance suffer from emulation and reengineering of conventional instruments. This has resulted in inefficient replications of conventional instruments and higher transaction costs.<sup>5</sup>

Moreover, the challenges associated with Basel III compliance and concerns about liquidity risk management need to be addressed. By relying on equity-based finance, Islamic banks incur a higher cost of capital, since by definition they

hold more equity than conventional banks. This places Islamic financial institutions at a disadvantage under Basel III's new core tier 1 capital requirements. The current standards of the IFSB and the Bank of International Settlements are in agreement on Basel III's guidelines on asset risk weighting, credit risk mitigation, market risk, operational risk, and eligible capital for Islamic financial institutions. Still, more work is needed to find a greater convergence on the rules governing risk weighting and the treatment of investment accounts in Islamic banks.

Islamic financial services are overly concentrated in the banking business, yet nonbank financial instruments, such as mortgages and mutual insurance *takaful*, are growing rapidly, especially in Southeast Asian markets (Ernst & Young 2011b, 12). For example, gross *takaful* contributions expanded by 67 percent in Indonesia in 2009. Key challenges to the future growth of the nonbank financial instruments are limited competition and lack of diversification. More work is also needed on consumer awareness and financial literacy. The Islamic mortgage industry is also underdeveloped. Strong growth can be expected in the GCC going forward, spurred by the increasingly affluent younger generations (about 65 percent of the population in the GCC is under the age of 30) and the advent of the institution of freehold property. Recent estimates show that Saudi Arabia alone may see Islamic mortgage assets rise to US\$100 billion in the coming years.

Despite the aforementioned challenges, the prospects for the expansion of Islamic finance are strong. Entrepreneurs in the business sector are demanding more Shariah-compliant products to finance their investments. Meanwhile, there are important factors that continue to contribute to the growth of Islamic finance (Mohieldin 2012, 1):

1. The commodity boom has generated surpluses in some Muslim countries that need to be allocated through financial intermediaries and sovereign wealth funds.
2. Through quality improvements and the development of new instruments, Islamic finance is increasingly considered a practical alternative to conventional instruments for savers and investors.
3. Conventional multinational financial institutions are offering Islamic windows and have increased their Islamic finance operations and portfolios to meet growing demand in London, Luxembourg, and other capitals.
4. The formation of Shariah-compliant indices for companies listed in stock markets is boosting the demand for Islamic finance.
5. Recent political developments in several majority Muslim countries point to a growing role for Islamic financial instruments.

## Concluding Remarks

During this ongoing period of rapid growth in Islamic finance, market participants need to maintain the quality of their services and avoid letting actual practices drift away from core principles of Islamic finance. As detailed earlier in this note, these emphasize avoidance of *riba* and *gharar*; adherence to the principles of risk sharing; respect for property rights and contractual obligations; and pursuit of good governance. Taken together, these will sustain the link between the financial sector and the real sector.

A meaningful development of the practice of Islamic finance will require abandoning the mechanical emulation of conventional instruments and packaging them as seemingly Islamic financial instruments. Investments in human capital and research and innovation are also necessary to facilitate the development of Islamic finance solutions and products to respond to economic needs and financing requirements.

By addressing the challenges noted above, Islamic finance could increasingly meet the preferences of local cultures and boost financial inclusion and intermediation. Islamic finance could also help mobilize financing for small and medium enterprises, as well as long-term funding for infrastructure and other development projects, which are critical for accelerating sustainable and inclusive growth.<sup>6</sup>

So far, Islamic finance has been driven predominantly by supply-side factors and considerations. However, as highlighted above, there are important factors from the demand side that are likely to change the dynamics of the practice of Islamic finance. One of the factors worthy of monitoring in the near future is the growing demand for Islamic financial products by entrepreneurs across sectors and with different sizes of operations. The second factor is a potential rise in demand by sovereign and quasi sovereign entities in accessing Islamic capital markets. This would help advance some Islamic finance products that were developed in theory, but had little chance of being implemented in practice, such as *mudarabah* and *musharakah*. Moreover, with greater emphasis on risk sharing, Islamic finance could contribute meaningfully to financial stability.

## About the Author

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## Notes

1. El-Gamal (2009, 58–60) provides a definition of *gharar*, distinguishing between major and minor forms, and quotes

- Mustapha Al-Zarka's definition of gharar as "the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling."
2. Tripp (2006, 57) cites Abd El-Qader Awdah, "Islam [is] a religion which concern[s] itself in some detail with the question of property and mentions that it 'had been the subject of certain defining in junctions from the outset of the Islamic revelation.'"
  3. Mawdudi (2011, 34–42) refers to the distinction between lawful and all prohibited means of livelihood with reference to the Quran; see also Ayub (2007, 64).
  4. For a brief discussion of the evolution of Islamic financial institutions, see Mohieldin (1995).
  5. El-Gamal (2009) highlights several examples of such "reengineered financial instruments" and suggests an alternative path for developing Islamic financial instruments.
  6. For a discussion of Islamic finance and financial inclusion, see Mohieldin and others (2011).

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## Annex I: Glossary of Key Terms for Islamic Financial Instruments

*Based on standardized Islamic Financial Definitions by the Accounting and Auditing Organization for Islamic Financial Institutions and Islamic Financial Services Board*

**Bai bithaman ajil** is a sale of goods on a deferred payment basis at a price that includes a profit margin agreed to by both parties.

**Mudarabah** is a partnership in profit between capital and work. It may be conducted between investment account holders as providers of funds and the Islamic bank. The Islamic bank announces its willingness to accept the funds of investment account holders, the sharing of profits being as agreed between the two parties, and the losses being borne by the provider of funds, except if they were due to misconduct, negligence, or violation of the conditions agreed upon by the Islamic bank.

**Murabahah** is a sale of goods with an agreed upon profit mark up. There are two types of murabahah sales: an example of the first type is when an Islamic bank purchases goods and makes them available for sale without any prior promise from a customer to purchase them. An example of the second type is when an Islamic bank purchases the goods ordered by a customer from a third party and then sells these goods to the same customer. In the latter case, the Islamic bank purchases the goods only after a customer has made a promise to purchase them from the bank.

**Musharakah** is a form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of the partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. However, losses are shared in proportion to the contributed capital.

**Sukuk** are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) the assets of particular projects.

**Takaful** is an arrangement for joint guarantee, whereby a group of participants agrees to support one another jointly for

losses arising from identified risks. Under this arrangement, participants contribute a sum of money as a commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage.

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