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Regulatory Framework of Islamic Social Finance

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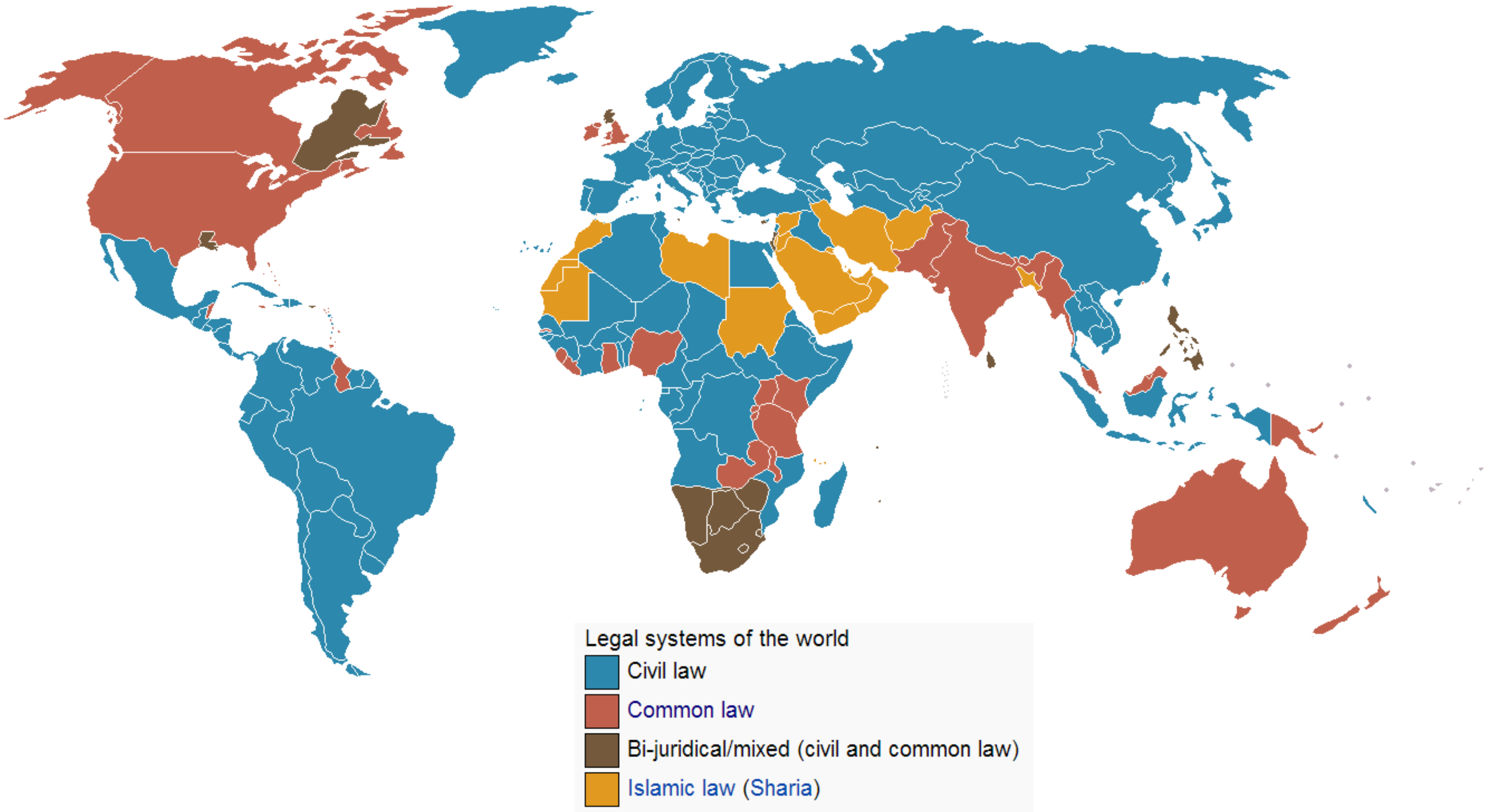
“The Social Responsibility of Business is to Increase its Profits”.

*(*Milton Friedman (*The New York Times Magazine* September 13, 1970).


Legal systems of the world
Civil law
Common law
Bi-juridical/mixed (civil and common law)
Islamic law (Sharia)

Diversity in the Legal Arrangements

Civil Law: Algeria, Djibouti, Egypt, Jordan, Indonesia, Lebanon, Syria, Tunisia, Turkey, Philippines and Thailand.

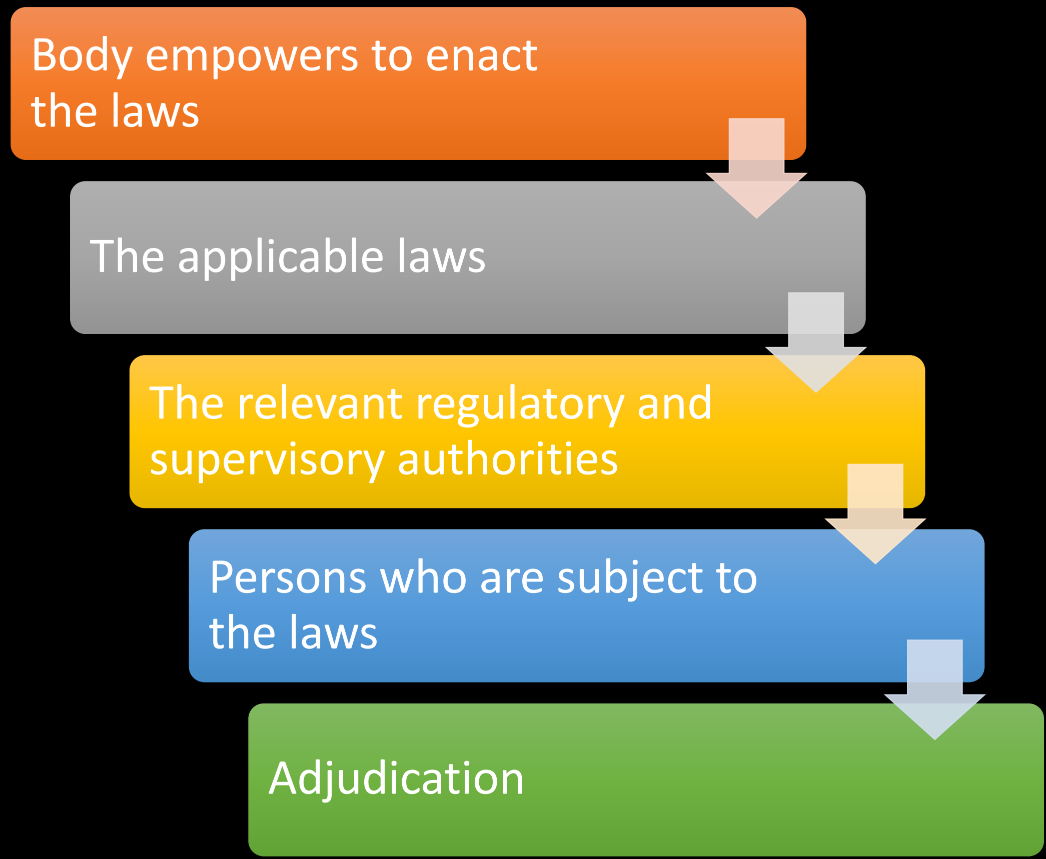
Common Law: Commonwealth countries, Bangladesh, Malaysia, Brunei, Hong Kong, Singapore, UK

Shariah: GCC Countries, Iran, Sudan, Pakistan and Yemen

WHY ENGLISH LAW IS THE PREFERRED GOVERNING LAW FOR BUSINESS TRANSACTIONS?

- Well-known, well-developed and reputable jurisprudence
- Independence of the judiciary, the experience and reputation of judges.
- The relative speed and efficiency with which commercial disputes can be resolved through the English courts or ADR mechanisms.
- Party Autonomy and Legal Certainty.
- Transparent, consistent, stable and predictable.
- Providing freedom of contract and a pro-business approach as having an emphasis on the text of the contractual arrangements between parties.

Regulatory Framework



What is Social Finance?

- Values-Based Investing
- Environmental, Social, Governance (ESG)
- Shareholder Activism
- Microfinance
- Social Enterprise
- Social Impact Portfolio
- Corporate Social Responsibility
- Zero Profit
- Positive Screens
- Financial First
- Impact First
- Socially Responsible Investing (SRI)
- Negative Screens
- Venture Philanthropy
- Patient Capital
- Strategic Philanthropy
- Non Profit
- Conscious Consumer

Why Social Finance?

There was a US$15 billion shortfall for funding of humanitarian needs. 218 million people each year were affected by disasters at an annual cost to the global economy that now exceeds $300 billion. (OCHA, 2016)

In the 57 OIC countries, 31% of the total population lives below the poverty line of US$ 1.25 per day (SESRIC, 2015).

5 of the OIC member countries account for over 0.5 billion of the world's poor with incomes below $2 a day or national poverty line. Most OIC member countries rank among the lowest as per standard development indicators. (Mahmood, 2015).

Islamic Social Finance

- Islamic finance should champion social finance as a key aspect of its mission, instead of merely being a follower of global trends.
- Social and ethical values as its foundational concept, Islamic finance can offer a unique perspective and a value-based approach to social finance.
- Islamic social finance institutions have the ability today to legitimise and coordinate private charitable initiatives in a way that can redouble their effectiveness.

Islamic Social Finance

- Zakah
- Awqaf
- Islamic Microfinance
- Social Impact Sukuk

ISLAMIC CSR FUNDS

- In 2016, Islamic financial institutions disbursed a total of US$683 million globally in *zakah*, *qard hasan* and charity funds. A total of US$606 million was disbursed by Islamic banks, US$43 million by non-banking institutions, which comprise consultancy firms, asset management firms, investment advisory firms, private equity firms, real estate investment trusts (REITs) and Islamic credit unions, and US$34 million by takaful companies. (Thomson Reuters, 2016)

Types of Organizations

Bank: a licensed financial intermediary

Co-operative Credit Union: a non-profit, member- based financial intermediary

Non-bank Financial institution: Pension fund, employee provident fund

Non-government Organization: a non-profit entity, typically not regulated by a banking supervisory agency

Others: Zakah and waqf institutions

Main Questions?

- How much regulation is right for the Islamic social finance sector? Do stringent laws and over-regulation stifle the sector?
- How do we harmonize the different regulatory frameworks governing institutions based on religious and secular philanthropy, co-operation, not-for-profit and for-profit finance?
- How do we develop a unified and integrated framework for the Islamic social finance sector?
- Lack of research on the Islamic commercial legal issues surrounding the practice of Islamic social finance

Zakah

20 out of 39 OIC countries could lift the extreme poor (those living on less than $1.25 per day) above the poverty line simply through the collection and distribution of *zakah* from domestic sources

In Indonesia, the actual *zakah* collected is just 0.03 percent of GDP against a potential of 1.59 percent, while the estimated resource shortfall is 0.41 percent of GDP.

In Pakistan, actual *zakah* collected is just 0.06 percent of GDP, against a potential of 1.74 percent, while the estimated resource shortfall is 0.71 percent of GDP.

In Sudan, the actual *zakah* collected is 0.33 percent of GDP against a potential of 1.44 percent and an estimated resource shortfall of 0.49 percent.

In Malaysia, the actual *zakah* collected is 0.24 percent of GDP, against the potential of 1.11 percent with an estimated resource shortfall of 0.01 percent of GDP. (Moheildin and Ors, 2012)

Zakah Potential

- US$ 200 billion to US$1 trillion are spent annually in zakat and sadaqah across the Muslim world, several times more than the conventional global humanitarian aid contributions.
- A minimum of US$600 billion of excess zakat from 40 OIC countries is potentially distributable annually for humanitarian action.
- However, contribution from the Muslim world to the humanitarian system is only 5-7%. Muslim countries' contribution to the Central Emergency Response Fund of the United Nations has been below 0.05% since 2006. (Mahmood, 2015)

Law on Zakah

Indonesia: Zakat Act 2011

Pakistan: Zakat Ordinance, 1980

India: No formal institutional or regulatory framework

Bangladesh: Zakat Fund Ordinance, 1982

Malaysia: Administration of the Religion of Islam (Federal Territories) Act 1993 and Enactments of the States

Singapore: Administration of Muslim Law Act, 1999

Brunei Darussalam: Laws of Brunei, 1/1984, Religious Council and *Kadi Courts*

Sudan: Zakah Act 2001

Zakat Law

Mandatory: Malaysia, Singapore, Sudan

Partially Mandatory: Pakistan, Nigeria

Voluntary: Indonesia, Brunei Darussalam, India, Bangladesh, Non-Muslim Majority countries

Institutional Structure for Zakah Management

Private actors (individual and institutional) with no role for state: India and Non-Muslim Majority Countries

Dual system with state and private institutional actors: Indonesia

Dual system with state and private actors (individual and institutional): Pakistan and Bangladesh

State agency as the sole entity responsible for zakah management: **Malaysia, Singapore & Brunei Darussalam**

Independent corporate Body: Sudan

Tax Rebate: Zakat paid is a deduction from tax payable: Malaysia

Tax Relief: Zakat paid is a deduction from taxable income: Indonesia, Pakistan, India* (Tax is reduced by "zakat paid" times the tax rate.) Sudan, incentives in the form of the benefits of compliance (e.g. tax incentives on zakah on salaries)

Allowance for corporates: Malaysia

Assets for which zakat has been deducted at source shall be excluded from taxable wealth: Pakistan

No land revenue on land on the produce of which zakat has been charged: Pakistan

*zakat to Non-profits treated as donations and qualify for tax benefit

In Saudi Arabia, the Department of *Zakah* and Income Taxes (DZIT) ensures a fully integrated *zakah* and tax system.

Tax Incentive

Zakah Development

- Indonesia: Increased by over 32 times over 10 years
- Pakistan: Increased by 40% over 3 years
- Singapore: Increased by 20.2% over 3 years
- Brunei Darussalam: Increased by 55% over 10 years
- Malaysia: Increased by 26.9 times over 20 years (IRTI, 2014)

Compulsory Zakah

Zakah may be either compulsory or voluntary in a given jurisdiction.

If zakah payment is compulsory, then there must be strong deterrents against non-payment

Law may prescribe physical and/or financial penalty against non-payment

Law may provide for forced recovery of due and unpaid zakah

Where *zakah* payment is made compulsory and non-compliance leads to penalties and punishment, weak enforcement can lead to low *zakah* collection,

Incentive on Zakah

In view of lack of enforcement mechanisms. The issue of incentivizing *zakah* payment is crucial.

Incentives in the form of benefits for compliance (such as tax incentives for levies of *zakt* on salaries), as well as costs for non-compliance (such as making *zakah* payment a precondition to other commercial transactions), work well.

Zakah payment may function as a perfect substitute for the direct taxes to the State and may be allowed as deductions to taxes payable. However, there must be absolute clarity on the issue, as well as coordination between *zakt* and tax authorities

Zakah appears to be influenced more by incentives that make zakah payment an attractive proposition and less by penalties and punishments.

Tax incentives for *zakah* payment usually take two forms. Some states permit the deduction of *zakah* paid from taxable earnings (e.g. Indonesia, Pakistan and most other countries). Others per- mit deduction of *zakah* paid from tax payable, as in case of Saudi Arabia and Malaysia.

Zakah Management

- State agency for zakah management must be in place
- Must be empowered to set regulations
- Must be empowered to enforce zakah collection
- Must be empowered to seek any information from any individual or entity for determination of zakah liabilities of muzakkis
- Must be empowered to demand any kind of assistance from other state agencies that is deemed necessary for effective zakah collection
- Must be empowered to punish unauthorized collection Agency must be empowered to enforce zakah distribution
- Should adhere to highest standards of accountability, transparency and good governance
- Should ensure separation of zakah funds from other forms of charity funds collected

Strong Deterrent and Penalty

- There should be strong deterrent in the form of financial penalty and/or physical punishments for dereliction of duty, fraud, dishonesty on the part of zakah officials
- There should be strict deterrent in the form of financial penalty and/or physical punishments against fraud, dishonesty and misappropriation of zakah funds
- There should be strict deterrent in the form of financial penalty and/or physical punishments against Shariah non-compliance

Transparency and Disclosure

- Must ensure separation of zakah funds from other forms of charity funds collected
- ZIs should place the funds, including undistributed surplus if any, in short-term safe and liquid schemes of Islamic financial institutions
- Must at regular intervals disclose the figures of zakah collection and utilization by them to the community with utmost transparency and in a spirit of sharing
- Must disclose the actual operational expenditure (including commission to agents, contribution to apex body) that is charged to zakah funds

Zakah in Secular Legal Environment

- Zakah and waqf sectors generally lack enabling legal and regulatory environments. There are no dedicated laws for the sectors that are tailored to take into account the unique and relevant Shariah norms.
- Mostly, the organizations operate as Foundations in the secular legal framework governing all forms of charities.
- On the positive side, however, the need to conform to the secular legal framework governing charities ensures transparency, accountability and better governance on the part of the Islamic foundations.

Waqf

Estimates of the economic potential of *waqf* assets in India indicate that there are about 490,000 registered *waqf* assets in India, with a total area of about 600,000 acres. The market value of the properties can be put at about $24 billion. If these properties are put to efficient and marketable use they can generate at least a minimum return of 10%-20%, which is about about $2.4-$4.4 billion per annum.

Indonesia, the market value of registered *waqf* land is about $60 billion. At a similar minimum rate of return of 10 percent, these assets may generate an annual cash flow of $6 billion, which is 0.849 percent of Indonesia's GDP. (Obaidullah and others 2014).

Law on Waqf

- Indonesia: Act of Republic of Indonesia No.41 on Waqf, 2004
- Pakistan: Provisional Waqf Ordinances 1979
- India: Wakaf Act, 1995
- Bangladesh: Waqf's Ordinance 1962
- Malaysia: Administration of the Religion of Islam (Federal Territories) Act 1993 and Enactments for the States
- Singapore: Administration of Muslim Law Act, 1999
- Brunei Darussalam: Laws of Brunei, 1/1984, Religious Council and *Kadi Courts,*
- Russia: Federal Law of 2006 No. 275 "non-profit organizations' endowment"
- Kazakhstan: The Law On religious activities and Religious Associations 2011

Regulatory Landscape

State controlled *waqf*, whereby *waqf* assets are vested in and administered by centralized state agencies; India, Pakistan, Singapore and Malaysia.

State registered *waqf*, with an oversight ministry or agency supervising the day-to- day management of *waqf* assets by a private: Bangladesh, Indonesia, Iran

Incorporated *waqf* existing under state charter. Muslims living in civil law and common law jurisdictions often establish *waqf* by charter, incorporating them as secular institutions such as charities, charitable companies by guarantee, foundations or associations. USA, Spain, Brazil, South Africa, New Zealand, Turkey

In the absence of regulation, but where *waqf* have been completely expropriated by the state: Countries that came under the French sphere of influence adopted the anti-substitution (trusts) approach to abolish *waqf* completely or in part. *Waqf* properties and lands were expropriated by the state such as Syria, Lebanon, Morocco, Tunisia and Algeria. In some countries, such as Egypt, Greece, western regions of Russia and Bosnia-Herzegovina *waqf* lands were nationalized.

Institutional Structure for Waqf

Indonesia: Badan Wakaf Indonesia as an independent institution “in order to improve and develop the national waqf”.

Bangladesh, Pakistan and India: waqf infrastructure under its Ministry of Minority affairs but with significant autonomy to waqf boards constituted at the provincial or state levels.

Malaysia and Brunei: Majlis as the sole owner-manager of waqf assets ruling out any mutawalli or privately managed awqaf.

Singapore: Ownership of all awqaf with MUIS and private management by mutawallis.

Sudan: The Diwan of National Waqf, a body corporate.

Nigeria: Sharia court of appeal to decide on Waqf

South Africa: Law for non-profit-organizations that is relevant for its organizations engaged in mobilization of zakah and Waqf.

UAE: General Waqf Authority

Tax Incentives on Waqf

- It is necessary to widen tax benefit range for the charity providers and to increase the amount of the deductions (adjustments) when calculating corporate income tax. Moreover, the deductions (adjustments) on income tax should be applicable for individuals too.
- *Waqf* to take advantage of tax benefits accruing to other non-profit or charitable institutions. These include tax exemptions on certain categories of income. Moreover, donations to the institutions are tax-deductible or given as a tax credit.
- In Turkey, tax incentives were introduced whereby donations to all *waqf*, with or without public benefit status, are exempted from gift and inheritance taxes. All donations made for maintenance, reparation, restoration and landscaping of cultural properties belonging to *awqaf* are now fully deductible from income or corporate taxes.
- *Waqf* in state-controlled regulatory models may or may not receive special tax treatment. In Saudi Arabia, *waqf* are not exempt from *zakah*.

The Coverage of an Ideal Legal Framework for Waqf

- Waqf law should provide a comprehensive definition of waqf that includes both permanent and temporary waqf.
- The waqf has been declared, it is irrevocable.
- It must explicitly cover various types of waqf: family and social waqf, direct and investment waqf, cash waqf, corporate waqf.
- The legal framework should not restrict making a waqf only to Muslim individuals and should permit both non- Muslims and institutional waqif as long as the purpose of waqf is religious or charitable.
- Work on the law of fiduciaries.
- Governance frameworks.
- A code of ethics for trustees.
- Compensation for professional *waqf* personnel and managers.

Waqf Should not be Restricted only to Immovable Properties

- The legal framework should not restrict the definition of the endowed asset to immovable tangible assets, such as real estate, but should also explicitly recognize movable, financial and intangible assets, e.g. cash, stocks, bonds and financial securities, transportation vehicles, rights on land and building, rights of leasing, and rights of intellectual property.
- Given the many benefits of cash and corporate waqf, law must explicitly provide a speficic framework, including their investment dimension.

Criteria for Mutawalli and Nazir

- Where waqf management is in private hands, the state agency as regulator should clearly stipulate and clear eligibility criteria for a mutawalli or nazir or trustee-manager not only covering aspects of integrity and trust-worthiness but also professional competence.
- Laws must clearly articulate the responsibility of waqf management that should not only emphasize preservation and protection of waqf assets, but also their development. The responsibility should also include transparent and honest reporting of financials.
- Laws must clearly stipulate the method of determination of remuneration of managers, sufficiently incentivizing sound and professional management of waqf assets.

Preservation and Protection of Waqf

- The law must explicitly prohibit the waqf asset from being used as a mortgage, confiscated, given away, sold, inherited, exchanged or being alienated into any form of right.
- The waqf asset may however be exchanged as an exception to the above general rule, when this is deemed to be in the public interest.
- Such exchange would however, require prior permission from the regulator or authorities.
- The regulatory framework must seek to strike a balance between concerns about preservation and development.
- Effective deterrents against misuse of waqf assets

Creation of New Waqf

- The legal framework must not put undue restriction on creation of new waqf.
- A simple process of registration with the regulatory body is both desirable and adequate.
- The legal framework should actually encourage creation of new waqf by minimizing financial and non-financial costs of waqf creation and management.
- The legitimization of temporary *waqf*, which allows a donor to pledge his property for a limited period.

Legal Issues on Waqf in Secular Legal Framework

- ***Legitimization of waqf within the legal system***
- A key issue relating to the possibility of establishing waqf relates to the possibility of ensuring perpetuity and irrevocability to the assets endowed. Restrictions on perpetuity in the law.
- ***Recovery of lost waqf:*** In some countries such as Bosnia and Herzegovina, Macedonia, Kosovo, the process of denationalization of assets originally belonging to religious communities has resulted in recovery of some lost waqf assets.

Islamic Microfinance

- The Consultative Group to Assist the Poor (CGAP) concluded, “Islamic microfinance has the potential to combine the Islamic social principle of caring for the less fortunate with microfinance’s power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law”. (CGAP, 2013)

Islamic Microfinance For Profit and Not For Profit

Member-based organizations called financial cooperatives, credit unions, baitul-mal-wat-tamweels.

Not-for-profit Islamic organizations providing microfinance services.

Not-for-profit societies, trusts, foundations and not-for-profit- companies that are not allowed to share profits from their operations with the promoters or founders.

Law on Islamic Microfinance

Indonesia, India, Pakistan and Bangladesh governed by multitude of laws

Baitul Maal wat Tamweels (BMTs) in Indonesia governed by Cooperative Act

Islamic financial cooperatives in India governed by Cooperative Act

Zakah-financed in Pakistan governed by secular laws applicable to not-for-profits, e.g. Societies Act, Trust Act

A Rationale for Microfinance Regulatory Laws

The laws applicable to the banking sector are deemed to be too restrictive for microfinance activities. At the other extreme the laws applicable to cooperatives may accord the necessary flexibility of operations.

A growing microfinance institution, if organized as a cooperative may face funding constraints due to the one-member-one-vote rule. Expansion of capital in a cooperative would require steady growth in membership.

A corporate entity makes it relatively easier to raise capital where voting rights are proportional to shares held. This realization has led to the search for dedicated laws for microfinance providers irrespective of whether these are organized as cooperatives or corporations or any other organization forms.

A general consensus seems to exist on the need for simple regulations that are not over-restrictive, which do not stifle creativity but improve transparency, accountability, good governance, and allow the IFIs to meet the capital needs of growth.

Tax Incentive

- To make Islamic microfinance more competitive, certain amendments in civil and tax legislation should be made.
- Regulators and policymakers in the region must shed their reservations about integrating Islamic philanthropy with for-profit microfinance.
- Specific tax incentives for relevant structures and institutions to promote exploration and implementation of Islamic social finance initiatives.

Social Impact Sukuk

- Investment discipline that considers environment, social and corporate governance criteria to generate long-term competitive financial returns and positive societal impact.
- Malaysian Securities Commission has officially provide in their regulatory policy, guidelines on issuance of SRI sukuk.

SRI Sukuk

- Preserve and protect the environment and natural resources;
- Conserve the use of energy;
- Promote the use of renewal energy;
- Reduce greenhouse gas emission; or
- Improve the quality of life for the society.

SRI SUKUK

- In May 2015, Khazanah National Bhd, the sovereign wealth fund of Malaysia, launched the first Ringgit-denominated sustainable and socially responsible investment sukuk to improve accessibility to quality education in Malaysia's government schools through its Trust Schools Programme.
- The US$500 million "Vaccine Sukuk" launched in December 2014 for the International Finance Facility for Immunisation was the first international socially responsible sukuk that provided funding to support immunization of children against preventable diseases in the poorest countries.

Key Components of Social Impact Sukuk

- Robust disclosure regime which includes prospectus and continuous disclosure requirements and checks and balances in form of a trustee and trust deed
- Mandatory credit rating for all sukuk offered to the retail market by a registered credit rating agency
- Enables retail sukuk to be issued and traded either on the Bursa Malaysia exchange or over-the-counter (OTC) via appointed banks

Tax Incentives

Tax neutrality provisions

Tax incentives

- Issuers
- Investors
- Intermediaries

Tax Deduction on PDS

- Specific tax incentives for relevant structures and institutions to promote exploration and implementation of social impact sukuk.
- Tax legislations provide exemptions for banking and Islamic securities for sale, purchase and lease of assets
- Tax deduction on expenses incurred in the issuance of Islamic private debt securities under the principles of 2010 Musharakah, Mudarabah, Ijarah and Istisna’
- Tax deduction on expenses incurred in the issuance of Islamic private debt securities under the principles of Ijarah and Wakalah

Legal Challenges

- With regard to *sukuk* development, the existence of the asset securitisation law in certain countries is not in line with *shari'a* dictates, wherein the draft of the asset securitisation law clearly states that securitisation can only be structured through debt.