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Sovereign Wealth Funds and Social Finance:

The Case for Islamic Finance and Impact Investing

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ABSTRACT: With the continuing political turmoil in the Middle East region and financial uncertainties in the global economy (as a result of 2008 financial crises), the governments in the MENA region are facing fiscal and budgetary constraints in trying to address the perennial issues of economic development, poverty alleviation, and jobs. What should be the appropriate role of government in the economy, especially when the global economy is facing slower growth. Between the blithe free-market solutions and impractical statist, interventionist, remedies, this paper argues that Islamic Finance, with its focus on moral and social objectives, and specifically Sovereign Wealth Funds, as a long term investors, are ideally positioned to pursue "Impact Investing" – making investments that generate social and environmental value as well as financial return – to foster social impact and economic development in the broader economy.

Introduction

The contemporary discourse on 'Islamic' Finance is a casualty of international security challenges arising from the Middle East (ME) and the Muslim World.[1] As with the lingering doubts about the motivations of the ME based SWF investment in Europe

[1] For example, see section entitled "Those with Subversive Motives" for a discussion of Shariah Complaint Finance and Sovereign Wealth Funds (pp. 47-62) in a report prepared for US Department of Defense, "Economic Warfare: Risks and Responses: Analysis of 21st century Risks in the Light of the Recent Market Collapse."

and the US, Islamic Finance and Islamic Banks generate similar political unease in western capitals. It is assumed that these entities have a global political agenda. For instance, for some in the US policy circles, the discussion of Islamic Finance is invariably conflated with national security issues, i.e., terror financing or illicit transfers of funds between unsavory actors from the Middle East.[2] We believe it has become imperative to move beyond this false articulation of Islamic Finance and rather to begin to view it as an alternative mode of finance and political economy. Three interrelated factors drive this thesis. First, as more mature markets struggle, Islamic Finance offers a complementary source of financial services. Second, with the ascendance of Islamist parties as a result of Arab Spring, the impetus for Islamic Finance is expected to rise. Third, demand for capital and financial services within the emerging markets of the Middle East-North Africa (MENA) region and Asia is expected to increase the relative demand for Islamic financial products.

Growth of Islamic Liquidity

The three major Islamic financial centers are Bahrain, Malaysia, and the United Arab Emirates (UAE).[3] The continuous political turmoil in Bahrain has compromised not only its standing as a reliable financial hub but also as the main Islamic financial center. As a result, Dubai and Qatar become contenders for the main financial gateway in the

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[2] Barber, Steve. "The "New Economy of Terror:" The Financing of Islamist Terrorism," *Global Security Studies*, Winter 2011, Volume 2, Issue 1. See also: Congressional Research Service Report, "Islamic Finance: Overview and Policy Concerns," November 30, 2010.

[3] Ernst & Young 2011-2012 Report on Islamic Finance and Banking. Accessible at: http://www.ey.com/Publication/vwLUAssets/IBCR_Report/$FILE/IBCRReport2011(LR)%20Final.pdf, p.65

Gulf region. In the case of Malaysia, Kuala Lumpur has benefitted from Bahrain's challenges to expand its role in sharia-complaint trading in the Gulf region.

Islamic Finance - more specifically Sharia-compliant financial services - is a US$1.2 trillion finance industry and is growing per year by 15%. It is led by Islamic capital debt market, composed principally of *Sukuk* (Islamic bonds)[4]. MENA banking assets increased to US$414 billion in 2010 and the region's Islamic banking industry is reported to double to US$990 billion by 2015.[5] Similarly, the net foreign assets of GCC increased to US$1.34 trillion (2011) from US$1.04 trillion in 2009. Returns on Islamic vehicles have generally tracked those of traditional equity and debt product

Importantly, from a global financial perspective, the growth of Islamic Finance has expanded beyond the immediate Gulf region and now encompasses nearly 50 Islamic banks and offshore banking centers from the UK and US to Russia.[6] This evolution is motivated by a desire to attract this growing source of financial capital, while expanding product and service offerings for investors, including indigenous Muslim populations.[7] London has emerged as the *de facto* hub for Islamic Finance in Europe. However, other regional centers (e.g. Luxembourg, Ireland, Switzerland, and Australia) are also actively participating.

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[4] "Thomson Reuters Launches New Global Islamic Index To Monitor Sukuk Market," Reuters Press Release, September 18, 2012.

[5] Quoted from Ernst & Young 2011-2012 Report on Islamic Finance and Banking. Accessible at: http://www.ey.com/Publication/vwLUAssets/IBCR_Report/$FILE/IBCRReport2011(LR)%20Final.pdf, p. 3

[6] See Islamic Finance, 2012

[7] For instance, in the UK, Islamic Finance is being leveraged for infrastructural development projects in the Shard of Glass and Chelsea Barracks. See Islamic Finance Report, The cityuk.com, 2012, p. 2.

The Compatibility of Islamic Finance and Impact Investing

At a time when there has been much questioning of the values underpinning the conventional financial system, Islamic Finance presents an alternative to traditional finance by offering both financial return, as well as a theoretical foundation for ethical investing, which, we argue, extends logically to investments that directly impact social and economic development

To illustrate this compatibility, we note firstly that Islamic Finance with its long-term, equity orientation is positioned to undertake investments with social impact – both in broader economy and in specific sectors – as these often have longer gestation periods. Unlike conventional finance, where the principle motive is profit generating, 'Islamic' finance connotes a more encompassing approach to business-society relations. Certainly Islamic Finance accepts the requirement for investors to earn acceptable returns. However returns serve as one dimension of Islamic Finance. Others importantly include social justice, *waqf* (benevolent loans), inclusion, and the sharing of resources between the privileged and the disadvantaged. Similarly Islamic Finance spurns riba (broadly speaking, excessive charging) and *gharar* (uncertainty, risk, speculation).[8]

Thus, what differentiates Islamic Finance from conventional finance are social value propositions, including philanthropy, corporate social responsibility, and equitable profit-sharing. However, Islamic Finance goes beyond SRI's scope of investment exclusion (e.g. alcohol, tobacco, blood diamonds) to focus on the social impacts of investments (e.g. homes for the poor, education, microfinance).

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[8] Mahmoud Mohieldin et al. "The Role of Islamic Finance in Enhancing Financial Inclusion in OIC Countries," 8th International Conference on Islamic Economics and Finance, December 2011. Qatar Faculty of Islamic Studies, Qatar Foundation. Paper accessible at: http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-5920

Impact investing - whether as an industry or asset class – has continued to evolve. As such it lacks a uniform definition and arguably suffers from methodological limitations.[9] For example, the Global Impact Investing Network (GIIN) defines impact investments as "investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."[10] GIIN emphasizes that such investments could be made across sectors and industries both in the developed and developing world with varied returns on investments. The Mulago Foundation alternatively describes provides an alternatively describes impact investing as "the practice of putting money—loans or equity—into impact-focused organizations, while expecting less than a market rate of return."[11] JP Morgan offers yet another perspective when it characterizes impact investing as "investments intended to create positive impact beyond financial returns". Interestingly it distinguishes impact investments from SRI from the latter's focus on minimizing "negative impact rather than proactively create positive social or environmental benefit."[12] Rather we agree with Usman Hayat that impact investing "can be viewed as an evolution of socially responsible investing and [that] it is the declared intention at the outset and the relative emphasis on making an impact that differentiates it."[13]

As fiscally distressed governments struggle to meet social and development challenges both Islamic Finance and impact investing can supplement traditional market sources by supplying financial capital to under-funded and under-resourced socio-

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[9] Hundal, Bim. "Impact Investing 'sideshow' lacks rigour, *The Financial Times*, May 1, 2012.
[10] GIIN: http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html
[11] Starr, Kevin. "The Trouble With Impact Investing," *Stanford Social Innovation Review*, p.1. January 24, 2012
[12] J.P. Morgan Report: *Impact Investments: An emerging asset class*, November 20, 2010. p.8
[13] Hayat, Usman. "Impact Investing: Making Money the Charitable Way," *The Financial Times*, November 4, 2012.

economic sectors. We argue therefore that Islamic Finance through specific instruments, such as *Skuku*, are entirely compatible with the principles of impact investing and capable of offering impactful solutions to funding in a variety of areas, including agriculture, microfinance, and real estate for the under- privileged.

Islamic Finance and Impact Investing: The Role of SWF

With respect to certain of the objectives of impact investors many Sovereign Wealth Funds (SWF), as long-term investors, demonstrate an appreciation for sustainability in their investment practices. For example, Norwegian GPFC has expanded its environmental portfolio to include renewable energy and technology.[14] The CIC has likewise has invested in sustainable energy sources, specifically solar and wind energy sectors.[15] Abu Dubai is using one of its smaller SWFs, Mubadala (AUM: US$46 billion), for the development of "Masdar City."[16] This is a multi-billion dollar project, in which the sovereign investment vehicle is being used by the state to develop a "green economy" not only as a hedge against a receding oil sector, but also to support strategic objectives, including increased employment, economic growth, and the development of a knowledge based economy. More broadly, the Masdar initiative complements the diversification

[14] Norway Government Pension Fund-Global: http://www.nbim.no/Global/Reports/2011/Annual%20report%202011/Arsrapport_11_ENG_web.pdf, p.9
[15] "China invested $45.5 billion in wind power and solar energy in 2011," accessible at: http://www.evwind.es/2012/04/14/china-invested-45-5-billion-in-wind-power-and-solar-energy-in-2011/17793/
[16] For background on Masdar city initiative, see: http://mubadala.ae/portfolio/masdar/

agenda outlined in the “The Abu Dhabi Economic Vision 2030,”[17] for sustainable evolution of its economy.[18]

Persian Gulf SWFs in particular account for 35% of all global SWF capital, representing around US$1.6 trillion dollars.[19] With the growing base of Islamic liquidity there is a genuine case for sovereign wealth funds to champion the growing internationalization of the [Islamic Finance] industry…[and to] deepen the Islamic capital market.”[20] Drawing upon the foundational principles of Islam through a rich set of financial instruments[21], all with the view to creating a more inclusive society with reduced poverty and inequality, Islamic Finance parallels the social imperatives of impact investing. We posit that GCC SWFs in maintaining a long-term investment horizon, can play a catalytic role in advancing the social agenda of both Islamic Finance and well-structure impact investment programs.[22]

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[17] The Abu Dhabi Economic Vision 2030: http://masdarcity.ae/userfiles/files/economic-vision-2030-executive-summary-mandate2.pdf

[18] Waki, Natsuko. “Sovereign funds to boost ethical investing,” *Reuters*, October 5, 2009. See also Catelli, Massimiliano and Fabio Scacciavillani. *The New Economics of Sovereign Wealth Funds* (Wiley Finance, 2012), p. 102

[19] The CityUK SWF Report, February 2012. Meanwhile, Massimiliano Catelli and Fabio Scacciavillani contend that “the Middle Eastern SWFs account for 40% of total assets.” See, *The New Economics of Sovereign Wealth Funds* (Wiley Finance, 2012), p.4

[20] Quoted from Ernst & Young 2011-2012 Report on Islamic Finance and Banking. Accessible at: http://www.ey.com/Publication/vwLUAssets/IBCR_Report/$FILE/IBCRReport2011(LR)%20Final.pdf, p. 3

[21] Examples include: (i.)*Mudarabah* (profit sharing); (ii.)*Murabahah* (sale on mutually agreed profit; Murabahah is “a contract for purchase and resale and allows the customer to make purchases without having to take out a loan and pay interest.”); (iii.)*Musharakah* (joint venture, where two or more business partners sharing in risk-reward of an investment partnership); (iv.)*Takaful* (an Islamic mutual fund), and (v.) *Sukuk* (a financial certificate, i.e. Islamic bond))

[22] Bolton, Patrick, Samama, Frederic, and Joseph E. Stiglitz. *Sovereign Wealth Funds and Long-Term Investments* (Columbia University Press, 2011). pp. 108-110.

The Challenges That Remain

We acknowledge that the advancement of Islamic Finance among SWFs has been anemic to date. Persian Gulf based states have avoided deploying their SWFs to invest in Islamic Finance. In doing so we believe they marginalize one of the most profitable and suitable investments for their long-term missions. Likewise impact investing has yet to be embraced by large-scale institutional investors, including SWF, principally for reasons of return and investment scale as each relates to their fiduciary or other stakeholder obligations. Both are formidable challenges, which will require creative solutions to overcome.

We believe that the principles of impact investing can reinforce and extend the social principles of Islamic Finance and its built-in risk management mechanism. These in turn can further strengthen the social values of impact investing. Both can form the foundation of an enlightened development agenda facilitated, at least in part, by sovereign investment vehicles. Bahrain and Malaysia, through their respective sovereign development funds, offer interesting cases in point. Could both build on their extensive expertise in Islamic Finance and leverage their SWFs to drive socio-economic development? Similarly can other Persian Gulf based SWFs - ADIA, SAMA, KIA, and QIA – leverage the structures of impact investing to serve their aspirations in building new cities and creating jobs through investments that enhance the quality of economic development and drive social impact? These questions and the challenges they raise will inform our future research.