**Moving Towards Community Driven Islamic Finance**

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**INTRODUCTION**

Islamic commercial banking assets continue to see significant growth over the years with global assets growing at almost 10% in 2014 and are forecasted to reach $3.25 trillion by 2020 (State of the Global Islamic Economy, 2015). In their fourth decade of existence, Islamic banking and financial institutions are spearheading the mega trend in Islamic finance, which is being recognized by many stakeholders in the global finance industry, and some describe it as shifting from “a very esoteric asset class to one that’s more… global” (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 by a rise in poverty levels in Muslim countries. Apart from some countries in Southeast Asia and the Middle East, there are high and increasing poverty levels in both urban and rural parts of most Muslim countries (Obaidullah and Khan, 2008). The target for the Millenium Development Goals (MDG) ended in the year 2015, and in spite of the achievement chalked in some areas, the important prime target of reducing absolute poverty remains a distant dream in some Islamic Development Bank (IDB) member countries (IDB 2009).While Islamic banking and finance institutions have indisputably contributed to economic growth, their impact on economic and social development is negligible (Asutay 2012).

Critics observe that, after existing for several decades, the Islamic finance sector has done little as far as real innovation is concerned but rather mimic conventional financial products. This observation is confirmed by some studies including Gan, Pei-Tha and Kian-Teng Kwek (2010) and Chong, Beng Soon and Liu, Ming-Hua (2009) which show 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 course to converging regarding the substance of their impact on economic growth and impact on the society as a whole. This development has the potential of skewing the original objectives of the Islamic finance as propounded by the Muslim scholars.

Many analysts and scholars opined that the Islamic finance sector was created in order to realize the unique value proposition of Islamic economics, i.e. the rerouting of financial resources towards the real economy on the basis of risk- and profit-sharing and the recognition of certain ‘higher objectives’ (maqāṣid) of the shari`a (the Islamic system of ethics and law) such as increasing the circulation of wealth among the members of society and improving the degree and scope of mutual support though current practice among Islamic banks is reduced to ‘negative screens in form’(El-Gamal 2006). Islamic economists over the years have been able to show the superiority of such a system with respect to resource allocation and distribution, justice, and stability of Muslim societies (Nienhaus, 2014). Others also contend that the Islamic finance sector was initially developed as a response to the challenge of undertaking finance transactions while avoiding prohibited financial practices, primarily riba. Asutay(2012) noted that in providing such solutions, the pioneers of Islamic finance were, in fact, realizing another higher purpose of the shari`a of alleviating hardship (mashaqqa).

Irrespective of the position taken, associating something with Islam as a standard, in any respect more especially 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 cannot be toyed with when Islam is the reference point. In any case, the original intention of Islamic finance proponents and these later concerns are not at odds. Analyses (including several studies by the World Bank and IMF) of the theoretical ramifications of the prohibitions of Qur’anically prohibited financial practices such as riba, *gharar* and *maysir* have demonstrated that an economy free of these elements is likely to be more stable, efficient and growth-oriented.

A critical analysis of the performance of Islamic financial institutions indicates that there is a growing divergence between the aspirations of the Muslim society and the practice of Islamic banks. This divergence mainly demonstrates itself in ethical and social expectations related areas, and therefore it is valid to claim the ‘social failure’ of Islamic banks with the evidence produced by a growing body of empirical literature (Asutay, 2012). This position is also held by Ali and Nisar (2016) which opined that based on a survey of literature in the field and many insightful conversations with its thought leaders over the last two decades, we can say that the belief in this hypothesis is widespread to the extent that it is taken to be true. It is also appropriate to say that the reasons for this failure have 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 aspirations of the masses can be attributed to many factors, such as the environment in which it exists and the tools with which it works with. Consider, for example, that many countries in which Islamic finance is popular are underdeveloped—economically, technologically and human resource-wise -for well-understood historical reasons. Consider also that Islamic finance’s expansion accelerated significantly only after Western institutions began to take a greater interest in it.

Further, the current financial drivers of Islamic Finance are shareholder directive based, focused on the findings of the conventional financial target customer statistics, and merging them with closely suitable Islamic hadiths and knowledge, never realizing that the major motivation of Islamic *shari’ah* has always been the benefit of people in volume rather than pin-point instances.

In spite of this, the flexible components of *maqasid al-shariah* have given way to a non-flexible and strangely less socially impactful industry which feels the driving force for the modern Islamic finance is its model. The outcome seems contradictory to the initial motivations that were based on the concept of *maqasid al-shariah* to look after the greater good of the people themselves.

When we look at the above discussion from a social angle, it may also be important to ask what role Islamic finance and banking should play in the society? How can Islamic banks move towards a ‘pull’ mode of operation from the current ‘push’ mode? For example, helping to lift people out of poverty is obviously a highly desirable goal, but how and to what degree should Islamic banks play a role in doing so? (i.e. looking to base its business model on social needs). Similarly, is it problematic that Islamic finance is not sufficiently concerned with the impact of its financial activities? Should, for example, an Islamic bank prioritize the funding of the construction of useful infrastructure such as an airport and motorway over more profitable, but less socially relevant avenues? What are the potential opportunities for increasing the contribution of Islamic social intermediation, such as from zakat and waqf to humanitarian action, in particular for local and regional level humanitarian organizations?

This study, therefore, aims at making certain proposals on how Islamic finance can move to the next level of sector’s development, mindful of the social impact of its operations.

**REVIEW OF ISLAMIC SOCIAL INTERMEDIATION**

It is established 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 its shari‘ah-compliance, it has, at the same time, developed a reputation as a banking system for the rich which provides little for the poorest of the poor. Indeed, Islamic finance institutions have not yet made significant forays into the area of microfinance, despite the fact Islamic finance is social justice-oriented (Ali, 2007). In other words, their attachment to ‘efficiency’ has been at the cost of ‘equity’ while Islamic Modern 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 developmental aims, (especially in the current scenario where many Muslim countries are under developed) and therefore conceptualized as providing the financial means for the development of societies rather than services for the markets.

Islam emphasizes on distributive justice, which is evident from the earliest Meccan Surahs, is a culmination of earlier Divine revelations, which are comprehensive, realistic and clear. Distribution ranks quite high in the Shari'ah hierarchy of values, and is an explicit Qur'anic criterion for evaluating a society, as evident in ayat 69:34 and 89:18 of the Holy Qur’an. Refusal to share with the needy is considered 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 do what is mandatory on him, and helping him not to be a burden on others. Thus, Monetary Waqf as a way to combat poverty fulfills a major economic goal in Islam.

In this ‘return,’ the implications of ‘Islamic’ in the title and therefore the aspirations of IME should be served through new institutions and perhaps through non-banking-financial institutions, which can include Islamic social banking (El-Gamal 2006; Asutay 2007b), Islamic microfinance (Ahmed 2004; Asutay 2010a), economic empowerment oriented awqaf (pious foundations), zakah funds for development, ar-rahn or Islamic pawnbroking institutions (Abdul-Razak 2011), Islamic development banks, social investment institutions, and ethical funds and so on.

**Zakat**

In Islam, two offerings, compulsory (such as Zakat) and optional (Sadaqa) engage in the drive of poverty alleviation through the redistributive approach. Islam institutes Zakat as compulsory for the wellbeing of qualifying Muslims. Zakat is a unique instrument for poverty mitigation as wealth is transferred from well-off people to worse-off people. Islam holds Zakat as one of the five pillars. According to the Quran: “The Zakat is meant only for the poor and needy, those who collect the tax, those whose hearts are to be won over, for the freeing of human beings from bondage, for the relief of those overwhelmed by debts, for the cause of God, and for the wayfarer: [this is] an ordinance from God- and God is All- Knowing, Wise”. (9:60).

Islam encourages charity and acts of benevolence rather than mandatory transfers like Zakat and Sadaqat al-Fitr. The Quran teaches us: (1) “And in your wealth, are obligations beyond Zakat.” (2) “In their wealth, there is a known right for those who ask for it and for the deprived”(70:24-25). In the case of strong economic disparity or poverty, such transfers would become obligatory (Sadeq, 1995).The zakat system is one amongst the various mechanisms in the Islamic economic system aimed at promoting equitable and just distribution of wealth(Sulaiman and Zakari(2015).

Zakat funds when collected and managed properly could be used to create a pool of funds which can be used in financing development activities and can replace government expenditures. If Zakat funds are properly managed, these funds could replace foreign aid and also has the potential of significantly reducing the debt burden of governments (Hassan and Khan, 2007). Though some scholars opined that Zakat cannot be used in certain ways, the broader maslaha of the society should not also be ignored in achieving resource redistribution.

The potential of zakat remains unrealized as actual zakah collected falls far short of its potential in most countries. For instance, the actual zakah mobilized according to latest figures is just 0.025 percent of GDP, while estimated resource gap is 0.41 percent of GDP in Indonesia, and 0.06 percent of GDP, while estimated resource deficit is 0.709 percent of GDP in Pakistan. In Malaysia the opposite is true as the actual zakah mobilized is 0.24 percent of GDP against an estimated resource gap of 0.012 percent of GDP (IRTI,2014).Its estimated that the annual zakah potential in Sudan, Nigeria and South Africa at about USD 1,843.51 million, USD 8,776.45 million and USD 178.87 million respectively. However, the actual collection in 2013 was USD 220 million, USD 3 million and USD 100 million respectively(IRTI,2015).

Key recommendations include enhancing the legal frameworks for Islamic social finance; institutionalizing zakah collection and distribution; encouragement of zakat funds investment by zakat recipients, offering unique microfinance products for smallholder farmers.

**Waqf**

Islam came to meet the waqf system but developed it into an institution with all the legal backings. From this time, it became one of the tools developed by the Muslims to fulfill many critical needs in various sectors that are today financed by the state. Some of these needs are; education, health care, national security, commercial and business activities, shelter and food for the poor and needy, transportation facilities, creating jobs for many people. Awqaf, is used to support non-income aspects of the poor such as health and education as well as increasing their access to physical facilities, resources, and employment (Sadeq,1995).The good thing about the waqf institutions is that it serves as one of the wealth redistribution institutions in Islam (Cizakca, 2011).

After the advent of the modern era, the practice of waqf has been declining in many regions owing to colonization and westernization. Some of the Middle Eastern countries abolished the family waqf during the middle of the twentieth century, and many Islamic countries nationalized the charity waqf, resulting in inefficient administration (Rashid, 2003).

In the Islamic system, Awqaf is an everlasting charity that means holding certain property and preserving it for the confined benefit of certain benevolent purposes. Although Awqaf applies to non-perishable properties such as fixed property, land or buildings, it can be applied to cash, books, shares, stocks, and other assets (Kahf, 1998).

There is a consensus among Islamic scholars on the validity of monetary waqf. Imams Al-Shafe’i and Ibn Hanbal accepted the validity of both immovable and movable properties as a subject matter of waqf (Al-Zuhaili, 2004 and Qureshi, 1990). Imam Zufar from the Hanafi School also approved all movable properties to be used as waqf including dirham and dinnar. Imam Malik had also consented to the using of both immovable and movable properties as objects of waqf including monetary waqf.

Monetary *waqf* can be defined as the encumbrance of an amount of money by a founder, (individuals, companies, institutions, corporations), and the allocation of its usufruct to perpetually take care of the wellbeing of the society (Abdel Mohsin, 2009).

Since monetary waqf is characterized by irrevocability, perpetuity, and inalienability, it leads to the attainment of higher objectives of maslaha such as the provision of goods and service in a sustainable and continuous way which is needed not only for the present generation but the future generations. This reduces the burden on government in providing public goods (Mohsin, 2013)

**HOW ISLAMIC BANKS CAN SUPPORT IN SOCIAL INTERMEDIATION**

**Model A: Islamic Bank with a Subsidiary**

A new viable model which can provide a vehicle for Islamic banks to support social impact finance is a bank with a subsidiary focused on social welfare. With this, a bank would have commercial financial activities and a subsidiary devoted to providing services to help the productive poor with a mix of funding sources principally from the charity.

To capitalize this bank, an innovative regulatory hand may provide that when a bank is being established, shareholders would be asked to agree to a small percentage (say about 5%) of capital raised to be used for establishing a subsidiary for social development. In addition to this the bank will allocate a percentage (about 10%) of annual profits to be given to the subsidiary.

The above model would allow the Islamic bank to be financially viable by conducting its commercial business while still investing in social development. The small percentage of (say 5 %) given to establishing a 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 maqasid angle where economic and social justice remain vital.

This arrangement will provide a unique opportunity for charity institutions to be institutionalized and transformed further. These charity institutions would collect donations from both individuals and 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.

Delinquent charges by Islamic banks can also be channeled to these established subsidiaries for them to use to finance productive entrepreneurs in a form of benevolent loans. Zakat management schemes can be incorporated into these models where the subsidiary bank serves as an intermediary between zakat payers and beneficiaries. Aside from this, this subsidiary can also be financed from the *tazkiah* funds of the various Islamic banks. Almost all Islamic banks have this *tazkiah* funds where they channel impure income into, and one of the prime use of these funds is for charity purposes.

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

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. Its of interest to note that a client who is unable to pay the debt genuinely becomes ghaarim (one burdened with debt) according to zakat rules in the Holy Qur’an (9:60). He thus becomes a legitimate recipient of zakat in order to pay back what he owes the microfinance. With this, guarantors of losses can pay the sums they pledge from their zakat obligation. This will incentivize many persons to become guarantors and is likely to have a significant multiplier effect on potential lenders to the microfinance. Thus, we see strong complimentarily between *zakat*, *sadaqa* and microfinance.

A two-tier *muḍarabah* model generally known as re-*muḍarabah* is a similar model to the above. With this arrangement, three parties are involved i.e., capital provider, intermediate *muḍarib* and the final *muḍarib*(Abdul Rahman 2007).In this arrangements, there is an extended scope of the capital provider which may be the government, *zakah* or *waqf* foundation, an Islamic bank or non-bank institutions. The funds disbursed by the capital provider is managed by the intermediate *muḍarib* which is typically a microfinance institution provider or non-bank financial institutions such as an Islamic venture capital and may give technical assistance to the final *muḍarib*. A micro-entrepreneur acting as the final *muḍarib* practically manages the business alone or in consultation with the intermediate *muḍarib* (Abdul Rahman, 2007 and Abdul Rahman 2010). Its of importance to mention that although these contracts are linked they are independent contracts on their own. This affords the opportunity to pool capital from many angels and channel these to financing bankable ideas which has the potential of value addition to economies in question to spur growth and tackle unemployment.

A closer look at the practice reveals that in a recent development, the United Arab Emirates (UAE) commenced innovative attempt at alliance between zakat and Islamic finance (Nagaoka, 2015). There is a sovereign entity called the “Zakat Fund” (ZF, Sunduq al-Zakat) which is tasked with the collection and disbursement of zakat in the UAE. In 2010, Abu Dhabi Islamic Bank came up with a novel service to collect zakat 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 zakat in 2011. Using these ATMs, customers can not only pay zakat but can also indicate the category of disbursement of zakat. Seemingly, these attempts would make the management of zakat achieve more efficiency (Nagaoka (2015).

*The case of Islami Bank Bangladesh Limited (IBBL)[[1]](#footnote-1)*

To bring the practicality of this model into the limelight, it is useful to discuss briefly what one Islamic bank is doing in this regard. Bangladesh has about 38% and 18% of the population people living under the poverty and ultra-poverty lines respectively, and this has been the cause of yawning rural-urban economic disparity. This is worsened by the high levels of illiteracy, lack of proper health and sanitation facilities. The country's economy is an agrarian one with the huge majority of the people living in rural areas. The agriculture sector seemed saturated and is provides a limited scope for employment which leads to an influx of rural population towards urban areas. Rural areas are characterized by Underemployment and unemployment phenomenon. The vast human resources have remained unutilized due to lack of education, proper training and concerted efforts to help grow the rural economy. It results in uneven distribution of income which causes a serious set back in balanced geographical growth as well as the growth of GDP.

In recognizing this desperate situation and an effort to responding to the unique problems of the community, IBBL launched the Rural Development Scheme (RDS) in 1995.The purpose of the Scheme in addition to providing Micro Investment facilities to the stakeholder is also to ensure various types of facilities and services are available to the ultra-poor and downtrodden people as a part of Integrated Development Approach as well as Corporate Social Responsibility drive of the bank. The coverage of the scheme includes: Humanitarian Assistance Program; Education Program; Capacity building or Training Program; Health & Medicare Program; Environment Protection Program.These areas were chosen to recognize that they affect directly the human development of the people.

The clients are provided investment up to BDT 10,000($145) at the first time with opportunity for enhancement of good performance, upon their requirement, by BDT 2,000 to BDT 5,000 in every next term up to the ceiling depending on the sector.

The return on investment is determined periodically and as at May 2016, 12.5% is set as the rate of return with a 2.5% rebate to encourage timely repayment. The main Islamic finance contract used are Bai-Muajjal and Musharaka with selection depending on the sector and purpose of the investment.

Interestingly the Performance of Rural Development has been phenomenal since its inception. The Scheme up to 31 May 2016 showed that 251 Branches of the Bank have seen functioning of the Scheme in their respective areas. These Branches are operational among the poor in 18,775 villages of 64 districts of the country. Presently, the number of clients is 959,513 since the start of the scheme. A total amount of BDT 142,626.49 million of investment facilities is provided of which 21,399.75 million are outstanding. The rate of recovery of the Scheme is impressively more than 99%. This shows that with commitment, Islamic finance can respond to the needs of the community and IBBL is achieving that which is a good case for other Islamic banks to learn from.

**Model B: Monetary *Waqf***

Assuming that there is an Islamic Bank of which a subsidiary is created to offer socially responsible services, for e.g. microfinance and qard hasan. The subsidiary will be solely owned or in arrangement with other corporations or individuals with similar interest. Some conventional banks have microfinance subsidiaries such as BOI Microfinance by Bank of Industry in Nigeria. A monetary waqf can source funding from four main general arrangements.

First, donations are given by those who wish to help the productive poor to access the economy. These individuals are generous philanthropists who have a soft side for the wellbeing of humanity.

Second, zakat is collected to help the needy. This money is kept in a separate account and accessible to qualifying poorly. This is disbursed according to strict criteria of zakat and may target unproductive poor such as the sick, aged and other vulnerable section of the society.

Third, bank depositors can sign off to allow the money they deposited to be used. Usually, depositors will agree to allow their money to be used either after they reach an agreed upon bank balance or for an appointed length of time.

Fourth, liquidity guarantors will pledge to give money when liquidity is needed. This special group of people is made of generous donors or philanthropists.

The money comes from bank depositors would constitute a portfolio to be disbursed to the productive poor using a microfinance model or qard hasan. If loan recipients default on their loans, the loans will be repaid from zakat funds. If investors in the bank wish to withdraw funds, donors and guarantors of liquidity will supply funds.

This model can take several forms in practice, and some countries have had 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 in this scheme is not only individual but private and public corporations. The originating founder, either the private or the public corporation, will establish an Associated Waqf Institution as the trustee. 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 donations that will be received from individuals and companies.

The incorporated waqf will then manage and invest the funds and when profit is made, qualifying projects are financed from the profits.

In a waqf deposit scheme, the Islamic bank subsidiary bank acting as a trustee, the founder, will deposit funds in a cash awqaf –linked account. The trustee(bank or microfinance company) will specify the list of beneficiaries such as health care, schools, etc. Proceeds from the management of the funds from the bank or microfinance will be channeled in financing the projects. This is practiced by two banks in Bangladesh, the Social Investment Bank Limited (SIBL) and the IBBL (Mannan, 1998). The only difference is that they do not have full fledged subsidiaries for the funds management.

Finally, we can also have 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.

**INFRASTRUCTURE FINANCING**

**Blended Finance**

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

Unlike conventional finance, Islamic banks driven by the higher objectives of *maqasid*, will be able to balance the taking of risk and social impact of their investments. This means that Islamic banks in their financing decisions will have to move away from only removing prohibitions with the lens of Shariah to looking at the social goals and environmental impact.

Notwithstanding emerging markets(which most Muslim countries fall into) contributing close to 49% of global GDP, a relative small portion out of the roughly $218 trillion in global capital markets flows annually to these high-potential markets due to risks (real or perceived) and market inefficiencies (OECD and World Economic Forum 2015) .The most significant barrier to private capital movements into these markets is that yields are often seen by conventional investors to be less proportionate with the level of perceived risks, which tends to be much higher than in more mature markets, often given weak regulatory frameworks and enabling environments[[2]](#footnote-2).

To respond to the inadequate investment flows to emerging economies, the world economic forum, came out with blended finance (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 development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets’.[[3]](#footnote-3)

BF is characterized by leverage, returns, and impact. It uses development finance and philanthropic funds to attract private capital for 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, geographies and using an array of instruments in infrastructure financing.

BF creates an avenue for development funders to respond to structural needs for the project 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 situations where there is a market failure that needs to be overcome (OECD, 2015)

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

For BF to be effective, Islamic development financial institutions such as Islamic Development Bank and Awqaf institutions will 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 so doing BF helps to facilitate risk-taking at tolerable levels to incentivize financing and investment without distorting functioning markets.

Development funders can play a variety of roles to address capital flow barriers in a BF model.

Firstly, shifting the investment risk-return profile with flexibility in capital and favorable terms. Development funders may decide to assume exposure to greater risk potential and give up commercial returns in investment in exchange for development impact. For example, a partial credit guarantee will be able to attract new investors by improving a project’s creditworthiness by limiting the downside losses, reducing the required return for that level of risk for other investors.

Secondly, 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 using the local expertise as leverage.

**Sukuk**

Sukuk is another potential source of funds for the financing of infrastructure by both the public and private sectors in Islamic capital markets. In theory, sukuk are meant to be securitized representations of unbroken shares in an underlying asset or service.

Sukuk market has grown over the years markedly with an aggregated sukuk issued between 1996 and September 2014 amounting to USD632 billion. Following the slowdown of sukuk issuance after the global financial crisis, the market has picked up again with the outstanding amount reaching USD 100 billion as at the end of the third quarter of 2014(Thomson Reuters,2015).

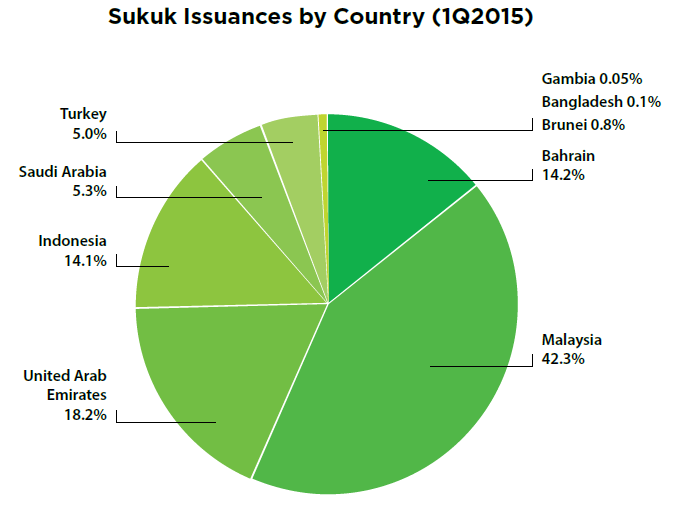
The successful experience of public and private sukuk issues signifies the potential of raising funds from private sector players and markets to finance infrastructure projects.

Greater proportion of the sukuk(66%)) issued was by government. Funds mobilized through the sukuk for infrastructure projects are relatively meagre as Islamic financing institutions, has not been forthcoming in financing the infrastructure sector. For example, according (S&P 2009), only a paltry 10% of the total of USD 14.9 billion sukuk issued in 2008 was for infrastructure financing and this trend is observed in the GCC. A total Shari’ah-compatible financing in the GCC stood at USD 40 billion, and only USD 9 billion went into infrastructure financing (Ernst and Young 2008).This is seen as a challenge to Islamic finance practice as the sukuk is seen by some as a veritable instrument in financing infrastructure and should be driving the effort in this direction. This stems from the fact that Islamic finance is not only about offering financial products that are Shari’ah compliant in technical-legal meaning, but beyond that, Islamic finance must fulfil its potential for managing a good economy, stimulating growth and development, establishing socio-economic justice and promoting employment and stability by adhering to the ethical principles and objectives of Shari’ah.

The positive experience of public and private sukuk issuances suggests the potential of raising funds from private sector players and markets to finance infrastructure projects. In acknowledging the magnitude of investments needed for infrastructure development around the world, G20 has recognized the role of project-based sukuk in partly filling the gap (Vizcaino 2015).

Some countries have had success in using sukuk to raise funds for developmental purposes in general and financing infrastructure in particular.In Sudan, the government has introduced Government Investment Certificates (GIC) to finance procurement, trade, and development projects (Ali 2005). The Central Bank of Iran has issued participation bonds for, among others things, development of infrastructure projects (Siddiqi 1999). Retail sukuk can also be used to finance infrastructure projects. DanaInfra Nasional Berhad (company owned by the Malaysian Ministry of Finance) issued the DanaInfra Retail Sukuk to finance the extension of the capital city's Mass Rapid Transit (MRT) rail network, and this is an example of how a retail sukuk can be used innovatively by the Public authority. What the company did was to sell three tranches of sukuk of RM1.6 billion, RM300 million and RM400 million with tenors of 7 to 20 years and was able to raise USD789.14. The price was MYR 100 per unit and requiring a minimum subscription of MYR 1000, the 7 year sukuk was paying a return of 4.23% per annum. The flexible channel of buying by Investors was provided such as internet banking or automated teller machines (ATMs) of participating banks and financial institutions (Star 2014 and DNB 2014).

Another way Islamic banks can support in community driven banking is by creating an opportunity for investors who have dual-goal of profit and social impact to invest by structuring deals in this respect. Hybrid sukuk comes handy in this regard. In a hybrid sukuk arrangement, for instance, a mudaraba sukuk. The contract is issued to fit the purpose of the project in question and the basic the basic framework required for the issuance of mudaraba sukuk is the establishment of a trust or its equivalent, say SPV by the Islamic bank. Interested investors then make payment to buy sukuk, which provides them ownership in an underlining asset, and this entitles them to a commensurate right to the income generated by that asset. The relationship between the SPV and the investors is a mudaraba partnership. The investors provide capital, and the SPV is the manager (Patel 2014). This kind of arrangement will afford sukuk holders to be entitled to vary profit depending on the performance of the asset underlining the sukuk. What this means is that the motivation for investing in this kind of asset will have extended beyond profit to the realm of profiteering to that of social impact. This will provide an impactful infrastructure development tools for economic growth. Figure 1 shows the sukuk issuance by country in 2015 with Malaysia as the leader in sukuk market.



Source: MIFC

**OTHER FINANCIAL MECHANISMS FOR ISLAMIC SOCIAL INTERMEDIATION**

**Crowdfunding**

There is an inherent problem that entrepreneurs faced with at the very beginning of their entrepreneurial initiative. This has to do with how to attract outside capital given that they lack collateral and sufficient cash flows and the presence of significant information asymmetry with investors (Cosh et al., 2009). To date, equity-based funding for startups and SMEs in the MENA region has largely been provided by venture capital firms and large angel investors leaving a funding gap for entrepreneurs trying to raise seed capital under $1–2 million (Alonso, 2015)

In recent time, some entrepreneurs have moved towards the Internet platform to seek directly financial help from the general public (the “crowd”) instead of going to financial investors such as business angels, banks or venture capital funds ( Lambert and Schwienbacher, 2010). This practice called “crowdfunding,” is used to source capital for 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 (Abrail, 2012).

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

Alonso (2015) studies reveal that Crowdfunding can be done in four ways such as equity, lending, reward and donation based. In equity-based crowdfunding, are compensated in a form of fundraiser’s equity-based or revenue, or profit-share arrangements. Conversely, in lending-based crowdfunding, funders receive fixed periodic income and expect repayment of the original principal. Donation -based crowdfunding arrangement is such that funders donate to projects that they want to support, with no expected compensation. Finally, regarding reward-based crowdfunding, the funders’ primary objective for funding is to gain a nonfinancial reward. In summary, equity-based and lending-based crowdfunding is motivated by for financial return, while donation-based and reward-based crowdfunding are used as vehicles to drive the beliefs and passions of funders.

Crowdfunding by their nature perfectly matches the Islamic finance proposition of providing finance for both profit and not-for-profit motives. With regards to the equity-based crowdfunding, Mudharabah or Musharakah contracts can be used to support entrepreneurs with bankable ideas with the crowd taking in equity in the business after it passes through shariah screening.

In Shariah compliant crowdfunding, interest cannot be charged on the money lent to borrowers. In this regard, qard hassan will be appropriate to use, and the reward from this will be from Allah 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 sadaqah and zakat as Islamic finance social intervention tools.

There are some Shariah compliant crowdfunding cases that can be cited and Shekra is an example. It's a Shariah-compliant crowdfunding platform established in Egypt at the end of 2012. Shekra’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 traditional financial institutions and banks. They emphasize on both social responsibility and Shariah-compliance with a special focus on upgrading the success rate of startups in the MENA region to match global standards. Shekra targets different projects that need funding from between $50,000 and $300,000, seeking to connect creative people with investors willing to invest in them(Alonso (2015)

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

Crowdfunding possesses the characteristics of ethical, fair distribution of wealth and obligations and these are valuable in Islamic finance. It can, therefore, be promoted in social intermediation drive by Islamic finance in Muslim economies, especially in technology, agriculture, health services, and education sectors (Marzban and Asutay, 2012).

**Mutualizations**

Mutual credit associations devoid of interest, such as classical rotating savings and credit associations (RoSCAs), are easily approbated by religious scholars of all schools, and widely accepted by Muslim subjects (El-Gamal, 2016). As part of the membership of RoSCA, the financial institution receives periodic Interest-free loans from other RoSCA participants, and then stagger its payment schedule in two or more RoSCAs and then convert 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 and give to individual members of the group at a time until the entire group members are covered based on agreed order.

Even though technically, the first recipient of the RoSCA achieves higher benefit, the order is usually driven by need, and social norms prescribe that one should continually agree to participate in a RoSCA when asked by someone in their social network, and this will lead to a strong sense of balanced reciprocity.

El-Gamal, El-Komi, Karlan, and Osman (2013) 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 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 are rejected by profit-seeking stockholder-owned financial institutions. This is the case, for example, for the poor customers targeted by credit union operations that leverage community 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 conventional banks because work of a loan officer cost approximately the same irrespective of the amount involved. This makes interest rates on microloans exceptionally high. For insurance purposes, these information asymmetries problem can result in market failures. This problem may be solved by risk-sharing mutual insurance schemes that emerge in traditional societies, even though the principle of *ex-ante* reciprocity is difficult to accept in some such contexts (Platteau,1997).

**Takaful**

The concerns about the validity of conventional insurance in the context of shariah acceptability in respect of prohibitions like riba, gharar and maysir have been raised since the early days of Islamic civilization and the modern debate over what should be the solution for mitigating losses from perils suffered from live events (Bhatty and Nisar, 2016).

Financial protection has always been a vital part of Islamic thought process, which has its roots from the system practiced by Arab tribes even before the arrival of Islam[[4]](#footnote-4). It was accepted and further improvised within the Islamic remit in various forms. As a result of this, the first experiment of takaful (Islamic Insurance) was grounded on the concept of cooperation (Taun) among members who patronize it.

Islam is in support of the basic idea of insurance. “A scheme whereby the resources of the members of a particular group are pooled together to help and protect fellow members from hardship arising out of certain events is in fact very much by the Islamic concepts of brotherhood and mutual co-operation among fellow men. It is, however, the way in which the Western system of insurance seeks to achieve this aim that is fraught with practices which transgress the teachings of Islam’’(Ramlah,1991)

In the past collective risk protection schemes operated by family relations had been effective for centuries, but with increasing population, diversification of the economies, changing lifestyles and growing individual wealth, these schemes reach their limits (Nienhaus, 2016).

The takaful operational model has evolved over the years with the early takaful operated not for profit. The aim of coming up with this takaful structures was to fill a need to provide protection in a fair and transparent manner where the risk is shared amongst policyholders, and the rights of policyholders and shareholders were clearly defined and segregated. This model was used by Islamic Insurance Company (promoted by Faisal Islamic Bank) in Sudan and Islamic Arab.

Various takaful models are being practiced (such as Mudarabah, Wakala) and modifications are still being sought from shariah scholars and practitioners. This is because the question of Tabarru as currently practiced has been a subject of controversy. The “fund” or “risk pool” is built from insurance premiums which are called takaful contributions. To give credence of the mutual cooperative principles, these contributions are considered donated for the cooperative benefit of participants in the pool. The argument lies in the fact that there is an expectation from participants to be reimbursed in a case of loss (Agha, 2010). This expectation contradicts with the condition of *tabarru* as once a donation is made there can be no anticipation of return as it is unlawful for the donor to seek direct benefit from the donated property.

Some proposals have come in response to this in a form of Waqf model. This basically seeks to address the issue arising out of conditional *tabarru*. Takaful operator in this model will initially establish a waqf with its own contribution and then all the contributions received from participants (as cash waqf) become part of the waqf fund which is then used to support the participants’ insured needs. Takaful operator earns returns out of the fee levied on the management of the waqf fund. Any income remaining is distributed among the participants or proposed to be distributed for social and charitable purposes, in the unlikely event of the fund being liquidated.

In bolstering financial inclusion, another group that should be addressed by *takāful* is people with low and volatile income who are currently excluded from the financial system.

If micro-takaful 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 be non-existent, nor shareholders are looking to taking a share of underwriting surplus. But for this to survive there may be may still need backing of an NGO or government body to play a role of lender of last resort (Nienhaus, 2016)

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