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World Bank Group and Islamic Financial Services

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Abstract

The WBG involved in Islamic Financial Services as client requested, and in order to complement conventional one, support economic development and poverty alleviation, expand access to finance, enhance financial stability and benefiting from growing Islamic financial assets. Areas of WBG involvement were capacity building in governance and risk management accounting issues, regulations and product development, and for financial inclusion, and improving legal and institutional framework of Islamic financial Institutions as well. The WBG also structured Islamic finance products for financing projects for Muslim communities and provided guarantees for supporting Islamic finance transactions. The WBG is also involved in issuing Sukuk for raising funds for development programs. The WBG involvement was productive and promoted Islamic financial services as a complementary to the conventional one.

Key words: World Bank Group-Islamic Financial Services-sukuk-risk sharing

Introduction

Since 1970s, Islamic financial services industry has grown at about 10 percent annually, and Shariah-compliant assets are currently valued at over 1 trillion dollars. Some studies suggest that Islamic banks could account for up to 40 to 50 percent of total deposits in countries with Muslim populations within the next decade. Countries with a growing Islamic financial services are all targeting expanding Shariah-based assets in their financial systems in the coming years. However, Islamic financial services are not restricted to majority Muslim countries and is becoming a growing industry in many non-Muslim countries. In the aftermath of the financial crisis, some of the causes of the financial crisis related to the use of extremely high leverage and a delinking of financial products from their underlying real sector assets. These issues are central concerns in Islamic financial services. Deleveraging and sharing risks are central to Islamic finance and materiality establishes a strong link between the real and financial sectors in the economy.

In this article I discuss utilizing Islamic financial services by the WBG. Therefore, in the introductory section, I define what means by the “World Bank Group” and “Islamic Financial Services”.

The WBG as an international organization comprises of five institutions: (establishment year)

IBRD: International Bank for Reconstruction and Development (1944)

IFC: International Finance Corporation (1956)

IDA: International Development Association (1960)

MIGA: Multilateral Investment Guarantee Agency (1966)

ICSID: International Centre for the Settlement of Investment Disputes (1988)

WBG is the world’s largest source of development finance.

"Islamic financial services" encompass all financial services and markets (including banking, Takaful [insurance], and money and capital markets and products), as well as the underlying legal, regulatory and financial infrastructure, which is operated within the concept of free of interest, and within the principles of risk sharing and materiality. Islamic financial services include Shariah-based financial products and markets that operate in a separate parallel market alongside conventional finance.

In this article I discuss the questions of "why" , "which" and "how" the WBG is engaged with Islamic financial services and the structuring of Islamic modes of financing for financing developmental projects at the WBG.

2-Why the WBG is involved in Islamic financial services?

It seems that the WBG objectives for engagement in Islamic financial services are:

First, to have Islamic financial services as a complement to conventional ones. The development of Islamic financial services help to improve the diversification of financial systems, widening the range of products and services available to clients.

Second, to support economic development and poverty alleviation. Given the growing importance of the Islamic financial services industry, the WBG is interested in Islamic finance from a developmental perspective. The growth of Islamic finance offers a valuable opportunity to further enhance the contribution of the financial system to growth and poverty reduction in the WBG client countries interested in developing domestic Islamic financial services.

Islamic finance emphasis on asset-backed financing and risk-sharing feature means that it could provide support for small and medium–sized enterprises (SME), as well as investment in public infrastructure.(IMF,2015,p.)

Third, expand access to finance. By expanding the range and reach of available financial services, Islamic finance could help to improve financial access and foster financial inclusion in the relevant countries. Notably, Islamic finance emphasizes partnership-style financing, which could be useful in improving the access of the poor and SMEs to financial services. It could also help to improve agricultural finance, contributing towards improved food security. With an estimated 650 million Muslims living on less than $2 a day, finding sustainable Islamic models could be the key to providing financial access to millions of Muslim poor who strive to avoid financial products that do not comply with Sharia (Islamic law).[1] Islamic finance promises to foster greater financial inclusion, especially of large underserved Muslim populations.

Fourth, enhance overall financial stability. Promoting financial intermediation based on Shariah could contribute to enhancing overall financial system stability, as there is some evidence that Islamic financial institutions may be more resilient to unforeseen shocks. In the Global Financial Crisis, Islamic financial institutions were relatively resilient, protected by their fundamental operating principles of risk sharing and avoidance of leverage and speculative financial products.

Islamic finance risk-sharing features and prohibition of speculation suggest that Islamic finance may, in principle, pose less systemic risk than conventional finance.(IMF,2015)

Fifth, to benefit from rapid growing Islamic financial assets, and establish partnerships with national authorities, international entities, and other stakeholders in Islamic financial services worldwide.

The rapid growth of Islamic financial assets in the World is driven by several factors, including: high liquidity and limited

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[1] Mayada EL-Zoghbi and Michael Tarazi,(2013) ,"Trends in Sharia-Compliant Financial Inclusion", March, World Bank CGAP Focus Notes No.84, p.1

investment alternatives in the MENA region; increased need for liquidity from non-Muslims in the wake of the global financial crisis; search for asset diversification by institutional investors (sovereign wealth funds, pension funds and reserve managers); large and expanding global Muslim population.[1]

The Islamic finance industry has attracted the attention of policy makers and international community as a possible channel through which to expand financial inclusion, particularly among Muslim adults. For the use of and demand for formal financial services among self-identified Muslim adults, in a sample of more than 65,000 adults from 64 economies, it finds that Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution. In an extended survey of adults in five North African and Middle Eastern countries with relatively nascent Islamic finance industries, the study finds little use of Sharia-compliant banking products, although it does find evidence of a hypothetical preference for Sharia-compliant products among a plurality of respondents despite higher costs.[2]

3-Areas of WBG involvements in Islamic financial services

On the question of "which", the WBG created an internal working group and developed a three-year work program on Islamic financial services.[3] In order to fulfill its working program, the WBG focused on the following areas:

[1] The World Bank Group, "Islamic Finance: Trends, Opportunities and Challenges", Technical Briefing: Tuesday, January 7, 2014

[2] Asli Demirguc-Kunt, Leora Klapper and Douglas Randall,(2013), "Islamic Finance and Financial Inclusion: Measuring Use of and Demand for Formal Financial Services among Muslim Adults",The World Bank Policy Research Working Paper,No.6642, October,p.30-32.

[3] The World Bank Group,(2011), "Islamic Economics and finance working Group, Three-Year Work Program" ,June.

First, Capacity building and knowledge management, sharing and dissemination. There are capacity constraints on governance, risk management, transparency and accounting issues relating to Islamic financial institutions. These are areas where the WBG has experts and systems to support the development of the Islamic financial services.

Second, Advocacy to influence policy direction in market development, regulatory approaches, and new instruments. The lack of cross-border harmonization and regulation of Islamic financial products and services is among the international barriers to building a global Islamic financial industry. The World Bank's capacity can be utilized to bring in scholars and practitioners to discuss complex, sensitive and controversial global issues. In addition, the WBG can play the facilitator role to build a broader acceptance of a wider range of Shariah compliant products and services.

The WBG has active engagement with key global standard setters (stakeholders), such as: Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for

Islamic Financial Institutions (AAOIFI), Islamic Development Bank (IDB) and International Islamic Financial Market (IIFM).

Third, Diagnostic and analytical work in Islamic finance, targeting issues impacting financial stability and enhancing access to financial services. The WBG incorporated Islamic financial services in the benchmark tool for analysis of the financial sector, that is, the Financial Sector Assessment Programs (FSAP) and FSAP focus on expanding access to finance for individuals, groups and communities that conduct Shariah compliant financial transactions. In many countries, the availability of non-interest based finance will improve access to finance among populations that are opposed to using conventional banking.

Fourth, Technical assistance on issues such as legal, regulatory, and institutional frameworks.

The World Bank group has a good expertise in conventional finance and can add value in Islamic finance, particularly in the areas of product development, risk management and governance. The Bank's contribution to the Islamic finance industry can focus on stability and issues related to sound regulatory and operational practices. This can be done through the Financial Sector Assessment Programs (FSAP), which are carried out jointly with IMF.

Working with IFSB, AAOIFI, the Islamic Development Bank, the WBG can help build the required regulatory and institutional capacities and infrastructure necessary to serve the underserved.

Fifth, Utilizing Islamic Financing by the WBG. On actual financing, the WBG structured financing facilities compliant with Shariah. [1]

Sixth, In October 2013, the World Bank inaugurated the Global Islamic Finance Center in Istanbul. It is an open trust fund that enables the WBG to scale up activities and contribute to development of Islamic finance globally. It aims to be a knowledge hub for development of Islamic finance globally, conducting research, training, providing technical assistance and advisory services to Bank clients.[2]

4-How the WBG structured Islamic Finance products;

On the question of how, the WBG financed and guaranteed several projects during last two decades. In this article, as

[1] Tunc Tahsin Uyanik, (2009),"The World Bank Strategy for Islamic Finance", 6th Islamic Financial Services Board Summit on the Future of Islamic Financial Services , The Islamic Financial Services Landscape, May 7 and The World Bank Group,(2011),"Islamic Economics and finance working Group, Three-Year Work Program" ,June, p.2,6-9.

[2] The World Bank Group, "Islamic Finance: Trends, Opportunities and Challenges", Technical Briefing: Tuesday, January 7, 2014

examples of how the WBG structured Shariah compliant financial products, I discuss the following projects and products.

First, IBRD Project for Turkey; (US$250 million) (TSKB)[1] on June, 2014

IBRD Investment Project Finance instrument extend a line of credit to TSKB, a private Development and Investment bank. Two structures that allow funds to be transferred from TSKB to participation bank PFIs[2] in an Islamic finance compliant way are:

(i) A Wakalah agency contract, combined with a Kafalah financial guarantee, between TSKB and PFIs. It is compliant with Shariah principles.

TSKB will act as the principal, extending an agency contract to a participation bank PFI, which will in turn act as the agent on behalf of TSKB to invest funds in accordance with Islamic finance principles (against a predetermined fee paid by TSKB to the PFI in return for the services provided). The PFI will finance SME[3] and EOE[4] operations and agree with TSKB on an expected return for its funds. More specifically, the participation bank PFI will act under a special purpose agency within well-defined financing parameters, i.e. restricted to financing SMEs and EOEs – a structure widely known in the industry as a restricted wakalah contract. In order to receive funds, PFIs will submit to TSKB a disbursement request (wakalah offer), seeking TSKB's acceptance to finance eligible enterprises/ transactions pursuant to the agency contract. The wakala contract will also incorporate the SME and EOE eligibility criteria.

[1] TÜRKİYE SINAİ KALKINMA BANKASI(TSKB)
[2] Participating Financial Institutions.(PFIs)
[3] Small and Medium Enterprises.(SMEs)
[4] Export Oriented Enterprises.(EOE)

In order to minimize moral hazard and adverse selection, the wakalah contract will be complemented by a kafalah financial guarantee contract from the PFI to TSKB. The PFI will provide TSKB a guarantee that it will repay for enterprises that cannot promptly fulfill their financial obligations. Two variants of the kafalah contract could be utilized. The first can be based directly on the PFI’s own capital. The second can be based on a kafalah guarantee pool that the PFI establishes internally, build up through partial contributions from realized returns collected from the well performing enterprises’ payback. The PFI is entitled to internalize the balance of this pool within its profits, but must also undertake to replenish it with a zero interest loan (Qard *Hassan*) in the incident of insufficient balance. This solution ensures incentive compatibility for the PFI to exert its outmost effort in screening and selection of enterprises, protecting the interest of TSKB and ensuring the highest quality of the enterprise portfolio.

(ii) Commodity Murabahah contract between TSKB and PFIs. The commodity Murabahah contract allows for a participation bank PFI to receive the funds from TSKB through the buying and selling of a commodity. TSKB buys a commodity (e.g. gold) from Broker A at an amount equivalent to the agreed upon funding. TSKB then sells it to the participation bank adding an agreed markup (on deferred installment payments under a deferred payment commodity sale. (bai muajjal murabahah). The participation bank sells the commodity to Broker B for the same amount transacted under the first purchase. As a result, the participation bank has received the funds to ultimately finance enterprises in an Islamic finance compliant way.

Figure: Wakalah agency contract, combined with a Kafalah financial guarantee

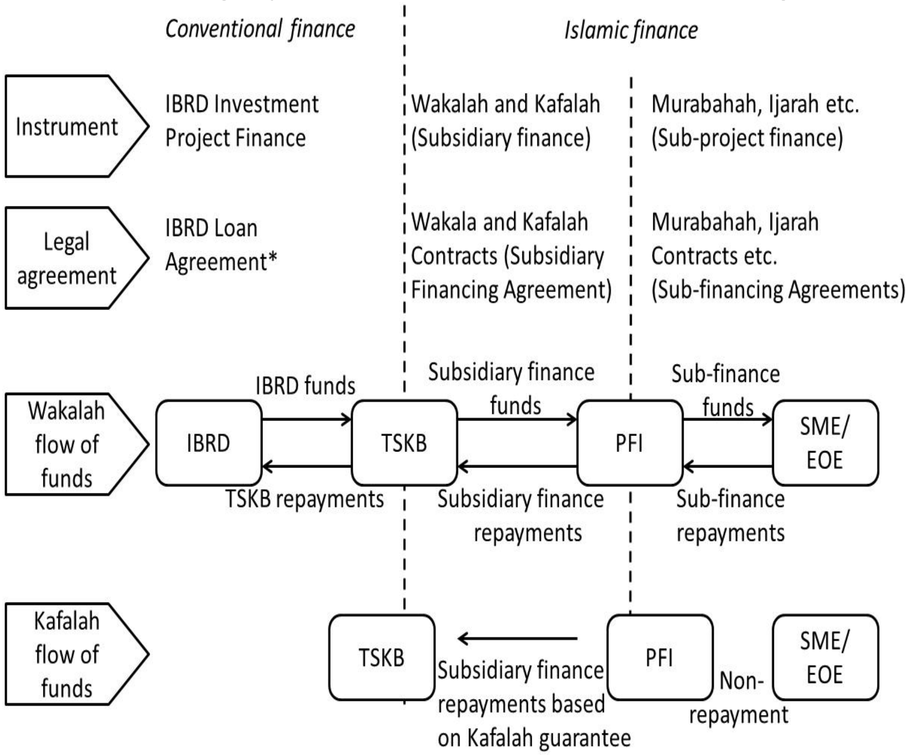


*Figure does not include the Guarantee Agreement with the Government of Turkey

The credit line will be intermediated by TSKB that will finance PFIs. TSKB will select PFIs. Subsidiary Financing Agreements will be signed between TSKB and PFIs, and the PFIs will in turn sub-finance private SMEs and EOEs, the final beneficiaries of the credit line, based on Sub-financing agreements.

The financing helps SMEs in the financing of their production cycle, overcoming challenges raised by long payment delays imposed by buyers. A SME (the seller) that sells its goods to a large renowned enterprise (the buyer). An invoice is generated against the goods, for deferred payment in a few months. The company buys the invoice from the seller and pays 80 percent of its face value immediately to the SME. When the buyer pays against the invoice, the company forwards the remaining payment to the SME, less a discount (the fee).

This mechanism allows SMEs to overcome constraints related to collateral and limited credit history, presenting an important alternative to traditional bank loans. This is not a loan (it does not create a liability on the balance sheet), but rather involves the sale of an asset.

It depends on receivables as underlying assets, unlike bank loans that require collateral, and is very common in industries where the business cycle involves long receivables, such as the textile and clothing industries. Furthermore, the company is more concerned about the creditworthiness of the buyer that will be paying against the invoice, rather than the selling SME. As a consequence, a SME with limited credit history may be able to be financed even if it can't qualify for a bank loan. This could be an important substitute for bank lending in markets

characterized by weak enforcement systems, given that it does not rely on collateral.

This mode is also particularly important for exporting enterprises, helping overcome challenges related to international trade. International trade poses significant challenges, including different languages and the difficulty in assessing the credit standing of a foreign party. The exporting seller (exporter) contacts a company in the importing buyer’s home country (importer). The import company determines the importing buyer’s credit rating, assumes the credit risk, performs the actual collection of the debts and transfers the funds to the export company. The export company is responsible to the import company for the acceptance of any recourse. [1]

Second, Jordan MSMEs financing;

SMEs often refrain from applying for bank loans due to their religious discomfort with interest-based borrowing. There has been a growing demand for Shariah-compliant financial products in Jordan (54 percent of SMEs have strong preference for Islamic finance products in the country).[2] However, Islamic Banks account for only 11 percent of total banks' financing to SMEs with 95 percent provided in the form of the markup financing instrument (Murabahah). SMEs' Shariah-compliant financing is constrained by banks' over collateralizing SMEs and reluctance to bear credit risks. This gap will be limited as the WB financing will promote the introduction of Islamic financial products that reduce underlying risks either through asset backed instruments (e.g. Ijarah) or provision of third party guarantee through Kafalah. This is expected to accelerate the industry's growth, and streamline SMEs access to Shariah-compliant financing.[3]

Third, MIGA's Support for Islamic Finance Transactions;

MIGA guaranteed two projects under Islamic financing structures:

[1] World Bank,(2014),"Project Appraisal Document on a Proposed Loan to the Turkiye Sinai Kalkinma Bankasi A.S(TSKB)", June 25,pp.23-25

[2] IFC,(2014),"Islamic banking opportunities across small and medium enterprises in MENA",May,p.

[3] World Bank,(2015)," Micro, Small and Medium Enterprise Development for Inclusive Growth in Jordan, Project Paper for financing",April,pp.3-4

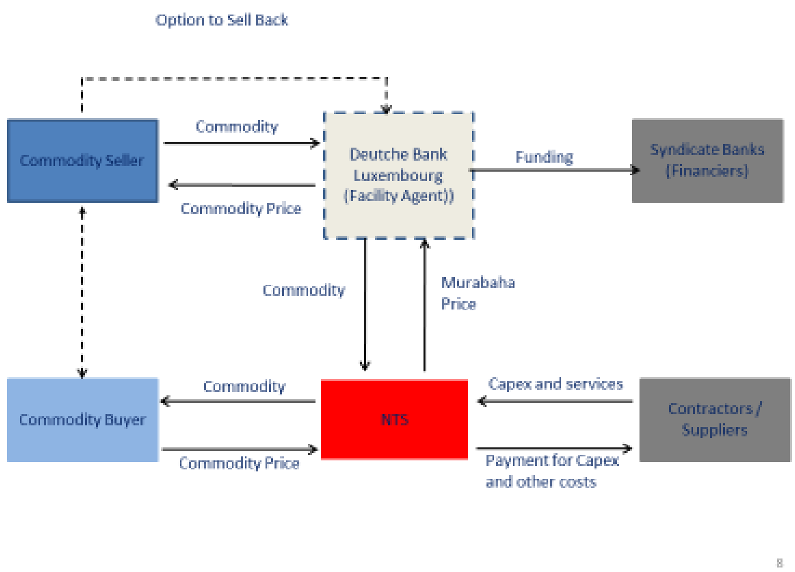
Project (1): Axis Telecoms Project, Indonesia (2011)

Guarantee Holders: Deutsche Bank Luxembourg SA, acting for itself, and as an Agent for the Saudi British Bank

Investment Covered: Dual currency (US Dollar and Saudi Riyal) "Murabaha" financing facility of USD 450 million to Natrindo Telepon Selular (NTS) in the Republic of Indonesia.

MIGA role is to guarantee the financing by a syndicate of banks.

Figure (1): Islamic Financing Structure for Axis Telecoms Indonesia



Project(2):Doraleh Container Terminal Project, Djibouti[1]

In 2007, MIGA was tapped to provide political risk insurance for a project in Djibouti that was being funded through an Islamic financing structure.

The main challenge faced by the agency was that the project's Islamic financing structure had payment obligations spread out across numerous agreements. MIGA structured its guarantee in a way that addressed the key risks that concerned the project financiers, while meeting the strict requirements governing the Islamic structure.

The Doraleh Container Terminal project involves the development, design, construction, management, operation, and maintenance of a new container port terminal in the city of Doraleh, Republic of Djibouti. It is being developed under a 30-year concession granted by the government of Djibouti to the main sponsors—DP World of the United Arab Emirates and Port Autonome International of Djibouti—via their joint-venture vehicle, the Doraleh Container Terminal.

MIGA issued guarantees totaling $427 million—$5 million for DP World's equity Increased liquidity in Islamic financial investment into DCT and $422 million in Islamic project financing—against the risks of currency transfer restriction, expropriation, breach of contract, war and civil disturbance. The Islamic project financing comprised 99 percent of the amounts allocated for the principal portion of the financing, DCT's future rental obligation, capitalized future premium.

The project financing was executed by combining the following key concepts of Shariah:

Musharaka: Through the Musharaka Agreement, DCT and the project financiers agreed to procure assets for the project

[1] MIGA,"MIGA and Islamic Finance", DORALEH CONTAINER TERMINAL PROJECT, DJIBOUTI, APRIL 2008,pp.1-4 and Hoda Moustafa," MIGA's Support of Islamic Finance Transactions",pp.1-17

jointly and committed to making respective capital contributions representing the financing plan's components.

Istisna'a: Through the Istisna'a Agreement, the partners appointed DCT as a procurer to construct the container terminal and ensure delivery of assets at the end of the construction period. Capital contributions under the Musharaka were paid to DCT, which in essence is equivalent to multiple drawdowns under a conventional lending arrangement.

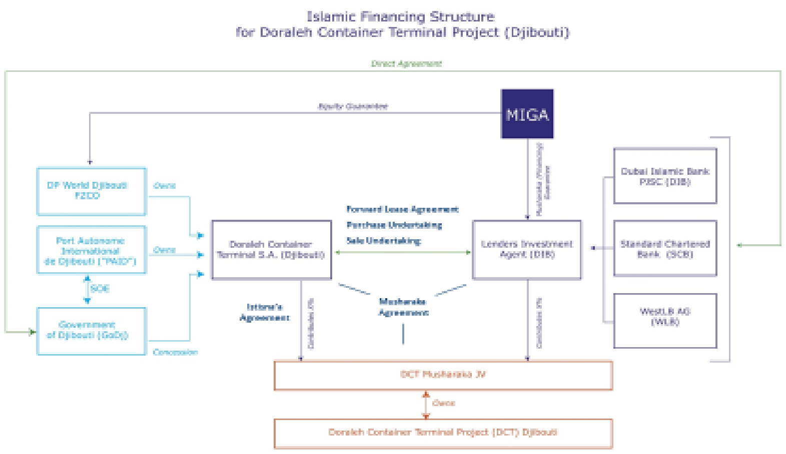
Ijara: The Lease Agreement allowed the project financiers (the lessor) to lease their co-ownership interest in the project to DCT (the lessee) in exchange of periodical rental payments linked to a floating benchmark. Given that the assets were under construction, the documentation allowed the project financiers to pay advance lease rentals during the construction period. After delivery and commencement of lease, the project financiers were to receive periodical lease rentals based on both floating and fixed rates, reflecting amortization of the financing.

For the obligations under Islamic financing, MIGA agreed to cover the following:

1- Advance rental and rental under the Forward Lease Agreement;
2- In the event that construction is not completed, the termination payment under the Istisna'a Agreement (but under the original lease schedule);
3- In the event that the Purchase Undertaking is exercised, DCT's payment obligation to purchase the assets from the project financiers (but under the original lease schedule);
4- In the event of an unwinding of the partnership and where none of the above amounts are payable, the amount owed by DCT as partner to the financiers under the Musharaka Agreement (but under the original lease schedule), which will

only include the "profit" component to the extent determined by a judge according to the Musharaka Agreement .[1]

Figure (2): Islamic Financing Structure for Doraleh Container



Fourth, **Sukuk ;** The World Bank has entered the capital market as an issuer, with two issues of Islamic bonds in 2005 by the World Bank Treasury and the IFC respectively in Malaysia. Then IFC issued its first $100 million Sukuk in Dubai and Bahrain - the first partial credit guarantee that complies with Islamic finance principles and invited Yemen's Saba Islamic Bank to join the IFC's global trade finance program as an issuing bank.[2]

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[1] MIGA,(2008)," MIGA and Islamic Finance: Doraleh Container Terminal Project, Djibouti, case study", April, pp.1-3

[2] Mahmoud Mohieldin,(2012), "The Role of Sukuk in Development", Istanbul, May 18, p.3

Vaccine Sukuk: In 2014, the World Bank dealt with US$500 million *sukuk* for the International Finance Facility for Immunisation ("IFFIm"). The World Bank serves as the Treasury Manager for IFFIm, an international organization that was established in 2006 to finance immunization, vaccine procurement and related health system strengthening programs in many of the poorest countries in the world. IFFIm's pledge have an aggregate nominal value of over US$6 billion. Based on the strength of these pledges, IFFIm raises funds in the international capital markets. The World Bank handles the capital markets fund raising activities.

The *sukuk*, a $500 million, three year issue that pays a variable profit rate and is based on the Shariah principle of *murabaha*. The World Bank worked with a group of financial institutions to structure and distribute the Vaccine *Sukuk*, that is, Standard Chartered Bank, Barwa Bank of Qatar, CIMB of Malaysia, National Bank of Abu Dhabi, and NCB Capital of Saudi Arabia – as well as Bank Islam Brunei Darussalam and Union National Bank of Abu Dhabi.

The transaction was IFFIm's first venture into the Islamic finance market and first transaction sold largely to Middle Eastern and Southeast Asian investors and compatible with Islamic finance principles. Previously, IFFIm's investor was located mainly in the United States, Europe and Japan. [1]

5-Conclusion;

The WBG involvement in Islamic financial services was productive and promoted Islamic financial services as a complementary to conventional financial services. This

[1] Michael Bennett,(2014)," VACCINE *SUKUK*: THE LATEST ELEMENT IN THE WORLD BANK'S ENGAGEMENT IN ISLAMIC FINANCE", Capital Market Department, The World Bank,p.2

involvement was effective in financial inclusion in Muslim communities, replenishing Islamic finance assets and financing development projects, creating jobs and reducing poverty. The WBG engagement with key global standard setters in Islamic financial services was also fruitful.

With the increasing demand of Muslim communities for Islamic mode of financing, it is expected to see the increasing share of Islamic assets and Islamic finance component in the portfolio of the WBG.

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1-Michael Bennett,(2014): ***Vaccine Sukuk: The Latest Element In The World Bank's Engagement In Islamic Finance***, Capital Market Department, The World Bank,p.2

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