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"**I for Impact: Blending Islamic Finance and Impact Investing for the Global Goals**"

Description: This report launched in May 2017, is the product of a joint initiative of Islamic Research and Training Institute, IDB Group, United Nations Development Programme (UNDP), and Istanbul International Center for Private Sector in Development (IICPSD).

by

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Summary

The scale and ambition of the 2030 Agenda for Sustainable Development, as embodied in the 17 SDGs, call for substantial financial and technical resources, estimated at US$5-US$7 trillion each year for the next 15 years. These sums are far beyond the scope of individual governments and the multilateral funding agencies. Private sector funding, capabilities and know-how need to be mobilized to sustain the new development agenda and the global partnership for sustainable development, to operationalize the policies and actions outlined in the Addis Ababa Action Agenda and end poverty within a generation.

Impact investment, defined as the deployment of funds with the aim to generate social and environmental impact as well as a financial return, has established itself as an important source of funding the SDGs. Its global reach is growing rapidly. As much as three quarters of total impact investment assets is in developing countries and a fifth is allocated to microfinance, contributing to development efforts. Private debt and equity together account for 65 percent of impact investments, with bonds a prominent instrument. While institutional investors are currently constrained from large-scale participation in impact investing by their legal and fiduciary responsibilities, high net-worth individuals (HNWIs) are key players. Impact investment funds and development finance institutions (DFIs) are also prominent as impact driven organizations. Critical drivers of impact investing include the failure of governments to increase and deliver on their ODA commitments and the emergence of the “value-investor”.

The Islamic finance sector, meanwhile, has grown from a market of US$200 billion in 2003 to an estimated US$ 1.8 trillion in 2014 , and is expected to reach US$2.7 trillion in 2021 . This represents a strong potential source of financing for the SDGs, fostering development and helping to end poverty. Although Organisation of Islamic Cooperation (OIC) member countries account for 22 percent of the world population, they house 40 percent of the world’s poor who live on US$1.25 a day or less. Reaching more of those at the bottom of the pyramid by deepening and widening the range of Islamic financing solutions available to the poor, especially microfinancing products, would be a major contribution to the 2030 Agenda. Its resilience to the 2008 financial crisis has enhanced the prominence of Islamic finance and the market for its products and services is growing. Its key pillars: asset backed; ethical; participatory and good governance underline its suitability for deployment in pursuit of the 2030 Agenda and the elimination of poverty. Islamic financial assets are currently concentrated in the three markets of Malaysia, Saudi Arabia and Iran. The Islamic fund industry, dominated by Malaysia, Saudi Arabia and Luxembourg, is growing, but still of limited scale. Individuals, notably HNWIs, Sovereign Wealth Funds, and pension funds, are among the key actual and potential investors. Among the DFIs, the Islamic Development Bank Group (IDBG), fully compliant with Islamic financing principles, is preeminent, with 57 member countries.

With their rigorous moral and social criteria, their emphasis on inclusiveness and broader understanding of business-society relations, the principles of Islamic finance and impact investing complement each other. Both Islamic finance and impact investment occupy value-based investment universes, associate themselves with a moral purpose, offer access to finance to those directly or indirectly kept out of the conventional financial investing arena and share a broader understanding of the relationship between business and society. These similarities suggest that bridging the two sectors offers a promising avenue to respond to the growing challenges related to development financing through collaboration, cross-learning and reaching new markets. “Islamic financing impact investing” offers a potent new mechanism for fulfilling SDG poverty-reduction targets by harnessing private sector finance targeted, in particular, at MSMEs that are often excluded from conventional financing mechanisms.

The market for impact investors can access new sources of finance and develop new markets by addressing Islamic finance; this will increase the range of impact investing tools and has the potential to help speed and simplify access to finance for small companies using Islamic financial instruments. For Islamic financiers, partnering with the impact investing sector, especially in monitoring and evaluation methodologies, offers the potential for expansion of scope and scale and for greater worldwide recognition. The poorer segments of society in OIC member countries could gain greater access to finance and development opportunities and the toolbox of Islamic financing instruments could be greatly enlarged.

Among the principle aims of this report is the identification of ways to enlarge the area of overlap between Islamic finance and impact investing and to develop collaborative strategies. It makes a number specific recommendations for this endeavour, based on research undertaken during preparation.

An enabling environment to promote "Islamic finance impact investing" should be created as part of the larger dialogue on inclusive financial systems and responsible investing principles. Support should be offered to the creation and functioning of an effective capital market system for Islamic finance impact investing, including supporting existing and new intermediaries. Well thought out, comprehensive regulatory, accountability, tax and legal frameworks are needed and it is important to raise the awareness of the current and potential levels of convergence of Islamic and impact investing. Standards for impact measurement and reporting should be established so that the sector's metrics are aligned with the common practices of the global impact investing community. Key stakeholders from governments, the private sector and support organizations in both the Islamic and conventional impact investing spaces should be brought together to discuss critical bottlenecks, learn from best practices, establish relationships and benefit from cross-pollination of ideas and shared beliefs. A centre of excellence should be established to take the lead in positioning Islamic finance impact investing as part of the global dialogue on politically neutral, inclusive financial systems and to connect innovators and interested parties to raise awareness and encourage cooperation.

To further these recommendations, UNDP and the Islamic Development Bank established the Global Islamic Finance and Impact Investing Platform (GIFIIP) in 2016 to position Islamic finance impact investing as one of the leading enablers of SDG implementation around the world through private sector engagement. UNDP and the Islamic Development Bank aim to create a collaborative working space among stakeholders to address above-mentioned challenges, and nurture an Islamic finance impact investing business ecosystem.

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Practical Means of Integrating *Zakāt* and *Waqf* Into The Poverty Reduction Agenda of OIC Member Countries

by

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The majority of the OIC member countries fall in the low or lower-middle-income category. The countries with low income accommodate more poor, with high-income inequality, unemployment, and hunger. They are spending less on their health and the progress in education is slow as well. They have low access to finance. All these factors reinforce each other and consequently, these countries are not getting out of poverty.

Social assistance or social safety net programs of various countries focus on reducing poverty and income inequality, risk and vulnerability. It has been observed that each country has at least one social assistance program. Conditional and unconditional in-kind transfers are equally prevalent among low-income, middle-income, and upper-middle-income countries, while in-kind assistance and public works programs are dominant in low-income and lower-middle-income countries. The cash-based transfer programs are expanding and now reaching one billion people of the developing countries. More than 1.9 billion people of the developing countries are beneficiaries of social safety net programs. Among the types of social safety net programs, cash transfer programs account for over 50 percent of the beneficiaries.

Social assistance covers about one-third of the population of the OIC member countries. The average per capita transfer in OIC member countries is USD 0.40 (PPP, 2005) per day. It reduced the income inequality by about 2 percent, poverty headcount by about 6 percent and poverty gap by about 12 percent. The targeting efficiency is very low (0.24). In the countries where coverage of poor, the amount transferred and the targeting efficiency is higher, this resulted in a higher drop in the incidence of poverty and income inequality compared to countries where any one of the aforementioned factors was lacking. It has been observed that CCT is more effective in reducing poverty headcount and poverty gap when the lowest 20 percent of the population is targeted compared to its effect on the extremely poor. The effect of CT on the headcount reduction is almost zero in the case of OIC lowest quintile compared to OIC extreme poor (about 4 percent). The effect of in-kind programs on headcount reduction and poverty gap is minimal.

Some countries like Palestine, Malaysia, Syria, and Pakistan performed well in reducing the poverty gap by CCT in the range of 50 percent to 97 percent. Other countries including Azerbaijan, Kyrgyz Republic, Yemen, Iraq, Gabon, Senegal, and Maldives were above the OIC member countries' average (about 20 percent), and the rest of the OIC member countries lagged behind in implementing CCT successfully. As for the income distribution, the effect of various components of social assistance was minimal.

To achieve broad-based growth and poverty reduction, most of the developing countries set their own investment priorities within the framework of PRSP. Generally, PRSP focuses on pro-poor growth, human development, provision of the basic services and social safety nets, and good governance. Countries are allocating sufficient amounts, raised through internal and external resources, to the identified areas for achieving objectives of broad-based growth and poverty alleviation. As observed, countries spend a handsome amount on social services. However, almost no country has explored the untapped source of raising revenue from social finance (i.e., *Zakāt* and *waqf*) for social assistance and making it a part of pro-poor budgetary expenditures.

Zakāt and *waqf* are important sources of revenue for the social assistance, but the Muslim communities and countries have not taken these institutions seriously. The actual collection of *zakāt* in the countries where *zakāt* is compulsory or voluntary is an insignificant proportion of their GDP. However, if *zakāt* is collected to its potential then the majority of the OIC member countries could generate enough *zakāt* funds that would be sufficient for the poor defined under USD 1.9, while other countries could partially fulfill their poverty gap reduction targets. If the target is the poor defined under USD 3.10 then some countries can generate sufficient resources for the reduction of poverty from their countries, while the majority of the other countries can generate *zakāt* resources to full their poverty gap requirements partially. Assuming that an international fund is established to which *zakāt* surplus countries contribute their surplus, which is then distributed to fill the poverty gap in each resource deficit country. Then a surplus fund can be generated after meeting the requirements of all the poor defined under USD 1.9 per day and half of the poor can be covered by this fund if the poor are defined under USD3.1 a day.

Estimating potential of *waqf* is difficult due to lack of data. However, a rough estimate of the potential of *waqf* in the case of Indonesia shows that it can generate about 0.85 percent of the GDP. No doubt social finance is a significant source of fund that can be utilized for the social assistance of the poor. Nevertheless, the question is how social finance can be managed and channelized for the optimal benefits targeted to the poor.

Muslims are paying their *zakāt* on their own to the poor and to different charitable institutions. However, all these transactions are not passing through proper channels, are un-recorded, unplanned and not a part of any strategy. Therefore, one cannot assess the effectiveness of *zakāt* in poverty alleviation. The same is the case with the institution of *Awqāf*.

On the other hand, it has been observed that countries are providing resources for education, health, and other basic services, but this is for all people and general purpose. Poor people cannot take benefits of such allocations due to user fees. Countries may continue with the PRSPs but special attention is needed for the poor.

We suggest that the extremely poor and the poor may be identified and the funds collected from *zakāt* and *waqf* may be earmarked for the poor. They may be provided free education and health services. They may not be charged user fees or there may be cash (conditional or non-conditional), or in-kind transfers. This will prepare them for the future and increase their earning capabilities, which will become a source of smoothing aggregate demand and growth in the economies.

For their immediate needs and for the unexpected events a system of permanent safety nets for the extremely poor and the poor may be designed within the PRSP. There should be direct cash transfers to the extremely poor, which is more effective in the case of the extremely poor, and conditional cash transfer to the lowest quintile, which is more effective in this case.

For raising funds, it is suggested that *zakāt* should be compulsory and be implemented in its true spirit. For additional funds, a voluntary fundraising movement through other charities and *waqf* may be the priorities of the Muslim communities and countries. Experience has shown that the countries covering a larger portion of the poor and transferring sufficient amounts, at least equal to poverty gap, and having high targeting efficiency was able to reduce poverty and income inequality significantly. This experience may be applied for any effective poverty reduction program of the countries.

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