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Islamic Finance as Social Impact Investing

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- The principles of Islamic finance, as defined by the Shariah, prescribe that finance must serve society and prohibit unfair and speculative activities. Because the Shariah prohibits usury (charging interest), Islamic finance is equity-based and shares common threads with community and ethical banking, and socially responsible investing.

- The defining difference between Islamic finance and conventional finance is risk sharing, rather than risk-shifting to the debtor[1]. An Islamic bank acts as a business partner in its customer's project, sharing in the venture's profits and losses. This is in sharp contrast to conventional banking, where the borrower has to repay interest and principal to the lender even if the project is losing money. This underscores the importance of risk management in Islamic finance.

- Even though Islamic finance was spared from the direct effects of the Global Financial Crisis (GFC) because its transactions must be linked to an underlying economic activity, the industry still suffered indirectly when the crisis triggered a decline in commodity and asset prices and a slowdown in real economic activities.

- Mainstream risk management failed during the GFC because of over-reliance on quantitative models that were flawed in measuring only statistical volatility, which ignored uncertainty (non-measurable risk)[2].

- Because Islamic finance is equity-based, with the sharing of risk and uncertainty, the issue of risk management and avoidance of moral hazard is even more critical than conventional finance. This requires a higher order of risk management and exercise of judgment under uncertainty, necessitating Islamic banks to:

    - Avoid speculation and be more focused on the social impact of Islamic finance investments;
    - Have more capital, liquidity and deeper risk management capabilities;
    - Develop more hands-on management that nurtures and controls against risks of fraud and incompetence of customers and investment projects.

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[1] *Zamir Iqbal, Abbas Mirakhor, Hossein Askari, and Noureddine Krichene (2012), Risk Sharing in Finance: The Islamic Finance Alternative, John Wiley & Sons (Asia) Pty, Singapore.*
[2] *Edesses, Michael, (2013), Risk and Uncertainty in Financial Markets – Implications for Asia, Fung Global Institute, available at http://www.fungglobalinstitute.org/*

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INTRODUCTION

By definition, Islamic finance is geared towards social enterprise and the creation of shared value within society. In order to achieve social impact investing that adds to social efficiency, sustainability and stability, Islamic finance requires a stronger form of governance, in addition to the oversight role of the Shariah Council, which ensures compliance with Islamic tenets.

Islamic banking means much more than just refraining from usury (charging interest), and observing religious/technical precepts. In conventional banking, the banker-customer relationship is that of a creditor-debtor. In Islamic banking, the financier acts as a partner/investor. The fundamental difference between conventional and Islamic finance is that of a debt contract as opposed to an equity contract. Conventional banking emphasizes profit-maximization, based on the assumption that individual self-interest will deliver overall societal well-being. Islamic banking, on the other hand, is based on the ethical and moral framework of the Shariah, and Islamic banks must incorporate both profits and social responsibility into their decision-making process.

From a relatively niche market at the end of the 20th century, Islamic finance has grown exponentially in the 21st century by a compound annual growth rate (CAGR) of 40.3 per cent between 2004 and 2012 to reach US$1.3 trillion, or just under 1 per cent of the global financial system. There are more than 600 Islamic financial institutions spread across 75 countries. Only 12 per cent of the 1.6 billion Muslims worldwide (one-fifth of the global population) currently use Islamic finance.

Nevertheless, the global Islamic financial services industry has grown in size and geographic coverage, encompassing new jurisdictions and more institutions[3]. The Islamic capital market, namely, the Sukūk or Islamic bond or funds and indices, continued to outpace most other global asset classes, growing by a CAGR of 44.0 per cent between 2004 and 2011. Additionally, Islamic equity indices have outperformed their conventional equivalents in the post-crisis period. Takāful (Islamic insurance) remains a nascent industry, but is expected to expand with growing market demand in Islamic countries, which comprise nearly one quarter of the world's population and US$5.8 trillion, or 8.4 per cent of world GDP.

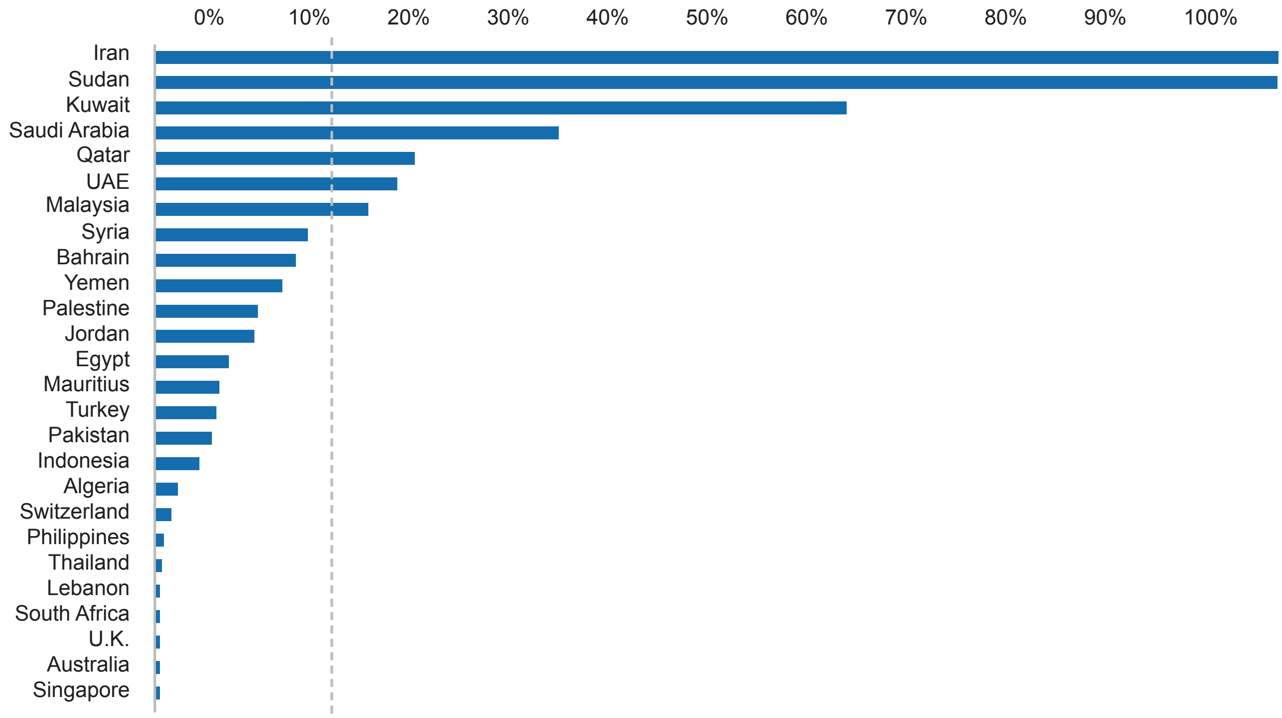
Exhibit 1 Composition of Islamic Financial Assets, (USD billion, 2012 e)

	Banking Assets	Sukūk Oustanding	Islamic Funds' Assets	Takāful Contributions
Asia	171.8	160.3	22.6	2.7
Gulf Cooperation Council (GCC)	434.5	66.3	28.9	7.2
MENA (exc. GCC)	590.6	1.7	0.2	6.9
Sub-Saharan Africa	16.9	0.1	1.6	0.4
Others	59.8	1.0	10.8	0.0
Total	1,273.6	229.4	64.2	17.2

Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, IFIS, The Banker, KFHR
Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still informaton gaps, data were estimated based on historical growth trends and country-specific assumptions to derive final figures.

[3] *Islamic Financial Services Board (IFSB). 2013. http://www.ifsb.org/index.php#*

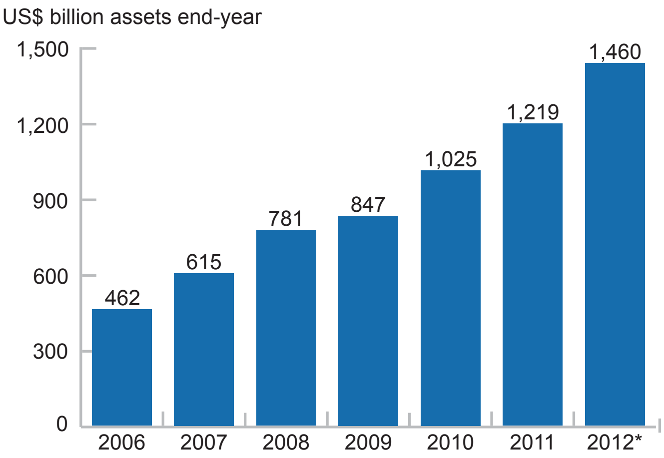
Exhibit 2 Islamic Banking Market Share by Jurisdiction (2012e)



Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR.

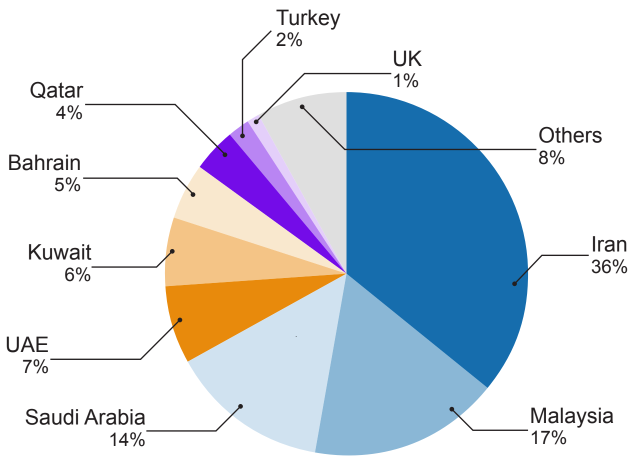
Latest estimates from TheCityUK[4] suggest that the global market for Islamic financial services, as measured by Shariah-compliant assets, has increased by one fifth to US$1.46 trillion in 2012 (Exhibit 3). TheCityUK also projects that Islamic financial assets could reach US$2 trillion by 2014. The largest centers remain concentrated in Malaysia and the Middle East, including Iran, Saudi Arabia, the United Arab Emirates and Kuwait (Exhibit 4).

Exhibit 3 Global Assets of Islamic Finance, 2012



**TheCityUK estimate*
Source: The Banker, Ernst & Young

Exhibit 4 Islamic Finance by Country



Source: The Banker

The GFC has revealed many flaws in conventional finance and its regulatory and risk management frameworks. As the Islamic financial industry transitions into a new era of growth and development, Islamic finance is also confronting the impact of evolving global regulatory reforms (including Basel III) that will affect not only the industry business model, but also its regulatory structure.

[4] *TheCityUK. Islamic Finance 2013. http://www.thecityuk.com/assets/Uploads/Islamic-finance-2013-F.pdf*

At the heart of the business and regulatory structure is its business and risk management model. The internationalization of Islamic finance has resulted in domestic Islamic financial systems becoming more inter-connected with other financial systems, resulting in risks being more rapidly transmitted across the financial system.

The Islamic Financial Services Board (IFSB) has put in place prudential standards in key areas of capital adequacy, risk management, corporate governance and Shariah governance. However, at the national and regional levels, the regulatory, supervisory and legal frameworks will need to reflect the growing cross-border dimensions of Islamic finance and its increased inter-connectivity. Islamic finance can only grow if there are efforts to strengthen the cross-border regulatory and supervisory cooperation arrangements in the relevant jurisdictions. In addition, there is necessity to strengthen further the international financial infrastructure, dispute resolution and exit mechanisms for Islamic finance.

Given the fact that Islamic finance requires a higher order of risk management and corporate governance, this would necessitate also higher capital and liquidity, and a lower overall leverage ratio, implying that the return on equity (ROE) may be lower for Islamic financial institutions than for conventional ones with higher levels of leverage. However, the fact that Islamic finance takes equity positions in high-growth enterprises should mean that a well diversified Islamic portfolio should be able to yield returns comparable to those of well-managed private equity firms.

In practice, other than its Shariah tenets, Islamic finance shares many of the same objectives, practices and challenges as social impact investing. The latter are investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return. In addition to the religious and ethical aspects, Islamic finance can make a catalytic difference in developmental challenges in areas like trade finance, small and medium sized enterprise funding, housing finance, affordable education, healthcare, clean water and environmental protection and energy efficiency.

Based upon the experience of the last thirty years and best practices, there is a need for Islamic finance to move towards more professional benchmarking and measurable impact on social issues and development.

As in the case of social impact investing, Islamic finance may require closer cooperation and deepening in four key aspects:

Supportive Policy Environment: So far, the creation of the IFSB standards body, the Accounting and Auditing Organization for Islamic Financial Institutions (AOFFI), the International Centre for Education in Islamic Finance (INCEIF), the International Shariah Research Academy for Islamic Finance (ISRA) and the International Islamic Liquidity Management (IILM), a facility to provide a wider range of instruments for Islamic liquidity management, means that a credible ecosystem has been built to further enhance Islamic finance. These would include the development of the required standards, talent pool and research and development on authoritative sources for Shariah interpretations on what is deemed acceptable for Islamic finance.

Furthermore, with the adoption of Islamic finance products, and trading by a number of non-Islamic financial institutions and financial centers, tax laws and regulatory frameworks have been revised to facilitate Shariah-compliant sukūk financial instruments. Almost all major international banks, including HSBC, Standard Chartered and Credit Agricole, now offer Islamic financial products and services.

Catalytic Role of Impact Investing: The key to entrepreneurial success is not just about access to finance. Equally important are the right ecosystem of infrastructure and regulatory environment, as well as the technical, marketing and management expertise necessary to take an idea or business vision and implement it to revenue-generation stage. As investors or business partners with a stake in the success of their customers, Islamic financial institutions have to take an active role in the corporate governance of their customers, a very different perspective from the passive role of conventional lenders.

Multidimensional Staffing: Successful social impact investing requires staff with multidimensional expertise who are able to understand the ecosystem of customers, the policy environment and also the challenges faced by customers, from consumers to entrepreneurs, large and small. Shared value creation requires the staff of Islamic financial institutions not to act as risk-shedders, but as risk sharers who must understand the unique risks and needs of the customers, including the necessary financial services that can create social/environmental value, while generating adequate financial returns.

Ethical Equity Investing Requires a Sustainable Entrepreneurial Model: Social impact investors face a dilemma of choosing between "financial return" and "social impact first". Similarly, Islamic finance requires a balance between financial and social objectives that necessitates a disciplined approach towards long-term sustainability, which would preclude running persistent losses. Hence, Islamic financial institutions must set clear deliverables with standards to measure impact and operational accountability. The staff and management would, therefore, need to demonstrate not only high ethical standards, but also entrepreneurial ability. They must understand that entrepreneurship with financial discipline is crucial to social development.

THE FUTURE OF ISLAMIC FINANCE

London recently became the first non-Muslim financial center to issue Islamic bonds (sukūks). With the creation of an Islamic finance index on the London stock exchange, "London, as one of the leading financial and cultural centers of the world, and the business gateway between the Muslim and non-Muslim world"[5] could well pave the way for Islamic finance to go global.

Various Islamic countries have recognized that there is considerable unrealized demand for Islamic financial services, which would require that the supply of Shariah-compliant products and services be increased, and that financial inclusivity be expanded.

There are three major areas for future cooperation, namely, development of Islamic financial instruments and markets, improving perception and enhancing awareness, and talent development and capacity building.

CONCLUSION

The internationalization of Islamic finance promises a more sustainable model for finance to serve the real sector, address poverty, financial inclusion and environmental sustainability issues. Being ethical and equity-based, Islamic finance faces similar opportunities and challenges as social impact investing in demonstrating that social investing with financial discipline and ethical tenets has its rightful place within the global financial system.

Taking Islamic finance to the next stage in terms of scale and market demand requires a concerted effort to promote awareness about its merits, especially in non-Islamic countries. At the same time, measures to address legal, tax, regulatory, accounting standards, infrastructure and other impediments specific to Islamic finance are important. In particular, the development of a comprehensive risk management framework that takes into consideration the special characteristics of Islamic financial transactions and practices would be critical in securing the sustainable growth and expansion of Islamic finance.

[5] *TheCityUK. 2013. http://www.thecityuk.com/assets/Uploads/Islamic-finance-2013-F.pdf*

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