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# The Role of Islamic Finance in Development

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## INTRODUCTION

This paper examines the role of Islamic finance in development.[1] The future role and growth of the Islamic finance industry over the next five to ten years seems to be dependent on various factors, including the untapped customer base and contemporary socio-political changes particularly prevalent in Arab countries (commonly referred to as the Arab Spring). The first factor is linked to a fundamental demographic observation, which recognizes that a major Muslim population (representing approximately 25% of the world's population) is currently underserved by an industry that presently only provides approximately 1% of total annual global financial intermediation. This represents an economic gap and a market opportunity that is begging to be narrowed. The second factor that seems to be playing a key role in shaping the role of the Islamic finance industry is the revival of Islamic thought in many countries around the world (more recently demonstrated by events in those countries affected by the Arab Spring). Besides bringing about various sociopolitical changes in many parts of the world, particularly in emerging and transitioning economies with significant Muslim communities, this revival of Islamic thought will also require the Islamic finance industry to play a key role in the economic development of such countries and communities. This in turn will also impact financial intermediation activities and institutions across those countries and communities. The precise form or character that such Islamic financial intermediation will take in those countries is uncertain: the manner in which existing or new governments will allow it to emerge and the basis upon which Islamic financial institutions will be able to operate remains unclear in many countries. In many respects, this uncertainty at a macro level echoes the issues of form and substance this paper is wrestling with at a micro level: What *form* will (or should) future Islamic financial activity take and what will it amount to in *substance*?

A complex philosophical question that the Islamic financial community seems to be wrestling with at the moment is whether the Islamic finance

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industry is providing development-based financial support and solutions to the community, and if not, then *should* the Islamic financial industry provide development-based financial support and solutions to the community? These questions are not dissimilar to the questions raised by legal positivism. In his *Treatise of Human Nature*, David Hume[2] argued that people invariably slip between, on the one hand, describing that the world *is* a certain way and saying, on the other hand, that we *ought* therefore to conclude on a particular course of action. Students of jurisprudence find themselves in a similar position while questioning what the law *is* (determined by historical social practice) and what the law *ought* to be (determined by moral considerations). Put simply, Islamic financiers need to ask: *Is* what I am doing today what I *ought* to be doing tomorrow?

In this paper, the author examines the following four key issues: Is Islamic finance an alternative to prevailing economic models? What is the potential role of the Islamic finance sector in national development? What is the role and responsibility of for-profit private entities offering Islamic financial services in development? And what is the role of Islamic finance in development in the light of empirical evidence?

## IS ISLAMIC FINANCE AN ALTERNATIVE TO PREVAILING ECONOMIC MODELS?

This paper makes certain assumptions about the nature of Islamic economics. It may be a risk doing so, but if we get stuck in a debate about what Islamic economics is, we face the greater risk of not progressing with the further questions regarding what Islamic financial intermediation is actually achieving and whether such achievements have the characteristics of development finance or require adaptation because they fail that test and ought to be changed. The first and foremost assumption is that the fundamental objective of Islamic economics and finance is to achieve socio-economic and distributive justice. To help an "Islamic economy" achieve this goal, the Islamic economic system imposes a set of relatively straightforward parameters that should be followed. Ayub identifies these parameters and explains them in three main categories: i) The prohibition of interest, excessive uncertainty, gambling, and other games of chance; ii) An emphasis on a social welfare system based on mutual help, character building, and behavioral changes; and iii) Care and dignity for the poor.[3] Secondly, the term "development" is invariably used with narrow meaning and definition when discussed in an Islamic financial context. For the purpose of this paper, development is about outcomes. Development would be deemed to occur with the reduction of poverty, inequality, and unemployment within a growing economy through enhancing the production of life-sustaining necessities (such as food, shelter, and health care), raising living standards

and individual self-esteem, expanding economic choice, and reducing fear.[4]

In the Islamic finance context, any discussion about the role of Islamic financial institutions in "development" invariably tends to spiral toward the lowest common denominator: namely, that Islamic finance is (or should be) about the provision of micro-finance and/or rural development.[5] This line of argument is not convincing, not least because such an approach would fail to mobilize the vast sums of money that are potentially available through the Islamic financial community. Such a focus would confine the Islamic finance industry to a restrictive area of activity that, despite its intrinsic merit, does not address the much larger developmental needs of many Muslim-majority countries. Further, defining "Islamic finance" in this way would shortchange both the wider *umma* as well as the shareholders of Islamic financial institutions (IFIs).

It is also important to realize that the conventional development agenda is much wider than such a limiting definition. Although such activity may often start with assisting agrarian communities in becoming more efficient (usually resulting in a shift toward greater "agro-industrialization" and eventually the urbanization of many communities), in the modern world many people live in cities (invariably in slum conditions). As these citizens seek to improve their lot, so there is a need for urbanization and industrial development that will enable them to build a future capable of fulfilling (and in due course exceeding) the UN development goals[6] (if we use these as our base case). Development finance, if properly undertaken, needs to help build the infrastructure (physical and intellectual) of the countries concerned, in order to deliver development goals in a far more sophisticated world than ever before.

It is interesting to note that development work is being carried out by a diverse array of organizations ranging from macro-development institutions (including but not limited to the International Finance Corporation [IFC], European Bank for Reconstruction and Development [EBRD], Commonwealth Development Corporation [CDC Group PLC] and the Islamic Corporation for the Development of the Private Sector [ICD]) to the micro-finance organizations and community development funds. Few commercial financial institutions would necessarily consider their role to be a "developmental" one in the same way as the aforementioned organizations (this is particularly the case if such activity connotes a return on investment that is less than "commercial").

The mandate of development finance organizations usually requires them to invest in areas where commercial banks will not and to take commensurately higher risks in the process. As a result, we often find development activity failing to be undertaken by governmental, quasi-governmental, or charitable organizations. This paper contends this is something that *ought* to be questioned by the wider financial community[7] and *must* be questioned by the Islamic financial community.

In the Islamic financial sector, the major developmental organization[8] is the ICD, whose mandate is

> to support the economic development of its member countries through [the] provision of finance to support sector projects in accordance with the principles of Shariah through promoting private sector development . . . Projects financed by ICD are selected on the basis of their contribution to economic development considering factors such as creation of employment and contribution to exports. ICD also attracts co-financiers for its projects and provides advice to governments and private sector groups on policies to encourage the establishment, expansion and modernization of private enterprises, development of capital markets, best management practices and enhance the role of market economy. ICD operates to complement the activities of IDB in member countries and also that of national financial institutions.[9]

This does at least indicate that some commercial IFIs are engaging alongside the ICD in certain of those projects that the ICD is involved with. The appendix to this paper contains some statistical data extracted from the series of ICD Annual Reports[10] that illustrate the breadth of this organization's engagement with the community.

Whilst the Qur'an, *hadith* and *fiqh al-muamalat* generally do not prohibit Muslim businessmen from engaging in trade with a view to making a profit, the type of activity they undertake should accord with broader principles: It should not be speculative in nature, it should be undertaken with an eye on the benefits the activity will bring to the community, and it should be undertaken pursuant to contracts that are equitable and transparent.

There is an ongoing debate in the Islamic financial community as to whether or not all current activity is truly in accordance with shari'a. The expression "in accordance" has been used purposefully because the author believes that the expressions "shari'a-compliant" or "shari'a-based" are not particularly helpful. In some respects they are too subtle and this means that people find them confusing. A similar criticism can be made of the expressions "asset-backed" versus "asset-based" in the continuing debate about what forms of *sukuk* are, or are not, permissible. It may also be worth noting that several of the more prominent scholars have publicly eschewed the relevance or helpfulness of the distinctions these terms seek to make and view them as unhelpful at best and positively harmful at worst.

The author's reservations about these expressions derive from the belief that the distinction simply bogs the industry down in a side discussion that misses much wider and more fundamental issues. The discussion itself is primarily concerned with the niceties of legal form, the shape of

a transaction, and whether or not a particular mode of financing simply replicates a conventional equivalent. Typically, the conclusion of this debate is that IFIs need to move toward a model that utilizes more profit and loss sharing techniques. Whilst this view cannot be dismissed, there are major concerns about the way in which its conclusion is being (or more accurately not being) addressed. Notwithstanding continuous internal talk and external pressure from academic and regulatory quarters, the industry simply is not developing credible solutions that will facilitate an orderly migration toward a different model of financial intermediation based on such principles. Whilst this debate continues, another important and fundamental concern risks being overlooked, namely whether or not capital originating in the Muslim world is actually being *properly deployed* for the greater good of the populations living in the countries concerned. A more user-friendly approach might frame the question thus: "Is Islamic finance doing what it says on the tin?"

We live in a crowded world. In the first few weeks of November 2011 we learned that the global population exceeds 7 billion people. For several years, the Islamic financial community has convinced itself that annual financial intermediation may be worth approximately 1% of the total global financial value (as mentioned earlier).[11] The vast majority of the world's Muslim population lives in emerging, growth, or transitional economies and has relatively low standards of living. By far, the majority of this population is both unbanked and aspiring to improve their lot. This suggests that if Islamic finance could be better mobilized, there is a target population that would fuel a significant growth opportunity for the industry. Development finance is needed and has a role to play in achieving this.

Islamic finance, where it is properly conducted, does (or should) offer an alternative to other forms of development finance. By *properly conducted*, the author means that implicit within the Islamic economic view, holders of capital *should* deploy that capital in risk-sharing activities (ideally) and with a view to improving the well-being of the *umma*. If this is not believed to be happening, we should be discussing why not. That question will be the focus of the remainder of this section.

One of the difficulties encountered in many Muslim-majority countries in the modern world is that the difference between "public" and "private" capital is not always easy to discern. The way specific countries are governed; the way they tax (or in some cases do not tax) their populations, and the way in which they manage government funding vary significantly. At its simplest, this means that the responsibility for allocating the natural resources of these countries is invariably unclear. In contrast, the visible consequences are all too often clear to observe: namely that over the past fifty years many Muslim-majority countries have failed to develop their economies and their "caring" infrastructure commensurate with their Western counterparts.

Interestingly, we are perhaps starting to witness a change in this now, particularly post the global financial crisis, as various countries with significant Muslim populations start to present themselves as strengthening economies that are also exhibiting a greater willingness to allow and adopt Islamic modes of finance. Countries like Indonesia and Turkey are good examples of such transformation. Many other Muslim and Muslim-majority countries will continue to face the challenges of growth and industrialization and each country will have to face such challenges in its own unique way. The extent to which the still nascent (potentially global) Islamic financial industry can "up its game" and contribute in a much more comprehensive way to solving those demands remains to be seen.

Another facet of the development challenge, and something the author has previously discussed, is the notion that the global financial crisis arrived "too early" for the Islamic financial industry. The extended impact of the global financial crisis and the continuing problems being encountered in extricating the global economy from the adverse effects of the crisis are marking some sort of extended watershed in global finance and global capitalism. In this situation, it is not apparent that the Islamic financial services industry has managed to make the most of the opportunity to impose (or at least outline) an alternative ethical and behavioral approach to the way finance is conducted around the world. The main reason for this failure is the unfortunate fact that the industry still lacks the products, the infrastructure, the capital, the scale, and the human resources needed to be able to vigorously expand and materially narrow the statistical "gap."

Ironically, the next challenge for the industry will be whether or not it can continue to hold onto the moral high ground it purports to occupy at present. The nexus between financial intermediation and real underlying business activity is important. Even where Islamic financiers went astray in some parts of the GCC, one can argue that in many cases physical assets (albeit unoccupied skyscrapers) at least represent *tangible evidence* of poor business planning; this contrasts with the "shadow economics" of the synthetic, often speculative, trading that was the product of much conventional financial engineering. As mentioned above and reiterated on November 6, 2011, in response to the "occupation" of grounds outside St. Paul's Cathedral, there are some senior bankers in the United Kingdom who have begun to acknowledge that Western bankers do need to start acting in a more responsible and ethical manner.[12]

A question that the stakeholders of the Islamic financial industry must consider is this: What are they willing to do with the capital entrusted to them in order to better serve the communities they live in? It seems that in order to answer this question, an equation revolving around a consideration of the following further questions has to be studied and conclusions drawn:

a) Where should the balance lie between private profit and public benevolence?
b) Is there an "appropriate" or "fair" profit that the "private entrepreneur" should be entitled to receive when funding projects for the greater good of the community? In a risk-sharing context, this would probably be better expressed as what sort of "return" should a financier "expect" to be able to make when undertaking such activity?
c) Are the shareholders of existing IFIs willing to accept the levels of profitability that are implicit in this equation? The point being that they will in all likelihood face lower returns than they may have enjoyed before the global financial crisis.
d) How many years of profitable activity were wiped out by the global financial crisis? Would it not be better to enjoy steady growth that benefits society and provides a reasonable (but not exorbitant) return to the capital provider?

Answers to questions of this nature will help us understand whether or not "private" capital will ever be truly mobilized with development goals at the forefront.

In theory, Islamic finance contains an embedded ethical driver. If the prevailing consensus is that this embedded driver is failing to ensure the right sort of conduct on the part of Islamic financiers and IFIs, what can be done to change this state of affairs? Is it too naïve to suggest that stakeholders need practical, easy-to-follow guidance on what it means to run a financial institution in a manner that *better accords* with shari'a principles? Alongside other prominent practitioners in the industry, the author has suggested that the Islamic financial community does need to develop a roadmap that outlines the goals of the industry and better describes the types of financial intermediation that IFIs are "expected" to undertake.[13] This will include such things as the development of infrastructure that genuinely addresses the factors that achieve the sort of developmental activity described above.

Another idea being discussed, particularly amongst younger Muslims interested in themes of social justice, ethical behavior, and sustainability, is that "white lists" of approved investment classes and assets could be developed. Such white lists would seek to encourage acceptable investment behavior on the part of Islamic finance professionals and firms.

Ideally, the industry should seek to achieve such goals with the use of better-designed tools or financial instruments that start to incorporate elements of profit and loss sharing. Such techniques do exist and it should not be beyond the intelligence of Islamic financial engineers to develop instruments that start to facilitate a "fairer" allocation (sharing) of risk and reward. Historically, there has been a singular failure to invest the time and

effort needed to design and deploy these tools in many Muslim or Muslim-majority countries. This needs to change.

## POTENTIAL ROLE OF ISLAMIC FINANCE SECTOR IN NATIONAL DEVELOPMENT

This section examines the role of the financial service sector in general, and the Islamic financial services sector in particular, in national development in the medium and long term. It also examines the role of the Islamic finance sector in the developing regions as well as globally. As mentioned previously, the inability to distinguish between public and private funds in many of the countries we are concerned with complicates the analysis and makes general statements very difficult to substantiate. In the conventional Western democratic model, governments are elected by the population and their mandate assumes certain responsibilities towards their citizens. The precise scope of these responsibilities may vary significantly between countries (the different approach to the state's responsibility for the provision of health care in the US and the UK is a good illustration of this) but essentially the government will provide a variety of public services and utilities. Governments fund their activities by raising taxes or borrowing in the international capital markets. They then have the task of allocating these limited funds to discharge all of the obligations for which they have assumed responsibility. The equation is straightforward to rationalize. In modern democratic states with elected governments and citizens who pay taxes, a sophisticated infrastructure exists for the redistribution of wealth. The efficiency (or otherwise) of such systems need not be considered for the purposes of this paper.[14] However, at its simplest and implicit in the model, it means that once citizens and corporations have discharged their tax burdens, their "duty" to society has in many respects been fulfilled. Provided taxes lawfully due are paid, the capitalist business model leaves shareholders to focus on maximizing returns.[15] In this model, "development finance" in its fullest sense is largely left to governmental and quasi-governmental bodies to undertake as part of the bundle of responsibilities assumed by government.

In more mature economies, a further effect sometimes witnessed is that of extremely wealthy entrepreneurs starting to give away or donate their accumulated wealth to charitable or social causes. Such individual citizens may build and endow educational institutions or devote resources to combat disease. The Bill and Melinda Gates Foundation is perhaps the best-known modern example of such phenomena. [16] However, such activity is no replacement for the deeper role of government in this sector.

This relatively simplistic formulation is challenged in much of the Muslim world by several factors:

a) First and foremost, the ethics embedded within Islam suggest that business activity should be tempered by notions of justice, equity, and fair dealing. In effect, businessmen do not necessarily have the same freedom to consider their duty to society as having been discharged merely by paying secular tax.
b) Secondly, many Muslim states (particularly in the GCC and MENA region) do not have the developed architecture of methodical tax collection and redistribution. Whilst the payment of *zakat* on hoarded wealth is a Pillar of the faith, does that payment suffice to discharge a Muslim citizen's obligation, whether to his conscience, to God (Swt), or to the *umma*? And *zakat* is not a progressive charge on hoarded wealth, so the rich do not pay proportionately more than the poor. At the time of the Prophet Muhammad, zakat may have been sufficient to alleviate the worst disparities in society. However, the ongoing dialogue within the Islamic financial community itself (and the clamor amongst academics and scholars—if not others—for more micro-finance initiatives, etc., is also indicative) suggests that it is probably not sufficient in today's world.
c) Thirdly, many financial institutions (conventional and Islamic) in these jurisdictions are effectively controlled by the government, because the ruler often has a direct or indirect shareholding in the firm concerned. This may mean that the government has the ability to direct such firms to deploy their resources in activities that support the paternalistic role of the ruler.

As a consequence of the foregoing, a discussion regarding the allocation of scarce resources in relevant Muslim jurisdictions needs to be entered into. These issues will become all the more pressing and their resolution of critical importance in many (if not all) of the countries swept up by the events of the Arab Spring. The affected jurisdictions are now faced with creating new political frameworks and the associated administrative institutions required for the orderly management of countries that hope to be "democratized" in some yet-to-be-ascertained fashion. At the forefront will be the need to draw new lines between public and private funds. The failure to manage this distinction in the past has undoubtedly been a factor in the poor development of the countries concerned, culminating in uprisings.

The type of approach that can be adopted in countries that have relatively small populations but significant wealth (one naturally thinks of countries like the UAE and Qatar) will not necessarily work in more populous countries like Egypt. The considerations change again in other parts of the world where major Muslim populations are found; for example, when looking at countries with massive populations such as Indonesia, or complex multi-religious and ethnic populations, like Nigeria. A "one size fits all" approach cannot work across such widely differentiated situations.

But in all these cases, what is the role of the financial services sector? In particular, what will Islamic finance have to say about where and how the lines between public and private funds should be drawn? Financial intermediation is a tool that both should and will have a role to play in the development of all these countries. Western states, conventional bankers, and others will also eventually invest in these countries notwithstanding the global financial crisis and prevailing political uncertainty. IFIs have a role to play and it is imperative that they step up and assume their role. If IFIs cannot identify opportunities and create markets in the developing, emerging, and growth economies that are the homes of much of the world's Muslim population, they can justifiably be accused of letting themselves and their Muslim brothers and sisters down. This has never been truer now than at any time since modern Islamic finance commenced.

Many of these countries will need to identify and develop methods of financial intermediation that can be designed to meet their differing needs and varying political systems. Islamic financial institutions will likely need to bring a new kind of thinking to bear on the different problems that will be faced. Some of the biggest issues many of these countries will have to deal with for the foreseeable future are right in the middle of the development agenda and include the following: The management of population growth; the development of sustainable supplies of energy, food, and water; major improvements in health care and education; and the creation of new jobs.

If largely Muslim countries want to handle the financial intermediation needed to support these massive demands in a manner that fits with their faith, they have to find a way of building a financial architecture that is "fit for purpose" and is able to operate on a far bigger scale than at present. With one or two minor exceptions, this activity is not happening at the moment.[17] The Islamic financial services sector clearly *ought* to have a medium- and long-term strategy and role in the development of countries and regions around the world where there are major Muslim population densities. Aside from the niceties of defining and classifying activities being discussed in this paper, the main issues that IFIs will face in the future are the lack of a consistent industry framework and the shortage of human resources. These issues are not new and have been well rehearsed by experts in the industry. An approach to building an industry framework far more substantial than anything contemplated in the past needs to commence, and imaginative lateral thinking will be needed to achieve it.

To provide one example, the issue of the day is the lack of liquidity instruments available to support the short-term money management requirements of the Islamic financial community. If this is a problem for a US$1 trillion industry, it has the potential to prevent a US$5 trillion industry ever emerging. The problems will also get worse in a global system where Basel III demands eligible collateral in the form of rated sovereign paper. Little paper of the right quality exists in the Muslim majority world, although

the International Islamic Liquidity Management Corporation (IILM) hopes to start making inroads into this problem.

Another radically different approach to managing short-term liquidity by exploiting Muslim-world commodity resources could solve the liquidity problem in one go. Imagine if all of the oil produced by Muslim states were traded via a platform (or platforms) that supported an alternative money market to that currently achieved via the LMA and Platinum and Palladium markets in London. A continuous "flow" of real commodities being bought and sold once only, as opposed to a stock of metal being shuffled around warehouses and sold and re-sold, would allow the natural carbon and mineral wealth of the countries concerned to underpin a truly shari'a-compliant real asset based financial system.

## ROLE AND RESPONSIBILITY OF FOR-PROFIT PRIVATE ENTITIES OFFERING ISLAMIC FINANCIAL SERVICES IN DEVELOPMENT

This section examines the extent to which for-profit private entities offering Islamic financial services can be charged with the responsibility of contributing to development. First and foremost, it is a question for every stakeholder in every IFI to resolve for their businesses and to reconcile in their consciences. The general purport of this paper suggests that for-profit IFIs *ought* to be playing a significant role in development activity. The following paragraphs seek to explore this further but also ask whether or not IFIs are actually already achieving these ends, albeit in a manner perhaps less obviously (or traditionally) thought of as "developmental."

If we begin with the premise that IFIs have a role to play in development, several fascinating supplemental questions then need to be considered. Should every IFI devote 100% of its time and resources to "development finance" or just a proportion of them? What existing activities being undertaken by IFIs already qualify as developmental? To answer this question, we have to return to the definition discussed above and reconsider exactly what we mean by "development" and "development finance."

Looking at the first question above, if the answer were a proportion, what should that proportion be: 10%, 25%, or 50%? Alternatively, in light of the juristic reasoning based on the saying of the Prophet Muhammad "one third is big or abundant" should the figure either "approach but not exceed" or should it be "not less than" one third of their resources? Would any such judgment have some unintended consequences? For example, could a situation arise—perhaps over time as patterns of behavior emerge—whereby several different "degrees" or "shades" or "types" of Islamic financial intermediation can be observed? In solving one problem, is another created: first class and second class Islamic financial activity? Do we have

this already? Would this be a worse problem or a better problem to have than the difficulties of legal artifice? Imagine a scenario where issues of form over substance have been resolved; would it then be logical to assume (or deduce) that *all* financial transactions carried out in accordance with the agreed form are by definition shari'a-compliant? The answer to this proposition would, in all probability, be no. Clearly, there are additional tests and these will concern the subject matter and purpose of a transaction. In this context, where does the definition of "development" start and where does it finish? This brings us right back to where this paper started and the question: What do we mean by "development"?

A different approach to the issue might take into account the ideas of King and Levine (1993).[18] This argument suggests that there is a close correlation between growth and the development of the banking sector. Banks do play a fundamental role by acting as facilitators of payments and stimulators of savings and deposits and allocating resources. Simply opening a shari'a-compliant retail banking operation—even on full commercial lines—in a country where the Muslim population is largely unbanked could be argued as sufficient to demonstrate the achievement of developmental goals. If this is the case, then arguably we are already beginning to see the green shoots of such activity.[19]

King and Levine's ideas also force us to reconsider the potential scope of what types of financial activity might be described as developmental financial activity. If we consider the different types of financial activity an IFI might engage in, we can review their activities by classifying "development" along the following lines:

a) Pure or narrow development activity. This applies to the type of activity generally defined earlier, namely activity specifically undertaken with a view to achieving the outcomes and goals identified by the UN;
b) General development activity. This has the potential to describe some of the general activities undertaken by banks (for example, when they commence general retail banking operations in previously unbanked communities or if they participate in facilities that support the activities of the ICD);
c) Bespoke development activity. This would encapsulate micro-finance and small-scale financial support to help improve the living standards of rural dwellers and the urbanized poor.

Implicit within the classification suggested above is that:

i) In the case of (a), pure or narrow development activity involves higher risks and subsidized financing led by a development agency—commercial banks may or may not participate in linked "commercial" facilities;

ii) In the case of (b), general development activity covers the wide range of commercial "for-profit" banking activity—one of the issues IFIs will be faced with in the coming years is how should (or can) they provide this sort of intermediation in jurisdictions that will undoubtedly be "difficult" places to operate for several years to come? This is particularly the case when we look at the Arab Spring nations and certain other Muslim or Muslim-majority countries.[20] There are already indications that several Gulf-based IFIs will be willing to make investments in these countries. Whilst that is to be encouraged, whether such firms can find ways to cooperate together and raise the significant capital sums that will be needed to aid the rebuilding of these countries remains to be seen. At the moment, there is limited evidence to suggest that these firms can work together in a holistic manner to achieve this; and

iii) In the case of (c), few "for-profit" institutions currently believe it is their role to provide bespoke development activity. Many of the renowned international shari'a scholars concur with this view: they generally believe that private "for-profit" institutions are not obliged to devote resources to activities that should be addressed by government or the "ruler."[21] In practice, there are some exceptions where banks devote a small percentage of their balance sheet (for example, up to 3%) to micro-finance and seek to run such activities along commercial lines.[22] Countries such as Indonesia do have an active shari'a-compliant micro-banking sector, but the author does not have sufficient information about how the sector operates to be able to comment on the applicability of the Indonesian approach in other markets.

If the classification of developmental activities suggested above (extrapolated from the work of King and Levine) is accepted, it may help to frame expectations as to what passes for development activity when scrutinizing the actual day-to-day activities of IFIs.

Embedded within the question of whether or not an IFI can be *charged with responsibility* for contributing to development is: What role does law have to play in the development arena? This issue can be approached from two different perspectives. Firstly, are there any legal injunctions that require or compel private, commercial concerns to *actively engage* in development-related financial intermediation? Secondly, are there legal impediments which actively prevent or hinder the ability of such firms to participate in such activity? Looking at the question of whether there are any legal injunctions that require or compel private, commercial concerns to *actively engage* in development-related financial intermediation: most legal systems impose a primary duty upon the board of directors to look after the interests of the company. In the UK, the duty of a director is to "act in the way he

considers, in good faith, would be the most likely to promote the success of the company for the benefit of its members as whole."[23] In the Companies Law Review that led to the established common law rule being enshrined in legislation, there was much discussion as to whether or not the duties of the directors should be extended beyond the company to third parties such as suppliers, local communities, the environment, or employees, etc. The conclusion was that the position should remain as described above but that directors should have regard to what the government termed "enlightened shareholder value," which would require directors to consider:

a) The likely long-term consequences of any decision;
b) The interests of the company's employees;
c) The need to foster business relationships with suppliers, customers, and others;
d) The impact of the company's operations on the community and the environment;
e) The desirability of the company maintaining a reputation for high standards of business conduct; and
f) The need to act fairly as between members of the company.[24]

These factors do not impose legally binding obligations to perform in a particular way, although the then–attorney general, Lord Goldsmith, when pressed on why the list was included in the Companies Act, expressed the view that if directors were not thinking in this manner then they should be.[25] However, provided the directors *have regard*, they may still take a decision that has an adverse impact, if they believe it would most likely promote the success of the company. In the United Kingdom at least, prudent directors should have their decisions documented to reflect the due regard they had for the list of factors (and any others) but this must be balanced against turning compliance into a box-ticking exercise. In this paper, these principles have only been considered from a UK law perspective. However, since most IFIs are incorporated under the laws of other jurisdictions, it would be appropriate to review the laws applicable to directors in their home countries to understand if their actions might be similarly circumscribed.

From a companies' law perspective, whilst there is no *legal* obligation upon the board of directors to undertake development activity, would they be at risk if, in so doing, they were perceived as failing to act in the best interests of the company? In other words, by actively engaging in development financing activity that might prove less remunerative than other "commercial" transactions, could the directors be accused of failing to maximize shareholder value? This question really identifies the very essence of the development dilemma from a shari'a perspective. In the minds of many critics of the Islamic finance industry, undertaking financial intermediation that achieves the developmental goals earlier described ought

to be the default business proposition. The fact that this does not seem to be happening at the moment raises the question: Why not?

Maximizing shareholder value over the long term may be the primary activity, but is it possible for the constitution of a company to have different aims? Ultimately, the focus of an IFI—and what shareholder value should mean for that institution—can be set by the shareholders. The purposes of the company can be set by the founder shareholders, or they can be amended subsequently by special resolution at the annual general meeting or extraordinary general meeting. The point being that there is no legal reason, or prohibition, against a financial institution determining that it will engage in a particular type of financial intermediation that may appear to be less remunerative than alternative types of financial activity it might otherwise be able or empowered to undertake. This general principle may be qualified in certain situations: for example, in a takeover offer the best price available to the shareholders will become the primary concern of the board of directors, and when a company is in financial difficulties the interests of the creditors become paramount. In the latter scenario, difficult decisions can arise in practice where the directors have to balance minimizing the loss to creditors whilst still promoting the success of the company as a whole.[26] However, the overall direction of the company is in the gift of the shareholders.

## ROLE OF ISLAMIC FINANCE IN DEVELOPMENT IN THE LIGHT OF EMPIRICAL EVIDENCE

It is appropriate to examine what, if anything, we can learn from empirical evidence about the role of Islamic finance in development. The author only had a limited opportunity to undertake a preliminary review of a limited amount of empirical evidence concerning the role of finance (Islamic and/or conventional) in the development of an economy. Empirical evidence derived from observing conventional financial systems does exist, is reasonably plentiful, and supports the premise that the financial sector plays an important role in the overall development of an economy.[27] Initial enquiries suggest that there appears to be limited evidence in the Islamic context. The papers that the author has reviewed tend to focus on the role of IFIs in general development work by providing simple banking services with little suggestion that pure development activity is undertaken.

When it comes to reaching conclusions about the achievement of IFIs in any sort of development role, one particular study suggested that the picture was not very encouraging in those countries that have tried to establish wholly Islamic financial systems. Ahmed cites financial disintermediation in Sudan during the period 1992–97 and the failure of Pakistan to eliminate *riba* as examples of two countries where the experiment to convert an economy to a wholly Islamic financial system has not worked.[28]

According to Ahmed there is a need to "analyze and evaluate" the role of the Islamic financial system in facilitating economic growth. In the analysis he conducted nearly a decade ago, he seems to have broadly concluded that whilst the "modes" of Islamic finance were "theoretically" capable of supporting economic growth, varying degrees of "operational problems" were a hindrance to effectiveness, particularly in the equity modes of finance (where the well-known issues of asymmetrical information and moral hazard prevail) and the difficulty of providing working capital finance. The functional problems identified by Ahmed still remains largely unresolved and it is clear that some fresh empirical studies would be needed to help illuminate any progress that may have been made. Islamic banks still do not have all of the tools they require in order to provide financial intermediation in the way it is needed to benefit emerging economies. Alternatively, where they have the tools, they either lack the desire to fund or simply do not have the scale to pursue appropriate developmental transactions. Some examples illustrate this:

a) Plain working capital remains difficult to provide.
b) Profit and loss sharing contracts are not favored because the risks of using them are perceived as being too high. More work needs to be done along the following lines:
   i) There is a lack of "bankable" instruments that offer some sort of balance in these risks—there are only a few examples of debt to equity instruments that have the characteristic of mezzanine finance. A wider universe of such instruments along a spectrum of risk/reward characteristics might offer a roadmap toward the type of systemic transformation discussed by Volker Nienhaus in his paper above;[29] and
   ii) Specialized financial institutions need to be established which are better equipped to focus on, understand, and manage the risk inherent in profit and loss financing. The industry has to find a way to create an architecture that allows such specialized finance firms to operate and may need to create a series of regulatory safety nets in order to do so.
c) Where means do exist for supporting large scale infrastructure—save for limited exceptions, IFIs have been bit players in providing debt facilities to support this type of activity. The lack of liquidity tools also makes the tenor of such transactions extremely hard to fund.

Ahmed also comments on the effectiveness of a financial system being a factor of how well-designed it is and the establishment of the legal, regulatory, and supervisory environment. Essentially, well-designed, robust systems with good laws that enforce contracts, protect creditors' claims, and have transparent accounting, etc., tend to facilitate better-developed financial

firms. This in turn supports economic growth. As mentioned above, Ahmed's general focus concerns the wider definition of growth and development rather than the narrower concept mentioned above. The overarching conclusion of Ahmed leans in favor of the author's earlier remarks that more work needs to be done to better understand the problems faced by institutions wanting to use profit-sharing models and to find ways of removing the constraints they face.

A more recent empirical study is that of Goaied and Sassi.[30] Their study notes that not all the studies on the links between the financial sector and growth are positive about the clarity of the link.[31] They therefore sought to test the theories regarding this effect by an empirical study of the ability of the "Islamic banking industry to lead . . . economic development" by looking at several MENA countries.[32] Some of the introductory remarks in this study about the superior characteristics of an Islamic financial system are less than convincing; however, what may be more disturbing is that these authors concluded that "financial development has an unfavorable effect on growth in [the] MENA region; even Islamic banks don't make an exception in the financial markets and show a weak relation with growth. It's not proved that MENA economies have benefited from a strong banking system or developed financial sector."[33]

Some of the empirical evidence may therefore be less than convincing about Islamic finance having played a positive role to date in the development finance arena, excepting of course the activities of the Islamic Development Bank. We know that law (secular law in any event) does not compel such activity but that shareholders whose outlook on life is through the prism of shari'a may have a moral incentive to reconsider the business philosophy of their firms. Assuming that shareholders were willing to change their investment return expectations, are there other legal or structural impediments that would still prevail against IFIs taking part in development activity? Worryingly, the answer is that hurdles do remain.

We have already looked at the difficulties encountered in many Muslim and Muslim-majority countries in distinguishing between public and private sources of funds. If public funds are not deployed or are insufficient, can private funds be deployed and if so, are the Islamic banks and capital markets able to help facilitate that deployment? The evidence is sketchy.

There is a generally well-founded understanding (often repeated by writers and commentators) that Islamic finance and infrastructure projects are an ideal fit. The design, development, construction, and financing of assets such as power stations, desalination plants, ports and airports, roads and bridges, schools and hospitals, and the general residential housing stock all present clearly identifiable asset-based opportunities. Many scholars and subject matter experts including Obaidullah[34] are of the view that Islamic finance has a lot to offer for developing the infrastructure sector in a shari'a-compliant and ethical manner, particularly in Muslim jurisdictions. Despite

this realization over a decade ago, the implementation of this ideal is still in its relative infancy. The irony of the situation can be understood by the example of shari'a-compliant BOT projects. As mentioned, over a decade ago, Obaidullah explained how traditional BOT techniques could be used in permissible Islamic contracts. He recognized that some of the risks involved in this type of finance were not necessarily palatable for private financial institutions but could be "mitigated by suitable government initiative."[35] The conclusions reached in Obaidullah's paper remain as true today as they were in 1999. Although there has been progress and there are sufficient examples of *istisna'a*, *istisna'/ijara* and a few cases of diminishing partnership (*musharaka mutanaqisa*) to be able to claim that many banking and legal practitioners are comfortable with the "bankability" of such structures, the sad reality is that there has been an insufficient volume of transactions and only limited progress in further structural development.[36]

The development and construction of civil infrastructure projects is typically the responsibility of the state, although, in many Western countries, the private sector has stepped in as various forms of privatization-driven or public/private partnership initiatives have evolved. The ostensible purpose of such initiatives has been to reduce the burden on the public purse, although recent studies (in the United Kingdom in particular), have started to question the overall financial effectiveness of such schemes. From an Islamic finance industry perspective there have been very few attempts by governments of Muslim countries to raise funding through the Islamic capital markets to support such projects and, as mentioned, there has been relatively little Islamic financing provided by commercial IFIs in support of such projects over the years. Attempts to privatize (in a Western sense) the delivery of various government services have also been limited, but this may have more to do with the issues that relate to the understanding of the difference between public funding and private sector funding. Services that generate revenue when provided by the ruler, or by a quasi-governmental entity, may be too attractive to relinquish to private providers on an arm's length basis in economies that do not raise taxes on income or capital gains.

This paper will conclude with a discussion concerning several examples of financial transactions that may be indicative of IFIs playing a role in development activity. Before doing that, it is worth mentioning some of the specific factors that currently militate against commercial IFIs participating in this sector, even assuming that their shareholders were directing them to do so. The factors discussed in the following paragraphs do not include generic issues such as the lack of legal certainty, bankruptcy codes, or non-capricious dispute resolution systems, since these apply equally to all forms of financial intermediation.

a) Liquidity and the funding model. At its simplest, the type of large-scale infrastructure projects that will make a difference to the needs

of the population have to be funded or paid for over many years.[37] The Islamic banking model relies on equity and *mudaraba*-based depositor funding and Islamic banks have to be sufficiently liquid to be able to respond to deposit redemption demands. This is the fundamental liquidity dilemma. These projects represent long life, illiquid investments that tie up bank capital for significant periods of time. Most Islamic assets are relatively short-term in tenor and it is safe to say that in the entire global infrastructure space there have only been a handful of shari'a-compliant deals financed with tenors in excess of ten years.

b) Scale. Islamic financial institutions are simply not yet big enough to handle the potential volume of the forecast infrastructure requirements of Muslim states over the next ten years or so. This means that single obligor limits and sectoral and geographic limits are rapidly reached. Although the market has witnessed a few benchmark-scale[38] Islamic financial transactions, the overall number of such deals remains relatively limited. A handful of large-scale infrastructure financings funded by full-fledged IFIs would rapidly start to absorb capacity in the market and threaten liquidity. The Islamic financial industry still appears to be immune to calls that it should start to consolidate in order to start building organizations that can have true pan-regional scale and reach. It seems unlikely that this will change in the near term unless financial regulators start to insist that institutions should become larger and/or stop issuing licenses for new firms. Some countries have sought to impose such policies in recent years as they have sought to clean up their financial service sectors and build stability. Nigeria and Indonesia both provide examples where this has happened. Interestingly, both of these countries are now being viewed as nascent Islamic finance jurisdictions in view of the demographic characteristics driving potential demand in each.

c) Who actually funds the large scale deals? To date (or more accurately, prior to the global financial crisis), the majority of the funding provided to Islamic project and infrastructure transactions (at least in the Middle East) has been from the windows of conventional banks. These multi-billion-dollar transactions were predominantly financed on a globally syndicated basis and have relied upon many Western institutions willing to take regional risk and first priority mortgage positions. Over the years, the author has helped a number of investor groups establish funds intending to be shari'a-compliant and targeting the infrastructure sector, but the ability of such funds to undertake major deals has proven to be limited.

d) Pricing. A further factor that has militated against the willingness of IFIs to participate in infrastructure projects (regardless of their

development characteristics) has been the relatively low returns available. Typical debt returns in these deals have been too low when measured against the cost of tying up capital in illiquid structures. Consequently, IFIs have favored commercial real estate in the belief that it is an asset class capable of delivering consistently more attractive returns.

e) Lack of sovereign funding techniques. A further factor that hinders the development of Islamic finance industry support for infrastructure is the relative dearth of sovereign capital market instruments. In the Middle East, the oil-rich economies have generally proven to be agnostic when it comes to the use of third party financing to fund many of these projects (whether conventional or Islamic). They have either funded the projects from current account revenue, or when financing them have been driven primarily by cost considerations (i.e., cheapness) and speed of execution. When Islamic tranches have been introduced, they have had to "fit into" the overall structure and accept *pari passu* pricing and ranking alongside the conventional debt. Since the majority of such funding was being provided via the Islamic windows of conventional banks, as previously mentioned, this has not generally been an issue. The desire of regional governments to utilize Islamic techniques has not extended to them doing a great deal to facilitate the development of alternative markets, particularly the Islamic capital markets. This is a significant issue: were it to be properly addressed, it has the potential to drastically change the complexion of the industry. A thriving sovereign *sukuk* issuance program would effectively become the lungs of the Islamic finance industry. The existence of a deep universe (i.e., a mix of short-term, medium-term and long-term papers with tradability where feasible, or the certainty of repeat issuance in the case of treasury bills) of shari'a-compliant, rated sovereign paper, backed or based (which of these matters not since the risk would be sovereign) on assets or outputs approved for shari'a purposes would achieve two goals:
   i) First, it would overcome some of the tenor problems because the paper could be held to maturity or sold as needed. Notwithstanding sovereign risk tensions in certain Western markets, such paper would ideally be treated as risk-free and/or fungible; and
   ii) Secondly, it would facilitate Islamic institutional support for development initiatives conducted by governments. The ability to liquidate means that it would attract a different type of capital, generally short-term in nature, and these instruments would eventually replace the short-term commodity deposit receipt. This might also overcome some of the pricing issues since much of the funding for these instruments should come from pools that were either previously un-invested (because of the lack of acceptable

forms of short-term/tradable instruments), or might otherwise have been invested in short-term commodity *murabaha*. These sources of funds would actively start to achieve returns where none were previously available. With increased tradability and fungibility, IFIs will be able to liquidate these instruments relatively easily in the event that they wish to take advantage of other investment opportunities as and when they arise and so should be more willing to participate in them.

These are precisely the sort of goals that the operations of the IILM are intended to start addressing. The IILM element will only be a part of the overall solution as it will provide a tool for converting Muslim-world government assets into a form of short-term and/or tradable paper. More work needs to be done at the primary issuance level to identify new and unique ways of creating *sukuk*.

## TRANSACTIONS AND CONCLUSIONS

In many respects it is extremely difficult to determine empirically, whether directly or indirectly, the effect (positive or negative) that any particular form of shari'a-compliant product, service, transaction, or financial intermediation might have upon any particular economy. Any attempt to aggregate such transactions and objectively assess their social impact will always be qualified by extraneous factors, statistical variables, and subjective views on the success or failure of the activity concerned. Arguably, there are only a limited number of countries[39] where an attempt could be made to determine if their gradual adoption of Islamic finance methods is noticeably improving the lot of the citizens of that country when assessed against an earlier period of time or reasonable assessments of what might have happened had Islamic finance not emerged.

In this difficult landscape, perhaps the only real test is to analyze specific transactions on a case-by-case basis with a view to assessing their impact on (a) the parties connected to them and (b) the immediate environment in which their affects can most likely be felt or measured. In doing this, the reader needs to realize that there is a wide universe of Islamic financial products, each operating in a slightly different way from the others. This means that the commercial, business, and/or social purpose of each product will vary and cannot necessarily be compared with a similar but slightly different form of financial intermediation. Although it garners all the news headlines, *sukuk* is not necessarily the most effective form of financial instrument when it comes to development-related activity, so one should not always assume that it will be relevant. None of the transactions discussed below were primarily financed using *sukuk*.

The first example is intended to create a conundrum for the reader: Would the construction of social housing targeted at the needy (i.e., people who may require government support in order to be able to afford to occupy housing on anything approaching commercial terms) be considered more "socially beneficial" than the construction of luxury homes built on a speculative basis for the very wealthy? Both schemes will create employment opportunities and stimulate the production and supply of construction goods and services within the economy, but one has an obvious social dimension as its primary purpose, while the other is driven purely by the profit motive. Do the secondary effects of job creation and raw material production outweigh the primary effect of providing housing in any assessment of these two activities from a developmental perspective?

Similarly, financing the construction of a new airport or a new shipping port may not be an obviously social undertaking if contrasted to building a school or a hospital, but each of these activities will add value and benefit to the communities in which they are constructed in different ways.

Does the establishment of a new shari'a-compliant wholesale investment bank in a secular country that then proceeds to facilitate shari'a-compliant investment in the real estate of that country or other business ventures qualify as acceptable development activity in an Islamic context? If the financial institution concerned were a retail bank offering current accounts to Muslim and non-Muslim customers in the same country, does that change the analysis? If the retail bank were to be established in a country with a significant Muslim minority population (perhaps 40% of the population), does that change the analysis?

Significant shari'a-compliant projects and capital market transactions have been taking place in recent years to facilitate the financing of power stations, heavy industrial facilities, LNG carriers, commercial aircraft, shopping centers, roads, bridges, schools, and hospitals. Transactions of the nature described have taken place in Muslim countries, in secular countries with significant Muslim populations, and in some cases in non-Muslim countries. Another interesting factor is that the source of funding for these deals varies significantly (as mentioned in one of the earlier observations[40]). The author is not providing statistical evidence to support this contention but, based on many years of transactional experience, a significant proportion of the funding for many large-scale infrastructure projects and "big ticket"[41] asset transactions in particular has been provided by Western banks who have been willing to participate in shari'a-compliant transactions at the request of the sponsors (in many cases, the sponsors have been MENA-region governments or government-related entities) who wanted to see them structured in this manner. One of the noticeable consequences of the global financial crisis is that the level of participation by local or regional investors has increased as Western firms have retracted in the last few

years. Consequently, when the profits from these activities flow back to the shareholders of the participating institutions, this too will increasingly benefit the citizens of Muslim states. Over time, this recirculation of capital may also start to have an impact on the regional economies that economists and statisticians can start to measure.

This paper was written with several objectives in mind. The first was to try and broaden the dialogue surrounding the discussion of Islamic financing in the development context. In particular it wished to direct a move away from the narrow and confining discussion that seeks to align Islamic finance with (and sometimes imply that this is its only acceptable form) micro-financing and similar initiatives. The paper discussed the identification of development goals in detail before seeking to identify and classify some wider definitions of development activity and explain how Islamic finance has a role to play with regard to each classification.

Secondly, the paper sought to compel the various stakeholders in Islamic financial institutions (but particularly the shareholders) to think more deeply about whether they are deploying their capital in the most appropriate manner in view of the embedded ethical driver that the author contends is the main factor differentiating the *proper conduct* of Islamic finance from mainstream conventional finance. The discussion regarding how to determine institutional behavior drew upon the distinction between what behavior *is* and what it *ought* to be. The paper recognized that this is not necessarily an all or nothing decision and that IFIs do have choices to make about how they deploy their capital. In the real world in which Islamic financiers operate, many different forms of financial intermediation are needed by a wide variety of customers, but the paper asks participants in the Islamic financial industry to consider whether they are making the right decisions about capital deployment and how those decisions will impact the communities they serve. It was also noted that as a matter of principle, there were no legal reasons why the shareholders could not embed a desired course of behavior, if it was felt necessary to empower the management of the firm to behave differently (i.e., in a manner that might not produce such financially remunerative returns as alternative but arguably less socially or developmentally based forms of investment).

Thirdly, the paper considered some of the empirical evidence regarding the impact IFIs were having on development issues. It was difficult to find readily available and convincing empirical evidence showing a positive impact. A reason for this may be that not enough work has been undertaken in this area and/or previous studies have focused on the narrower definition of development, which the author contends is not the right approach. The Islamic financial services industry is in a continuing state of growth, development, and evolution. The paper identifies several of the well-known areas where the industry needs to continue the process of development to help create more of the tools it requires to deliver its wider goals.

In many respects, the ability of the Islamic financial services industry to respond to the huge opportunities it faces in the Arab Spring nations, as well as in other Muslim communities in other parts of the world (where major populations are presently under-serviced by the financial services industry in general), will depend upon whether it can achieve efficiency and productivity gains combined with a significant increase in scale. The recent economic story of China has been about a nation lifting millions of people out of poverty through the growth of its economy and the emergence of a more affluent middle class. The Muslim populations around the world do not have the advantage of a single government directing policy and behavior as in China, but they do have a common belief system that allows cross-border communication in a unique way. For many years the major challenge faced by the Islamic financial community has been how to raise awareness about what it is doing and to instill credibility in its own communities. That challenge remains the same today, but one way to unlock these opportunities would be to demonstrate that the industry *is* doing what it *ought* to do. If Islamic financiers can deliver the wider development goals discussed in this paper in a manner that is coherent, reliable, and recognized and broadly understood by the wider population, they will have a better chance of securing the future of the industry.

# APPENDIX

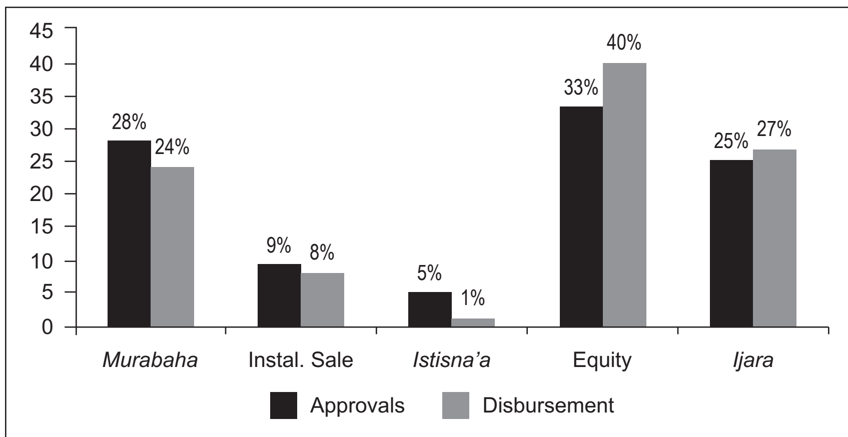
## The role of the ICD in the development sector

The following has been extracted from pages 23–24 of the ICD Annual Report 1433H (2011–12).

### 1. Approvals and disbursement since inception, by mode of finance

Since its inception in 1999, ICD's accumulated gross approvals reached $2.59 billion, which was allocated to 243 projects across the member countries. The cumulative gross approvals of ICD by modes of finance include 78 projects in equity for $862.4 million, 57 in *murabaha* for $718.3 million, 61 in *ijara* for $651.5 million, 39 in installment sale for $223.1 million, and eight projects in *istisna'a* for $134.1 million. By the end of 1433H, 33 percent of approvals were allocated to equity participation, followed by 27 percent in *murabaha*; the rest was distributed to other modes of financings (Figure 1).

**Figure 1. Approvals and Disbursement since Inception, by Mode of Finance**




In terms of disbursement, ICD disbursed a total of $1.022 billion. The disbursement also varies according to the modes of finance. While equity and *murabaha* projects acquired the largest share, amounting to 64.6 percent, *ijara* operations accounted for 26.7 percent, followed by installment sale and *istisna'a* at 7.8 and 0.75 percent respectively (Figure 1).

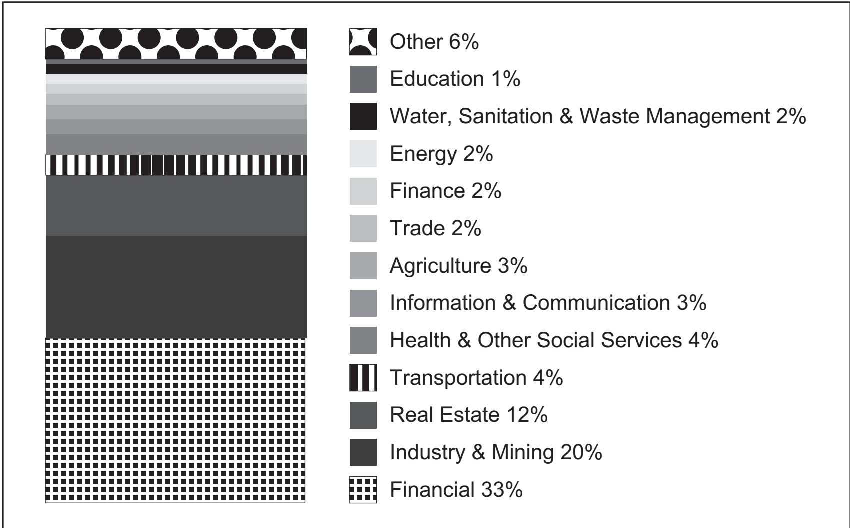
### 2. Approvals since inception, by sectors

Sector-wise accumulated approvals are spread over a number of industries, ranging from financial to real sector industries such as infrastructure, agriculture, oil and gas, manufacturing, and others. As a priority sector, the

financial industry accounted for the largest share, representing 33.1 percent of the gross approvals since inception. The industrial and mining sector has the second largest share with a gross approved amount of $730.7 million. This is followed by the real estate, transportation, health, and other social services, accounting for 21 percent of gross approvals.

The remaining $461.6 million, representing 18 percent of the accumulated approvals, are allocated to seven different sectors (Figure 2).

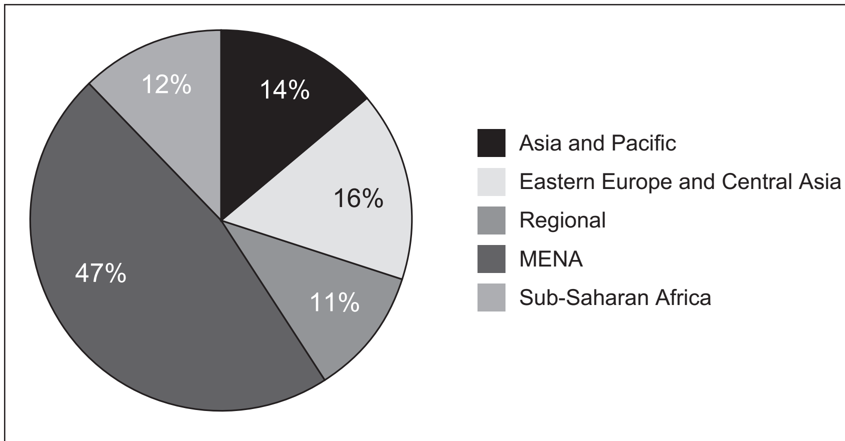
**Figure 2. Approvals since Inception, by Sectors**




### 3. Approvals since inception, by region

In terms of geographic distribution, ICD's approvals also underscore diversity. Between 1420H and 1433H, investment operations managed to reach 39 member countries, in addition to a number of regional projects that cover several economies. The Middle East and North Africa (MENA) region accounts for the bulk of ICD's accumulative approvals, representing 47 percent of the gross approvals. This is followed by regions such as Eastern Europe and Central Asia (16 percent), Asia and the Pacific (14 percent) and Sub-Saharan Africa (12 percent). The share of regional projects covering several countries stood at 11 percent of the gross approvals (Figure 3).

**Figure 3. Approvals since Inception, by Region**




## Endnotes

1. Readers of this paper are asked to keep in mind that the approach to this topic has been framed around several key factors that influence the discussion. First, the author has a legal background and is a practitioner whose predominant experience has included advising financial institutions and their customers in the profit-seeking private sector as well as governmental bodies in the public sector. Second, the author has always adopted a practical, business-orientated approach to problem solving. Third, the author does not claim familiarity with the technical jargon used in the development sector, so has endeavored to utilize non-technical language wherever possible.
2. David Hume, *A Treatise of Human Nature* (Oxford: Clarendon, 2007).
3. Muhammad Ayub, *Understanding Islamic Finance* (England: John Wiley & Sons, 2007).
4. Shahid Saleem, *Role of Islamic Banks in Economic Development* (Graduate research chapter) (quoting Dudley Seers [1969] and Todaro & Smith) (February 2008), 4–5. Also available at SSRN, USA website as http://ssrn.com/abstract+989055.
5. Kjetil Bjorvatn, "Islamic Economics and Economic Development," *Forum for Development Studies* 2 (1998): 237.
6. This is a reference to the indices developed by the United Nations to measure development: (a) the Human Development Index, which measures a country's average achievements in three dimensions (i) life expectancy; (ii) educational attainment; and (iii) adjusted real income per person ($PPP) and (b) the Poverty Index, which measures deprivation using the percentages of (i) people expected to die before 40; (ii) illiterate adults; (iii) people without access to health services and safe water; and (iv) underweight children at age five.
7. There are signs that some firms in the wider financial community have started to question their own behavior in these terms in the aftermath of the global financial crisis and as a response to government and public pressure in certain countries such as the United Kingdom. We have also witnessed the establishment of several social financing programs and initiatives, but this movement (if it can be so described) is still in its very early days.

8. At this stage of the discussion the author has not considered *zakat*, *waqf* funds, and other charitable endowments, although the role of each may be a factor in the response to some of the questions raised in this paper.
9. The Islamic Corporation for the Development of the Private Sector, "About ICD," http://www.icd-idb.com/irj/portal/anonymous?NavigationTarget=navurl://85a1ba033d81e8e0a1a5e77d882f0924 (Assessed on July 9, 2013).
10. Available at: http://www.icd-idb.com/irj/portal/anonymous?NavigationTarget=navurl://6ffc30fb99f5cf6f264ee200b61abf32&LightDTNKnobID=926820335&guest_user=icd_en.
11. Although quoting this figure, the author is not convinced about its accuracy, since it is based on extrapolations of work done several years ago. Further primary research is needed to validate its accuracy, not least because the figure may be higher now.
12. Ken Costa (former chairman of Lazard International), "The City Must Rediscover its Morality," *Financial Times*, November 6, 2011. This was one particular article that caught the author's eye amongst several being written in a similar vein around the period concerned.
13. Mukhtar Hussain, Global Chief Executive Officer, HSBC Amanah, is one such practitioner who, speaking at the 2011 Euromoney Annual Islamic Finance conference in London, also addressed this issue.
14. In the context of the present situation in Europe there is a case to be made that the problems being faced by Greece have arisen precisely because that model has been found wanting in that state because the institutions of government failed to collect the taxes they needed to redistribute.
15. It may be arguable that the precise balancing point of this equation has been shifted in the case of some firms post the global financial crisis. The author has in mind the majority state-owned financial institutions in the United Kingdom where governmental inputs are having degrees of influence on certain aspects of the behavior of such firms. In the UK too the morality of previously lawful tax "avoidance" is being brought into doubt by the political class as the government seeks to limit leakage from the tax system. This is a boundary whose edges may start to become blurred in the near future.
16. The Bill & Melinda Gates Foundation was established in 1994 and is based in Seattle, USA.
17. The establishment of the International Islamic Liquidity Management Corporation (IILM) is one such exception and an example of an attempt to fill an important missing element of the wider enabling environment in which the Islamic financial services industry seeks to operate as discussed above.
18. R. King and R. Levine, "Finance and Growth: Schumpeter Might be Right," *Quarterly Journal of Economics* 108 (1993): 717–735; R. King and R. Levine, "Finance Entrepreneurship and Growth: Theory and Evidence," *Journal of Monetary Economics* (1993): 513–540.
19. For some examples, consider Abu Dhabi Islamic Bank's operations in Sudan and Egypt; ABG's aspirations to open branches in Libya; the operations of Maybank and CIMB in Indonesia and their desire to expand those businesses; and finally the launch of Jaiz Bank in Nigeria and the recently launched Bank Nizwa in Oman.
20. The author has been speaking with participation bankers in Turkey recently where participatory banking has made strong inroads in the Turkish SME space. Talking

to the bankers involved, they explain how they focus on building close relationships with their clients so as to help mitigate the risk of asymmetrical information and moral hazard.

21. This statement is based on evidence stemming from discussions the author has participated in attended by scholars about the topic during the course of several "closed door" debates.
22. Bank Syariah Mandiri in Indonesia offers one such example.
23. Section 172(1) of the Companies Act 2006 (United Kingdom).
24. Section 172 of the Companies Act 2006 (United Kingdom).
25. Richard Slynn, "Directors' Duties," *A Practitioner's Guide to Directors' Duties and Responsibilities*, Tim Boxell (London: 2007), 73–112.
26. See: Tim Boxell, "Chapter One," *A Practitioner's Guide to Directors' Duties and Responsibilities*, 3rd ed., City & Financial Publishing.
27. Ibid footnote 22 and works referred to in these monographs that sought to empirically test the argument of Joseph A. Schumpeter, *An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle,* translated from the German by Redvers Opie, with a new introduction by John E. Elliott (New Brunswick, NJ: Transaction Books, 1983).
28. Habib Ahmed, "The Islamic Financial System and Economic Growth: An Assessment," *Islamic Finance and Economic Development*, edited by Munawar Iqbal and Ausaf Ahmad (New York: Palgrave Macmillan, 2005) 29–48. In the case of Sudan Ahmed states that ". . . there has been financial dis-intermediation in the country during 1992–1997. Furthermore the financial sector has failed to mobilize resources for investment . . ." and with respect to Pakistan he says: ". . . the reversal of the judgment on eliminating *riba* in Pakistan by the Sharia'a Appellate Bench of the Supreme Court shows the difficulties of implementing a comprehensive Islamic financial system. In the note to this remark, Ahmed also explains that on June 24, 2002, the Sharia'a Appellate bench of the Supreme Court of Pakistan set aside its earlier judgment in which it had directed the government of Pakistan to eliminate *riba* from the economy by June 30, 2002.
29. Ibid.
30. Mohammed Goaied and Sefallah Sassi, *Financial Development and Economic Growth in the MENA Region: What about Islamic Banking Developmen*t (2010).
31. Ibid.
32. Ibid.
33. Ibid.
34. Mohammed Obaidullah, "Designing Islamic Contracts for Financing Infrastructure Development," *Islamic Finance: Local Challenges, Global Opportunities* (Cambridge, MA: Islamic Finance Project, Harvard Law School, 1999).
35. Ibid.
36. Although one of the more interesting developments during this period has been the willingness of shari'a scholars to broaden the underlying asset classes capable of being financed in certain *sukuk* and other transactions, from purely tangible assets to assets that may not always be tangible in the traditional sense of being physical things that can be touched but are the measurable outputs of modern industrial processes or services. Typical examples include the ability to finance telecoms companies by reference to units of "air time" generated by their transmission networks or the right to fly as measured in the ATKMs (available tonne kilometers are units used in

the aviation industry to measure total capacity and formed the basis of the Emirate Airline *sukuk* issued in March 2013).

37. Very often we are contemplating projects that require billions of dollars of funding to support. An example is the announcement in Saudi Arabia of the award of contracts worth US$22.5 billion for the design and construction of a Metro rail system in Riyadh, the capital of Saudi Arabia (as reported in *The Gulf News*, Tuesday, July 30th, 2013).
38. For this purpose, transactions worth in the region of US$1 to 5 billion or above.
39. At the present time, perhaps only Malaysia, Saudi Arabia, and the UAE are capable of being studied in this context. They represent examples of three distinctively different types of economies where the penetration of Islamic financial intermediation has been most marked in recent years. Although Iran and Sudan both have theoretically wholly shari'a-compliant financial systems, they are both closed, or virtually closed, economies and this means it is difficult to make any realistic, independent assessment of how efficient they might be, or if they offer any form of helpful demonstration effect to other economies.
40. See paragraph c) above, "Who funds the large scale deals?"
41. The expression "big ticket" is not a term of art but is usually a reference to the financing of high-value assets such as ships, floating oil production and storage platforms, aircraft and satellites, etc.