

CRITICAL REVIEW WITH META-ANALYSIS

Moving Towards Community Driven Islamic Finance

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Abstract. Contemporary Islamic Finance is seen by many as operating in the ‘push’ mode, with incumbent players pushing their version of products in the market, rather than working in a ‘pull’ mode, where society’s requirements would drive industry evolution. The Islamic finance industry has been criticized because the profit aspect of running operations overshadows the altruistic aspect of Islamic Finance (IF) and easily marketable solutions are more common than socially relevant products to benefit the wider communities. The paper has assessed and provided an account of the current scenario and made certain proposals on how IF can move to the next level by capitalizing on various opportunities available at hand. Different models including microfinance, crowdfunding, blended finance, ‘mutuals’, and *takāful* are reviewed in this light, identifying business models more suited to social needs. In conclusion, it is important that Islamic finance has to move beyond its current practice by developing other non-banking institutions as this will help in responding to the unique needs of human societies in general and Muslim communities in particular.

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INTRODUCTION

Islamic commercial banking assets continue to see a significant growth over the years with the global assets forecasted to reach \$3.25 trillion by 2020 (Thomson Reuters, 2015). In their fourth decade of existence, the Islamic banking and financial institutions are spearheading a mega trend in Islamic finance, which is being recognized by the stakeholders in the global finance industry, while some describe it as shifting from “a very esoteric asset

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class to one that's more... global" (The Economist, 2014). This shows the acceptability of Islamic banking model in the world especially in the Middle East, North Africa, and Asia.

This growth is paralleled, in contrast, by a rise in poverty levels in many Muslim-majority countries. Except for some selected countries in Southeast Asia and the Middle East, there are high and increasing poverty levels observed in both urban and rural parts of the most Muslim-majority countries (Ahmed, Mohieldin, Verbeek, & Aboulmagd, 2015). The target for the Millennium Development Goals (MDGs) ended in 2015, and in spite of the achievements observed in some areas, the prime target of reducing absolute poverty remains a distant dream in some Islamic Development Bank (IDB) member countries (IDB, 2015). While Islamic banking and finance institutions have indisputably contributed to grow, their overall impact on the economic and social development is negligible (Asutay, 2012).

Many analysts and scholars believe that the Islamic Financial Institutions (IFIs) were originally created to realize the unique value proposition of Islamic economics, (i.e. channelling financial resources towards the real economy on the basis of risk and reward sharing principle) and the realization of certain 'higher objectives' (*maqāṣid*) of the Sharī'ah such as better and equitable distribution of wealth among various sections of the society and improving the degree and scope of mutual support. However, the current practice among the Islamic banks is observed to be contented just by certain negative screens in form (El-Gamal, 2006). Islamic economists over the years have been arguing for the superiority of the Islamic Economic system with respect to resource allocation and distribution, justice, and stability (Nienhaus, 2014). Contrarily, there are others who contend that the IFIs were initially developed as a response to the challenge of undertaking financial transactions while avoiding prohibited financial practices, primarily *ribā*. Asutay (2012) notes that in providing such solutions, the pioneers of Islamic finance were, in fact, realizing another higher purpose of the Sharī'ah i.e. alleviating hardship (*mushaqqah*).

The Professed Failure of Islamic Finance Industry

Critics observe that even after working for several decades now, the IFIs have done little as far as real innovation in terms of new products is concerned, rather it has just mimicked the conventional financial products. This observation is discussed and confirmed by some studies including (Farooq, 2013), Gan and Kwek (2010), Chong and Liu (2009) - the last one shows the correlation between the profitability of Islamic banks and the change in the interest rates and monetary operations. This gives an impression that Islamic and conventional finance are on the course of convergence as far as their impacts on economic growth and the society as a whole are concerned. This development has a potential reputation risk which in due course might lead to entire Islamic banking and finance industry losing its sheen and customers' trust. It is also not sure whether these current customers are happy or confined to just the "*ḥalāl*" or "Sharī'ah-compliant" stamp issued by the Sharī'ah scholars?

Islam emphasizes on distributive justice, and there are many verses of the Qur'ān and a number of *ahādīth* that talk about this principle, which is the culmination of earlier divine revelations, which are comprehensive, realistic, and clear (Ahmad & Hassan, 2013). Distribution ranks quite high in the Sharī'ah hierarchy of values, and is an explicit Qur'ānic

criterion for evaluating a society, as evident in the verses (59:7, 69:34) and (89:18) of the Holy Qur'ān. Refusal to share with the needy is considered a transgression "طغيان". If a person's poverty can be relieved by providing micro-finance, this becomes a high-priority method because we are helping the individual to empower him to take care of his needs, and not to be a burden on others. Similarly, monetary *waqf*, as a way to combat poverty, fulfills a major economic goal in Islam.

Irrespective of the position taken, associating something with Islam as a standard, in any respect, more so especially in the financial business models with commercial aspirations has deep implications on the spectrum of dealings and responsibilities. In this regard, the social impact of any business can't be ignored or marginalized when Islam is the reference point. In any case, the original intention of Islamic finance proponents and the current concerns are not at odds with each other. Analyses (including several studies by the World Bank and IMF) of the theoretical ramifications of the Qur'ānic prohibitions of many of the conventional financial practices such as *ribā*, *gharar*, and *maysir* have demonstrated that an economy free of these elements is likely to be more stable, efficient, and growth-oriented (Nienhaus, 2014).

A critical analysis of the performance of the IFIs indicates a growing divergence between the aspirations of the Muslim community and the practices of the Islamic banks. This divergence mainly demonstrates itself in the areas linked to the ethical and social expectations, and therefore, it would not be invalid to claim the 'social failure' of the Islamic banks with the level of evidences produced by a growing body of analytical and empirical literature (Asutay, 2012). This position is also held by Ali and Nisar (2016), based on a survey of literature in the field and many insightful conversations with the industry leaders over the last two decades, who conclude that this hypothesis is widespread. However, it may be important to add that the reason for this failure has more to do with the human weakness than any shortcomings in the principles or theoretical foundations of Islamic finance.

The perceived failure of the Islamic finance industry in realizing the aspirations of the masses can be attributed to many factors, such as the regulatory and social environment in which it exists and the tools with which it works. In addition, there are many internal factors to IFIs, such as the organizational structure, business targets, growth strategy, etc. Consider, for example, that many countries in which Islamic finance is relatively more popular are underdeveloped - economically, technologically, and human resource-wise. Consider also that Islamic finance's expansion accelerated significantly only after the Western institutions began to take greater interest in it. Also consider the fact that the entire Islamic banking and finance industry works under the regulations more biased towards debt-based products. Equity is taxed while debt continues to enjoy tax benefits across the globe.

It is argued that the essential purpose of institutions engaged in Islamic finance is to enable Shari'ah-compliant financial activity. While the field has shown great strides in increase in asset size, it has, at the same time, earned a reputation as a banking system mainly focusing on the rich, neglecting the poorer sections of the society. Islamic financial institutions have not yet made significant forays into the area of microfinance, despite the fact that Islamic finance is social justice-oriented (Ali, 2007). In other words, their attachment to 'efficiency'

has been at the cost of ‘equity’ while Islamic Moral Economy (IME) as the foundation and framework for Islamic finance prioritizes social as well as economic optimality by placing emphasis on ‘equity’ (Asutay, 2012). Thus IME, conceptually, suggests that Islamic finance should be more than financial contracts as it represents a holistic approach to financing a society. Also, Islamic finance is rooted in the developmental aims, (especially in the current scenario where many Muslim-majority countries are underdeveloped) and, therefore, conceptualized as providing the financial means for the development of societies, in addition to services for the markets.

The implications of ‘Islamic’ in the title will, therefore, imply that the aspirations of IME should be served through new institutions and perhaps through non-banking financial institutions, which can include Islamic social banking (Asutay, 2007; El-Gamal, 2006), Islamic microfinance (Ahmed, 2004; Asutay, 2010), social inclusion (Ayub, 2015), economic empowerment-oriented *awqāf* (pious foundations), *zakāh* funds for development, Islamic development banks, social investment institutions, and ethical funds and so on.

Hence, the objective of this paper is to explore the possibility of the Islamic finance institutions aiming at evolving the Islamic moral-based economy and harmonious societies bridging the gap between the poor and the rich. In that way, only the Islamic finance system will be community-driven. The paper considers how Islamic banking can be used as a driver for the socio-economic advancement of the Muslim communities even in their profit-making. With this, the social impact of the Islamic banks will be internalized.

When we look at the above discussion from a social angle, it may be pertinent to ask what role Islamic finance and banking should be playing in the society? How can the Islamic banks move towards a ‘pull’ mode of the operation from the current ‘push’ mode? Pull mode refers to the inclusive financial products that are desired by the community as a whole; for example, products that will help lift people out of poverty. It is obviously a highly desirable goal, but how and to what degree should the Islamic banks play a role in doing so? Similarly, isn’t it problematic that Islamic finance is not sufficiently concerned with the impact of its financial transactions? Should, for example, any Islamic non-banking financial institutions not prioritize funding of the construction of useful infrastructure such as an airport and motorway over a more profitable, but less socially relevant avenue? What are the potential opportunities for increasing the contribution of Islamic social intermediation, such as from *zakāh* and *waqf* to humanitarian action, in particular for local and regional level humanitarian organizations? The push mode is where the current practice of Islamic finance is functioning-IFIs replicating products that are being offered by the conventional institutions, not focusing on the *maqāṣid al-Sharī‘ah*.

MAKING ISLAMIC FINANCE COMMUNITY-DRIVEN

What is Community-Driven Islamic Finance?

Community-driven Islamic finance would be looking at how it might incorporate the needs of the communities in financing operations as a form of social and economic support. This is not new as the World Bank, through “Community-Based Development” or “Community-Driven Development” has put forward financing schemes, project design, decision-making,

and management of investment funds, in terms of which the needs of the participating communities are considered (Mansuri & Rao, 2003). Overall, these measures are expected to deliver better social, economic, and environmental progress and assist in alleviating poverty in the underdeveloped areas.

The concept of community development is well-engrained in the Islamic economics literature and in the making of distinctively Islamic pro-development modes of financing. The general perception is that Islamic banking and finance are established, in the context of a high importance attributed to the social development and human well-being within the Islamic worldview (Sairally, 2007). In the Islamic economics literature, many scholars have argued that Islamic finance is supposed to play a socially responsible role in promoting the socio-economic development (e.g., Ayub, 2015; Chapra, 1985; Siddiqi, 1983; Warde, 2000).

Financial Inclusion through Microfinance Subsidiaries

A new viable way which can provide an opportunity for the Islamic banks to support social impact finance is through the banks with a subsidiary that is focused on social welfare. With this, a bank would have commercial financial activities as usual and a subsidiary devoted to providing services to help the productive poor with a mix of funding sources principally from charity and other similar sources and structured like a microfinance or non-banking entity. This is not entirely new as some Islamic banks and conventional banks such as IBBL in Bangladesh and Citibank have subsidiaries that are targeting the welfare of the community, but certain considerations proposed here could enhance the sustainability and the impact that these institutions can have on the communities they operate in.

With regards to capitalisation, it may be stipulated by the banking regulation that when a bank is being established, shareholders would be required to agree to a small percentage (say about 5%) of the capital raised to be used for establishing a subsidiary for social development. In addition to this, the bank may be required to allocate a certain percentage (let's say 5%) of the annual profits to be passed on to the subsidiary. This will require a huge government will and commitment particularly in the Muslim-majority countries.

The above model would allow the Islamic banks to be financially viable by conducting commercial business while still investing in social development. The small percentage of (say 5%) given towards establishing the subsidiary would be similar to an administrative fee paid by the traditional bank. This, of course, will be in the realm of ethics as the bank will look at it from a broader *maqāṣid* angle where economic objectives and social justice remain vital.

There can be an integration of charity institutions with these subsidiaries to draw some synergies. This arrangement will provide a unique opportunity for the charity-based institutions to be institutionalized and transformed by working with these subsidiaries in the collection and disbursement of funds. When the charity-focused institutions collect donations from both individuals and other organizations, the funds can then be invested in areas that will directly have an impact on the lives of the poor, such as health, education, skills training, entrepreneurship, and the like.

Further funding for the subsidiary can be sourced from delinquent charges by the Islamic

banks. Such charges can be channeled to the subsidiaries to finance productive entrepreneurs through *qard al-ḥasan* or benevolent loans. *Zakāh* management schemes can be incorporated into these models where the bank subsidiary would be serving as an intermediary between the *zakāh* payers and the recipients. Aside from this, this subsidiary can also be financed from the *tazkīyah* funds of various Islamic banks. Almost all Islamic banks have such *tazkīyah* funds where they channel impure income into public good.

An innovation that this micro-financing may employ is that some of the temporary financial resources that it receives from the depositors may be used. This opens a largely untapped source for microfinance from the demand deposits. For instance, depositors to an Islamic bank may direct the bank to transfer some funds to the subsidiary as *qard al-ḥasan* which is paid back at agreed terms. To ensure that there is an un-interruptible flow of funds to the lenders of the subsidiary microfinance, certain persons can offer to make available the financial resources through a benevolent loan from their accounts for the microfinance purpose.

In a situation where the microfinance is unable to recover funds advanced to the clients, there can be an arrangement for guaranteeing of these losses through donations from philanthropy to the microfinance. It's of interest to note that a client who is unable to pay the debt genuinely becomes *ghārim* (one burdened with debt) according to *zakāh* rules in the Holy Qur'ān (9:60). He thus becomes a legitimate recipient of *zakāh* in order to pay back what he owes to the microfinance. With this, the guarantors of losses can pay the sums they pledged from their *zakāh* obligation. This will incentivize many persons to become the guarantors and is likely to have a significant multiplier effect on the potential lenders to the microfinance. Thus, we see strong complementarity between *zakāh*, *ṣadaqah*, and microfinance. In this regard, a number of microfinance studies have been conducted using different models (Ali, 2011).

Another way the Islamic banks can manifest their impact within their communities is by establishing a monetary *waqf*, assuming that there is an Islamic bank of which a subsidiary is founded as a *waqf* with the aim to offer socially responsible services, e.g. microfinance as *qard al-ḥasan*. The subsidiary will be owned or work jointly with other corporations or individuals with similar interest. Already, some conventional banks have microfinance subsidiaries such as BOI Microfinance by Bank of Industry in Nigeria.

The Islamic banks as promoters of the *waqf* can invite other interested parties to join and can even issue *waqf* certificates to the public to raise the required capital. Also, if there is an existing *waqf* property such as land, this can be developed further in the context of providing microfinance to the productive poor in the community.

This arrangement can take several forms in practice, and some countries have already gained some experiences in using the monetary *waqf* to drive their social impact agenda. In a corporate monetary *waqf* scheme as practiced in Malaysia, Turkey, India, Pakistan, and Bangladesh, the founder of this scheme is not only any individual but also private and public corporations (Mohsin, 2013). The originating founder, either the private or the public institution, will establish the *waqf*. Other patrons of the *waqf* are asked to contribute a portion of their profit or contributions to the corporate *waqf* on a regular basis apart from the dona-

tions that will be received from other individuals and corporations. The incorporated *waqf* will then manage and invest the funds and when profit is earned, qualifying projects will be financed.

In a *waqf* deposit scheme, the Islamic bank's subsidiary for microfinance acts as a trustee. The founder will deposit funds in a cash *awqāf*-designated account. The trustee will specify the list of beneficiaries in the areas such as health care, education, etc. Earnings from the management of the funds from the bank or microfinance will be channeled into financing the projects. This is practiced by two banks in Bangladesh, the Social Investment Bank Limited (SIBL) and the IBBL (Mannan, 1998).

Finally, there can also be a co-operative monetary *waqf* scheme. This scheme is a public *waqf* which has been practiced in Uzbekistan (Sievers, 2002). The scheme provides the basic needs of the people.

A two-tier *mudārabah* model, also known as re-*mudārabah* is a similar arrangement to the above. With this arrangement, three parties are involved i.e., capital provider, intermediate *mudārib*, and the final *mudārib* (Abdul Rahman, 2007). There is an extended scope of the capital provider which may be the government, *zakāh* or *waqf* foundation, an Islamic bank or non-banking institutions. The funds disbursed by the capital provider are managed by the intermediate *mudārib* which is typically a microfinance provider or non-banking financial institution such as an Islamic venture capital and may give technical assistance to the final *mudārib*. A micro-entrepreneur acting as the final *mudārib* practically manages the business alone or in consultation with the intermediate *mudārib* (Abdul Rahman, 2007, 2010). It's important to mention that although these contracts appear linked to each other, they are independent of each other. This accords the opportunity to pool the capital from varied sources and channel these into financing viable business ideas which have the potential of value addition to the society and the real economy.

A few cases on how the Islamic financial institutions are working with the *zakāh* distribution institutions are discussed below:

Abu Dhabi Islamic Bank and Zakāh Fund

A case in point is the United Arab Emirates (UAE), where there is an innovative attempt of an alliance between *zakāh* and Islamic finance (Nagaoka, 2015). In this arrangement, there is a sovereign entity called the “*zakāh* Fund” (ZF, *Sunduq al-zakāh*) which is tasked with the collection and disbursement of *zakāh* in the UAE. In 2010, Abu Dhabi Islamic Bank came up with a novel idea to collect *zakāh* on behalf of ZF through the bank's ATMs, mobile phones, and the bank counters at its branches. Additionally, ZF also installed its own ATMs for collecting *zakāh* in 2011. Using these ATMs, customers not only pay *zakāh* but also indicate the category of disbursement of *zakāh*. These kinds of initiatives would make the management of *zakāh* more efficient and impactful (Nagaoka, 2015).

The Case of Islami Bank Bangladesh Limited (IBBL)¹

For highlighting the practicality of some of the suggestions, it is useful to share what an

¹This section is sourced from IBBL and can be seen at <http://www.islamibankbd.com/rds/introduction.php>

Islamic bank is already doing to achieve the same goals of community-oriented Islamic banking, although in a different way through the Rural Development Scheme (RDS). This scheme recognizes the unique needs of the community within which they operate and has been successful. Bangladesh has about 38% and 18% of the population living under the poverty and ultra-poverty lines respectively, and this has been the major cause of yawning rural-urban economic disparity. The situation is worsened by the high levels of illiteracy, lack of proper health, and sanitation facilities. The country's economy is mainly agrarian with a huge majority of the people living in the rural areas depending on agriculture for their livelihood. The agriculture sector seemed to have saturated and provides a limited scope for productive employment leading to migration of people from rural to urban areas. Rural areas are characterized by underemployment and unemployment phenomena. The vast human resource remains unutilized due to the lack of education, proper training, and concerted efforts to help grow the rural economy. It has resulted in an uneven development and acute income disparities across regions.

In the circumstances as described above, IBBL launched its Integrated Rural Development Scheme (IRDS) in 1995. The purpose of the Scheme, in addition to providing micro-investment facilities to the stakeholders, was to ensure that various types of facilities and services are made available to the ultra-poor and downtrodden as a part of the Integrated Development Approach (IDA) as well as the Corporate Social Responsibility drive of the bank. The coverage of the scheme included: Humanitarian Assistance Program; Education Program; Capacity building or Training Program; Health & Medicare Program; Environment Protection Program. These areas were chosen to recognize the importance of human development.

The clients are provided investment support up to BDT 10,000 (\$145) first time with the opportunity for an enhanced support on good performance such as BDT 2,000 to BDT 5,000 in every next term up to the ceiling level based on specific sectors. The return on investment is determined periodically and as of May 2016, 12.5% is set as the rate of return with a 2.5% rebate to encourage timely repayment. The main Islamic finance contracts used are *bai' al-mu'ajjal* and *mushārahah*² with a selection depending on the sector and purpose of the investment.

Interestingly, performance of the Scheme has been phenomenal since its inception. The data showed that by the end of May 2016, 251 branches of the Bank had been implementing the Scheme in their respective areas. These branches are operational in over 18,000 villages of 64 districts of the country. The Scheme has served nearly a million poor since its inception. A total amount of BDT 142,626.49 million of investment facilities has been provided of which 21,399.75 million are outstanding. The rate of recovery of the Scheme is impressively above 99%. This shows that with the commitment, Islamic finance can respond to the needs of the community and IBBL has shown a path that can be experimented by other Islamic banks as well.

²The *mushārahah*-based return is determined at the maturity of the investment.

Crowdfunding

Attracting seed and growth capital is an inherent problem faced by most entrepreneurs, given that they lack collateral and sufficient cash flows and also due to the presence of significant information asymmetry with the investors (Cosh, Cumming, & Hughes, 2009). To date, equity-based funding for startups and SMEs in the MENA region has largely been provided by the venture capital firms and large angel investors leaving a funding gap for the entrepreneurs trying to raise a seed capital under \$1-2 million (Alonso, 2015).

In recent time, some entrepreneurs have moved towards the internet-based platforms to seek direct investment from the public (the “crowd”). These investors seemingly get a better deal with the general public than from the professional investors such as business angels, banks or venture capital funds (Lambert & Schwiendbacher, 2010). This practice called “crowdfunding” is utilized to source funding for the project-specific investments as well as for starting up new ventures. Crowdfunding can be defined as a type of participative online activity where an individual, institution, company or non-profit organization proposes to a pool of individuals of varying knowledge, heterogeneity, and number, through a flexible open call, the undertaking of a task on a voluntary basis which always entails mutual benefit.

Crowdfunding takes some features of the traditional resource-pooling and social-networking phenomena with an added innovation such as involving consumers who act as investors, providing monetary support to the others expecting some kind of payoffs, either monetary or non-monetary (Ordanini, Miceli, Pizzetti, & Parasuraman, 2011).

Alonso (2015) reveals that crowdfunding can be done in four ways such as equity, lending, reward, and donation-based. In equity-based crowdfunding, the investors are compensated in a form of fundraiser’s equity-based or revenue, or profit-share arrangements. Conversely, in lending-based crowdfunding, the fund providers receive a fixed periodic income and principal repayment at the maturity. Donation-based crowdfunding arrangement is such that the funders donate to the projects that they like to support, without expecting any compensation. Finally, in reward-based crowdfunding, the funders’ primary objective is to gain a non-financial reward. In summary, equity-based and lending-based crowdfunding are motivated by financial returns, while donation-based and reward-based crowdfunding are used as vehicles to drive the beliefs and passions of financiers.

Crowdfunding by its nature perfectly matches with the Islamic finance proposition of providing finance for both profit and not-for-profit motives, except in case of lending on interest. With regards to the equity-based crowdfunding, *muḍārabah* or *mushārah* contracts can be used to support the entrepreneurs with bankable ideas with the crowd taking equity in the business after it passes through the Sharī‘ah and business screening processes.

In Sharī‘ah-compliant crowdfunding, interest can’t be charged on the money lent to the borrowers. In this regard, *qard al-ḥasan* will be a better and more appropriate tool to use especially for those who have social impact motivations. Donation and reward-based crowdfunding will be easy to apply in Islamic finance as these are similar to *ṣadaqah* and *zakāh* as Islamic finance social intervention tools.

There are some Sharī‘ah-compliant crowdfunding cases that can be cited and ‘*shirkah*’ is such an example. It’s a Sharī‘ah-compliant crowdfunding platform established in Egypt

in 2012. *Shirkah's* main mission is to fill the funding gap for those startups or already established companies which are too big for microfinance and too small for the traditional financial institutions and the banks. They emphasize on both social responsibility and Shari'ah-compliance with a special focus on upgrading the success rate of startups in the MENA region. *Shirkah* targets different projects that need funding between \$50,000 and \$300,000, seeking to connect creative people with the investors willing to invest in them (Alonso, 2015).

Projects are expected to pass through Shari'ah screening and the startups and companies are not allowed to raise additional capital based on interest or in Shari'ah non-compliant manner. From a legal angle, investors take part in the ownership of the project and gain rewards based on Profit and Loss (PLS) principle, which ensures a fair distribution between the shareholders and the entrepreneurs.

Crowdfunding possesses the characteristics of ethical, fair distribution of wealth and obligations, and these are valuable exploits in Islamic finance. It can, therefore, be promoted in the area of community-driven Islamic finance in the Muslim economies, especially in the sectors like technology, agriculture, health services, and education (Asutay & Marzban, 2012).

Fintech is another innovation frontier for crowdfunding. Islamic finance can utilize this digital investing to attract a new level of service for a broader customer base. This was the topic of discussion at the 2016 World Islamic Banking Conference in Manama, Bahrain. In this conference, the Central Bank of Bahrain's (CBB) Governor, Rasheed Al-Maraj announced that CBB would be issuing special regulation on Fintech.

Rehbar, India-based financial consultancy, has also bundled services such as due diligence of business deal structuring, performance monitoring, and facilitating monthly profit payment with its business funding activities.³

Mutual Credit and Saving Institutions

Mutual credit associations devoid of interest, such as classical Rotating Savings and Credit Associations (RoSCAs) have been usually approbated by the religious scholars of all schools, and widely accepted by the Muslims across countries (El-Gamal, 2016). As part of the membership of RoSCA, the financial institution receives periodic interest-free loans from the other RoSCA participants, staggers its payment schedule in two or more RoSCAs, and then converts the zero-interest short-term funds that it receives into longer term positive return through lease and credit sale basis. At an individual group level, the group contributes money to be given to the members of the group by rotation until all the group members get finance in a mutually agreed manner.

Even though technically, the first recipient of the RoSCA achieves greater benefit, the order is usually driven by need and the social norms prescribing that one should continually agree to participate in a RoSCA when asked by someone in their social network, and this leads to a strong sense of balanced reciprocity (El-Gamal, 2006).

³rehbar.co.in/about-us

El-Gamal, El-Komi, Karlan, and Osman (2014) have found both theoretical and empirical/experimental evidence that a variation on the RoSCA known in Egypt as *gam'iya*, with added guaranty against default for participants, produces higher take-up rates and higher repayment rates than Grameen-style microfinance offerings. In Afghanistan, the World Council of Credit Unions (WOCCU) reported the successful premiering of credit unions that found some success as early as 2007, avoiding ruling against conventional financial models in part by using the mutual ownership argument (WOCCU, 2007).

The prime advantage of mutual financial institutions is their capacity to provide care to those who might be rejected by the profit-seeking stockholder-owned financial institutions. This is the case, for example, for the poor customers targeted by the credit union operations that leverage community's social capital and networks in the provision of credit at reasonable costs. Of course, it is worth mentioning that information asymmetries make catering to the same poor customers very costly to the conventional banks because work of a loan officer costs approximately the same irrespective of the loan amount involved. This makes the interest rates on microloans exceptionally high. For insurance purposes, these information asymmetry problems can result in market failures. This problem may be solved by risk-sharing mutual insurance schemes that have emerged in the traditional societies, even though the principle of *ex-ante* reciprocity is difficult to accept in a few such contexts (Plateau, 1997).

Takāful

The concerns about the validity of conventional insurance in the context of Sharī'ah acceptability in respect of the prohibitions like., *ribā*, *gharar*, and *maysir* have been raised since early 20th century and the scholars and financial experts have extensively debated over what should be the solution for mitigating the losses from perils suffered from the adverse events (Bhatty & Nisar, 2016).

Financial protection has always been a vital part of the Islamic thought process, which has its roots from the system practiced by the Arab tribes even before the arrival of the Prophet (PBUH).⁴ It was accepted and further improvised within the Islamic remit in various forms. As a result of this, the first experiment of *takāful* (alternative to insurance) was grounded on the concept of cooperation (*ta'āwun*) among the members who patronize it.

Islam strongly supports the idea of safeguarding one's property. Any scheme whereby the resources of the members are pooled together to help and protect the fellow members from hardship arising out of certain events is encouraged. However, the way in which the commercial or proprietary insurance seeks to achieve this aim is fraught with dangers of transgressing the Islamic teaching (Mahmood, 1991). In the past, collective risk protection schemes operated mainly by family relations had been effective for centuries (Nienhaus, 2016).

The *takāful* operational model has evolved over the years with the early *takāful* not operating for profit. The aim of coming up with this *takāful* structure was to fill a need to provide protection in a fair and transparent manner where the risk was shared amongst the

⁴http://www.takafulprimer.com/Resources/takaful_report_primer_2013.pdf

policyholders, and the rights of policyholders and shareholders were clearly defined and segregated. This model was used by the Islamic Insurance Company (promoted by Faisal Islamic Bank) in Sudan and the Islamic Arab Insurance Company, Saudi Arabia.

Various *takāful* models are being practiced (such as *mudārabah*, *wakālah*, *waqf*) and modifications are still being sought from Sharī‘ah scholars and practitioners. This is because the concept of donation (*tabarru‘*) as currently practiced by the *takāful* companies to address the issue of excessive uncertainty (*gharar*) has been a subject of differing opinions. The “risk fund” or “risk pool” is built through contributions (premiums). For giving Sharī‘ah credence, these contributions are considered donated for the mutual benefits of the participants in the joint pool. The argument lies in the fact that these contributions are made in expectation on the part of donors to get reimbursement in case they themselves face a loss (Agha, 2009). This expectation contradicts with the nature of *tabarru‘* which if given in some expectation, then becomes a price and no longer remains a donation.

Some proposals have come in response to this issue in the form of *waqf* model. This basically seeks to address the issue arising out of the conditional *tabarru‘* (Ali & Nisar, 2016). *Takāful* operator in this model proceeds by establishing a *waqf* first through its own contribution and then the contributions received from the participants (also considered as a contribution to the *waqf*) become a part of the *waqf* pool which is then used to support the participants’ insured needs. *Takāful* operator earns returns out of the fee levied on the management of the *waqf* fund. Any remaining surplus is either distributed among the participants or proposed to be used for the social and charitable purpose as of this *waqf*.

For improving financial inclusion, micro-*takāful* can be used as a tool for providing Sharī‘ah-compliant finance protection to the poor and ultra-poor. If micro-*takāful* were to be set up on a purely mutual basis, then *qard* would not be such an issue as tension between risk sharing and risk transfer would not arise. Shareholders in that case would also not be eyeing for a share in the underwriting surplus. But for this to survive, there may still be a need to provide some backing through an NGO or a government body to provide comfort and play the role of a lender of last resort in case of any shortage in the pool to meet its commitment (Nienhaus, 2016).

Blended Finance (BF)

For the transformation of developing economies and achieving SDGs, there is the need for countries to put a development plan in place by the policy makers. The needs for infrastructure, health, education, agriculture, and other developmental requirements pose a big challenge in this regard. It’s estimated that almost \$4.5 trillion per year investment will be required in the developing countries between 2015 and 2030, which in comparison with the current investment levels leaves an annual investment gap in the sectors critical to the SDGs of around \$3.1 trillion (UNCTAD, 2014).

Unlike conventional finance, the Islamic banks driven by the higher objectives of Sharī‘ah (*maqāṣid al-Sharī‘ah*) should be able to balance the risk and social impact of their investments. This means that the Islamic financial institutions need to move away from their current screening of removing only prohibitions and start looking at the social goals and the

environmental impacts.

Notwithstanding, from the emerging and frontier markets (which most Muslim-majority countries fall into) contributing close to 49% of the global GDP, a relatively small portion out of the roughly \$218 trillion in the global capital markets flows annually to these high-potential markets due to risks (real or perceived) and market inefficiencies.⁵ The most significant barrier to the private capital movements into these markets is that the yields are often seen by the conventional investors to be less proportionate to the level of perceived risks, which tends to be much higher in more mature markets, often given weak regulatory frameworks and enabling environments.⁶

In order to respond to the inadequate investment flows to the emerging economies, the World Economic Forum came out with BF as a vehicle to mobilize resources from investors who will look beyond the risk of their investment to the social impact. BF is ‘the strategic use of the development finance and philanthropic funds to mobilize private capital flows to the emerging and frontier markets’.⁷

BF is characterized by leverage, returns, and impact. It uses the development finance and philanthropic funds to attract private capital for the projects with prime motivation for investments that drive social, environmental, and economic progress as well as financial returns based on real and perceived risks. BF has the potential to be deployed across a range of structures, sectors, and geographies using an array of instruments to finance infrastructure.

BF creates an avenue for the development funders to respond to the structural needs for the projects at different periods of their life cycle and market maturity. This is done by providing an improved risk-return proposition for the private sector, thus helping to narrow the funding gaps that impede development objectives in the situations of market failures (OECD, 2015).

The BF model seems to find a fit with the development financing objective of Islamic finance as it provides a risk-adjusted view of investment moving towards a social impact. Islamic finance with its social mandate reflects this arrangement and can make a strategic use of this to channel resources to finance the development-oriented projects in the Muslim-majority countries.

For BF to be effective, the Islamic development financial institutions such as Islamic Development Bank and *awqāf* institutions would have to play an important role. The corporation among various stakeholders will provide a synergy for development and philanthropic actors to apply their unique set of financial and non-financial tools to help private investors overcome the seeming barriers to investment, unlocking significant new resources for development. By doing so, BF helps to facilitate risk-taking at tolerable levels to incentivize financing and investment.

Development funders can play a variety of roles to address the capital flow barriers in a BF model. Firstly, by shifting the investment risk-return profile with flexibility in capital

⁵Blended Finance and Sustainable Development Partnership, Initiative Informal Consultation of the Advisory Group for Investment and Development/DAC 15 March 2016 (AM), OECD Conference Centre, Paris.

⁶ibid

⁷ibid; OECD and World Economic Forum. BF in the Private Sector Context, 2015. Accessed at BlendedFinance@weforum.org

and favorable terms, the development funders may decide to assume exposure to a greater risk potential and give up commercial returns in investment in exchange for the development impact. For example, a partial credit guarantee will be able to attract new set of investors by improving a project's creditworthiness by limiting the downside losses, reducing the required return for that level of risk for other investors. Islamic Development Bank is already playing a role in this but it has to be expanded by bringing other players to provide a flow of capital. Secondly, the development funders can utilize their local knowledge, expertise, and presence to help bridge knowledge gaps of investors and banks necessary for a successful transaction. The sourcing of deals, due diligence, and structuring can all be facilitated by leveraging through the local expertise.

CONCLUSION

This study aims at bringing to the attention of stakeholders in Islamic banking and finance the need to move towards responding to the socio-economic needs of the Muslim communities. The discussion reveals that though Islamic finance has registered a tremendous growth in the past 40 years of its existence, the socio-economic impact on the Muslim communities has not been out of the ordinary. In the light of this, the paper proposes various ways through which an Islamic bank can respond to the needs of their catchment communities by fulfilling the dual objectives of profit-making and creating a social impact.

The paper has looked at various ways in which the Islamic finance can have the larger social impact, including operating Islamic microfinance as a subsidiary where the institutions of *zakāh*, *ṣadaqah*, and *awqāf* can be leveraged. Also, crowdfunding, blended finance, *takāful*, and mutual credit can be considered as means of achieving greater social relevance. It's important to conclude that Islamic banking has to move beyond banking by developing other non-banking institutions as this will help in responding to the unique needs of the Muslim communities.

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