Role of Islamic Finance in Achieving SDGs and Shared Prosperity (SP)

Prof. Habib Ahmed
Durham University Business School
Presentation Outline

• SP, SDGs and Finance

• Islamic Finance, SP and SDGs
  – Gaps: Household Sector
  – Gaps: Business Sector

• The Way Forward
SP & SDGs: Introduction

• Shared prosperity (SP): ‘fostering the well-being of the bottom 40 per cent of the population’

• Sustainable Development Goals—17 SDGs can be classified in broad categories
  – Inclusive growth
    • eradication of hunger and poverty, employment for all, reduce income equality, ensuring availability of water, sanitation, health
  – Social development and justice
    • justice to all, gender equality, heath and well being for all, equitable quality of education
  – Resilient economic systems and sustainability
    • develop resilient infrastructure, making safe and sustainable human settlements and societies, sustainable agriculture and industries, ensuring sustainable consumption and production
  – Environment
    • access to affordable and sustainable energy, action against climate change and its impact and conserve terrestrial and marine resources
Finance, SP & SDGs?

• At current levels of investments developing countries will face a gap of $2.5 trillion annually to achieve SDGs (UNCTAD 2014)

• The financial sector has an important role to fill the gap and promote SP & SDGs

• Quantity and quality of finance can directly impact SP and economic elements of SDGs by affecting
  – Economic growth
  – Income inequalities
  – Resilience, Sustainability and Environment
Finance and Growth

• Aggregate level evidence on finance and growth is mixed
• Recent evidence at disaggregate level
  – Higher credit to private sector slows growth beyond a threshold level
    • In middle-income countries relationship is positive and in high income countries it becomes negative
    • Bank loans reduce growth more than financing done by bonds
  – Higher credit affects growth negatively more when it goes to the household sector than the business sector
  – Higher financing through stock markets boosts growth in most OECD countries
Finance and Inequality

• Some empirical work at aggregate level show financial sector growth improves income equality

• Recent work on OECD show expansion of the financial sector increases income inequality (both credit and stock market capitalisation are used as indicators for the financial sector) (Denk and Cournede 2015).

• Partly explained by credit distribution
  – In the business sector, smaller and medium size firms face more financial constraints relative to larger firms (Beck and Derirguc-Kunt 2006)
  – Households with higher incomes benefit more than their poorer counterparts from credit-financed investments (OECD 2015)
Finance and Resilience, Sustainability and Environment

• Stability of the financial sector itself is important
  – Instability can affect real sector adversely (GFC)

• Financial sector can reduce risks and vulnerability in the household and business sectors (risk mitigation and transference)

• Financial sector can promote sustainability/environment issues by including environmental risk assessment along with other assessments
  – Increasing awareness of ESG issues in the financial sector
  – ESG related investments estimated at USD 13.6 trillion in 2011 (representing 21.8% of the total assets managed)
    • Europe ($ 8.7 trillion or 64.5% of the total)
    • US ($ 3.7 trillion or 27.6% of the total) [SGIA 2013]
Financial Sector, SP & SDGs: Building Blocks—Functions

- Functions of financial system
  - managing risks, transferring economic resources, dealing with incentive problems, pooling of resources, clearing and settling payments (to facilitate trade), providing price information (Merton and Bodie 1995)
  - trading of risk, allocating capital, monitoring managers, mobilizing savings, easing trading of goods (Levine 1997: 689)

- For SP and SDGs, the following functions are considered:
  - Mobilizing savings/asset management
  - Allocating capital/financing
  - Managing risks (household, business and environmental)
Presentation Outline

• SP, SDGs and Finance

• Islamic Finance, SP and SDGs
  – Gaps: Household Sector
  – Gaps: Business Sector

• The Way Forward
Islamic Finance—Vision

• Islamic economists—economy based on Islamic principles will fulfill the *maqasid al Shari’ah*
  – Produce a vibrant and stable economy balancing equity and growth
  – financial system would be *Shari’ah* compliant, ethical, inclusive, resilient and promote social and economic development

• Islamic finance has had impressive growth, but questions raised about its quality
  – Too much focus of legal compliance
  – Social/ethical goals not achieved
## Summary of Empirical Studies

<table>
<thead>
<tr>
<th>Paper</th>
<th>Shari'ah compliance</th>
<th>Stakeholders</th>
<th>Charitable Activities</th>
<th>Social &amp; Environmental Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kamla &amp; Rammal (2013) (19 banks)</td>
<td>Good</td>
<td></td>
<td>Moderate</td>
<td>Insignificant</td>
</tr>
<tr>
<td>Haniffa &amp; Hudaib (2007) (7 banks)</td>
<td>Good</td>
<td>Good</td>
<td>Insignificant</td>
<td></td>
</tr>
<tr>
<td>Maali et. al. (2006) (29 banks)</td>
<td>Good</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Insignificant</td>
</tr>
<tr>
<td>Aribi &amp; Arun (2012) (9 banks)</td>
<td>Good</td>
<td></td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

**CONCLUSION** | GOOD | GOOD/MOD. | MODERATE | INSIGNIFICANT |
Islamic Finance, SP and SDGs: Gaps

<table>
<thead>
<tr>
<th>Financial Functions</th>
<th>Household sector</th>
<th>Business Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Poor (1)</td>
<td>Non-poor (2)</td>
</tr>
<tr>
<td></td>
<td>Micro &amp; small enterprises (3)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medium &amp; large enterprises (4)</td>
<td></td>
</tr>
<tr>
<td>Mobilizing savings/asset management</td>
<td>MS1(?)</td>
<td>MS2(√)</td>
</tr>
<tr>
<td></td>
<td>MS3(?)</td>
<td>MS4(√)</td>
</tr>
<tr>
<td>Allocating capital/financing</td>
<td>AC1(?)</td>
<td>AC2(√)</td>
</tr>
<tr>
<td></td>
<td>AC3(?)</td>
<td>AC4(√)</td>
</tr>
<tr>
<td>Managing risks</td>
<td>MR1(?)</td>
<td>MR2(√)</td>
</tr>
<tr>
<td></td>
<td>MR3(?)</td>
<td>MR4(√)</td>
</tr>
</tbody>
</table>
Savings: Account Penetration

Account penetration
Adults with an account at a formal financial institution (%)

<table>
<thead>
<tr>
<th>Region</th>
<th>Account Penetration</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGH-INCOME ECONOMIES</td>
<td>89</td>
</tr>
<tr>
<td>EAST ASIA &amp; PACIFIC</td>
<td>55</td>
</tr>
<tr>
<td>EUROPE &amp; CENTRAL ASIA</td>
<td>45</td>
</tr>
<tr>
<td>LATIN AMERICA &amp; CARIBBEAN</td>
<td>39</td>
</tr>
<tr>
<td>SOUTH ASIA</td>
<td>33</td>
</tr>
<tr>
<td>SUB-SAHARAN AFRICA</td>
<td>24</td>
</tr>
<tr>
<td>MIDDLE EAST &amp; NORTH AFRICA</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Demirgüç-Kunt and Klapper 2012.
Financing: Sources of Loans

*Figure 3.1*

Sources of new formal and informal loans

Adults borrowing from source in the past year (%)

- Informal Lender
  - Bank, credit union, or microfinance institution
  - Retail store (store credit)
  - Friends or family

High-income economies

Latin America & Caribbean

South Asia

East Asia & Pacific

Europe & Central Asia

Middle East & North Africa

Sub-Saharan Africa

Note: Respondents could report borrowing from more than one source.

Source: Demirgüç-Kunt and Klapper 2012.
Reasons for Loans

3.2 Figure
Reasons for loans reported by borrowers in developing economies
Adults with an outstanding loan for purpose specified (%)

- Funeral or wedding: 3%
- Purchase of home or apartment: 3%
- Home construction: 5%
- School fees: 5%
- Emergency or health purposes: 11%

Note: Respondents could report borrowing for more than one purpose.
Source: Demirguc-Kunt and Klapper 2012.
Insurance Services

**Figure 4.1**

**Purchasers of health insurance**

Adults paying personally for health insurance (%)

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle East &amp; North Africa</td>
<td>3</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>3</td>
</tr>
<tr>
<td>Europe &amp; Central Asia</td>
<td>4</td>
</tr>
<tr>
<td>South Asia</td>
<td>5</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>7</td>
</tr>
<tr>
<td>East Asia &amp; Pacific</td>
<td>37</td>
</tr>
</tbody>
</table>

*Source: Demirgüc-Kunt and Klapper 2012.*
Hierarchy of Household Financial Needs

Transference Planning
- Estate planning

Investing for Goals
- Mutual funds
- Retirement plans

Emergency Planning
- Emergency funds
- Insurance

Money Management
- Checking & savings accounts
- Credit/financing for filling expenditure gaps
### Islamic Finance, SP & SDGs: Product Gaps for Poor Households

<table>
<thead>
<tr>
<th>Financial Functions</th>
<th>Financial Institutions</th>
<th>Capital Markets</th>
</tr>
</thead>
</table>
| Mobilizing savings/asset management | • Checking and Savings deposits  
• Investment accounts | • Retail *sukuk*  
• Mutual funds  
• Retirement plans |
| Allocating capital/financing  | • Short-term financing  
• Medium to long-term financing (house, fixed assets, etc.)  
• Education financing |                               |
| Managing risks               | • Emergency funds (including *qard hasan*)  
• Micro-*Takaful*               |                               |
Financial Needs of Firms

• According to Extent of Permanence
  – Fixed Capital
  – Working Capital

• According to Period of Use
  – Long-term capital
  – Medium-term capital
  – Short-term capital
Available Financing Options for Firms
Financing Gaps for Micro & Small Firms
<table>
<thead>
<tr>
<th>Financial Functions</th>
<th>Financial Institutions</th>
<th>Capital Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobilizing savings/asset management</td>
<td>• Checking and Savings accounts</td>
<td></td>
</tr>
<tr>
<td>Allocating capital/financing</td>
<td>• Short/medium/long term financing</td>
<td>• Listing opportunities of smaller firms</td>
</tr>
<tr>
<td></td>
<td>• Leasing</td>
<td>• Social and short-term sukuk</td>
</tr>
<tr>
<td></td>
<td>• Trade credit</td>
<td></td>
</tr>
<tr>
<td>Managing risks</td>
<td>• <em>Takaful</em></td>
<td>• Risk-sharing sukuk</td>
</tr>
<tr>
<td></td>
<td>• Risk-sharing instruments</td>
<td></td>
</tr>
</tbody>
</table>
Presentation Outline

• SP, SDGs and Finance

• Islamic Finance, SP and SDGs
  – Gaps: Household Sector
  – Gaps: Business Sector

• The Way Forward
Islamic Finance, SP and SDGs: Way Forward: Product Level Issues

• IF contribution to SP and SDGs would require
  – Innovative Shari’ah-based products that satisfy the financial needs of poor households and MSEs in both financial institutions and capital markets
  – Products must have features that fulfill the risk/return features/preferences on both supply and demand sides

• Need investments in R&D to come up with innovative Shari’ah based products
Islamic Finance, SP and SDGs: Organizational Level Issues

• Need organizational diversity to provide various financial services at different levels

• Islamic alternatives of conventional NBFIs
  – Islamic cooperatives, leasing companies, venture capital, crowd funding, etc.

• Unique new organizations
  – Modaraba companies
  – NBFIs integrated with the social sector (zakah and waqf)
Islamic Finance, SP and SDGs: 
*Shari’ah* Related Issues

- Conceptual—the focus of *Shari’ah* compliance is on avoiding prohibitions (negative screening)

- Need to expand the notion of *Shari’ah* compliance to include *maqasid* perspective

- Need to include positive screening by examining
  - Social goals
  - Environmental impact
Conclusion

• Enormous financial needs to meet the goals of SP & SDGs
• Islamic finance—gap between theory and practice limits its role
• To contribute to SP and SDGs, need to change orientation of IF
• Key to constructive role of IF in SP & SDGs will depend on
  – Changing notion of *Shari’ah* compliance to include broader social and environmental goals
  – Innovative and efficient products
  – Efficient and effective organizations
  – Enabling legal and regulatory environment