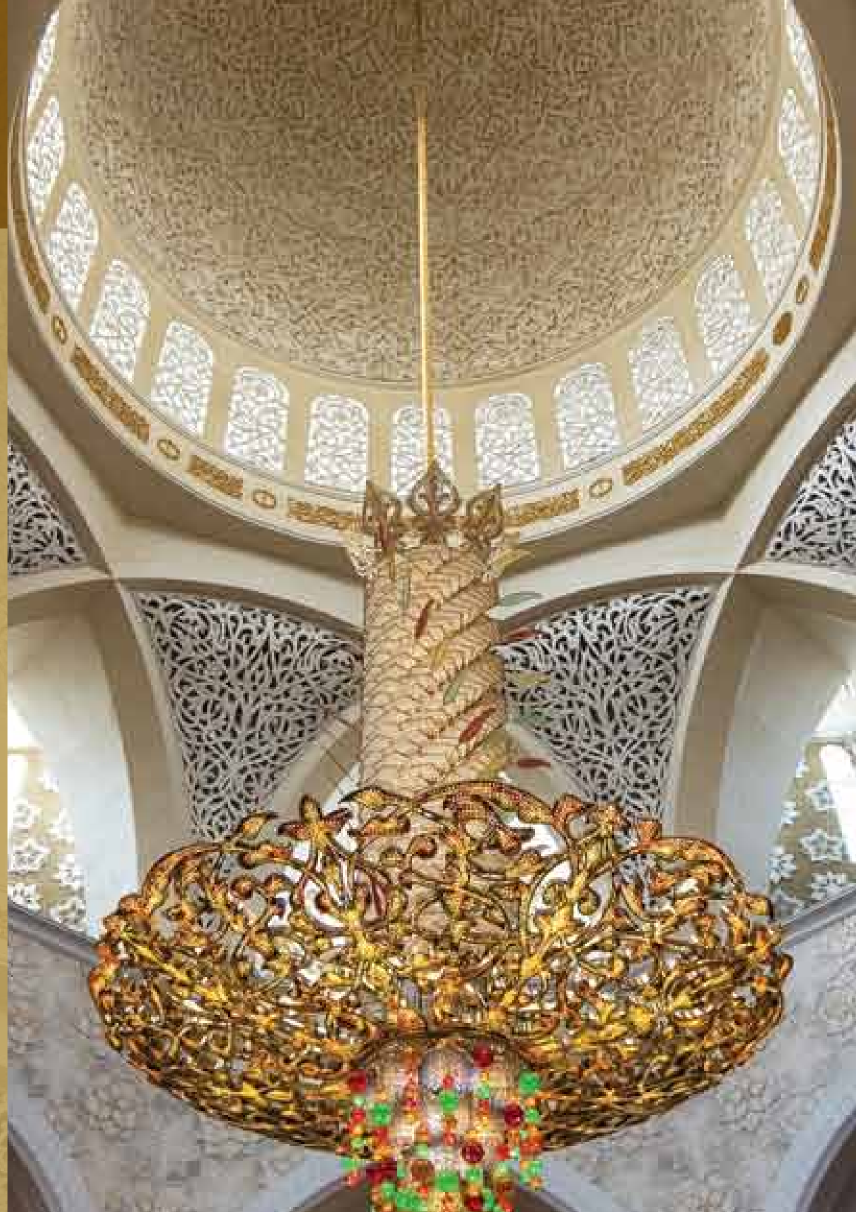
Global Report on Islamic Finance 2018

Overview



The Role of Islamic Finance in Financing Long-term Investments

ISLAMIC DEVELOPMENT BANK GROUP

WORLD BANK GROUP

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This booklet contains the overview, as well as list of contents, from *Global Report on Islamic Finance 2018: The Role of Islamic Finance in Financing Long-term Investments*. An electronic copy of the final, full-length report, once published, will be available at http://www.irti.org/English/Pages/Publications.aspx and https://openknowledge.worldbank.org/ and print copies can be ordered at http://amazon.com. Please use the final version of the report for citation, reproduction, and adaptation purposes.

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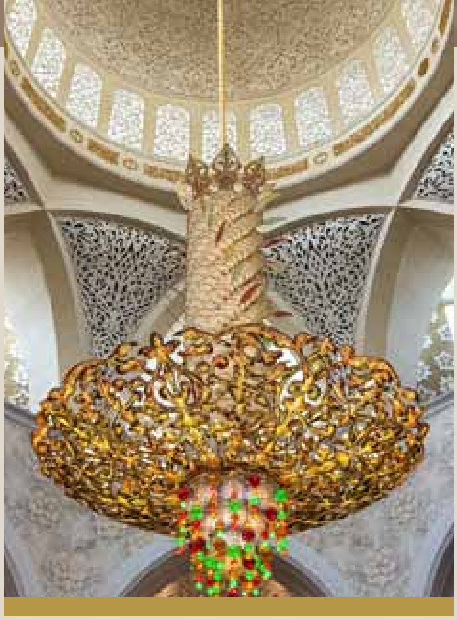

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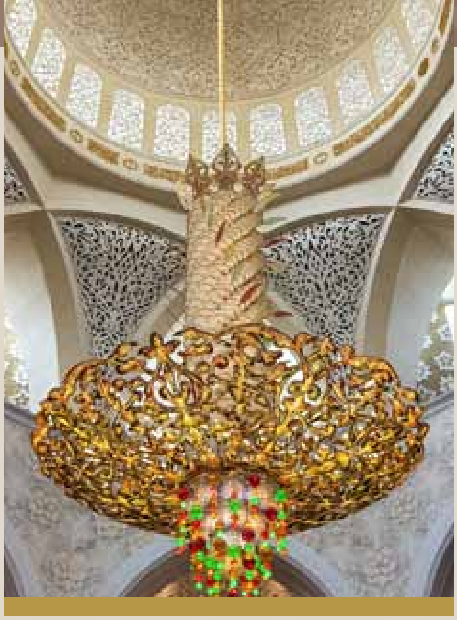


Foreword

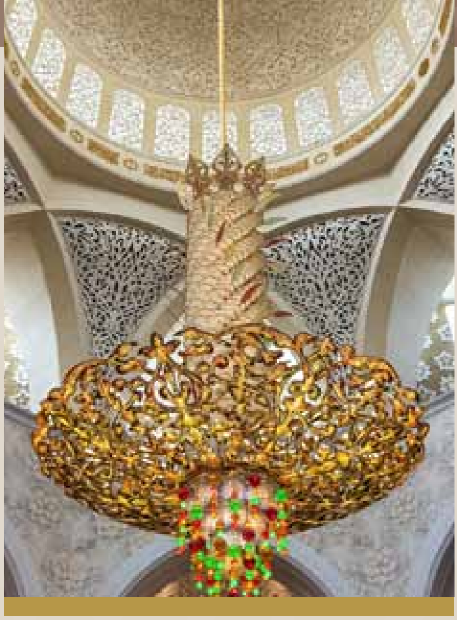
The development community is facing the challenge of mobilizing financing for long-term investments needed to eradicate poverty, provide education, access to clean water and fight climate change. It appears that there is no shortage of funds as trillions of dollars are invested in securities earning negligible or sometimes negative returns. The question remains: what are the key impediments to attracting funds for long-term investments? This joint report by the Islamic Development Bank (IDB) Group and the World Bank Group (WBG) attempts to address this question. The theme of the report is quite relevant, timely and has been well justified.

The report rightly proposes incentivizing "risk sharing" and asset-backed finance as the potential mechanism to attract financing for long-term investments. One of the major features of risk-sharing finance is that all participants have 'skin-in-the-game' resulting in alignment of interests. By its very nature, Islamic finance based on the principles of risk sharing (equity and asset-backed financing) offers the right ingredients to mobilize long-term financing provided an enabling legal, regulatory, and financial ecosystem is developed. Therefore, Islamic finance can and should occupy this space to make a difference.
For more than 40 years, the IDB has been practicing Islamic finance and striving to promote economic development through its operations. For attaining long-term sustainable development, the IDB has embarked on a new initiative to reposition the bank in the changing development finance landscape in the wake of the 2030 global agenda for sustainable development. Under the new initiatives, the IDB Group is committed to forging partnerships with both public and private sector, insists on the development of financial markets and financial infrastructure, and the wider role of private sector in economic development. In addition, the emphasis is on enhancing the governance mechanism to provide close monitoring and risk mitigation required for risk-sharing system. In this context, the IDB Group is providing support for the development of financial sectors conducive to Islamic finance globally.

The joint initiative of the IDB Group and the WBG also reflects a global view regarding the Islamic finance and the role it can play to improve the financing for the long-term investments. I believe the periodic publication of the Global Report on Islamic Finance will not only help to direct the future growth of Islamic finance but also boost the economic development.

I congratulate the technical teams from both institutions on completion of this important report.

Dr. Bandar M. H. Hajjar
President, Islamic Development Bank Group
April 2018



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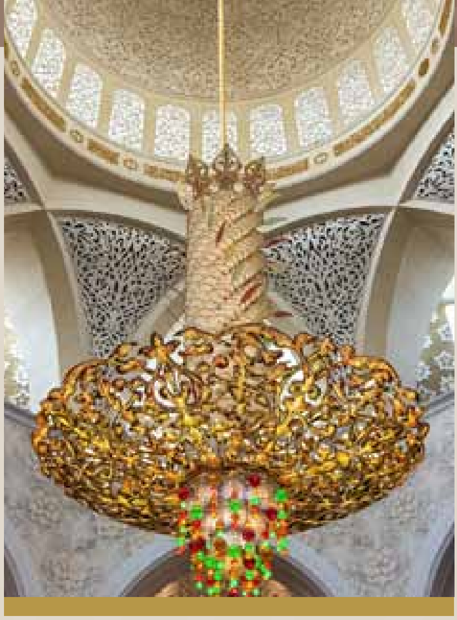


Executive Summary

Long-term finance plays a major role in sustainable economic development because it helps advance structural transformation of economies, stimulates development of infrastructure, and provides funds for fixed investments to enhance production capacity. The need for funding long-term investments is so huge that resources by governments, multilateral development banks, and other traditional development partners remain insufficient. The role of the private sector is critical in meeting the challenges of long-term financing needs. However, the existing financing patterns clearly indicate the preference of investors for assets with short-term maturity despite their meagre returns. Thus, extending the maturity structure of finance is a key policy challenge for the development community.

Market factors under existing conditions, together with systemic biases toward short-term debt and risk transfer mechanisms, substantially reduce the availability of funding for long-term financing, which creates deficiencies in resource allocation and a gap in long-term funding, despite the ample supply of global savings. While the gap exists globally, it is particularly critical in developing economies because it hampers the implementation of much-needed investment projects to enhance welfare. This edition of the Global Report on Islamic Finance presents a global perspective on the needs for and impediments to long-term financing. To deal with the ongoing underfunding problem in long-term investments, it proposes the use of Islamic finance, which is based on risk sharing rather than risk transfer, and thus offers many advantages.

Key impediments to raising long-term financing

The report identifies many impediments on both the systemic and the usual demand and supply level in mobilizing funds for long-term investments. Although there are several issues stifling the financing for long-term investments, the report finds that the most important impediments are the over-allocation of savings to short-term and medium-term instruments, excessive leveraging, and incentives for risk transfer. The risk-transfer paradigm of conventional finance not only constrains funding for long-term investment but also reinforces the plight of overleverage and short-termism in the current global financial system that is responsible for many more challenges for the contemporary global economy.

Risk-sharing and Islamic finance

The potential of long-term finance can be unlocked by adopting a risk-sharing structure that reduces the systemic risk and moral hazards associated with the conventional risk-transfer structures. The sharing of risks and contingency of returns can allow socially optimal projects to be undertaken that might otherwise seem unfeasible from a risk-transfer perspective. Risk-sharing also enables the commitment to mutuality and long-term horizons in investing.

Against this backdrop, the report introduces Islamic finance as one of the possible ways to meet the challenges of providing adequate funds to long-term investments on a sustainable manner. Risk sharing is the preferred organizational structure for Islamic economics and finance. Islamic economics and finance offer a framework based on risk-sharing that can serve a viable means of long-term investment financing. Importantly, Islamic finance can mobilize resources to the real sector, rather than channeling much-needed funds to the money markets. This risk-sharing framework attempts to address the shortcomings of the conventional model. It is based on four pillars: institutional foundations in line with Islam's rules of behavior; accountable governance and legal system; a long-term investment horizon; and mobilization of funds on the basis of sharing risks among parties.

Challenges for Islamic finance

The exceptional growth of the Islamic finance industry in the last decade is a remarkable development, but it began from a low base and still constitutes a small fraction of global finance. The risk-sharing nature of Islamic finance has attracted attention in all financial sectors, including banking, capital markets, and insurance. The report provides a comprehensive review of the status and development of various sectors and how each sector is contributing to long-term financing. The main finding from this analysis is that despite the huge potential, Islamic financial sector is a small player in the global financial markets and requires a concerted push for the regulatory and legal changes to take root.

The report highlights several challenges for Islamic finance in mobilizing funds to long-term impactful investments. To reduce uncertainty and provide protection of property and investors rights, macroeconomic and political stability, institutional development, and an enabling legal and regulatory regime are necessary. At the micro level, the organizational framework of financial institutions and the diversity of financial instruments offered determine the extent to which long-term financing needs are met. Currently, Islamic financial institutions are subject to the similar regulatory regime as conventional institutions, thus forcing them to develop financial instruments similar to conventional instruments, even if those instruments are *Sharīʿah*-compliant. However, this stricture limits the full benefits that could be obtained through the risk-sharing feature of Islamic finance.

The report reviews the status and developments of Islamic finance for a sample of 12 member countries of the Organisation of Islamic Cooperation (OIC) in the light of the 10 years that have elapsed since the foundational report, Islamic Financial Services Industry Development: Ten-Year Framework and Strategies 2007 (IRTI and IFSB 2007), was issued. The findings suggest that countries are at different levels of development with respect to the key recommendations related to the developments in national plans and strategies, the legal and regulatory frameworks, the *Sharīʿah* governance regime, liquidity infrastructure, and deposit insurance schemes. Some countries, such as Indonesia, Malaysia, Oman, and Pakistan, have adopted national action plans for the development of the Islamic financial sector, including separate Islamic financial laws. In other member countries, adoption is still at very early stages.

Policy Recommendations

Despite the remarkable growth of Islamic finance, policy interventions are needed in several areas to better utilize the merits of Islamic finance in mobilizing funds for long-term investments. The report's policy recommendations have a dual aim: not only to promote Islamic finance to make the provision of long-term financing more efficient, but also to encourage a global paradigm shift away from overreliance on short-term instruments toward adding economic value. To these ends, the report offers two main sets of recommendations:

Strengthen the financial system by developing a supportive legal, administrative, and regulatory environment

A financial sector with weak governance and lack of transparency is hampered by market frictions, inefficiencies, and financial exclusion. Fundamental institutional problems and market failures need to be addressed to reduce uncertainty and protect property and investors rights, which are impeding the mobilization of long-term financing at both the systemic and the usual demand and supply levels. The report recommends the following:

- Introduce a supportive legal, administrative, and regulatory infrastructure that establishes and protects investors' rights, provides effective mechanism for dispute resolution, institutes a sound insolvency framework, and strengthens financial supervision for the efficient mobilization of resources on the basis of risk sharing.
- Adhere to strong corporate governance values that increase the accountability and transparency of the financial system.
- Enhance coordination among standard-setting bodies to provide unified *Sharīʿah,* regulatory, and accounting treatments.
- Develop secondary markets to provide liquidity in the markets for long-term financing instruments.

Enhance the institutional framework and diversity of instruments for long-term financing

This report finds that institutions and instruments associated with risk-sharing finance can mitigate agency conflicts because all parties partake of the risks as well as the rewards: that is, they have "skin in the game." However, few instruments are available to serve this purpose, mainly because universal regulatory requirements are commonly adopted to cover both conventional and Islamic financial institutions. The report emphasizes that innovations in financial institutions and instruments that promote risk-sharing and asset-backed financing are essential not only to deleverage the financial system but also to make it more conducive to long-term finance. A financial system based on asset-backed financing would encourage real transactions and growth in the real sector. To this end, the report makes the following policy recommendations:

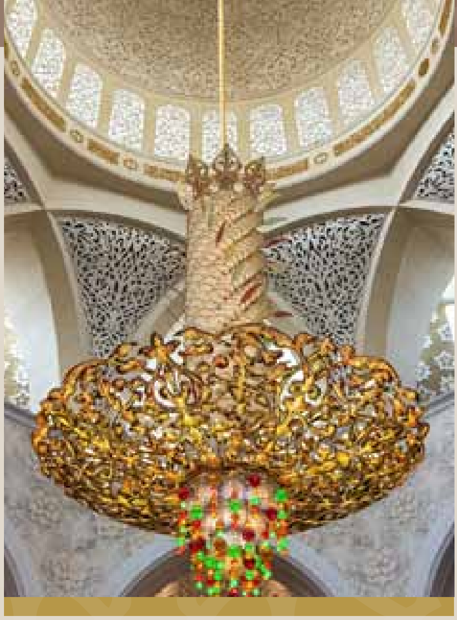
- Promote the development of capital markets for *Sharīʿah*-compliant instruments to mobilize resources for long-term projects by engaging institutional investors, including pension funds, sovereign wealth funds, asset management firms, venture capitalists, and private equity firms.
- Engage Islamic banks in *Sharīʿah* -compliant syndicated financing to finance long-term and larger projects.

- Introduce regulations to unlock the potential of Islamic banks to provide long-term financing using investment accounts.

- Provide incentives for Islamic financial innovation based on FinTech solutions, especially for mobilizing the dormant Islamic social sector to support investments with environment and social as well as economic impacts (impact investing). Crowdfunding, for example, can pool resources (*Zakāt, Ṣadaqāt, Waqf*) from small surplus units and channel them toward investment in large-scale projects that would otherwise be beyond the scope of any one individual.

- Capitalize on blended finance and public-private partnerships (PPPs) by developing new products and expanding existing ones to increase the use of Islamic finance for projects of mutual benefit to the public and private sectors.

The report demonstrates how risk-sharing finance can play a key role in mobilizing funds to long-term investments and provides examples of the ways that Islamic finance can be utilized to release the potential of long-term financing that advances social, environmental, and economic goals.



Overview

The adoption of the Sustainable Development Goals (SDGs) by the development community testifies to a shared responsibility toward the well-being and empowerment of mankind. To achieve the desired sustainable development, there is a huge need for investment in capacity-building assets. The United Nations estimates a gap of $2.5 trillion between the annual investment needs of the SDGs of $3.9 trillion and current annual investments of $1.4 trillion (UNCTAD 2014). The challenge posed by the scale of funding requirements is further aggravated by the need to commit funds for long-term horizons. Moreover, there is broad consensus that to deal with the complex challenges of climate change, growing urbanization, and social imbalances, the world needs to invest more in long-term sustainable projects.

The need for long-term funding for investment to expand the sustainability and productive capacity of the modern economy was explored in a World Bank Report in 2015. The findings of the report (World Bank 2015) suggest that by its nature, long-term finance exerts a stabilizing influence on the financial system. Long-term investors can provide necessary support during economic downturns, given their extended investment horizon, countercyclical strategies, and emphasis on long-term value. In contrast to short-term liquidity-chasing investors, long-term investors mitigate investees' rollover risks (risks associated with the refinancing of the debt) and fund crucial societal needs. Access to long-term investment vehicles can also improve households' welfare by allowing them to smooth their consumption over time and share the benefits of economic growth. Long-term financing is often considered to be an important driver of sustainable economic development, helping in structural transformation, infrastructure investments, and budgetary support.

Although estimates of long-term investment financing needs vary considerably and are not necessarily precise, studies conclude, unanimously, that the needs are extremely large. Over the next 15 years (2016–30), the global economy will need to invest $50 trillion to $90 trillion in infrastructure assets such as urbanization investments, transport systems, energy systems, water and sanitation projects, and telecommunication systems (Woetzel et al. 2016; Bhattacharyna, Oppenheim, and Stern 2015). This translates into almost doubling the current infrastructure spending of $2 trillion to $3 trillion per year. At the firm level, long-term financing is generally used to acquire fixed assets, equipment, and the like. Empirical evidence suggests that the use of long-term finance is associated with better firm performance. Access to long-term financing was significantly constrained after the global financial crisis of 2007–09. While the impact varied across countries of different income grouping, small and medium enterprises in lower-middle- and low-income countries were hardest hit. Lack of long-term finance exposes deserving firms to roll-over risks, which may in turn dissuade longer-term fixed investments, with adverse effects on economic growth and welfare. The World Bank Group estimates a funding gap of $2.1 trillion to $2.6 trillion for micro, small, and medium enterprises (MSMEs) globally (Stein, Ardic, and Hommes 2013).

The mobilization of funding for long-term investments is faced with many impediments on both the systemic level and through the usual demand and supply factors. Leveraging and incentives for risk transfer, the unavailability of financially viable long-term projects, political myopia, macroeconomic instabilities, high entry barriers, inadequate risk assessment frameworks, weak legal and institutional frameworks, illiquidity in the financial markets, fiscal consolidation, and restrictive lending environments are the main issues stifling the financing for long-term investments.

On the other hand, it is obvious that the problem is not the paucity of financial resources, as there is an ample supply of global savings to meet the needs of long-term investment. According to World Bank estimates, more than $10 trillion is invested in negative interest rate bonds; $24.4 trillion is invested in low-yield government securities; and $8 trillion is sitting in cash, waiting for better investment opportunities (World Bank 2017). Thus, the problem is the "allocation" of these resources, which vastly underfund long-term investment.

In this regard, various policy initiatives have been endorsed to mobilize international organizations (including the International Monetary Fund, the Organization for Economic Co-operation and Development, the World Bank Group, and Islamic Development Bank Group) to address the potential detrimental effects of a prolonged underfunding of long-term investment. While there are small differences of opinion as to the specifics of the proposals to addressing the gap, they agree on the diagnosis. Islamic economics and finance, owing to its nature of risk-sharing and equity participation, provide an alternative perspective and solution to the ongoing challenges mentioned.

To explore the potentially pivotal role of Islamic finance in long-term financing, the World Bank Group and Islamic Development Bank Group decided to focus on the topic of "Financing Long-Term Investments" as the general theme for the second edition of the Global Report on Islamic Finance (GRIF). This report has five main objectives:

To deepen understanding of the significance of long-term financing by documenting why long-term financing is needed.

To provide a critique of the traditional financing model of transferring risk by presenting the theoretical rationales and discussing policy issues related to financing of long-term investments from the perspective of Islamic economics and finance.

To formulate a theoretical framework that emphasizes the central role of risk-sharing as a mechanism for acquiring long-term investment for sustainable economic development and provide some empirical evidence of widespread needs for long-term investments.

To review recent developments and trends in Islamic finance as a means of long-term financing, and to discuss challenges that Islamic finance faces in mobilizing long-term finance.

To explore policy options to remove key barriers impeding the development of Islamic financial industry for long-term financing.

The report identifies the existing tendency of conventional finance to transfer risk to be one of the underlying reasons for over-allocation of savings to short-term and medium-term instruments. This tendency not only constrains funding for long-term investment, but is also responsible for many more problems and challenges for the contemporary global economy, including stagnation of economies around the world, constrained private investment, the decline in productivity, and the sizable increase in global debt since the global financial crisis.

This report suggests adopting a risk-sharing solution to address the risk-transfer problem impeding long-term investments. Risk-sharing financing may resolve some of the major problems and meet the challenges associated with risk transfer. The risk-sharing mechanism has the potential to create a culture of trust, increase investment (by funding projects that are rationed out of risk-transfer markets), reduce individual risk aversion through collective risk taking, and increase financial inclusion (Bowles 2013). All these advantages increase x-efficiency in the economy, which is the ability to get maximum output from the inputs, leading to expanded productivity (Leibeinstein 1966). More importantly, risk-sharing finance reduces inequality of income and wealth distribution by allowing lower-income classes to become holders of real assets and builders of wealth.

Given the benefits of risk sharing, the report addresses the question as to why there is so much reluctance to risk-sharing financing and suggests that current economic development models rely heavily on the leverage and liquidity in the financial markets. However, both these factors impede the provision of long-term funding due to the higher uncertainty associated with the long-term contracts and the procyclical nature of credit markets.

Another reason for the prevalence of leverage-based risk-transfer instrument is the set of market imperfections leading to ex ante adverse selection by the lenders and ex post moral hazard of the borrowers. The presence of such market imperfections creates a consistent rift between the borrower and the lender. In a debt contract, the lender attempts to address the market imperfections by requiring collateral and charging a risk premium to compensate lenders for the default of the borrower. However, in the event of default, the lender still pushes for recovery from the borrower and restricts further lending. In such a scenario, any of the potential causes of distress in the financial system may perpetuate a vicious cycle of defaults and crisis due to borrowing restrictions and liquidity constraints. There is mounting evidence suggesting that interest-bearing debt and leveraged balance sheets pose systemic problems and can potentially undermine sustainability.

One of the important elements in the collateral and risk premium approach is the unilateral motives of the lender for the recovery of loan and interest without regard to the fate of the venture. This undermines the commitment to mutuality among the parties in a financing relationship, enhances individual risk aversion, and discourages investment for long-term projects.

In this regard, these problematic aspects of leverage-based risk-transfer type of financing have been under question for years, especially after the global financial crisis. A number of recent studies have offered fundamental critiques of the collateral and risk premium approach. Taleb (2008) regards the higher amount of equity as a necessary condition to control extraordinary and unexpected risks, which he referred to as black swans.[1] Taleb posits a view of risk relationships that is systemic. A player that thinks systemically looks at the system organically, rather than mechanically, recognizing that the system must adapt itself to the changing context and environment, from both endogenous and exogenous sources of change. By contrast, conventional debt finance models have a partial and fundamentally self-interested view of risk relationships.

Bowles (2013) emphasizes that risk-sharing contracts have characteristics that mitigate the risk of contract violations arising from the agency conflict. Gintis (2002) argues that the self-interested "rational" actor (Homo economicus) depicted in

[1] Taleb discusses in his seminal book (2007) that unexpected events which are considered extreme outliers play significantly larger roles than regular occurrences. Thus, any analysis omitting outliers lacks substantial portion of information. This idea has implications on finance as well as history, science, finance, and technology. In finance, Taleb's Black Swan Theory is acknowledged in the discussion of tail risks. A conservative approach to leverage, i.e. strong equity capital, may limit the probability of tail risks.

neoclassical economics is one of the types of human subjects characterized as engaging in strategic interactions.

On the other extreme of the Homo economicus, Gintis posits Homo reciprocans, who exhibits strong reciprocity, and a propensity to cooperate and share with others— even when there are no plausible future rewards or benefits from so behaving. This reciprocal approach emphasizes mutuality, commitment ("skin in the game"), incentives to focus on the common good of the parties to the contract, and horizontal governance, which is self-enforcing (in contrast to the top-down governance of risk-transfer contracts).

Islam endorses risk sharing as the preferred organizational structure for all economic and financial activities. From this perspective, Islamic economics and finance offer a framework based on risk sharing that can serve a viable means of long-term investment financing. Importantly, Islamic finance can mobilize resources to the real sector, rather than channeling much-needed funds to the money markets. This risk-sharing framework attempts to address the shortcomings of conventional model. It is based on four fundamental pillars: 1) institutional foundations in line with Islam's rules of behavior; 2) an accountable legal system and modes of governance; 3) a long-term investment horizon; and 4) mobilization of funds on the basis of sharing risks among parties.

Establishing efficient institutions and an institutional framework in line with the objectives of Islam is essential to creating an enabling environment for long-term finance. While institutions lay the foundation of a system, a sound legal system and an appropriate governance mechanism is needed to ensure smooth functioning of the financial system. The need is more pronounced in contracts based on risk sharing, given the contingent nature of parties' claims and the limitation of human foresight. The core principle of risk sharing in Islamic finance stipulates that investors and users of funds share the outcome of the project or asset being financed. Encouraging financial instruments that promote risk sharing and asset-backed financing could make the financial system more conducive to long-term finance. The development of equity-based capital markets could play an important role in mobilizing resources without creating leverage in the economy. Islamic finance is well suited for long-term financing because of its emphasis on materiality, property rights, risk sharing, and addition of value. The report, however, highlights several challenges for Islamic finance in mobilizing funds for long-term investment that supports broader goals of serving the economy, society, and the environment. The biggest challenge in achieving the potential of Islamic finance for funding long-term investments lies in the dominance of the Islamic banking subsector. The underdevelopment of Islamic capital markets is another impediment that undermines an important channel through which long-term investment financing is normally provided. Further challenges are the lack of prerequisites for risk-sharing-based Islamic finance, including property rights and good governance; market failures and policy distortions; lack of awareness of the full cost of risk transfer; and under-utilization of the Islamic social sector as an area of long-term investment.

To advance discussion about the state of acquiring long-term funding using the risk-sharing mechanisms, the report provides an empirical review of long-term investment financing from the perspective of Islamic finance. The review identifies a well-functioning financial system as one that is based on appropriate governance mechanisms, supporting infrastructure that enhances risk sharing, and institutional arrangements to promote trust and cooperation to support financing for long-term investments. With this standard in mind, the review then considers the broader challenges in creating an enabling environment for long-term financing. Specifically, the review compares the relative state of member countries of the OIC with respect to the rest of the world in terms of their ability to and progress in creating this enabling environment. The review analyses factors affecting the supply of and demand for risk-sharing long-term finance, such as macroeconomic and political stability, institutional development, and risk-sharing friendliness. It also examines the relative status of financial development and long-term financing in the member of the OIC countries.

Having drawn an accurate picture of Islamic finance as a means of mobilizing funds for long-term investments, the report concludes by providing a set of policy recommendations to address the issues highlighted and to ensure that prerequisites are in place to unlock the potential of Islamic finance for long-term financing in OIC member countries. Table O.1 summarizes the recommendations and policy interventions suggested in the report.

Table O.1. Policy Recommendations

Challenges	Policy recommendations: Public policies	Policy recommendations: Financial institutions
Political and macro-economic environment	• Enhance political and macroeconomic stability to reduce long-term risks. • Pursue prudent monetary and fiscal policies to keep inflation low. • Strengthen the institutional framework to promote protection of property rights, rule of law, good governance, and sound infrastructure to enhance credit information and information about long-term projects. • Establish stable and predictable legal and regulatory environments to reduce long-term risks. • Provide appropriate incentives for long-term financing to all stakeholders. • Ensure effective enforcement of contracts over longer terms. • Work on changing the investment culture and behavior to favor long-term investments.	• Provide appropriate tax incentives for extending maturities. • Enable *Sharīʿah* compliant risk-mitigating mechanisms for extending maturities. • Review the regulatory and accounting treatments of assets held with long-term horizons to assess their systemic impact on the appetite for long-term investment. • Establish sectionally specific investment banks and deepen their involvement in the economy in order to boost the mobilization of funds for long-term investments through risk-sharing–based mechanisms.
Dominance of an over-exposed Islamic banking subsector	• Amend the legal and regulatory framework regarding financial markets, institutions and instruments to pave the way for the development of nonbank Islamic financial sector. • Increase competition in the financial sector by promoting other nonbank financial institutions (NBFIs). • Improve market infrastructure to support and expand Islamic capital and *Ṣukūk* markets.	• Establish Islamic NBFIs, such as leasing/*Ijārah* companies and Islamic investment banks. • Develop and expand Islamic institutional investors (mutual funds, pension funds, and the like). • Encourage the establishment of risk-sharing insurance and reinsurance (*Takāful and re-Takāful*) companies owned by the stakeholders of risk-sharing Islamic financial institutions to help mitigate the reluctance to engage risk-sharing–based financing. • Adopt best-practice guidelines to reinforce long-term horizons in the governance and portfolio management of Islamic institutional investors and sovereign wealth funds (SWFs). • Increase the efficiency of structural surpluses in national savings by redirecting them to SWFs with a long-term horizon.

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Table O.1. Policy Recommendations *(continued)*

Challenges	Policy recommendations	
	Public policies	**Financial institutions**
Lack of prerequisites for Islamic finance based on risk sharing	• Create an enabling environment for risk-sharing–based fund mobilization. • Ensure the level playing field for risk-sharing–based finance by eliminating the relevant legal and regulatory impediments as well as the debt-equity tax bias. • Reorient institutional environment to support asset- and equity-based long-term financing. • Strengthen the information infrastructure to enhance credit market information on long-term projects.	• Establish organizations that utilize asset- based and equity-based financing (leasing companies, venture capital firms, private equity firms, crowd-funding platforms, and the like). • Improve the quality of corporate governance to support firm's long-term viability and financing. • Consider providing risk mitigation mechanisms such as risk-sharing public-private partnerships that enhance long-term investment prospects. • Improve skills to manage long-term risks.
Market failures and policy distortions	• Change regulatory and tax regimes to create a level playing field for debt and equity. • Create credit information schemes to assess the credit history and ratings of firms and individuals. • Create incentives to promote long-term savings. • Provide guarantees and risk insurance to reduce uncertainty related to long-term investments.	• Develop efficient products that promote long-term savings and investment. • Create incentives that promote equity- based long-term financing. • Strengthen accounting and disclosure rules, internal and external auditing systems, corporate governance, auditing systems that verify *Shari'ah* compliance, and *Shari'ah* compliance screens.
Financial education and consumer protection	• Improve financial literacy of Islamic financial products for entrepreneurs and households. • Strengthen the legal and institutional environment for contract enforcement protecting investors' rights.	• Highlight the benefits of long-term risk-sharing modes to both investors and financial institutions.
Underutilization of the Islamic social sector	• Reform the legal and regulatory environment to support long-term investment in the Islamic social sector.	• Develop innovative solutions to re-invigorate the Waqf sector for investing in long-term projects.
NextGen Islamic finance	• Develop an enabling regulatory framework to ensure the smooth functioning of Fintech markets. • Establish educational institutions to develop adequate knowledge and skills exist on Islamic finance in general and capital markets and institutions in particular. • Promote innovation by providing supporting institutional set-ups.	• Develop financial institutions reflecting the broader goals of serving the economy, society, and the environment. • Develop innovative fintech-based financial institutions to provide diverse financial products.

Overview of the Chapters

The report consists of two parts. The first part, covering chapters 1 to 4, constitutes the theoretical background by providing discussions on the significance of long-term finance, policy challenges, and recommendations to address these issues, as well as an investigation of the effectiveness of the Islamic finance framework in promoting financing for long-term investments. The second part, covering chapters 5 to 9, is derived from the selected papers presented at the 2nd Annual Symposium on Islamic Economics and Finance: Developing Long-Term Financing and Islamic Capital Markets, jointly organized by the World Bank and the Islamic Development Bank and Guidance Financial Group in Rabat, Morocco on December 8–9, 2016.

Chapter 1 discusses the importance of long-term financing in driving sustainable economic development and helping in structural transformation, infrastructure investments, and budgetary support. Estimates of long-term investment financing needs vary considerably and are not necessarily precise. However, studies conclude, unanimously, that needs are extremely large and are unlikely to be met by the public sector alone. Capital from the public, private, and voluntary sectors must be mobilized to fill funding gaps.

Mobilization efforts are faced with various impediments with respect to both systemic factors and the usual demand and supply factors. The 2007–09 global financial crisis exposed flaws in finance theory and current practices and highlighted the need to revisit some conceptual frameworks. Most notably, the chapter considers the financial infrastructure, peripheral supporting institutions, and legal environment and finds that they reinforce bias toward debt and risk transfer mechanisms, inducing overleverage and short-termism in the current global financial system.

The demand for long-term investment financing by project planners is constrained by the availability of financially viable long-term projects, political myopia, macroeconomic instabilities, and high entry barriers, among other impediments. The supply of long-term investment financing is constrained by the lack of adequate risk assessment frameworks; weak legal and institutional frameworks; and illiquidity and investors' short-termism, which are main obstacles in the way of the efficient allocation of savings and capital.

The chapter deals with the issue of sustainability in long-term investment financing. It criticizes current financial systems, which are characterized by financialization, and the supply of a narrow range of debt-based instruments that transfer risk, such as bank credit and bonds, by entities that lack commitment to long-term horizons. As a viable alternative, the chapter proposes risk-sharing long-term finance. Risk sharing can provide the necessary financing without the need to take on excessive leverage, which could in turn help stabilize government spending and reduce debt servicing pressures. Unlike other modes of finance, risk sharing is favorable to long-term impact financing made in companies, organizations, and funds with the aim of generating social or environmental benefits alongside (or instead of) a financial return. Sharing the risks of economic and financial transactions also ensures the stability of the financial system. This in turn will increase the allocation of resources to the real sector, rather than channeling excessive financial flows to the financial sector, leading to over-financialization of the economy.

Risk sharing is one of the most important aspects of Islamic finance. The chapter provides a theoretical framework for acquiring long-term investment from an Islamic finance perspective. In a truly risk-sharing framework, Islamic finance can serve the real sector of economy more effectively in an equitable and sustainable manner than conventional finance. Indeed, the vision of Islamic finance is to offer itself as a source of stability against the plight of overleverage and short-termism in the current global financial system.

Chapter 2 empirically investigates the effectiveness of elements of the Islamic finance framework put forward in chapter 1 in promoting financing for long-term investments. These elements are used to characterize a well-functioning financial system as one based on appropriate governance mechanisms, supporting infrastructure that enhances risk-sharing, and institutional arrangements that promote trust and cooperation. This comprehensive approach offers a more functional view of a long-term sustainable financial system than the narrow focus on traditional one-dimensional proxies, such as the depth of financial markets.

The investigation depicts and compares the relative state of member countries of the OIC with respect to the rest of the world in terms of broader challenges in creating an enabling environment for long-term financing. The chapter's findings validate the hypothesis that financing based on risk-sharing principles promotes long-term investments. The strength of the presence of Islamic finance in a country (measured by the share of *Ṣukūk* issuance and Islamic banking in GDP) is positively correlated with the financial development index.

To assess the relative status of OIC countries with respect to long-term financing compared to their counterparts, two proxies are used. The first proxy is the percentage of firms citing the maturity of loans as insufficient. The second proxy is fixed asset investment.

With respect to the first proxy, the chapter finds that firms in OIC countries are more likely to be denied financing on the basis of the size and maturity of their loan application. Small firms are more vulnerable than their counterparts in this regard.

With reference to the source of investments, small and medium firms tend to prefer internal funds. Use of external finance, such as banks, seems to be weaker in OIC countries compared to non-OIC countries. Moreover, OIC countries lack a well-developed institutional investor base.

Chapter 3 presents an overview of developments and challenges in the Islamic financial sector. It does so by analyzing the development in various sectors of Islamic finance, with a special focus on risk-sharing and long-term financing aspects, where possible. At present, the bulk of Islamic finance is provided by Islamic banks. The future of long-term Islamic funding depends very much on the development of non-bank financial intermediaries. These include Islamic capital markets, *Takāful* markets, other institutional investors such as pension funds, sovereign wealth funds, private equity funds, and *Awqāf* (endowment funds). The long-term nature of many of these non-bank financial intermediaries means that they can act as shock absorbers in many financial markets.

Awqāf are currently underutilized. They have the potential to engage the private sector and become a systemic approach to overcome the shortages in long-term financing. *Awqāf* are rich in one of the important factors of production—land—as they involve the donation of a building, plot of land, or other real assets. However, they are short on other factors such as capital, labor, and organization. Given that the problem of long-term financing is not simply of time, but is also a problem of size and scale, *Awqāf* may well be used to alter projects' cash flows by providing a factor of production of significant value, so as to reduce the otherwise large upfront cost and make the project a viable business case for the private sector.

The chapter examines recent innovations in financial technology (fintech)—such as "smart" contracts, decentralized autonomous organizations (DAOs), block-chains, crypto-currencies, and crowd funding—that are closer to the spirit of Islamic law of contracts, with an undiluted focus on cooperation, transparency, and avoidance of any kind of uncertainty regarding the settlement of contracts.

Given the complexity and multidimensionality of the challenges at hand, no single authority can drive change and mobilize long-term finance alone. A collaborative and concerted approach is needed by multilateral development banks and organizations. This would involve system-wide monetary, fiscal, and structural policies to correct disincentives to risk transfer that lie at the core of the current conventional financial system. The recommendations proposed in the chapter are based on principles with universal application across geographical areas and financial systems.

In the sphere of Islamic finance, efforts to mobilize significant funding for investments with a long-term horizon are impeded by the dominance of the Islamic banking subsector; the lack of prerequisites for risk-sharing-based Islamic finance—including well-functioning institutions and rules of behavior that protect investors, creditors, and property rights; trust in government and institutions; rule of law; good governance; and a developed financial system; market failures and policy distortions; lack of awareness of the full cost of risk transfer; and underutilization of the Islamic social sector as an area of long-term investment.

Chapter 3 identifies a number of areas in which policy interventions are needed to shift away from overreliance on short-term instruments toward adding economic value through a complete spectrum of Islamic financial instruments and unlocking of maturities. The empirical analysis in chapter 3 lends support to this proposition. It indicates that a country characterized by better governance structure comprising a sound regulatory and supervisory framework, rule of law, strong institutions, and an effective government is more likely to issue long-term *Ṣukūk* than short-term or medium-term *Ṣukūk*.

Chapter 4 presents an overview of the overall status of the business and regulatory environment in the OIC member countries. It also discusses the specific status of some key legal and regulatory infrastructure institutions in a sample of 12 OIC member countries (Bangladesh, the Arab Republic of Egypt, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Saudi Arabia, Senegal, Sudan, Turkey and United Arab Emirates) representative of different geographical regions and the levels of development of the Islamic finance sector. The 2014 Mid-term Review by the Islamic Development Bank Group, the Islamic Research & Training Institute, and the Islamic Financial Services Board is used to gauge the status of the business and regulatory environment, focusing on key elements to promote a robust Islamic financial services industry. They include:

- National plans and strategies for Islamic finance
- The legal framework
- The regulatory framework
- The *Sharīʿah* governance regime
- Liquidity infrastructure
- Deposit insurance schemes

On average, OIC member countries score better than the world average in the Doing Business scale and lower than the world average in terms of their regulatory environment.

Drawing on the report's discussions and findings, the chapter concludes by providing a roadmap for supportive public policy, a sound enabling environment, and conducive financial infrastructure to strengthen Islamic finance and provide appropriate incentives for long-term financing. The full spectrum of necessary policy reforms extends beyond banks to include institutional investors, Islamic capital markets, the Islamic social sector, and Islamic fintech. Policy makers are strongly urged to consider the impact of any policy regime on the incentives of different types of investors to participate in the long-term financing market before implementing that policy. Deliberation is necessary to avoid the pitfalls of some of the existing standards and regulations, which are unintendedly detrimental to long-term investments.

Most of the solutions proposed in the conventional finance literature to overcome short-termism of financing deal only with creating new products, energizing dormant players (such as revitalizing pension funds and activating institutional investors), and improving the quality of institutions and governance.

These measures will definitely help in extending the tenure of available financing, but they are not sufficient. Similar policies are often recommended for the Islamic finance sector. This recommendation is also beneficial, as approximately the same forces that can help long-term investments in conventional finance can help enhance long-term finance in Islamic financial sector.

However, these recommendations do not go far enough. Islamic finance has much greater potential to increase the proportion of sustainable long-term finance if a culture of risk sharing and equity financing is developed and the institutional environment is improved.

Chapter 5 discusses sovereign wealth funds (SWFs) in the context of Sharī'ah-compliant long-term infrastructure finance. The chapter provides an overview of SWFs, as well as stylized facts and trends in this segment. In addition to their transactions, the chapter presents a sectoral analysis of SWF investments. The chapter suggests that SWFs could play a significant role in providing infrastructure financing because, at least theoretically, infrastructure investment matches the profile of institutional investors such as SWFs. First, it matches the long-term duration SWFs' liabilities, which can provide duration hedging. Second, it provides significantly more attractive yields, exceeding those obtained in the fixed income market, although with more or less the same level of risk and volatility—and perhaps even less. Third, investments in infrastructure assets linked to inflation could hedge the fund liabilities of some SWFs with pension mandates that are also linked to inflation. Therefore, SWFs originating from Islamic countries should be invited and encouraged by their governments to invest in Sharī'ah-compliant infrastructure funds established by either the sovereign or public or private international financial institutions. After showing that SWFs around the world have mainly been shying away from infrastructural investments, this chapter argues that the collaboration between Islamic financial institutions and SWFs could provide a ripe opportunity for *Sharīʿah*-compliant public-private partnership (PPP) infrastructure investments in OIC member countries that would satisfy the objectives and mandates of both the Islamic financial institutions and SWFs, while significantly contributing to the economic prosperity of these economies in the both the short term and long term.

Chapter 6 sheds light on the potential of Islamic crowdfunding for long-term financing. It is evident that economies have recently been constrained by tightening access to finance amid growing need for long-term investments. It is evident that countries have recently been bound to face with incremental challenges to close the funding gap amid growing need for long-term investments vis-a-vis tightening access to finance. New collective funding methods such as crowdfunding could provide solutions to the challenges in mobilizing long-term funds. Current demand for crowdfunding is high and crowdfunding is increasingly viewed as an alternative investment portfolio for investors to invest their surplus funds in specific projects. Providing the conceptual framework of crowdfunding as a tool for SMEs and infrastructure development—particularly in the form of Waqf land—this chapter attempts to discover the viability of crowdfunding, including Islamic crowdfunding, as a long-term investment instrument and source of portfolio diversification for investors. Crowdfunding takes advantage of crowd-based decision making and innovation and applies it to the funding of SMEs project and infrastructure development. This mode of raising initial capital has proven to be feasible in various countries. The potential of this mode to be as an alternative tool for long-term financing in Muslim-majority countries is great.

Chapter 7 discusses the use of *Ṣukūk* in infrastructure financing, particularly in PPP projects, while highlighting the challenges in raising funds for infrastructure projects through *Ṣukūk* issuances, and measures to overcome these issues. This chapter explores the reasons behind the underdevelopment of *Ṣukūk* in financing infrastructure projects—even though *Ṣukūk* are considered to be one of the instruments that might be highly efficient in mobilizing resources to finance infrastructure projects. In this regard, the chapter focuses on the main challenges that developing countries may face while issuing *Ṣukūk* to develop infrastructure projects, and provides some policy recommendation to make the use of *Ṣukūk* more beneficial to economic development. The chapter also discusses the role of the private sector in developing infrastructure, and its expected role in developing countries. The chapter suggests that different structures of *Ṣukūk* may have different impact on the public debt. If the *Ṣukūk* do not relieve the government of its financial commitments, their impact would be similar to conventional debt instruments. Accordingly, the chapter presents the success factors of the PPP mechanism, and shows that *Ṣukūk* issuance for financing PPP projects requires very specific arrangements that developing countries must have to make good use of its benefits. The chapter also discusses the legal and institutional aspects of the *Ṣukūk* issuance in PPPs.

Chapter 8 investigates the notion of "doing well while doing good" by examining the performance of indexes for Islamic equity, sustainability equity, and Islamic sustainability equity and comparing them against the global equity market benchmark. Specifically, the chapter addresses three key issues that are of concern to most investors: How different are the global portfolio's efficient frontiers that comprise the four types of equities? What are the driving factors behind these differences in index performance? and Do the performance and volatilities of these four indexes vary across time-periods and regimes? To this end, the chapter includes an empirical analysis of performance of sustainability and Islamic equities within the global asset classes portfolio. Overall, the findings reveal that investors do not have to pay a price for engaging in Islamic or sustainable investments. In fact, combining Islamic and sustainability investing strategies has been and can be more rewarding, particularly during economic booms, bullish equity markets, and the period of the global financial crisis. These results are consistent across individual as well as global portfolio levels. The chapter provides recommendations on how the Islamic finance industry can proactively drive mainstream sustainability investing, thereby contributing to long-term investment and sustainable capital market development.

Chapter 9 explores the implications of informational efficiency for long-term investment and financing through an empirical analysis of information efficiency of Islamic depositary receipts (a negotiable financial instrument that is traded in a local capital market but represents ownership of a foreign company's publicly traded securities). After identifying several elements of information efficiency in the market for depositary receipts (DRs), the study shows that the mispricing of Islamic DR-stocks is affected by economic growth, the foreign country's legal system, and whether DRs are issued as sponsored or unsponsored. The investigation also finds that Islamic DRs behave similarly to conventional and socially responsible DRs. Another important finding is that portfolio returns based on either Islamic DRs or their underlying shares are almost identical. This suggests that a foreign investor can seek exposure to the US equity market by investing in local firms with DR programs. On the other hand, there is evidence that developing country Islamic DRs trade at higher premiums and that civil law country DRs have higher premiums. Nevertheless, the study finds DR listings to be associated with a lower cost of equity for all types of DRs except Islamic DRs, for which the evidence is split. Overall, the possibility of financing long-term projects at a lower cost of equity through DR programs should be important for Sharī'ah-compliant firms.

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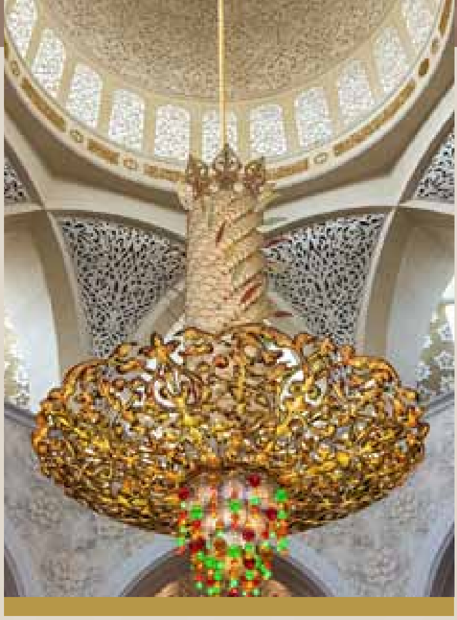

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1	Financing for Long-term Investments: A Risk-Sharing Islamic Finance Model	Alaa Alaabed Andrew Sheng Dawood Ashraf World Bank staff
2	An Empirical Islamic Finance Framework for Financing Long-Term Investment	Rasim Mutlu Salman Syed Ali
3	Developments and Challenges in the Islamic Financial Sector	Dawood Ashraf Muhammed Obaidullah Umar Taufiq World Bank staff
4	Policy Response to Development of Islamic Financial Industry for Long-Term Financing	Alaa Alaabed Habib Ahmed World Bank staff
5	*Sharīʿah*-Compliant Long-term Infrastructure Finance and Sovereign Wealth Funds	Amin Mohseni-Cheraghlou
6	The Potential of Islamic Crowdfunding for Long-Term Financing	Anwar Allah Pitchay Etsuaki Yoshida Hassanudin Bin Mohd Thas Thaker Mohamed Asmy Bin Mohd Thas Thaker
7	Challenges in Infrastructure Financing through *Ṣukūk* Issuance	Houssem Eddine Bedoui Rami Abdelkafi
8	Doing Well while Doing Good: Islamic Investing and Sustainable Equity Investing	Adam Ng Ginanjar Dewandaruc Ruslan Nagayeva Wajahat Azmia
9	Informational Efficiency of Islamic Depositary Receipts: Implications for Long-term Investment and Financing	Jahangir Sultan

Notes

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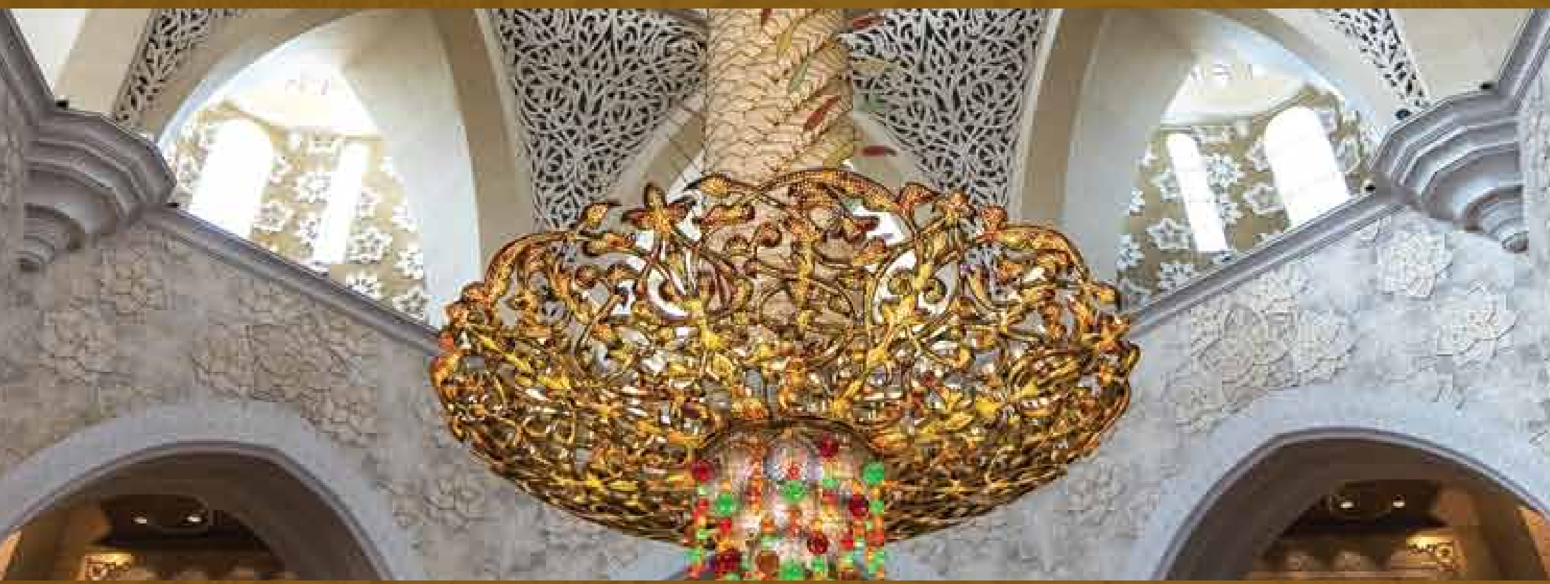

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