



WORLD BANK GROUP
Finance & Markets

Unlocking Islamic Finance for Long-Term Growth and Development

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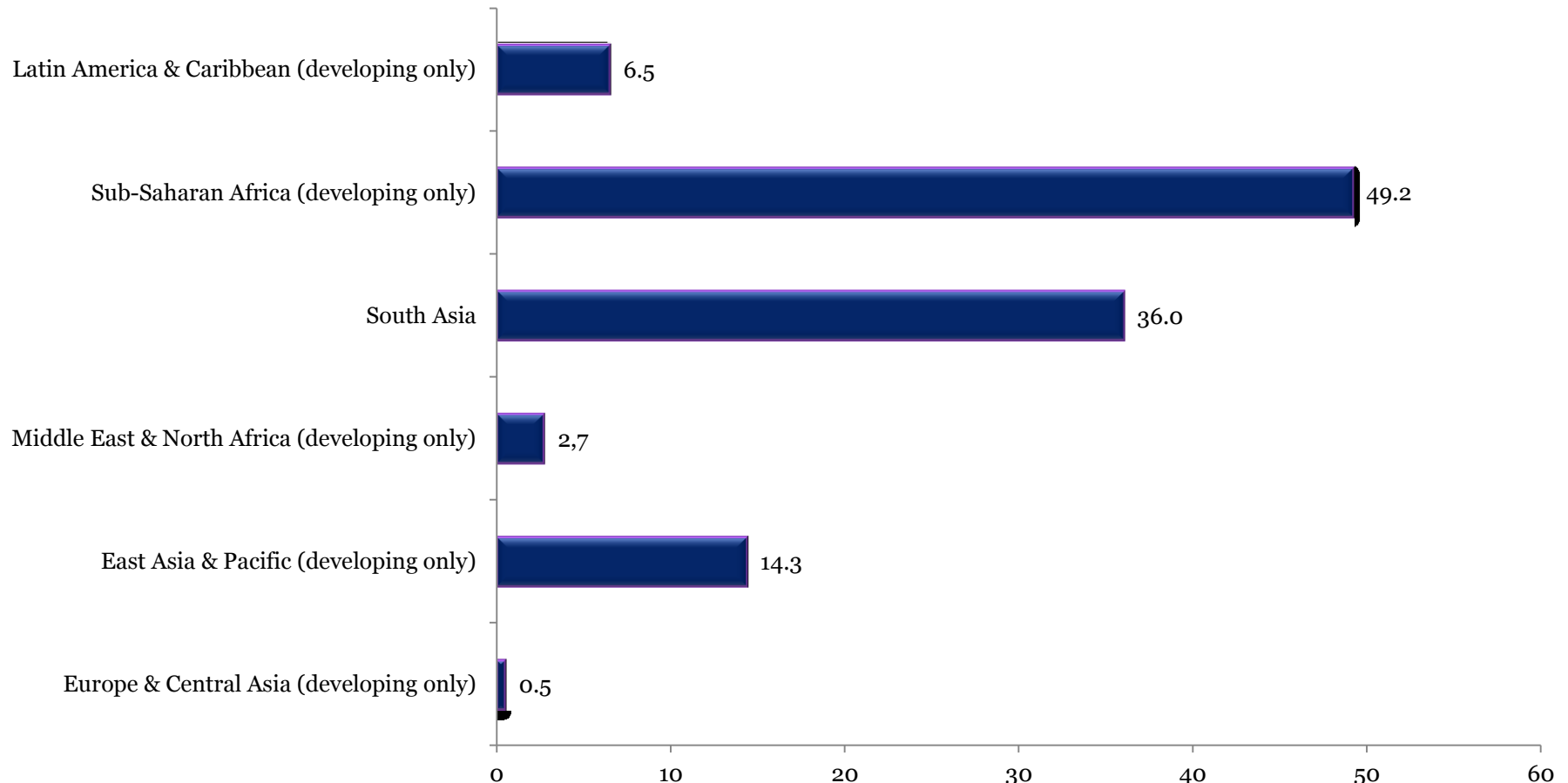
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The Challenge

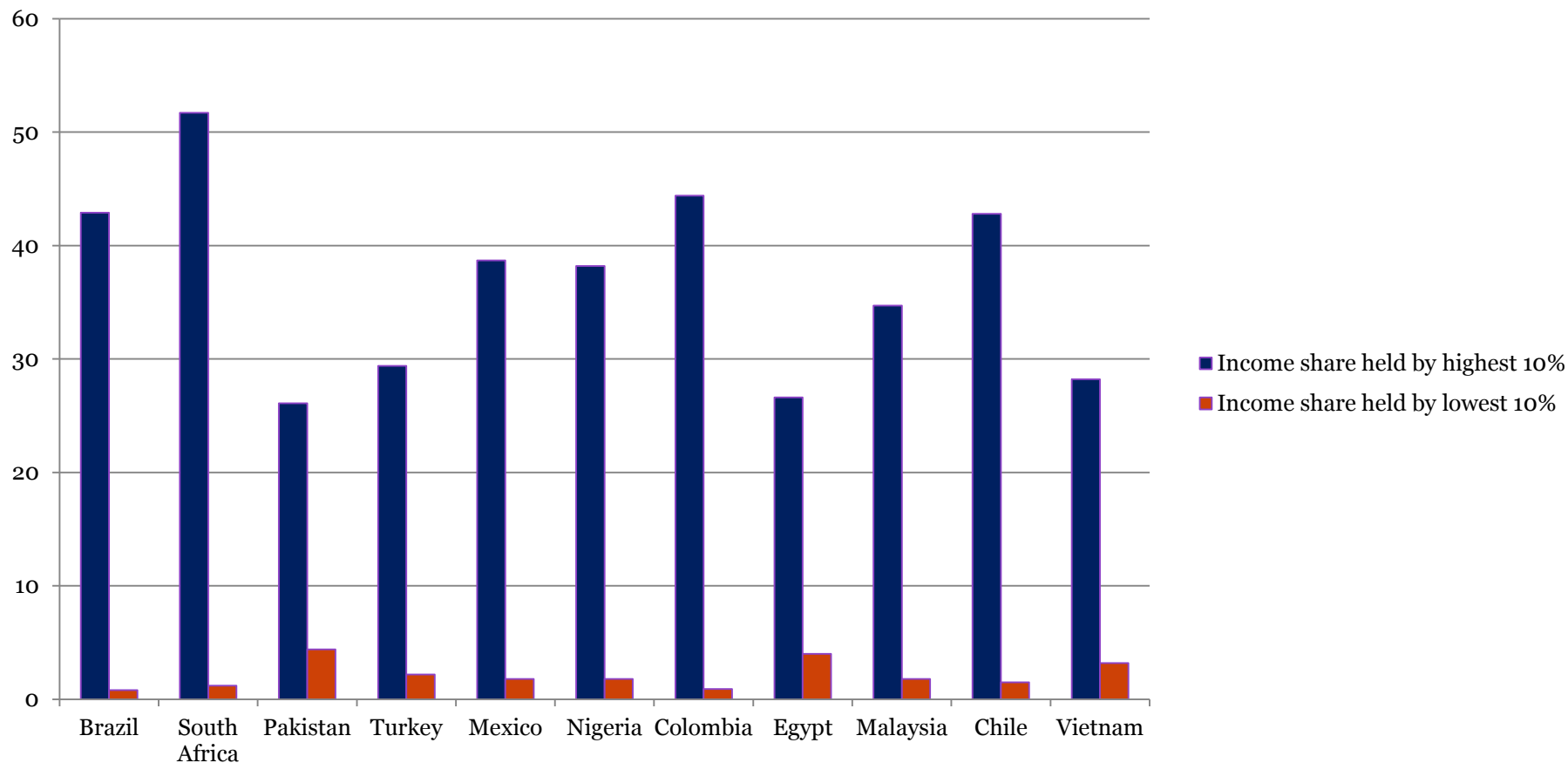
Despite a rapid decline in poverty over the last three decades, over 1 billion people still live in extreme poverty

Percentage of population living on less than \$1.25 per day (PPP)



Although many countries have experienced substantial increases in prosperity, inequality of income and opportunities continue to persist

Distribution of national incomes (% shares)



The Bank is committed to ending extreme poverty at the global level and boosting shared prosperity

End extreme poverty

Reduce the percentage of people living on less than \$1.25 a day to no more than 3 percent globally by 2030

Promote shared prosperity

Foster income growth for the bottom 40% of the population in every country

Achieving these goals will require concerted action in different areas

Increasing private sector-led growth and employment

- Reliable financing of business enterprises, including SMEs
- Investing in infrastructure
- Supporting innovation and entrepreneurship
- Expanding job opportunities

Translating growth into poverty reduction

- Addressing inequalities of income and opportunities
- Focus on pro-poor, inclusive growth and safety nets for vulnerable groups
- Improving access to basic health, education, sanitation and infrastructure

Ensuring sustainability of growth and poverty reduction

- Tackle climate change and its effects
- Promote fiscal sustainability
- Improving governance and institutional foundations of economic development

Why Does the Financial Sector Matter?

Well-functioning financial systems mobilize and allocate resources to the most productive ventures

Financial systems provide critical financing to business enterprises, thereby boosting economic growth, prosperity and job creation

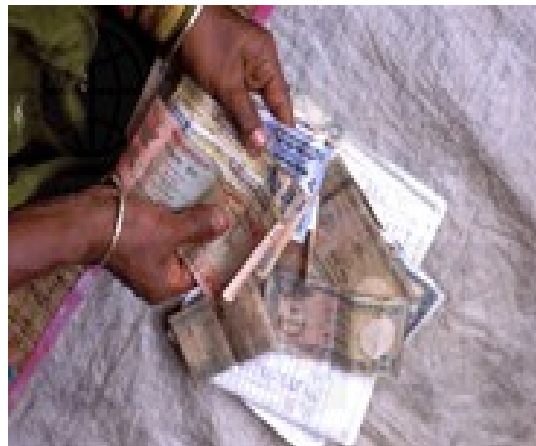
Financial markets also provide long-term financing for infrastructure, an essential foundation for sustainable growth and development



Well-developed and well-functioning financial systems are also directly important for the poor

Sound financial institutions and markets enable households to save, invest and take advantage of income-generating opportunities

Reliable access to savings, credit, insurance, pensions and remittances assist households in smoothing consumption, managing risk and dealing with adverse shocks



Financial systems also matter because when they malfunction, there are dire consequences for the real economy

The global financial crisis created 22 million new unemployed in a single year as many economies around the world slid into recession (*World Development Report, 2013*)

In a crisis, the poor are often the most vulnerable to the loss of assets, increased unemployment and the disappearance of income-generating opportunities



Research has also shown that financial sector development reduces poverty levels and income inequality

Honohan P. (2004). *Financial development, growth and poverty: how close are the links?* World Bank Policy Research Working Paper 3203, February.



Financial depth is negatively associated with headcount poverty, even after taking account of mean income and inequality.

Beck T., Demirgüç-Kunt A., & Levine, R. (2004). *Finance, inequality and poverty: cross- country evidence.* World Bank Policy Research Working Paper, 3338



Financial intermediary development reduces income inequality by disproportionately boosting the income of the poor and therefore reduces poverty.

Jalilian, H. and Kirkpatrick, C. (2005). 'Does Financial Development Contribute to Poverty Reduction?', *Journal of Development Studies*, Vol. 41, No. 4, pp. 636– 656.



Up to a threshold level of economic development, financial sector growth contributes to poverty reduction through the growth-enhancing effect.

Recent Trends in the Islamic Finance Industry

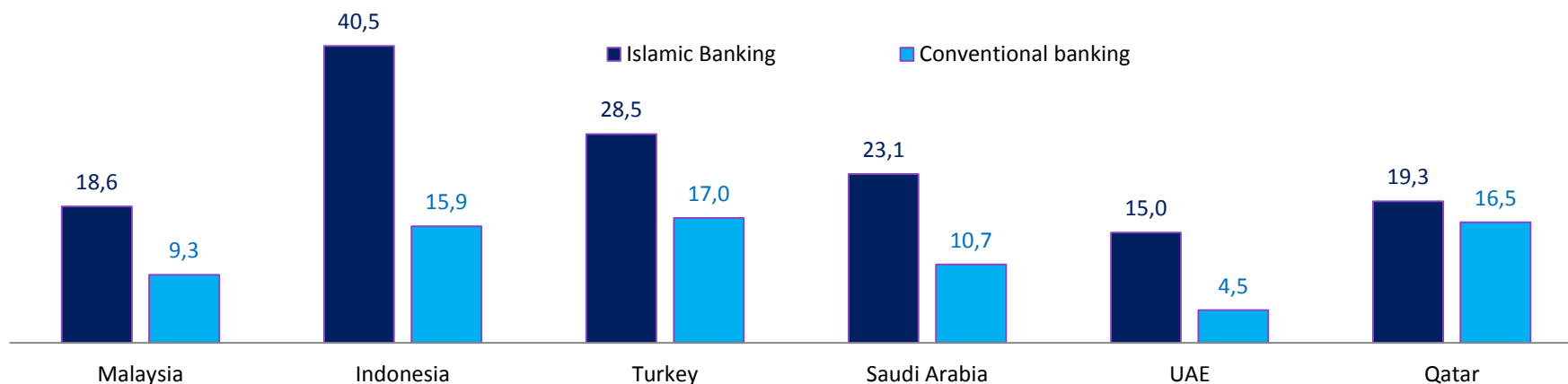
Islamic financial assets have been growing rapidly, now estimated at roughly \$2 trillion



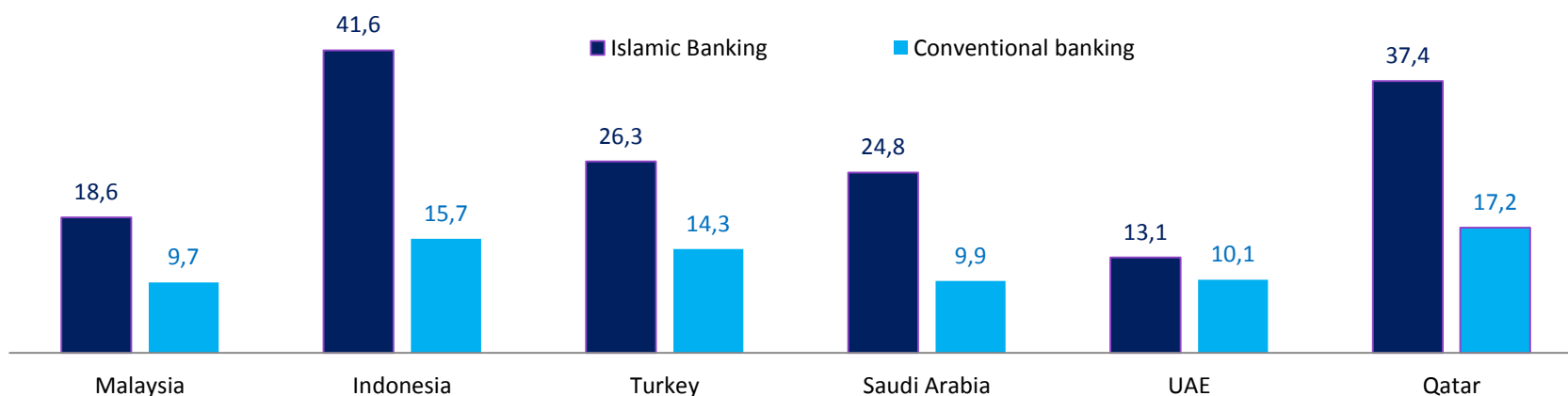
*****Please see Annex 2 for details on Islamic Modes of Financing***

In many countries, Islamic banking assets have grown faster than conventional banking assets

Growth of Islamic Banking and Conventional Banking Assets in selected countries (2008-2013) (%)



Growth of Islamic Banking and Conventional Banking Deposits in selected countries (2008 -2013) (%)



The rapid growth of Islamic finance has been driven by several factors

High liquidity and limited investment alternatives in the MENA region

Increased need for liquidity and increased interest from non-Muslims in the wake of the global financial crisis

Search for asset diversification by institutional investors (sovereign wealth funds, pension funds and reserve managers)

Large and expanding global Muslim population

Although Shariah-compliant banking assets are mostly domiciled in majority Muslim countries.....

Country	Global Share (%)
Iran	39.7
Saudi Arabia	13.7
Malaysia	9.8
UAE	9.1
Kuwait	9.0
Qatar	4.1
Turkey	2.7
Bahrain	2.3
Indonesia	1.5
Egypt	1.1

.....there is increasing interest in Islamic finance from non-Muslim countries

2010

- UK Treasury introduces the Financial Services and Markets Act to support Islamic finance and the issuance of corporate *Sukuk*
- Luxembourg Tax Authority clarifies tax treatment of *murabahah* and *sukuk* transactions to level playing field with conventional products
- France revises tax regulations covering *Sukuk*, *ijarah*, *ististna'a* and *murabaha* to remove discrepancies

2012

- UK Government launches Islamic Finance Task Force
- German banking regulator hosts Islamic finance conference in Frankfurt

2014

- Sovereign *Sukuk* issues by UK, Hong Kong SAR, China, and South Africa
- Corporate *Sukuk* issue by Goldman Sachs

What Does Islamic Finance Have to Offer?

Specific features of Islamic finance give it the potential to significantly enhance growth and reduce poverty

Partnership- and equity style financing

Profit and loss sharing

Socially responsible investments

Emphasis on tangibility

“You cannot sell what you do not own”

The development of Islamic finance improves overall financial sector development

Improving financial stability

- Islamic financial institutions may be more resilient to unforeseen shocks
 - They also help to further diffuse risk in the financial system (the spare tire argument)
-

Improving depth, breadth and efficiency

- Diversification of financing sources
 - Providing competition to conventional financial institutions
-

Enhancing access to financial services

- Widening the range of products and services available to businesses and households
- Improving access of the underserved to financial services

Available data show that a large number of people do not use formal financial services due to religious reasons

East Asia and Pacific

3%

South Asia

13%

Europe and Central Asia

15%

Sub-Saharan Africa

30%

Middle-East and North Africa

32%

Source: FINDEX database, The World Bank

Islamic finance can contribute directly to boosting growth, reducing inequalities and enhancing the sustainability of growth

Financing business enterprises, including SMEs and innovative entrepreneurs

Financing infrastructure projects

Improving the poor's access to financial services

Supporting social investments in education and health

Supporting “green” investments to address climate change

Islamic Finance in Practice

Egypt Promoting Innovation for Inclusive Financial Access Project (\$300 million)

Bank project with \$30 million Islamic Finance component

Step 1

Conventional line of credit from IBRD to Social Fund for Development (SFD)

Step 2

SFD enters into a Partnership agreement with Islamic Banks (*Musharakah*), with 1:1 matching

Step 3

SFD extends funds to Islamic Banks

Step 4

Islamic Banks match SFD contribution and extend financing to SMEs; banks and SFD share returns

- Islamic Banks are free to set the terms of financing to beneficiaries
 - Financing may be for working capital or investment purposes
 - Financing is only denominated in domestic currency

Turkey Frontier Finance Project (\$250 million)

Bank project with \$160 million Islamic Finance component

Step 1

Conventional line of credit from IBRD to Industrial Development Bank of Turkey (TSKB)

Step 2

TSKB enters into an agency agreement with Participation Banks (*Wakala*)

Step 3

TSKB extends funds to Participation Banks

Step 4

Participation Banks acting as agents of TSKB extend financing to SMEs and receives a fee from TSKB for services rendered

- Participation Banks free to set the terms of financing to beneficiaries
 - Financing may be for working capital or investment purposes
 - Financing may be denominated in any currency
 - Maturity of not less than 2 years

Islamic Infrastructure Finance

2007: Queen Alia International Airport, Jordan (IsDB project)

Description

25-year PPP concession for rehabilitation, expansion and operation of the airport

Project Value

\$680 million

Islamic Financing

\$100 million from Islamic Development Bank

Tenor

18 years including 5 year gestation period

Structure

Phased payments for *Istisna'a* (construction) agreement plus *Ijara* lease agreement upon completion

Socially Responsible Sukuk

2014: International Finance Facility for Immunization Sukuk (issue managed by WB Treasury)

Description

Socially responsible *Sukuk* for immunization of children in the world's poorest countries

Amount

\$500 million

Sukuk Type and Tenor

3-year *Sukuk Al-Murabaha*

Issue rating

Aa1 by Moody's

Profit rate

US\$ 3-month LIBOR + 0.15% p.a., payable quarterly in arrears

Afghanistan: Islamic Investment and Financial Cooperatives

Description

30+ member owned, controlled and operated Sharia-compliant credit unions in Southern and Eastern Afghanistan

Members

Small and medium scale business owners, farmers, women and low and medium income households

Governance

Members elect their institutions' directors and receive back a portion of any profits as a dividend

Products

Share savings, *murabaha* facilities for working capital (e.g. fertilizer and fuel) and *ijara* facilities for equipment (e.g. tractors)

2013 Performance Data

Gross Loan Portfolio	\$21.4 million
Number of active borrowers	23, 000
Average loan balance per borrower	\$936
Number of depositors	104,000
Total deposits	\$3 million

Sources: <http://www.mixmarket.org/es/mfi/iifc-group>; WOCCU (2012), *Islamic Finance in Afghanistan*

Akhuwat: Islamic Microfinance in Pakistan

Description

Interest free microfinance to the poor; no application fees and no processing fees; outreach through mosques and churches

Beneficiaries

Poor individuals and families; 2 guarantors required

Governance

Funds come from philanthropic donations; large number of volunteers help raise funds; Board gets no remuneration

Products

Family and “liberation loans”, as well as loans for education, health, emergency, housing, and marriage purposes

2015 Performance Data

Number of borrowing families	762,000
Recovery rate	99%
Total disbursed	\$126 million
Number of branches	342 in 207 cities
Number of active loans	330,000 for a portfolio of \$38.7 million

Source: Akhuwat, www.akhuwat.org.pk/progress_report.asp

Looking Ahead

The gap between the potential and the reality of Islamic finance remains substantial—practice lagging behind concepts

Short-term *murabahah* financing is still predominant

Doubts about the consistent application of profit and loss-sharing principle

Increasing tendency to mimic conventional products

Nonetheless, the opportunity to expand Islamic Finance is promising and concerted action is required in several areas

Enhancing corporate governance and risk management

Enhancing the regulatory and supervisory framework

Promoting standardization of products and documentation

Strengthening bankruptcy and insolvency frameworks

Raising public awareness (financial literacy)

Increasing the number of skilled professionals

Through the Finance and Markets Global Practice, the World Bank is very active in fostering the development of Islamic finance globally and in individual client countries

**Knowledge and
Advisory Services**

**Financial
Services**

**Convening
Services**

World Bank Global Islamic Finance Center in Istanbul

Annex 1: Key Principles of Islamic Finance

Key Principles of Islamic Finance

Prohibition of interest on transactions (*riba*)

Prescribed modes of financing: profit- and loss-sharing (PLS) and non-PLS

Financing linked to real assets, the performance of which determines the return to the investor (materiality)

Avoidance of transactions involving uncertainty (*gharar*)

Prohibition of financing or investment in certain activities (e.g. alcohol, armaments, gambling)

Zakat (compulsory religious alms tax) provides a sustainable resource for inclusion and solidarity through financial support to the deprived and the poor.

Moral values and ethics (good conduct); trust, respect for contracts and property rights

Annex 2: Islamic Modes of Financing

Islamic Modes of Financing (i)

Mode of Financing	Key Features
<i>Mudaraba</i> Trustee finance contract (PLS)	One party contributes capital while the other contributes effort or expertise; profits shared according to a predetermined ratio; investor not guaranteed a return and bears any financial loss; no fixed annual payment; financier has no control on how venture is managed
<i>Musharaka</i> Partnership; equity participation contract (PLS)	Both parties contribute capital; profits shared by a pre-determined ratio, not necessarily in relation to contributions; losses shared in proportion to capital contributions; both parties share and control how investment is managed; each partner liable for the actions of the other
<i>Murabaha</i> Sale with agreed mark-up (non-PLS)	Financing purchase of assets for a profit margin; asset purchased on behalf of client and resold at a pre-determined price; payment could be lump sum or in installments; ownership of asset remains with bank till full payments made

Islamic Modes of Financing (ii)

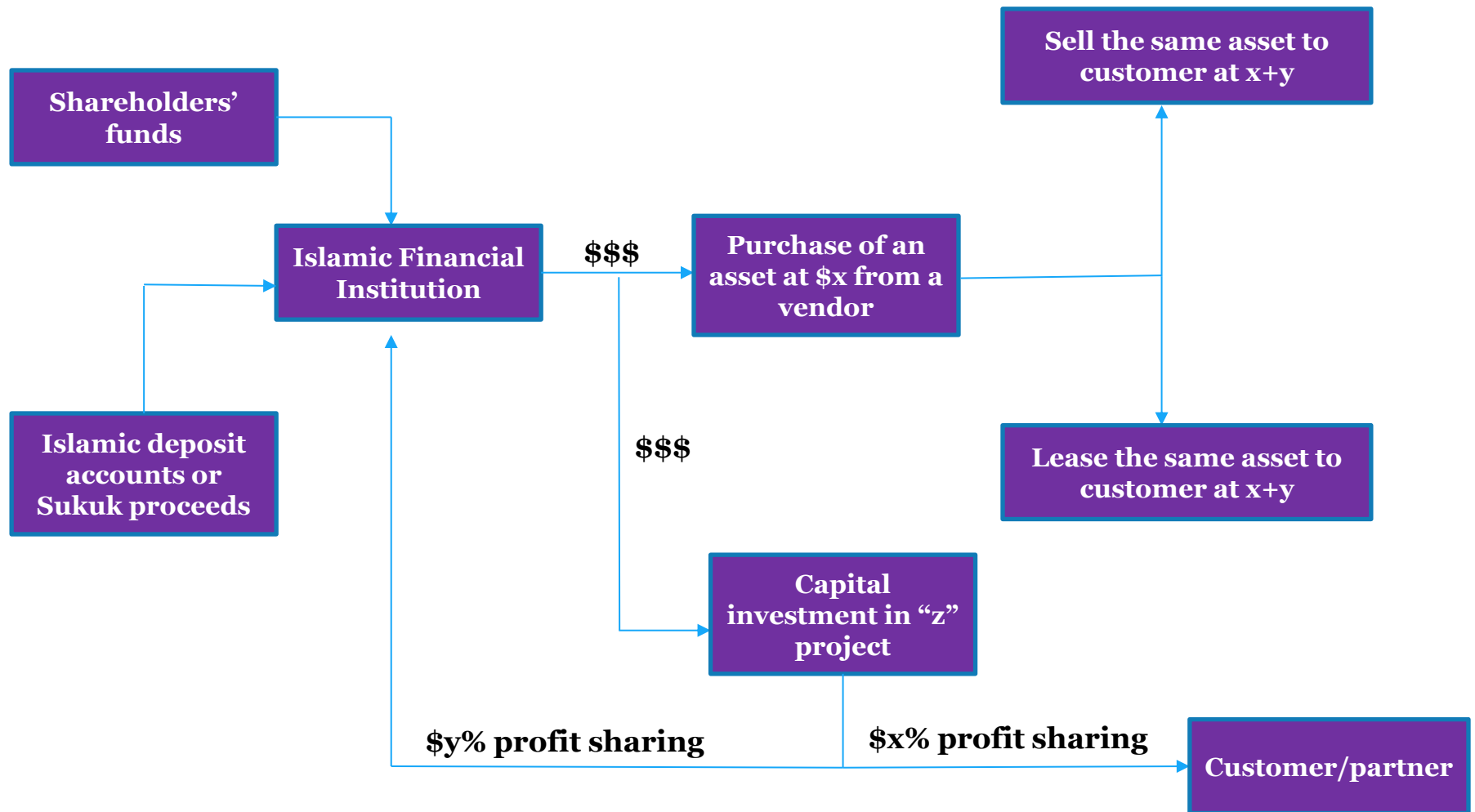
Mode of Financing	Key Features
<i>Sukuk</i> Certificates of ownership (PLS)	Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) the assets of particular projects.
<i>Ijara/Ijara wa iqtina</i> Operational and financial Lease (non-PLS)	Bank purchases asset on behalf of client; allows usage of asset for a fixed rental payment; ownership of asset remains with the bank but may gradually transfer to the client who eventually becomes the owner (<i>ijara wa iqtina</i>)
<i>Takaful</i> Islamic Social Solidarity Scheme (PLS)	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.

Islamic Modes of Financing (iii)

Mode of Financing	Key Features
<i>Istisna</i> Work-in-progress financing (non-PLS)	Agreement to sell a non-existent asset to a customer; asset to be manufactured or built according to the buyer's specifications; to be delivered on a specified future date at a pre-determined selling price; usable for construction or pre-shipment export finance
<i>Salam</i> Purchase with deferred delivery (non-PLS)	The bank makes full prepayments for future delivery of a specified quantity and quality of goods on a specified date; typically used for commodity finance
<i>Qard al hasan</i> Interest free benevolence loan (non-PLS)	Zero-return loan to needy and poor people; borrower only obligated to repay the principal; can be financed through Zakat contributions

Annex 3: The Business of Islamic Banking

The Business of Islamic Banking



End