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Islamic Finance Could Aid Modestly In Achieving Sustainable Development Goals

Primary Credit Analyst:
Mohamed Damak, Dubai (971) 4-372-7153; mohamed.damak@standardandpoors.com

Secondary Contacts:
Emmanuel F Volland, Paris (33) 1-4420-6696; emmanuel.volland@standardandpoors.com
Elie Heriard Dubreuil, London (44) 20-7176-7302; elie.heriard.dubreuil@standardandpoors.com

Research Assistant:
Bida Blume, Dubai

Table Of Contents

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Islamic Finance Could Aid Modestly In Achieving Sustainable Development Goals

In September 2015, the UN General Assembly adopted its 2030 agenda for sustainable development, comprising 17 sustainable development goals (SDGs) and 169 measurable targets centered on five pillars: people, planet, prosperity, peace, and partnership. The UN has stressed that striving for sustainable development will require a revitalized global partnership between all stakeholders.

Islamic finance could play a role--a modest one at least--in meeting some of the SDGs, in Standard & Poor's Ratings Services' opinion, particularly those that are in line with the core principles of Islamic finance. Some sukuk issues by global multilateral lending institutions over the past few years illustrate this point although their overall amount remains small compared with multilateral lending institutions' (MLIs) conventional debt issuance. Still, Islamic finance will likely remain a modest contributor due to the industry's small size and the issues it has yet to resolve to unlock its global potential.

Overview

- Islamic finance could contribute to achieving some of the UN's sustainable development goals.
- Recent sukuk issuances by some global multilateral lending institutions provide some examples.
- However, Islamic finance will play a modest role given the industry's small size and steps yet to be taken to unlock its global potential.

Islamic Finance Principles And Products Are Compatible With Some Sustainable Development Goals

To be considered Sharia-compliant, a financial institution or transaction needs to meet the Koran's tenets against usury and uncertainty. Perhaps the most famous principle of Islamic finance is the prohibition of Riba. Depending on the school of thought, Riba has been defined as interest or excessive interest, leading to slavery. Sharia doesn't consider money as an asset on its own because it is not tangible; therefore, it may not earn a return from the simple fact of time elapsing. Instead, return can be earned on risk taking activities, as long as the burden or reward is shared between the bank and its client. Although the principle of profit and loss sharing has not been fully or always applied properly in the past, we think that the industry is slowly inching in this direction. Sharia also prohibits uncertainty of payout, gambling, or speculation (Gharar), and encourages responsible behavior. Moreover, Sharia-compliant transactions must be backed by tangible and identifiable assets that anchor the financial sector in the real economy. Lastly, Islamic finance forbids investment in or dealings with those industries banned under Sharia: notably alcohol and brewing, tobacco, weapons and armaments, or pork-based products. The ultimate goal of these principles is to create a sustainable, equitable, and socially responsible financial system.

Looking at the UN SDGs and the principles of Islamic finance, we consider that there are some similarities. For

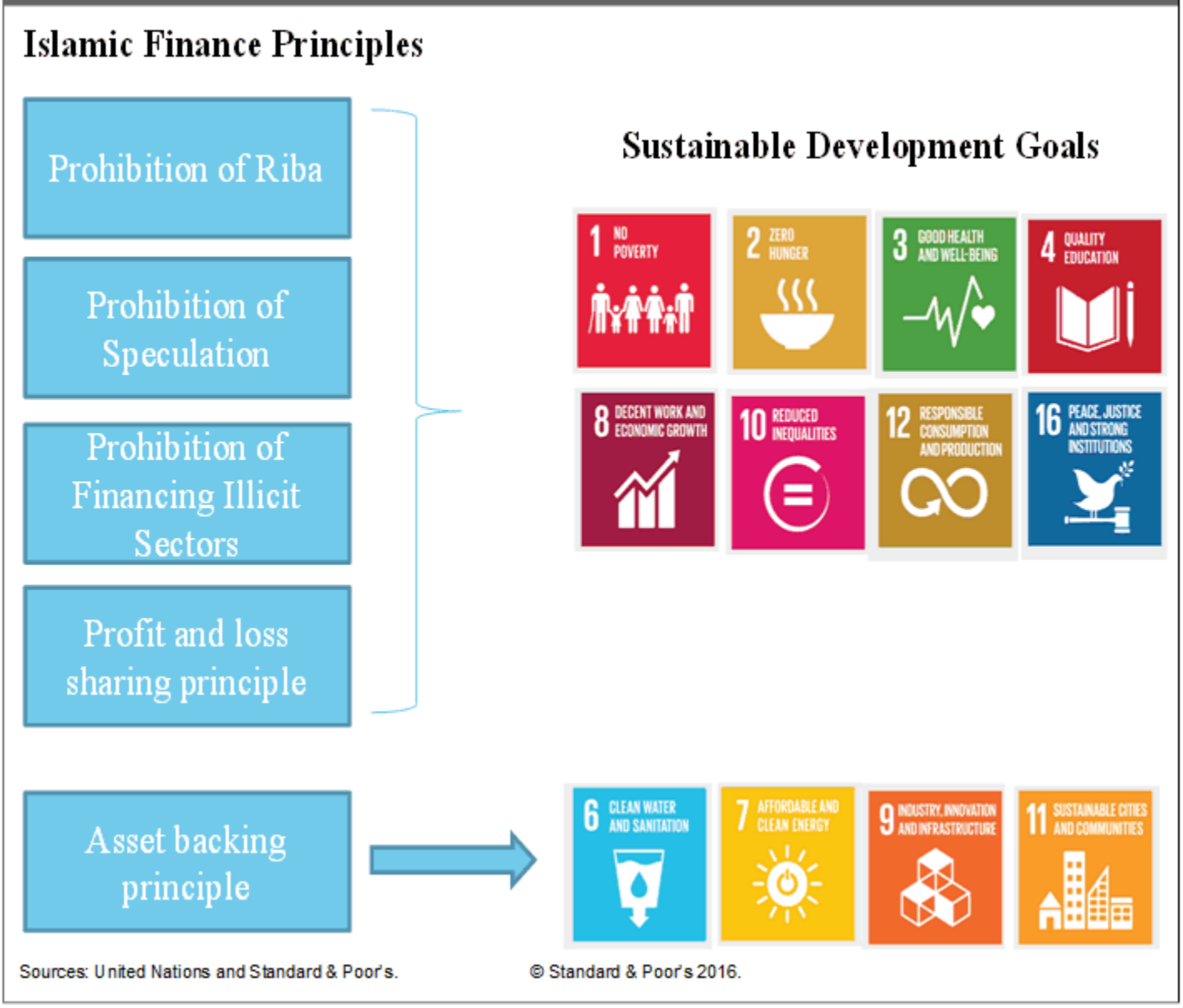
example, the principle requiring underlying assets in each Islamic financial transaction makes Islamic finance a good match for the financing of infrastructure, which is part of SDGs 6, 7, 9, and 11. Another example comes from the parallel between the prohibition of financing certain sectors such, as weapons and armaments, and SDG 16, aiming to promote peaceful and inclusive societies.

Islamic finance also uses some specific products that can be used to finance SDGs. The first two SDGs aim to end poverty in all forms, and halt hunger and achieve food security in the world. Although these two objectives could probably be dealt with through the use of concessional loans from MLIs or bilateral loans from developed countries, Islamic finance has its own forms of concessional lending, specifically:

- Qard Hassan, consisting of a loan granted for welfare purposes or to bridge short-term funding requirements where the borrower is required to repay only the principal.
- Zakat, which is one of the five pillars of the Islamic religion and is similar to a tax that is levied on wealth that exceeds a certain threshold. Zakat is used for social welfare purposes without any expectations of repayment or remuneration.
- Waqf, consisting of a donation of an asset or cash for religious or charitable purposes with no intention of reclaim.

Lastly, the principle of profit and loss sharing inherent to Islamic finance could, if implemented properly, contribute to achieving SDG 10, related to reducing inequality and easing the negative impact of economic swings. This principle has not been applied properly in the past but, in our view, the industry is slowly inching toward its more stringent application (see "Why Profit And Loss Sharing May Be Gaining Ground In Islamic Finance," published March 1, 2016, on RatingsDirect).

Chart 1
Islamic Finance Core Principles And UN Sustainable Development Goals



Sources: United Nations and Standard & Poor's. © Standard & Poor's 2016.

Global Multilateral Lending Institutions May Opt To Increase Their Use Of Islamic Finance Given The Similarities Between Some Principles And The SDGs

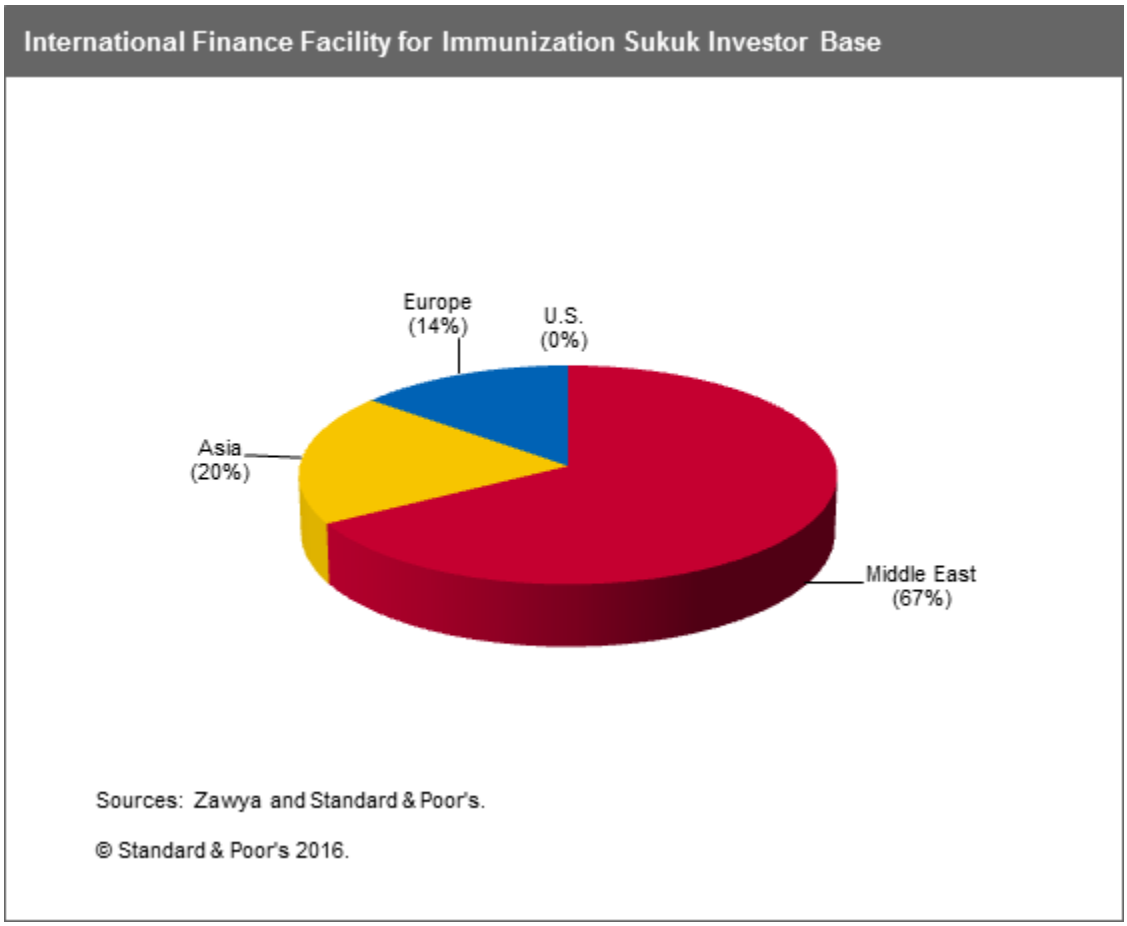
Apart from the Islamic Development Bank Group (IDB) and the role it fulfills in financing the infrastructure in its Organization of Islamic Conference (OIC) member countries, we have seen only a few examples of interest in Islamic finance from other global MLIs in the past few years. The International Finance Facility for Immunization (IFFIm), which focuses on raising funds for the immunization and vaccine procurements programs of Gavi, the Vaccine Alliance

(SDG-3), was the first among global MLIs to tap the sukuk market twice. In 2014, the IFFIm issued a $500 million sukuk that was oversubscribed by 1.4x. This was followed by another sukuk for $200 million that attracted similar interest from investors, with an oversubscription of 1.6x. In the same vein, the International Finance Corporation (IFC) also tapped the market through a $100 million sukuk in 2015 after a first issue in 2009, with underlying assets consisting of private-sector projects in the Middle East and North Africa.

Although the oversubscription rates are somewhat lower for these MLIs' sukuk than for some governments or private sector sukuk issued over the past few years, we consider that access to the sukuk market could offer MLIs the opportunity to diversify their funding bases and tap liquidity that is not allowed to go the conventional route. By our estimates, the overall size of the investor base looking to invest in Sharia compliant instruments such as sukuk at about $500 billion worldwide. With the IFFIm sukuk, for instance, around 65% of the investors were based in the Middle East and financial institutions made up three-quarters of the total.

In addition, with Basel III deadlines approaching for some Islamic finance core markets and the chronic lack of high quality liquid assets (HQLA) in the industry, we think sukuk issues by MLIs might attract some interest. Most MLIs have high credit ratings ('AA' and above) and benefit from HQLA eligibility under the Basel III liquidity coverage ratio. With the significant role global MLIs will have to play in achieving the SDGs and given the compatibility of some of their operations with the principles of Islamic finance, we expect to gradually see more sukuk issuance from global MLIs in the next few years.

Chart 2

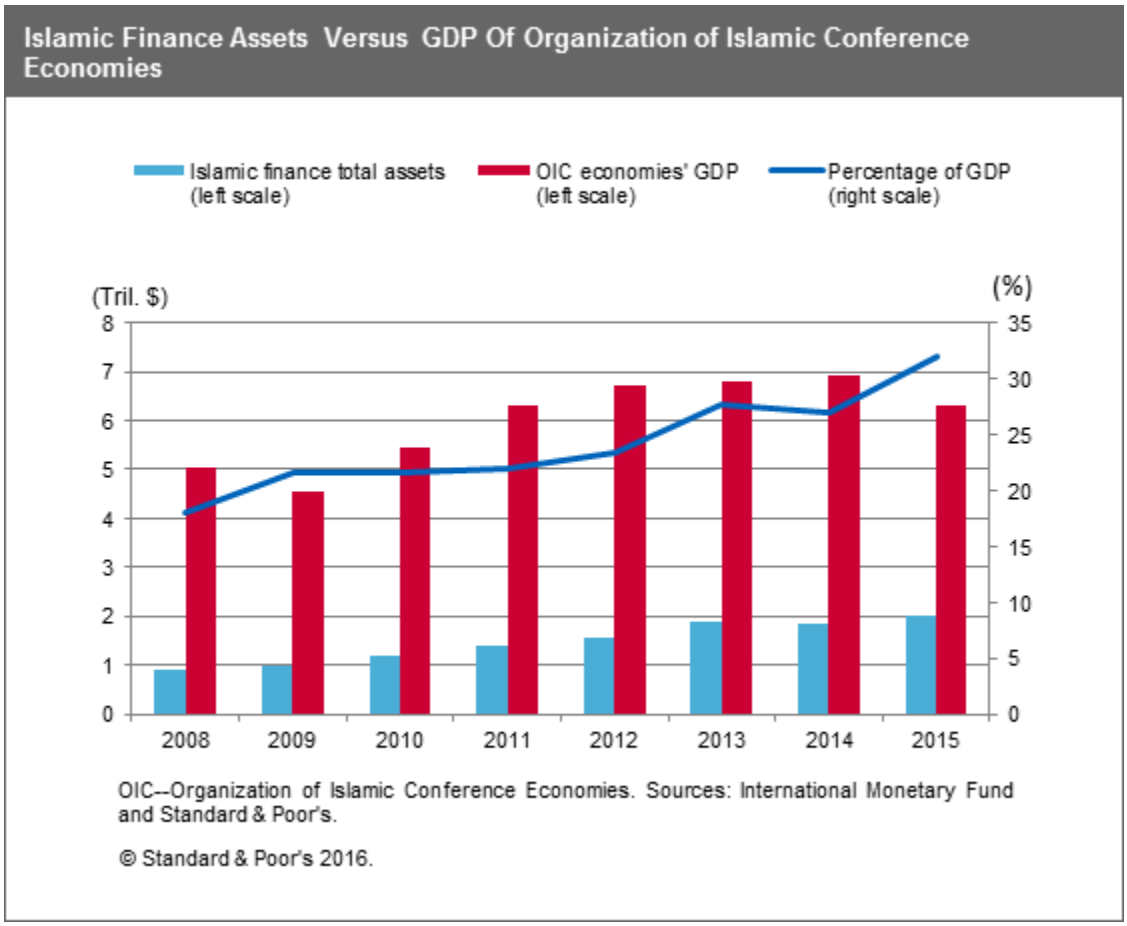


Islamic Finance Could Help But Its Contribution Will Be Modest

We think that Islamic finance's contribution to financing some SDGs will likely remain modest. This is mainly because of the industry's small size compared with the overall financial system, even in the economies of OIC member countries.

We estimate Islamic finance assets were worth about $2.1 trillion at year-end 2015, compared with more than $7 trillion of cumulative GDP of the economies of the OIC countries at the same date. Similarly, we project that sukuk issue volumes will reach $50 billion-$55 billion in 2016, representing only a negligible fraction of conventional issues globally. Assuming the industry continues its efforts to improve standardization and reduce the usual timeframe for issuing sukuk, Islamic finance could attract new issuers such as MLIs or governments that might see the industry as a way to diversify their investors' base and fund their SDG agendas.

Chart 3



Related Research

- Why Profit And Loss Sharing May Be Gaining Ground In Islamic Finance, March 1, 2016
- The Global Sukuk Market: The Correction Is Here To Stay, Jan. 8, 2016
- Islamic Finance To Still Grow In 2016 But With A Sag, Oct. 18, 2015
- Glossary Of Islamic Finance Terms: August 2015 Update, Aug. 10, 2015

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com