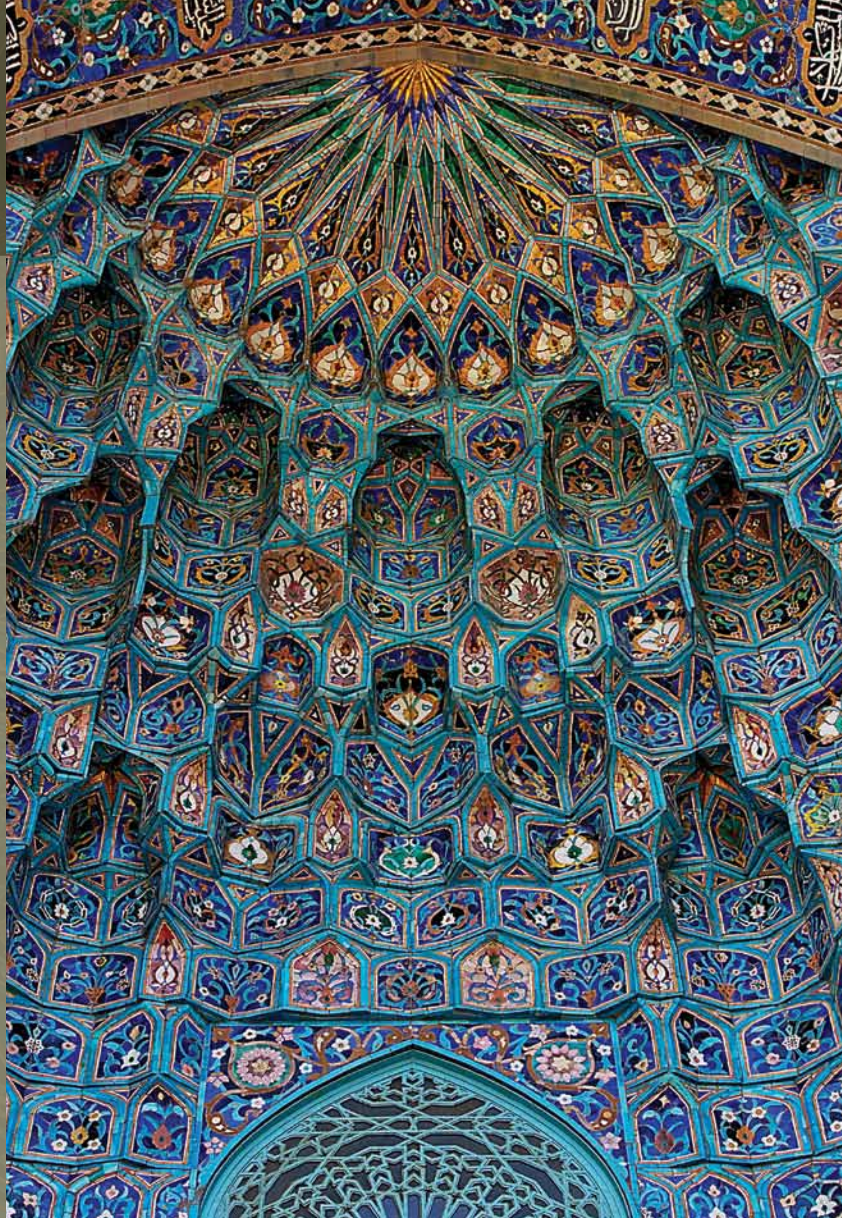
GLOBAL REPORT ON
ISLAMIC FINANCE 2016

OVERVIEW



ISLAMIC FINANCE

A Catalyst for Shared Prosperity?

WORLD BANK GROUP

GLOBAL REPORT ON ISLAMIC FINANCE 2016

ISLAMIC FINANCE

A Catalyst for Shared Prosperity?

Overview

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This booklet contains the overview, as well as a list of contents, from *Global Report on Islamic Finance 2016; Islamic Finance: A Catalyst for Shared Prosperity?* doi: 10.1596/978-1-4648-0926-2. A PDF of the final, full-length book, once published, will be available at https://openknowledge.worldbank.org/ and print copies can be ordered at http://Amazon.com. Please use the final version of the book for citation, reproduction, and adaptation purposes.

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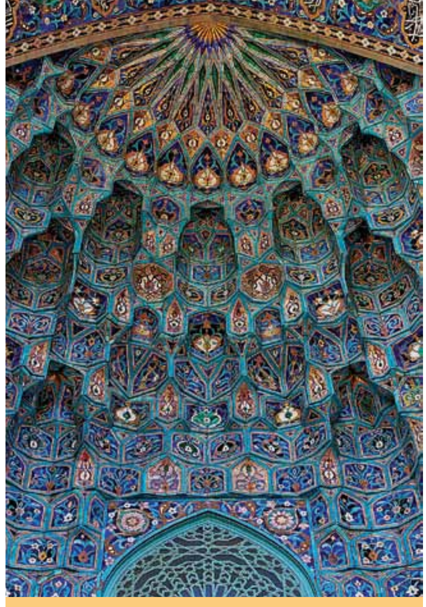
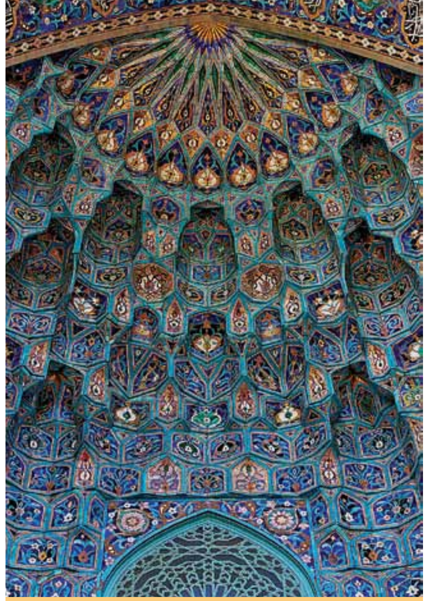


Contents



Foreword

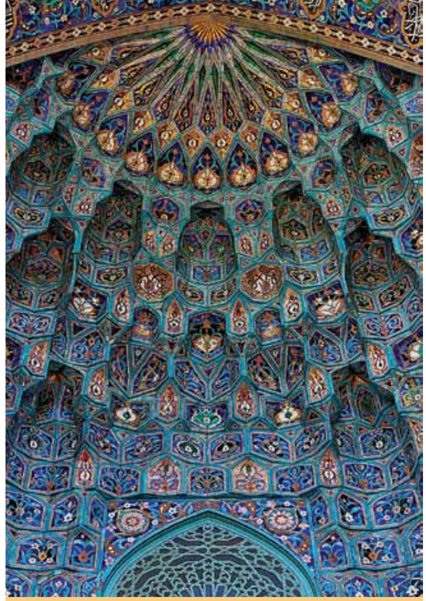
Under a joint initiative of the Islamic Development Bank Group and the World Bank Group, the inaugural *Global Report on Islamic Finance* has been prepared with a focus on the widening disparity of global wealth and how Islamic finance can help in enhancing shared prosperity. This Report is timely, as world leaders have adopted the 2030 Agenda for Sustainable Development, which includes a set of Sustainable Development Goals (SDGs) to end poverty, fight inequality and injustice, and tackle climate change by 2030. The Islamic Development Bank Group, in its 2016–25 Strategic Plan, gives priority to inclusive and sustainable socioeconomic development among member-countries within its role in advancing Islamic finance globally.

Besides imposing social and environmental costs, severe inequality adversely affects economic growth and wealth creation. The question that needs to be addressed is how to minimize the disparity in wealth and enhance shared prosperity. Given its potential role in economic development, Islamic finance can contribute toward achieving these objectives. Accordingly, the joint initiative of the Islamic Development Bank Group and the World Bank Group provides detailed research under the general theme "Islamic Finance: A Catalyst for Shared Prosperity."

The *Global Report* provides a comprehensive overview of the existing status of various Islamic finance sectors and identifies major challenges hindering the growth of Islamic finance. It also identifies policy interventions and tools for policymakers to leverage the principles of Islamic finance in an effort to eradicate extreme poverty and work toward a more equitable distribution of wealth. The main message of the Report is that Islamic finance, built on a foundation of social and economic justice, can contribute to shared prosperity through the principles of inclusive participation and risk sharing.

The experts from both institutions who helped creating this Report come with vast experience and technical knowledge and provide dual perspectives on finance, enabling readers to connect with the Islamic perspective of finance. The joint initiative highlights that there is a lot that we can learn from one another. We hope that this Report will be the beginning of a fruitful and productive collaboration among international and multilateral institutions to serve our global community.

Dr. Ahmed Mohamed Ali
President, Islamic Development
Bank Group
September 2016



Acknowledgments

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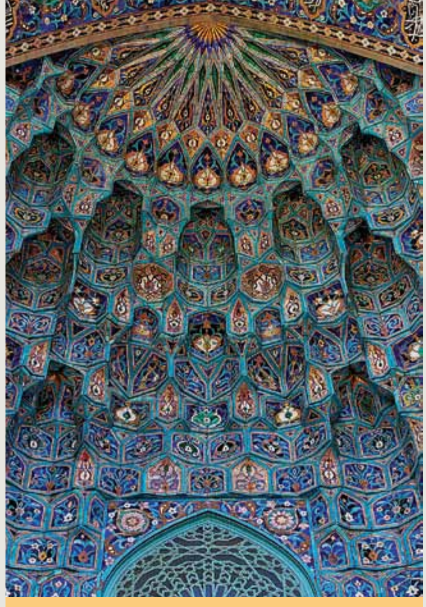

Overview

There is broad consensus that the objective of economic development is not only to boost economic growth but also to share prosperity with all segments of society through equitable distribution of income and wealth. The trickle-down approach asserts that higher productivity and industrial advancement lead to higher gross domestic product (GDP) growth, which will improve the well-being of all segments of the society, including the poorest and most marginalized in a country. However, recent experience has shown that the immediate impact of such a growth-led policy can be an undesirable concentration of wealth in the hands of a few, while the growth benefits trickle down to the extremely poor only over a relatively long period of time. Inequality increased considerably in the aftermath of financial crisis of 2007–08. The seriousness of the problem is highlighted by a few striking facts:

- Almost half of the world's wealth is now owned by just 1 percent of the population (Working for the Few 2014).
- The richest 10 percent of the world's population hold 86 percent of the world's wealth, and the top 1 percent alone account for 46 percent of global assets (Credit Suisse 2013).
- In the United States, the wealthiest 1 percent has captured 95 percent of growth since 2009, while the bottom 90 percent has become poorer (Working for the Few 2014).

There is growing realization that despite good intentions, development policies have led to an undesirable imbalance in income and wealth distribution. Given the significant evidence of growing inequality, its adverse effects on economic growth, and its social costs, among other wide-ranging negative impacts, there is an ongoing debate as how to minimize extreme inequality and enhance shared prosperity. Much has been said about the damages of high inequality of income and wealth to society. It erodes trust, creates barriers to social mobility for current and future generations, increases social resentment, undermines effective governance, creates a "winner-take-all" society, and breaks down social solidarity. While income and wealth inequality undermine economic performance, shared prosperity and economic performance support each other; there is no trade-off.

In this regard, several global agencies, including the United Nations, place an emphasis on inclusive and sustainable development rather than mere economic development.

The World Bank Group has revised its mission for the first time in 30 years and has included promotion of share prosperity one of the two goals, in addition to reducing the number of people living in extreme poverty.[1] Similarly, the new 10-Year Strategy of the Islamic Development Bank Group (IDBG) (2016–25) also aims at promoting inclusive and sustainable socioeconomic development among member countries by providing a leadership role in promoting Islamic finance globally.

Although, the development community's concern about growing inequality and the imbalance in distribution of wealth has led to a realization that equitable sharing of prosperity is essential, there is difference of opinion as to the approaches to achieve this goal. Islamic economics and finance provide an alternative perspective and solution to the development challenges mentioned. Given the potential role of Islamic finance in economic development, the World Bank Group and IDBG decided to focus on the topic of "Islamic Finance and Shared Prosperity" as the general theme for the inaugural edition of the *Global Report on Islamic Finance (GRIF)*. This Report has three main objectives:

- Develop understanding of the theoretical foundation of Islamic finance and shared prosperity
- Review recent development and trends in various sectors of Islamic finance, such as banking, capital markets, and social finance
- Identify policy interventions and tools for policy makers to leverage Islamic finance to eradicate extreme poverty and ensure equitable distribution of wealth.

The Report develops a theoretical framework to analyze the progress of Islamic economics and finance based on four fundamental pillars: an institutional framework and public policy oriented to the objectives of sustainable development and shared prosperity in line with the broader objectives of Islam; prudent governance and accountable leadership; promotion of an economy based on risk sharing and entrepreneurship; and financial and social inclusion for all, promoting development, growth, and shared prosperity. The risk-sharing and asset-based financing nature of Islamic finance and its potential contribution to growth and inclusive prosperity have considerable merit, particularly in light of the mounting evidence of the negative effects of debt and leverage on the economy. For example, two recent seminal works by Mian and Sufi (2014) and Turner (2015) document the strong relationship of household leverage to financial crisis and instability, and their adverse effect on economic growth.

Islamic finance, through its core principles, advocates for the just, fair, and equitable distribution of income and wealth during the production cycle and provides mechanisms for redistribution to address any imbalances that may occur. Islamic finance's approach to redistribution is based on a balanced blend of income-based redistribution through redistributive instruments and asset-based redistribution through the notion of risk sharing (dispersion of ownership). The income-based redistribution approach offers only a partial solution because it takes the current income distribution as given and aims at fairer distribution of future GDP. By contrast, asset-based redistribution is basically a risk-sharing approach; it empowers equity participation by the lower-income groups in the society. Rewards are shared, but so is risk. By making the poor direct holders of real assets in the real sector of the economy, it reduces their aversion to risk. It also creates positive incentives for behavioral factors that enhance productivity (such as trust, truth telling, and hard work) through the design of contracts that reduce or eliminate the difference between principles and agents and are conducive to the advancement of the interests of all parties to a contract (Mirakhor 2015).

Islamic finance is very relevant to the Sustainable Development Goals (SDGs), the global development agenda for 2015–30, which requires unprecedented mobilization of resources to support their implementation. Because of the transformative and sustainable nature of the new development agenda, all possible resources must be mobilized if the world is to succeed in meeting its targets. Given the principles of Islamic finance that support socially inclusive and development promoting activities, the Islamic financial sector has the potential to contribute to the achievement of the SDGs. Particularly in member-countries of the Organisation of Islamic Cooperation (OIC), where policy makers are challenged with high levels of inequality and highly indebted households, firms, and sovereigns, a solution provided by Islamic finance could lead to sustainable development and enhanced shared prosperity. Mobilization of Islamic financial institutions, capital markets, and the social sector in promoting strong growth, enhanced financial inclusion, and intermediation, reducing risks and vulnerability of the poor, and more broadly contributing to financial stability and development will be pivotal in achieving the SDGs in countries with a serious commitment to Islamic finance.

Despite encouraging developments and a rich theoretical foundation, there are a number of aspects where policy interventions or improvements in policy effectiveness are needed to develop Islamic finance to boost shared prosperity. These include enhancing the harmonization, implementation, and enforcement of regulations; creating institutions that provide credit and other information, which in turn support the provision of equity-based finance, particularly to small and medium enterprises (SMEs) and microenterprises; development of capital markets and *ṣukūk* (Islamic bond) products to help finance large infrastructure projects; and regulatory recognition of products from other jurisdictions to expand the markets through cross-border transactions.

To overcome challenges and to realize the full potential of Islamic finance, a serious and consorted effort by stakeholders is required. A summary of findings of the Report follows.

Going Beyond Banking

The Islamic banking sector is the dominant component of the Islamic finance industry. It has grown exponentially in the last two decades, accumulating nearly $1.9 trillion in assets and spreading across 50 Muslim and non-Muslim countries around the world.

Financial intermediation through risk-sharing contracts, as well as financial inclusion by Islamic banks, could contribute to shared prosperity—provided that Islamic banks pursue risk-sharing intermediation and increase the allocation of credit to the micro, small, and medium enterprises (MSME) sector. Islamic banking is not typical conventional banking; rather, it is mode of financial intermediation offering banking and asset management services. Current practices are restraining its full potential because of attempts to replicate conventional banking.

To live up to the ideals of Islamic finance, Islamic banks face many challenges, ranging from the gap between the prevalence of debt-based instruments and the aspirations of financing predominantly through equity and risk sharing, to the need for increased social capital, and the challenges of creating an enabling regulatory framework. To contribute to shared prosperity, the Islamic banking sector should focus on six key areas of improvement, and adopt best practices. These include:

1. Creating an enabling regulatory environment by supporting consistent regulations; ensuring consistent implementation of the Basel III and Islamic Financial Services Board (IFSB) frameworks; ensuring that systemic risks in dual banking systems (conventional and Islamic) are addressed; and implementing cross-border supervision
2. Introducing innovative risk-sharing products and services, rather than replicating conventional risk-transfer products
3. Harmonizing *sharīʿah* governance through efforts to unify cross-country *sharīʿah* rulings about Islamic finance, which would help accelerate the growth of the industry
4. Enhancing the scale and access to Islamic finance to include low-income earners
5. Improving liquidity and ensuring stability
6. Bolstering human capital and literacy in Islamic finance.

Developing Vibrant Capital Markets

Capital markets through equity- and asset-based finance could play a critical role in reducing poverty by providing opportunities for poor to build assets. Islamic capital markets are relatively young, but are second largest segment of the Islamic finance sector, after banking. The *ṣukūk* (Islamic bond) market has grown considerably over the last decade. *Ṣukūk* offer great potential for promoting shared prosperity because of their suitability for financing infrastructure, raising funds for new businesses, encouraging entrepreneurship, and supporting economic development. Unlike other asset classes, they offer a hybrid profile between pure equity and debt, and are thus attractive to a wide range of investors and finance seekers, again with a positive potential for shared prosperity.

Development of vibrant capital markets is the essential ingredient for Islamic finance. There is the need for incentives to encourage risk sharing, particularly through the development of markets for equity trading. This is hindered by the perverse tax treatment that classifies interest as a tax-deductible expense. In order to create a level playing field for debt and equity, there is a need to eliminate the tax shelter on interest payments. Tax neutrality for *ṣukūk* issuers and investors could further boost the market. The use of *ṣukūk* by governments and governmental agencies' to mobilize financing is essential to develop a long-term yield curve and to develop a corporate *ṣukūk* market, as well as to promote transparency and efficiency of the asset pricing.

Promoting the Nonbank Financial Institutions Sector

International financial systems are realizing the growing importance of nonbank financial institutions (NBFIs) such as housing finance, leasing, and asset management, especially their potential contribution to economic development. The risk-sharing and asset-backed nature of Islamic finance products is more suitable for providing financial services through NBFIs. This sector is currently underdeveloped and underutilized in Islamic finance, and therefore should be given priority by policy makers.

A good place to start is with Islamic insurance. Besides providing protection against risk and uncertainty, *takāful* could play a critical role in enhancing financial inclusion, reducing poverty, achieving inclusive economic growth, and boosting shared prosperity. *Takāful* can provide important benefits to households and firms. Greater access to financial services for both households and firms may help reduce income inequality and accelerate economic growth. Protection against unexpected shocks to income and enhanced productivity through better health for the poor and the vulnerable segment of the society through micro*takāful* could become an effective tool for combating poverty. With the growth of Islamic microfinance, especially in member-countries of the Organisation for Islamic Cooperation (OIC), there is need to develop the micro*takāful* industry to provide protection against uncertain events and loss of income.

To attain a robust Islamic financial NBFI sector that will promote inclusive economic development and shared prosperity, certain requirements must be met, including supportive institutions and public policy; responsible governance and leadership; promotion of risk sharing and entrepreneurship; and a sound regulatory and supervisory framework. Serious supply- and demand-side and legal challenges must be overcome. Increasing the number and diversity of Islamic NBFIs, together with increasing the range of products offered to various segments, are two major challenges on the supply side. On the demand side, low levels of financial literacy about the products and services offered by Islamic NBFIs; cultural, social, and physical barriers; insufficient consumer protection practices; and reputation- and credibility-related challenges are the biggest obstacles hindering further improvement of Islamic NBFIs. A balanced and enabling regulatory and taxation framework that also fosters cross-border investments in the Islamic NBFI sector is also needed.

Alleviating Poverty and Sharing Prosperity through Islamic Social Finance

Islamic social finance advocating a sharing economy and promoting redistribution could play a significant role in helping achieve the twin development objectives of ending extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population. The institutions and instruments of Islamic social finance are rooted in redistribution and philanthropy. Such interventions, involving *qard hasan*, *zakat*, and *ṣadaqāt*,[2] can potentially address the basic needs of the extremely poor and the destitute and create a social safety net. The instrument of *awqāf* (Islamic endowments or trusts) is ideal for the creation and preservation of assets that can ensure a flow of resources to support the provision of education, health care, and other social goods. These Islamic institutions can play a critical role in the realization of the global vision of generating sufficient income-earning opportunities; investing in people's development prospects by improving the coverage and quality of education, health, and sanitation; and protecting the poor and vulnerable against sudden risks of unemployment, hunger, illness, drought, and other calamities. These measures would greatly boost shared prosperity, improving the welfare of the least well-off.

The role of Islamic social finance has great significance in countries with high levels of exclusion and deprivation. This Report estimates that for most countries in South and Southeast Asia and Sub-Saharan Africa, the resource needs to alleviate deprivation could be met adequately if the potential of institutions of *zakāt* and *waqf* were realized, even if only in part.

Public Policy Interventions

In an environment of constrained sources of development financing, timely public policy interventions are the need of the hour. Islamic finance, with its rich theoretical promise to fight poverty and enhance prosperity, could play the role of a catalyst. Despite recent encouraging developments and the growth of Islamic finance, there are a number of areas in which policy interventions or improvements in policy effectiveness are needed to further develop Islamic finance and boost shared prosperity. Lower-income countries are lagging behind higher-income countries in terms of developing Islamic finance to enhance shared prosperity. The significance of timely and effective policy cannot be overemphasized.

This Report identifies areas in different sectors that could guide policy makers in formulating policy interventions to meet the objective of leveraging Islamic finance to alleviate poverty and enhance shared prosperity. These include enhancing implementation and enforcement of regulations; creating institutions that provide credit and information that in turn support the provision of equity-based finance, particularly to SMEs and microenterprises; developing capital markets and *ṣukūk* products to help finance large infrastructure projects; harmonizing regulations; and regulatory recognition of products from other jurisdictions to expand the markets through cross-border transactions.

The process of identifying policy interventions and areas to focus has been going on for more than a decade. Notably, the IDBG and IFSB jointly prepared a Ten-Year Framework Document and Mid-Term Review (MTR). These and other initiatives emphasize incorporating the use of Islamic finance in national development plans, as well as building master plans to develop the Islamic finance sector domestically. Recently, the G-20 has made similar recommendations to better integrate Islamic finance with global financial systems. This Report identifies additional areas for policy recommendations.

Table O.1 summarizes recommendations and policy measures for each sector with respect to each pillar of the development framework for Islamic finance discussed in this Report. Without the right enabling environment, Islamic finance may not be able to attain the potential expected from it. However, with adequate policy interventions and

TABLE 0.1 Recommendations and Policy Interventions by Sector

	Institutional framework and public policy	*Governance and leadership*	*Risk sharing and entrepreneurship*	*Financial and social inclusion*
Banking	• Create an enabling regulatory environment by supporting consistent regulations, and ensuring consistent implementation of the Basel III and Islamic Financial Services Board (IFSB) framework. • Ensure that systemic risks in dual banking systems (conventional and Islamic) are addressed. • Implement cross-border supervision. • Improve liquidity. • Ensure stability.	• Harmonize *sharīʿah* governance through efforts to unify cross-country *sharīʿah* rulings about Islamic finance.	• Introduce innovative risk-sharing products and services, rather than replicating conventional risk-transfer products.	• Enhance the scale and access to Islamic finance to include low-income earners. • Bolster human capital. • Increase Islamic finance literacy.
Capital markets	• Create a level playing field for debt and equity instruments by: o Eliminating the tax shelter on interest expense o Allowing tax-free transfer of assets in asset-backed *sukūk*—or at least treating the transfer fee as a tax-deductible expense.	• Incorporate higher ethical standards through transparent governance mechanism and robust regulatory framework. • Improve *shari'ah* governance: o Align *shari'ah* screening standards for equities across jurisdictions o Publish *shari'ah* screening standards, and list compliant equities for the convenience of investors on a periodic basis • Provide disclosures relevant to *shari'ah* compliance, especially events that may trigger noncompliance in the regular reporting of firms. • Strengthen resolution frameworks and investor protection mechanisms.	• Encourage investment in equities, which is the purest form of risk-sharing that not only distributes wealth more equitably but also creates more jobs and enhances shared prosperity. • Improve the scalability and liquidity of *sukūk* by providing an enabling environment for trading *sukūk* in secondary markets. • Provide incentives for issuing long-term *sukūk* based on more equity-like structures such as *muḍārabah* and *mushārakah*.	• Introduce retail *sukūk* for smaller investors • Relax the condition for listing of companies in order to provide a larger universe of equities for investment.

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TABLE 0.1 Recommendations and Policy Interventions by Sector *(continued)*

	Institutional framework and public policy	*Governance and leadership*	*Risk sharing and entrepreneurship*	*Financial and social inclusion*
Takāful	• Adopt a holistic approach while formulating the policy guidelines for the industry that takes into consideration both the industry and consumers in a *shari'ah*-compliant manner. • Design policies that balance the protections for participants' rights with the need for effective pricing, greater solvency, operators' financial sustainability, good business conduct, and relevant disclosures. • To avoid confusion among Muslims, a board consisting of *shari'ah* scholars at the national level may provide guidance as to how to implement *takāful*. • Expand investment through the Islamic capital market to provide flexibility in the implementation of the risk-based capital regime.	• Establish clear and transparent corporate governance and regulatory framework for formal as well as informal *takāful* operations. • Regulate the *takāful* industry based on its risk characteristics. A risk-based approach may be desirable; however, this should take into consideration the difference between conventional insurance and *takāful*. • Set requirements for solvency purposes on the investment activities of *takāful* in order to address the risks faced by the operators.	• Introduce *takāful* and *microtakāful* as a mode for pooling of risk and assets. • The long-term *shari'ah*–compliant investment from the savings and investments in *takāful* funds can be a critical source for economic development. • Encourage investment in capital market instruments	• Allow participants to use *microtakāful* for savings and investment. • Allow *microtakāful* for family, health, crops, livestock, and property based on the cooperative (*Wakālah*-partner) model.

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TABLE 0.1 Recommendations and Policy Interventions by Sector *(continued)*

	Institutional framework and public policy	*Governance and leadership*	*Risk sharing and entrepreneurship*	*Financial and social inclusion*
Nonbank financial institutions (NBFIs)	• Develop policies that require strong investor protection and stringent disclosure requirements as far as the investment is concerned. • Ensure that the products and activities of NBFIs comply with *shari'ah*.	• Develop legal infrastructure to support contract enforcement: a prerequisite for the development of the financial sector, as it not only reduces transactions costs but also enhances investor confidence. • Clearly define regulatory requirements such as licensing, disclosure, and corporate governance.	• Enhance diversification by directing more financing to small and medium enterprises relative to larger firms. • Develop skills and alternative approaches to mitigate risks (moral hazard) through proper monitoring and evaluation.	• Increasing the number and diversity of Islamic NBFIs. • Encourage Islamic NBFIs to provide Islamic financial services in countries where establishing Islamic banks is not possible due to legal and regulatory restrictions.
Islamic social finance	• Recognize the diversity in *zakāt* management practices across globe and create an adequately flexible and enabling regulatory environment. • Introduce/reform the *waqf* regulatory framework in order to establish *waqf* as an institution in the voluntary sector. • Recognize Islamic social finance as sustainable means of absorbing operational costs and providing "affordable" financing to the poor.	• Create a network of supporting infrastructure institutions, including research, training, and advocacy for the sound and orderly function of Islamic social finance institutions. • Develop a sound governance system that recognizes the significance of trust and credibility as key drivers underlying Islamic social finance. • Harmonize the financial reporting of Islamic social finance institutions to enhance transparency.	• Mitigate and absorb high risks with financing to the poor through mechanisms rooted in philanthropy and benevolence. • Make innovative use of *zakāt* and *waqf* to create risk management tools (credit enhancement/guarantees and *microtakāful*).	• Recognize self-exclusion as a key problem due to religious, cultural, and ethical beliefs of the poor. • Enhance social and human capital through community empowerment initiatives funded through the sustainable Islamic social funding instrument.

an enabling financial infrastructure, Islamic finance could become a catalyst for alleviating poverty and promoting inclusive prosperity.

Brief Overview of Chapters

Chapter 1 lays the theoretical framework of the role of Islamic economics and finance in promoting development, growth, and shared prosperity. This framework is based on four fundamental pillars: an institutional framework and public policy oriented to the objectives of sustainable development and shared prosperity in line with the broader objectives of Islam; prudent governance and accountable leadership; promotion of an economy based on risk sharing and entrepreneurship; and financial and social inclusion for all.

The first pillar is crucial because having a sound institutional framework and appropriate public policies are the foundation upon which the other pillars must rest and can function optimally. Institutions play a critical role in this framework, as they implement the rules prescribed by the tenets of Islam. The institutions also adhere to the core objectives of Islam (commonly known as *maqāṣid al-sharī'ah*, or Objectives of *Sharī'ah*) that lay the foundation to formulate the policies promoting economic and social justice, preservation of human rights, dignity, health, and the intergenerational wealth of the society.

The second pillar focuses on developing a governance mechanism and accompanying compliance system based on the objectives and institutions prescribed by the first pillar. The ethically based governance, leadership, and compliance system helps increase the transparency and accountability in the public, private, and social sector institutions of the overall economic system, and hence strengthens trust in the system. Trustworthy and capable leadership can ensure protection of rights of the vulnerable or those who could be vulnerable (as in future generations). Increased trust and better governance in turn strengthen the institutional framework, which enables better implementation of better public policies.

The third pillar is the distribution channel; it works at both the individual and organizational level. One of the central features is the advocacy of risk sharing and promotion of entrepreneurship. This is one of the most important aspects of Islamic finance, which differentiates it from the conventional approach of overreliance on debt-dominated instruments that shift or transfer risk. Sharing the risks of economic and financial transactions also ensures the stability of the financial system. In addition, risk sharing with equitable sharing mechanisms encourages entrepreneurship and innovation because counterparties receive their fair share in the investment. 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 overfinancialization of economy.

An important component of risk sharing in Islamic economics is risk sharing through Islamic instruments of redistribution. Without this channel, certain segments of the society could easily be left out of the system, which would marginalize them and decrease the full productive potential and social harmony of society. This redistribution of income and wealth is not charity; rather, it is an endowment that would enable them to conduct their lives honorably and have an equal opportunity to contribute productively to society.

The fourth pillar aims to ensure that the fruits of higher growth are distributed to every segment of the society inclusively, either through participation in the economic growth or through Islam's instruments of redistribution. Since member-countries of the Organization of Islamic Cooperation (OIC) have predominantly Muslim populations—for whom certain methods of conventional finance could contradict their faith and thus exclude them from the financial system—using a new framework of economic development and finance could help increase financial and social inclusion, which could facilitate equal opportunity.

Chapter 2 presents a snapshot of the current state of the extreme poverty and income disparity globally and compares it with the OIC countries. A brief analysis of the historical trend in several metrics with respect to select benchmarks against the framework of economic development developed in chapter 1 is provided as well. Finding and discussing the root causes of the disparities between OIC and non-OIC countries is beyond the scope of this Report and is left for future research.

Extreme poverty has been reduced considerably around the world in the past two decades—although at a slower pace within the group of OIC countries than globally. OIC countries are very diverse in terms of income group, geography, and culture, and are tied only by religion. The rate of poverty alleviation among the extreme lower-middle-income and lower-income countries is higher for OIC member-countries than for the non-OIC group. Among the regional differences, in Sub-Saharan Africa, OIC countries have exhibited higher poverty reduction than the non-OIC countries in the same region. However, OIC countries have lagged behind non-OIC countries in terms of poverty reduction in East Asia and South Asia. In terms of the income disparity, there is no significant difference between OIC and non-OIC countries. In both groups of countries, the top decile receive the major share of the income.

To assess the state of shared prosperity, various indexes are used as a proxy for each pillar of shared prosperity, as discussed in chapter 1. In terms of the institutional framework and public policy, the rule of law index score is negative for all groups of countries except for the high-income group, clearly highlighting the need to strengthen the legal system in order to break out of the poverty cycle. The Government Effectiveness Index indicates a similar trend for governance and leadership; on average, countries from the lower and lower-middle income groups trail behind the high-income group, highlighting the importance of governance and leadership in enhancing shared prosperity.

As an admittedly imperfect proxy for risk sharing, this Report uses the inverse of the correlation between consumption and income. OIC countries on average have a better risk-sharing environment than non-OIC countries. The capital market could be a better proxy for entrepreneurship. However, stock markets are not established in most lower-middle and lower-income countries. The development of capital markets with wider access to the public under a strong legal and governance framework is desirable to promote shared prosperity in countries where poverty is still prevalent. In terms of social and financial inclusion, OIC countries tend to borrow less from formal financial institutions, which may indicate self-exclusion due to religious reasons. Developing the Islamic finance sector may enhance financial inclusion.

In summary, chapter 2 presents the state of affairs with respect to trends in poverty alleviation and income distribution, which can be used by policy makers to formulate policy interventions and to identify areas to strengthen, keeping in mind the objective of leveraging Islamic finance for alleviating poverty and enhancing shared prosperity.

Chapter 3 focuses on the Islamic banking sector, which is the dominant component of the Islamic finance industry, accounting for more than three-quarters of the industry's assets. Islamic banking is based on key Islamic principles of prohibiting exploitation, emphasizing ethical standards, promoting moral and social values, and rewarding enterprise (linking risk and reward). The aspiration of Islamic banking is the creation, equitable distribution, and circulation of wealth in order to promote economic and social justice and to satisfy customers' needs for *sharīʻah*-compliant investments and financing opportunities. This wealth creation and its fair distribution ensure shared prosperity. Islamic banking contributes to shared prosperity through its impact on economic growth, as a provider of capital for economic activities, and through the risk-sharing characteristics of its products.

The key features of risk-sharing contracts, and financial inclusion through increased banking options, contribute to shared prosperity. Islamic banking can have a positive impact on financial intermediation by the poor, which ultimately should boost the mobilization of savings and prosperity. In addition, Islamic banks have a social responsibility that transcends the maximization of profits.

Chapter 4 addresses how capital markets can contribute to enhancing shared prosperity by facilitating long-term financing through tradable instruments that enable easy market entry and exit. In a pure equity-based and risk-sharing framework, Islamic capital markets can serve the real sector of economy more effectively in an equitable and sustainable manner than conventional capital markets. The main requirements to facilitate the development of Islamic capital markets are similar to those for conventional capital markets: notably, protecting property rights, controlling market manipulation and fraudulent practices, maintaining fair pricing, and supporting the rule of law. However, there are additional requirements for the sound development of Islamic capital markets: particularly the promotion of risk-sharing and asset-based finance in light of the prohibition of debt-based finance.

At present, there is no organized stock exchange that is operating in full compliance with *sharī'ah* principles. Any investor in the Islamic equity market invests in the shares of *sharī'ah*-compliant companies or in a publicly offered portfolio consisting of these equities offered through unit trusts, mutual funds, or exchange traded funds (ETFs). There are several prevailing standards for screening equities, including screens offered by major index provider companies such as the Financial Times Stock Exchange (FTSE), Standard and Poor's (S&P), Dow Jones, and Morgan Stanley Capital International (MSCI). The empirical evidence provided in the Report suggests that Islamic equity indexes based on the S&P's *sharī'ah* screening standard perform at least as well on average as their conventional counterparts—despite lower diversification, due to the exclusion of financial products and stocks backing activities prohibited by *sharī'ah*.

The *ṣukūk* (Islamic bond) market has grown considerably over the last decade. *Sukūk* are now used for financing by corporate and sovereign entities. The *ṣukūk* market recovered quickly after the global financial crisis and peaked in 2012. Issuance declined somewhat in 2014 and 2015, but it is still considerably higher than its precrisis level. *Ṣukūk* offer great potential for promoting shared prosperity due to their suitability for financing infrastructure, raising funds for business, and supporting economic development. Unlike other asset classes, they offer a hybrid profile between pure equity and debt, and are thus attractive to a wide range of investors and finance seekers, again with a positive potential for shared prosperity.

A MTR of the Islamic financial services industry jointly prepared by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and the IFSB highlights some of the major challenges hindering the development of Islamic capital markets. First is the need for incentives to encourage risk sharing: in particular, through the development of markets for equity trading. This is hampered by the perverse tax treatment that classifies interest as a tax-deductible expense. In order to create a level playing field for debt and equity, there is a need to eliminate the tax shelter on interest payments. Second, because asset-backed *ṣukūk* could be more costly to structure than conventional securities, there is a case for allowing these expenses to be tax deductible. In addition, provision should be made for tax exemption on the asset transferred in sale-based structures because such transfers are a precondition for *sharī'ah* compliance. The authorities may wish to extend the favorable treatment of *ṣukūk* further by exempting investors from income and capital gains tax. This could apply where *ṣukūk* are used to fund specific development projects, rather than for unspecified government or corporate expenditures.

The MTR highlights the lack of a uniform approach to Islamic capital market regulation and governance. It is important for Islamic capital markets to be seen as incorporating higher ethical standards through transparent governance mechanisms and robust regulatory frameworks. It would also be helpful for market confidence and perceptions of financial product integrity if *sharī'ah* governance standards were harmonized. This would facilitate cross-border activities in both primary and secondary markets, and the acceptance of contracts across regions and across schools of thought and markets. The MTR urges the adoption of the *sharī'ah* standards proposed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the IFSB, with *sharī'ah* boards taking full responsibility for the capital market products they approve.

The chapter also cites liquidity constrains as an impediment: notably the lack of depth in the secondary market in *ṣukūk,* reflecting limited issuance and the preference of investors to hold *ṣukūk* to maturity rather than trade. Greater pricing transparency and faster settlement procedures are recommended to encourage *ṣukūk* trading. Revaluation of the underlying assets may also be justified for the resolution of disputes and investor protection. A high level of financial literacy is needed by those investing and trading in Islamic financial markets, especially with respect to legal and *sharī'ah* safeguards and the nature of the risks shared rather than transferred.

Chapter 5 focuses on *takāful,* the Islamic counterpart of conventional insurance. The scheme is similar to a mutual insurance concept, but complies with Islamic Law, and is based on concepts of mutual solidarity and risk sharing. A group of participants agree to support one another jointly for the losses arising from specified risks. The scheme is managed on the participants' behalf by a *takāful* operator. The *takāful* industry has two unique characteristics: mutual risk sharing and *sharī'ah* compliance. In order to make it feasible, viable, and accessible to all segments of the society, there should be a globally acceptable *takāful* business model.

Takāful, as an infant industry, faces many challenges. Sound public policy is needed to balance protection for participants' rights with the requisite for effective pricing, greater solvency, operators' financial sustainability, good business conduct, and relevant disclosures. One of the major challenges for *takāful* operators is that *sharī'ah*-compliant investment opportunities are lacking in many jurisdictions; thus the operators do not have adequate venues for long-term and stable investments offering desirable risk and return profiles. As a result, *takāful* operators lack access to adequate portfolio and risk management instruments to adequately match and hedge their liabilities. Development of Islamic capital markets, particularly s*ukūk*, is essential for further development of the *takāful* industry.

Chapter 6 discusses the growing importance of NBFIs and highlights the important linkages of the products and services offered by NBFIs to shared prosperity. The chapter covers Islamic asset management, housing finance, and some specialized NBFIs, such as *muḍārabah* (risk-sharing partnerships) and *ijārah* (leasing) financing companies. The chapter argues that NBFIs in an economy add to the development of a diverse financial sector that expands the menu of products to better serve dynamic needs of the society.

A diverse financial sector also increases the stability of the financial system. NBFIs can serve as back-up institutions that may help stabilize the financial sector when negative shocks adversely affect the dominant financial institutions, notably banks. Moreover, a well-developed NBFI sector can provide services to those segments of the society that are not adequately served by the formal banking sector. In this way, NBFIs have great potential to promote shared prosperity more effectively.

Despite the low levels of development in most of countries with a high Muslim population, Islamic NBFIs have gained momentum since the global financial crisis, especially on the asset-management side. Assets under management of Islamic funds exceeded $60 billion as of 2014, with an average annual growth of 13.5 percent between 2008 and 2014. A case can be made to exploit the synergies between socially responsible investments and s*ukūk* as an alternative tool for mobilizing financing that could attract Islamic and socially responsible investors to make a visible contribution to sustainable development. Advocating for the potential of Islamic NBFIs for SMEs, chapter 6 presents a case study of novel *sharīʿah*-compliant crowdfunding to demonstrate how Islamic finance can be deployed to enhance SMEs' access to finance. The chapter also includes some highlights and cases on Islamic house financing, *muḍārabah,* and *ijārah* companies that when properly implemented have the potential to improve financial inclusion in most OIC developing markets.

Chapter 7 provides an overview of alternative asset classes in Islamic finance and explores how this sector could enhance shared prosperity. As alternative investments are a diverse asset class, there are no all-embracing regulations or guidelines that can be applied. Usually alternative investments are under the remit of securities or capital market regulators, rather than being the responsibility of central banks. Among OIC countries, the Malaysian Securities Commission and the Capital Markets Authority of Saudi Arabia have played leading roles in identifying the issues that arise with alternative investments. The Kuala Lumpur-based IFSB has not yet issued any standards specifically on alternative investments, as it focuses more on Islamic banking, capital markets, and *takāful*, although it has published Guiding Principles for Islamic Collective Investment Schemes. There is clearly a case for more comprehensive guidance on alternative investments by the IFSB, as its membership includes regulatory authorities from the OIC states.

Regulators should at least try to ensure that their policies do not inhibit risk-sharing and asset-based financing. These are core principles of Islamic finance that are particularly applicable to investment in alternative assets. There is a case for encouraging the establishment of nonbank Islamic financial institutions that can serve investors seeking alternative assets. The IFSB and national regulators should take the initiative in providing an enabling environment, specifically by drafting guidelines that could be applied to *sharīʿah*-compliant alternative investment. They need to consider the incentive structures for new entrants and the governance framework that can best promote the use of risk-sharing partnerships such as *muḍārabah* and *mushārakah* for alternative investments.

At the same time, it must be recognized that those involved in alternative investments are typically sophisticated investors who do not need protection in the same way as retail investors. Many analysts urge so-called "light touch" regulation for alternative investments, as this reduces transaction costs, which ultimately get passed on to the investors. The European Union and the United Kingdom have relatively liberal directives on alternative investments. Nevertheless, in the case of Islamic investment, the *sharīʿah* oversight should not be "light touch": otherwise this might undermine the credibility of the investments for the pious. There would be reputational risks to the financial institutions offering such investments, and potential reputational damage to the scholars involved in approving the investments.

Sharīʿah scholars working on Islamic finance need to address the issue of the permissibly of alternative asset classes more comprehensively. At the international level, this includes the OIC Fiqh Academy, which has issued *fatāwá* (religious opinions) on many Islamic financing contracts, but not specifically on alternative investments. The *sharīʿah* scholars advising securities regulators also have a role to play, although at present only the Securities Commission in Kuala Lumpur has a formal s*hariʿah* board. It has produced a joint report on Islamic capital markets in collaboration with another Kuala Lumpur-based institution, the International *Sharīʿah* Research Academy (ISRA). A similar joint initiative in the field of Islamic alternative asset classes would be welcomed by the world-wide Islamic finance community.

Chapter 8 advocates that Islamic social finance could play a significant role in helping achieve the twin development objectives of ending extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population. The institutions and instruments of Islamic social finance are rooted in redistribution and philanthropy. Such intervention, involving *zakāt* and *ṣadaqāt* (charity), can potentially address the basic needs of the extremely poor and the destitute and create a social safety net. The chapter reports several creative experiments using *zakāt* and *waqf,* including creating an interest-free credit pool funded with *zakāt* and *ṣadaqāt;* supporting community-driven development using *zakāt* and *ṣadaqāt* funds; creating a guarantee fund with *zakat;* providing affordable health care through corporate *waqf;* and engineering a *waqf* to provide relief and rehabilitation.

Policies are needed to support the efficient mobilization of Islamic social finance, efficient utilization and management of such resources, and their integration with microfinance to make it more inclusive and affordable. At the macro and meso levels, these include policies to create enabling legal, regulatory, and fiscal frameworks and to provide a supportive infrastructure. At a micro level, these include policies to enhance the accountability and transparency of the institutions, improve their governance structures, and diversify their product offerings, while transforming the poor into financially literate and more responsible clients.

Chapter 9 provides a roadmap for supportive public policy, a sound enabling environment, and conducive financial infrastructure to support the development of Islamic finance and its effectiveness in delivering the socioeconomic benefits expected from it. As Islamic finance caters to the needs of real economic activities and provides financing by taking on the risk of the business or the economic activities it finances, policies to develop that Islamic financial sector cannot be pursued in isolation from broader public policy concerning economic development, business promotion, and social advancement.

Islamic finance at present is working within a system that is heavily biased in favor of debt-based financing. The financial infrastructure, peripheral support institutions, and legal environment are more conducive to debt than other modes of financing. Thus, creating an enabling environment to support the proper growth and socially beneficial development of risk-sharing aspect of Islamic finance is important. This entails cross-sectoral, well-coordinated, and timely reforms in financial sector regulations; in legal provisions for new types of institutions; in contract enforcement; and in tax treatment. Such changes lie beyond the capacities of individual financial institutions; hence the role of government and financial sector regulators and stakeholders is particularly important.

Efforts are underway at the national and supra-national levels to develop and enhance the impact of Islamic finance. At the international level, various financial infrastructure institutions are developing standards for accounting, auditing, governance, *sharī'ah*-compliance, regulation, and supervision for the Islamic financial sector. Multilateral cooperation at the international level helped create a Ten-Year Framework and Strategies Document for the development of Islamic financial sector, which underwent a MTR in 2013. The MTR emphasizes Enablement, Performance, and Reach as three pillars of strategic importance, and proposed 20 initiatives within these three pillars that can be pursued by individual countries and their respective regulatory authorities. It is hoped that this undertaking will help coordinate policies and consolidate efforts to develop Islamic finance across countries. Some countries have used these recommendations as guides to come up with their own national plans to foster the development of Islamic finance.

The issue of development of the Islamic financial sector to increase shared prosperity was also a part of the agenda of the Group of Twenty (G-20) in 2015. The World Bank and International Monetary Fund offered suggestions at the national and international level to better integrate Islamic finance with the global financial system. At the national level, recommendations included adapting regulatory and supervisory frameworks to take into account the industry's specific features such as risk-sharing where deemed appropriate; exploring means for enhancing the liquidity management of Islamic banks; adapting tax systems to avoid placing Islamic finance instruments at a disadvantage; providing the right incentives to ease access to asset-based and equity-like financing, particularly for SMEs. At the global level, the G-20 calls for systematically incorporating the industry's features in global standards and guidance, and developing accounting and statistics standards especially for *sukūk;* granting membership to Islamic finance standard-setters in the consultative groups of global standard-setters, with the view to strengthen the emerging cooperation between these institutions; and stepping up the engagement of international financial institutions and multilateral development banks in Islamic finance through analytical work, policy advice, and capacity development.

Chapter 9 also provides an overview of recent policy initiative taken by Indonesia, Malaysia, and Pakistan as case studies to highlight recent developments in, and the enactment and implementation of, policies to promote shared prosperity. Islamic financial sector development and financial inclusion are integrated within the national development or financial development plans of these three countries. Strengthening *sharī'ah* governance, improving the alignment of the national-level banking regulations with the principles issued by international Islamic financial infrastructure institutions, and establishing diversified financial institutions has become an explicit part of their agenda. Similarly, financial inclusion, its promotion by integrating *zakāt* and *awqāf*, and fostering the financing of a wider set of economic sectors, are gaining policy importance.

In an effort to align Islamic financial sector development with its long-term economic development plan, Indonesia has issued a road map for Islamic banking development, a road map for Islamic capital market development, and a road map for sustainable finance. These are targets for improving the resilience and competitiveness of the Islamic financial sector, promoting economic growth and well-being, and supporting the national commitment to environmental protection. Indonesia is also working toward integrating the collection and distribution of *zakat* into its financial system.

Islamic finance has been a priority area in Malaysia for three decades. In 2013, it enacted a comprehensive Financial Services Act to consolidate Islamic financial sector regulations, improving *sharī'ah* governance, properly differentiate Islamic deposit taking from investment activities, and provide relevant regulations for both. These efforts foster proper risk sharing between the financial institutions and their clients.

Pakistan has a strategic plan in place to develop Islamic finance. It also developed a National Financial Inclusion Strategy that encompasses many of the areas needed to develop Islamic finance. It is one of the few countries with well-developed regulatory framework for microfinance and has a microfinance credit information bureau. Pakistan has a system of *zakāt* collection and distribution at both the private and public levels.

Notes

1. Specifically, the goals are to end extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population. See "Ending Poverty and Sharing Prosperity," http://www.worldbank.org/content/dam/Worldbank/gmr/gmr2014/GMR_2014_Full_Report.pdf.
2. *Qard hasan* is a voluntary loan, without any expectation by the creditor of any return on the principal. *Zakāt* are obligatory contributions to the poor and marginalized payable by all Muslims having wealth above a certain threshold. *Sadaqāt* are recommended contributions to the less privileged or less able.

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