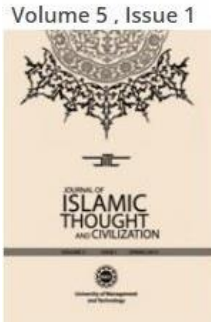

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The Role of Islamic Finance in Sustainable Development

Abstract

The current global inclination is to utilize non-renewable resources responsibly and create a world that future generations can survive in. In order to achieve this aspiration, countries all over the world agreed upon a set of sustainable development goals (SDGs). Sustainable development is a concept that incorporates meeting "the needs of the present without compromising the ability of future generations to meet their own needs". This depends largely upon economic growth. Islamic finance has been highlighted in recent research regarding impact on financial sector due to its considerable growth. The purpose of this paper is to discuss the major perspectives in which Islamic Financial Institutions (IFIs) play a fundamental role in the achievement of sustainable development goals. The literature suggests five main aspects which are reviewed from the perspective of existing research.

Key Words: *Developing Infrastructure, Financial Inclusion and stability, Islamic Financial Institutions, Sustainable Development*

Introduction

"Globally capital is plentiful. The financial resources are there. But they must be unlocked, mobilized, channeled and used more effectively for sustainable development." -Wu Hongbo (Undersecretary General, Economic and Social Affairs)

The current global inclination is to utilize non-renewable resources responsibly and create a world that future generations can survive in. In order to achieve this aspiration, countries all over the world agreed upon a set of millennium development goals (MDGs). The relative success of the MDGs led to a shorter term vision with similar targets, the sustainable development goals (SDGs). These 17 SDGs have been identified in Appendix A.

Sustainable development is a concept that incorporates meeting "the needs of the present without compromising the ability of future generations to meet their own needs." The heart of achieving this vision lies in three facets: economic growth, social inclusion and environmental protection. Islamic finance plays a crucial role in the first two aspects, making its analysis necessary. It can be useful in understanding how this system can contribute in achieving sustainable development.

Figure 1: IFIs and Sustainable Developments- Important Aspects

Islamic finance has been highlighted in recent research regarding its impact on the financial sector due to its considerable growth. The compound annual growth rate (CAGR) of Islamic assets worldwide was approximately 17% from 2009 until 2013. Furthermore, it is expected to cross two trillion through new market expansion.[1] The current market is concentrated geographically in the Middle East and Asia. This growth is significant when considering the numbers, however research indicates that growth is not the only important factor- realization and achievement of social goals is equally essential.[2]

The purpose of this paper is to discuss major avenues in which Islamic Financial Institutions (IFIs) play a fundamental role in the achievement of sustainable development goals. This encompasses five key areas to be considered (outlined in the conceptual framework in Appendix B). The researchers begin the discussion with the role of Islamic Finance Institutions in contributing to the financial sector's stability and resilience, followed by inclusive finance and reducing vulnerability for the poor and mitigating risk. Finally the contribution of IFIs to environmental and social issues, as well as infrastructural development is reviewed. Each perspective is discussed with reference to existing research under the themes of contribution through financial institutions, capital markets and social sector. This division is essential as past studies and information concentrate on these three main themes when considering sustainable development.

1. Financial Sector Stability and Resilience

One of the fundamental preconditions in achieving economic growth is financial sector stability. The recent global financial crisis has demonstrated the latent impact of the financial sector on the real output of the economy and welfare reduction.[3] Amongst other reasons, one of the main causes of the financial crisis was identified as high levels of debt.[4][5][6] Past research also indicates that economies with excessive debt are also subject to lower economic growth. Interestingly, private sector debt and household debt both impact growth the same way.[7][8] The best counter measure to this is to increase the proportion of equity financing to debt.[9][10]

Instruments such as mortgage backed securities, credit default swaps and collateralized debt obligations all associated with speculation reached a value of $596 trillion in 2007, just before the financial crisis.[11] Another key point is the size of the derivative market, expanding to approximately ten times the world economy. Taken together, debt financing and derivatives can be used for hedging purposes; however, when used extensively for speculation their lack of association to real assets create new and complex risks.[12] This risk exposure can result in losses that are over and above the original investment.[13]

This indicates that IFIs have a unique offering that can contribute to financial stability – asset backed financing, free from speculation. These principles connect the financial sector to the real economy, restraining the amount of debt financing that can be issued. This is the primary reason why IFIs perform better during financial crises.[14] Similarly, when comparing the performance of IFIs with conventional banks, IFIs are characteristic of higher capitalization and liquidity, hence more stable than their counterparts.[15]

While there are significant differences in the philosophy of Islamic and conventional banks, research also indicates that their operations might not be so divergent. For instance, IFIs are also dominated by debt-financing[16 17] and certain products, such as *sukuks* have similar features as conventional bonds and mortgage backed securities.[18] There are two factors that must be considered when addressing the role of the financial sector and sustainable development- financial institutions and capital markets.

The essential contribution of IFIs to sustainable development comes from equity-based financing, which diminishes exposure to systemic risks and contributes to overall stability.[19 20] However, IFIs are essentially built on the same systems as conventional banks, making their operational and organizational structures inefficient and inadequate at handling equity financing based risks.

Solely equity based institutions include non-banking financial institutions such as *modarabas*. These institutions are established as per the *Modaraba* Companies and *Modaraba* Floatation and Control Ordinance 1980 and represent the ideal risk sharing, equity based financing principles of IFIs.[21] These institutions can be used for crowd funding that result in real economic activity, leading to monetary and societal benefits. A comparable *Shari'ah* compliant organization called *Shekra* was established in Egypt in 2013 to provide an avenue to investors for venture capital financing.[22]

Although the primary constraint in the expansion of equity based institutions is a lack of knowledge, various opportunities do exist. The involvement of professionals who understand both the business risks (strong monitoring and control) as well as the financial risks (managing counter-party risk) of equity finance are scarce.

2. Inclusive Finance

Sustainable development and the appropriate allocation of finance are essential for the Muslim world since Muslim countries are ranked amongst the poorest nations in the world.[23] An essential requirement of poverty alleviation in association with sustainable development is the availability of financial services for the poor. The majority of the financial services available tend to cater to those well above the poverty line.[24] The research shows that approximately 72 percent of the Muslim world does not utilize any formal financial services.[25] Furthermore, approximately 20 to 40 percent avoid the use of financial services because of interest. Economic, social and religious reasons all cater to the low percentage of financial inclusion in Muslim countries.

Considering these reasons as well as the demographics of the regions, the most reasonable form of inclusive finance would be through *Shari'ah* compliant microfinance. Consideration should be given to the risks, costs and sustainability of establishing Islamic microfinance institutions that could help eradicate poverty and achieve sustainable development.[26]

Islamic microfinance institutions are the key to establishing sustainable avenues for inclusive finance. While conventional finance organizations tend to shy away from this type of financing (due to its higher risk and resource allocation), it can help IFIs to establish the social role that

Shari'ah principles advocate.[27] Research also indicates that successful financial inclusion requires the provision of microfinance at various levels, for maximum outreach to various market segments. Market data already indicates that microfinance is more prevalent in IFIs than their conventional counterparts.[28] This prevalence is due to existing networks of bank branches which allow easier access to larger number of clients, supported by existing operations which allow efficient transactions. On the other hand it is also contested that expansion of operations is not the same as serving the poor segments of the population.[29]

Central bank policies ensure the provision of financial services to different sections of the population and can ensure financial inclusion and stability in the long run. Beyond banks, it is also possible for financial institutions such as non-profit organizations to serve this section of the population. Cooperatives, credit unions and mutual insurance companies can offer a wide variety of services including savings, financing, financial planning and banking, etc. which can enhance financial inclusion.[30] The reciprocating nature of these organizations leads to the very nature of social impact in *Shari'ah* principles.

The capital market involvement of IFIs remains constrained primarily due to regulatory restrictions. *Shari'ah* based microfinance institutions cannot accept deposits that limit their scale of operations. An alternate that has worked very successfully in the past includes raising funds from the capital market (such as through a bond) which can then be used for microfinance.[31] *Sukuks* are the key to allowing IFIs to achieve financial inclusion. As a financing/investment platform, this product has the capacity to bring together diverse investors, as demonstrated in the IDR issue in Indonesia.[32]

The greatest role of IFIs in the development of the social sector for financial inclusion is through *zakat* and *waqf*. This currently lacks integration with the broader financial structure- if *zakat* and *waqf* are incorporated in the institutional structure/financial sector and regulated appropriately, then outreach and sustainability can be achieved.[33] Given the charitable nature of *zakat* and *waqf*, it can also contribute to support which would result in long run poverty alleviation. *Waqf*-based models have been previously suggested through research and utilized with considerable success.[34] *Waqf* based micro-finance and interest free loans ensure capital outreach and poverty alleviation.

3. Reducing Vulnerability of the Poor and Mitigating Risk

Risk management strategies in any economy, bring benefit to poor and establish growth along with modernism.[35] It has been argued in various studies that low income groups are forced towards poverty traps with more of risk events.[36] Strong mechanisms against risks create more sustainability of social features.[37] These strong mechanisms are supportable with the institutional framework. More of formal and informal sector involvement would again build diversification of risk for household and societies. Shiller[38] has categorized risk management areas such as insurance for livelihood, bankruptcy, inequality insurance to safeguard the distribution of income and social security benefits.

Financial sector's risk mitigation projects are for enhancing social benefits. Islamic financial sector is unique in terms of risk sharing as compared to risk transferring.[39] *Takaful* is one of the risk mitigating tool in Islamic financial market but one of the problems is that the size of the sector is very small. According to[40] IFSB (2014) the *takaful* constitutes only 1.1% of total Islamic financial assets. In 2012, 38.7% of the 200 total *takaful* operators were working in the GCC region, followed by 20.1% in South East Asia. The small size of *takaful* operations reflects the low dispersion of overall insurance in most of the countries in the region. However, *takaful* increased at an average annual rate of 18% internationally during 2007-2012, indicating a prospective growth possibility of these services in the upcoming years. The size of operation of these administrations is extensive, yet they have not been fruitful in achieving opportunities for the poor.[41]

Takaful T&T Friendly Society (TTTFS) is a not-for-profit, multipurpose helpful in Trinidad and Tobago that gives *microtakaful* administrations straightforwardly to the poor. TTTFS has managed to moderate surpluses throughout the years that have reliably brought about an expansion in reserves and the conveyance of refunds. While the plan gives *takaful* administrations to the poorer segments of the populace, it covers a limited set number of individuals. Another illustration of a not-for-profit association serving the necessities of the poor is Peramu Foundation in Indonesia, which gives *microtakaful* to its microfinance customers and non-customers. Utilizing the backhanded methodology, it offers the *microtakaful* administrations to the poorer segments of populace as a specialist of other built up *takaful* administrators.[42]

Zakat and *waqf* can be utilized to decrease the powerlessness and upgrade the versatility of the poor. While generally *zakat* and *waqf* have gone about as wellbeing nets, their application can be extended to secure the non-poor why should defenseless getting to be poor because of antagonistic shocks. One methodology is to give interest free credits (*qard-e-hassan*) to the powerless. Research shows that in Sudan, *Diwan al Zakat* has started loaning to farmers to empower them to purchase fundamental inputs; the credits are reimbursed after the harvest.[43] This strategy has expanded the profitability of farmers and expanded *zakat* accumulation from agriculturists, identical to 74.4 percent of the advances. If there should arise an occurrence of negative shocks, *zakat* can be utilized for obligation alleviation of the poor. Another compelling approach to diminish helplessness is to utilize *zakat* and *waqf* assets to pay the month to month *takaful* commitments (premiums) to support against some characterized risks. This plan can expand the infiltration of *takaful* administrations among the poor.

4. Contribution to Environmental and Social Issues

A few studies find that the Islamic financial sector's part in tending to environmental and social objectives is either little or non-existent. In a review of the social reporting of 19 Islamic banks, Kamla and Rammal[44] did not discover any confirmation of Islamic banks adding to social improvement or having any 'genuine plans focusing on neediness end or upgrading fair redistribution of wealth in the public arena.' They reason that the 'inability to make social equity the center estimation of their operations has added to the disappointment of Islamic banks to satisfy their ideological cases'. While Haniffa and Hudaib[45] discover high scores for responsibility of Islamic banks towards partners, for example, borrowers and representatives, the dedication towards society scored the most reduced.

A study of social reporting of 29 Islamic banks[46] finds 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.[47] 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*[48] finds that though they did some corporate philanthropy, social responsibility was not an integral part of their business policy.

Evidence from Islamic capital markets additionally uncovers comparable examples. The main part of the Islamic investment screening utilized for the securities exchanges applies negative and exclusionary criteria. The center of the screening is on lawful forbiddances, for example, interest-construct wage and in light of prohibited sectors, for example, betting, entertainment, liquor, and so on. The present practice does not have any significant bearing positive screening criteria, and responsibility to socially responsible business practices to bolster ESG objectives is by all accounts immaterial.[49] For instance, issues, for example, worker rights, human rights, and environmentally-accommodating creation are excluded in the contemporary Islamic speculation choice making forms.[50]

The commitment of Islamic financial establishments to environmental and social objectives would partially rely on how the more extensive objectives (*maqasid*) of Islamic law are conceptualized and executed. One reason of the poor execution of Islamic banks in such manner is that the contemporary ideas of social and environmental maintainability have not been fused in *maqasid* and ideas identified with *Shari'ah* consistence. Elevating *maqasid* to incorporate the more extensive environmental and social points of view at the operational level would, accordingly, require adjusting the idea of *Shari'ah* based financing and embracing the environmental and social objectives as crucial parts of significant *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.

Islamic financial establishments can likewise advance social and environmental objectives in a roundabout way by putting resources into the social sector to build the ability to deliver social goods. Given that numerous *waqf* properties lie in prime regions of business significance, investments to add to these benefits could significantly build their return. Islamic Development Bank (IDB) set up the *Awqaf* Properties Investment Fund (APIF) in 2001 to prepare assets to advance and add to the *Awqaf* properties around the world. APIF puts resources into *waqf* properties that are socially, monetarily, and financially suitable utilizing *Shari'ah*-agreeable methods of financing. Reacting to the popularity for capable contributing, different assets managing social issues, (for example, social effect and wander charity) and the earth, (for example, environmental change, carbon and ecological assets) have been propelled in created economies.[51] Because of an absence of mindfulness, the development of Islamic-capable venture reserves has been inadequate. The act of moral financing in Islamic capital markets has been basically centered around negative screening to stay away from organizations in specific parts, for instance, liquor, tobacco, and so on and those not satisfying determined money related proportions identified with obligation levels and impermissible pay. Positive screening of organizations identified with ESG issues is new to the business and has yet to grab hold in the Islamic capital markets.

As on account of money related foundations, the capital markets can likewise add to the advancement of the social area as a rule and *waqf* resources specifically. One sample of an inventive *sukuk* used to create *waqf* properties is that of Lord Abdul Aziz *Waqf* in Makkah, Saudi Arabia. Utilizing a timeshare bond structure, USD 390 million was raised for a residency of for a long time to develop the Zam Tower Complex ashore neighboring the Blessed Mosque in Makkah.[52]

Improving the part of *zakat* and *waqf* in social development would require a recovery of these foundations, including the determination of two issues. To begin with, there is a need to facilitate the advantages on which *zakat* can be possible by amending the meanings of riches to reflect contemporary times. One explanation behind the poor gathering of *zakat* continues is the utilization of customary understandings that reject numerous present day resources/properties on which *zakat* ought to be paid. Numerous customary resources, for example, livestock are not possessed by most people, while numerous advanced resources, for example, stocks are excluded under the meaning of riches.[53] Second, the productivity and adequacy of *zakat* organizations regarding accumulation and dispensing should be made strides. This would require different measures at the legitimate, institutional and operational levels.

Correspondingly, there is a requirement for a multifaceted way to deal with resuscitate the *waqf* division so it can assume an essential part in social development. A couple of nations have found a way to renew the *waqf* segment. For instance, the Sudanese *Awqaf* Power has looked for gifts to make new *waqf* and set up a venture/development office to add to the current *waqf* properties to make them more useful in expansion of income.[54]

5. Infrastructure Development

Infrastructure facilities give the fundamental foundations to business and trade, improve competitiveness, and are important determinants of long run growth. Sustainable infrastructure development would require utilizing approaches that are amicable towards the environment and society. Factoring in the need to moderate climate change includes an extra cost of US$ 0.7 trillion every year related to green investments.[55]

Traditionally, governments have been in charge of giving infrastructure facilities, in most countries they are loaded with vast deficits and debt and think that it is difficult to generate assets. The immense interest for infrastructure investments calls for partnerships between private and public sectors, with the latter assuming a facilitating part. The contribution of the private sector in giving infrastructure financing, in any case, is still little. World Bank[56] estimates that 70-75% of total infrastructure financing in creating countries is given by the public sector, 10% originated from authority development assistance and the remaining 15-20% from the private sector. There is a need to concoct innovative courses in which new players and lenders can fill the crevice and contribute to the development of sustainable infrastructure.

Considering the real economy and inclinations for risk sharing investments and social investments, the infrastructure sector gives a perfect business chance to Islamic finance. In addition, infrastructure project would be reliable with the Islamic financing, as these tend to benefit large part of society. The Islamic financial sector, nonetheless, has not been prospective in financing the infrastructure sector. For instance, out of an aggregate USD 40 billion *Shari'ah*-perfect financing in the GCC, just USD 9 billion went into infrastructure financing.[57]

Another potential source of assets for base financing by government and private sectors is through Islamic capital markets. After a log jam of *sukuk* issuance after the worldwide financial crisis, the *sukuk* market has gotten again with the remarkable sum achieving $245.3 billion amid the principal portion of 2013 (IFSB 2014). The major percentage of the *sukuk* (65.9%) was issued by governments. The finances raised by utilizing *sukuk* for infrastructural tasks are generally little. For instance, out of an aggregate of USD 14.9 billion in *sukuk* issues amid 2008, just USD 1.6 billion was utilized for foundation.[58] Late figures demonstrate that the offer of private sector *sukuk* used to fund foundation sectors is unassuming, with 9.1% being utilized for force and utilities and 7.4% for transport.[59]

Syndicated financing is typically used to diversify the sources and risk of financing for macro infrastructure investments. Generally being a new industry, *Shari'ah*-consistent syndicated financing is little and immature.[60] One of the initially syndicated Islamic venture money arrangements was financing a tranche of the USD 1.8 billion Hub River Power Project in Pakistan in 1994. In this first private infrastructure venture with restricted response in Pakistan, Al Rajhi Bank and Investment Corporation and IICG Islamic Investment Bank financed a USD 92 million scaffold financing office to secure and introduce power turbines for the undertaking.[61] The capability of utilizing *Shari'ah* compliant syndicated financing for infrastructure ventures later on can be relied upon to enhance with the development of the business.

The successful experience of public and private *sukuk* issues represents the possible prospective of raising funds from private sector group and markets to finance infrastructure projects. Some economies have had significant achievement in using *sukuk* to raise funds for developmental use in general and financing infrastructure in particular. In Sudan, the government has initiated Government Investment Certificates (GIC) to finance procurement, trade, and development projects.[62] Bank Milli (the Central Bank of Iran) has issued participation bonds for, among others things, construction of infrastructure projects.

Concluding Remarks

The purpose of this paper is to discuss the major aspects in which Islamic Financial Institutions (IFIs) play a fundamental role in the achievement of sustainable development goals. From the perspective of financial stability and resilience, literature indicates that financial institutions should focus upon creating organizational diversity and switch to portfolios with larger proportions of equity based financing. In addition, new equity financing based firms should be established. Capital markets can be enhanced through the expansion/introduction of equity based instruments in capital markets and increasing the opportunities for small and medium firms to be listed publicly. Further, issuance of public and private risk sharing *sukuk* would create additional opportunities for investors and borrowers. From the perspective of inclusive finance, financial institutions can establish special units to serve microfinance in Islamic banks to reach more individuals and achieve organizational diversity. Social *sukuk* and retail *sukuks* can be utilized in capital markets while *zakat* and *waqf* based funds and microfinance institutions can be used to serve the social sector. From the perspective of reducing vulnerability and mitigating risk, financial institutions offer a saving opportunity for the poor and can create a platform for the expansion of *micro-takaful*. The social sector can be served through the use of *zakat* and *waqf* as safety nets. When addressing the role of IFIs in resolving social and environmental issues, financial institutions can utilize the *macro-maqasid* perspective in operations and direct financing to the development of the social sector. In addition, capital markets can use positive screening and social *sukuk* to develop *waqf*. In turn, the social sector can expand *zakat* and *waqf* base and increase the efficiency and effectiveness of use of these funds. Lastly, to ensure a developing infrastructure, financial institutions should target syndicated finance while capital markets utilize *sukuks* for infrastructural development.

Appendix A: Sustainable Development Goals

Figure 2: Sustainable Development Goals (Source: UN SDG Website - http://www.un.org/sustainabledevelopment/sustainable-development-goals/)

Appendix B: Conceptual Framework

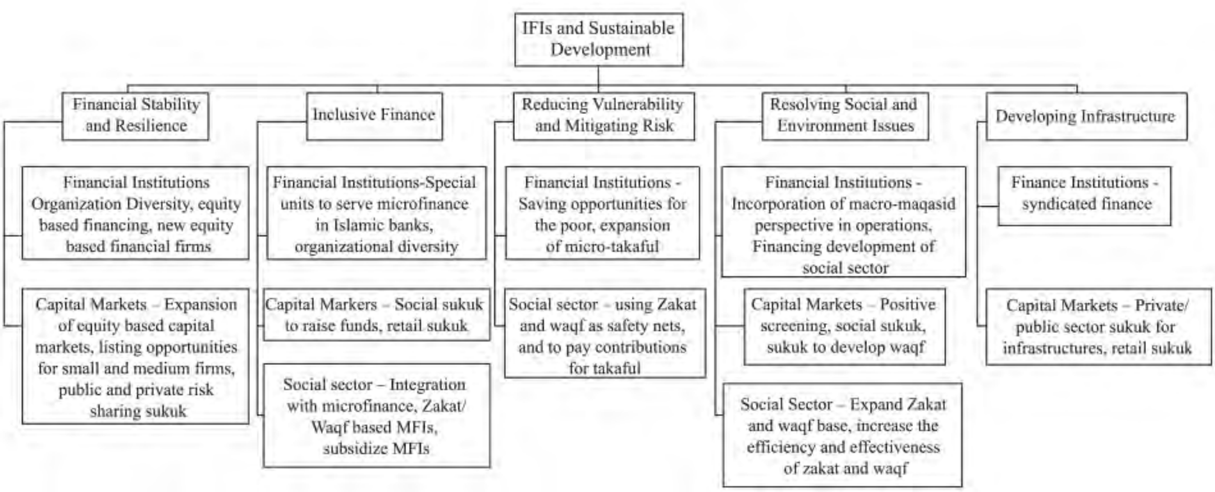

Figure 3: Framework on the Role of IFIs in Sustainable Development

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